Statement of the Monetary Policy Committee

18 November 2010

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

Introduction

Since the previous meeting of the MPC, the outlook for domestic inflation has improved further against the backdrop of a continued negative domestic output gap and sustained strength in the exchange rate of the rand. Persistently low growth in the United States (US) and renewed quantitative easing, combined with renewed concerns about the solvency of some euro area countries, are expected to prolong the current environment of low global interest rates and continued capital flows to emerging market economies. While a number of cost–push factors are beginning to pose some upside risk to domestic inflation, the overall risks to the inflation outlook are assessed to be fairly evenly balanced.

Recent developments in inflation

The year-on-year inflation rate as measured by the consumer price index (CPI) for all urban areas declined to 3,2 per cent in September 2010, compared with 3,5 per cent in August. Goods price inflation measured 1,5 per cent in September, while services inflation amounted to 5,2 per cent. The categories of housing and utilities (mainly electricity) and miscellaneous goods and services (predominantly insurance costs) together contributed 2,2 percentage points of the 3,2 per cent inflation outcome. CPI excluding administered prices measured 2,6 per cent, while administered prices excluding petrol measured 9 per cent.

Of the twelve broad CPI categories, only one category had an inflation rate that was within the target range of 3 to 6 per cent, while the inflation rates of six categories were below the lower end of the target range. Five categories, with a combined weighting of 34,6 per cent, had inflation rates above the 6 per cent level.

Having peaked at 9,4 per cent in June 2010, producer price inflation has since moderated somewhat and measured 6,8 per cent in September. Despite higher global food price trends, agricultural prices and manufactured food prices continued to decline on a year-on-year basis. This indicates subdued pressure on food prices in the coming months at the consumer level, where food prices increased at a year-on-year rate of 1,2 per cent.

The outlook for inflation

The lower-than-expected inflation outcomes contributed to a further downward adjustment in the inflation forecast of the Bank throughout the forecast period to the end of 2012. Targeted CPI inflation averaged 3,5 per cent in the third quarter of 2010. A similar average outcome is expected during the fourth quarter, resulting in an expected average inflation rate of 4,3 per cent for 2010. Inflation is then expected to remain at an average of 4,3 per cent in 2011 and to increase to 4,8 per cent in 2012. In the final quarter of 2012 inflation is expected to average 4,8 per cent, compared with the previous forecast of 5,1 per cent.

The more favourable forecast is a result of an expected moderation in administered price inflation, a more appreciated nominal effective exchange rate of the rand, as well as lower-than-expected actual inflation outcomes, which lowered the starting point of the forecast.

Inflation expectations as reflected in the survey conducted by the Bureau for Economic Research (BER) at Stellenbosch University during the third quarter have been revised downwards for all categories of respondents. Expectations have been on a consistent downward trend since reaching a peak in the second quarter of 2009. Nevertheless, in contrast to expectations of the financial analysts, who expect inflation to remain within the target range over the forecast period, the expectations of trade unions and business executives remain outside the target range. According to this survey, inflation is expected to average 5,7 per cent in 2010, and 6,1 per cent and 6,4 per cent in 2011 and 2012 respectively.

The Reuters consensus survey of financial analysts, conducted in October, also shows a more favourable outlook with inflation expected to average 5,5 per cent in 2012. Break-even inflation rates as derived from the inflation-linked bonds have also declined significantly across all maturities, to levels of around 5 per cent.

The global economic recovery has continued in an uneven manner, with downside risks to the growth outlook in a number of the advanced economies including the US, Japan and the euro area. Further fiscal stimulus in the US appears unlikely, suggesting that the burden of supporting the flagging growth and persistent unemployment will fall disproportionately on monetary policy. The recent resumption of quantitative easing, against a backdrop of deflation fears, indicates that monetary policy in the US is likely to remain highly expansionary for some time. There is heightened uncertainty in the euro area with the focus, once again, shifting to the peripheral countries, as concerns relating to the solvency of the Irish banking system and the sustainability of Irish public-sector deficits have raised fears of possible contagion within Europe and possibly to the global financial sector. Spreads on sovereign debt have widened again in some of the Southern European countries after a relatively steady period, and in some instances have exceeded the levels reached in April 2010, when sovereign debt concerns reached their peak.

