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 near-term inflation outlook has deteriorated with the partial reversal of the recent petrol price declines, emerging upside pressures on food and possible further electricity tariff increases. The rand exchange rate has depreciated further, adding to upside inflation risks, against the backdrop of the expected, but uncertain, tightening of US monetary policy. The domestic economy, however, remains weak amid electricity supply constraints, and relatively subdued domestic demand.

The year-on-year inflation rate as measured by the consumer price index (CPI) for all urban areas measured 4,4 per cent and 3,9 per cent in January and February respectively. The lower trend in inflation was mainly due to lower petrol prices, but recent oil price and exchange rate developments suggest that this is likely to be the low point for the medium term inflation trajectory. The February outcome was marginally above market consensus and the Bank’s forecast of 3,8 per cent, partly as a result of higher than expected health insurance price inflation of 9,6 per cent.

Petrol prices declined by 26,6 per cent in February, while food price inflation measured 6,5 per cent in February, down from 6,6 per cent in January. By contrast, core inflation, which excludes food, petrol and electricity, remained near the upper end of the inflation target range, having measured 5,8 per cent in both January and February.

The favourable impact of the lower oil price was also evident in the headline producer price inflation for final manufactured goods, which measured 3,5 per cent and 2,6 per cent in January and February respectively compared with 6,5 per cent and 5,8 per cent in the preceding two months. The downward trend is also expected to reverse in the face of adverse fuel and food price developments.

According to the Bank's latest forecasts, inflation is now expected to average 4,8 per cent in 2015, compared with the previous forecast of 3,8 per cent. A first quarter average of 4,2 per cent is now projected as the low point, compared with 3,5 per cent previously. The strong base effects in the first quarter of 2016 are expected to result in a temporary one-quarter breach of the inflation target during that quarter, at 6,7 per cent, with the average for the year expected to measure 5,9 per cent compared with 5,4 per cent previously. Inflation is expected to average 5,5 per cent in the final quarter of the year, compared with the previous forecast of 5,3 per cent.

The forecast for core inflation is more or less unchanged at 5,5 per cent and 5,2 per cent in 2015 and 2016 respectively, the latter up marginally from 5,1 per cent. The peak is still expected at 5,8 per cent in the first quarter of 2015. The deterioration in the headline forecast is due to an expected acceleration in food price inflation, and the impact of the higher fuel and Road Accident Fund levies on the petrol price, due to be implemented in April. This is in addition to the current under-recovery on the petrol price. The international oil price assumption remains unchanged from the previous meeting, with a moderate increase over the next two years. The electricity price assumption is also unchanged, with increases of 11,6 per cent assumed from July 2015 and July 2016. However, there is a high possibility of significant further electricity tariff increases.

Inflation expectations, as reflected in the Bureau for Economic Research (BER) survey conducted in the first quarter of 2015, improved for all respondents for 2015, but returned to levels around the upper end of the target range in the next two years. On average, expectations for 2015 declined from 5,8 per cent to 5,4 per cent, with a one percentage point decline in the expectations of analysts to 4,4 per cent, and a 0,2 percentage point decline in expectations of business people and trade union officials to 6,0 per cent and 5,7 per cent respectively. However, expectations for 2016 and 2017 are higher, with expectations of the categories of respondents ranging between 5,6 per cent and 6,2 per cent in 2016, and between 5,3 per cent and 6,3 per cent in 2017.

The global economic outlook remains uncertain, with a moderate slowdown in the US and China, and an improvement in the outlook and performance of the euro area and Japan. The US grew at a rate of 2,2 per cent in the fourth quarter of 2014, down from 5,0 per cent in the previous quarter, as the stronger dollar impacted negatively on export growth and investment. Nevertheless, the longer term growth outlook remains positive. By contrast, the weaker euro and accommodative ECB monetary policy have contributed to improved growth prospects in the region, particularly in the core countries. In the fourth quarter of 2014, euro area growth surprised on the upside at 1,3 per cent and ECB forecasts for 2015 have been revised upwards by 0,5 percentage points to 1,5 per cent. The Japanese economy emerged from two quarters of negative growth, recording a growth rate of 1,5 per cent in the fourth quarter.

The larger emerging markets continued to be a drag on global growth. China's economic prospects remain relatively subdued with most domestic demand indicators weakening since the beginning of the year. Consensus forecasts are for both Russia and Brazil to record negative growth rates in 2015. The outlook for the Indian economy, by contrast, is more positive.

