Statement of the Monetary Policy Committee

24 November 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.

Since the previous meeting of the Monetary Policy Committee (MPC), the global economic and political landscape has changed significantly following the presidential election in the United States (US). The high degree of uncertainty surrounding the economic policies of the new administration is expected to persist for some time, creating a more challenging and volatile environment for emerging markets in particular. Higher US long bond yields, along with expectations of a tighter stance of monetary policy by the US Federal Reserve (Fed) than previously expected, have contributed to the reversal of the recent positive sentiment towards emerging markets. The prospect of rising protectionism and its implications for world trade are also a concern.

These developments have also affected capital flows to South Africa, with implications for the rand and bond yields. Domestic growth and inflation dynamics have remained more or less in line with expectations, but risks to the inflation outlook have increased moderately.

The year-on-year inflation rate, as measured by the consumer price index (CPI) for all urban areas, measured 6,1 per cent and 6,4 per cent in September and October respectively, compared with 5,9 per cent in August. The October outcome was marginally above the forecast of the South African Reserve Bank (SARB). Food price inflation accelerated further to a recent high of 12,0 per cent, with the category of food and non-alcoholic beverages contributing 1,8 percentage points to the overall inflation outcome. Goods price inflation measured 7,1 per cent in October, up from 6,6 per cent in September, with non-durable goods inflation increasing to 7,6 per cent. Services price inflation increased from 5,6 per cent to 5,8 per cent. The SARB's measure of core inflation – which excludes food, fuel and electricity – measured 5,7 per cent, up from 5,6 per cent.

Producer price inflation for final manufactured goods measured 6,6 per cent in September and October, down from 7,2 per cent in August. The main contributor to the October outcome was the category of food products, beverages and tobacco products, which contributed 4,0 percentage points and reflects the continued impact of the drought on food prices.

The latest inflation forecast of the SARB is broadly unchanged over the forecast period, despite a moderate upward adjustment to the food price forecast in the later quarters. The annual averages are unchanged at 6,4 per cent for 2016 and 5,8 per cent and 5,5 per cent respectively in the coming two years. Inflation is expected to peak at 6,6 per cent in the fourth quarter of this year, marginally lower than in the previous forecast, with a sustained return to within the target range still expected to occur during the second quarter of 2017. The higher food price assumption is offset by a slightly more appreciated exchange rate assumption.

Core inflation is expected to average 0,1 percentage points less in each year of the forecast period compared with the previous forecast, at 5,6 per cent this year and 5,5 per cent and 5,2 per cent in 2017 and 2018 respectively. Core inflation is expected to remain within the target range over the forecast period, with a peak of 5,8 per cent in the final quarter of this year.

The annual inflation expectations of economic analysts, as reflected in the Reuters Econometer survey conducted in November, are broadly unchanged since September and are similar to those of the SARB. The median forecast for the current and next two years are 6,3 per cent, 5,8 per cent and 5,6 per cent respectively. Bond market expectations implicit in the break-even inflation rates, i.e. the yield differential between conventional government bonds and inflation-linked bonds, increased in the wake of the recent depreciation of the rand. They remain above the upper end of the inflation target range.

The global outlook became increasingly uncertain during the year following the decision of the United Kingdom (UK) to leave the European Union and the outcome of the US presidential election. While the new policy direction in the US is still unclear, the markets have interpreted the outcome as being positive for US growth in the short run, with commitments to tax cuts and higher fiscal spending on infrastructure. These policies are expected to result in higher growth and inflation, particularly against the backdrop of an increasingly tight labour market. Nevertheless, the timing and extent of the expenditure boost is highly uncertain at this stage.

While an increase in infrastructure expenditure could be positive for commodity prices, other aspects of the possible new policy direction are likely to have an adverse effect on emerging markets. These include a possibly more aggressive tightening of US monetary policy in response to higher inflation and growth, which could also reduce the multiplier effect of the fiscal expansion. Together with the recent sharp increase in US long bond yields, the possibility of such actions has led to a reversal of capital flows to emerging markets, reminiscent of the market reaction to the so-called US taper tantrum in 2013. The impact on emerging market currencies and bond markets, including in South Africa, is already evident. Given the high degree of uncertainty, the financial markets may have overreacted.

A further concern for emerging markets is the potential change of trade policies that may impact on existing trade treaties, as well as unilateral increases in tariff protection in the US. The outlook for emerging markets has therefore become more uncertain. The lingering concerns about the sustainability of the recovery in the Chinese economy have been revived by the possibility of tariff increases on Chinese exports. Countries with strong direct trade links with the US, in particular Mexico, are most vulnerable to increased trade barriers. A more protectionist US stance could reinforce the already slow growth of global trade.

