# Statement of the Monetary Policy Committee

29 March 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 Monetary Policy Committee (MPC) the intensity of the financial crisis in the eurozone appears to have subsided somewhat, but the very mixed signals indicate that the crisis is not necessarily resolved. Despite the positive indications, the global outlook remains fragile amid doubts about the strength of the United States (US) recovery, a recession in Europe, the extent of a slowdown in China and higher international oil prices.

Domestic economic growth remains constrained, but the improved performance of the South African economy in the fourth quarter of 2011 and some positive developments in the global economy indicate a slightly better outlook than previously expected. The most recent inflation outcome surprised on the downside and there has been a slight downward revision to the inflation forecast while inflation expectations continue to be anchored around the upper end of the inflation target band. Inflation appears to be somewhat more broad-based but in line with our previous forecasts, and the risks to the outlook remain evenly balanced.

The year-on-year inflation rate as measured by the consumer price index (CPI) for all urban areas was 6,1 per cent in February, down from 6,3 per cent in January. This favourable outcome was primarily the result of a moderation in food price inflation, from 10,7 per cent to 10,1 per cent. The categories of food, housing and utilities, and transport together accounted for 4,2 percentage points of the inflation outcome. CPI inflation excluding food, petrol and electricity increased from 3,9 per cent in December to 4,3 per cent in January, and was unchanged in February.

Year-on-year producer price inflation has continued its moderating trend, measuring 8,9 per cent and 8,3 per cent in January and February 2012 respectively. Agricultural price inflation declined from 7,9 per cent in January to 4,6 per cent in February, while manufactured food price inflation remained unchanged at 10,9 per cent.

The inflation forecast of the Bank is marginally lower than at the time of the previous meeting of the MPC. Inflation is still expected to peak in the second quarter of 2012 but at a slightly lower rate of 6,5 per cent and to average 6,1 per cent in the final quarter of 2012 and 5,6 per cent in the subsequent quarter. Inflation is expected to measure 5,2 per cent by the end of the forecast period at the end of 2013. The slightly improved inflation trajectory is mainly a result of a less depreciated exchange rate assumption. Following the change in the electricity tariffs by the National Energy Regulator of South Africa (NERSA), the electricity price assumption has been reduced from 17,3 per cent to 12,0 per cent. Given the low weight of electricity in the CPI basket, the impact on the forecast was marginal.

The forecast for core inflation, as measured by headline inflation excluding food, electricity and petrol, continues to show an upward trend, reflecting possibly more broad-based inflation pressures and base effects. This measure is expected to peak at an average of 5,4 per cent in the final quarter of 2012, which is marginally lower than in the previous forecast.

Inflation expectations, as reflected in the Survey of Inflation Expectations conducted by the Bureau for Economic Research (BER) at Stellenbosch University during the first quarter of 2012, appear to have remained relatively anchored around the upper end of the inflation target range. Respondents expect inflation to average 6,1 per cent in both 2012 and 2013, and 6,0 per cent in 2014. Compared with the previous survey, the forecast for 2012 is unchanged, while that for 2013 is up by 0,1 percentage point. Business executives are the most pessimistic, with expectations of 6,5 per cent for both 2013 and 2014. The expectations of financial analysts are marginally higher than those reflected in the latest Reuters survey of market analysts, which shows expected inflation to average 6,2 per cent in 2012 and 5,7 per cent in the following two years.

The immediate threat to the global economy posed by the European sovereign debt crisis appears to have subsided somewhat, but significant risks remain. Market signals in respect

of what progress is being made with the resolution of the crisis are mixed, but spreads on sovereign debt of the affected European economies have narrowed significantly, partly as a result of the Greek debt swap, and liquidity provision by the ECB, which has been directed in part to increased purchases of sovereign debt by banks. Despite these positive developments, the eurozone economy is still expected to experience a recession 2012 in the face of widespread fiscal austerity and tight bank lending conditions. Continued deleveraging by banks is a considerable risk, given potential spillover effects.

The US economy shows signs of improvement but the economy still has a negative output gap and there are some doubts about the sustainability of this growth performance. The Chinese economy has shown signs of slowing, but a hard landing is not generally expected. Emerging-market growth generally is also more subdued, and the policy tightening that had been a feature of many of these economies earlier in 2011 has either stopped or been reversed.

Global inflation appears to be broadly contained amid slowing growth and declining food price trends. However, international oil price developments, driven mainly by geopolitical factors, are posing an increasing risk not only to inflation, but also to the growth outlook.