Global financial markets continue to be dominated by changing expectations of the timing and speed of normalisation of US monetary policy. Favourable labour market data in the past weeks in the US resulted in a strong appreciation of the US dollar against most currencies, as expectations of the start of policy tightening were brought forward. However, these expectations were tempered following the March FOMC meeting where the growth and inflation forecasts were downgraded. Uncertainty persists regarding the timing of the first interest rate increase. The FOMC has not only re-emphasised the gradual nature of the expected path of interest rates, but the members' individual expectations of the interest rate path were also revised down significantly. In response to this guidance, the dollar weakened somewhat against most currencies.

While the US prepares to tighten monetary policy, the global trend has generally been towards policy easing or maintaining an accommodative bias. Both Japan and the euro area have continued with their quantitative easing while a number of countries have eased their policy further, amid benign inflation pressures and concerns about deflation in some countries.

The volatile global trends were reflected in the high degree of volatility in the rand/dollar exchange rate. Since the previous MPC meeting, the rand depreciated by about two per cent against the US dollar, but traded in a wide band of around R11,27 and R12,52 against the dollar, with a marked recovery after the recent FOMC meeting. Over the same period, the rand was more or less unchanged against the euro. On a trade-weighted basis, the rand depreciated by 0,7 per cent. Although the rand movement reflected US dollar strength to a large degree, the rand was also negatively impacted by domestic factors including the weak January trade data, and issues relating to Eskom and the domestic growth outlook.

The rand is expected to remain volatile while uncertainty regarding the outlook for US monetary policy persists. The commencement of US interest rate increases, when it happens, is expected to put the currency under pressure. The rand is also expected to remain sensitive to developments on the current account of the balance of payments. The marked narrowing of the trade account in the fourth quarter, reflective of higher export volumes and lower import volumes, contributed to the narrowing of the deficit to 5,1 per cent of GDP in that quarter, and to 5,4 per cent for the year. At this stage it is unclear whether or not this represents the beginning of a sustained compression of the current account, after a long period of real exchange rate depreciation. While lower international oil prices are expected to continue to impact favourably on the import bill, as oil imports account for just under 20 per cent of merchandise imports, the wide trade deficit in January, should it persist, suggests that the adjustment may remain slow.

Although the current account deficit to date has been relatively comfortably financed, the global capital flow environment is increasingly challenging, particularly against the backdrop of expected increases in US interest rates. During the fourth quarter of 2014, the deficit was financed primarily through flows into the banking sector. Year to date, net sales of bonds and equities by non-residents as reported by the exchanges, suggest that net portfolio flows on the financial account of the balance of payments in the first quarter may be negative for the second consecutive quarter.

The outlook for the domestic economy remains overshadowed by the electricity supply constraint, which appears to have had an adverse effect on recent economic activity. This constraint is likely to persist for some time, and has resulted in a downward revision of short-term potential output to between 2,0 and 2,5 per cent. Nevertheless, some improvement on the 2014 growth rate of 1,5 per cent is expected in 2015, in the absence of protracted work stoppages. The Bank's growth forecast for 2015 is unchanged at 2,2 per cent, and marginally lower at 2,3 per cent for 2016. The Bank's leading indicator of economic activity, which had followed a moderately declining trend in 2014, also suggests a continuation of the sluggish growth outlook.

Underlying this outlook is the continued weakness in growth of gross fixed capital formation, which contracted by 0,4 per cent during 2014, with private sector fixed investment contracting by 3,4 per cent, despite some recovery in the final quarter of the year. The main contribution to fixed capital formation came from general government, which accounts for a relatively small proportion of the total. With business confidence subdued, and amid binding electricity supply constraints, the prospects for a meaningful acceleration remain weak.

Initial high frequency data for 2015 are also a cause for concern, should the trends persist. Both real mining and manufacturing output contracted on a month-on-month basis in January; the Kagiso PMI declined sharply to below the neutral 50 level in February; the RMB/BER business confidence index declined to below the neutral 50 level in the first quarter of 2015 to 49 points, with the decline most marked in the manufacturing sector; and the building sector also shows signs of slowing, with both buildings completed and new plans passed declining, along with lower confidence in the sector, particularly with respect to residential construction.

Against this backdrop, employment growth has stagnated and likely to remain low: according to the Quarterly Employment Statistics of Statistics South Africa, formal sector non-agricultural employment contracted by 0,2 per cent over four quarters in the final quarter of 2014, with growth in public sector employment more than offset by job-shedding in the private sector.

Growth in final consumption expenditure by households increased marginally to an annualised quarterly rate of 1,6 per cent in the fourth quarter of 2014, and measured 1,4 per cent over the year. Both retail trade and wholesale trade sales declined on a month-to-month basis in January, and the outlook remains uncertain as the potential boost to consumption from lower petrol prices has been partially reversed. However, confidence of retailers, particularly of durable goods, remains relatively high. High debt levels, low employment growth and continued tight credit conditions are likely to constrain consumption expenditure growth in the absence of strong increases in real disposable incomes or strong positive wealth effects.

