

# Statement of the Monetary Policy Committee

17 July 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 economic growth outlook has deteriorated against the backdrop of protracted strike action in the mining and manufacturing sectors. The economy contracted in the first quarter of 2014, and the growth outlook for the rest of the year remains subdued amid low business confidence. Compounding the MPC's policy dilemma, inflation has breached the upper end of the target range, driven primarily by the exchange rate depreciation and rising food prices, while a possible wage-price spiral resulting from recent wage settlements and wage demands considerably in excess of inflation and productivity growth have added to the upside risk to the inflation outlook.

The year-on-year inflation rate as measured by the consumer price index (CPI) for all urban areas measured 6,6 per cent in May, up from 6,0 per cent and 6,1 2 per cent in March and April 2014 respectively. The main driver of this marked acceleration was food and non-alcoholic beverage price inflation which measured 8,8 per cent in May compared with 7,0 per cent and 7,8 per cent in the previous two months respectively. This category contributed 1,3 percentage points to the headline CPI outcome, compared with a recent low of 0,5 percentage points in December 2013. The categories of food, housing utilities and transport together accounted for 4,2 percentage points of the inflation outcome in May, compared with 3,7 percentage points in the previous month. The transport index increased at an annual rate of 8,9 per cent, from 6,8 per cent in April, despite a 15 cents per litre decline in the petrol price in May. Core inflation, which excludes food, petrol and electricity, remained unchanged at 5,5 per cent for the third consecutive month. Administered price inflation excluding petrol was unchanged from the previous month at 6,5 per cent. The headline producer price inflation for final manufactured goods moderated slightly from 8,8 per cent in April to 8,7 per cent in May, driven in part by lower agricultural product inflation.

The marginal improvement in the Bank's forecast of headline inflation at the previous meeting has been more or less reversed, as recent food price developments surprised on the upside. Inflation is now expected to average 6,3 per cent in 2014, compared with 6,2 per cent previously, with the quarterly peak of 6,6 per cent (previously 6,5 per cent) still expected in the fourth quarter, following a slight moderation in the third quarter. The forecast average inflation for 2015 increased to 5,9 per cent from 5,8 per cent, while the forecast for 2016 increased marginally to 5,6 per cent, and to 5,5 per cent in the final quarter of that year. Inflation is still expected to return to within the target band during the second quarter of 2015 provided that there are no further shocks to the system, particularly from possible higher tariff increases being granted to Eskom by the National Energy Regulator of South Africa (Nersa) from 2015.

The forecast for core inflation is unchanged. This measure is expected to average 5,6 per cent and 5,7 per cent in 2014 and 2015 respectively, moderating to 5,5 per cent in 2016, with the moderate upward pressure coming from the lagged effects of the exchange rate depreciation rather than evidence of strong domestic demand pressures. As before, the MPC sees the risks to the headline inflation forecast to be skewed to the upside.

Inflation expectations as reflected in the survey conducted by the Bureau for Economic Research (BER) at Stellenbosch University have remained anchored at the upper end of the target band. The average inflation expectation of analysts, business people and trade union officials for this year and next year has remained unchanged for six consecutive quarters at 6,1 per cent for both years, declining to 5,9 per cent in 2016. Within these categories, the largest change was by business people for 2016, where expectations increased from 6,2 per cent in the previous survey to 6,4 per cent. However, their expectation for 2015 moderated slightly. Inflation expectations of households for 2014 declined from 6,7 per cent in the first quarter to 6,3 per cent in the second quarter.



The Reuters survey of inflation expectations of economic analysts conducted in May remained more or less unchanged since the previous survey, with a slight upward shift. The outcome of the survey shows a divergence of views among analysts as to whether inflation will peak in the second or fourth quarter of 2014. On average, the expectation is for inflation to peak in the second quarter, at an average of 6,4 per cent, and to return to within the target range in the first quarter of 2015. According to the survey, annual inflation is expected to average 6,2 per cent in 2014, and 5,7 per cent and 5,5 per cent in the subsequent two years respectively.

