Monetary Policy Review

3 June 2014

Pretoria

Introduction

- Domestic monetary policy entered a tightening cycle in January 2014, against a challenging global and domestic backdrop

- Continued upside risks to inflation materialised and resulted in breach of the inflation target

  - Inflation driven by food, petrol and exchange-rate related pressures
  - Risks remain to the upside with the exchange rate a particular concern, in part driven by global considerations
  - But economic growth is slowing, with downside risks

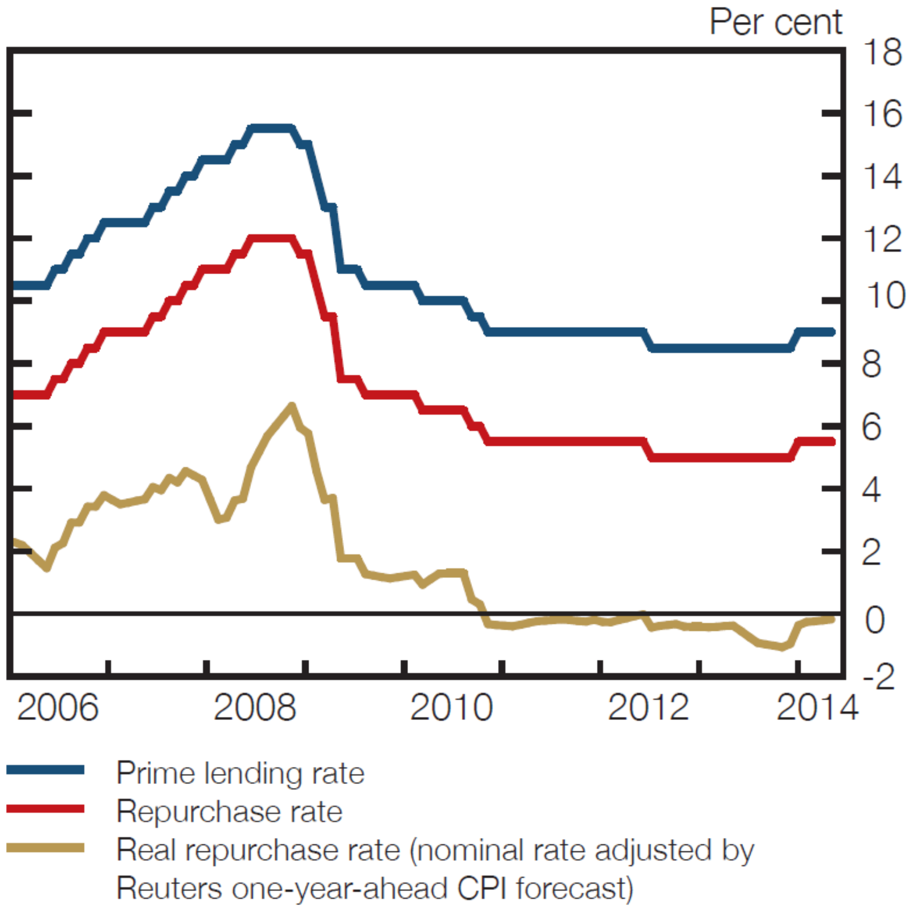
Introduction (continued)

- Global environment giving mixed messages
  - Expected improved advanced economy performance, with changing expectations of monetary policy normalisation impacting on the pattern of global capital flows
  - Slowing Chinese growth leading to weaker commodity prices
  - Emerging markets generally slowing, but less accommodative monetary policy stances

Monetary Policy Stance

The repo rate was raised to 5,5 per cent in January. The real rate remains marginally negative, supporting growth

Monetary policy and the prime lending rate



Sources: Reuters and South African Reserve Bank

Monetary policy stance

- During 2013, persistent dilemma of rising inflation, with upside risk, and a subdued growth outlook

- Monetary policy has been accommodative: with a negative output gap, was more tolerant of inflation close to the upper end of the band

- Upside pressures on inflation mainly of a cost-push nature and a depreciating rand, no strong signs of demand pressures

Monetary policy stance

- In January, marked upward revision of the inflation forecast, with upside risk, mainly driven by food and exchange rate considerations, despite moderate exchange rate pass-through

- Some positive indications of a solid growth outlook

- The MPC indicated that we have entered a tightening interest rate cycle

- Cycle driven by inflation pressures, and the prospects of higher interest rates in the US and other advanced economies (global policy normalisation)

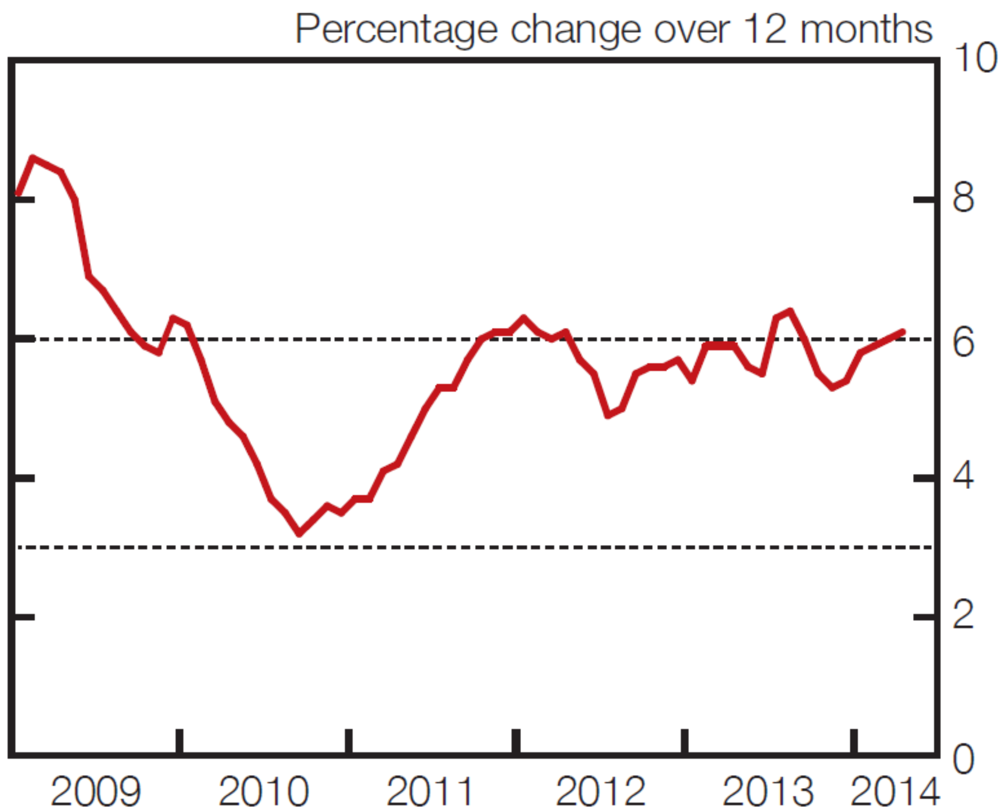
Monetary policy stance

- However, the timing and extent of the domestic interest rate cycle will be highly data dependent, influenced to some extent by the global policy cycle, and sensitive to the domestic growth outlook.
- In March and May, the policy rate was left unchanged
- Slight moderation in the upside risks to inflation, while the growth outlook deteriorated

Inflation: Outcomes and the evolution of the outlook

Headline inflation breached the upper bound of the target range in April, in line with the Bank's forecast

Consumer price inflation: Targeted inflation*



* CPI for all urban areas

Source: Statistics South Africa

Inflation has risen since the end of 2013, driven by food prices in particular and rand depreciation

Contributions to targeted inflation

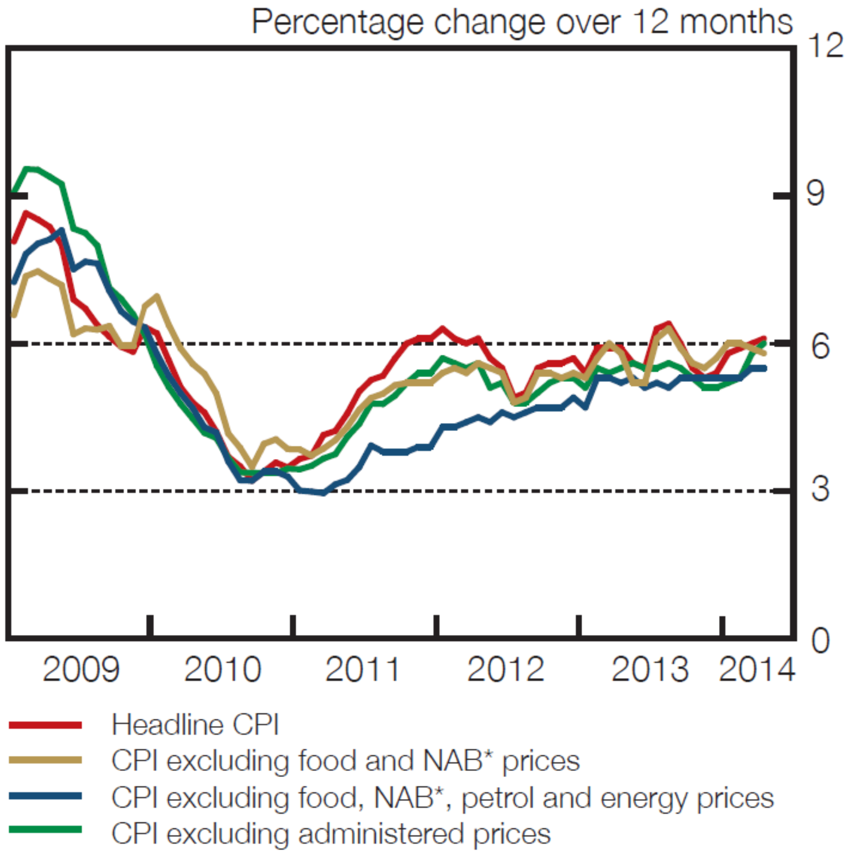
Percentage change over 12 months* and percentage points

