Statement of the Monetary Policy Committee

23 September 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), risks to the global economic outlook have increased against the backdrop of a slowing Chinese economy. These risks, in conjunction with continued capital outflows from emerging markets, have resulted in heightened global financial market volatility and have contributed to the decision by the United States Federal Reserve (the Fed) to maintain its current monetary policy stance. This delay has added uncertainty to an already volatile global setting.

The domestic economic outlook has deteriorated following the surprise contraction in the second quarter of the year. At the same time, the rand experienced a further significant depreciation in response to domestic and global developments, intensifying the upside risks to the inflation outlook. The combination of sharply slowing growth and rising inflation compounds the dilemma facing monetary policy.

The year-on-year inflation rate, as measured by the consumer price index (CPI) for all urban areas measured 5,0 per cent and 4,6 per cent in July and August respectively.

The decrease in the inflation in August was mainly the result of changes in the housing and utilities as well as transport indices. Having reached a recent high of 5,8 per cent in both January and February, the Bank's measure of core inflation – which excludes food, fuel and electricity – amounted to 5,3 per cent in August, down from 5,4 per cent in July.

Producer price inflation (PPI) for final manufactured goods increased from 3,3 per cent in July to 3,4 per cent in August, down from 3,7 per cent in June. The upward trend is expected to continue in the coming months as the impact of higher agricultural crop and food prices becomes more apparent.

The inflation forecast of the Bank has changed marginally, with a near-term improvement and a slight medium-term deterioration. Inflation is now expected to average 4,7 per cent in 2015, from 5,0 per cent previously, and then to breach the upper end of the target range in the first quarter of 2016, with a peak of 6,7 per cent (previously 6,9 per cent). Inflation is then expected to settle at around the top end of the target range, with a further temporary breach of 6,2 per cent in the final quarter. This breach is mainly due to the base effects from the lower starting point for the petrol price in the fourth quarter of this year. The forecast for 2017 follows a slow downward trend, with inflation measuring 5,7 per cent in the final quarter. The changes in this trajectory are mainly due to the more depreciated starting point for the real effective exchange rate, which is offset to some extent by a lower international oil price assumption.

The forecast for core inflation is marginally higher in the later quarters, but with an unchanged expected average of 5,4 per cent in 2016 and slightly higher at 5,3 per cent in 2017, up from 5,2 per cent.

Inflation expectations, as measured by the survey conducted in the third quarter by the Bureau for Economic Research, are more or less unchanged; they remain at the upper end of the target range. Average inflation expectations for 2016 are unchanged at 6,1 per cent and reverted to 5,9 per cent for 2017, following the decline to 5,8 per cent in the previous quarter. As before, there were marked differences between the different categories of respondents, with the 2017 expectations averaging 5,4 per cent for financial analysts, 6,5 per cent for business people and 5,9 per cent for trade unionists. Average five-year inflation expectations declined from 6,0 per cent to 5,9 per cent, but those of business people reverted to their 2014 level of 6,5 per cent, from 6,3 per cent previously.

Median annual inflation expectations of market analysts, as reflected in the Reuters Econometer survey, are almost identical to those of the Bank's forecast and more or less unchanged since the previous survey. The break-even inflation rates derived from the inflation-linked bonds have increased moderately since the previous meeting and have remained above the upper end of the target range across all maturities.

The global economic outlook has become more uncertain since the previous meeting of the MPC, driven in part by the strong financial market reactions to the deteriorating outlook for the Chinese economy. Although growth prospects in the United States (US) remain positive, they have been clouded by growing concerns about possible spillbacks from a slowdown in emerging markets, particularly in China, as well as from the impact of the strong dollar. Euro area growth moderated in the second quarter and remains relatively subdued, while real output in Japan declined.

