

Statement of the Monetary Policy Committee

23 July 2015

Issued by Lesetja Kganyago, 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 environment has been dominated by heightened uncertainty relating to the debt crisis in Greece and the sharp decline in equity prices in China. While the tail risks from these events appear to have dissipated somewhat, uncertainties still remain. At the same time, the risks associated with financial market volatility related to the timing of the first increase in the United States (US) policy rate persist.

Domestically, the growth outlook remains weak, as both the supply and the demand sides remain constrained amid declining business and consumer confidence. The inflation forecast has deteriorated slightly since the previous meeting, notwithstanding the lower-than-expected outcome in June. Headline inflation is expected to breach the upper end of the target range during the first two quarters of next year, while upside risks posed by the exchange rate have increased.

The year-on-year inflation rate, as measured by the consumer price index (CPI) for all urban areas, stood at 4,6 per cent and 4,7 per cent in May and June respectively.

The latter surprised on the downside due to, inter alia, lower-than-expected increases in food price and rental inflation, with upside pressures coming from higher petrol prices. The categories of housing and utilities, food and non-alcoholic beverages, and miscellaneous goods and services contributed 3,1 percentage points to the overall inflation outcome. The South African Reserve Bank's (the Bank) measure of core inflation – which excludes food, fuel and electricity – moderated from 5,7 per cent in May to 5,5 per cent in June.

Producer price inflation (PPI) for final manufactured goods continued its upward trend, having reached a low point of 2,6 per cent in February. In April and May, the PPI measured 3,0 per cent and 3,6 per cent respectively. The latter was above market consensus, driven by higher-than-expected food, beverage and tobacco product prices which, at 2,2 percentage points, were also the main contributor to the annual change in the PPI. The upward trend is expected to persist, driven by rising agricultural crop prices and electricity tariffs.

The inflation forecast of the Bank has changed marginally since the previous meeting of the MPC, with headline inflation now expected to average 5,0 per cent in 2015, up from 4,9 per cent previously. The forecast for the first two quarters of next year has also been revised upwards by 0,1 percentage points to 6,9 per cent and 6,1 per cent respectively, with a return to within the target range by the third quarter. However, the forecast average inflation for both 2016 and 2017 is unchanged at 6,1 per cent and 5,7 per cent respectively.

The forecast for core inflation is unchanged and is expected to average 5,6 per cent in 2015, moderating to 5,4 per cent and 5,2 per cent in the next two years. As before, much of the persistence of core inflation at these levels is attributed to high levels of wage growth, currency depreciation, and inflation expectations entrenched at the upper end of the target range.

The headline inflation forecast assumes electricity price increases of 13,0 per cent in July 2016 and July 2017. Although the current multi-year price determination allows for an 8 per cent increase from July next year, Eskom is expected to apply for a clawback on diesel usage, and this accounts for the additional 5 percentage point assumption in the model. The main assumptions underlying the model are listed in the annexure to this statement.

Inflation expectations, as reflected in the survey conducted by the Bureau for Economic Research (BER) at Stellenbosch University, have shown a near-term deterioration but are more or less unchanged over the two-to-three-year horizon. Average inflation expectations for 2015 and 2016 increased by 0,2 percentage points, to 5,6 per cent and 6,1 per cent respectively, but declined marginally to 5,8 per cent for 2017. The deterioration was mainly driven by marked



increases, of 0,6 and 0,4 percentage points respectively, by analysts for 2015 and 2016, and smaller increases by business people. The expectations of analysts and trade unionists remain within the target range but close to its upper end. The expectations of business people are above the target range, with a deterioration over all three years. Average five-year inflation expectations increased from 5,8 per cent to 6,0 per cent.

The median inflation expectations of analysts polled in the Reuters Econometer Survey are almost identical to the Bank's forecast. The break-even inflation expectations, as reflected in the yield differential between conventional government bonds and inflation-linked bonds, are relatively unchanged since the previous meeting and remain above the target range for all maturities.

