Statement of the Monetary Policy Committee

17 March 2016

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), headline inflation has exceeded the upper end of the target range as pressures from higher food prices in particular have intensified. Although the longer-term inflation outlook has improved somewhat, inflation is still expected to remain outside the target range for an extended period, and upside risks remain. The domestic economic growth prospects remain fragile following a fairly broad-based weakening in the final quarter of last year, while global economic prospects remain uncertain.

The year-on-year inflation rate as measured by the consumer price index (CPI) for all urban areas increased markedly in January to 6,2 per cent, up from 5,2 per cent in December. Food price pressures intensified, with food and non-alcoholic beverages inflation accelerating to 6,9 per cent, up from 5,9 per cent previously. Goods price inflation increased from 4,6 per cent to 6,5 per cent, mainly due to higher food prices and base effects of petrol prices, while services price inflation increased from 5,7 per cent to 6,0 per cent. The Bank's measure of core inflation, which excludes food, fuel and electricity, which had been relatively stable for some time, increased from 5,2 per cent in December to 5,6 per cent in January. Part of this may reflect some evidence of higher exchange rate pass-through.

Producer price inflation for final manufactured goods was also indicative of increased cost pressures, having increased from 4,8 per cent in December 2015 to 7,6 per cent in January. The main contributor to this acceleration was the category of food, beverages and tobacco products which contributed 2,8 percentage points to the January outcome.

The latest inflation forecast of the Bank has improved somewhat but, nevertheless, the protracted, albeit lower, breach remains a serious concern. Inflation is now expected to average 6,6 per cent and 6,4 per cent in 2016 and 2017 respectively, compared with 6,8 per cent and 7,0 per cent previously. The forecast period has been extended to the end of 2018, and the forecast average for that year is 5,5 per cent. Inflation is expected to peak at 7,3 per cent in the fourth quarter of 2016, down from 7,8 per cent previously, and to return to within the target range, to 5,5 per cent, during the fourth quarter of 2017. Inflation is then expected to remain within the target range for the rest of the forecast period. These changes are due in part to the higher interest rate assumption following the increase in the repurchase (repo) rate at the previous meeting, a slightly less depreciated exchange rate assumption, and downward revisions to the international oil price and electricity tariff assumptions. The latter follows the National Energy Regulator of South Africa's (NERSA) decision to grant a lower-than-expected tariff adjustment of 9,4 per cent to Eskom. These pressures are counteracted to some extent by a higher food price forecast.

The forecast for core inflation reflects a marginal near-term deterioration, reflecting expected exchange rate and wage cost pressures, but is slightly improved for 2017. Core inflation is expected to breach the upper end of the target range in the second quarter of 2016 for four consecutive quarters, with a peak at 6,5 per cent in the third and fourth quarters of 2016. This measure is expected to average 6,2 per cent in 2016, and 5,7 per cent and 5,2 per cent in the subsequent two years.

The survey of inflation expectations conducted by the Bureau for Economic Research in the first quarter of 2016 presents a mixed picture. Although average expectations remain unchanged at 6,2 per cent for 2016 and 2017, those of analysts increased significantly, while expectations of business people and trade unions moderated for both years. Inflation is expected to average 6,0 per cent in 2018, with both analysts and trade unionists expecting inflation to be within the target range. The five-year average inflation expectations remained unchanged at 6,1 per cent and have been stable within a range of between 5,8 per cent and 6,2 per cent since the first quarter of 2012.

The near-term expectations of economic analysts as reflected in the Reuters Econometer survey also increased following the depreciation of the rand in December. In the survey conducted in March, the median expectation for 2016 and 2017 was 6,4 per cent and 6,3 per cent respectively, but inflation is expected to return to within the target range in 2018 at a 5,6 per cent average. Bond market expectations implicit in the break-even inflation rates are more or less unchanged since the previous meeting and remain at fairly elevated levels.

The international economic outlook remains challenging following a marked decline in global growth in the fourth quarter of 2015 as well as a continued moderation in industrial production in the advanced economies. This included a slowdown in the United States (US) amid contractions in business fixed investment and exports, and a weakening in consumer spending. Some improvement is expected in the first quarter, although growth is expected to remain below potential in the coming months. Subdued growth is expected in the Japanese economy following a contraction in the fourth quarter, with only a slightly more favourable outlook for the euro area and the United Kingdom.

