Statement of the Monetary Policy Committee

12 May 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 MPC, the inflation outlook has deteriorated further, mainly as a result of external cost–push factors. Underlying demand conditions remain relatively restrained, and are not seen to pose a significant risk to the inflation outlook at this stage. However, there are elevated risks that these external price shocks could ultimately feed through to more generalised inflation.

The domestic economic recovery has been sustained, although still at relatively moderate rates, and there are no signs of a significant increase in employment. Moreover, the international outlook remains uncertain, and the economic recovery has become more hesitant in the past weeks, in the wake of renewed concerns about peripheral Europe, the earthquake in Japan and higher commodity prices.

The year-on-year inflation rate as measured by the consumer price index (CPI) for all urban areas increased to a higher-than-expected level of 4,1 per cent in March 2011, from 3,7 per cent in February. The main contributions to the inflation outcome came from food, housing and utilities, and transport which, together, accounted for 2,9 percentage points. Food price inflation increased markedly to a year-on-year rate of 5,1 per cent from 3,5 per cent in February, while petrol and electricity prices increased at rates of 16,9 per cent and 19,3 per cent respectively. Administered price inflation excluding petrol remained unchanged at 9,1 per cent. Underlying inflation pressures remained relatively stable, and in February and March CPI inflation excluding food and petrol measured 3,4 per cent; the lowest rate since September 2006.

Year-on-year producer price inflation reversed its recent downward trend and measured 6,7 per cent and 7,3 per cent in February and March respectively. Electricity, mining and quarrying, and products of petroleum and coal were the main contributors to this upward trend. In contrast to developments at the CPI level, food price pressures remained relatively subdued in February and March. Agricultural and manufactured food prices increased by 2,7 per cent and 2,9 per cent respectively in March.

Since the previous meeting of the MPC, there has been a further upward revision to the Bank's CPI forecast. Inflation is now expected to reach the upper limit of the inflation target range during the final quarter of 2011 and to peak at 6,3 per cent in the first quarter of 2012, before returning to within the target range by the second quarter of 2012 and remaining close to the upper limit of the range for the rest of that year. Inflation is expected to average 5,1 per cent in 2011 and 6,0 per cent in 2012, compared with averages of 4,7 per cent and 5,7 per cent forecast at the time of the previous meeting. The upward adjustment is mainly due to revised assumptions regarding administered price increases over the forecast period.

The survey of market analysts conducted by Reuters also reflects a further upward adjustment in the inflation forecasts. In the April survey the mean forecast of CPI inflation measured 5,0 per cent for 2011, and 5,8 per cent for 2012; up from 4,8 per cent and 5,7 per cent respectively in the March survey. Expectations for 2013 were unchanged at 5,7 per cent. The break-even inflation rates, as reflected in the yield differential between conventional government bonds and inflation-linked bonds have also exhibited an upward trend.

The global economic environment continues to be characterised by uneven recoveries within and across regions. Growth prospects in a number of the advanced economies, including the United States (US), the United Kingdom and some European economies remain uncertain in the face of the need for fiscal consolidation and risks posed by higher commodity prices, which have the potential to destabilise inflation and growth. Unemployment has also remained persistently high in a number of industrialised countries, notably in the US and Spain. Spending in Europe, in particular, has been constrained in part by the undercapitalisation of a significant portion of the banking sector. There are heightened concerns about the ability of some of the peripheral European countries, particularly Greece, Ireland and Portugal, to meet their debt obligations and this poses a systemic risk to the region. Lower growth in Japan and the disruption to the global supply chain caused by the earthquake and its aftermath are also likely to impact negatively on near-term global growth prospects.

By contrast, growth in emerging markets has generally remained strong, with evidence of overheating in some countries, particularly in Asia and Latin America.

Global headline inflation has increased, driven primarily by higher food and other commodity prices, particularly oil. In advanced economies core inflation appears to be generally subdued against the backdrop of persistent output gaps. However, in a number of emerging market economies, supply-side pressures have been accompanied by strong aggregate demand pressures and above-trend growth, resulting in a generally tighter monetary policy environment.

Since the MPC's previous meeting, the exchange rate of the rand against the US dollar has been relatively volatile. During this period, the rand fluctuated in a range of R6,95 and R6,54 against the US dollar, and on a trade-weighted basis the rand depreciated by 0,9 per cent. These developments were affected to a significant extent by the depreciation of the US dollar against other currencies, driven in part by the expected continuation of the accommodative stance of monetary policy in the US. The relatively strong rand exchange rate persisted despite continued purchases of foreign exchange by the Bank.

Other factors underpinning rand strength during this period included strong commodity prices, the narrower current-account deficit and a resumption of portfolio flows to South Africa. Since the beginning of April, non-residents have purchased around R27,1 billion worth of domestic bonds and equities, and net purchases year to date stand at R14,5 billion. This marked a reversal of the negative trend in portfolio capital flows experienced by South Africa and some other emerging markets since the final quarter of 2010.

