South African Reserve Bank

PRESS STATEMENT

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STATEMENT OF THE MONETARY POLICY COMMITTEE

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Since the previous meeting of the Monetary Policy Committee (MPC) the inflation outlook has improved. This was mainly due to the further appreciation of the rand exchange rate following the benign market reaction to the US Fed monetary policy tightening, as well as the significant narrowing of the domestic current account deficit. A more positive growth outlook in the advanced economies has also contributed to a more favourable environment for emerging markets generally. However, the recent heightened domestic political uncertainty has reversed some of these exchange rate gains, and the risk of further rand weakening overshadows the inflation outlook.

Domestic growth prospects remain constrained, although the low point of the cycle is probably behind us. Demand pressures are expected to remain weak amid low business and consumer confidence.

The year-on-year inflation rate as measured by the consumer price index (CPI) for all urban areas moderated to 6.3% in February, from 6.6% in January, in line with the market consensus expectation. Food price inflation, which measured 10.0%, moderated for the second consecutive month following its recent peak of 12.0% in December. The contribution of the category of food and non-alcoholic beverages to the overall inflation outcome declined from 1.9 percentage points in January to 1.7 percentage points in February. The Bank's measure of core inflation, which excludes food, fuel and electricity, measured 5.2%, down from 5.5%. This follows a recent peak of 5.9% in December 2016.

Producer price inflation for final manufactured goods measured 5.6% in February compared with 5.9% in January. The category of food products, beverages and tobacco products decelerated for the sixth consecutive month to 8.4%, following its recent peak of 13.4% in August last year.

The inflation forecast of the Bank has improved, reversing most of the deterioration seen at the previous meeting of the MPC. Headline inflation is now expected to return to within the target range during the second quarter of 2017 compared with the fourth quarter previously, and to remain within the range for the rest of the forecast period. CPI inflation is expected to average 5.9% for the year, compared with 6.2% in the previous forecast, while the forecast for 2018 has moderated from an average of 5.5% to 5.4%. The forecast period has been extended to 2019, with an expected average of 5.5% for the year.

This improvement is mainly due to a more appreciated exchange rate assumption. Despite the recent depreciation, the current level of the rand is still consistent with the exchange rate assumption in the forecast. Although the international oil price assumption remains unchanged, the exchange rate is expected to lead to lower petrol price inflation, and is reflected in a downward revision to the assumption for administered prices. This favourable trend is partially offset by a slower pace of disinflation in food and non-alcoholic beverages, driven by an expected acceleration in poultry prices in particular. Food price inflation is now expected to average 7.4% and 5.2% in 2017 and 2018, compared with 7.0% and 5.0% previously.

The forecast for core inflation is marginally lower than before at an average of 5.4% in 2017, and unchanged at 5.2% in 2018. An average core inflation of 5.3% is expected in 2019.

Inflation expectations as measured by the Bureau for Economic Research show a deterioration over the near-term in particular. The average expectation for 2017 has increased from 5.8% to 6.2%, with the largest upward revisions coming from businesses and labour respondents. The average expectation for 2018 increased marginally from 5.8% to 5.9%, while the expected inflation for 2019 is 6.0%. By contrast, average inflation expectations over five years declined by 0.1 percentage point to 5.7%.

Median inflation expectations of economic analysts as reflected in the Reuters Econometer survey conducted in March, are more or less unchanged since January. Inflation is expected to average 5.8% in 2017, and 5.5% and 5.4% in the coming two years, roughly in line with the Bank's forecast. Inflation expectations implicit in the break-even inflation rates (the yield differential between conventional bonds and inflation linked bonds) had declined since the previous meeting, but have since spiked following the recent depreciation of the rand, and remain above the 6.0% level for longer-dated maturities.

The global economy shows continued signs of a broad-based improvement. The growth outlook in the US remains favourable with business confidence indices at high levels. However, there is growing uncertainty about the timing and size of the expected fiscal stimulus. Tax reform may take longer than anticipated following the recent failure to repeal the Affordable Care Act.

