Statement of the Monetary Policy Committee

20 March 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

In February 2000 an announcement was made by government that an inflation targeting framework had been adopted for monetary policy purposes. This change was made to improve the co-ordination between monetary policy and other macro-economic policies, as well as to make monetary policy more transparent and accountable. Under this framework the Reserve Bank and more specifically the Monetary Policy Committee was given the task to achieve an average rate of increase in the overall consumer price index for metropolitan and other urban areas excluding mortgage interest costs (the CPIX) of between 3 and 6 per cent for the year 2002. The CPIX measure of inflation was chosen to ensure a wide coverage of consumer items, but without the mortgage interest cost component that would perversely fall as monetary policy was relaxed, and vice versa.

In 2002 the rate of increase in the CPIX averaged 10 per cent, or 4 percentage points above the upper limit of the target range. In the light of this outcome the Reserve Bank wishes to inform the public in general why the actual inflation rate deviated from the target. The Bank would also like to spell out what measures have been taken to bring the inflation rate within the target band in due course.

The inflation outcome for 2002

The Monetary Policy Committee is of the opinion that four factors were mainly responsible for the acceleration in the rate of increase in the general price level in 2002. First and foremost the rapid rise in the prices of consumer goods and services was related to the sharp depreciation in the external value of the rand in the second half of 2001. The nominal value of the rand on a trade-weighted basis declined by 34,3 per cent from the end of June 2001 to the end of that year. Initially the weakness of the rand was mainly linked to the contagion effects of the political situation in Zimbabwe and financial stability problems experienced in emerging-market economies such as Argentina and Turkey. Later developments in the exchange rate of the rand were characterised by typical financial market behaviour under the circumstances which prevailed at the time where further declines in the exchange rate of the rand became a self-fulfilling prophecy based on market expectations.

The increased risk aversion of international investors caused asset fund managers to withdraw portfolio investments from South Africa. These sales of South African securities increased the demand for dollars in the domestic currency market, which put downward pressure on the exchange rate of the rand. At the same time, importers made advance payments to avoid paying more in rand for foreign currency denominated purchases of goods abroad at a later stage, while exporters delayed the repatriation of foreign-currency earnings to obtain expected higher rand proceeds from a depreciating currency. The effects of the leads and lags in foreign payments and receipts on the exchange rate of the rand were aggravated by the appearance of a deficit on the current account of the balance of payments during the second half of 2001.

A second factor leading to the acceleration in inflation during 2002 was the rise in domestic food prices which had already started from the middle of the preceding year. The prices of food increased by no less than 16,7 per cent in 2002. If the increases in food prices are excluded from the overall CPIX, the rate of increase in the prices of other goods and services averaged 7,8 per cent in 2002.

Food prices are generally a highly volatile component in consumer expenditure and can have a significant impact on other price developments in South Africa. The substantial rise in food prices during 2002 can to a large extent be attributed to the depreciated value of the rand. After the liberalisation of agricultural pricing, export and import parity prices have generally set the lower and upper bounds to the prices of domestically produced agricultural goods. The rise in international prices of grain products together with the depreciation of the rand caused the prices of food in South Africa to rise considerably. Moreover, the regional demand and supply of crops in southern Africa shifted the prices of agricultural goods higher owing to a movement away from export parity pricing to import parity pricing.

Thirdly, the acceleration in the prices of consumer goods and services was the result of increases in international oil prices during 2002. After the Brent price of oil had stabilised around US$20 per barrel in January and February 2002, it started to move higher and reached an average of approximately US$28 per barrel in December 2002. This increase was mainly related to concerns about a possible US-led attack on Iraq and disruptions in the supply of oil due to general strikes in Venezuela.

Fourthly, the inflation outcome in 2002 was affected by large increases in some administered prices. In particular, the prices of medical and education services and water rates continued to increase at very high rates of approximately 10 per cent or more in 2002, following on even higher increases in 2001. Assessment rates and fees for sanitary services and refuse removal also rose at a high rate in 2002. As a result, the increase in the prices of all administered goods and services averaged 8,4 per cent in 2002, or was about equal to the increase in the preceding year. High increases in administered prices, which have a weight of almost 25 per cent in the CPIX, continue to make it extremely difficult to bring inflation down to the targets set by government.