Domestic economic growth is lower than that of our emerging-market peers. The Bank's forecast for economic growth is 3,6 per cent (previously 3,7 per cent) and 3,9 per cent for 2011 and 2012 respectively. The composite leading business cycle indicator of the Bank is suggestive of the continued recovery in the economy. Manufacturing sector output growth has improved somewhat against the backdrop of positive business confidence. In March the year-on-year increase in the physical volume of manufacturing output measured 4,6 per cent, compared with 5,7 per cent in February. On a three-month on three-month basis, the increase was 4,0 per cent.

Consistent with this recovery, the Kagiso Purchasing Managers Index has remained above the neutral level since November 2010, although the positive trajectory seen in the past few months was reversed marginally in April. Despite these positive developments, the level of output remains below that attained before the global crisis and the sector remains characterised by underutilised capacity. The utilisation of production capacity measured 79,4 per cent in February 2011, compared with 81,6 per cent in November 2010 and 78,4 per cent in February 2010.

Mining output has been more subdued in the past months. Mining production declined by 1,4 per cent on a year-on-year basis in March, but when comparing the three months to March with the preceding three months, an increase of 0,4 per cent was recorded. The construction sector also remains under pressure, with the real value of building plans passed declining by 18,2 per cent on a month-to-month basis in February, and by 13,1 per cent on a year-on-year basis. The First National Bank (FNB) Civil Construction Index continued the downward trend that has been evident since 2008.

The positive momentum observed in the past few quarters in the growth in household consumption expenditure appears to have been sustained. However, these levels are not giving rise to any obvious inflationary pressures and there are tentative signs that this momentum may be levelling off. Year-on-year real retail sales growth moderated from 6,3 per cent in January to 5,6 per cent in February. On a month-on-month basis, real retail sales declined by 1,0 per cent in February, but increased by 2,2 per cent when comparing the three months to February 2011 with the previous three months. Year-on-year growth in new vehicle sales declined to 8,0 per cent in April, from

22,8 per cent in March. This slowdown has been ascribed to the high number of public holidays in that month and to the impact of the disaster in Japan on the sector.

Growth in credit extension to the private sector remains relatively subdued. The twelve-month growth rate of total loans and advances to the private sector measured 5,3 per cent in March, but annualised growth in the first quarter of 2011 declined to 4,5 per cent, from 5,4 per cent in the previous quarter. Growth was driven mainly by other loans and advances, particularly general loans, and by a recovery in instalment sale and leasing finance, reflecting strong motor vehicle sales. Twelve-month growth in mortgage advances declined from a recent high of 4,8 per cent in November 2010 to 2,9 per cent in March 2011, consistent with the continued weakness in the housing market.

Credit extended to the corporate sector increased at a year-on-year rate of 2,3 per in March 2011, compared with 1,3 per cent in January, amid tentative indications that banks may have relaxed their risk premiums somewhat. Demand for credit by the household sector remains constrained by high debt levels and the high number of consumers with impaired debt records. The ratio of impaired advances to gross loans and advances has remained at around 5,8 per cent since December 2010, mainly attributable to retail debt. The fact that this ratio has not declined further over the past six months is cause for concern.

According to the Quarterly Labour Force Survey published by Statistics South Africa, the unemployment rate in the first quarter of 2011 stood at 25,0 per cent, marginally lower than the 25,2 per cent measured in the first quarter of 2010. Despite the unfavourable employment environment, wage settlements and unit labour cost increases remain at levels in excess of inflation. According to Andrew Levy Employment Publications, the overall average wage settlement rate in collective bargaining agreements amounted to 8,2 per cent in the first quarter of 2011. Unit labour costs increased by 7,7 per cent in the fourth quarter of 2010, with labour productivity growth declining from 3,1 per cent in the third quarter to 2,2 per cent in the fourth quarter.

The main risks to the inflation outlook continue to emanate from cost–push pressures, including administered prices. The acceleration in food price inflation is expected to persist for some time, despite indications that global food price inflation may have peaked.

The international oil price has also displayed a marked degree of volatility in the past week, when prices fell by as much as US$13 in one day. Having risen sharply over recent weeks, the price of oil reached a peak of around US$126 per barrel. The price of Brent crude oil today, 12 May, has fallen and is about US$3 per barrel lower than that prevailing at the time of the previous MPC meeting. While international oil prices are not expected to decline further in the near term, it is unclear if prices will consolidate at current levels, or if they will continue on their upward path. In the past two months the domestic petrol price has increased by 8,8 per cent, and by 17,4 per cent since the beginning of the year.

The MPC continues to be of the view that the underlying inflation pressures are mainly of a cost–push nature. These developments are expected to result in a temporary breach of the upper limit of the target band during the first quarter of 2012. It is recognised that these pressures have the real potential to generate second-round effects, which can result in more generalised inflation.

In the light of the above, the MPC has decided to keep the repurchase rate unchanged at 5,5 per cent per annum, for the time being. Given the upside risks to the inflation outlook, the MPC will monitor closely any indications of second-round effects on inflation emanating from these cost pressures. The MPC will not hesitate to respond in a timely manner to signs that threaten to move inflation out of the target range on a sustained basis. In addition, the MPC will remain vigilant with respect to any inflation risks that could emanate from domestic demand developments.