OVERVIEW

Price stability reduces uncertainty in the economy, contributing to stronger economic growth and employment creation over time. Furthermore, a low and stable inflation rate protects the purchasing power of the rand. Hence the need for low inflation, particularly for the poor who have limited means of protecting themselves against continually rising prices.
ACHIEVING AND MAINTAINING PRICE STABILITY

The interest rate is the main tool used to manage inflation. The SARB sets the repurchase (repo) rate, which is the rate at which banks borrow from the SARB. This in turn impacts the interest rates that banks charge their customers, as well as other interest rates in the economy.

Over the long run, central banks have a high degree of control over inflation in their economies. In the short run, shocks like droughts can cause inflation to rise, however, these effects tend to be temporary. For prices to keep increasing year after year, central banks have to create extra money. In turn, by controlling the supply of money, central banks have the capacity to manage inflation over time. Given this power, many central banks, including the SARB, have a primary mandate of controlling inflation. Low and predictable inflation provides several benefits. It protects the spending power of consumers, especially in poorer households which are often most vulnerable to inflation. It also permits lower interest rates, particularly for longer-term borrowing, as lenders can charge less to protect their investments from inflation.

Although these are the most important benefits a central bank can provide for a country, over the shorter run monetary policy can also influence the level of output and employment, albeit in a limited way. For instance, when an economy is operating below its potential, lower interest rates can help it recover. Accordingly, inflation-targeting central banks typically also consider how their decisions will affect variables like growth and unemployment. However, the central bank cannot permanently control real output in the same way it can control inflation. This is why inflation targeting is the SARB’s core mission.

WHAT IS MONETARY POLICY?

Monetary policy is the process through which the SARB influences interest rates in the economy to ensure price stability.

WHY AN INFLATION-TARGETING APPROACH?

This approach results in the target being clearly articulated, reducing uncertainty and supporting transparency and accountability. Successful implementation of inflation-targeting also helps to anchor inflation expectations.

HOW IS INFLATION MEASURED?

Inflation is measured by defining a basket of goods and services used by a ‘typical’ consumer and then keeping track of the changes in the cost of that basket. Statistics South Africa is the official compiler of the consumer price index (CPI) which is the measure of inflation.

WHAT ARE THE RISKS TO MAINTAINING INFLATION WITHIN THE TARGET RANGE?

A weakening rand exchange rate could potentially accelerate inflation. For example, increasing uncertainty about future economic policy or further ratings downgrades could prompt capital outflows, pushing up borrowing costs and putting pressure on the rand.

External shocks such as increases in international oil prices or drought will make certain goods more expensive.

Remuneration increases in excess of inflation and productivity increases tend to push up prices.

WHAT DOES THE SARB CONSIDER WHEN MAKING INTEREST RATE DECISIONS?

The MPC decides the short-term interest rate appropriate for achieving the SARB’s price stability mandate, defined as an inflation rate of 3–6%. Meetings take place once every two months, and provide an opportunity for the committee members to review economic data and discuss the appropriate monetary policy response.

The committee’s decisions take into account the variable medium-term horizon for inflation and the time lags between policy adjustments and economic effects, which are between 12 to 24 months. The flexible inflation-targeting framework allows for temporary deviations from the target in response to shocks to inflation beyond the control of monetary policy.

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PUBLIC ENGAGEMENT ON THE MPC DECISION

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The SARB achieved success for SFA 1. Since April 2017, inflation has been within the target range and is projected to remain within the range over the three-year forecast horizon. Inflation expectations, as measured through the Bureau for Economic Research (BER) survey, have also remained consistent with the target range. For most of the reporting year, expectations fluctuated around the upper end of the range, however in the first quarter of 2018 expectations for 2019 moderated, declining to 5.3%. The SARB would prefer to see inflation expectations anchored around the mid-point of the target range.

Established the foundations of the cross-cutting policy-relevant research agenda. A key focus is to determine and establish how the research agenda will be delivered and a key outcome for the next financial year will be to embed and strengthen this capability. The research agenda will assist the SARB to better understand the synergies between the SFAs, particularly SFAs 1, 2 and 4.

Is reviewing the Economic Research and Statistics Department’s modelling and forecasting process with completion expected around May 2018. The department achieved its research objectives in various thematic areas of the agenda.

To anchor inflation expectations, the SARB:

Continued to publish policy relevant economic analysis and provide the public with more information about the underlying assumptions that drive the SARB’s two-year forecast of the economy. The government and other stakeholders were also provided with improved economic statistics relevant to the formulation and implementation of macroeconomic policy. To meet its objectives to anchor expectations closer to the mid-point of the target range, the SARB will continue to enhance its stakeholder engagement programme by more effectively targeting sectors and groups that influence price setting.
OVERVIEW OF THE WORLD ECONOMY

The global economy has enjoyed a robust and synchronised recovery, making the current upswing the strongest and most sustained growth phase since the rebound from the global financial crisis in 2010. The improvement has been broad based with notable upswings in advanced economies, while key emerging markets such as Brazil and Russia exited protracted recessions. The current upswing, however, remains largely cyclical, with few signs in recent years of an increase in global potential output growth.

