# Statement of the Monetary Policy Committee
9 December 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

Revised national accounts statistics released by Statistics South Africa show that growth in real gross domestic product continued to gather momentum during the course of 2004 and reached a seasonally adjusted and annualised rate of 5½ per cent in the third quarter of the year. This good performance of domestic production was supported by relatively buoyant global economic conditions, an improvement in South Africa's terms of trade, rising export volumes and strong domestic demand. Even more significant is that the acceleration in economic growth was accompanied by an increase of roughly 196 000 jobs in the formal non-agricultural sectors in the twelve months up to June 2004 without any meaningful pressure on domestic prices. In fact, CPIX inflation has remained within the inflation target range of between 3 and 6 per cent for the past 14 months.

## 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) moved into the target range in September 2003. This was accomplished largely owing to persistent monetary and fiscal discipline applied by the authorities, the benefits that are accruing as a result of microeconomic reforms, the appreciation in the external value of the rand, and moderate increases in food prices. CPIX inflation receded further from 5,4 per cent in September to 4,0 per cent in December 2003. Mainly as a consequence of a rise in petrol and diesel prices, twelve-month CPIX inflation increased to 5,0 per cent in June 2004, before declining to 3,7 per cent in September. Increases in transport running costs were responsible for a somewhat higher CPIX inflation figure of 4,2 per cent in October 2004. If petrol and diesel prices are excluded from the CPIX index, the rate of increase over twelve months in the prices of other consumer goods and services declined from 5,7 per cent in September 2003 to 3,5 per cent in October 2004.

As could be expected with the appreciation in the external value of the rand, disinflation in the prices of consumer goods made the largest contribution to the improved inflation outcome in South Africa. Despite the effect of changes in international oil prices, the twelve-month rate of increase in the prices of consumer goods was below the lower limit of 3 per cent of the inflation target in 8 of the 14 months up to October 2004. Increases in petrol and diesel prices mainly brought about higher increases in the other months. The prices of certain consumer goods such as those of furniture and equipment, clothing and footwear, and vehicles actually declined over the twelve months up to October 2004. However, the prices of alcoholic beverages, tobacco and transport running costs continued to rise at rates considerably above the upper limit of the inflation target of 6 per cent.

The twelve-month rate of increase in the prices of consumer services consistently remained above the upper limit of the inflation target. These prices are not directly affected by changes in the external value of the rand and normally take longer to adjust to changed circumstances. The rate of increase in these prices nevertheless also slowed down significantly in 2004. Measured over a period of twelve months, the rate of increase in the prices of consumer services included in the CPIX declined from a peak of 8,6 per cent in September 2003 to 6,3 per cent in October 2004.

The effect of the stronger rand on the prices of goods is clearly illustrated by developments in the prices of imported goods included in producer prices. The prices of these goods measured over a period of one year started to decrease from April 2003 and continued declining up to October 2004. These cheaper imports enabled domestic producers to moderate price increases. As a result, the rate of increase in the prices of domestically produced goods amounted to only 2,7 per cent for the year ended October 2004.

## The inflation outlook

The inflation outlook generally remains positive, but there are certain developments that will have to be monitored closely by the Monetary Policy Committee to ensure that inflation remains within the target range. Of particular significance for the continuance of inflation within the target range are the lower inflation expectations. Inflation expectations are very prominent in the inflation process. The recent lower inflation expectations recorded by the Bureau for Economic Research of the University of Stellenbosch, which fell within the inflation target range for the second consecutive quarter, clearly illustrate the improved credibility of monetary policy. These levels of expectations are also an important signal that inflation could remain at low levels.

As already noted, the strength of the rand has been an important factor contributing to bringing inflation down in South Africa and countering the effects of the increase in international oil prices on domestic costs. Although the deficit on the current account of the balance of payments has increased considerably during the course of 2004, this shortfall has been comfortably financed by an inflow of funds from the rest of the world. This clearly reflects the confidence of non-residents in the performance of our economy. At the same time domestic expenditure on goods and services has continued to rise rapidly. All the main expenditure aggregates contributed to this growth, but the rates of increase in expenditure on durable consumer goods and fixed capital formation were high. Both these expenditure components have a high import content.

The growth in the world economy has contributed to the increase in the volume of South African exports as well as the improvement in the terms of trade, which have to some extent offset the rise in imports. The International Monetary Fund expects global economic growth to be around 5 per cent in 2004, followed by a slower but still relatively high rate of 4 per cent in 2005. This should support the growth in South African exports and alleviate pressures on the balance of payments that could arise from the additional imports which may be engendered by further increases in domestic demand.

