Statement of the Monetary Policy Committee

21 November 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), the headline inflation rate has returned to within the inflation target range. Despite this favourable development, inflation is expected to remain uncomfortably close to the upper end of the target band. Moreover, the upside risks to the inflation outlook remain elevated, dominated by uncertainties primarily relating to both the timing and the speed of the tapering of the United States (US) Fed's bond purchasing programme.

The domestic growth outlook remains fragile, with third-quarter growth expected to have been adversely affected by the protracted work stoppages in the motor vehicle sector in particular, which also contributed to a decline in exports. Both business and consumer confidence remain at low levels. The MPC therefore continues to face the dilemma of upside risks to inflation, against a backdrop of a weaker growth outlook and a possible further depreciation of the currency.

Having breached the upper end of the inflation target range in July and August, the year-on-year inflation rate, as measured by the consumer price index (CPI) for all urban areas, declined to 6,0 per cent in September and 5,5 per cent in October. Food and non-alcoholic beverages inflation surprised on the downside, moderating to 4,3 per cent from 6,0 per cent in September, and contributing 0,6 percentage points to the annual CPI increase, compared with 0,9 percentage points in the previous month. Petrol prices increased at a year-on-year rate of 9,3 per cent, down from 12,8 per cent in September. Core inflation, which excludes food, petrol and electricity, was unchanged at 5,3 per cent, while administered price inflation excluding petrol increased marginally to 7,1 per cent. The headline producer price inflation for final manufactured goods was unchanged in September at 6,7 per cent.

The headline inflation forecast of the Bank is more or less unchanged since the previous meeting of the MPC. The forecast average inflation rates for 2013 and 2014 are 5,8 per cent and 5,7 per cent respectively, both years 0,1 percentage point lower than in the previous forecast. The forecast for 2015 is unchanged at 5,4 per cent, with inflation expected to average 5,3 per cent in the final quarter of that year. Inflation is expected to remain within the target range for the entire forecast period, with a peak of 5,9 per cent in the second quarter of 2014.

The forecast for core inflation for 2013 is unchanged at an average of 5,2 per cent, but has deteriorated for 2014 when it is expected to average 5,6 per cent compared with the forecast of 5,4 per cent previously. The forecast for 2015 remains at 5,3 per cent, ending the year at 5,1 per cent. This upward drift of the underlying inflation measure continues to be driven by the lagged effects of the depreciation of the rand exchange rate and the impact of higher unit labour costs.

The global economy is characterised by a hesitant multispeed recovery. The outlook for the US remains positive following third-quarter growth of 2,8 per cent, notwithstanding the fiscal headwinds and the unresolved budget and fiscal cliff issues, which remain downside risks. The employment data have generally been positive, prompting speculation that the Fed may begin cutting back on its programme of bond purchases sooner than previously anticipated. There is a great deal of uncertainty around the timing and pace of tapering. The timing is likely to be highly sensitive to labour market developments, and we expect the pace to be gradual to avoid undue impacts on financial markets. However, as evidenced earlier this year, the financial markets' reaction will be key to the process and to spillover effects.

While the United Kingdom (UK) economy also appears to be growing relatively strongly, with annualised growth of 3,2 per cent in the third quarter of 2013, hopes for a rebound in the eurozone have been undermined by weak growth in the third quarter. Having emerged from a prolonged recession in the second quarter, the region recorded an annualised growth rate of 0,4 per cent in the third quarter, with contractions in a number of countries, including France and Italy, and a slowdown in Germany. The Japanese economy shows signs of a sustained recovery, but growth moderated to 1,9 per cent in the third quarter, from around 4 per cent in the previous two quarters.

The slowdown in emerging markets remains broad-based but there are signs that some countries, particularly in emerging Asia, may be responding to the recovery in the advanced economies. The outlook for China has also improved and it is expected to maintain its growth rate of around 7,5 per cent, amid recent moves towards further structural reforms. Subdued growth is expected in most of the larger Latin American economies, including Brazil and Mexico.

Monetary policy in the advanced economies is expected to remain highly accommodative for some time against the backdrop of subdued headline and core inflation, as well as persistently high rates of unemployment. Despite the expected reversal of quantitative easing, the US policy rate is expected to remain at the zero bound for much longer, while slow growth and the risk of deflation prompted the recent further easing of monetary policy by the European Central Bank. Inflation in the UK has declined to below the upper threshold of 2,5 per cent. Emerging-market economies are facing generally higher inflation dynamics, due in part to exchange rate reactions to expectations of Fed tapering. Inflation pressures have prompted monetary policy responses in a number of countries including Brazil, India and Indonesia, who have all raised rates.