Growth prospects in Japan and Europe are also more promising, with the PMI reaching a six-year high in the euro area, led by the services sectors in France and Germany. The extent to which the sustainability of this improvement is dependent on the highly accommodative monetary policy stance is still unclear.

The outlook for emerging markets is also more positive, in part driven by the recovery in the advanced economies, and stronger demand in China. Firmer commodity prices have also helped, but an oversupply of some commodities could limit these gains.

Global inflation provides a mixed picture with the recent decline in international oil prices threatening to reverse the broad-based increases in headline inflation in the advanced economies. Some inflation normalisation is evident in the US and the euro area, but Japan is showing less momentum in price and wage growth. Inflation in the UK is expected to overshoot the target for some time, as the economy adjusts to a weaker currency. Similarly, inflation experiences in a number of emerging economies have reflected divergent currency movements.

The US Fed raised its policy rate in March in response to the stronger inflation trend and improved growth outlook. While this action was widely expected, the gradual nature of the expected interest rate cycle implicit in the forward guidance surprised the markets. Policy rates are expected to remain at low levels for some time in most of the advanced economies until more favourable inflation and growth dynamics are more firmly entrenched.

For the past few months the rand exchange rate had been relatively resilient, along with a number of other emerging market currencies. While most measures of emerging market risk have narrowed over recent months, those for South Africa have widened again over the past few days. The rand has depreciated significantly in response to increased domestic political uncertainty and the exchange rate has re-emerged as an upside risk to the inflation outlook. Since the previous meeting of the MPC, the rand has appreciated by 3.9% against the US dollar, by 4.0% against the euro and by 3.4% on a trade-weighted basis.

The prospect of US monetary policy tightening had been seen as a risk to the exchange rate. However, the rand and other peer currencies strengthened in response to the Fed actions in March, indicative of revised market expectations of a more moderate tightening cycle than that priced in.

The rand has also been underpinned by favourable terms of trade trends. Furthermore, the improving trend of the deficit on the current account of the balance of payments has reduced the perceived vulnerability of the rand to possible capital flow reversals. However, while significant adjustment of the current account has occurred, the deficit is not expected to remain at the level seen in the fourth quarter of last year.

The domestic growth outlook remains weak following the negative growth recorded in the fourth quarter of 2016. The 2016 annual GDP growth of 0.3% is likely to have been the low point of the growth cycle, and a mild recovery is expected over the forecast period. The Bank's forecast for GDP growth has been revised up by 0.1

percentage points in both 2017 and 2018, to 1.2% and 1.7%, with growth of 2.0% forecast for 2019. While growth is still expected to be below estimated potential output growth of around 1.4% in the near term, the output gap is expected to narrow to some extent in the later part of the forecast period. The more favourable growth outlook is consistent with the Bank's leading indicator of economic activity which has increased for six consecutive months.

The main drivers of growth are expected to be net exports and positive, albeit weak, household consumption expenditure growth. Some impetus is expected to come from fixed capital formation in the outer period of the forecast. At a sectoral level, the agricultural sector is expected to return to positive growth following good rains in a number of regions and improved maize crop estimates. A modest recovery in the manufacturing sector is expected following two consecutive months of the Absa PMI being above the neutral 50 point level, while the mining sector is forecast to respond to more favourable commodity prices.

Low growth in gross fixed capital formation remains a downside risk to growth in the short term. In 2016 gross fixed capital formation contracted for the first time since 2010, with the ratio of fixed capital formation to GDP declining from 20.4% in 2015 to 19.6% in 2016. Private sector investment remains particularly weak, having contracted for five successive quarters. This is reflected in the RMB/BER Business Confidence Index which increased marginally in the first quarter of 2017, but at 40 index points remains well below the neutral level of 50. The BER Manufacturing survey shows a sharp decline in expected capital investment over the next 12 months, with the political climate cited as the main reason.

