Statement of the Monetary Policy Committee

12 August 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

The inflation outcome during the first six months of 2004 was more favourable than had been thought to be the case at the previous meeting of the Monetary Policy Committee. The actual year-on-year increases in the consumer price index in metropolitan and other urban areas when mortgage cost is excluded (CPIX) was much better than forecast. The lower base, combined with the recent rise in the value of the rand, has resulted in a lower projection for CPIX inflation in the next two years. Although CPIX inflation is still expected to rise over the forecast period, it will probably not breach the upper 6-per-cent level of the target range, as previously concluded, provided that the assumptions made in the projection are not too wide off the mark. These results are expected to be achieved in combination with robust growth rates in domestic production as well as demand.

The inflation outcome

The twelve-month rate of increase in the CPIX rose from 4,0 per cent in December 2003 to 4,8 per cent in February 2004, before slowing down to 4,4 per cent in March and remaining at that level for the next two months. In June 2004 CPIX inflation rose to 5,0 per cent mainly due to increases in petrol and diesel prices. This was probably a temporary spike in CPIX inflation because the prices of petrol and diesel were reduced in the next two months. If changes in petrol and diesel prices are excluded from the CPIX, the year-on-year rate of increase in the prices of other consumer goods and services continued to slow down from 4,9 per cent in February 2004 to 4,0 per cent in June. CPIX inflation has now been within the inflation target range for a period of ten consecutive months.

Measured from quarter to quarter at seasonally adjusted and annualised rates, CPIX inflation declined from 7,2 per cent in the first quarter of 2004 to 5,2 per cent in the second quarter. The deceleration in CPIX inflation was discernible in most of the main categories of consumer goods and services and the prices of certain products actually declined, such as those of clothing and footwear, food and soft drinks, and of new and used vehicles.

In contrast to these developments, the running cost of vehicles, and the prices of water, education and alcoholic drinks and tobacco rose at quarterly annualised rates in excess of 10 per cent. The rates of increase over twelve months in the prices of these goods and services and in the cost of medical services were also still well above the upper limit of the inflation target range. These high increases were largely due to changes in administered prices and indirect taxes. However, recent announcements by the government indicate a greater determination to moderate increases in administered prices as part of the co-ordination of policies to achieve the objective of price stability.

The all-goods production price index declined in the second half of 2003 to a lower level in January 2004 owing to a decline in the prices of imported goods and relatively low rates of increase in the prices of domestically produced goods. From February 2004 this index started to move upwards, with the result that the all-goods production price inflation measured over twelve months became positive in May and amounted to 1,3 per cent in June. The quarter-to-quarter rate of increase in production prices, seasonally adjusted and annualised, rose from 0,2 per cent in the first quarter of 2004 to 4,7 per cent in the second quarter. These recent increases in production prices are consistent with the expected rise in consumer prices in the coming months since consumer prices normally react to changes in the prices charged by producers with a time lag.

The favourable inflation outcome was at first achieved with slower growth in the domestic economy. Growth in real gross domestic product deteriorated in 2003 and averaged only 2 per cent for the year as a whole. Production volumes were affected by a hesitant global economic recovery, a deterioration in the international price competitiveness of domestic manufacturers and a decline in agricultural output. In the latter part of 2003 growth started to gather momentum and in the first quarter of 2004 amounted to a seasonally adjusted annualised rate of 3 per cent in reaction to a more accommodative monetary and fiscal policy stance, stronger global growth and increased business and consumer confidence. Data, such as manufacturing and mining output, wholesale and retail trade volumes and the number of new vehicles sold, indicate that the economy continued to grow briskly in the second quarter of the year.

The inflation outlook

As already indicated, the inflation outlook is generally promising and CPIX inflation is expected to stay within the inflation target range over the next two years, but it could move close to the upper boundary of the target range in the second half of 2005. One of the main factors responsible for the recent and expected future low inflation is the decline in import prices, brought about by the further rise in the external value of the rand and low global inflation. Import price inflation, measured over periods of twelve months, has been negative since April 2003, or for a period of fifteen months.

South African import prices will be influenced, in the first instance, by global inflation. As could be expected with the significant increase that has been experienced in international commodity prices since the beginning of 2002, consumer price inflation has started to rise in most of the major industrialised economies. For example, year-on-year core inflation in the United States of America increased from 1,1 per cent in January 2004 to 1,9 per cent in June, and the corresponding rate of increase in the harmonised index of consumer prices in the euro area rose from 1,6 per cent in February 2004 to 2,4 per cent in June. These increases are, however, coming from low levels. A marked acceleration in global inflation to high levels is not foreseen, particularly because of the continued strong productivity growth in some of these countries combined with a tightening in the monetary policy stance.

