Statement of the Monetary Policy Committee

2 February 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

The inflation outlook remains promising despite the risks posed by an uncertain global environment. World growth is expected to remain buoyant in most regions, although international oil price developments continue to weigh on global growth and inflation prospects. At the same time, world growth has underpinned international commodity prices which, along with positive non-resident investor sentiment, have contributed to the recent strength in the rand. This has been despite monetary policy tightening in a number of countries, in particular the United States of America and the euro area.

Domestically, there are few signs of a slowdown in domestic demand. Output growth in the manufacturing and mining sectors have shown some signs of moderation in the final quarter of 2005, although overall growth is expected to remain relatively strong. Domestic demand conditions and oil price uncertainties pose the biggest risk to the inflation outlook.

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) declined to 3,7 per cent in November, but increased to 4,0 per cent in December. Although domestic petrol prices were decreased by a total of R0,61 in these two months, these prices nevertheless increased on a year-on-year basis by 17,7 per cent and 16,0 per cent, respectively. If petrol prices were excluded from this index, CPIX inflation would have measured 3,0 per cent and 3,4 per cent in November and December, respectively. For the year as a whole, CPIX inflation averaged 3,9 per cent in 2005 compared to 4,3 per cent in 2004.

Services price inflation has declined consistently since June 2005, and measured 5,0 per cent and 4,7 per cent in November and December, respectively, compared to 5,2 per cent in October. Administered price inflation has also continued to decline, falling to 7,5 per cent and 7,0 per cent in November and December, respectively. If petrol prices were excluded, administered prices would have increased at a year-on-year rate of 4,3 per cent in each of the three months to December 2005, more or less in line with overall CPIX inflation.

Clothing and footwear continue to put downward pressure on inflation, and prices in these two categories declined at year-on-year rates of around 4 per cent in the last four months of 2005. By contrast, food prices rose at an annual rate of 4,0 per cent in December, compared to the average for the year of 2,1 per cent. The December increase in food prices mainly was attributable to meat prices which rose at a year-on-year rate of 6,9 per cent, compared to 1,1 per cent the previous month.

Production price inflation has exhibited a more discernible rising trend, with year-on-year producer price inflation measuring 4,5 per cent and 5,1 per cent in November and

December, respectively. Imported goods inflation measured 5,7 per cent and 6,5 per cent in these two months while domestically produced goods increased by 4,0 per cent and 4,6 per cent, respectively. Producer price inflation for 2005 as a whole averaged 3,1 per cent compared to 0,6 per cent the previous year.

The outlook for inflation

Since the previous MPC meeting, the inflation forecast of the South African Reserve Bank has changed somewhat, with the inflation trajectory now expected to follow a more moderately rising trend compared to that discussed at the previous meeting. According to the central forecast, CPIX inflation is expected to peak at around 4,9 per cent in the first quarter of 2007 whereafter it is expected to decline slowly to reach around 4,7 per cent at the end of the forecast period.

As usual the MPC considered the factors that brought about this outlook as well as the related risks. The robust domestic demand is an important factor which could negatively affect the inflation outcome. To date, however, there have not been any significant inflationary consequences, although this could change if demand growth were to accelerate unchecked.

Indications are that household consumption expenditure growth has remained strong. According to the latest FNB/BER survey, consumer confidence reached a record high in the fourth quarter of 2005. New vehicle sales reached an all-time high in December, and increased by 25,7 per cent over the year as a whole. Retail sales have also continued to grow robustly, and recent trading and earnings updates from retailers, as well as credit extension data, suggest that sales growth in November and December of 2005 probably matched or exceeded the 7,7 per cent year-on-year growth recorded in October.

The strong domestic demand has been underpinned by the growth in credit extension. Total loans and advances to the private sector grew at year-on-year rates of around 20 per cent during October and November 2005, and rose to 21,4 per cent in December. This growth in total loans and advances has been driven mainly by an increase in asset-backed credit. Mortgage advances extended to the household sector remain particularly strong.