REAL GLOBAL OUTPUT GROWTH AND CONTRIBUTIONS FROM ADVANCED AND EMERGING MARKET ECONOMIES (%)

Advanced economies have maintained strong growth momentum. In the USA, recovery has been solid and is likely to remain supported by fiscal stimulus in 2018 and 2019. Unemployment has fallen to an 18-year low of 3.9%, while inflation has eluded the central bank’s 2.0% inflation target, resulting in a modest monetary policy tightening cycle. However, some signs of wage acceleration at the start of 2018 raised fears that the Federal Reserve may have to increase interest rates faster than expected.

Economic activity in the euro area has also been on a solid footing driven mainly by domestic demand, including a pickup in investment. Many European economies have performed relatively strongly. By contrast, economic activity in the United Kingdom (UK) lost some momentum, as higher inflation eroded consumer demand and uncertainty over the economic implications of Brexit may have weighed on corporate investment.

Emerging markets have benefitted from higher commodity prices, stronger import demand in advanced economies and accommodative monetary policy. China has maintained relatively high levels of growth above 6%, driven mainly by robust net exports against a backdrop of improving global trade conditions. Meanwhile, China’s services sector has grown steadily, offsetting a moderation in the secondary sector and signalling an ongoing re-balancing of the economy.

DOMESTIC REAL ECONOMY DEVELOPMENTS

South Africa’s real gross domestic product (GDP) expanded by a moderate 1.3% in 2017, from a post-crisis low of 0.6% in 2016. The pickup in growth mainly reflected a rebound in the agriculture and mining sectors from particularly weak levels in 2016. Nonetheless, 1.3% growth remains weak both by historical and ‘peer country’ standards. The average emerging market growth rate in 2017, for instance, was 4.7%. Real per capita income has also been on the decline and unemployment has remained persistently high, reaching a peak of 27.7% in the third quarter of 2017, and settling at 26.7% in the first quarter of 2018.
Against the backdrop of persistently low domestic growth, government finances posted large and sustained fiscal deficits in recent years. As a consequence, government debt levels increased to 50.7% of GDP in 2017. South Africa is now rated sub-investment grade by Fitch and Standard & Poor’s (S&P). While Fitch has a BB+ rating for both local and foreign currency debt, S&P has a split rating: the long-term foreign currency rating at BB and the local currency rating at BB+. Accordingly, the 2018 Budget Review proposed a number of measures to rebuild confidence and to return public finances to a sustainable path. These measures included a 1-percentage point hike in the value-added tax (VAT) rate to 15%, as well as a marginal reduction in the expenditure ceiling.

South Africa’s external financing needs, on the other hand, have improved somewhat. The country’s current account deficit has been declining substantially, reaching 2.5% of GDP in 2017, owing to improving terms of trade, as well as the more robust economic conditions of its trading partners. However, given South Africa’s low savings rate, the country is likely to continue to run sizable twin deficits on the current account and the budget over the medium term.

The SARB’s forecasts indicate some improvement over the medium term with growth anticipated to reach 2.0% in 2020. The recovery is mainly on account of stronger business confidence, which should allow for a recovery in investment. The continued upswing in the global economy should also provide additional spill-overs to South Africa in the form of firmer exports. The pickup in domestic growth also entails continued growth in household consumption in light of households’ reduced debt burdens and continued gains in real disposable income, despite the rise in indirect taxes. Nonetheless, the improvement in growth is muted and expansion is projected to remain below long-term averages over the medium term.

### INFLATION DYNAMICS

Domestic consumer price inflation decelerated rapidly throughout 2017 to below the mid-point of the 3-6% target range in January 2018. The moderation in consumer price inflation resulted largely from a reduction in supply side cost pressures amid relatively subdued domestic demand. Food and electricity prices slowed notably, while the appreciation in the rand exchange rate since 2016 lowered the price of imported goods significantly. Food inflation fell from 12.1% in December 2016 to 4.6% in January 2018 as drought conditions gave way to record harvests (except for the Western Cape). Underlying inflation has also declined, averaging 4.7% in 2017, versus a long-run average of 5.0% between 2003 and 2016. Core inflation receded to its lowest level in six years at the start of 2018 from a peak of 5.9% in December 2016.