The outlook for many emerging-market economies remains weak, with continuing recessions in Brazil and Russia. The slowdown in China appears to be broad-based, with a declining Purchasing Managers' Index (PMI), moderating consumer demand, and lower imports and exports. The uncertain prospects for China remain a source of intense speculation and uncertainty for the rest of the global economy.

There are few signs of global inflation pressures, with inflation below target in most advanced economies, particularly in Japan and the euro area. These trends, combined with slowing growth, have prompted looser monetary policies in a number of advanced economies, and accommodative policies are likely to persist. Contrary to this trend, the US Federal Reserve is expected to continue on its normalisation path, but at a gradual pace. By contrast, exchange-rate-induced inflationary pressures persist in a number of emerging economies, particularly in Latin America, where more sustained tightening can be expected.

The rand exchange rate has recovered somewhat from the lows experienced in December and January, but nevertheless remains highly volatile and vulnerable to domestic and external developments. Since the previous meeting of the MPC, the rand traded in a wide range of between around R16,40 and R15,07 against the US dollar, and has appreciated by 4,5 per cent against the US dollar, by 0,9 per cent against the euro, and by 2,0 per cent on a trade-weighted basis.

A number of factors contributed to the appreciation of the rand during this period. These included the reaction to further monetary policy easing in the advanced economies, and the moderation of the US normalisation path; policy stimulus measures in China which overshadowed disappointing Chinese economic data; and the reaction to domestic monetary tightening. Offsetting factors included the weak domestic growth outcome and higher inflation outlook; the increased risk of a sovereign ratings downgrade; and domestic political developments which have had a significant impact on the rand in the past few days in particular.

The exchange rate was also negatively impacted by the wider-than-expected current-account deficit and its slow pace of adjustment to a depreciated exchange rate. The adjustment is expected to remain slow, particularly in the context of declining global trade. While the current account was adequately financed in the fourth quarter of 2015, the lack of portfolio capital flows remains a concern, despite expectations of some improvement of flows to emerging markets in 2016. According to JSE Limited (JSE) data, since the beginning of the year, non-residents have been net purchasers of bonds to the value of around R6 billion, but net sellers of South African equities to the value of around R20 billion.

The domestic economic growth outlook has deteriorated further. Annual economic growth of 1,3 per cent in 2015 was in line with the Bank's expectations, but the forecasts for 2016 and 2017 have been revised down from 0,9 per cent and 1,6 per cent to 0,8 per cent and 1,4 per cent respectively. Growth of 1,8 per cent is forecast for 2018. The potential output growth estimate remains unchanged at 1,5 per cent, rising to 1,8 per cent by 2018. The weak growth trend remains consistent with the Bank's leading business cycle indicator which declined further in December. Although the Rand Merchant Bank/Bureau for Economic Research (RMB/BER) business confidence index was unchanged in the first quarter, it remained at its five-year low and masked a collapse in the manufacturing confidence index.

The gross domestic product (GDP) slowdown was fairly broad-based, with contractions in the agriculture, manufacturing, and transport and communications sectors. The outlook for the first quarter for mining and manufacturing is constrained, following sharply negative growth rates in both sectors in January, particularly in mining. Although the Barclays PMI increased marginally in February, it remained below the neutral 50-point level for the seventh consecutive month, and capacity utilisation in the sector also remains relatively low. The continuing drought also points to an unfavourable outlook for the agricultural sector.

While growth in expenditure on gross fixed capital formation improved in the final quarter of 2015, it remains low at an annual growth rate of 1,4 per cent. Although capital expenditure by the private sector turned positive in the fourth quarter, it was concentrated in the renewable energy sector, while in most other sectors real capital investment contracted. These growth and investment trends create an unfavourable climate for making inroads into the unemployment rate which increased marginally to 24,5 per cent in the fourth quarter of 2015 from 24,3 per cent a year earlier.

Growth in consumption expenditure by households increased in the final quarter of 2015, but at 1,6 per cent was still at relatively low levels. While retail sales growth on a year-on-year basis was fairly resilient, the consecutive month-to-month contractions in real retail trade sales growth in December and January could signal further pressures on consumption expenditure, consistent with the low levels of consumer confidence. Total new vehicle sales continue to decline although, more positively, there was strong vehicle export growth in February.

