Statement of the Monetary Policy Committee

23 May 2013

Issued by Gill Marcus, Governor of the South African Reserve Bank, at a meeting of the Monetary Policy Committee (MPC) in Pretoria

The South African economy is facing a number of domestic challenges, while headwinds from the fragile and uneven global recovery remain a constraint to growth. The uncertain, and increasingly difficult, labour relations environment continues to dominate the economic landscape, contributing to declining domestic and foreign investor confidence. The growing vulnerability of the economy to changes in sentiment has been reflected in the depreciating and volatile exchange rate, which was already under pressure from the widening deficit on the current account of the balance of payments. Although inflation is forecast to remain relatively contained, these factors have raised the upside risks to the outlook at a time of worsening real growth prospects.

The year-on-year inflation rate as measured by the consumer price index (CPI) for all urban areas was 5,9 per cent in April 2013, unchanged from the previous two months. However, the drivers of the overall rate changed somewhat. Food price inflation measured 6,3 per cent in April, reversing the downward trend that had prevailed since November 2012. The contribution of food to overall inflation remained unchanged at 0,9 percentage points, while housing and utilities contributed 1,4 percentage points. Administered prices increased by 8,9 per cent, and by 7,8 per cent excluding petrol. Core inflation, which excludes food, petrol and electricity, measured 5,2 per cent – marginally up from 5,1 per cent in March. The headline producer price inflation for final manufactured goods measured 5,7 per cent in March – up from 5,4 per cent in February.

The inflation forecast of the Bank has remained relatively unchanged since the previous meeting of the MPC. Inflation is now expected to average 0,1 percentage points lower in 2013 and 2014 at 5,8 per cent and 5,2 per cent respectively, and to average 5,0 per cent in 2015. A temporary breach of the upper end of the target range is still expected in the third quarter of 2013, but at a lower average level of 6,1 per cent (6,3 per cent previously), followed by a gradual moderation of inflation to 4,9 per cent in the final quarter of 2015. The slight improvement is due to changed assumptions about international commodity prices, including oil, and lower global inflation.

The forecast for core inflation for 2013, at an average of 5,3 per cent, is significantly higher than the forecast of 4,8 per cent previously. This follows the sharp increase in medical insurance costs in the February CPI. Core inflation is also expected to be adversely affected over the coming months by increases in a number of other administered prices, particularly water and municipal rates and taxes. This measure is expected to peak at 5,4 per cent in both the third and fourth quarter of 2013, and to average 5,0 per cent and 4,6 per cent in the coming two years. Despite the higher near-term trend, this indicator is still assessed to reflect an absence of significant demand pressures.

Inflation expectations, as reflected in the Reuters survey of analysts conducted in April, has remained relatively stable for some months. The forecast is the same as the Bank's for 2013, although higher for the next two years but still within the target range. The relatively anchored inflation expectations at the upper end of the target range are also evident in the survey conducted by the Bureau for Economic Research (BER) at Stellenbosch University in the first quarter of 2013. Overall, respondents expect inflation to average 6,0 per cent in both 2013 and 2014, and 6,1 per cent in 2015.

The global economic environment remains challenging, with different regions growing at varying rates. Within the advanced economies, the United States (US) appears to be showing a number of positive signs of recovery: the University of Michigan's consumer confidence index is at its highest in almost six years; labour market developments have been more favourable; and there are strong wealth effects from the booming equity market as well as from the recovering housing market. However, headwinds can be expected from the fiscal contraction resulting from the fiscal cliff compromise and the spending cuts that were part of the recent sequester. The impact of this contraction is expected to be as high as 2 percentage points of GDP.

The eurozone remains in recession, having contracted at an annualised rate of 0,9 per cent in the first quarter of 2013, compared with a contraction of 2,7 per cent in the previous quarter. The French economy has recorded two consecutive quarters of negative growth, while Germany managed to avoid recession by recording annualised growth of 0,3 per cent in the first quarter of this year. The eurozone is constrained by continued deleveraging by households, banks and governments, and the region is also characterised by increasing financial fragmentation. Although a slower pace of fiscal consolidation in the periphery has been agreed to in terms of the bail-out agreements, negative or, at best, very low growth is expected to persist in the region for some time.

The Japanese economy rebounded from its 2012 recession in the first quarter of 2013, but it is still too soon to assess the impact of the fiscal, monetary and structural policy stimulus packages that were announced recently. The yen exchange rate, which has depreciated by around 30 per cent against the US dollar since October 2012, is likely to contribute positively to growth.

