Statement of the Monetary Policy Committee

16 October 2003

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

Introduction

The Monetary Policy Committee on 15 and 16 October 2003 undertook a detailed assessment of recent economic and financial developments in South Africa and the rest of the world. The main findings of the Committee were that the international economy is continuing to recover, albeit in a protracted and uneven fashion; there seems to be little reason for inflationary pressures to rise in South Africa's main trading-partner countries; there has been a major realignment of currencies in the world as a result of developments around the US dollar; domestic economic growth has slowed down; the external value of the rand has recovered to levels last seen in the middle of 2001; domestic final demand is continuing to increase, supporting domestic production as well as the growth in the volume of imported goods, although there are imbalances particularly in the externally-exposed sectors; employment creation remains one of the main problems in South Africa; and most importantly from a monetary policy perspective, inflation pressures have abated further and this is expected to continue.

The inflation outcome

The year-on-year rate of increase in the CPIX (the overall consumer price index for metropolitan and other urban areas, excluding the interest cost of mortgage bonds), which had dropped from 11,3 per cent in October 2002 to 6,4 per cent in June 2003, picked up marginally to 6,6 per cent in July before falling again to 6,3 per cent in August. Although this brought the rate of increase in the CPIX to its lowest level in twenty-one months, it was still above the upper boundary of the inflation target.

The deceleration in CPIX inflation was mainly due to a slower rate of increase in food prices and transportation costs. If energy and food prices are excluded from the CPIX, the twelve-month rate of increase in the prices of other goods and services declined from 7,7 per cent in October 2002 to 6,8 per cent in June 2003. Subsequently, this rate of increase rose to 7,0 per cent in July and then declined to 6,9 per cent in August.

More disconcerting, however, is the fact that the year-on-year rate of increase in the prices of services included in the CPIX has continued to accelerate from 7,4 per cent in October 2002 to 8,0 per cent in June 2003 and 8,4 per cent in August. This acceleration in service prices excluding mortgage costs was mainly due to increases in rental costs and in the prices of medical, communication and education services.

Moreover, the rate of change over one month in the CPIX accelerated markedly in July and August 2003 to levels last recorded in the closing months of 2002. The recent more rapid rise in CPIX inflation was to a large extent the result of increases in the running costs of motor vehicles, which can fluctuate considerably from month to month. The prices of a number of other goods, however, also rose at somewhat higher rates. However, the average month-on-month annualised percentage changes in CPIX for the latest three months amounted to 4,83 per cent.

Recent developments in production prices have been far more promising. The twelve-month rate of increase in the all-goods production price index, which had dropped from 14,6 per cent in October 2002 to 2,3 per cent in June 2003, fell further to 0,2 per cent in August. The driving force behind this slowdown in production prices was the recovery in the international exchange value of the rand from about the second half of 2002. As a result of this recovery in the exchange rate of the rand, the prices of imported goods generally declined in absolute terms from March 2003.

The year-on-year rate of increase in the prices of goods produced domestically also decelerated markedly from 14,2 per cent in October 2002 to 4,4 per cent in June 2003 and 2,6 per cent in August. Most of the prices of the various categories of domestically produced goods showed similar slower rates of increase, with the notable exception of the prices of tobacco and metal products which continued to rise at increasing rates. Food prices fell by 11,4 per cent in the year to August 2003, as the prices of grain, fruit, meat and some other agricultural products declined. At the manufactured level, food prices decreased at a year-on-year rate of 0,5 per cent in August 2003, whereas the corresponding rate of increase in September 2002 amounted to 30,1 per cent.

The inflation outlook

The decline in the production prices of food and the slower rate of increase in the all-goods production price index bode well for a slowdown in consumer price inflation in the coming months provided that discipline is applied, particularly in the determination of administered prices. Changes in production prices generally affect consumer prices with a lag before the benefits of lower production price inflation are passed on to consumers.

