Statement of the Monetary Policy Committee

27 March 2014

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

Since the previous meeting of the Monetary Policy Committee (MPC), the global economic environment has remained challenging, notwithstanding some improvement in sentiment. Key factors affecting the environment include the possibility of an earlier-than-expected increase in the United States (US) policy rate in 2015, further evidence of a slowdown in China, and geo-political tensions arising from the situation in Ukraine.

The domestic economic outlook remains subdued amid continued strikes in the platinum sector and uncertainty regarding a stable and sufficient electricity supply in the coming months. While the most recent inflation forecasts suggest marginal improvements in the medium term, upside risks to the inflation outlook persist despite the recent appreciation of the rand, which remains vulnerable to shifts in global risk sentiment and adverse domestic developments. Together with downside risks to growth, this continues to pose a dilemma for monetary policy.

The year-on-year inflation rate as measured by the consumer price index (CPI) for all urban areas measured 5,8 per cent and 5,9 per cent in January and February 2014 respectively, up from 5,4 per cent in December 2013. This marked upward trend was in line with the forecasts of the South African Reserve Bank (the Bank). Food and non-alcoholic beverage price inflation reversed its previous downward trend, measuring 4,3 per cent and 5,4 per cent in the past two months, compared with the recent low of 3,5 per cent in December. The contribution of this category to the overall CPI inflation increase was 0,8 percentage points in February 2014, compared with 0,5 in December 2013. The petrol price, which was the other main contributor to the higher CPI inflation in February, increased at a year-on-year rate of 14,0 per cent. Core inflation, which excludes food, petrol and electricity, was unchanged at 5,3 per cent, the sixth consecutive month at this level. This was despite upward pressures from exchange rate sensitive categories such as clothing and footwear, and motor vehicle inflation, which were offset to some extent by a lower rate of increase in medical insurance costs. Administered price inflation excluding petrol measured 6,9 per cent. The headline producer price inflation for final manufactured goods measured 7,7 per cent in February, compared with 7,0 per cent in January.

The Bank's forecast of headline inflation is unchanged for 2014 and is expected to average 6,3 per cent, with the peak of 6,6 per cent still expected in the fourth quarter. The forecast average inflation for 2015 declined from 6,0 per cent previously to 5,8 per cent, with inflation expected to average 5,6 per cent in the final quarter of that year, compared with 5,9 per cent previously. This improvement is mainly the result of the lagged effect of the repurchase (repo) rate increase. Inflation is still expected to breach the upper end of the target range in the second quarter of 2014, and to return to within the target range in the second quarter of 2015, when it is expected to measure 5,9 per cent.

The outlook for core inflation has improved and is expected to average 5,6 per cent in both 2014 and 2015, compared with the previous forecast of 5,8 per cent and 5,9 per cent for these two years respectively. Notwithstanding this improvement, the upward pressures continue to be seen to be coming from the lagged effects of the exchange rate depreciation. The MPC still assesses the risks to the inflation outlook to be skewed to the upside, as extended periods of overshooting of the exchange rate remain a possibility in the current uncertain global environment. There is also a risk that the current low level of pass-through may not persist.

Inflation expectations as measured by the survey conducted by the Bureau for Economic Research (BER) in the first quarter of 2014, remained unchanged at an average of 6,1 per cent for both 2014 and 2015, with inflation of 5,9 per cent expected in 2016. Although the 2014 expectations of analysts increased to 6,1 per cent from 5,6 per cent in the previous survey, the expectations of business people declined to 6,2 per cent from 6,4 per cent, with trade union expectations unchanged at 6,1 per cent. Analysts expect inflation to moderate during the next two years to within the target range, while business and labour respondents expect inflation to remain steady at just over 6 per cent, indicating that expectations continue to be relatively well anchored, albeit at the upper end of the target band.

The Reuters survey of economic analysts conducted in March 2014 shows that inflation expectations of economists are more or less unchanged since the previous survey and also remain, on average, anchored at the upper end of the band. The expectation is that inflation will breach the upper end of the target range in the third and fourth quarters of 2014 at an average rate of 6,1 per cent before returning to within the target range.