		2013			2014			
	Weights	**Oct**	**Nov**	**Dec**	**Jan**	**Feb**	**Mar**	**Apr**
Goods inflation*	49,86	4,9	4,6	4,8	5,7	6,1	6,2	6,3
Services inflation*	50,14	6,0	5,9	5,9	6,0	5,7	5,9	5,9
Targeted inflation*	**100,00**	**5,5**	**5,3**	**5,4**	**5,8**	**5,9**	**6,0**	**6,1**
Food and non-alcoholic beverages	15,41	0,6	0,6	0,5	0,7	0,8	1,1	1,2
Food	14,20	0,6	0,5	0,5	0,6	0,8	1,0	1,2
Housing and utilities	24,52	1,3	1,3	1,3	1,3	1,3	1,4	1,4
Transport	16,43	1,0	1,0	1,0	1,3	1,3	1,2	1,1
Petrol	5,68	0,5	0,4	0,6	0,8	0,8	0,5	0,5
Miscellaneous	14,72	1,1	1,1	1,0	1,0	1,0	1,0	1,0
Other	28,92	1,5	1,3	1,6	1,5	1,5	1,3	1,4
Of which:								
CPI for administered prices*	18,48	7,8	7,3	7,8	9,3	9,1	7,6	7,4

Sources: Statistics South Africa and own calculations

The broadest measure of core inflation started increasing after a period of stability, reflecting exchange rate pass-through

Core measures of inflation

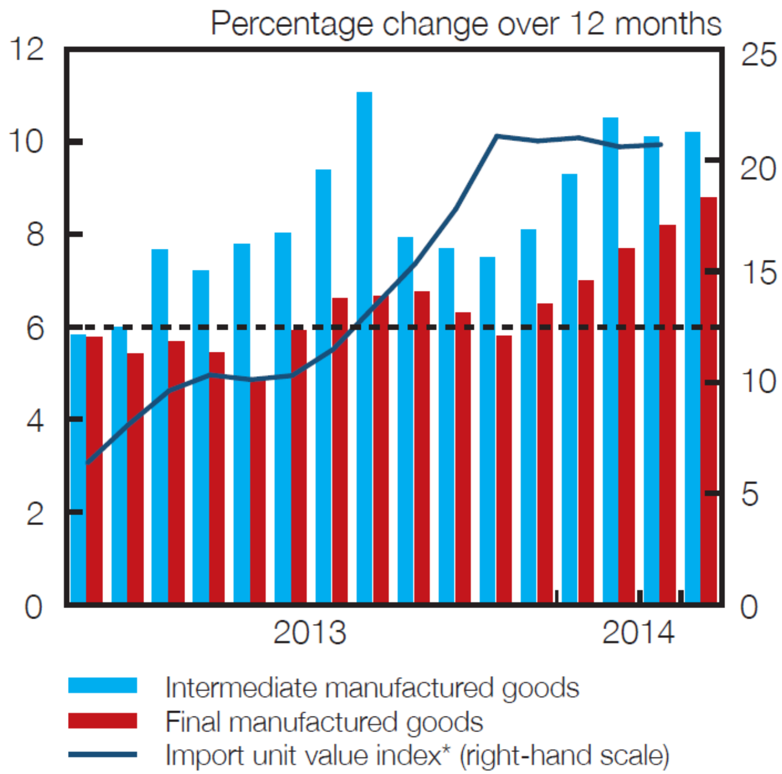


* NAB: Non-alcoholic beverages

Source: Statistics South Africa

Producer prices have trended higher suggesting strong cost pressures from currency depreciation

Price pressures

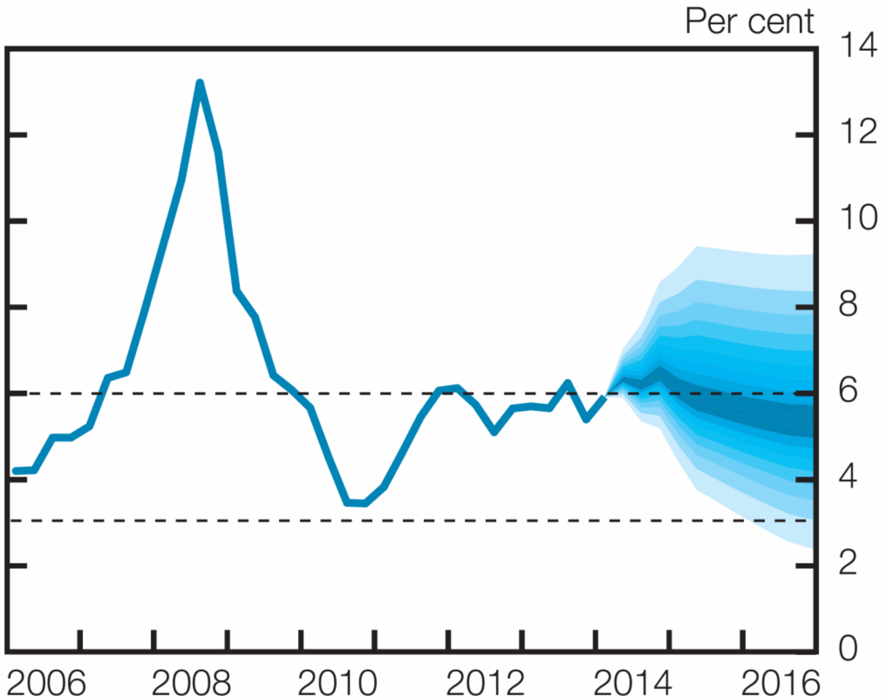


* Import unit value indices measure inflation in imported commodities using customs-level data from the South African Revenue Service

Source: Statistics South Africa

Inflation breached the target in April and is projected to stay above the target for four quarters, with upside risk

Targeted inflation* forecast



----- 3–6 per cent inflation target range

* CPIX for metropolitan and other urban areas until the end of 2008; CPI for all urban areas thereafter

Source: South African Reserve Bank

Evolution of the Bank's targeted inflation forecasts

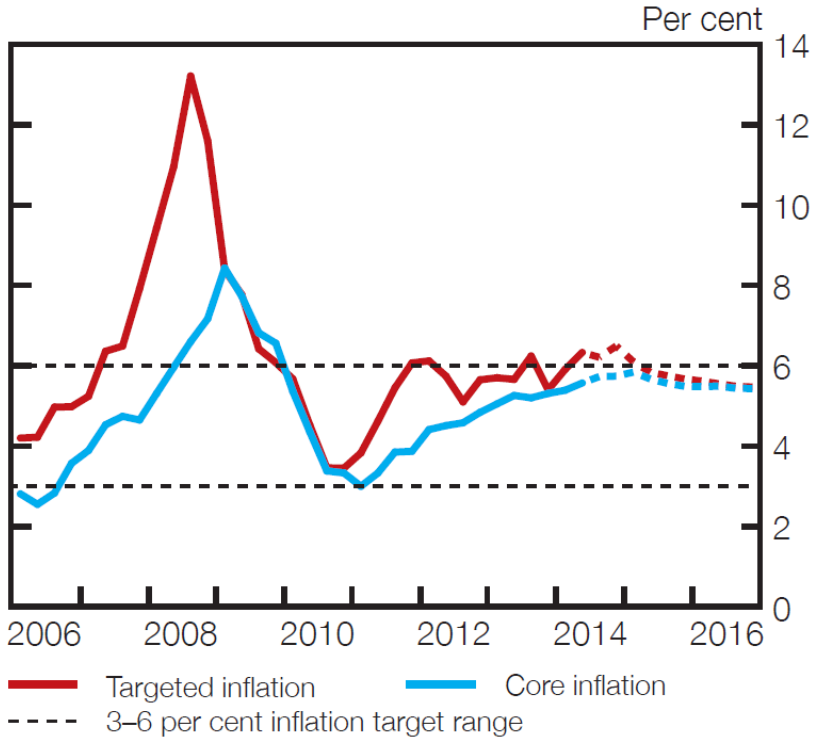
Per cent

MPC meetings	2014	2015	2016
November 2013	5,7	5,4	
January 2014	6,3	6,0	
March 2014	6,3	5,8	
May 2014	6,2	5,8	5,5

Source: South African Reserve Bank

Core inflation is expected to remain below 6 per cent

Targeted and core inflation forecasts



Source: South African Reserve Bank

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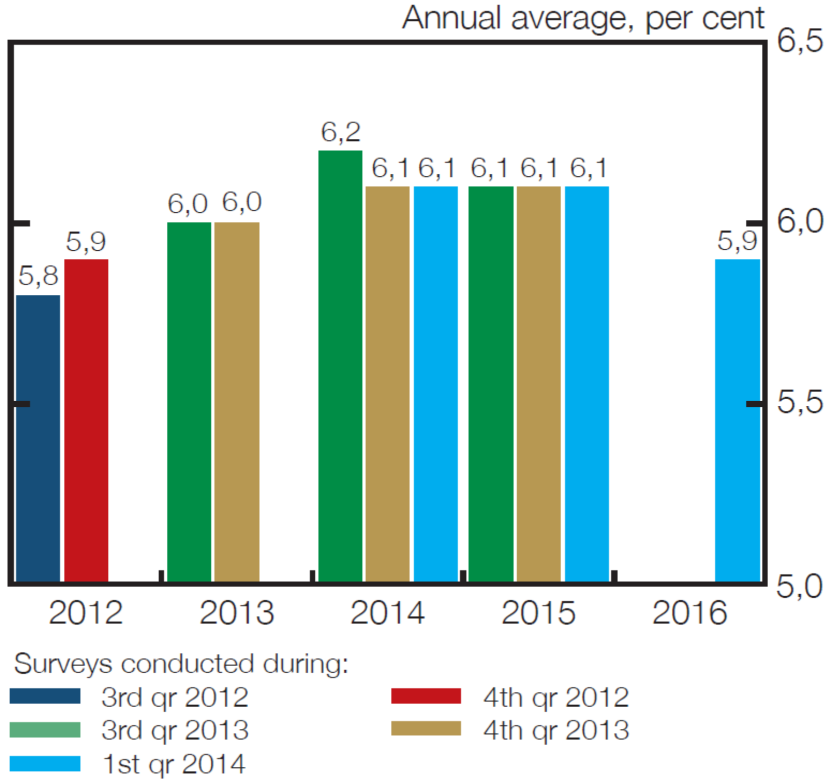
Source: South African Reserve Bank

Inflation expectations still clustered around the top end of the target.

