South African Reserve Bank

PRESS STATEMENT
EMBARGO DELIVERY
21 May 2015

STATEMENT OF THE MONETARY POLICY COMMITTEE

Issued by Lesetja Kganyago, Governor of the South African Reserve Bank

The challenges facing monetary policy have persisted, and, as expected, the downward trend in inflation which was mainly attributable to the impact of lower oil prices, has reversed. Headline inflation is expected to breach temporarily the upper end of the target range early next year, and thereafter remains uncomfortably close to the upper end of the target band for most of the forecast period. The upside risks have increased, mainly due to further possible electricity price increases. The exchange rate also continues to impart an upside risk to inflation as uncertainty regarding impending US monetary policy continues. Domestic demand, however, remains subdued while electricity constraints continue to weigh on output growth and general consumer and business confidence.

The year-on-year inflation rate as measured by the consumer price index (CPI) for all urban areas measured 4,0 per cent and 4,5 per cent in March and April respectively. The petrol price increase of R1,56 per litre in April resulted in a decline in the rate of disinflation from the transport category, from -5,0 per cent in March to -1,1 per cent in April, while food price inflation moderated further. The main contributions to the April headline rate came from the categories of food and non-alcoholic beverages, housing and utilities, and miscellaneous goods and services, which together accounted for 3,2 percentage points of the outcome. Core inflation, which excludes food, petrol and electricity, moderated from 5,7 per cent in March to 5,6 per cent in April.

Producer price inflation for final manufactured goods appears to have reached a low point in February at 2,6 per cent, following the 3,1 per cent outcome in March, higher than market consensus. While food price inflation moderated, the main upside contribution came from coal and petroleum products where disinflation slowed. The recent increase in international oil prices and higher agricultural crop prices, along with further electricity price increases from mid-year are likely to sustain the upward momentum.

The inflation forecast of the Bank has changed since the previous meeting of the MPC. Inflation is now expected to average 4,9 per cent in 2015, with a first quarter low of 4,1 per cent. A temporary breach of the upper end of the inflation target band is still expected during the first quarter of 2016, to peak at 6,8 per cent, and to decline to 6,0 per cent by the second quarter of that year. An average inflation rate of 6,1 per cent is forecast for the year. The forecast period has now been extended to the end of 2017, with an average inflation rate of 5,7 per cent expected for the year, and 5,6 per cent in the final quarter.

The forecast for core inflation has also increased marginally, to 5,6 per cent in 2015, and to 5,4 per cent in 2016. Core inflation is expected to average 5,2 per cent in 2017, with a final quarter average of 5,1 per cent. Much of the persistence of core inflation at these levels is attributed to high levels of wage growth, currency depreciation and inflation expectations entrenched at the upper end of the target range.

The headline inflation forecast assumes electricity price increases of 13,0 per cent from July 2015 and July 2016 in line with the original multi-year price determination process of Nersa. However, the application by Eskom for a further 12,6 per cent increase from 1 July 2015 will be decided at the end of June. Given the uncertainty regarding this decision, both in terms of quantum and timing of implementation, it has not been incorporated into the forecast, but poses a significant upside risk. Should Nersa fully accede to the Eskom request, a higher peak of headline inflation as well as a more extended breach of the target can be expected. The direct and indirect effects of such an increase could increase average inflation by around 0,5 percentage points over a year.

The BER inflation expectations survey for the second quarter of 2015 will only be released in June. Median inflation expectations as reflected in the Reuters Econometer poll, at 4,9 per cent and 5,9 per cent for 2015 and 2016, are similar to the Bank’s forecast, although there is a fairly wide dispersion between respondents. The break-even inflation rates, as reflected in the yield differential between conventional bonds and inflation-linked bonds, have been more volatile, and are above the upper end of the target range over all maturities, having reversed their earlier declines this year.

The outlook for the global economy is broadly unchanged since the previous meeting of the MPC. The US growth forecast for 2015 has been revised down by about half a percentage point following the broad-based first quarter estimate of 0,2 per cent, although this deterioration is generally believed to be temporary. Growth of around 3,0 per cent is now expected in 2015, still above estimated potential. Eurozone growth has surprised on the upside, and while still relatively subdued at an expected 1,5 per cent for 2015, there are indications that the region is responding to the ECB monetary stimulus. Any possible fall-out from the debt crisis in Greece remains uncertain. Japan is expected to growth by just below one per cent this year.

Growth in some of the larger emerging markets remains weak. Negative growth is being experienced in Brazil and Russia, and although the Chinese economy is still slowing, with first quarter growth of around 5,3 per cent, a hard landing is not expected amid further monetary policy easing. By contrast, the Indian economy has been performing strongly, partly in response to policy reforms. While growth in Africa has remained relatively robust, downside risks have emerged in some of the oil and commodity-producing countries.

