Statement of the Monetary Policy Committee

22 September 2016

Issued by Lesetja Kganyago, Governor of the South African Reserve Bank, at a meeting of the Monetary Policy Committee in Pretoria

Headline consumer price inflation declined to within the target range of 3–6 per cent in August, in line with the expectations of the South African Reserve Bank (the Bank). Nevertheless, higher inflation outcomes are forecast in the near term before a sustained return to within the target range during 2017. While domestic economic growth prospects appear more favourable following the positive surprise in the second quarter of this year, the outlook remains constrained against a backdrop of weak domestic fixed investment and low levels of business and consumer confidence.

Risks from the global environment persist, although the volatility in global financial markets in the wake of the Brexit decision has subsided. Prospects for a resumption of monetary policy tightening in the United States (US) remain a key risk to the pattern of global capital flows and to emerging market exchange rates in general, with continued uncertainty regarding the timing and pace of future moves.

The year-on-year inflation rate, as measured by the consumer price index (CPI) for all urban areas, measured 6,0 per cent and 5,9 per cent in July and August respectively, down from 6,3 per cent in June. Food price inflation accelerated to a recent high of 11,6 per cent, with the category of food and non-alcoholic beverages contributing 1,7 percentage points to the overall inflation outcome. Goods price inflation measured 6,1 per cent in August, down from 6,5 per cent in July, while services price inflation was unchanged at 5,7 per cent. The Bank's measure of core inflation – which excludes food, fuel and electricity – was also unchanged at 5,7 per cent.

Producer price inflation for final manufactured goods increased in June and July to 6,8 per cent and 7,4 per cent respectively, following a decline to 6,5 per cent in May. This acceleration was mainly due to the impact of the drought on manufactured food price inflation, which measured 12,6 per cent in July. This was its highest level since January 2009. Producer price inflation for agricultural products also remained elevated at around 20 per cent.

The latest inflation forecast of the Bank has improved over the first four quarters of the forecast horizon, and remains more or less unchanged for the rest of the period. Inflation is expected to peak at 6,7 per cent in the fourth quarter of this year, compared with 7,1 per cent previously, with an earlier sustained return to within the target range now forecast to occur during the second quarter of 2017. Inflation is expected to average 6,4 per cent in 2016 and 5,8 per cent in 2017, compared with 6,6 per cent and 6,0 per cent previously. The forecast for 2018 is unchanged at an average of 5,5 per cent. The downward revisions are due in part to a lower starting point, lower administered price inflation assumptions (including petrol, electricity, and rates and taxes inflation) as well as a less depreciated exchange rate assumption.

Compared with the previous forecast, core inflation is expected to average 0,1 percentage point less, at 5,7 per cent in 2016 and 5,6 per cent in 2017, and is unchanged at 5,3 per cent in 2018. Core inflation is expected to remain within the target range over the forecast period, with a peak of 5,9 per cent in the final quarter of this year.

Inflation expectations, as reflected in the survey conducted by the Bureau for Economic Research, have remained relatively unchanged, but with some variations between the different groups of respondents. Average inflation expectations declined by 0,2 per cent to 6,0 per cent for 2017 and remained unchanged at 5,9 per cent for 2018. While the expectations of both analysts and business people declined, those of trade union officials remained unchanged for 2017 but increased for 2018. The long-term, five-year-ahead inflation expectations are unchanged at 5,9 per cent, and remain uncomfortably close to the upper end of the target range.

The inflation expectations of analysts, as reflected in the Reuters Econometer survey, have also shown successive declines during the past few months, with the median expectation for inflation to return to within the target range during the second quarter of 2017. The longer-term expectations of market participants implicit in the break-even inflation rates (the yield differential between conventional bonds and inflation-linked bonds) declined further since the previous meeting of the Monetary Policy Committee (MPC), although they remain above the upper end of the inflation target range.

The global growth outlook remains subdued, amid slowing growth in the advanced economies and a general downward revision to forecasts. Although prospects for the US economy remain relatively favourable, outcomes have not been consistently positive, as evidenced by the recent weak consumer expenditure and manufacturing sector data. Nevertheless, labour market conditions have improved and the investment slowdown appears to have bottomed.

