Statement of the Monetary Policy Committee

13 June 2002

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

Inflationary pressures increased sharply in the first few months of 2002 largely as a result of the depreciation in the external value of the rand in the last half of 2001 and rising expectations of price increases. The change in price expectations was clearly reflected in a considerable increase in households' purchases of durable consumer goods in the last quarter of 2001. As the depreciated rand impacted on prices, the year-on-year increase in consumer prices excluding the interest cost on mortgage bonds (CPIX) rose from 5,8 per cent in September 2001 to 8,8 per cent in April 2002. The quarter-to-quarter rate of increase in CPIX inflation was even more pronounced, rising from a seasonally adjusted and annualised level of 6,8 per cent in the fourth quarter of 2001 to 11,6 per cent in the first quarter of 2002.

Apart from the weaker currency, food price increases were at first the main factor contributing to the acceleration in inflation. These food price increases were partly related to the depreciated value of the rand because domestic prices are charged at levels approximating those determined internationally. Shortages of certain types of food produced in the Southern African region also brought about higher food prices. Later the increases in consumer prices became more broadly based. The CPIX inflation excluding food prices rose from a year-on-year rate of 5,3 per cent in December 2001 to 6,9 per cent in April 2002. Moreover, the quarter-to-quarter seasonally adjusted and annualised inflation rate of non-food products increased from 3,9 per cent in the fourth quarter of 2001 to 9,0 per cent in the first quarter of 2002.

Higher international oil prices expressed in dollars and rand were a further important element in the acceleration in inflation. The average monthly price per barrel of Brent crude oil rose from US$18,60 in December 2001 to US$25,38 in May 2002, while the rand price per barrel increased from R217,40 to R257,83 over the same period.

All these factors also had a hand in an acceleration in production price inflation. The quarter-to-quarter and annualised rate of increase in the all-goods production price index rose strongly from 11,3 per cent in the fourth quarter of 2001 to 27,3 per cent in the first quarter of 2002. When measured over periods of twelve months, production price inflation accelerated from 8,2 per cent in November 2001 to 14,8 per cent in April 2002.

Consumer and production price inflation both accelerated during the first four months of 2002, and the risks of slightly exceeding the inflation target in 2003 are still rather high. Moreover, a number of recent developments could impact on the inflation outlook in the period ahead. These include:

- *Recent stronger rand.* The nominal effective exchange rate of the rand rose by nearly 15 per cent from the end of 2001 to 13 June 2002. The rand therefore recouped a significant part of the decline in its weighted value of just more than 34 per cent during 2001. This appreciation in the external value of the rand has already brought about and may in future result in actual price reductions of products such as fuel, or food where import or export parity pricing methods are applied. In addition, the stronger rand may also dampen price increases in other products. However, it is important to take account of the fact that the weighted exchange rate of the rand is still 19 per cent below its level at the beginning of 2001.

- *Improvement in balance of payments*. The current account of the balance of payments, seasonally adjusted and annualised, changed from a deficit of R2,7 billion in the fourth quarter of 2001 to a surplus of R4,2 billion in the first quarter of 2002. A steep decline in dividend payments to non-residents was primarily responsible for this change. The surplus trade balance in the first quarter of 2002 remained virtually unchanged from its level in the preceding quarter.

  In addition, a substantial surplus was recorded on the financial account of the balance of payments. The conversion of a reserve-related loan of US$1,5 billion of the Reserve Bank into a liability of the National Treasury was largely responsible for this favourable outcome in the financial account. A reversal of the leads and lags in payments and receipts arising from foreign trade, was also responsible for the net inflow of capital. This is substantiated by a reduction in the average remittance period of exporters' proceeds from customer foreign-currency accounts at authorised dealers from 116 days in the last two months of 2001 to 79 days in April 2002.

  The balance of payments outlook at present seems promising. The depreciated external value of the rand, the increase in gold and other international commodity prices and a recovery in the world economy should lead to higher export values and prevent excess demand conditions from recurring during 2002. A more positive sentiment by non-residents indicates a greater willingness to invest in South Africa. These developments could support the external value of the rand and dampen price increases, provided that they are not disrupted by international political and economic events or other exogeneous shocks.

- *Surplus production capacity.* There is considerable surplus production capacity in the South African economy. This is confirmed by the index of the utilisation of production capacity which amounted to 80,6 per cent in the first quarter of 2002. In addition, economic growth at just more than 2 per cent is clearly below the potential growth rate of the economy. At present there seems to be little danger that supply constraints could arise in the economy.

- *Fiscal discipline.* The government applies continued fiscal discipline which has led to an exceptionally low fiscal deficit before borrowing and net repayments on domestic debt. The medium-term projections of the government indicate that this fiscal discipline will be maintained in the coming years.

- *Slowdown in but still high rate of increase in monetary expansion.* The month-to-month rate of increase in both the broadly defined money supply and total bank credit extension slowed down considerably during 2002. In fact, bank credit extension declined somewhat in absolute terms from the high level that it had reached in January 2002. Towards the end of 2001 and the beginning of the current year the credit extended by banks was affected by the pre-emptive buying of durable consumer goods in anticipation of price increases. Despite the recent slower pace of growth in monetary expansion, the level of growth in both money supply and bank credit extension is still too high. Measured over a period of twelve months, the money supply increased by 17,5 per cent and total bank credit extension by 10,7 per cent in April 2002.

- *Rising nominal unit labour cost.* The year-on-year rate of increase in nominal unit labour cost picked up from 2,7 per cent in the second quarter of 2001 to 6,8 per cent in the fourth quarter (latest available information). This is a concerning development because there is a close relationship between consumer price inflation and changes in unit labour cost. Moreover, the recently announced increases in salaries and wages in the private and public sector do not bode well for inflation if they are not neutralised to some extent by a rise in productivity.

- *Continued high inflation expectations.* According to a survey undertaken by the Bureau for Economic Research of the University of Stellenbosch, the inflation expectations of the business sector, financial analysts, the trade union movement and households continued to increase in the second quarter of 2002. Higher inflation expectations were also reflected in a continued decline in the real yield on government's inflation-linked R189 bond from a monthly average of 5,1 per cent in November 2001 to 4,1 per cent in May 2002.

At present there are still considerable risks that may prevent the attainment of the inflation target for 2003. The risks that the Reserve Bank cannot disregard are in particular the high salary and wage increases, developments in the oil price and the exchange rate of the rand, the continued high level of growth in money supply and bank credit extension, high inflation expectations and the uncertainties about political and economic developments in some parts of the world. Econometric projections based on a number of different scenarios also show that the average inflation rate in CPIX in the year 2003 will be close to the upper level of the inflation target.

In view of these risks, the Monetary Policy Committee has decided to increase the repurchase rate of the South African Reserve Bank by a further 100 basis points to 12,5 per cent with effect from 14 June 2002.