Statement of the Monetary Policy Committee

20 September 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, the global growth outlook has weakened further. However, the near-term risks to global financial markets arising from the eurozone debt crisis seem to have subsided somewhat following the announcement of the bond purchase programme by the European Central Bank. While this appears to be a positive step, significant risks still remain. At the same time, the global environment has been impacted by further monetary easing in the United States (US) and Japan.

Domestically, inflation continued to surprise on the downside, although it appears that the short-term low point could have been reached. Despite a number of upside supply-side risks, inflation is expected to remain contained within the target range over the forecast period. The growth outlook, however, has deteriorated somewhat in response to both domestic and global developments.

The year-on-year inflation rate as measured by the consumer price index (CPI) for all urban areas was 5,0 per cent in August 2012; up from 4,9 per cent in July. The categories of food, housing and utilities, and transport together accounted for 3,0 percentage points of the inflation outcome. Food prices increased by 5,1 per cent, petrol by 9,3 per cent and electricity by 10,0 per cent. Core inflation, as measured by the exclusion of food, petrol and electricity from CPI, measured 4,6 per cent; up from 4,5 per cent in July. Administered prices excluding petrol increased at a year-on-year rate of 7,5 per cent.

Year-on-year producer price inflation moderated to 5,4 per cent in July 2012, having measured 6,6 per cent in each of the previous three months. A reversal in the downward trend in food price inflation was observed, although still at relatively low levels, with agricultural prices increasing at a year-on-year rate of 3,0 per cent in July, compared with a recent low of 1,7 per cent in May and 2,2 per cent in June. Manufactured food prices increased by 7,7 per cent and 8,0 per cent in June and July respectively.

The inflation forecast of the Bank reflects a moderate deterioration for 2013 compared with the previous forecast, and a relatively flat trajectory over the entire forecast period. Inflation is now expected to average 5,3 per cent in the final quarter of 2012, 5,2 per cent in 2013 and 5,0 per cent in 2014. The near-term deterioration is mainly due to higher expected petrol and food inflation. Core inflation appears to be well contained, with a peak of 4,9 per cent expected in the final quarter of 2012, compared with the previous forecast peak of 5,4 per cent. This measure is now expected to average 4,6 per cent in both 2013 and 2014.

Inflation expectations as reflected in the survey conducted by the Bureau for Economic Research (BER) at Stellenbosch University in the third quarter of 2012 were again virtually unchanged, particularly for 2013 and 2014, and remain anchored at around the upper end of the target range. Respondents expect inflation to average 5,8 per cent in 2012 and 6,0 per cent in 2012 and 6,2 per cent in 2014 respectively.

There is, however, a divergence of views between the respondents: while all categories of respondents expect average inflation to be within the target range in 2012, trade union officials and business executives expect it to exceed the upper end of the target range in both of the following two years. This is in contrast to financial analysts who expect inflation to average just over 5 per cent in both of these years.

The survey conducted by Reuters indicates that market analysts expect inflation to average 5,3 per cent in 2013 and 5,4 per cent in 2014. Market expectations as reflected in the break-even inflation rates initially increased after the previous meeting of the MPC, but have since declined somewhat. Expectations over the various maturities continue to reflect expectations of inflation within the target range.

The global growth outlook remains weak, notwithstanding significant policy initiatives announced by the United States Federal Reserve (the Fed), the ECB and Bank of Japan, and the initial positive reaction from global financial markets. The decision by the Fed to engage in a further round of quantitative easing was prompted by an assessment that the expected growth trajectory was not strong enough to generate a sustained improvement in the labour market. The US economy grew at an annualised rate of 1,7 per cent in the second quarter of 2012, and the outlook is clouded by the risk of a severe fiscal contraction early next year. The outcome of the US elections in November 2012 will be critical in determining the prospects for a favourable resolution of this "fiscal cliff". In the meantime the attendant risks have had an adverse impact on investment expenditure in the US and various indicators of industrial output point to a subdued growth outlook.

In the eurozone the immediate risks posed by the continuing debt crisis appear to have abated somewhat with the announcement by the ECB of its Outright Monetary Transaction (OMT) or bond purchase programme. In addition, two important event risks were also avoided following the decision of the Federal Constitutional Court in Germany to uphold the ratification of the treaty to establish the European Stability Mechanism, although under specific conditions, and the pro-euro outcome of the Dutch election. The precise workings of the OMT, particularly the issues relating to conditionality, are still uncertain, but the initiative has bought some time to implement more permanent solutions. Despite this potential progress, the risk of a Greek exit from the eurozone remains, and growth prospects in the region have deteriorated following the overall contraction in the second quarter of this year, continued bank deleveraging and a further decline in cross-border lending. The UK economy has contracted for three consecutive quarters, while Japanese economic growth also moderated markedly in the second quarter. The impact of the US actions on the Japanese yen prompted a surprise increase of ¥10 trillion by the Bank of Japan in the size of its asset purchase programme. Although the yen depreciated in response, the impact appears to have been short-lived.

