South African Reserve Bank

Press Statement
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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 inflation outlook has deteriorated significantly, mainly due to exchange rate and food price developments. The rand has depreciated considerably in response to domestic and external developments, while the impact of the worsening drought on food prices is becoming increasingly evident. The outlook is complicated by the fact that the domestic growth outlook has weakened further. The global backdrop has also become more challenging particularly for emerging markets, and downside risks to the sustainability of the recovery in the advanced economies have increased.

The year-on-year inflation rate as measured by the consumer price index (CPI) for all urban areas measured 5,2 per cent in December, up from 4,8 per cent in November. This increase was broadly in line with market and the Bank's expectations, and reflected in part the delayed response of food price inflation to the impact of the drought on agricultural prices. Food and non-alcoholic beverages inflation accelerated to 5,9 per cent, up from 4,8 per cent previously and contributed 0,9 percentage points to the overall CPI outcome. Goods price inflation increased to 4,6 per cent from 3,8 per cent previously mainly due to higher petrol and food prices, while services price inflation remained unchanged at 5,7 per cent. The Bank's measure of core inflation, which excludes food, fuel and electricity, remained relatively stable at 5,2 per cent, up from 5,1 per cent in November.

Producer price inflation for final manufactured goods increased from 4,3 per cent in November to 4,8 per cent in December. The category of food, beverages and tobacco products contributed 2,1 percentage points to the December outcome.

The latest inflation forecast of the Bank shows a marked deterioration. Having averaged 4,6 per cent in 2015, inflation is now expected to average 6,8 per cent in 2016 and 7,0 per cent in 2017. This compares with the previous forecast of 6,0 per cent and 5,8 per cent for these years. Inflation is still expected to breach the upper end of the target in the first quarter of 2016, but is now expected to remain outside the target for the entire forecast period. A peak of 7,8 per cent is expected in the fourth quarter of 2016 and the first quarter of 2017, followed by a moderation to 6,2 per cent in the final quarter of that year (5,7 per cent previously). The changes in the forecast are mainly due to a significantly more depreciated real exchange rate assumption, and higher expected food price inflation. These upward revisions more than offset the impact of the lower international oil price assumption. The electricity price assumption remains unchanged from the previous meeting.

The forecast for core inflation has also deteriorated, although to a lesser degree than that for headline inflation. Core inflation is expected to breach the upper end of the target range for four consecutive quarters from the third quarter of 2016, with a peak of 6,4 per cent in the final quarter of 2016 and the first quarter of 2017. This measure is expected to average 6,0 per cent in 2016, and 5,9 per cent in 2017, and to moderate to 5,5 per cent by the final quarter of next year. The deterioration in the forecast is mainly due to the more depreciated exchange rate assumption and expected higher unit labour costs.

Inflation expectations as reflected in the survey conducted by the Bureau for Economic Research show a marginal upward movement for 2016 but a more pronounced deterioration for 2017, with average inflation expectations increasing from 5,9 per cent to 6,2 per cent, mainly due to the changes in expectations of trade union officials. Five-year inflation expectations edged up to 6,1 per cent, also mainly due to changes in the expectations of trade union officials. This survey was concluded prior to the depreciation of the rand in December, so the outcome of the next survey will be closely monitored.

The impact of the rand exchange rate weakness on market forecasts is evident in the changes to the Reuters Econometer survey between December and January. Median inflation expectations were stable in November and December, at 5,9 per cent and 5,8 per cent for 2016 and 2017, but increased in January to 6,0 per cent and 6,1 per cent. The median forecast for 2018 is 5,7 per cent. Break-even inflation rates also increased significantly across all maturities, with the 5-year maturities rising to current levels of around 7,3 per cent.

The global growth outlook appears to have worsened somewhat in recent weeks, contributing to a correction in global equity markets. Although most of the downward revisions to global growth have been due to the deteriorating prognosis for emerging markets, more recently the risks of a slowdown in the US have increased, amid declining consumer expenditure, and the impact of low oil prices and a strengthening dollar on business investment. However, despite the fourth quarter slowdown, growth of around trend is still generally expected. While the recovery in the euro area remains modest, the growth forecasts for the UK and Japan have generally been revised down.