Although the short-term impacts of the Brexit vote on the economy of the United Kingdom (UK) have not been as negative as initially feared, growth forecasts have been revised down as concerns persist regarding the longer-term investment outlook. The euro area recovery remains steady but subdued. The Japanese economy remains caught in a deflation and low growth bind, following a weak second quarter.

The recent firmer trend in commodity prices has improved growth prospects for commodity-producing emerging markets in particular, along with more favourable capital inflows. It is unclear how long these positive developments will continue. Indications are that the negative growth cycles in both Russia and Brazil have turned; both countries are expected to record positive, but weak rates of growth in the near term. The Chinese economy appears to have stabilised following concerns about a slowdown earlier in the year, but concerns regarding the financial sector persist.

Given the broadly benign global inflation environment, apart from in some emerging markets, monetary policies have generally remained accommodative, with further loosening or a loosening bias in a number of the advanced economies. A notable exception is the US, where the bias remains for a resumption of interest rate normalisation but the timing remains uncertain. Following the decision of the Federal Reserve yesterday to keep rates unchanged, the market expectation is for the next move to be in December. The data-dependent nature of future decisions means that these prospects are likely to change with new data releases, imparting a degree of volatility to financial markets and to global capital flows. The US policy rate trajectory is still expected to be moderate.

The exchange rate of the rand has been affected by these global events, but has also been impacted by domestic fundamentals and political developments. Since the previous meeting of the MPC, the rand has traded in a range of R13,28 and R14,73 against the US dollar – and has appreciated by 6,3 per cent against the US dollar, by 4,3 per cent against the euro, and by 5,2 per cent on a trade-weighted basis.

The rand initially appreciated markedly in line with other emerging market currencies as the chances of US Federal Reserve tightening receded in August following disappointing labour market data. At that stage, the rand recorded its strongest level since October 2015. This trend was reversed following increased domestic risk perceptions, which were also reflected in rising domestic government bond yields. More recently, the rand has been positively affected by the stronger gross domestic product (GDP) growth outcome and a significant narrowing of the current account deficit, following a sizeable trade account surplus in the second quarter. Although this may in part reflect a delayed adjustment to the depreciated exchange rate of the rand, the trade surplus is not expected to be sustained at similar levels in the coming months.

The marked appreciation of the rand during the past few days appears to be driven by expectations of unchanged US monetary policy as well as by speculation regarding possible purchases of the rand related to a major M&A transaction. The rand, however, remains vulnerable to future changes in the US monetary policy stance, domestic political developments as well as to the risk of a possible ratings downgrade later in the year. Nevertheless, the upside risk to inflation from the exchange rate appears to have moderated somewhat.

The domestic economy remains weak despite the positive growth surprise in the second quarter of 2016, when an annualised growth rate of 3,3 per cent was recorded. This was driven by a rebound in the primary sector and a surge in real exports. Mainly as a result of the higher starting point, the Bank's forecast for economic growth for 2016 has been revised upwards: from 0 per cent to 0,4 per cent. The forecasts for the next two years have been increased too, albeit marginally by 0,1 percentage points, to 1,2 per cent and 1,6 per cent respectively. Estimates of potential output growth are unchanged, implying a persistence of below-potential growth. The trend in the Bank's composite leading indicator of economic activity remains indicative of subdued growth.

While the second quarter growth performance was more favourable, data for July suggest that this improvement is unlikely to be sustained in the third quarter. Both the mining and manufacturing sectors recorded negative month-to-month growth rates in July, and the Barclays Purchasing Managers' Index (PMI) declined sharply in August following five consecutive months above the neutral 50-point mark. Stresses are also evident in the construction sector, with a further sharp decline in building plans passed during July.

