Statement of the Monetary Policy Committee
11 December 2003

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 *Medium Term Budget Policy Statement* released on 12 November 2003 it was announced that the Bank's inflation target, previously specified as an annual average, will henceforth take the form of a continuous inflation target of between 3 and 6 per cent for CPIX inflation measured over a period of twelve months. It is the well-considered view of the Government and the South African Reserve Bank that this change should lead to a more effective management of monetary policy and inflation expectations. Since September, CPIX inflation has been within the target range and the Bank's task will continue to be to keep it within the lower and upper boundaries of the band.

Developments in inflation

Twelve-month CPIX inflation declined from a peak of 11,3 per cent in October 2002 to 5,4 per cent in September 2003. It then declined further to 4,4 per cent in October 2003. The inflation rate was brought to the mid-point of the target range by the sustained maintenance of prudent monetary and fiscal policies together with the recovery in the international exchange value of the rand and a moderation in food price increases. The quarter-to-quarter rate of change in CPIX inflation also declined sharply from a seasonally adjusted and annualised rate of 12,1 per cent in the fourth quarter of 2002 to 2,2 per cent in the second quarter of 2003, before rising to 5,1 per cent in the third quarter.

More particularly, a slower rate of increase in the prices of consumer goods was mainly responsible for the improvement in overall inflation. Measured over periods of twelve months, the rate of increase in the prices of consumer goods came down from a recent high of 13,0 per cent in October 2002 to 2,1 per cent in October 2003. The most significant deceleration was displayed by changes in food prices. The twelve-month rate of increase in food prices declined from 20,9 per cent in October 2002 to 2,4 per cent in October 2003.

As the prices of services respond with a delay to exchange rate changes and a number of service providers do not face much competition in the domestic market, the rate of increase in the prices of services excluding mortgage costs has on balance risen during 2003. Measured over a period of twelve months, service inflation rose from a low of 6,2 per cent in March 2002 to 8,6 per cent in September 2003, before declining marginally to 8,3 per cent in October. Household costs and the prices charged for communication, education and health services were mainly responsible for the rise in service price inflation. The stickiness of administered prices was therefore to a large extent responsible for the persistence of higher service price inflation.

The inflation outlook

The inflation outlook over the coming months as well as over the long term can be described as promising. The favourable short-term outlook is confirmed by recent developments in production price inflation, which generally affects consumer price inflation with a short lag. As a result of declines in the prices of imported goods and a considerable slowdown in the rates of increase in the prices of domestically produced goods, the year-on-year rate of increase in the all-goods production price index slowed down from 15,4 per cent in September 2002 to 0,2 per cent in August 2003. In September and October the twelve-month rate of change in production prices even became negative. These declines should contribute to a continuing moderation in consumer price inflation over the short term.

Over the longer term most conditions also seem favourable for the containment of CPIX inflation. The international economic environment has improved considerably in recent months. Indicators generally seem to signal stronger economic performance in the United States and a number of Asian countries, especially China. A stronger world economy should benefit international commodity prices, in particular, and South African exports in general. The acceleration in global growth is expected to have only a small impact on prices and world inflation will probably remain at low levels.

The expected acceleration in global economic growth will probably be accompanied by rising international interest rates. Both the Reserve Bank of Australia and the Bank of England have already increased their official interest rates.

Oil prices are not expected to be a major threat to domestic inflation in the coming months. The world oil demand and supply generally seem to be in balance, with relatively large oil inventories in OECD countries. Moreover, conditions favour a more rapid increase in production than in demand. Most analysts therefore expect oil prices to decline somewhat in the next two years.

Domestically, most conditions also seem to endorse the maintenance of price stability. The growth in real gross domestic product at 2 per cent in the first nine months of 2003 compared to the same period in the preceding year, is clearly well below the growth potential of the country. This is confirmed by the ample spare capacity in the manufacturing sector where the utilisation of production capacity amounted to 80,6 per cent in the third quarter of 2003.

In view of the success achieved with the lowering of the inflation rate, inflation expectations in South Africa have declined during the past year. The results of the Survey of Inflation Expectations undertaken for the South African Reserve Bank by the Bureau for Economic Research (University of Stellenbosch) show that inflation expectations have come down further in the fourth quarter of 2003. However, at 6,4 per cent in 2004 and 6,7 per cent in 2005, the public on average still expect the inflation rate to remain above the upper boundary of the inflation target in the next two years.