A number of factors are expected to constrain consumption expenditure despite the persistence of wage and salary increases in excess of inflation. These factors include rising inflation and higher interest rates, high levels of household debt, and negative wealth effects from low or negative asset price growth. Furthermore, credit extension to households by the banking sector remains subdued, in contrast to the more vibrant growth in credit extension to the corporate sector, particularly with respect to mortgage advances on commercial properties and renewable energy investments.

The recent budget tabled in parliament provides for a fiscal consolidation path which sees the consolidated government budget deficit declining from an estimated 3,2 per cent of GDP in 2016/17 to 2,4 per cent in 2018/19. This is expected to be achieved through a combination of a lower expenditure ceiling and increased tax revenues. This path, if realised, can be expected to moderate inflation somewhat while improving South Africa's credit metrics and confidence in general.

Food price pressures, driven by the drought and the depreciated exchange rate, have intensified by more than previously forecast and remain a significant upside risk to inflation. Manufactured food price inflation measured 7,8 per cent in the producer price index (PPI), while agricultural prices increased by 25,9 per cent, with cereals and other crops increasing by 79,2 per cent. These increases are expected to impact with a lag on consumer prices. Annual CPI food price inflation is now expected to peak at 11,6 per cent in the final quarter of 2016, compared with 11,3 per cent previously.

International oil prices have recovered somewhat from their lows of below US$30 per barrel seen in January as the global oversupply appears to have subsided in the wake of production cutbacks in a number of countries. Although the Bank has reduced its oil price assumption for the forecast period, it still assumes an upward trajectory as in the previous forecast. However, there is some upside risk to this forecast, should some agreement on an output freeze be reached by some of the larger producers. The domestic petrol price was reduced by about 69 cents per litre earlier this month, to its lowest level since March 2015. However, the current under-recovery, driven mainly by higher international product prices, suggests that this decline could be substantially reversed in April. This increase will be in addition to the 30 cent per litre increase in the fuel levy announced in the budget.

Although the inflation forecast has improved moderately since the previous meeting of the MPC, the Committee remains concerned about the protracted nature of the breach of the target. Furthermore, the Committee assesses the risks to the forecast to be on the upside. The main risk factors relate to the exchange rate and food prices. The exchange rate of the rand continues to be highly volatile and vulnerable to changes in both domestic and external developments. While the pass-through from the exchange rate to inflation is still relatively low, there are signs that this may be increasing.

Food prices have been accelerating faster than previously expected due to the weaker exchange rate and the intensification of the drought, resulting in an upward revision to the food price forecast. The Committee views the risks to this forecast to be on the upside, particularly for 2017 when fairly strong favourable base effects are expected. A more protracted drought, combined with a weaker exchange rate and restocking of herds, may keep food price inflation elevated for a longer period than currently forecast. The Committee also assesses the risks to the international oil price assumption to be on the upside.

The MPC is cognisant of the fact that demand pressures on inflation remain subdued, and indications are that household consumption expenditure is likely to remain constrained. Nevertheless, the recent increase in core inflation and its expected upward trend is indicative of broader inflationary pressures and possible second-round effects from supply-side shocks. While the evolution of inflation expectations is critical in this regard, at this stage there is no clear evidence of a deterioration in longer-term inflation expectations, but they remain at an elevated level.

The Committee remains concerned about the weak growth outlook amid negative business and consumer confidence. The growth challenges facing the economy are compounded by the deteriorating outlook for global growth. The Committee assesses the risk to the growth outlook to be on the downside.

Given the upside risks to the inflation forecast and the protracted period of the expected breach, the MPC decided that further tightening was required to complement the previous moves. Accordingly, the MPC decided to increase the repurchase rate by 25 basis points to 7,00 per cent per annum, effective from 18 March 2016. Three members favoured a 25 basis point increase while three members preferred no change. Ultimately, the Committee decided on an increase.

The Committee faced the continuing dilemma of a deteriorating inflation environment and a worsening growth outlook. The MPC remains sensitive to the possible negative effects of policy tightening on cyclical growth, but will remain focused on its mandate of maintaining price stability.

