South African Reserve Bank

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STATEMENT OF THE MONETARY POLICY COMMITTEE

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

Since the previous meeting of the Monetary Policy Committee the global environment has been dominated by heightened uncertainty relating to the debt crisis in Greece and the sharp decline in equity prices in China. While the tail risks from these events appear to have dissipated somewhat, uncertainties still remain. At the same time, the risks associated with financial market volatility related to the timing of the first increase in the US policy rate persist. Domestically, the growth outlook remains weak, as both the supply and demand sides remain constrained amid declining business and consumer confidence. The inflation forecast has deteriorated slightly since the previous meeting, notwithstanding the lower-than-expected outcome in June. Headline inflation is expected to breach the upper end of the target range during the first two quarters of next year, while upside risks posed by the exchange rate have increased.

The year-on-year inflation rate as measured by the consumer price index (CPI) for all urban areas measured 4,6 per cent and 4,7 per cent in May and June respectively.

The latter surprised on the downside, due inter alia to lower than expected increases in food price and rental inflation, with upside pressures coming from higher petrol prices. The categories of housing and utilities, food and non-alcoholic beverages, and miscellaneous goods and services contributed 3,1 percentage points to the overall inflation outcome. The Bank's measure of core inflation, which excludes food, fuel and electricity, moderated from 5,7 per cent in May to 5,5 per cent in June.

Producer price inflation for final manufactured goods continued its upward trend having reached a low point of 2,6 per cent in February. In April and May, the PPI measured 3,0 per cent and 3,6 per cent respectively. The latter was above market consensus, and driven by higher than expected food, beverage and tobacco product prices, which, at 2,2 percentage points, was also the main contributor to the annual change in the PPI. The upward trend is expected to persist, driven by rising agricultural crop prices and electricity tariffs.

The inflation forecast of the Bank has changed marginally since the previous meeting of the MPC, with headline inflation now expected to average 5,0 per cent in 2015, up from 4,9 per cent previously. The forecast for the first two quarters of next year has also been revised up by 0,1 percentage point to 6,9 per cent and 6,1 per cent respectively, with a return to within the target range by the third quarter. However, the forecast average inflation for both 2016 and 2017 is unchanged at 6,1 per cent and 5,7 per cent.

The forecast for core inflation is unchanged, and expected to average 5,6 per cent in 2015, and moderating to 5,4 per cent and 5,2 per cent in the next two years. As before, 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 2016 and July 2017. Although the current multi-year price determination allows for an 8 per cent increase from July next year, Eskom is expected to apply for a claw-back on diesel usage, and this accounts for the additional 5 percentage point assumption in the model. The main assumptions underlying the model are listed in the annexure to this statement.

Inflation expectations as reflected in the survey conducted by the Bureau for Economic Research at Stellenbosch University have shown a near-term deterioration, but are more or less unchanged over the 2 to 3 year horizon. Average inflation expectations for 2015 and 2016 increased by 0,2 percentage points, to 5,6 per cent and 6,1 per cent, but declined marginally to 5,8 per cent for 2017. The deterioration was mainly driven by marked increases of 0,6 and 0,4 percentage points by analysts for 2015 and 2016, and smaller increases by business people. The expectations of analysts and trade unionists remain within the target, but close to the upper end of the target range. The expectations of business people are above the target range with a deterioration over all three years. Average 5-year inflation expectations increased from 5,8 per cent to 6,0 per cent.

The median inflation expectations of analysts polled in the Reuters Econometer survey are almost identical to the Bank’s forecast. The break-even inflation expectations as reflected in the yield differential between conventional government bonds and inflation linked bonds are relatively unchanged since the previous meeting, and remain above the target range for all maturities.

Global economic growth has been revised downwards recently, mainly due to the weak first quarter outcome in the US. While the recovery in the US still appears to be on track amid continued improvements in the labour market, growth this year is expected to be closer to the 2 per cent level, compared with expectations of around 3 per cent earlier in the year. The steady, but slow improvement in the euro area has continued, following a better-than-expected first quarter outcome. However, the outlook for the region will be dependent in part on avoiding negative spillovers from the Greek debt crisis. The near term risks from this crisis appear to have been averted for now, but the longer term sustainability of the Greek debt burden remains a concern. Growth in Japan is expected to remain positive but subdued.

