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 November meeting of the Monetary Policy Committee (MPC), a second wave of Covid-19 infections has peaked in South Africa and in many other countries. It is expected that these waves of infection will continue until vaccine distribution is widespread and populations develop sufficient immunity to curb virus transmission.

Although the virus will continue in new waves, the rollout of vaccines is expected to boost global growth prospects generally. We have therefore revised global growth for 2021 higher.[1] However, global distribution of vaccines is likely to be slow, creating an uneven pace of global economic recovery in 2021. The International Monetary Fund (IMF) had forecast global gross domestic product (GDP) to have contracted by about

[1] Global growth in the QPM model is a trade-weighted average of South Africa's trading partners. For 2020 this is now at -3.6% (up from -3.9% in November) and revised up to 5.0% for 2021. Based on the October 2020 World Economic Outlook, the IMF expects global growth of 5.2% in 2021.

4.4% in 2020 and to expand by 5.2% in 2021 -- their new forecasts will be released on the 26th of January.

While financial asset prices were volatile for much of the past year due to pandemic-related developments and geopolitical events, recent months have seen markets strengthen. Capital flows to emerging markets have generally picked up when compared to the outflows experienced in March and April last year. Although global policy rates look set to remain accommodative, risk aversion is likely to persist through 2021, particularly where economies fail to take advantage of improved global prospects or run large macroeconomic imbalances.

In the third quarter of 2020, the South African economy grew by 66.1% quarter on quarter, seasonally adjusted and annualised, compared to the Bank's expected 50.3% growth. The growth rate for the full year is now expected to be -7.1%, compared to the contraction of 8.0% expected at the time of the November meeting. However, our projection for the 4th quarter of 2020 is expected to be lower than previously forecast. And while lockdown restrictions currently in place are considerably less restrictive than in 2020, we expect growth in the first quarter of 2021 to remain muted.

Despite very robust terms of trade and stronger exports, getting back to pre-pandemic output levels will take time. Sharply lower public and private investment last year and continued weakness in 2021 will weigh on growth prospects. GDP is now expected to grow by 3.6% in 2021 and by 2.4% in 2022.[2] GDP growth of 2.5% is expected in 2023.

Overall, risks to the domestic growth outlook are assessed to be balanced. Global growth, vaccine distribution, a low cost of capital and high commodity prices are supportive of growth. However, new waves of the Covid-19 virus are likely to periodically weigh on economic activity both globally and locally. In addition, constraints to the domestic supply of energy, weak investment and uncertainty about vaccine rollout remain serious downside risks to domestic growth.

Accommodative policies in many advanced economies and the improved economic outlook continue to support recovery in global financial markets and some strengthening in international capital flows. So far this has resulted in a trickle of fresh

[2] Compared to 3.5% and 2.4%, respectively, in November.

capital flows to South Africa, and financing conditions remain uncertain as reflected in the exceptionally steep yield curve.[3]

These favourable global conditions saw the rand appreciate by 1.7% since the November meeting. Since January 2020, the rand has, however, depreciated by 8.0% against the USD and remains below its estimated long-run equilibrium value. The implied starting point for the rand forecast is R15.70 to the US dollar, compared with R16.50 at the time of the previous meeting.

Headline consumer price inflation averaged 3.3% in 2020, in line with the Bank's expectation, and is the lowest rate since 2004. The Bank's forecast for 2021 is slightly higher at 4.0% (up from 3.9%) and is 4.5% (up from 4.4%) for 2022. The forecast for 2023 is 4.6%. Core inflation averaged 3.3% in 2020. The forecasts for 2021 and 2022 are unchanged at 3.4% and 4.0%, respectively. In 2023, core inflation is expected to be 4.3%.

Despite an upward revision to potential growth, higher growth in 2020 and in 2021 implied a small narrowing of the output gap over the forecast period, compared to the November meeting. Global producer price inflation, food price inflation and oil prices have risen.[4] A more appreciated nominal exchange rate in recent months is expected, however, to moderate some inflationary pressure.

The overall risks to the inflation outlook appear to be balanced in the near and medium term. Local food price inflation is higher but expected to remain broadly contained. The Committee additionally notes the significant but likely temporary reduction in medical insurance price inflation this year. Given low pass-through, risks to inflation from currency depreciation are expected to stay muted. However, additional exchange rate pressures could result from fiscal risks. While there are no demand side pressures evident, electricity and other administered prices remain serious concerns.

Expectations of future inflation appear more stable after sustained moderation last year, although those of households continue to moderate from quite high levels.

[3] Measured by the EMBI+ premium over emerging market averages and as an absolute value over time.
[4] Our assumptions are now for oil prices to average about $50 per barrel in 2021, rising to $55 per barrel in 2022 and $57 per barrel in 2023.

Market-based expectations for short and medium-term inflation have eased slightly, while longer-term inflation expectations remain higher.[5]

The Committee notes that the slow economic recovery will help keep inflation below the midpoint of the target range for this year and next. Unless risks outlined earlier materialise, inflation is expected to be well contained in 2021, before rising to around the midpoint in 2022 and 2023.

Against this backdrop, the MPC decided to keep rates unchanged at 3.5% per annum. Two members of the Committee preferred a 25 basis point cut and three preferred to hold rates at the current level.

The implied policy rate path of the Quarterly Projection Model (QPM) indicates two increases of 25 basis points in the second and third quarters of 2021.

Monetary policy has eased financial conditions and improved the resilience of households and firms to the economic implications of Covid-19, and continues to be accommodative. The steps taken by the Bank have ensured adequate liquidity in domestic markets. In addition, regulatory relief provided to banks has sustained lending to households and firms.

While monetary policy will continue to support the economic recovery, a faster growth rate depends on implementing prudent macroeconomic policies and structural reforms. Lower administered prices and productivity-adjusted wage settings aligned to projected inflation would also generate important macroeconomic gains. Such steps will enhance the effectiveness of monetary policy and its transmission to the broader economy.

Economic and financial conditions are expected to remain volatile for the foreseeable future. In this highly uncertain environment, policy decisions will continue to be data

[5] The latest Bureau for Economic Research (BER) survey expectations for 2020 are 0.1ppt higher at 3.7%, unchanged in 2021 at 4.2% and 0.1ppt lower in 2022 at 4.5%. Household inflation expectations have eased further to 5.3% from 5.9%. Market analysts (Reuters Econometer) expect inflation to remain unchanged at 3.3% for 2020, lower at 3.8% in 2021 and at 4.2% in 2022. Inflation is expected to be 4.5% in 2023. 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 3.2% for the 5-year and 5.0% on the 10-year breakeven. 15-year breakeven inflation sits at 6.2%.

dependent and sensitive to the balance of risks to the outlook. The MPC will seek to look through temporary price shocks and focus on second round effects. As usual, the repo rate projection from the QPM remains a broad policy guide, changing from meeting to meeting in response to new data and risks.

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The next statement of the Monetary Policy Committee will be released on 25 March 2021

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