Daniel Mminele: Outlook for monetary policy in South Africa

Address by Mr Daniel Mminele, Deputy Governor of the South African Reserve Bank, at the JP Morgan Investor Seminar, Washington DC, 16 April 2016.

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Good morning, Ladies and Gentlemen

Thank you to JP Morgan for the opportunity to again participate in this seminar, which takes place on the margins of the International Monetary Fund and World Bank Spring Meetings. I have been requested to give you an update on the monetary policy outlook for South Africa. Those of you who joined us last year may recall that I talked about heightened uncertainty complicating the conduct of monetary policy. If anything, the environment has become more complex for policymaking in both emerging and advanced economies, South Africa being no exception.

Let me start by reiterating the primary mandate of the South African Reserve Bank (SARB), which is to achieve and maintain price stability in the interest of balanced and sustainable economic growth. It should be noted that price stability is pursued within a flexible inflation targeting monetary policy framework, with the target band for headline consumer price inflation being 3 to 6 percent. In practice this implies that the SARB will tolerate temporary breaches of the inflation target in the interest of smoothing out short-term fluctuations in economic growth. However, a persistent breach of the inflation target range will require a policy response to achieve sufficiently low inflation that promotes competitiveness and provides an enabling environment for sustainable growth and employment creation, in addition to protecting the purchasing power of the currency.

Last month, the monetary policy committee (MPC) stated that the upside risks to the inflation forecast, coupled with the protracted period of the expected breach of the inflation target range, was the primary motivation for increasing the repo rate by a further 25 basis points to 7 percent, bringing the cumulative increase to 200 basis points since the beginning of the tightening cycle in January 2014. Let me now turn to some of the factors that have and are likely to influence the monetary policy outlook.

Global economic developments

The World Economic Outlook (WEO) that has just been released by the International Monetary Fund (IMF) has confirmed recent observations that the global recovery remains weak. I can afford to be brief on some of the details given that the WEO has enjoyed wide coverage over the last couple of days.

Global growth is forecast to reach 3.2 percent in 2016 and 3.5 in 2017, representing, yet again, a downward revision to the growth outlook. The growth outlook for most advanced countries (AEs) is notably weaker and the same can also be said for the emerging market economies (EMEs), with the exception of emerging Asia.

For some time, the global recovery has been underpinned by the performance in emerging markets with the expectation that the global growth momentum will gain traction as the pace of recovery in advanced countries picked up. Unfortunately, these expectations have not been fully realised. Emerging market economies, which currently make up around 58 percent of global gross domestic product (GDP), still continue to account for a significant portion of world growth. However, the economic performance across emerging markets as a whole is uneven and generally weaker. With the exception of India, most major emerging market economies have had disappointing growth outcomes as depicted by the recent recessions in Brazil and Russia and the slowdown in China.

Of concern, is that the global recovery is not only weaker, but that the deterioration in the global environment over the last year has been accompanied by greater downside risks. The drop in commodity prices, uncertainty in financial markets, volatile capital flows, subdued external demand and geopolitical influences, coupled with the refugee crisis, have been some of the major headwinds adversely impacting global economic developments. Unfortunately, these factors will continue to have a bearing on the economic outlook for both emerging market economies and the global economy as a whole. Given the globalised nature of EMEs – South Africa included – this implies that international influences, although of an exogenous nature, will form an integral part of the policy landscape in emerging economies.

Global inflation pressures remain subdued with both current and projected inflation rates below target in most advanced economies. These developments, combined with below potential growth have prompted expansionary monetary policies in a number of advanced economies, which are very likely to persist over the forecast horizon. In contrast, inflationary pressures have been rising in a number of emerging economies, mainly on account of currency depreciation rather than as a result of rising international price pressures. South African inflation outcomes have also been subjected to more prominent exchange rate pressures recently, an issue I will come back to later on. So in general, global inflation remains at modest and subdued levels and, with oil prices projected to remain at low levels, international cost pressures are unlikely to pose a major risk to inflation outcomes across the globe.

South Africa's economic outcomes and outlook

Recent indicators show that real economic growth in South Africa slowed marginally to an annualised rate of 0,6 percent in the fourth quarter of 2015 from 0,7 percent in the third quarter resulting in a growth rate of 1,3 percent for 2015 as a whole. In fact, there has been a steady deceleration in South African real GDP growth over the last five years from 3 percent in 2011 to 1,5 percent in 2014 and 1,3 percent in 2015. The growth rate in 2015 was the lowest in the past 17 years barring the contraction in 2009.

