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

South Africa's inflation and growth dynamics continue to highlight the policy dilemma facing monetary policy. Although headline CPI inflation has moderated since February, the respite is expected to be temporary, as food and petrol price pressures continue to intensify. The recovery in the rand exchange rate in April also proved to be short-lived, as both domestic and external factors weighed on the currency. At the same time, domestic economic growth continues to disappoint. While there are signs that the economy may be reaching the low point in the growth cycle, the recovery is expected to be slow with downside risks. Global economic growth and financial market conditions have stabilised somewhat since the previous MPC meeting, but a high degree of risk and uncertainty persists.

The year-on-year inflation rate as measured by the consumer price index (CPI) for all urban areas has moderated after reaching a recent high of 7,0 per cent in February. In March and April, CPI inflation measured 6,3 per cent and 6,2 per cent. Food price pressures continued unabated, with food and non-alcoholic beverages inflation accelerating to 11,0 per cent in April, up from 9,5 per cent previously. Goods price inflation moderated from 6,9 per cent to 6,7 per cent, while services price inflation was unchanged at 5,7 per cent. The Bank's measure of core inflation, which excludes food, fuel and electricity measured 5,5 per cent, up from 5,4 per cent in March. While the impact of the weaker exchange rate remains relatively low, there are indications of increased pass-through in some categories, particularly new motor vehicles and appliances.

Producer price inflation for final manufactured goods moderated significantly from 8,1 per cent in February to 7,1 per cent in March, mainly as a result of a sharp fall in fuel prices. Manufactured food product price inflation accelerated to 10,5 per cent, with the category of food, beverages and tobacco products contributing 3,1 percentage points to the March outcome. Agricultural prices increased by 23,1 per cent in March, with cereal and other crop prices increasing by 50,0 per cent year-on-year.

The latest inflation forecast of the Bank shows a moderate near-term deterioration compared with the previous forecast, but there is some improvement in the medium-term outlook. The breach of the upper end of the target range, while still protracted, is now slightly shorter, with inflation expected to fall within the range during the third quarter of 2017. Inflation is now expected to average 6,7 per cent in 2016 compared with 6,6 per cent previously. In 2017 and 2018 inflation is expected to average 6,2 per cent and 5,4 per cent, marginally down from the previous forecast. The expected peak, at 7,3 per cent in the fourth quarter of 2016, is unchanged. The downward revisions are due in part to the higher interest rate assumption, a slightly less depreciated exchange rate assumption, a wider output gap and a lower electricity price assumption. These pressures are counteracted to some extent by a higher near-term food price forecast, and the impact of upward revisions to the international oil price assumptions.

The forecast for core inflation is slightly improved, with a lower forecast for 2016 of 5,9 per cent from 6,2 per cent previously. Forecasts for 2017 and 2018 are unchanged at 5,7 per cent and 5,2 per cent. Core inflation is expected to breach the upper end of the target range in the third quarter of 2016 for four consecutive quarters, with a peak of 6,2 per cent (previously 6,5 per cent) in the third and fourth quarters of 2016 and the first quarter of 2017.

The BER survey of inflation expectations is only due for release in July. The median expectations of economic analysts, as reflected in the Reuters Econometer survey conducted in May are more or less unchanged compared with the previous survey, and are slightly higher than those of the Bank for 2016 and 2017. In the latest survey, the median expectations for 2016 and 2017 were 6,7 per cent and 6,4 per cent, with inflation expected to be within the target range in 2018, at an average of 5,7 per cent. Bond market expectations implicit in the break-even inflation rates are more or less unchanged since the previous meeting and remain at fairly elevated levels.

Global growth remains hesitant following a disappointing first quarter in the US and the UK in particular. While labour market conditions in the US have improved, low corporate profits have constrained investment. However, consensus forecasts show that a moderate improvement is expected in the coming months, but at a lower rate than previously expected. The outlook for the UK is clouded by the possibility of an exit from the EU, while the prospects for the Japanese economy remain uncertain. By contrast, the growth outlook in the euro area is more promising, driven by improvements in Germany and France in particular, although there are concerns that the recent momentum may be fading.

