South African Reserve Bank

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STATEMENT OF THE MONETARY POLICY COMMITTEE

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Since the previous meeting of the Monetary Policy Committee, the sharp decline in international oil prices has contributed to a more benign global inflation environment. This development may also ameliorate the deteriorating growth outlook in some regions by providing a boost to consumption expenditure. Lower oil prices have also had a favourable impact on domestic headline inflation, with the medium-term forecast improving relative to the previous forecast. However, the underlying inflation pressures, as reflected in core inflation, persist.

The domestic growth outlook remains challenging, but after two quarters dominated by the fall-out from extended strikes, some recovery is expected, but demand remains subdued. The coming quarters are expected to see an improved performance in the mining and manufacturing sectors, but the outlook is inhibited by domestic structural constraints, as well as by a weak global economy and the continued declining trend in non-oil commodity prices. Growth next year is expected to remain weak.

The year-on-year inflation rate as measured by the consumer price index (CPI) for all urban areas measured 5,9 per cent in both September and October, having measured 6,4 per cent in August. Downward pressure on inflation in October came from continued moderation in food and petrol prices. Food price inflation continued its downward trend, measuring 8,0 per cent in October, down from 8,7 per cent previously, while petrol prices increased by 2,4 per cent. Core inflation, which excludes food, petrol and electricity, moderated to 5,6 per cent in September from 5,8 per cent in August, but measured 5,7 in October, reflecting primarily continued exchange rate pass-through to some goods categories.

Administered price inflation excluding petrol measured 6,4 per cent in October, down from 6,5 per cent in September. Headline producer price inflation for final manufactured goods, which reached a recent high of 8,8 per cent in April, measured 7,2 per cent and 6,9 per cent in August and September respectively, driven in part by lower food and fuel price inflation.

The Bank's forecast of headline inflation has improved since the previous meeting of the MPC, mainly due to the impact of declining international oil prices. Having reached a peak of 6,5 per cent in the second quarter of this year, inflation is now expected to average 5,9 per cent in the final quarter of 2014, and average 6,1 per cent for the year, compared with 6,2 per cent previously. The downward trend is expected to continue into next year, with inflation forecast to reach a low of 5,1 per cent in the second quarter, and to average 5,3 per cent for the year, compared with

5,7 per cent previously. The forecast for 2016 has been revised down from 5,8 per cent to 5,5 per cent, and is expected to measure 5,4 per cent in the final quarter of the year.

The forecast for core inflation, by contrast, is more or less unchanged at an average 5,6 per cent and 5,7 per cent in 2014 and 2015 respectively, reaching a peak of 5,9 per cent in the first quarter of 2015 (previously 5,8 per cent), and moderating to 5,3 per cent in 2016, down from 5,5 per cent previously. The MPC assesses the risk to the headline inflation forecast to be broadly balanced.

The results of the fourth quarter inflation expectations survey of the BER will only be released in December. Market-based surveys, as reflected in the Reuters Econometer survey, however, show that the median CPI inflation expectation of analysts has remained unchanged over the past two months at 5,7 per cent and 5,5 per cent for 2015 and 2016 respectively. Break-even inflation rates (the yield differential between conventional government bonds and inflation linked bonds) declined since the previous meeting and reflect expectations within the target range for 5 year maturities, and marginally above the upper limit of the inflation target range at 10 year maturities.

The US and the UK remain the main drivers of global growth although more broadly, global growth may get some impetus from lower oil and food prices, which should provide some boost to consumers. US economic growth was better than expected in the third quarter, with the first advanced estimate of 3,5 per cent, and the unemployment rate declining to 5,8 per cent, the lowest level since June 2008. The UK recorded growth of 2,8 per cent in the third quarter, while the unemployment rate was unchanged at 6,0 per cent. The Japanese economy contracted for a second consecutive quarter during the third quarter, and has prompted a reconsideration of a further VAT increase next year. The response to the further additional monetary stimulus announced recently remains uncertain amid a tighter fiscal policy stance. The Eurozone outlook also remains bleak, including in the core countries such as France and Germany, although lower food and oil prices, coupled with further monetary easing may have a positive impact.

The outlook for emerging markets is mixed, with emerging Asian economies expected to benefit most from the positive spillovers from the US recovery. This is expected to offset in part the adverse impact of the slowdown in China, where growth is expected to be lower than in the past few years, as the economy rebalances away from investment towards consumption. This moderation is expected to continue to impact negatively on commodity prices. The Indian economy is showing signs of sustained recovery, while the other Brics partners, Russia and Brazil, face significant growth headwinds. Oil exporters generally are expected to face challenges from international oil price weakness.

