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

There are a number of key developments that this meeting of the Monetary Policy Committee (MPC) had to consider, not least among them on the domestic front the challenge of moderate growth, rising inflation, a depreciated currency, a wider current account deficit as well as difficult labour relations and unemployment that remains stubbornly high.

Since the previous meeting of the MPC the domestic inflation outlook has deteriorated slightly. Risks posed by the depreciation of the rand exchange rate have overshadowed the more favourable developments, including lower electricity price increases and some moderation in food price inflation. Nevertheless inflation is expected to remain contained within the target range apart from a temporary breach in the third quarter of 2013. The domestic economic growth prospects remain fragile amid continued tensions in the labour market, particularly in the mining sector.

The global economy is still characterised by a multispeed recovery. However, recent events in Europe, particularly as they affect Cyprus, have increased risk and uncertainty in the region, and have the potential to reignite the banking and sovereign debt crisis and undermine growth prospects further. The global outlook is also clouded by the fiscal gridlock in the United States that remains unresolved.

The year-on-year inflation rate as measured by the consumer price index (CPI) for all urban areas was 5,9 per cent in February 2013, up from 5,4 per cent in January. The upside surprise in the February was mainly due to the increase in medical insurance costs, which resulted in the contribution to CPI from miscellaneous goods and services increasing from 0,7 percentage points to 1,1 percentage points. This category also impacted on core inflation, which increased markedly from 4,7 per cent in January to 5,3 per cent in February. Petrol prices also contributed to the upward trend having increased by 11,9 per cent. Food price inflation measured 6,3 per cent, down from a recent high of 7,5 per cent in November 2012, and its contribution to overall inflation declined from 1,0 percentage points to 0,9 percentage points. Administered prices increased by 8,9 per cent, and by 7,5 per cent excluding petrol, year-on-year. The producer price inflation for final manufactured goods measured 5,8 per cent in January[1].

The inflation forecast of the Bank reflects a slight deterioration in the inflation outlook for 2013 compared with the previous forecast. The forecasts incorporate the new CPI weights and rebasing announced by Statistics South Africa, as well as the lower electricity price increase of 8 per cent granted to Eskom by Nersa. Inflation is now expected to average 5,9 per cent in 2013 and 5,3 per cent in 2014, compared with the previous forecasts of 5,8 per cent and 5,2 per cent for these respective years. Inflation is expected to breach temporarily the upper end of the target range in the third quarter of 2013, when it is expected to average 6,3 per cent, and then to moderate gradually to 5,2 per cent in the final quarter of 2014. This deterioration is largely due to the depreciation of the rand and higher petrol prices, which more than offset the impact of the lower electricity price increases and a lower starting point.

The forecast of core inflation is more or less unchanged for 2013 but higher for 2014, yet still indicates the continued absence of significant demand pressures. This measure is expected to peak at 5,1 per cent in the second quarter of 2014, and to average 4,8 per cent and 4,9 per cent in 2013 and 2014, respectively. This

[1] Statistics South Africa has adopted a “stages-of-production” concept for the PPI and no longer produces one aggregated series. The five producer price series are PPI for final manufactured goods; intermediate manufactured goods; electricity and water; mining; and agriculture, forestry and fishing. The PPI for final manufactured goods is regarded as best representing the effects of price changes through the five stages of production.

forecast is likely to be adjusted upwards in the light of the increase in medical insurance costs announced earlier today.

Inflation expectations as reflected in the Reuters survey of analysts conducted in February 2013 have remained more or less unchanged since December. Expectations remained anchored within the target range but close to the upper end, and, as with the Bank’s forecast, the peak is expected in the third quarter of 2013.

The global economic outlook presents a mixed picture following a disappointing fourth quarter in most of the advanced economies. Recent data from the United States indicate positive trends in the labour market and household consumption expenditure due in part to positive wealth effects from the housing and equity markets. However, uncertainty about the possible negative impulse from fiscal tightening continues amid political differences over fiscal policy. Economic growth is still expected to remain below trend in 2013.

The outlook for some of South Africa’s other main advanced-economy trading partners is less positive. The Eurozone remains in recession, and is not expected to recover before mid-2013 at the earliest. The tail risks from a sovereign debt crisis appeared to have subsided, but the uncertainty created by the inconclusive Italian general election, and the crisis in Cyprus, have renewed concerns about the stability of the region. The outlook for the UK economy remains subdued against the backdrop of continued fiscal austerity.

Growth prospects in the Asian economies are more positive. The Japanese economy is expected to be bolstered by positive consumer sentiment in response to fiscal and monetary stimuli, but the response on the capital expenditure side is still cautious. Nevertheless an improved growth performance is expected, particularly given the 18 per cent depreciation of the yen against the US dollar since October 2012. Growth in China is expected to be sustained at relatively robust levels as fixed investment expenditure remains strong despite a moderation in consumption expenditure growth. Growth in other emerging markets remains positive.

