Statement of the Monetary Policy Committee

12 June 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 rate of inflation has declined further since the last meeting of the Monetary Policy Committee. In particular production price inflation slowed down to low levels. Changes in production prices, which generally precede similar changes in consumer prices, fell back from a peak year-on-year rate of increase of 15,4 per cent in September 2002 to 8,1 per cent in January 2003 and to 3,3 per cent in April. In fact the all-goods production price index measured from quarter to quarter declined at a seasonally adjusted and annualised rate of 3,2 per cent in the first quarter of 2003, while it had increased by 5,3 per cent in the fourth quarter of 2002 and by 25,8 per cent in the first quarter of 2002. The recovery of the rand, moderating food price inflation and a disciplined monetary policy stance eased price pressures.

Even more significant is that the decline in production prices was not only confined to lower prices of imported goods related to the recovery in the external value of the rand, but the prices of domestically produced goods also declined at an annualised quarter-to-quarter rate of 0,9 per cent in the first quarter of 2003. Moreover, all the categories of domestically produced goods experienced disinflation in the first quarter of 2003. Prices of imported goods declined at an annualised rate of 10,0 per cent in the first quarter of 2003.

The revised consumer price index for metropolitan and other urban areas excluding the interest cost of mortgage bonds (the CPIX) also improved significantly. The year-on-year rate of increase in the CPIX decelerated from a peak of 11,3 per cent in November 2002 to 9,3 per cent in February 2003 and 8,5 per cent in April. CPIX inflation declined at a faster pace from a seasonally adjusted and annualised rate of 12,1 per cent in the fourth quarter of 2002 to 4,8 per cent in the first quarter of 2003.

Had the figures not been revised, the quarter to quarter annualised rate of growth in the CPIX would have amounted to 6,3 per cent in the first quarter of 2003. Measured over a period of twelve months the revision of the CPIX was also significant. However, the turning point and pattern of change between the previous and revised monthly series coincide fairly closely.

Factors favouring lower inflation

A number of developments favour a reduction in the inflation rate:

- Low inflation in the rest of the world. Global inflation is generally expected to remain low and consumer prices in advanced economies could even reach an average rate below 2 per cent in 2003. The sluggish world economic performance and weak household demand could promote continuing disinflationary pressures.

- The recovery in the external value of the rand. The nominal value of the effective exchange rate of the rand increased by 26,0 per cent during the year up to the end of December 2002 and by a further 0,9 per cent in the first five months of 2003. Although the pass-through effect of the recovery of the rand is usually much smaller than in the case of a depreciation, the current available information indicates that some of the direct and indirect effects of the changed external value of the rand have already benefited disinflation in the CPIX.

- The ending of the war in Iraq. The end of the war in Iraq and the fact that oil supplies were not materially affected, has removed some of the uncertainties about the international economic environment. However, tensions in the Middle East persist. The surge in the average oil price per barrel from US$24,50 in November 2002 to US$32,65 in February 2003, came to an abrupt end at the beginning of the Iraqi war. Brent crude oil prices then dropped to an average of US$25,76 per barrel in May. Together with the recovering rand, this decline in oil prices led to a considerable reduction in domestic fuel prices in May and June 2003, which should also assist in bringing the rate of inflation down to lower levels.

- Improvement in inflation expectations. The recent survey by the Bureau of Economic Research of the University of Stellenbosch clearly indicates that inflation expectations of analysts, business, labour and households are subsiding. A decline in long-term inflation expectations is also indicated by a 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 just below 6 per cent from April 2003. Inflation expectations play an important role in the inflation containment process.

- Surplus production capacity in manufacturing. The utilisation of production capacity in manufacturing declined to 80,3 per cent in the first quarter of 2003, or to a level considerably below what would normally be regarded as full capacity utilisation. A clear downward trend is also discernible in total unfilled orders at constant prices from the middle of 2002, which makes any capacity constraints unlikely in the near future.

