South African Reserve Bank

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STATEMENT OF THE MONETARY POLICY COMMITTEE

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

Since the previous meeting of the Monetary Policy Committee the domestic inflation forecast has improved slightly, but the inflation trajectory remains uncomfortably close to the upper end of the target range. At the same time the domestic economic growth outlook has deteriorated further, with declining growth in both consumption expenditure and gross fixed capital formation, as confidence remains low. The combination of stubborn inflation and a sluggish growth outlook continues to pose a difficult dilemma for monetary policy.

The global environment has been characterised by increased financial market volatility, following heightened speculation relating to the timing and extent of US monetary policy normalisation. This impacted on emerging market currencies in general, and on the rand in particular. This was further illustrated after yesterday's FOMC meeting, which reaffirmed the gradual pace of US monetary policy normalisation, and its data dependent nature. However, despite increased political instability and significant risks in a number of regions, the international oil price has declined along with continued weakness in global food prices, contributing to a more benign global backdrop for the domestic inflation outlook.

The year-on-year inflation rate as measured by the consumer price index (CPI) for all urban areas surprised on the upside at 6,4 per cent in August, having measured 6,6 per cent and 6,3 per cent in June and July 2014 respectively. The higher turnout was mainly due to higher-than-expected food prices, which had been anticipated to continue their recent downward trend. Downward pressure was exerted by petrol prices which increased by 5,8 per cent, down from 8,3 per cent in July. The categories of food, housing utilities and transport together accounted for 3,8 percentage points of the inflation outcome in August, unchanged from the previous month. Core inflation, which excludes food, petrol and electricity, increased to 5,8 per cent, from 5,7 per cent in July, driven mainly by the impact of the weaker exchange rate on some goods categories.

Administered price inflation excluding petrol measured 6,5 per cent, up from the 6,4 per cent in July. The headline producer price inflation for final manufactured goods, which reached a recent high of 8,8 per cent in April, measured 8,1 per cent and 8,0 per cent in June and July respectively, driven in part by lower agricultural product inflation.

The Bank's forecast of headline inflation is slightly more favourable than that presented at the previous meeting, mainly a result of lower expected food and petrol price pressures. Whereas for some time inflation had been forecast to peak at an average of 6,6 per cent in the fourth quarter of this year, the peak now appears to have occurred in the second quarter, at an average of 6,5 per cent. Inflation is now expected to average 6,2 per cent in 2014, compared with 6,3 per cent previously, and 5,7 per cent in 2015, (5,9 per cent previously), and to return to within the target range in the first quarter of 2015 instead of the second quarter as previously forecast. The inflation forecast for 2016 increased to 5,8 per cent from 5,6 per cent, mainly as a result of the revised electricity price assumption following the review of Eskom tariffs by Nersa. The revised assumption makes provision for electricity price increases of 11,6 per cent from July 2015 and again from July 2016.

The forecast for core inflation is unchanged at an average 5,6 per cent and 5,7 per cent in 2014 and 2015 respectively, reaching a peak of 5,8 per cent in the first quarter of 2015, and moderating to 5,5 per cent in 2016. As before, the MPC sees the risks to the headline inflation forecast to be skewed to the upside, with possible renewed pressure coming from the exchange rate.

Inflation expectations, as reflected in the survey conducted by the Bureau for Economic Research at Stellenbosch University in the third quarter of 2014, have again remained more or less unchanged, and anchored at around the upper end of the target range. Inflation is expected to average 6,2 per cent in 2014 and 6,1 per cent and 6,0 per cent in 2015 and 2016 respectively. As usual, there is a fairly wide dispersion of expectations between the different categories of respondents. While business people expect inflation to average 6,4 per cent in 2015 and 2016, analysts' expectations average 5,7 per cent and 5,4 per cent. Expectations of trade unionists are for 6,2 per cent in both years, and all categories of respondents expect inflation in the current year to average 6,2 per cent. Household inflation expectations for 2014 remained unchanged at 6,3 per cent.

