Statement of the Monetary Policy Committee

19 July 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), there have been further indications of a generalised slowdown in the global economy, amid the continuing risks posed by the banking and sovereign debt crisis in the eurozone. This negative outlook has contributed to renewed monetary policy easing in a number of countries, including in emerging-market economies, in an environment of declining commodity prices and subdued global inflation.

Domestic inflation has continued its downward trend, and is expected to remain within the target range over the forecast period. However, despite some moderate employment creation over the past year, the economic growth outlook appears to be threatened by global developments and deteriorating domestic business and consumer confidence.

The year-on-year inflation rate as measured by the consumer price index (CPI) for all urban areas was 5,5 per cent in June 2012, down from 5,7 per cent in May. The categories of food, housing and utilities, and transport together accounted for 3,5 percentage points of the inflation outcome. Food prices increased by 6,0 per cent, petrol by 14,2 per cent and electricity by 17,1 per cent on a year-on-year basis. Core inflation, as measured by the exclusion of food, petrol and electricity from CPI, increased in line with expectations from 4,4 per cent in May to 4,6 per cent in June. Administered prices, excluding petrol, increased at a year-on-year rate of 8,7 per cent in both May and June.

Year-on-year producer price inflation moderated further, measuring 6,6 per cent in both April and May 2012, its lowest rate of increase since April 2011. More than half of this outcome was accounted for by mining and quarrying and electricity price increases. Food price inflation continued its downward trend with agricultural prices increasing at a year-on-year rate of 1,7 per cent in May, while manufactured food prices increased by 8,4 per cent.

The inflation forecast of the Bank has been revised downwards since the previous meeting of the MPC, apart from the final quarter of 2014 when a slightly higher outcome is forecast. With inflation expected to have peaked at an average of 6,1 per cent in the first quarter of 2012, it is now expected to continue to moderate over the next few quarters, reaching a low of 4,9 per cent in the second quarter of 2013. Inflation is then expected to remain fairly stable around the 5 per cent level to the end of 2014. Inflation is expected to average 5,6 per cent in 2012, and 5,1 per cent in both 2013 and 2014. The improved forecast is mainly due to lower-than-expected recent inflation outcomes.

The forecast for core inflation is also more favourable, although the upward trend is expected to continue in the short term. Core inflation is expected to measure 5,4 per cent in the final quarter of 2012 and the first quarter of 2013, before declining and averaging 4,8 per cent in 2014.

Inflation expectations as reflected in the survey conducted by the Bureau for Economic Research at Stellenbosch University in the second quarter of 2012 were almost unchanged since the previous quarter and remain anchored at around the upper end of the target range. On average, respondents expect inflation to average 6,1 per cent in 2012 and 6,0 per cent and 6,1 per cent in the next two years respectively. The break-even inflation rates declined across all maturities since the previous meeting of the MPC to within the target range.

The outlook for the global economy has worsened somewhat since the previous meeting of the MPC, with mounting evidence of a broad-based global slowdown. Negative indicators include a fall in the global manufacturing Purchasing Managers Index (PMI) to its lowest level in three years. The lack of meaningful progress towards a resolution of the eurozone crisis continues to be a source of global instability and risk, despite initiatives to stabilise the banking sector. The growth outlook for the region remains negative, as fiscal austerity measures and bank deleveraging continue to impact adversely on growth and on unemployment rates that have reached new euro-era highs. In the first quarter of 2012, most of the eurozone members recorded negative or marginally positive growth, particularly those in the periphery. The United Kingdom (UK) economy is currently also experiencing a recession.

The United States (US) economy slowed in the second quarter and the outlook has deteriorated. Concerns relating to the so-called fiscal cliff (the possible sharp contraction of fiscal policy in 2013) are beginning to weigh on consumption and investment decisions, and these pressures are expected to intensify during the second half of this year. Any resolution of this issue seems unlikely before the end of 2012.

Spill-over effects have also been felt in emerging markets. China recorded a growth rate of 7,6 per cent in the second quarter of 2012, the slowest since early 2009, amid a property-market downturn and weak exports. It is still unclear if the policy responses of the Chinese authorities will be sufficient to contain this trend. Materially slower growth has also been recorded in India and Brazil.