- Prudent fiscal policy. The government remains fully committed to pursuing sound fiscal policies. This is demonstrated by the low level of the non-financial public-sector borrowing requirement of 1,0 per cent of gross domestic product in the fiscal year 2002/03 and by the planning of the fiscus as presented in the Medium Term Budget Policy Statement of the year 2002. Although the borrowing requirement ratio is slightly higher than the ratio of 0,8 per cent recorded in the fiscal year 2001/02, it is very low by any international comparison. Government has also succeeded in reducing its debt as a ratio of gross domestic product from 45,7 per cent at the end of March 2002 to 41,2 per cent at the end of March 2003.

- Slower monetary growth. The rate of increase in the broadly defined money supply (M3) declined from a peak of 20,6 per cent in May 2002 to 5,9 per cent in March 2003. However, it rose to 10 per cent in April. The growth over twelve months in the banks' claims on the domestic private sector, excluding investments and bills, accelerated from 9,1 per cent in February 2003 to 12,7 per cent in April. The household sector was mainly responsible for this rise in bank credit extension.

Inflation risks

Large pay increases continue to be a major risk factor for the containment of inflation. This risk becomes even more crucial if it is accompanied by a slowdown in labour productivity growth. In 2002 the average nominal remuneration per worker in the formal non-agricultural sectors of the economy amounted to 9,9 per cent, compared with an already high 9,1 per cent in 2001. Over the same period, the growth in total labour productivity in the economy declined from 4,8 per cent to 2,8 per cent. As a result, nominal unit labour costs in the formal non-agricultural sectors increased at a rate of 7,0 per cent in 2002. Increases at these levels, if sustained going forward, could jeopardise the positive inflation outlook.

Despite the relatively tight monetary stance, the growth in final domestic demand was sustained. Having increased at an average rate of 4 per cent in 2002, the quarter-to-quarter annualised rate of increase in final domestic demand amounted to 3½ per cent in the first quarter of 2003.

Real final consumption expenditure by households increased at an annualised rate of 2½ per cent in the first quarter of 2003, or at roughly the rate attained in the preceding quarter. The steady growth in real consumption expenditure by households was possibly underpinned by the tax cuts announced in the Budget of February 2003. Consumers incurred debt to maintain consumption expenditure and to acquire assets, which led to an increase in the ratio of household debt to disposable income from 51 per cent in the fourth quarter of 2002 to 53 per cent in the first quarter of 2003.

Real government consumption expenditure also increased at the same pace as that recorded in the fourth quarter of 2002. In addition, the increase in real fixed capital formation amounted to 8½ per cent in the first quarter of 2003. The growth in capital formation continued in all the sectors of the economy, with the exception of the agricultural sector which was affected adversely by the recovering rand and in some instances by weather conditions.

The high growth in domestic final demand was accompanied by a marked slowdown in economic activity. The growth in South Africa's real gross domestic product declined from an annualised rate of 2½ per cent in the fourth quarter of 2002 to 1½ per cent in the first quarter of 2003. The further slowdown in domestic output growth was evident in all the sectors of the economy, with a decline in the real value added of the primary and manufacturing sectors. This downward movement in economic activity can mainly be attributed to a decline in the volume of exports related to a depressed global economy and the recovery in the external value of the rand. The level of the real effective exchange rate of the rand in the first quarter of 2003 was, nevertheless, still well below the average level in 2000, i.e. before the recent sharp fluctuations in the exchange rate of the rand.

In the first quarter of 2003 the current account of the balance of payments moved into a deficit, albeit to the still low level of ½ a per cent of gross domestic product. If the current account deficit continues to widen it could lead to pressures on domestic inflation.

Inflation projections

Projections of the likely rate of inflation for 2004, calculated by using the Reserve Bank's core and other forecasting models, indicate that on the policy stance to date, the average rate of increase in the CPIX will be close to the midpoint of the inflation target band in 2004.

Monetary policy stance

Taking these factors into consideration as well as the widening of the differential between South African interest rates and those of our major trading partners owing to a general decline in international interest rates, the Monetary Policy Committee has decided to reduce the repo rate by 150 basis points to a level of 12 per cent per year effective from 13 June 2003.

In taking this decision, the committee recognises the progress achieved so far in reducing inflation and the prospect that inflation may fall within the target range later this year. But the committee will remain vigilant to the risks going forward, particularly those relating to wage settlements, administered prices and the uncertain outlook for the global economy. The committee will be ready to take whatever actions are necessary in either direction in the light of the way future risks materialise.