Statement of the Monetary Policy Committee

12 October 2006

Issued by Mr T T Mboweni, Governor of the South African Reserve Bank, at a meeting of the Monetary Policy Committee in Pretoria

Introduction

Recent domestic economic developments indicate that the risks to the inflation outlook to which the Money Policy Committee (MPC) drew attention in previous statements remain. The domestic economy continues to grow at a brisk pace while domestic demand growth has sustained its vibrancy, buoyed by strong credit extension. The deficit on the current account of the balance of payments continues to be at levels which may strongly influence the exchange rate outlook. The exchange rate has depreciated further since the previous MPC meeting and broad-based pressure from producer prices has become more pronounced.

Internationally, oil prices have moderated somewhat, which has allowed for a reduction in petrol prices in two consecutive months. However, in line with declining oil prices, commodity prices in general have also declined recently. The outlook for the international economy remains positive although there are still uncertainties relating to the growth outlook in the United States of America. The latest *World Economic Outlook* of the International Monetary Fund (IMF) says that global growth is expected to moderate slightly from 5,1 per cent in 2006 to 4,9 per cent in 2007. Against the background of generally tighter monetary policies globally, world inflation is expected to remain under control and average 3,7 per cent next year, slightly higher than the April projection of the IMF.

Recent developments in inflation

Inflation has continued to display an upward trend. Year-on-year inflation as measured by the consumer price index for metropolitan and other urban areas excluding the interest cost on mortgage bonds (CPIX) has increased in each month since April of this year when it measured 3,7 per cent. By August this year, CPIX inflation had increased to 5,0 per cent. Goods prices increased at a year-on-year rate of 6,0 per cent compared to 3,5 per cent for services in August. The main inflation drivers in the goods category were again food and petrol prices. The prices of a number of food products have been increasing at high rates, in particular meat prices which increased at year-on-year rates of 15,2 per cent in August. Meat has a weight of about 7 per cent in the CPIX basket, and in August its contribution to CPIX inflation was similar to that of petrol and diesel. Petrol and diesel prices, which have a weight of 5,04 per cent in the CPIX basket, increased at year-on-year rates of 22,1 per cent. By contrast, clothing, footwear and furniture and equipment prices continued to decline, while administered prices excluding energy increased at a year-on-year rate of 4,2 per cent.

Production price inflation increased markedly and across a broad spectrum of categories. Measured year on year, production price inflation had increased to 9,2 per cent in August 2006. Of particular concern was the 9,6-per-cent increase in domestically produced goods inflation, up from 8,1 per cent the previous month. Imported goods inflation measured 7,8 per cent in August compared with 8,2 per cent in July. The categories displaying the highest month-on-month increases were agricultural products, manufactured food and electricity, gas and water.

The outlook for inflation

In the short term, the increase in CPIX inflation is expected to be moderated somewhat by the reductions in the domestic petrol price, amounting to R0,36 and R0,50, which took effect in September and October, respectively. Pressures emanating from production prices, however, indicate that some countervailing movements can be expected. The outcome of the Bank's forecasting models shows that over the forecast period, inflation is expected to continue its upward trend towards the upper end of the target range and remain at levels of around 6 per cent between the second and fourth quarters of 2007. Thereafter CPIX inflation is expected to decline gradually to reach around 5,4 per cent by the end of the forecast period in the fourth quarter of 2008.

Market expectations of inflation, as indicated by the break-even inflation rates (i.e. the yield differential between inflation-linked bonds and conventional government bonds), also show an upward trend over the shorter maturity range. Inflation expectations as reflected in the survey conducted on behalf of the Bank by the Bureau for Economic Research (BER) have also moved higher. Compared to the previous quarter, inflation expectations during the third quarter of this year increased in respect of every forecast year. Average inflation expectations increased by 0,5 per cent for 2006 to 4,9 per cent, while for 2007 they increased by 0,4 per cent to 5,3 per cent. Inflation is then expected to decline to 5,0 per cent in 2008. Despite this upward movement, expectations are still within the inflation target range during all the forecast years. Given the importance of inflation expectations in the price and wage formation process, it is vital that the MPC remains vigilant to ensure that expectations stay entrenched within the 3-to-6-per-cent range.

A number of factors have contributed to the adverse inflation outcomes and outlook, and continue to pose a risk to future outcomes. Domestic expenditure remained buoyant in the second quarter of this year. Real domestic final demand increased at an annualised rate of 10 per cent in the second quarter, with strong growth in final consumption expenditure by both households and general government, as well as fixed capital formation.

Strong household consumption expenditure remains one of the primary risk factors. In the second quarter of this year, household consumption expenditure increased at an annualised rate of 8 per cent, the highest quarter-on-quarter growth rate since 1995. There are few indications that this trend has been reversed despite the most recent interest rate changes. However, it is recognised that it is possibly too early to assess fully the impact of monetary policy actions. One tentative indication of a possible slowdown in demand growth is seen in motor vehicles sales. In the third quarter of this year, sales of new motor vehicles declined by 0,3 per cent. On a month-on-month basis, sales in September declined by 3,6 per cent.

