Statement of the Monetary Policy Committee

14 June 2001

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 13 and 14 June 2001 the Monetary Policy Committee analysed international and domestic economic developments in order to evaluate the monetary policy stance. After lengthy deliberations the Committee decided that the repo rate should decline by 100 basis points to 11,0 per cent with effect from 15 June 2001. The Committee believes that this should lead to downward adjustments in the lending rates of banks. This decision was based primarily on the following considerations:

International economic developments

The economic performance of the United States of America remains weak with first-quarter growth now estimated at a seasonally adjusted annualised rate of 1,3 per cent, i.e. only marginally higher than the 1,0 per cent in the fourth quarter of 2000. Inventory depletion was higher than expected in the first three months of 2001, though private consumption expenditure is still supporting economic growth. Industrial production, particularly durable goods production, declined in April. This brought the capacity utilisation rate of manufacturing enterprises to its lowest level in more than a decade. The manufacturing sector continued to shed jobs and productivity declined in the first quarter for the first time since 1995. This latter development caused a rise in unit labour costs, which may, if sustained over time, put upward pressure on inflation.

The Japanese economy appears to be heading for a recession. In the first quarter of 2001, real gross domestic product declined by 0,8 per cent. Lower industrial production figures in April point to an even weaker second quarter. Growth in the euro area is also starting to show some effects arising from developments in the United States, with growth in total production amounting to an annualised rate of 2,2 per cent in the first quarter of 2001. The global economic slowdown further curbed demand for British exports, leading to a decline in the industrial production of the United Kingdom in February and March 2001. Asian and Latin American economies were also adversely affected by the slower world economic growth. Particularly in non-Japan Asia, the downturn has been more marked than originally expected. The IMF World Economic Outlook nevertheless still forecasts world growth of 3,2 per cent for 2001, compared with 4,8 per cent in 2000.

As a result of the poor short-term outlook for the United States' economy, the Federal Open Market Committee (FOMC) reduced interest rates by a further 50 basis points on 15 May 2001. This has been the fifth cut in interest rates since the beginning of the year, with the benchmark rate moving from 6,50 to 4,00 per cent. The European Central Bank decreased rates by 25 basis points in May 2001. Other countries that have reduced official interest rates since the last meeting of the Monetary Policy Committee, include Denmark, Canada, Israel and New Zealand. None of these countries, however, have decreased rates to the same extent as the United States. By contrast, interest rates in Brazil, where the inflation rate is still above the target range, were raised during May.

Although there are currently no strongly pervasive inflationary trends, higher inflation has been evident in the euro area and some Asian and Latin American countries. The international oil price has moved above the upper end of the OPEC target and, if sustained, could put upward pressure on world inflation. However, OPEC appears to be committed to maintaining oil prices within the target band of US$22 to US$28 per barrel.

Real domestic economic developments

The growth in real gross domestic product in South Africa also slowed down further from an annualised rate of 4 per cent in the third quarter of 2000 to 3 per cent in the fourth quarter and 2 per cent in the first quarter of 2001. At first the lower rate of increase in output could be attributed to a decrease in agricultural production. However, in the first quarter of 2001 output growth slowed down in most sectors, with the exception of financial services and the mining industry.

The general slowdown in economic activity in the first quarter of 2001 once again proves that the fortunes of the South African economy are inextricably interwoven with the global economy. It is almost inevitable that domestic activity will be influenced by changes in international economic conditions. The current global slowdown led to a decline in South African exports and harmed the goods-producing and the trade sectors of the economy. These developments, in turn, affected most of the tertiary sector activities.

Aggregate domestic demand increased by 2½ per cent in the first quarter of 2001. Private household spending on durable goods, gross fixed capital formation by the private sector and inventory accumulation by manufacturers and traders increased during the first quarter.

Households were prepared to incur debt to finance part of their purchases of durable goods, which resulted in some increase in their debt-to-income ratio. At about 56 per cent in the first quarter, this ratio is high but does not seem to have any serious underlying risks. Increases in real private fixed capital formation were reported over the full spectrum of production sectors and were not confined to a few large projects. In addition, businesses added to their stocks of intermediate and finished goods. By contrast, government consumption expenditure at constant prices rose modestly.

In line with the growth in expenditure, there was some indication towards the end of 2000 that employment was improving. The number of people employed in the formal private non-agricultural sectors of the economy increased during the fourth quarter of 2000. However, public-sector employment declined further.

Domestic monetary and fiscal conditions

The seasonally adjusted and annualised quarter-to-quarter growth in the broadly defined money supply (M3) accelerated from 4,9 per cent in the third quarter of 2000 to 14,7 per cent in the fourth quarter and 19,2 per cent in the first quarter of 2001. The year-on-year growth in M3 also increased sharply from 7,5 per cent in December 2000 to 12,3 per cent in April 2001. This acceleration reflected increases in aggregate domestic demand, but M3 growth outpaced the rate of increase in the narrower aggregates because of a comparatively strong rise in longer-term deposits of the public.

Growth in total bank credit extension slowed down from an annualised 18,9 per cent in the fourth quarter of 2000 to 2,8 per cent in the first quarter of 2001. The year-on-year growth in bank credit extension, however, remained below 10 per cent in the first four months of 2001. The largest part of this increased demand for credit came from households.

Public finances were characterised by disciplined spending in the fiscal year ended 31 March 2001. As a result of this, and with national government revenue exceeding earlier expectations, the deficit before borrowing was reduced to a level well below that which had originally been budgeted. The non-financial public-sector borrowing requirement amounted to only 2,2 per cent of gross domestic product in fiscal 2000/01, compared with an average ratio of 4,2 per cent in the preceding five fiscal years.

