Statement of the Monetary Policy Committee

28 November 2002

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

CPIX inflation, i.e. the increase in the consumer price index for metropolitan and other urban areas excluding mortgage interest cost, accelerated from 5,8 per cent in September 2001 to 12,5 per cent in October 2002 when measured over a period of twelve months. The increase in the quarter-to-quarter CPIX index was even more pronounced from an annualised rate of 3,8 per cent in the second quarter of 2001 to 12,7 per cent in the third quarter of 2002.

The acceleration in inflation from within to considerably above the inflation target range of 3 to 6 per cent was at first caused mainly by exogenous factors, such as the depreciation of the rand in the last half of 2001, rising food prices and an increase in oil prices during 2002. However, even if petrol, diesel and food prices are excluded from the CPIX index, the prices of other components rose from a quarter-to-quarter annualised rate of 1,1 per cent in the second quarter of 2001 to 5,8 per cent in the fourth quarter and 11,2 per cent in the third quarter of 2002. In October 2002 the year-on-year increase in the prices of these other components amounted to 9,5 per cent. The continued acceleration in consumer prices was mainly due to steep increases in the prices of services, whereas the rate of increase in the prices of non-food goods started to level off.

Although there is still no evidence that consumer price inflation is decreasing, a number of factors indicate that we may be close to the point where inflationary pressures could start to abate, namely:

- Inflation in the production prices of goods, which generally precedes changes in consumer price inflation, has slowed down significantly. The quarter-to-quarter rate of increase in the production prices of goods came down from 26,0 per cent in the first quarter of 2002 to 10,4 per cent in the third quarter. This appreciably slower growth in production prices was discernible in both domestically produced and imported goods in the third quarter of 2002. The year-on-year increase in the total production price index amounted to 14,6 per cent in October 2002, which was lower than the 15,4 per cent in the preceding month.

- A strengthening in the external value of the rand. The exchange rate of the rand showed a meaningful improvement from the beginning of October 2002. After a relatively weak performance during the third quarter of 2002, the rand has recovered most of its losses since the beginning of October. As a result, the weighted exchange rate of the rand on 27 November 2002 was about 22 per cent higher than at the end of last year.

- A decline in international oil prices. Crude oil prices dropped sharply by almost 12 per cent in dollar terms, and 23 per cent in rand terms, from the beginning of October 2002. This represents a reversal of the distinct upward trend in international oil prices that started towards the end of 2001.

- Slower growth in bank credit extension to households and business enterprises. The twelve-month growth rate in credit extended by the monetary sector to the private sector declined from a recent high of 15,6 per cent in January 2002 to 9,3 per cent in September 2002. This decline was not only due to a reversal in the leads and lags in foreign payments and receipts that were experienced in the last quarter of 2001, but was also evident in instalment sale and leasing finance, mortgage advances and other loans and advances to households.

- A deceleration in the pace of growth in the more broadly defined money supply aggregates. The quarter-to-quarter seasonally adjusted and annualised growth rate in M3 fell from 18,2 per cent in the second quarter of 2002 to 8,9 per cent in the third quarter. Moreover, hardly any growth was recorded in M1 and M2 during the third quarter of 2002, but M1A again increased at a high rate.

- Continued excess production capacity in the economy. The utilisation of production capacity in manufacturing amounted to about 81 per cent in both the second and the third quarter of 2002, which is still way below the level that is normally regarded as a reflection of full production capacity. The real capital outlays by private business enterprises, public corporations and general government also continued to grow rapidly during the first three quarters of 2002.

- No signs of excess spending in the economy. Although the current account on South Africa's balance of payments changed from a surplus in the second quarter of 2002 to a deficit in the third quarter, this deficit at less than ½ per cent of gross domestic product is small and clearly sustainable at present in view of the strong performance in the external value of the rand.

- Persistent fiscal discipline applied by the authorities. Further considerable increases in revenue collections from taxes on income and profits as well as from taxes on goods and services made it possible to absorb higher government expenditure and to increase the primary surplus of the government, i.e. the balance on the government's accounts excluding interest payments. The Minister of Finance accordingly indicated in the *Medium Term Budget Policy Statement* in October 2002 that the national government's deficit before borrowing is expected to amount to only 1,6 per cent of gross domestic product in the current fiscal year.

Despite these factors favouring a slowdown in inflation, there are still significant upside risks that could prevent the increase in the CPIX index from moving towards the inflation target. Of these, the high inflationary expectations, recent increases in some administered prices and the faster growth in nominal unit labour cost are probably the most serious. Wage settlements considerably higher than productivity increases could severely hamper the containment of inflation. In addition, high increases in administered prices are clearly not desirable if we are serious about combatting inflation. The public authorities need to place this matter high on their list of priorities. Discipline is necessary if we want to reach the inflation targets. At the same time, business should realise that the advantages of the still lower external value of the rand could quickly be eroded by excessive price increases.

Provided that this discipline is applied and that there are no further exogenous shocks, the CPIX inflation should start to move towards the inflation target. This is also confirmed by a number of forecasts of inflation generated by our econometric models.

After careful consideration of the recent and expected future economic developments and of the underlying factors that could impact on inflation, the Monetary Policy Committee came to the conclusion that the current level of short-term interest rates is appropriate to bring the rate of inflation within the target range. The Committee therefore decided to keep the repurchase rate of the Bank unchanged at 13,5 per cent per annum.