Statement of the Monetary Policy Committee

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Issued by Gill Marcus, Governor of the South African Reserve Bank, at a meeting of the Monetary Policy Committee (MPC) in Pretoria

Introduction

The longer-term inflation outlook remains relatively favourable, notwithstanding some base effects that are likely adversely to affect the inflation outcomes in the short term. Domestic consumption expenditure remains under stress and there are no perceived risks to the inflation outlook from this source. Despite the continued contraction of private-sector gross fixed capital formation, the domestic economic growth outlook appears to have improved, but is expected to remain below the potential output growth for some time. The global economy is characterised by an uneven recovery across regions and some risks persist, while the global inflation outlook appears to be contained.

Recent developments in inflation

The year-on-year inflation rate as measured by the consumer price index (CPI) for all urban areas declined from 6,1 per cent in September 2009 to 5,9 per cent and 5,8 per cent in October and November respectively. The categories of housing and utilities, and miscellaneous goods and services remained the single biggest contributors to the inflation outcome in November, having contributed 1,7 and 1,5 percentage points respectively. These categories were mainly driven by electricity and insurance cost increases. Food price inflation continued to moderate and measured 4,0 per cent in November, while administered prices excluding petrol and paraffin increased by 11,0 per cent, primarily as a result of electricity price increases.

Producer prices declined at year-on-year rates of 3,3 per cent and 1,2 per cent in October and November respectively. The underlying producer price trends in the food sector remained favourable for further moderation in food price inflation at the consumer level. In November agricultural prices increased at a year-on-year rate of 0,9 per cent, while manufactured food prices declined by 1,1 per cent.

The outlook for inflation

CPI inflation is expected to increase to above the target range in the coming three months, due to technical base effects related to petrol price changes. Current forecasts indicate that inflation could measure around 6,5 per cent in December and January, before moderating in the subsequent months. Because of the forward-looking nature of monetary policy, the focus of the Monetary Policy Committee (MPC) is on the longer-term expected trend of inflation. The CPI inflation forecast by the South African Reserve Bank (the Bank) is predominantly unchanged since the November forecast. In line with market forecasts, inflation is expected to return to within the inflation target range on a sustained basis in March 2010, and remain within the target range until the end of the forecast period in the final quarter of 2011, when it is forecast to average 5,4 per cent.

Since the previous MPC meeting, Eskom has modified its tariff application to the National Energy Regulator of South Africa (NERSA). Given the continued uncertainty related to the electricity tariff increases, the forecast does not make provision for the full multi-year increases of 35 per cent requested by Eskom, and electricity price increases of 25 per cent in 2010 and 2011 are assumed. The outcome of the Eskom application is expected to be announced in February.

The most recent inflation expectations survey conducted by the Bureau for Economic Research (BER) at Stellenbosch University shows that in the fourth quarter of 2009 there were no significant changes in expectations compared with the previous survey. According to the survey, inflation is expected to average 7,5 per cent in 2010 and 7,7 per cent in 2011. While both business and trade union respondents continued to expect inflation to remain outside the target range, the forecasts of financial analysts deteriorated moderately but remained within the target range. The latter forecasts were in line with the Reuters survey, which in January showed that market analysts expect inflation to average 5,7 per cent and 5,8 per cent in 2010 and 2011 respectively.

The demand-side pressures on inflation have been persistently weak, and the MPC remains of the view that there are no significant upside risks to the inflation outlook emanating from this source.

Real final consumption expenditure by households has contracted on a quarter-on-quarter annualised basis since the third quarter of 2008. In the third quarter of 2009 household consumption expenditure declined by 2,0 per cent. This weak trend appears to have continued in the final quarter of 2009. Real retail trade sales declined at a year-on-year rate of 6,6 per cent in November 2009 and by 5,9 per cent in the three months to the end of November compared with the same period in 2008. Wholesale trade sales also declined in November. New vehicle sales continue to show some signs of improvement, but nevertheless contracted by 7,2 per cent in December on a year-on-year basis. Consumer confidence appears to have improved, however, as reflected in the First National Bank (FNB)/BER consumer confidence index which recorded its highest reading since the first quarter of 2008.

Adverse employment trends and employment insecurity are likely to constrain household consumption expenditure. According to Statistics South Africa's Quarterly Employment Statistics, employment levels decreased further during the third quarter of 2009, despite a more favourable growth performance. Formal non-agricultural employment declined by 4,2 per cent in this quarter, representing almost 110 000 jobs. Employment is expected to lag the growth recovery.

