Statement of the Monetary Policy Committee

10 November 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 has been no meaningful progress to resolving the sovereign debt crisis that is engulfing the euro area, with the primary focus now on Italy and Greece. The interlinked nature of the debt crisis and concerns about the banking sector in Europe, coupled with the inability of the advanced economies to generate sustained growth, continues to weigh negatively on the global economic outlook. The heightened uncertainty has had implications for the pattern of global capital flows and exchange rates in emerging markets.

The domestic economic recovery remains hesitant. The relatively weak economy has ensured that demand pressures on inflation are restrained at this stage. Nevertheless exogenous supply-side factors have resulted in a deterioration of the inflation outlook, with a more protracted breach of the inflation target expected in 2012.

The year-on-year inflation rate as measured by the consumer price index (CPI) for all urban areas increased to 5,7 per cent in September 2011, up from 5,3 per cent in August. The categories of food, housing and utilities, and transport together accounted for 4,0 percentage points of the September outcome. Food price inflation accelerated from 7,3 per cent in August to 8,7 per cent. Petrol and electricity prices increased by 26,2 per cent and 17,3 per cent respectively. Administered price inflation, excluding petrol was unchanged at 8,8 per cent. CPI inflation excluding food, petrol and electricity remained unchanged at 3,8 per cent in September.

Year-on-year producer price inflation continued its strong upward trend, increasing by 10,5 per cent in September, from 9,6 per cent in August. These price developments were strongly influenced by global commodity price movements as well as by the depreciation of the rand exchange rate. Price increases in the categories of mining, electricity and products of petroleum and coal, as well as other manufacturers remained the major contributors to the producer price inflation outcome. Food prices also continued their higher trend, with agricultural prices increasing by 10,7 per cent and manufactured food prices by 8,8 per cent in September.

The inflation forecast of the Bank has shown a modest increase since the previous meeting of the MPC. Inflation is expected to breach the upper end of the target range in the final quarter of 2011 and to peak in the first quarter of 2012 at around 6,3 per cent, before declining gradually and returning to within the target range in the final quarter of 2012. Inflation is expected to measure 5,2 per cent in the final quarter of 2013. The Bank's forecast of core inflation, which excludes food, petrol and electricity, continues to show a moderately rising trend, with the peak of around 5,2 per cent expected in the first quarter of 2013.

Market expectations of inflation, as reflected in the Reuters survey of financial analysts, show expectations to be anchored around the upper level of the inflation target range over the medium term. In the October survey inflation was expected to peak at an average of 6,1 per cent in the first quarter of 2012, and to measure 5,4 per cent by the second quarter of 2013. Break-even inflation rates have moderated against most maturities since the previous meeting.

The global growth outlook continues to be characterised by heightened uncertainty, with weak growth and declining consumer confidence in a number of the major advanced economies. The protracted crisis in the euro area has now spread beyond the peripheral countries, despite recent attempts to devise a credible and workable approach to contain the problem. The risks created by these developments are likely to exacerbate the low or negative growth expected in the region, amid increased fiscal austerity, tightened bank lending standards and deleveraging, and tightening conditions in the European interbank markets. Weak growth is also forecast for the United Kingdom and Japan.

On the positive side, fears of a return to recession in the United States (US) have dissipated somewhat with a higher-than-expected growth outcome in the third quarter, driven mainly by a recovery in household consumption expenditure. Although employment increased in the past quarter, the unemployment rate is expected to remain at elevated levels for some time, along with persistent weakness in the housing market.

Growth in many of the emerging markets has moderated during the year. Growth forecasts have generally been revised down, and are sensitive to developments in the advanced economies. China has experienced a policy-induced slowdown, but fears of a possible hard landing have receded somewhat. Significant growth reductions have been experienced in a number of Latin American and emerging European countries.

Headline inflation appears to have peaked in many of the advanced economies, and is expected to moderate in line with declining economic activity and the softer trend in commodity prices. Inflationary pressures remain at elevated levels in many of the major emerging-market economies.

The exchange rate of the South African rand continues to be subject to changes in risk aversion in global financial markets. Since the previous meeting of the MPC, the rand has fluctuated between R7,70 and R8,50 to the US dollar, but has generally traded in a more narrow range of between R7,80 and R8,00. On a trade-weighted basis, the rand has depreciated by around 18,6 per cent since the beginning of the year. Since the last meeting of the MPC the rand has appreciated by 1,0 per cent on a trade-weighted basis and by 1,4 per cent against the US dollar. Although the rand tends to be more volatile than most of its emerging-market peers, the movements of the currency have been in line with other emerging-market and commodity-linked currencies.

The exchange rate has also been influenced to some extent by volatile capital flows. Non-residents have been persistent net sellers of South African equities for most of 2011, with cumulative net sales since the beginning of the year amounting to R16,6 billion. Between April and August, non-residents were net buyers of bonds to the value of R58,4 billion but as the European crisis intensified, net sales of R17,0 billion were recorded in September. In October this trend was reversed somewhat with non-resident net purchases of R9,8 billion. Year to date net purchases of bonds and equities amount to R29,4 billion.

The uncertainty related to the exchange rate imparts an upside risk to the inflation outlook. However, unless the rand continues on a depreciating trend, the impact is likely to be relatively limited and should dissipate in the short to medium term. While the rand is not expected to return to its previous elevated levels, consensus forecasts indicate an expectation of a moderate appreciation from the current levels in the course of 2012. This is largely dependent on global developments.