The global economy continues to exhibit mixed signals regarding the economic growth outlook. Since the previous meeting of the MPC, consensus forecasts for growth in 2014 have been revised downwards for the United States (US) and the eurozone, but those for Japan and the United Kingdom (UK) have been revised upwards. The earlier optimism that the US would grow at around 3 per cent in 2014 has been moderated following the 2,9 per cent annualised contraction in the first quarter, partly as a result of severe weather conditions and a decline in expenditure on health care. Most analysts now expect US growth to be closer to 2 per cent. This weaker growth is despite larger-than-expected improvements in the unemployment rate. The outlook for the eurozone has also deteriorated, following weak industrial output in Germany in May, and slowing growth in France and Italy. Real output in Japan is expected to contract in the second quarter following the surge in expenditure in the first quarter in advance of the increase of consumption taxes. The UK recovery, however, appears to be sustained with growth of around 3 per cent expected in 2014.

The outlook for emerging markets remains relatively subdued, but some emerging Asian economies have benefited from stronger US growth. The Chinese economy is expected to grow by just under 7,5 per cent in 2014, although concerns about the shadow banking system remain. Subdued growth is expected in a number of emerging markets, including Brazil, Russia, Thailand and Argentina.

Global financial-market developments remain dominated by expectations of changes in monetary policy in the advanced economies, amid concerns that the current low interest rate and low volatility environment may encourage excessive risk taking and asset price bubbles. By contrast to a number of emerging-market economies, inflation remains benign in the advanced economies, although the risk of deflation in the eurozone persists. The UK is expected to be the first advanced economy to raise interest rates, but at a moderate pace, while the US is generally not expected to begin the process of normalisation before the third quarter of 2015. However, the tapering of bond purchases by the US Federal Reserve (Fed) is expected to continue at a steady pace. This process is fully discounted in the markets, and is expected to be completed later this year.

By contrast, the European Central Bank (ECB) has recently announced a range of new monetary policy measures aimed at stimulating the economy through encouraging bank lending and preventing deflation, while Japanese monetary policy is expected to remain highly stimulatory for some time. Since the previous meeting of the MPC, a number of countries have reduced their policy rates, including the eurozone, Sweden, Mexico, Hungary and Turkey, while the tightening cycle continued in New Zealand.

The exchange rate of the rand continues to pose an upside risk to the inflation outlook. Having appreciated to a level of R10,29 against the US dollar soon after the previous MPC meeting, the rand exchange rate followed a depreciating trend, reaching a new trading range of between R10,60 and R10,80 since the beginning of June. Since the previous meeting, the rand has depreciated by 2,6 per cent on a trade-weighted basis. The appreciation of the rand in May was in response to more benign global factors as market participants absorbed the forward guidance provided by the central banks in the advanced economies. This contributed to lower risk aversion and renewed flows to emerging markets in general. Since the previous meeting, non-resident net purchases of bonds and equities have amounted to R7,2 billion, and R44,2 billion since the beginning of February.

Despite these inflows, since early June the rand has largely decoupled from its emerging-market peers, and depreciated relative to most currencies, as it reacted to deteriorating domestic



fundamentals. These included the negative gross domestic product (GDP) growth rate, the adverse reports from the ratings agencies, and the protracted nature of the platinum and metal workers' strikes. The impact of the platinum-sector strikes on exports began to be felt in April and May, and it is estimated that during these two months the value of platinum group metals (PGM) exports was around R20 billion lower than during the first quarter. This is likely to put pressure on the current account of the balance of payments in the second quarter, following a narrowing of the deficit in the first quarter to 4,5 per cent of GDP.

South Africa's growth outlook has deteriorated since the previous meeting of the MPC, compounded by continued labour disruptions. Following a contraction of 0,6 per cent in the first quarter, the outlook for the second quarter is expected to be positive but subdued, particularly in the light of weak mining and manufacturing data in May. The Bank's latest forecast, which assumes a speedy resolution of the metal workers' strike, sees growth in 2014 at 1,7 per cent, compared with 2,1 per cent previously and 2,8 per cent at the beginning of the year. Growth forecasts for the coming two calendar years have been reduced to 2,9 per cent and 3,2 per cent, from 3,1 per cent and 3,4 per cent respectively. The Rand Merchant Bank (RMB)/BER Business Confidence Index remained low and unchanged at 41 index points in the second quarter of 2014, with a sharp decline particularly evident among manufacturers. The Bank's leading indicator of economic activity declined moderately, reflecting subdued growth expectations.