Emerging market growth prospects, particularly for commodity-producing countries, remain constrained amid persistent capital outflows. The outlook is heavily influenced by the slowing Chinese economy but there are conflicting views as to whether a hard landing can be expected. There is also uncertainty regarding the efficacy of policy reforms that have been undertaken. Perceptions of the modifications to the renminbi exchange rate regime as well as equity market volatility have added to this uncertainty.

Global inflation pressures remain benign, reinforced by a further decline in international oil prices, but there have been upward revisions in some emerging markets. Monetary policies in most advanced economies are expected to remain accommodative. The slow pace of normalisation in the US is expected to continue, but further easing is expected in Japan and the euro area, while the Bank of England has indicated that monetary policy tightening is still some way off. Divergent monetary policy paths are also expected in the emerging markets. Commodity importers with sound macroeconomic fundamentals have scope for further easing, while some commodity producers, particularly those experiencing exchange rate-induced inflationary pressures, have been in a tightening mode, despite slowing growth.

The exchange rate of the rand depreciated markedly since the previous meeting of the MPC, contributing significantly to the deterioration in the inflation forecast. Since the previous meeting, the rand has depreciated by 13,5 per cent against the US dollar, by 15,2 per cent against the euro, and by 12,9 per cent on a trade-weighted basis. The muted reaction of the exchange rate to the start of US Fed normalisation suggested that this move was more or less priced in, but this was overshadowed by the impact of domestic developments on the exchange rate earlier in the month.

In early January, the rand reacted further to growing concerns about the outlook for the Chinese economy. While most emerging market currencies were affected, since the previous meeting of the MPC, the rand's depreciation has been in excess of most of its emerging market peers. Other indicators such as widening credit spreads and the sharp increase in domestic bond yields point to a higher risk premium attached to South African assets.

Although at current levels the rand may appear to be undervalued, divergences from equilibrium can persist for some time. Furthermore, the current account adjustment remains slow, with the deficit expected to widen further in the face of continued weakness in commodity prices and higher drought-induced agricultural imports. The financing of the deficit will also be more challenging in an environment of persistent capital outflows from emerging markets. Since the previous meeting, non-residents have been net sellers of South African bonds and equities.

From a monetary policy perspective, a key risk to the inflation outlook is not only the possibility of further depreciation, but also the extent to which the there is a change in the pass-through dynamics, which have been relatively muted in recent years.

The domestic economic growth outlook remains weak, with further downward revisions to the Bank's forecast. Growth in 2015 is estimated to have averaged around 1,3 per cent, and is expected to moderate to 0,9 per cent in 2016, before accelerating to 1,6 per cent in 2017. This compares with the previous forecast of 1,5 per cent and 2,1 per cent for 2016 and 2017. The Bank's estimate of potential output growth was revised down from 1,9 per cent to 1,5 per cent for 2016, and from 2,1 per cent to 1,6 per cent for 2017. Although there was a marginal increase in the Bank's leading business cycle indicator in November, the trend remains negative, consistent with the subdued outlook. The RMB/BER business confidence index declined further in the fourth quarter of 2015, to its lowest level in five years.

High frequency data indicate that the mining sector remains under pressure in the face of declining commodity prices and weak demand. Despite a recovery in the third quarter, the manufacturing sector outlook remains negative. Capacity utilisation has declined further and the Barclays PMI, which has remained well below the neutral level for some months, is consistent with a contraction in the fourth quarter. The continuing drought also means that near-term respite for the agricultural sector is unlikely.

Underlying this growth outlook is the continued low growth in gross fixed capital formation, with private sector investment contracting in the third quarter. The prospects for formal sector employment growth therefore remains bleak: the Quarterly Employment Statistics survey of Statistics South Africa reports static employment levels over the four quarters to the third quarter of 2015.

Growth in consumption expenditure by households also moderated in the third quarter, with contractions in spending on durable and non-durable goods. Domestic motor vehicle sales reflected this weakness although recent retail sales data, particularly with respect to semi-durable goods, suggest there may have been a modest improvement in the final quarter of last year. However, the decline in the

FNB/BER consumer confidence index in the fourth quarter of 2015 to a fourteen year low suggests that household consumption expenditure is likely to remain constrained.