Growing concerns about the risk of an abrupt slowdown in the Chinese economy have been fuelled by excess capacity in the real-estate market and in the industrial sectors of the economy. The recent equity market correction, the surprise devaluation of the renminbi as well as the uncertain policy responses have added to these concerns. While, to date, the actual slowdown has been relatively moderate, a hard landing could have a severe impact on global markets and on commodity prices in particular.

These developments have had an adverse effect on the outlook for commodity producers, particularly emerging-market economies, but Asian economies with close trade links with China have also been affected. The deteriorating terms of trade have compounded the impact of continued capital flows from emerging markets in anticipation of US monetary policy normalisation. Consensus growth forecasts for most Latin American and Asian economies have accordingly been revised downwards.

Lower commodity prices have contributed to a more benign global inflation environment, although some emerging markets are experiencing inflationary pressures through depreciating currencies. In the US, concerns about the possible restraining effect of the appreciating dollar on domestic economic activity and inflation, coupled with global financial market volatility and the risk of a sharp slowdown in emerging markets, were key factors in the decision to delay the commencement of monetary policy normalisation. The European Central Bank has indicated that further monetary easing is being contemplated, while developments in Japan suggest that monetary policies will remain highly accommodative for some time.

Domestic financial markets, including bond and equity markets, have not been immune to the turmoil in global markets. Although the rand has been one of the more volatile currencies, having fluctuated in a range of between around R12,60 and just over R14,00 against the US dollar since the previous MPC meeting, its trend depreciation over the year has not been significantly different to those of other commodity currencies and a number of other peer emerging economies. Since the previous meeting of the MPC, the rand has depreciated by about 9 per cent against the US dollar, by about 10 per cent against the euro, and by about 8 per cent on a trade-weighted basis.

The rand was negatively affected by developments in China, continued speculation regarding the timing of US policy 'take-off', and the weaker-than-expected gross domestic product (GDP) growth outcome. The rand reacted positively to the US decision to maintain its policy stance as well as to the narrowing deficit on the current account of the balance of payments.

The rand exchange rate remains an upside risk to the inflation outlook. As noted in previous statements, a key uncertainty for the MPC is the extent to which the US policy normalisation is already priced into the currency. The fact that the rand appreciated in response to the Fed's decision suggests that some depreciation is likely when US rates are increased. However, the extent is uncertain, with the possibility of a temporary overshoot in a highly volatile environment.

A further uncertainty relates to the sustainability of the contraction in the current account of the balance of payments in the second quarter when a deficit of 3,1 per cent of GDP was recorded. While this narrowing is attributed in part to temporary factors, there appears to be some evidence that both export and import volumes are responding to the depreciation of the rand and the weaker economy. However, the Bank expects this process of adjustment to remain slow, with the export response inhibited by a number of factors, including headwinds from the slowing global economy, electricity supply constraints and declining tourism receipts.

The domestic economic growth outlook has deteriorated compared with the previous forecast. This follows the surprise annualised contraction of 1,3 per cent in the second quarter of this year. While the MPC is of the view that a further contraction is unlikely in the third quarter, the outlook remains relatively weak amid declining business and consumer confidence. The Bank's forecast for growth has been revised down by half a percentage point in each year of the forecast period, to 1,5 per cent in 2015 and to 1,6 per cent and 2,1 per cent respectively in the subsequent two years. The Bank's estimate of potential output for 2015 has also been revised down to 1,8 per cent. The risks to the growth outlook are now seen to be more or less balanced. This weak outlook is consistent with the Bank's leading indicator of economic activity, which has exhibited a more pronounced downward trend in recent months.

The growth disappointment was particularly evident in the goods-producing sectors of the economy, with contractions in agriculture, mining and manufacturing, although growth in the services sectors also moderated. The agricultural sector remains constrained by the continuing drought, and although mining output increased in July, prospects are being negatively affected by weak commodity prices, lower global demand and the risk of industrial action in parts of the sector. Manufacturing output also increased marginally in July, but the decline in the Barclays Purchasing Managers' Index (PMI) to below the neutral 50 level in August and a further decline in capacity utilisation suggest a challenging outlook.

