Statement of the Monetary Policy Committee

19 January 2012

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 outlook for domestic inflation and economic growth has deteriorated, posing a serious challenge for monetary policy going forward. Inflation is now expected to remain above the upper end of the target range for a more extended period, but there is still no evidence of significant demand pressures in the economy. While economic growth in the fourth quarter was likely to have exceeded that in the previous two quarters, the forecast for growth in 2012 has been revised downwards. The primary reason for the worsening domestic growth outlook is the risk of contagion from the persistent crisis in Europe, which shows no sign of a speedy resolution.

The year-on-year inflation rate as measured by the consumer price index (CPI) for all urban areas was 6,1 per cent in December 2011, unchanged from November. The categories of food, housing and utilities, and transport together accounted for 4,4 percentage points of the December outcome. Food price inflation accelerated further to 11,6 per cent, from 11,1 per cent in November, while petrol prices increased by 26,4 per cent. Administered price inflation excluding petrol was unchanged at 8,7 per cent. CPI inflation excluding food, petrol and electricity remained unchanged at 3,9 per cent, indicating relatively benign core inflation outcomes.

Producer price inflation moderated from a year-on-year rate of 10,6 per cent in October 2011 to 10,1 per cent in November. The impact of the depreciated rand exchange rate is evident in the 15,9 per cent increase in the price of imported commodities. Food price inflation remained elevated, with agricultural prices increasing at a year-on-year rate of 12,1 per cent in November, and manufactured food prices increasing by 8,4 per cent.

The inflation forecast of the Bank has been subject to a further upward revision. Inflation is now expected to remain outside the upper end of the target range for the whole of 2012, and to peak in the second quarter of 2012 at around 6,6 per cent before declining gradually and returning to within the target range in the first quarter of 2013. Inflation is expected 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, with the peak of around 5,5 per cent expected in the first two quarters of 2013. The main factor contributing to the upward revision of the forecast is the changed assumption relating to the exchange rate of the rand, which was partly offset by the downward adjustment to the global growth assumption.

Inflation expectations, as reflected in the survey conducted by the Bureau for Economic Research at Stellenbosch University in the fourth quarter of 2011, have increased moderately but have remained relatively anchored around the upper end of the inflation target range. Inflation is expected to average 6,1 per cent in 2012, compared with 5,9 per cent expected in the previous survey. Expectations for 2013 increased from 5,9 per cent to 6,0 per cent. All categories of respondents revised their forecasts moderately upwards for both years, except for business executives whose expectations for inflation in 2013 remained unchanged at 6,3 per cent.

The global outlook remains clouded by the worsening situation in the eurozone, and growth forecasts for the region have generally been revised down amid widespread sovereign ratings downgrades. It is now generally accepted that the eurozone is likely to experience a recession in 2012, but the extent and duration is still uncertain. The increasingly fragile sentiment is exacerbated by the lack of resolution of the sovereign debt crisis and the consequent increase in sovereign debt yields; further fiscal austerity measures in the region; and the impact on the real economy of higher capital requirements for banks and consequent bank deleveraging. Tightened lending standards have also had cross-border implications for a number of emerging-market economies, particularly in Eastern Europe and Latin America.

Although the OECD leading indicators and global PMIs are trending downwards, the economic growth outcomes in Japan and the United States have been more favourable than was the case in mid-2011. The unemployment rate in the US has declined, and both consumption and investment expenditure have shown some signs of recovery, although downside risks from fiscal consolidation and the continued weakness in the housing market remain.

Growth in emerging-market and developing countries, while still relatively favourable, is also expected to moderate somewhat, in part due to contagion effects from the European crisis as well as policies that have been aimed at curbing domestic demand pressures. Economic growth in China is also expected to slow, but a hard landing is not anticipated. Sub-Saharan Africa, which has become an increasingly important destination for South African exports, is expected to continue to grow at a rate in excess of 5 per cent.

Global inflation appears to be moderating, as weaker demand has contributed to declines in food and commodity prices. Oil prices, however, have been underpinned by risks to supply due to geopolitical factors.

The rand exchange rate has continued to display a relatively high degree of volatility in response to erratic changes in global risk aversion. Since the previous meeting of the MPC the rand has traded in a range of between R7,93 and R8,60 to the US dollar, but for the past month the range has generally been between R8,00 and R8,20 . Since the previous meeting, the rand has remained more or less unchanged against the dollar, and appreciated by about 6 per cent per cent against the euro, reflecting the influence of the euro/dollar exchange rate on the domestic currency. On a trade-weighted basis, the rand appreciated by almost 3 per cent over the same period.

South Africa's experience with portfolio capital flows during 2011 was similar to the general emerging-market experience of slowing bond inflows and net equity outflows. For the year as a whole non-resident purchases of bonds amounted to R42 billion, while net sales of equities to the value of R17 billion were recorded.

