SOUTH AFRICAN RESERVE BANK

PRESS STATEMENT

21 July 2022

STATEMENT OF THE MONETARY POLICY COMMITTEE

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

In the wake of the Covid-19 pandemic and aggravated geo-political tensions, the global economy has entered a period of persistently high inflation and weaker economic growth. Many developing economies have yet to recover fully from the pandemic. Global economic conditions remain fragile.

Russia's war in Ukraine will continue to impair production and trade of a wide range of energy, food and other commodities. The supply of energy to the Euro Area is limited as winter approaches, and is likely to reduce growth this year and next. With rapid inflation and withdrawal of policy stimulus, the United States will also experience slower economic growth. China's recovery from the Covid-19 outbreak and resultant lockdowns remains uncertain. The much-needed resumption of international travel and tourism will take time to generate large benefits.

Taking these and other factors into account, the SARB's forecast for global growth in 2022 is revised down from 3.5% in the May meeting to 3.3%, and is lowered to 2.5% (from 2.7%) for 2023 and 2024.[1] The International Monetary Fund (IMF) has signalled

[1] Global growth in the QPM model is a trade-weighted average of South Africa's trading partners.

a lower global growth forecast for 2022 and 2023 in its upcoming *World Economic Outlook Update*.[2]

Although policy settings in advanced economies remain broadly accommodative, policy normalization by major central banks has accelerated, and higher yields are tightening global financial conditions. Investor appetite for riskier assets is weaker and asset values in major markets have declined sharply.

Last year saw the South African economy expand by 4.9%. This year the economy is expected to grow by 2.0%, revised up from 1.7%. Growth in output in the first quarter of this year surprised to the upside, at 1.9%, stronger than the 0.9% expected at the time of the May meeting. Despite this outcome, flooding in Kwa-Zulu Natal and more extensive load-shedding are expected to result in a contraction of 1.1% in the second quarter. Growth in the third and fourth quarters is forecast to be 0.7% and 0.4%, respectively.

The economy is forecast to expand by 1.3% in 2023 and by 1.5% in 2024, below the previous projection of 1.9% for both years at the time of the last meeting.[3] Despite these downward revisions, economic growth remains above a low rate of potential.[4] Private investment has strengthened on the back of the recovery, but public sector investment remains weak. Household spending remains supportive of growth, but is likely to soften next year due to higher inflation, lower asset prices, and rising interest rates. Tourism, hospitality and construction should see stronger recoveries as the year progresses.

[2] An update to the *World Economic Outlook* will be released on 26 July.

[3] The growth forecast includes expected changes in the policy rate.

[4] Potential growth for 2022 is 0.5% (from 0.6%), 0.8% (from 0.9%) in 2023 and unchanged at 1.1% in 2024.

With potential growth revised somewhat lower for this year and expected GDP growth higher, the output gap narrows slightly faster over the forecast period. The output gap is expected to turn positive in the second quarter of 2023. Overall, and after revisions, the risks to the medium-term domestic growth outlook are assessed to the downside.

Commodity price movements in recent months have been mixed. The export price of coal has increased alongside oil, while prices for metals have declined. Oil prices spiked to around US$130 per barrel in the early days of the conflict in Ukraine. While oil prices currently sit at around US$106 per barrel, we expect them to stay higher than we did in May, and to average US$108 per barrel for 2022, US$92 per barrel in 2023 and US$85 per barrel in 2024.[5]

South Africa's export commodity price basket has come down from earlier peaks and is now forecast to rise by 3.2% for the year as a whole (down from 9.5%), before falling in 2023 by about 19.0% and by a further 8.0% in 2024. As a result of these export and import price and volume developments, the current account balance is expected to register a surplus of 2.0% of GDP this year, falling to 0.4% in 2023 and to reach a deficit of 0.4% in 2024.[6]

Although fiscal risk has eased on the back of better tax revenue and reduced borrowing needs, financing conditions remain tight and the yield curve for rand-denominated bonds is steep. Ten-year bond yields increased to about 11.4% in recent months.

[5] The Brent crude oil assumptions in May were US$103, US$90, and US$85, respectively.

[6] In May, the current account surplus for 2022 was expected to be about 2.1% of GDP, 0.8% in 2023 and 0.0% in 2024.

Policy normalisation in major economies and the slowdown in China have contributed to rand depreciation in recent months. The implied starting point for the rand forecast is R16.10 to the US dollar, compared with R15.88 at the time of the previous meeting.[7]

While economic growth is slowing globally, inflation continues to surprise to the upside. Sustained policy accommodation, supply shortages and other restrictions have sharply increased the prices of many goods, services and commodities.[8] Producer price increases continue to pass-through to wages and consumer prices globally. Our estimate for inflation in the G3 is revised higher to 6.9% in 2022 (from 6.3%) and up to 3.0% in 2023 (from 2.7%), and stays unchanged at 2.0% in 2024.[9]

A higher global oil price and rand weakness contribute to higher expected fuel price inflation for this year at 38.9% (up from 31.2%) and to 4.5% in 2023 (up from -0.3%). Local electricity price inflation is unchanged at 11.0% in 2022, 9.2% in 2023, and 10% in 2024.

