South African Reserve Bank

PRESS STATEMENT
EMBARGO DELIVERY
29 January 2014

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, the expected cutback in quantitative easing by the US Fed has begun. Although the initial response in global financial markets was generally fairly muted, emerging markets have subsequently experienced a high degree of turbulence, particularly in the wake of renewed fears of a slowdown in China. While the Fed action signals a recovery in the US, and the UK economic outlook is also improving, it does not mean that the global financial crisis is over. Rather, we are now entering a phase of the crisis that is creating new challenges for emerging market economies.

In the longer run a sustained recovery in the US should be positive for the global economy in general, but the adjustment to the withdrawal of quantitative easing is likely to create significant short to medium-term challenges. How to respond to a combination of sharply depreciating currencies, capital outflows, slowing growth, rising inflation, significant current account and/or fiscal deficits and deteriorating confidence is posing policy challenges and very difficult trade-offs for many emerging markets.

The rand exchange rate has been one of the currencies affected by these developments, and the recent depreciation of the rand, if sustained, will raise significantly the risk to the inflation outlook. Our inflation forecast shows a marked deterioration, despite the absence of clear evidence of domestic demand pressures.

The recent inflation data reflects positive outcomes that belie the incipient risks, largely from the depreciation of the currency, that our forecasts highlight. The year-on-year inflation rate as measured by the consumer price index (CPI) for all urban areas measured 5,3 per cent in November 2013 and 5,4 per cent in December, resulting in an average annual inflation rate of 5,7 per cent for 2013. Food and non-alcoholic beverage price inflation continued to moderate from a recent peak of 7,1 per cent in August, to 3,8 per cent in November and 3,5 per cent in December. The contribution of this category to the average CPI increase was 0,5 percentage points in December compared with 0,6 percentage points in the previous month. The petrol price, which was the main contributor to the higher overall inflation in December, increased at a year-on-year rate of 10,0 per cent, up from 7,7 per cent in November. Core inflation, which excludes food, petrol and electricity, has been unchanged at 5,3 per cent for the four months to December, while administered price inflation excluding petrol measured 6,8 per cent. The headline producer price inflation for final manufactured goods measured 5,8 per cent in November, compared with 6,3 per cent in October.

The headline inflation forecast of the Bank has deteriorated since the previous meeting of the MPC, mainly as a result of revisions to the assumptions regarding the rand exchange rate. The forecast average inflation rate for 2014 is 0,6 percentage points higher at 6,3 per cent, and 0,6 percentage points higher at 6,0 per cent in 2015, with inflation expected to average 5,9 per cent in the final quarter of that year. Inflation is expected breach the upper end of the target range in the second quarter of 2014, and to reach a peak of 6,6 per cent in the final quarter of the year, before declining to 6,0 per cent in the second quarter of 2015.

Core inflation, which averaged 5,2 per cent in 2013, is expected to average 5,8 per cent in 2014, compared with 5,6 per cent in the previous forecast, while the forecast for 2015 has increased from 5,3 per cent to 5,9 per cent. The deterioration in this measure of underlying inflation continues to be driven primarily by the lagged effects of the depreciation of the rand exchange rate.

Inflation expectations appear to have remained relatively anchored at the upper end of the target range. According to the survey conducted in the fourth quarter of 2013 by the Bureau for Economic Research at Stellenbosch University, average inflation expectations of respondents measured 6,1 per cent for both 2014 and 2015 and have remained more or less unchanged since 2011. There is, however, some divergence between the average expectations of respondents, which range between 5,6 per cent and 6,4 per cent in 2014, and 5,5 per cent and 6,5 per cent in 2015. Financial analysts have the lowest forecasts, which are also reflected in the latest Reuters survey that indicates expectations of 5,6 per cent and 5,5 per cent in 2014 and 2015 respectively.

While the economic growth outlook for a number of emerging market economies has deteriorated somewhat in recent months, the prospects in the advanced economies have improved, particularly in the US and the UK. However, the recovery remains uneven and not without risks. In the US, growth is being driven by a recovery in the housing market, robust private sector demand, and a dissipation of the negative impulse from fiscal consolidation. In its latest World Economic Outlook (WEO) update, the IMF forecasts growth of 2,8 per cent in 2014 for the US, compared with 1,9 per cent in 2013. The outlook for the Eurozone remains fragile and uneven, particularly in the Southern periphery where the risk of deflation, strong fiscal consolidation and weak banking sectors are constraining the recovery. Eurozone growth in 2014 is expected to remain subdued at around 1,0 per cent.

The Japanese economy has maintained its positive growth but there are still doubts about its sustainability in the absence of continued fiscal stimulus. The outlook for the Chinese economy is increasingly uncertain, given the challenge of containing the excessive increase in credit extension without adversely impacting on growth. Although a growth rate of around 7,5 per cent is still generally expected, the latest PMI, which suggests a contraction of industrial production, indicates some downside risk to this outlook. This uncertainty has contributed to increased risk aversion and volatility in financial markets of emerging economies in recent weeks, and is also likely to impact negatively on commodity prices.

