

Statement of the Monetary Policy Committee

19 November 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 inflation forecast has remained relatively unchanged but the risks to the forecast have increased. The key risks are a marked depreciation of the rand; worsening drought conditions and their likely impact on food prices; and the possibility of additional electricity tariff adjustments. At the same time the economy remains weak despite an improved performance in the manufacturing sector, but both the mining and agricultural sectors appear to have contracted further in the third quarter.

Although global financial markets have stabilised somewhat since the previous meeting, the outlook for emerging markets in particular remains challenging. The United States Federal Reserve (the Fed) is likely to raise its policy rate in December, and further volatility in financial markets can be expected in the lead-up to this.

The year-on-year inflation rate, as measured by the consumer price index (CPI) for all urban areas, measured 4,7 per cent in October, following two consecutive months at 4,6 per cent. Food and non-alcoholic beverages inflation surprised again on the downside at 4,8 per cent, with a contribution of 0,7 percentage points to the overall CPI outcome. Services price inflation remained unchanged at 5,6 per cent, while goods price inflation increased to 3,7 per cent from 3,6 per cent previously. The Bank's measure of core inflation – which excludes food, fuel and electricity – amounted to 5,2 per cent, down from 5,3 per cent in the previous two months.

Producer price inflation for final manufactured goods increased from 3,4 per cent in August to 3,6 per cent in September. The main pressure came from the category of food, beverages and tobacco products, which contributed 2,0 percentage points to the outcome. Food and agricultural crop price developments are expected to sustain the upward trend in producer price inflation in the coming months.

The latest inflation forecast of the Bank shows a slight near-term improvement while the medium-term forecast is marginally higher. Inflation is now expected to average 4,6 per cent in 2015, and 6,0 per cent and 5,8 per cent in the next two years. The anticipated breach of the upper end of the target range in the first quarter of 2016 is now expected to average 6,4 per cent, compared with 6,7 per cent forecast previously. The trajectory for the rest of the year is also slightly lower than previously forecast, with a temporary breach in the fourth quarter of 6,1 per cent. The forecast for 2017 follows a slow downward trend, with inflation still expected to measure 5,7 per cent in the final quarter. The changes in the forecast are due to a lower starting point for the forecast, lower international oil price assumptions, and an adjustment to fees for higher education which are more or less offset by a more depreciated starting point for the real effective exchange rate.

The forecast for core inflation is marginally higher, with an expected average of 5,5 per cent in 2016 and 5,4 per cent in 2017, mainly due to the more depreciated exchange rate assumption.

The inflation expectations survey of the Bureau for Economic Research (BER) is only due for release in December. The median inflation forecast of analysts polled in the latest Reuters Econometer survey is similar to that of the Bank, and has also declined marginally since the previous survey. The break-even inflation rates, while having improved since the previous meeting, remain above the upper end of the target range.

Divergent global developments continue to create a challenging environment for monetary policy. Although the United States (US) recovery appears to be sustained, with further improvements in the labour market, the strong dollar poses downside risks to both growth and inflation. The United Kingdom (UK) economy also remains on its recovery path. By contrast, the recovery in



the euro area is much weaker, although the outlook is more favourable than it was earlier in the year. The Japanese economy has contracted for two consecutive quarters, with positive but slow growth expected in the coming quarters.

The Chinese economy shows signs of stabilising, aided by policy stimulus, but the medium-term outlook remains a concern. There is still some uncertainty regarding the extent to which services output and consumption have compensated for the decline in industrial output and investment. The tail risk of a hard landing remains, which could have a significant impact on countries with direct trade linkages, particularly those in Asia, as well as on commodity prices.

Brazil and Russia remain in recession, while the strong performance of the Indian economy has been sustained following a number of structural reforms. The outlook for sub-Saharan Africa, while still positive, has deteriorated in the wake of lower commodity prices, and further weakening could create greater headwinds for South African manufactured exports to this region.

Global inflation trends are benign, with concerns about deflation abating in most advanced economies. Despite significant currency depreciations in commodity-producing economies in particular, inflation pressures have generally been surprisingly contained, with a few exceptions. Emerging markets have had differing experiences: a number of countries in Latin America, particularly commodity producers, have tightened policy in recent months in response to incipient inflationary pressures, while those with low inflation, particularly in Asia, have loosened policy further.

In the advanced economies, monetary policy divergence is expected to continue. Monetary policy is set to remain accommodative in the euro area and Japan, with the possibility of further quantitative easing, against a backdrop of slow growth and benign inflation pressures. In the US, inflation and labour market dynamics as well as communication from the Fed suggest that, in the absence of any major surprises or shocks, an increase in the policy rate can be expected in December. Market expectations are for monetary policy tightening in the UK to commence sometime in the second half of 2016, later than previously expected.

