Statement of the Monetary Policy Committee

15 November 2001

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 carefully assessed recent international and domestic economic developments at its meeting on 14 and 15 November 2001 to decide on the appropriate monetary policy stance. Based on this analysis, the Committee decided to maintain the current monetary policy stance. In arriving at this decision, the following developments were regarded as important:

International economic developments

Since the previous meeting of the Monetary Policy Committee it has become apparent that the tragic events in the United States on 11 September 2001 have exacerbated the economic downturn in most countries. After this incident, consumer and business confidence deteriorated considerably in the United States and Europe while economic conditions remained depressed in Japan. International tourism declined and most airlines suffered major losses. The generally negative sentiment heightened the risk of a more prolonged downturn in the world economy.

In the United States, production contracted for the first time since 1993 at an annualised rate of 0,4 per cent in the third quarter of 2001 and an even more severe decrease is expected for the fourth quarter. Consumer confidence in October dropped to its lowest level in almost 8 years, while unemployment continued to rise. In the euro area, the growth in real gross domestic product was down in the second quarter of 2001, with a substantial further downturn in industrial production. In contrast to these developments, the real gross domestic product of the United Kingdom is estimated to have grown at a seasonally adjusted and annualised rate of 2,4 per cent in the third quarter, up from the 1,8 per cent recorded in the second quarter of 2001.

The economic downturn in the United States and the continued poor performance of the Japanese economy had a negative effect on the East Asian economies. Countries such as Hong Kong, Malaysia, Singapore and Taiwan are experiencing negative growth rates. On top of this the Argentina debt problems continue to impact negatively on Latin America in particular, and emerging markets in general. The attack on the United States resulted in reduced access to global financial markets and a deeper decline in international commodity prices. In contrast to what had at first been expected, the downturn also led to a significant decline in the demand for crude oil, and international oil prices reached a two-year low. The Organisation of Petroleum Exporting Countries (OPEC) is finding it increasingly difficult to keep the oil price between its chosen band of US$22 and US$28 per barrel, despite indications of a further cut in the production quota.

In reaction to the international slowdown, most countries have adopted a more lenient fiscal and monetary policy stance. Many countries have announced tax reductions, increased government expenditure and reduced their interest rates. The Federal Funds rate in the United States has been lowered to only 2 per cent, its lowest level in forty years. If the inflation rate is taken into account, the real federal funds rate is negative. Other central banks that have lowered official rates since the previous meeting of the Monetary Policy Committee include those of the United Kingdom, the euro area, Canada, Switzerland, Australia, New Zealand, Hong Kong, Taiwan, Hungary and Poland.

Real domestic economic developments

At first the downturn in economic activity hardly affected the South African economy. In fact, growth in the real gross domestic product rose from an annualised rate of 2 per cent in the first quarter of 2001 to 2½ per cent in the second quarter. However, a sharp decline in exports has led to a considerably lower estimate for growth in the third quarter. The slowdown in real economic activity was broadly based. Output in the primary sectors and manufacturing declined, and slower growth was recorded in the real value added by almost all the major sectors in the economy.

Despite the slowdown in aggregate production, real gross domestic expenditure increased in the third quarter of 2001, following a decline of 2 per cent in the preceding quarter. The driving force behind the increase in domestic spending in the third quarter was a strong performance in real domestic final demand and a more modest decline in inventories. Household consumption expenditure and gross fixed capital formation continued to increase strongly. However, lower increases in the operating surpluses of business enterprises led to a further decline in the domestic saving ratio.

On the labour front, there were tentative signs of a bottoming out in the rate of decline in employment in the formal non-agricultural sectors of the economy. This seems to be confirmed by the more stable official unemployment rate recorded over the past year. Although work stoppages and industrial stayaways affected production, increases in labour productivity continued to moderate the increase in labour costs. On average, nominal unit labour cost rose by about 3½ per cent in the first half of 2001 compared with the same period in the preceding year.