This strong demand is supported by higher asset prices and increased credit extension to the private sector. Share prices on the JSE Limited reached new record highs recently while house prices have continued to increase, albeit at a slower rate. Growth over twelve months in total loans and advances extended to the private sector grew at a level of 26,1 per cent in August. Mortgage advances continued to be the largest component of credit extension. This component is likely to react to interest rate changes with a lag, given the time taken to finalise property transfers. The higher rates of credit extension have contributed to the further increase in household indebtedness which in the second quarter of this year rose to 70 per cent of household disposable income.

Growth in money supply (M3) remains brisk. Twelve-month growth in money supply decelerated from 23,0 per cent in June to 21,2 per cent in July before accelerating marginally to 21,4 per cent in August. The income velocity of circulation of M3 declined from 1,43 in the first quarter of 2006 to a low of 1,37 in the second quarter. This is yet another indication of ample liquidity in the South African economy.

Recent exchange rate developments might pose a risk to the inflation outlook. Since early May, the rand has depreciated on a trade-weighted basis by almost 22 per cent. At these levels, it is possible that some pass-through to higher prices might occur. The challenge for monetary policy is to ensure that this effect is minimised. Part of the explanation for the recent adjustment in the rand exchange rate lies in the reaction of the market to the current-account deficit which has averaged over 6 per cent of gross domestic product during the first half of this year. Other factors influencing the exchange rate include the lower commodity prices, the repricing of risk in a number of emerging markets and a general tightening of monetary policy globally.

While noting potential risks that may emanate from the relatively high deficit on the current account of the balance of payments, the MPC noted that this deficit continues to be reasonably well financed. The overall balance-of-payments situation is in surplus and has allowed further improvements in the external position of the country, with official reserves continuing to improve. Official gross gold and other foreign exchange reserves stood at US$24,6 billion at the end of September 2006 and net reserves amounted to US$21,2 billion.

Food prices also pose a significant risk to inflation. Food prices in general have increased by 7,2 per cent and agricultural prices at the producer price level have increased at a year-on-year rate of 20,4 per cent. In 2005 food price inflation averaged 2,1 per cent and exerted significant downward pressure on the overall inflation trend. Higher maize prices are also likely to be sensitive to exchange rate developments. Maize product inflation in CPIX is on an upward trend but is still relatively low, having measured 4,7 per cent in August, and further pressure is expected from this source.

There have, however, been some positive developments. In particular, the threat to inflation posed by the international oil prices has subsided to some extent. Having reached levels of almost US$80 per barrel in August of 2006, the price of Brent crude has now fallen to below US$60 per barrel. The timing of this adjustment has happened by chance or luck, as a high and rising oil price coupled with a depreciating rand would have had a marked and rapid impact on inflation. In August and September, the decline in international oil prices more than offset the upward pressure exerted by the exchange rate on petrol prices. Despite this positive development, the MPC considers the risk to inflation from this source still to be on the upside. The tight supply-and-demand conditions in the oil markets coupled with the sensitivity of oil prices to geopolitical tensions mean that oil prices could respond quickly to any new adverse developments. Furthermore, the decision by the Organization of Petroleum Exporting Countries to cut quotas by 1 million barrels per day could slow the decline in oil prices.

Labour market developments do not appear to pose a threat to the inflation outlook at present. Having increased by 7,3 per cent in the first quarter of this year, unit labour costs increased by 3,2 per cent in the second quarter. Trends in inflation expectations will be critical in the months ahead. Should expectations increase significantly above those indicated earlier, this is likely to be reflected in higher wage demands which may impact on the price formation process. Although at this stage wage costs do not pose a threat to inflation, these developments will be closely monitored by the MPC.

The developments outlined above have taken place against the background of a buoyant economy. In the second quarter of this year, the economy grew by 4,9 per cent on an annualised basis, compared to 4 per cent in the previous quarter. Nevertheless economic growth this year is still expected to be lower than the 4,9 per cent average recorded last year. At these levels, growth is still in line with, or slightly above, what our studies indicate to be the potential output of the economy. The Rand Merchant Bank/BER Business Confidence Indicator is still at a high level, while the Investec/BER Purchasing Manager's Index (PMI), although lower in October, still reflects a positive outlook for the manufacturing sector. The recent BER manufacturing survey indicates that although there has been a marginal decline in confidence in the consumer goods sector, the capital and intermediate goods sectors have maintained a positive outlook.

Monetary policy stance

Having considered in detail all the recent economic data and other developments impacting on inflation, the MPC remains concerned about the outlook for inflation and is of the view that the risks to the outlook are still on the upside. Accordingly, the MPC has decided that a further upward adjustment in the repo rate is appropriate at this juncture. The repo rate is therefore increased by 50 basis points to 8,5 per cent per annum with effect from Friday, 13 October 2006. The MPC will continue to monitor all economic, financial and other relevant developments and stands ready to act in order to ensure that the monetary policy stance remains consistent with achieving the inflation target.