The outlook for the rand exchange rate remains highly dependent on global risk appetite. While the rand remains vulnerable to global developments, it has been relatively stable in the past few weeks, and consensus forecasts reflect an expectation that the current levels will be sustained for a protracted period. But this is significantly dependent on global sentiment and developments.

The outlook for domestic economic growth remains subdued. According to the Bank's forecast, the annual real growth rate in 2011 is estimated to have been in the region of 3,1 per cent, but the outlook for 2012 and 2013 has deteriorated relative to the previous forecast, mainly due to a downward revision to the global growth assumption. Growth in 2012 is expected to average 2,8 per cent compared with 3,2 per cent in the previous forecast, while the forecast for growth in 2013 has been revised down from 4,2 per cent to 3,8 per cent. This implies a further expected widening of the output gap during this period.

Despite the less favourable outlook, some improvement is expected in the mining and manufacturing sectors, which both contracted in the second and third quarters of 2011. Although mining output contracted further in October, it rebounded on a month-on-month basis in November, but the change in the three months to November compared to the previous three months showed a contraction of 0,7 per cent. The manufacturing sector experienced positive growth in October and November, with the physical volume of manufacturing output increasing at a three-month-on-three-month rate of 2,6 per cent. Nevertheless, the sector is expected to remain under pressure. Following four consecutive months of increases, the Kagiso PMI declined to below the neutral 50 level to 49,4 in December.

The construction sector also remains subdued, notwithstanding an increase in the real value of building plans passed in November, and a slight increase in the First National Bank (FNB) Building Confidence Index in the fourth quarter. On the positive side, the sector could benefit from the continued but slow improvement in the growth of gross fixed capital formation which increased at an annualised rate of 5,6 per cent in the third quarter of 2011. According to the

Rand Merchant Bank (RMB)/BER Business Confidence Index, business confidence remains relatively low, having declined marginally in the fourth quarter of 2011.

Despite the weak economic performance in the third quarter, employment growth surprised on the upside. According to the *Quarterly Employment Survey* of Statistics South Africa (Stats SA), formal non-agricultural employment increased by 47 300 in the quarter and by 207 000 year on year, with the bulk of the increases in the second and third quarters coming from the private sector. This trend is consistent with that observed in the *Quarterly Labour Force Survey*. However, the employment losses suffered during the recession have still not been recovered and future employment prospects remain uncertain given the fragile economic outlook.

Growth in consumption expenditure by households continues to be the main driver of growth in the economy but growth rates remain moderate and are not expected to pose a risk to inflation. Real final consumption expenditure by households increased at an annualised rate of 3,7 per cent in the third quarter of 2011, up from 3,3 per cent in the previous quarter, but lower than the levels recorded in previous quarters. Real retail sales grew at a year-on-year rate of 6,8 per cent in November, while on a three-month-to-three-month basis growth of 3,1 per cent was recorded. According to the FNB/BER Consumer Confidence Index, consumer confidence increased marginally in the fourth quarter of 2011.

Consumption expenditure continues to be constrained by relatively tight lending standards by banks, high levels of household debt and consistently above-average increases in a range of administered prices which reduce the amount available for household discretionary expenditure.

The gradual deleveraging by households has continued, with the ratio of household debt to disposable income declining further from 75,8 per cent in the second quarter of 2011 to 75,0 per cent in the third quarter, compared with a peak of 82,3 per cent in 2009. The decline in the ratio, however, reflects the fact that disposable income is increasing at a faster rate than debt accumulation.

Trends in credit extension have remained subdued and more or less unchanged since the previous meeting of the MPC, with year-on-year growth in banks' loans and advances to the private sector measuring 6,0 per cent in both October and November. Mortgage advances remained relatively depressed in line with the weak state of the housing market, and increased by 1,9 per cent in November. The main drivers of credit extension in November were the 6,0 per cent increase in instalment sales credit and leasing finance, reflecting improved motor vehicle sales, and other loans and advances which increased at a year-on-year rate of 12,6 per cent in both October and November. This category was driven mainly by general loans which include unsecured lending.

The main pressures on inflation continue to emanate primarily from cost-push pressures. Administered prices remain a concern in the inflation outlook. The price of electricity has been an important driver of inflation, and increases of 17,3 per cent are assumed for both 2012 and 2013. However, the current National Energy Regulator of South Africa (NERSA) determination ends in mid-2013 and subsequent price increases are yet to be determined. The case for further significant above-inflation increases is questionable. The determination of administered prices should not act as an inhibitor to growth and investment.

International oil prices have been subject to conflicting pressures. Downside pressures have emanated from the weaker global growth environment, while upside pressures emanate from geo-political factors which have raised fears of possible supply disruptions. Nevertheless, the price of Brent crude oil has been surprisingly stable and, despite some volatility, is at similar levels to those prevailing at the time of the previous MPC meeting. Domestic petrol prices have decreased by a cumulative 16 cents per litre since early November, but the current under-recovery suggests that a further increase can be expected in February.

