South African Reserve Bank

PRESS STATEMENT

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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 (MPC), domestic inflation has breached the upper end of the target range. This development was in line with our forecast and we continue to expect inflation to moderate somewhat in the final quarter of this year. While the outlook for the domestic economic growth environment remains unchanged, it has been overshadowed by protracted work stoppages. Where wage agreements have been reached, these have generally been above the headline inflation rate, contributing to the upside risk to the inflation outlook.

During this period, global financial markets have been dominated by continued speculation about the speed and timing of tapering of quantitative easing by the

US Fed. The uncertainty related to this event resulted in a high degree of volatility and weakening in a number of emerging market economies foreign exchange and bond markets since May. The decision by the Fed to delay tapering surprised the markets, and emerging market currencies in particular responded strongly with many seeing significant overnight currency appreciation. The Fed emphasised the data dependent nature of its decision, indicating that this respite could prove to be temporary, as speculation regarding the timing of future tapering is likely to continue whenever positive data emerges from the US.

The year-on-year inflation rate as measured by the consumer price index (CPI) for all urban areas increased to 6,3 per cent in July and 6,4 per cent in August. Food and non-alcoholic beverages inflation measured 7,1 per cent in August, up from 6,8 per cent in July, while petrol prices increased at a year-on-year rate of 23 per cent. Core inflation, which excludes food, petrol and electricity, measured 5,1 per cent, down from 5,2 per cent in July, while administered prices excluding petrol moderated to 7,0 per cent. The headline producer price inflation for final manufactured goods accelerated to 6,6 per cent in July, up from 5,9 per cent in June.

The inflation forecast of the Bank has deteriorated further since the previous meeting of the MPC. The forecast for 2013 is unchanged at an average of 5,9 per cent, but inflation is now expected to average 5,8 per cent in 2014 compared with 5,5 per cent in the previous forecast. The forecast for 2015 has been raised from

5,2 per cent to 5,4 per cent, and inflation is expected to average 5,3 per cent in the final two quarters of that year. The current breach of the inflation target is still expected to be temporary, and the peak was possibly reached in August. The deterioration in the forecast is mainly due to changes in assumptions related to the exchange rate of the rand and petrol prices, but given the overnight developments these assumptions will be revisited on an ongoing basis.

The forecast for core inflation for 2013 is 0,1 percentage point lower, at an average of 5,2 per cent. This measure is then expected to average 5,4 per cent and 5,3 per cent in the coming two years, compared with the previous forecasts of 5,2 per cent and 5,0 per cent respectively, and to measure 5,1 per cent in the final quarter of 2015. This upward drift of underlying inflation is due to the lagged effects of the depreciation of the rand exchange rate and the impact of higher unit labour costs.

Inflation expectations, as measured in the survey conducted in the third quarter of 2013 by the Bureau for Economic Research, have remained stable around the upper end of the target range. It is of concern to the MPC that inflation is expected to average 6,0 per cent in 2013 and 6,2 per cent and 6,1 per cent in the subsequent two years respectively. Business respondents expect inflation to average 6,4 per cent in both 2014 and 2015, slightly lower than in the previous forecast, while expectations of trade unionists are unchanged from the previous survey, at 6,2 per cent and 6,3 per cent for these respective years. The expectations of economic analysts have deteriorated slightly since the previous survey but still expect inflation to average below 6,0 per cent over the period, and to average 5,8 per cent and 5,5 per cent in 2014 and 2015 respectively.

Global economic prospects have improved in a number of the advanced economies, but downside risks remain. Growth in the US appears to be gradually improving, despite fiscal headwinds, and most forecasts are for growth in excess of 2,5 per cent in 2014. There are, however, a number of downside risks to the outlook which were also highlighted by the Fed. Financial conditions have tightened since the initial tapering announcement, and there are fears that the significantly higher mortgage rates and the observed downturn in mortgage applications could derail the nascent recovery in the housing market, posing a risk to household consumption expenditure. Fiscal policy is also seen as a source of downside risk, with the debt ceiling issue expected to resurface in mid-October. Failure to find resolution could result in further unplanned fiscal expenditure cuts.

The Eurozone emerged from its protracted recession in the second quarter of 2013 led by Germany, but economic growth is expected to remain weak and below trend for some time. This negative outlook is compounded by fragile political environments in a number of countries, including uncertainty regarding the ability of some of the peripheral countries to meet the conditions of their bail-out clauses amid stringent fiscal consolidation measures and deteriorating debt dynamics, and slow progress towards a banking union. The Japanese economy appears to be responding to the stimulus packages and the weaker yen, but it is still too early to assess the sustainability of the recovery.

Fears of a marked slowdown in China have abated somewhat following strong growth in industrial production in August, amidst easing liquidity and bank lending conditions. While there are some concerns that the recent improvement is based on an unsustainable credit boom, growth in excess of 7 per cent in 2014 is generally expected.