In general, both domestic and external factors have been responsible for the lacklustre performance of the South African economy. *Inter alia,* these have included, muted domestic and external demand conditions, domestic supply-side constraints (most notably electricity supply constraints), a decline in international commodity prices, and the effects of the drought on agricultural output and prices. Of particular concern is the poor performance of the agricultural sector given its impact on both growth (output) and inflation (prices). As a result of the worst drought in decades, this sector contracted in all four quarters of 2015 resulting in an annual contraction of 8,4 percent for 2015 as a whole.

The decline in international commodity prices has had a strong bearing on South Africa's export and growth outcomes. For 2015 as a whole, the US dollar price of the basket of South African non-gold export commodities declined by approximately 21,5 percent following the decrease of 9,4 percent in 2014.

Despite a marginal quarter-on-quarter improvement in the terms of trade, South Africa's trade deficit widened in the final quarter of 2015. When combined with the larger shortfall on the services, income and current transfer account, the deficit on the current account of the balance of payments increased to 5,1 percent of GDP in the fourth quarter of 2015 from –4,3 percent and –3,1 percent in the previous two quarters respectively.

The SARB has officially identified November 2013 as the upper turning point in the business cycle, implying that the South African economy is now officially in a downward phase of the business cycle. In addition, subdued business and consumer confidence levels do not augur well for growth outcomes going forward. The SARB's most recent forecast shows GDP growth of 0,8 percent for 2016, significantly down from 1,5 percent projected in November 2015 and 2,9 percent in November 2014. The recently released WEO is more pessimistic, forecasting 0,6 percent growth for the South African economy in 2016 and 1,2 percent in 2017. The SARB forecasts for 2017 have also been revised down to 1,4 percent and 1,8 percent in 2018.

The most recent estimates by the SARB indicate that potential output growth of the South African economy has declined from 1,9 percent to 1,5 percent for 2016, and from 2,1 percent to 1,6 percent for 2017. With lower growth outcomes, the output gap is expected to remain negative over the forecast horizon. The policy challenge is to ensure that the economy is not trapped in a cycle of persistent low growth. South African policymakers are fully aware that we have to avoid the risk of becoming trapped in what Christine Lagarde, the MD of the IMF, has termed the "new mediocre".

The budget, which was tabled in February, reinforces the need to provide support to economic growth, albeit against a background of deteriorating prospects for tax revenue collection. The budget sets out to accomplish this through a path of more rapid fiscal consolidation. In the main, the budget focuses on containing administrative expenditure (most notably salaries) while maintaining investment and other core expenditure items at levels that will be supportive of economic growth.

The package of tax measures that have been introduced in the 2016 Budget has also spread the additional tax burden over several revenue sources so as to limit the adverse short-term impact on growth. As a ratio of GDP, the deficit of national government is projected to narrow from 4,2 percent in the 2015/16 fiscal year to 2,9 percent by fiscal 2018/19. It is noteworthy that the budget sets out a more rapid adjustment path than what was envisaged in the 2015 Medium Term Budget Policy Statement in October last year. These projected outcomes are commendable in the current circumstances, and if implemented effectively, will contribute to dampening inflationary pressures and impact favourably on investor confidence and South Africa's credit rating metrics.

South Africa's inflation outcome and outlook

The trajectory for the year-on-year inflation rate as measured by the consumer price index (CPI) has increased significantly over the last three months. Consumer inflation measured 7 percent in February, up from 6,2 percent in January and 5,2 percent in December 2015. On a month-to-month basis, headline CPI increased by 1,4 percentage points between January 2016 and February 2016. Headline CPI inflation for February exceeded both the Reuters and Bloomberg consensus forecast of 6,8 percent for February 2016, mainly as a result of an acceleration in food price inflation.

Following sharp increases in agricultural food prices in earlier months as a result of the severe drought conditions, food price inflation increased markedly by 1,8 percentage points to 8,8 percent in February 2016 – the highest level since August 2014. Food price inflation at the producer level registered 9,0 percent in February, significantly up from the 7,8 percent recorded in January. Agricultural food prices on the other hand has also followed a similar trend, increasing by 27,2 percent in February as compared to 25,9 percent in January 2016. These increases are expected to impact consumer prices with a lag. In addition, current indications are not encouraging for the expected agricultural output for the coming season. According to the most recent estimates (February 2016), the agricultural land or area under cultivation will be approximately 26 percent smaller than last year. Further, maize which has an important direct and indirect impact on overall food inflation will have to be imported in the coming year in order to meet the annual domestic and commercial consumption of roughly 9,6 million tons. The SARB forecasts as at the March MPC meeting – which did not consider the February inflation numbers – showed that annual CPI food price inflation was expected to peak at 11,6 percent in the final quarter of 2016 as compared to the forecast of 11,3 percent at the beginning of 2016. Food price pressures, which have intensified in recent months pose a significant upside risk to inflation.