Since the previous meeting of the MPC, the rand has appreciated in line with declining risk aversion in global financial markets. The volatility of the rand has also moderated, with the rand fluctuating in a range of between R7,45 and R7,78 to the US dollar since the beginning of February. Since the beginning of the year, the rand has appreciated by 5,0 per cent against the US dollar, by 2,3 per cent against the euro, and by 4,8 per cent on a trade-weighted basis. The Reuters poll in February reflects an expectation that the rand will continue to trade at around current levels for the rest of the year. However, the currency is expected to remain sensitive to changes in global investor sentiment.

The pattern of portfolio flows to South Africa has persisted, with non-residents being net buyers of bonds and net sellers of equities despite a resumption of net flows into emerging equity markets in general. Since the beginning of the year, non-residents' net purchases of bonds have totalled R17,5 billion, while net sales of equities have totalled R6,0 billion.

The domestic economic outlook appears slightly more favourable against the backdrop of a more positive global outlook. In 2011 an annual real growth rate of 3,1 per cent was recorded, following a fourth quarter growth rate of 3,2 per cent. The latter was driven mainly by positive contributions from the manufacturing and mining sectors, partly reflecting some normalisation following the impact on the third quarter growth performance of industrial action and other disruptions. The Bank's gross domestic product (GDP) growth forecast was revised marginally upwards to 3,0 per cent in 2012, compared with 2,8 per cent in the previous forecast, mainly as a result of a slightly more favourable global outlook, which remains uncertain. The growth forecast for 2013 has increased from 3,8 per cent to 3,9 per cent. This moderately improved outlook is consistent with the increase in the Rand Merchant Bank/BER Business Confidence Index in the first quarter of 2012 to above the neutral level of 50, as well as the positive trend observed in the Bank's composite leading indicator. Nevertheless, the expected growth rates remain disappointing and still imply a persistence of the negative output gap.

Notwithstanding the improved forecast, the outlook for the mining sector continues to disappoint with an annualised growth rate of 0,7 per cent in the final quarter of last year. In January 2012 mining output contracted at a month-on-month rate of 4,6 per cent, and output in February is expected to have been negatively impacted by industrial action, maintenance shut-downs and electricity supply constraints.

More positively, the recovery in the manufacturing sector is expected to continue. The physical volume of manufacturing output increased by 1,2 per cent on a month-on-month basis in January, while the Kagiso/BER Purchasing Managers Index increased significantly from 53,2 index points in January to 57,9 index points in February, its highest level since February 2010. Nevertheless, the sector is still characterised by excess capacity, which is likely to constrain investment in this sector.

Trends in gross fixed capital formation are also encouraging, with an annualised growth rate of 7,2 per cent in the fourth quarter of 2011, and 4,4 per cent for the year. Nevertheless, the

ratio of gross fixed capital formation to GDP at 18,9 per cent, is still significantly below the peak of 24,6 per cent reached in the final quarter of 2008. The renewed focus by government on infrastructure expenditure and successful implementation should underpin fixed capital formation, and also give a boost to the domestic construction sector which remains under pressure. There are concerns, however, that continued underspending on infrastructure by provincial and local governments, as well as possible electricity supply constraints, could retard these developments.

Formal-sector employment growth was relatively low in the fourth quarter of 2011. According to the Quarterly Employment Statistics (QES) of Statistics South Africa, formal sector employment grew at a quarter-on-quarter rate of 0,3 per cent but, on a seasonally adjusted basis, the growth was in fact slightly negative, and by 1,6 per cent over four quarters, amounting to 130 000 employees. Formal-sector employment will have to grow by a further 131 000 to reach the levels achieved in 2008 before the crisis.

Household consumption expenditure remained robust in the final quarter of 2011 when it grew at an annualised rate of 4,6 per cent, compared with 3,8 per cent in the previous quarter, and by 5,0 per cent for the year. This category was the largest contributor to GDP growth in 2011. The increased pace of spending, particularly on durable goods, was consistent with a further increase in disposable income of households, positive wealth effects and a low interest rate environment.

At these growth rates, consumption is not expected to pose a significant risk to inflation, and there are some indications that consumption expenditure growth may have peaked following the 0,6 per cent contraction in retail sales growth in January and a moderation in new vehicle sales growth in February. The First National Bank/BER Consumer Confidence Index also remained unchanged at a relatively neutral level in the first quarter of 2012.

There has been a gradual increase in the growth of credit extension in recent months, reflecting in part the increase in consumption expenditure. Having fluctuated around 6 per cent for much of 2011, 12-month growth in total loans and advances to the private sector increased to 7,4 per cent in December 2011 and 7,3 per cent in January 2012. Growth in mortgage advances has remained subdued at 2,4 per cent in January, with the main driver coming from the category of "other loans and advances". All the components of this category showed strong 12-month growth in January: credit card advances increased by 11,1 per cent (a three-and-a-half-year high); bank overdrafts by 14,5 per cent, having experienced negative growth between January 2009 and March 2011; and general loans which moderated slightly to 15,5 per cent in January from 17,6 per cent in December.