Divergent prospects are evident in the emerging markets. Russia and Brazil remain in recession, but there are signs of some stabilisation in China, as the economy appears to be responding to government policy initiatives. This improvement, along with a weaker US dollar, has resulted in some recovery in commodity prices, as well as a pick-up in portfolio flows to emerging markets. Of some concern is the persistent deterioration in growth forecasts for sub-Saharan Africa, which includes some of South Africa's important trading partners. The region is now expected to underperform the global economy in 2016, for the first time in 16 years, as the effects of lower commodity prices and drought take their toll.

Global inflation pressures remain benign, with low energy prices still having an impact, although this effect is likely to dissipate with the recent upward trend in oil prices. The latest data show declining prices in the euro area and Japan, and low inflation in the US and the UK. Inflation has remained relatively higher in a number of Latin American economies, particularly those experiencing currency depreciation. As a result of these trends, asynchronous monetary policies persist. While policies are generally accommodative amid subdued growth, particularly in many advanced economies, a number of emerging markets have maintained a tightening bias in response to inflation pressures. The US Fed is expected to continue with its slow pace of policy rate normalisation but there is a high degree of uncertainty regarding the timing of the next increase.

The rand exchange rate has remained volatile, and following a few weeks of relative strength, has resumed a weakening path and continues to pose an upside risk to the inflation outlook. Since the previous meeting of the MPC, the rand has traded in a range between R14,20 and R15,90 against the US dollar, and has depreciated by 1,5 per cent against the dollar, by 0,9 per cent against the euro, and by 1,2 per cent on a trade-weighted basis.

During this period the rand was initially favourably impacted by improved commodity prices, the narrower trade balance, and expectations of a slower pace of US Fed monetary policy tightening. However, these gains were reversed as global growth concerns resurfaced in early May, and other domestic factors, including the low growth outlook, concerns about a possible ratings downgrade and more recently heightened political uncertainty impacted adversely on the currency.

Although the capital flow environment for emerging markets has improved recently, this has not applied to equity flows. South Africa's experience has mirrored this, but with stronger equity outflows. According to the JSE, since the beginning of the year, net sales of domestic equities by non-residents have amounted to R56 bn. By contrast, non-residents have been net purchasers of domestic government bonds (year-to-date R23 bn), although the past two weeks has seen net sales.

The domestic economic growth outlook remains weak, with the Bank's GDP growth forecast for 2016 revised down from 0,8 per cent to 0,6 per cent. While a recovery is still expected in the next two years, the forecasts for both these years have been revised down by 0,1 percentage point to 1,3 per cent and 1,7 per cent. With the estimates of potential output unchanged, the output gap is expected to widen over the forecast period. The Bank's leading indicator of economic activity continued its downward trajectory in February, consistent with the constrained outlook.

Recent high-frequency data paint a particularly bleak picture of the first quarter of this year, following a sharp contraction in mining output, minimal growth in the manufacturing sector, and declines in electricity production and consumption. While the Bank's forecast for GDP growth in the quarter is barely positive, it does represent the low point of the forecast, and a slow upward trend is expected going forward. This view is consistent with the favourable developments in the Barclays PMI which has recovered fairly strongly, to above the neutral 50-level for the past two months. The real value of building plans passed, particularly non-residential, increased markedly on a 3-month-to-3-month basis, indicative perhaps of some life in the construction sector, despite very low levels of business confidence in the sector.

However, while the recent modest recovery in commodity prices may impact positively on mining output, prices remain low and the sector remains beset by higher input costs and regulatory uncertainty. The continuing drought is also expected to put further strain on the agricultural sector.

The economic slowdown is also reflected in labour market trends, with the unemployment rate rising to 26,7 per cent in the first quarter of 2016, from 26,4 per cent a year earlier. Although employment growth was positive over the year to the first quarter, the year-on-year growth rate moderated significantly, with employment losses recorded in a number of sectors including manufacturing, agriculture and transport.

Household consumption expenditure also remains subdued, with low growth in retail sales in the first quarter. While there was a welcome increase in exports, new vehicle sales also continue to decline. The FNB/BER consumer confidence index recovered to some extent in the first quarter of the year, although it still remains at depressed levels, and indicates a low willingness to spend and utilise credit among consumers.