Speculation regarding tapering has been the main driver of rand exchange rate volatility since the previous meeting of the MPC. The rand appreciated to around R9,55 against the US dollar following the September decision by the Fed to delay tapering, and then reached a level of around R10,45 following the November Federal Open Market Committee meeting when market expectations were for an earlier start to tapering. More recently the rand has appreciated somewhat as the expected timing was pushed back by the markets, and also in response to the South African Revenue Service (SARS) release of new trade data. The rand has depreciated by 17 per cent against the US dollar since the beginning of the year, and by 15 per cent on a trade-weighted basis.

The exchange rate of the rand remains an increasingly upside risk to the inflation outlook, notwithstanding the relatively slow pass-through to consumer prices to date. The challenge facing the MPC is not only to anticipate the timing and speed of Fed tapering, but also to try to assess the extent to which tapering is already priced into the exchange rate. There is a risk that, should there be a stronger or more disorderly response by the markets to actual Fed tapering, the reaction of the exchange rate could be more extreme.

These developments have been reflected in the non-resident activity in the domestic bond and equity markets. In September and October, when expectations of Fed tapering were modified, non-residents were net buyers of bonds to the value of R17 billion, more or less reversing the net sales that followed the initial reaction in May. Since early November, however, when risk aversion returned, net sales of bonds have amounted to R9,7 billion. At the same time, net sales of equities have amounted to R14,5 billion. Year to date, non-resident purchases of bonds and equities have totalled R12,8 billion and R4,8 billion respectively.

A further risk is the deficit on the current account of the balance of payments, which makes the exchange rate more sensitive to possible capital flow slowdowns or reversals. In the second quarter of 2013 the deficit amounted to 6,5 per cent of GDP, and the published trade data suggest that a further deterioration of the trade account can be expected following the temporary collapse of motor vehicle exports and significantly higher imports in the third quarter. The actual outcome may be ameliorated to some extent by the recent inclusion by SARS of South Africa's merchandise trade data with its Southern African Customs Union (SACU) partners in the trade statistics, made possible by the modernisation of the customs data collections systems. The new inclusive data have resulted in a significant adjustment to the trade statistics published by SARS.

However, in compiling the balance-of-payments accounts in the past, the Bank made estimates of South Africa's trade with Botswana, Lesotho, Namibia and Swaziland, based on various sources. The historical trade data in the balance-of-payments accounts will be revised to account for the differences between the new data and our own previous estimates. These revisions will be published in the December Quarterly Bulletin on 3 December, and may also result in minor revisions to the gross domestic product (GDP) data. Nevertheless, the underlying trend of the current account is not expected to change significantly.

The domestic economic growth outlook remains fragile. Following a rebound of growth to an annualised 3,0 per cent in the second quarter of 2013, the third-quarter outcome is expected to be significantly lower, and more in line with the 0,9 per cent recorded in the first quarter of this year. The Bank's forecast for growth in 2013 has been revised down from 2,0 per cent to 1,9 per cent, while the forecasts for 2014 and 2015 have been revised down to 3,0 per cent and 3,4 per cent respectively, from 3,3 per cent and 3,6 per cent. This is consistent with the Bank's composite leading business cycle indicator which continues to trend sideways, while the RMB/BER Business Confidence Index at 43 points was more or less unchanged in the fourth quarter, indicative of a subdued outlook.

The adverse third-quarter growth outcome is largely due to a quarter-to-quarter contraction of 2,1 per cent in the manufacturing sector, in part a consequence of the protracted strikes that resulted in a 27,9 per cent decline in the production of motor vehicles, parts and accessories in that quarter. Reflecting these developments, the Kagiso PMI declined to 50,0 index points in September from 55,6 points in August, but recovered somewhat to 50,7 index points in October. Industrial action and safety-related stoppages also impacted negatively on mining output, but despite negative growth in August and September, a positive quarter-to-quarter growth rate of 1,4 per cent was recorded.

Encouragingly, the construction sector is showing signs of recovery with a generally steady upward trend in the value of real building plans passed, and the confidence of building contractors in the business confidence index increasing to its highest level in almost six years.

The moderating trend in the growth of consumption expenditure by households that has been evident for some time appears to have continued into the third quarter. Retail trade sales recorded a quarter-to-quarter increase of only 0,4 per cent in that quarter, and a month-to-month contraction of 0,7 per cent in September, although wholesale trade was more robust. This is consistent with the FNB/BER Consumer Confidence Index which had reached a ten-year low in the third quarter of 2013, with only a marginal improvement in the fourth quarter.

The trends in credit extension are likely to constrain consumption expenditure in the short to medium term. Twelve-month growth in total loans and advances measured 8,4 per cent in September, down from 9,0 per cent in August, while the quarterly growth rate was 5,3 per cent in the third quarter. There are clear indications of a sharp decline in lending to households. Twelve-month growth in general loans to households, mostly unsecured lending, declined to 14,2 per cent in September, the lowest rate of growth since February 2010, while annualised growth over three months was 2,8 per cent. In August and September a contraction was recorded in this category. Growth in mortgage lending, at below 3 per cent, remained subdued despite a small acceleration in September, mainly driven by commercial mortgages. By contrast, instalment sale credit remained buoyant, while twelve-month growth in total loans and advances to companies increased to 10,6 per cent.

