Statement of the Monetary Policy Committee

24 January 2013

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 some improvement in global financial market sentiment, but economic growth prospects in a number of the major advanced economies or regions remain constrained. Downside risks to the outlook persist as the structural problems in many countries, and in the eurozone, in particular, are still unresolved. Monetary policy in most countries is likely to remain accommodative in the absence of clear evidence of a sustained recovery, particularly against the backdrop of a relatively benign global inflation environment.

Despite a generally positive reaction to the ANC elective conference, ongoing labour conflict, the proposed scaling down of mining operations and ratings agency downgrades are symptomatic of the challenging domestic outlook. In the absence of coherent and consistent structural policy initiatives domestic economic growth is expected to continue to be well below both what is possible and required to make significant inroads into unemployment. In contrast to the situation in most advanced economies, the risks to the inflation outlook remain on the upside, due, in large part, to continued exchange rate and wage cost pressures.

The year-on-year inflation rate as measured by the consumer price index (CPI) for all urban areas was 5,7 per cent in December 2012, up from 5,6 per cent in November. The categories of food and non-alcoholic beverages, housing and utilities, and transport together accounted for 3,5 percentage points of the inflation outcome. Food price inflation moderated from 7,5 per cent in November to 7,0 per cent, mainly as a result of lower meat and grain price increases. Core inflation, as measured by the exclusion of food, petrol and electricity from CPI, which had been unchanged at 4,7 per cent since September, increased to 4,9 per cent in December, mainly as a result of increases in services price inflation and in line with the Bank's forecast. Administered prices increased by 8,8 per cent, and by 7,6 per cent excluding petrol.

Having reached a recent low of 4,2 per cent in September 2012, year-on-year producer price inflation increased to 5,2 per cent in both October and November. This reversal of the previous downward trend was mainly due to price increases in mining and quarrying, agricultural products and manufactured food. Agricultural prices increased at year-on-year rates of 6,3 per cent and 5,9 per cent in October and November respectively, while manufactured food prices increased at rates of 10,9 per cent and 11,1 per cent in these months respectively.

The inflation forecast of the Bank reflects a further deterioration in the inflation outlook for 2013 compared with the previous forecast. The forecasts do not yet incorporate the new CPI weights and rebasing recently announced by Statistics South Africa, but these changes will be incorporated formally into the Bank's next forecast. The impact on the inflation trajectory is likely to be marginal. Having averaged 5,6 per cent in 2012, inflation is now expected to average 5,8 per cent in 2013 and 5,2 per cent in 2014, compared with the previous forecasts of 5,5 per cent and 5,0 per cent for the respective years. Inflation is expected to peak at 6,1 per cent in the third quarter of 2013 and then to moderate gradually to 5,1 per cent in the final two quarters of 2014. This deterioration is largely due to higher expected food price inflation, the lagged effects of the depreciation of the rand and higher expected unit labour costs.

The forecast of core inflation is more or less unchanged, indicating the continued absence of significant demand pressures. This measure is expected to peak at 5,0 per cent in the first two quarters of 2013, and to average 4,9 per cent and 4,5 per cent in 2013 and 2014 respectively.

Inflation expectations remain anchored at around the upper end of the inflation target range. According to the Survey of Inflation Expectations conducted by the Bureau for Economic Research (BER) in the fourth quarter of 2012, inflation is expected to average 6,1 per cent in 2013 and 6,2 per cent in 2014. This represents a marginal increase of 0,1 percentage point for 2013 compared with the previous survey, while the forecast for 2014 is unchanged. Business executives are the most pessimistic about inflation, having raised expected inflation rates to 6,6 per cent and 6,7 per cent in 2013 and 2014, while trade union respondents reduced their forecasts to 6,1 per cent and 6,6 per cent respectively for these years. The forecasts of financial analysts increased marginally, but remain within the target range for the forecast period. For the past four quarters expectations for the next five years have remained unchanged at 6,2 per cent.

The global growth outlook remains challenging, notwithstanding improved sentiment in global financial markets following the interim deal related to the fiscal cliff in the US. The fiscal issues have not been fully resolved, with decisions on expenditure cuts and the debt ceiling delayed till later this year. While the worst-case fiscal scenario has been avoided, the uncertain fiscal outlook is likely to contribute to continued sub-trend US growth. On the positive side, there are continued signs of a recovery in the US housing market and improved corporate profitability.

Although sovereign debt risks in the eurozone have subsided for now and bond spreads on peripheral European debt have narrowed significantly, the region is likely to remain in recession for much of the year, as fiscal tightening and balance-sheet repair by banks and households continue. The unemployment rate has now reached 11,8 per cent, with youth unemployment at 24 per cent. The outlook for Germany, the main growth driver in the region, has also deteriorated. Growth prospects in the UK remain relatively weak, while the outlook for Japan is uncertain despite the announcement of substantial fiscal and monetary policy stimuli.