These trends suggest that monetary policy in the advanced economies will remain accommodative for some time despite recent fears in the financial markets of an early reversal of quantitative easing in the US. The relatively weak growth outlook in the advanced economies has contributed to the subdued global inflation environment.

The exchange rate of the rand continues to pose the main upside risk to the inflation outlook. Since the beginning of the year, the rand has depreciated by 8,4 per cent against the US dollar and fluctuated within a range of R8,45 and R9,26. However, given the significant realignment of global currencies, and particularly the depreciation of the Japanese yen and the pound sterling against the US dollar, the trade weighted depreciation since the beginning of the year was more moderate at 5,6 per cent.

Domestic factors contributing to the recent rand depreciation include continued work stoppages in parts of the mining sector, which also have the potential to disrupt electricity supplies, and the further widening of the deficit on the current account of the balance of payments, which measured 6,3 per cent in 2012. Some narrowing of the deficit is expected during the course of the year in response to the depreciation, although the degree of response will be constrained by weak demand from advanced economies as well as strong infrastructure-related import demands. Mining export growth will also be dependent on the resolution of labour market issues with a resumption of full production, and on the extent of possible shaft closures.

Equity and bond flows to emerging economies have generally moderated in the past few months, making for a more challenging global environment for financing the deficit. Inflows into South African bond and equity markets have, however, been sustained, and year-to-date non-resident net purchases of equities and government bonds have totaled R6,1 bn and R11,3 bn respectively. These flows have, however, been volatile, and the growing proportion of bonds owned by non-residents, currently around 37 per cent of the total outstanding stock of debt could constrain the pace of inflows.

The rand is likely to remain sensitive to both domestic and global developments. The exchange rate is expected to remain volatile and subject to overshooting, and further sustained depreciation would increase the upside risk to the inflation outlook. The Reuters Econometer survey conducted in February shows that most analysts still expect the rand to appreciate from current levels during the year, although the degree of dispersion is indicative of the uncertainty around these forecasts. According to this survey, the consensus forecast for the rand/US$ exchange rate at the end of 2013 is R8,61, with a range of forecasts between R9,19 and R7,80.

Domestic growth prospects remain relatively subdued notwithstanding a better-than-expected fourth quarter GDP growth outcome and positive developments in the mining and manufacturing sectors in January. The economy grew by 2,5 per cent in 2012, having recorded annualised growth of 2,1 per cent in the fourth quarter, despite a 9,3 per cent contraction in the mining sector. The moderate pace of recovery is expected to continue in 2013. The Bank's forecast is for growth of 2,7 per cent this year, marginally up from the previous forecast of 2,6 per cent, and 3,7 per cent in 2014, compared with a previous forecast of 3,8 per cent. The risks to these forecasts are assessed to be on the downside.

The flat trajectory of the Bank's leading indicator of economic activity is consistent with this forecast. Growth this year is therefore expected to remain below potential output growth of 3,5 per cent, and this is expected to result in a slight widening of the Bank's revised estimate of the output gap which, at 2,0 per cent, reflects the continued subdued state of the economy.

The mining sector recorded year-on-year growth of 7,3 per cent in January, with 3-month-on-3-month growth of 5,4 per cent following four consecutive months of contraction. Neverthless the sector is expected to remain under pressure given the unsettled labour relations environment. The outlook for manufacturing appears to have improved, but this recovery is still very tentative. The sector grew at a year-on-year rate of 3,9 per cent in January, and by 1,8 per cent on a 3-month-on-3-month basis. This was consistent with improvements in the Kagiso Purchasing Managers Index, which increased from 49,1 in January to 53,6 in February.

Growth in gross fixed capital formation, which measured 5,7 per cent in 2012, has been on a moderate upward trend since 2009, driven mainly by investment growth of around 9 per cent by public corporations and general government. Private sector investment growth moderated from 4,6 per cent in 2011 to 3,9 per cent in 2012 due in part to excess capacity in manufacturing and electricity supply constraints.

While household consumption expenditure has been the main driver of growth since 2010, its contribution to growth has been diminishing. The general absence of demand pressures in the economy is reflected in the continued moderation in the growth in real consumption expenditure by households, which grew by 3,5 per cent in 2012 compared with 4,8 per cent in 2011. Nevertheless, growth in consumption of durable goods remained robust at 11 per cent, compared with demand for services which grew at only 1,8 per cent in 2012. Sales of new motor vehicles declined on both a month-on-month and on a three-month-on-three-month basis in February.

Retail trade sales in January appear to reflect this weakening trend, with a 3-month-on-3-month decline of 0,7 per cent, and a lower than expected year-on-year increase of 1,9 per cent. There are indications that consumption growth may moderate further in 2013 amid slower real income growth, higher inflation, elevated household debt levels, and a possible slow-down in credit extension to consumers.

