Statement of the Monetary Policy Committee

26 February 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

Since the previous meeting of the Monetary Policy Committee the rate of CPIX inflation has remained below the mid-point of the inflation target range. The success achieved in bringing inflation down to levels last experienced in the 1960s has been a major accomplishment of the macroeconomic policies pursued by the authorities, prudent monetary policy, disciplined fiscal policy, the significant recovery in the external value of the rand and the moderation in food price increases.

All indications are that, on the basis of this improved inflation performance, the pick-up in growth that is already evident is likely to improve during 2004 and 2005.

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 6,3 per cent in August 2003, and moved below the 6 per cent upper limit of the inflation target range to a value of 5,4 per cent in September. CPIX inflation then slowed down further to a year-on-year rate of 4,0 per cent in December 2003, before increasing marginally to 4,2 per cent in January 2004. For the year 2003 as a whole CPIX inflation averaged 6,8 per cent, compared with 9,3 per cent in 2002.

Measured from quarter to quarter, the slowdown in CPIX inflation was even more impressive. This rate of increase in the CPIX decreased from a seasonally adjusted and annualised level of 12,4 per cent in the second quarter of 2002 to 1,2 per cent in the fourth quarter of 2003.

A number of factors contributed to the deceleration in the inflation rate in South Africa. Particularly important in this context was the 4 percentage points increase in the repo rate during 2002. This restrictive monetary policy stance and the discipline applied in government finances led to a decline in inflation expectations. The recovery in the exchange rate of the rand from the beginning of 2002 assisted in this process and eventually led to a decline in the prices of imported goods. In addition to these more fundamental factors, slower rates of increase in food and energy prices also contributed to the lowering of inflation. In fact, if energy and food prices are excluded from the CPIX, the twelve-month rate of increase in the prices of other goods and services declined from a peak of 8,0 per cent in November 2002 to 5,6 per cent in January 2004.

Prices for services excluding the cost of mortgage bonds remained sticky. After fluctuating around a level of 8 per cent in the first nine months of 2003, the twelve-month rate of increase in these prices moderated somewhat from a peak of 8,6 per cent in September 2003 to 7,8 per cent in January 2004. By contrast, the rate of increase over twelve months in the prices of consumer goods fell from 13,4 per cent in October 2002 to 2,2 per cent in January 2004.

A slowdown in the rate of increase in the prices of domestically produced goods and the decline in the prices of imported goods caused the year-on-year rate of increase in the all-goods production price index to decrease from 15,4 per cent in September 2002 to 0,2 per cent in August 2003. Subsequently, the production price index declined throughout the last five months of the year. For the year 2003 as a whole, overall production prices rose by (+)1,7 per cent compared to 14,2 per cent in 2002. The year-on-year rate of decrease in the all-goods production price index moderated from (-)1,8 per cent in December 2003 to (-)1,4 per cent in January 2004.

The inflation outlook

Not only did the inflation outcome improve since the previous meeting of the Monetary Policy Committee, but the inflation outlook generally also remained favourable. Most analysts and economic commentators expect CPIX inflation to remain within the inflation target range over the next two years. Inflation is projected to accelerate moderately in the course of 2004 to levels close to the upper limit of the inflation target, followed by somewhat slower rates of increase during 2005. These expected developments are consistent with projections made by the Reserve Bank's core econometric and other models.

A number of factors will probably help to keep inflation within the target range during the next two years. Firstly, the generally low inflation in the rest of the world will continue to assist South Africa in containing domestic inflation. Strong global economic growth driven by the United States and Asia is expected to occur in an environment of relatively stable prices which bodes well for domestic price increases.

Secondly, the slowdown in aggregate domestic production in 2003 has led to a decline in the utilisation of production capacity of manufacturing enterprises from a seasonally adjusted rate of 81,2 per cent in the third quarter of 2002 to 79,6 per cent in the fourth quarter of 2003. Although the world economic recovery has set in motion an upswing in international commodity prices, some of these benefits to economic growth in South Africa have been neutralised by the exchange rate developments. Moreover, real gross domestic fixed investment again increased significantly in 2003. As a consequence, the acceleration in domestic economic growth is unlikely to lead to capacity constraints in the near future.

Thirdly, the fiscal discipline applied by government has materially contributed to the lowering of inflation and the Budget for fiscal year 2004/05 is supportive of the inflation target.