In addition, monetary conditions signal a continued positive environment for low inflation. Measured over twelve months, growth in the broadly defined money supply (M3) registered a ten-year low rate of 5,1 per cent in August 2003 before picking up somewhat to 5,5 per cent in September and 6,2 per cent in October. However, bank credit extension continued to increase at rates of about 12 per cent over a twelve-month period. Bank credit extension to households has increased strongly related to a corresponding relatively high growth in personal disposable income, lower interest rates and a prolonged period of high house price increases. In addition, companies made use of alternative sources of finance such as corporate bonds and commercial paper.

Fiscal policy is expected to remain disciplined. Although the *Medium Term Budget Policy Statement* 2003 sets out a strategy to endorse growth and development through investment in infrastructure, education and skills development, poverty reduction and public service delivery, the increased expenditure will be financed in such a way as not to threaten price stability. The national government deficit is projected to average about 3 per cent of gross domestic product over the next three fiscal years and will be financed mainly from domestic sources without crowding out the needs of the private sector.

Despite these favourable international and domestic conditions, projections made with the Reserve Bank's forecasting models indicate that inflation pressures could start to build up in 2005. These forecasts show that the rate of inflation in CPIX could reach a lower turning point in the course of 2004 and edge up to higher levels in 2005. CPIX inflation should, however, remain below the upper boundary of 6 per cent of the inflation target.

The main reason for this projected increase in inflation pressures is the strong domestic final demand for goods and services. In the first nine months of 2003, compared with the same period in the preceding year, the growth in domestic final demand amounted to no less than 4 per cent. Growth in personal disposable income and an increase in bank credit extension caused real private consumption expenditure to rise by about 3 per cent over this period, while real government consumption expenditure increased by 4 per cent and fixed capital formation by 9 per cent. The reduction of the repo rate by 500 basis points between June and October 2003 is expected to contribute to further increases in domestic final demand in 2004. Although some of this increased demand will be met by imported goods, domestic economic performance should eventually move closer to potential growth and start to put pressure on prices.

The foreseen strong domestic demand could also impact on the current account of the balance of payments through increased imports. However, this should be countered to a large extent by the expected international economic recovery and an increased demand for South African exports and rising international commodity prices. The projected deficit on the current account of the balance of payments should therefore not lead to inflation pressures provided that it continues to be financed by financial inflows.

Other risks to the forecasted inflation outcome over the next two years include:

- Changes in the rate of increase of food prices. A slowdown in the rate of increase in food prices was a major contributing factor to the lower rate of CPIX inflation achieved during 2003. At present, climatic conditions are generally viewed as being unfavourable and thus expectations are that crop output could be poor. Even if this situation should improve, it is unlikely that developments in food prices will again make such a major contribution to the lowering of inflation in the next year.

- The exchange rate. The recovery in the external value of the rand during both 2002 and 2003, had a major impact on the lowering of inflation in the course of the latter year. The appreciation in the exchange rate of the rand, together with low international inflation, has contributed to a decline in the measured prices of imported goods over twelve months since April 2003. It is impossible to predict what the external value of the rand will do over the coming months.

- Nominal unit labour cost. Wage settlements which exceed increases in labour productivity with a considerable margin can give rise to substantial increases in unit labour costs and price pressures. Wage settlements during the past year averaged around 9 per cent, while growth in labour productivity has continued to slow down to low levels. It is anticipated that wage settlement rates could decelerate significantly during 2004 as they will be negotiated against the background of lower rates of inflation. Wage increases could nevertheless still be well above productivity increases, leading to further increases in nominal unit labour costs.

Monetary policy stance

As already indicated, interest rates have been reduced significantly during the last half of 2003. These decreases in interest rates were undertaken after careful consideration of the inflation outlook at the time to ensure that CPIX inflation moves into and remains within the inflation target. With inflation expected to remain within the target range in the forecast period looking ahead, and taking the above-mentioned risks into account, the Monetary Policy Committee (MPC) has decided to reduce the repo rate by 50 basis points to 8,0 per cent per annum as of 12 December 2003. The MPC will continue to monitor all the risk factors to the inflation outlook. If the outlook deteriorates, the committee will not hesitate to change the monetary policy stance.