The price of Brent crude oil increased by more than 70% between mid-2017 and May 2018, reaching levels over US$70 per barrel. In November 2017, the Organization of the Petroleum Exporting Countries (OPEC) and other non-OPEC producers agreed to extend production cuts of 1.8 million barrels per day until the end of 2018. Attempts to reduce supply have also benefitted from collapsing production in Venezuela – one of the world’s largest oil exporters. While higher oil prices have led to increased USA shale production, the combination of solid growth in world oil consumption, OPEC compliance with its production targets and geo-political tensions have pushed crude prices over US$75 per barrel. Over the medium term, world oil prices are not forecast to increase significantly from current levels given the potential supply response from new producers, which have managed to reduce marginal costs significantly.
World food developments have been favourable over the past two years, with prices declining steadily in dollar terms from the high levels reached in early 2016. Bumper domestic crops, following a prolonged drought in the northern parts of South Africa in 2016, and positive exchange rate factors have further contributed to a steady decline in local food prices. South African food inflation averaged 6.9% in 2017, with a peak of 8.7% in the first quarter of 2017. Meat prices, however, have remained elevated, averaging 12.8% in 2017, thus limiting the deceleration in overall food price in 2017. Higher poultry prices contributed significantly to the acceleration in overall meat price inflation in 2017. Several factors, including import tariffs on certain poultry products, as well as the outbreak of avian flu in Europe and later in South Africa, severely affected domestic poultry and egg prices throughout most of 2017. Overall food price inflation is expected to accelerate somewhat in 2018, mainly on account of higher VAT rates.

Food and petrol prices are volatile and mostly unresponsive to monetary policy. Policymakers therefore pay close attention to underlying inflation. The composition of SARB’s preferred measure of core inflation is largely two thirds services and one third goods; and excludes food, non-alcoholic beverages, petrol and electricity prices.

The goods subcomponent averaged 3.3% in 2017 and is expected to increase slightly to 3.5% by 2019. Services inflation has been more rigid, reflecting the stronger influence of relatively sticky wage growth. Nonetheless, it moderated to 5.5% in 2017 from a post-global financial crisis average of 5.8%, as a slowdown in actual and owners’ equivalent rents extended to some other sectors. The varying projections of these two subcomponents are mainly explained by the fluctuations in the exchange rate and inflation expectations.

The exchange rate is one of the key drivers of inflation in South Africa and its impact is transmitted through import prices. Changes in the exchange rate tend to pass through to consumer prices with a lag. The rand exchange rate has been on an appreciating trend since early 2016. By early March 2018, the rand was back at 2015 levels against the US dollar and in trade-weighted terms. The appreciation in the rand has had a clear impact on core inflation, with the core goods subcomponent – including items such as vehicles, household appliances and clothing – slowing more abruptly than the services subcomponent.

Longer-term inflation expectations, which have been fairly sticky at the upper end of the target range over the post-crisis period, have started to come down. In fact, short-term expectations have moved quite rapidly, while longer-term expectations have adjusted more slowly. This is an important monetary policy
achievement as inflation expectations influence price- and wage-setting behaviour in the economy. With inflation expectations for the next two years having declined to 5.4% in the first quarter of 2018 – the lowest level since this question was added to the BER survey in 2011 – the prospects for inflation are encouraging.

**MONETARY POLICY DECISIONS**

Monetary policy decisions affect the economy with a lag of approximately one to two years. Headline inflation numbers, however, are sometimes distorted by temporary shocks such as large movements in oil prices. For this reason, policymakers aim to look through these shocks, and focus on underlying inflation trends. Moreover, policymakers also consult alternative measures of inflation designed to exclude volatile items.

Inflation has gradually declined to within the 3–6% target range, averaging 5.3% in 2017. The shocks that pushed headline inflation in early-2018 to below 4.5% (unusually low electricity and food price gains, and import price deflation from a stronger rand) are now fading, and higher taxes, particularly VAT, will raise inflation again in the near term. The SARB’s inflation forecasts have also consistently projected a return to above the target mid-point. In recent years, the SARB has been emphatic that the 3–6% target should not be interpreted as a 6% target, and that policymakers would prefer to have inflation expectations anchored around the 4.5% mid-point.

Over the past few years, the mix of high political uncertainty, persistent fiscal deficits and credit rating downgrades have continued to present upside risks to the inflation outlook. In such a context, the MPC has been forced to maintain a cautious approach, even when confronted with weak domestic demand growth and a negative output gap, which typically curbs demand-driven price pressures. Consequently, the policy response has taken the form of moderate relaxation, with the repo rate declining 50 basis points from its starting point of 7% in January 2017. However, the SARB’s own estimates of the neutral real interest rate suggests that policy remains marginally accommodative and hence, the room for additional rate cuts remains limited in the absence of a more durable improvement in the inflation outlook.

The growth forecast has improved steadily, but remains below long-run averages and potential growth. This is mainly due to a lack of structural reforms, which are largely outside the scope of monetary policy. Despite the higher levels of consumption expenditure by households in the latter part of 2017, overall demand remains weak; however, monetary policy is providing some support to the economic recovery as the level of real interest rates has remained slightly below long-run norms in recent quarters.