Statement of the Monetary Policy Committee

22 April 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

In the first two months of 2004 the rate of CPIX inflation has risen moderately but remains well within the target range of 3-6 per cent. This increase in the inflation rate was nevertheless slightly less than the forecast of the Reserve Bank. The Reserve Bank's projections for the inflation rate in the first two months of the year were higher than the actual figures. These results are therefore still within our projections indicating that the rate of inflation is likely to remain in the inflation target range over the next two years.

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) rose from 4,0 per cent in December 2003 to 4,2 per cent in January and 4,8 per cent in February 2004. If energy and food prices are excluded, the year-on-year rate of increase in the prices of other goods and services included in the CPIX has fluctuated around a level of about 5,7 per cent over the four months up to February 2004.

The higher level of CPIX inflation excluding energy and food prices was due to continued high increases in the prices of services. The twelve-month rate of increase in the prices of services included in the CPIX measured around 8 per cent during the first two months of 2004. In particular, high rates of increase were recorded in the rent of fixed property, medical costs and educational fees and the wages of domestic workers were adjusted upwards by the Minister of Labour's determination. The consumer prices of goods on a year-on-year basis rose from 2,0 per cent in December 2003 to 3,0 per cent in February 2004 largely due to increases in the running cost of motor vehicles.

Measured from month to month and adjusted for seasonal factors, CPIX inflation rose from low rates of increase in the last three months of 2003, to levels of 1,0 per cent in January 2004 and 0,8 per cent in February. These monthly rates were the result of increases in the prices of petrol and diesel, food, alcoholic drinks and medical expenses. The prices of goods and services for most other categories continued to decline in the first two months of 2004.

The inflation outlook

Despite these increases in the CPIX, the inflation outlook over the coming months as well as over the longer term continues to be favourable. Recent developments in the production price index, which affect the CPIX with a short lag, should continue to restrain consumer price inflation over the short term. From the second half of 2003, the all-goods production price index has generally declined from month to month. The seasonally adjusted percentage change over one month in the production price index in January 2004 was again negative, followed by an increase of 0,1 per cent in February. Measured over a period of twelve months, the all-goods production price index has declined in every month since September 2003, but the rate of decline has moderated somewhat from 2,5 per cent in November 2003 to 1,0 per cent in February 2004.

This decline in production price inflation can mainly be ascribed to the recovery in the external value of the rand. The year-on-year change in the prices of imported goods became negative in April 2003, and in February 2004 this rate of decline amounted to 8,0 per cent. The decline in the prices of imported goods affected the inflation in domestically produced goods, which slowed down considerably during the course of 2003. The twelve-month rate of increase in the prices of domestically produced goods picked up somewhat from 0,2 per cent in November 2003 to 1,6 per cent in January 2004.

These developments clearly indicate that production prices should exert hardly any pressure on consumer prices over the short term. The expected developments in the CPIX over the coming months will mainly be related to exogenous developments, such as changes in energy prices, indirect taxes and food. As the second-round effects of these increases are expected to be small and because a number of other factors are still favouring low increases in prices, the long-term inflation outlook is still promising.

The expected acceleration in global economic growth noted in previous statements of the Monetary Policy Committee, has now been confirmed by recent international statistical releases. In the USA, the UK, Japan, China and other countries in Asia, economic growth was quite strong in the second half of 2003. A moderate economic recovery also became discernible in the production figures of the euro area. The growth in the world economy has been accompanied by a steep increase in international commodity prices. Despite this rise in commodity prices, world inflation has remained at low levels and is expected to remain so for the rest of 2004.

Some pressure has been exerted on domestic prices by the increase in oil prices in 2004 due to output restrictions by OPEC, political tensions in the Middle East and Venezuela, and concerns about oil stocks in the United States. Although this may give rise to short-term increases in consumer prices, oil prices should, however, not be a major threat to inflation over the long term because oil demand and supply are expected to be more or less in balance.