BER surveys of headline CPI inflation expectations



Source: Bureau for Economic Research, Stellenbosch University

Economic growth: Outcomes and the evolution of the outlook

Negative supply shocks led to a -0,6 per cent contraction in growth in the first quarter of 2014 (the first contraction since 2009)

Real domestic sectoral growth rates

Per cent*

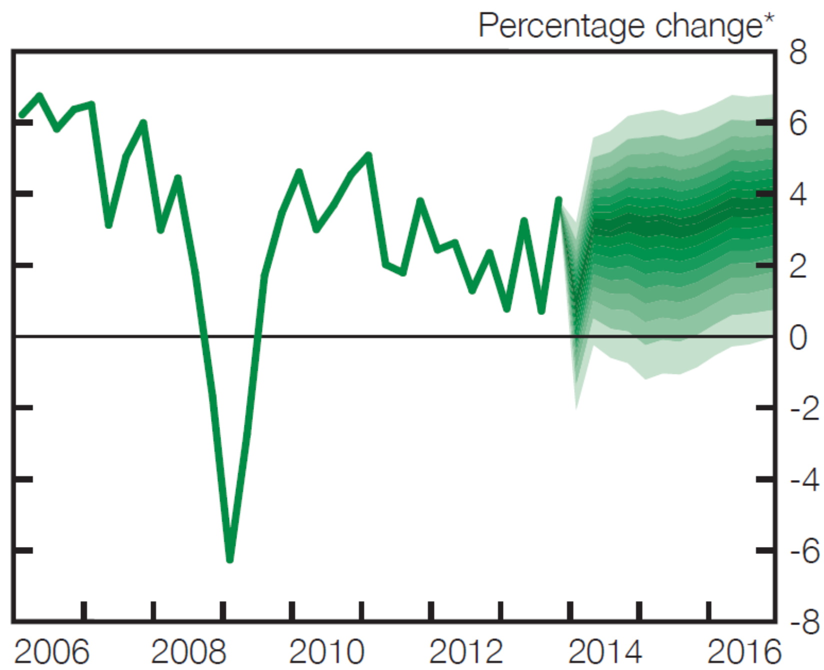
Sector	2012	2013					2014
	Year	1st qr	2nd qr	3rd qr	4th qr	Year	1st qr
Mining	-3,6	13,4	-5,4	11,4	15,7	3,1	-24,7
Gross value added at basic prices excluding the primary sector	2,8	0,0	4,0	-0,1	3,3	1,8	0,7
Manufacturing	2,1	-7,9	11,7	-6,6	12,3	0,8	-4,4
Wholesale and retail trade, catering and accommodation	3,8	2,1	3,1	1,3	2,3	2,2	2,1
Gross domestic product	**2,5**	**0,8**	**3,2**	**0,7**	**3,8**	**1,9**	**-0,6**

* Quarterly data refer to quarter-on-quarter growth at seasonally adjusted annualised rates

Sources: Statistics South Africa and own calculations

Growth remains weak and uneven. The growth outlook has deteriorated markedly and risk is to the downside

Real GDP growth forecast



* At seasonally adjusted annualised rates

Source: South African Reserve Bank

Evolution of the Bank's real GDP growth forecasts

Per cent

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November 2013	3,0	3,4	
January 2014	2,8	3,3	
March 2014	2,6	3,1	
May 2014	2,1	3,1	3,4

Source: South African Reserve Bank

Short-term indicators corroborate the subdued growth outlook

Domestic economic sentiment indicators

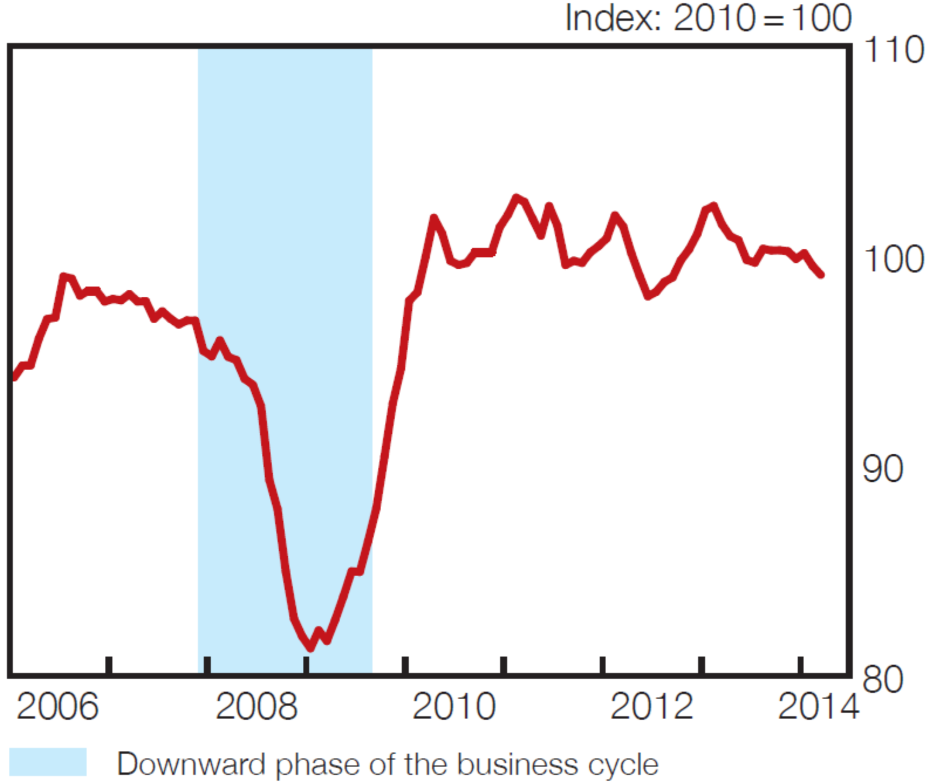
	Historic range		Most recent		As at *MPF**	
					Nov	Jun
	Low	High	Low	High	2013	2014
RMB/BER Business Confidence Index	10	91	23	55	43	41
Kagiso/BER Purchasing Managers' Index	34,1	63,7	46,6	55,6	50,7	44,3
FNB/BER Consumer Confidence Index	-33	23	-8	15	-7	-6

* Improved/worsened since previous *MPF*

Sources: Kagiso Securities, Rand Merchant Bank, First National Bank and the Bureau for Economic Research, Stellenbosch University

The composite leading business cycle indicator continues to move sideways

Composite leading business cycle indicator



Note: The direction of movements of this indicator show the expected movements in aggregate economic activity over the next 6 to 12 months

Source: South African Reserve Bank

Demand- and supply-side determinants of inflation

The demand-side of the economy is weak, led by slowing household consumption expenditure, reducing demand pressures on inflation

Growth in expenditure on GDP

Per cent*

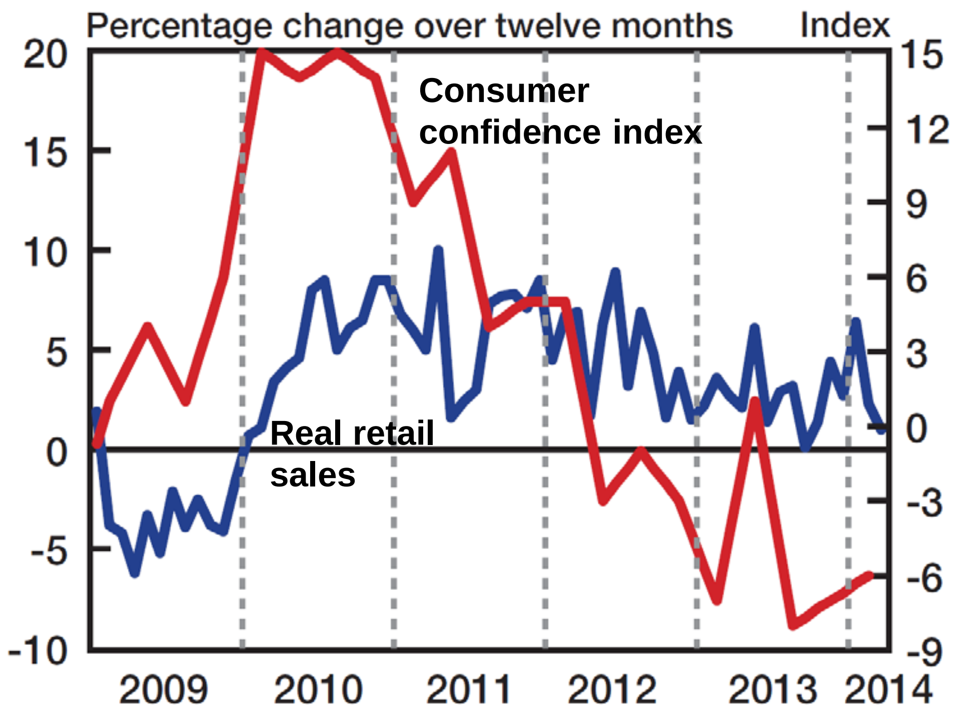
	2012	2013				
	Year	1st qr	2nd qr	3rd qr	4th qr	Year
Final consumption expenditure						
Households	3,5	2,4	2,5	2,1	2,0	2,6
General Government	4,0	2,8	1,7	1,5	2,0	2,4
Gross fixed capital formation	4,4	3,8	5,6	7,0	3,1	4,7
Gross domestic expenditure	**4,0**	**5,3**	**3,2**	**-0,8**	**-3,6**	**2,2**
Exports of goods and services	0,4	5,9	9,0	16,7	3,9	4,2
Imports of goods and services	6,0	21,5	7,3	7,0	-18,9	4,7
Gross domestic product	**2,5**	**0,8**	**3,2**	**0,7**	**3,8**	**1,9**

