South African Reserve Bank

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STATEMENT OF THE MONETARY POLICY COMMITTEE

Issued by Lesetja Kganyago, Governor of the South African Reserve Bank

Since the previous meeting of the Monetary Policy Committee (MPC), the inflation forecast has remained relatively unchanged but the risks to the forecast have increased. The key risks are a marked depreciation of the rand; worsening drought conditions and their likely impact on food prices; and the possibility of additional electricity tariff adjustments. At the same time the economy remains weak despite an improved performance in the manufacturing sector, but both the mining and agricultural sectors appear to have contracted further in the third quarter.

Although global financial markets have stabilised somewhat since the previous meeting, the outlook for emerging markets in particular remains challenging. The US Fed is likely to raise its policy rate in December, and further volatility in financial markets can be expected in the lead-up to this.

The year-on-year inflation rate as measured by the consumer price index (CPI) for all urban areas measured 4,7 per cent in October, following two consecutive months at 4,6 per cent. Food and non-alcoholic beverages inflation surprised again on the downside at 4,8 per cent, with a contribution of 0,7 percentage points to the overall CPI outcome. Services price inflation remained unchanged at 5,6 per cent, while goods price inflation increased to 3,7 per cent from 3,6 per cent previously. The Bank's measure of core inflation, which excludes food, fuel and electricity, measured 5,2 per cent, down from 5,3 per cent in the previous two months.

Producer price inflation for final manufactured goods increased from 3,4 per cent in August to 3,6 per cent in September. The main pressure came from the category of food, beverages and tobacco products which contributed 2,0 percentage points to the outcome. Food and agricultural crop price developments are expected to sustain the upward trend in PPI in the coming months.

The latest inflation forecast of the Bank shows a slight near-term improvement, while the medium-term forecast is marginally higher. Inflation is now expected to average 4,6 per cent in 2015, and 6,0 per cent and 5,8 per cent in the next two years. The anticipated breach of the upper end of the target range in the first quarter of 2016 is now expected to average 6,4 per cent, compared with 6,7 per cent previously. The trajectory for the rest of the year is also slightly lower than previously forecast, with the temporary breach in the fourth quarter of 6,1 per cent. The forecast for 2017 follows a slow downward trend, with inflation still expected to measure 5,7 per cent in the final quarter. The changes in the forecast are due to a lower starting point for the forecast, lower international oil price assumptions, and an adjustment to fees for higher education which are more or less offset by a more depreciated starting point for the real effective exchange rate.

The forecast for core inflation is marginally higher, with an expected average of 5,5 per cent in 2016, and 5,4 per cent in 2017, mainly due to the more depreciated exchange rate assumption.

The BER inflation expectations survey is only due for release in December. The median inflation forecast of analysts polled in the latest Reuters Econometer survey is similar to that of the Bank, and also declined marginally since the previous survey. The breakeven inflation rates, while having improved since the previous meeting, remain above the upper end of the target range.

Divergent global developments continue to create a challenging environment for monetary policy. Although the US recovery appears to be sustained with further improvements in the labour market, the strong dollar poses downside risks to both growth and inflation. The UK economy also remains on its recovery path. By contrast, the recovery in the euro area is much weaker, although the outlook is more favourable than it was earlier in the year. The Japanese economy has contracted for two consecutive quarters, with positive, but slow growth expected in the coming quarters.

The Chinese economy shows signs of stabilising, aided by policy stimulus, but the medium-term outlook remains a concern. There is still some uncertainty regarding the extent to which services output and consumption has compensated for the decline in industrial output and investment. A tail-risk of a hard landing remains, which would have a significant impact on countries with direct trade linkages, particularly those in Asia, as well as on commodity prices.

Russia and Brazil remain in recession, while the strong performance of the Indian economy has been sustained following a number of structural reforms. The outlook for sub-Saharan Africa, while still positive, has deteriorated in the wake of lower commodity prices, and further weakening could create greater headwinds for South African manufactured exports to this region.