Emerging markets remain the main global source of growth, but there are signs of moderation in some of the systemically important countries, particularly China, India and Brazil. The rebalancing of the Chinese economy away from fixed capital formation and production towards internal consumption has resulted in some slowdown, which has contributed to the declining trend of global commodity prices.

The persistence of slow global growth and weaker commodity prices have resulted in a moderation in global inflation. This is particularly the case with respect to energy prices in the advanced economies. This combination of lower inflation and slow growth prompted further monetary easing by the European Central Bank, and with Japan yet to begin with its quantitative monetary easing, these accommodative policy stances are likely to persist for some time. While there are concerns about the possible risks posed to financial markets and global capital flows by an early reversal of the US monetary policy stance, any such action is likely to be extremely cautious, and is only expected to begin once a sustained recovery is well entrenched. There are, however, growing concerns that the buoyant conditions in the financial markets in many countries are indicative of bubbles caused by excessive global liquidity, rather than reflecting underlying positive growth prospects.

Movements in the exchange rate of the rand continue to be impacted by external developments, but since mid-2012 they have been compounded by domestic factors, which have undermined investor sentiment. The increasingly fraught labour relations environment, and high wage demands in the mining sector in particular, are likely to continue to impact adversely on the volume of mining exports against a backdrop of falling international commodity prices and concerns about the widening of the current-account deficit of the balance of payments. These developments also have the potential to affect, directly and indirectly, South Africa's credit ratings, and increase the cost of much-needed finance. The rand has also been influenced in recent weeks by the hedging related to renewable energy projects and by a strengthening dollar. Since the previous meeting of the MPC, the rand has depreciated by around 4,6 per cent against the US dollar and by 3,7 per cent on a trade-weighted basis.

Despite the current negative sentiment towards the rand, non-residents have remained net buyers of bonds and equities this year. Since January, non-residents have been net buyers of equities to the value of R12,7 billion, and bonds to the value of R22,5 billion. However, these positive inflows can reverse very quickly in response to changing risk perceptions. Furthermore, any hedging of these exposures, as is sometimes the case during periods of rand weakness, puts pressure on the rand even though the underlying assets are still held by non-residents.

As we have noted previously, the impact of the weaker rand on inflation is dependent on the extent, speed and duration of the depreciation, as well as the phase of the business cycle. While some of the recent decline reflects changes in the underlying fundamentals, the rand remains highly vulnerable to changes in sentiment. The rand has a tendency to overshoot in either direction and, at times, for extended but uncertain periods, which makes the impact on inflation difficult to forecast. The current level of the exchange rate, if sustained, poses a significant upside risk to the inflation outlook.

Domestic growth prospects remain fragile amid low consumer confidence, continued output disruptions in the mining sector, electricity supply constraints and a weak global environment. The growth forecast of the Bank has been revised down from 2,7 per cent to 2,4 per cent for 2013 and from 3,7 per cent to 3,5 per cent in 2014. Growth is expected to accelerate to 3,8 per cent in 2015. At these growth rates, the negative output gap will widen further before stabilising next year, and begin to close during 2015. This outlook is consistent with the flat trajectory of the Bank's leading indicator of economic activity. Notwithstanding the increase in the Rand Merchant Bank/BER Business Confidence Index in the first quarter of 2013, given the difficult labour relations environment in the country and the risks to global growth, the downside risk to growth remains as does the possibility of increased job losses.

Although the physical volume of mining production recorded a quarter-to-quarter increase of 6,1 per cent in the first quarter of 2013 following the disruptions in the previous quarter, output contracted on a month-to-month basis in both February and March. The outlook for the sector remains bleak, with threats of shaft closures and retrenchments, falling commodity prices, high wage demands, and a risk of protracted periods of industrial action and further supply disruptions.

Manufacturing production declined in the first quarter of 2013 compared with the previous quarter, although the extent of the decline is complicated by the seasonal adjustment for the Easter weekend, which fell over March and April. The Kagiso Purchasing Managers Index, which increased marginally above the neutral 50 level in April, reflects the uncertain outlook for the sector. The depreciated value of the rand should improve the competitiveness of the sector, provided that gains are not eroded by rising wages and prices. The weaker rand is expected to result in some narrowing of the trade deficit. However, the subdued global demand, together with robust import volume growth, driven to a large extent by infrastructure projects, suggests that the net export position will remain negative over the forecast period and continue to be a constraint on growth. Nevertheless, the BER Manufacturing Confidence Index, while still low, improved somewhat in the first quarter.