This brief exposition of the major reasons why the inflation target was not met in 2002 indicate that it was largely due to extraordinary events that could not be foreseen and which were beyond the control or influence of monetary policy. At the beginning of 2002, when it had already become apparent that the inflation target would not be met, the Reserve Bank considered whether to make use of the escape clause, which recognises circumstances which could temporarily lead to deviations from the target. In the end the Bank decided that it would be unwise to make use of this clause. Continued monetary discipline was regarded as essential for price stability and sustainable high economic growth. It was also argued at the time that the negative effect of higher interest rates on short-term economic growth would be neutralised to a large extent by the very competitive external value of the rand.

Rather than opting for a temporary increase in the inflation target, the Monetary Policy Committee decided that corrective measures should be applied. The committee affirmed that it was highly unlikely that any measures would bring the inflation rate to within the target range for 2002 because of the long lags between interest rate increases and a slowdown in inflation. The objective of the committee accordingly became focused on bringing the rate of increase in CPIX within the target range as soon as possible with the least short-term cost to economic growth and employment creation.

The first corrective step was already taken at a special meeting of the Monetary Policy Committee early in January 2002. At this meeting the committee decided to increase the repurchase rate of the Bank by 100 basis points to counter rising inflation expectations. Monetary policy was tightened further at the subsequent three scheduled meetings of the Monetary Policy Committee. At all three meetings the repurchase rate was increased by 100 basis points to bring the level to 13,5 per cent in September 2002. On the basis of expected inflation, this led to a significant increase in real short-term interest rates in South Africa and therefore a tightening in monetary policy.

At the November meeting of the Monetary Policy Committee it was decided that the right dose of monetary discipline had been applied and that there were some signs that inflation pressures were abating. The committee therefore kept the repurchase rate unchanged because this level of the rate was regarded as appropriate to bring the inflation rate within the target range in due course.

Current inflation outlook

Since the last meeting of the Monetary Policy Committee the inflation outlook has improved further. This is specifically confirmed by a slowdown in the prices of production goods, which generally precedes similar changes in consumer price inflation. The recent recovery of the rand and a lower rate of increase in food prices have curbed the rise in the prices of both imported and domestic goods. As a result, the year-on-year rate of increase in the all-goods production price index declined from 15,4 per cent in September 2002 to 8,1 per cent in January 2003. An even more impressive reduction in the seasonally adjusted and annualised quarter-to-quarter production price inflation has been recorded from 25,8 per cent in the first quarter of 2002 to 5,0 per cent in the fourth quarter.

Other factors pointing to an improved inflation outlook, include the following:

- A recovery in the exchange rate of the rand. The weighted exchange rate of the rand increased by 26,0 per cent from the end of December 2001 to the end of December 2002 and by a further 5,9 per cent up to 20 March 2003. This brought the level of the nominal effective exchange rate of the rand close to its level at the end of 2000, i.e. just before the weakening of the rand in 2001. Sound macro-economic policies, relatively high domestic interest rates in comparison to developed countries, a reduction in risk aversion towards emerging market economies, improved international credit ratings of South Africa and the weakness of the dollar were possibly responsible for this recovery of the rand.

- Slowdown in food price increases. Food price inflation moderated somewhat from a year-on-year increase of 19,3 per cent in October 2002 to 15,4 per cent in January 2003. Although this latter rate of increase is still very high, the recovery of the rand, the decline in international grain prices and expected good summer crops should bring food price increases to significantly lower levels.

- Slower momentum in the growth of money supply. The seasonally adjusted and annualised quarter-to-quarter growth in the broadly defined money supply (M3) declined sharply from 32,1 per cent in the first quarter of 2002 to 7,1 per cent in the fourth quarter. Measured over a period of twelve months, the growth in M3 came down from 17,8 per cent in October 2002 to 9,9 per cent in January 2003.

- Continued moderate growth in bank credit extension. Growth over twelve months in bank credit extension to the private sector declined from 15,6 per cent in January 2002 to only 4,7 per cent in December, but then rose again to 12,7 per cent in January 2003. The January 2003 figure, however, was distorted by regulatory and accounting changes specifying that certain transactions must be reported on a gross rather than a net basis. These changes particularly affected the investments of banks in private sector entities. If these items are excluded, the rate of increase in the loans and advances of banks to the private sector, measured over a period of twelve months, declined from 10,3 per cent in August 2002 to 7,9 per cent in December, and then increased moderately to 8,9 per cent in January 2003.