Twelve-month growth in banks' total loans and advances to the private sector measured 8,9 per cent in January, following growth of 10,0 per cent in December. Loans and advances to the corporate sector grew by 7,5 per cent in January, and to the household sector by 9,9 per cent. Growth in general loans to households - mainly unsecured lending - moderated to 30,1 per cent following a recent peak growth of 39,3 per cent in June. General loans to households amounted to 8,3 per cent of total loans and advances, and 14,6 per cent of loans and advances to household. Growth in this category of lending is likely to be constrained by lower income growth and high household debt levels. Household debt to disposable income measured 75,8 per cent in the final quarter of 2012. Non-mortgage debt as a percentage of total household debt increased from 37 per cent in the third quarter of 2009 to 46 per cent in the final quarter of 2012.

The trend in wage settlements remains an upside risk to the inflation outlook, although recent data is somewhat contradictory. The minimum wage in the agricultural sector has been increased by 52,2 per cent, and indications from the Andrew Levy Employment Publications are that wage settlements in collective bargaining agreements picked up significantly from 6,8 per cent in the third quarter of 2012 to 8,2 per cent in the fourth quarter. According to Statistics South Africa, average salaries and wages per worker in the non-agricultural sector increased over four quarters by 7,0 per cent in the final quarter of 2012, down from 8,9 per cent in the previous quarter, while unit labour cost increases declined from 7,4 per cent to 5,7 per cent in the same period.

The MPC remains concerned about the possible impact of excessively high wage increases on employment growth. Employment in the formal non-agricultural sector increased by 1,0 per cent during 2012, compared with annual employment growth of 1,6 per cent in 2011. This included employment growth of 0,2 per cent in the mining and quarrying industry and a 0,3 per cent contraction in the manufacturing sector. In the fourth quarter of 2012 mining sector employment increased by 1,000 employees, following a decline of 16,000 in the third quarter.

Of concern is the seasonally adjusted annualised decline of 0,7 per cent in total non-agricultural employment during the fourth quarter of 2012.

The recent national government budget tabled before parliament reflects a difficult balance between a commitment to medium-term fiscal consolidation and the need for counter-cyclical policy. The projected deficit of 5,7 per cent for the past fiscal year was wider than initially budgeted for, a result of lower revenue due to weaker economic growth. The fiscal deficit as a percentage of GDP is budgeted to be 5,1 per cent in the 2013/14 fiscal year, and to decline to 3,6 per cent by 2015/16. The government net debt/GDP ratio is expected to stabilise at around 40 per cent in 2015/16, well below the international benchmark for debt sustainability of around 60 per cent.

There are indications that the pressures on inflation emanating from food prices may be moderating. Food price inflation at the consumer price level declined from a recent high of 7,5 per cent in November 2012 to 6,4 per cent in January and 6,3 per cent in February. A similar trend is evident at the producer price level where manufactured food inflation declined to 5,9 per cent in January, compared with a recent peak of 11,1 per cent in November 2012. Similarly, producer price inflation in agricultural products moderated from a recent high of 6,3 per cent in October 2012 to 3,5 per cent in January. Global agricultural commodity prices have declined on average by almost 20 per cent since their recent peak in

August 2012, and expectations are for further moderation in the absence of adverse weather shocks.

Administered prices continue to put upside pressure on inflation, although lower electricity price increases from the third quarter will dampen some of these pressures. The petrol price, which has increased by a cumulative R1,24 per litre since January 2013, remains an upside risk. Although global oil prices have declined over the past few weeks, resulting in an over-recovery of the petrol price so far this month, it is unlikely to be sufficient to offset the adverse exchange rate impacts and the fuel levy increases, and a further increase in the petrol price is likely in April.

The MPC continues to assess the balance of risks to the inflation outlook to be on the upside, mainly due to the exchange rate and wage pressures. These upside risks are mitigated in part by lower risk from food price inflation. Underlying inflation appears to be relatively contained, consistent with the moderating trend in consumption expenditure by households.

The economic growth outlook is more or less unchanged from the previous meeting of the MPC, and risks to the outlook remain on the downside. The unresolved labour disputes in the mining sector pose a significant risk to the exchange rate and to economic growth through their negative impact on export revenues, employment growth and investor perceptions of South Africa.

However, the depreciated exchange rate provides an opportunity for the manufacturing sector in particular to become more competitive despite the challenging export environment. Ensuring that this increase in competitiveness is sustained will require improved productivity and the containment of wage and other cost pressures, which underlines the need to keep inflation under control.

The MPC continues to assess the monetary policy stance to be appropriately accommodative given the persistence of the negative output gap. At the same time, further accommodation remains constrained by the upside risks to the inflation outlook. The MPC has therefore decided to keep the repurchase rate unchanged at 5,0 per cent per annum. The Committee will continue to apply monetary policy consistent with its mandate of price stability within a flexible inflation targeting framework.

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