The global growth recovery remains asynchronous amid sustained improvements in the US and UK, and deteriorating prospects in the Eurozone and Japan. Although growth in the US is not expected to exceed the 2,2 per cent achieved in 2013, this is mainly a result of the contraction during the first quarter of this year. Real output growth of 4,2 per cent was recorded in the second quarter of 2014, and consensus forecasts are for growth rates of around 3 per cent in the next two quarters. Similar growth rates are expected in 2015. At the same time the unemployment rate has been declining at a faster pace than previously anticipated. While the growth outlook for the UK remains positive, possible downside risks could emerge should Scotland vote for independence from the United Kingdom.

Growth in the Eurozone has remained weak, with the German economy also under pressure following a contraction in the second quarter. Sanctions on Russia are expected to be an additional constraint affecting the Eurozone's growth outlook. Although the Japanese economy appears to be recovering from the VAT-induced slump in the second quarter, the recovery looks fragile.

While emerging Asia appears to be benefiting most from the US recovery, emerging markets generally are facing increasing headwinds. Signals coming out of China continue to be mixed, amid a sharp slowdown in industrial production in August. Latin American economies also face a challenging outlook, particularly in Argentina, Venezuela and Brazil, which is currently experiencing a technical recession. Growth in sub-Saharan Africa is expected to remain relatively strong, although commodity producers may be adversely affected by lower commodity prices and possible spillover effects from the Ebola outbreak.

There is a continued absence of significant upside global inflation risks, despite pressures experienced in some emerging markets. The various indicators of US inflation remain well contained below the 2 per cent level, while the fear of deflation in the Eurozone persists. Declining international oil and food prices, along with a number of other commodity prices, are expected to reinforce the current benign global inflation environment.

The divergent growth outlooks in the advanced economies are likely to be the main drivers of monetary policy developments. The UK is expected to tighten monetary policy early next year. The stronger performance of the US labour market has led to heightened speculation that normalisation may begin earlier than previously anticipated. These expectations resulted in an appreciation of the US dollar against most currencies, as well as rising long-term US Treasury yields ahead of yesterday's FOMC meeting. At yesterday's press conference the FOMC Chair reaffirmed the view that policy normalisation will occur gradually, but is contingent on no surprises to employment growth or inflation in either direction.

The data dependent nature of the forward guidance means that changes in the outlook for inflation, unemployment and growth are likely to lead to bouts of global financial market uncertainty in advance of FOMC meetings in the coming months.

At the same time, however, the ECB has loosened monetary policy and has indicated its willingness to embark on some form of quantitative easing should this be necessary. Monetary policy is also expected to remain accommodative for some time in Japan. Since the previous meeting of the MPC, policy rates have been reduced in the Eurozone, Israel, South Korea, Chile and Hungary, and increased in Russia and New Zealand.

Following a few weeks of relative stability, the rand exchange rate weakened in the past few days in response to US dollar strength, as well as the widening deficit on the current account of the balance of payments to 6,2 per cent of GDP. Since the previous meeting of the MPC, the rand initially traded in a range of R10,50 and R10,75 against the US dollar, but has weakened since early September reaching a low of R11,07. On a trade-weighted basis, however, the rand depreciated by 0,4 per cent, having appreciated against the euro and the British pound. The rand is expected to remain sensitive to changes in sentiment regarding possible changes in US policy which will affect the appetite for emerging market assets generally, as well as to possible impacts from geopolitical risks and domestic factors.

Since the previous MPC, non-residents have been net sellers of bonds to the value of R29,3 billion, but this has been offset in part by net purchases of equities to the value of R16,2 billion over the same period. Year to date there have been net outflows of bonds and equities to the value of R6,3 billion. These trends indicate that financing of the current account through portfolio inflows is likely to become increasingly challenging.

