Statement of the Monetary Policy Committee

24 November 1999

Issued by Mr T T Mboweni, Governor of the South African Reserve Bank, at the second meeting of the Monetary Policy Committee (MPC) in Pretoria

The Monetary Policy Committee today made a detailed assessment of international economic conditions, domestic economic developments and the monetary policy stance. The main conclusions of the Committee are summarised in this statement.

International economic developments

The world economic conditions are generally expected to be favourable at the advent of the new millennium. In contrast to much of the 1990s, favourable economic conditions are projected for the advanced economies in 2000. Although economic growth is expected to decline slightly in the United States, its level will still be high. In the European Union and Japan the growth rate in real gross domestic product should accelerate. A sharp increase is projected in the economic growth rates of most emerging-market economies in Africa, Asia and Latin America.

The higher world economic growth is expected to take place under relatively stable economic conditions. Inflation rates should remain low in advanced economies and decline in most emerging-market economies. Current forecasts generally show sustainable balance of payments positions, while unemployment is expected to decline in the advanced economies. The creation of employment opportunities, however, still remains a challenge in many of the emerging-market economies.

The monetary policy stance has been tightened in the United States, Canada and the European Union in recent weeks based on signs of higher growth in money supply, bank credit extension and other aggregates indicating a build-up of inflationary pressures. The rise in short-term interest rates has on the whole been accompanied by a moderate decrease in long-term yields and interest rates.

Domestic real economic developments

Clear signs of an upturn in economic activity are apparent in South Africa. Four consecutive quarters of positive growth have been recorded. Moreover, the seasonally adjusted and annualised change in real gross domestic product accelerated consistently from ½ per cent in the fourth quarter of 1998 to 2 per cent in the second quarter of 1999 and slightly more than 3 per cent in the third quarter. This increase in domestic production was mainly propelled by a rise in real private consumption expenditure, the accumulation of inventories and an increase in agricultural production. To a large extent, the outcome was a result of a reduction in interest rates, the demutualisation of life assurance companies, good agricultural conditions and the fact that inventories had previously been run down. A sustainable economic recovery will be dependent largely on the export performance of the country. Fortunately, world economic conditions appear to be more favourable for a rise in South Africa's exports.

Despite the recovery in economic activity, the total number of people employed in the non-agricultural sectors of the economy declined by 50 000 in the first half of 1999. This decrease occurred mainly in the employment of public authorities in terms of the objective to create a smaller but more efficient government service. Although strikes and work stoppages increased during the course of 1999, labour productivity rose. This development, together with a slowdown in the rate of increase in the nominal salaries and wages per worker, was responsible for a decrease in the growth of nominal unit labour costs from a year-on-year rate of 6,4 per cent in the first quarter of 1999 to 4,8 per cent in the second quarter.

The Monetary Policy Committee also took note of recent reports from the private sector on the impact that the spread of HIV/Aids may have on economic activity.

Domestic monetary developments

The lower rate of increase in nominal unit labour costs contributed to the significant decline in consumer price inflation, which dropped to a year-on-year rate of 1,7 per cent in October 1999. More importantly, this decline was assisted by the fall of 8,5 percentage points in mortgage bond rates from October 1998. Other important measures of inflation, such as the core and production price indices, showed a distinct rising trend during 1999. Sharp increases in petrol and diesel prices from the beginning of 1999 were primarily responsible for this upward movement.

The growth rate in broad money supply (M3) measured over twelve months slowed down from a peak of 19,4 per cent in June 1998 to below the upper boundary of the money supply guidelines of 10 per cent from February 1999 and amounted to 7,8 per cent in September. The seasonally adjusted and annualised quarter-to-quarter growth in M3, however, recently accelerated again from 1,4 per cent in the second quarter of 1999 to 16,2 per cent in the third quarter. Broadly similar developments were discernible in both total and private-sector credit extended by the banking sector.

Domestic money and capital markets

Money market interest rates eased considerably in the course of 1999 in accordance with the direction stipulated by the Reserve Bank. By contrast, bond yields generally showed a steadily rising trend from the beginning of the second quarter of 1999 in response to changes in international interest rates and perceived domestic inflationary tendencies. From the middle of October 1999 the longer term interest rates began to decline moderately. The country and currency risk premiums of investment in South Africa decreased sharply.

Activity in the bond and share market remained buoyant. The value of real-estate transactions improved markedly in 1999 from the very low levels at the end of 1998. Non-residents participated heavily in the bond and share market, and their net portfolio investments amounted to no less than R50 billion from the end of 1998 to 22 November 1999. Non-residents' net purchases on the Johannesburg Stock Exchange came to R36 billion over this period and contributed to the increase in the monthly average price level of all classes of shares by 45 per cent over the period from September 1998 to October 1999. Bond holdings by non-residents rose by R14 billion from the beginning of 1999 to date.