A number of other developments also suggest that consumer price inflation could subside further. Among these, the most important is probably that inflation expectations, which are of great importance in the price determination process in South Africa, have improved considerably during 2003. This is clearly illustrated by the decrease in the break-even inflation rate, measured as the difference between the nominal yield on conventional bonds and the real yield on inflation-linked bonds. Expected inflation derived in this way has decreased from 8,0 per cent in February 2002 to 5,0 per cent in September 2003. The inflation expectations survey of the Bureau for Economic Research (University of Stellenbosch) substantiates these findings. According to this survey, CPIX inflation is expected to fall in the next three years.

In addition, there are at present no signs of any supply constraints in the economy which could have an impact on prices. The increase of 1½ per cent in gross domestic product in the first half of 2003 was well below the potential growth rate of the economy, while manufacturing output declined in the first eight months of 2003. The increasing gap between actual output growth and potential growth is clearly illustrated by the capacity utilisation index of manufacturing which came down to 79 per cent in the second quarter of 2003.

The fiscal discipline applied by government also favours a further decline in the inflation rate. Although a more expansionary fiscal policy stance has been adopted, the fiscus still projects a deficit before borrowing and debt repayment for the fiscal year 2003/04 that should have little effect on prices. The results of national government finance for the first five months of the fiscal year confirm government’s commitment to prudence.

A further development signalling lower future inflation is the slowdown in the growth of the monetary aggregates. The increase over twelve months in the broadly defined money supply (M3) came down from 9,1 per cent in June 2003 to 5,1 per cent in August 2003. The narrower monetary aggregates on the whole showed a similar pattern, but the loans and advances of the banks to households and business enterprises increased at a year-on-year rate of 12 per cent in August. This was probably a reflection of the sustained domestic final demand for goods and services. Large increases in mortgage advances reflecting the expansion in the real-estate market made a major contribution to the rise in bank credit extension to the private sector.

Finally, the recovery in the nominal effective exchange rate of the rand from the exceptionally low level at the end of 2001 should be of assistance in containing inflation. The trade-weighted value of the rand increased by 24 per cent in 2002 and by nearly 16 per cent in the first nine months of 2003. At its current level the nominal effective exchange rate of the rand is close to levels attained in the middle of 2001. Although this has somewhat affected the profitability of exports and the price competitiveness of domestically produced goods, the recovery in the external value of the rand has contributed materially to the lowering of the inflation rate. The impact of the rand recovery on the current account of the balance of payments has so far been moderate and has been easily financed.

The projections of our econometric models confirm this favourable domestic inflation outlook. These projections, based on the current policy stance, indicate that it is likely that CPIX inflation will move below the upper boundary of 6 per cent of the inflation target during the fourth quarter of 2003 and remain well within the target range in 2004 and 2005.

A major risk to this projected inflation outcome is the recent wage settlement rates of around 10 per cent. These settlements have been made after the year-on-year rate of increase in nominal remuneration per worker in the formal non-agricultural sectors of the economy averaged 10,6 per cent in the first quarter of 2003. At the same time productivity growth has continued to slow down. In the first quarter of 2003 the year-on-year rate of increase in labour productivity amounted to 1,7 per cent, with the result that the corresponding rate of increase in nominal unit labour cost came to 8,7 per cent. Such a rate of increase in nominal unit labour cost can be absorbed over the short term without an acceleration in inflation. Over the long term it will inevitably lead to an acceleration in price increases. However, since wage negotiations have been backward looking, the recent improvement in the inflation rate could bring about a moderation in wage demands in the coming months.

Monetary policy stance

In view of this generally favourable inflation outlook and taking into consideration the positive impact of the current monetary policy stance on inflation in South Africa going forward, the Monetary Policy Committee has decided to reduce the repo rate by a further 150 basis points to a level of 8,5 per cent effective from 17 October 2003. The Monetary Policy Committee will continue to monitor all the risk factors to the inflation outlook. If the outlook deteriorates, the Committee will not hesitate to change the monetary policy stance.

Dates of Monetary Policy Committee meetings for 2004

The Governor's Committee has scheduled six MPC meetings for 2004, which will take place on the following dates:

Monetary Policy Committee meetings for 2004

1	2	3	4	5	6
27 February	22 April	10 June	12 August	14 October	9 December