The current account deficit in the second quarter of 2014 was wider than generally expected by the markets, following the 4,5 per cent of GDP recorded in the first quarter. This widening was a result of increased dividend outflows, lower dividend inflows following a large once-off inflow during the first quarter, and weak export growth, impacted to some extent by the platinum strike. Export growth in the third quarter is expected to remain constrained by the slow return to full capacity production by the platinum mines and the strike in the steel and engineering sector in July, which had significant spillover effects on the manufacturing sector in general. The current account is anticipated to narrow gradually over time.

The domestic economic growth outlook remains weak following growth rates of -0,6 per cent and 0,6 per cent in the first and second quarters of the year respectively. These growth rates are well below potential output growth and indicative of a widening output gap. Partly as result of this outcome, as well as the expected impact of the metal workers strike in July, the Bank's forecast for GDP growth for 2014 has been revised down further to 1,5 per cent, from 1,7 per cent previously, with the risks still assessed to be on the downside. The forecasts for both 2015 and 2016 have been revised down by 0,1 percentage points, to 2,8 per cent and 3,1 per cent respectively. The Bank's leading indicator of economic activity continues to trend sideways, consistent with a subdued growth outlook. Business confidence, as reflected in the RMB/BER business confidence index, remains negative despite a five index point increase to 46 in the third quarter. Adding to prevailing concerns are indications from Eskom that electricity supply constraints may be more severe and endure for longer than previously expected.

The near-term outlook for mining remains subdued, with platinum production not expected to return to full capacity before the end of the year. In July, mining production recorded a broad-based year-on-year decline of 7,7 per cent, but a 0,9 per cent increase on a month-to-month basis. Manufacturing output declined significantly in July, recording year-on-year and month-to-month contractions of 7,9 per cent and 5,4 per cent respectively, largely due to the impact of the four-week strike in the steel and engineering sub-sector. Capacity utilisation in the sector declined from 82,1 per cent in the first quarter of 2014 to 80,6 per cent in the second quarter. More positively, the Kagiso PMI reflected some improvement in sentiment in August, with the index rising 3,1 index points to 49, marginally below the neutral level, while the construction sector has recorded growth rates of 5 per cent in the first two quarters of the year.

Growth prospects have been constrained by the weakening trend in gross fixed capital formation which grew at an annualised rate of 0,5 per cent in the second quarter. Real fixed capital expenditure by both the public corporations and the private sector contracted during the quarter. Of particular concern is the continued downward trend over the past three quarters in private sector investment, despite higher capital outlays in the manufacturing sector. This has been reflected in the continued slow pace of employment creation in the private sector and the rise in the unemployment rate to 25,5 per cent in the second quarter of 2014.

Consumption expenditure by households also continued its moderating trend which began in the first quarter of 2012, amid declining real disposable income growth. Annualised growth of 1,5 per cent was recorded in the second quarter of 2014. The slowdown was particularly marked in the durable and semi-durable goods categories, probably impacted by the prolonged strikes in the mining and manufacturing sectors. Retail trade sales contracted by 0,9 per cent in June on a month-to-month basis, but increased by 1,2 per cent in July, higher than generally expected. Wholesale trade sales contracted by 5,2 per cent month-to-month in July, and by 4,6 per cent year-on-year. Domestic vehicle sales have also slowed. Given the above, somewhat surprisingly the FNB/BER consumer confidence index increased from -6 to +4 in the second quarter.

Trends in credit extension to households are consistent with the weak growth in household consumption expenditure, showing a further divergence between credit extension to households and to the corporate sector. Growth in total loans and advances over the year measured 9,7 per cent in July, with lending to the corporate sector increasing by 17 per cent, and to households by 4,1 per cent. The latter reflects continued sluggish growth in mortgage credit extension and tighter credit criteria for unsecured lending in particular. Twelve-month growth in general loans to households, which is mainly unsecured lending, reached a low of 0,2 per cent in July, while growth over three months exhibited an annualised contraction of 2,5 per cent. This decline is across all income groups, but more pronounced at the lower levels. A positive development is that household debt to disposable income moderated from 74,4 per cent in the first quarter to 73,5 per cent in the second quarter.

