Statement of the Monetary Policy Committee

13 April 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

Strong consumer demand and rising international oil prices continue to pose a threat to the inflation outlook. Household consumption spending has continued to grow at high levels, and there are few signs of moderation. Consumer confidence is at an all-time high, and this has been reflected in higher household debt, strong credit extension and a widening of the current-account deficit of the balance of payments.

These developments have occurred against a backdrop of resurgent international oil and other commodity prices, and a strongly growing world economy. Robust global growth, persistent international imbalances and the perceived need for caution going forward have resulted in further monetary policy tightening by many of the world's major central banks, and the general expectation is that the international interest rate cycle has not yet reached its peak. World inflation, however, remains under control at low levels.

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 4,5 per cent in February of this year, having measured 4,0 per cent and 4,3 per cent in the previous two months, respectively. Petrol price increases are the main cause of this upward trend in inflation. If petrol prices were excluded, CPIX inflation would have averaged 3,4 per cent in December 2005 and 3,3 per cent in both of the subsequent two months. Transport running costs increased at year-on-year rates of 21,5 per cent and 24,6 per cent in January and February 2006, respectively.

Services price inflation has continued to decline steadily, to the extent that in January and February this year it was lower than goods price inflation. In February, services price inflation measured 4,0 per cent compared to goods price inflation of 4,8 per cent. Administered price inflation excluding petrol is now significantly lower than overall CPIX inflation, and measured 3,6 per cent and 3,5 per cent in January and February, respectively. Some categories of goods continued to contribute significantly to the favourable inflation outcome. Of note were the price declines in the categories of clothing and footwear, and furniture and equipment. By contrast, food price inflation edged up further at rates of 4,3 per cent and 4,5 per cent in January and February, respectively. This was mainly as a result of significant year-on-year increases in the prices of meat, fish and fruit. Prices of grain products however rose at very low rates, despite the sizeable increase in maize prices during the latter part of 2005.

Production price inflation remained unchanged at 5,5 per cent in February compared to January. Imported goods inflation measured 6,4 per cent and 6,9 per cent in these two months, while prices of domestically produced goods increased by 5,2 per cent and 5,1 per cent, respectively. The higher imported price inflation is primarily due to the impact of increased energy prices. If energy costs were excluded, production price inflation would have measured 3,5 per cent in both January and February.

The outlook for inflation

The inflation outlook remains benign, although there are significant risks. The most recent central forecast of the Bank is similar to that seen at the February 2006 meeting of the Monetary Policy Committee (MPC). According to the forecast, inflation is expected to peak at a level just below 5 per cent in the first quarter of 2007, then decline to a level of around 4,6 per cent, and to remain there until the end of the forecast period in 2008.

A number of factors have contributed to this positive inflation outlook. Wage settlements thus far have continued to be generally well contained and in line with the inflation target range. In the fourth quarter of 2005, nominal unit labour cost in the formal non-agricultural sector of the economy increased over four quarters at a rate of 2,5 per cent, compared to a revised figure of 4,5 per cent in the previous quarter. For the year as a whole, unit labour cost increased by 3,3 per cent, compared to 6,5 per cent in 2004. The latest Andrew Levy Employment Publications report shows that wage settlements averaged 6,3 per cent in the first quarter of 2006.

These wage developments reflect to some extent entrenched expectations that inflation will remain within the inflation target range. Further evidence of this is contained in the latest inflation survey conducted by the Bureau for Economic Research (BER) at the University of Stellenbosch. According to this survey, all respondents expected inflation to decline further in the first quarter of 2006. CPIX inflation expectations for 2006 declined from an average of 5,2 per cent in the fourth quarter of the past year to an average of 4,4 per cent in the first quarter of 2006. When expectations regarding 2006 were recorded in the first quarter of 2004, the expected average inflation rate was 6,4 per cent. According to the survey, CPIX inflation is expected to remain below 5 per cent over the forecast period to the end of 2008. Inflation expectations as indicated in the long-term break-even inflation rates, measured as the yield differential between conventional bonds and inflation-linked bonds, also continue to reflect expectations that inflation will remain within the inflation target range.

