Statement of the Monetary Policy Committee

24 March 2011

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

The domestic growth prognosis has improved, and the recovery is expected to be sustained, although not at rates sufficient to make appreciable inroads into the unemployment situation in South Africa. Household consumption expenditure has been the main driver of growth, whereas growth in fixed capital formation has remained weak. At this stage, there are no discernible inflationary pressures coming from the demand side of the economy.

The global recovery appears to have remained on track, but the unresolved European sovereign debt crisis, rising international oil prices, partly a result of geo-political events, and the tragic events in Japan may moderate the pace of recovery in the near term. Global inflation risks have also increased, particularly in emerging-market economies, a number of which have tightened their monetary policy stances in recent months.

The year-on-year inflation rate as measured by the consumer price index (CPI) for all urban areas measured 3,7 per cent in January and February. Food price inflation, while still low, has been increasing. In February it measured 3,5 per cent and contributed 0,6 percentage points to the overall inflation outcome. On a month-on-month basis, food prices declined by 0,1 per cent. Housing and utilities, primarily electricity, contributed 1,5 percentage points to the outcome. Petrol prices increased at a year-on-year rate of 12,3 per cent, while administered prices excluding petrol increased by 9,1 per cent. CPI inflation excluding administered prices was unchanged at 2,7 per cent, while CPI inflation excluding food and petrol measured 3,4 per cent.

Year-on-year producer price inflation continued its recent downward trend in January when it measured 5,5 per cent, compared with 5,8 per cent in December 2010. Food price pressures remained relatively subdued in January despite marked increases in global food prices. Manufactured food and agricultural prices increased by 1,5 per cent and 0,5 per cent respectively. This suggests that food price increases at the consumer price level may be moderated in the near term.

The trajectory of the Bank's CPI forecast has changed somewhat since the MPC's previous meeting. Nevertheless, inflation is still expected to remain within the target range over the entire forecast period. Inflation is now expected to average 4,7 per cent in 2011 and 5,7 per cent in 2012. This represents an upward adjustment of approximately half a percentage point in 2012. Inflation is expected to peak at 5,8 per cent in the first quarter of 2012 before declining to 5,6 per cent in the fourth quarter. The upward adjustment is mainly due to revised assumptions regarding the international oil price over the forecast period.

The survey conducted by Reuters also reflects a moderate upward adjustment in the inflation forecasts. In the February survey the mean forecast of CPI inflation increased by 0,2 percentage points to 4,7 for 2011, and by 0,4 percentage points to 6,0 per cent for 2012. Inflation expectations for 2013 remained more or less unchanged at around 5,7 per cent. Break-even inflation rates have increased to above the 6 per cent level over the longer-term maturities.

Inflation expectations as reflected in the survey conducted by the Bureau for Economic Research (BER) at Stellenbosch University in the first quarter of 2011 also indicate a slight deterioration in financial analysts' expectations. However, there was some improvement in the expectations of business executives and trade unionists. Inflation is now expected to average 5,3 per cent in 2011 and 5,7 per cent in 2012, compared with 5,5 per cent and 6,2 per cent in the previous survey. Inflation is expected to average 6,0 per cent in 2013. While all categories of respondents expect inflation to remain within the target range in 2011 and 2012, business and trade union expectations average 6,2 per cent in 2013, compared with 5,6 per cent for financial analysts.

The global economic recovery, although uneven, is expected to continue, led by a strong performance in global manufacturing. However, significant downside risks remain, due to the confluence of shocks that have the potential to stall the nascent recovery. These shocks include higher international oil prices, driven in part by events in the Middle East and North Africa, and the recent disasters in Japan, which could have a negative impact on the global manufacturing supply chain. The sovereign debt crisis in the euro area remains a concern, with credit default swap (CDS) spreads signalling increased risks of sovereign debt defaults. The United States' (US) outlook appears favourable, but the weak housing market and the ability of the economy to sustain growth once the fiscal stimuli dissipate during the year are some of the risks that persist.

Growth in emerging markets remains robust, but Asian economies in particular may be negatively impacted by the recent developments in Japan. The global growth outlook may also be dependent on the extent to which the authorities in China manage to slow their economy down.

The global inflation outlook has also deteriorated somewhat in the face of higher oil and food prices, although in some of the advanced economies there is a marked divergence between core and headline inflation. This reflects the relatively weak underlying demand conditions, and the generally accommodative monetary policies in these countries. In the faster-growing emerging markets, inflation pressures are more pronounced and monetary policy tightening has become more widespread.

The strong capital inflows to emerging markets that were a feature of most of 2010 have slowed down and in some instances reversed. South Africa has also experienced net sales of bonds since November, and in the year to date, net sales of bonds and equities by non-residents have amounted to R19,2 billion. Despite these net sales and the continued purchase of foreign exchange by the Bank, the rand exchange rate has remained firm but volatile.

The rand exchange rate has remained relatively unchanged since the previous meeting of the MPC, but has fluctuated between R6,80 and R7,33 per US dollar during this period. Part of the recent strength of the rand can be ascribed to US dollar weakness. During this period, the US dollar depreciated by almost 5 per cent against the euro, despite rating downgrades in a number of euro area countries. Since the previous meeting, the rand has depreciated by over 3,0 per cent against the euro and by about 1,0 per cent on a trade-weighted basis.

Domestic growth prospects appear to have improved moderately. Real gross domestic product (GDP) grew by 2,8 per cent in 2010, and at an annualised rate of 4,4 per cent in the fourth quarter. The Bank's forecast has increased somewhat since the previous MPC meeting, with GDP growth now expected to average 3,7 per cent and 3,9 per cent in 2011 and 2012 respectively. These growth rates, while an improvement, are still too low to have a significant impact on the unemployment rate, which measured 24,0 per cent in the fourth quarter of 2010. According to Statistics South Africa, formal non-agricultural employment increased by approximately 65 000 jobs in that quarter. The more favourable growth performance was driven mainly by the mining and manufacturing sectors.