Growth in gross fixed capital formation moderated to 1,0 per cent in the second quarter, with general government providing the only notable increase. The weak contribution from the private sector is reflected in the further sharp decline in the Rand Merchant Bank/Bureau for Economic Research (RMB/BER) Business Confidence Index to its lowest level since 2011. The only area where private-sector investment increased markedly was with respect to energy-generation projects. This disappointing scenario does not bode well for employment growth, despite the decline in the official unemployment rate to 25,0 per cent in the second quarter, mainly due to growth in informal sector employment.

Growth in the consumption expenditure by households also reflects the subdued demand conditions in the economy, with a moderation in growth to 1,2 per cent in the second quarter, with some resilience only evident in semi-durable goods consumption. Retail sales grew only marginally in July, amid a sharp decline in the business confidence of retailers. The weakness in durable goods sales is evident in the lower new vehicle sales in August, particularly commercial vehicles.

Consumers are expected to remain constrained against the backdrop of slow employment growth, declining disposable income growth and rising inflation. Furthermore, the pace of credit extension to households, which remains negative in real terms, is expected to be affected further by the tighter affordability criteria following the implementation of amendments to the National Credit Regulations. At the same time, household deleveraging has continued, with the debt-to-disposable-income ratio moderating further to 77,8 per cent in the second quarter of 2015, its lowest level since 2006. Credit extension to the corporate sector, by contrast, has been buoyant, particularly with respect to general loans and mortgage advances.

No new data concerning wage and unit labour cost developments have become available since the previous meeting of the MPC, but trends are expected to be relatively unchanged, with average nominal wage growth in excess of inflation contributing to the persistence of inflation at higher levels.

Although food price developments have been relatively benign, they remain a concern to the MPC, with the expectation of an acceleration in the coming months as the impact of the drought feeds through to consumer prices. This is despite the favourable impact of falling prices at the global level. Domestic food price inflation at the consumer level appears to have reached a low point of 4,3 per cent in June, increasing marginally to 4,4 per cent in July and August.

The pressures are expected to come from the drought-induced increases in agricultural price inflation for cereals and crops which increased at a year-on-year rate of 38,7 per cent in July.

The recent decline in international oil prices has provided some respite to inflation pressures, with the price of Brent crude oil currently trading at around US$10 per barrel lower than at the time of the previous MPC meeting. The current global oversupply of crude oil, coupled with the slowdown in China, is expected to keep oil prices contained in the short to medium term. The MPC has revised down its oil price assumption by between US$3 and US$4 per barrel in each of the coming years. However, the MPC assesses the risk to the oil price assumption to be on the downside, particularly in the short term. The domestic petrol price declined by a cumulative R1,20 per litre in August and September, and current trends suggest that no significant change is likely in October, with the weaker rand offsetting the impact of the falling dollar price of oil.

The inflation outlook remains a concern for the MPC, with the risks to the forecast assessed to be on the upside. Although two breaches of the target are now expected – in the first and fourth quarters of next year – they are expected to be temporary and primarily the result of base effects from lower petrol prices four quarters previously.

Nevertheless, the MPC is concerned that the longer-term inflation trajectory remains uncomfortably close to the upper end of the target range, and given the upside risks to inflation, the probability of a more extended breach than currently forecast is relatively high. A sustained breach of the target range brings with it the danger of impacting negatively on inflation expectations, which are currently sticky at the upper end of the target range.

The MPC is also concerned about domestic growth prospects, with the economy contracting in the second quarter. Growth is expected to remain constrained by global developments and associated uncertainty and volatility, low business and consumer confidence, and electricity supply shortages. Domestic inflation is not driven by demand factors, and the outlook for household consumption expenditure has deteriorated. However, we have to be mindful of the second-round effects of supply-side shocks on inflation.