Domestic monetary and fiscal conditions

Growth in the broadly defined money supply remained brisk in the third quarter of 2001. Quarter-to-quarter growth has been in the double-digit range since the fourth quarter of 2000, and amounted to a seasonally adjusted and annualised rate of 17,0 per cent in the third quarter of 2001. Twelve-month growth in M3 also accelerated considerably from 9,2 per cent in January 2001 to 17,9 per cent in August, but then receded somewhat to 14,5 per cent in September. Moreover, the recent strong rise in the supply of money occurred in long as well as shorter-term deposits, the latter normally being associated with a rise in domestic expenditure.

The growth in total domestic credit extension by the banking sector slowed down from a twelve-month rate of increase of 10,4 per cent in December 2000 to 6,7 per cent in September 2001. This mainly reflected a rise in government deposits with banks, together with a decline in the gross claims of the government over the past 18 months. Credit extension to the private sector was less subdued, recording twelve-month rates of increase straddling the 10 per cent level over the past year and registering 9,6 per cent in September 2001. Growth in mortgage advances, instalment sale credit and leasing finance remains brisk, while the increase in other loans and advances is also starting to pick up. The recent increases in private-sector credit extension by the banks are probably related to the financing of international trade.

The government's *Medium Term Budget Policy Statement* of 30 October 2001, reaffirmed the prudent principles adhered to by the fiscal authorities. Although higher increases in social and infrastructural expenditure have been projected, strong growth in government revenue collection is forecast to maintain low deficits. The national government deficit for 2001/02 is now estimated at 2,3 per cent of gross domestic product, i.e. somewhat lower than an earlier budget projection of 2,5 per cent in February 2001. This deficit is then expected to increase slightly to 2,6 per cent in the fiscal year 2002/03, before receding again somewhat. The total public-sector borrowing requirement is also estimated at a magnitude of less than 2,5 per cent of gross domestic product in the current and each of the next three fiscal years. Moreover, the financing of these deficits should not present any problems. All budget parameters therefore remain conservative and supportive of the inflation target path.

Domestic financial markets

Turnover in the bond market remained high with record transactions of R3,3 trillion in the third quarter of 2001. The market was characterised by strong demand from domestic investors and net sales by non-residents. Foreign sales started in early 2000 and persisted in 2001, with market sentiment strongly influenced by concerns about emerging-market stability, political events in other parts of Africa and the protracted weakness of the rand. At the same time, bond yields moved to eighteen-year lows in October and early November 2001, with the R153-bond, for example, trading at 10,10 per cent on 14 November 2001.

Activity in the secondary share market remained brisk in the first ten months of 2001 and foreign investor sentiment was bullish. Reflecting their underlying optimism about future economic prospects, non-residents' net purchases of shares totaled R25,8 billion over this period, compared with R17,4 billion in 2000 as a whole. As a result, domestic share prices rose by 4,5 per cent from the beginning of 2001 up to 10 September, in contrast to the poor performance of most other stock exchanges. Following the World Trade Center attacks, share prices fell by nearly 15 per cent until 21 September 2001. Subsequently they recovered again by about 24 per cent up to 14 November 2001.

After following the lowering of the repo rate by 50 basis points, money market rates have been fairly stable. The SAONIA rate currently fluctuates at a level of 60 to 80 basis points below the Bank's repo rate, whereas other interbank funding fluctuates between about 100 and 125 basis points below the repo rate.

Turnover in the real-estate market slowed somewhat in the first seven months of 2001, but was firmer in August and September. This brought the estimated value of transactions in the first nine months of the year to a level that was 15 per cent higher than in the corresponding period of 2000. Year-on-year increases in nominal house prices moved down, but remained in the double-digit range in the third quarter of 2001.

Balance of payments and exchange rate developments

The current account of the balance of payments (seasonally adjusted and annualised) changed from a surplus of R6,3 billion in the second quarter of 2001 to a provisionally estimated deficit of just more than 1 per cent of gross domestic product in the third quarter. This deterioration in the current-account balance was mainly the result of a substantial decline in exports, related to weak international demand and lower international commodity prices.