Global economic growth has been revised downwards recently, mainly due to the weak first-quarter outcome in the US. While the recovery in the US still appears to be on track amid continued improvements in the labour market, growth this year is expected to be closer to the 2 per cent level compared with expectations of around 3 per cent earlier in the year. The steady but slow improvement in the euro area has continued, following a better-than-expected first-quarter outcome. However, the outlook for the region will in part depend on avoiding negative spillovers from the Greek debt crisis. The near-term risks from this crisis appear to have been averted for now, but the longer-term sustainability of the Greek debt burden remains a concern. Growth in Japan is expected to remain positive but subdued.

The Chinese economy grew at a year-on-year rate of 7,0 per cent in the second quarter, but some moderation is expected in the coming quarters. The sharp correction in the Chinese equity markets appears to have been contained by strong intervention by the authorities, and the impact on the broader economy is expected to be relatively limited, but it does point to some fragility in the financial sector. The slowdown in China has continued to impact on commodity prices, with the platinum price, for example, declining to its lowest level in six years. The prospects for a number of other larger emerging-market economies, particularly Russia and Brazil, remain weak.

Global inflation pressures, particularly in the advanced economies, remain benign, reinforced by declining commodity prices, including that of oil. Against this backdrop, the monetary policy stances in most advanced and emerging-market economies have either remained unchanged or become more accommodative since the previous MPC meeting, with the exception of Brazil where interest rates were increased further. Monetary policies in the advanced economies are likely to remain asynchronous: highly accommodative stances in the eurozone and Japan are likely to persist for some time, while a start of monetary policy tightening is likely in the US sometime this year, followed by the United Kingdom (UK).

The rand exchange rate has been relatively volatile and depreciated significantly since the previous meeting of the MPC. The rand, along with a number of other emerging-market currencies, has been particularly sensitive to changing global risk perceptions relating to the Greek crisis, the volatility in Chinese equity markets, declining commodity prices, and expectations of the start of US monetary policy tightening. Since the previous meeting of the MPC, the rand has traded in a wide band of between R11,82 and R12,58 against the US dollar. Over the period, the rand has depreciated by 5,0 per cent against the US dollar, by 3,6 per cent against the euro, and by 3,5 per cent on a trade-weighted basis.

The rand found some support from the improved current-account outcome of 4,8 per cent of gross domestic product (GDP) in the first quarter of 2015 and the more favourable recent trade data. While these better outcomes may reflect the depreciated real effective exchange rate, further gains are likely to be constrained by the recent decline in commodity prices. The Bank forecasts a current-account deficit of around 4,6 per cent of GDP for the year.

Global capital flows have remained relatively volatile against the backdrop of changing risk perceptions. This has been reflected in non-resident bond and equity flows: according to data from the JSE Limited (JSE), non-residents were net sellers of South African government bonds to the value of R12,7 billion in May and June, but were net buyers of equities to the value of R17,7 billion. To date in July, non-residents have been net buyers of equities and bonds to the value of R3,7 billion and R2,4 billion respectively.

The rand remains a significant risk factor to the inflation outlook given the vulnerability of both the rand and long bond yields to possible US interest rate increases as well as a deterioration in South Africa's terms of trade. The inflation forecast assumes a relatively stable real effective exchange rate over the forecast period, implying a nominal effective depreciation in line with inflation differentials between South Africa and her major trading partners. A nominal depreciation in excess of this would pose an upside risk to inflation, although this risk could be ameliorated to some extent should the relatively low pass-through from the exchange rate to inflation persist. The extent to which US policy tightening is already priced into the exchange rate also remains uncertain.

The domestic growth outlook remains subdued amid continued electricity-supply constraints as well as weak business and consumer confidence. Growth in the first quarter of 2015 measured 1,3 per cent, and high-frequency data suggest that second-quarter growth is likely to be broadly similar. The Bank's forecast for growth in each year of the forecast period has been revised down marginally, to 2,0 per cent in 2015 and 2,1 per cent in 2016, rising to 2,6 per cent in 2017 when some easing of the electricity-supply constraint is assumed. However, risks to growth are still assessed to be moderately on the downside. The recent further decline in the Bank's composite leading business cycle indicator also suggests a continuation of the weak growth outlook.

