Statement of the Monetary Policy Committee

14 October 2004

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

Introduction

Inflation has receded to historically low levels and has consistently remained within the CPIX inflation target of between 3 and 6 per cent in the past twelve months. This favourable outcome is mainly the result of disciplined monetary and fiscal policies pursued by the authorities. The low rates of increase in the general price level of South Africa have been recorded in an economic environment characterised by an expansion in real gross domestic product, which has now lasted for nearly 6 years, notwithstanding the recent period of slower growth in the world economy. Achieving low inflation has allowed interest rates to be reduced and has provided an additional platform for economic growth. Increases in the volume of exports were at first mainly responsible for the steady growth in domestic production. More recently, growth in real gross domestic expenditure picked up considerably and reached a level at a seasonally adjusted and annualised rate of 13 per cent in the second quarter of 2004.

The inflation outcome

The twelve-month rate of increase in the consumer price index for metropolitan and other urban areas excluding the interest cost of mortgage bonds (the CPIX) decreased from a peak of 11,3 per cent in October and November 2002 to 5,4 per cent in September 2003. CPIX inflation then remained within the inflation target range and declined further to 3,7 per cent in August 2004. If energy prices are omitted, year-on-year CPIX inflation amounted to 3,5 per cent in August 2004.

The deceleration in inflation can mainly be attributed to slower rates of increase in the prices of consumer goods. The year-on-year rate of increase in the prices of consumer goods decreased from 13,0 per cent in October 2002 to 3,8 per cent in September 2003 and 2,0 per cent in December. It then fluctuated between 2 and 4 per cent in the ensuing period largely depending on adjustments in the prices of petrol and diesel. In August 2004 the year-on-year rate of increase in these prices amounted to 2,1 per cent.

In contrast to the prices of consumer goods, the prices of consumer services remained stubbornly high owing especially to continued high increases in administered prices. The twelve-month rate of increase in the prices of consumer services included in the CPIX at first increased from 7,4 per cent in October 2002 to 8,6 per cent in September 2003. It then declined marginally to 8,1 per cent in February 2004, before moving down more markedly to 6,6 per cent in August.

The significant effect that the recovery in the exchange rate of the rand has had on the improvement in domestic inflation is clearly illustrated by developments in the prices of producer goods. The prices of imported goods, which had increased at a year-on-year rate of 17,2 per cent in September 2002, started to decline from April 2003. Since then these prices have declined continuously for a period of seventeen months. In August the index value of the prices of imported goods was approximately 10 per cent lower than at its peak in October 2003.

The decline in the prices of imported goods has materially influenced the adjustments in the prices of domestically produced goods. Although the prices of goods produced in South Africa continued to increase, the rate of increase slowed down considerably and amounted to a year-on-year level of 2,3 per cent in August 2004. As a result, the year-on-year rate of increase in the all-goods production index was 1,1 per cent in this month.

The inflation outlook

The low rate of increase in production prices augers well for inflation going forward. Thus the inflation outlook over the longer term is promising. The Bank's forecasts show that CPIX inflation should stay within the boundaries of the inflation target range over the next two years, moving moderately higher over the coming year, but thereafter easing somewhat.

A number of factors are probably responsible for this favourable inflation outlook. One of the developments that has led to lower recorded inflation has been the decline in inflation expectations. According to the Survey of Inflation Expectations by the Bureau for Economic Research at the University of Stellenbosch commissioned by the South African Reserve Bank, expected CPIX inflation has declined to within the inflation target range for the three years from 2004 to 2006. This is the first time since the inception of the survey in the third quarter of 2002 that CPIX inflation expectations for all three forecast years have fallen within the target range. This is a welcome development indeed.

A number of other factors support a low inflation outcome. These include the fiscal prudence applied by government, an improved outlook for food prices (despite the serious drought in some parts of the Western Cape), commitment by the public authorities to contain administered price increases and low inflation, on average, in the rest of the world.

