Statement of the Monetary Policy Committee

19 May 2000

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

The Monetary Policy Committee meeting over two days made a detailed assessment of recent economic and financial market developments. The main conclusions of the committee are summarised in this statement.

International economic developments

International economic indicators that have become available since the last meeting of the Monetary Policy Committee confirm that a strong recovery is taking place in the world economy. According to the latest forecast of the International Monetary Fund, world economic growth is projected to rise from 3,3 per cent in 1999 to 4,2 per cent in 2000. This is expected to be accompanied by a decline in world inflation, despite an acceleration in the average inflation rate of advanced economies.

In the United States the first quarter growth rate amounted to a robust 5,4 per cent, the labour market remained tight, and rising labour costs fed through to higher inflation rates. The year-on-year consumer price inflation was in excess of 3 per cent in recent months, putting upward pressure on interest rates. On 16 May the Fed funds rate was therefore increased by a further 50 basis points to 6,5 per cent. The rising interest rates continue to attract significant capital flows into the United States, with a consequent loss of capital in other developed and developing economies. In addition, the volatility and generally downward tendency in United States share prices impacted negatively on other stock exchanges, particularly those in the emerging-market economies.

Good growth prospects in the euro area did not prevent the euro from depreciating to record low levels against the dollar and sterling. The weaker euro, combined with strong credit demand, increased pressures on prices and caused the European Central Bank to raise its benchmark interest rate by 25 basis points on four occasions since August 1999 to 3,75 per cent. On 11 May 2000 the Bank, however, decided to keep its rate unchanged.

The Bank of England has maintained an unchanged repo rate since the beginning of February 2000, as the impact of the strong exchange rate is expected to offset inflation pressures emanating from domestic demand growth and the tight labour market. Deflationary conditions continued in Japan with further decreases in consumer prices in the beginning of 2000. Japanese credit demand is weak and businesses are reducing debts as part of balance-sheet restructuring.

Economic growth prospects in Asia and Latin America remain good, although their stock markets were hit hard by the Wall Street correction. Inflation pressures in emerging-market economies have subsided. In the first few months of this year, economic conditions in sub-Saharan Africa were influenced to a large extent by political events in some of these countries.

Oil prices recorded a new six-week high on 19 May 2000 amid a combination of bullish fundamentals and speculative buying. Since the beginning of April, gold has traded within a range of $270 to $285 per fine ounce.

Domestic real economic developments

Initial indications are that the growth in real gross domestic production seemed to have slowed down in the first quarter of 2000. This development in the economic recovery process occurred despite further growth in the tertiary sectors. Agricultural output probably declined and the growth of manufacturing production may have levelled off. Real domestic expenditure was affected by a decline in real consumption expenditure of general government, but nevertheless appears to have expanded further because of increases in household consumption expenditure, fixed capital formation and inventories.

The Monetary Policy Committee noted the release of comprehensive labour statistics by Statistics South Africa, which indicates that total employment rose over the period 1996 to 1998. Little new information on the labour market has become available which would give reason to believe that formal-sector employment increased in the first four months of 2000.

Domestic monetary and financial conditions

The slowdown in the growth of labour costs during 1999 was neutralised by other price increases. As a result, the twelve-month rate of increase in the consumer price index for metropolitan and other urban areas, excluding interest rates on mortgage bonds, (CPIXmu) continued to rise from 6,5 per cent in October 1999 to 7,8 per cent in April 2000. Rising oil and food prices were the main driving forces behind this acceleration in inflation. Measured from quarter to quarter, the annualised rate of increase in this index also rose from 6,4 per cent in the third quarter of 1999 to 8,7 per cent in the first quarter of 2000.

The twelve-month rate of increase in the broadly defined money supply (M3) increased from a low of 5,5 per cent in August 1999 to 13,9 per cent in February 2000, before declining to 10,0 per cent in March. The quarter-to-quarter seasonally adjusted and annualised growth rate in M3 slowed down from 19,1 per cent in the fourth quarter of 1999 to 10,5 per cent in the first quarter of 2000.

The year-on-year growth in bank credit extended to the private sector receded from 9,6 per cent in January 2000 to 8,3 per cent in March. Mortgages, instalment sales and leasing finance picked up during the first quarter of 2000. In contrast to the pattern of the preceding three years, the increase in credit extension to the private sector in the first quarter of 2000 was concentrated in the household rather than the corporate sector.

Domestic financial markets

Financial market activity generally remained buoyant in the first 4½ months of 2000, but share market turnover per trading day receded somewhat in April and the first half of May. Share prices fell by 28 per cent from a peak on 17 January 2000 to a low on 17 April, but on balance strengthened again by 12 per cent up to 18 May. Prices and turnover in the property market firmed appreciably during the first quarter of 2000.

Capital-raising activity in the primary capital markets was rather subdued in the first quarter of 2000, owing mainly to the substantial reduction in the public-sector borrowing requirement.

