Statement of the Monetary Policy Committee

20 January 2011

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

Since the previous meeting of the Monetary Policy Committee (MPC), there have been more convincing signs that the recovery in the global economy will be sustained. However, growth in the advanced economies is expected to be slow and is subject to a number of downside risks, including the sovereign debt crisis that continues to beset the eurozone. The more promising global growth outlook, as well as the unfavourable weather conditions, has implications for commodity prices, particularly those of food and energy. These pressures are likely to pose an increasing risk to both the global and domestic inflation outlook. Nevertheless, domestic inflation is expected to remain within the target range for the forecast period.

Domestically, the output gap remains negative and gross domestic product (GDP) growth is expected to remain below potential over the next two years. However, there are indications that the outlook for output growth, while hesitant, is somewhat more positive. The recovery in household consumption expenditure appears to be sustained.

The year-on-year inflation rate as measured by the consumer price index (CPI) for all urban areas moderated to 3,5 per cent in December from 3,6 per cent in November 2010. The average inflation rate for 2010 was 4,3 per cent compared with 7,1 per cent in 2009. Food price inflation in December measured 1,4 per cent, unchanged on a month-on-month basis. The main contributor to the inflation outcome remained housing and utilities, primarily electricity, which contributed 1,5 percentage points to the 3,5 per cent outcome. Administered prices excluding petrol increased at a rate of 9,1 per cent in both November and December.

Year-on-year producer price inflation reached a recent peak of 9,4 per cent in June 2010, and has declined moderately since then. In November, the producer price index (PPI) increased by 6,2 per cent, compared with 6,4 per cent the previous month. The impact of the exchange rate on producer prices is still clearly evident, with the prices of imported commodities increasing at a year-on-year rate of 0,5 per cent. Manufactured food prices increased by 0,6 per cent, while agricultural prices declined by 0,3 per cent.

The CPI forecast of the Bank has been revised upwards since the MPC's previous meeting. Nevertheless, the domestic inflation trajectory is still expected to remain within the target range over the entire forecast period to the end of 2012. Inflation is now expected to average 4,6 per cent in 2011 and 5,3 per cent in 2012. The upward adjustment is mainly due to revised assumptions of the international oil price over the forecast period, and we will continue to monitor global inflation trends closely.

The Bank's forecast is similar to the Reuters consensus forecast. In the December survey, the mean forecast of CPI inflation was 4,5 per cent for 2011, 5,4 per cent for 2012 and 5,6 per cent for 2013. These forecasts were slightly higher than those in the November survey. The break-even inflation rates across all maturities also continue to reflect inflation expectations within the target range.

Inflation expectations as reflected in the survey conducted by the Bureau for Economic Research (BER) at Stellenbosch University in the fourth quarter of 2010 continued to trend downwards. For the first time, average expectations for 2011 are within the inflation target band at 5,5 per cent. The expectations of all categories of respondents declined, with both business executives and trade union officials expecting inflation to average 6,0 per cent, while those of the financial analysts declined to 4,5 per cent.

All categories of respondents expect inflation to increase again in 2012 when it is expected to average 6,2 per cent.

The global economic outlook remains uncertain but there appears to be increasing optimism that the recovery, albeit relatively weak, will be sustained. Most forecasts have been revised upwards in recent months but indicate that global growth is expected to be slower in 2011 than in 2010. However, the prospects remain uneven across countries and regions, and a number of risks remain.

Growth in the United States (US) continues to be supported by strong monetary and fiscal intervention, while growth in Japan remains subdued. In the euro area, the recovery is being driven by strong growth in Germany but this is expected to moderate in 2011. In the rest of the euro area, confidence has declined in the wake of the worsening sovereign debt crisis, which remains a major risk to the outlook. Recent co-ordinated measures appear to have stabilised the sovereign debt markets for now, but significant risks remain and a further escalation of the crisis could impact negatively on global growth prospects.

The emerging markets continue to outperform the advanced economies, with strong recoveries in consumption and investment in the major emerging-market economies.

