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 (MPC), the near-term inflation outlook has deteriorated, but the longer-term outlook is more or less unchanged. The expected inflation profile has been negatively affected by higher international oil prices and a persistence in elevated food price inflation despite improved rainfall in many of the drought-stricken regions. At the same time, the rand has displayed some resilience. While some of the key risks to the rand appear to have subsided for now, they could re-emerge at any stage.

Global growth prospects are mixed amid policy uncertainty, primarily in the US and the UK. The domestic growth outlook remains challenging, although a modest improvement is expected over the forecast period.

The year-on-year inflation rate as measured by the consumer price index (CPI) for all urban areas measured 6,8 per cent in December, up from 6,6 per cent in November. The December outcome surprised on the upside relative to the Bank's forecast and the market consensus expectation of 6,5 per cent. The main sources of this surprise included food prices, housing rentals, recreation and culture, and restaurants and hotels. Food price inflation remained elevated at 12,0 per cent in December, matching the recent high recorded in October 2016. The contribution of the category of food and non-alcoholic beverages to the overall inflation outcome has remained unchanged at 1,8 percentage points for the past 3 months. Goods price inflation measured 7,8 per cent in December, up from 7,7 per cent in November, while services price inflation increased from 5,6 per cent to 5,9 per cent. The Bank's measure of core inflation, which excludes food, fuel and electricity measured 5,9 per cent, up from 5,7 per cent.

Producer price inflation for final manufactured goods measured 6,9 per cent in November, compared with 6,6 per cent in October. The main contributor to the November outcome was the category of food products, beverages and tobacco products which contributed 3,9 percentage points.

The inflation forecast of the Bank has deteriorated since the previous meeting of the MPC. Headline inflation is now expected to only return to within the target range during the final quarter of 2017, and to average 6,2 per cent for the year, compared with 5,8 per cent in the previous forecast. The forecast for 2018 is more or less unchanged at an average of 5,5 per cent. The peak of the forecast remains at 6,6 per cent, which was recorded in the final quarter of 2016, and this level is now expected to persist in the first quarter of 2017. This deterioration is mainly due to changed assumptions regarding international oil prices, the domestic fuel prices and the outlook for food prices, which more than offset the more favourable exchange rate assumption.

By contrast, the forecast for core inflation is unchanged, averaging 5,5 per cent and 5,2 per cent in 2017 and 2018 respectively.

Inflation expectations as reflected in the survey conducted by the Bureau for Economic Research during the fourth quarter of 2016 showed average inflation expectations for 2017 declining from 6,0 per cent in the third quarter to 5,8 per cent. The same outcome is expected for 2018, as well as for 5-year inflation expectations. Despite the slight moderation, expectations remain more or less anchored at the upper end of the target range, but with a narrower divergence between the different groups of respondents than is usually the case. The expectations of these groups ranged from 5,6 per cent to 6,0 per cent for 2017, and from 5,4 per cent to 6,0 per cent for 2018. The outcome may have been distorted by the marked decline of 0,6 percentage points for the trade union respondents.

The median annual inflation expectations of market analysts as reflected in the Reuters Econometer survey are relatively unchanged at 5,8 per cent and 5,5 per cent for 2017 and 2018. Bond market expectations implicit in the break-even inflation rates declined across all maturities since the previous meeting, though remain above the target range.

The global economic outlook remains uncertain, despite increased optimism regarding US growth following the US presidential elections. There is still a great deal of uncertainty regarding the policies of the new administration, particularly with respect to the size of the promised fiscal stimulus. While some of the initial optimism has since been tempered somewhat, US growth is expected to be relatively strong, but with some downside risks posed by a stronger dollar. Uncertainty also persists regarding the prospects for the UK economy, as the terms of the disengagement from the EU are unlikely to be resolved for some time. The steady but slow growth recovery in the Eurozone is expected to continue, but upcoming elections in a number of countries could pose risks to the outlook, alongside ongoing concerns about the prospects for the Italian economy.

The outlook for emerging markets is also unclear, given conflicting developments. Commodity prices, especially industrial commodities, have risen in recent months, but protectionist threats from the US, if carried through, could undermine world trade and have an adverse effect on emerging markets in particular. These countries are also highly dependent on Chinese growth, which is expected to remain above the 6 per cent level. However, given the credit-driven nature of recent Chinese growth, there are fears of an unsustainable credit bubble which could expose financial sector vulnerabilities, and undermine the growth outlook.