* Quarterly data refer to quarter-on-quarter growth at seasonally adjusted annualised rates

Note: Data for 2012 and 2013 as published in the March 2014 *Quarterly Bulletin*

Source: South African Reserve Bank

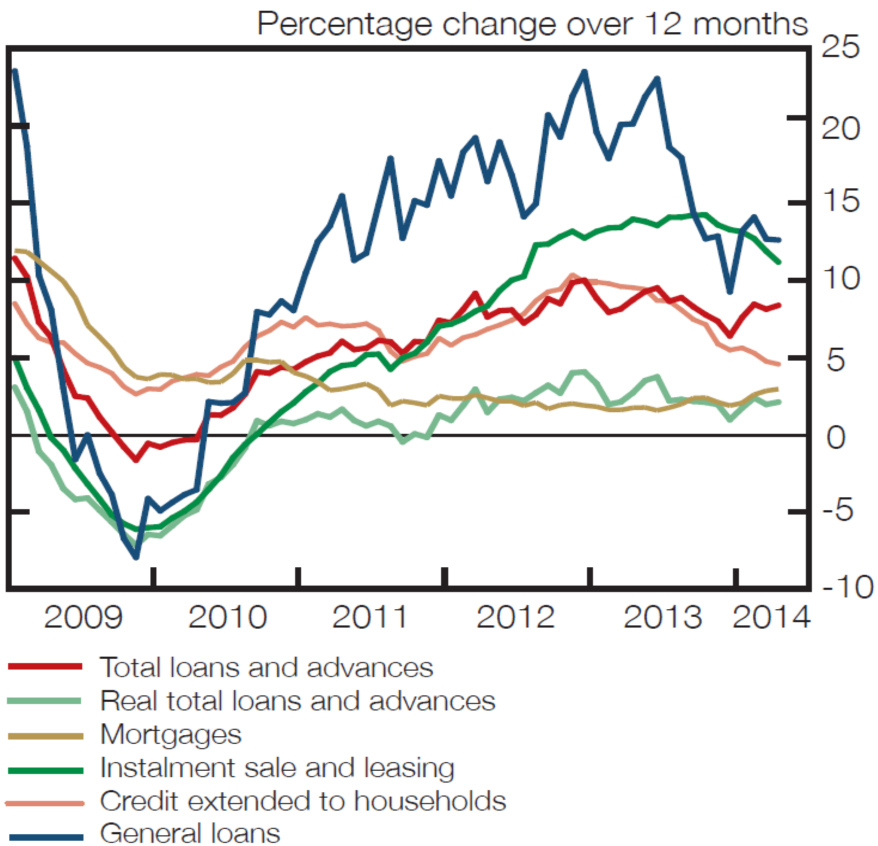
Real retail sales growth slowing amid low consumer confidence



Source: Statistics South Africa

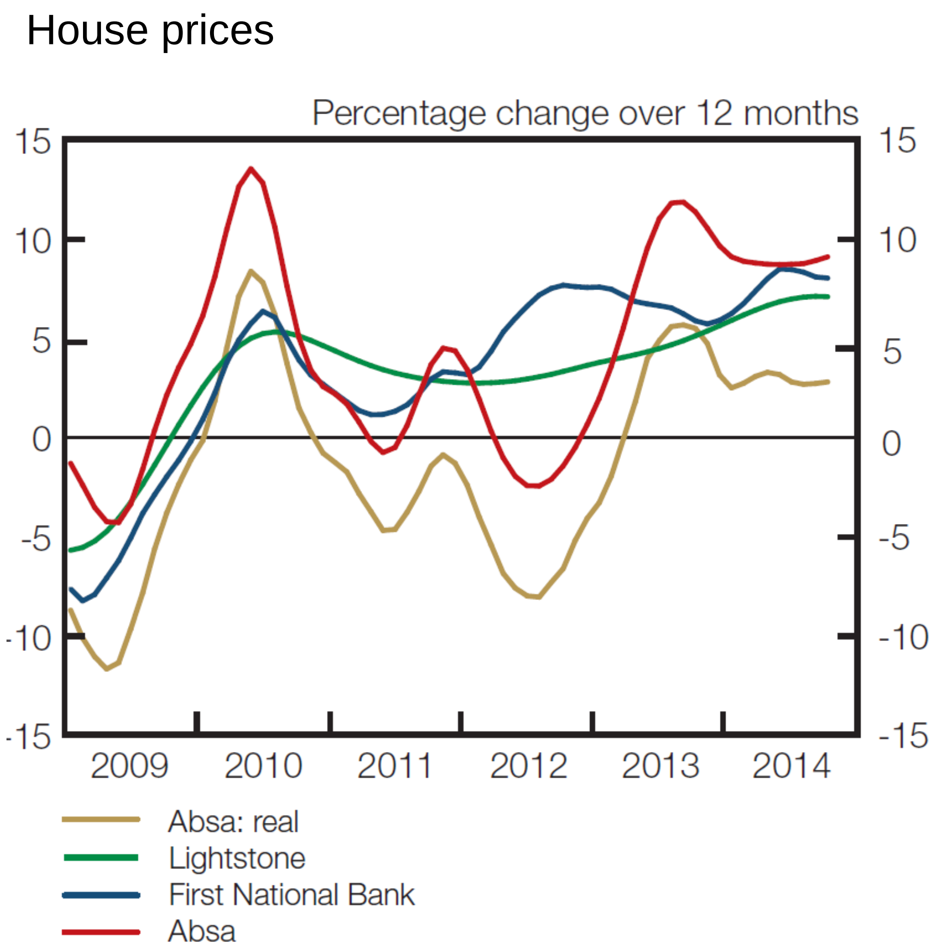
Credit growth remains weak, and credit to households decelerated with unsecured lending declining sharply

Banks' loans and advances to the private sector



Source: South African Reserve Bank

Moderate house price growth implies limited wealth effects on consumption



Sources: Sources: Absa, First National Bank, Lightstone and own calculations

Fiscal consolidation path continues: accommodative, but no strong fiscal impulse

Public finance medium-term estimates

Percentage of GDP

Consolidated government*	2013/14		2014/15		2015/16		2016/17	
	MTBPS	Budget	*MTBPS*	Budget	*MTBPS*	Budget	*MTBPS*	Budget
Revenue	28,7	29,2	28,6	29,0	28,5	28,9	28,7	29,1
Expenditure	32,8	33,2	32,7	33,0	32,3	32,6	31,7	31,9
Budget balance	-4,2	-4,0	-4,1	-4,0	-3,8	-3,6	-3,0	-2,8
Total net loan debt**	39,3	39,7	41,4	41,9	43,1	43,5	43,9	44,3
Public-sector borrowing Requirement		6,6		6,1		5,9		4,3

* Includes national government, provinces, social security funds and selected public entities

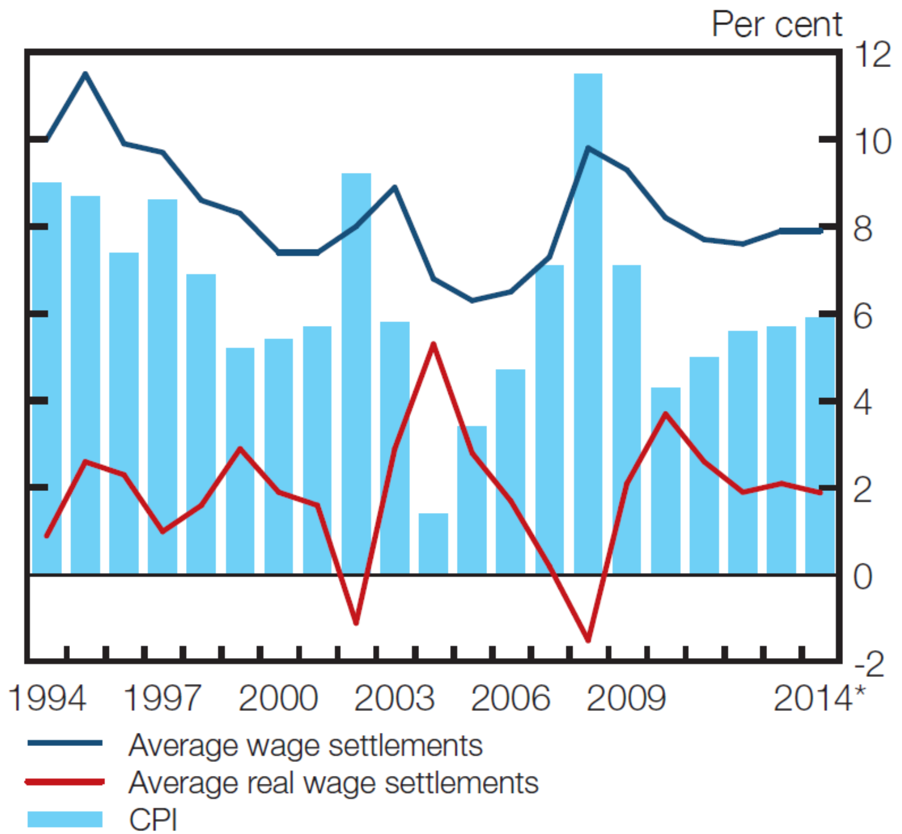
** National government

Note: Owing to a change in presentation of budget statistics, the budget balance now includes extraordinary receipts and payments

