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 April meeting of the Monetary Policy Committee (MPC), the Covid-19 pandemic continues to spread globally, with wide-ranging and deep social and economic effects. Current forecasts from the IMF show global gross domestic product (GDP) decreasing by about 3.0% this year.[1] Economic contractions are expected to be deepest in the second quarter of 2020, with gradual recoveries in the third and fourth quarters of the year. The strength of the global economic recovery will depend

[1] Global growth in the QPM model is a trade-weighted average. For 2020 this is now at -3.4% and 4.3% for 2021.

in part on how quickly countries are able to open up for economic activity *safely*, and in particular how effectively societies comply with social distancing rules. The World Health Organisation advises that further complications from the virus are being identified and the pandemic is unlikely to end quickly, with the virus coming in waves over time.

The crisis has caused extreme volatility in financial asset prices with sharp and deep market sell-offs followed recently by a partial recovery. Investor interest in higher-yielding assets has improved somewhat in recent days, but the general environment reflects pronounced levels of risk aversion, in particular for emerging market currencies, equities and bonds. Uncertainty about future global economic prospects, trade relationships and supply chains has increased again.

Policy responses to the crisis have generally been robust, with the magnitudes dependent on the degree of policy space available to countries. The US Federal Reserve has taken further steps to expand its balance sheet and the European Central Bank (ECB) has made similar commitments. Emerging and developing economies generally have less policy space available and credit is more expensive. The International Financial Institutions (IFIs) have made available extraordinary levels of emergency financial support to respond to Covid-19.[2]

The Covid-19 outbreak has major health, social and economic impacts, presenting challenges in forecasting domestic economic activity. The compilation of accurate economic statistics will also remain severely challenged. The Bank currently expects GDP in 2020 to contract by 7.0%, compared to the 6.1% contraction forecast in April. Even as the lockdown is relaxed in coming months, for the year as a whole,

[2] About 57 countries have been granted funds from the IMF's Rapid Financing Instrument and the Rapid Credit Facility.

investment, exports and imports are expected to decline sharply. Job losses are also expected to be widespread.

Easing of the lockdown will support growth in the near term and some high frequency activity indicators show a pickup in spending from extremely low levels. However, getting back to pre-pandemic activity levels will take time. GDP is expected to grow by 3.8% in 2021 and by 2.9% in 2022.

South Africa's terms of trade remain robust. Commodity export prices have eased in recent weeks, but are still at healthy levels. Oil prices remain generally low. The spot price for Brent crude oil is currently around $34 per barrel, and is expected to remain around these levels in coming months, contributing to reduced petrol price inflation. For our forecast, the Brent crude oil price is expected to average $37 per barrel in 2020 and $45 per barrel in 2021.

Exceptionally accommodative policies and the relaxation of lockdowns in many advanced economies have supported a partial recovery in global financial markets, but financing conditions for emerging markets remain uncertain. Domestically, credit risk associated with public borrowing needs remains very high, contributing to non-resident investors' sales of about R149 billion of local-currency denominated assets.

The rand has depreciated by 22.9% against the USD since January and by 0.7% since the April meeting of the MPC. The implied starting point for the rand forecast is R18.40 to the US dollar, compared with R17.80 at the time of the previous meeting. Resident investors have increased purchases of long-term bonds, helping to ease yields in recent days, but the yield curve remains exceptionally steep.[3]

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

The Bank's headline consumer price inflation forecast averages 3.4% for 2020 and 4.4% in 2021 and 2022. The forecast for core inflation is lower at 3.5% in 2020, 3.8% in 2021, and 4.1% in 2022.

The overall risks to the inflation outlook at this time appear to be to the downside, but less clearly so compared to conditions in March and April. Global producer price and food inflation appear to have bottomed out. Oil prices remain low but have recovered somewhat. Local food price inflation is also expected to remain contained. Risks to inflation from currency depreciation are expected to stay muted while pass-through remains slow. However, electricity and other administered prices remain a concern. Upside risks to inflation could also emerge from heightened fiscal risks and sharp reductions in the supply of goods and services.

Expectations of future inflation continued to soften but broadly remain around the mid-point of the band. Market-based expectations for short and medium-term inflation have fallen, while long-term inflation expectations remain higher.[4]

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

[4] The latest Bureau for Economic Research (BER) survey has expectations for 2020 down by 0.4ppts to 4.4% and to 4.6% (from 5.0%) for 2021. Five-year-ahead inflation expectations also eased to 4.7% (from 4.9%). Market analysts (Reuters Econometer) expect inflation to be 3.5% (from 4.2%) for 2020, 4.1% (from 4.6%) in 2021 and to remain unchanged at 4.5% for 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 2.5% for the 5-year and 5% on the 10-year breakeven. 15-year breakeven inflation sits at 6.4%.

Against this backdrop, the MPC decided to cut the repo rate by 50 basis points, taking it to 3.75% per annum, with effect from 22 May 2020. Three members preferred a cut of 50 basis points and two preferred a cut of 25 basis points.

The implied path of policy rates over the forecast period generated by the Quarterly Projection Model indicates two repo rate cuts of 25 basis points in the next two quarters of 2020.

Monetary policy can ease financial conditions and improve the resilience of households and firms to the economic implications of Covid-19. In addition to continued easing of interest rates, the Bank has eased regulatory requirements on banks and has taken important steps to ensure adequate liquidity in domestic markets. These actions are intended to free up more capital for 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 further reduce existing constraints on 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.

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The next statement of the Monetary Policy Committee will be released on 23 July 2020.

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