The global economic recovery continues to be uneven, with a first quarter slowdown in growth in the advanced economies compared with the fourth quarter of 2013, due in part to severe weather conditions, particularly in the US. Nevertheless, the underlying US growth prospects remain relatively favourable despite a slower pace of employment growth, amid positive investment and consumption indicators. The United Kingdom economy continues to show signs of sustained improvement, with declining inflation and unemployment rates as well as a buoyant housing market. The eurozone's growth prospects remain weak, although there are signs of a modest recovery, and the unemployment rate appears to have peaked. Japanese economic growth in the fourth quarter of 2013 was lower than expected, and there are indications that the recovery could be losing momentum.

The global outlook is, however, overshadowed by unfolding developments in the Ukraine and Russia regarding Crimea, although to date contagion effects have been limited to those countries with direct trade and financial links with the region. The other downside risk factor relates to a deteriorating outlook in a number of the larger emerging market economies, including Brazil, Russia and China. Recent short-term data from China indicate that economic growth could decline below the government's target of 7,5 per cent, at a time of increased risks in the banking sector.

The slowdown in China is expected to maintain downward pressure on global commodity prices, particularly industrial commodities, while there are upside risks to some commodities, particularly oil and grains, from the tensions in Crimea.

Global inflation pressures remain benign, particularly in the advanced economies. Since the previous meeting of the MPC, the US has continued its steady path of tapering, although the financial markets now believe that the first interest rate increases may occur earlier in 2015 than previously expected. Over the same period, monetary policy has been tightened in New Zealand, Brazil and Russia, and loosened in Israel, Thailand, Chile and Hungary.

The exchange rate of the rand has been relatively volatile since the previous meeting of the MPC, having fluctuated in a wide range between R10,60 and R11,39 against the US dollar. There has been an appreciating trend over this period, in line with an improving risk sentiment towards emerging markets. Since the previous meeting of the MPC, the rand has appreciated by about 2,4 per cent against the US dollar, and by 2,2 per cent on a trade-weighted basis.

While the risk to the inflation outlook from the exchange rate may have moderated somewhat since the previous meeting, these risks are still assessed to be on the upside. The MPC is of the view that the exchange rate will continue to be highly sensitive to both domestic and global developments, remaining prone to further bouts of volatility and protracted periods of overshooting.

The current account of the balance of payments narrowed significantly, from 6,4 per cent of gross domestic product (GDP) in the third quarter of 2013 (revised down from 6,8 per cent previously) to 5,1 per cent of GDP in the following quarter, with a deficit for the year of 5,8 per cent. The contraction of the trade account was a result of both a 3,6 per cent decline in the value of merchandise imports and a 0,9 per cent increase in export earnings. Although we expect the current account to respond to the depreciated exchange rate, this adjustment is likely to be gradual and some widening of the trade deficit is expected in the first quarter of 2014. Constraining factors include the protracted nature of the strike in the platinum sector and the relatively inelastic import demand, particularly with respect to imported capital equipment. Promisingly, net exports made positive contributions to GDP growth in the final two quarters of 2013.

Tapering by the US Federal Reserve and the expectation of US interest rate normalisation continued to impact on the pattern of global capital flows and financial market volatility. The domestic yield curve flattened since the previous MPC meeting, as the short end increased in response to monetary tightening, while the long end of the curve shifted downwards. In contrast to emerging markets in general, South Africa experienced net inflows into the equity markets in February and March 2014 totalling R11,6 billion, following net sales of R25,1 billion between November 2013 and January 2014. Non-residents remained net sellers of bonds but at a slower pace: net sales of bonds amounted to R46,0 billion over the same three-month period, but moderated to R1,2 billion in February 2014, and net purchases of R2,1 billion in March to date.