The exchange rate of the rand fluctuated somewhat in the period since the previous MPC meeting. In line with emerging-market and commodity currencies, the rand depreciated against the US dollar, reaching a level of almost R6,40 in the third week of March. Thereafter it appreciated, and in early April it briefly fell below the R6,00 to the US dollar level, before settling at its current level of around R6,12. This is similar to the level prevailing at the previous MPC meeting. On a trade-weighted basis, the rand has not changed much since the previous meeting, but has appreciated by around 2 per cent since the beginning of the year. The reasons for these movements include changes in the exchange rate of the US dollar against the euro; changes in investor sentiment towards emerging markets; and continued inflows to the domestic foreign exchange market. In addition, strong commodity price movements, in particular gold and platinum prices, have generally supported the exchange rate of the rand.

Fiscal policy is expected to remain supportive of monetary policy, with a moderate deficit of 1,5 per cent of GDP forecast for the 2006/07 fiscal year. Higher-than-expected tax revenue collection in the past financial year resulted in a revised estimated deficit of 0,5 per cent of GDP, compared to an initial estimate of 3,1 per cent.

South Africa's GDP growth, although still robust, has shown some signs of moderation in the past few months to levels more in line with potential output. Growth in 2005 measured 4,9 per cent, the highest growth rate since the early 1980s. However, by the fourth quarter of the past year, the quarterly annualised growth rate had declined to 3,3 per cent, mainly due to a contraction in the mining sector and a slowdown in the manufacturing sector. Indications are that both manufacturing and mining real growth remain under pressure in the first quarter of 2006. Overall business confidence nevertheless remains high: For example, the latest RMB/BER Business Confidence Index shows that the index is marginally below the record high measured in late 2004.

Despite the positive elements in the inflation outlook, there are a number of significant risks, all of which are seen to be on the upside. Consumer demand continues to grow at a brisk pace and shows few signs of abating. In 2005 household consumption expenditure grew by 6,9 per cent. Similar levels of growth have been recorded since the middle of 2003 when nominal interest rates began to decline. The latest FNB/BER consumer confidence index for the first quarter of 2006 surpassed its previous high in the previous quarter. Growth in motor vehicles sales has moderated slightly, but the levels are still high. Consumer demand is also underpinned by wealth effects arising from strong asset price growth. Prices on the JSE Securities Exchange continued to reach new highs, and according to the Absa house price index, house prices also continued to increase, although at a slower year-on-year rate of 13,7 per cent in March.

Growth in credit extension to the private sector reflects the increase in consumer expenditure. Growth over twelve months in total loans and advances accelerated from 21,3 per cent in December 2005 to 22,2 per cent in February 2006. Asset-backed credit growth accelerated from 25,5 per cent to 27 per cent over the same period. These developments have, among other things, contributed to a further decline in gross national savings to 13 per cent of GDP, and an increase in household indebtedness: The ratio of household debt to disposable income had risen to just below 66 per cent in the final quarter of 2005. The cost of servicing this debt, while still low, nevertheless increased from 6¾ per cent of disposable income in the third quarter of 2005 to 7 per cent in the fourth quarter.

Developments on the current account of the balance of payments are becoming an increasing source of concern to the MPC. The current-account deficit as a percentage of GDP averaged 4,2 per cent in 2005, compared to 3,4 per cent in 2004. In the fourth quarter, the deficit had risen to 4,5 per cent of GDP, despite a contraction in the trade deficit during this period. This was due to increased interest and dividend payments, an inevitable consequence of increased capital inflows. As noted in previous statements, 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. To date, the deficits have been more than financed by capital inflows which, in turn, are being attracted in part by the improved growth prospects in the economy. These inflows enabled the Bank to further increase its holdings of foreign exchange reserves. By the end of March, official gross foreign exchange reserves had increased to US$23 billion, while the international liquidity position had increased to US$19,5 billion.

International factors also pose a risk to the inflation and interest rate outlook. In February the price of Brent crude fell to around US$55 per barrel. This respite was short-lived, and as a result of renewed geopolitical tensions and tight demand and supply conditions, international oil prices have risen significantly. Brent crude is currently trading at levels of almost US$70 per barrel. The price of 93 octane petrol increased by R0,22 per litre in April, which more than offset the R0,11 per litre decline in March. Currently the under-recovery on the petrol price is averaging around R0,30 per litre.

Monetary policy stance

The MPC perceives the risks to inflation to be on the upside. In particular, the MPC is mindful of the threats posed by strong credit extension, consumer demand, the widening current-account deficit and rising international oil prices. Nevertheless, given the benign inflation outlook at present, and having considered all the relevant factors, the committee has decided to keep the repo rate unchanged at 7 per cent per annum.