South African Reserve Bank

PRESS STATEMENT

EMBARGO DELIVERY

18 July 2013

STATEMENT OF THE MONETARY POLICY COMMITTEE

Issued by Gill Marcus, Governor of the South African Reserve Bank

The period since the previous meeting of the Monetary Policy Committee (MPC) has been dominated by the reaction of the global financial markets to statements by the US Federal Reserve that a slowdown in quantitative easing may begin sooner than previously anticipated. The news impacted on capital flows to emerging markets, with outflows from bond markets in particular, but yields on long term bonds of advanced economies were also affected. While some of the initial fears have been addressed by further guidance from the Fed, this episode gives some insight into the difficulties that could be faced in fine-tuning exit strategies from highly accommodative monetary policies, particularly at a time when global growth remains weak.

These events had a significant impact on the exchange rate of the rand, creating further upside risks to the inflation outlook at a time when the domestic economy has shown increased signs of vulnerability. There has consequently been no let-up in the policy dilemma faced by monetary policy: that of a widening output gap in a worsening inflation environment.

The year-on-year inflation rate as measured by the consumer price index (CPI) for all urban areas surprised on the downside at 5,6 per cent in May 2013, having measured 5,9 per cent for the previous three consecutive months. However, this decline is likely to have been temporary as it was due in part to a 73 cent per litre decrease in the petrol price in May, which has since been reversed by an 84 cent per litre increase in July. Food price inflation increased further from 6,3 per cent in April to 6,7 per cent, and accounted for 1,0 percentage point of CPI inflation. The other main contributors to the inflation outcome were housing and utilities and miscellaneous goods and services which contributed 1,4 and 1,1 percentage points respectively. Administered price inflation declined to 6,3 percent from 8,9 per cent in April due to the petrol price decline. Excluding petrol, administered price inflation was unchanged at 7,8 per cent. Core inflation, which excludes food, petrol and electricity, measured 5,3 per cent, marginally up from 5,2 per cent in April. The headline producer price inflation for final manufactured goods measured 4,9 per cent in May, compared with 5,4 per cent in April.

Despite the lower starting point, the inflation forecast of the Bank has deteriorated since the previous meeting of the MPC. Inflation is now expected to average 0,1 and 0,3 percentage points higher in 2013 and 2014 at 5,9 per cent and 5,5 per cent respectively, while the forecast for 2015 has been raised from 5,0 per cent to 5,2 per cent. A temporary breach of the upper end of the target range is still expected in the third quarter of 2013, but at a higher average level of 6,3 per cent (6,1 per cent previously), followed by a return to within the target range by the final quarter of the year. The deterioration is mainly due to continued currency weakness and higher-than-expected petrol price increases.

The forecast for core inflation for 2013 is unchanged at an average of 5,3 per cent in 2013 and is now expected to peak at 5,5 per cent in the fourth quarter. This measure is then expected to moderate and to average 5,2 per cent and 5,0 per cent in the coming two years, compared with the previous forecasts of 5,0 per cent and 4,6 per cent respectively. This upward drift in the forecast in the absence of obvious excess demand pressures suggests that there may be emerging underlying pressures, possibly due to the lagged effects of the depreciation of the rand exchange rate.

Inflation expectations appear to have remained anchored around the upper end of the inflation target range. According to the survey conducted by the Bureau for Economic Research at Stellenbosch University during the second quarter of 2013, inflation expectations of all the categories of respondents remained almost unchanged compared with those of the previous quarter. Overall, the survey found that inflation is expected to average 6,0 per cent in 2013 and 6,1 per cent in the next two years, with financial analysts' expectations below those of the business executives and trade union officials over the whole forecast period and within the target range. The former category is consistent with the Reuters survey which reflects expectations of an average of 5,9 per cent in 2013, and moderating to 5,6 per cent and 5,4 per cent in the following two years, respectively.

The global economic growth outlook has remained fragile due to the continuing deeper recession in the Eurozone and a slowdown in a number of systemically important emerging market economies. Several forecasters, including the IMF, have downgraded Eurozone growth forecasts against the backdrop of a slowdown in Germany, and continued risks emanating from Portugal, Italy and Spain. In its recent World Economic Outlook update, the IMF reduced its 2013 forecast for Eurozone growth by 0,2 percentage points to -0,6 per cent, with a weaker recovery than previously forecast in 2014. Although the US economic recovery appears to be gaining some traction, headwinds from the fiscal contraction remain, and first quarter economic growth, at an annualised 1,8 per cent, was weaker than the initial estimate of 2,5 per cent. The sustainability of the recovery is also at risk from rising long-term bond and mortgage interest rates in response to expectations of a tapering off of asset purchases by the Fed. There are tentative signs of stronger growth in Japan, but the sustainability of the recovery remains uncertain.

