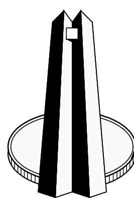

South African Reserve Bank

PRESS STATEMENT

EMBARGO DELIVERY

20 July 2017

STATEMENT OF THE MONETARY POLICY COMMITTEE

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

Since the previous meeting of the Monetary Policy Committee the inflation outlook has improved. Food price inflation has moderated faster than expected, domestic demand pressures remain subdued and international oil prices have declined. Despite a degree of volatility, the rand exchange rate has been relatively resilient in the face of expected monetary policy tightening in some advanced economies, as well as domestic political risks and uncertainties. Risks to the inflation outlook still remain.

At the same time, domestic growth prospects have deteriorated further following the surprise GDP contraction in the first quarter of 2017. The economy has now recorded two successive quarters of negative growth, and although a near-term improvement is expected, the outlook remains challenging. A number of sentiment indicators and data points have reached levels last seen during the 2009 recession, at the height of the global financial crisis.

The year-on-year inflation rate as measured by the consumer price index (CPI) for all urban areas measured 5.4% and 5.1% in May and June, in line with the Bank's short-term forecast. Food and non-alcoholic beverage inflation measured 6.9% in both months, with the contribution to the overall inflation outcome unchanged at 1.2 percentage points. Meat prices continued to accelerate, and at 13.0%, contributed to the downside stickiness of food price inflation. The Bank's measure of core inflation, which excludes food, fuel and electricity, measured 4.8% in both months.

Producer price inflation for final manufactured goods measured 4.6% in April and 4.8% in May. The further moderation in food prices was reflected in the PPI with the category of food products, beverages and tobacco products decelerating for the seventh consecutive month to 5.8%. The divergent trends between the subcategories of "products of crops and horticulture" and "live animals" persisted, with year-on-year changes of -24.4% and 21.4% respectively.

The Bank's forecast for headline CPI inflation has shown a marked improvement since the previous meeting. The annual average forecast has been revised down by 0.4 percentage points in 2017 and 2018, and by 0.3 percentage points in 2019, to 5.3%, 4.9% and 5.2%. A lower turning point of 4.6% is expected in the first quarter of 2018 (previously 5.1%), and an average of 5.2% is forecast for the final quarter of 2019.

The main drivers of the improved forecast were the lower starting point; revised assumptions regarding international oil prices, domestic electricity tariffs and the real effective exchange rate; and a wider output gap. These assumptions are set out in the annexure to this statement. Food price inflation is also expected to be more subdued, due to a lower starting point and more favourable domestic crop estimates. Despite a persistent upward trend in meat price inflation, the forecast for food price inflation has

been revised down from 7.7% to 7.3% for this year; and from 5.4% to 5.1% in 2018. The forecast for 2019 is unchanged at 5.5%.

The improvement is also evident in the core inflation outlook, with average forecasts of 4.8% for 2017 and 2018, and 4.9% for 2019. This compares with previous forecasts of 5.0%, 5.1% and 5.3% for these years. This improvement is driven in part by lower unit labour costs, in addition to the exchange rate and output gap developments.

Inflation expectations as reflected in the survey conducted by the Bureau for Economic Research show a marginal improvement, with average expectations slightly below 6% in all three years. The decline was most marked among analysts, particularly over the first two survey years, and to a lesser extent among labour unionists. Both these categories of respondents expect inflation to be within the target range over the forecast period. The expectations of business respondents are largely unchanged and remain above 6% for all three years. By contrast, average 5-year expectations of all groups edged up from 5.7% to 5.9%, and ranged between 5.5% for analysts and 6.3% for business respondents.

Median inflation expectations of market analysts improved over the near term. According to the Reuters Econometer survey conducted in July, expected inflation declined by 0.2 percentage points to 5.5% in 2017 and to 5.3% in 2018, compared with the May survey. However, the longer term trend is reversed with an expectation of 5.5% in 2019. Expectations implicit in the difference between nominal bonds and inflation-linked bonds have also declined slightly since the previous meeting, with the 5-year break-even rate at 5.3%.