Global inflation remains benign, but the partial recovery in the international oil price has ameliorated the deflationary risks in some of the advanced economies in particular. Higher, but still low, inflation expectations contributed to a sharp rise in bond yields in some of the advanced economies, with spillovers to other bond markets. However, most central banks remain in loosening mode, with further reductions in policy interest rates in a number of countries since the previous meeting of the MPC. A notable exception has been Brazil, where monetary policy was tightened for the third time this year.

Global financial markets remain focused on the timing of US monetary policy tightening. Low inflation and the weaker first quarter growth outcome have pushed out expectations regarding the starting date, but financial markets generally expect the first move to be during 2015, most likely in September, followed by a gradual data dependent tightening cycle. Continued financial market volatility is likely to ensue with each relevant data release.

The uncertainty regarding US growth prospects contributed to a weakening of the dollar against most currencies in recent weeks. Since the previous meeting of the MPC the rand traded in a relatively narrow band of between R11,80 and R12,20 against the US dollar, and is currently almost unchanged since then. However, in line with dollar weakening, the rand has depreciated by 0,6 per cent against the euro and by 4,0 per cent against the pound sterling. On a trade-weighted basis, the rand has depreciated by 0,3 per cent.

The rand continues to be vulnerable to the ebbs and flows of global risk perceptions and associated capital flows, particularly in response to anticipated changes to US monetary policy. At the same time, there is a great deal of uncertainty regarding the extent to which US monetary policy normalisation has been priced into the rand. However, past patterns suggest that some further pressure is likely on the exchange rate and long bond yields as the start of the US tightening cycle becomes more certain. Reflecting this uncertainty, non-resident bond and equity flows have been quite volatile. According to JSE data, non-residents have been net buyers of bonds and equities to the value of around R15 billion since the beginning of this year.

The rand therefore remains an upside risk to the inflation outlook, although the degree of upside risk is tempered somewhat by the continued relatively low level of pass-through to consumer price inflation. The Bank estimates that the actual pass-through could be about half of what is currently implied in the forecast model, but it is still uncertain as to whether this reflects a permanent change or a temporary phenomenon which can reverse rapidly.

The domestic growth outlook remains weak, amid continued electricity supply constraints and low and declining levels of business and consumer confidence. The Bank's forecast for GDP growth is marginally down from the previous forecast: growth is expected to average 2,1 per cent and 2,2 per cent in 2015 and 2016, and to increase to 2,7 per cent in 2017. Growth for the next two years therefore is expected to be more or less in line with our estimate of short-term potential output growth of between 2,0 and 2,5 per cent. It also suggests that the negative output gap, currently estimated at around 1,5 per cent, is likely to persist. This forecast makes an assumption regarding the persistence of electricity shortages, which are expected to be relieved somewhat only in 2017. However, the risks to growth are assessed to be on the downside. The moderate decline in the Bank's composite leading business cycle indicator also suggests a continuation of the sluggish growth outlook.

Despite a strong performance by the mining sector in March, first quarter growth is expected to be subdued and much lower than the 4,1 per cent measured in the fourth quarter of 2014. According to Statistics South Africa, the physical volume of mining output increased at a quarter-to-quarter rate of 1,9 per cent in the first quarter. Platinum group metals output was particularly strong in March with a month-on-month increase of 26,6 per cent. By contrast, manufacturing output appears to have contracted by about 0,6 per cent in the quarter, consistent with the continued decline in the Kagiso PMI, down to 45,4 index points in April, and the slight decline in capacity utilisation in the manufacturing sector. The real value of building plans passed declined for a fourth successive month in February, in line with a weaker FNB/BER Building Confidence index in the first quarter of the year.

Consumption expenditure by households is expected to remain relatively subdued, as higher personal tax rates take effect and the benefits of lower petrol prices dissipate. There are mixed signals from the retail trade sales which rebounded strongly in February but then contracted in March on a month-on-month basis. A quarterly growth rate of 0,9 per cent was recorded in the first quarter of 2015. Growth in expenditure on durable goods in particular is expected to decline, as reflected in the sluggish new vehicle sales, which decreased further in April. The FNB/BER consumer confidence index declined sharply in the first quarter of 2015, signalling modest growth in consumption expenditure going forward.

