South African Reserve Bank

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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, inflation has breached the upper end of the target band and is expected to remain outside the target for some time. This development was in line with the Bank's inflation forecast, which is more or less unchanged since the previous meeting of the MPC. The exchange rate has appreciated somewhat since its lows in January in response to a more benign global monetary policy environment, moderating some of the near-term upside risks to inflation. Nevertheless, risks to the inflation outlook remain skewed to the upside.

Despite a more favourable global growth environment, the domestic economic growth outlook has deteriorated markedly. There is still no end in sight to the protracted strike in the platinum sector, and the economic and social costs are escalating and are potentially devastating. Both the mining and manufacturing sectors appear to have contracted in the first quarter, with electricity supply constraints adding to the weak outlook. Against this backdrop, monetary policy faces an increasingly challenging scenario.

The year-on-year inflation rate as measured by the consumer price index (CPI) for all urban areas measured 6,0 per cent and 6,1 per cent in March and April 2014 respectively, up from 5,9 per cent in February. Food and non-alcoholic beverage price inflation accelerated significantly, measuring 7,0 per cent and 7,8 per cent in the past two months, compared with a recent low of 3,5 per cent in December. The contribution of this category to headline inflation was 1,2 percentage points in April compared with 0,8 percentage points in February. The categories of food, housing utilities and transport together accounted for 3,7 percentage points of the inflation outcome in April. Core inflation, which excludes food, petrol and electricity, measured 5,5 per cent in March and April after six consecutive months at 5,3 per cent. Administered price inflation excluding petrol continued its gradual decline, measuring 6,5 per cent in April, from 6,7 per cent in March. The headline producer price inflation for final manufactured goods measured 8,2 per cent in March, compared with 7,7 per cent in February, driven mainly by food prices, and is indicative of further upside pressures on CPI inflation in the near term.

The Bank's forecast of headline inflation changed marginally since the previous meeting. Inflation is expected to average 6,2 per cent in 2014, compared with 6,3 per cent previously, with the peak of 6,5 per cent (previously 6,6 per cent) expected in the fourth quarter. The forecast average inflation for 2015 remained unchanged at 5,8 per cent. The forecast horizon has been extended and inflation is expected to average 5,5 per cent in 2016, and 5,4 per cent in the final quarter of that year. Inflation is still expected to remain outside the target band from the second quarter of 2014 until the second quarter of 2015.

The outlook for core inflation is also largely unchanged. This measure is expected to average 5,6 per cent and 5,7 per cent in 2014 and 2015 respectively, compared with the previous forecast of 5,6 per cent for both years, moderating to 5,5 per cent in 2016. The upward pressure is assessed to be a response to the lagged effects of the exchange rate depreciation rather than evidence of strong domestic demand pressures. The MPC still sees the risks to the inflation forecast to be skewed to the upside, and remains concerned that the current low level of pass-through may not persist.

The Reuters survey of inflation expectations of economic analysts conducted in May is more or less unchanged since the previous survey. Inflation is expected to average 6,3 per cent in the second quarter, and 6,2 per cent in the final two quarters of this year, before returning to within the target at an average of 5,8 per cent in the first quarter of 2015. Annual inflation is expected to average 6,2 per cent in 2014, and 5,6 per cent and 5,4 per cent in the subsequent two years respectively, somewhat lower than the Bank’s forecast.

The global economic outlook remains mixed. Growth in the US stalled in the first quarter as a consequence of the severe weather conditions, while retail sales in April were below expectations. Despite downside risk to growth from the housing market, the recovery is expected to remain on track, although at a lower rate than that forecast earlier in the year. While the Fed expects growth of between 2,8 and 3,0 per cent for 2014, the market consensus is closer to 2,5 per cent. The UK economic recovery also appears to be resilient, despite some slack in the economy. By contrast, the Eurozone continues to lag, following a lower-than-expected annualised growth rate of around 0,8 per cent in the first quarter.

The annualised growth rate of 5,9 per cent recorded by the Japanese economy in the first quarter of this year is not expected to be sustained as higher consumption taxes take effect, and consensus forecasts are for annual growth of around 1,5 per cent. The Chinese economy grew at an annualised rate of 5,8 per cent in the first quarter of 2014 amid weakening trends in industrial production and retail sales. Although an annual growth rate of between 7,0 - 7,5 per cent is still generally expected, there are concerns that the loss of momentum in the property market and declining credit growth could pose downside risks to growth.

The shift in global growth dynamics toward the advanced economies has been reinforced with a number of emerging markets facing a more challenging outlook. Low growth is expected in a number of the larger economies, including Brazil, Russia, Argentina, Turkey and Thailand, but some analysts have revised upwards their growth forecasts for India. More positively, growth in sub-Saharan Africa is expected to average 5,4 per cent, but this is vulnerable to weaker commodity prices in the event of slower growth in China.