Global inflation trends are also benign, with concerns about deflation abating in most advanced economies. Despite significant currency depreciations in commodity-producing economies in particular, inflation pressures have generally been surprisingly contained, with a few exceptions. Emerging markets have had differing experiences: a number of countries in Latin America, particularly commodity producers, have tightened policy in recent months in response to incipient inflationary pressures, while others with low inflation, particularly in Asia, have loosened policy further.

In the advanced economies, monetary policy divergence is expected to continue. Monetary policy is set to remain accommodative in the euro area and Japan, with possible further quantitative easing, against a backdrop of slow growth and benign inflation pressures. In the US, inflation and labour market dynamics, as well as Fed communication, suggest that in the absence of any major surprises or shocks, an increase in the policy rate can be expected in December. Market expectations are for monetary policy tightening in the UK to commence sometime in the second half of 2016, later than previously expected.

Although volatility in global asset markets has moderated amid improving risk sentiment, emerging market foreign exchange markets have been relatively volatile and vulnerable to capital outflows. In the past three months South Africa has also seen net portfolio outflows: since the end of August, according to the JSE data, nonresident sales of equities amounted to R25,9 billion, while net bond sales amounted to R5,9 billion.

The rand exchange rate has been particularly volatile, even compared to its peers, as domestic factors also impacted on the currency. Since the previous meeting of the MPC, the rand has appreciated by about 1,0 per cent against the euro but has depreciated by around 3,0 per cent against the dollar, and by 1,5 per cent on a trade-weighted basis. As before, the extent to which Fed tightening has been priced into the exchange rate remains uncertain. Nevertheless, a high degree of volatility and overshooting of the exchange rate may be expected in the lead-up to, and in the immediate aftermath of the start of the US interest rate cycle. Fed communication of future moves will be key. To date, the indications are that a moderate policy hiking cycle will be pursued.

The domestic economic growth prospects remain subdued amid weak business confidence, but a further contraction in the third quarter is not expected. The Bank's forecast for GDP growth has been revised down marginally for 2015 and 2016 to 1,4 per cent and 1,5 per cent, but remains unchanged at 2,1 per cent for 2017. The estimate of short-term potential output remains unchanged at 1,8 per cent for this year, rising to 2,1 per cent in 2017. The Bank's composite leading business cycle indicator declined further in August, consistent with the fragile outlook.

The manufacturing sector recovered somewhat in the third quarter, mainly due to a surprisingly strong performance in September, and is expected to have contributed positively to GDP growth. However, the Barclays PMI declined further in October, and has been below the neutral level of 50 for three consecutive months, suggesting a constrained outlook for the sector. The mining sector is expected to subtract from

GDP growth following a further contraction in the third quarter, while the continuing drought points to a third successive quarterly contraction for the agricultural sector. The outlook for the construction sector is constrained following significant declines in new building plans passed, and reflected in a 9 point drop in the FNB/BER Building Confidence Index.

Against this backdrop, formal sector employment trends remain disappointing. According to the Quarterly Employment Statistics survey of Statistics South Africa, employment in the formal non-agricultural sector declined in the second quarter of 2015, as the private sector continued to shed jobs. Although the Quarterly Labour Force Survey indicates an increase in the number of persons employed in the third quarter, the number of unemployed persons rose sharply in the quarter as the number of new entrants increased. Consequently, the official unemployment rate increased to 25,5 per cent in the third quarter.

There are minimal demand side pressures in the economy, with consumption expenditure by households continuing to be inhibited inter alia by low consumer confidence, declining disposable income growth and slow employment growth. The latest retail trade sales data suggest that household expenditure may have lost further momentum in the third quarter. Durable goods sales remain under pressure, as indicated in the intensification of the downward trend in motor vehicle sales in recent months.

Consumption expenditure is also constrained by the continued slow growth in credit extension to households by banks. Unsecured lending remains subdued, and is likely to be impacted further by the recently announced caps on interest rates by the DTI, while the decline in growth in instalment sale credit and leasing finance is indicative of the softer motor vehicle sales. Credit extension to corporates remains robust, particularly commercial mortgage finance, which reflects in part a switch away from funding in the bond market by property funds.