The Chinese economy grew at a year-on-year rate of 7,0 per cent in the second quarter, but some moderation is expected in the coming quarters. The sharp correction in the Chinese equity markets appears to have been contained by strong intervention by the authorities, and the impact on the broader economy is expected to be relatively limited, but it does point to some fragility in the financial sector. The slowdown in China has continued to impact on commodity prices, with the platinum price, for example, declining to its lowest level in six years. The prospects for a number of other larger emerging market economies, particularly Russia and Brazil, remain weak.

Global inflation pressures, particularly in the advanced economies remain benign, reinforced by declining commodity prices, including oil. Against this backdrop, the monetary policy stances in most advanced and emerging market economies have either remained unchanged or become more accommodative since the previous MPC meeting, with the exception of Brazil where interest rates were increased further. Monetary policies in the advanced economies are likely to remain asynchronous: highly accommodative stances in the Eurozone and Japan are likely to persist for some time, while a start of monetary policy tightening is likely in the US sometime this year, followed by the UK.

The rand exchange rate has been relatively volatile and depreciated significantly since the previous meeting of the MPC. The rand, along with a number of other emerging market currencies, has been particularly sensitive to changing global risk perceptions relating to the Greek crisis, the volatility in the Chinese equity markets, declining commodity prices and expectations of the start of US monetary policy tightening. Since the previous meeting of the MPC, the rand traded in a wide band of between R11,82 and R12,58 against the US dollar. Over the period, the rand has depreciated by 5,0 per cent against the US dollar, by 3,6 per cent against the euro and by 3,5 per cent on a trade-weighted basis.

The rand found some support from the improved current account outcome of 4,8 per cent of GDP in the first quarter of 2015, and the more favourable recent trade data. Whilst these better outcomes may reflect the depreciated real effective exchange rate, further gains are likely to be constrained by the recent decline in commodity prices. The Bank forecasts a current account deficit of around 4,6 per cent of GDP for the year.

Global capital flows have remained relatively volatile against the backdrop of changing risk perceptions. This has been reflected in non-resident bond and equity flows: according to JSE data, non-residents were net sellers of South African government bonds to the value of R12,7 billion in May and June, but were net buyers of equities to the value of R17,7 billion. To date in July, non-residents have been net buyers of equities and bonds to the value of R3,7 billion and R2,4 billion respectively.

The rand remains a significant risk factor to the inflation outlook given the vulnerability of the rand and long bond yields to possible US interest rate increases, as well as a deterioration in South Africa’s terms of trade. The inflation forecast assumes a relatively stable real effective exchange rate over the forecast period, implying a nominal effective depreciation in line with inflation differentials between South Africa and her major trading partners. A nominal depreciation in excess of this would pose an upside risk to inflation, although this risk could be ameliorated to some extent should the relatively low pass-through from the exchange rate to inflation persist. The extent to which US policy tightening is already priced into the exchange rate also remains uncertain.

The domestic growth outlook remains subdued, amid continued electricity supply constraints, and weak business and consumer confidence. Growth in the first quarter of 2015 measured 1,3 per cent, and high frequency data suggest that the second quarter growth is likely to be broadly similar. The Bank’s forecast for growth in each year of the forecast period has been revised down marginally, to 2,0 per cent in 2015 and 2,1 per cent in 2016, and rising to 2,6 per cent in 2017 when some easing of the electricity supply constraint is assumed. However, the risks to growth are still assessed to be moderately on the downside. The recent further decline in the Bank's composite leading business cycle indicator also suggests a continuation of the weak growth outlook.

The RMB/BER business confidence index has declined for two consecutive quarters, measuring 43 index points in the second quarter of 2015, with confidence in the manufacturing sector particularly low, at 29 index points. The physical volume of manufacturing production has contracted on a month-on-month basis in three of the first five months of this year, and this sector is expected to record negative growth in the second quarter. Although the PMI improved in May and June, it remains around the 50 index point level, consistent with a constrained outlook. The mining sector, by contrast, has displayed some resilience, particularly in the PGM sub-sector, although the weaker platinum and palladium prices are expected to create further headwinds.

Underlying this subdued growth outlook is the persistent weakness in growth in gross fixed capital formation, particularly by the private sector. These trends contributed to a contraction in non-agricultural formal sector employment on both a quarter-on-quarter basis, and a year-on-year basis. During the four quarters to the first quarter of 2015, over 41 000 jobs were shed, of which just over 30 000 were in the private sector.