As a result of higher global food prices, local food price inflation is also revised up and is now expected to be 7.4% in 2022 (up from 6.6%), and 6.2% in 2023 (up from 5.6%). The food price inflation forecast for 2024 is unchanged at 4.2%.

The Bank's forecast of headline inflation for this year is revised higher to 6.5% (from 5.9%). Higher food, fuel, and core inflation are expected to keep headline inflation elevated at 5.7% in 2023 (up from 5.0%). Headline inflation of 4.7% is expected in 2024, unchanged since the May meeting.

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[7] The rand has depreciated by about 6.3% to the US dollar since the May meeting and 7.2% year to date.

[8] World food prices continue to rise. The assumption used for the forecast for USD-denominated world food prices in 2022 is revised higher from 15.3% to 22.3%.

[9] The G3 comprises the United States, the Eurozone, and Japan. The latest CPI inflation in the respective components sits at 9.1%, 8.6% and 2.4%.

Core inflation is forecast higher at 4.3% in 2022 (up from 3.9%), rising to 5.6% (from 5.1%) in 2023. Our forecast for core inflation in 2024 is slightly higher at 4.9% (from 4.8%). Core goods and services price inflation are forecast higher through to the end of 2024, compared to May when only core goods inflation was rising each year.[10] Nominal wages are forecast to rise by 5.6% in 2022, 7.3% in 2023 and 5.7% in 2024.

The risks to the inflation outlook are assessed to the upside. Global producer price and food price inflation continued to surprise higher in recent months and may do so again. Russia's war in Ukraine is likely to persist for the rest of this year and may have significant further effects on global prices. Oil prices increased strongly from the start of the war and may rise further as stresses in energy markets intensify. Electricity and other administered prices continue to present short- and medium-term risks. Given below-inflation assumptions for public sector wage growth and higher petrol and food price inflation, considerable risk still attaches to the now elevated nominal wage forecast.

Higher than expected inflation has pushed major central banks to accelerate the normalisation of policy rates, tightening global financial conditions and raising the risk profiles of economies needing foreign capital. We now expect G3 interest rate levels for the forecast period to be twice as high as expected in May.[11] On balance, and with few exceptions, capital flows and market volatility are expected to remain elevated for emerging market assets and currencies.

Alongside currency depreciation, other risks to the inflation outlook, such as increased food and fuel prices, have been realised, pushing up unit labour costs and

[10] Core goods refers to total CPI goods excluding food and NAB, fuel and energy, whereas services include all surveyed services within the CPI basket.
[11] The weighted average of G3 policy rates is forecast to be 1.2% in 2022, 3.0% in 2023 and 3.1% in 2024.

expectations of future inflation. Average surveyed expectations of future inflation have increased to 6.0% for 2022 and 5.6% for 2023.[12] Expectations for inflation based on market surveys have increased to 6.5%.[13] Long-term inflation expectations derived from the break-even rates in the bond market have also increased.[14]

In the second quarter of this year, headline inflation breached the target range and is expected to remain above it until the second quarter of 2023. By the fourth quarter of 2024, we expect headline inflation to revert to the mid-point of the target range, on the back of declining fuel and food inflation. The forecast takes into account the policy rate trajectory indicated by the Bank's Quarterly Projection Model (QPM). 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.

Against this backdrop, the MPC decided to increase the repurchase rate by 75 basis points to 5.50% per year, with effect from the 22nd of July 2022. Three members of the Committee preferred the announced increase. One member preferred a 100 basis points increase. Another member preferred a 50 basis point increase.

The revised repurchase rate path remains supportive of credit demand in the near term, while raising rates to levels consistent with the current view of inflation risks. The

[12] The (Q2) Bureau for Economic Research (BER) survey expectations rose above the target midpoint to 6.0% (5.1%) for 2022 and 5.6% (5.0%) for 2023.

[13] Market analysts (Reuters Econometer) in July expect inflation to be higher at 6.5% (6.0%) in 2022, 5.0% (4.7%) in 2023 and 4.4% in 2024.

[14] 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 6.97% for the 5-year and 7.49% on the 10-year breakeven. 15-year break-even inflation sits at 7.64%.

aim of policy is to stabilise inflation expectations more firmly around the mid-point of the target band and to increase confidence of hitting the inflation target in 2024.[15]

Guiding inflation back towards the mid-point of the target band can reduce the economic costs of high inflation and enable lower interest rates in the future. Achieving a prudent public debt level, increasing the supply of energy, moderating administered price inflation and keeping wage growth in line with productivity gains would enhance the effectiveness of monetary policy and its transmission to the broader economy.

Economic and financial conditions are expected to remain more volatile for the foreseeable future. In this uncertain environment, monetary 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 potential second round effects and the risks of de-anchoring inflation expectations. The Bank will continue to closely monitor funding markets for stress.

Lesetja Kganyago

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The next statement of the Monetary Policy Committee will be released on 22 September 2022.

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[15] The forecasted trajectory for the repurchase rate implies a rise in the inflation-adjusted repo rate from -1.7% for 2021 to -2.0% for 2022, 1.0% for 2023, and 2.0% in 2024. The real repurchase rate calculation here is based on the 1-quarter ahead inflation forecast and are annual average rates.