The outlook for emerging markets, particularly those in Asia, is more positive. The Chinese economy appears to have stabilised following concerns about a possible hard landing, and consensus forecasts suggest some growth acceleration in 2013 in both China and India. Growth in Africa is expected to be sustained at rates in excess of 5 per cent, while Latin American growth is expected to be more restrained, but an improvement on 2012.

The rand exchange rate continues to pose an upside risk to the inflation outlook. The exchange rate has been impacted by the widening deficit on the current account of the balance of payments during 2012 and changing global and domestic risk perceptions, particularly relating to the adverse developments in the South African labour market, and the downgrades by the various ratings agencies. Since the previous meeting of the MPC, the rand has been fairly volatile, having appreciated initially from R8,94 to the US dollar, to R8,45 at the end of the year, but subsequently depreciated to current levels of around R9,00. Since the beginning of the year, the rand has depreciated by 6,1 per cent on a trade-weighted basis and by about 6,6 per cent against the US dollar.

While the rand is expected to remain sensitive to domestic and global developments and continued volatility can be expected, most analysts do not expect significant further sustained depreciation in the coming months. The depreciation of the rand is expected to help moderate the current-account imbalance, although platinum export growth may be undermined to some extent by possible shaft closures. However, financing of the deficit may be more challenging despite relatively high domestic nominal bond yields, as sentiment towards South Africa has deteriorated, and non-residents already hold over one-third of the stock of outstanding government bonds.

Non-resident net purchases of domestic bonds totalled R88,6 billion during 2012, due in part to South Africa's inclusion in the Citibank World Government Bond Index. However, the pace of inflows declined substantially in the final quarter of the year, when net purchases amounted to R10,6 billion. Since the beginning of 2013, net purchases by non-residents have amounted to R4,3 billion. While non-residents were net sellers of equities during 2012 to the value of R3,4 billion, they were net buyers to the value of R7,3 billion in November and December. Year to date, however, the negative trend regarding equities has continued with net sales of R2,3 billion as growth prospects remain weak.

Domestic economic growth remains fragile and below potential following an annualised growth rate of 1,2 per cent in the third quarter of 2012, and an estimated growth rate of around 2,5 per cent for the year. A similar outcome is expected in 2013 with growth of 2,6 per cent forecast, revised down from 2,9 per cent in the previous forecast. A more favourable outcome of 3,8 per cent is forecast for 2014, compared with 3,6 per cent previously, driven in part by a more favourable global outlook. However, the risks to these forecasts are assessed to be on the downside, given uncertainties and instability in parts of the mining and agricultural sectors in particular. Constraints to growth are both external and internal. To achieve a higher internally-generated growth rate would require a serious commitment to implementing a range of structural reforms and making the necessary trade-offs as outlined in the National Development Plan.

The outlook for parts of the mining sector is bleak, following continued labour disputes and announcements of possible closures of shafts and mines, a consequence of increased cost pressures, weak global demand and prices. Although mining output increased on a month-to-month basis in November, on a three-month-to-three-month basis a contraction of 10,4 per cent was recorded.

There are mixed signals pertaining to the outlook for the manufacturing sector. The real volume of manufacturing production increased by 2,3 per cent in November, its highest month-on-month rate in 4 years, due in part to a rebound from widespread strike activity in previous months, and growth in the fourth quarter is estimated to have been relatively robust. Capacity utilisation has also increased. However, the Kagiso PMI declined to below the 50 index point level to 47,4 in December, indicating an expectation of some contraction in the sector.

The negative business sentiment evident in the confidence indicators is also reflected in the continued weakness in private-sector gross fixed capital formation. Recent developments in the mining sector are likely to reinforce this weakness as plans are scaled back. Investment expenditure is likely to remain underpinned by the government and state-owned enterprises. In the third quarter of 2012, gross fixed capital formation grew at an annualised rate of 7,2 per cent, but private-sector capital formation, which accounts for just under two thirds of the total, only grew at a rate of 2,8 per cent.

Growth in consumption expenditure by households moderated as expected in the third quarter of 2012 when it increased by 2,6 per cent. The main driver of the moderation was the decline in expenditure growth on services and non-durable goods. However, there are also signs of moderation in the growth of expenditure on durable and semi-durable goods, and the depreciated exchange rate is likely to sustain this trend. Growth in motor vehicle sales has slowed in recent months, and there was a marked decline in the confidence of new vehicle traders reported by the BER. Despite the higher-than-expected increase in retail trade sales in November, the quarterly rates suggest further moderation in growth. The FNB/BER Consumer Confidence Index declined by 2 index points to -3 index points in the final quarter of 2012.