There are tentative signs of global inflation edging up, as fears of deflation recede amid higher energy and food prices. As expected, the US Fed tightened monetary policy in December, and signalled further increases to come. However, the pace of increase is still expected to be relatively moderate amid a highly uncertain economic policy environment. Both the ECB and the Bank of Japan have maintained their highly accommodative policy stances. This divergence between the advanced economies is likely to persist for some time.

The rand has displayed a degree of resilience since the previous meeting of the MPC, having traded in a relatively narrow range of between R14,22 and R13,46 against the US dollar. Since the previous meeting, the rand has appreciated by 5,6 per cent against the US dollar and by 4,2 per cent on a trade-weighted basis. The rand was positively impacted by the decisions of the ratings agencies not to downgrade the sovereign foreign credit rating to sub-investment grade, although this remains a risk in the coming months. The limited response of the rand exchange rate to the increase in the US policy rate in mid-December suggests that the move had been largely priced in. A gradual pace of tightening is expected in the US, with the rand vulnerable to any upside surprises in this respect.

The rand has been positively affected by the improvement in the terms of trade, following the recent modest increase in commodity prices. Although the overall current account deficit is expected to narrow over the forecast period, it remains relatively wide. In line with the recent improved capital flows to emerging economy bond markets, non-residents have been net buyers of South African bonds since the beginning of the year, while equity net sales have continued. This follows persistent net sales of both bonds and equities during the last three months of 2016.

The domestic growth outlook remains weak and more or less unchanged since the previous meeting of the MPC. The Bank expects growth to have averaged 0,4 per cent in 2016, although recent monthly data for the fourth quarter suggest that there may be a downside risk to this forecast. The forecast for 2017 has been revised down marginally to 1,1 per cent (from 1,2 per cent), and remains unchanged at 1,6 per cent for 2018. This improved outlook relative to 2016 is consistent with the recent upward trend in the composite leading indicator of the Bank. By contrast, the RMB/BER Business Confidence Index declined again in the fourth quarter, following a recovery in the previous quarter. Much of this decline was driven by the new vehicle sector.

The recent monthly data paint a bleak picture for the fourth quarter of 2016. Mining production, which had improved in the second and third quarters, contracted in both October and November. However, improved commodity prices are expected to help the sector in the coming months. The manufacturing sector recorded low but positive growth in November, following a month-to-month decline in October. The Barclays Purchasing Managers' Index (PMI) declined further in December, and recorded its fifth consecutive month below the neutral 50 level.

The low level of business confidence is reflected in the continued, but slower, contraction in real gross fixed capital formation. Gross fixed investment has contracted for four consecutive quarters, and has been particularly marked in the private sector. This has contributed to the persistent labour market weakness, with formal non-agricultural employment (excluding temporary election-related employment) remaining unchanged in the year to the third quarter of 2016. The official unemployment rate increased to 27,1 per cent, its highest level since the inception of the Quarterly Labour Force Survey in 2008.

Wage growth appears to be responding to the weak labour market environment. Year-on-year nominal wage growth per worker moderated for a fifth consecutive quarter in the third quarter of 2016, down to 5,8 per cent. Following a small decline in labour productivity growth, nominal unit labour costs in the formal non-agricultural sector increased to 5,7 per cent. The slower nominal wage growth per worker is consistent with the lower wage settlement rates reported by Andrew Levy Employment Publications.

Household consumption expenditure data paint a mixed picture. Growth in household consumption expenditure accelerated to 2,6 per cent in the third quarter despite a further contraction in durable goods consumption. Real retail trade sales declined in October, but increased markedly in November on a month-to-month basis. By contrast wholesale trade sales contracted in both months. Domestic new vehicle sales remained subdued following further declines in the final quarter of last year.

Notwithstanding some improvement, consumers remain under pressure and consumer confidence remains low, as indicated in the sharp contraction in the FNB/BER Consumer Confidence Index in the fourth quarter. Households remain highly indebted despite a further moderation in the debt ratio, and the subdued housing and equity markets have contributed to an absence of strong wealth effects. Slower wage growth along with stagnant employment growth and expected tax increases in the forthcoming budget are also likely to dampen consumption expenditure.