A key constraint to the growth outlook remains the sluggish state of domestic gross fixed capital formation, which contributed negatively to GDP growth during the first two quarters of this year. In the second quarter of 2016, domestic fixed investment contracted in both the private and the public sectors (including government and public corporations). Private-sector fixed investment has recorded negative or zero growth for six consecutive quarters, reflecting low levels of business confidence. The Rand Merchant Bank/Bureau for Economic Research (RMB/BER) business confidence index remains below the neutral level despite an improvement in the third quarter.

This adverse investment climate and rising costs have contributed to the further deterioration in employment prospects, particularly in the mining and manufacturing sectors. The official unemployment rate increased to 26,6 per cent in the second quarter, from 25,0 per cent a year earlier. The increase in employment that was recorded in the second quarter was almost entirely attributable to temporary employment opportunities related to the municipal elections.

Consumption expenditure by households remains weak, despite a return to positive growth following the first-quarter contraction. The annualised growth of 1,0 per cent suggests that consumers remain under pressure. Durable goods consumption continued to contract in the second quarter and is consistent with the further decline in the First National Bank/Bureau for Economic Research (FNB/BER) consumer confidence index. In July, retail trade sales declined further, in contrast to positive wholesale trade sales. Domestic new vehicle sales continued their negative trend in July and August, while exports of motor vehicles have remained robust.

The outlook for consumption expenditure growth is expected to remain constrained given the unfavourable employment outlook, the absence of significant positive wealth effects, and the slow pace of growth in the real disposable income of households. Average wage growth and wage settlement rates have declined slightly, but there are risks of increases in excess of inflation and productivity gains.

Credit extension to households continues to contract in real terms, likely driven by both supply- and demand-side considerations. However, there has been a moderate increase in mortgage credit extension. As before, growth in credit extension to the corporate sector has been more resilient but below its recent peaks.

Food prices remain a significant driver of inflation given the persistent drought, although long-range weather forecasts suggest improved rainfall prospects in the coming months. Food price inflation is still expected to reach a peak in the fourth quarter of this year, at around 12,3 per cent, slightly lower than forecast previously. Spot and futures prices of wheat and maize have declined in recent weeks, but meat prices are expected to rise further as farmers restock their herds. Global food price inflation has increased, mainly due to an acceleration in the price of sugar.

International oil prices have fluctuated between US$40 and US$50 per barrel for the past six months, amid uncertainty relating to a possible supply freeze by the Organization of the Petroleum Exporting Countries (OPEC). The assumption for Brent crude oil in the Bank's forecasting model is unchanged, and assumes a moderate increase over the forecast period. After two consecutive months of price declines totalling R1,17 per litre, the domestic petrol price is expected to increase in October due to adverse movements in both the exchange rate and international product prices.

The MPC has noted improvements in the expected inflation trajectory during the course of the year. Apart from the tighter stance of monetary policy, this has also been driven by lower starting points, as inflation surprised at times on the downside, and changed assumptions underlying the forecast. The expected peak in headline inflation is notably lower, and an earlier return to within the target range is also expected. Most of the changes have been for the current and coming year, whereas the changes in the forecast for 2018 have been marginal. Changes to the core inflation forecast have been less pronounced, but it is no longer expected to breach the upper end of the target range. Despite these improvements, the longer-term inflation trajectory remains uncomfortably close to the upper end of the target range, with high wage settlement rates and inflation expectations contributing to this persistence.

The MPC assesses the risks to the inflation forecast to be more or less balanced at this stage. The current level of the rand is stronger than that implicit in the forecast, and, in conjunction with continued low levels of pass-through from the rand to inflation, the risks are assessed to have moderated somewhat. However, some of the positive factors impacting on the rand may be temporary, and the currency remains vulnerable to both domestic and external shocks.

The other major risk to the inflation outlook relates to food prices. The forecast still expects food prices to peak in the final quarter of this year. The future trajectory of these prices will be highly dependent on the normalisation of rainfall in the coming months. Favourable weather patterns could see food price inflation falling faster than that implicit in the forecast.

Despite the improved growth performance in the second quarter, the growth outlook remains constrained, as reflected in the more or less unchanged outlook for the next two years. The MPC assesses the risk to the growth forecast to be broadly balanced as growth prospects remain dependent on global conditions, the implementation of structural reforms as well as changes in business and consumer confidence.