Sources: National Treasury, *Medium Term Budget Policy Statement* (*MTBPS*), October 2013 and *Budget Review 2014*

On the supply-side, spikes in inflation risk provoking higher wage demands which could lead to further inflation

Average annual inflation and wage settlements

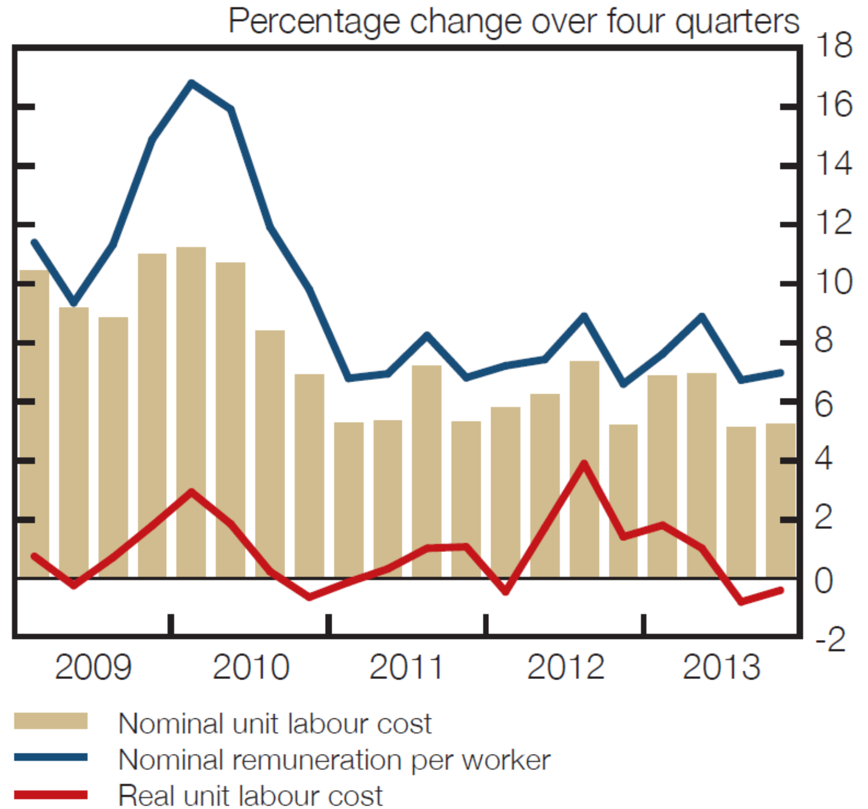


* Data for 2014 are for the first three months of the year

Sources: Andrew Levy Employment Publications, Statistics South Africa and own calculations

Growth in unit labour costs have moderated, but upside risks

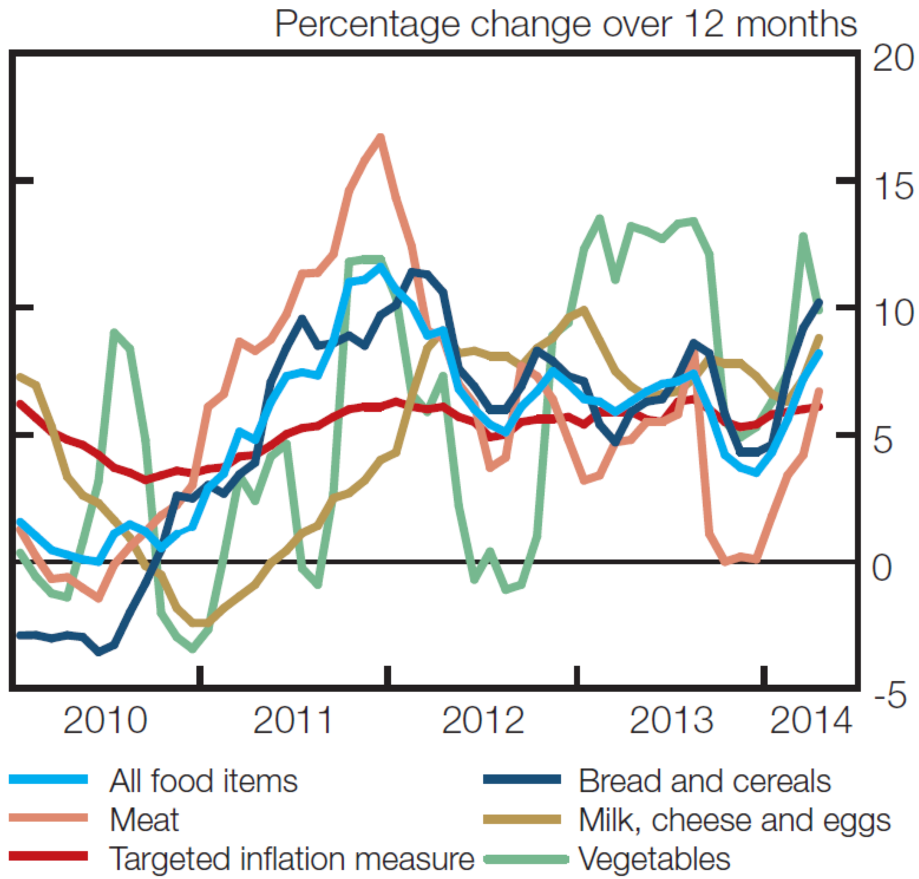
Remuneration per worker and unit labour cost in the formal non-agricultural sector



Sources: Statistics South Africa and own calculations

However, food prices remain a risk to the inflation outlook with meat and cereal prices rebounding strongly

Targeted inflation* and food inflation

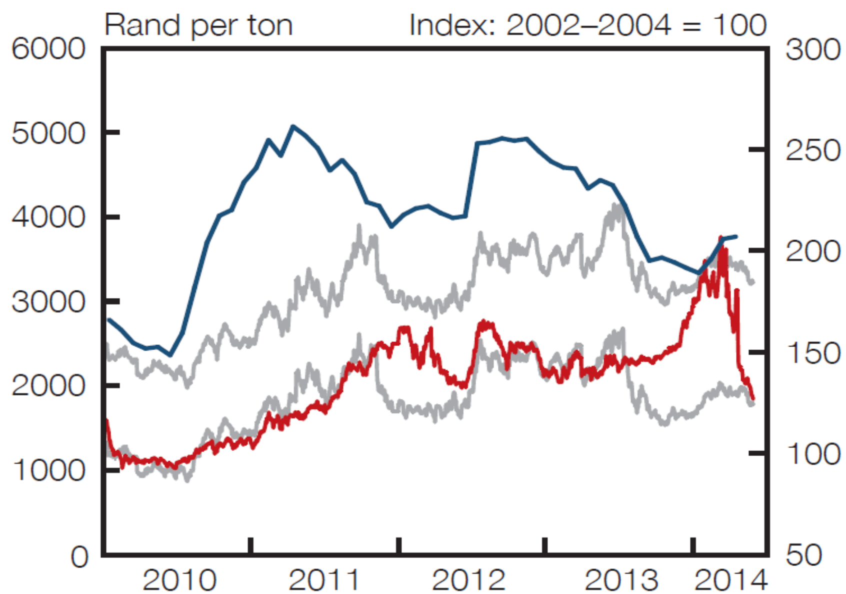


* CPI for all urban areas

Source: Statistics South Africa

International food inflation subdued. Local maize prices declined recently – this should mitigate some price pressures

Maize and cereals prices



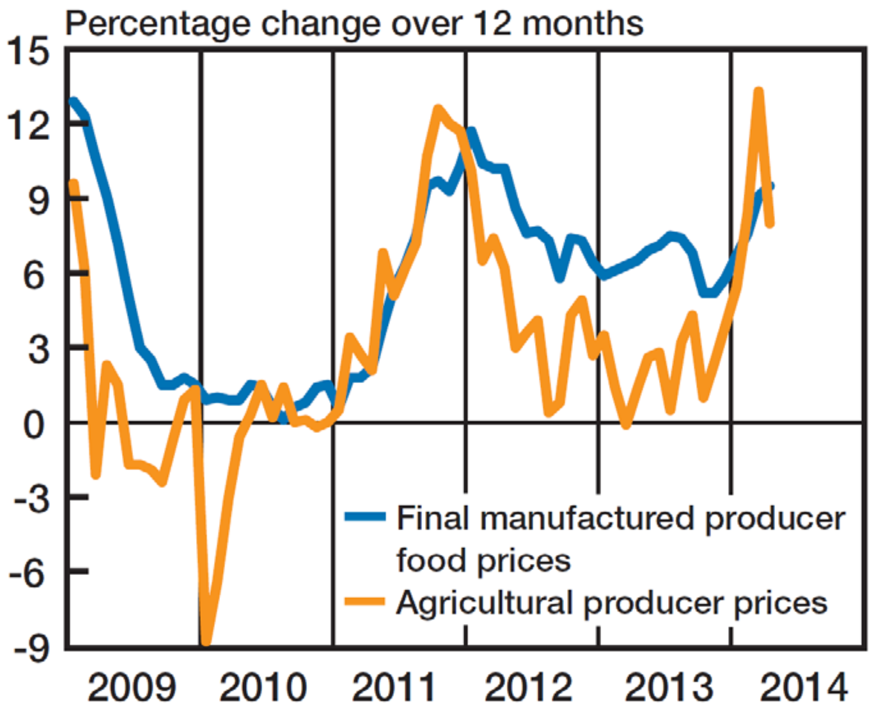
White maize SAFEX spot price
FAO cereal price index (right-hand scale)

* The top grey line is the import parity price and the bottom grey line is the export parity price. These prices are the theoretical upper and lower bound prices for commodities.

