Statement of the Monetary Policy Committee

22 November 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 domestic growth outlook has deteriorated, while the upside risks to inflation have increased. Widespread labour market instability and work stoppages have reduced output and export volumes, with the potential for employment losses. Risks to the inflation outlook have been increased by a further depreciation of the rand exchange rate, partly in response to these developments, as well as by a possible higher trend in wage settlements and the impact of the reweighting and rebasing of the CPI basket by Statistics South Africa (Stats SA).

At the same time the global environment remains challenging with slowing growth in a number of regions, declining global industrial output, the worsening Japanese outlook, continued uncertainty regarding United States (US) fiscal policy and a resurfacing of concerns relating to the resolution of the crisis in the eurozone, which is now in recession.

The year-on-year inflation rate as measured by the consumer price index (CPI) for all urban areas at 5,6 per cent in October 2012, and up from 5,5 per cent in September, was 0,2 percentage points above the market consensus. The categories of food and non-alcoholic beverages, housing and utilities, and transport together accounted for 3,5 percentage points of the inflation outcome. The upside surprise was mainly attributable to food prices which increased by 2,8 per cent month on month, and 6,7 per cent on a year-on-year basis. Core inflation, as measured by the exclusion of food, petrol and electricity from CPI, measured 4,7 per cent, unchanged from September. Administered prices excluding petrol increased at a year-on-year rate of 7,5 per cent.

Year-on-year producer price inflation moderated further to 4,2 per cent in September, having measured 5,1 per cent in August. This favourable trend was driven mainly by lower rates of increase in the prices of mining products. A marked acceleration was seen in the food-related categories, with agricultural prices increasing at a year-on-year rate of 5,2 per cent in September, compared with 4,3 per cent in August and a recent low of 1,7 per cent in May. Manufactured food prices increased by 9,0 per cent and 10,1 per cent in August and September respectively.

The inflation forecast of the Bank reflects a deterioration in the inflation outlook for 2013 compared with the previous forecast. Inflation is now expected to average 5,6 per cent in the final quarter of 2012, and 5,6 per cent for the year. It is expected to average 5,5 per cent in 2013 and 5,0 per cent in 2014, with a peak of 5,7 per cent expected in the first quarter of 2013. This near-term deterioration is mainly due to higher expected food price inflation and the recent depreciation of the rand. Core inflation remains contained, indicating the absence of significant demand pressures. This measure is expected to peak at 5,0 per cent in the first quarter of 2013, and to average 4,8 per cent and 4,5 per cent in 2013 and 2014 respectively.

These forecasts do not incorporate the new CPI weights and rebasing recently announced by Stats SA as the finer details of these revisions, including the introduction of new products, and the method of linking the old and new baskets, have not yet been finalised. Preliminary evidence suggests that a slight upward bias to the Bank's central projection for headline CPI inflation could occur in 2013. On the assumption that the rate of increase in price changes for most goods and services, apart from food and electricity, is more or less unchanged, the combined average upward bias would be relatively small, in the order of around 0,2 percentage points. The new weights and the rebased index will be incorporated formally into the Bank's forecast in 2013 after the revisions have been finalised by Stats SA.

Inflation forecasts of financial analysts surveyed by Reuters have also been revised upwards. Financial analysts now expect inflation to average 5,5 per cent in 2013, compared with 5,3 per cent in the previous survey. The expectation for 2014 remains unchanged at 5,4 per cent. It is unclear if these forecasts already take account of the changes to the CPI weights.

The break-even inflation rates have also exhibited a moderate upward trend since the previous MPC meeting.

The global economic outlook has deteriorated somewhat with a return to recession in the eurozone. The prospects for the region remain bleak amid procyclical fiscal austerity, continued household- and banking-sector deleveraging in a tighter regulatory environment, and renewed concerns relating to the unresolved sovereign debt crisis. The deepening recession has served to heighten the solvency risk of the peripheral countries. The recently announced Outright Monetary Transactions (OMT) programme by the European Central Bank remains yet to be activated. The Japanese economy contracted in the third quarter and leading indicators point to a possible recession. Although the United Kingdom economy experienced positive growth in the third quarter, the outlook is negative as the favourable impact from the Olympic Games dissipates.

The prognosis for the US economy remains highly dependent on progress in resolving the so-called fiscal cliff. The related uncertainty has already adversely affected investment decisions, and while some last-minute political compromise is likely, the ultimate extent of the fiscal contraction and its impact on growth are still unclear. Failure to resolve this issue could result in a recession and derail the nascent recovery in the housing market.

Prospects for emerging markets, while still positive, have also deteriorated somewhat during the past months, contributing to the downside risk to the global recovery. Trend growth rates in Asia are declining, and both China and India are expected to experience weaker growth rates, with possible implications for commodity prices.