Significant currency depreciation and weaker growth prospects are also evident in a number of other large emerging economies, particularly Brazil, Russia and Turkey, while the outlook for the Indian economy appears to have improved somewhat.

Global inflation remains benign despite abundant liquidity. However, spillover effects from increasingly divergent monetary policies are creating a difficult and volatile environment for emerging markets. There is still some uncertainty regarding the pace of tapering by the Fed in the coming months, and although market expectations are that the US policy rate is unlikely to increase before at least mid-2015, long term bond yields have increased to around 2,8 per cent from around 1,6 per cent in May 2013. A further sustained improvement in UK growth and employment trends has brought forward the prospect of monetary tightening by the Bank of England. However, monetary policy is expected to remain highly accommodative in Japan and the Eurozone where the risk of deflation persists.

The expectation of tapering by the Fed since May 2013 resulted in significant outflows from emerging economies domestic bond and equity markets, putting pressure on exchange rates and long term bond yields, particularly in those countries with sizeable current account deficits. Some countries, including Brazil, Turkey, Indonesia and India, responded by tightening monetary policy, either in reaction to inflationary pressures or in an attempt to stem the depreciation. Since May 2013, cumulative interest rate increases have amounted to 300 basis points in Brazil and 75 basis points in India. The most recent instance has been Turkey which raised its overnight interest rate (MFR) by 425 basis points to 12 per cent.

The impact of these developments on the rand exchange rate has resulted in a marked increase in the upside risk to the inflation forecast, despite the relatively muted pass-through to date. Since the previous MPC meeting, the rand has depreciated by about 7,4 per cent against the US dollar, by 9,0 per cent against the euro and by 8,0 per cent on a trade weighted basis. Year to date the rand/dollar depreciation has been about 3,5 per cent.

In the final two months of 2013, total net sales by non-residents of South African domestic government bonds and equities amounted to R21,0 bn and R19,4bn respectively. These flows effectively reversed the inflows that occurred during the earlier part of the year, with net purchases of bond and equities for 2013 by non-residents amounting to R1,3 bn, compared with R85,2 bn for 2012. Year-to-date net sales of equities and bonds have totaled R19,3 bn, of which R15,6 bn were bonds.

While the recent rand weakness is part of a general emerging market phenomenon, it has been reinforced by idiosyncratic factors including declining terms of trade, on-going labour disputes, and the higher-than-expected current account deficit in the third quarter.

Although to date the current account has been slow to react to the depreciation of the rand, the trade surplus of R0,8 bn recorded in November may signify a possible narrowing of the current account deficit in the fourth quarter of 2013. However, given the volatility of the monthly trade data, it is too early to assess whether or not this is the beginning of a sustainable trend. The extent to which the strikes in the mining sector and resulting decline in exports are likely to impede the current account adjustment further will depend on the duration of the strikes and the extent to which lost output can be compensated for by running down inventories.

The economic growth outlook remains subdued amid continued low business confidence. Growth in the fourth quarter of 2013 is estimated to have recovered somewhat from the low base of 0,7 per cent in the third quarter, and annual growth in 2013 is estimated to have been around 1,9 per cent. Although an improved outcome is forecast for 2014, growth is still expected to remain below estimated potential output of between 3,0 and 3,5 per cent. The Bank's forecasts for growth in 2014 and 2015 have been revised to 2,8 per cent and 3,3 per cent respectively, down from 3,0 per cent and 3,4 per cent in the previous forecast round. The Bank's composite leading business cycle indicator continues to trend sideways, and was marginally negative in November.

The mining sector is expected to remain under pressure in the face of work stoppages in the major platinum mines, with the risk of these disruptions spreading to the gold mines. Mining output recovered somewhat in the fourth quarter of 2013 from the September lows, and the sector is expected to have made a positive contribution to fourth quarter growth. The manufacturing sector is also expected to have exhibited stronger growth in the final quarter, following the strike-induced contraction in the third quarter. However, the sector has yet to exhibit a meaningful response to the weaker exchange rate, and the Kagiso PMI declined to just below 50 index points in December, for the first time since April 2013.

The construction sector presents a mixed picture. The FNB/BER building confidence index remained unchanged at 48 index points in the fourth quarter of 2013, the highest level in 5 years. However, the upward trend in the real value of building plans passed observed in the earlier part of 2013 has leveled off, and there was a notable decline in November by 12,5 per cent on a month-to-month basis, and a 14,5 per cent decline on a year-on-year basis. The outlook for civil construction, by contrast, appears to be more favourable.

These restrained developments in the real sector have contributed to the slow pace of employment creation in the economy, and continued job losses in the private sector remain a concern. According to the Quarterly Employment Statistics (QES) survey of Statistics South Africa, formal sector employment increased by 13,400 in the year to the third quarter of 2013, or by 0,2 per cent. In the third quarter of 2013, employment losses were most pronounced in mining and construction.