Global inflation remains benign amid relatively stable food and energy price trends. Financial markets appear to have priced in continued steady tapering of quantitative easing in the US, and recent guidance from the Fed appears to have reduced the degree of volatility and uncertainty in financial markets regarding the pace and timing of monetary policy normalisation. Policy rates look set to increase at a moderate pace in the US and UK during 2015, while the possibility exists of further easing in Japan and the Eurozone, where the risk of deflation persists. Since the previous meeting of the MPC, monetary policy has been tightened in New Zealand, Brazil and Russia in response to inflation pressures or exchange rate concerns, but eased slightly in Hungary.

With global financial markets pricing in a slower pace of US policy normalisation, global risk appetite has improved. Apart from sizeable outflows from Russia in the wake of the crisis in the Ukraine, capital flows to emerging markets have resumed, or outflows slowed, resulting in generally appreciating EM currencies and declining long bond yields. This improved sentiment has also impacted on the rand exchange rate, which appreciated by 3,3 per cent against the dollar and by 3,1 per cent on a trade-weighted basis since the previous meeting of the

MPC. During this period the rand traded in a range of between around R10,70 and R10,29 against the US dollar.

Portfolio flows to South Africa have been in line with general global trends. Following cumulative net sales of South African government bonds and equities by non-residents of R71 bn from November 2013 to the end of January 2014, net purchases of bonds and equities since the beginning of February have totaled R8,3 bn and R29,9 bn respectively. Year-to-date net inflows into bonds and equities total R7,6 bn.

While recent exchange rate developments have afforded some near-term respite from further inflation risks from the exchange rate, the MPC is mindful of the sensitivity of the rand to both global and domestic factors.

The rand is expected to remain vulnerable to changing global perceptions of US monetary policy and associated capital flows. However, while the recent appreciation is more a reflection of changing global risk perceptions rather than a specific re-assessment of South African fundamentals, domestic factors have also impacted on the rand. The exchange rate is likely to remain sensitive to domestic factors, including developments in the current account of the balance of payments and perceptions of its sustainability. In particular, the ongoing strike in the platinum sector is expected to begin to have a significant negative impact on exports, now that inventories are reaching low levels, and a further extension of the strike could impede the required current account adjustment process.

The domestic economic growth outlook has deteriorated markedly, with the reversal of a number of the tentative positive signs observed at the beginning of the year. The Bank's forecast for economic growth for 2014 has been revised down from 2,6 per cent at the previous meeting to 2,1 per cent, implying a further widening of the negative output gap. The forecast for 2015 remains unchanged at 3,1 per cent, and growth in 2016 is expected to average 3,4 per cent. However, the risks to these forecasts are increasingly to the downside against the renewed possibility of electricity load-shedding, among other factors. The Bank's leading indicator of economic activity declined marginally in February, and the sustained sideways movement confirms the subdued outlook, amid weak business confidence. The RMB/BER business confidence index declined by two index points to 41 index points in the first quarter of 2014.

The first quarter growth outcome was negatively affected by contractions in both the mining and manufacturing sectors. In the first quarter of 2014 the physical volume of mining production declined by 6,8 per cent (not annualised) when compared with the previous quarter. This decline was not confined to the platinum group metals, with production declining in seven of the twelve mining sub-components and expectations are for this negative trend to continue.

The physical volume of manufacturing production declined by 1,6 per cent (not annualised) in the first quarter of the year. The contraction was also broad based and the outlook for the sector remains subdued as reflected in the marked decline in the Kagiso PMI to 47,4 index points in April. This follows two consecutive months when the index was above 50 points. The new sales orders component of the PMI remained well below 50 for the second consecutive month. There appears to be continued underutilisation of manufacturing production capacity, particularly with respect to durable goods production.

The favourable trend in the real value of building plans passed during the past two years has been maintained in keeping with rising levels of building confidence. The real value of building plans passed increased by 13,6 per cent on the 3-month-to-3-month basis in March 2014, and by 5,9 per cent on a year-on-year basis.

The unemployment rate remained elevated at 25,2 per cent in the first quarter of 2014 in a declining growth environment. This follows a decline in employment in the first quarter of 2014 of 122,000 jobs, although on a seasonally adjusted basis the decrease was 32,000.

Consumption expenditure by households is expected to remain constrained in the face of continued weakness in credit extension, rising inflation, high consumer indebtedness, as well as the knock-on effects of the mining strike, where the cumulative loss of wages is estimated to have exceeded R8 billion. Real retail sales grew by 0,6 per cent on a quarter-to-quarter basis in the first quarter of this year, having declined in March by 1,4 per cent on a month-to-month basis. New vehicle sales declined by 0,7 per cent on a 3-month-to-3-month basis in April, and by over 10 per cent on a year-on-year basis while NAAMSA expects new vehicle sales to contract over the year. Although the FNB/BER consumer confidence index improved marginally in the first quarter of 2014, it remained at a low level of -6.