Growth momentum is also somewhat weaker in some of the systemically important emerging-market economies, particularly in China, Brazil and India, in the face of weakening external demand. A number of countries have responded by easing monetary policy and, as in the case of Brazil, by introducing measures to stimulate domestic demand and competitiveness.

Global inflation remains relatively benign, given the weak demand, but supply-side shocks in the form of higher food prices, due to droughts in the US and some parts of eastern Europe, and resilient international crude oil prices pose a risk to the outlook. Both of these shocks are not only a risk to inflation, but could also represent an additional drag on near-term growth; a combination that poses enormous challenges to monetary policy.

The rand exchange rate has fluctuated generally within a range of R8,10 and R8,50 against the US dollar since May, and continues to be affected by changing risk perceptions in global financial markets. More recently, the rand appears to have decoupled from the euro and reacted to domestic issues, including the wider-than-expected current-account deficit and developments in parts of the mining sector, following the tragic events at Marikana.

The rand has, however, been underpinned, to some extent, by continued inflows into the domestic bond markets in the lead-up to South Africa's inclusion in the Citi World Government Bond Index (WGBI). Non-resident purchases of South African bonds have amounted to R12,1 billion since the previous meeting of the MPC, and R74,5 since the beginning of 2012. These inflows are expected to persist for some time as non-resident portfolios adjust to the WGBI inclusion. Although the rand, along with most other currencies, initially appreciated against the dollar following the announcement of further quantitative easing by the Fed, it depreciated against the euro following the positive response to the announcement of the OMT. Since the previous meeting of the MPC, the rand has depreciated by about 2,4 per cent against the dollar, by 7,5 per cent against the euro and by 5,0 per cent on a trade-weighted basis. Over this period the dollar depreciated by 5,5 per cent against the euro.

The current account of the balance of payments has emerged as a risk to the exchange rate outlook following the widening of the deficit to 6,4 per cent of GDP in the second quarter. The Bank's forecast for the current account in 2012 is for a deficit in the order of 5¼ per cent of gross domestic product (GDP). This widening deficit is a consequence of declining commodity exports, and increased imports and service payments. The current-account deficit has been financed mainly through portfolio inflows, but could pose a risk to the exchange rate unless it moderates over the coming months.

The domestic economic growth outlook remains constrained by the weak global outlook and by recent work stoppages in the mining sector. The economy recorded a growth rate of 3,2 per cent in the second quarter of 2012, but this reflects a distortion arising from the strong contribution from the mining sector, which recovered from a deep contraction in the first quarter. Non-mining real output growth measured 1,7 per cent, due in large part to negative growth in the manufacturing sector.

The Bank's leading indicator has declined for four consecutive months, and the Bank's growth forecasts have been revised down. Real GDP growth is now expected to average 2,6 per cent in 2012 and 3,4 per cent in 2013, compared with 2,7 per cent and 3,8 per cent in the previous forecasts. Notwithstanding these downward revisions, the Bank sees further risks to the downside.

Recent high-frequency data point to a lacklustre growth performance in the third quarter. Mining output contracted by 1,5 per cent in July compared with June and the impact of the recent strikes in the mining sector is yet to be reflected in the data. The physical volume of manufacturing production contracted by 1,1 per cent on a month-on-month basis in July, while the year-on-year increase of 5,8 per cent was exaggerated by weak base effects. The Kagiso PMI, which has been moderating consistently since February, declined further in August and remains marginally above the neutral level of 50.

The First National Bank (FNB)/BER Business Confidence Index improved in the third quarter following the sharp decline in the second quarter, but remained below the neutral level. The survey reflected very negative sentiment among manufacturers and building contractors, while the vehicle trade exhibited high and rising levels of confidence, as reflected in robust vehicle sales.

The real value of building plans passed declined in June and July 2012 after a tentative recovery in the previous two months. While positive growth was observed in the non-residential sector up to June, building activity in the residential sector remains subdued, indicative of the weak housing market. By contrast, confidence in the civil construction index has improved, in line with increased civil construction activity.

Growth in gross fixed-capital formation increased to 5,7 per cent, contributing 1,2 percentage points to overall GDP growth. Private-sector investment remains weak, with annualised growth rates of 1,8 per cent, and 2,4 per cent in the first and second quarters of 2012. By contrast, fixed-capital formation by public corporations grew at an annualised rate of 9,1 per cent in the second quarter.

Formal-sector employment growth has remained weak. According to the Quarterly Employment Statistics (QES) released by Statistics South Africa, employment growth over four quarters to the second quarter of 2012 measured 1,5 per cent. This represents an increase of 123 300 jobs, one third of which were in the public sector. Although the current level of formal-sector employment is still about 60 000 less than that attained before the onset of the crisis, the trend remains positive even if too slow.