The RMB/BER business confidence index has declined for two consecutive quarters, measuring 43 index points in the second quarter of 2015, with confidence in the manufacturing sector particularly low, at 29 index points. The physical volume of manufacturing production has contracted on a month-on-month basis in three of the first five months of this year, and this sector is expected to record negative growth in the second quarter. Although the Purchasing Managers' Index (PMI) improved in May and June, it remains around the 50 index point level, consistent with a constrained outlook. The mining sector, by contrast, has displayed some resilience, particularly in the platinum-group metals (PGMs) subsector, although the weaker platinum and palladium prices are expected to create further headwinds.

Underlying this subdued growth outlook is the persistent weakness in growth in gross fixed capital formation, particularly by the private sector. These trends contributed to a contraction in non-agricultural formal sector employment, both on a quarter-on-quarter and on a year-on-year basis. During the four quarters to the first quarter of 2015, over 41 000 jobs were shed, of which just over 30 000 were in the private sector.

Although consumption expenditure of households improved somewhat in the first quarter of 2015, this was probably induced by temporary factors, including the decline in the petrol price and lower food price inflation. However, following the increase in personal income taxes alongside higher electricity tariffs and a reversal of the petrol price declines, the outlook for consumption expenditure has deteriorated. This negative outlook is reflected in slowing retail sales growth, declining motor vehicle sales, and the continued weak pace in credit extended to households by the banking sector. Tighter affordability criteria as well as proposals to cap interest charges on unsecured loans are likely to constrain bank credit extension to households further. This is in contrast to the continued buoyant growth in credit extension to the corporate sector. Against this backdrop, the FNB/BER consumer confidence index reached a 14-year low in the second quarter of 2015.

Notwithstanding the recent moderation in nominal wage growth, the pace of growth remains high and contributes to the persistence of inflation at higher levels. Year-on-year growth in nominal salaries and wages per worker moderated to 6,7 per cent in the first quarter of 2015, from 7,3 per cent in the previous quarter. Adjusting for productivity increases, due in part to employment reductions, labour cost increases declined to 4,1 per cent in the first quarter. According to Andrew Levy Employment Publications, the average settlement rate in collective bargaining agreements declined to 7,8 per cent in the first half of 2015, compared with 8,1 per cent in 2014 as a whole.

Food prices remain a concern to the MPC, despite the continued moderation of food price inflation at the CPI level having measured 4,6 per cent in May and 4,3 per cent in June. However,



the continuing drought in parts of the country has contributed to the upside risk to the outlook, despite benign global food price inflation. Maize and wheat prices have increased significantly since the beginning of the year, and we are yet to see the full impact on consumer prices. At the PPI level, however, cereal and crop price inflation accelerated to 17,8 per cent in May, and both wheat and maize prices are now trading at around import parity levels.

International oil prices have been somewhat weaker since the previous meeting of the MPC, following higher output by Saudi Arabia and the prospects of a resumption of oil exports by Iran. This follows two consecutive months of oil prices in the range of US\$60–65 per barrel. Since early July, spot prices have traded below US\$60 per barrel, while futures prices are currently trading at around US\$58 per barrel for December delivery. The Bank's forecast assumes a moderate increase in oil prices over the forecast period. Domestic petrol prices have increased by about 90 cents per litre in the past two months. Should current trends persist, a price reduction of around 40 cents per litre is likely in August.

While the June inflation outcomes were below expectations, this respite is expected to be temporary. The persistence of forecast inflation at elevated levels and the continued upside risks to the outlook remain a concern to the MPC. Although inflation is currently within the target range, given the lags in monetary policy changes on inflation, the focus of policy continues to be on the medium-term trend and to ensure that inflation remains comfortably and sustainably within the target range.

Inflation is expected to breach the upper end of the target range for two quarters, and the medium-term trajectory remains uncomfortably close to the upper end of the target range. The upside risks make this trajectory vulnerable to any significant changes in inflation pressures.