Although volatility in global asset markets has moderated amid improving risk sentiment, emerging-market foreign-exchange markets have been relatively volatile and vulnerable to capital outflows. In the past three months, South Africa has also seen net portfolio outflows: since the end of August, according to JSE Limited data, non-resident sales of equities amounted to R25,9 billion while net bond sales amounted to R5,9 billion.

The rand exchange rate has been particularly volatile, even compared to its peers, as domestic factors also impacted on the currency. Since the previous meeting of the MPC, the rand has appreciated by about 1,0 per cent against the euro but has depreciated by around 3,0 per cent against the dollar and by 1,5 per cent on a trade-weighted basis. As before, the extent to which Fed tightening has been priced into the exchange rate remains uncertain. Nevertheless, a high degree of volatility and overshooting of the exchange rate may be expected in the lead-up to, and in the immediate aftermath of, the start of the US interest rate cycle. Fed communication of future moves will be key. To date, indications are that a moderate policy hiking cycle will be pursued.

Domestic economic growth prospects remain subdued amid weak business confidence, but a further contraction in the third quarter is not expected. The Bank's forecast for gross domestic product (GDP) growth has been revised down marginally for 2015 and 2016 – to 1,4 per cent and 1,5 per cent respectively – but remains unchanged at 2,1 per cent for 2017. The estimate of short-term potential output remains unchanged at 1,8 per cent for this year, rising to 2,1 per cent in 2017. The Bank's composite leading business cycle indicator declined further in August, consistent with the fragile outlook.

The manufacturing sector recovered somewhat in the third quarter, mainly due to a surprisingly strong performance in September, and is expected to have contributed positively to GDP growth.



However, the Barclays Purchasing Managers' Index (PMI) declined further in October, and has been below the neutral level of 50 for three consecutive months, suggesting a constrained outlook for the sector. The mining sector is expected to subtract from GDP growth following a further contraction in the third quarter, while the continuing drought points to a third successive quarterly contraction for the agricultural sector. The outlook for the construction sector is constrained following significant declines in new building plans passed, reflected in a 9-point drop in the First National Bank (FNB)/BER Building Confidence Index.

Against this backdrop, formal sector employment trends remain disappointing. According to the *Quarterly Employment Statistics* survey of Statistics South Africa (Stats SA), employment in the formal non-agricultural sector declined in the second quarter of 2015, as the private sector continued to shed jobs. Although the *Quarterly Labour Force Survey* indicates an increase in the number of persons employed in the third quarter, the number of unemployed persons rose sharply in the quarter as the number of new entrants increased. Consequently, the official unemployment rate increased to 25,5 per cent in the third quarter.

There are minimal demand-side pressures in the economy. Consumption expenditure by households continues to be inhibited by, inter alia, low consumer confidence, declining disposable income growth and slow employment growth. The latest retail trade sales data suggest that household expenditure may have lost further momentum in the third quarter. Durable goods sales remain under pressure, as indicated in the intensification of the downward trend in motor vehicle sales in recent months.

Consumption expenditure is also constrained by the continued slow growth in credit extension to households by banks. Unsecured lending remains subdued and is likely to be affected further by the recently announced caps on interest rates by the Department of Trade and Industry, while the decline in growth in instalment sale credit and leasing finance is indicative of the softer motor vehicle sales.

Credit extension to corporates remains robust, particularly commercial mortgage finance, which reflects in part a switch away from funding in the bond market by property funds.

The recent *Medium-Term Budget Policy Statement (MTBPS)* signalled government's continued commitment to fiscal consolidation, although at a slower pace. Most of the expanded deficit is attributable to lower-than-expected tax revenues in response to the weaker growth outlook.

Trends in wage growth remain a concern and contribute to the persistence of inflation at elevated levels. Year-on-year growth in salaries and wages per worker accelerated to 8,7 per cent in the second quarter of 2015; after adjusting for labour productivity increases, total unit labour costs increased from 4,3 per cent to 5,1 per cent. By contrast, the average wage settlement rate in collective bargaining agreements recorded by Andrew Levy Employment Publications recorded a moderation to 7,7 per cent in the first three quarters of the year, compared with 8,1 per cent in 2014.

Apart from the exchange rate, the main upside risks to inflation come from possible electricity tariff and food price increases. Eskom's application for a Regulatory Clearing Account (RCA) to the National Energy Regulator (NERSA) to claw back excess expenditure of R22,8 billion is likely to lead to a further tariff increase, although the quantum and timing is uncertain. This is in addition to the 12,2 per cent tariff increase already built into the inflation forecast for next year. No provision is made for the RCA application in the forecast at this stage, but it is regarded as an upside risk.

