Statement of the Monetary Policy Committee

21 July 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), the global economic outlook has deteriorated. Events in the eurozone appear to have entered a new phase, with the focus moving from the peripheral countries to some of the larger economies in the region. The global systemic risks posed by any failure to overcome the sovereign debt crisis are enormous, and are exacerbated by the potential failure to resolve the debt ceiling crisis in the United States (US). These events are taking place against the backdrop of a slowdown in growth in many of the advanced economies.

The domestic economic recovery has continued, but in a hesitant manner. The strong performance of the economy in the first quarter of the year is unlikely to have been repeated in the second quarter, and growth prospects will also be dependent on global developments. Domestic inflation has been increasing in line with expectations, driven mainly by cost-push pressures, but more broad-based pricing pressures are beginning to emerge.

The year-on-year inflation rate as measured by the consumer price index (CPI) for all urban areas increased to 5,0 per cent in June 2011, from 4,6 per cent in May. As was the case in the previous few months, the main contributions to the inflation outcome came from food, housing and utilities, and transport categories which, together, accounted for 3,6 percentage points of the 5,0 per cent outcome in June. Food price inflation continued its marked upward trend, measuring 7,3 per cent in June, from 6,3 per cent in May. Petrol and electricity prices increased at rates of 21,4 per cent and 19,0 per cent respectively in June. Administered price inflation excluding petrol was unchanged in June at 9,3 per cent.

The underlying inflation trends have remained relatively moderate. In May and June CPI excluding food and petrol measured 3,7 per cent and 3,9 per cent respectively, while CPI excluding food, petrol and electricity measured 3,2 per cent and 3,5 per cent in these months.

Year-on-year producer price inflation has displayed some volatility in recent months, partly as a result of commodity price fluctuations. Producer prices increased by 6,6 per cent and 6,9 per cent in April and May respectively, compared with 7,3 per cent in March. Price increases in electricity and products of petroleum and coal were major contributors to the PPI outcome, but there were also significant increases in food prices, which had until recently remained subdued. Agricultural prices increased by 6,8 per cent in May, from 2,1 per cent in April, while manufactured food prices increased at rates of 3,4 per cent and 4,8 per cent in April and May respectively.

The inflation forecast of the Bank has shown a slight near-term deterioration since the previous meeting of the MPC. Inflation is now expected to breach marginally the upper end of the target range in the final quarter of 2011, and to average 6,3 per cent in the first quarter of 2012. Thereafter it is expected to remain at the upper end of the target range for the next two quarters, before declining somewhat in the final quarter of the year. The forecast period has been extended to the end of 2013 and inflation is expected to decline gradually during the year, to measure 5,6 per cent in the final quarter of 2013. The Bank's forecast of core inflation shows a moderately rising trend, peaking at around 5 per cent in the second quarter of 2012.

Inflation expectations for 2011 as reflected in the survey conducted by the Bureau for Economic Research (BER) at Stellenbosch University had been declining for six consecutive quarters, but remained unchanged in the second quarter of 2011. Expectations for 2012 increased marginally, but remained within the target range, and declined for 2013. The average inflation expectation for the three main categories of respondents was 5,3 per cent for 2011 and 5,8 per cent for the next two years.

Inflation expectations as measured by the Reuters survey of financial analysts showed very little change when compared to the forecasts at the time of the previous MPC meeting, with inflation expected to remain, on average, within the upper end of the target range until the end of 2013. Inflation expectations as reflected in the break-even inflation rates of the inflation-linked bonds have moderated slightly since the previous meeting.

The MPC assesses the risks to the global economic environment to be on the downside, and continued weakness in the economies of the US and United Kingdom has extended the likely duration of monetary accommodation, particularly in the face of declining fiscal stimuli.

Risks relating to debt sustainability in peripheral Europe have intensified, with further ratings downgrades to some countries. The focus has also moved beyond the periphery to larger countries such as Spain and Italy. As long as the sovereign debt crisis is unresolved, confidence will not be restored and periodic bouts of risk aversion can be expected to contribute to a high degree of volatility in financial markets. There are concerns that a disorderly write-down of this debt could have systemic implications because of the high exposure of European banks to the debt of these countries.