Credit extension to the private sector reflects the weak demand and tight credit supply conditions, and is also seen as a constraint on spending. There are, however, indications that the strict lending criteria applied by banks in response to higher perceived risk and rising impaired advances may be easing. In November 2009 impaired advances as a percentage of total gross loans and advances increased to 5,9 per cent from 5,8 per cent the previous month. Total loans and advances to the private sector contracted by 2,0 per cent in November compared with the previous year. This was the third consecutive month of credit contraction. The only component of credit extension that recorded positive nominal growth was mortgage advances, which grew at a 12-month rate of 3,0 per cent. These developments were also reflected in the level of household debt, where the ratio of household debt to disposable income declined from 80,1 per cent in the second quarter of 2009 to 79 per cent in the third quarter. This relatively high level of debt is expected to continue to constrain consumption expenditure.

While the combination of increased unemployment, the lack of access to credit and the need to repair impaired household balance sheets is expected to dominate consumption trends in the coming quarters, there have been some positive developments with respect to wealth effects. House prices have shown signs of improvements, with the Absa and FNB house price indices showing positive but moderate growth. Equity prices have recovered somewhat since their lows in March of 2009, but the recent equity market decline both domestically and abroad shows that some volatility may persist in line with uncertainty relating to the sustainability of the global recovery.

There are continued signs that the domestic economic recovery is under way following the 0,9 per cent annualised gross domestic product (GDP) growth rate measured in the third quarter of 2009. However, the recovery is expected to remain relatively subdued and below the potential growth rate of the economy for some time. The forecast of the Bank is that GDP growth will average 2,0 per cent in 2010 and 3,0 per cent in 2011. Nonetheless, it could take some time until pre-recession levels of output are reached. The more positive outlook is in line with the continued positive trends seen in the composite leading business cycle indicator of the Bank, which increased strongly again in November. The coincident indicator also exhibited a slight upward movement. These trends are in line with the more positive outlook seen in the Rand Merchant Bank (RMB)/BER business confidence index during the fourth quarter of 2009.

The manufacturing sector has also shown signs of some recovery and is expected to contribute positively to the 2009 fourth quarter growth outcome. The physical volume of manufacturing production declined at a year-on-year rate of 4,7 per cent in November, but increased by 3,9 per cent in the three months to November compared to the previous three months. The Kagiso Purchasing Managers Index (PMI) also reflected a positive outlook in November and December. However, the manufacturing sector may be constrained by weak domestic demand, while external demand will be impacted by the strength of the global recovery as well as, in part, by exchange rate developments.

The rand has remained a positive factor from an inflation perspective. However, the MPC is cognisant of the negative impact of the rand's movements during the past year on some sectors of the economy. Since the previous MPC meeting, the rand/dollar exchange rate has fluctuated between around R7,28 and R7,73. On a trade-weighted basis, the rand has remained more or less unchanged since the previous meeting. Much of the volatility of the exchange rate during this period can be explained by general volatility in the international foreign exchange markets where the US dollar fluctuated in a range of US$1,41 and US$1,51 against the euro.

With the decline of risk aversion in global markets, emerging markets in general, including South Africa, have also had to deal with significant capital inflows. These inflows have put upward pressure on a number of emerging market currencies. Intervention to prevent these appreciations is often costly and not always effective. At the same time, the possibility of reversals of these flows, should global sentiment change, poses a risk to the exchange rate outlook in these countries.

The global recovery has continued with relatively strong performances in some of the emerging-market economies. However, risks and vulnerabilities still remain, particularly in a number of countries in the euro area, and the recovery is expected to remain relatively slow in some economies that are important export destinations for South African goods. Unsustainable fiscal positions, as well as the need to reverse previous unconventional monetary policy interventions, may also pose a risk to the global growth outlook. The global environment remains benign from an inflation perspective. Despite moderately higher commodity prices, there are no significant risks to the global inflation outlook.

Other supply-side or exogenous factors are not expected to impart a significant upside risk to the inflation forecast. International oil prices appear to have stabilised somewhat over the past months and moderate increases have been assumed over the forecast period. The outlook for food price inflation, as reflected in producer prices and futures prices, is favourable and these prices are unlikely to pose an upside risk to the inflation outlook for some time despite higher food prices in international markets.

The risk to the inflation outlook emanating from wage developments appears to have subsided somewhat. Wage settlements are still in excess of inflation, but have been declining in nominal terms. Average nominal remuneration per worker in the formal non-agricultural sector moderated to 7,6 per cent in the third quarter of 2009, while the nominal unit labour cost increase in the third quarter compared with the same quarter the previous year measured 5,7 per cent.

Electricity price increases remain the single biggest risk to the inflation outlook. There is the risk that increases granted to Eskom could be markedly higher than those assumed in the Bank's forecast, and there is also the risk that the second-round effects of these increases may be underestimated by the forecasting model.

Monetary policy stance

The MPC noted that inflation is likely to remain close to the upper end of the target range over the forecast period and is of the view that the risks to this outlook are fairly evenly balanced. Electricity price increases pose the biggest upside risk, counteracted by the weak state of domestic demand. Against this background the MPC has decided to keep the repurchase rate unchanged at 7,0 per cent per annum.