The slowing growth in various emerging market economies including China, Brazil and Russia illustrate the difficulties of decoupling from the advanced economies, with the IMF revising its forecasts for 2013 for China from 7,8 per cent to 7,5 per cent; Russia from 3,4 per cent to 2,5 per cent; and Brazil from 3,0 per cent to 2,5 per cent. The deteriorating outlook for emerging markets has been compounded by the recent capital flow reversals that impacted adversely on domestic bond and currency markets in particular. While financial markets have stabilised somewhat, the risks posed to emerging economies in general, including South Africa, by normalisation of monetary policy in the US in the future, are evident.

The combination of slower growth in China and the stronger US dollar has also impacted negatively on commodity prices, although oil prices have been underpinned by risks related to recent events in Egypt. Global inflation remains benign and monetary policy is expected to remain accommodative in the advanced economies for some time, as indicated in the forward guidance provided by the ECB, the Bank of England and the Fed, notwithstanding a possible slower pace of quantitative easing in the US. By contrast, a general tightening bias is evident in a number of emerging markets in response to recent capital flow and exchange rate developments.

Movements in the exchange rate of the rand continue to pose the main upside risk to the inflation outlook. Since the previous meeting of the MPC exchange rate volatility has increased and the rand generally traded in a range between R9,60 and R10,36 against the US dollar. Since the beginning of the year the rand has depreciated by 14,2 per cent against the US dollar and by 11,1 per cent on a trade weighted basis. Much of the recent volatility and weakness has been in line with the reaction of a number of other emerging market currencies to fears of US monetary policy tightening. The rand has also been negatively impacted by lower commodity prices.

Domestic bond yields increased significantly in response to capital outflows and higher bond yields in the advanced economies. The yield on the 10-year government bond, for example, increased by more than 100 basis points since the financial market turbulence in late May. Net sales of domestic government bonds by non-residents amounted to R17,4 bn in May and June. In July non-residents became net buyers again with net purchases of R3,0 bn, bringing the year-to-date net total to R5,2 bn. Having been net sellers of South African equities in both 2011 and 2012, non-residents have returned to the market, with year-to-date net purchases of R23,3 bn.

Despite a 15,5 per cent nominal effective depreciation of the rand exchange rate since January 2012, the pass-through to inflation has been relatively muted, particularly when compared with previous episodes of currency weakness. This is probably a reflection of the weak pricing power in some sectors of the economy in a low growth environment. Nevertheless the risk remains that these pricing pressures may intensify at some stage, particularly if the exchange rate depreciates further from current levels.

Market expectations are for a moderate appreciation of the rand in the coming months, although these expectations have been tempered in recent surveys. According to the Reuters Econometer survey conducted in June, analysts on average expect a rand/dollar exchange rate of R9,70 at the end of 2013, and R9,40 at the end of 2014. There is, however, a wide dispersion between the forecasters, reflecting a high degree of uncertainty. Despite a slight narrowing of the current account deficit in the first quarter of 2013 to 5,8 per cent of GDP, the depreciated currency reflects this deficit against a backdrop of declining terms of trade and more uncertain global capital flows.

The outlook for domestic economic growth has weakened further, following the first quarter annualised growth rate of 0,9 per cent. While more favourable outcomes can be expected in the subsequent quarters of this year, overall annual growth is likely to be lower than the 2,5 per cent growth rate recorded in 2012. The Bank’s growth forecast for 2013 has again been revised down from 2,4 per cent to 2,0 per cent, and from 3,5 per cent to 3,3 per cent for 2014. Growth is expected to accelerate to 3,6 per cent in 2015, compared with 3,8 per cent previously. The risks to the outlook are still assessed to be on the downside, particularly in the face of further delays in overcoming electricity supply constraints. In line with these subdued growth prospects, the RMB/BER Business Confidence Index declined from 52 in the first quarter of 2013 to 48 in the second quarter, consistent with the continued sideways movement of the Bank's leading indicator of economic activity.

The outlook for the mining sector remains bleak following a 0,7 per cent year-on-year contraction in May. Although production showed positive month-to-month growth for the first time in four months, on a three-month-to-three-month basis the sector contracted by 1,4 per cent. There are indications that the manufacturing sector will make a positive contribution to growth in the second quarter following the annualised 7,9 per cent contraction in the first quarter. In May the sector expanded by 2,2 per cent on a year-on-year basis, and by 0,9 per cent on a three-month-to-three-month basis. This more positive trend is also indicated in the Kagiso PMI which increased by 1,2 index points to 52,6 in July,

The real value of building plans passed remains on a moderately upward trend despite a decline in May. The FNB construction confidence index reflects some improvement, having increased by 4 points to 41 in the second quarter of 2013, although the civil construction index declined somewhat over the same period.

Underlying the sluggish economic growth outlook is the low growth in real gross fixed capital formation, which moderated from an annualised 4,3 per cent in the fourth quarter of 2012 to 2,5 per cent in the first quarter of 2013. Private sector fixed investment growth slowed from 3,8 per cent to 2,8 per cent over this period, and reflected lower outlays in all sectors apart from agriculture, construction and finance. Work stoppages at Eskom's Medupi plant also impacted negatively on investment by state-owned enterprises in the quarter. Fixed investment expenditure is likely to remain affected by low business confidence and prolonged electricity supply constraints.