Global inflation is expected to moderate in the face of benign food price inflation and falling international oil and other commodity prices. While this is welcome in the higher inflation regions, particularly emerging markets, it does aggravate deflationary risks in some of the advanced economies, particularly in the Eurozone and Japan. Monetary policy stances are expected to remain ultra-loose in these two regions, with a significant stimulus package announced recently in Japan and the ECB is anticipated to conduct further asset purchases. The US Fed has ended its programme of quantitative easing, but at this stage it is not contracting its balance sheet and proceeds from maturing assets are being reinvested. Although the general expectation is that the US Fed will begin raising interest rates in mid-2015, there are also some expectations that the more benign inflation outlook could delay this. Forward guidance from both the Bank of England and the US Fed is that any adjustment is likely to be gradual, and policy rates may be lower than their estimated long run normal rates for some time despite the improved growth outlooks. Since the previous meeting of the MPC, policy rates have increased in Brazil, Russia and Indonesia, but reduced in Sweden, South Korea, Chile and Poland.

The exchange rate of the rand has been relatively volatile since the previous meeting, in response to external and domestic factors including changing expectations of the timing of the first US interest rate increase as well as the downgrade of South Africa's credit rating by Moody's Investor Service. Although the rand initially weakened sharply against the US dollar, at one stage reaching a level of R11,36 against the US dollar, this move has since largely been reversed. Since the previous meeting of the MPC, the rand has depreciated marginally against the US dollar, but appreciated by 2,1 per cent and 3,5 per cent against the euro and sterling respectively, and by 1,8 per cent on a trade weighted basis.

The rand is expected to remain susceptible to sudden shifts in sentiment regarding changes in monetary policy stances in the advanced economies, and the continued uncertainty regarding the extent to which US normalisation is already priced in to the exchange rate. The asynchronous nature of advanced economy monetary policies is expected to complicate the outlook and outcomes. However, the rand is likely to remain more sensitive to changes in financial conditions in the US than in Japan and the Eurozone. The persistently slow adjustment of the current account deficit also makes the rand vulnerable to swings in sentiment that raise concerns about the financing of this deficit. Although the lower oil prices should reduce the oil import bill, its positive impact on the deficit may be limited by further declines in other commodity prices.

The volatility in portfolio capital flows is indicative of fickle global investor sentiment. Net bond sales by non-residents amounted to R12,6 bn in September and R2,1 bn in October and a further R1,5 bn to date in November. In the equities market, having been marginal net sellers in September, non-residents were net buyers to the value of R5,7 bn in October but net sellers of R6,3 bn to date.

The domestic growth outlook remains subdued. Although an improved growth outcome is expected in the third quarter, following the 0,6 per cent growth in the second quarter, this is off a low base following prolonged strikes in the mining and manufacturing sectors. The Bank's forecast for GDP growth in 2014 has declined marginally from 1,5 per cent to 1,4 per cent, and forecasts for 2015 and 2016 have been revised down from 2,8 per cent and 3,1 per cent to 2,5 per cent and 2,9 per cent respectively. This restrained outlook is consistent with the Bank's composite leading indicator of economic activity which continues to trend sideways, with a slight upward move recently. The RMB/BER business confidence index improved in the third quarter, but at 46 index points, remains below the neutral level of 50.

The mining sector appears to be recovering to some extent from the strike-affected first half of the year, and is expected to contribute positively to third quarter growth, following two consecutive quarters of contraction. The physical volume of mining production increased by 0,7 per cent in the third quarter compared with the second quarter, and further increases can be expected in the final quarter, as platinum output is still below pre-strike levels. By contrast, although the physical volume of manufacturing production increased in September, the month-long strike in the steel and engineering industry in July contributed to a quarter-to-quarter contraction of 1,3 per cent in the third quarter. Sentiment indicators suggest that the outlook for the sector remains bleak, with the manufacturing confidence index still at very low levels and capacity utilisation rates back at 2011 levels. More positively, the Kagiso PMI edged above 50 index points in October for the first time since March, driven mainly by the inventory and new sales orders sub-indices.

The outlook for the construction sector is more positive, with the real value of building plans passed increasing for the fourth successive month in August. On a three-month-to-three-month basis, an increase of 9,8 per cent was recorded. However, while the various building confidence indices have generally improved, they remain below the neutral level.

The weak pace of economic growth is mirrored in the unemployment rate, which, according to the Quarterly Labour Force Survey of Statistics South Africa measured 25,4 per cent in the third quarter, compared with 24,5 per cent a year earlier. Total employment increased at a year-on-year rate of 0,5 per cent in the quarter. At the same time the number of discouraged workers increased sharply, by almost 100,000, and now total 2,5 million.

Consumption expenditure by households has remained relatively subdued, but there are signs of a moderate increase in the quarterly growth rate, as the negative effects of the protracted strikes on consumption dissipate. Consumption expenditure could be positively impacted by lower petrol prices. Although retail sales growth declined by 0,8 per cent (non annualised) in September, quarter-to-quarter growth of 0,9 per cent was recorded in the third quarter, and 2,3 per cent year-on-year. Similarly, wholesale trade sales contracted in the third quarter, but increased by 5,9 per cent on a year-on-year basis. Motor vehicle sales have also shown some signs of recovery, although domestic sales are expected to be lower this year than in 2013. Retail sector confidence improved, with the BER reporting retailer confidence above the neutral level for the first time in two and a half years. Consumer confidence, however, declined significantly in the third quarter following an unexpected increase in the second quarter.

