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, the inflation outlook has been dominated by the further decline in international oil prices, from around US$75 per barrel in late November to current levels of around US$46 per barrel. Domestic petrol prices declined by almost R2 per litre over the period (and over R3 per litre since August), and a further sizeable decrease is expected in February. This decline in domestic prices occurred despite some offsetting effects from a further depreciation of the rand against the US dollar.

The near-term inflation outlook has therefore changed significantly, but the favourable impact of these developments on both inflation and growth in the longer term will depend on the persistence of the oil price decline. Even a moderate increase in oil prices going forward will reverse the favourable inflation trajectory, and the inflation and growth benefits, while welcome, are expected to be temporary. At the same time, the impact of load shedding and a deterioration of the global growth outlook are likely to offset some of the positive impacts of the lower petrol price on domestic growth.

The year-on-year inflation rate as measured by the consumer price index (CPI) for all urban areas maintained its recent downward trend and measured 5,8 per cent and 5,3 per cent in November and December respectively, down from its recent peak of 6,6 per cent in May and June 2014. This trend reflected continued moderation in food and petrol prices. Food price inflation measured 7,4 per cent in December, down from 7,7 per cent in November, while petrol prices declined by 5,5 per cent. By contrast, core inflation, which excludes food, petrol and electricity, remained near the upper end of the inflation target range, but moderated to 5,7 per cent in December from 5,8 per cent previously.

Headline producer price inflation for final manufactured goods was also favourably impacted by declining oil and agricultural crop prices, and measured 6,5 per cent and 5,8 per cent in November and December respectively compared with 6,9 per cent and 6,7 per cent in the preceding two months.

The decline in international oil prices has prompted a downward revision of the oil price assumption in the Bank’s forecasting model, with a significant impact on the near-term inflation forecast. The longer term impact will be dependent on the persistence of these lower prices, which have been a reaction to global supply and demand factors as well as a change in the behavior of key oil producers. With supply still plentiful and global growth prospects remaining relatively subdued, lower oil prices are expected to persist for some time. However, our forecast makes provision for a moderate increase over the next two years.

Having averaged 6,1 per cent in 2014, inflation is now expected to average 3,8 per cent in 2015, compared with the previous forecast of 5,3 per cent, and to reach a low of 3,5 per cent in the second quarter of this year compared with 5,1 per cent previously. The steep decline in 2015, however, produces a strong base effect in 2016, and, when combined with a slightly higher oil price assumption and a depreciated nominal effective exchange rate of the rand, results in an average inflation forecast of 5,4 per cent for the year (5,5 per cent previously), and 5,3 per cent in the final quarter.

The impact on core inflation is far less pronounced. Core inflation is expected to average 5,5 per cent and 5,1 per cent in 2015 and 2016 respectively, from 5,7 per cent and 5,3 per cent previously. The peak is expected at 5,8 per cent in the first quarter of 2015.

Inflation expectations as reflected in the survey conducted by the Bureau for Economic Research at Stellenbosch University moderated from 6,1 per cent in the third quarter of 2014 to 5,8 per cent in the final quarter. Analysts and trade unionists revised their forecasts for 2015 downwards by 0,3 percentage points to 5,4 per cent and 5,9 per cent respectively, while the forecasts of business people were 0,2 percentage points lower at 6,2 per cent. Forecasts for 2016 are unchanged for the latter category, but both analysts and trade unionists expect a 0,1 percentage point increase in 2016 relative to 2015. While this downward revision is a welcome development, it is too early to assess whether or not this represents the start of a sustained downward trend. At these levels, expectations still remain uncomfortably close to the upper end of the target range.

According to the Reuters poll of economic analysts conducted in January, the median inflation expectation is 5,0 per cent in 2015, rising to 5,5 per cent in 2016. The low point of the inflation trend is expected in the second quarter, with the median at 4,6 per cent, but with expectations ranging from 3,4 per cent to 5,9 per cent. Inflation expectations as reflected in inflation linked bonds have been volatile, having increased in response to the weaker exchange rate in November, but since mid-December have exhibited a steep decline. Both the 5-year and 10-year break-even rates have declined to levels below 5,5 per cent.

The global economic growth outlook remains mixed, despite a strong performance by the US economy, lower international oil prices and the quantitative easing announced by the ECB. The US economy grew at an annualised rate of 5,0 per cent in the third quarter of 2014, the fastest quarterly growth since 2003. The unemployment rate continued to decline as job creation accelerated, and lower oil prices have provided a boost to consumption expenditure. Growth in the UK also remains robust, despite slower fourth quarter growth. By contrast, growth prospects in a number of other advanced economies have deteriorated, with Japan in a technical recession and the Eurozone remaining weak amid fears of deflation.

