SOUTH AFRICAN RESERVE BANK

PRESS STATEMENT

22 July 2021

STATEMENT OF THE MONETARY POLICY COMMITTEE

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

Despite steady improvements in vaccination rates, stronger confidence and better global economic growth, the Covid-19 virus continues to weigh on global prospects. Vaccination rates are lagging in many emerging market and developing countries. Until populations develop sufficient immunity to curb virus transmission, waves of infection are likely to continue. As indicated by South Africa's public health authorities, a third wave of virus infection is currently peaking. Additionally, by raising uncertainty and reducing investor confidence, the recent unrest in parts of the country is likely to slow our ongoing recovery.

Lockdowns and other restrictive measures that remain in place in a number of countries will continue to weigh on economic activity, particularly in sectors dependent on close contact, such as travel, tourism, hospitality and leisure. The International Monetary Fund's (IMF) April forecast for global gross domestic product (GDP) for 2021 is 6.0%, and will be updated later this month. The SARB's forecast for global growth in 2021 now sits at 6.1%.[1] For 2022, we expect global growth of 4.4% and 3.4% in 2023. Recoveries in emerging market and developing economies are expected to lag those in advanced economies, in large part due to a slower pace of vaccinations.

Although policy settings in advanced economies remain accommodative, the spread of the Delta variant, higher global inflation, and uncertainty about the normalisation path for interest rates continue to cause financial market and capital flow volatility. This is reflected in persistent risk aversion, especially towards emerging market economies that fail to take advantage of improved global prospects or run large macroeconomic imbalances.

The domestic economy grew by 4.6% in the first quarter of 2021, much stronger than the 2.7% expected at the time of our May meeting. That outcome reflected better sectoral growth performances and robust terms of trade. Commodity prices have remained high, sustaining income gains despite higher oil prices.

However, recent unrest and economic damage could have lasting effects on investor confidence and job creation. We estimate the unrest to have fully negated the better growth results from the first quarter, resulting in an unchanged estimate of 4.2% for growth in 2021.

The direct and indirect costs of recent events will likely further slow South Africa's economic recovery. Although some sectors, notably mining and manufacturing have largely recovered to pre-pandemic levels, production remains muted in sectors harder hit by the pandemic and in regions now affected by the unrest. The Bank's investment

[1] Global growth in the QPM model is a trade-weighted average of South Africa's trading partners. The IMF's global forecast for 2022 sits at 4.4%.

forecast was revised up for this year but remains constrained. Household spending is still expected to be healthy, in line with better than expected salaries and wages, rising asset prices and low interest rates.

GDP is expected to grow by 2.3% in 2022 and by 2.4% in 2023, unchanged since the May meeting.

Overall, and after revisions, the risks to the medium-term domestic growth outlook are assessed to be balanced. High export prices, stronger household incomes and a somewhat better investment outlook are backed up by generally supportive global conditions, despite ongoing financial volatility. Recent events in the country, their impact on vaccinations, a longer than expected lockdown, limited energy supply and policy uncertainty pose downside risks to growth.

The current account surplus remains substantial and reflects good growth and higher prices for exports, still moderate prices for imported oil, and slowly reviving demand for imported consumer and investment goods. This surplus is expected to give way to a modest current account deficit by next year (2022), as exports slow and imports accelerate.[2] Although financing conditions have improved and fiscal risk has eased, the yield curve for rand-denominated bonds remains steep. Long bond yields have returned to pre-pandemic levels of around 9.0% on 10-year bonds.

The generally favourable global conditions and strong commodity export prices have kept the currency close to its long-run equilibrium level, with a year to date appreciation of 4% on a trade-weighted basis. Since the May meeting, the rand has depreciated

[2] The current account is expected to be in surplus of 3.7% of GDP in 2021, shifting to a deficit of -0.1% in 2022.

by 0.5% on a trade-weighted basis. The implied starting point for the rand forecast is R14.40 to the US dollar, compared with R14.46 at the time of the previous meeting.