Domestic financial markets

Activity in the secondary bond and share market generally remained strong in the first five months of 2001. Bond yields, which move inversely to bond prices, declined from a monthly average of 12,9 per cent in December 2000 to 11,9 per cent in May. Share prices rose by 24 per cent from the most recent low in May 2000 to February 2001. The average monthly level of share prices then declined by 8 per cent until April, before increasing again by 9 per cent to an all-time high in May 2001.

Money-market conditions remained relatively stable throughout the first five months of 2001, with the liquidity requirement fluctuating between R8 billion and R11,7 billion. Since the last meeting of the Monetary Policy Committee, overnight rates have increased by approximately ½ percentage point. By contrast, longer-term money-market rates eased, resulting in a substantial flattening of the money-market yield curve.

Balance of payments and foreign exchange market

A small deficit of R0,5 billion was recorded in the overall balance of payments in the first quarter of 2001, which put some downward pressure on the exchange rate of the rand.

Despite the already noted increase in domestic demand, the surplus on the current account of the balance of payments improved in the first quarter of 2001. After adjustment for seasonal factors and annualised, this surplus increased from R2,5 billion in the fourth quarter of 2000 to R6,9 billion in the first quarter of 2001. This was largely the result of a decline in interest and dividend payments to the rest of the world. The volume of merchandise exports declined in the first quarter of 2001, but export earnings were boosted by a general improvement in export prices following the depreciation of the rand. Simultaneously, higher prices for imported goods dampened the demand for imports, holding back growth in the nominal value of imports.

The deficit on the external financial account exceeded the surplus on the current account of the balance of payments. This deficit was mainly the result of direct investments made abroad by South African companies wishing to expand their activities in other parts of the world and a rise in foreign assets related to trade finance. Portfolio capital, on a net basis, continued to flow into the country. The net purchases of domestic shares by non-residents amounted to R15,9 billion in the first five months of 2001. This was offset to some extent by net sales of bonds to the value of R3,6 billion over the same period. In May, however, non-resident investors were net buyers of bonds to the amount of R2,8 billion.

After the exchange rate of the rand had been under considerable pressure during the first four months of 2001, it regained most of its losses in May due in large measure to the restructuring of the De Beers Diamond Corporation which led to a substantial inflow of capital. The trade-weighted value of the rand, which had declined by 3,0 per cent from the end of 2000 to 25 April 2001, was therefore on 14 June 2001 only 0,9 per cent below its level at the end of last year.

Monetary policy

Consumer and production prices clearly indicate that inflation is slowing down. CPIX inflation, targeted to attain an annual average rate of between 3 and 6 per cent in the year 2002, fell from a year-on-year rate of 8,2 per cent in August 2000 to 6,7 per cent in April 2001. Measured from quarter to quarter and at seasonally adjusted and annualised rates, CPIX inflation came down from 8,8 per cent in the second quarter of 2000 to 6,1 per cent in the fourth quarter and remained at that level in the first quarter of 2001. All-goods production price inflation slowed down on a year-on-year basis from 10,0 per cent in December 2000 to 8,1 per cent in April 2001, and on a quarter-to-quarter basis from 11,8 per cent in the first quarter of 2000 to 8,5 per cent in the first quarter of 2001.

This moderation in price increases was mainly the result of more moderate rises in food and energy prices, which had shown exceptionally large increases in 2000. More fundamentally, the slowdown in inflation was related to the moderate rise in unit labour costs over the past two years. This relieved pressure on price increases in an environment that is now relatively open to foreign competition. Although growth in domestic demand has accelerated noticeably, there is still no sign of excessive aggregate demand. Moreover, the current account of the balance of payments has been in surplus during the past two quarters. The rate of capacity utilisation in manufacturing at about 80 per cent is clearly still well below any level that could put pressure on prices, and the private sector has continued to increase investment over the past five quarters. The recent pace of growth of money supply is, however, somewhat disconcerting. Fortunately, it has still been relatively constrained in cheque and transmission deposits, which are usually held mainly for transaction purposes.

With continued fiscal and monetary discipline, the target range of inflation in the year 2002 is achievable. This is supported by the projections made using the Reserve Bank's suite of models. However, the latest quarterly survey of inflation expectations by the Bureau of Economic Research of the University of Stellenbosch indicates a slight increase in average inflation expectations for the year 2001 through 2003. The upside risks for inflation remain primarily developments in the international price of oil, the second-round effects of last year's depreciation of the rand and continued increases in administered prices.

After carefully considering these risks, the Monetary Policy Committee decided that the repo rate should be reduced. Amongst other factors considered by the Committee in reaching this decision were the following changes that have taken place since the beginning of the year:

- A clearly discernible declining trend in inflation in line with the projections of the Committee that the average annual rate of increase in CPIX will be in the target range in 2002.
- A stronger external value of the rand. After the trade-weighted value of the rand had decreased sharply in the first four months of 2001, it started to increase from the end of April to just below the level that it had reached at the end of 2000.
- Only moderate signs of any pressure on inflation arising from the depreciation of the rand during 2000.
- A current account of the balance of payments that changed from a deficit in the third quarter of 2000 to two consecutive quarterly surpluses.
- Greater stability in international oil prices than during 2000.
- A declining trend in long-term bond yields.

Continued moderation in nominal wage increases, no signs of excessive aggregate demand growth and an underutilisation of production capacity were also factors taken into consideration by the Committee.