The recent Medium-Term Budget Policy Statement signalled a continued commitment to fiscal consolidation by government, although at a slower pace. Most of the expanded deficit is attributable to lower expected tax revenues in response to the weaker growth outlook.

Trends in wage growth remain a concern, and contribute to the persistence of inflation at elevated levels. Year-on-year growth in salaries and wages per worker accelerated to 8,7 per cent in second quarter of 2015, and after adjusting for labour productivity increases, total unit labour costs increased from 4,3 per cent to 5,1 per cent. By contrast, the average wage settlement rate in collective bargaining agreements recorded by Andrew Levy Employment Publications recorded a moderation to 7,7 per cent in the first three quarters of the year, compared with 8,1 per cent in 2014.

Apart from the exchange rate, the main upside risks to inflation come from possible electricity tariff and food price increases. Eskom’s Regulatory Clearing Account (RCA) application to Nersa to claw back excess expenditure of R22,8 billion is likely to lead to a further tariff increase, although the quantum and timing is uncertain. This is in addition to the 12,2 per cent tariff increase already built into the inflation forecast for next year. No provision is made for the RCA application in the forecast at this stage, but it is regarded as an upside risk.

A higher food price trajectory has been incorporated in the forecast for some time, but food price inflation has surprised on the downside in recent months, despite sharp increases in maize and cereals prices earlier in the year. However, the increased intensity of the drought which has led to downward revisions of the domestic maize crop estimate, as well as incipient pressures evident in both the PPI and CPI, suggest that an acceleration in food price inflation is likely, adding to the upside risk to the inflation outlook.

By contrast, international oil price developments are expected to remain benign with current spot prices below US$45 per barrel, somewhat lower than those assumed over the forecast period. Although petrol prices have contributed to a succession of downside inflation surprises in recent months, the beneficial impact of lower international oil prices on domestic petrol prices has been offset to some extent by the depreciation of the rand. The latest data suggest that, should current trends continue, a small drop in the petrol price can be expected next month despite the further depreciation of the rand.

Although the inflation forecast is relatively unchanged since the previous meeting, the upside risks to the inflation outlook are more pronounced. As noted, these risks relate to the persistent exchange rate depreciation, electricity tariffs and food prices, and are assessed to outweigh possible downside risks from lower international oil prices and subdued exchange rate pass-through. While these factors cannot be dealt with directly through monetary policy, the concern of the Committee is that failure to act could cause inflation expectations to become unanchored and generate second-round effects and more generalised inflation. Although core inflation has remained steady and inflation expectations to date have been relatively anchored, they remain at uncomfortably elevated levels.

The general approach of the MPC is to attempt to see through exogenous shocks and react to second-round effects. However, shocks of a persistent nature, for example extended periods of currency depreciation or drought, or multi-year increases in electricity prices make it more difficult to disentangle these first and second round effects.

In the absence of demand pressures, the MPC had to decide whether to act now or later. On the one hand, given the relative stability in the underlying of core inflation, delaying the adjustment could give the MPC room to re-assess these unfolding developments at the next meeting, and avoid possible additional headwinds to the weak growth outlook. On the other hand, delaying the adjustment further could lead to second-round effects and require an even stronger monetary policy response in the future, with more severe consequences for short-term growth.

Complicating the decision was the deteriorating economic growth outlook. Although the change to the growth forecast was marginal, the risks to the outlook, which were more or less balanced at the previous meeting, are now assessed to be on the downside.

Against this difficult backdrop, the MPC decided to increase the repurchase rate by 25 basis points to 6,25 per cent per annum effective from 20 November 2015. Four members preferred an increase, while two members favoured an unchanged stance.

Despite the increase, the MPC still views the monetary policy stance to be accommodative. The continuing challenge is for monetary policy to achieve a fine balance between achieving our core mandate of price stability and not undermining short-term growth unduly. Monetary policy actions will continue to focus on anchoring inflation within the target range while remaining sensitive, to the extent possible, to the fragile state of the economy. As before, any future moves will therefore be highly data dependent.

Lesetja Kganyago

GOVERNOR

Contact person:
Candice Jeffreys
+27 12 313 4209
Candice.Jeffreys@resbank.co.za