Statement of the Monetary Policy Committee

10 June 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 rate of CPIX inflation has remained well within the target range of 3 – 6 per cent for the past eight months, i.e. from September 2003 to April 2004, despite increases in international oil prices. In general most factors favour a continuation of inflation within this range and inflation expectations have generally improved. Recent evidence indicates that there has been an acceleration in economic growth. South Africa has now experienced eighteen (18) consecutive quarters of economic expansion, this being the longest upward phase of the business cycle on record.

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 11,3 per cent in October and November 2002 to 4,4 per cent in both March and April 2004. Although these latest rates of inflation are marginally above the year-on-year rate of 4,0 per cent in December 2003, they have remained well within the inflation target range.

The rates of increase over twelve months in the prices of consumer goods have been below the lower limit of the inflation target range since October 2003 and amounted to 2,6 per cent in April 2004. By contrast, prices of consumer services continued to increase at year-on-year rates of around 8 per cent over this same period and only recently came down to 7,6 per cent in April 2004. Increases in administered prices were mainly responsible for the continued high increases in the prices of services.

Measured from quarter to quarter and adjusted for seasonal factors, CPIX inflation accelerated from an annualised rate of 1,1 per cent in the fourth quarter of 2003 to 7,2 per cent in the first quarter of 2004. Seasonally adjusted and annualised, the month-to-month increase in the CPIX amounted to 5,8 per cent in April. These higher rates could mainly be attributed to increases in the prices of petrol, alcoholic beverages and tobacco, and were related to increases in international oil prices and excise duties.

In addition to the monetary and fiscal discipline applied by the authorities, the steadier performance of the exchange rate of the rand has continued to contribute to the maintenance of price stability. Improved agricultural conditions from the beginning of 2004 also assisted in moderating consumer food price increases.

However, the prices of fresh meat started to rise rapidly in the first four months of 2004. Together with increases in the rates charged for electricity, gas and water and international oil prices, this contributed to a reversal in the rate of decline in the all-goods production price index. While production prices continued to decrease in the first four months of 2004, the year-on-year rate of decline slowed down from 2,5 per cent in November 2003 to 0,2 per cent in April 2004. This was mainly due to an increase in the year-on-year change in prices of domestically produced goods from 0,2 per cent to 2,1 per cent over the same period. However, the prices of imported goods declined further at relatively high rates in the first four months of 2004.

The inflation outlook

In the short run, developments in international oil prices, through their impact on domestic fuel costs, are likely to be a source of supply-side upwards pressure on inflation. The monthly average spot price of Brent crude oil increased from US$25,0 per barrel in April 2003 to US$37,5 per barrel in May 2004 and on some days exceeded US$40 per barrel. Geopolitical uncertainties together with a strong growth in demand, a curtailment of production and the build-up of strategic stocks were mainly responsible for this price behaviour. Over the short term, the announced intention to increase oil production of OPEC countries in July and August 2004, should hopefully help to reduce prices below recent peak levels. But it is unclear whether prices will fall back fully to the OPEC target band. Over the medium to longer term, oil demand and supply are expected to be more or less in balance which could lead to a correction in international prices.

Against this background and taking all other factors into account, it is possible that year-on-year rates of increase in the CPIX could temporarily breach the upper level of the target band towards the end of 2004 and the early part of 2005. Any such breach is expected to be short-lived, with the likelihood that CPIX inflation will return to within the range shortly thereafter.

Looking further ahead, the inflation outlook generally remains favourable and inflation expectations also support this view.

Despite a sharp rise in international commodity prices, world inflation is expected to remain at low levels. The International Monetary Fund forecasts that the annual percentage change in global consumer prices will decline from 3,7 per cent in 2003 to 3,2 per cent in 2005. This lower inflation is forecast within an environment of continued world economic growth notwithstanding current higher international oil prices.

The rate of increase in domestic production picked up in the first quarter of 2004. Faster growth in output is likely to be sustained throughout this year and 2005 given the strength of domestic demand. For the moment, domestic producers still have considerable excess production capacity, so that at present pressures arising from supply constraints do not appear to be having a marked effect on domestic production price increases. Moreover, the growth rate of total real gross domestic fixed capital formation amounted to 8½ per cent in 2003 and preliminary information indicates that it continued to grow at a high rate in the first quarter of 2004.

Although government in its latest Budget projected the public-sector borrowing requirement as a ratio of gross domestic product to rise somewhat from 2,8 per cent in fiscal 2003/04 to 3,2 per cent in fiscal 2004/05, the budget proposals also indicated that this is intended to be a temporary phenomenon. It is envisaged that this ratio will decline again to 2,7 per cent in fiscal 2006/07, clearly demonstrating the determination of the government to preserve fiscal discipline. Recent announcements by the government indicate a greater determination to take active steps to moderate administered price increases within the context of inflation targeting.

With the exception of meat and deciduous fruit prices, the outlook for most other food prices generally seems to be favourable. Paradoxically, meat prices usually rise with improved agricultural conditions when farmers postpone the marketing of livestock. The prices of deciduous fruit will probably be affected by the current low rainfall in the Western Cape. Favourable agricultural conditions in the rest of the country should help to contain increases in other food prices.

Domestic final demand continued to increase substantially in the first quarter of 2004 as substantiated by indicators such as retail sales, the sales of motor vehicles and credit extension to households. The impact of the increase in domestic expenditure on South Africa's trade balance was moderated somewhat by the acceleration in the growth of domestic production. As a result, the deficit on the current account of the balance of payments is likely to be smaller than was the case in the fourth quarter of 2003.

Preliminary estimates suggest that this deficit was more than fully financed by a surplus on the financial account, including unrecorded transactions. These transactions enabled the Reserve Bank to increase its gross international reserves further from US$8,2 billion at the end of December 2003 to US$10,0 billion at the end of March 2004. At the end of May 2004 these reserves stood at about US$10,5 billion. In view of these developments the external value of the rand has been more stable in the first five months of 2004 than in the preceding three years.

Growth in money supply and total loans and advances of banks remains fairly brisk while the income velocity of circulation was at a historically low level of 1,6 in the first quarter of 2004. The twelve-month growth rate in the broadly defined M3 increased from 12,3 per cent in December 2003 to 14,9 per cent in February 2004, before coming down to 12,4 per cent in April. Twelve-month growth in total loans and advances of around 12 per cent was recorded from April 2003 to March 2004. In April this growth receded to 9,9 per cent, mainly on account of high base effects.

The increase in the average nominal remuneration per worker amounted to 8,6 per cent in 2003 and wage settlements in collective bargaining agreements are predicted to average between 7½ and 8½ per cent for 2004. Although this indicates a declining trend when compared with the year-to-year rate of increase in labour remuneration per worker of about 9½ per cent in 2002, it is still considerably in excess of productivity increases. Nominal unit labour cost accordingly continued to increase at high rates. Particularly disconcerting is the fact that nominal unit labour cost in manufacturing enterprises rose by as much as 11,2 per cent in 2003. This could give rise to inflationary pressures in domestic production prices.

Monetary policy stance

Taking the above-mentioned factors into consideration, in particular the risks to the inflation outlook, together with further increases in domestic demand, the Monetary Policy Committee has nevertheless decided to maintain the current monetary policy stance and keep the repo rate unchanged at 8,0 per cent per annum. The Monetary Policy Committee will continue to monitor all the risk factors to the inflation outlook. If the outlook changes, the Committee will review its stance.