For some time the exchange rate of the rand has been determined primarily by external developments, particularly changing global risk perceptions. More recently, domestic factors appear to have become dominant determinants of the exchange rate. These include the increased risk posed to the economic outlook by labour market developments in the mining and agricultural sectors in particular; the widening deficit on the current account of the balance of payments, which is likely to have been exacerbated by the stoppages; and the ratings downgrades by two rating agencies while also retaining a negative outlook. Since the previous meeting of the MPC, the rand has depreciated by about 6,7 per cent against the US dollar, by 5,8 per cent against the euro, and by 5,8 per cent on a trade-weighted basis.

Inflows into the domestic bond market associated with South Africa's inclusion in the World Government Bond Index of Citibank probably helped to moderate the degree of depreciation over this period. Since the beginning of the year, net purchases of South African bonds by non-residents have totalled R85,2 billion. By contrast, non-residents have been net sellers of South African equities since the beginning of the year to the value of R6,8 billion.

The rand is expected to remain sensitive to both unfolding domestic economic and political developments, in addition to global risk perceptions. The extent to which the weaker rand feeds into inflation will be dependent on the trading range of the rand going forward and the duration of these moves. Most analysts do not expect further weakening of the rand from current levels, and a number of them expect some recovery. However, the rand is expected to remain volatile and subject to overshooting, and its depreciation poses an increased upside risk to the inflation outlook.

The domestic economic growth outlook has deteriorated recently, largely as a result of the continued global slowdown and aggravated by domestic events. Mining output has declined significantly as a result of work stoppages and there are likely to be longer-term implications for output, exports and employment as the mines adjust to higher labour costs. Labour unrest in parts of the agricultural sector is also expected to affect output and prices adversely.

Recent high-frequency data indicate that third-quarter growth was well below the 3,2 per cent recorded in the second quarter. Mining output contracted at a quarter-to-quarter rate of 3,2 per cent in the third quarter and further contractions are expected in the fourth quarter. The physical volume of manufacturing production was adversely affected by the road freight transport sector strike in September when a contraction of 2,3 per cent was recorded on a month-to-month basis. For the quarter as a whole manufacturing output increased by 0,3 per cent. The outlook for the sector remains negative, with the Kagiso Purchasing Managers Index declining to a level of 47,1 in October, reflecting an expectation of contraction in the coming months.

The Bank's forecast of gross domestic product (GDP) growth has been revised downward from 2,6 per cent to 2,5 per cent in 2012. Growth in 2013 is now expected to average 2,9 per cent, compared with 3,4 per cent previously, while the growth forecast for 2014 has been revised down from 3,8 per cent to 3,6 per cent. Moreover, the risks to this forecast remain on the downside. The RMB/BER Business Confidence Index declined marginally in the fourth quarter and remains below the 50 index level.

Consumption expenditure by households appears to have lost some momentum recently following the 2,9 per cent annualised growth rate in the second quarter. Consumer confidence in the third quarter, as measured by the FNB/BER Consumer Confidence Index improved marginally, but was still at low levels that were not consistent with robust consumer spending. Nevertheless, growth in retail trade sales, which account for about half of household consumption expenditure, has been relatively resilient having grown at a quarter-to-quarter rate of 1,9 per cent in the third quarter. However, passenger vehicle sales and expenditure on services were subdued.

There is, however, still little evidence of demand pressures on inflation. The resilience of consumer demand has been attributed to a number of factors, including low interest rates, relatively low inflation, real income growth, high growth rates in unsecured lending, and until recently a relatively strong exchange rate. Some of these factors may be a constraint on expenditure going forward, especially when combined with higher administered price increases which constrain discretionary spending.

The MPC is concerned about the recent trend in wage settlements and the potential negative impact on the economy, particularly on growth and investment. These developments could also result in lower growth in employment creation or an absolute decline in employment. Although the reported headline increases granted in some of the settlements are higher than the actual average increases, there is no doubt that the increases granted are well above inflation. This has the potential to increase aggregate demand and prices with a risk of a possible wage-price spiral, which could negate the real benefits of these wage increases to workers. However, the impact will be moderated to some extent by the inevitable job losses that are likely to accompany such increases in the context of a slowing economy. The cost-push effect of these wage increases will therefore depend on the actual increase in the total wage bill and unit labour cost developments.

The most recent wage data, which do not yet incorporate these latest trends, show that in the second quarter of 2012 growth in unit labour costs was 6,1 per cent, while Andrew Levy Employment Publications reported average wage settlement rates in collective bargaining agreements of 7,4 per cent for the first nine months of 2012. Wage settlements at these levels were not assessed to pose a major risk to inflation and these trends will be closely monitored as the collective bargaining landscape has become more fractious.

It is also too early to assess the impact of recent developments on employment. According to the Quarterly Labour Force survey, total employment increased by about 200 000 in the third quarter of 2012, but the increased number of unemployed workers resulted in the unemployment rate increasing to 25,5 per cent in September. It is expected, however, that the positive employment trend in the non-gold mining sector observed during the past year is likely to have reversed or slowed down, while the negative employment trends in manufacturing and gold mining are likely to persist. The net effect of higher wages and lower employment on aggregate expenditure is therefore still unclear at this stage.

