Statement of the Monetary Policy Committee

26 July 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 made a detailed analysis of recent economic developments at its meeting on 26 July 2001 to decide on the most appropriate monetary policy stance. After these deliberations the Committee decided that the repo rate should remain unchanged at 11,0 per cent. This decision was based primarily on the following considerations:

International economic developments

Oil prices, which had declined in June, continued to drift down in July and have traded around a level of US$24 per barrel in the past week. These developments, in conjunction with weaker international demand, have contributed to reduced pressure on inflation rates in many parts of the world. Headline inflation in the United States fell from a year-on-year rate of 3,6 per cent in May 2001 to 3,0 per cent in June. Similar declines were also recorded in the United Kingdom and the euro area. Japan continued to be characterised by deflation, while inflation rates in developing countries tended downwards.

The outlook for world economic growth remains bleak. Forecasts of the Federal Reserve System for economic growth in the United States range from 1,25 to 2 per cent for 2001. After nine months of decline, the industrial production of the United States in June 2001 was 3,6 per cent below its level in the preceding year. Indications are that the euro area slowdown has continued into the second quarter of 2001, and in Germany the growth rate is expected to fall below 1 per cent. Japan is still struggling to move out of a recession, and a decrease in the demand for primary products affected the economic growth of emerging-market economies.

International conditions have been overshadowed recently by events in Argentina and Turkey. Renewed fears that Argentina would default on its external debt and continued problems in the banking sector in Turkey put pressure on emerging-market exchange rates and spreads on foreign currency denominated debt in general. In particular, the currencies of Brazil, Chile, Indonesia and Poland have been affected seriously by the increase in risk aversion and weaker international stock markets. The Brazilian currency, for example, has declined by nearly 27 per cent since the beginning of the year, despite a cumulative increase of 325 basis points in official interest rates. From 3 July 2001 the exchange rate of the rand also depreciated sharply, bringing its value *vis-á-vis* the US dollar on 26 July down to a level that was 8,1 per cent below the level at the end of 2000. On a trade-weighted basis, however, the rand decreased by a more modest 3½ per cent over the same period.

Real domestic economic developments

Most domestic economic indicators suggest that the slowdown in the growth of real economic activity continued in the second quarter of 2001. The physical output of the manufacturing sector declined in the first five months until May 2001. Wholesale trade at constant prices also declined from the high levels at the end of 2000, while the three-months moving average of retail sales in April 2001 was also 0,5 per cent down from its peak in December 2000. Similarly, total new vehicle sales in the second quarter of 2001 were about 8,8 per cent lower than the peak in the first quarter of 2001. Other indicators, such as electricity generated and the real value of buildings completed, confirm a slowing in economic growth in the second quarter of 2001. In contrast to these developments, the physical volume of mining production increased in the first five months of this year.

The positive signs of some recovery in private-sector employment during the fourth quarter of 2000 were not sustained in the first quarter of 2001. According to the latest information, the number of workers in the regularly surveyed formal non-agricultural sectors declined by 2,1 per cent from the first quarter of 2000 to the first quarter of 2001. However, it is encouraging to note that the rate of increase in non-agricultural nominal unit labour cost increased at a slower pace in the first quarter of 2001 than in the fourth quarter of last year. In the manufacturing sector, unit labour cost increased by barely 0,5 per cent in the first quarter of 2001. This important component of the inflation process therefore does not pose any threat to an acceleration in inflation.

Domestic monetary and fiscal conditions

The annual growth in the broadly defined money supply (M3) accelerated from 6,5 per cent in November 2000 to 13,5 per cent in May 2001. The narrowly defined money supply aggregates increased at a much slower pace than M3, indicating that the rise in the broad money supply could partly be attributed to an increase in longer-term deposits by the private sector. Such longer-term deposits are in most cases not used to purchase goods and services and may be less of an inflationary threat than shorter-term deposits.

Bank credit extension to the private sector increased by 10,0 per cent in May 2001 compared with the same month in the preceding year. The growth in instalment sale credit and leasing finance gained momentum in the first five months of 2001, reflecting the firm private households' demand for durable goods. Mortgage advances also accelerated considerably in support of the solid performance of the property market.

Government expenditure in the first two months of fiscal 2001/02 increased by 14,0 per cent compared with the same period in the preceding year. This high increase was recorded despite the fact that the payment of the bonuses of civil servants for the first three months of the calendar year were not paid in April as had been the case in previous years. The increase in government revenue measured over a twelve-month period amounted to 11,7 per cent in the first two months of fiscal 2001/02, with the result that the cumulative budget deficit in this period resembled its usual seasonal pattern.

Domestic financial markets

Lively trading conditions prevailed in the bond market during the second quarter of 2001. The value of turnover in the secondary bond market increased by 4,6 per cent from the first quarter of 2001 to the second quarter. Non-resident transactions in the bond market, however, fell over the same period, with the result that they now account for only about 10 per cent of total turnover.