Apart from the risks to the fragile global recovery, there are also significant risks to financial stability emanating from these developments in the advanced economies. Should the problems in the euro area not be resolved in an orderly manner, there are risks of a sudden reversal of capital flows to emerging markets.

By contrast, growth in the emerging markets has remained buoyant and in some instances monetary policy has been tightened in response to increased demand pressures. Furthermore, the strong growth in Asia, and China in particular, has underpinned commodity prices, which have contributed to the stronger trend in inflation in these countries. It the extent to which growth in the emerging markets can be sustained independently of a recovery in the industrialised economies is still unclear. Despite the higher commodity prices, global inflationary pressures remain relatively benign.

The quantitative easing has continued to have spillover effects on emerging-market economies. The search for yield resulting from this increase in liquidity has implications for the exchange rates of the recipient countries. South Africa has been no exception in this respect and appreciation pressures are expected to persist for some time, in the absence of renewed bouts of global risk aversion. The exchange rate therefore remains a downside risk to the inflation outlook.

Since the previous meeting of the MPC, the rand has appreciated by over 3 per cent against the US dollar and is more or less unchanged on a trade-weighted basis. This has been despite lower domestic interest rates and the higher pace of reserve accumulation in the past two months. In October the Bank acquired the proceeds of the foreign purchase of Didata, which were in excess of US$ 2 billion. The recent observed volatility in the bilateral rand exchange rates has been mainly as a result of the volatility in the euro/dollar exchange rate. From a policy perspective, focus is maintained on the trade-weighted exchange rate.

The domestic growth outlook remains subdued and below-trend growth is expected to persist. The forecast of the Bank is relatively unchanged since the previous meeting of the MPC, with GDP growth remaining at 2,8 per cent for 2010 and expected to average 3,3 per cent and 3,6 per cent in 2011 and 2012 respectively. The composite leading business cycle indicator of the Bank has been trending sideways since April, suggesting a possible moderation in the pace of recovery in the months ahead. Private sector gross fixed capital formation is expected to have remained weak in the third quarter of 2010.

The manufacturing sector, in particular the motor vehicle and components sector, was hit particularly hard by industrial action, which contributed to the contraction of manufacturing output in the sector in the third quarter. Year-on-year growth in manufacturing sector output in September measured 1,4 per cent, much lower than market expectations, while output contracted by 1,5 per cent on a quarter-on-quarter basis in the third quarter. This was consistent with the declining manufacturing capacity utilisation in the third quarter, as well as the weakening Kagiso Purchasing Managers Index, which has returned to below the neutral level of 50. The construction and civil engineering sectors are also facing a challenging outlook. By contrast, output growth in the mining sector improved markedly in the third quarter and contributed positively to third-quarter GDP growth. The Rand Merchant Bank (RMB)/BER business confidence index has been increasing, but still reflects negative sentiment overall. As a result of these trends, unemployment in the economy has shown little sign of reversing.

There are indications of recovery in household consumption expenditure in the economy. Retail trade sales decreased by 1,4 per cent on a month-on-month basis in August, but increased by 0,4 per cent in September. On a year-on-year basis, the increase was 6,1 per cent. Although vehicle sales have grown significantly on a year-on-year basis, the short-term trends have moderated somewhat but were likely to have been impacted by the industrial action in this sector. Consumer confidence, as reflected in the FNB/BER consumer confidence index remains relatively high, but was largely unchanged during 2010. Household consumption expenditure is expected to be supported by positive wealth effects as is reflected in higher asset prices and lower interest rates, but constrained by high unemployment and significant household debt levels.

