Statement of the Monetary Policy Committee

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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 risks to the previously benign inflation outlook in South Africa have increased over the past few weeks. Uncertainties relating to the future movements of US interest rates have had reverberations in international financial markets, with negative consequences for a number of emerging markets in particular. This has put some downward pressure on commodity prices and has contributed to a marked depreciation of the rand since the previous meeting of the Monetary Policy Committee (MPC). These events have occurred at a time of continued geopolitical tensions which have driven international oil prices to new record highs.

Domestically, consumer demand has remained robust, and there are few signs of moderation. Growth in credit extension has continued at a brisk pace and household debt has continued to rise, while the current-account deficit of the balance of payments has widened further. Domestic output growth in the first quarter of 2006 returned to a level more in line with potential output following the improved performance of the manufacturing sector in the first quarter of 2006.

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 by a 3,7 per cent year-on-year rate in April, having measured 3,8 per cent and 4,5 per cent in the previous two months, respectively. Petrol price movements continue to account for much of the volatility in CPIX inflation. If petrol prices were excluded, CPIX inflation would have fluctuated within a band of 3,0 per cent and 3,7 per cent since July 2004, and would have averaged 3,3 per cent in April 2006. Motor vehicle running costs declined to year-on-year rates of increase of 13,7 per cent and 9,5 per cent in March and April. This can be compared to respective increases of 21,5 per cent and 24,6 per cent in the previous two months.

Goods price inflation declined to 4,1 per cent and 3,9 per cent in March and April, respectively, compared to 4,8 per cent in February. The lower trend of goods price inflation was influenced by the lower rates of increase in vehicle running costs, and the continued decline in the prices of clothing and footwear, furniture and equipment and motor vehicles. Food price inflation increased further, measuring 5,5 per cent and 6,2 per cent in March and April, respectively. The main categories contributing to the higher food price inflation were meat, fish and vegetables. Although grain price increases remained relatively low, there were signs of acceleration in this category, as the impact of the higher maize prices began to be felt at the consumer level. Grain product prices increased by 3,9 per cent in April, compared to a modest fall in prices in January. Services price inflation remained below that of goods inflation and measured 3,5 per cent in both March and April of this year. Administered prices increased at a year-on-year rate of 5,2 per cent in April, while administered prices excluding petrol increased by 3,3 per cent.

Production price inflation has remained relatively stable at around 5,5 per cent for the first four months of 2006. Imported goods prices increased by 6,7 per cent and 6,1 per cent in March and April, respectively, while prices of domestically produced goods increased by 5,0 per cent and 5,5 per cent in these months, respectively.

The outlook for inflation

Compared to the previous forecast of the Bank, the latest forecast shows a marked deterioration in the inflation outlook, particularly in the short term. Whereas the previous forecast projected CPIX inflation to peak at a level just below 5 per cent in the first quarter of 2007, it is now expected to breach the upper end of the target range and to peak at a level of 6,2 per cent at that time. CPIX inflation is then expected to fall below the upper end of the target by the next quarter, and by the third quarter it is projected to decline further to 5,2 per cent. Inflation is then expected to continue to moderate gradually to reach 4,8 per cent by the end of 2008. The main reason for the deteriorating outlook is a significant upward revision of the international oil price assumptions.

The most recent inflation expectations survey of the Bank conducted by the Bureau for Economic Research at the University of Stellenbosch shows that expectations for 2006 have remained more or less unchanged, although there has been a slight deterioration in expectations for 2007 and 2008. The revisions were mainly a result of an upward adjustment of expectations of trade unionists, and this brought them in line with the expectations of analysts and business executives. Inflation is now expected to average 4,9 per cent in both 2007 and 2008, compared to expectations in the first quarter of 2006 of 4,6 per cent and 4,8 per cent for these two years, respectively. These expectations are in line with the inflation expectations as indicated in the long-term break-even inflation rate, measured as the yield differential between conventional bonds and inflation-linked bonds, which measured 4,8 per cent at the end of May 2006.

Favourable factors to the inflation outlook include the continued fiscal discipline, the moderate trend in unit labour costs and the benign world inflation. The International Monetary Fund expects world inflation to decline from a projected 3,8 per cent in 2006 to 3,5 per cent next year, despite higher international oil prices.

