Statement of the Monetary Policy Committee

22 September 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 downside risks to the global and domestic growth prospects have increased. Growth in some of the advanced economies has weakened against the backdrop of financial market turbulence, generated in large part by the unresolved European sovereign debt crisis. Although economic growth in emerging markets is expected to continue to outperform that of the advanced economies, these economies are unlikely to emerge unscathed from the challenging environment. Heightened risk aversion has resulted in increased volatility of capital flows globally and a flight from what are perceived to be more risky emerging-market assets. These developments have impacted on the domestic capital and foreign-exchange markets.

Recent data have confirmed the fragile and uneven nature of the domestic economic recovery, and unfavourable forward-looking indicators are consistent with a downward revision of the Bank's economic growth forecast. At the same time, a number of exogenous factors have continued to put upward pressure on domestic inflation. This combination of declining growth and rising inflation poses a challenge to monetary policy going forward, and is a feature being experienced in a number of emerging markets.

The year-on-year inflation rate as measured by the consumer price index (CPI) for all urban areas was unchanged at 5,3 per cent in August 2011. The categories of food, housing and utilities, and transport together accounted for 3,7 percentage points of the August outcome. Although food price inflation moderated from 7,5 per cent in July to 7,3 per cent, further acceleration is expected in the coming months. Administered price inflation excluding petrol declined from 9,3 per cent in July to 8,8 per cent in August. Underlying inflation trends remained relatively well contained with CPI excluding food, petrol and electricity declining from 3,9 per cent in July to 3,8 per cent in August.

Year-on-year producer price inflation followed a strong upward trend, increasing by 7,4 per cent and 8,9 per cent in June and July respectively. Price increases in the categories of mining, electricity, and products of petroleum and coal remained the major contributors to the PPI outcome, but there were also significant contributions from chemical and other manufactures. Food prices continued to trend higher: agricultural prices increased by 5,1 per cent and 6,2 per cent in June and July respectively, while manufactured food prices increased at rates of 5,9 per cent and 6,3 per cent in these months.

The inflation forecast of the Bank has remained more or less unchanged since the previous meeting of the MPC. Inflation is still expected to breach marginally the upper end of the target range in the final quarter of 2011 and to peak in the first quarter of 2012 at around 6,2 per cent before returning to within the target range in the second quarter. Inflation is then expected to decline gradually and to measure 5,5 per cent in the final quarter of 2013. The Bank's forecast of core inflation, which excludes food, petrol and electricity, shows a moderately rising trend, peaking at around 5,1 per cent in the second and third quarters of 2013.

Inflation expectations, as reflected in the survey conducted in the third quarter of 2011 by the Bureau for Economic Research at Stellenbosch University, on average, remain within the target range for the forecast period ending 2013. Inflation is expected to average 5,5 per cent in 2011 and 5,9 per cent in both 2012 and 2013. This represents slight upward adjustments for all three years. While financial analysts and trade union officials expect inflation to remain within the target range over the forecast period, business executives expect average inflation to exceed moderately the upper end of the target range in the coming two years.

Inflation expectations as measured by the Reuters survey of financial analysts also remain fairly stable at the upper end of the target range. According to the survey, inflation is expected to average 5,8 per cent and 5,6 per cent in 2012 and 2013 respectively.

The growth performance in the advanced economies has remained weak. There is a general expectation of even weaker outcomes in the near-term, although it is still unclear if the stalled state that many economies find themselves in will translate into a recession. The International Monetary Fund, in its latest World Economic Outlook, has reduced its forecast for growth in the United States (US) by 1,0 per cent in 2011 and by 0,9 per cent in 2012 to 1,5 per cent and 1,8 per cent respectively. euro area growth has been revised down to 1,6 per cent and 1,1 per cent in these two years. The risks are seen to be on the downside.

This slowdown comes against the backdrop of a deterioration in the sovereign debt crisis in the euro area and the inability of the member countries to reach agreement on a credible and workable solution. Concerns have also spread to the European banking sector, particularly to those banks with exposures to peripheral Europe, resulting in ratings downgrades of a number of French and Italian banks. Growth in the US is also being affected by continued weakness in the housing market and political disagreements on the pace and nature of fiscal consolidation.