Growth in total loans and advances to the private sector by banks has continued to an increase at a moderate pace, having increased by 4,1 per cent in September. This figure was somewhat inflated by technical factors such as the acquisition of mortgage loan books and a general loan book by banks from non-banks in the past three months. Mortgage advances were again the main contributors to the positive trend, increasing by 4,8 per cent on a year-on-year basis in both August and September. Growth in instalment sale credit and leasing finance turned marginally positive after 17 consecutive months of contraction, while other loans and advances accelerated to a year-on-year growth of 4,5 per cent in September, from 0,4 per cent in August. Credit card advances and bank overdrafts, however, continued to contract.

In the banking sector, impaired advances to gross loans and advances declined marginally to 5,7 per cent in September 2010, having reached a peak of slightly over 6 per cent in November 2009. There is, however, some evidence that the banks are still charging higher spreads above the repurchase rate than was the case before the crisis, which indicates that the recent monetary policy easing has not been fully passed through to new borrowers.

The fiscal policy stance has tightened moderately with the narrowing of the expected deficit before borrowing from the original estimate of 6,5 per cent to a revised estimate of 5,3 per cent for the current fiscal year, representing an estimated structural deficit of 4,1 per cent. The deficits for the coming fiscal years have also been adjusted downwards, and a 3,2 per cent deficit is expected in 2013/14. Most of the adjustment has been due to higher-than-expected revenue collections.

The main risks to the inflation outlook continue to emanate from cost–push factors. These include wage trends and administered prices. Food and petrol prices are also identified as potential longer-term risks.

There are some tentative indications of moderation in wage growth. According to Andrew Levy Employment Publications, the average wage settlement rate amounted to 8,3 per cent in the first nine months of 2010, compared with 9,3 per cent in 2009 as a whole. However the Quarterly Employment Survey of Statistics South Africa indicates that in the second quarter of 2010 the year-on-year average nominal remuneration per worker increased by 15,8 per cent. The unit labour cost increase, which adjusts for productivity increases, amounted to 10,8 per cent, up from 10,3 per cent in the previous quarter.

Global food prices have been affected by adverse weather conditions in a number of regions, but the impact on domestic prices has been counteracted in part by the rand exchange rate trends and the bumper maize crop. The exchange rate has also moderated domestic petrol price increases. Having remained relatively stable in a narrow range for the past few months, the price of Brent crude oil has increased over the past weeks to above the US$80 per barrel level, resulting in a cumulative increase in domestic petrol prices of 25 cents per litre in October and November, and a further increase is likely in December. Global oil prices are, however, expected to be constrained somewhat by slow growth in the advanced economies.

Monetary policy stance

In considering the prevailing conditions and data, it is important to emphasise that the focus, notwithstanding any immediate impact or influence, is on the situation that might exist 12 to 18 months hence. There are significant voices and varied opinions aired in the public domain, all expressing a view on what needs to be done. While it is important to listen and hear what is being said, it is the responsibility of the MPC to determine the path of interest rates without fear or favour. And this is what we will continue to do.

The MPC has taken cognisance of the improved longer-term inflation outlook and assesses the risks to this outlook to be fairly evenly balanced. The domestic economic recovery remains fragile and the adverse global developments make the growth outlook more uncertain. The MPC believes that while monetary policy cannot determine the long-term growth path of the economy, it can impact on cyclical deviations of output from potential output. The view of the MPC is that there is room for further stimulus, given the weakness in the supply side of the economy.

The MPC has accordingly decided to reduce the repurchase rate by 50 basis points to 5,5 per cent per annum with effect from 19 November 2010. This action is viewed to be consistent with the continued attainment of the inflation target. The scope for further downward movement, however, is seen to be limited, given the signs of recovery in household consumption expenditure and credit extension. This will be assessed on an ongoing basis.

Addendum to the Monetary Policy Committee statement of 18 November 2010

The MPC meeting schedule for 2011 is as follows:

18–20 January 2011
22–24 March 2011
10–12 May 2011
19–21 July 2011
20–22 September 2011
8–10 November 2011