Statement of the Monetary Policy Committee

14 April 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

Over the past two months, the global environment has continued to be characterised by uncertainty. International oil prices have reached record highs despite increases in output quotas by the Organization of the Petroleum Exporting Countries (OPEC) and have confounded expectations of a short-lived spike. Higher oil prices have resulted in a downward revision of global growth estimates. The imbalances in the US remain, and the outlook for the dollar remains uncertain. Against the dollar, the rand has generally traded in a range higher than that in 2004.

Domestically, expenditure remains strong and the robust economic growth has been accompanied by six consecutive quarters of employment growth in the formal non-agricultural sectors of the economy. However, there has recently emerged evidence of some slackening of activity in the manufacturing sector. Despite the uncertain global environment, the inflation outlook remains favourable.

Recent developments in inflation

Inflation as measured by the consumer price index for metropolitan and other urban areas excluding the interest cost on mortgage bonds (CPIX) has remained within the inflation target range of 3 – 6 per cent for the past 18 months. After declining to 3,6 per cent in January of this year, it declined further to 3,1 per cent in February. This is the lowest rate of increase of CPIX since the inception of this measure of inflation. The recent downward movement was due, in part, to consecutive decreases in the petrol price totaling 65 cents per litre between December 2004 and February 2005.

Increases in most of the other components of the CPIX were also well contained, while footwear and clothing prices continued to decline. Food prices also continued to increase at a subdued year-on-year rate of 1,6 per cent in February while total goods price inflation measured 1,8 per cent. Of particular significance is the fact that services inflation has continued its gradual downward trend. In January year-on-year services inflation declined below the upper end of the inflation target range to 5,9 per cent, and declined further to 5,6 per cent in February. This was the first time since the introduction of inflation targeting that services inflation had been at these levels. This partly reflects progress made by the public authorities in curbing administered price increases. The overall administered price index however remains above the target range because of the impact of the petrol price, which has a significant weighting in this index.

Production price inflation has also remained low, to an important degree due to the impact of the exchange rate of the rand. In January and February, the respective year-on-year inflation rates for the overall production price index (PPI) were 1,4 per cent and 1,2 per cent. Prices of imported goods increased year on year by 0,3 per cent in January, and declined by 0,7 per cent in February. However, the prices of domestically produced goods also remained well contained. In the first two months of this year, the year-on-year inflation in these prices declined to 1,9 per cent and 1,8 per cent, respectively, as the prices of agricultural products, manufactured foodstuff and textiles declined.

The outlook for inflation

Despite the uncertainties created by the oil market developments, the outlook for inflation remains favourable. The continued low level of production price inflation indicates that significant generalised upward pressure on consumer prices is not expected in the short term. However, the recent increases in the petrol price of 42 cents per litre in March and 40 cents per litre in April and possible further increases expected next month suggest that CPIX inflation may have reached its low turning point in February. According to our central forecast, CPIX inflation will begin to rise moderately over the coming months to peak at a level of around 5,25 per cent early next year before resuming a downward trajectory towards the mid-point of the inflation target range.

This favourable forecast is underpinned by a number of factors. The latest inflation expectations survey conducted on behalf of the Bank by the Bureau for Economic Research (BER) at the University of Stellenbosch shows a significant decline in inflation expectations. According to the survey, CPIX inflation expectations have reached their lowest level since the BER started the survey in 2000. For the first time, all groups of respondents expect inflation to be below the upper end of the inflation target band. On average CPIX inflation is expected to be at 4,5 per cent, the mid-point of the band for 2005, down from 5,5 per cent in the previous survey. CPIX inflation is also expected to remain within the target range for the next 3 years. This outcome indicates that there is an increasing acceptance by the South African population that the low levels of inflation achieved over the past 18 months can be sustained. These improved expectations are corroborated by the gap between the nominal yield on conventional bonds and the real yield on inflation-linked bonds. Although the expected long-term inflation implied by these yields has risen since the February lows, it nevertheless indicates longer-term expectations comfortably within the target range.

Government's fiscal policies also remain supportive of monetary policy. Higher than expected tax revenues have resulted in a deficit before borrowing significantly lower than the original estimate of 3,1 per cent and the revised estimate of 2,3 per cent of gross domestic product (GDP) announced in the Budget. Other positive factors include continued low world inflation, progress being made with respect to administered prices and low levels of food price increases in part as a result of the bumper maize crop.