Subdued levels of household consumption expenditure are reflected in credit extension by banks to households, where the divergence between households and corporates continues. Growth in credit extension to the corporate sector was 13,9 per cent in March 2015, compared with 3,6 per cent to households. The latter is reflective of continued weak growth across all the main categories of credit, influenced by both supply and demand factors. These trends are likely to be reinforced further by the implementation of affordability assessment regulations as part of revisions to the National Credit Regulations in March. The impending changes in the Basel III regulatory requirements are also contributing to relatively tight credit conditions. At the same time, weak employment growth, high debt levels and continued household deleveraging, as well as expectations of higher interest rates may have impacted on the demand for credit.

Trends in remuneration growth remain a concern to the MPC. Average wage and salary growth has been in excess of inflation for some time, imparting some degree of automatic indexation to wage settlements, and therefore maintaining higher levels of inflation. In the fourth quarter of 2014, year-on-year growth in nominal remuneration per worker in the non-agricultural formal sector increased by 7,7 per cent. Once accounting for labour productivity growth of 1,3 per cent, unit labour costs showed an increase of 6,3 per cent, from 5,7 per cent in the previous quarter. According to Andrew Levy Employment publications, the average wage settlement rate in collective bargaining agreements measured 7,9 per cent in the first quarter of 2015. The public sector wage settlement appears to have been settled at an increase of 7 per cent, but the full impact on the total government wage bill is still unclear. Upside risks to inflation from wage pressures are still expected, with the unresolved settlements in the coal and gold mining sectors of particular concern.

While high wage settlements could underpin household consumption expenditure, this could be offset in part by inevitable reductions in employment.

Food price inflation is expected to contribute to upside inflation pressures. This is despite the continued moderation of global food prices and a recent declining trend of food price inflation at the CPI level and lower meat price inflation at the producer price level. Food price inflation measured 5,0 per cent in April following eight successive months of moderation. Similarly, final manufactured food producer price inflation moderated to 5,8 per cent in March. However, domestic drought conditions have resulted in a need to import yellow maize, contributing to maize prices rising close to import parity levels. These pressures, along with the weaker exchange rate, are expected to reverse the favourable trend in food price inflation by the second half of this year.

The international oil price appears to have stabilised in the US$60-US$70 per barrel range, as capital expenditure plans have been scaled back following the collapse of prices in the later part of last year. Since the previous meeting of the MPC, Brent crude oil prices have increased by about US$10 per barrel. Domestic petrol prices remained unchanged in May, but a further increase of around 50 cents per litre, should current trends persist, is likely in June, attributable mainly to higher international product prices.

Although the upward revision of the inflation forecast was relatively small, the persistence of medium term inflation at elevated levels and the deteriorating risks to the outlook are an increasing concern to the MPC. While currently the breach is expected to be temporary, the longer term trajectory is close to the upper end of the target range, and the upside risks make this trajectory vulnerable to any significant changes in inflation pressures.

The main risks to the outlook remain electricity tariff increases, the exchange rate and wage settlements. Significant additional electricity tariff increases are likely to cause inflation to diverge significantly from the target range for a more extended period than our baseline forecast suggests. The rand remains vulnerable to global market reaction to US policy normalisation, particularly in the context of South Africa’s twin deficits. Any significant weakening of the exchange rate in reaction to US monetary policy tightening could cause inflation to diverge even further from target, and set in motion an exchange rate-inflation spiral. Furthermore, the possibility of a wage-price spiral, should settlements well in excess of inflation become an economy-wide norm, also poses a risk to the outlook.

The MPC recognises that domestic inflation is not driven by demand factors that are more easily dealt with through monetary policy responses. Household consumption expenditure remains relatively subdued. While monetary policy should generally look through supply side shocks, such as large electricity tariff increases and oil price changes, we have to be mindful of the second-round effects of such shocks. In particular, we need to monitor closely the possible impact on inflation expectations which remain uncomfortably close to the upper end of the target range over the longer term.

Growth remains fragile, constrained by electricity shortages and low business confidence and the risk to the outlook remain on the downside. But this cannot be solved by monetary policy alone. Monetary policy action will need to achieve a fine balance between achieving our primary mandate of price stability and not undermining growth unduly.

The MPC has decided to keep the repurchase rate unchanged at this meeting. Four members of the committee favoured an unchanged stance while two favoured a 25 basis point increase. The deteriorating inflation outlook suggests that this unchanged stance cannot be maintained indefinitely. The MPC will continue to closely monitor the evolution of inflation expectations and other factors that could undermine the longer term inflation outlook and stands ready to act when appropriate.

From the next meeting in July the Bank will take further steps to increase transparency by publishing the assumptions underlying the Bank's forecast with the MPC statement.

Lesetja Kganyago

GOVERNOR

Contact person:
Nosipho Theyise
+27 12 313 3465
Nosipho.Theyise@resbank.co.za