Inflation developments and prospects also appear to reflect the divergent growth trends. Persistent large negative output gaps in the advanced economies have helped to contain inflation pressures, despite rising international oil and food prices. There is still some risk of deflation in the US, although this risk is declining. By contrast, inflation in emerging markets has been increasing, partly as a result of stronger demand pressures but also as a result of the higher weights of energy and food in the consumer price baskets. These trends have resulted in generally tighter monetary policies in emerging markets, but monetary accommodation is expected to persist in most of the major industrialised countries for some time.

The exchange rate of the rand has been relatively volatile since the previous meeting of the MPC, when it was around R7,00 against the US dollar. By early January the rand had appreciated to R6,55, but has since retraced to levels prevailing at the time of the previous meeting. During this period, non-residents became net sellers of rand-denominated bonds as expectations that there would be further interest rate reductions were reversed, but were net buyers of domestic equities.

Factors influencing the exchange rate during this period included developments in the euro/dollar exchange rate, further acceleration in commodity prices and persistent capital flows to emerging markets.

In the absence of general risk aversion, or a tightening of the monetary policy stances in the advanced economies, the rand exchange rate is expected to remain relatively strong. Since the previous meeting of the MPC, the nominal effective exchange rate of the rand depreciated by 0,4 per cent.

During 2010 total direct foreign-exchange reserve accumulation by the Bank and National Treasury amounted to US$7,4 billion, or a spend of just over R53 billion. Despite this, the rand continued to appreciate – 12 per cent against the US dollar during 2010 – and remained strong. Portfolio and foreign direct investment inflows continued, and the net purchases of bonds and equities by non-residents amounted to R89,5 billion in 2010. The Bank will continue to accumulate foreign-exchange reserves as and when possible.

Domestic GDP growth remains subdued, with growth of 2,6 per cent in the third quarter of 2010. Although there are mixed signals about the sustainability of the output recovery, high-frequency data indicate a stronger fourth quarter performance, and forecasts for 2011 have generally been subject to moderate upward revision. The Bank's forecast was also adjusted marginally and growth is now expected to average 3,4 per cent in 2011. The forecast for 2012 is unchanged at 3,6 per cent. The composite leading business cycle indicator of the Bank has been relatively flat in the past few months and declined moderately in October, reflecting the uneven growth prospects.

Gross domestic fixed capital formation is still subdued, having increased by 0,9 per cent in the third quarter of 2010. This rate of investment growth remains too low to impact meaningfully on output growth, and is currently primarily dependent on state-owned enterprises' pipeline commitment to infrastructure, while investment in the manufacturing sector is being constrained by low levels of capacity utilisation. The labour market appears to have stabilised in the third quarter when employment levels were more or less unchanged, although unemployment remains stubbornly high at 25,3 per cent.

The recovery in the manufacturing sector remains hesitant. Manufacturing output increased by 4,6 per cent on a year-on-year basis in November, compared with 2,3 per cent in October. Production of motor vehicles, parts and accessories, in particular, including vehicle exports which increased by 52,8 per cent quarter-on-quarter in the final quarter of 2010, have exhibited robust growth,.

The Kagiso Purchasing Managers Index (PMI) confirms the uncertain outlook. Following a strong improvement in the index in November to a level in excess of the neutral level of 50, it declined again in December, although still indicating an expansion of the sector. The mining sector has also been improving and grew at a year-on-year rate of 9,6 per cent in November. The Rand Merchant Bank (RMB)/BER Business Confidence Indicator remained relatively unchanged throughout 2010, but with a negative outlook.

The recovery in domestic consumption expenditure appears to be sustained. Real final consumption expenditure by households increased at an annualised rate of 5,9 per cent in the third quarter of 2010. Strong expenditure growth was observed in all components of consumption. Real retail trade sales increased at a year-on-year rate of 7,8 per cent in November 2010. New vehicle sales also continued their strong performance, having increased by almost 30 per cent in December. Consumer confidence as reflected in the First National Bank (FNB)/BER Consumer Confidence Index has been at a relatively high level during the past year.