The long bond yield declined from an average of 12,1 per cent in April 2001 to 11,3 per cent in June 2001. The endorsement of lower inflation expectations by the Reserve Bank when it lowered the repurchase rate by 100 basis points on 15 June 2001 gave further impetus to the decline in bond yields. The yield on the R153 bond declined from 11,49 per cent on 15 June 2001 to 10,63 per cent on 26 July 2001. Turnover in the secondary share market remained high in the first six months of 2001, probably related to volatile share-price movements and corporate restructuring. The all-share index of the JSE Securities Exchange increased, on balance, over this period, performing much better than most other stock exchanges. However, from 14 June this index started to decline, affected primarily by the prices of banking, industrial, platinum-mining and information technology shares.

In the money market, the daily liquidity provided to the market has fluctuated between R9,8 billion and R7,7 billion since the previous meeting of the Monetary Policy Committee. These figures reflect the somewhat easier money-market conditions which prevailed in the period from March to May 2001. As could be expected, the reduction in the repo rate resulted in a much steeper money-market yield curve. At first most of the money-market rates declined by only 75 basis points with the reduction in the repo rate, more or less in line with the decline in the prime lending rates. After the prime rate was brought down by a further 25 basis points with effect from 16 July 2001, money-market rates came down further. Currently most of the money-market rates have declined by more than 1 percentage point since the lowering of the repo rate on 15 June 2001.

Balance of payments

Preliminary estimates indicate that South Africa's overall balance of payments improved significantly in the second quarter of 2001. The larger overall surplus was obtained essentially because of a change from a deficit to a surplus on the financial account, while the current account of the balance of payments probably remained in surplus.

Seasonally adjusted and annualised, the surplus on the trade account increased only marginally from R38,6 billion in the first quarter of 2001 to R39,3 billion in April and May 2001. A moderate contraction in the value of merchandise exports was more than offset by an increase in the value of net gold exports. The value of merchandise exports shrank somewhat over this period in line with the slower growth internationally and a sharp decline in commodity prices, especially in the price of platinum.

The financial account of the balance of payments is expected to have registered a sizeable surplus in the second quarter of 2001. The net inward movement of foreign capital resulted mainly from the restructuring of the stockholding in the De Beers Diamond Corporation and net portfolio inflows into the country. The national government borrowed €500 million on the international capital market in April 2001 and ¥30 billion in June 2001. In addition, non-residents remained net purchasers of domestic shares in the second quarter of 2001. These net purchases to the value of R7,2 billion were to some extent offset, as in previous quarters, by the net sales of bonds by non-residents amounting to R2,1 billion. This brought the net purchases of shares and bonds to R5,1 billion.

These capital inflows made it possible for the Reserve Bank to reduce its net oversold open position in foreign exchange from US$9,4 billion at the end of March 2001 to US$5,3 billion on 30 June 2001. On 18 July 2001, the net open position in foreign exchange declined further to US$4,8 billion when the Reserve Bank purchased the proceeds of government's recent Samurai bond issue of ¥60 billion.

Monetary policy

Recently released consumer and production price statistics indicate that inflationary pressures have abated further in South Africa. The twelve-month rate of increase in the consumer price index for metropolitan and other urban areas excluding mortgage cost (CPIX), which is used as the benchmark for inflation targeting, has continued to decline from 8,2 per cent in August 2000 to 6,4 per cent in June 2001. To a large extent this decline has been due to lower rates of increase in the prices of food and oil products. From February 2001 the prices of consumer services also slowed down from a year-on-year rate of 8,9 per cent to 6,7 per cent in June 2001. Measured from quarter to quarter and adjusted for seasonal influences, the rate of increase in CPIX slowed down from 6,1 per cent in the first quarter of 2001 to 3,8 per cent in the second quarter.

The rate of increase over twelve months in the all-goods production price index declined from 10,0 per cent in December 2000 to 8,6 per cent in June 2001. This decline in the growth of production prices was to a large extent the result of a slowdown in the rate of increase in the prices of imported goods from 15,0 per cent in December 2000 to 10,0 per cent in June 2001. Lower international oil prices and an appreciation of the rand during May and June, together with low inflation levels in trading-partner countries, contributed to the moderation of import prices. The rate of increase in the prices of domestically produced goods also slowed down further in the first half of 2001. The quarter-to-quarter seasonally adjusted and annualised rate of increase in production prices amounted to 6,7 per cent in the second quarter of 2001, compared with 8,5 per cent in the first quarter of the year.

Most of the recent developments, with the notable exception of the depreciation of the rand during July, point to a further decline in domestic inflation. Moderate credit growth, strong productivity growth, low rates of increase in nominal unit labour cost, a surplus on the current account of the balance of payments, a decline in international oil prices and continued fiscal and monetary prudence, are all factors favourable to the containment of inflation. It is, however, important that the secondary effects of the depreciation in the external value of the rand are carefully monitored. A further cause for concern is the fact that administered prices have been rising faster than average consumer prices over the past two years. With continued monetary and fiscal discipline, the projections of the Reserve Bank nevertheless show that the average annual rate of increase in CPIX should fall within the target range of 6 to 3 per cent in 2002.