Statement of the Monetary Policy Committee
3 August 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

Domestic inflation is on an upward trend, with food price inflation adding to the pressures emanating from persistent petrol price increases. Household consumption spending has continued to grow at a strong pace and consumer confidence remains high. This has been reflected in strong credit extension and preliminary indications are that the deficit on the current account of the balance of payments might have remained high in the second quarter. These factors, combined with a general depreciation of the rand, have resulted in a further deterioration in the inflation outlook.

In the recent past there has been considerable volatility in international financial markets in general, and in emerging markets in particular. These developments have centered around the uncertainty about the future path of interest rates globally. However, the latest developments appear to suggest that some calm may be returning to the financial markets, as evidenced by the narrowing spreads on emerging-market debt.

Recent inflation developments

Inflation as measured by the consumer price index for metropolitan and other urban areas excluding the interest cost on mortgage bonds (CPIX) increased at a year-on-year rate of 4,8 per cent in June, compared to 3,7 per cent in April and 4,2 per cent in May. This upward trend is not only attributable to petrol price increases. If petrol prices were excluded, CPIX would have measured 3,5 per cent and 3,8 per cent in May and June, respectively. This latter figure is the highest rate of increase of this measure since June 2004. Food price inflation has also made a significant contribution to this upward trend.

Prices of petrol and diesel increased at year-on-year rates of 13,2 per cent and 22,7 per cent in May and June, respectively. Food price inflation has been increasing steadily since late 2005. In November last year, year-on-year food price increases measured 2,0 per cent. In each subsequent month food price inflation increased, and measured 7,2 per cent in June. Significant increases in the prices of meat, fish and vegetables have been the major contributors to this trend. Grain product prices have not fully responded to the sizeable increase in maize prices since the latter part of last year although some upward pressure is evident. In June, the grain products inflation component of CPIX measured 3,8 per cent compared to 0,2 per cent in January 2006.

Most of the other CPIX categories continue to exhibit low rates of price increases, while the categories of clothing and footwear, and furniture and equipment have shown persistent price declines. Services price inflation has declined continuously in the past few months and measured 3,3 per cent year on year in June 2006. Administered prices excluding petrol are predominantly services and therefore have exhibited a similar trend but at marginally lower rates of increase.

Indications of possible consumer price pressures come from production price inflation which increased at a year-on-year rate of 7,6 per cent in June, compared to 5,5 per cent and 6,3 per cent in April and May, respectively. Although food and energy were important drivers of these increases, the pressure was more broad based. If food and energy were excluded, production price inflation would have measured 4,5 per cent in June, compared to 2,9 per cent in April, and 3,6 per cent in May of this year. Some of the upward pressure in June can be attributed to the change to winter electricity tariffs.

The outlook for inflation

Since the previous meeting of the Monetary Policy Committee (the MPC), the inflation forecast of the Bank has deteriorated moderately. The most recent central forecast of the Bank projects inflation to peak above the 6-per-cent level and to remain outside the target range for the first two quarters of 2007. Thereafter, based on the current assumptions, CPIX inflation is projected to decline slowly to reach a level marginally above 5 per cent by the end of 2008.

It seems to us that the use of the forecast in monetary policy decisions needs to be further explained. The MPC does not use the forecast in a mechanical way as the basis for policy making. The forecast provides a broad guide to possible inflation outcomes, but the MPC relies on its judgement about possible future developments. No model can adequately capture all the relevant dynamic processes in any economy. It is worth emphasising that the model outcomes are also dependent on the assumptions that are fed into it. Furthermore, the MPC takes a view of the risks to the forecast.

The exchange rate has exhibited considerable volatility, and has been fluctuating between levels of around R6,70 and R7,50 to the US dollar since the June MPC meeting. The behaviour of the rand was initially related to increased global risk aversion, combined with concerns relating to domestic balance-of-payments imbalances. More recently, expectations that the monetary policy tightening cycle globally may be at or near its peak have prompted an appreciation of the rand to current levels of around R6,90. On a trade-weighted basis, the rand has depreciated by about 14 per cent since the beginning of the year, and by 2,5 per cent since the previous MPC meeting. Some pass-through from the exchange rate to prices can be expected, particularly to domestic petrol prices, which have increased by a cumulative R0,56 in July and August. Exchange rate movements accounted for about R0,44 of this adjustment. The prospects for the rand going forward, and the associated risks to inflation, depend to some extent on the global interest rate trend.