Growth in corporate sector borrowing during the first half of the year was dominated by the agricultural sector, electricity supply (renewable energy projects) as well as wholesale and retail trade sectors. The cost of bank funding appears to have increased recently as a result of changed regulatory requirements relating to the implementation of Basel III, the impact of the bail-in of certain African Bank Limited creditors and the consequent rating action by Moody's Investor Service, all of which could result in tighter funding conditions.

No new wage and unit labour cost data have been released since the previous meeting of the MPC, although settlements in the steel and engineering sector and the clothing sector have been well above current and expected inflation rates. The MPC remains concerned about the apparent delinking of wage demands and some wage settlements from underlying inflation and productivity growth trends, as well as the possible impact of forthcoming wage negotiations, including in the public sector. These concerns relate to settlements at all levels, including executive pay. Excessive wage settlements could have adverse impacts on employment, inflation, the general competitiveness of the economy and the profitability and viability of small businesses in particular.

Notwithstanding the 9,5 per cent increase in July, food price inflation is expected to slow over the coming months. Pipeline pressures from agricultural prices continue to moderate following sharply lower maize prices since March, while manufactured food price inflation declined to 8,5 per cent in July compared with 9,5 per cent in April. International food prices, as reflected in the FAO international food price index, declined for the fifth consecutive month in August in response to positive maize and wheat supply conditions. These developments are expected to impact favourably on domestic consumer prices, although base effects are likely to interrupt the declining year-on-year trend in the final months of the year.

International oil prices declined in recent weeks, having traded in a range of between US$105-US$114 per barrel for the year to the end of July. Since August, the price has fallen below this range and is currently trading at around US$98 per barrel. This is despite rising tensions and instability in the Middle East and conflict in the Ukraine, events that in the past would likely have resulted in an oil price spike. As a result of this lower price, the domestic petrol price was reduced by 67 cents per litre in September, having been unchanged in August. At this stage there is an average over-recovery on the petrol price due to the lower international price, but the favourable impact is being partially offset by continued rand weakness.

Despite the slight near-term improvement in the inflation outlook and the relatively stable inflation expectations, the MPC is concerned that the forecast remains uncomfortably close the upper end of the target band. Given the upside risks to the forecast, the proximity to the upper end of the band makes the inflation outcomes highly vulnerable to changes in inflationary pressures.

A key upside risk is the exchange rate, which is vulnerable to the slow pace of adjustment to the current account deficit, as well as to the uncertainty surrounding the future path of monetary policy in the advanced economies. At this stage it is difficult to assess the extent to which normalisation of US monetary policy is already priced in to the rate.

The MPC remains concerned about the risks of a wage-price spiral, should settlements well in excess of inflation and productivity growth become the economy-wide norm. Such developments could also undermine South Africa's international competitiveness and delay the current account adjustment.

The deterioration in the longer term inflation trajectory relative to the previous forecast is a result of the revised tariff increases granted to Eskom by Nersa. The view of the Committee is that such relative price adjustments should not be reacted to automatically. However, while the focus of monetary policy should be on the second round effects of these increases, this is complicated given the multi-year nature of the adjustment.

While inflation is the primary focus of the Committee, the MPC is also mindful of the anaemic state of the domestic economy, rising unemployment and the downside risk to its growth forecast. Domestic expenditure has deteriorated further, particularly private sector fixed capital formation, and, together with continued moderation in household consumption expenditure, is indicative of the lack of demand pressures in the economy.

The MPC is still of the view that interest rates will have to normalise over time. However, given the slightly improved inflation outlook notwithstanding the upside risks, the stable inflation expectations and the downside risks to the weak growth outlook, the MPC has decided that the repurchase rate will remain unchanged at 5,75 per cent per annum.

Despite the 75 basis point increase so far this year, monetary policy remains accommodative, and will continue to be supportive of the domestic economy subject to achieving its primary inflation targeting objective. Future decisions will, as always, be highly data dependent.

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