Statement of the Monetary Policy Committee

16 November 2000

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

At a meeting on 15 and 16 November 2000 the Monetary Policy Committee reviewed current and likely future economic developments to arrive at a decision regarding the monetary policy stance. The main conclusions of the committee are summarised in this statement.

International economic developments

Oil prices continue to affect international economic developments. International crude oil prices remained at levels above US$30 per barrel despite the release by the United States of 30 million barrels from its Strategic Petroleum Reserve, and the increase in output by the Organisation of Petroleum Exporting Countries (OPEC), which intended to maintain the price of crude oil at between US$22 to US$28 per barrel. Uncertainty in the Middle East and the onset of the northern hemisphere winter are factors maintaining the upward pressure on oil prices.

There are also signs that economic activity in the United States may have started to slow down. The increase in the real gross domestic product of the United States decelerated from a seasonally adjusted and annualised rate of 5,6 per cent in the second quarter of 2000 to 2,7 per cent in the third quarter. Largely as a result of higher oil prices, the overall consumer price index in the United States increased by 3,5 per cent over the twelve months to September 2000. In addition, the labour market remained tight and unit labour costs rose in the third quarter following an increase in remuneration and a decline in productivity growth. The current account deficit also remains high. A downturn in industrial production in the United States could have a negative effect on international commodity prices in general and South Africa's exports in particular.

A slight moderation is also expected in the growth of the euro area in the third quarter of 2000 after the economy had performed well in the first half of 2000. High oil prices and a depreciation in the exchange rate of the euro have maintained upward pressure on inflation. The twelve-month rate of increase in the Harmonised Index of Consumer Prices accelerated from 2,3 per cent in August 2000 to 2,8 per cent in September. In the United Kingdom, real economic growth appears to have moderated as well, but inflation remains under control.

Economic growth in the emerging-market economies of Latin America and Asia also seems to have abated somewhat. Most countries in these regions recorded lower second-quarter growth than in previous quarters. Inflation generally appears to be under control, except in Indonesia where significant increases have been recorded over the past few months. Inflation rates in the Southern African Development Community (SADC) continued to diverge significantly. The Common Monetary Area members together with Botswana, Tanzania, Mauritius and Seychelles generally managed to maintain inflation rates below 10 per cent, but in the other SADC countries prices continued to rise rapidly.

Domestic real economic developments

Domestic economic growth, which had been subdued in the first half of 2000, seems to have picked up in the third quarter. Estimates made by the Reserve Bank indicate that the growth in production accelerated in all the major sectors, with agriculture and manufacturing in particular performing well. Agricultural output was pushed to higher levels by the late harvesting of a bumper maize crop in the third quarter, and strong internal and external demand bolstered manufacturing production.

Preliminary estimates indicate that real gross domestic expenditure increased sharply in the third quarter of 2000, after contracting in the previous quarter. Both final demand and inventory accumulation were responsible for this turnaround. Expenditure on durable goods resulted in continued strong consumer demand and there are signs that households have become more prepared to finance their transactions by incurring debt. Fixed investment in the private sector rose further, indicating a more positive outlook for future growth in demand.

Despite the growth in aggregate production and some moderation in wage increases, Statistics South Africa reports that employment in the non-agricultural sectors of the economy decreased further by nearly 150 000 jobs in the first half of 2000. The low growth in wages helped to keep the increase in unit labour costs down, and thus to contain price inflation.

Domestic monetary and fiscal conditions

The broadly defined money supply (M3) rose significantly in August and September, after actually declining over the seven-month period to the end of July 2000. This development reflects the stronger performance of the economy in the third quarter, leading to an average annualised growth rate of M3 in August and September of 27,8 per cent. M3 nevertheless continued to register single-digit twelve-month rates of increase in the first nine months of 2000.

Credit extension to the domestic private sector also increased more rapidly in the third quarter of 2000. In July and September, in particular, credit rose at very high rates. However, this rise was mainly due to changes in the method of reporting investments by banks. After allowing for these technical changes, the adjusted annualised growth rate in credit extension to the private sector still amounted to almost 14 per cent from the end of June to the end of September, as opposed to only about 6 per cent in the first six months of the year.

The borrowing requirement of the non-financial public sector declined from 4,7 per cent of gross domestic product in the first half of the fiscal year 1999/2000 to 2,4 per cent in the corresponding period of 2000/2001. An increase in the surplus of provincial governments and an improvement in the finances of the non-financial public enterprises led to this decline. The national government’s deficit remained well-contained. Although fiscal projections provide for increased expenditure over the next three years, this is not expected to have a significant impact on the government’s budget deficit.

Domestic financial markets

Turnover in the bond, share and futures markets has remained brisk since August 2000, following somewhat subdued conditions in the preceding four months. The depth and breadth of the primary bond market were increased by the introduction of stripped bonds by the private sector in September 2000.