The domestic economic growth outlook remains subdued. Despite a rebound in the fourth quarter of 2013, when an annualised growth rate of 3,8 per cent was recorded, economic growth is expected to remain below potential of between 3,0 per cent and 3,5 per cent in 2014, with a consequent widening output gap. The Bank's forecast for economic growth has declined marginally to 2,6 per cent in 2014, compared with 2,8 per cent previously, while the forecast for 2015 has been revised down from 3,3 per cent to 3,1 per cent. The risks to this forecast are seen to be on the downside, given the protracted strike in the platinum sector and electricity supply constraints. This deterioration comes amid continued low levels of business confidence, with the RMB/BER Business Confidence Index declining to 41 index points in the first quarter of 2014, the fourth consecutive month at a level below the neutral 50 index points. The sideways movement of the composite leading business cycle indicator of the Bank also points to a restrained outlook.

The growth outcome in the fourth quarter of 2013 was led by strong growth in the manufacturing sector in particular, following the strike-induced contraction in the previous quarter. In January 2014, a 2,5 per cent year-on-year rate of growth in manufacturing output was recorded. According to the BER manufacturing survey, business confidence in the sector remains low despite increasing to 41 index points in the first quarter of the year, from 36 previously. There are, however, some positive signs in the sector, with the Kagiso Purchasing Managers' Index (PMI) increasing to 51,7 index points in February, and the BER's indicators for manufacturing export sales and orders improving further in the first quarter of 2014, to their highest level in ten years.

Despite strong performance in the fourth quarter of 2013, the outlook for the mining sector remains bleak: mining output contracted at a month-on-month rate of 1,1 per cent in January of this year, and the ongoing strike in the platinum sector is likely to impact adversely on mining output and exports.

Growth in real gross fixed capital formation accelerated to 4,7 per cent in 2013, compared with 4,4 per cent in the previous year. During the past year, real capital outlays by the private sector increased by 5,5 per cent, while public corporations and general government investment increased by 3,1 per cent and 3,5 per cent respectively.

Consistent with moderate economic growth, employment growth has remained weak. According to the *Quarterly Employment Statistics (QES)* of Statistics South Africa, employment levels in the formal non-agricultural sector increased marginally at a seasonally adjusted rate of 0,2 per cent in the fourth quarter of 2013, or by 5 100 employment opportunities. In the year to the fourth quarter of 2013, the increase was 0,5 per cent or 40 900 jobs, with the public sector contributing 39 000 of these jobs. Overall, private-sector employment declined during the fourth quarter of 2013, with losses most pronounced in the gold mining, construction and electricity sectors.

The weakening trend in the growth in household consumption expenditure continued into the final quarter of 2013, with growth of 2,0 per cent recorded, and its contribution to GDP growth declining from 2,3 percentage points in 2012 to 1,7 percentage points in 2013. Growth for the year averaged 2,6 per cent, while consumption expenditure by general government averaged 2,4 per cent. Household spending on durable goods remained firm, but grew at a slower pace of 6,9 per cent, and is likely to moderate further as vehicle sales come under increasing pressure. Total domestic new vehicle sales declined in February 2014 by 2,6 per cent on a month-to-month basis and by 3,1 per cent year on year. Although real retail trade sales exceeded market expectations in January following a month-to-month increase of 0,8 per cent and a 6,8 per cent increase year on year, the outlook for consumption expenditure is expected to be constrained by slow employment growth, high debt levels of consumers, slow rates of growth in credit extension and the higher interest rate environment.

Growth in government consumption expenditure is expected to be contained. According to the recent budget, the expenditure cap has been maintained and a consolidated budget deficit of 4,0 per cent of GDP is estimated for 2014/15, in line with that of the past fiscal year. A faster pace of fiscal consolidation is indicated, with the deficit-to-GDP ratio expected to decline to 2,8 per cent in 2016/17.

Bank credit extension to the private sector has maintained its weak underlying trend, particularly with respect to credit extended to households, reinforcing expected pressures on household consumption expenditure. By contrast, credit extension to the corporate sector was relatively robust, with growth rates of around 10 per cent. Although twelve-month growth in total loans and advances to the private sector increased from 6,4 per cent in December 2013 to 7,6 per cent in January 2014, credit extension to households increased by 5,5 per cent and 5,6 per cent in these two months respectively. This probably reflects both supply- and demand-side considerations. Mortgage lending remained weak, with twelve-month growth of 2,1 per cent in January, amid moderate house price growth. Twelve-month growth in general loans to households (mainly unsecured lending) continued its downward trend, measuring 5,0 per cent in January, the lowest rate of growth since February 2005. Instalment sale credit and leasing finance has remained buoyant but is growing at a more moderate pace, in line with declining vehicle sales.