Sources: Grain South Africa and the Food and Agriculture Organization (FAO)

Strong pipeline pressures coming from producer prices

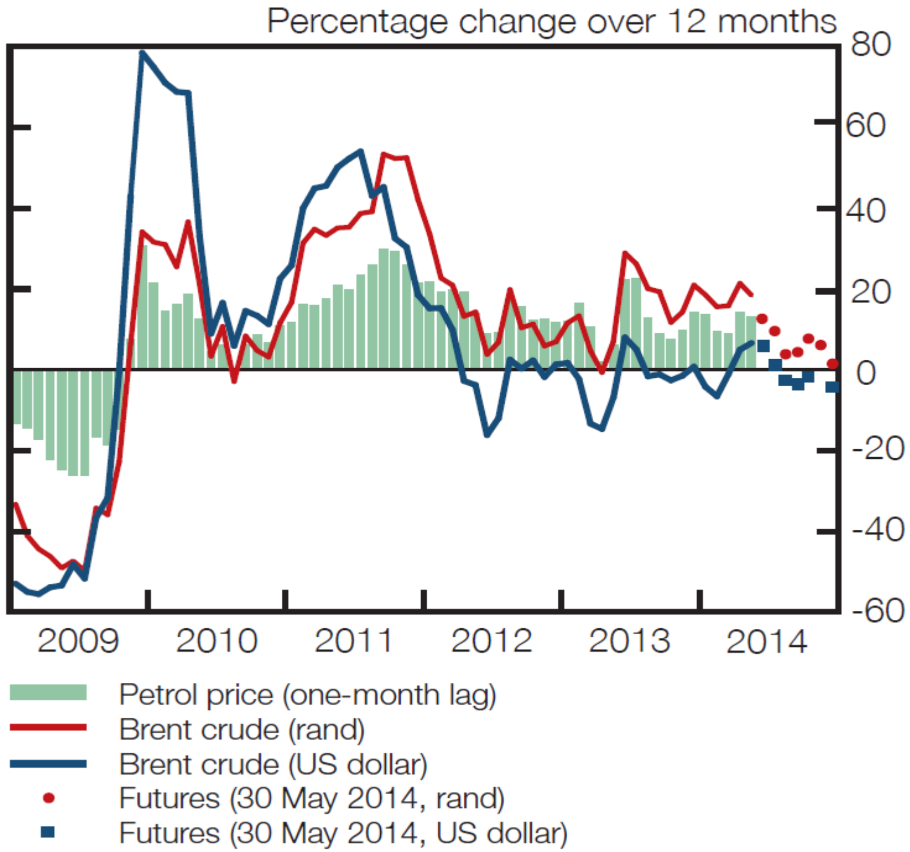
Producer price index for food



Source: Statistics South Africa

Crude oil prices have been stable, but the petrol price volatile, mainly responding to the rand exchange rate.

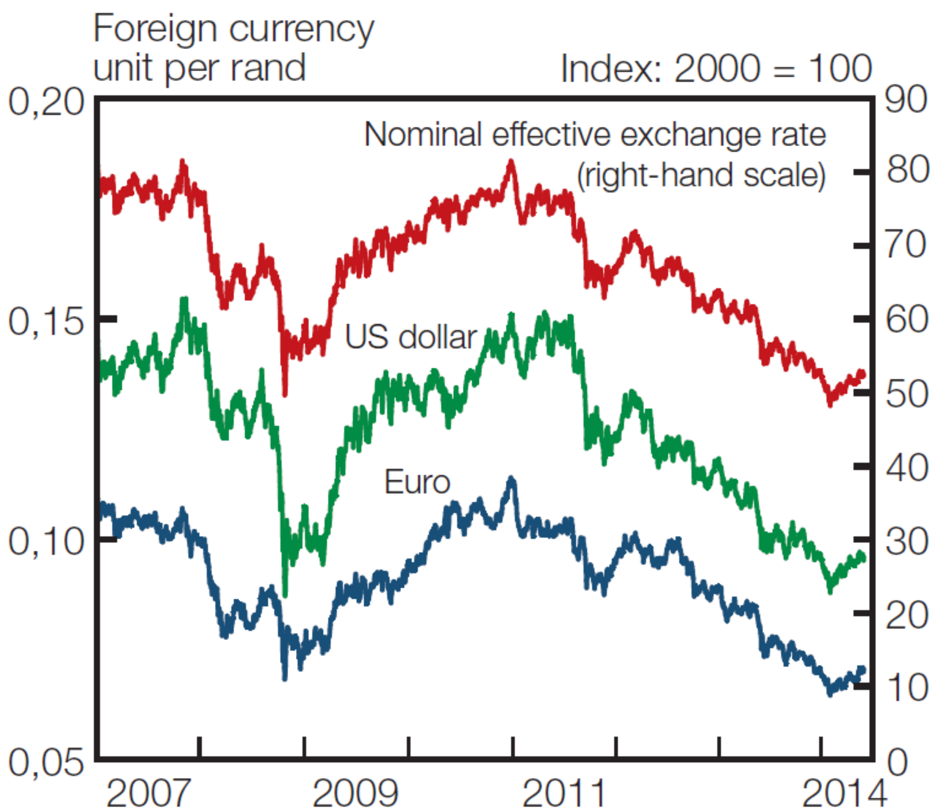
The spot and futures prices of Brent crude oil and the petrol price



Sources: Department of Energy, Bloomberg, JSE Limited and own calculations

The rand has been on a depreciating trend since 2011, although pass-through to inflation relatively muted

Exchange rates of the rand

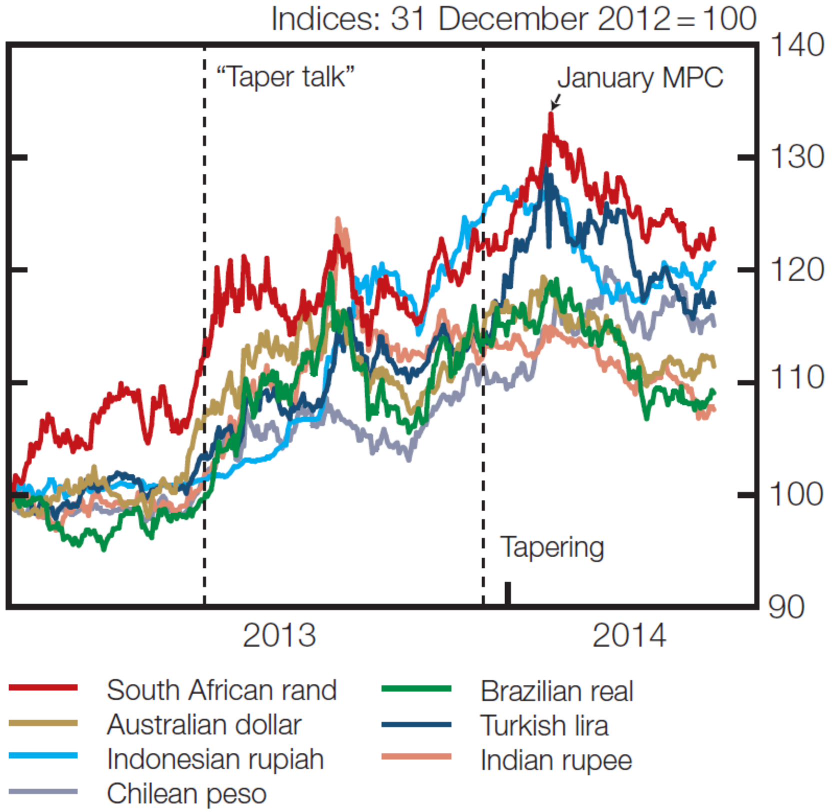


Note: A depreciation is represented by a downward movement in the above graph

Sources: Bloomberg and South African Reserve Bank

The rand moved broadly in line with other emerging-market currencies in 2013/14, in response changing global risk perceptions