Credit extension maintained its moderate upward trend during 2010. Total loans and advances to the private sector increased by 4,4 per cent in November. Growth over 12 months in mortgage advances has fluctuated around 4,8 per cent since August 2010, reflecting a loss of momentum in the real-estate market. House prices increased somewhat in the first half of 2010, but since then the rate of increase has declined, with some house price indexes indicating that prices have been falling.

Growth in instalment sale and leasing finance, and other loans and advances maintained a positive trend. Within the latter category, growth in credit card advances was positive for the first time since the end of 2008. Bank overdrafts were the only major category that continued to contract, although at a slower rate. Household debt remains high at 78,5 per cent of disposable income.

However, lower interest rates have reduced the ratio of debt-service costs to disposable income to 7,8 per cent, compared with 12,6 per cent in the third quarter of 2008.

Expenditure has been positively affected by growth in real disposable income, lower interest rates and some favourable wealth effects. Share prices on the JSE Limited have reached levels in line with the peaks reached before the onset of the global financial crisis. In 2010 the all-share index increased by 16,1 per cent.

Risks to the inflation outlook emanating from global commodity price increases have become more evident. These risks relate mainly to oil and food price developments. Having fluctuated in the range of US$70–US$80 per barrel for much of 2010, the price of Brent crude oil began to increase in late November and is currently at around US$98 per barrel. The surge in oil prices is due in part to stronger global oil demand and the exceptionally cold weather in the northern hemisphere. These price trends were also affected by US dollar developments, particularly following the announcement of additional quantitative easing by the US Federal Reserve in November.

The domestic petrol price, which has been cushioned, to some extent, by exchange rate developments, has increased by 66 cents per litre since September 2010, and by 11 per cent over the past year.

Since September, the rand exchange rate has offset the petrol price increase by a cumulative 45 cents per litre.

Global food prices have also continued to increase, driven by tight food supplies, changing weather patterns and rising demand in emerging-market economies. To date South Africa has been shielded, to some degree, from these increases by the exchange rate and the bumper maize crop. Domestic maize prices have been increasing since the middle of 2010, but in January 2011 were still about 11 per cent lower than a year ago. By contrast, South Africa is a net importer of wheat, which has increased in price by almost 40 per cent over the past year. Although producer price developments suggest that domestic food price inflation will remain low in the short term, these global developments, unless reversed, will inevitably impact on consumer food price inflation.

Administered prices and wage settlements remain upside risks to the inflation outlook. Although wage increases have moderated slightly over the past months, they are still significantly in excess of the current and expected inflation outcomes. According to Statistics South Africa, the year-on-year rate of increase in average nominal remuneration per worker in the formal non-agricultural sector declined from 15,8 per cent in the second quarter of 2010 to 12,6 per cent in the third quarter. Once labour productivity developments are accounted for, unit labour cost increases amounted to 10,9 per cent and 9,3 per cent in these two quarters respectively. According to Andrew Levy Employment Publications, the average wage settlement in the first nine months of 2010 amounted to 8,3 per cent compared with 9,3 per cent in 2009.

The current level of the repurchase rate is at its lowest level in nominal terms in over 30 years, while the real interest rate is at a level below 1 per cent. This has helped with the recovery in consumption expenditure and should also stimulate domestic investment and growth by reducing the cost of borrowing. However, low interest rates on their own cannot ensure sustainably higher long-run trend growth and employment creation.

The MPC has taken note of the improving growth outlook for the economy, and is of the view that the recovery in domestic consumption expenditure will be sustained. While there are increasing risks to the inflation outlook, they emanate primarily from external cost–push factors, and inflation is expected to remain within the target range until the end of the forecast period.

The MPC has therefore decided to keep the repurchase rate unchanged at 5,5 per cent per annum. At this stage there are no signs of incipient excess demand in the economy, and unless there are significant unexpected changes in the global or domestic outlook, the monetary policy stance is expected to remain relatively stable for some time. The MPC will continue to monitor developments closely and stands ready to act should the need arise.

Statistical tables