Trends in bank credit extension to the private sector have remained characterised by declining growth in advances to households, while advances to corporates have been buoyant. Total loans and advances grew at a twelve month rate of 8,8 per cent in September, but excluding mortgages the growth rate was 13,5 per cent, compared with a recent high of 18,6 per cent in December 2012. Credit extension to the household sector grew by 3,7 per cent in September, as unsecured lending remained weak despite a reversal of the negative growth trend in the month, but credit to the corporate sector grew by 15,3 per cent. Twelve-month growth in mortgage advances to households remained at levels below 3 per cent, while instalment sale credit and leasing finance continued its downward trend, with growth of 6,9 per cent. These trends are likely to constrain consumer demand in the coming months.

According to the October Medium Term Budget Policy Statement, government remains committed to its policy of fiscal consolidation, in order to prevent an increase in the debt ratio to unsustainable levels. The fiscal deficit is expected to decline from a projected 4,7 per cent of GDP in the current fiscal year to 3,0 per cent in 2017/18.

This is expected to be achieved through adherence to a nominal expenditure growth ceiling, and increased tax revenues. The ability to achieve the nominal expenditure targets will be determined to an important degree by the public sector wage settlement.

Wage trends remain broadly unchanged since the previous meeting of the MPC. According to Andrew Levy Employment publications, wage settlement rates averaged 8,0 per cent in the first nine months of the year. Nominal remuneration per worker as well as productivity trends in the formal non-agricultural sector were distorted by the significant increase in temporary employees by the Independent Electoral Commission, which contributed to the decline in the year-on-year increase in remuneration from 6,3 per cent to 3,5 per cent, while productivity declined by 1,6 per cent. The net result was a marginal increase in unit labour costs of 5,2 per cent in the second quarter, from 5,1 per cent previously.

Food price inflation remains a major driver of inflation, but is expected to continue to moderate in the coming months. Food price inflation appears to have peaked at 9,5 per cent in August, and has since moderated to 8,0 per cent in October, as lower producer prices of crops and cereals, which declined by 6,3 per cent in September, are beginning to have an impact at the consumer price level. Restocking of herds following the drought last year, however, has kept meat price inflation elevated. Food price pressures also remain benign at the global level, with the Food and Agricultural Organisation international food price index declining for seven consecutive months to its lowest level since August 2010.

International oil prices have declined markedly since their recent peak in June of around US$115 per barrel to current levels of below US$80 per barrel. This decline reflects a combination of factors, including increased supply coming from the US and Libya, moderating demand from China in particular, and changes in the internal dynamics within the OPEC cartel. The general expectation in the market is that these lower prices could persist for some time. Although some of the advantage of lower international oil prices has been offset to some extent by a weaker rand exchange rate, domestic petrol prices have declined by a cumulative R1,17 per litre since August, and should current trends continue, a further decline of around 70 cents per litre can be expected in December.

The marked decline in international oil prices has had a significant impact on the medium term outlook for headline inflation in the global economy and in South Africa. At this stage it is unclear whether this is a temporary shock, or if it will be sustained or decline further. As with an oil price increase, we would look through the impact effect and focus on the possible second round effects of this decline. The possibility that oil prices are sustained at current levels introduces a degree of downside risk to the inflation forecast.

The domestic growth outlook remains challenging, and the risks to the forecast are assessed to be moderately on the downside. The MPC does not see significant signs of excess demand pressures that are impacting on the inflation outlook and household consumption expenditure is expected to remain constrained.

At the same time, despite its recent relative stability, the exchange rate remains an upside risk to the inflation outlook, vulnerable to changing perceptions of the timing of global monetary policy adjustments, and the slow pace of contraction in the current account deficit. The extent to which policy normalisation is already priced into the exchange rate is also unclear.

A further upside risk to the inflation forecast comes from a possible increase in wage settlement rates in excess of inflation and productivity growth in the coming year.

In light of this assessment, the MPC sees the overall risk to the headline inflation forecast to be more or less balanced. However, given the elevated level of core inflation, and the fact that headline inflation is expected to increase later in the forecast period as the first round effect of the oil price decline dissipates, the Committee remains vigilant and will continue to monitor developments closely.

The Committee remains of the view that interest rates will have to normalise over time. However, given the lower trajectory of headline inflation and the continued weak state of the economy**,** the MPC has unanimously decided to keep the repurchase rate unchanged at 5,75 per cent per annum at this stage.

The timing of future interest rate increases will be dependent on a range of factors, including the evolution of inflation expectations, the speed of normalisation of monetary policy in the US and the state of the domestic economy.

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