Emerging markets are still expected to experience faster growth than the advanced economies, but remain vulnerable to contagion effects from a possible significant slowdown or recession in the advanced economies. In line with the current two-speed global economy, inflation trends are higher in the emerging economies, driven mainly by food and energy prices.

Over the past two years, the extraordinarily low interest rate environment in the advanced economies has resulted in significant capital flows to emerging markets, with consequences for their exchange rates and asset prices. However, the pattern of flows has not been smooth. During bouts of global risk aversion, there has been a tendency for these flows to reverse to so-called safe havens. Risk aversion associated with recent events in the US and Europe has resulted in a high degree of volatility of flows to emerging markets, including South Africa.

Since the beginning of the year, non-residents have been net sellers of equities to the value of R16,9 billion and net buyers of bonds to the value of R44,3 billion. However, since the beginning of September, non-residents were net sellers of both bonds and equities valued at R4,6 billion and R7,6 billion respectively.

These recent outflows, together with increased risk aversion, have contributed to the high degree of volatility observed in the JSE All-share Index, in domestic bond yields and in the exchange rate of the rand. Since the previous meeting of the MPC, the rand has traded in a range against the US dollar of between R6,68 and R8,33 per US dollar, and has depreciated by around 15,6 per cent against the dollar, by 11,0 per cent against the euro and by 12,7 per cent on a trade-weighted basis. Since the beginning of the year the rand has depreciated by 18,6 per cent against the US dollar.

The depreciation of the rand poses a potential upside risk to the inflation outlook. However, the degree of this risk will depend on the extent and persistence of the depreciation trend which, in turn, will be influenced by the duration and intensity of global risk aversion. The rand tends to be more sensitive to changes in global risk perceptions than most of its emerging-market peers. At this stage, the MPC still considers the upside risk to the inflation outlook from this source to be relatively moderate, but rising.

Domestic economic growth remains disappointing, with the negative output gap widening to around 3 per cent in the second quarter of 2011 and gross domestic product (GDP) growing by 1,3 per cent, following the 4,5 per cent increase recorded in the first quarter. Both the primary and secondary sectors contracted in the second quarter, while real value added by the tertiary sector increased only marginally. Widespread industrial action, which continued into the third quarter, contributed to this subdued outcome, and is expected to weigh negatively on third-quarter prospects as well.

Recent high-frequency indicators are also not very favourable. Mining production contracted at a year-on-year rate of 5,1 per cent in July, and by 4,3 per cent on a month-on-month basis. Manufacturing output declined at a month-on-month and year-on-year rate of 6,0 per cent in July, confirming the sharp decline to 44,2 index points observed in the Kagiso/BER Purchasing Managers' Index (PMI) in July. Despite a modest recovery in August to 46,7 index points, the

PMI remained below the neutral 50 level, pointing to a further possible contraction in the sector. The construction sector also remains subdued with both the first First National Bank (FNB) Building Confidence Index and the FNB Civil Construction Index remaining at very low levels, while there was a further decline in the number of building plans passed in the third quarter.

Overall business confidence, as reflected in the Rand Merchant Bank (RMB)/BER Business Confidence Index, has declined for two consecutive quarters, and at 39 index points is well below the neutral level of 50. The Bank has lowered its forecast for average growth in 2011 to 3,2 per cent, down from 3,7 per cent, while the forecast for 2012 has been reduced from 3,9 per cent to 3,6 per cent. The forecast for 2013 remains unchanged at 4,4 per cent. The lower forecast is a result of the lower-than-expected outcome in the second quarter, as well as a downward adjustment to the global growth assumption. The risks to this outlook are seen to be on the downside.

The lower growth trajectory does not bode well for employment creation, which has been relatively muted. According to Statistics South Africa, employment in the formal non-agricultural business sector increased by 0,1 per cent or 5,701 people in this second quarter of 2011. The outcome was, however, negatively affected by the decline in public-sector employment associated with the termination of contracts of temporary employees hired for the municipal elections.