Balance of payments and foreign exchange market

The current account of the balance of payments moved into a deficit from the second quarter of 1999 despite the still low level of economic activity in South Africa. The shift from a surplus to a deficit in the current account balance mainly reflected a deterioration in South Africa's terms of trade, which was partly offset by a decline in the volume of imports. The volume of South Africa's merchandise exports has not reacted much to the improved world economic conditions.

The financial account of South Africa with the rest of the world was characterised by the already mentioned large net inflow of portfolio investments. Foreign direct inflows into South Africa were relatively small. Further integration of South Africa into the world economy also led to large direct investments in other countries by residents. Moreover, in the third quarter of 1999 there seems to have been a substantial shift from foreign to domestic financing of trade transactions.

The overall surplus on the balance of payments and the utilisation of foreign credit facilities by the Reserve Bank to prevent any liquidity problems at year-end, resulted in a sharp increase in the Reserve Bank's gross international reserves to R42,6 billion at the end of October 1999. From the end of June to 16 November 1999, the net open position in foreign currency of the Reserve Bank declined from an oversold position of US$18,3 billion to US$14,5 billion.

The external value of the rand nevertheless fluctuated in a somewhat unsystematic way during the first ten months of 1999. As a result, the nominal effective exchange rate of the rand, on balance, showed almost no change from the end of 1998 to the middle of November 1999. This implies that there was a moderate increase in the real effective exchange rate of the rand over this period.

Stability in the financial sector

Relative stability was maintained in the financial sector during the third quarter of 1999, but there were some signs of liquidity shortages probably related to perceptions with regard to the possible effects of Y2K developments. The Reserve Bank continues to monitor these developments, and provided more liquidity to the banking sector.

The gross overdues of the banking sector as a ratio of loans and advances increased in the third quarter of 1999 to 4,73 per cent from 4,66 per cent in the preceding quarter. However, accounts overdue in respect of so-called other loans and advances continued to grow, whereas the growth in overdue amounts on mortgage payments moderated noticeably.

Monetary policy developments

Smaller banks were at times forced to make use of the marginal lending facility of the Reserve Bank and of their balances on cash reserve contra accounts due to liquidity problems. In view of these temporary developments, the Reserve Bank supported a decline in the liquidity requirement of banks from R10,3 billion on 13 October to R6,2 billion on 24 November 1999.

The Bank also continued with its neutral signals to the market by supplying fully in the daily liquidity requirements of banks. The repo rate accordingly continued to decline consistently by 1 basis point per day. From 23 September 1999 (the date on which the banks announced a 1 percentage point cut in their prime lending rates) the repo rate has declined further by 74 basis points.

After careful consideration of international and domestic economic developments, the Monetary Policy Committee of the Reserve Bank decided that the repo rate should be fixed at a level of 12 per cent. This fixed rate will apply as a temporary measure, until the next Monetary Policy Committee meeting, which can be convened as circumstances require.

This deviates from the agreed signalling procedures. We have taken this decision, given a possible year-end liquidity situation in the international and national money markets, arising primarily from the Y2K phenomenon. Although no disruptions are foreseen, the Bank is of the opinion that temporarily establishing a fixed, stable repo rate is in the interests of overall financial stability over this millennium change.

The Monetary Policy Committee also agreed to a reduction in the marginal lending rate. The marginal lending rate was initially introduced at one percentage point above the repo rate. This rate was then increased dramatically to a level of 20 percentage points above the repo rate as a result of the impact of the global financial crisis. In view of more stable conditions internationally, the marginal lending rate will be reduced from its current level of 15 percentage points to 5 percentage points above the repo rate, i.e. to 17 per cent from 25 November 1999.

Preparations to introduce inflation targeting

Considerable progress has been made with the preparatory work for the implementation of inflation targeting in South Africa. Discussions have taken place between staff of the Department of Finance, Statistics South Africa and the Reserve Bank about technical issues such as the price index which could be used and the targets which could be applied. International experts in inflation targeting were invited to participate in a round table discussion about inflation targeting with officials of the government and the Reserve Bank, as well as with some members of Parliament.

Improvements have been made to the forecasting techniques of inflation in the Reserve Bank. The Bank has already made considerable progress in developing a core model for the forecasting of inflation. In addition to the core model, Philips-curve models, other small-scale macroeconomic models, vector autoregressive models and calibrated models will be developed. The computer capacity of the Bank will be improved as part of the preparations for inflation targeting. The Reserve Bank has been in consultation with other central banks and a programme has been put in place for the improvement of the macroeconometric models. The Monetary Policy Committee reconfirmed the Reserve Bank’s commitment to ensure the widest possible consultation process as part of implementing inflation targeting.