South African Reserve Bank

PRESS STATEMENT

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STATEMENT OF THE MONETARY POLICY COMMITTEE

Issued by Lesetja Kganyago, Governor of the South African Reserve Bank

Since the May meeting of the Monetary Policy Committee (MPC), near-term indicators point to weaker-than-anticipated global economic activity. Global financial conditions have eased, as central banks in advanced economies signaled a move towards monetary accommodation. However, downside risks remain and are dominated by escalating trade and geo-political tensions.

In the domestic economy, GDP contracted in the first quarter due to a combination of supply-side and demand-side factors. Monthly inflation outcomes have stayed around the mid-point of the inflation target range, as food and services price inflation remain subdued. The medium-term inflation outlook is unchanged.

The year-on-year inflation rate, as measured by the consumer price index (CPI) for all urban areas, was 4.5% in May (up from 4.4% in April). Goods price inflation was 4.2%, while services price inflation was 4.6%. The Bank's measure of core inflation, which excludes food, fuel and electricity, was 4.1%. Producer price inflation for final manufactured goods decreased to 6.4% (compared to 6.5% in April).

The inflation forecast generated by the SARB's Quarterly Projection Model (QPM) is for headline inflation to average 4.4% in 2019 (down from 4.5%). The projections for 2020 and 2021 remain unchanged at 5.1% and 4.6%, respectively. Headline CPI inflation is expected to peak at 5.4% in the first quarter of 2020 and settle at 4.5% in the last two quarters of 2021. The forecast for core inflation is lower at 4.4% in 2019 (down from 4.5%), 4.7% in 2020 (down from 4.8%) and is unchanged at 4.5% in 2021.

Electricity, food and fuel price inflation have shaped the trend in headline inflation. The assumptions for Brent crude oil in the QPM have been revised down from US$69.50 to US$67 for 2019. The assumptions for 2020 and 2021 are unchanged at US$68. Fuel price inflation is expected to average 3.2% in 2019 and to peak at 13.1% in the first quarter of 2020. Although food price inflation has continued to surprise on the downside, it is expected to start rising from the end of 2019 and to peak at 5.6% in the second and third quarters of 2020.

Inflation expectations have continued to moderate. According to the Bureau for Economic Research (BER) second quarter survey, expectations are for headline inflation of 4.8% in 2019. Inflation expectations for 2020 and 2021 eased to 5.0% and 5.2%, respectively. Five-year-ahead inflation expectations remain unchanged at a historic low of 5.1%.

The inflation expectations of market analysts in the July 2019 Reuters Econometer survey have been revised lower to 4.5% (from 4.7%) in 2019 and 5.0% (from 5.2%) in 2020 and remain unchanged at 5.0% in 2021.

Market-based expectations implicit in the break-even inflation rates (i.e. the yield differential between conventional and inflation-linked government bonds) have declined significantly since our last meeting, reflecting a firmer exchange rate and subdued domestic and global inflation pressures. Five-year break-even rates decreased to 4.5% and ten-year break-even rates decreased to 5.3%, the lowest level since January 2015.

Global GDP is expected to average 3.3% in 2019 and stabilise around 3.5% from 2020. While global growth remains relatively healthy overall, recent indicators on trade and manufacturing have deteriorated sharply and a range of downside risks to growth remain. Growth in world trade volumes contracted for the fifth consecutive month, declining by 2.1% in April 2019. Trade tensions remain heightened, weighing on market confidence and lowering investment. Other downside risks include geo-political developments and high levels of corporate and sovereign debt. Across most countries, there is limited policy space to respond to shocks.

Inflation outcomes and inflation expectations in most advanced economies remain below targeted levels. Recent communication by the Federal Reserve Bank and the European Central Bank indicate that in the absence of significant shocks, monetary policy will remain accommodative over the medium term. However, market expectations of the extent of future central bank actions appear high, creating the risk of significant market volatility should these not materialise.

Emerging market currencies are firmer, reflecting a combination of US dollar weakness and shifting market sentiment. However, country specific factors remain important, with currencies of countries with stronger macroeconomic fundamentals having fared better.

Since the May MPC, the rand has appreciated by 3.3% against the US dollar, by 2.4% against the euro, and by 2.3% on a trade-weighted basis. The implied starting point for the rand is R14.30 against the US dollar, compared with R14.40 at the time of the previous meeting. At these levels, the QPM assesses the rand to remain slightly undervalued. While the rand has benefited from improved sentiment towards riskier assets, it underperformed its emerging market peers due to idiosyncratic factors. Domestic growth prospects and fiscal risks rate high among investor concerns.

GDP contracted by 3.2% in the first quarter, reflecting weakness in most sectors of the economy. The sharp quarterly decline was primarily caused by electricity shortages and strikes that fed into broader weakness in investment, household consumption and employment growth. Based on recent short term indicators for the mining and manufacturing sectors, a rebound in GDP is expected in the second quarter of 2019.

Continued low business confidence remains a concern for the MPC. The Absa Purchasing Managers' Index averaged 46.3 points in the second quarter, remaining below the neutral level. The RMB/BER Business Confidence Index remains unchanged at 28 points. The SARB's composite leading business cycle indicator continued to trend lower.

The SARB now expects GDP growth for 2019 to average 0.6% (down from 1.0% in May). The forecast for 2020 and 2021 is unchanged at 1.8% and 2.0% respectively.

The MPC assesses the risks to the growth forecast to be balanced in the near term but remains concerned about longer term risks. Investment prospects will continue to be limited in the absence of structural reforms. The escalation of trade tensions could have further negative impacts.

While some cyclical factors constrained recent GDP growth outcomes, the Committee remains of the view that current challenges facing the economy are primarily structural in nature and cannot be resolved by monetary policy alone. Implementation of prudent macroeconomic policies together with structural reforms that raise potential growth and lower the cost structure of the economy remains urgent.

The MPC welcomes the continued downward trend in recent inflation outcomes and the moderation in inflation expectations of about one percentage point since 2016. The Committee would like to see inflation remain close to the mid-point of the inflation target range on a more sustained basis, with inflation expectations also anchored around these levels.

The overall risks to the inflation outlook are assessed to be largely balanced. Demand side pressures are subdued, wages and rental prices are expected to increase at moderate rates and global inflation should remain low. In the absence of shocks, relative exchange rate stability is expected to continue.

However, the impact of upside risks to the inflation outlook could be significant. Global financial conditions can abruptly tighten due to small shifts in inflation outlooks in advanced economies and changing market sentiment. Domestically, the financing needs of State-Owned Enterprises (SOE) could place further upward pressure on the currency and long-term market interest rates for all borrowers. Food, electricity and water prices also remain important risks to the inflation outlook.

Against this backdrop, the MPC unanimously decided to reduce the repurchase rate by 25 basis points to 6.5% per annum with effect from 19 July 2019.

Monetary policy actions will continue to focus on anchoring inflation expectations near the mid-point of the inflation target range in the interest of balanced and sustainable growth. In this persistently uncertain environment, future policy decisions will continue to be highly data dependent, sensitive to the assessment of the balance of risks to the outlook, and will seek to look-through temporary price shocks.

The implied path of policy rates generated by the Quarterly Projection Model was for one cut of 25 basis points to the repo rate by the end of fourth quarter of 2019. The endogenous interest rate path is built into the growth and inflation forecast. The implied path remains a broad policy guide which could change in either direction from meeting to meeting in response to new developments and changing risks.

Lesetja Kganyago

GOVERNOR

The next statement of the Monetary Policy Committee will be released on 19 September 2019.

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