Statement of the Monetary Policy Committee

14 March 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 began to build up during the fourth quarter of 2001, activitated by the first-round effects of the depreciation in the value of the rand and steep increases in food prices. This became clearly reflected in the quarter-to-quarter change in the all-goods production price index (PPI) which rose from a seasonally adjusted and annualised rate of 6,4 per cent in the third quarter of 2001 to 11,3 per cent in the fourth quarter. The twelve-month rate of increase in this index also accelerated from 7,8 per cent in September 2001 to 8,3 per cent in December and 11,5 per cent in January 2002.

As could be expected, CPIX inflation was not immediately affected to the same extent because of the lag between producer and consumer price increases. The quarter-to-quarter increase in the CPIX index nevertheless rose from an annualised rate of 5,9 per cent in the third quarter of 2001 to 6,8 per cent in the fourth quarter. Measured over periods of twelve months, CPIX inflation accelerated from below the psychologically important level of 6 per cent in September 2001 to 6,5 per cent in December and 7,1 per cent in January 2002.

This increase in consumer price inflation was mainly due to changes in food prices. The CPIX inflation excluding food rose by only 5,6 per cent in January 2002 when compared with the same month in the preceding year. The steep increase in food prices, in turn, was largely the result of a depreciation in the external value of the rand. On a trade-weighted basis the exchange rate of the rand declined by more than 34 per cent in the last half of 2001. Import and export parity pricing have become common practice in the now largely deregulated agricultural sector. Despite relatively good crops in 2001, food prices accordingly increased substantially. In particular, a rise in the maize price was the main driver of food price inflation because of its effect on the prices of other agricultural produce.

The depreciated value of the rand also began to affect the prices of other commodities towards the end of 2001. The weakness of the rand was probably related to a number of factors, such as domestic spending in excess of national disposable income, unfounded expectations of an immediate abolition of exchange control, leads and lags in foreign payments and receipts and negative socio-political perceptions of the region. Although changes in monetary policy will have little impact on the first-round price effects of the depreciation of the rand, it is nevertheless important that measures be taken to prevent a continuation of upward price adjustments. The timely response of monetary policy is intended to help prevent second-round price increases, making the attainment of the inflation target far less onerous.

A tighter monetary policy stance is also indicated by other developments, including:

- A rise in inflation expectations. The survey conducted by the Bureau for Economic Research of the University of Stellenbosch, released today, clearly indicates that inflation expectations in South Africa have increased. This is confirmed by other indicators of inflation expectations such as the higher and steeper yield curve and the increase in the monthly average implied or break-even inflation rate since December 2001. (This rate equates the nominal return on government's conventional long-term bonds with the real yield on inflation-linked bonds.)

- Domestic spending in excess of national disposable income. Growth in domestic expenditure accelerated during the second half of 2001. This was the combined result of an increase in inventory investment and real domestic final demand. The consumption expenditure of households and government as well as gross fixed capital formation continued to increase at a steady pace. The higher rates of growth in domestic spending than in income were reflected in deficits on the current account of the balance of payments in the third and fourth quarters of 2001. These deficits, which were still relatively small, mainly reflected a strong demand for imports and a decline in the volume of exports which were neutralised somewhat by an improvement in the terms of trade. Projections show that the current account will remain in deficit during most of 2002. It is also disconcerting that the rise in domestic spending was accompanied by a substantial increase in credit growth. The quarter-to-quarter growth in the credit extension of banks to the private sector accelerated considerably from an annualised rate of 2,8 per cent in the first quarter of 2001 to 14,2 per cent in the third quarter and 17,9 per cent in the fourth quarter.

- A rising trend in nominal unit labour cost. Unit labour cost picked up from an average rate of 2,9 per cent in 2000 to a year-on-year rate of 4,3 per cent in the first nine months of 2001. The unit labour cost in the manufacturing industry rose even more sharply from a year-on-year rate of 1,6 per cent in the first quarter of 2001 to 7,1 per cent in the third quarter. This development reflects a slower pace of increase in productivity than in nominal compensation of labour.

- The high growth in money supply. Although the quarterly growth in the broadly defined money supply slowed down in the fourth quarter of 2001, growth over twelve months remained high at levels of 17,0 per cent in December 2001 and 19,3 per cent in January 2002. Moreover, the narrowest monetary aggregate (MIA) continued to increase at exceptionally high quarter-to-quarter rates in the second half of 2001. This may merely reflect a strong preference for liquid assets, but it could also indicate a positioning to step up future spending.

Although the effects of these developments can be neutralised to some extent by the excess production capacity in the economy and continued fiscal discipline, the Monetary Policy Committee is of the opinion that they warrant a more restrictive monetary policy stance. The committee has therefore decided to increase the repurchase rate by 100 basis points to 11,50 per cent per annum with effect from 15 March 2002. It is expected that this will lead to similar adjustments in deposit and lending rates in the domestic market.

The Monetary Policy Committee realises that this increase might have a negative effect on domestic economic growth over the short term in an international environment characterised by a hesitant and apparently slow economic recovery. Monetary discipline is, however, essential for price stability and sustainable high economic growth. The negative effect of higher interest rates on short-term growth may also be neutralised to a large extent by the very competitive external value of the rand, which will in all likelihood lead to substantially higher exports when the world economic recovery gathers momentum.