The weak business confidence is mirrored in the 2,6 per cent growth in gross fixed capital formation in the first quarter of 2014. Growth in fixed investment by the private sector, which accounts for about two thirds of gross fixed capital formation, weakened further, from 2,4 per cent in the fourth quarter of 2013 to 1,0 per cent in the first quarter of 2014.

The mining sector contracted by an annualised 24,7 per cent in the first quarter of 2014, and although mainly driven by the strike-induced decline in PGM output, the contraction was fairly broad-based across the sector. Despite a higher-than-expected performance in April, the data for May show that the outlook for the second quarter is also bleak. In May the physical volume of mining output declined by (a non-annualised) 3,1 per cent on a month-to-month basis, and by 5,6 per cent on a three-month-to-three-month basis, with PGM output declining by 34,1 per cent. While the strike is over and miners are returning to work, PGM production is not expected to normalise for some time, and possible shaft closures could reduce the longer-term potential of the sector.

The manufacturing-sector performance in the first two months of the second quarter has also been disappointing, following the 4,4 per cent contraction in the first quarter. In May manufacturing output declined by 3,7 per cent on a year-on-year basis, and by 2,0 per cent on a three-month-on-three-month basis. The sector was negatively impacted by electricity supply constraints and the platinum-sector strike, while the current strike by metal workers is likely to undermine the outlook for the third quarter. The Kagiso Purchasing Managers' Index (PMI) registered a slight improvement in June, measuring 46,6 index points, but has remained below the neutral 50 index point level for three consecutive months.

Trends in employment growth are indicative of the weak private-sector investment. Although formal non-agricultural employment increased for the third consecutive quarter in the first quarter of 2014, all the gains were in the public sector. While overall employment increased by 42 000 jobs in the year to the end of March, 49 000 jobs were created in the public sector while the private sector shed jobs, particularly in the mining sector where almost 29 000 jobs were lost.

Final consumption expenditure by households remains the main driver of GDP growth, but with a declining contribution of 1,2 percentage points in the first quarter of 2014. Growth in household consumption expenditure, which measured 2,6 per cent in 2013, declined to 1,8 per cent in the first quarter of 2014, with a marked moderation in the growth of expenditure on durable goods and a contraction in spending on non-durable goods. Real retail sales growth contracted by 0,8 per cent on a three-month-to-three-month basis in May, and increased at a month-to-month rate of 0,8 per cent. Domestic motor vehicle sales declined by 2,3 per cent on a year-on-year basis, but increased by 4,7 per cent on a month-to-month basis in June. Despite these weak



trends, consumer confidence surprised on the upside in the second quarter, with the FNB/BER Consumer Confidence Index increasing from -6 to 4 index points, although respondents do not deem the present time as appropriate to buy durable goods.

Growth over twelve months in total loans and advances to the private sector measured 8,2 per cent in May 2014, but the divergent trends in bank credit extended to households and the corporate sector have continued. Growth in credit extended to the corporate sector has been steadily increasing since the beginning of the year, measuring 13,3 per cent in May, due in part to renewable energy contracts. By contrast, growth in credit extended to the private sector has continued to trend downwards, to measure 4,3 per cent in May. Twelve-month growth in general loans to households, mainly unsecured lending, declined to 2,8 per cent in May; its lowest growth since February 2005. Mortgage credit extension remained within the 2 to 3 per cent range observed since January 2013, and instalment sale credit and leasing finance also continued to moderate from growth rates of around 13 per cent in the second half of 2013 to 8,6 per cent in May. These credit extension trends to households reflect a combination of weakening household consumption expenditure and stricter bank lending criteria for unsecured loans in particular. Household debt to disposable income remains elevated, but declined marginally to 74,5 per cent in the first quarter of 2014.