Credit extension to households has increased marginally recently, particularly with respect to mortgage and general loans. However, these increases remain low and negative in real terms, while instalment sale credit continues to slow. Tighter National Credit Act Regulations related to affordability assessments became effective from September, and are expected to constrain credit to households further. While credit extension to corporates remains robust, it is relatively narrow-based, and reflects in part increased demand for mortgage loans by property funds.

Wage and salary trends continue to contribute to the persistence of inflation at higher levels. Year-on-year growth in nominal salaries and wages, while lower in the third quarter of last year, was still above the upper end of the inflation target range. After adjusting for labour productivity increases, growth in total unit labour costs slowed marginally to 5,0 per cent in the third quarter. Andrew Levy Employment Publications reported an average wage settlement rate in collective bargaining agreements of 7,7 per cent in 2015.

Food prices remain a significant risk to the inflation outlook. The surge in agricultural commodity prices since early 2015 is beginning to impact on consumer food price inflation, and these pressures are likely to increase in the light of the persistent drought and the weaker exchange rate. This is despite continued moderation in global food prices. Although previous forecasts had incorporated an expectation of higher food price inflation, recent adverse developments have resulted in a further deterioration of the Bank’s food price forecast, which is now expected to peak at around 11 per cent in the fourth quarter of this year.

International oil prices have declined to multi-year lows since the previous MPC meeting. The global oversupply and consequent low prices are expected to persist in the short term, particularly following the lifting of sanctions against Iran. But with marginal producers expected to shut down or reduce production, prices are expected to follow a moderate upward trend over the forecast period. The impact of this upward trend on domestic petrol prices has contributed to the higher inflation forecast in 2017 in particular. The potentially favourable impact of the international oil price decline on domestic petrol prices has been more or less offset by the depreciation of the rand. Petrol prices have declined only marginally since November, and the current under-recovery suggests a possible increase of around 7 cents per litre in February.

Previously the Committee expressed concerns about the growing risks to the inflation outlook, mainly due to exchange rate and food price risks. These risks appear to be materialising and have contributed to the significant deterioration of the inflation forecast. The intensity of the drought has brought about a sizeable revision to the Bank’s food price outlook, while the exchange rate has depreciated significantly more than expected. While oil prices have a moderating impact on the inflation outlook in the near term, base effects and the assumed upward trajectory contribute to the adverse inflation outlook in 2017. The forecast also incorporates changes in administered prices, in particular for water, while an upside risk remains regarding electricity tariff increases.

The MPC assesses the risks to the inflation outlook to be relatively balanced. While there may be potential for further rand weakness in the short-term given the negative outlook for emerging markets in general as well as domestic factors, the lower observed exchange rate pass-through remains a mitigating factor. However, there is still uncertainty as to the sustainability of this low pass-through, particularly in the face of large nominal exchange rate movements as recently experienced. The upside risk from the exchange rate is more or less offset by the downside risks from the international oil price assumptions and projected food price inflation.

Demand pressures remain constrained, and the focus of the MPC will therefore be on the evolution of inflation expectations and indications of second-round effects of the exogenous shocks to the inflation outlook. There are some indications that inflation expectations may have deteriorated, but the extent of this will become more evident in the coming surveys. The trend in core inflation provides some indication of the possible emergence of second-round effects. Although core inflation has remained relatively contained in recent months, it is expected to accelerate and to exceed the upper end of the inflation target range for some time in response to exchange rate and wage pressures.

The Committee faced the continuing dilemma of a deteriorating inflation environment and a worsening growth outlook. The risks to the growth outlook are assessed to be on the downside, despite the downward revision to the forecast.

Given the deterioration in the inflation outlook, the MPC decided to increase the repurchase rate by 50 basis points to 6,75 per cent per annum, effective from 29 January 2016. Three members supported a 50 basis point increase, two members preferred a 25 basis point increase, while one member preferred no change.

The MPC still views the stance of monetary policy to be accommodative. Despite the rate increase, the real repurchase rate remains low given the higher expected inflation over the period. The MPC will remain focused on its core mandate of containing inflation within a flexible inflation targeting framework. As noted on a number of occasions in the past, the MPC is of the view that the growth constraints facing the economy are primarily of a structural nature and cannot be solved solely by monetary policy. Nevertheless, the MPC remains sensitive, to the extent possible, to the possible negative impact of monetary policy actions on cyclical growth. As before, future moves will be highly data dependent.

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