Household consumption expenditure is, however, expected to be supported to some extent by wage trends. According to Andrew Levy Employment publications, the overall average wage settlement rate in collective bargaining agreements was 7,9 per cent in the first nine months of 2013, compared with 7,6 per cent for 2012 as a whole. Although a number of these settlements are generally well below the initial demands, they are considerably above the upper band of the inflation target, and pose a potential risk to the inflation outlook.

According to the *Quarterly Labour Force Survey* of Statistics South Africa (Stats SA), the official unemployment rate moderated to 24,7 per cent in the third quarter of 2013, from 25,5 per cent a year earlier. This follows an increase in employment of 2,8 per cent or 383,000 jobs over that period. This implies that the economy has only now returned to the same levels of employment attained before the crisis. These figures, however, are in contrast to the Quarterly Employment

Statistics of Stats SA which showed a 0,1 per cent growth in the formal non-agricultural sector from June 2012 to June 2013, and which correlates more closely with GDP trends.

Fiscal policy, as outlined in the *Medium Term Budget Policy Statement*, continues to be countercyclical, attempting to balance the need to support the economy and the need for fiscal consolidation. A deficit of 4,2 per cent is projected for the current fiscal year, and is expected to narrow to 3,0 per cent by 2015/16. Non-interest real expenditure growth is capped at an average of 2,2 per cent over the next three years, and the three-year agreement with civil service unions, due to expire in 2015, is expected to limit the growth in the public sector wage bill. This pace of consolidation should stabilise the net national debt at 44 per cent in 2017/18.

Food price inflation moderated to 4,2 per cent in October, from 6,0 per cent in September, with the deceleration in price increases being broad-based. Final manufactured producer food price inflation declined from 7,5 per cent peak in July to 6,8 per cent in September. Agricultural product prices increased by 4,3 per cent at the producer price level in September, with cereals and other crop prices declining by 6,8 per cent. This was in line with lower international food commodity prices, which offset the impact of the weaker exchange rate to some extent. While food price inflation may continue to moderate in the short term, upside pressures can be expected from the exchange rate and the fact that meat price declines, due in part by drought-induced culling, are unlikely to persist.

International oil prices have remained relatively contained below the US$110 per barrel level since the previous MPC meeting. These prices continue to be dominated by political developments in the Middle East, and the global growth outlook. Should international oil prices and the exchange rate remain at current levels, a small increase in the domestic petrol price is likely in December following a cumulative 48 cents decrease in October and November. It is important to note, however, that further weakness in the exchange rate will pass through quickly into these prices.

Despite the better-than-expected October inflation outcome, the MPC continues to assess the risks to the inflation outlook to be on the upside, mainly as a result of further potential exchange rate pressures. Tapering by the Fed is inevitable, but until a decision is taken financial markets globally are likely to experience heightened volatility. There is a high degree of uncertainty regarding the extent to which US policy actions are already priced in to the exchange rate.

Compounding the risks to the exchange rate is the stubbornly wide current-account deficit, notwithstanding recent revisions to the trade data. The deficit increases South Africa's sensitivity to global spillover effects. The MPC is mindful of the adjustment lags and will be watching carefully for signs of a positive current-account response. We need to take advantage of the depreciated exchange rate and not allow the benefits to be eroded through higher wage and other input prices. Action will be required should the adjustment mechanism not operate effectively.

While the exchange rate impact on CPI is increasingly evident in the core inflation measure, to date the pass-through has been relatively muted. But this is unlikely to persist should there be a significant further depreciation.

At the same time the policy dilemma is underlined by the deterioration in the growth outlook. The committee assesses the risks to be on the downside, amid continued supply disruptions and low business and consumer confidence. The downward trend of household consumption expenditure is indicative of relatively weak demand conditions in the economy, and slower bank credit extension to households is likely to reinforce this trend.

The inflation forecast remains uncomfortably close to the upper level of the inflation target range but our central forecast remains within the target. Given the increased upside risks to the outlook, we do not see room for further monetary accommodation. We will continue to monitor developments carefully on an ongoing basis and remain committed to act as required. The MPC has decided to keep the repurchase rate unchanged at 5,0 per cent per annum at this stage.

The MPC meeting dates for 2014 are as follows:

27–29 January 2014 (Monday–Wednesday)
25–27 March 2014 (Tuesday–Thursday)
20–22 May 2014 (Tuesday–Thursday)
15–17 July 2014 (Tuesday–Thursday)
16–18 September 2014 (Tuesday–Thursday)
18–20 November 2014 (Tuesday–Thursday)