The short-term fallout of the Brexit vote on the UK economy has been limited to date, in part due to the accommodative monetary policy response. The longer-term impact remains unclear as the terms of withdrawal are still to be negotiated and there are concerns that a delay in clarity could undermine investment. The Eurozone is expected to continue with its slow but steady recovery, and the Japanese economy continues to battle with deflation.

Global inflation remains generally benign. Since the previous meeting of the MPC, a number of countries have loosened monetary policy. Expansionary policies are expected to persist in the Eurozone, Japan and the UK, despite emerging inflation pressures in the latter. By contrast, a persistence of significant outflows from emerging markets in response to the possibility of a tighter US monetary policy stance could pose challenges for monetary policies in a number of these economies.

These new global developments have impacted on the domestic bond and foreign exchange markets. The rand appreciated steadily from the middle of October in response to some positive domestic developments as well as inflows from a large mergers and acquisitions transaction. The currency was trading at around R13,20 against the US dollar just before the elections. It then reached its weakest point of R14,60 against the US dollar in the wake of the surprise outcome, before recovering somewhat. Domestic long bond yields (R186) initially spiked by about 60 basis points, but the increase has since moderated to about 25 basis points. Since the previous meeting of the MPC, the rand has depreciated by about 5,7 per cent against the US dollar and by about 1,1 per cent on a trade-weighted basis.

The rand is expected to remain sensitive to changes in the stance of US monetary policy. A US rate increase is generally expected in December and probably largely priced in, but of greater significance for the rand will be the signals from the Federal Open-market Committee (FOMC) regarding the trajectory of future increases. The rand will also remain sensitive to the sovereign ratings announcements due later this month and early in December.

On the positive side, the rand has been given support by the generally improved trade account in recent months. However, the deficit on the current account of the balance of payments is expected to have widened in the third quarter of this year.

The financing of the deficit may become more challenging should the recent significant non-resident sales of bonds and equities persist. During October and on a month-to-date basis, non-residents have been net sellers of domestic bonds and equities to the value of R42,7 billion and R19,7 billion respectively.

The domestic economic growth outlook remains subdued, although the low point of the cycle appears to be behind us. The SARB's forecast remains unchanged at 0,4 per cent for 2016 and 1,2 per cent and 1,6 per cent respectively for the next two years. While the estimate for potential real gross domestic product (GDP) growth was revised down marginally to 1,3 per cent, rising to 1,5 per cent by 2018, the output gap is expected to remain negative over the forecast period. The SARB's composite leading business cycle indicator improved in August and September, continuing a recent generally positive albeit gradual upward trend.

Available monthly data suggest that growth in the third quarter is likely to be positive but well below the rate recorded in the second quarter. The mining sector contributed positively to GDP growth in the quarter. The physical volume of manufacturing output declined despite a positive month-to-month outcome in September. The Barclays Purchasing Managers' Index (PMI), which declined further in October, has remained below the neutral 50 index point level for three consecutive months. The weak trends in manufacturing are consistent with the continued low levels of business confidence despite a moderate improvement in the third quarter. More positively, the services sector is expected to sustain its positive growth rate, with the tourism sector being particularly buoyant.

Consumption expenditure by households remains subdued, with declining retail trade sales and static wholesale trade sales in the third quarter of this year. Although new motor vehicle sales increased sharply on a month-to-month basis in October, a sizeable proportion of this is attributed to car rental companies; challenging conditions in the new vehicle sector persist.

Consumers continue to face a number of constraints. Employment growth is particularly weak. Household debt levels, while moderating, are still elevated. And wealth effects are muted amid stagnant equity and residential property markets. Furthermore, growth in credit extension to households remains subdued.

The slow growth in household disposable incomes is also reflected in a gradual decline in wage growth, with growth in nominal remuneration per worker declining to 5,8 per cent in the second quarter. When an adjustment is made for the increase in labour productivity, growth over four quarters in nominal unit labour costs measured 5,1 per cent in the second quarter. The Andrew Levy Employment Publications survey reports an average wage settlement rate in collective bargaining agreements of 7,5 per cent in the first three quarters of the year and 7,1 per cent in the third quarter. This may be indicative of wage settlements becoming more sensitive to the persistently high unemployment rates.

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According to the Medium Term Budget Policy Statement (MTBPS) released in October, fiscal consolidation is set to continue at a measured pace. A moderate degree of slippage is expected in the near term, as tax receipts are negatively affected by the economic slowdown. In order to prevent an excessive widening of the fiscal deficit, the MTBPS proposes a reduction in the expenditure ceiling and tax increases, to be announced in February. A revised deficit of 3,4 per cent of GDP is expected in the current fiscal year, steadily narrowing to 2,5 per cent of GDP in the 2019/20 fiscal year.