As already indicated, the recovery in the external value of the rand since the beginning of 2002 has been a significant factor supporting the positive inflation outcome. The external value of the rand has been relatively steady in 2004. The volatility in the exchange rate of the rand has moderated and the rand has become generally more stable in the foreign exchange markets over this period.

Going forward it is difficult to predict movements in exchange rates. To a large extent the external value of the rand will depend on balance-of-payments developments. The deficit on the current account of South Africa's balance of payments widened in the first half of 2004 to a seasonally adjusted and annualised value of R31,8 billion, or 2,5 per cent of gross domestic product. Preliminary trade figures for July and August indicate that a further deficit on the current account will probably be recorded in the third quarter of 2004.

The deficit on the current account was comfortably financed by large financial inflows. The net financial inflow into the country (including unrecorded transactions) amounted to approximately R40 billion in the first six months of 2004. These inflows consisted mainly of government long-term loans, increases in the short-term liabilities of banks, portfolio capital and trade finance provided by non-residents. The large net financial inflows enabled the Bank to increase the official foreign exchange holdings of the country from US$8,0 billion on 31 December 2003 to US$12,4 billion at the end of September 2004.

The rates of increase in consumption expenditure and capital formation have also led to an acceleration in the growth of gross domestic product and have probably narrowed the gap between potential and actual domestic production.

The favourable projected inflation outcome could also be at risk due to developments in the international oil market. The monthly average Brent crude price of oil has increased from a lower turning point of US$18,60 per barrel in December 2001 to US$29,88 per barrel in December 2003 and US$42,81 per barrel in September 2004. At present Brent crude oil is trading around US$50 per barrel. This increase in international oil prices occurred despite an increase in the production of oil by OPEC countries. Geopolitical developments and a number of disruptions to oil production have led to perceived tight supply conditions, while demand has remained strong as a result of the world economic recovery, particularly high economic growth in China, and stock building.

Over the longer term continued high increases in nominal unit labour cost could put pressure on price increases. Having averaged 5,0 per cent in 2003, the rate of increase in labour cost per unit of production in the formal non-agricultural sectors of the economy rose to a year-on-year rate of 6,3 per cent in the first quarter of 2004 and 7,8 per cent in the second quarter. These increases in unit labour cost were recorded in spite of the fact that the rate of increase in nominal remuneration per worker in the formal non-agricultural sectors of the economy slowed down. However, labour productivity growth decreased in the first quarter of 2004, and in the second quarter of this year labour productivity declined in absolute terms.

In addition, the growth of the monetary aggregates suggests that some inflation pressures could arise over the long term. Growth in the broadly defined money supply (M3), which had been relatively firm in the first six months of 2004 when measured on a year-on-year basis, rose from 11,8 per cent in June to 13,3 per cent in August. The more narrowly defined monetary aggregates increased at even considerably higher rates in July and August 2004. Moreover, the increases in the money supply aggregates were moderated to some extent by disintermediation, i.e. the extension of loans between organisations in the non-bank private sector.

The twelve-month growth rate in credit extension to the private sector, excluding investments and bills discounted, rose from a low of 8,9 per cent in June 2004 to 11,5 per cent in August. In evaluating these growth rates it is important to take into account that they were influenced by the disintermediation practices just referred to, as well as by a shift from domestic to foreign financing of international trade. It was mainly enterprises that undertook these transactions, while households increasingly made use of bank credit extension. This is clearly reflected in the growth of asset-backed loans of banks, which are mainly made to households. In August 2004 these kinds of loans were 18,8 per cent above their level in the same month of the preceding year.

Cognisance may usefully be taken also of the likely impact of external developments, in particular the timing and manner of the processes of adjustment to existing international imbalances.

Monetary policy stance

The Monetary Policy Committee has concluded that leaving the repo rate unchanged at 7,5 per cent per annum at this meeting would be consistent with CPIX inflation remaining within the target range in the forecast period. However, the Committee will continue to monitor the various factors which impact on inflation and will accordingly make any decisions based on the inflation outlook going forward.