Although the risks of higher electricity tariffs have not materialised yet, other upside risks persist. The rand remains vulnerable to the global market reaction to US monetary policy normalisation, particularly in the context of South Africa's twin deficits. Pressures on the exchange rate have been exacerbated by the recent significant decline in commodity prices, which are likely to impede the favourable current-account adjustment. Some of the rand adjustment has already occurred since the previous MPC meeting, but further reaction to US monetary policy tightening could cause inflation to diverge even further from target and set in motion an exchange rate-inflation spiral. Further upside risks are expected to come from food prices, which have yet to react to the significant increases in spot prices of agricultural commodities.

The MPC has been indicating for some time that it is in a hiking cycle in response to rising inflation risks and a normalisation of the policy rate over time. The MPC is cognisant of the fact that domestic inflation is not driven by demand factors, and the outlook for household consumption expenditure remains subdued. Economic growth remains subdued, constrained by electricity-supply disruptions as well as low business and consumer confidence, and the risks to the outlook remain on the downside. However, as emphasised previously, the MPC must be mindful of the risk of second-round effects on inflation, and it is concerned that failure to act against these heightened pressures and risks will cause inflation expectations to become entrenched at higher levels.

The MPC has therefore decided to continue on its path of gradual policy normalisation. Accordingly, the repurchase rate will increase by 25 basis points to 6,0 per cent per annum with effect from 24 July 2015. Four members favoured the 25 basis point increase, while two members favoured an unchanged stance.

The expected inflation trajectory implies that the real repurchase rate remains low and possibly still slightly negative at times, and below its longer-term average. The monetary policy stance therefore remains supportive of the domestic economy. The continuing challenge is for monetary policy to achieve a fine balance between achieving the Bank's core mandate of price stability and not undermining short-term growth unduly. Monetary policy actions will continue to be sensitive, to the extent possible, to the fragile state of the economy. As before, any future moves will therefore be highly data-dependent.

Annexure

Summary of assumptions

1. Foreign-sector assumptions

| Percentage changes (unless otherwise indicated) | Actual | | Forecast | | |
|--|--------|-------|----------|---------|---------|
| | 2013 | 2014 | 2015 | 2016 | 2017 |
| 1. Real GDP growth in South Africa's major trading partner countries | 3,1% | 3,1% | 3,0% | 3,3% | 3,3% |
| | | | (3,3%) | (3,5%) | (3,4%) |
| 2. International commodity prices in US\$ (excluding oil) | -6,4% | -9,8% | -17,0% | 0,0% | 5,0% |
| | | | (-14,0%) | (5,0%) | (5,0%) |
| 3. Brent crude (US\$/barrel) | 108,8 | 99,2 | 60,2 | 65,0 | 68,1 |
| | | | (60,2) | (65,0) | (68,1) |
| 4. World food prices (US\$)..... | -1,6% | -3,8% | -14,0% | 1,5% | 2,5% |
| | | | (-11,0%) | (2,0%) | (2,5%) |
| 5. International wholesale prices | 0,3% | -0,1% | -2,2% | 0,8% | 1,3% |
| | | | (-2,0%) | (1,0%) | (1,5%) |
| 6. Real effective exchange rate of the rand (index 2010 = 100) | 81,91 | 79,17 | 81,29 | 80,50 | 80,50 |
| | | | (81,60) | (81,30) | (81,30) |
| 7. Real effective exchange rate of the rand..... | -10,1% | -3,3% | 2,7% | -1,0% | 0,0% |
| | | | (3,1%) | (-0,4%) | (0,0%) |

2. Domestic-sector assumptions

| Percentage changes (unless otherwise indicated) | Actual | | Forecast | | |
|--|--------|------|----------|---------|---------|
| | 2013 | 2014 | 2015 | 2016 | 2017 |
| 1. Real government consumption expenditure | 3,3% | 1,9% | 1,0% | 1,5% | 1,5% |
| | | | (2,0%) | (1,5%) | (1,5%) |
| 2. Administered prices | 8,7% | 6,7% | 2,8% | 9,6% | 8,4% |
| | | | (2,5%) | (9,5%) | (8,3%) |
| – Petrol price | 11,8% | 7,2% | -7,2% | 11,7% | 6,4% |
| | | | (-8,4%) | (11,1%) | (6,5%) |
| – Electricity price..... | 8,7% | 7,2% | 9,7% | 12,5% | 13,0% |
| | | | (10,1%) | (13,1%) | (13,1%) |
| 3. Potential growth | 2,2% | 2,1% | 2,1% | 2,2% | 2,3% |
| | | | (2,2%) | (2,2%) | (2,4%) |
| 4. Repurchase rate (per cent)..... | 5,00 | 5,57 | 5,75 | 5,75 | 5,75 |
| | | | (5,75) | (5,75) | (5,75) |