Credit extension to the private sector moderated on a quarter-to-quarter basis in the third quarter of 2012, when an annualised increase of 5,4 per cent was recorded. Twelve-month growth in total loans and advances to the private sector was 8,8 per cent in September. However, mortgage loan growth remained subdued. When this category is excluded, loans increased at a significant twelve-month rate of 16,6 per cent. The main impetus has come from the persistently strong growth in unsecured lending to households, and this has been related to real income growth particularly in the public sector. Growth in unsecured lending to households remains in excess of 30 per cent but there are some tentative signs that this growth may be moderating. Although to date this has not represented a systemic risk, as it is still a small part of total loans and advances, this is being carefully monitored by the Bank. Unsecured lending has probably helped to underpin household consumption expenditure.

The fiscal policy stance, as reflected in the *Medium Term Budget Policy Statement* (*MTBPS*) remains supportive of the economy through its contra-cyclical stance. Although the goal of fiscal consolidation is being maintained, the timing has been pushed out further, as lower expected growth is likely to result in lower revenues. Growth in expenditure is projected to remain the same as that set out in the February budget, and no large boost to aggregate demand is expected that could impact on the inflation outlook.

Food prices remain a significant risk to the inflation outlook. Global food prices, while still high, have declined from recent peaks. The impact of this shock is still to fully filter through to domestic prices. Although there is usually a lag between the impact of global food price developments on domestic prices, the impact appears to have been felt more quickly than is generally the case. The recent depreciation is also expected to exacerbate the upside risk to food prices. Futures prices, however, indicate that maize prices may be moderating following a better-than-expected domestic harvest.

International oil prices have remained relatively unchanged since the previous meeting of the MPC, although in the past few days have increased following ongoing hostilities in the Middle East. Domestic petrol prices declined in November despite the depreciation of the rand and, should the exchange rate and international product prices remain at current levels, a further moderate decline can be expected in December. However, international prices remain highly dependent on the global growth outlook and political developments in the Middle East.

Since the previous MPC meeting the domestic landscape has seen a marked change. While the global crisis remains unresolved, South Africa has seen significant developments that have impacted on the economic outlook and confidence. These domestic developments, if not addressed in a comprehensive and constructive manner, have the potential to derail the progress made to date whereby South Africa has been able to withstand the worst contagion effects of the ongoing global crisis.

While recognising that there are real issues that underlie the recent wave of wildcat strikes, the Bank is concerned about the conduct of some of the parties involved in the recent labour market instability and, in particular, the unacceptable levels of violence that have accompanied the strikes. It is critical that both employers and employees take constructive steps to address the fraught relations that appear to be prevalent in a number of areas. Employers need to better appreciate the contribution to stability that an informed, experienced, skilled and organised workforce can make, and also need to be better informed about, and sensitive to, the conditions and circumstances of their employees. An important element of this is to take measures that enable employees to be better informed about the financial situation, strategy and future plans of the companies and sectors that they work in.

At the same time employees need to ensure an end to the use of violence in labour relations. In their quest for fair and decent employment conditions, employees need to recognise the potential negative effects of unsustainable cost structures on employment levels and competitiveness in the absence of improved productivity. In the prevailing conditions there is the danger of a wage-price spiral and, inevitably, it will be the workers who bear the brunt of the fallout.

The costs are not only the direct costs in terms of lost production, but also the possible increased costs of finance. In the context of a very weak global economy, where South Africa should strive to be a destination of choice and thereby grow the economy and achieve the pursued developmental and employment goals, the ability to attract investment and improve the country's ratings must be a clear objective.

While many of the strikes appear to have been resolved, long-term resolution of the underlying causes requires ongoing, concerted action on the part of all the parties involved. We need cohesion and certainty of policy, as well as unity of purpose to build an inclusive, longer-term vision. The National Development Plan is a broad unifying framework that has been adopted by both Cabinet and Parliament, and could form the base to take the country forward, enabling South Africa to play an effective role in the continent as a favoured trading and investment partner.

The MPC assesses the balance of risks to the inflation outlook to be on the upside, given the continued pressure of food prices, uncertainty of the exchange rate movements and the reweighting and rebasing of the CPI. Furthermore, the possible impact of higher wage increases could exert further upward pressure on inflation notwithstanding the concerns that recent developments in the labour market could impact negatively on employment. The MPC considers that the demand pressures on inflation at this stage remain relatively benign, as evidenced in the contained trend of underlying inflation. There are also signs of moderation of consumption expenditure against the backdrop of a weak supply side of the economy. The negative output gap is expected to persist for some time, and the balance of risks to the growth outlook remains on the downside.

In the light of these factors, the MPC is of the view that the current accommodative stance remains appropriate and has therefore decided to keep the repurchase rate unchanged at 5,0 per cent per annum. As always, the MPC will monitor developments closely and will not hesitate to act in a manner consistent with its mandate.

Addendum to the Monetary Policy Committee statement of 22 November 2012

The Monetary Policy Committee meeting schedule for 2013 is as follows:

22–24 January 2013

18–20 March 2013

21–23 May 2013

16–18 July 2013

17–19 September 2013

19–21 November 2013