Lower oil and other commodity prices have had divergent implications for growth forecasts of different emerging market economies. Deteriorating prospects in some emerging markets contributed to the lowering of the IMF's 2015 global growth forecast by 0,3 percentage points to 3,5 per cent, with notable downward revisions to Brazil, China, Mexico, Nigeria, and Russia. Growth in China is now expected to moderate to 6,8 per cent from 7,4 per cent in 2014 as the economy continues to rebalance towards domestic consumption and reduce vulnerabilities in its banking system. Although Africa remains one of the high-growth regions, weaker commodity prices pose a risk to the outlook.

The impact of lower oil prices on global inflation is expected to influence monetary policy responses. Although the US Fed has indicated that policy rates are still likely to rise from around the middle of the year, recent market expectations are pricing in a later start, as inflation remains low. Furthermore, Fed guidance suggests that normalisation, when it does begin, is likely to be at a gradual pace. Whereas the UK had been expected to be the first of the advanced economies to begin raising policy rates in the first half of this year, the lower expected inflation trajectory has changed expectations to later in 2015 or early 2016.

While the UK and US contemplate monetary tightening, the ECB has embarked on open-ended quantitative easing, amid risks of deflation, and the slowdown in Japan is also expected to result in a resumption of asset purchases. Since the previous meeting of the MPC, monetary policy rates have been lowered in Canada, China, Denmark, Egypt, India, Norway, Switzerland and Turkey, while policy has been tightened in Brazil, Nigeria, and Russia.

Global foreign exchange market volatility increased in recent weeks in anticipation of quantitative easing by the ECB; possible risks to the euro from the Greek elections;

the ending of the Swiss franc floor against the euro; and changing expectations regarding the timing and pace of US policy normalisation. Since the previous MPC meeting, the euro depreciated by about 10 per cent against the US dollar. Over the same period, the rand depreciated by 5 per cent against the US dollar and by 1,5 per cent against the pound sterling, but appreciated by about 6 per cent against the euro. Given the relatively high weight of the euro in the trade-weighted index, the nominal effective exchange rate of the rand depreciated by 0,6 per cent.

Market perceptions of a possible delay in US normalisation, coupled with the ECB action, has changed global market risk sentiment and improved the near-term prospects for capital flows to emerging markets. This follows a generalised sell-off in December. These flows are likely to be highly volatile and expected to be more discriminating than in the past. The spill-over effects of the ECB quantitative easing on the rand are therefore not expected to be as pronounced as was the case with the US quantitative easing.

Capital flows to South Africa have been in line with these global developments. During December, non-resident net sales of bonds and equities amounted to R17,9 billion and R8,2 billion respectively. This trend reversed in late December, as portfolio flows to emerging markets resumed, and in the first three weeks of January, non-residents were net purchasers of bonds to the value of R5,8 billion, while net equity sales amounted to R1,5 billion.

The rand has also been affected by domestic factors, including the disappointing domestic growth and current account deficit outcomes, as well as a resumption of load shedding by Eskom. The rand is expected to remain sensitive to developments on the current account of the balance of payments, which measured 6,0 per cent of GDP in the third quarter of 2014. Non-oil commodity prices have been on a declining trend since around 2011, so the recent decline in the oil price represents a positive terms of trade shock that could have a favourable impact on the current account. However, this effect is expected to be limited, in part due to the possible constraining effects of load-shedding on exports.

The domestic economic growth outlook remains subdued. Despite an expected growth acceleration in the fourth quarter of 2014 following an annualised growth rate of 1,4 per cent in the previous quarter, growth for 2014 is expected to average 1,4 per cent, with at least one percentage point lost to work stoppages. The Bank's forecast for growth in 2015 has been revised down from 2,5 per cent to 2,2 per cent, and that for 2016 from 2,9 per cent to 2,4 per cent. This forecast attempts to take account of electricity supply disruptions which more than offset the positive growth impact of lower oil prices. The Bank's composite business cycle indicator has followed a moderate downward trend in the past months, confirming the subdued outlook. More positively, the RMB/BER business confidence index returned to net positive levels for the first time since the first quarter of 2013, when it increased by 5 points to 51 index points in the fourth quarter of 2014.

The mining sector, which expanded output by 6,2 per cent on a three-month-to-three-month basis in November, is expected to contribute positively to fourth quarter growth, despite the 1,2 per cent month-to-month contraction in that month. Nevertheless, platinum output still remains below pre-strike levels, and the sector is likely to face headwinds in 2015 from lower commodity prices and electricity supply uncertainty. The outlook for the manufacturing sector, which contracted for three consecutive quarters, is looking more positive following the resolution of the strikes in the sector, with a three-month-to-three-month increase in November of 4,1 per cent. However, output declined by 2,1 per cent on an month-to-month basis due to electricity supply disruptions. The Kagiso PMI declined to 50,2 index points in December from 53,3 points in November, indicating an expectation of positive, but subdued growth in the sector.

Although gross fixed capital formation was the largest contributor to GDP growth in the third quarter of 2014, the trend remains weak. Growth in gross fixed capital formation measured 2,1 per cent in the third quarter of 2014 following two consecutive quarters of contraction. While the private sector investment reversed its negative trend in the previous two quarters, at 0,7 per cent it remains extremely low.

