Statement of the Monetary Policy Committee

10 February 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

The world economic outlook remains positive. Preliminary estimates made by the International Monetary Fund indicate that world economic growth reached nearly 5 per cent in 2004 – the highest figure in almost three decades. Moreover, this growth was widespread, with particularly high increases in China and other non-Japan Asian countries, the United States of America and a number of emerging-market economies. Economic growth in the Euro area was more moderate at about 2 per cent, but was nevertheless considerably higher than the 0,5 per cent recorded in 2003. Although the IMF forecast indicates some moderation in global economic growth during 2005, it is generally projected to amount to the still high figure of 4 per cent for the year as a whole.

These buoyant world economic conditions together with strong domestic demand led to an acceleration in the rate of increase in the real gross domestic product of South Africa from a seasonally adjusted and annualised rate of 3 per cent in the fourth quarter of 2003 to 5,6 per cent in the third quarter of 2004. National accounts statistics are not yet available for the fourth quarter of 2004, but production statistics for some sectors seem to indicate that growth was firm. However, there are indications of a slowdown in manufacturing sector output growth. Employment in the formal non-agricultural sectors of the economy increased in 2004 after a prolonged period of decline, while domestic inflation remained within the inflation target of 3 to 6 per cent.

The inflation outcome

Since the previous meeting of the Monetary Policy Committee the consumer price index for metropolitan and other urban areas excluding the interest cost of mortgage bonds (the CPIX) has fluctuated around the mid-point of the target range. Owing largely to increases in petrol and diesel prices, the twelve-month growth rate of CPIX at first rose from 4,2 per cent in October 2004 to 4,6 per cent in November. The subsequent decline in the running costs of motor vehicles and lower food prices brought the increase in CPIX down to 4,3 per cent in December. The twelve-month rate of increase in the CPIX excluding petrol, diesel and food prices rose slightly from 4,1 per cent in October 2004 to 4,3 per cent in December.

Measured from quarter to quarter at seasonally adjusted and annualised rates, CPIX inflation accelerated from 2,7 per cent in the third quarter of 2004 to 5,0 per cent in the fourth quarter. This acceleration in the pace of inflation was mainly due to more rapid increases in the prices of goods and occurred in most of the main goods categories with the exception of new and used vehicles.

For the year 2004 as a whole CPIX inflation averaged 4,3 per cent, compared with 6,8 per cent in 2003. The lower inflation was, to a large extent, brought about by continued monetary and fiscal discipline applied by the authorities, an appreciation in the external value of the rand and moderate increases in food prices. These factors had a major impact on the prices of goods, with the result that the rate of increase in the prices of goods averaged only 2,9 per cent in 2004. In contrast, the inflation in service prices included in the CPIX remained stubbornly high at an average of 7,0 per cent. In particular, medical costs and education fees increased at rates well above the upper limit of the inflation target.

For the second year in a row production price inflation in South Africa remained low. The average rate of increase in the all-goods domestic price index amounted to 1,7 per cent in 2003 and 0,6 per cent in 2004. This was largely due to the continued strength of the rand in the foreign exchange markets. The effect of the appreciation in the exchange rate of the rand is clearly illustrated by the further decline of 3,9 per cent in the prices of imported goods in 2004. This decline in the cost of imported goods enabled domestic producers to contain price increases. Consequently, the average rate of increase in the prices of domestically produced goods slowed down from 3,9 per cent in 2003 to 2,3 per cent in 2004.

The rate of decline in the prices of imported goods moderated markedly in the fourth quarter of 2004, but the rate of increase in the prices of domestically produced goods slowed down. Consequently, the rate of increase in the all-goods production price index declined from a seasonally adjusted and annualised level of 2,3 per cent in the third quarter of 2004 to 0,7 per cent in the fourth quarter.

The inflation outlook

In the last quarter of 2004 the rand appreciated further as the United States dollar weakened against the euro and other currencies. During 2005 to date the nominal effective exchange rate of the rand has eased back slightly as the dollar has steadied but nevertheless remains still stronger than the average for 2004 as a whole. The recent easing in the trade-weighted average value of the rand was accompanied by an increase in the Brent price of oil from about US$40 to US$45 over the same period. However, the short-term outlook for inflation improved because the petrol price per litre was lowered further by 44 cents in January and 2 cents in February.

Over the longer term there are a number of developments which could also lead to a favourable inflation outcome. As indicated in the last MPC statement, the recent improvement in inflationary expectations is of particular significance in this regard owing to the prominent role that these expectations play in the monetary policy transmission mechanism. Inflation expectations which fall within the inflation target signal that CPIX inflation could be maintained within the target range of 3 to 6 per cent in the forecast period.