Exchange rate performance against the US dollar



Sources: Reuters and own calculations

Global growth and policy developments

Global growth outlook is improving

Global growth rates

Per cent

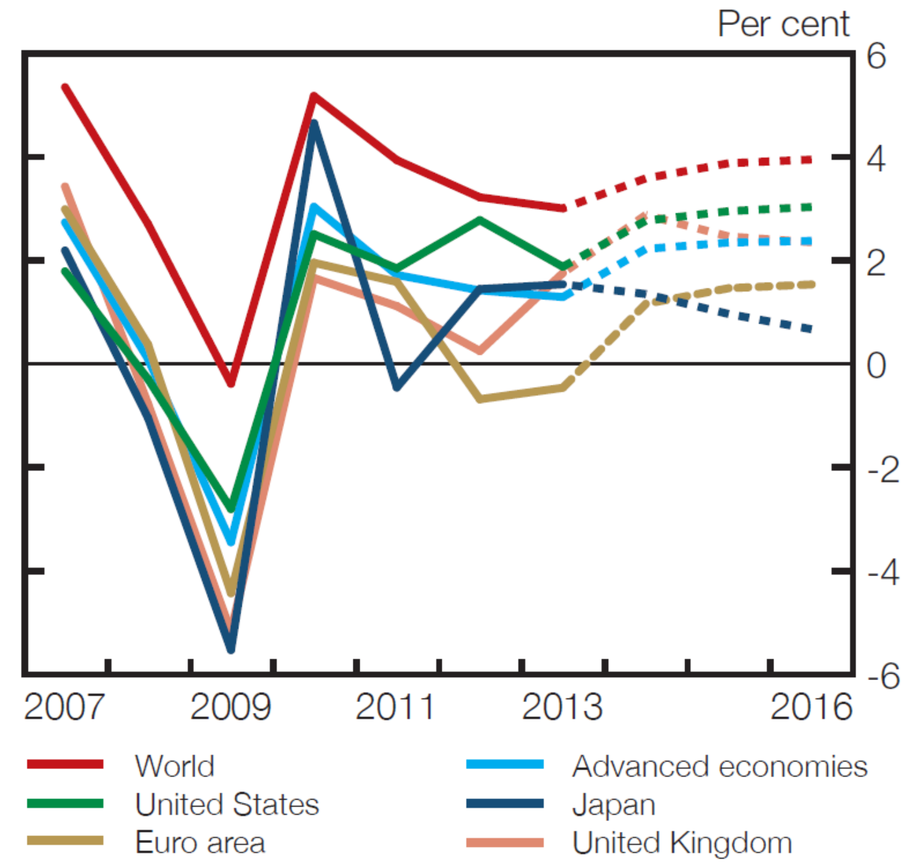
	Long-run average*	Outcomes				Estimates		
		2010	2011	2012	2013	2014	2015	2016
World	3,4	5,2	3,9	3,2	3,0	3,6	3,9	4,0
Advanced economies	2,9	3,0	1,7	1,4	1,3	2,2	2,3	2,4
Emerging-market and developing countries	4,3	7,5	6,3	5,1	4,7	4,9	5,3	5,4
Sub-Saharan Africa	3,2	5,6	5,5	4,9	4,9	5,4	5,5	5,8

* Long-run average: average growth rates from 1980 until 2006

Source: International Monetary Fund, *World Economic Outlook*, April 2014

Improved advanced economy performance could boost export demand (but possibility of earlier normalisation)

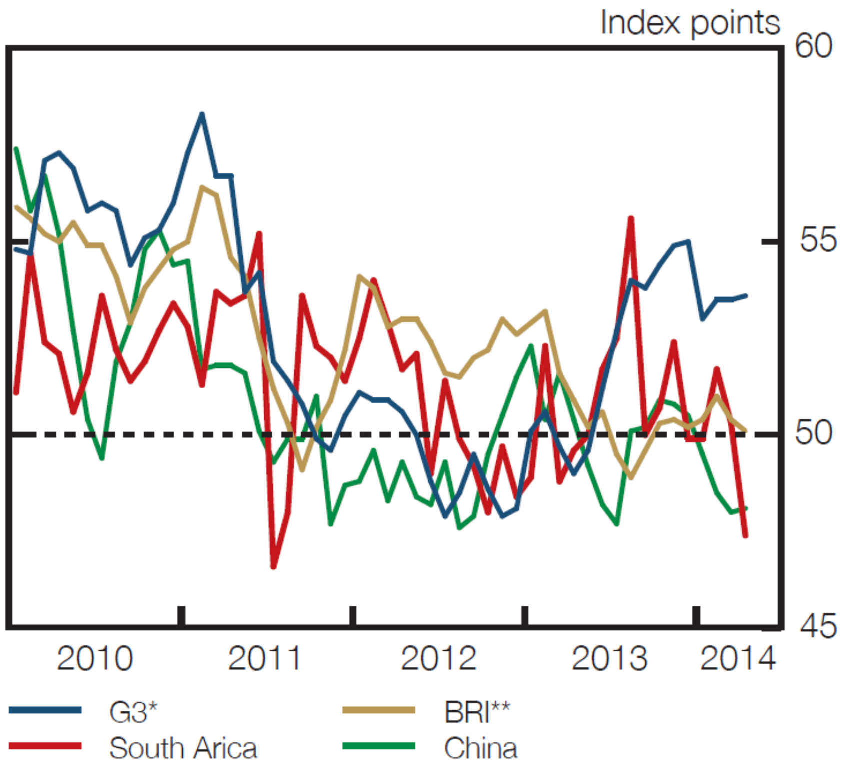
Growth rates in advanced economies



Source: International Monetary Fund, *World Economic Outlook*, April 2014

China heads a broad emerging-market slowdown

Purchasing Managers' Indices



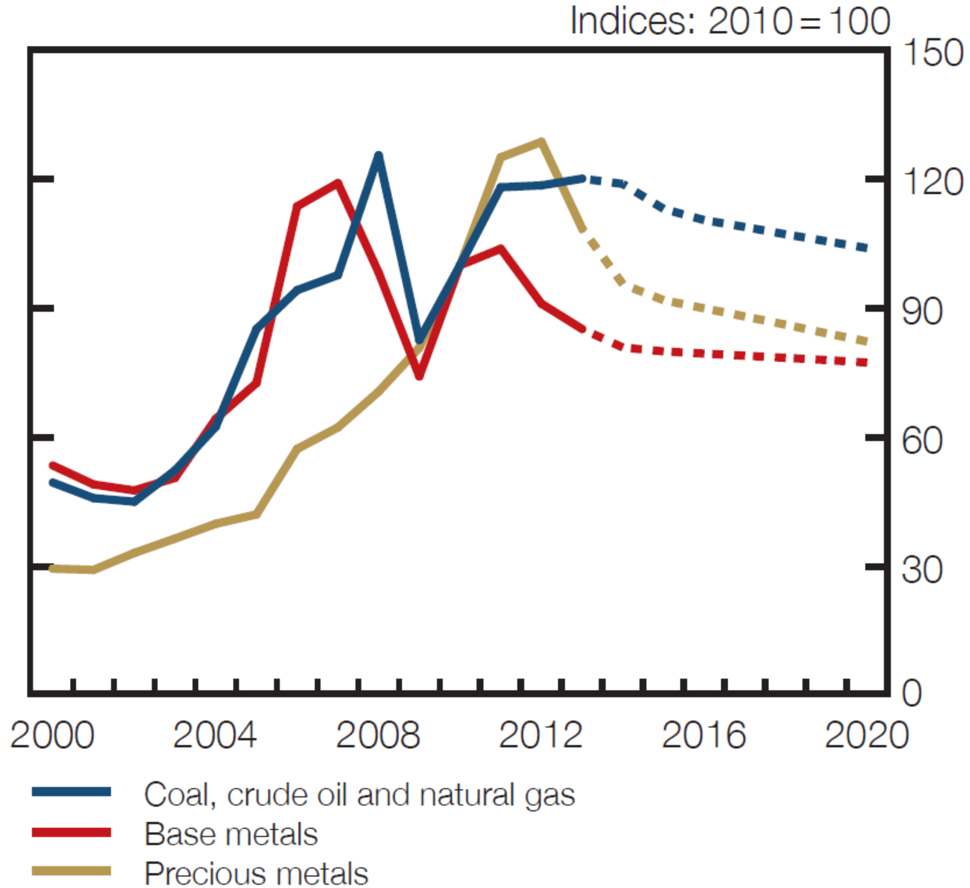
* G3: Purchasing power parity (PPP)-weighted index of PMIs of the United States, Japan and the euro area

** BRI: PPP-weighted index of PMIs of Brazil, Russia and India

Sources: JPMorgan; International Monetary Fund, *World Economic Outlook*, April 2014; and own calculations

… impacting commodity prices and hence potential export-related income. But global inflation is relatively subdued

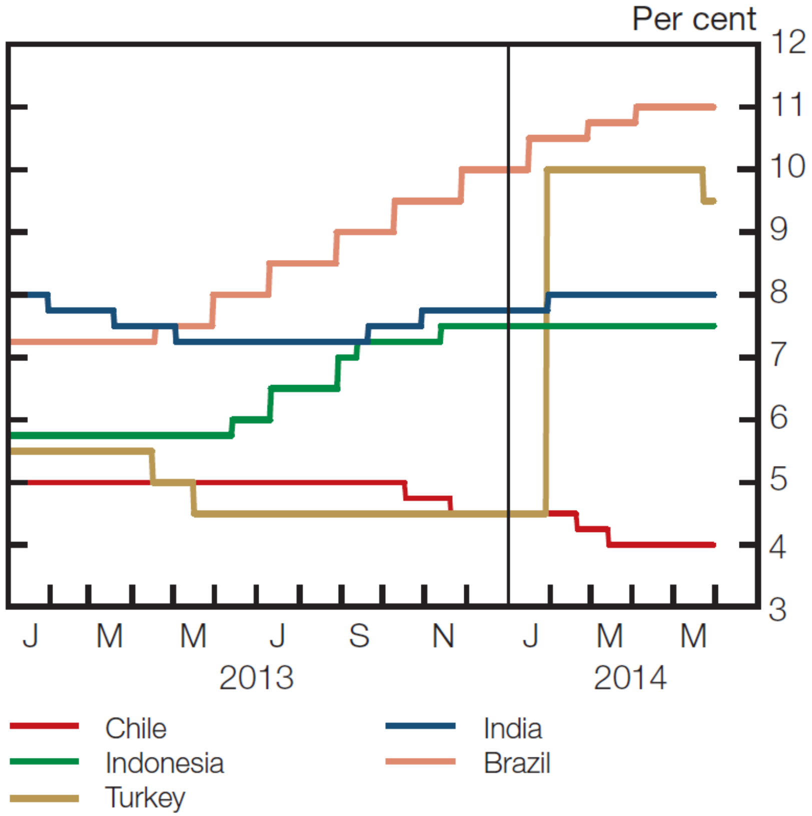
Real commodity prices



Source: World Bank

Tapering and the prospect of policy normalisation has reduced capital flows to emerging markets, resulting in a generally tightening monetary policy bias