Although consumption expenditure of households improved somewhat in the first quarter of 2015, this was probably induced by temporary factors including the decline in the petrol price and lower food price inflation. However, following the increase in personal income taxes alongside higher electricity tariffs and a reversal of the petrol price declines, the outlook for consumption expenditure has deteriorated. This negative outlook is reflected in slowing retail sales growth, declining motor vehicle sales and the continued weak pace in credit extended to households by the banking sector. Tighter affordability criteria as well as proposals to cap interest charges on unsecured loans are likely to constrain bank credit extension to households further. This is in contrast to the continued buoyant growth in credit extension to the corporate sector. Against this backdrop, the FNB/BER consumer confidence index reached a 14-year low in the second quarter of 2015.

Notwithstanding the recent moderation in nominal wage growth, the pace of growth remains high and contributes to the persistence of inflation at higher levels. Year-on-year growth in nominal salaries and wages per worker moderated to 6,7 per cent in the first quarter of 2015, from 7,3 per cent in the previous quarter. Adjusting for productivity increases, due in part to employment reductions, labour cost increases declined to 4,1 per cent in the first quarter. According to Andrew Levy Employment Publications, the average settlement rate in collective bargaining agreements declined to 7,8 per cent in the first half of 2015, compared with 8,1 per cent in 2014 as a whole.

Food prices remain a concern to the MPC, despite the continued moderation of food price inflation at the CPI level having measured 4,6 per cent in May and 4,3 per cent in June. However, the continuing drought in parts of the country has contributed to the upside risk to the outlook, despite benign global food price inflation. Maize and wheat prices have increased significantly since the beginning of the year, and we are yet to see the full impact on consumer prices. At the PPI level, however, cereal and crop price inflation accelerated to 17,8 per cent in May, and both wheat and maize prices are now trading at around import parity levels.

International oil prices have been somewhat weaker since the previous meeting of the MPC, following higher output by Saudi Arabia, and the prospects of a resumption of oil exports by Iran. This follows two consecutive months of oil prices in the range of US$60-65 per barrel. Since early July, spot prices have traded below US$60 per barrel, while futures prices are currently trading at around US$58 per barrel for December delivery. The Bank's forecast assumes a moderate increase in oil prices over the forecast period. Domestic petrol prices have increased by about 90 cents per liter in the past two months, but should current trends persist, a price reduction of around 40 cents per litre is likely in August.

While the June inflation outcomes were below expectations, this respite is expected to be temporary. The persistence of forecast inflation at elevated levels and the continued upside risks to the outlook remain a concern to the MPC. Although inflation is currently within the target range, given the lags in monetary policy changes on inflation, the focus of policy continues to be on the medium term trend, and to ensure that inflation remains comfortably and sustainably within the target range.

Inflation is expected to breach the upper end of the target range for two quarters, and the medium term trajectory remains uncomfortably close to the upper end of the target range. The upside risks make this trajectory vulnerable to any significant changes in inflation pressures.

Although the risks of higher electricity tariffs did not materialise as yet, other upside risks persist. The rand remains vulnerable to global market reaction to US monetary policy normalisation, particularly in the context of South Africa’s twin deficits. The pressures on the exchange rate have been exacerbated by the recent significant decline in commodity prices, which are likely to impede the favourable current account adjustment. Some of the rand adjustment has already occurred since the previous meeting, but further reaction to US monetary policy tightening could cause inflation to diverge even further from target, and set in motion an exchange rate-inflation spiral. Further upside risks are expected to come from food prices, which have yet to react to significant increases in spot prices of agricultural commodities.

The MPC has indicated for some time that it is in a hiking cycle in response to rising inflation risks, and a normalisation of the policy rate over time. The MPC is cognisant of the fact that domestic inflation is not driven by demand factors, and the outlook for household consumption expenditure remains subdued. Economic growth remains subdued, constrained by electricity supply disruptions and low business and consumer confidence and the risks to the outlook remain on the downside. However, as emphasised previously, we have to be mindful of the risk of second-round effects on inflation, and the committee is concerned that failure to act against these heightened pressures and risks will cause inflation expectations to become entrenched at higher levels.

The MPC has therefore decided to continue on its path of gradual policy normalisation. Accordingly, the repurchase rate will increase by 25 basis points to 6,0 per cent per annum with effect from Friday 24 July 2015. Four members favoured a 25 basis point increase, while two members favoured an unchanged stance.

The expected inflation trajectory implies that the real repurchase rate remains low and possibly still slightly negative at times, and below its longer term average. The monetary policy stance therefore remains supportive of the domestic economy. The continuing challenge is for monetary policy to achieve a fine balance between achieving our core mandate of price stability and not undermining short term growth unduly. Monetary policy actions will continue to be sensitive, to the extent possible, to the fragile state of the economy. As before, any future moves will therefore be highly data dependent.

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