The expectation of an end to US quantitative easing prompted a sell-off of emerging market assets, which has the risk of further undermining the weaker growth outlook that has been apparent for some time. While financial markets in these countries have reacted positively to the Fed's decision not to begin tapering at this stage, the underlying weaknesses are expected to persist.

Monetary policy in the advanced economies remains highly accommodative, and forward guidance suggests that low policy rates will be maintained for some time. Inflation in the advanced economies remains very low but there is speculation that a faster-than-expected decline in the US unemployment rate could prompt an earlier start to normalisation of monetary policy in the US. Some emerging markets, notably Brazil, Indonesia, Turkey and India have either tightened monetary policy in response to currency depreciation, implemented a range of direct controls on capital flows or engaged in direct intervention in the foreign exchange markets.

The exchange rate of the rand has been highly volatile since the previous meeting of the MPC, against the backdrop of a widening current account deficit, domestic labour disputes, and the reversal of capital flows to emerging market economies. The rand’s strong co-movement with other emerging market currencies suggests that external factors predominated over this period. Since the previous MPC meeting, the rand has fluctuated in a range between around R9,55 and R10,50 against the US dollar and appreciated by 2,3 per cent against the dollar, but is more or less unchanged on a trade weighted basis.

The uncertainties related to possible changes in US monetary policy have been reflected in the volatile non-resident activity in the domestic bond and equity markets. Following net sales of domestic bonds to the value of R17,9 bn between May and August in reaction to the Fed tapering announcement, non-residents have been net purchasers of bonds in September to the value of R9,3 bn, bringing the cumulative total since the beginning of the year to R14,9 bn. Non-resident appetite for domestic equities has remained strong following net sales in 2011 and 2012, with year-to-date net purchases of R28,3 bn.

The risks to the inflation outlook from the exchange rate remain elevated and dependent on its future trend. A sustained depreciation trend could pose a significant risk to the inflation outcome. While there are some signs of generalised price pressures evident in the producer price index, to date the pass-through to consumer price inflation has been relatively muted, given the weak pricing power in the current low growth environment.

The rand is expected to remain sensitive to global sentiment as well as to the current account deficit, which widened to 6,5 per cent of GDP in the second quarter of 2013. The deficit is expected to narrow in the coming months in response to the depreciated currency. However, this response is expected to be slow, given the import-intensive nature of capital expenditure by the state-owned enterprises in particular. Furthermore, export revenues are hampered by weak external demand, strike activity in the mining and motor vehicles sectors in particular, and declining terms of trade. The stepping up of exports is critical to address the current account deficit. While the rand has appreciated significantly in the last few days, the experience of the past few months is indicative of its vulnerability to future changes in US monetary policy.

The domestic growth outlook is unchanged since the previous MPC meeting. The real GDP growth rate of 3,0 per cent recorded in the second quarter of 2013 was driven mainly by a recovery in the manufacturing sector, following the marked contraction in the first quarter. Despite the rebound, growth was below the estimated potential of around 3,5 per cent and the negative output gap widened further. The Bank's forecast of GDP growth is unchanged: we still expect growth to average 2,0 per cent in 2013, and 3,3 per cent and 3,6 per cent in the next two years respectively. The composite leading business cycle indicator of the Bank declined slightly in June, continuing its broadly sideways movement, confirming the subdued growth outlook. Business sentiment remains weak: the RMB/BER Business Confidence Index declined from 48 index points in the second quarter to 42 index points in the third quarter.

There are, however, tentative signs of improvement in the manufacturing sector. The Kagiso PMI increased to its highest level in 6 years, and in July the physical volume of manufacturing production increased by 3,5 per cent on a month-to-month basis, and 5,4 per cent year-on-year. Capacity utilisation also increased marginally in the second quarter of 2013 to 81,3 per cent. Despite these positive trends, manufacturing output is expected to be adversely affected by protracted strikes, particularly in the motor vehicle sector. Mining output, which contracted in the second quarter, is expected to contribute positively to growth in the third quarter, following strong increases in production in July and a relatively quick resolution of the strikes in the gold mining sector.

Growth in real gross fixed capital formation remains relatively weak, at an annualised rate of 2,7 per cent in the second quarter of 2013. A positive feature is the acceleration in the growth of private sector fixed investment expenditure to 4,4 per cent, which more than offset the decline in outlays by the public corporations, mainly due to unplanned construction delays. Gross fixed capital formation as a percentage of GDP increased marginally to 19,5 per cent in the second quarter, still well below the levels of around 24 per cent reached in 2008 and the National Development Plan target of 30 per cent by 2030.

Employment trends remain extremely subdued, consistent with the slow pace of economic growth. According to the Quarterly Employment Statistics (QES) of Stats SA, formal non-agricultural employment increased by a mere 7,000 employees or 0,1 per cent between the quarters ended June 2012 and June 2013. Of great concern is the loss of jobs in the tradeable sectors of the economy. Over this period there was a loss of 23,000 employees in the mining sector and a total of 7,000 in the manufacturing and construction sectors, while there was an increase of 26,000 employees in the community, social and personal services industry.