Fiscal policy is set to continue on its consolidation path. As outlined in the recent Budget Review, the projected deficit for both 2014/15 and 2015/16 is estimated at 3,9 per cent of GDP, despite lower GDP growth forecasts, and is expected to narrow to 2,5 per cent of GDP by 2017/18. This is envisaged to be achieved through a combination of lower expenditure compared with the 2014 budget estimate and higher tax revenues. This is expected to exert a moderate constraining effect on household consumption expenditure growth.

Trends in bank credit extension to the private sector have remained relatively unchanged, with highly divergent patterns in loans granted to the corporate and household sectors. While growth over twelve months in total loans and advances to the private sector measured 8,3 per cent in January, credit extended to corporates increased by 14,3 per cent while that to households increased by 3,5 per cent. Growth across all the main categories of credit extension to households has remained subdued in recent months, despite a slight increase in unsecured lending off a low base. Both mortgage credit extension and instalment credit and leasing finance reflected slow growth in housing and motor vehicle sales. Commercial mortgages, by contrast, experienced buoyant growth.

The recent higher trend in wage settlements has the potential to put further upside pressure on inflation. Nominal remuneration per worker over four quarters increased by 7,7 per cent in the fourth quarter of 2014, and, after accounting for changes in labour productivity, resulted in a unit labour cost increase of 6,2 per cent, up from 5,7 per cent in the previous quarter. The Andrew Levy Employment Publications survey shows that during 2014, the average wage settlement rate in collective bargaining agreements amounted to 8,1 per cent, compared with 7,9 per cent in 2013. The public sector wage settlement is still not agreed, and the outcome is expected to have an important bearing on the general trend of wage settlements in the economy in 2015.

The recent downward trend in consumer food price inflation is forecast to be reversed in the coming months, following the severe drought in some of the maize producing areas of the country. With drastically reduced maize crop estimates, South Africa is expected to become a net importer of maize during the year, and spot prices have moved closer to import parity. The spot price of white maize, for example, has increased by around 30 per cent since the beginning of the year, reinforced by a depreciating currency and despite moderating global prices. Meat prices have also remained elevated.

International oil prices have been relatively volatile but at vastly lower levels than those prevailing for much of 2014. Having reached a low of around US$45 per barrel in January, Brent crude oil prices increased to around US$62 per barrel at the end of February, before declining to current levels of around US$57 per barrel. The partial recovery in the international oil price, in conjunction with the recent depreciation of the rand against the US dollar, and the impending fuel and RAF levies, will have reversed a large part of the favourable impact on domestic petrol prices, which had declined by about R4 per litre between August 2014 and February 2015.

The respite to the headline inflation outlook from lower international oil prices appears to have been short-lived. However, the expected breach of the target range in 2016 is likely to be temporary and the main drivers of the deterioration of the inflation forecast are exogenous. While the MPC will look through these developments, the Committee remains concerned about the possible impact on inflation expectations which remain at the upper end of the target range over the longer term.

The rand exchange rate continues to be the main upside risk to the inflation outlook, and remains highly vulnerable to the timing and pace of US monetary policy normalisation. The extent to which US rate increases are priced into the exchange rate remains uncertain. While the weaker euro has provided some offset, and therefore a more moderate depreciation of the trade-weighted exchange rate, this effect is partial. Furthermore, the rand will also remain sensitive to domestic developments, including the slow pace of contraction in the deficit on the current account of the balance of payments.

Wage and salary increases in excess of inflation and productivity growth also pose an upside risk to inflation. The Committee assesses the risk to the inflation outlook to be on the upside, with the possibility of further electricity tariff increases accentuating this risk.

At the same time, the growth outlook remains constrained by electricity supply concerns and low business confidence, and the risks to the growth forecast are assessed to be moderately on the downside. Demand pressures on inflation remain muted, reinforced by a moderately tighter fiscal policy stance.

In its previous statement the Committee noted that the more favourable inflation path allowed for some room to pause in the process of domestic monetary policy normalisation. The deterioration in the outlook suggests that this scope has narrowed. However, given the uncertainties related to US policy normalisation and the weak state of the domestic economy, the MPC has unanimously decided to keep the repurchase rate unchanged for now.

The timing of future interest rate increases will be dependent, as before, on a range of domestic and external factors. The MPC will remain vigilant and will not hesitate to act in order to maintain the integrity of the inflation targeting framework.

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