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 July meeting of the Monetary Policy Committee (MPC), the Covid-19 pandemic has abated in South Africa. A range of other countries however continue to experience a rapid spread of the virus. The economic effects of the crisis have been extensive and a recovery to pre-pandemic levels will take several years. Current forecasts from the IMF show global gross domestic product (GDP) contracting by about 4.9% this year, although the general economic outlook has improved somewhat.[1] Second quarter GDP outcomes for most economies have been massively negative, as expected. At this stage, third and fourth quarter recoveries for 2020 are expected to be robust. However, the pace of growth into 2021 could be modest,

[1] Global growth in the QPM model is a trade-weighted average of South Africa's trading partners. For 2020 this is now at -4.2% (up from -4.7% in July) and revised up to 4.7% for 2021. Based on the June update of the World Economic Outlook, the IMF expects global growth of 5.4% in 2021.

depending on control of new virus outbreaks, the extent of supply and demand losses, and future growth in investment and productivity.

Volatility in financial asset prices remains high, as virus developments and geopolitical events continue to impact heavily on market sentiment. While capital flows to emerging markets have generally picked up compared to the outflows experienced in March and April, the global environment continues to reflect pronounced levels of risk aversion.

Policy responses to the crisis have generally been robust across countries. In recent months, many fiscal and monetary authorities have opted to wait for new data to gauge conditions and assess the speed of economic recovery before making further adjustments.

The Covid-19 outbreak has had major health, social and economic impacts, presenting difficulties in forecasting domestic and global economic activity. The compilation of accurate economic statistics has and will remain severely challenged. On 8th September, Statistics SA released their estimate of second quarter growth in GDP and revised the first quarter figure slightly. As expected, output was severely negative, with seasonally adjusted and annualised quarterly GDP contracting by 51%, across all sectors except agriculture which expanded.

The Bank now forecasts a GDP contraction of 8.2% in 2020, compared to the 7.3% contraction forecast in July. The lower second quarter is followed by revised projections of a stronger expansion in the third and fourth quarters of 2020.

Further easing of the lockdown has supported economic growth. High frequency indicators generally show a pickup in economic activity from extremely low levels in

April and May. However, getting back to pre-pandemic output levels will take time. With a sharp decline in investment, potential growth estimates have been lowered, resulting in a smaller output gap over the forecast period. GDP is expected to grow by 3.9% in 2021 and by 2.6% in 2022.[2]

South Africa's terms of trade remain robust. Commodity export prices are high, while oil prices remain generally low. The Brent crude oil price increased between July and September, and is expected to average about $42 per barrel in 2020, rising to $47 per barrel in 2021 and $52 per barrel in 2022.

The rand has depreciated by 14.5% against the USD since January and remains below its estimated long-run equilibrium value, despite considerable appreciation since June. The implied starting point for the rand forecast is R17.07 to the US dollar, compared with R17.93 at the time of the previous meeting.

Risks to the growth outlook are assessed to be balanced, but this is tentative and open to adjustments given the wide range of shocks hitting the economy, uncertainties involving the effectiveness of policy, and the sensitivity of sentiment to news flow.

The exceptionally accommodative policies in many advanced economies and improved economic outlooks have supported a partial recovery in global financial markets. But this has so far resulted in only a trickle of fresh capital flows to emerging markets, and financing conditions remain uncertain.

The sharp rise in South Africa's public financing needs arising from falling tax revenue and higher spending has been financed by higher private sector savings and borrowing from international financial institutions. Alongside SARB liquidity-

[2] Compared to -7.0%, 3.8% and 2.9%, respectively, in July.

management operations, resident investors, including banks, have increased purchases of sovereign bonds, helping to ease yields in recent weeks. However, the yield curve remains exceptionally steep, reflecting ongoing credit risk associated with high public borrowing needs.[3]

The Bank's headline consumer price inflation forecast averages 3.3% in 2020 and is lower than previously forecast at 4.0% in 2021 and at 4.4% in 2022. The forecast for core inflation is lower at 3.4% in 2020, and remains broadly stable at 3.7% in 2021, and 4.0% in 2022.

The overall risks to the inflation outlook at this time appear to be balanced. Global producer price and food inflation have bottomed out. Oil prices remain low. Local food price inflation is expected to remain contained. Risks to inflation from currency depreciation are expected to stay muted while pass-through remains low. While there are no demand side pressures evident, electricity and other administered prices remain a concern. Additional exchange rate pressures could result from heightened fiscal risks.

Importantly, expectations of future inflation continued to soften this year and have shifted slightly below the mid-point of the band for 2021. Market-based expectations for short and medium-term inflation have eased slightly, while longer-term inflation expectations remain higher.[4]

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[3] Measured by the spread between the R2036 and R2048 to the R186 bonds.

[4] The latest Bureau for Economic Research (BER) survey has expectations for 2020 down by 0.3 ppts to 3.6% and to 4.2% (from 3.9 and 4.5%) for 2021. Five-year-ahead inflation expectations eased from 4.7% to 4.5%. Household inflation expectations down from 6.2% to 5.9%. Market analysts (Reuters Econometer) expect inflation to be 3.3% (from 3.1%) for 2020, 4.2% (from 4.0.%) in 2021 and at 4.4% (from 4.3%) in 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 3.3% for the 5-year and 5.5% on the 10-year breakeven. 15-year breakeven inflation sits at 6.4 %.

Despite a higher than expected inflation outcome in July and elevated levels of country financing risk, the Committee notes that the economic contraction and slow recovery will keep inflation below the midpoint of the target range for this year. Barring risks outlined earlier, inflation is expected to be well contained over the medium-term, remaining below but close to the midpoint in 2021 and 2022.

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 indicates no further repo rate cuts in the near term, and two rate increases in the third and fourth quarters of 2021.

Monetary policy has eased financial conditions and improved the resilience of households and firms to the economic implications of Covid-19. The Bank has taken important steps to ensure adequate liquidity in domestic markets. Regulatory capital relief has also been provided, sustaining lending by financial institutions 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 enhance the effectiveness of monetary policy and its transmission to the broader economy.

Global economic and financial conditions are expected to remain volatile for the foreseeable future. In this highly uncertain environment, future 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.

Lesetja Kganyago

GOVERNOR

The next statement of the Monetary Policy Committee will be released on 19 November 2020.

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