The trend in wage settlements poses an upside risk to the inflation outlook, and these pressures are likely to intensify in the current difficult labour relations environment. According to Andrew Levy Employment Publications, the average wage settlement rate in collective bargaining agreements increased from 7,9 per cent in the first quarter of 2014 to 8,1 per cent in the second quarter. However, increases over four quarters in nominal unit labour costs in the formal non-agricultural sector declined from 5,9 per cent in the fourth quarter of 2013 to 4,8 per cent in the first quarter of 2014. The MPC is concerned that recent wage settlements in the mining sector and current demands in the metals sector could set a precedent for wage demands more generally. Unless accompanied by higher productivity, such settlements could generate a wage-price spiral, and are also likely to have a negative impact on employment trends. While the focus has generally been on wage demands, there is an imperative for attention to also be paid to excessive salaries and bonuses of management and executives.

Food prices have been one of the main drivers of inflation since the beginning of the year and have generally surprised on the upside in recent months. There are, however, some tentative indications that we may be near the peak: in May manufactured food producer price inflation moderated for the first time since October 2013 and measured 8,9 per cent, down from 9,5 per cent in April. Agricultural producer price inflation declined from a recent peak of 13,3 per cent in March to 6,7 per cent in May reflecting in part the sharp decline in maize prices to export parity price levels. Prices of cereals and other crops declined by 0,8 per cent in May, having reached a recent peak of 27,6 per cent in February. Global food price pressures are also benign, with the year-on-year inflation rates as reflected in the Food and Agriculture Organization (FAO) food price index being negative for twelve consecutive months. Apart from weather-related risks, the overall trend in food prices will remain highly sensitive to exchange rate developments.

Despite recent geopolitical risks, particularly in Ukraine and Iraq, international oil prices have remained relatively stable. Apart from a brief spike to a level of around US\$115 per barrel in June, the price of Brent crude oil has generally traded in a range of US\$105 and US\$110 per barrel, and is currently at around US\$105 per barrel. Domestic petrol prices have therefore been driven primarily by exchange rate changes. Following the appreciation of the rand in April, the petrol price was reduced by a total of 37 cents per litre in May and June, but this was largely reversed in July when the price increased by 31 cents per litre. If the current trends persist, a further small increase in the petrol price can be expected in August.

The MPC remains concerned about weak growth, the widening output gap and the negative employment outlook. The strike in the platinum sector contributed to the downward revision of the growth forecast, and the latest forecast has not factored in the possibility of a protracted work stoppage by the metal workers, which would potentially have much wider ramifications because of the direct linkages to other sectors of the economy. This weak growth outlook, however, is not something that monetary policy can ameliorate.



The MPC is also increasingly concerned about the inflation outlook and the further upside risks to the forecast. Although the exchange rate remains a key factor in this regard, the possibility of a wage-price spiral, should wage settlements well in excess of inflation and productivity growth become an economy-wide norm, has increased. Although the inflation trajectory has not deteriorated markedly since the previous meeting, upside risks have increased, and it is expected to remain uncomfortably close to the upper end of the target range when it does eventually return to within the target. The upside risk factors make this trajectory highly vulnerable to any significant changes in inflation pressures.

Although inflation expectations have remained relatively anchored, should inflation persist outside the target band, these expectations risk becoming dislodged.

The MPC is, however, cognisant of the fact that the inflation pressures do not reflect excess demand conditions in the economy. Household consumption expenditure remains weak and credit extension to households is contracting in real terms. However, we do have to be mindful of second-round effects of supply-side shocks.

The MPC faces an increasingly difficult dilemma of rising inflation and slowing growth. The core mandate of the Bank remains price stability but, at the same time in achieving this mandate, we have to be mindful of the impact of our actions on economic growth and tread a fine line between acting effectively to address the inflation objective while not undermining growth unduly.

The MPC has decided to continue on its gradual normalisation path and raise the repurchase rate by 25 basis points to 5,75 per cent per annum, effective from Friday, 18 July. Given the expected inflation trajectory, the real repurchase rate remains slightly negative and well below its longer-term neutral level. The monetary policy stance remains supportive of the domestic economy and, as before, any future moves will be gradual and highly data-dependent.

We would like to reiterate that monetary policy should not be seen as the growth engine of the economy. The sources of the below-par growth performance are largely outside the realms of monetary policy. In the short term, an improvement in the interaction and relationships between management and labour is essential to foster a climate of trust and confidence, and get South Africa back to work. Given that the key headwinds preventing a return to trend growth are structural, there is an urgent need to implement necessary structural reforms, as envisaged in the National Development Plan, in order to achieve higher and more inclusive growth.