The decline in the yield on long-term government bonds which had been apparent from May 2000, halted from August onwards. Since then bouts of profit taking and fluctuations in non-residents' transactions in South African bonds have contributed to more volatility in bond yields. From 18 October bond yields generally started to move to lower levels, despite the weakening of the rand and a widening of credit spreads globally. This could perhaps reflect lower inflation expectations as well as the low demand for loanable funds by the government.

From the end of August up to 15 November 2000 non-residents decreased their holdings of South African bonds by R6,9 billion. However, over the same period they continued to purchase South African equities to the amount of R9,4 billion. This contributed to an increase in share prices over this period. On 15 November 2000 the average price level of all classes of shares was nevertheless still 10,7 per cent below the peak on 17 January 2000.

Although the banks kept their prime and call rates unchanged after the 25 basis point increase in the repo rate on 17 October, other money market rates generally rose somewhat. The rate on six-month negotiable certificates of deposit, for example, rose by 27 basis points up to 15 November 2000. Expectations of future rate increases were also heightened immediately after the increase in the repo rate.

Balance of payments and foreign exchange market

The Monetary Policy Committee's concern that the current account of the balance of payments would change from a surplus in the second quarter of 2000 to a deficit in the third quarter, was confirmed by the statistics that became available after the special meeting on 16 October 2000. This reversal in the current-account balance was the result of a rise in the volume of imports, weaker exports of agricultural commodities, a deterioration in South Africa's terms of trade and a widening of the deficit on the services account of the balance of payments.

Fortunately this deficit could at first be funded by means of capital inflows from the rest of the world. There was a sizeable surplus on the financial account of the balance of payments in the third quarter of 2000, essentially due to a turnaround of portfolio capital flows from a net outflow in the second quarter of 2000 to a net inflow in the third quarter. These inflows also brought about a further increase in the country's total holdings of foreign reserves to the equivalent of about 16 weeks' worth of imports of goods and services at the end of September.

As already indicated, the inflow of portfolio capital seems to have slowed down since the beginning of September. This is also reflected in the spreads at which South Africa's foreign currency debt trades. The ten-year US dollar tap-bond of the government, for example, was trading at a spread of around 365 basis points on 15 November 2000, compared with 321 basis points at the end of August and its original spread of 275 basis points when issued in March 2000.

This reversal in sentiment towards emerging markets and the deficit on the current account put further pressure on the exchange rate of the rand. The nominal effective exchange rate of the rand accordingly declined by about 5 per cent from 20 September 2000 to 15 November 2000. From the beginning of the year the weighted value of the rand has now declined by no less than 10½ per cent. This could have inflationary consequences if it is not countered by other developments.

Monetary policy

The weakness of the rand, a steep rise in the cost of imported crude oil and an upward shift in food prices, were the main factors responsible for a sharp increase in consumer prices excluding mortgage costs (CPIX). The twelve-month rate of increase in the CPIX rose from 6,5 per cent in October 1999 to 8,1 per cent in September 2000. However, if energy and food prices are excluded from this index, CPIX inflation actually declined from 6,8 per cent to 6,7 per cent over the same period. This indicates that there are still no visible second-round effects on consumer prices, arising from these exogenous shocks.

A number of positive fundamental factors were probably responsible for this favourable inflation outcome. These include low growth in nominal unit labour costs, surplus production capacity, little evidence of excessive growth in domestic demand, moderate growth in the money supply and bank credit extension, prudent fiscal and monetary policies and increased competition as a result of import tariff reforms.

However, there are signs that the second-round effects of these external shocks are appearing in production prices. Production price inflation, measured over one year and excluding crude oil and food prices, rose steeply from 3,2 per cent in November 1999 to 5,7 per cent in September 2000. Price increases have been recorded in most of the components of the production price index excluding oil and food prices. This could indicate that CPIX inflation will be affected indirectly by external factors in the coming months because increases in production prices normally precede increases in consumer price inflation. The influence on consumer prices will depend on competitive forces in the economy and will be tempered in the medium term by the prudent fiscal and monetary policies.

The upside risks for inflation are substantiated by the results of an inflation expectations survey conducted by the Bureau of Economic Research of the University of Stellenbosch in October 2000. This survey shows that the inflation expectations of the trade union movement increased from July to October 2000. The inflation expectations of the business and finance sector, however, remained largely unchanged.

In view of the analysis of the present and probable future price developments, and building on the decision of the special meeting of the Monetary Policy Committee of 16 October 2000, the committee has decided to maintain the current monetary policy stance. However the Monetary Policy Committee will continue to closely monitor any further effects of the depreciation of the exchange rate and the continued high prices of petroleum.