The constrained growth outlook does not bode well for employment creation in the economy. According to the Quarterly Labour Force Survey, in the fourth quarter of 2016 compared to the fourth quarter of 2015, employment increased by 0.3% while the number of unemployed grew by 11.3%. This resulted in an increase in the unemployment rate by 2.0 percentage points to 26.5%.

Consumption expenditure by households, which grew by 0.8% in 2016 remains subdued amid low consumer confidence. While growth of 2.2% was recorded in both of the final two quarters of the 2016, negative retail and wholesale trade sales growth in December and January underscore the likely persistence of this weakness. New vehicle sales continued to decline in February, although exports increased significantly.

These trends are expected to persist as the impact of a higher tax burden, low employment growth and weak wealth effects take their toll on consumption expenditure. In addition, credit extension by banks to the private sector continues to grow at low rates, particularly to households amid a further decline in the household debt to disposable income ratio. Expenditure will be supported to some extent by positive but moderate real income growth.

Fiscal policy as outlined in the recent budget remains committed to a steady pace of deficit reduction over the next three years. Lower tax revenues relative to budget – partly a consequence of slower economic growth – have resulted in a shortfall to be filled by a combination of lower expenditure growth, increased fuel levies and other excise duties, and a number of tax changes. These include limited compensation for fiscal drag and a higher marginal tax bracket for high-income earners. The tax increases are expected to act as a drag on household consumption expenditure, particularly for middle and upper income earners.

International oil prices have declined following increased oil inventories and weak compliance with the OPEC-brokered deal to restrict output, and an increase in shale gas production in the US. Although Brent crude oil prices increased by about 10% in the wake of this agreement, these gains have been largely reversed, with oil prices back in the region of US$50 per barrel for the past three weeks. The impact on the domestic petrol price will be evident in April when a reduction is expected, despite the 39 cent increase in the Road Accident Fund and fuel levies provided for in the February budget.

Since the previous MPC meeting the inflation outlook has improved. However, the risk to the inflation forecast has been affected by the reaction of the of the exchange rate to the current elevated levels of political uncertainty. At current levels of around R13.00 against the US dollar, the exchange rate is still moderately stronger than the level implied in the exchange rate assumption in the forecast. However, the rand is likely to react further to unfolding developments until a greater degree of certainty and confidence is restored. The possibility of significant overshooting of the exchange rate in the short run also cannot be ruled out. As always, the MPC will attempt to “look through” short term fluctuations and focus on longer term trends in its policy settings.

The MPC remains concerned about the elevated level of inflation expectations. While the near-term reversal was not unexpected, given the deterioration of the short-term inflation outlook in January, the longer term expectations remain anchored uncomfortably at the upper end of the target range.

Not all the inflation risk factors are on the upside. The deterioration in the forecast at the previous meeting was due in part to a higher international oil price assumption. This assumption has not been adjusted to reflect the recent market developments. There is a downside risk to this assumption, given the possibility of these more moderate trends persisting.

A further downside risk comes from electricity price increases, which could turn out to be lower than the 8.0% currently in the forecast from mid-2017. The final price determination by the energy regulator is yet to be announced.

Overall, the MPC assesses the risk to the inflation outlook to be moderately on the upside, mainly due to the high degree of exchange rate uncertainty.

The MPC sees no evidence of significant demand pressures impacting on inflation. The growth outlook remains disappointing, and the MPC is concerned that increased political uncertainty could impact negatively on private sector investment and household consumption expenditure, and further undermine employment growth. The risks to the growth outlook are therefore assessed to be on the downside.

In light of these developments the MPC has decided to keep the repurchase rate unchanged at 7.0% per annum. Five members preferred an unchanged stance and one member preferred a 25 basis point reduction.

The MPC is of the view that we may have reached the end of the tightening cycle. However the Committee would like to see a more sustained improvement in the inflation outlook before reducing rates. This assessment may however change if the inflation outlook and the risks to the outlook deteriorate.

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