South Africa's growth performance improved during the first quarter of 2006 to a rate of 4,2 per cent, compared to the revised 3,2-per-cent growth in the fourth quarter of last year. The improved performance occurred despite contractions in both agriculture and mining. The manufacturing sector made a good recovery and grew by 4,3 per cent following a mild contraction in the final quarter of 2005. The latest Investec/BER Purchasing Manager's Index indicates that this improved performance may continue in the second quarter, despite the downturn recorded in April. Overall growth in 2006 is expected to remain more or less in line with potential output.

Although inflation is expected to remain within the target range for most of the forecast period, the risks are still seen to be on the upside. Household real consumption expenditure increased in the first quarter of 2006, at a rate roughly the same as that in the previous quarter, and in line with the 6,9 per cent increase in 2005. Motor vehicle sales remain at a high level although on a month-on-month basis a 4,1-per-cent decrease was recorded in May of this year.

These developments continue to be reflected in the growth of credit extension. Twelve-month growth in bank loans and advances extended to the private sector measured

23,1 per cent in April compared to 24,3 per cent in March, while asset-backed credit extended to the private sector continued to grow strongly at a year-on-year rate of 27,2 per cent in April, reflecting strong growth in mortgage advances. This has resulted in a further increase in consumer indebtedness. In the first quarter of 2006, the ratio of household debt to GDP had risen to approximately 68 per cent, compared to 65½ per cent the previous quarter. The cost of servicing the debt has remained fairly stable at around 7 per cent.

High levels of expenditure contributed to the continued widening in the deficit on the current account of the balance of payments in the first quarter of 2006. This has arisen in part as a result of weak export volume growth and higher volumes and values of crude oil imports, particularly in January and February, when signficantly large trade deficits were recorded. The widening deficit has nevertheless been more than financed by capital inflows. These inflows enabled the Bank to further increase its holdings of foreign exchange reserves. By the end of May, official gross gold and other foreign exchange reserves had increased to US$24,1 billion, while the international liquidity position had increased to US$20,4 billion.

The international environment has posed increased risks to the inflation outlook. Since the previous meeting of the MPC the exchange rate of the rand has come under pressure as a result of developments in international financial and commodity markets. Previously the relative exchange rate stability had contributed to the positive inflation outlook. In the past weeks, the rand has depreciated against all the major currencies at a time when the US dollar has been weakening against other major currencies. The decline in commodity prices and the re-rating of emerging market risk contributed to the depreciation of the rand from around R6,12 to the US dollar at the time of the previous MPC meeting to current levels of around R6,80, and from R7,42 to the euro to current levels of around R8,65. On a trade-weighted basis, the rand has depreciated by approximately 13 per cent since the previous MPC meeting.

The continued uncertainties on the international financial and commodities markets add to inflation risk, but may be a part of the adjustment to changing risk perceptions of emerging markets. Of significance is the fact that South Africa's spreads have not widened by as much as those of a number of other emerging markets and there does not appear to be a strong exodus by non-residents from the domestic bond and capital markets. In fact over the past few weeks, non-residents have remained net buyers of South African bonds and equities. However, in line with a number of other markets internationally, share prices on the JSE Securities Exchange have come under pressure, and the all-share index has retreated from a recent all-time high of just over 22 000 in May to current levels just below 20 000.

According to the IMF, world growth is expected to average a robust 4,9 per cent this year compared to the previous forecast of 4,3 per cent, and 4,7 per cent next year. Uncertainties arise, however, in the interpretation of recent events in the international markets. It is unclear at this stage whether they are simply a reflection of a temporary correction in the markets, or a more sustained period of volatility which could undermine world growth in general and in emerging markets in particular.

Adding to the uncertainty is the continued risk posed by international oil prices. Since the previous meeting of the MPC, the price of Brent crude oil has averaged around US$70 per barrel and fluctuated between a new record high of just below US$75 per barrel in the third week of April and the current level around US$68. These developments have been a result of tight supply and demand conditions, as well as continued geopolitical tensions, which have kept the oil price at a high level. These higher oil prices have been felt domestically in the pump price of petrol. The R0,22 per litre increase in April was followed by increases of R0,39 and R0,36 per litre in May and June, respectively. Approximately R0,14 of the most recent increase is a result of exchange rate movements.

Monetary policy stance

On the basis of the detailed analysis of the economy which is summarised above, the MPC has decided that a moderate adjustment in the repo rate is warranted at present. Accordingly the repo rate is increased by 50 basis points to 7,5 per cent per annum with immediate effect. The MPC will continue to monitor economic developments and all the relevant risks which might have a bearing on the continued attainment of the inflation target.