Another important recent development which bodes well for inflation is the marked moderation in salary and wage increases. The rate of increase in nominal remuneration per worker in the formal non-agricultural sectors of the economy moderated from 9,6 per cent in 2002 to 8,7 per cent in 2003 and 6,3 per cent in the year to the third quarter of 2004. Unfortunately, labour productivity growth which averaged 4,5 per cent in 2003, came down to year-on-year figures of 1,1 per cent in the second quarter of 2004 and 1,3 per cent in the third quarter. As a result, the rate of increase in nominal unit labour cost rose from 4,0 per cent in 2003 to 4,9 per cent over the year up to the third quarter of 2004.

Other factors that could contribute to the maintenance of low inflation in the next two years include the commitment by the government to fiscal prudence and of the public authorities to low administered price increases, moderation in the increases in food prices and continued low inflation internationally. The International Monetary Fund expects global inflation to remain at about 3,5 per cent in 2005.

The major risks to the achievement of the inflation target have not changed to any significant extent since the previous meeting of the Monetary Policy Committee. These include the following:

- The sustained strong growth in domestic demand as a result of lower interest rates, tax deductions, still relatively high personal disposable income growth, positive wealth effects arising from increases in the prices of real estate, shares and bonds, the need for expenditure on infrastructural development and the extension of the production capacity of the economy. The continued strength in demand led to an acceleration in the growth rate of the economy to a seasonally adjusted and annualised rate of 5,6 per cent in the third quarter of 2004. Although some indicators point to a slowdown in the rate of economic growth in the fourth quarter, capacity constraints could eventually put pressure on domestic prices.

- The increase in domestic demand also brought about an increase in the deficit on the current account of the balance of payments due to a sharp rise in the demand for imported goods and services. The rise in imports was partly neutralised by higher exports arising from strong international economic growth and increases in international commodity prices. The deficit on the current account was easily financed by a substantial inflow of portfolio and trade-related capital from the rest of the world, which made it possible to increase the official foreign reserves.

- The continued increases in money supply in 2004. The growth over twelve months in the broadly defined money supply (M3) amounted to 12,8 per cent in December 2004, which was lower than at the end of the preceding quarter but slightly higher than the 12,3 per cent in December 2003. Quarter-to-quarter seasonally adjusted and annualised growth in M3 rose from 13,0 per cent in the third quarter of 2004 to 17,6 per cent in the fourth quarter. During the course of 2004 there was a reallocation of funds from longer term deposits to short-term deposits. Increases in these deposits usually reflect a rise in the transaction demand for money.

- The strong demand for bank credit in 2004. The twelve-month growth rate in the total loans and advances of banks rose from 12,5 per cent in December 2003 to 16,3 per cent in December 2004. The quarterly growth in total loans and advances increased from a seasonally adjusted and annualised rate of 12,5 per cent in the third quarter of 2004 to 27,2 per cent in the fourth quarter. Asset-backed credit was largely responsible for this acceleration. The demand for these kinds of loans measured over a period of twelve months increased from 16,3 per cent in December 2003 to 22,8 per cent in December 2004. In contrast, the twelve-month growth rate of overdrafts, outstanding balances on credit cards and general advances slowed down over the same period, but these loans picked up somewhat in the fourth quarter of 2004.

- The likely impact of external developments, in particular the timing, manner and speed of the processes of adjustment to existing global imbalances. How far these adjustments will run in the months ahead remains unclear. The monetary policy stance in South Africa will continue to focus on maintaining inflation within the inflation target range, and will weigh among others the impact of these adjustments on the rand, the impact of such movements on the medium-term outlook for inflation, and the need for South Africa to have a competitive and stable exchange rate.

The recent favourable developments have improved our inflation forecasts and have led to a downward revision of inflationary pressures over the forecast period up to the end of 2006. According to our central forecast, CPIX inflation could rise moderately during 2005 to a little above the midpoint of the range and then ease somewhat during the rest of the forecast period.

Monetary policy stance

The Monetary Policy Committee deliberated extensively on the appropriate policy stance at this particular point in time. Given the presence of so many uncertainties and given the balance of risks, the MPC decided to maintain the current stance and keep the repo rate unchanged at 7,5 per cent per annum. The MPC will continue to monitor developments in the economy and the factors affecting inflation very closely and will stand ready to adjust the stance in either direction if necessary, depending on the outlook for inflation.