South African Reserve Bank

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STATEMENT OF THE MONETARY POLICY COMMITTEE

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Since the previous meeting of the Monetary Policy Committee, the global economic and political landscape has changed significantly following the US presidential election. 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 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 Bank's forecast. 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 Bank'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 Bank 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 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 point 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. 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 Bank. The median forecast for the current and next two years are 6,3 per cent, 5,8 per cent and 5,6 per cent. Bond market expectations implicit in the breakeven 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 has become increasingly uncertain during the year following the UK decision 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 possible 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, are already evident. Given the high degree of uncertainty, the financial markets may have over-reacted.

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 Brexit on the UK economy has been limited to date, due in part 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 and 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 M&A 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 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 month-to-date, non-residents have been net sellers of domestic bonds and equities to the value of R42,7 bn and R19,7 bn respectively.

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

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.

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, and steadily narrowing to 2,5 per cent of GDP in the 2019/20 fiscal year.

Food price inflation remains a significant driver of inflation, and is 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 OPEC agreement 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 Bank’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 Committee 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 remain. 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

Committee retains the view that we may be close to the end of the hiking cycle, there may be a reassessment of this position should the upside risks transpire.

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