Domestically, most conditions seem to endorse the containment of inflation within the target range. Domestic demand conditions are not at present a source of inflationary pressure, with the growth in real gross domestic product at an annualised rate of 1½ per cent in the fourth quarter of 2003 being well below the growth potential of the economy. This is confirmed by the ample spare capacity in manufacturing where the utilisation of production capacity amounted to 79,6 per cent in the fourth quarter of 2003. It is particularly noteworthy that inflation expectations have continued to decline as evidenced in the latest Bureau for Economic Research (Stellenbosch University) inflation expectations survey, commissioned by the South African Reserve Bank, published today.

The widespread rains in the first three months of 2004 have improved the agricultural outlook considerably. Most crop estimates have been revised upwards and shortages of agricultural produce should not have a serious impact on food prices. This is also reflected in the recent decline in the maize price. Over the short term, the improved weather conditions could lead to higher meat prices as farmers will now probably be inclined to build up their herds of livestock.

Another important factor that should contribute to price stability is the continued fiscal discipline applied by government. The fiscal policy announced in the Budget for the fiscal year 2004/05 is being pursued in a prudent manner which should not place pressure on domestic prices.

As with any prognosis about likely future developments, there are a number of uncertainties that could impact on this outlook and which the MPC will continue to monitor closely. Strong domestic demand has had a big impact on the volume of imports, which rose sharply in the second half of 2003. Over this same period exports did not perform well. Fortunately, these developments were offset to some extent by a substantial improvement in South Africa's terms of trade, reflecting the increases in international commodity prices. The deficit on the current account of the balance of payments nevertheless amounted to 1,8 per cent of gross domestic product in the fourth quarter of 2003. Trade statistics for the first two months of 2004 indicate that the current-account deficit probably increased further over these two months. The surplus on the trade account of the balance of payments declined from a seasonally adjusted annualised level of R14,3 billion in the fourth quarter of 2003 to R7,6 billion in the first two months of 2004.

The deficits on the current account of the balance of payments have been comfortably financed by inflows of capital. Moreover, the rand has demonstrated greater stability in recent months with the nominal effective exchange rate of the rand currently at around the same level that it was at in the latter part of 2003. It is impossible to predict what the external value of the rand will be over the coming months, but a widening in the deficit on current account does increase the risk of accelerating inflation.

A further factor when considering the inflation outlook is the continued strong growth in nominal unit labour cost. Although the rate of increase in these costs has declined from 6 per cent in 2002 to 5 per cent in 2003, the salaries and wages per worker still increased at a rate of 8,6 per cent in 2003.

The recent growth in money supply may also be an early indicator of potential inflationary pressures in the longer term. Measured over twelve months, growth in M3 remained around 12 per cent from September 2003 to January 2004 and then accelerated to just above 15 per cent in February. This latest month's increase in M3 was to a large extent due to a decline in government deposits reflecting the redemption and coupon interest payments on government bonds.

The increase in money supply growth was not accompanied by an acceleration in bank credit extension to the private sector. The twelve-month growth rate in total loans and advances of banks to the private sector remained stable at levels of around 12,5 per cent in the first two months of 2004, i.e. at about the same rate as during the last half of 2003.

The process of adjustment of global economic imbalances, and the risk of continuing geopolitical tensions, could be a source of increased international instability which could impede the present recovery in the world economy and pose threats to low inflation and growth in emerging-market economies. In the short term, a particular concern in this context is the risk of pressure on domestic fuel costs arising from the prevailing higher oil prices.

Monetary policy stance

Taking these factors into consideration, the central expectation of the Monetary Policy Committee is that CPIX inflation will remain within the target range during the forecast period while the economy should pick up momentum. This momentum could be greatly assisted by appropriate sustainable supply-side measures. Accordingly the Monetary Policy Committee has 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 factors affecting the inflation outlook. If the outlook changes, the Committee will not hesitate to change the monetary policy stance.