Statement of the Monetary Policy Committee

12 September 2002

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

The year-on-year increase in the consumer price index for metropolitan and other urban areas, excluding the influence of mortgage interest cost (CPIX), increased from 5,8 per cent in September 2001 to 9,9 per cent in July 2002. The acceleration in the quarter-to-quarter CPIX inflation rate was even more pronounced from an annualised rate of only 3,8 per cent in the second quarter of 2001 to 11,5 per cent in the second quarter of 2002. The twelve-month rate of increase in the all-goods production price index also rose from 7,8 per cent in September 2001 to the high level of 15,2 per cent in July 2002.

This increase in inflationary pressures arose largely because of the sharp downward movement in the value of the rand in the last quarter of 2001. In addition, the international price of oil increased from a monthly average of about US$19 per barrel in December 2001 to nearly US$26 per barrel in July 2002. The depreciation in the external value of the rand at first mainly influenced food prices. From the beginning of 2002 the rise in prices became more widespread and inflationary expectations began to increase. When excluding food price changes, CPIX inflation picked up from a year-on-year level of 5,4 per cent in December 2001 to 7,8 per cent in July 2002. Containment of these price increases, including administered prices, is essential to reduce inflation. This requires a concerted effort by all concerned.

The continued increase in year-on-year production price inflation indicates that consumer price inflation will rise further in the coming months because there is normally a lag of approximately 2 months before production price increases affect consumer prices. Although the quarter-to-quarter rate of increase in production prices declined somewhat in the second quarter of 2002, it is still very high at a seasonally adjusted and annualised level of 14,2 per cent. Moreover, this slowdown can to a large extent be attributed to a strengthening of the rand in the first five months of 2002. By contrast, the price of domestically produced manufactured goods continued to increase at annualised rates in excess of 20 per cent in the first two quarters of 2002.

Taking these developments into consideration, it is not surprising that inflationary expectations have increased significantly despite efforts by the Reserve Bank to curtail price increases. According to the expectations survey of the Bureau for Economic Research of the University of Stellenbosch done for the Reserve Bank, respondents expect CPIX inflation to amount to 7½ per cent in 2003 and then to decline only slightly to 7,0 per cent in 2004. At these levels, inflation expectations are well above the upper level of the inflation target range, but they moderate over time.

Nominal unit labour cost rose from 2,9 per cent in 2000 to 4,8 per cent in 2001 and 6,4 per cent in the year to March 2002. Faster growth in nominal unit labour cost is usually associated with higher consumer price inflation. According to survey results obtained from NMG-Levy Consultants and Actuaries, the average annual rate of wage settlements in the first half of 2002 amounted to about 7,5 per cent, i.e. wage increases did not accelerate in the first six months of the year. Recent wage settlement rates announced in the media are, however, considerably higher. This implies that if labour productivity does not increase commensurately, there could be further upward pressure on consumer prices.

Another factor that could lead to increased inflationary pressures is the decline in the nominal effective exchange rate of the rand of 11½ per cent from the end of May 2002 to the end of August. This weakness of the exchange rate coincided with a reduction in the holdings of domestic securities by non-residents, amounting to nearly R12 billion in July and August, which almost neutralised the net purchases of securities by non-residents in the first six months of the year. This probably reflected concerns about problems in emerging markets, including Zimbabwe. Although the draft mining charter is not government policy it was nonetheless perceived negatively by foreign and domestic investors, particularly in an environment of heightened risk aversion to emerging-market assets following the crisis in Argentina and fears of a debt default in Brazil.

The developments that have so far led to higher inflation are therefore mainly exogeneous or cost-push factors, which cannot be directly influenced by changes in the level of short-term interest rates. At present there are no signs of excess spending or production capacity constraints, while fiscal discipline has been maintained by the authorities. It is, however, always important to take into consideration that cost-push and excess monetary demand factors are interacting elements or different aspects of the same process, rather than totally separate causes of different processes. Autonomous cost-push or exogeneous factors cannot on their own lead to an inflationary process if they are not accommodated by a monetary expansion. When autonomous price increases occur without increases in the money supply, bank credit extension and inflationary expectations, such increases are self-terminating. But when they are supported by accommodating monetary developments, inflationary pressures will become self-perpetuating.

As already indicated, inflationary expectations are already very high. Moreover, growth over twelve months in the broadly defined money supply (M3) amounted to 17,4 per cent in July 2002. Although this growth rate was lower than the 20,6 per cent recorded in May 2002, the reduction was to a large extent due to increased tax collections, which reduced the private sector's deposits with banks included in M3 while raising government deposits which do not form part of money supply. It is also true that a large part of this increase in M3 was the result of increases in long-term deposits, which are less likely to be related directly to aggregate nominal spending on goods and services. The narrower defined monetary aggregates, however, also rose significantly. To the extent that the deposits at banks could be used to purchase goods and services, they are an indication of possible spending that may exceed the economy's production potential in the future, and therefore create inflationary pressures.

The growth over twelve months in bank credit extended to the private sector slowed down moderately from a high level of 15,6 per cent in January 2002 to 11,7 per cent in July. Measured from quarter to quarter, growth in credit extension to the private sector fell from 19,6 per cent in the first quarter of 2002 to only 1,9 per cent in the second quarter. This considerably decreased rate of credit expansion was mainly the result of a reversal in the leads and lags in the payments for and receipts from foreign transactions. Earlier borrowing associated with these international trade transactions was mostly repaid in the second quarter when the external value of the rand strengthened. It therefore reflected a slower rate of credit extension to the corporate sector. Credit extended to households by banks hardly seems to have been affected by the increase in interest rates during 2002 and continued to rise rapidly.

In view of these accommodating monetary developments, the Monetary Policy Committee has decided to increase the repurchase rate by a further 100 basis points to 13,50 per cent with effect from 13 September 2002. It is expected that this will lead to similar adjustments in deposit and lending rates in the domestic market. Although this will mean that interest rates in South Africa have been increased by 4 percentage points from the beginning of the year, this will in fact bring the banks' real prime overdraft rate back to approximately the level prevailing during the first few months of 2002. The banks' real twelve-month deposit rate before taxation will amount to only approximately 2 per cent if it is adjusted by this increase. The inflation-adjusted yield on long-term government bonds in July 2002 came to only 1,2 per cent.

Consequently, the level of interest rates cannot be regarded as a major factor which has had or will have a significant constraining effect on production growth. This statement is supported by the fact that domestic final demand has continued to grow strongly. Moreover, export volumes increased considerably in the second quarter of 2002, as part of the lagged effect of the depreciation of the rand. Export growth contributed to maintaining a surplus on the current account of the balance of payments, which alleviated the pressure on the exchange rate of the rand mainly arising from the recent portfolio capital outflow. Export increases should further assist the economy in the attainment of healthy growth levels, while the current increase in interest rates should bring the inflation rate to within the target range.