Given the improvements in the inflation forecast, the weak domestic economic outlook and the assessment of the balance of risks, the MPC has unanimously decided to keep the repurchase rate unchanged at 7,0 per cent per annum.

The MPC remains concerned about the overall inflation trajectory which remains in the upper end of the inflation target range. The MPC is of the view that, should the current forecasts transpire, we may be close to the end of the tightening cycle. The MPC is aware that a number of the favourable factors which have contributed to the improved outlook can change very quickly, resulting in a reassessment of this view. The bar for monetary accommodation, by contrast, remains high, as the MPC would need to see a more significant and sustained decline of the inflation trajectory to within the inflation target range.

Summary of assumptions: Monetary Policy Committee meeting on 22 September 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%	2,7%	2,9%	3,1%
					(3,0%)	(3,3%)
2. International commodity prices in US$ (excluding oil).........................	-6,4%	-9,8%	-19,3%	-4,5%	5,5%	1,0%
				(-8,5%)	(1,0%)	(1,5%)
3. Brent crude (US$/barrel)	108,8	99,2	52,5	44,3	53,5	57,5
				(44,6)		
4. World food prices (US$)	-1,6%	-3,8%	-18,7%	-4,9%	3,0%	3,0%
				(-6,0%)	(2,0%)	
5. International wholesale prices..	0,3%	-0,1%	-3,5%	-1,1%	1,1%	1,2%
				(-1,3%)	(1,0%)	
6. Real effective exchange rate of the rand (index 2010 = 100)	81,91	79,17	80,08	75,67	78,00	78,00
				(74,01)	(75,00)	(75,00)
7. Real effective exchange rate of the rand...	-10,1%	-3,3%	1,1%	-5,5%	3,1%	0,0%
				(-7,6%)	(1,3%)	

2. Domestic-sector assumptions

Percentage changes (unless otherwise indicated)	Actual			Forecast		
	2013	2014	2015	2016	2017	2018
1. Real government consumption expenditure	3,8%	1,8%	0,2%	1,5%	1,0%	1,0%
2. Administered prices...	8,7%	6,7%	1,7%	5,1%	6,7%	7,3%
				(5,7%)	(7,4%)	(7,9%)
– Petrol price	11,8%	7,2%	-10,7%	1,0%	7,0%	7,9%
				(2,2%)	(7,6%)	
– Electricity price..	8,7%	7,2%	9,4%	9,3%	7,7%	8,0%
				(9,6%)	(8,5%)	(9,0%)
3. Potential growth...	2,0%	1,7%	1,5%	1,4%	1,5%	1,7%
4. Repurchase rate (per cent)..	5,00	5,57	5,89	6,91	7,00	7,00

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 90 and 91.

Selected forecast results: Monetary Policy Committee meeting on 22 September 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	6,5	6,2	6,2	6,7	6,4	6,2	5,8	5,8	5,5	5,8	5,4	5,4	5,5	5,6	5,5
							(6,2)	(6,5)	(7,1)	(6,6)	(6,6)	(6,1)	(5,8)	(5,5)	(6,0)	(5,4)	(5,5)	(5,5)	(5,6)	(5,5)
2. Core inflation..................................	5,7	5,6	5,3	5,2	5,5	5,5	5,5	5,7	5,9	5,7	5,8	5,7	5,5	5,4	5,6	5,3	5,3	5,3	5,4	5,3
							(5,5)	(5,9)	(6,1)	(5,8)	(6,0)	(5,9)	(5,4)	(5,2)	(5,7)	(5,2)	(5,2)	(5,3)	(5,4)	(5,3)

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	2,3%	1,6%	1,3%	0,4%	1,2%	1,6%
				(0,0%)	(1,1%)	(1,5%)
2. Current account as a ratio to nominal GDP.............................	-5,9	-5,3	-4,3	-4,0	-4,2	-4,4
				(-4,2)	(-4,4)	(-4,7)

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