At a global level, a wide range of prices is accelerating, including raw materials, intermediate inputs and food, reflecting both global supply shortages and rising demand. So far, this has had relatively limited pass-through to consumer prices. Our estimate for inflation in the G3 economies was revised slightly higher for 2021 to 2.2% (from 2.0%) and lower in the outer years.[3]

Oil prices are revised up, and petrol price inflation is sharply higher at 15.3% (up from 12.5%).[4] Local electricity prices are unchanged at 10.6%.

Headline consumer price inflation for 2021 is revised slightly higher to 4.3% (up from 4.2%), and revised lower to 4.2% (from 4.4%) in 2022. For 2023, headline consumer price inflation remains unchanged at 4.5%.

The forecast for core inflation is revised lower to 2.9% in 2021 (down from 3.0%) and to 3.7% in 2022 (down from 4.0%). Core inflation is expected to be 4.3% in 2023, unchanged from the May forecast.

The Bank's forecast reflects higher food and petrol prices that push up near term headline inflation, before moderating in the latter half of this year and into 2022. Compared to the May meeting, the current growth forecast implies a wider output gap in the near term. While economic activity strengthens over the forecast period, the

[3] The G3 comprises the United States, the Eurozone, and Japan.
[4] The forecast for petrol prices in 2022 are revised up from 3.9% in May to 5.5% currently. Our assumptions are now for oil prices to average $66 per barrel in 2021 and $65 per barrel in 2022 and $63 in 2023.

current exchange rate level and modest growth in unit labour costs contain the expected rise in core inflation.

The risks to the short-term inflation outlook are assessed to the upside, despite weaker than expected services inflation outcomes in recent months. Rapid global producer price inflation and supply shortages created by disruptions to local transport networks increase these inflation risks. Food price inflation, already very high globally, surprised to the upside in recent months. Petrol, electricity and other administered prices also continue to present short-term risks.

Average surveyed expectations of future inflation have increased by 0.3 percentage points, to 4.2% for 2021 and by 0.2 percentage points, to 4.4% for 2022. Market-based expectations for inflation are slightly higher for 2021 and lower over longer horizons.[5]

Given the medium and long-term projections set out above, a weaker currency, higher domestic import tariffs, and escalating wage demands present longer-term upside risks to the inflation forecast.

Despite higher expectations and continued upside risks, the Committee expects inflation to be contained in 2021 and 2022, before rising to around the midpoint of the inflation target range in 2023.

[5] The (Q2) Bureau for Economic Research (BER) survey expectations for 2021 rose to 4.2% (up from 3.9%), to 4.4% from 4.2% for 2022, and to 4.5% from 4.4% for 2023. Market analysts (Reuters Econometer) in July expect inflation to be higher at 4.3% (from 4.2%) in 2021, and 4.4% in 2022, up from 4.3%, and unchanged at 4.4% 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 now sit at 4.6% for the 5-year and 5.88% on the 10-year breakeven. 15-year breakeven inflation sits at 6.37%.

Against this backdrop, the MPC decided to keep rates unchanged at 3.5% per annum. The decision was unanimous.

The implied policy rate path of the Quarterly Projection Model (QPM) indicates an increase of 25 basis points in the fourth quarter of 2021 and in each quarter of 2022.

These repurchase rate levels reflect a highly accommodative policy stance through the end of 2022, keeping financial conditions supportive of credit demand as the economy recovers from the pandemic and associated lockdowns.[6] The Bank has ensured adequate liquidity in domestic markets and will continue to closely monitor funding markets for stress. In addition, regulatory relief provided to banks continues to support lending to households and firms.

Better anchored expectations of future inflation could keep interest rates lower for longer, and can be realised by achieving a stable public debt level, increasing the supply of energy, moderating administered price inflation and keeping wage inflation low into the recovery. 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 uncertain environment, policy decisions will continue to be data 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.

[6] This implies a rise in the inflation-adjusted repo rate from about -1.0% for 2021 to about 0.5% by the end of 2022. The real repurchase rate calculation here is based on the 1-quarter ahead inflation forecast.

Lesetja Kganyago

GOVERNOR

The next statement of the Monetary Policy Committee will be released on 23 September 2021.

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