Growth in bank credit extension to households continued to moderate, while that to companies has remained relatively robust. The twelve month growth in total loans and advances to the private sector measured 8,2 per cent in March 2014, driven by a 12,7 per cent increase in credit extension to companies, related in part to the awarding of a new round of renewable energy contracts. By contrast, growth in credit extension to households moderated further to 4,8 per cent, as unsecured lending continued its downward trend. Growth over twelve months in general loans to households, mainly made up of unsecured lending, measured 3,5 per cent in March, the lowest rate of growth since 2005. Growth in mortgage advances to households remained below 3 per cent, in line with the relatively subdued volume growth in the housing market. While growth in instalment sale and leasing finance recorded annual growth of 10,1 per cent in March, it is on a declining trend, particularly with respect to households. These trends in credit extension are expected to remain a constraint on consumption expenditure growth.

The trend in wage settlements is more or less unchanged. According to Andrew Levy Employment Publications, the overall average wage settlement rate in collective bargaining agreements was unchanged from the previous year, at 7,9 per cent in the first quarter of 2014. However the main wage negotiations are yet to be completed, in particular the re-negotiation of a new multi-year agreement in the Steel and Engineering Bargaining Council. The outcome of this, as well as the impasse in the platinum sector, could have an important bearing on the general trend of wage settlements.

Food prices remain a risk to the inflation outlook, although the risk may have moderated somewhat following the sharp reversal in domestic maize prices in recent weeks. Having reached a peak of almost R3,800 per ton in March, maize prices declined in May to around R2,000 per ton, and an 8 per cent decline over the year. This was in response to an upward revision of the domestic maize crop forecast, now expected to be 11 per cent higher than last year, which has resulted in a move from import to export parity prices. This development, if sustained, could help ameliorate the considerable pipeline pressures that have been evident in the producer price index since the beginning of the year. Final manufactured producer food price inflation accelerated to 9,1 per cent in March and further pressures are evident in the agricultural producer price inflation for cereals which measured 26,5 per cent in March, although this is expected to moderate in response to lower spot prices.

The international oil price has remained within the range of US$105-US$111 for some time. The domestic price of petrol has benefited from the stronger trend in the exchange rate over the past weeks. In May the price of 95 octane petrol declined by 15 cents per litre, following a 7 cent per litre increase in April, and, should current trends continue, a further reduction can be expected in June.

The MPC continues to face the difficult dilemma of dealing with upside risks to inflation and a deteriorating domestic economic growth outlook. Although the breach of the upper end of the inflation target band was in line with the Bank's forecast, the risks to the forecast remain on the upside. The policy dilemma is increased by the fact that inflation is seen to be driven primarily by supply side factors, while demand conditions in the economy remain subdued.

Although the immediate pressures from the exchange rate are lower than was the case earlier in the year, the exchange rate remains a significant source of upside risk to the forecast. The respite from the stronger exchange rate could be temporary and respond quickly to changes in both domestic and external conditions. Although the pass-through from the exchange rate to inflation is still relatively low, there are indications of some acceleration. In addition, food prices are expected to add further upside impetus to inflation in the near term, but this risk may have moderated to some extent given the sharp decline in the maize prices and low global food inflation.

As indicated earlier, the Bank's economic growth forecast for 2014 has been revised down significantly to 2,1 per cent, and the first quarter growth outcome is anticipated to be the lowest quarterly growth rate since the recession in 2009. Although growth in the second quarter is expected to improve somewhat, the risks to the 2014 growth forecast are strongly on the downside, with developments in the mining sector an ongoing cause for concern. The demand side of the economy is also weakening: household consumption expenditure growth continues to moderate amid slower credit extension to households, high levels of consumer debt levels and moderate job growth. However, the weak state of the economy cannot be resolved through monetary policy actions alone.

The committee continues to hold the view that we are in a rising interest rate cycle, and interest rates will have to be normalised in due course. We embarked on this process with our first move in January 2014. At this stage the pace and timing of normalisation in the advanced economies appears to have been pushed out further and may be more moderate than previously believed. We are also aware that this can change very quickly.

Accordingly, the committee decided to keep the repurchase rate unchanged at 5,5 per cent per annum at this stage.

Future actions will be data dependent and determined by developments in the inflation outlook and inflation expectations. Inflation is currently at uncomfortable levels and a marked deterioration in the outlook may require action that we will not hesitate to take. The MPC reiterates that a rising interest rate cycle does not mean that rates will be raised at each meeting, or by the same amount each time.

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