The slower domestic economic growth in the second quarter of 2011 appears to have continued in the third quarter and the forecast of the Bank has been subject to downward revision. Real GDP growth in 2011 is now expected to average 3,0 per cent, compared with 3,2 per cent in the previous forecast. The growth forecasts for 2012 and 2013 have been revised down to 3,2 per cent and 4,2 per cent from 3,6 per cent and 4,4 per cent respectively. The downward revision is a result of revised assumptions primarily of international commodity prices and global growth.

The composite leading business cycle indicators of the Bank continued the moderate downward trend that began in February. It decreased for the second consecutive month in August, corroborating the expected restrained economic conditions.

There has been some normalisation of manufacturing activity following widespread industrial action in July. The physical volume of manufacturing output increased at a year-on-year rate of 7,7 per cent in September, following the revised 5,9 per cent increase in August. On a quarter-on-quarter basis, a slight contraction of -0,1 per cent was measured in the third quarter. Despite the recent recovery, the Kagiso/BER PMI remained marginally above the neutral 50 level in September and October, in line with subdued global PMIs.

Mining output has continued its overall downward trend, with the physical volume of mining output declining by 5,1 per cent in September on a quarter-on-quarter basis and by 5,4 per cent on a year-on-year basis. The construction sector remains under stress with the FNB/BER civil construction index declining further in the third quarter.

Despite the disappointing growth outcomes, the *Quarterly Labour Force Survey* published by Statistics South Africa indicates that the number of people employed increased by 195 000 in the third quarter of 2011. The prospects for further employment creation are uncertain, given the slowing growth of the domestic economy and the fragile global economic environment.

Growth in consumption expenditure by households is expected to have remained relatively subdued following its moderation in the second quarter of 2011 to 3,8 per cent from 5,2 per cent in the previous quarter. When comparing the three months to August with the previous three months, real retail trade sales increased by 0,7 per cent. The BER Retail Survey for the third quarter of 2011 shows that business confidence among retailers, at a level of 48, remained below the neutral level of 50. These trends reflect, in part, concern about employment, slower wage and income growth, and declining levels of consumer confidence. Other factors expected to constrain consumption expenditure include high levels of household debt, constrained access to credit and consistently above-average increases in a range of administered prices which reduce the amount available for household discretionary expenditure.

Growth in credit extension to the private sector remains lacklustre, reflecting both supply-and-demand considerations. After reaching a recent high of 6,1 per cent in July, 12-month growth in banks' total loans and advances extended to the private sector moderated to 5,3 per cent in September. Twelve-month growth in mortgage advances declined to 1,9 per cent, consistent with the subdued state of the domestic housing market. The main driver of credit extension was the category of other loans and advances, in particular general loans, which grew at a rate over 12 months of 12,9 per cent, down from 17,9 per cent in August. General loans account for 11 per cent of total loans and advances to households. The ratio of impaired advances as a percentage of gross loans and advances of banks has declined to 5,1 per cent in September 2011, down from 5,9 per cent in September 2010, indicating some improvement in the balance sheets of the banks.

According to the *Medium Term Budget Policy Statement (MTBPS)*, fiscal policy is set to be more expansionary than indicated in the main budget in February. Nevertheless the commitment to medium-term deficit consolidation remains. For the current fiscal year, the deficit is expected to increase from 5,3 per cent of GDP to 5,5 per cent, compared with the 4,6 per cent deficit recorded in 2010/11, and is expected to decline to 3,3 per cent of GDP by 2014/15. The wider deficit for the current year is a result of a 0,7 per cent of GDP increase in expenditure, and lower tax revenues of 0,3 per cent of GDP which result from the slower economic growth. The primary deficit is expected to decline from 2,9 per cent of GDP in the current year, to 0,5 per cent in 2014/15. If maintained within the parameters as set out in the *MTBPS*, the fiscal consolidation and debt dynamics should be sustainable.

Food prices continue to pose an upside risk to the inflation outlook, and a further acceleration of food inflation is expected in the near term. This follows the marked food and agricultural price increases at the PPI level, and the depreciation of the exchange rate which has contributed to the increase in maize prices in recent weeks. Global food prices have remained relatively stable over the past months, albeit at high levels, and could signal some relief going forward.

International oil prices have remained relatively stable since the last meeting of the MPC and are expected to remain constrained by the weak growth outlook in the advanced economies. At current prices, Brent crude oil is about US$10 per barrel lower than the peak prevailing earlier in 2011. At present there is a small over-recovery on the domestic petrol price and, if maintained, could provide some relief to consumers following four consecutive months of price increases which has resulted in domestic petrol prices being at their highest levels ever. Other administered prices, particularly electricity, are expected to maintain upside pressure on the inflation rate.

The MPC remains of the view that the underlying inflation pressures are of a cost–push nature and that the subdued state of domestic demand and output will contribute to core inflation remaining contained, notwithstanding the continued pressures from some administered prices. However, the committee is concerned that the change in the profile of the inflation forecasts and the extended breach of the upper end of the inflation target range may impact adversely on inflation expectations. At this stage the breach of the upper limit is still expected to be relatively small and inflation is expected to return to within the target range by the end of 2012.

The committee assesses the risks to the inflation outlook to be on the upside mainly due to cost–push pressures. The exchange rate is also seen to pose some upside risk to the outlook, while downside risks are seen to come from possible contagion effects from the European crisis and associated slow growth. The committee is aware of the dangers of a disorderly resolution of the crisis and the systemic implications for the global and domestic economy, and remains ready to act appropriately should the need arise.

Under the prevailing circumstances the MPC has decided to keep the repurchase rate unchanged at 5,5 per cent per annum.