Statement of the Monetary Policy Committee

9 June 2005

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 (MPC) there have been a number of developments significant for monetary policy. Although still at relatively high levels, the international oil price appears to have stabilised somewhat at more moderate levels than in March and April. At the same time there has been a significant strengthening of the US dollar against the euro, which contributed to the recent depreciation of the rand. Domestically, expenditure and credit extension remain robust, while a contraction in the manufacturing sector has resulted in a moderation of overall output growth. Although the inflation outlook has changed somewhat, CPIX inflation is still expected to remain well within the target range during the forecast period.

Recent developments in inflation

The rate of increase in the consumer price index for metropolitan and other urban areas less mortgage interest cost (CPIX) has remained within the mandated target range of 3 – 6 per cent since September 2003. Year-on-year CPIX inflation rose from the February low of 3,1 per cent to 3,6 per cent and 3,8 per cent in March and April, respectively. This recent upward trend has been due almost entirely to consecutive increases in the petrol price totalling 82 cents per litre in March and April. Most of the short-term volatility in the inflation rate over the past few months can be attributed to petrol price developments. If petrol and diesel prices are excluded, annual CPIX inflation increased marginally from 3,2 per cent in February to 3,3 per cent in March and April. The annualised quarter-on-quarter seasonally adjusted rate of increase of CPIX in the first quarter of this year amounted to 2,1 per cent compared to 5,0 per cent in the fourth quarter of 2004.

Inflation in the other categories of the CPIX index has remained well contained, although services prices have increased marginally over the past two months to a year-on-year 6 per cent rate in April compared to 5,6 per cent in February. Goods price inflation over the same period rose from 1,8 per cent to 2,7 per cent. Food price inflation remained subdued at 1,4 per cent in April while prices of furniture, vehicles and clothing and footwear continued to decline. Administered prices (as measured by Statistics South Africa) were strongly influenced by petrol price changes. However, if we exclude this component, annual administered price inflation continued its declining trend from 6,9 per cent in February to 6,7 per cent in April, still above the upper end of the inflation target range.

The higher international oil prices also had an impact on production price inflation, although the impact was cushioned in part by the rand exchange rate. Year-on-year changes in production prices measured 1,9 per cent and 1,8 per cent in March and April respectively, up from the 1,2 per cent measured in February of this year.

The outlook for inflation

The inflation outlook, although still generally favourable, has changed somewhat as a result of a number of recent developments. Perhaps the most significant development since the previous MPC meeting has been the behaviour of the rand exchange rate.

Since the previous meeting the rand has moved from R6,18 against the US dollar to a level of around R6,80 on 9 June, after having reached levels of over R6,90 during May.

Although the rand exchange rate was affected primarily by US dollar movements, the rand depreciated moderately against the euro as well. On a trade-weighted basis, the rand has depreciated by about 5,7 per cent since the previous meeting. At current levels the rand is within the range in which it traded for much of last year, although the move back to this trading range is unlikely to have a significant impact on the inflation outlook.

The rand exchange rate is likely to continue to be dominated by US dollar developments. Although US growth estimates for 2005 have been scaled back moderately, it is expected to significantly outperform growth in the euro area, Japan and the United Kingdom. Nevertheless, significant macroeconomic imbalances remain, contributing to the uncertain outlook for the US dollar.

Although the inflation outlook is not expected to be markedly affected by these recent exchange rate developments, in the near term the impact will be seen on the petrol prices which are determined primarily by the international crude oil prices and the exchange rate. The international price of Brent crude oil declined from levels of around US$55 per barrel at the time of the previous MPC meeting and stabilised at lower levels, averaging around US$48 per barrel in May. The lower international oil price allowed for a 16 cents per litre petrol price reduction in June, after the further 20 cent per litre increase in May. Although the international oil prices have moved in a relatively narrow trading range over the past few weeks, Brent crude has risen again above the US$50 per barrel level in the past few days, reflecting the uncertainty and volatility in the market. The combination of these higher prices and the current levels of the rand are likely to result in a further increase in the domestic petrol price in July.

