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 March meeting of the Monetary Policy Committee (MPC), the Covid-19 pandemic has spread globally and its impact is being felt through all economies. Current estimates from the IMF show global growth contracting this year by about 2.9%.[1] Economic contractions are expected to be deepest in the second quarter of 2020, with some recovery expected in the third quarter of the year. The strength of the recovery into the fourth quarter and 2021 will depend on how quickly countries are able to open up for economic activity *safely*, requiring sustainable social distancing rules, safety processes put in place by businesses and public institutions, and capacity of hospitals to accommodate those in need. Current indications from the World health

[1] Global growth in the QPM model is a trade-weighted average. For 2020 this is now at -2.6% and 4% for 2021.

Organisation are that the pandemic is unlikely to end quickly, with shorter, less virulent waves hitting over time.

The uncertainties of the crisis have led to extremely high volatility in financial asset prices, with sharp and deep market sell-offs followed by a partial recovery. At this stage, the sustainability of that recovery remains uncertain, and global markets remain in risk-off mode. This has implications for emerging markets and South Africa in particular, as investor appetite for rand-denominated equities and bonds is expected to remain weak.

Policy responses to the crisis have generally been robust, with the magnitudes dependent on the degree of policy space available to countries. The US Federal Reserve has taken further steps to expand its balance sheet. The European Central Bank (ECB) has made similar commitments. Emerging and developing economies generally have less policy space available and credit is more expensive, and for this reason, the International Financial Institutions (the IMF, the World Bank) and others have made available extraordinary levels of emergency financial support.

The Covid-19 outbreak will have a major health and social impact, and forecasting domestic economic activity presents unprecedented uncertainty. With that in mind, the Bank expects GDP in 2020 to contract by 6.1%, compared to the -0.2% expected just three weeks ago. GDP is expected to grow by 2.2% in 2021 and by 2.7% in 2022.

South Africa's lockdown has been extended by an additional 14 days, bringing the total lockdown period to 35 days. Both the supply and demand effects of this extension reduce growth and deepen it in the short-term, as businesses stay shut for longer and households with income spend less. This will likely also increase job losses, with further consequences for aggregate demand. The impacts will be particularly severe for small businesses, and individuals with earnings in the informal sector.

Some factors will support growth, including where businesses are able to open under the current rules, new jobs being created to service more needs under the lockdown, and sustained government spending, both through normal operations and crisis-related spending and programmes. The faster the global economy recovers from the crisis, as China appears to be gradually doing now, the more positive growth spillovers will strengthen for South Africa, including healthy price levels for commodity exports.

Nonetheless, prices for many commodities have fallen as a result of weaker demand globally. The spot price for Brent crude oil is currently around $31 per barrel, despite a new agreement reached by Opec and other producers to make large oil production cuts. For our forecast, the Brent crude oil price is expected to average $42 per barrel in 2020 and $45 per barrel in 2021, very close to the March forecast.

As noted earlier, while advanced economies conduct exceptionally accommodative policies, global financing conditions are no longer supportive of emerging market currency and asset values. Credit risk has risen back to 2008 levels and about R100 billion of local assets have been sold by non-resident investors. The rand has depreciated by 22.6% against the USD since January and by 17.3% since the March meeting of the MPC. The implied starting point for the rand forecast is R17.80 to the US dollar, compared with R15.40 at the time of the previous meeting.

Slightly lower oil prices and sharply lower domestic growth pulls down on the inflation forecast, while negative global sentiment and fiscal risks have led to equally aggressive currency depreciation and upside pressure on inflation. The timing and size of these contradictory impulses suggests that they are not perfectly offsetting, with weaker inflation in the near term likely giving way to higher inflation later in the forecast period.

The Bank' s headline consumer price inflation forecast averages 3.6% for 2020, 4.5% for 2021, and 4. 4% in 2022. The forecast for core inflation is lower at 3.8% in 2020, 4.0% in 2021, and 4.2% in 2022.

The overall risks to the inflation outlook at this time appear to be to the downside. Electricity pricing remains a concern but has moderated somewhat. Risks to inflation from recent currency depreciation are expected to be muted as pass-through is slow. Global producer price inflation has decelerated. Lower oil prices will reduce petrol prices in the near term. International food prices have eased and local food price inflation is expected to remain low, in part due to higher domestic production levels.

Expectations of future inflation broadly remain around the mid-point of the band, although market-based expectations have recently ticked up in response to the depreciation of the currency.[2]

Weaker domestic growth and greater fiscal risks have resulted in a downgrade by Moody's credit rating agency and confirmation of a negative outlook by Fitch, a weaker currency and higher borrowing costs for government, banks and firms. South Africa's risk profile has increased.

Despite this rise in country risk, the Committee notes that the more prolonged lockdown and slower recovery creates downside risk to inflation and allows further

[2] The latest Bureau for Economic Research (BER) survey has expectations for 2020 down by 0.4ppts to 4.4% and to .4.6% (from 5.0%) for 2021. Five-year-ahead inflation expectations also eased to 4.7% (from 4.9%). Market analysts (Reuters Econometer) expect inflation to be, 4.2% (from 4.4%) for 2020, 4.6% (from 4.7%) in 2021 and 4.5% (from 4.6%) for 2022. Market-based rates are calculated from the break-even inflation rate, which is the yield differential between conventional and inflation-linked bonds. These sit at 4.7% for the 5-year and well over 6% on the 10-year breakeven.

space for monetary policy to respond to the virus-induced demand shock to the economy. Barring severe and persistent currency and oil shocks, inflation is expected to be well contained, remaining below the midpoint of the target in 2020 and close to the midpoint in 2021.

Against this backdrop, the MPC decided to cut the repo rate by 100 basis points. This takes the repo rate to 4.25% per annum, with effect from 15 April 2020. The decision was unanimous.

The implied path of policy rates over the forecast period generated by the Quarterly Projection Model indicates five repo rate cuts of 25 basis points extending into the first quarter of 2021.

Monetary policy can ease financial conditions and improve the resilience of households and firms to the economic implications of Covid-19. In addition to continued easing of interest rates, the Bank has taken steps to ensure adequate liquidity in money and government bond markets and to ease capital requirements to free capital for onlending by financial institutions. Each of these steps make more capital available to households and firms.

Monetary policy however cannot on its own improve the potential growth rate of the economy or reduce fiscal risks. These should be addressed by implementing prudent macroeconomic policies and structural reforms that lower costs generally, and increase investment opportunities, potential growth and job creation. Such steps will further reduce existing constraints on monetary policy and its transmission to lending.

Global economic and financial conditions are expected to remain highly volatile for the foreseeable future. In this highly uncertain environment, future decisions will continue to be highly data dependent, sensitive to the balance of risks to the outlook and will seeks to look through temporary price shocks. As usual, the repo rate projection from the QPM remains a broad policy guide which can change from meeting to meeting in response to changing data and risks.

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The next statement of the Monetary Policy Committee will be released on 21 May 2020.

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