Growth in consumption expenditure by households moderated from 2,8 per cent in the second quarter to 2,3 per cent in the third quarter, and is expected to remain relatively constrained by disappointing employment growth and a modest rise in credit extension. Slow growth was particularly evident in the consumption of non-durable goods and services. Real expenditure on durable goods remained strong, with growth of 9,3 per cent. Nevertheless, domestic new vehicles sales appear to be under pressure, having contracted by 3,3 per cent on a quarter-to-quarter basis in the final quarter of 2013. Although retail trade sales increased by 1,2 per cent on a month-to-month basis in November 2013, they increased only marginally, by 0,1 per cent, when the three months to November are compared to the previous three months. Consumer confidence, as reflected in the FNB/BER consumer confidence index, remained at a low level of -7, a marginal improvement from the previous quarter.

Growth in credit extension by the banking system to the private sector continued to lose momentum. Twelve-month growth in total loans and advances to the private sector moderated to 7,4 per cent in November, with credit extension to households measuring 5,9 per cent, compared with 10,4 per cent at the same time in 2012. Twelve-month growth in general loans to households, mainly unsecured lending, measured 8,1 per cent in November, the lowest rate of growth since April 2009, while annualised growth over three months showed a contraction of 0,8 per cent. Although there has been an increase in commercial mortgage credit extension, growth in outstanding residential mortgages remains subdued at 1,3 per cent. Instalment sale credit and leasing finance has continued to be relatively brisk, but could moderate if motor vehicle demand continues to decline. Household debt as a percentage of household disposable income declined slightly from 75,8 per cent in the second quarter to 75,5 per cent in the third quarter of 2013.

Wage settlement rates, as measured by Andrew Levy Employment Publications, measured 7,9 per cent during 2013. However, according to QES data, growth in nominal remuneration per worker declined from 8,8 per cent in the year to the second quarter of 2013, to 6,6 per cent in the year to the third quarter. For the economy as a whole, despite a small decline in labour productivity growth, unit labour cost growth declined over the year from 6,9 per cent in the second quarter to 4,9 per cent in the third quarter. However there are important sectoral differences. For instance, unit labour cost growth in the manufacturing sector accelerated from 5,6 per cent to 6,9 per cent during the same period, while nominal remuneration per worker in the mining sector increased by 9,0 per cent.

Food prices have been the main contributor to the downside surprises in inflation in the past two months, with prices increasing by 3,5 per cent in December. Global food prices generally declined during the year amid improved wheat and maize harvests. The rand exchange rate, coupled with disappointing domestic harvests due to drought in some areas, has impacted adversely on the domestic maize and wheat prices in recent weeks, with the spot prices of maize increasing by about 12 per cent during January, following increases of around 20 per cent between August and December 2013. These pressures have not as yet been observed in the producer price index where cereal and other crop prices declined by one per cent over the year in November. Persistent drought conditions in a number of regions have resulted in the culling of cattle, leading to extremely low meat price inflation since September (0,1 per cent in December). However, these favourable food price outcomes are not expected to persist as higher spot grain prices work through to consumer prices.

Although the exchange rate pass-through has generally been relatively muted to date, the impact on the petrol price has been almost immediate. International oil prices have been fairly stable, with Brent crude oil trading in a range of between US$106 and US$109 during January. In December and January the domestic petrol price was increased by a cumulative 55 cent per litre, and a further significant increase, in excess of 30 cents per litre, can be expected in February, primarily as a result of the weaker exchange rate. Sustained upside pressure from petrol prices on inflation can therefore be anticipated should the rand continue to depreciate.

The MPC carefully considered the economic challenges facing South Africa and the appropriate policy response. On the one hand, inflation forecasts indicate the possibility of being out of the target range for an extended period, largely due to the impact of the depreciating currency. The risks to the inflation forecast are seen to be significantly on the upside. Large adjustments to the exchange rate will inevitably impact on inflation, even in conditions of relatively low pass-through such as we have been experiencing.

On the other hand, the growth outlook remains of concern. Credit extension is low and declining, few jobs on a net basis are being created, and gross fixed capital formation, particularly from the private sector, is significantly below what is required.

Capital outflows and a current account deficit exacerbate the difficulties that lie ahead. Exchange rate pressures are expected to intensify as markets adjust to the new pattern of global capital flows. Although monetary policy in the advanced economies remains accommodative, the process of normalisation has begun, and the spillovers have implications for our own monetary policy.

The primary responsibility of the Bank is to keep inflation under control and ensure that inflation expectations remain well anchored. The depreciation experienced so far could improve our international competitiveness, provided that it is not eroded through higher wage and other input prices.

In the light of these circumstances and taking account of policy trade-offs, the MPC has decided to increase the repurchase rate by 50 basis points to 5,5 per cent per annum as of 30 January 2014. The MPC is of the view that, notwithstanding this increase in the repo rate, monetary policy remains accommodative. Further moves in the repo rate will be highly data dependent. We will continue to monitor developments closely and will not hesitate to act as required in keeping with our mandate.

Gill Marcus
GOVERNOR

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