Employment growth remains subdued, particularly in the private sector. In the year from March 2012 to March 2013, employment grew by 1,0 per cent, or 80,000 workers, of which 65,000 were in the public sector, although this number was inflated by temporary appointments relating to municipal by-elections in the first quarter of the year. Employment contracted in the mining and manufacturing sectors during this period. The official unemployment rate increased from 24,9 per cent in the fourth quarter of 2012 to 25,2 per cent in the first quarter of 2013. Of particular concern is the increase in the youth unemployment rate to 52,9 per cent in the first quarter.

Slower growth in real consumption expenditure by households is indicative of declining consumer confidence and the relative lack of excessive demand pressures in the economy. Household Consumption expenditure growth moderated to 2,3 per cent in the first quarter of 2013, driven mainly by more subdued demand for durable goods, particularly motor vehicles. Real retail trade sales surprised on the upside in May with year-on-year growth of 6,2 per cent. Nevertheless, retail trade sales increased by 0,5 per cent in the three months ending May compared with the previous three months, suggesting a continuation of the moderate growth in sales.

Consumption expenditure is expected to be constrained by high petrol and electricity costs, high consumer debt levels and declining growth in credit extension to households. Despite a moderation in the growth of household debt in the first quarter of 2013, the ratio of household debt to disposable income was unchanged at 75,4 per cent, as growth in real disposable income also slowed.

Twelve-month growth in total loans and advances extended to the private sector increased by 9,3 per cent in May, but excluding mortgage advances the increase was 16,8 per cent. In the first five months of 2013, general loans (mainly unsecured lending) continued to account for the bulk of the increase in credit extension, but at a slower pace, particularly to households. Twelve-month growth in general loans to households declined from a recent peak of 35,4 per cent in September 2012 to 24,4 per cent in May 2013. The slowdown is more pronounced when measured over three months. In the three months to the end of May 2013, annualised growth was 11,3 per cent, compared with rates of increase in excess of 30 per cent during 2012.

One of the upside risks to inflation remains wage and salary increases. In the first quarter of 2013, a stronger upward trend was observed with growth in nominal remuneration per worker increasing from 6,6 per cent in the fourth quarter of 2012 to 7,5 per cent. With slower productivity growth, this implied an increase in unit labour cost growth from 5,2 per cent to 6,7 per cent. These increases are consistent with the overall average wage settlement rate in collective bargaining agreements published by Andrew Levy Employment Publications, which increased from 7,6 per cent in 2012 to 7,9 per cent in the first quarter of 2013.

Other upside risks to the inflation outlook emanate from food prices, which have been accelerating over the past few months following a low of 4,6 per cent in September 2012. Food price pressures are intensifying at the producer price level, with manufactured food product prices increasing by 6,9 per cent in May. Although agricultural product inflation remained subdued at 2,6 per cent, this was mainly due to the 13,0 per cent decline in live animal prices which offset the 10,4 per cent increase in cereal and other crop prices. More favourably, global food prices have declined as a result of expectations of bumper crops in some of the main grain producing countries. The FAO international cereals price index decreased by 10,1 per cent since September 2012.

Global oil prices have broken out of their recent trading range of between US$100 and US$105, mainly due to political developments in the Middle East.

However, the relatively subdued global growth outlook, particularly in China, is likely to restrain these price increases. The current under-recovery of around 36 cents per litre on the domestic petrol price is mainly due to international price developments, and indicates that a further petrol price increase can be expected in August.

The MPC continues to face conflicting policy choices relating to rising inflation and slowing growth. Inflation is expected to resume its upward trajectory following the brief respite in May. However, despite the upward trend in core inflation, there are no strong signs of excess demand pressures and the forecast for headline inflation suggests that the breach of the target may be short-lived. The main upside risk to the inflation outlook is the exchange rate and much will depend on the strength of the pass-through to inflation, which to date has been relatively muted. However, the risk remains that these pressures could be mounting, particularly if further currency weakness occurs and affects inflation expectations, which are currently anchored at the upper end of the target range. In addition, the outcome of the present round of wage bargaining will be critical in determining the extent of wage pressure on the inflation outlook.

The output gap has widened, and is only anticipated to begin to narrow during 2015, when growth is expected to be more or less in line with potential. The downside risk to growth has already resulted in the Bank being more tolerant of inflation at the upper end of the target range than would normally have been the case, an approach that is consistent with a flexible inflation targeting framework.

While the upside risks to the inflation outlook reduce the scope for further accommodation, a tightening of the monetary policy stance does not automatically follow. This will be highly dependent on how we see the inflation trajectory unfolding in this very uncertain environment. In other words, it has become even more data dependent. At this stage a sustained breach of the inflation target is not our central forecast. However, we are concerned about the revised higher trajectory of core inflation and macroeconomic vulnerabilities that are increasingly evident. The MPC is mindful of these conflicting pressures and the challenging domestic and global environment, and will continue to monitor developments closely and act appropriately to achieve its mandate. The MPC has decided to keep the repurchase rate unchanged at 5,0 per cent per annum.

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