The constrained outlook for household consumption expenditure is indicative of the absence of demand pressures in the economy. This is also confirmed in the weak wealth effects and the continued slow pace of credit extension to households. Although some improvement has been seen in this regard, growth remains negative in real terms, and is mainly related to mortgage advances and general loans, particularly unsecured lending. Growth in credit extension to corporates remains strong, but moderated in March.

Wage growth appears to be moderating, with growth in nominal remuneration per worker in the formal non-agricultural sector declining to below 6 per cent in the fourth quarter of 2015, mainly due to lower private sector remuneration growth. Once adjusting for labour productivity, growth in unit labour costs remained unchanged at 5,0 per cent in that quarter.

Food prices remain a significant risk to the inflation outlook in the face of persistent drought and exchange rate weakness. These pressures are evident in both the consumer price and producer price indices. Although for some time the MPC had been expecting an acceleration in food price inflation, the recent increases have surprised on the upside, and more aggressive food price increases are now forecast for the near term. The Bank now expects food price inflation to peak at around 12 per cent in the final quarter of this year. However, should food prices stabilise or decline later in the year, there is the potential for downside base effects next year. Futures prices suggest that both maize and wheat prices are expected to remain elevated for the rest of the year, reinforced by a sizeable increase in the domestic wheat import tariff.

The international oil price assumptions in the forecasting model have been increased, with the price of Brent crude oil remaining firmly above the US$40 per barrel level since the second week of April. Demand has surprised on the upside, and, despite an increase in supply from Iran, output has declined in a number of countries. This upward price trend may, however, be contained by high levels of inventories. Domestic petrol prices have increased by a cumulative R1,00 per litre since March, mainly due to higher international prices and an increase in the fuel levy. Should current exchange rate and international oil price trends persist, a further significant increase can be expected in June.

The MPC faced the continuing dilemma of upside risks to the inflation forecast and a worsening growth outlook. The risks to the growth outlook are assessed to be on the downside, particularly in the short term, despite the downward revision to the forecast. Both the mining and agricultural sectors are expected to weigh heavily on the first quarter growth outcome, and the outlook is therefore dependent in part on whether these sectors rebound in the coming quarters.

The Committee remains concerned about the inflation outlook and the extended breach of the target. Although the inflation forecast has shown a moderate improvement over the medium term, the risks are still assessed to be on the upside. The exchange rate remains highly sensitive to domestic political developments and risks of an earlier-than-expected tightening in US monetary policy. The exchange rate implicit in the forecast is stronger than the current level, imparting a significant degree of upside risk. While pass-through from the exchange rate to inflation remains relatively subdued, there are indications that this may be increasing. There is also some upside risk to the international oil price assumption.

The Committee remains concerned that inflation expectations remain at uncomfortably high levels. Although core inflation has remained relatively contained in recent months, with a lower peak now expected, it is forecast to accelerate and exceed the upper end of the inflation target range for four quarters in response to exchange rate and wage pressures.

Some countervailing risks are also evident. While there is a risk that food prices may accelerate faster in the near term, the longer term forecast assumes that food prices will stabilise by year end, allowing for favourable base effects next year. However, should food prices, particularly grains, decline in response to a normalisation of weather patterns, a much sharper downward food inflation trajectory could transpire. The absence of demand pressures, and risks to consumption expenditure growth may also contribute to downside risks.

The increase in the repo rate at the previous MPC meeting contributed to the improvement in the longer-term inflation forecast, and that move should be seen in conjunction with previous actions in the cycle and the lagged effects of monetary policy. The MPC felt that there is some room to pause in this tightening cycle and accordingly decided to keep the repurchase rate unchanged for now at 7,0 per cent per annum. Five members preferred no change, while one member preferred a 25 basis point increase.

The MPC remains focused on its inflation mandate, but sensitive to the extent possible to the state of the economy. The MPC will not hesitate to act appropriately should the inflation dynamics require a response, within a flexible inflation targeting framework. Future moves, as before, will continue to be highly data dependent.

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