* The figures in brackets represent the previous assumption of the Monetary Policy Committee (MPC).

Foreign-sector assumptions

1. **Trading partner gross domestic product (GDP)** growth is determined broadly using the Global Projection Model (GPM) of the International Monetary Fund (IMF), which is then adjusted to aggregate the GDP growth rates of South Africa's major trading partners on a trade-weighted basis. Individual projections are done for the four largest trading partners: the euro area, China, the United States (US) and Japan. The remaining trading partners are grouped into three regions: Emerging Asia (excluding China), Latin America and the Rest of Countries bloc. The assumption takes account of country-specific 'consensus' forecasts as well as IMF regional growth prospects.
2. The **commodity price index** is a weighted aggregate price index of the major South African export commodities based on 2010 prices. The composite index represents the total of the individual commodity prices multiplied by their smoothed export weights. Commodity price prospects generally remain commensurate with global liquidity as well as commodity supply/demand pressures as reflected by the pace of growth in the trading partner countries.
3. The **Brent crude oil price** is expressed in US dollar per barrel. The assumption incorporates an analysis of the factors of supply, demand (using global growth expectations) and inventories of oil (of all grades) as well as the expectations of the US Energy Information Administration (EIA), Organization of the Petroleum Exporting Countries (OPEC) and Reuters.
4. **World food prices** uses the composite food price index of the Food and Agriculture Organization of the United Nations (FAO) in US dollar. The index is weighted using average export shares and represents the monthly change in the international prices of a basket of five food commodity price indices (cereals, vegetable oil, dairy, meat and sugar). World food price prospects incorporate selected global institution forecasts for food prices as well as imbalances from the anticipated trend in international food supplies relative to expected food demand pressures.
5. **International wholesale prices** refers to a weighted aggregate of the producer price indices (PPIs) of South Africa's major trading partners, as per the official real effective exchange rate calculation of the South African Reserve Bank (the Bank). Although individual country consumer price inflation (CPI) forecasts provide a good indication for international wholesale price pressures, the key drivers of the assumed trend in global wholesale inflation are oil and food prices as well as expected demand pressures emanating from the trends in the output gaps of the major trading partner countries. Other institutional forecasts for international wholesale prices are also considered.
6. The **real effective exchange rate** is the nominal effective exchange rate of the rand deflated by the producer price differential between South Africa and an aggregate of its trading partner countries (as reflected in the *Quarterly Bulletin* published by the Bank). Although the nominal rate is a weighted average of South Africa's 20 largest trading partners, particular focus is placed on the rand outlook against the US dollar, the euro, the Chinese yuan, the British pound and the Japanese yen. The assumed trend in the real effective exchange rate remains constant from the latest available quarterly average over the projection period. However, due to the time delay in the calculation of the real effective exchange rate, the most recent trend in the nominal effective exchange rate is adjusted with the assumed trend for the domestic and foreign price differential for the current quarter. This may result in a technical annual adjustment over the current and next forecast year that differs from zero.

Domestic-sector assumptions

1. **Government consumption expenditure** (real) is broadly based on the most recent National Treasury budget projections. However, since these projections take place twice a year, the most recent actual data points also play a significant role in the assumptions process.
2. **Administered prices** represent the total of regulated and non-regulated administered prices as reflected by Statistics South Africa (Stats SA). Their weight in the consumer price index basket is 18,48 per cent and the assumed trend over the forecast period is largely determined by the expected pace of growth in petrol prices, electricity tariffs, school fees as well as water and other municipal assessment rates.