- Excess production capacity. The utilisation of production capacity in manufacturing, which had amounted to 81,1 per cent in the third quarter of 2002, declined to 80,1 per cent in the fourth quarter. The increase in excess production capacity was the combined result of increased capital outlays by manufacturing enterprises and a slowdown in the growth of manufacturing output. It also seems unlikely that capacity constraints will arise in the near future because of an apparent weakening in the demand for manufactured goods as signalled by a recent decline in unfilled orders.

- Surplus on the current account of the balance of payments. The current account of the balance of payments turned around from a seasonally adjusted and annualised deficit of R2,2 billion in the third quarter of 2002 to a surplus of R4,3 billion in the fourth quarter. The current account was also in surplus to the amount of R3,3 billion for the year as a whole, clearly indicating that there are no signs of excess spending in the South African economy. The improvement in the current account balance was largely the result of the higher gold price leading to a higher value of net gold exports. This development, together with an increase in the prices of exported goods and services, neutralised a decline in the volume of merchandise exports and a rise in merchandise imports. Projections of current account aggregates show that future excess spending also seems unlikely.

- Continued fiscal discipline. Although government adopted a more expansionary fiscal policy stance from 2001/02, fiscal discipline continued to be applied. It is estimated that the deficit before borrowing and debt repayment will reach 2,4 per cent of gross domestic product in the fiscal year 2003/04, and that it will be maintained more or less at this level in the next two years. At these levels, the finances of government should not present any difficulties for monetary policy.

The above-mentioned promising developments will need to be maintained if a meaningful reduction in CPIX inflation is to be achieved. After the year-on-year rate of increase in the CPIX had accelerated from a low level of 5,8 per cent in September 2001 to 12,7 per cent in November 2002, it retraced only modestly to 11,3 per cent in February 2003. Moreover, the seasonally adjusted and annualised quarter-to-quarter increase in CPIX inflation rose from 11,1 per cent in the second quarter of 2002 to 14,5 per cent in the fourth quarter. These high levels of CPIX inflation leave little room for complacency on the part of monetary policy.

Considerable risks still exist that could prevent the rate of increase in the CPIX from moving into the target range during the course of 2003. Among these risks the recent high rates of increase in the average nominal remuneration per worker in the formal non-agricultural sectors of the economy combined with a slowdown in labour productivity growth, are probably the most disconcerting. As a result, average year-on-year growth in nominal unit labour cost reached 7,4 in the first nine months of 2002, which could bring about considerable upward pressure on future price inflation. It has been found in the past that high rates of increase in unit labour costs invariably lead to an acceleration in domestic inflation.

In the current circumstances, the insecure international economic environment is a further risk factor to take into consideration when determining monetary policy. Considerable uncertainty exists regarding the economic impact of the war in Iraq and about the pace of the underlying recovery in the world economy.

Another major risk factor for monetary policy is that prices of goods and services determined by government agencies have continued to increase rapidly and there are still few signs that these increases are tapering off. As already indicated, these administered prices form a large part of the CPIX. In addition, they also affect other prices indirectly. It is therefore of the utmost importance that macroeconomic and microeconomic policies be co-ordinated closely to achieve optimum results with overall economic policy.

Monetary policy stance

Although there are still important risks prevalent that could have a negative effect on the inflation outcome, conditions have become generally more favourable for a decline in domestic inflation. This is confirmed by projections using the Reserve Bank's forecasting models, which indicate that there is a strong likelihood that CPIX inflation will move within the target band during the course of the year. However, the forecasts also indicate that the average rate of increase in the CPIX may only be slightly below the upper band of the inflation target in 2004. Taking this into consideration, as well as the risks identified above, the Monetary Policy Committee has decided to maintain the repurchase rate at its current level of 13,5 per cent per annum.

In addition, the Reserve Bank wants to confirm that, consistent with our inflation-targeting monetary policy framework, we have no intermediate policy targets or guidelines and we are committed to allowing the value of the rand to be determined by the market. Recently, with the recovery of the rand, the Reserve Bank has on occasion taken the opportunity to purchase dollars for our reserves on a moderate scale. These operations have helped to reduce the Bank's net open position in foreign currency from US$1,8 billion at the end of November 2002 to US$1,3 billion on 13 March 2003. Such operations purely represent normal prudent management of the Reserve Bank's balance sheet as is ordinarily the case in central banking. They are in no way directed at seeking to influence a particular level of the rand, whose value will continue to be set by the market.