Statement of the Monetary Policy Committee

24 May 2012

Issued by Gill Marcus, Governor of the South African Reserve Bank, at a meeting of the Monetary Policy Committee (MPC) in Pretoria

Since the previous meeting of the Monetary Policy Committee (MPC) the risks posed to the global and domestic economy from the crisis in Europe have intensified. The mounting speculation about a possible Greek exit from the eurozone has shaken financial markets, as the dangers of contagion effects translating into a global crisis escalate. These developments have the potential to undermine the fragile recovery in the advanced economies further, and reinforce the current slowdown seen in some of the major emerging-market economies.

The global uncertainties impart a downside risk to the domestic economic growth outlook which remains relatively subdued. The turbulence in the financial markets has caused the rand to depreciate, but the associated risk to the inflation outlook is offset to some extent by the lower international oil prices and depends on how sustained the depreciation will be. Inflation is, nevertheless, expected to remain within the target range over the medium term.

The year-on-year inflation rate as measured by the consumer price index (CPI) for all urban areas was 6,1 per cent in April, up from 6,0 per cent in March. The increase relative to March was mainly due to the 71 cent per litre increase in the petrol price in April, which includes the higher levies that were announced in the budget. The categories of food, housing and utilities, and transport together accounted for 4,2 percentage points of the inflation outcome. Core inflation, as measured by the exclusion of food, petrol and electricity from CPI, increased from 4,4 per cent in March to 4,5 per cent in April. Food price inflation reversed the downward trend observed since December 2011, and increased from 8,9 per cent in March to 9,1 per cent in April. This was in line with expectations, and a resumption in the downward trend is expected in May.

Year-on-year producer price inflation moderated further, measuring 8,3 per cent and 7,2 per cent in February and March 2012 respectively. Food inflation continued to decline, particularly at the agricultural level. Agricultural price inflation, which reached a recent peak of 12,9 per cent in October 2011, declined from 4,6 per cent in February 2012 to 4,1 per cent in March. Manufactured food price inflation declined from 10,9 per cent to 9,6 per cent over the same period.

The inflation forecast of the Bank is lower over the near term than at the time of the previous meeting of the MPC. Inflation is seen to have peaked in the first quarter of 2012 at 6,1 per cent compared with the previous forecast when a peak of 6,5 per cent in the second quarter was anticipated. Inflation is expected to average 6,0 per cent in the second quarter of 2012 and thereafter to follow a gradually declining trend within the target range. The forecast period has been extended to the end of 2014, and inflation is expected to average 6,0 per cent in 2012, 5,5 per cent in 2013, 5,0 per cent in 2014, and 4,7 per cent in the final quarter of that year. The improved near-term forecast is due to lower-than-expected recent inflation outcomes, which lowered the starting point of the new forecast.

The forecast for core inflation continues to show a moderate upward trend in the short to medium term. This measure is expected to peak at an average of 5,5 per cent in the second quarter of 2013, marginally higher than in the previous forecast, before moderating, and averaging, 4,5 per cent in the final quarter of 2014.

The survey of financial analysts conducted by Reuters in April also indicated an expectation of lower inflation compared with the March survey. Analysts expect inflation to return to within the CPI target range in the final quarter of 2012, and to average 5,5 per cent in the subsequent two years.

Global economic prospects continue to cloud the domestic outlook. The stabilising impact of earlier European Central Bank interventions, particularly the Long Term Refinancing Operations (LTRO), appears to be losing momentum, and their positive impact on spreads on some peripheral European country debt proved to be short-lived. These spreads have risen to levels similar to those prevailing before the first LTRO in November. Uncertainties posed by, and the ramifications of, a possible Greek exit from the eurozone have resulted in heightened risk aversion in financial markets. Volatility is likely to persist unless decisive political decisions are taken. However, the fluid political dynamics in the region have increased the unpredictability of policy responses. Growth in the eurozone remains weak, with a technical recession being avoided because of a stronger-than-expected outcome in Germany. However, almost half of the European Union countries are experiencing recessions against the backdrop of continued bank deleveraging, banking stress in some countries, fiscal consolidation, and high and rising unemployment.