Monetary policy interest rates of selected countries



Source: National central banks

Risks to the outlook

Global risks

The exchange rate remains vulnerable to a number of global risks including:

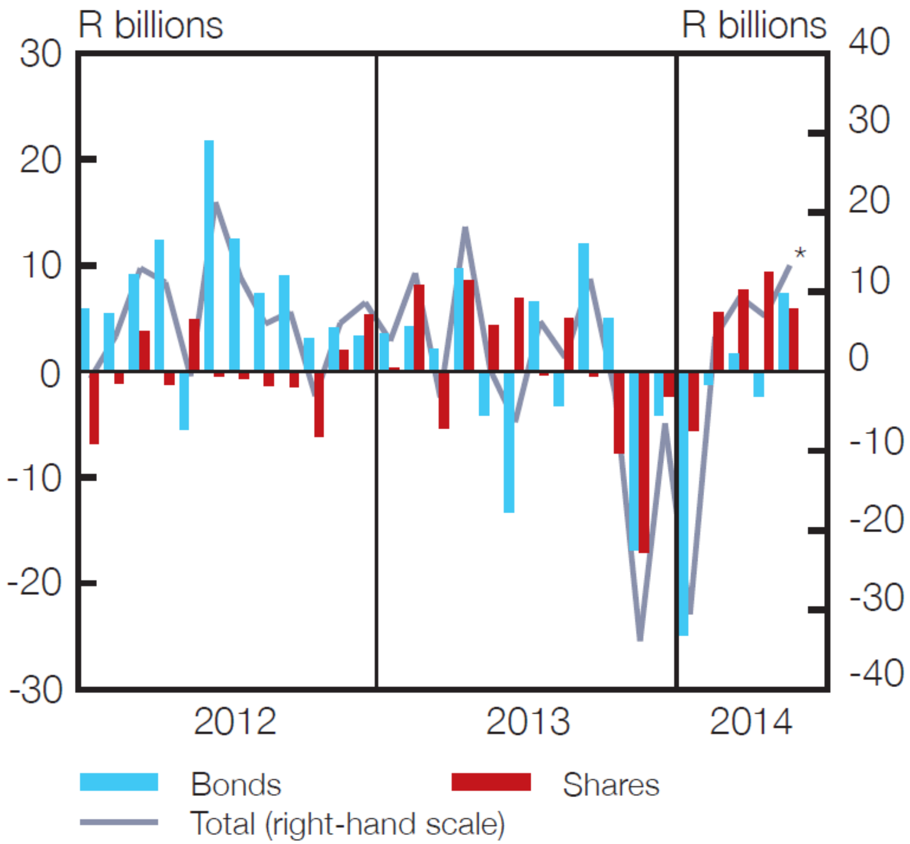
- world monetary policy normalisation
- capital flows
- the current-account deficit

Monetary policy normalisation

- Normalisation in the advanced economies will happen. The question is when and by how much?
- Not a synchronised normalisation, so we are in for a protracted period of volatility
- This will impact on exchange rates and monetary policy in emerging markets in general

Strong net outflows from November to January reverted to inflows, providing some support to the currency

Monthly non-resident net purchases of domestic securities

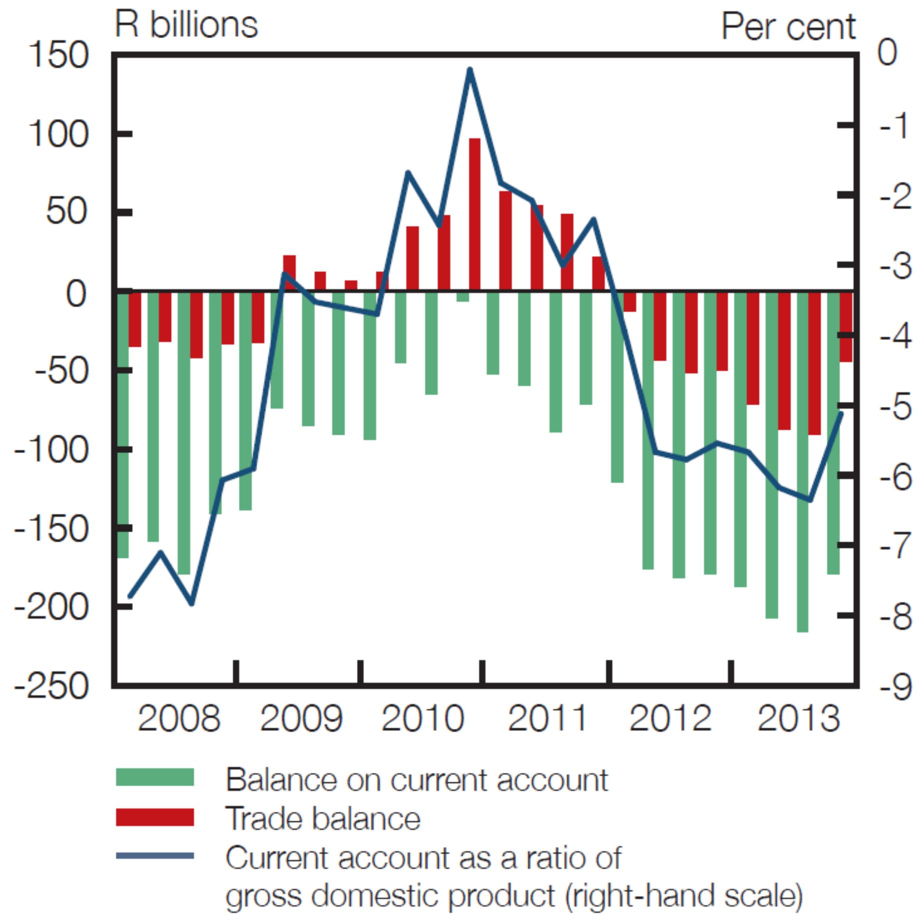


* Data to 29 May 2014

Source: JSE Limited

The current-account deficit remains a source of vulnerability, with slow response to the depreciation

Trade and current accounts*



* Data are seasonally adjusted

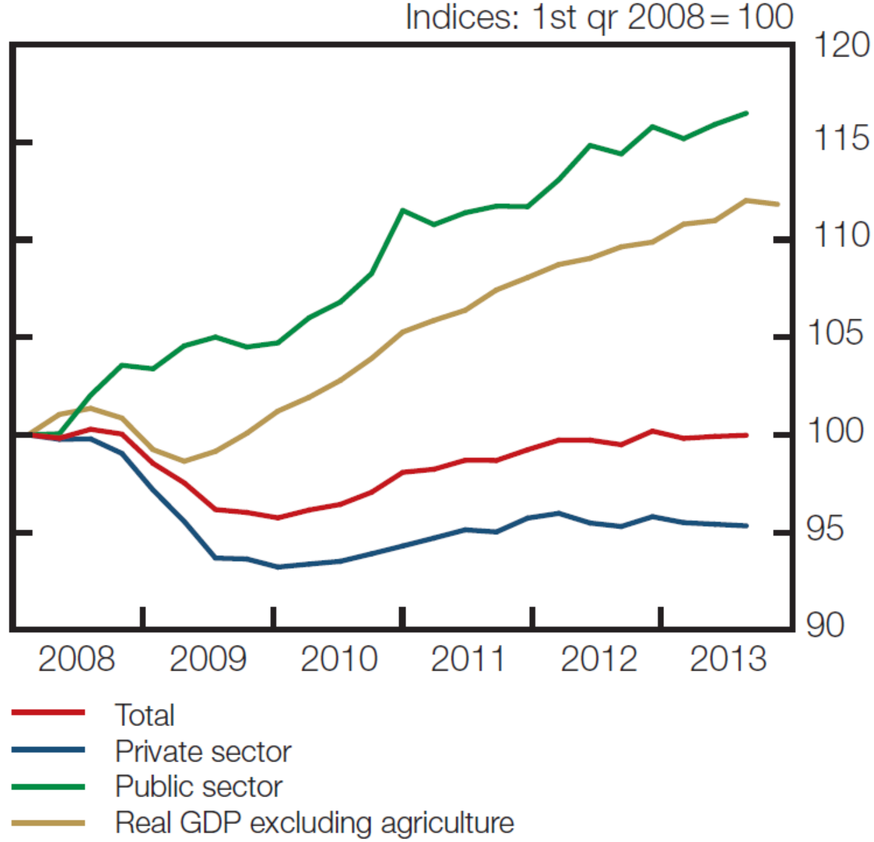
Source: South African Reserve Bank

Domestic risks

- The economy remains vulnerable to supply shocks that amplify the country's vulnerability, in particular:
- an unreliable electricity supply
- A fractious labour relations environment and protracted strikes are undermining investor confidence, growth and employment
- Employment creation remains that most significant challenge to long-term economic stability and growth

Employment growth remains the most significant challenge to long-term economic stability

Formal non-agricultural employment and GDP*



* Data have been seasonally adjusted

Sources: Statistics South Africa, Quarterly Employment Statistics; and South African Reserve Bank

Conclusion

- The policy environment is characterised by rising inflation and a deteriorating growth outlook
- Inflation to remain out of target until the second quarter of 2015
  - Upside risks stem from the volatile exchange rate
  - This may be exacerbated by increasing pass-through
  - Weak household consumption expenditure contributing to subdued demand side pressures on inflation

Conclusion

- The monetary policy stance remains accommodative
- Global capital flows have become more erratic as the advanced economies move towards monetary policy normalisation
- Domestic monetary policy is in a moderate rising interest rate cycle which will be determined to some extent by the speed of global policy normalisation; adjustments will not necessarily happen every meeting, or by the same amount
- Monetary policy will continue to be conducted within a flexible inflation targeting framework that allows MPC decisions to be sensitive to changing data and the fragility of the domestic economy.

Thank you