Final consumption expenditure by households was again the main contributor to GDP growth, contributing 1,9 percentage points. Nevertheless, expenditure growth moderated to 2,9 per cent in the second quarter, mainly due to the contraction in real outlays on services. Expenditure on goods, particularly durable and semi-durable goods, remained robust. Retail sales also grew at a more moderate year-on-year rate of 4,2 per cent in July 2012. Despite the decline in total new vehicle sales in August, the positive momentum in this sector seems to have been sustained, although exports to Europe are expected to remain under pressure. The FNB/BER Consumer Confidence Index increased marginally in the third quarter following a large decline in the second quarter, but remains at a low level. At these levels, consumption expenditure is not seen to pose a risk to the inflation outlook.

Following a recent high in March 2012, growth in credit extension to the private sector has moderated. Twelve-month growth in banks' total loans and advances declined from 9,2 per cent in March, to 8,1 per cent, and 7,3 per cent in June and July respectively. Credit extension to the household sector increased at a rate of 8,1 per cent in July, while credit extended to the corporate sector eased somewhat. Mortgage loans remained subdued, while instalment sale credit and leasing finance reflected the robust vehicle sales.

Growth in general loans to households, which is mainly unsecured lending, accelerated to 32,8 per cent in July, but was still below the peak growth of 39,3 per cent experienced in June 2011. Growth in unsecured lending to companies moderated to 8,3 per cent in July, from a recent high of 16,1 per cent recorded in March. The continued high rates of unsecured lending have contributed to rising household debt, with the ratio of household debt to disposable income increasing from 75,6 per cent to 76,3 per cent between the first and second quarters of 2012. There is no evidence that unsecured lending has had an adverse impact on the asset quality of the banking sector, as impaired advances as a percentage of gross loans and advances measured 4,4 per cent in July compared with 5,5 per cent a year earlier.

The trends in wage growth have been relatively benign from an inflation perspective. Measured over four quarters, nominal unit labour cost growth was 6,1 per cent in both of the first two quarters of 2012. According to Andrew Levy Employment publications, the overall wage settlement rate in collective bargaining agreements amounted to 7,7 per cent in the first half of 2012, while the public sector settled on an increase of 7,0 per cent. However, there is a risk that the recent wage settlements in the mining sector could set a precedent for wage demands more generally.

Food and petrol prices are the main upside risks to the inflation outlook. Following a sharp spike in July 2012, global grain prices stabilised and then moderated, but remain at elevated levels. Futures prices indicate an expectation that these prices may have stabilised and may subside in the medium term. Domestic spot prices of maize and wheat followed global trends, having increased by about 40 per cent and 20 per cent respectively between the beginning of June and the end of July. These increases are expected to filter through to domestic consumer prices in the coming months.

The price of Brent crude oil continued its recent upward trend, reaching around US$117 per barrel on 14 September, or US$12 per barrel higher than at the time of the previous MPC meeting. However, the Saudi Arabian government commitment to increasing the supply of oil has elicited a price response, with oil prices declining to current levels of around US$108 per barrel. How sustainable this impact will be remains to be seen, given the geo-political factors prevailing in the Middle East. The domestic price of petrol has increased significantly as a result, largely offsetting the recent price decreases. Since August, the price of petrol has increased by a cumulative R1,15 per litre, and a further increase is expected in October.

The MPC remains concerned about the risks posed to the domestic economy from the global environment. The actions of the ECB appear to have reduced immediate liquidity concerns in the region and have had a positive impact on sentiment. The continued risk of a possible Greek exit and its contagion effects are likely to hang over the markets for some time. The fundamental problems of the eurozone remain, and low or negative growth is likely to persist going forward.

Despite renewed stimulus in the US, growth is expected to remain subdued, at least until the "fiscal cliff" issue is resolved. This negative global outlook, which is reinforced by a slowdown in Asia, poses a downside risk to domestic growth prospects, particularly in the form of a weaker export performance.

The domestic outlook is also likely to be constrained by local developments, particularly in the mining sector, which have the potential to undermine the already-fragile private-sector investment sentiment despite the accommodative macroeconomic policy environment. While the Bank's forecast for growth has been revised down, the MPC assesses that further risks are somewhat on the downside.

Recent inflation outcomes have been more or less in line with the Bank's expectations, but some upside pressure is still expected from food and petrol price increases. Demand pressures are, however, expected to remain benign. The exchange rate poses a potential risk to the inflation outlook, particularly in the event of an unsustainable widening of the deficit on the current account of the balance of payments. To date, the rand has remained relatively resilient. The committee assesses the risks to the inflation forecast to be more or less balanced.

At its previous meeting the MPC assessed that conditions justified a pre-emptive loosening of the monetary policy stance. Although global and domestic growth conditions remain challenging, the MPC is of the view that a further reduction in the repurchase rate is not appropriate at this stage. The MPC has therefore decided to keep the repurchase rate unchanged at 5,0 per cent per annum. This accommodative stance is assessed to be consistent with the Bank's price stability mandate, and conducive to encouraging growth and domestic investment. Further actions going forward will be highly dependent on global and domestic developments that may change the risks to the outlook.