The current turmoil in Europe poses a danger to global prospects generally, along with high oil prices. The United Kingdom economy is in recession and growth in the United States (US) and Japan has also moderated. Although growth in the US is expected to remain positive for the rest of this year, the risks to the outlook come mainly from a possible sharp fiscal adjustment at the beginning of next year.

Growth in emerging markets remains positive, but some loss of momentum has been observed. The Chinese Purchasing Managers' Index (PMI) declined further in May, and downside risks to growth are likely in emerging markets in the event of an unfavourable and disorderly eurozone outcome. Growth in sub-Saharan Africa continues to be robust, but could be negatively affected by weaker commodity prices. World inflation remains relatively contained despite high international oil prices.

Movements in the rand exchange rate continued to be dominated by changing investor sentiment in international financial markets. Since the previous MPC meeting, rand volatility increased and it appreciated to a level of R7,65 against the US dollar before resuming a depreciating trend. The exchange rate was given some impetus by the announcement in April of the possible inclusion of the rand in the Citibank World Global Bond Index. However, renewed concerns about the eurozone outlook caused the rand to depreciate further, in tandem with the weakening euro, reaching a level of around R8,40 against the US dollar. This was despite net purchases of bonds and equities by non-residents over that period. Since the previous meeting of the MPC, non-residents have been net purchasers of bonds and equities to the value of R16,4 billion. Over the same period, the rand has depreciated by 9 per cent against the US dollar, by 3 per cent against the euro and by 6,2 per cent on a trade-weighted basis.

The extent to which the rand depreciation feeds into the inflation outlook depends on the extent and duration of the moves. This, in turn, is likely to be highly dependent on the timing and nature of the developments in the eurozone, and therefore a protracted period of exchange rate volatility is possible. In the absence of a speedy resolution to the crisis, the rand is likely to remain at current levels or even weaken further in the event of a disorderly unravelling of the eurozone crisis. Under such circumstances, the unfavourable impact on inflation could be ameliorated to some extent by offsetting movements in international oil prices. However, the exchange rate has re-emerged as an upside risk to the inflation outlook.

The deteriorating global outlook poses a downside risk to domestic growth. The Bank's central forecast for gross domestic product (GDP) growth has more or less remained unchanged since the previous meeting of the MPC at 2,9 per cent for 2012, and 3,9 per cent for 2013. Growth is expected to average 4,1 per cent in 2014. The output gap (around 3,5 per cent) is only expected to begin to contract in the course of 2013. However, the possible contagion effects from a further slowdown in Europe will impact on domestic growth through the trade channel, imparting a downside risk to this forecast. The Bank's composite leading business cycle indicator has been increasing slowly, consistent with the uncertain economic environment.

Recent developments underscore the continued fragile and uneven nature of the recovery. Mining output contracted at a seasonally adjusted rate of 5,5 per cent in the first quarter of this year, a result of strike action, safety-related stoppages and temporary closures for maintenance. Commodity prices are expected to remain under pressure due to global uncertainties.

The performance of the manufacturing sector has been more positive, with the physical volume of manufacturing production having increased at a seasonally adjusted rate of 1,9 per cent in the first quarter of 2012, and is therefore expected to make a strong contribution to first-quarter GDP growth. However, manufacturing production contracted on both a year-on-year basis (-2,7 per cent) and a month-on-month basis (-4,3 per cent) in March. The Kagiso PMI reflects the slowing momentum in the sector: having increased markedly in February to 57,9, it declined in the subsequent two months, but at 53,7 in April still indicates positive growth in the sector. The utilisation of production capacity in manufacturing increased marginally to 80,5 per cent in the first quarter of 2012 from 80,1 per cent in the previous quarter.

The construction sector reflects the hesitant recovery in the economy. While the sectoral growth performance appears to have improved, particularly with respect to civil construction in the first quarter of 2012, the real value of building plans passed declined for the third successive month in March, reversing the recent positive trend. The three-month-on-three-month decline was 10,2 per cent, while the year-on-year decline was 24,2 per cent.