In response to these developments, monetary policy has been eased in a number of both advanced and emerging-market countries. In the UK, the Bank of England increased the size of its asset purchase programme, and although the Federal Open Market Committee has not resumed its programme of quantitative easing, the maturity extension programme has been extended and monetary policy is expected to remain highly accommodative for a prolonged period.

Global inflation continues to be benign, given the slowing growth prospects and lower commodity prices. One area of risk to the inflation outlook emanates from the higher grain prices in response to the continuing drought in the US.

The increasingly unfavourable and volatile global backdrop continues to impact on the rand exchange rate, primarily through changing risk perceptions in global financial markets. Since the previous meeting of the MPC, exchange rate volatility has increased and the rand has fluctuated in a range of between R8,06 and R8,70 against the US dollar, partly in response to fluctuations of the euro against the US dollar. The rand has, however, appreciated since the previous meeting by around 3,4 per cent against the US dollar, by 5,5 per cent against the euro and by 3,7 per cent on a trade-weighted basis.

During this period the rand was also impacted by strong inflows into the domestic bond market, following the confirmation that South Africa will be included in the Citibank World Government Bond Index (WGBI) from late September. Since the beginning of the year, non-residents have been net purchasers of South African government bonds to the value of R60,1 billion. In June alone net purchases of bonds by non-residents amounted to R21,7 billion, the second-highest monthly inflow ever into the bond market. Much of this is estimated to have been real money inflows, which possibly contributed to the generally appreciating exchange rate trend in that month and declining yields in the domestic government bond market. These inflows are expected to persist for some time after the actual inclusion in the index, and will not only help fund the fiscal deficit but also the widening current-account deficit of the balance of payments.

The rand is expected to remain vulnerable to erratic shifts in global risk perceptions. While a deterioration of global risk sentiment could cause further rand weakness, this could be offset to some extent by continued inflows into the bond market or the possible resumption of quantitative easing in the US.

The domestic economy appears to be slowing further, following the 2,7 per cent annualised growth rate recorded in the first quarter of 2012. The Bank's forecast of gross domestic product (GDP) growth for 2012 has been revised down from 2,9 per cent to 2,7 per cent, and to 3,8 per cent in 2013. The forecast for 2014 remains unchanged at 4,1 per cent. However, given the possibility of a more widespread global downturn, the risks to this forecast are seen to be on the downside, with the external impact coming through trade links and commodity prices. The Bank's estimate of the output gap is unchanged at around 3,5 per cent. The composite leading business cycle indicator of the Bank declined for the second consecutive month in April, indicative of the uncertain and subdued outlook.

The mining sector is expected to achieve positive but modest growth in the second quarter of 2012 following the 16,8 per cent annualised contraction in the first quarter. In May the three-month-to-three-month growth was 1,3 per cent and 0,8 per cent on a year-on-year basis. Despite this improvement, the mining sector is expected to face a number of challenges, including declining commodity prices, and further domestic cost pressures which have already resulted in stresses for some platinum mines.

The manufacturing sector, which grew at an annualised rate of 7,7 per cent in the first quarter of 2012, is showing some signs of moderation in the second quarter. In May the sector grew at a year-on-year real rate of 4,2 per cent, but contracted by 0,9 per cent on a three-month-to-three-month basis. The Kagiso/BER Purchasing Managers Index fell to 48,2 index points in June, its lowest level since August 2011, as the sub-indices for business activity and new sales orders declined further. This is consistent with the weaker RMB/BER Business Confidence Index which declined by 11 index points to 41 in the second quarter.

Growth in real gross fixed capital formation lost momentum, having moderated from an annualised 7,2 per cent rate in the final quarter of 2011 to 5,3 per cent in the first quarter of 2012. Of concern is the substantial decline in the growth of private-sector fixed capital formation to 1,8 per cent, following successive quarters of steady increases in excess of 5 per cent during 2011. This development, if sustained, will contribute to the fragility of the growth outlook. By contrast, increases of 13,1 per cent and 9,3 per cent were recorded by public corporations and general government, reflecting capital spending on infrastructure. This was consistent with the improvement in the FNB/BER Civil Construction Confidence Index. However, the FNB Building Confidence Index declined further and remains at low levels, with the real value of building plans passed declining by 8,7 per cent on a three-month-to-three-month basis in April.