Import price inflation is also dependent, in the second instance, on the external value of the rand. Having recovered during 2002 and 2003 from the sharp fall in the latter part of 2001, the nominal effective exchange rate of the rand increased by a further 9 per cent until the end of July 2004. This sharp rise in the average exchange rate of the rand has distorted the planning of many enterprises in the country and has had a serious negative impact on international price competitiveness with the resultant stress being witnessed in the export earnings of manufacturing and mining companies. At the same time, the exchange rate of the rand has also contributed to lower imported inflation and, looking forward, to a lower prospective profile of CPIX inflation within the target range.

Currency markets are unpredictable and so is the future performance of the exchange rate of the rand, which is, among other things, subject to balance of payments developments. South Africa's international trade balance has declined from a surplus at a seasonally adjusted annualised rate of about R30 billion in the second quarter of 2003 to nearly R15 billion in the first quarter of 2004 and a deficit of R5,5 billion in the second quarter. However, if special factors affecting the trade balance are excluded, such as purchases of commercial aircraft and military equipment, the trade balance has remained broadly unchanged over the past three quarters. Moreover, the turnaround to a negative overall trade balance did not affect the exchange rate of the rand because it was easily financed by an inflow of capital. The future external value of the rand might depend to a large extent on the behaviour of these financial inflows.

Concern about the influence of another exogenous factor, food prices, has dissipated somewhat. At the beginning of 2004 the Monetary Policy Committee noted the severe drought in many parts of the country, combined with the rise in global food prices. Widespread rains in the summer-rainfall area led to upward revisions of crop estimates, and shortages of maize and other grains should not negatively affect agricultural prices. Despite the heavy rains in the winter-rainfall areas, evidence suggests that some parts are still in the grip of a drought. The recent reversal in global food prices should alleviate pressures that could arise from poor agricultural conditions.

An important positive development on the inflation front has been the declining trend of inflation expectations in the country. This is clearly illustrated by the Survey of Inflation Expectations of The Bureau for Economic Research at the University of Stellenbosch undertaken on behalf of the Reserve Bank in the second quarter of 2004. According to this survey, CPIX inflation expectations have declined continuously. In contrast to this, the break-even inflation rate calculated as the difference between the nominal yield on government bonds and the real yield on inflation-linked bonds within the five-to-nine-year maturity range, has increased in 2004. This approximation of long-term inflation rose from a low of 4,8 per cent in December 2003 to 6,1 per cent in May 2004, before recently declining to 5,6 per cent in July.

A number of other factors support a positive inflation outlook. These include the low levels of utilisation of manufacturing production capacity, continued fiscal prudence and more restraint in administered price increases. In addition, the twelve-month growth in total loans and advances extended by banks to the domestic private sector declined from a peak of 12,6 per cent in February 2004 to 8,9 per cent in June. However, part of this lower growth is due to disintermediation as the corporate sector is funding capital outlays and other expenditure to an increasing extent outside the banking sector.

The most important risks over the short term to this positive inflation outlook are probably global imbalances, exchange rate movements and increases in international oil prices. In particular, the rise in oil prices presents a major threat to inflation over the short term. Brent crude oil prices have increased from levels of around US$24 per barrel in May 2003 to almost US$40 per barrel in May 2004. This rise in international oil prices reflected mainly ongoing geopolitical tensions in the Middle East and a strong demand for oil in the United States and China. Although oil prices declined somewhat in June 2004 to levels of around US$34 per barrel when the OPEC countries stated that they would increase production, this did not last long and at present oil prices are fluctuating around levels of US$42 per barrel. Such high prices will not only have an impact on inflation, but could also neutralise to some extent the recent improvements in the global economy as well as South Africa's terms of trade and growth.

Over the longer term, the current growth in nominal unit labour cost could be a significant threat to low inflation as well. This growth in nominal unit labour cost rose from an average of 5,0 per cent in 2003 to a year-on-year rate of 5,9 per cent in the first quarter of 2004.

Another development which could have an impact on inflation over the long term is the higher rate of increase in domestic demand reflecting the reduction in interest rates, rising real disposable income and the higher priority assigned to infrastructural development. National accounts statistics are not yet available for the second quarter of 2004, but available indicators, such as retail sales, signal that domestic demand continued to increase rapidly in this quarter.

Growth in the money supply also remained relatively brisk, while the income velocity of circulation reached historically low levels in the first half of 2004. The twelve-month growth rate in the broadly-defined money supply (M3) increased from 12,3 per cent in December 2003 to 14,9 per cent in February 2004, before declining to 12,1 per cent in June. Moreover, it was mainly the growth in the transaction demand for money that was responsible for the high rates of increase in M3 during the first half of 2004.

Monetary policy stance

Against this background, the Monetary Policy Committee took note of the moderate improvement in the outlook for inflation noted above, and came to the conclusion that it would be appropriate and prudent to lower the repo rate by 50 basis points to 7,5 per cent per annum with effect from Friday 13th of August 2004. The Committee will continue to monitor the various factors that impact on inflation and will accordingly make any future decisions based on the inflation outlook.