Domestically, expenditure continues to expand at a robust pace, although there were signs of some moderation in the first quarter of 2005. The twelve-month rate of increase in real retail sales was 6,8 per cent in March, up from the 3,4 and 6,0 per cent increases in January and February respectively, but below the annual average increase of almost 10 per cent in 2004. Motor vehicle sales again reached record levels in May when a year-on-year increase of 30,7 per cent was recorded. The property market has also remained firm, although the rate of increase in prices has moderated significantly. Higher real disposable incomes as a result of wage settlements in excess of inflation, together with lower interest rates are likely to give continued support to domestic demand. Provisional estimates show that household debt as a proportion of disposable income rose to 60 per cent in the first quarter of this year compared to 58 per cent in the fourth quarter of 2004. The debt service ratio, however, remains low at around 6,5 per cent.

The high levels of expenditure have been reflected in stronger growth in the money supply and credit extension in particular. Growth in M3 has continued at an annual rate of around 12 per cent, although it accelerated by 13,9 per cent in April. M3 deposit holdings of households increased by 9 per cent year on year, compared to 16,5 per cent for the corporate sector. The twelve-month growth in total loans and advances increased to 19,7 per cent in April, compared to increases of around 17 per cent in the previous three months. The year-on-year growth in asset-backed credit remained at around 23 per cent in March and April, reflecting the strong demand for durable goods and mortgage advances.

Lower inflation expectations remain entrenched, with the latest survey from the Bureau for Economic Research at the University of Stellenbosch showing little change from the previous quarter. Inflation expectations for all categories of respondents are still comfortably within the inflation target range for the next three years. Although there was a slight increase in the forecasts of the market analysts, this was offset by a similar decline in inflation expectations of the trade unionists. Also noteworthy is the fact that new business executive respondents had the same low expectations as those who have participated for some time.

Potential pressure on inflation from the supply side of the economy has dissipated. Growth in gross domestic product (GDP) declined from an annualised rate of 4,0 per cent in the fourth quarter of 2004 to 3,5 per cent in the first quarter of 2005. As expected, the slower growth was due primarily to the 1,9 per cent contraction in the manufacturing sector. This was partly a consequence of the strong rand which impacted negatively on the export and import-competing subsectors of manufacturing. This trend was also reflected in the continued downward trend in the leading business cycle indicator and the decline in manufacturing capacity utilisation from 85,5 per cent in the third quarter of 2004 to 84,6 per cent in the first quarter of this year. The slower rate of growth of 2,7 per cent in the agricultural sector also contributed to the overall slowdown. By contrast, the mining sector grew by an annualised rate of 9,1 per cent. The volume of gold production, however, declined to its lowest level since the 1930s. When measured over four quarters, GDP growth was 4,2 per cent.

The high expenditure growth has also resulted in a higher value of merchandise imports, although the increase of 2,5 per cent in April was significantly less than the 10,1 per cent increase recorded in March. Exports, however, which have been increasing steadily since February rose by 7,1 per cent in April. These developments have resulted in an improvement in the trade balance, and may result in a moderate decline in the overall current account deficit which measured 4 per cent of GDP in the fourth quarter of last year. By the end of May gross foreign exchange reserves had increased to US$17,2 billion, and the international liquidity position had increased to US$13,7 billion. The increase in reserve levels reflects a combination of foreign exchange operations conducted by the Bank for own account as well as on behalf of customers, including foreign exchange purchases arising from a foreign direct investment (FDI) transaction.

Other supportive factors include the benign world inflation which has been affected only marginally by the higher international oil prices, and continued fiscal discipline in South Africa. Administered price increases are still above the upper end of the inflation target range, but the downward trend continues, although at a slow pace. Food price inflation has remained low while production price developments also indicate that there are few pressures emanating from rising input costs in the short run.

The risks to the inflation outlook appear to be fairly evenly balanced. According to the forecasting model of the Bank, CPIX inflation is still expected to remain comfortably within the target range of 3 – 6 per cent for the forecast period. The central forecast is for CPIX inflation to peak in the first quarter of 2006 at a slightly higher level than previously forecast, and then to decline to a level of around 4,8 per cent at the end of the fourth quarter of 2006. This moderately higher forecast is in part a consequence of revised expectations relating to petrol prices and the exchange rate, and the easing in monetary conditions.

Monetary policy stance

Taking all of the above into consideration the Monetary Policy Committee has come to the conclusion that the current monetary policy stance remains appropriate to maintain inflation within the target range. This means that the repo rate remains unchanged at 7 per cent per annum. The MPC will continue as usual to monitor closely all the developments in the economy and the factors influencing inflation, and will stand ready to adjust the stance in either direction if necessary, depending on the outlook for inflation.