Summary of assumptions: Monetary Policy Committee meeting on 17 March 2016*

1. Foreign-sector assumptions

Percentage changes (unless otherwise indicated)	Actual			Forecast		
	2013	2014	2015	2016	2017	2018
1. Real GDP growth in South Africa's major trading-partner countries...	3,0%	3,1%	2,8%	2,8%	3,2%	3,5%
			(2,8%)	(2,9%)	(3,3%)	
2. International commodity prices in US$ (excluding oil)........................	-6,4%	-9,8%	-19,3%	-13,2%	2,0%	3,0%
			(-19,3%)	(-15,0%)	(1,0%)	
3. Brent crude (US$/barrel)	108,8	99,2	52,5	37,0	45,0	50,5
			(52,5)	(41,0)	(50,0)	
4. World food prices (US$)	-1,6%	-3,8%	-18,7%	-3,0%	2,0%	3,0%
			(-18,5%)	(-2,8%)	(2,7%)	
5. International wholesale prices...	0,3%	-0,1%	-3,5%	-1,5%	0,8%	1,0%
			(-3,4%)	(-1,0%)	(1,0%)	
6. Real effective exchange rate of the rand (index 2010 = 100)	81,91	79,17	80,08	71,27	71,27	71,27
			(80,06)	(70,45)	(70,45)	
7. Real effective exchange rate of the rand...	-10,1%	-3,3%	1,1%	(-11,0%)	0,0%	0,0%
			(1,1%)	(-12,0%)	(0,0%)	

2. Domestic-sector assumptions

Percentage changes (unless otherwise indicated)	Actual			Forecast		
	2013	2014	2015	2016	2017	2018
1. Real government consumption expenditure	3,3%	1,9%	0,3%	1,5%	1,0%	1,0%
			(0,3%)	(1,5%)	(1,5%)	
2. Administered prices...	8,7%	6,7%	1,7%	5,3%	8,4%	8,7%
			(1,7%)	(8,0%)	(9,9%)	
– Petrol price	11,8%	7,2%	-10,7%	0,0%	10,2%	9,4%
			(-10,7%)	(7,9%)	(12,4%)	
– Electricity price..	8,7%	7,2%	9,4%	10,1%	9,5%	10,0%
			(9,4%)	(12,2%)	(13,0%)	
3. Potential growth...	2,1%	1,8%	1,6%	1,5%	1,6%	1,8%
			(1,6%)	(1,5%)	(1,6%)	
4. Repurchase rate (per cent)...	5,00	5,57	5,89	6,71	6,75	6,75
			(5,89)	(6,25)	(6,25)	

The figures in brackets represent the previous assumptions of the Monetary Policy Committee.

* For an explanation of foreign-sector assumptions and domestic-sector assumptions, see pages 84 and 85.

Selected forecast results: Monetary Policy Committee meeting on 17 March 2016

Selected forecast results (quarterly)

Year-on-year percentage change	Actual					Forecast														
	1	2	3	4	2015	1	2	3	4	2016	1	2	3	4	2017	1	2	3	4	2018
1. Headline inflation............................	4,2	4,6	4,7	4,9	4,6	6,4	6,0	6,6	7,3	6,6	7,1	6,9	6,1	5,5	6,4	5,4	5,5	5,6	5,7	5,5
				(4,9)	(4,6)	(6,2)	(6,1)	(7,0)	(7,8)	(6,8)	(7,8)	(7,3)	(6,7)	(6,2)	(7,0)					
2. Core inflation..................................	5,7	5,6	5,3	5,2	5,5	5,7	6,1	6,5	6,5	6,2	6,4	6,0	5,3	5,0	5,7	5,0	5,2	5,2	5,3	5,2
				(5,2)	(5,5)	(5,4)	(5,9)	(6,3)	(6,4)	(6,0)	(6,4)	(6,1)	(5,7)	(5,5)	(5,9)					

The figures in brackets represent the previous forecasts of the Monetary Policy Committee.

Selected forecast results (annual)

Per cent	Actual			Forecast		
	2013	2014	2015	2016	2017	2018
1. Real gross domestic product (GDP) growth	2,2%	1,5%	1,3%	0,8%	1,4%	1,8%
			(1,3%)	(0,9%)	(1,6%)	
2. Current account as a ratio to nominal GDP.............................	-5,8	-5,4	-4,4	-4,6	-4,7	-4,9
			(-4,2)	(-5,2)	(-5,3)	

The figures in brackets represent the previous forecasts of the Monetary Policy Committee.