According to Andrew Levy Employment Publications, the overall average wage settlement rate in collective bargaining agreements amounted to 7,7 per cent in the first nine months of 2011, compared with 8,2 per cent in 2010. However there are indications that the downward trend in nominal remuneration may have reversed. According to Stats SA, growth in average remuneration per worker increased by 8,6 per cent in the third quarter of 2011 compared with the same quarter in 2010, up from 6,4 per cent and 7,4 per cent in the previous two quarters respectively. Adjusting for declining labour productivity trends, this has resulted in growth in nominal unit labour costs increasing from 5,2 per cent in the first quarter to 8,3 per cent in the third quarter of 2011. These developments could pose further upside risk to the inflation outlook.

Food prices remain a major driver of inflation, influenced by both local and global factors. Domestic food prices have been negatively affected by the recent depreciation of the rand, and a smaller-than-expected maize crop which contributed to the doubling of the domestic maize price over the past year. Futures prices of maize suggest that some relief may be expected during the first half of 2012. Furthermore, global food prices have been declining, with the Food and Agriculture Organization (FAO) Food Price Index falling by 11,3 per cent in December 2011, compared to its most recent peak in February of that year. Nevertheless, domestic food price inflation at the consumer level is expected to remain relatively high for some time.

The MPC has reflected on the various risks to the inflation outlook and considers these risks to be fairly evenly balanced, notwithstanding the reality that the exchange rate remains a significant source of uncertainty. The main downside risk continues to emanate from global economic developments.

The MPC remains of the view that inflation pressures are primarily of a cost-push nature, but is concerned that a persistent upward trend in inflation and prolonged breach of the inflation target could have an adverse effect on inflation expectations which could reinforce the upward inflation dynamics. However, the MPC is also cognisant of the slowing domestic economy and feels that given the lack of demand pressures, monetary tightening at this stage would not be appropriate. At the same time, the nominal policy rate is at a long-term low and the real policy rate is slightly negative, indicating a monetary policy stance that is accommodative and supportive of the real economy.

The MPC maintains a preference for a stable interest rate environment, given the conflicting pressures on monetary policy at this stage. However, the committee will continue to monitor domestic and global economic and financial developments and the risks to the outlook, and remains ready to act appropriately to ensure the attainment of the inflation target over the medium term while being supportive of the domestic economy. The MPC has therefore decided to keep the repurchase rate unchanged at 5,5 per cent per annum.

Notes to tables

Government finance statistics of extra-budgetary institutions – Table S–65

As from fiscal 2009/10, data for *extra-budgetary institutions, non-financial and financial public enterprises and corporations* in tables S–65, S–71 and S–73 have been revised with audited annual financial statements and in accordance with the updated *Institutional Sector Classification Guide for South Africa* published in December 2011. At the macro level the revisions had no significant statistical impact on the data.

The *extra-budgetary institutions survey* has been improved and institutions such as the Armaments Corporation of South Africa (ARMSCOR), the Independent Development Trust (IDT), the South African Maritime Safety Authority (SAMSA) and others have been included in the analysis, whereas the South African Bureau of Standards (SABS) and the Council for Scientific and Industrial Research (CSIR) have been moved to the analysis of *non-financial public enterprises and corporations*.

Government finance statistics of non-financial public enterprises and corporations – Table S–71

The analysis of *non-financial public enterprises and corporations* now includes additional institutions such as the CSIR, SABS, Broadband Infrastructure Company, South African Express, State Diamond Traders, and certain water authorities, whereas institutions such as ARMSCOR, SAMSA and some other minor institutions have been removed and incorporated in the analysis of extra-budgetary institutions.

Government finance statistics of financial public enterprises and corporations – Table S–73

The *financial public enterprises and corporations* analysis now excludes data for the IDT, which was moved to *extra-budgetary institutions.* Mpumalanga Housing Finance Company was removed from the analysis as from April 2010 subsequent to the merger with the Mpumalanga Economic Growth Agency, which falls under *non-financial public enterprises and corporations*.

Selected household assets and liabilities at year-end – Table S–130

This is a new table. It presents estimates of the total assets and liabilities of the household sector and selected major items on the aggregate household balance sheet, valued at year-end. The presentation of the additional table is a further step to expand the scope of South Africa's national accounts within the framework provided by the System of National Accounts (SNA), a set of guidelines that provide a comprehensive conceptual and accounting framework for macroeconomic analysis. The estimates of household assets and liabilities are compiled by the South African Reserve Bank, and will be updated annually.

National accounts: Ratios of selected data – Table S–150

A series indicating the household sector's debt-service cost relative to disposable income has been added to Table S–150. The quarterly values of the ratio reflect the interest cost of servicing the household sector's debt as a percentage of household disposable income; the data are seasonally adjusted. The annual ratio is calculated as the average of the relevant four quarterly values. The debt-service cost ratio is a frequently used measure of the interest burden of the household sector.