The global growth backdrop remains positive, with sustained upswings evident in most regions. This is despite continued uncertainty regarding economic policy reforms in

the US. Nevertheless, growth rates and potential output estimates are still generally lower than those in the pre-crisis period. While there are lingering concerns about financial stability risks from the shadow banking sector in China, the recent strong performance of the economy has contributed to the favourable environment for emerging markets.

Underlying global inflation trends remain benign, with inflation below target in most of the advanced economies, notwithstanding the positive growth prognosis and tightening labour markets. An exception is the UK where inflation has accelerated in the wake of the Brexit-induced depreciation of sterling. The subdued global inflation outlook is reinforced by generally slow wage and productivity growth in developed economies.

Despite the absence of inflationary pressures, central banks in a number of advanced economies have signalled intentions to move from highly accommodative monetary policy stances. These countries include the US, the UK, the euro area and Canada. This process is unlikely to be smooth or perfectly synchronised and could generate bouts of uncertainty. In the US, expectations of further near-term rate increases by the Fed have been scaled down following a succession of downside inflation surprises. The gradual nature of the planned balance sheet contraction by the Fed has also been well communicated and appears to be largely priced in by the markets.

While changing expectations regarding ECB and US monetary policy in particular have impacted on a number of emerging market currencies and bond yields, the reaction has been relatively muted, and a repeat of the 2013 so-called taper tantrum episode is not expected. Those economies that were most sensitive to that episode have much improved macroeconomic balances, and their currencies are less vulnerable to

possible spill-over effects from gradual monetary tightening in the advanced economies.

The rand has also been affected by these changing expectations, as well as by domestic political developments, including concerns about a proposal to change the SARB's monetary policy mandate. While the rand is more or less unchanged since the previous meeting of the MPC, it has been relatively volatile, having fluctuated in a range between R12.60 and R13.60 against the US dollar.

The rand's relative resilience had been underpinned by the generally positive sentiment towards emerging markets, as well as by sustained trade surpluses. The current account deficit is still expected to widen over the forecast period, but the degree of widening has been revised down. The rand remains vulnerable to increased global risk aversion, domestic political shocks, and to the possibility of further ratings downgrades.

The domestic growth outlook remains a concern, following the surprise broad-based GDP growth contraction during the first quarter of this year. With the exception of the primary sector, all sectors recorded negative growth. While positive growth is expected in the second quarter, the Bank's annual growth forecasts have been revised down further. The forecast for 2017 has been adjusted down from 1.0% to 0.5%, and the forecast for 2018 is down from 1.5% to 1.2%. Growth of 1.5% is expected in 2019, compared with 1.7% previously.

As a result of these trends, the output gap has widened somewhat despite a further downward revision to potential output growth by 0.3 percentage points for each year, to 1.1% in 2017 and rising to 1.3% in 2019. The weak outlook is consistent with the decline in the RMB/BER Business Confidence Index to levels last seen during the

recession following the global financial crisis. The SARB's composite leading business cycle indicator has also moderated somewhat since January.

Monthly data for both the mining and manufacturing sectors in April and May suggest that, in the absence of a sharp contraction in June, these sectors are likely to contribute positively to growth in the second quarter, along with the continued rebound in the agricultural sector. The recovery is nevertheless expected to be modest, particularly in the light of a sharp fall in the ABSA Purchasing Mangers' Index in June, which returned to below the neutral level of 50 index points. The construction sector also remains under pressure following the marked fall in building plans passed in the first quarter of this year, with the negative trend continuing into April.

The continued poor performance of gross fixed capital formation contributes to the weak state of the economy. Although private sector investment recorded positive growth after five consecutive quarters of contraction, at a growth rate of 1.2% it remains very subdued. Given the extremely low level of business confidence, a near-term improvement is unlikely. Policy uncertainty, a recent example being in the mining sector, is likely to constrain investment.