Consumption expenditure by households, which was the main driver of growth in 2011, has shown some signs of moderation. Real retail sales contracted at a quarter-to-quarter rate of 1,2 per cent in the first quarter of 2012, although the year-on-year increase was 6,8 per cent. Nevertheless, household consumption expenditure is still expected to contribute positively to GDP expenditure in the first quarter, albeit at a slower rate than the annualised 4,6 per cent measured in the final quarter of 2011. New vehicle sales growth remains positive, although the short-term momentum has slowed notably in recent months. Motor vehicle exports are also being adversely affected by the weakness in the eurozone economy.

The outlook for consumption expenditure will be determined in part by employment and wage settlement trends, and by credit extension. These developments are likely to underpin expenditure at sustainable levels. According to the *Quarterly Labour Force Survey* of Statistics South Africa, the number of people employed increased by 304 000 from the first quarter of 2011 to the first quarter of 2012, despite the unemployment rate increasing from 25,0 per cent to 25,2 per cent over the same period.

According to Andrew Levy Employment Publications, the overall average wage settlement rate in collective bargaining agreements was 7,3 per cent in the first quarter of 2012. The outlook for wage growth is likely to be impacted to a significant degree by the outcome of the public-sector wage negotiations.

Credit extension to the private sector has accelerated recently despite subdued mortgage lending. Twelve-month growth in total loans and advances by banks to the private sector measured 9,2 per cent in March 2012, the highest growth rate since February 2009. This was mainly underpinned by growth in the category of other loans and advances, which was driven initially by household sector demand. However, in the first three months of 2012 corporate-sector demand has been more significant, possibly reflecting improved business activity. Twelve-month growth in total loans and advances to households measured 6,8 per cent in March. This includes the growth in the largely unsecured general loans to households. Growth in this category moderated to a still-high 29,4 per cent, from a peak of 39,3 per cent in June 2011. However, notwithstanding the need to monitor carefully developments with respect to unsecured lending, there are no signs of stress in the banking sector. Impaired advances as a percentage of gross loans and advances have declined steadily from 5,8 per cent in March 2011 to 4,6 per cent in March 2012.

International crude oil prices have moderated in recent weeks in line with the deteriorating global outlook and a significant increase in Saudi Arabian production. Having traded at around US$125 per barrel since mid-February, the price of Brent crude oil declined in mid-April to below US$110 per barrel. The domestic petrol price increased by a cumulative 99 cents per litre in April and May. However, a sizeable reduction is expected in June, despite partially offsetting exchange rate movements.

Food prices have continued their moderating trend, which is expected to continue in the short term notwithstanding the reversal in April that was due to base effects. Domestic maize prices are substantially lower than those prevailing at the beginning of the year and have reverted to trading close to export parity levels. However, global food prices have increased in the first quarter of this year, and although they remain well below the levels reached in 2011, may indicate further food price pressures in the medium term.

Administered price increases, on average, remain in excess of the upper end of the target range and are the main factor keeping upside pressure on inflation. Administered price inflation measured 11,6 per cent in April, and 8,9 per cent when excluding petrol. The main drivers included the 17,3 per cent increase in electricity prices and the 9,0 per cent increase in education costs. Communication costs, by contrast, continued to decline.

The greater uncertainty in Europe and associated global financial market turbulence have impacted on the perceived risks to the outlook for both domestic inflation and growth. The MPC is of the view that these developments pose a downside risk to the hesitant domestic growth prospects.

The balance of risks to the inflation outlook is less clear. While the inflation forecast appears to be more favourable, there are renewed upside risks from a possible further weakening of the exchange rate. However, countervailing pressures could come from weaker demand and lower commodity prices, particularly those of oil. On balance, the committee judges these risks to the inflation outlook to be somewhat on the upside.

In this highly volatile and uncertain environment the MPC is of the view that it is appropriate to maintain the current accommodative monetary policy stance, given the continued absence of clear signs of excess demand pressures. The MPC has therefore decided to keep the repurchase rate unchanged at 5,5 per cent per annum. However the committee will continue to monitor events closely and assess the risks to the outlook on an ongoing basis, and stands ready to act in either direction should it be deemed appropriate.