According to projections by the International Monetary Fund, global inflation could decline marginally from 3,8 per cent in 2004 to 3,6 per cent in 2005. Countries where inflation has started to rise during 2004, such as the United States of America and the newly industrialised countries in Asia, have already taken corrective steps to prevent any further acceleration. Moreover, the recent substantial increase in international oil prices seems to have levelled off in November. The price of Brent crude oil that averaged US$49 per barrel in October 2004 and at one stage during the month reached US$52 per barrel, declined to an average of US$43,45 per barrel in November. However, the oil market is still very nervous, as clearly illustrated by daily fluctuations in prices. The low rates of increase in other international prices should nevertheless contribute to the containment of domestic inflation.

After recovering in 2002 and 2003, the rand has performed more steadily for much of 2004, with reduced volatility helped by the progress which the Bank has made in strengthening the official foreign exchange reserves. Towards the end of this year, the rand has strengthened further. These latest developments reflect a generalised weakening in the US dollar; hence other currencies, including those of some of South Africa's main trading partners, have experienced similar movements.

The weakening in the dollar appears to be part of a process of adjustment in international imbalances. How far this adjustment will run in the months ahead is unclear. The monetary policy stance in South Africa will continue to focus on maintaining inflation within the target range and, to that end, will need to weigh, among other things, the sustainability of recent movements in the rand, the impact such movements may have on the medium-term outlook for inflation, and the desirability of a competitive and stable exchange rate for the rand.

Other factors that could assist the monetary authority in maintaining inflation within the inflation target range include the commitment by the public authorities to low administered price increases and a generally favourable outlook for food prices despite the drought in certain parts of the country. In addition, the *Medium Term Budget Policy Statement* shows a continued determination by the government to maintain fiscal prudence.

The economy will nonetheless have to be managed carefully to maintain price stability. It is in particular very important that capacity constraints be prevented as far as possible. The recent narrowing and perhaps even future disappearance of the gap between potential and actual output could lead to inflationary pressures. The economy is still operating below full capacity, but there are some signs that capacity constraints are starting to appear. Shortages in the domestic production of cement, other building materials and human resources required by the construction sector are examples in this regard. The utilisation of manufacturing production capacity has also increased. Fortunately, domestic fixed capital formation is rising rapidly and decisions have been made by the relevant authorities to upscale the skills development endeavour in the country.

Other developments indicating that it may become more difficult to maintain low inflation include the following:

- The decline in the growth of labour productivity from a year-on-year rate of 3,3 per cent in the first quarter of 2004 to 0,5 per cent in the second quarter. This decrease was due to an increase in formal non-agricultural employment without a concomitant rise in production, as well as a rise in the number of workdays lost as a result of strikes and other forms of industrial action. With the nominal remuneration per worker rising at 7,6 per cent in the year to the second quarter of 2004, it is important that labour productivity rises. These developments caused the year-on-year rate of increase in nominal unit labour cost to rise further from 5,4 per cent in the first quarter of 2004 to 7,1 per cent in the second quarter.

- The recent strong growth in the broadly defined money supply (M3) from a year-on-year rate of 11,8 per cent in June 2004 to 14,9 per cent in October. The increase in M3 deposits over these four months was concentrated in the short and medium-term deposits of the corporate sector and largely reflected the reduced opportunity cost of holding such deposits and the robust growth in domestic expenditure and production. As a result, the rate of increase in the narrower monetary aggregates exceeded the increase in M3. Such growth in monetary aggregates, if maintained, is usually a signal that the rate of inflation could increase over time.

- The acceleration in the twelve-month growth rate in total loans and advances of banks to the private sector from 8,9 per cent in June 2004 to 15,1 per cent in October. Asset-backed credit was mainly responsible for this increase, but in September and October overdrafts, credit cards and general advances started to rise significantly. The increase in the total loans and advances of banks was more or less evenly distributed between the household and corporate sectors over the past four months. Although the outstanding debt of households and the corporate sector is still low, the pace of acceleration in bank credit extension needs to be carefully monitored.

Notwithstanding these signals that inflation could perhaps build up over time, our projections show that with an unchanged monetary policy stance, CPIX inflation will probably not breach the upper 6 per cent of the inflation target during the forecast period up to the end of 2006. The further strengthening of the rand over the past two months and the decline in international oil prices in November resulted in a somewhat lower projected inflation path than that published in the *Monetary Policy Review* in November 2004. Inflation should rise somewhat during the course of 2005, but the upper turning point in the third quarter of that year is now expected to be somewhat lower than that forecast previously. In 2006, CPIX inflation is expected to be comfortably within the target range.

## Monetary policy stance

Taking the above developments into consideration, the Monetary Policy Committee has decided to maintain the current monetary policy stance and to keep the repo rate unchanged at 7,50 per cent per annum. As always, the committee will remain vigilant and will stand ready to adjust the repo rate if the inflation outlook changes.