Inflation is now expected to average 6,6 percent and 6,4 percent in 2016 and 2017, compared to the 6,8 percent and 7,0 percent forecasted at the beginning of the year. It is expected to peak at 7,3 percent in the fourth quarter of 2016 and only return to within the target range during the fourth quarter of 2017. This represents a protracted breach implying that underlying pressures remain elevated.

Let me now turn to a discussion of some of the underlying inflationary pressures in the economy. The SARB's forecast shows that core inflation will breach the upper end of the target range in the second quarter of 2016 for four consecutive quarters, with a peak at 6,5 percent in the latter half of 2016. Core inflation is expected to average 6,2 percent in 2016, and 5,7 percent and 5,2 percent in the next two years, respectively.

Average inflation expectations have remained undesirably close to the upper target level of 6 percent despite inflation outcomes at times being close to the midpoint of the target range during 2015. Inflation expectations as measured by the Bureau of Economic Research (BER) at the University of Stellenbosch at the end of 2015 revealed that average headline inflation expectations over the forecast horizon (i.e. one and two years) had shifted above 6 percent.

More recently, the BER survey presents a more mixed picture. In the survey conducted during the first quarter of 2016, the expectations of analysts increased significantly, while those of business representatives and trade unions have moderated for both years. However, average expectations are unchanged at 6,2 percent for 2016 and 2017 while inflation is expected to average 6,0 percent in 2018. The short-term expectations of economic analysts, as reflected in the Reuters Econometer survey in March, show that the median expectation for 2016 and 2017 was 6,4 percent and 6,3 percent respectively, with inflation returning to within the target range to average 5,6 percent in 2018.

In addition, market-based measures of expectations over the longer run (5 to 10 years) indicate that break-even inflation rates remain at elevated levels. More recently, while these rates have declined to around 7 percent from 8 percent in December, they are significantly above the average level for 2015 and the upper inflation target level. While there is little evidence of a deterioration in longer-term inflation expectations, they are anchored at elevated levels. So in essence, inflation expectations over the forecast horizon, as well as over the longer term, are uncomfortably close to the upper target level and this has been one of the factors considered by the MPC at its most recent meeting in March 2016.

Of particular significance for monetary policy has been the movement in the value of the rand. There has been a steady depreciation in the currency over the last five years. The rand depreciated by approximately 30 percent against the dollar in 2015, reaching historical lows in December 2015 mainly as a result of an adverse market reaction to domestic political developments associated with changes in the finance ministry. While the rand exchange rate has recovered from the lows experienced in December 2015, it remains volatile and vulnerable to domestic and external developments. While exchange rate pass-through to inflation has been low in recent years, the sustained and substantial depreciation in the currency was identified by the MPC as a significant threat to inflation outcomes over the forecast horizon. However, the recovery in the exchange rate in recent weeks is welcome, and if sustained, will favourably influence the risk profile associated with the inflation trajectory over the forecast horizon.

Conclusion

Currently, the policy dilemma is one of trying to address the deterioration in the inflation outlook against the background of a weakening growth outlook. Inflation is currently outside the inflation target range and the latest forecasts suggest it will return to within the target band only in late 2017. Inflationary pressures are underpinned by supply-side shocks, mainly related to exchange rate and food price movements. Some of the inflation risks previously identified materialised earlier and more forcefully than anticipated. Under these circumstances, monetary policy cannot afford to be complacent and should strive to manage inflation expectations to ensure that these shocks do not result in second-round impacts and a generalised increase in prices.

The overall monetary policy stance continues to be supportive of the weak economy with the necessary policy tightening having proceeded at a moderate pace, showing sensitivity for the weak growth environment while seeking to counter mounting inflationary pressures in the economy. It is, however, worth reiterating that over the long run South Africa's growth prospects are best served by keeping inflation within the target range, and not by looking to exploit a temporary trade-off between growth and inflation. In these times of uncertainty and volatility, the SARB will remain focused on its mandate and continue to be a beacon of stability by implementing its policy framework in a forward-looking, consistent, transparent, and as far as possible, predictable manner.

Thank you.

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