In previous statements the MPC expressed concerns about the expanding deficit on the current account of the balance of payments. Current-account deficits are a reflection of higher domestic expenditure and are not in themselves inflationary. There is, however, a possible risk to the exchange rate if the deficits are perceived to be unsustainable, particularly if the deficits are reflecting higher consumption expenditure. The recent exchange rate reaction to the higher deficit is indicative of this, but it is also part of the macroeconomic adjustment process. In order for the exchange rate to play its part in this process, it is important that the exchange rate changes are not simply offset by higher inflation.

The current-account deficit is expected to be adequately financed through capital inflows, although the focus of non-residents has shifted from the equity market towards the domestic bond market. In July, non-residents became net sellers of shares to the value of R2 billion, while non-resident net bond purchases totalled R11,8 billion in the same month, compared to net sales of R1,3 billion in June.

Household consumption expenditure, which grew at an annualised rate of 7 per cent in the first quarter of this year, shows few signs of abating. The FNB/BER Consumer

Confidence Index declined marginally in the second quarter of 2006, but nevertheless remains close to historically high levels. Motor vehicle sales continue to exhibit strong growth. New vehicle sales grew by 20,8 per cent in the year to July.

This higher consumer demand has been underpinned by low nominal interest rates, rising real incomes, and wealth effects arising from strong asset price growth. The residential property market remains buoyant, although the rate of increase in house prices has declined somewhat during 2006. According to the Absa House Price Index, house prices recorded year-on-year increases of 13,6 per cent in June. Prices on the JSE Securities Exchange have been somewhat volatile with the Alsi fluctuating between 18 380 and a high of 21 592.

Growth in credit extension to the private sector reflects the growth in consumer expenditure and higher property prices. Growth over twelve months in total loans and advances accelerated from 22,5 per cent in May 2006 to 23,2 per cent in June. Asset-backed credit growth, which accounts for a significant part of the increase in total loans and advances, has remained around 27 per cent since February 2006.

Until recently, wage developments presented a benign picture. During 2005, unit labour cost in the formal non-agricultural sector increased by 3,4 per cent, providing further evidence that wage pressures were well contained. However, in the first quarter of 2006, nominal unit labour cost increased by 7,6 per cent compared to the same quarter of the previous year, and up from an increase of 2,6 per cent in the fourth quarter of 2005. This development is attributed in part to a decline in labour productivity in the first quarter of 2006 compared to the first quarter last year, as employment outpaced output growth. It is too early to tell if this represents a reversal of the previous trend, but as a significant number of wage negotiations are concluded in the third quarter, these developments will be closely monitored. Wage settlement surveys conducted by Andrew Levy Employment Publications show that settlements have averaged 6,2 per cent in the first half of 2006, compared to 6,3 per cent in 2005 as a whole.

Preliminary indications are that economic growth, although still robust, continues to show some moderation compared to the 4,9 per cent achieved in 2005, and consequently poses little threat to the inflation outlook. The RMB/BER Business Confidence Index declined in the second quarter, although it remains at a high level. Manufacturing output growth has shown some signs of sustaining the first quarter recovery after the subdued levels in the second half of 2005. The physical volume of manufacturing production increased by 4,4 per cent on a year-on-year basis in May, while the Investec/BER Purchasing Managers Index has increased for six consecutive months, with the measure for July indicating a strongly positive outlook for the sector. Mining production, however, remains under pressure. Total mining production decreased by 6,8 per cent year on year in May although in the past three months mining production increased by 5,4 per cent compared to the previous three months, mainly as a result of increased platinum group metals production.

International factors also pose a risk to the inflation and interest rate outlook. International oil price developments remain a significant source of concern. In mid-June the price of Brent crude oil had declined to levels of around US$66 per barrel as a result of higher reported inventories. However, by the end of June, oil prices had risen to levels of around US$75 per barrel as a result of strong demand pressures, supply constraints and rising geopolitical tensions. In July the price of Brent crude oil averaged almost US$74 per barrel, compared to US$68 per barrel in June.

Despite the relatively subdued global inflation environment, inflationary pressures have begun to emerge in a number of countries. This has prompted further tightening of monetary policy by several central banks in the past few months.

Monetary policy stance

The MPC remains concerned about the longer-term threats to the inflation outlook and has therefore decided that a further adjustment to the repo rate would be prudent. Accordingly, the repo rate is increased by 50 basis points to 8,0 per cent per annum with immediate effect. The MPC will, as is always the case, remain vigilant in order to ensure that CPIX inflation stays within the inflation target range.