Consistent with the moderation in domestic production, growth in real gross domestic expenditure also declined, from an annualised growth rate of 7,9 per cent in the first quarter of 2011, to 1,3 per cent in the second quarter. A positive development was the further acceleration in the growth of real gross fixed-capital formation, albeit off a low base, from an annualised rate of 2,7 per cent in the first quarter to 4,0 per cent in the second quarter. Nevertheless the ratio of gross fixed capital formation to GDP, at 18,9 per cent, is still well below the peak of 24,6 per cent measured in the fourth quarter of 2008.

Consumption expenditure by households has been the main driver of growth to date. However, in the second quarter of 2011, growth in consumption expenditure moderated to an annualised rate of 3,8 per cent, compared with an increase of 5,2 per cent in the first quarter. Real retail trade sales increased at a year-on-year rate of 2,8 per cent in July, but declined by 0,7 per cent in the three months to July compared with the previous three months. Growth in motor vehicle sales, while still positive, has also declined. Consumption patterns may have been distorted somewhat by the high base effects arising from the 2010 FIFA World Cup™ tournament and a clearer picture should emerge in August. The RMB/BER Consumer Confidence Index has declined for two consecutive quarters, underlying the fragility of the outlook.

Consumption expenditure is expected to remain constrained to some extent by low rates of credit extension and continued debt deleveraging by households. The ratio of household debt to disposable income declined further to 75,9 per cent in the second quarter of 2011 from a peak of 82,0 per cent in the first two quarters of 2008. Twelve-month growth in total loans and advances extended by banks to the private sector has fluctuated around 6 per cent in the three months to July. Mortgage advances, which is the largest category of credit, grew at a year-on-year rate of 2,9 per cent, consistent with the slow pace of recovery in the domestic property market. The main driver of growth in credit extension was the category of other loans and advances, in particular general loans which reflect primarily corporate-sector borrowing. This category grew by almost 15 per cent in the year to end of July.

Nominal wage settlements have continued to moderate somewhat and have been lower than many of the highly publicised initial demands. Nevertheless, wage increases have been well above the upper end of the inflation target range.

The main upside risks to the inflation forecast continue to emanate from administered prices and exogenous factors. Since the previous meeting of the MPC the price of Brent crude oil has fluctuated in a range of around US$104 and US$118 per barrel. The outlook for the oil price will be determined in part by global growth developments, and in particular by the extent to which China is affected by the slowdown. The recent depreciation of the South African rand against the US dollar is likely to contribute to a further increase in the domestic petrol price in October.

Food prices are also expected to maintain their upward momentum for some time. The major global food price indices have remained relatively stable but at elevated levels during the past few months. However, global wheat and maize prices have increased markedly, and have impacted on the domestic prices of these commodities. These increases have been compounded by the weaker exchange rate of the rand. The price of white maize, for example, has increased by over 70 per cent during the past year, but futures prices reflect some expected moderation in the medium term.

The MPC remains of the view that the underlying inflation pressures are mainly of a cost–push nature, and at this stage there is no evidence of significant second-round effects from these increases. Although the inflation trend remains on an upward trajectory, both headline and core inflation forecasts appear to be consistent with the continued attainment of the inflation target over time. Demand-side pressures remain subdued and are expected to be constrained in the short to medium term. Inflation expectations also appear to be relatively well anchored.

However, there have been some changes in the MPC's assessment of the risks to the inflation outlook. The recent volatility in the rand exchange rate has imparted a degree of upside risk to the inflation forecast. Although the rand may not return to the elevated levels reached in the earlier part of 2011, the MPC considers some of the recent volatility to be of a short-term nature, influenced by the vagaries of global risk aversion. Downside risks are seen to come from the heightened risks to global growth and its consequences for the domestic economy. The overall risks to the inflation outlook are assessed to be delicately balanced. The MPC will continue to assess the changing risk profile of the inflation outlook and monitor closely those factors that could push inflation outside the target on a sustained basis.

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 is, however, concerned at the potential impact of the current global turmoil on domestic economic prospects and stands ready to act appropriately should the need arise.