Growth in final consumption expenditure by households has been on a declining trend since the first quarter of 2012, but may have bottomed out, having increased from 2,3 per cent in the first quarter to 2,5 per cent in the second quarter. There was a notable increase in the consumption of durable goods, which could include pre-emptive buying ahead of possible exchange rate-induced price increases, as reflected in the sharp decline in new vehicle sales in August. The moderate trend in consumer demand is also reflected in the 2,8 per cent year-to-year increase in retail trade sales in July, and the month-on-month decline of 0,5 per cent.

The FNB/BER Consumer confidence index increased significantly in the third quarter and expenditure is expected to be positively affected by high wage settlements and positive wealth effects. Nevertheless consumption expenditure growth is expected to be constrained by low employment creation, high household debt levels, declining rates of credit extension to households, and high petrol and electricity price increases, all of which are likely to curtail discretionary spending.

The trend of wage settlements remains an upside risk to inflation and job creation. The current wage bargaining round has seen a wide range of settlements, generally above the current inflation rate. According to Andrew Levy Employment Publications, the overall average wage settlement rate in collective bargaining agreements was 7,9 per cent in the first half of 2013 and this is likely to have increased in the third quarter. According to data derived from the QES, average salary and wages per worker over four quarters increased by 8,7 per cent in the quarter ending June 2013, but when accounting for productivity increases, the unit labour cost increase amounted to 6,8 per cent. The ultimate impact on inflation will depend in part on the increase in the total wage bill, as the impact of higher wages may be offset by job losses or slower employment creation. We are concerned that the increase in productivity, although relatively low, reflects job losses and a switch to more capital intensive production.

The moderate pace of bank credit extension to the private sector has been maintained with twelve-month growth of 8,7 per cent in total loans and advances recorded in July. Installment sale credit and leasing finance remained robust, while growth in general loans to households, which is mainly unsecured lending, declined to 20,2 per cent in July, the lowest rate of growth since August 2010. The shorter term trends for unsecured lending are more marked, with growth in the three months to July measuring 11,0 per cent and negative growth in loans of less than R30,000. Growth in mortgage credit extension has remained subdued. Twelve-month growth in credit extension to the corporate sector declined from 10,5 per cent in June to 8,7 per cent in July, with some indications that this reflects a lack of demand by corporates. They remain relatively cash flush and have also placed increasing reliance on corporate bond issues

Food prices are a risk to the inflation outlook, although the continued downward trend of international food prices has helped to offset the impact of the weaker rand on maize and wheat prices. Consumer food inflation measured 7,4 per cent in August, while at the producer price level, manufactured food price inflation measured 7,5 per cent in July. Price increases of agricultural products, by contrast, were muted at 0,5 per cent in July, with year-on-year declines in the prices of cereals and meat, but strong increases, of 21,4 per cent, in fruit and vegetable prices.

The immediate risks to inflation from international crude oil prices appear to have abated for now following a decline in the political risk premium, but prices remain highly sensitive to developments in the Middle East in particular. Having increased to a level of around US$118 per barrel in response to events in Egypt and Syria, the price has since moderated to around US$110 as the risk of US military action in Syria has subsided. Petrol prices increased at a year-on-year rate of 23,0 per cent in August, but favourable base effects and the small decline in the price in September are likely to result in a far lower rate of petrol price inflation in that month. The combination of a lower oil price and a stronger exchange rate observed in recent days is likely to result in a further moderate price decline in October, reversing the expectation earlier in the month of a further significant increase.

The Monetary Policy Committee assesses the risks to the inflation outlook to be on the upside, mainly due to exchange rate and wage pressures. The decision of the Fed to delay tapering has provided a temporary reprieve to the exchange rate. However, the continued uncertainty relating to the timing of the inevitable slowdown in bond purchases and its data dependent nature, imply that emerging market currencies, including the rand, are likely to experience a protracted period of volatility. In the short run these developments may have moderated the risk to inflation from the exchange rate, but medium to longer term risks remain, which will be assessed on an ongoing basis

The MPC remains mindful of the conflicting policy choices that it faces. The breach of the upper end of the inflation target is expected to be temporary, but the longer term trajectory is uncomfortably close to the upper end of the target range. At the same time, there are still no significant demand side pressures in the economy and consumption expenditure growth is subdued. The output gap continues to widen, and the employment data show that there is very little net employment creation in the economy, while employment in the manufacturing and mining sectors has been declining. Consumers remain under pressure with persistently high debt to disposable income ratios, further exacerbated by the rising cost of petrol and other administered prices.

Currently, a sustained breach of the inflation target is not our central forecast, but the upside risks to the inflation outlook require careful monitoring. Should the risks to the medium-term inflation outlook deteriorate significantly the MPC will not hesitate to take appropriate action in order to maintain the integrity of the inflation targeting framework and to anchor inflation expectations at a lower level. At this stage, however, given the global uncertainties and downside growth risks, the MPC has decided to keep the repurchase rate unchanged at 5,0 per cent per annum.

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