There are a number of upside risks to the inflation outlook, the primary one being the exchange rate which has already depreciated significantly against the advanced economy currencies in response to global developments, and is still likely to react further to the commencement of US monetary policy tightening. A further risk emanates from possible higher multi-year increases in electricity tariffs from the middle of next year.

Downside risks to the inflation outlook include international oil prices, should they be sustained at current levels. In addition, weak domestic demand may continue to constrain pricing power in the economy. The Committee nevertheless assesses the overall risks to the inflation outlook to be on the upside.

As noted in previous statements, the MPC has to achieve a fine balance between realising its core mandate and not undermining short-term growth unduly. The MPC has unanimously decided to keep the repurchase rate unchanged for now at 6,0 per cent per annum.

The MPC remains on a gradual policy normalisation path. It will continue to monitor developments closely, and will not hesitate to act appropriately should the risks to the inflation outlook deteriorate materially. As before, any future moves remain highly data-dependent.

Annexure

Summary of assumptions: Monetary Policy Commitee meeting on 23 September 2015*

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	3,0%	3,1%	2,8%	3,3%	3,3%
	(3,1%)	(3,1%)	(3,0%)	(3,3%)	(3,3%)
2. International commodity prices in US$ (excluding oil)	-6,4%	-9,8%	-17,9%	-5,0%	0,0%
			(-17,0%)	(0,0%)	(5,0%)
3. Brent crude (US$/barrel)	108,8	99,2	57,1	61,5	65,5
			(60,2)	(65,0)	(68,1)
4. World food prices (US$)...	-1,6%	-3,8%	-16,2%	1,6%	2,5%
			(-14,0%)	(1,5%)	(2,5%)
5. International wholesale prices	0,3%	-0,1%	-3,0%	0,5%	1,0%
			(-2,2%)	(0,8%)	(1,3%)
6. Real effective exchange rate of the rand (index 2010 = 100)	81,91	79,17	81,41	80,50	80,50
			(81,29)	(80,50)	(80,50)
7. Real effective exchange rate of the rand...	-10,1%	-3,3%	2,8%	-1,1%	0,0%
			(2,7%)	(-1,0%)	(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%	0,5%	1,5%	1,5%
			(1,0%)	(1,5%)	(1,5%)
2. Administered prices	8,7%	6,7%	2,0%	9,9%	8,5%
			(2,8%)	(9,6%)	(8,4%)
– Petrol price..	11,8%	7,2%	-9,8%	12,9%	6,6%
			(-7,2%)	(11,7%)	(6,4%)
– Electricity price..	8,7%	7,2%	9,4%	12,2%	13,0%
			(9,7%)	(12,5%)	(13,0%)
3. Potential growth...	2,1%	1,9%	1,8%	1,9%	2,1%
	(2,2%)	(2,1%)	(2,1%)	(2,2%)	(2,3%)
4. Repurchase rate (per cent)...	5,00	5,57	5,86	6,00	6,00
			(5,75)	(5,75)	(5,75)

The figures in brackets represent the previous assumption of the MPC.
* For an explanation of foreign-sector assumptions and domestic-sector assumptions, see pages 94 and 95.

Selected forecast results: Monetary Policy Committee meeting on 23 September 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	4,6	4,9	5,2	4,7	6,7	5,9	6,0	6,2	6,2	5,9	5,8	5,7	5,7	5,8
							(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)	(5,7)
2. Core inflation	5,4	5,6	5,7	5,7	5,6	5,7	5,6	5,4	5,3	5,5	5,4	5,4	5,4	5,5	5,4	5,4	5,3	5,3	5,3	5,3
							(5,7)	(5,6)	(5,5)	(5,6)	(5,5)	(5,4)	(5,4)	(5,3)	(5,4)	(5,3)	(5,2)	(5,2)	(5,1)	(5,2)

Figures below the forecast in parentheses represent the previous MPC forecast.

Selected forecast results (annual)

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

Figures below the forecast in parentheses represent the previous MPC forecast.