On balance, the MPC does not assess growth in household consumption expenditure to be excessive or to pose significant inflationary risks, and further moderation is possible. Factors that affect the outlook for consumption expenditure, both positively and negatively, include concerns regarding employment, wage settlements, credit extension particularly unsecured lending, and administered price increases which impact on discretionary spending.

The upward momentum of banks' total loans and advances to the private sector has continued, with twelve-month growth of 9,9 per cent recorded in November, the highest growth rate since February 2009. Excluding mortgage advances, which remain subdued, the increase in November was 18,3 per cent. Bank credit extension to the household sector increased by 10,4 per cent. General loans to households, which is mainly unsecured lending, while still exhibiting rates of growth in excess of 30 per cent, shows some signs of moderation amid reports that banks are becoming more cautious in extending new loans in this category. Access to new loans may also be constrained by the increased size of outstanding debt. However, despite rising debt levels, household debt to disposable income appears to have stabilised at around 76 per cent.

The MPC remains concerned about the potential impact of the higher level of wage settlements on employment and inflation. There are indications that wage increases are trending higher, with growth in nominal remuneration per worker increasing from 7,2 per cent in the second quarter of 2012 to 8,1 per cent in the third quarter. Once productivity increases are accounted for, this translates into unit labour cost increases of 6,1 per cent and 6,7 per cent in these respective quarters. According to Andrew Levy Employment Publications, the overall average wage settlement rate in collective bargaining agreements amounted to 7,4 per cent in the first nine months of 2012.

The MPC is mindful of the danger of a possible wage-price spiral and further employment losses should unaffordable real wage demands be granted while economic growth remains constrained. The risks to inflation should this scenario play itself out are significant in the absence of productivity gains.

The subdued pace of employment creation in the private sector has been further undermined by the fractious nature of recent wage negotiations and the announcement of further possible restructuring in the mining sector, which would involve the closure or mothballing of mines or shafts. According to the Quarterly Employment Statistics survey of Statistics South Africa, non-agricultural formal sector employment grew by 1,0 per cent or 82 000 employees in the year to September 2012. Almost two-thirds of this increase was accounted for by the public sector, while net job losses over this period were experienced in the manufacturing and construction sectors, with employment in the mining sector unchanged. However, in the third quarter of 2012, 15 000 jobs were shed in the mining sector and there are fears that this trend could continue. Employment in the agricultural sector, which is not covered by the survey, is also at risk.

Food prices continue to pose a significant near-term risk to the inflation outlook, although there are signs that these price pressures may moderate during the year as a result of favourable base effects, as well as the recent moderation in global and domestic wheat and maize prices. The price of these commodities will also be influenced by developments in the exchange rate of the rand and unpredictable weather patterns.

Administered prices remain on average well in excess of the upper end of the target range, and there is as yet no clarity about the new Eskom tariffs to be implemented later this year. At this stage a 16 per cent tariff increase is assumed in the forecast. International oil prices have remained relatively stable for the past few months and are more or less unchanged from the previous meeting of the MPC. Futures prices reflect an expectation of some moderation in coming months, but some volatility can be expected. The domestic price of petrol, which is also impacted by the exchange rate, declined by a cumulative 34 cents per litre since early November, but much of this decline is likely to be reversed in February.

The MPC continues to assess the balance of risks to the inflation outlook to be on the upside. While the risks to the forecast emanating from food prices may have diminished somewhat, particularly over the medium term, the exchange rate and wage settlements remain the key upside risk factors. While the reweighting and rebasing of the CPI is still to be finalised, the impact is likely to be marginal, but on the upside. Core inflation trends indicate that demand pressures are relatively contained, and household consumption expenditure has continued to moderate.

Risks to economic growth are assessed to be on the downside, particularly given the uncertain outlook for the mining industry and ongoing unsettled labour relations. The negative output gap is therefore expected to persist. The MPC remains concerned about the possibility of a wage-price spiral and its potential to exacerbate the high level of unemployment in the economy. As we noted in the previous MPC statement, concerted action is needed on the part of all the parties involved. We need cohesion of policy and decision-making to provide the necessary certainty for sustainable economic growth and development.

The monetary policy stance remains accommodative and appropriate, with the real policy rate remaining slightly negative, notwithstanding the expected temporary breach of the inflation target. However, further accommodation at this stage is constrained by the upside risks to the inflation outlook. The MPC has therefore decided to keep the repurchase rate unchanged at 5,0 per cent per annum. As always, the MPC will monitor developments closely and will not hesitate to act in a manner consistent with its mandate.