By contrast, there are encouraging trends in other parts of the world. The reconstruction of the Japanese economy in the wake of the natural disasters has begun to have some positive impact on that country's growth rate. Growth in emerging markets has generally remained strong, and fears of a marked slowdown in Chinese growth have been allayed somewhat by robust second quarter growth performance.

Global inflation has been driven primarily by food and oil price developments. There are, however, some indications that these price pressures may have peaked. Both the International Monetary Fund and Food and Agricultural Organization food price indices have shown a flattening out since the beginning of the year. International oil prices have contributed to, and in turn have also been constrained by, the slowdown in global growth.

The bouts of risk aversion relating to developments in the euro area have impacted on the volatility of the rand exchange rate. Since the previous MPC meeting, the rand has fluctuated within a range of R6,67 and R7,02 against the US dollar. The current level of the rand exchange rate against both the dollar and the euro has remained more or less unchanged since the previous MPC meeting. In recent months the rand has also been affected by a number of actual and expected direct investment transactions, and by net purchases of bonds and equities by non-residents totalling around R32,6 billion since the beginning of May. Net bond purchases by non-residents amounted to R34,1 billion, while net sales of equities amounted to R1,5 billion.

From a macroeconomic perspective, the rand has remained relatively strong despite heightened global risk aversion, and despite continued purchases of foreign exchange by the Bank with the support of National Treasury. Between September 2009 and August 2010, the rand dollar exchange rate fluctuated in the range of around R7,40 to R7,80. Since September of 2010, the rand has generally traded in the range of around R6,60 to R7,00, apart from a short period in early 2011 when it breached the R7,20 level.

The domestic economic recovery remains fragile. Annualised GDP growth in the first quarter of 2011 measured 4,8 per cent, driven primarily by a 14,5 per cent growth in the manufacturing sector. This performance is not expected to be sustained in the second quarter: the monthly data for manufacturing-sector output in April and May suggest that unless there is a major upside surprise in June, the positive contribution of the sector to second quarter growth is likely to be minimal. The Kagiso Purchasing Managers Index, while still indicating positive growth in the sector, has declined for three consecutive months. Some of the slowdown in manufacturing can be ascribed to temporary factors such as the impact of the earthquake in Japan on the global motor industry supply chain. The outlook for the sector will also be influenced by developments in Europe, which is a significant market for South African-manufactured exports. Growth in the physical volume of mining production was weak in April and May.

Growth in gross fixed capital formation improved in the first quarter of 2011 to register an annualised growth rate of 3,1 per cent. This was mainly due to the higher levels of investment by public corporations. Growth in private-sector fixed capital formation, while rising, was still subdued at 2,7 per cent.

Despite the expected growth slowdown in the second quarter, the forecast of the Bank for gross domestic product growth in 2011 and 2012 remains unchanged at 3,7 per cent and 3,9 per cent respectively, while growth in 2013 is expected to average 4,4 per cent. With a potential output growth rate of around 3,5 per cent, the estimates of the Bank show that the output gap, although closing, is still negative at around 2,5 per cent. This is consistent with the fact that the levels of output in both the manufacturing and mining sectors are still below pre-crisis levels, as is the level of capacity utilisation in the manufacturing sector. Business confidence, as reflected in the Rand Merchant Bank/Bureau for Economic Research Business Confidence Index, reversed its positive trend when it declined to below the neutral 50 level in the second quarter of 2011. Confidence in the construction sector remains at an extremely low level, and the real value of new building plans passed declined further in April.

Household consumption expenditure, which grew at an annualised rate of 5,2 per cent in the first quarter of 2011, has been the main driver of the domestic growth recovery. There are indications that this growth may have moderated in the second quarter. The robust growth in real retail sales in April was more than offset in May when a month-on-month decline of 4,7 per cent was measured, while the year-on-year growth rate was zero. New vehicle sales increased by 12,6 per cent year on year, but declined by 4 per cent in the second quarter compared with the previous quarter. The First National Bank/Bureau for Economic Research Consumer Confidence Index increased marginally in the second quarter of 2011, but remains below levels reached in 2010.