The outlook for household consumption expenditure – in recent years the main driver of growth – appears to have weakened with the FNB/BER Consumer Confidence Index declining to a nine-year low in the first quarter of 2013. Retail sales grew at a modest quarter-to-quarter rate of 0,6 per cent in the first quarter of this year, while sales contracted on a month-to-month basis in March. This was consistent with the decline in the BER Retail Confidence Index in the first quarter. New vehicle sales growth, while increasing significantly on a year-on-year basis, moderated to 0,1 per cent on a three-month-to-three-month basis in April 2013.

Consumption expenditure by households is expected to be constrained in part by lower real income growth, significant increases in the price of electricity and petrol, and high debt levels. The slowdown in expenditure growth has also been related to the moderation in some categories of credit extension by banks. Year-on-year growth in total loans and advances to the private sector moderated steadily from a recent peak of 10 per cent in December, to 8,1 percent in March 2013. Excluding the weak growth in mortgage advances, year-on-year growth in loans and advances declined from 18,5 per cent in December 2012 to 14,5 per cent in March. Although growth in unsecured lending to households remains at high levels, it has declined continuously since September 2012, to measure 27,9 per cent in March. This moderating trend is expected to continue, due in part to the increasing number of impaired advances in this category of lending at some of the banks. However, the ratio of total impaired advances to total loans and advances in the banking sector continues to decline and stands at just below 4 per cent.

A number of sectors in the economy are entering into wage-bargaining rounds. The MPC is increasingly concerned about the prospect of settlements well above inflation and productivity growth, and the risk of protracted and disruptive strike action, with negative implications for growth and exports. Furthermore, excessively high settlements will come at the expense of retention of employees, employment creation and could result in higher inflation. The risk of a wage-price spiral remains high. This would negate the benefits of wage increases to workers, and undermine the competitive gains of the currency depreciation. According to Andrew Levy Employment Publications, the overall wage settlement rate in collective bargaining agreements increased from 7,6 per cent in 2012 to 7,9 per cent in the first quarter of 2013. Should this upward momentum continue, it is likely to impart an upside risk to inflation. At a time of high and rising unemployment, and slowing growth, the imperative of an economy-wide commitment to wage and salary restraint at all levels, including executive pay, cannot be over-emphasised.

International oil prices are expected to remain constrained by the subdued global growth environment, but vulnerable to political developments in the Middle East in particular. Having reached a recent high of around US$118 per barrel in mid-February of this year, Brent crude oil prices have remained in a range of between US$97 and US$105 per barrel since April. The domestic price of petrol increased by 12 cents in April, but declined by 73 cents in May, mainly as a result of lower international oil prices. Although there is currently a small average over-recovery on the petrol price, recent exchange rate movements have raised the probability of further petrol price increases in the near term.

The higher CPI food price increases in April may have reversed the favourable food price developments observed in recent months. Since the end of November 2012 to date, domestic maize prices have declined by about 17 per cent and wheat prices by around 9 per cent. This is reflected in the producer price index for agriculture which increased at a year-on-year rate of 1,4 per cent in February and declined by 0,2 per cent in March. Manufactured food prices, by contrast, increased by 6,1 per cent and 6,3 per cent in the same months respectively, in line with CPI food price increases. The exchange rate poses an upside risk to food inflation as the prices of agricultural commodities such as wheat and maize are based on international prices.

The MPC is increasingly concerned about the deteriorating outlook for the South African economy. There are a number of critical domestic issues that are contributing to the vulnerability of the economy that need to be addressed. urgently These include the financing of the deficit on the current account of the balance of payments; the fractious labour relations environment and the associated risks of protracted work stoppages and excessive wage increases; electricity supply constraints; upside risks to inflation; downside risks to growth and employment creation in a context of high unemployment; and declining domestic and foreign investor confidence which could impact directly on capital flows. These interrelated developments are reflected in the volatility and weakness in the exchange rate. There is an urgent imperative for all parties – government, business, labour and civil society – to interact and address these issues and vulnerabilities at a national level. While the Bank is prepared to play its part, many of these challenges are beyond the role, scope and effectiveness of monetary policy.

While a depreciated exchange rate is part of the balance-of-payments adjustment mechanism, the competitive advantages thereof need to be realised through price and wage restraint. In the absence of such restraint, the outcome is simply higher inflation, with the risk of an exchange rate–inflation spiral. Given the current unsettled environment in the economy, the MPC assesses the risks to inflation to be on the up side, while many of the above factors contribute to a downside risk to growth.

The MPC assesses the current stance of monetary policy to be accommodative. Given the risks outlined above, the scope for further monetary easing is limited at this stage. The MPC has therefore decided to leave the repurchase rate unchanged at 5 per cent per annum. The MPC is ready to act appropriately in either direction in the event of material changes in the outlook.