Fourthly, oil prices are not expected to be a threat to domestic price increases in the next two years despite the recent increases in the retail prices of petrol and diesel. The world oil demand and supply seem to be more or less in balance and OPEC continues to manage production limits to avoid large disruptive price movements. Most analysts still expect oil prices to decline somewhat in the coming months.

Lastly, but by no means least, the recommended tariff increases of some public utility companies also auger well for the inflation outlook.

Although the inflation outlook is generally positive, certain recent developments signal a moderate increase in CPIX inflation during 2004, which will have to be carefully monitored by the Monetary Policy Committee. Of particular concern is the consistent tendency of the wage settlement process to ignore the forward-looking inflation target. The carry-over effect of these tendencies will continue to put pressure on price increases in 2004. An anticipated moderation in wage settlement rates in the course of the year in line with the inflation target and a rise in productivity could, however, lead to lower rates of increase in nominal unit labour costs.

Another development which could cause higher increases in consumer prices is the severe drought in some parts of South Africa. Low rainfall in important agricultural regions is expected to reduce the maize and other grain crops in 2004. This could be neutralised to a large extent by the run down of inventories or the increase in imports, but the future price of maize has already increased substantially from the beginning of December 2003. An anticipated rise in international food prices could also lead to an acceleration in the prices of domestic food products. Even if these effects on food prices are small, it seems unlikely that the positive impact that food prices had on the lowering of the inflation rate during 2003 will again occur in 2004.

Perhaps even more important for the future inflation outlook is the continued acceleration in the growth of domestic final demand for goods and services. National accounts statistics are not yet available for the fourth quarter of 2003. However, many indicators, such as retail trade at constant prices, the purchases of new and used vehicles, and electricity consumed, signal that domestic demand continued to increase at a high rate during the last half of 2003. Moreover, the full effect of the substantial reduction in interest rates from June 2003 will only become apparent in the course of 2004.

As the growth in domestic demand exceeded the rate of increase in production, the surplus on the current account of the balance of payments in 2002 changed to a deficit in the first quarter of 2003. Trade statistics for the fourth quarter of the year indicate that this deficit could have widened further to a preliminary estimated 2 per cent of gross domestic product. Although this is a sizeable deficit, it was easily financed by the surplus on the financial account. This financial inflow also paved the way for a build-up of net foreign reserves.

A further deficit on the current account of the balance of payments is projected for 2004, but this deficit is not expected to exceed 2 per cent of gross domestic product. However, it seems unlikely that the positive effect that the significant recovery in the exchange rate of the rand had on inflation during 2003 will be as pronounced this year.

The high domestic demand has been financed to some extent by means of bank credit extension and the issuing of bonds by government and the private sector. The total net issues of fixed-interest securities listed on the Bond Exchange of South Africa of both the public and private sector amounted to R59,1 billion in 2003, compared with net redemptions of R10,1 billion in 2002. The year-on-year growth in underlying bank credit extension to the private sector (i.e private-sector credit extension excluding investments and bills discounted) has risen from 7,8 per cent in December 2002 to around 12 per cent since April 2003 and amounted to 12,9 per cent in December. However, quarter-to-quarter growth in such advances slowed down from a seasonally adjusted and annualised rate of 22,3 per cent in the second quarter of 2003 to 7,4 per cent in the fourth quarter.

Growth in money supply remained relatively subdued. Growth over twelve months in the broadly defined money supply (M3) slowed down to a ten-year low of 5,1 per cent in August 2003, before picking up to 8,4 per cent in December. Similarly, the quarter-to-quarter seasonally adjusted and annualised growth in M3 declined from 13,1 per cent in the second quarter of 2003 to 4,4 per cent in the third quarter and rose to 9,5 per cent in the fourth quarter. This moderate growth in money supply reflected the low growth in domestic economic activity, the low inflation environment and lower interest rates on deposits of all maturities. To some extent it was also due to the substitution of investments in promissory notes of banks not included in money supply for investments in negotiable certificates of deposits which form part of money supply due to a change in the regulations regarding stamp duties payable on these instruments.

Monetary policy stance

Taking these factors into account, 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 continues to pick up momentum. 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 risk factors to the inflation outlook. If the outlook changes, the committee will not hesitate to change the monetary policy stance.