A higher food price trajectory has been incorporated in the forecast for some time, but food price inflation has surprised on the downside in recent months despite sharp increases in maize and cereals prices earlier in the year. However, the increased intensity of the drought (which has led to downward revisions of the domestic maize crop estimate) as well as the incipient pressures evident in both the PPI and the CPI suggest that an acceleration in food price inflation is likely, adding to the upside risk to the inflation outlook.



By contrast, international oil price developments are expected to remain benign, with current spot prices below US\$45 per barrel, somewhat lower than those assumed over the forecast period. Although petrol prices have contributed to a succession of downside inflation surprises in recent months, the beneficial impact of lower international oil prices on domestic petrol prices has been offset to some extent by the depreciation of the rand. The latest data suggest that, should current trends continue, a small drop in the petrol price can be expected next month despite the further depreciation of the currency.

Although the inflation forecast is relatively unchanged since the previous meeting, the upside risks to the inflation outlook are more pronounced. As noted, these risks relate to the persistent exchange rate depreciation, electricity tariffs and food prices, and are assessed to outweigh possible downside risks from lower international oil prices and subdued exchange rate pass-through. While these factors cannot be dealt with directly through monetary policy, the MPC is concerned that failure to act could cause inflation expectations to become unanchored and generate second-round effects and more generalised inflation. Although core inflation has remained steady and inflation expectations to date have been relatively anchored, they remain at uncomfortably elevated levels.

The general approach of the MPC is to attempt to see through exogenous shocks and react to second-round effects. However, shocks of a persistent nature – for example extended periods of currency depreciation or drought, or multi-year increases in electricity prices – make it more difficult to disentangle these first- and second-round effects.

In the absence of demand pressures, the MPC had to decide whether to act now or later. On the one hand, given the relative stability in the underlying core inflation, delaying the adjustment could give the MPC room to re-assess these unfolding developments at the next meeting and avoid possible additional headwinds to the weak growth outlook. On the other hand, delaying the adjustment further could lead to second-round effects and require an even stronger monetary policy response in future, with more severe consequences for short-term growth.

Complicating the decision was the deteriorating economic growth outlook. Although the change to the growth forecast was marginal, risks to the outlook – which were more or less balanced at the previous meeting – are now assessed to be on the downside.

Against this difficult backdrop, the MPC has decided to increase the repurchase rate by 25 basis points to 6,25 per cent per annum effective from 20 November 2015. Four members preferred an increase while two members favoured an unchanged stance.

Despite the increase, the MPC still views the monetary policy stance as being accommodative. 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 focus on anchoring inflation within the target range while remaining 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: Monetary Policy Committee meeting on 19 November 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%	3,1%	3,3%
			(2,8%)	(3,3%)	(3,3%)
2. International commodity prices in US\$ (excluding oil)	-6,4%	-9,8%	-18,2%	-7,0%	-0,5%
			(-17,9%)	(-5,0%)	(0,0%)
3. Brent crude (US\$/barrel)	108,8	99,2	54,9	56,0	60,0
			(57,1)	(61,5)	(65,5)
4. World food prices (US\$).....	-1,6%	-3,8%	-18,0%	-2,8%	2,7%
			(-16,2%)	(1,6%)	(2,5%)
5. International wholesale prices	0,3%	-0,1%	-3,2%	0,2%	0,8%
			(-3,0%)	(0,5%)	(1,0%)
6. Real effective exchange rate of the rand (index 2010 = 100)	81,91	79,17	80,41	77,00	77,00
			(81,41)	(80,50)	(80,50)
7. Real effective exchange rate of the rand.....	-10,1%	-3,3%	1,6%	-4,2%	0,0%
			(2,8%)	(-1,1%)	(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%
			(0,5%)	(1,5%)	(1,5%)
2. Administered prices.....	8,7%	6,7%	1,7%	7,7%	8,1%
			(2,0%)	(9,9%)	(8,5%)
– Petrol price.....	11,8%	7,2%	-10,6%	7,2%	6,4%
			(-9,8%)	(12,9%)	(6,6%)
– Electricity price	8,7%	7,2%	9,4%	12,2%	13,0%
			(9,4%)	(12,2%)	(13,0%)
3. Potential growth.....	2,1%	1,9%	1,8%	1,9%	2,1%
			(1,8%)	(1,9%)	(2,1%)
4. Repurchase rate (per cent)	5,00	5,57	5,86	6,00	6,00
			(5,86)	(6,00)	(6,00)

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 19 November 2015

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

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%	1,4%	1,5%	2,1%
			(1,5%)	(1,6%)	(2,1%)
2. Current account as a ratio to nominal GDP ...	-5,8	-5,4	-4,2	-4,6	-4,6
			(-4,2)	(-4,4)	(-4,4)

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



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).