The last-mentioned category is mainly made up off unsecured lending, where loans to households continue to grow at rates of around 30 per cent. While this is still a relatively small proportion of total loans and advances, it appears to be an increasingly important source of funding of consumer credit. At this stage it is not translating into excessive consumption expenditure, but this trend towards unsecured lending is being carefully examined to ensure a better understanding of what constitutes this lending.

Despite the resulting higher household indebtedness, the ratio of household debt to disposable income declined further to 74,6 per cent in the final quarter of 2011, compared with the peak of 82,7 per cent in the first quarter of 2008. The household debt-service-costs-to-disposable income are at levels well below their long-term average.

The recent national government budget tabled before parliament indicates a moderately tighter fiscal policy stance compared with that in the October 2011 Medium Term Budget Policy Statement (MTBPS), and the commitment to medium-term fiscal consolidation remains. The fiscal deficit as a percentage of GDP is now budgeted to be 4,6 per cent in the 2012/13 fiscal year, compared with 5,2 per cent in the MTBPS, and to decline to 3,0 per cent by 2014/15. The government gross debt: GDP ratio is expected to peak at 42,4 per cent in 2014/15 (and the net debt: GDP ratio at 38,5 per cent), which is much lower than the international benchmark for debt sustainability of around 60 per cent.

Cost–push pressures remain the main drivers of inflation, but there have been some favourable developments with respect to administered prices. NERSA accepted Eskom's proposal for an average electricity tariff increase of 16 per cent for the 12 months beginning 1 April compared with the previous approved increase of 25,9 per cent. The guidelines for municipal tariff increases is 11,03 per cent compared with 16,6 per cent previously. Nevertheless, nearly all administered price increases remain in excess of the upper end of the target range, apart from communications and television licences.

Wage settlements on average remain in excess of inflation. According to Andrew Levy Employment Publications, the average wage settlement rate in collective bargaining agreements declined to 7,7 per cent in 2011. Growth in nominal remuneration per worker declined from 8,8 per cent in the year to the third quarter of 2011, to 6,0 per cent in the fourth quarter. Unit labour costs declined from 8,4 per cent to 5,0 per cent over this period.

Oil prices remain a risk to the outlook and have increased by around US$15 per barrel since the previous meeting, mainly as a result of increased geopolitical risk. While an escalation of these risks could cause further upward pressures, oil price increases are likely to be constrained by the fact that higher oil prices could derail the global recovery and therefore reduce demand. Domestic petrol prices have been impacted by these global developments. In the past two months, petrol prices have increased by 62 cents per litre, but would have been significantly higher were it not for the more appreciated exchange rate. A further sizeable increase is expected in April, which will include a 28 cent per litre increase in the fuel levy.

Food prices remain an important determinant of inflation, and as noted earlier, were the main contributors to the downward movement of CPI inflation in March. Some further moderation, partly a result of base effects, may be expected over the coming months. Global food price indices were declining consistently in 2011, but there has been some reversal of this trend in January and February. Nevertheless, global food prices remain well below the levels reached in the first few months of 2011. The impact of these developments on domestic prices will also depend on the rand exchange rate and local harvests. There has been some moderation in domestic grain price increases, following sharp increases in maize prices in the second half of 2011. We therefore could see a further moderation in food price inflation in the coming months, but the longer-term outlook is uncertain.

The MPC is of the view that while the main pressures on inflation are of a cost–push nature, there is some evidence that these pressures may be becoming more broad-based. However, these developments are in line with our previous forecasts and are expected to remain contained by the relatively subdued state of the domestic economy. Although at this stage the committee assesses the risks to the inflation outlook to be fairly evenly balanced, greater vigilance will be required going forward.

The main upside risk to inflation is seen to emanate from global oil prices, and while food price inflation is expected to moderate in the short run, the longer-term risks remain. The exchange rate is, as always, highly uncertain, but the risk posed to inflation in recent months has subsided somewhat, given the less-volatile, albeit uncertain, global environment.

Domestic economic growth is expected to remain below potential. In the light of this and the expected medium-term inflation trajectory, the committee is of the view that at this stage the current stance of monetary policy is appropriate to support the real economy while at the same time maintaining its commitment to achieve the inflation target over the medium term. The MPC has therefore decided to keep the repurchase rate unchanged at 5,5 per cent per annum.