Not all the positive factors identified in the previous statement of the Monetary Policy Committee (MPC) have improved, however. Unit labour cost developments present a mixed picture. The previous MPC statement commented on the marked moderation in salary and wage increases. Revisions to the *Survey of Employment and Earnings* undertaken by Statistics South Africa now indicate that average earnings rose by 7,2 per cent and 10,5 per cent in the third and fourth quarters, respectively. With labour productivity growth declining to 0,6 per cent and 0,4 per cent in those quarters, it implies an increase in unit labour cost in the formal non-agricultural sectors of the economy of 6,6 per cent in the third quarter compared to the original estimate of 4,9 per cent, and 10,1 per cent in the fourth quarter. The average unit labour cost increase for 2004 was 7,3 per cent compared to 4,0 per cent in the previous year. While these figures taken at face value should be a cause for concern, they do not necessarily reflect a reversal of the downward trend in reported nominal wage settlements which, according to recent surveys, averaged below 7 per cent in 2004 and around 6 per cent in the first quarter of 2005. These figures appear to confirm the lagged nature of wage settlements and the continuing adjustment to lower inflation rates. Because of their importance to the inflation process, these developments will be closely monitored by the MPC.

There are a number of upside risks to the inflation outlook which the MPC has taken cognisance of. The most important risk factor remains the uncertainty relating to international oil prices. The price of Brent crude has averaged around US$54 per barrel since the beginning of April compared to US$45 per barrel in February, and the outlook for oil prices has become increasingly uncertain.

Domestic expenditure continues to be robust. Growth in real gross domestic expenditure averaged 6,5 per cent in 2004 and real final demand averaged 6,8 per cent. This was a result of acceleration in real household and government consumption expenditure and real gross fixed capital formation. The strong growth in private-sector consumption continues to be sustained by relatively low nominal interest rates, higher asset prices, higher levels of consumer confidence and increased real disposable incomes.

The higher levels of expenditure continue to be reflected in the money supply aggregates and credit extension by the banking sector. Although the year-on-year monthly rates of increase in M3 have remained fairly stable at around the 12 per cent level, the quarter-to-quarter annualised rate of increase in the fourth quarter of 2004 amounted to 17,6 per cent. In January and February of 2005 the month-on-month annualised growth rate of loans and advances of banks to the private sector was 22,5 per cent and 20,6 per cent, respectively. This was mainly the result of asset-backed credit growth which recorded similar rates of increase. However, the rate of increase in house prices has been moderating for the past year.

Real gross domestic product growth averaged 3,7 per cent in 2004 compared to 2,8 per cent in 2003. As expected, the quarter-on-quarter annualised growth rate of 4,0 per cent in the fourth quarter of 2004 was slower than the previous quarter rate of 5,7 per cent. Moreover, there is evidence of a slackening of activity in the manufacturing sector. The outlook for growth, and for exports in particular, will depend to a significant degree on growth developments internationally.

Although output growth has been robust, the higher expenditure growth has continued to put pressure on the current account of the balance of payments. The current account deficit widened in the fourth quarter of 2004 to 4,0 per cent of GDP, up from 3,1 per cent in the third quarter. It measured 3,2 per cent of GDP for the year as a whole. However as has been the case for the past three years, these deficits continue to be comfortably financed by inflows on the financial account of the balance of payments. This enabled the Bank to continue building up the levels of foreign exchange reserves at a moderate pace – gross foreign exchange reserves rose to US$15,9 billion and the international liquidity position to US$12,4 billion at the end of March.

The prospects for the international economy have become more uncertain and the International Monetary Fund (IMF) and the World Bank have both revised down their forecast for growth in 2005, particularly in the euro area and Japan. The IMF has also warned of an increasingly unbalanced global expansion and the risks posed by higher oil prices, rising inflationary pressures, and the large and growing indebtedness of the United States to the rest of the world. Given the continued imbalances in the US economy, the outlook for the US dollar remains uncertain.

The rand exchange rate will continue to be affected by these developments. The rand strengthened after the previous MPC meeting, but has weakened more recently as a result of the stronger dollar and the generalised weakness in emerging-market assets. It is nevertheless slightly stronger than it was at the time of the previous meeting and has traded over the past six months at a range higher than for the main part of 2004.

Monetary policy stance

The MPC has carefully reviewed the above-mentioned developments and future prospects for inflation of the economy, taking particular account of the areas of uncertainty identified and the associated risks.

The MPC welcomed the evidence of a further material decline in inflation expectations and noted that, on balance, the outlook for inflation on the basis of the central forecast was that CPIX inflation would remain comfortably within the target range of 3 – 6 per cent over the next two years, even taking account of the impact of the recent rise in oil prices. Although the overall performance of the South African economy seems to be reasonably well sustained, the MPC noted with concern evidence of some slackening in activity in some sectors of the economy as a result of the move by the rand to a higher trading range over the past six months. It remains the view of the MPC that a competitive and stable exchange rate would contribute to continuing sustainable growth in output and employment. Taking all of the above-mentioned developments into consideration, the MPC has decided to reduce the repo rate by 50 basis points to 7,0 per cent per annum with immediate effect. The MPC is convinced that this is appropriate in the circumstances, and consistent with maintaining inflation within the target range.

The MPC will continue to monitor domestic and international developments closely, and will not hesitate to adjust rates as and when necessary to ensure that inflation remains within the target range mandated by the government of 3 – 6 per cent.