Final consumption expenditure by households, which grew by 5,0 per cent in 2011, also appears to be slowing somewhat, with growth having moderated to 3,1 per cent in the first quarter of 2012. While real retail sales increased by 6,4 per cent on a year-on-year basis, the momentum appears weaker, with sales declining by 0,8 per cent on a month-on-month basis in May, while in the three months to May compared with the previous three months, sales increased by 0,4 per cent. The FNB/BER Consumer Confidence Index deteriorated in the second quarter, with the index declining from 5 to -3, the lowest level of the index since 2008. According to the RMB/BER Business Confidence Index, confidence of retailers declined markedly during the same period to its lowest level in two years. Somewhat anomalously, new vehicle sales have remained relatively buoyant.

Growth in credit extension to the private sector remains relatively subdued, with twelve-month growth in total loans and advances to the private sector increasing by 8,0 per cent in May. Growth in credit extension to the corporate sector moderated during April and May, while credit extension to households continued to increase, with growth over twelve months of 7,5 per cent in May. This includes the growth in general loans (including personal loans) which has shown a softer trend but still at elevated levels of 30,4 per cent. Mortgage advances remained subdued, reflecting continued weakness in the housing market, while instalment sale credit and leasing finance increased steadily in line with positive vehicle sales. Despite the increase in personal loans, household debt to disposable income declined further to 74,7 per cent in the first quarter of 2012. Personal loans now account for 11,0 per cent of total household debt, but have not led to excessive consumption expenditure.

Formal-sector employment creation has remained slow. According to the Quarterly Employment Statistics (QES) of Statistics South Africa, in the four quarters to the first quarter of 2012, just over 100 000 jobs were created, representing an increase of 1,2 per cent.

The outlook for wage growth is uncertain. Growth in nominal remuneration per worker declined from 6,8 per cent in the year to the fourth quarter of 2011, to 6,6 per cent in the first quarter of 2012, while unit labour cost increases declined from 5,8 per cent to 5,7 per cent. This trend may have been reversed recently. According to Andrew Levy Employment publications, the average wage settlement rates amounted to 7,7 per cent in the first half of 2012. The outcome of the public-sector wage settlement will be important in this respect.

Administered price increases have remained relatively unchanged, but we still await Nersa's determination of tariff increases to be granted to Eskom for the coming years. Some of the other important cost-push factors may have reached a lower turning point recently. Domestic food price inflation is still expected to moderate further in the short term, but the medium-term outlook is clouded by the drought-induced increases in maize, wheat and soya bean prices in the US. This has already impacted on domestic prices of both maize and wheat, and poses some upside risk to the inflation outlook.

Brent crude oil prices also rebounded from their recent lows of around US$90 per barrel, partly due to geopolitical factors. Currently oil is trading at around US$105 per barrel, well below the levels of almost US$130 per barrel that prevailed earlier this year, and prices are expected to be constrained by weak global demand. The domestic petrol price has declined by a total of R1,40 per litre in the past two months, although a slight increase may be recorded next month.

The MPC is concerned about the increased downside risks posed to the domestic economy by global developments. The problems in the eurozone are likely to persist for a protracted period and since the previous meeting the negative growth outlook has spread beyond Europe, in particular to the US, China, India and other emerging-market economies. The negative spill-over effects to South Africa are likely to intensify. This unfavourable outlook is reinforced further by the fragile domestic private-sector investment and consumption trends which are confirmed by declining business and consumer confidence. The MPC therefore sees the risks to the growth forecast to be on the downside.

The MPC also considered the inflation environment to have improved somewhat, notwithstanding possible pressures coming from food and energy prices in the medium term. Upside pressure on inflation could be offset to some extent by lower global commodity prices, while demand pressures are expected to remain muted. Although the exchange rate is likely to remain vulnerable to global risk aversion, the rand has shown some resilience in recent weeks. The MPC expects inflation to remain within the target range over the forecast period and sees the risks to the inflation forecast to be relatively balanced.

In the light of these developments the MPC views the prevailing conditions to be appropriate for further monetary accommodation to the economy that will not undermine the inflation outlook. The MPC has therefore decided to reduce the repurchase rate by 50 basis points to 5,0 per cent from Friday, 20 July 2012. While it is recognised that such a move on its own will not overcome the challenges facing the economy, it is felt that it can help alleviate some of the pressures faced by some sectors. A sustained increase in the potential output of the economy will require a concerted and co-ordinated effort from both government and the private sector. The MPC will continue to monitor both domestic and global developments, and will act appropriately in line with its mandate.