Asset price developments and their related wealth effects have probably also contributed to the consumption boom. The housing market remains buoyant, although the rate of increase in house prices has moderated somewhat. In December 2005, the Absa house price index increased on a month-on-month basis by 0,7 per cent. Moreover, the recent stellar performance of the JSE Securities Exchange could also impact on consumer demand. In the past few months, share prices have continued to reach new highs. Since reaching a low point for 2005 in April, the all-share index has increased by approximately 60 per cent.

The brisk domestic demand has had an impact on the current account deficit which increased to 4,7 per cent of GDP in the third quarter of 2005.

A sizeable trade surplus was recorded in December following a sharp decline in imports. This has contributed to a significant narrowing of the trade deficit from R19,6 billion in the third quarter to R1,4 billion in the fourth quarter of 2005. This is likely to result in a narrowing of the current account deficit in that quarter.

Continued strong domestic demand is expected to maintain pressure on the current account. However the current account deficit continues to be more than adequately financed by capital inflows which, in turn, are being attracted by improved economic growth prospects in South Africa. The overall balance of payments has remained in surplus, and the level of official gross gold and foreign exchange reserves increased to US$22,2 billion at the end of January 2006.

The coincident business cycle indicator declined slightly in October 2005, although indications are that the economy is still growing at a healthy but perhaps more moderate pace. The physical volume of mining production declined in October and November, while manufacturing output declined in October, mainly as a result of supply issues in the petroleum industry related to the change to lead-free fuel. Although refinery shut-downs continued into November, manufacturing output recovered somewhat in that month, recording a year-on-year growth of 2,1 per cent. The latest Investec Purchasing Managers Index (PMI) also indicates that there might be a general slackening in manufacturing-sector growth. The various business confidence indices indicate that confidence generally remains at high levels.

Two exogenous factors, namely oil and food price developments, are potential risks to the inflation outlook. At the time of the previous MPC meeting the price of Brent crude oil was around US$55 per barrel, but since the beginning of 2006 international oil prices have again risen to levels of around US$65 per barrel. Apart from continued strong demand for oil, upward pressure on prices has emanated from supply threats related to geo-political concerns. The higher prices have already resulted in a domestic petrol price increase of R0,14 per litre in February, which more than offset the R0,06 per litre decrease in January.

Developments in food price inflation are also a potential concern. As noted earlier, food price inflation has accelerated but is still relatively low. Food price inflation is expected to be higher in 2006, partly as a result of the low base in 2005. Furthermore, the higher food price inflation evident in production prices, along with higher maize prices, also point to a possible acceleration in retail food price inflation going forward.

There are a number of factors which have contributed to the positive inflation outlook. These include continued fiscal discipline, low world inflation and well-anchored inflation expectations. Inflation expectations as indicated in the long-term break-even inflation rates, measured as the yield differential between conventional bonds and inflation-linked bonds, point to some improvement in inflation expectations since the previous meeting.

Nominal wage growth recorded a year-on-year increase of 7,9 per cent in the third quarter of 2005. However, positive productivity growth ensured that unit labour cost increases have remained consistent with the inflation target. Unit labour cost in the formal non-agricultural sectors recorded annual increases of 3,5 per cent and 4,2 per cent in the second and third quarters of 2005, respectively. Unit labour cost in manufacturing grew at an annual rate of 0,2 per cent in the third quarter. These moderate trends in wage increases are consistent with the latest Andrew Levy Employment Publications report which shows that average wage settlements declined from 6,9 per cent in 2004 to 6,3 per cent in 2005.

Since the previous meeting of the MPC, the nominal effective exchange rate of the rand has appreciated by approximately 1,7 per cent. During this period, the rand has fluctuated between R6,75 to the US dollar in November 2005 and R5,95 in January, and is currently trading at levels of around R6,10. The strengthening of the rand was in part a reflection of US dollar depreciation. In addition, the rand was supported by high commodity prices, expectations of further foreign direct investment inflows, positive South African economic data as well as strong demand from non-residents for South African equities.

Monetary policy stance

There are significant risk factors to the inflation outlook that the Monetary Policy Committee is mindful of. Nevertheless, the Monetary Policy Committee has decided for now to leave the repo rate unchanged at 7 per cent per annum. The MPC will continue to exercise vigilance in order to ensure that CPIX inflation stays within the inflation target range.