Statement of the Monetary Policy Committee

14 August 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

Since the last meeting of the Monetary Policy Committee the rate of inflation has slowed down further to a level just above the upper limit of the inflation target range. The sharp decline in inflation in the first half of 2003 has been a major accomplishment of the prudent monetary policy stance adopted during 2002 combined with the recovery in the external value of the rand. The increase in short-term interest rates in 2002 served to contain inflation and inflationary expectations. Aggregate production began to grow at a slower rate from the middle of 2002. Although aggregate domestic demand continued to increase strongly, supported by government spending, sections of the business sector have experienced some pressure on their earnings and profitability largely as a consequence of a reduction in exports.

The inflation outcome

The rate of increase in the consumer price index for metropolitan and other urban areas excluding the interest cost of mortgage bonds (the CPIX), slowed down further in May and June 2003. The year-on-year rate of increase in the CPIX, which had decelerated from a peak of 11,3 per cent in November 2002 to 8,5 per cent in April 2003, came down to 6,4 per cent in June. Although this slower growth was largely a result of a lower rate of increase in food prices and an actual decline in fuel prices, the prices of other consumer goods and services also increased at a slower pace. The twelve-month rate of increase in the CPIX excluding food and energy prices amounted to 6,8 per cent in June 2003, compared to 8,0 per cent in November 2002.

Measured from quarter to quarter at seasonally adjusted and annualised rates, there was an even more significant decline in CPIX inflation from 11,9 per cent in the fourth quarter of 2002 to 2,1 per cent in the second quarter of 2003. In fact, the prices of a number of categories of consumer goods and services, such as grain products, meat, clothing, footwear, transport goods and reading matter, actually declined in the second quarter of 2003.

Despite the stickiness in the prices of services when inflation began to subside, the quarter-to-quarter seasonally adjusted and annualised rate of increase in the prices of all services slowed down from 13,2 per cent in the fourth quarter of 2002 to 3,8 per cent in the second quarter of 2003. Measured on a year-on-year basis, the inflation in services amounted to 9,5 per cent in June 2003. This still high rate of inflation was mainly due to the low level of the base for year-on-year growth calculations in the preceding year.

Changes in the all-goods production price index fell back considerably from a peak year-on-year rate of 15,4 per cent in September 2002 to 1,2 per cent in May 2003, but then rose slightly to 2,3 per cent in June. However, the latter rise in production prices could mainly be attributed to an increase in electricity tariffs for the high-demand winter months, and probably will have only a temporary effect on domestic inflation.

Measured from quarter to quarter, the overall production price index has declined in both the first and second quarters of 2003. This decline was to a large extent related to the recovery in the external value of the rand and low inflation rates in South Africa's main trading-partner countries, which brought about a decrease in the prices of imported goods throughout the first half of 2003. The prices of domestically produced food products also declined in the first two quarters of 2003. Despite this actual decline in production prices of food, the consumer prices of most types of food are still rising, albeit at low rates. The full advantage of the lower food prices has therefore not as yet been passed on to the consumer.

The inflation outlook

Not only did the inflation outcome improve over the past two months, but the inflation outlook generally remains promising. Most commentators and economists expect inflation to come down over the short term and to remain at this lower level over the long term. The expected further improvement in long-term inflation is confirmed 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 5,9 per cent in April 2003 and 5,1 per cent in July.

A number of other developments also favour a further decline in consumer price inflation. First, the fiscal discipline applied by government has materially contributed to the lowering of inflation in the immediate past and will continue to be supportive of monetary policy in the future.

Second, the recovery in the external value of the rand favours future moderate price increases in South Africa. The nominal effective exchange rate of the rand has increased by approximately 13 per cent in the first seven months of 2003. Even after this increase, the level of the real effective exchange rate of the rand was still below the index values in early 2000, leaving domestic producers in a more competitive situation in export markets than at the turn of the century.

Third, the generally low inflation in the rest of the world is assisting South Africa in combating domestic inflation. In addition, international oil markets are somewhat more stable.

Fourth, the slowdown in aggregate production has led to a decline in the utilisation of production capacity in manufacturing from 81,1 per cent in the third quarter of 2002 to 80,3 per cent in the first quarter of 2003. It seems unlikely that capacity constraints will arise in the near future taking the international and domestic economic conditions into consideration.

Although the inflation outlook generally still seems to be favourable, there are certain developments in the domestic economy which require the Monetary Policy Committee to remain vigilant. Of particular concern were the recent wage settlement rates of around 10 per cent. Nearly all the salary and wage increases in 2003 have been above the current inflation rate and have been negotiated in an environment of declining productivity. High nominal unit labour costs will therefore inevitably put pressure on price increases. In addition, high rates of increase in some administered prices are also a cause for concern.

Another development in the domestic economy which could lead to increasing inflation pressures has been the continued strong aggregate domestic demand for goods and services. National accounts statistics are not yet available for the second quarter of 2003. However, many indicators, such as wholesale and retail trade at constant prices, new and used vehicle sales, real value of buildings completed and electricity consumed, signal that domestic final demand was sustained at a relatively high level in the first half of 2003.

The strong performance of domestic demand combined with a slowdown in total domestic production, have led to a reversal in the balance on the current account of the balance of payments from a surplus to a deficit of about ½ per cent of gross domestic product in the first quarter of 2003. In the second quarter of 2003, a moderate decline in merchandise imports could not neutralise a much larger fall in exports. This caused the trade balance to shrink from a seasonally adjusted and annualised value of R32 billion in the first quarter of 2003 to R23,5 billion in the second quarter. However, the consequent larger current-account deficit was financed by inflows on the financial account without putting any significant pressure on the exchange rate of the rand. Going forward if the current account continues to behave in the same fashion it could lead to pressure on domestic inflation.

The high domestic demand in the first half of 2003 has been financed to some extent by means of bank credit. The year-on-year growth in underlying bank credit extension to the private sector (i.e. private-sector credit extension excluding investments and bills discounted) amounted to 12,7 per cent in June 2003, compared with 7,8 per cent in December 2002. The quarter-to-quarter growth rate in underlying bank credit extension to the private sector rose even more sharply from 12,4 per cent in the first quarter of 2003 to 22,4 per cent in the second quarter. Money supply has also recently accelerated. Although the twelve-month growth rate of the broadly defined money supply (M3) has remained at single-digit levels in the first six months of 2003, the momentum of growth in M3 has accelerated considerably over the past three months. This is clearly reflected in the quarter-to-quarter annualised growth rate in M3 which rose from 2,0 per cent in the first quarter of 2003 to 13,5 per cent in the second quarter.

Monetary policy stance

These developments clearly demonstrate that a careful balance needs to be struck in the determination of monetary policy. The welcome fall in inflation, and the prospect going forward that inflation will remain in line with the target range of 3 – 6 per cent, gives scope for an easing of the monetary policy stance. But against that there needs to be balanced the continuing buoyancy of final domestic demand, and the risks to inflation from the specific sources of cost pressures identified above. Taking all this into account the Monetary Policy Committee has decided to reduce the repo rate by 100 basis points to a level of 11 per cent effective from 15 August 2003. The course of any future movements in the repo rate, in either direction, will continue to be judged by the committee in the light of the outlook for inflation against the inflation target.