The trend in wage settlements has remained relatively unchanged. According to Andrew Levy Employment Publications, the overall average wage settlement rate in collective bargaining agreements measured 7,9 per cent in 2013, compared with 7,6 per cent in 2012. Data from Stats SA show that the growth in nominal remuneration per worker increased from 6,7 per cent in the year to the third quarter of 2013 to 7,0 per cent in the fourth quarter. Once the slight increase in productivity growth is accounted for, this translates into a unit labour cost increase of 5,2 per cent in the fourth quarter. While this appears to be relatively contained, there are wide variations across sectors, and the outcome of wage negotiations during the year in an unsettled labour relations environment will be an important determinant of inflation pressures.

As anticipated, the favourable trend of food prices in the CPI has reversed, and pressures are expected on headline inflation from this source despite the moderation of prices at the global level. Having reached a recent low of 3,5 per cent in December 2013, consumer food price inflation increased to 4,3 per cent and 5,6 per cent in the subsequent two months. Final manufactured producer food price inflation accelerated to 7,6 per cent in February 2014, and further pressures are evident in the agricultural producer price inflation for cereals and other crops which accelerated from -8,2 per cent in August 2013 to 27,6 per cent in February 2014.

This contributed to the 7,4 per cent increase in bread and cereals prices at the consumer price level in February. The wheat and maize prices reflect exchange rate pressures and domestic drought conditions. Although futures prices indicate some possible moderation in the coming months following the recent rains, near-term pressures remain.

International oil prices have been relatively unaffected by the Crimean crisis, and the price of Brent crude oil fluctuated between a relatively narrow range of US$106 and US$111 per barrel since the previous meeting. The exchange rate has been the main driver of the rand petrol price, which increased by a cumulative 75 cents per litre in February and March. The recent appreciation of the rand has resulted in the current over-recovery in the petrol price, and this is expected to offset in part the 20 cents per litre fuel levy increase due to be implemented in April.

The MPC is acutely aware of the policy dilemma of rising inflation pressures in a subdued economic growth environment. Despite a marginal improvement in the medium-term inflation forecast, the trajectory remains uncomfortably close to the upper end of the target range.

The main upside risk to the forecast continues to come from the exchange rate, which, despite the recent relative stability, remains vulnerable to global rebalancing. The expected normalisation of monetary policy in advanced economies is unlikely to be linear or smooth, and the timing and pace is uncertain.

The rand is also vulnerable to domestic idiosyncratic factors, including protracted work stoppages, electricity supply constraints, and the slow adjustment of the current-account deficit. Pass-through from the exchange rate to prices has been relatively muted to date but there is some evidence that it is accelerating. However, the forecast already incorporates a higher pass-through than has been experienced up to now.

At the same time, the domestic economic outlook remains fragile, with the risks assessed to be on the downside. Demand pressures remain benign as consumption expenditure continues to slow amid weakening credit extension to households and high levels of household indebtedness. The upward trend in the core inflation forecast is assessed to reflect exchange rate pressures rather than underlying demand pressures.

Given the lags with which monetary policy operates, the MPC will continue to focus on the medium-term inflation trajectory. The committee is aware that too slow a pace of tightening could undermine inflation expectations and may require more aggressive tightening in the future. Consistent with our mandate, a fine balance is required to ensure that inflation is contained while minimising the cost to output.

The real policy rate is currently below what can be considered normal in the long run and is likely to increase over the medium term. The pace of tightening will depend on a number of factors, including projected inflation, inflation expectations, the state of the economy and global developments. At this meeting, the MPC decided to keep the repo rate unchanged at 5,5 per cent per annum.

We wish to reiterate that even though we are in a tightening cycle, there will not necessarily be a change in the stance at every meeting, and that the increments may not always be of the same magnitude.