The MPC expects household consumption expenditure to be constrained by a number of factors, including subdued credit market conditions, high levels of household debt, negative wealth effects and persistently high rates of unemployment.

Growth in total loans and advances extended by banks to the private sector remain relatively subdued and grew at a year-on-year rate of 5,5 per cent in May, compared with 6,0 per cent in April. Growth in "other loans and advances" , particularly general loans, was the major driver, as growth in mortgage loans – the largest category of loans – was restrained at around 3 per cent, in line with the weak housing market. The subdued state of the credit markets reflects in part the high levels of consumer indebtedness, which measured 77 per cent of personal disposable income in the first quarter of 2011. The ratio of impaired advances to gross loans and advances has remained at elevated levels for some time but declined marginally to 5,73 per cent in May.

Wealth effects have been negatively affected by the subdued housing market. The various house price indices indicate that house prices are falling in real terms, although there appears to be some positive nominal growth. While the JSE Limited is at relatively high levels, it is vulnerable to correction in the event of a significant global slowdown. Although household net wealth to disposable income has recovered somewhat since the recession, it is still below the peak reached in 2007.

Employment trends have been improving slowly. According to the Quarterly Employment Survey of Statistics South Africa, formal non-agricultural employment increased by 2,6 per cent in the first quarter of 2011, compared with the first quarter of 2010. This represented an increase of 212 000 jobs, just over half the number of formal-sector jobs lost during the crisis. The majority of jobs created have been in the public sector and the recovery in employment in the private sector remains slow.

Wage settlement rates have been declining, with Andrew Levy Employment Publications reporting an average overall wage settlement rate in collective bargaining agreements of 7,5 per cent in the first half of 2011, compared with 8,2 per cent in 2010 as a whole. Similarly, nominal unit labour costs, which account for productivity changes, moderated to 5,2 per cent in the first quarter of 2011, from 7,7 per cent in the fourth quarter of 2010. However, given that most of the wage negotiations take place in the second half of the year, and that some of the recent high-profile settlements appear to have reversed the moderating trend, this positive outcome could change. Should these higher trends set a precedent for other wage settlements, this could represent a significant upside risk to the inflation outlook. The high trends in executive remuneration increases are also cause for concern.

Food and oil price developments remain the major risks to the inflation outlook. As noted above, international food prices appear to have levelled out. Domestic food price inflation has lagged global trends, and further increases can be expected in the near term. However, these increases could be constrained should the favourable global developments persist.

The price of Brent crude oil, currently at around US$117 per barrel, is at levels similar to those prevailing at the time of the previous meeting of the MPC. The price has experienced some volatility in recent weeks, particularly following the release of oil stocks by the International Energy Agency in June, when the price declined to US$106 per barrel. Although supply conditions are expected to remain tight, further upside potential is likely to be constrained by the uncertain global growth outlook. These developments allowed for a 31 cent per litre reduction in domestic petrol prices in July, following a 2 cent per litre decline in June. However, an increase is expected in August.

The view of the MPC continues to be that the underlying inflation pressures are mainly of a cost-push nature, notwithstanding signs of a possible moderate increase in underlying inflation. Despite the upside risks posed by cost-push factors, the MPC sees a number of downside risks to the inflation outlook, with the risks being seen to be delicately balanced. These risks include the continued fragile nature of the domestic recovery and risks posed by the ramifications of a possible disorderly debt default in the eurozone.

It is, however, recognised that should there be unexpectedly high inflation outcomes, particularly with respect to underlying inflation trends, this could impact negatively on inflation expectations, which to date appear to be relatively well anchored. For this reason, the MPC is not complacent and will remain vigilant and continue to monitor closely any indications of second-round effects on inflation emanating from these cost pressures and from the changing risk profile of the inflation outlook.

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. The MPC will not hesitate to respond timeously to signs that threaten to move inflation out of the target range on a sustained basis.