The secondary market in bonds continued to suffer from selling pressures which started in mid-April. Regional events, adjustments in US security markets and higher international interest rates weighed heavily on the bond market and led to large net sales of securities by non-residents. Having been net investors in South African bonds to the amount of R16,5 billion from the beginning of 1999 until the end of January 2000, non-residents became net sellers and their sales totalled R17,0 billion up to 18 May 2000. Although these net sales by foreigners impacted negatively on bond yields, the weakening of approximately 115 basis points from the beginning of March was muted when compared with the magnitude of swings in bond yields over the past decade.

The adverse developments in the bond market were reflected in a change of the shape of the yield curve. The level of the yield curve shifted higher across the full maturity spectrum, while a more pronounced upward movement at the longer end led to a steepening of the curve. Despite this upward movement in rates, the inflation-adjusted yield on long-term bonds rose only marginally.

Money-market rates remained stable throughout April, but moderate increases in the rates of some money-market instruments, such as negotiable certificates of deposit, bankers' acceptances and forward rate agreements, became apparent in early May. Through operations such as foreign exchange swaps, reverse repurchase transactions and the issuing of debentures, the Reserve Bank steered the daily liquidity requirement of banks to a level of between R7,1 billion and R9,1 billion during April and the first half of May, and continued to provide fully in the estimated liquidity requirements at the daily repo auctions.

Balance of payments and foreign exchange market

The overall balance of payments position remained healthy in the first quarter of 2000. Trade figures indicate that the current account deficit probably decreased somewhat. A substantial increase in the value of imports was offset by a strong export performance. The increase in exports was mainly the result of higher export values of mining and manufactured products. A decline in the volume of oil imports was neutralised by an increase in international oil prices, leaving the value of oil imports at more or less the level of the second half of 1999. The rise in imports during the first quarter of 2000 was mainly due to imports of manufactured goods.

On the financial account of the balance of payments the already mentioned large net sales of bonds by non-residents were more than offset by net purchases of South African equities and other capital inflows. This enabled the Reserve Bank to reduce its net open foreign currency position by US$2,8 billion in the first four months of 2000 to a level of US$10,2 billion at the end of April.

Despite the fundamentally sound overall balance of payments, the exchange rate of the rand together with currencies in Europe, Australia, New Zealand and a large number of emerging-market economies in Asia and Latin America, came under considerable pressure. From the beginning of the year the rand depreciated against the US dollar from a level of R6,15 to the dollar to more than R7,00 to the dollar from the first week of May 2000. The rand also depreciated somewhat against the United Kingdom pound and Japanese yen, but fared better against the euro. The weighted average value of the rand accordingly declined by about 7½ per cent from 31 December 1999 to 18 May 2000. This decline in the rand was largely related to the strength of the US dollar and perceptions about the effect of developments in some sub-Saharan countries.

Stability in the financial sector

Conditions in the banking sector remained stable during the first quarter of 2000. Improvements in the efficiency of banks and their short-term liquidity mismatch, slightly higher returns on assets and equities, as well as a lower dependency of banks on wholesale deposits for funding, contributed to overall stability. In addition, total gross overdues of banks decreased from R29,2 billion in the fourth quarter of 1999 to R28,7 billion in the first quarter of 2000, or by 1,7 per cent. The quarterly decrease recorded in total overdues was evident in all three types of overdue accounts, i.e. in mortgages, instalment credit and other loans and advances.

Provisioning by banks for bad and doubtful loans and advances remained adequate. Total provisions as a percentage of gross overdues rose from 58,6 per cent from the fourth quarter of 1999 to 60,2 per cent in the first quarter of 2000. International best practice suggests that the ratio of total provisions to total gross overdues of 40 per cent is adequate. The South African situation clearly indicates that our position is solid and sound.

The problems experienced by FBC Fidelity Bank have been resolved in a manner that is good for depositors and for the banking sector as a whole. FBC Fidelity Bank was placed under curatorship in October 1999 when it experienced a liquidity crunch. Nedcor's takeover demonstrates that a bank can successfully be taken out of curatorship.

Monetary policy

The immediate upside risk for inflation in South Africa has increased as a result of the recent volatility in currency markets, the depreciation of the rand and a renewed increase in the oil price. The secondary effects of oil price increases, the higher rand values of imports and rising food prices during 2000, are expected to result in inflation pressures over the short term which will be monitored meticulously by the Reserve Bank.

Domestic economic conditions, however, remain sound and indications are at present that the inflation rate will be in the targeted band set for the year 2002. The recent depreciation of the rand, despite a healthy overall balance of payments position, could be followed by a correction in the trade-weighted value of the rand over the coming months, especially if a reversal should occur in portfolio outflows.

There are a number of other factors that bode well for the medium to longer-term outlook for inflation. These include relatively modest increases in nominal unit labour costs, the discipline applied by government in expenditure allocations and the progress made with revenue collections. The excess production capacity in the economy and modest growth in money supply and bank credit extension in the first quarter of 2000 are also very important. Moreover, a prudent monetary policy will continue to be pursued by the authorities in the coming months. If signs appear that stronger inflationary pressures are building up in the economy, the Reserve Bank will not hesitate to take appropriate measures.

Taking all the above circumstances into consideration, the Monetary Policy Committee has decided to maintain its current policy stance.