As a consequence, employment growth has been minimal, and the prospects are unfavourable. Given the need for fiscal consolidation, a continued decline in government's contribution to employment creation is expected. The official unemployment rate increased to 27.7% in the first quarter of this year.

Consumption expenditure by households contracted in the first quarter of this year, amid a further deterioration in consumer confidence. Although the monthly retail sales data suggest a more positive outcome for the second quarter, this improvement is likely to be offset in part by a decrease in new vehicle sales in the quarter. The outlook

for consumption expenditure is expected to remain weak, amid employment uncertainty and higher tax burdens.

These consumption trends are mirrored in the continued moderation in credit extension to households. Growth in mortgage advances and instalment sales credit finance remained subdued, reflective of the difficult conditions in the housing and vehicle markets. General loans to households increased moderately in May, but off a low base. Credit extension to the corporate sector, by contrast, remains relatively buoyant, but on a downward trend.

Wage trends have been an important contributor to the persistence of inflation at higher levels. There are, however, indications of some moderation in average salaries, and related unit labour costs, which are expected to remain below the 6% level over the forecast period. The outcome of a number of multi-year wage agreements that are due for renewal in 2017 will be closely watched as they could pose a risk to the inflation trajectory.

The persistent global oil supply glut, along with increased shale gas production in the US, have undermined efforts by OPEC and other producers to support prices through output restrictions. Since the beginning of June, Brent crude oil prices have traded at levels below US$50 per barrel, and the Bank's oil price assumptions have been revised down over the forecast period. These recent oil price trends, along with the stronger exchange rate, contributed to a 69 cent per litre reduction in the petrol price in July. Following a weakening of the rand and a partial recovery in crude oil prices, a moderate petrol price increase is expected in August.

The inflation outlook has improved significantly since the previous meeting of the MPC and has been fairly broad-based. The lower core inflation outlook is indicative of weaker underlying inflation pressures, at a time when the impact of exogenous shocks on headline inflation has been dissipating. These shocks include drought-induced food price inflation and to a lesser extent international oil price increases earlier this year that have since been reversed.

A number of risks to the inflation outlook persist and the MPC assesses the risks to the inflation outlook to be broadly balanced. Although the rand has been relatively resilient, it remains vulnerable to heightened political uncertainty, global monetary policy developments and possible further credit ratings downgrades. On the positive side, it is supported by a sustained narrowing of the current account deficit and positive investor sentiment towards emerging markets.

A further upside risk relates to the possible supply side shock of a large electricity tariff increase from July next year. Eskom has approached Nersa for an increase of around 20%, but the current forecast assumes an increase of 8%. This assumption will be adjusted in line with any new determinations made by Nersa.

The MPC also remains concerned that inflation expectations remain sticky at the upper end of the target range. To the extent that these expectations are formed adaptively, they should adjust downwards if the lower inflation trajectory is sustained. The MPC would prefer expectations to be anchored closer to the mid-point of the target range.

Underlying demand in the economy is extremely weak and the MPC is concerned about the deterioration in the growth outlook over the forecast period. This decline is broad-based. It is unclear where the drivers of accelerated growth will come from in the absence of credible structural policy initiatives that will reduce uncertainty and increase business and consumer confidence. The MPC assesses the risks to the revised growth forecast to be slightly on the downside.

Given the improved inflation outlook and the deteriorated growth outlook, the MPC has decided to reduce the repurchase rate by 25 basis points with effect from 21 July 2017, to 6.75% per annum. Four members preferred a reduction, while two members preferred an unchanged stance.

As we have emphasised on numerous occasions, the MPC does not view monetary policy as the solution to the structural growth constraints in the economy. Nor does it believe that a reduction in interest rates will provide a significant stimulus to growth in the current environment of low confidence and political uncertainty. It will however provide some relief at the margin.

In this highly uncertain environment, future policy decisions will be dependent on data outcomes and our assessment of the balance of risks. We remain vigilant and would not hesitate to reverse this decision should the inflation outlook and risks deteriorate.

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