The weak growth and investment trends are reflected in the slow rate of formal sector employment creation. According to the Quarterly Employment Survey of Statistics South Africa, employment levels decreased by 5,9 per cent on a seasonally adjusted basis in the third quarter of 2014, mainly due to the termination of temporary employment contracts related to the general elections in the second quarter. This contributed to the annualised 20,8 per cent decline in public sector employment, while private sector employment over the quarter increased by 0,1 per cent or 2,000 jobs. Compared with a year ago, employment increased by 1,0 per cent, predominantly in the public sector.

Growth in real final consumption expenditure by households remains weak, despite a slight acceleration in the third quarter of 2014 to 1,3 per cent from 1,1 per cent in the previous quarter. However, expenditure on durable goods increased at an annualised rate of 6,2 per cent, and reflected in stronger new vehicle sales. Retail trade sales improved in November with a month-to-month increase of 1,5 per cent, and year-on-year by 2,6 per cent. Consumption expenditure is expected to get some boost from lower petrol prices. Consumer confidence, while still relatively low, also showed a slight improvement in the fourth quarter of 2014, having increased to a level of zero from the previous level of -1.

Trends in bank credit extension to the private sector continue to reflect tight conditions for households while credit to the corporate sector remains buoyant. Growth over twelve months in total loans and advances to the private sector measured 8,7 per cent in November. However, growth in loans to households, which has been steadily declining over the year, reached a low of 3,6 per cent in November, while that to the corporate sector recorded 15,2 per cent. Growth in general loans to the private sector, mainly unsecured lending, remains weak, despite an increase to 2,9 per cent in November; growth in instalment sale credit and leasing finance moderated further to 6,1 per cent; while mortgage advances continued to grow below 3 per cent in line with the subdued housing market. These trends are assessed to be a reflection of both continued tight credit conditions and weak demand, as household indebtedness remains high.

Wage settlements indicate a continuation of above-inflation wage and salary increases. According to Stats SA data, nominal remuneration per worker in the formal non-agricultural sector increased at a year-on-year rate of 6,9 per cent in the third quarter of 2014. With labour productivity growth of 0,3 per cent, growth in nominal unit labour costs amounted to 6,7 per cent in the quarter. According to Andrew Levy Employment Publications the average settlement rate in collective bargaining agreements amounted to 8,1 per cent in 2014, compared with 7,9 per cent in 2013. The outcome of the public sector wage settlement, due to be implemented in April, is expected to have an important bearing on the general trend of wage settlements in the economy in 2015.

Food prices remain a major source of inflation pressure with increases still in excess of the headline inflation rates. However, the moderation observed in recent months is expected to continue, despite the reversal of the downward trend in manufactured food prices at the producer level since October. Agricultural food price inflation remains low, having measured 1,4 per cent in December, with a bumper maize crop expected this year. Global food prices have continued to decline, with the Food and Agricultural Organisation food price index declining by 3,7 per cent in 2014.

The inflation landscape has changed significantly in recent weeks, but the outlook for international oil prices is highly uncertain. Unless a persistent oil price decline is assumed, the impact on the inflation trajectory will dissipate over time. The key issue for the MPC is the extent to which second round effects become evident and lead to a more generalised inflation moderation over the forecast period, and to a further and sustained decline in inflation expectations. The forecast of core inflation at this stage indicates a relatively muted decline in underlying inflation.

The rand exchange rate against the US dollar remains an upside risk to the inflation outlook and is vulnerable to the timing and pace of US policy normalisation, despite the partial offset from a weaker euro. Further depreciation of the rand against the US dollar could also erode the positive benefits of lower oil prices on inflation. The slow pace of contraction of the current account will continue to keep the rand sensitive to both domestic and external factors.

Along with the exchange rate, wage and salary increases in excess of inflation and productivity growth remain an upside risk to the inflation outlook. Unless nominal wage increases moderate in the lower inflation environment, the beneficial effects of the depreciated currency on competitiveness will be eroded. The MPC views the overall risks to the inflation outlook to be more or less balanced, with no evidence of excess demand pressures on inflation.

Notwithstanding a downward revision to the growth forecast, the risks are assessed to be moderately on the downside. This is due to the likely protracted nature of the electricity supply constraints, and their consequences for domestic output as well as for business and consumer confidence. However, given the supply side nature of this constraint, the impact of further monetary policy accommodation on growth is likely to be limited, in the absence of progress being made in the alleviation of electricity constraints. In addition, the implementation of structural reforms is necessary to raise potential growth.

For some time we have emphasised that we are in a process of interest rate normalisation. The lower inflation path gives us some room to pause in this process, particularly against the backdrop of continued weakness in the economy. The MPC has therefore unanimously decided to keep the repurchase rate unchanged at 5,75 per cent per annum.

The MPC is aware that the moderation in inflation could raise expectations of lower interest rates. The MPC is of the view that the bar for further accommodation remains high and would require a sustained decline in the inflation rate and inflation expectations.

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