The **petrol price** is an administered price and comprises 5,68 per cent of the overall basket. The basic fuel price (which currently accounts for roughly half of the petrol price) is determined by the exchange rate and the price of petrol quoted in US dollars at refined petroleum centres in the Mediterranean, the Arab Gulf and Singapore. The remainder of the petrol price is made up of wholesale and retail margins as well as the fuel levy and contributions to the Road Accident Fund (RAF). Since most taxes and retail margins are changed once a year, the assumed trajectory of the petrol price largely reflects the anticipated trend in oil prices and the exchange rate.

The **electricity price** is an administered price measured at the municipal level with a weight of 4,13 per cent in the CPI basket. Electricity price adjustments generally take place in July and August of each year, and the assumed pace of increase over the forecast period reflects the multi-year price determination (MYPD) by the National Energy Regulator in respect of Eskom, with a slight adjustment for measurement at municipal level.

3. The pace of **potential growth** is derived from the Bank's semi-structural potential output model. The measurement accounts for the impact of the financial cycle on real economic activity and introduces economic structure via the relationship between potential output and capacity utilisation in the manufacturing sector (See *South African Reserve Bank Working Paper Series WP/14/08*).
4. The **repurchase rate**, or the 'repo rate', is the official monetary policy instrument and represents the interest rate at which banks borrow money from the Bank. Although the rate is held constant over the forecast period, this assumption is relaxed in alternative scenarios where, for instance, the policy rate responds to deviations of output from its potential and the gap between future inflation and the inflation target, in other words, via a stylised 'Taylor rule', one that is based on market expectations of the future path of the policy rate, and other paths (as requested).



Selected forecast results: Monetary Policy Committee Meeting on 23 July 2015

| Selected forecast results (quarterly) | | | | | | | | | | | | | | | | | | | | | |
|---------------------------------------|--------|-----|-----|-----|----------|-----|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|
| Year-on-year percentage change | Actual | | | | Forecast | | | | | | | | | | | | | | | | |
| | 1 | 2 | 3 | 4 | 2014 | 1 | 2 | 3 | 4 | 2015 | 1 | 2 | 3 | 4 | 2016 | 1 | 2 | 3 | 4 | 2017 | |
| 1. Headline inflation | 5,9 | 6,5 | 6,2 | 5,7 | 6,1 | 4,2 | 4,7 | 5,2 | 5,8 | 5,0 | 6,9 | 6,1 | 5,8 | 5,7 | 6,1 | 5,7 | 5,6 | 5,6 | 5,6 | 5,6 | 5,7 |
| | | | | | | | (4,6) | (5,0) | (4,6) | (4,8) | (6,8) | (6,0) | (5,9) | (5,8) | (6,1) | (5,7) | (5,7) | (5,6) | (5,6) | (5,7) | (5,7) |
| 2. Core inflation | 5,4 | 5,6 | 5,7 | 5,7 | 5,6 | 5,7 | 5,7 | 5,6 | 5,5 | 5,6 | 5,5 | 5,4 | 5,4 | 5,3 | 5,4 | 5,3 | 5,2 | 5,2 | 5,2 | 5,1 | 5,2 |
| | | | | | | | (5,7) | (5,5) | (5,4) | (5,6) | (5,4) | (5,4) | (5,4) | (5,4) | (5,4) | (5,3) | (5,2) | (5,1) | (5,1) | (5,1) | (5,2) |

Selected forecast results (annual)

| Per cent | Actual | | | | Forecast | | |
|--|--------|------|--------|--------|----------|--------|--|
| | 2013 | 2014 | 2015 | 2017 | 2016 | 2017 | |
| 1. Real gross domestic product (GDP) growth..... | 2,2% | 1,5% | 2,0% | 2,6% | 2,1% | 2,6% | |
| | | | (2,1%) | (2,7%) | (2,2%) | (2,7%) | |
| 2. Current account as a ratio to nominal GDP | -5,8 | -5,4 | -4,6 | -4,6 | -4,6 | -4,6 | |
| | | | (-4,7) | (-4,6) | (-4,6) | (-4,7) | |