A further constraint to consumption expenditure growth has been the weak credit extension to the private sector, which, at 4,5 per cent in November, was the lowest year-on-year growth since late 2010. While growth in credit extension to the household sector was particularly subdued, that to the corporate sector also moderated in the second half of 2016. The strongest decline was seen in mortgage credit extension for commercial property.

Food price inflation is expected to decline following good rainfall in parts of the country. Spot prices for both maize and wheat have declined significantly, and a markedly higher maize crop is expected this year. However, the impact on prices at the consumer level are yet to be felt, with meat prices likely to lag other food price categories as farmers restock their herds. Although the Bank’s inflation forecast assumes that food price inflation has more or less peaked, the pace of moderation is expected to be slower than in the previous forecast. Food price inflation is now expected to average 7,0 per cent during 2017, compared with 6,5 per cent previously. Food price disinflation is expected to be constrained or delayed by higher fuel costs and a rising trend in global food prices.

Brent crude oil prices increased by over 20 per cent to almost US$60 per barrel in response to the OPEC-brokered agreement to restrict production. Prices have since moderated to current levels of around US$55 per barrel. The sustainability of this agreement and its longer-term impact on prices is uncertain, given the possibility of offsetting developments. A number of oil producers were exempt from the agreement; there are incentives and scope for cartel members to exceed their quotas; and US shale producers have already increased production in response to higher prices. These factors are likely to constrain oil price increases. While the Bank’s oil price assumption has been revised up, the trajectory is relatively flat. Despite the stronger rand exchange rate, the domestic price of 93 octane petrol increased by 50 cents per litre in January, and a further increase can be expected in February.

The MPC has noted the marked deterioration in the inflation forecast since the previous meeting, as well as the extension of the expected breach of the upper level of the target range by a further two quarters. Inflation is now expected to return to within the target range in the final quarter of 2017. While this is a cause for concern, the main drivers of this deterioration are supply side shocks, in particular oil and food prices. The increase in the international oil price is not expected to be a start of a new oil price spiral. Various supply side factors are expected to constrain oil prices going forward in the absence of any major global political risks that would threaten production. While the food price forecast has been adversely affected by higher input costs, a steady decline in food price inflation is still expected.

The more favourable rand exchange rate has been an important factor in offsetting some of the negative impacts of these developments. Despite a turbulent second half of 2016, both domestically and globally, the rand has been relatively resilient. Furthermore, the current level of the rand is stronger than that implicit in the forecast, and pass-through to inflation continues to be relatively muted. Nevertheless it remains vulnerable to both domestic and external shocks.

As always, the approach of the Committee is to look through the first-round effects of exogenous shocks, but remain focused on the possible emergence of second-round effects which could require a policy response. At this stage, the longer-term trajectory over the relevant policy horizon is unchanged, as is the forecast for core inflation. In particular, the MPC will take note of possible changes in the longer-term inflation expectations, which had shown tentative signs of moderation in the fourth quarter of 2016. The MPC assesses the risks to the inflation outlook to be moderately on the upside.

The domestic growth outlook has remained largely unchanged despite a possible weaker outcome in the fourth quarter of 2016. While some improvement is anticipated over the forecast period, growth is expected to remain below potential. The risks to the growth forecast are assessed to be broadly balanced. Growth prospects remain dependent on uncertain but tentatively improving global conditions, and their impact on commodity prices. Domestically, some improvement in agricultural production can be expected. However, a significant improvement in growth prospects requires the implementation of structural reforms which could contribute to increased business and consumer confidence.

In light of these developments and the assessment of the balance of risks, the MPC has unanimously decided to keep the repurchase rate unchanged at 7,0 per cent per annum.

The MPC remains focused on the medium- to longer-term inflation outlook, but the deterioration of the shorter-term outlook requires increased vigilance. Furthermore, the MPC remains concerned that the longer-term inflation trajectory continues to be uncomfortably close to the upper end of the target range. The Committee retains the view that we may be near the end of the hiking cycle. However, should second-round effects emerge that undermine the longer-term inflation outlook, there may be a reassessment of this view.

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