Food price inflation remains a significant driver of inflation. It remains sensitive to the continuing drought. While food price inflation is still expected to moderate from early 2017, the pace of decline is expected to be slower than previously forecast. This has led to an upward revision to the food price assumption in the forecast during the outer quarters in particular. The change is mainly due to the delayed impact of meat prices, which are now expected to peak only in early 2018 as farmers rebuild their herds during 2017.

Brent crude oil prices reached a year-high of US$52 per barrel in early October following the decision of the Organization of the Oil Exporting Countries (OPEC) to curtail production. Since then, prices have declined following doubts about the prospects for an agreement on the distribution of production cuts across the cartel. Some price volatility is expected in the short run as negotiations on production cuts continue. The SARB's forecast maintains the assumption of a moderate upward trajectory of international oil prices over the forecast period. The domestic price of 93 octane petrol increased by a cumulative 88 cents per litre in October and November, with almost all of the increase due to higher international product prices. The current over-recovery indicates that, should current trends persist, about half of that increase could be reversed in December.

The MPC is of the view that a high degree of uncertainty surrounds the nature and timing of possible policy changes emanating from significant developments in the global economic environment. This elevated uncertainty creates a more challenging environment especially for emerging markets, as evidenced in the recent changed pattern of capital flows. Financial markets are thus likely to remain volatile for some time.

Since the previous meeting of the MPC, the inflation forecast has remained largely unchanged. Whereas the risks to the inflation forecast were previously assessed to be more or less balanced, the MPC now assesses the risks to be moderately to the upside. This is mainly due to the possible impact of adverse global developments on the exchange rate. The risk of domestically generated shocks to the exchange rate also remains. Nevertheless, despite its high degree of volatility, the rand has displayed relative resilience in the face of numerous shocks over the past year.

The domestic growth outlook is unchanged and remains constrained against the backdrop of weak business and consumer confidence. The risks to the growth forecast are assessed to be broadly balanced. Domestic demand pressures remain weak, and consumers are expected to remain under pressure for some time.

The MPC has accordingly decided to keep the repurchase rate unchanged at 7,0 per cent per annum. The decision was unanimous.

The MPC remains concerned that the inflation trajectory is uncomfortably close to the upper end of the target range. Furthermore, the uncertain environment and moderately higher risks to the inflation outlook require continued vigilance. While the MPC retains the view that we may be close to the end of the hiking cycle, this position may be reassessed should the upside risks transpire.

Summary of assumptions: Monetary Policy Committee meeting on 24 November 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%	3,0%	2,8%	2,9%	3,1%
			2,8%	2,7%		
2. International commodity prices in US$ (excluding oil)........................	-6,4%	-9,8%	-19,3%	-4,5%	5,5%	1,0%
3. Brent crude (US$/barrel)	108,8	99,2	52,5	44,0	53,5	57,5
				(44,3)		
4. World food prices (US$)	-1,6%	-3,8%	-18,7%	-1,6%	5,5%	2,5%
				(-4,9%)	(3,0%)	(3,0%)
5. International wholesale prices..	0,3%	-0,1%	-3,5%	-1,2%	1,1%	1,2%
				(-1,1%)		
6. Real effective exchange rate of the rand (index 2010 = 100)	81,91	79,17	80,08	76,67	81,00	81,00
				(75,67)	(78,00)	(78,00)
7. Real effective exchange rate of the rand..	-10,1%	-3,3%	1,1%	-4,3%	5,7%	0,0%
				(-5,5%)	(3,1%)	

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%	5,2%	6,4%	7,6%
				(5,1%)	(6,7%)	(7,3%)
– Petrol price	11,8%	7,2%	-10,7%	1,4%	5,7%	8,9%
				(1,0%)	(7,0%)	(7,9%)
– Electricity price..	8,7%	7,2%	9,4%	9,3%	7,7%	8,0%
3. Potential growth...	2,0%	1,7%	1,5%	1,3%	1,4%	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 24 November 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	6,1	6,6	6,4	6,1	5,7	5,8	5,5	5,8	5,5	5,5	5,5	5,6	5,5
								(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)
2. Core inflation..................................	5,7	5,6	5,3	5,2	5,5	5,5	5,5	5,7	5,8	5,6	5,6	5,6	5,5	5,4	5,5	5,2	5,2	5,2	5,3	5,2
								(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)

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%
2. Current account as a ratio to nominal GDP.............................	-5,9	-5,3	-4,3	-3,8	-4,3	-4,4
				(-4,0)	(-4,2)	

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

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), the 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 index (CPI) inflation 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** (commonly called 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).