Despite considerable leads and lags in foreign payments and receipts and speculation against the exchange rate of the rand, a surplus was nevertheless recorded on the financial account of the balance of payments in the third quarter of 2001. Capital inflows during the third quarter could mainly be attributed to non-residents' net purchases of domestic equities listed on the share market, foreign direct investments and the government's borrowing on international capital markets.

The deficit on the current account was fully offset by a surplus on the financial account, leaving the net international reserves of the country nearly unchanged in the third quarter of 2001. Revaluation gains resulting from the depreciation of the rand and a syndicated loan of the central bank and government caused the gross gold and other foreign reserves to increase sharply. Import cover therefore improved from about 16 weeks' worth of imports of goods and services at the end of June 2001 to 20 weeks at the end of September 2001 – its highest level ever recorded.

This relatively sound overall balance-of-payments position notwithstanding, since 11 September the rand has depreciated from R8,54 against the dollar to R9,70 on 14 November 2001. The decline in the nominal effective exchange rate of the rand since the beginning of the year is approximately 19 per cent as at 14 November 2001.

Monetary policy

The global economic slowdown and lower oil and other international commodity prices have helped to subdue domestic inflationary pressures in recent months. As a result, inflation has moderated meaningfully in all the broad measures of price change.

Over periods of twelve months, overall consumer price inflation in metropolitan and other urban areas, excluding interest cost on mortgage bonds, i.e. CPIX, declined from 8,2 per cent in August 2000 to 5,8 per cent in September 2001. Calculated from quarter to quarter and expressed at seasonally adjusted and annualised rates, the rate of increase in CPIX rose from 4,5 per cent in the second quarter of 2001 to 5,8 per cent in the third quarter. This rate still falls within the target range of between 3 and 6 per cent set for 2002 and 2003. Food prices contributed materially to the acceleration in CPIX inflation in the third quarter of 2001, but there was a modest acceleration in price growth even when omitting food prices from the index.

Production price inflation has also slowed down in recent months. The twelve-month rate of increase in the all-goods production price index declined from 10,0 per cent in December 2000 to 7,8 per cent in September 2001. The recent slowdown in production price inflation resulted mainly from lower international prices of crude petroleum. If energy is excluded, the twelve-month rate of increase in production prices fluctuated around 8 per cent in the first nine months of 2001. This was largely due to stable rates of increase in the prices of domestically produced goods over this period.

Most of the factors favourable for the containment of inflation in the coming months, which were outlined in the previous Monetary Policy Statement, still apply. Downward pressure on price increases is largely related to low increases in unit labour cost, subdued inflation in trading-partner countries, surplus production capacity in the economy, continued adherence to fiscal and monetary discipline, moderate credit growth and the recent decline in oil prices. Moreover, the deterioration in the current account of the balance of payments in the third quarter of 2001 was not due to excess demand conditions but rather to a weaker international demand for South African goods. The Reserve Bank projections therefore indicate that the inflation target for 2002 will be met.

The risk of higher inflation has, however, increased since the previous meeting of the Monetary Policy Committee. The weighted exchange rate of the rand against a basket of currencies has now declined substantially. To a large extent the effect of the depreciation of the rand has been absorbed by reduced labour costs and lower profit margins. The growth in operating surpluses of business enterprises has declined considerably in the third quarter of 2001. An expected lower demand for goods and services might lead to a further squeeze on profit margins. In the recent round of wage negotiations, wage settlements were higher than the inflation rate. In the event that wage growth exceeds productivity gains, pressure will be exerted on inflation.

Following the recommendations of the Joint Technical Committee on Inflation Targeting composed of officials of the South African Reserve Bank and the National Treasury, agreement was reached between the South African Reserve Bank and the Government on inflation targets for the period 2003 to 2005. For 2003 the inflation target is to remain at 3 to 6 per cent, while for 2004 and 2005 it is to be lowered to 3 to 5 per cent. These targets will be taken into account in all future monetary policy decisions.