A number of high-frequency indicators suggest that the growth momentum will be sustained. The composite leading business cycle indicator has maintained its positive trend, and the Kagiso/BER Purchasing Managers Index has remained above the neutral level since November 2010, suggesting a favourable outlook for the manufacturing sector. The physical volume of manufacturing production increased at a moderate year-on-year rate of 1,3 per cent in January, but the three-month-on-three-month rate increased by 2,8 per cent. However, output levels are still below those achieved before the crisis and the sector remains characterised by underutilised capacity. The utilisation of production capacity increased from 79,2 per cent in the third quarter of 2010 to 80,7 per cent in the fourth quarter compared with a pre-crisis average of around 85 per cent.

Output in the mining sector has maintained its general upward trend, notwithstanding the 1,9 per cent month-on-month decline in January. Reflecting these developments, the Rand Merchant Bank/BER business confidence index increased significantly in the first quarter of 2011 to reach a level above neutral for the first time in three years. The building sector was the only sector in which negative sentiment was recorded. This is consistent with the quarter-on-quarter decline in the real value of new building plans passed in the fourth quarter of 2010, and the persistently low level of the First National Bank (FNB) civil construction index.

Domestic growth prospects will also be dependent on developments in gross fixed capital formation, which declined by 3,7 per cent in 2010 and made a negative contribution to GDP in that year. In the fourth quarter of 2010 an annualised increase of 1,5 per cent was recorded. Capital expenditure by public corporations increased by 3,3 per cent in the fourth quarter of 2010, while private-sector investment, which declined by 4,4 per cent over the year, grew at an annualised rate of 1,6 per cent in the same quarter.

The relatively weak capital expenditure growth contributed to the decline in imports which, along with improved commodity prices, allowed for a marked decline in the deficit on the current account of the balance of payments to 0,6 per cent of GDP in the fourth quarter of 2010. However, should capital expenditure pick up, as envisaged by the public corporations, the current-account deficit is likely to widen.

Real final consumption expenditure by households increased by 5,1 per cent in the final quarter of 2010, indicative of continued positive consumer sentiment and positive disposable income growth. This category of expenditure made the largest contribution – 2,8 percentage points – to growth in GDP during the year. There are indications that although consumption expenditure growth will remain relatively robust, it is unlikely to accelerate to excessive levels in the short term.

The FNB/BER consumer confidence index declined in the first quarter of 2011, but still remains at a relatively high level. This was consistent with the decline in confidence, albeit from high levels, evident among retailers in the business confidence index, and the retail trade sales growth in January, which was below market expectations. Expenditure on durable goods, in particular new motor vehicles, has been strong.

Consumption expenditure is expected to be constrained to some extent by the continued high levels of household indebtedness, which declined marginally to 77,6 per cent of disposable income in the fourth quarter, and the further increase in the number of consumers with impaired credit records since the implementation of the National Credit Act. Banks' ratio of impaired advances to gross loans and advances has remained relatively unchanged at around 5,8 per cent for some time.

Bank credit extension to the private sector has remained subdued. Total loans and advances by banks to the private sector have been growing at an annual rate of around 4 per cent since September 2010, driven largely by mortgage loans and general loans, mainly to the household sector. Growth in mortgage advances, however, declined from 4,8 per cent in November 2010, to 3,8 per cent in January 2011, reflecting the subdued state of the property market.

The various house price indices all indicate that house prices are either falling or increasing at very low nominal rates. This, combined with the recent decline in equity prices, may contribute to a moderation of the impact of wealth effects on consumption.

The recent national government budget tabled before parliament indicates a moderately looser fiscal policy stance through a slower pace of fiscal deficit reduction compared with that in the October 2010 Medium Term Budget Policy Statement (MTBPS). The fiscal deficit is now estimated to decline to 3,8 per cent of GDP by the 2013/14 fiscal year compared with 3,2 per cent in the MTBPS. The government debt-to-GDP ratio is expected to peak at 43,1 per cent in 2013/14, which is much lower than the internationally acceptable norm of around 60 per cent.

High real wage settlements have been a significant upside risk to the inflation outlook. However, there are indications that nominal wage settlement rates may be moderating. According to Andrew Levy Employment Publications, the overall average wage settlement rate in collective bargaining agreements amounted to 8,2 per cent in 2010, compared with a rate of 9,3 per cent in 2009. Similarly, the downward trend in year-on-year growth in unit labour costs continued into the fourth quarter of 2010 when it measured 7,7 per cent, compared with 9,3 per cent in the previous quarter. This positive trend, if continued, may contribute meaningfully to attaining an environment of low inflation and employment creation.

The biggest risks to the inflation outlook remain food and administered prices, in particular oil prices. International oil prices had already accelerated in the latter part of 2010 in response to strong global demand and this upward trend has been reinforced by the geopolitical events in the Middle East and North Africa, which have raised concerns about the security of oil supplies. Should these political issues be resolved soon, the underlying demand pressures are likely to still keep oil prices at relatively elevated levels. Since the previous MPC meeting, Brent crude oil prices have increased by almost US$20 per barrel. Domestic petrol prices have increased by just under R1 per litre since January 2011, and a further upward adjustment is expected in April, in addition to the increased fuel levy.

The MPC is of the view that the risks to the inflation outlook are on the upside. However, these risks and underlying pressures are mainly of a cost–push nature. 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 significant upside risks to the inflation outlook, the MPC will closely monitor any indications of second-round effects on inflation emanating from these cost pressures.