Statement of the Monetary Policy Committee

11 October 2007

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

Introduction

Since the previous meeting of the Monetary Policy Committee (MPC), the turbulence in the international financial markets has subsided somewhat. South Africa's financial markets have emerged from this episode relatively unscathed. The rand exchange rate has returned to levels that prevailed before the recent turbulence in the financial markets, and the all-share price index on the JSE Limited has recovered and reached new highs.

Inflation has remained above the upper limit of the inflation target range and inflation expectations have risen somewhat in the wake of the higher inflation trend. Risks to the inflation outlook persist although there are some signs that the economy is responding to the tighter monetary policy stance. Inflation reacts with a lag to monetary policy changes, and the challenge for the MPC was to assess whether the observed response will be sustained and sufficient to bring inflation back to within the target range.

Recent developments in inflation

CPIX inflation measured 6,4 per cent in both May and June of 2007 and then increased to 6,5 per cent in July before moderating to 6,3 per cent in August. Broader underlying pressures remain evident, and if food and energy were excluded, CPIX inflation would have measured 5,0 per cent in July and August. Food prices increased at year-on-year rates of 10,2 per cent and 11,3 per cent in July and August, respectively, despite some moderation in meat price increases.

Services price inflation continued its steady upward movement, measuring 5,8 per cent in August compared to 4,6 per cent in January 2007. Administered prices excluding petrol increased by 6,8 per cent and 7,4 per cent in July and August, respectively, having been steady around the 5,5 per cent level for the first half of the year. Petrol price reductions in both July and August resulted in a 6,0 per cent year-on-year increase in petrol prices in July and a 0,5 per cent decline in August which, along with further declines in the prices of clothing, footwear and furniture, contributed to the slight moderation seen in the August inflation rate.

Production price inflation has declined steadily after peaking at 11,3 per cent in May 2007. In August it measured 9,5 per cent, with imported goods inflation and domestic goods inflation measuring 9,7 per cent and 9,3 per cent, respectively. Both agricultural and manufactured food prices have continued to accelerate, indicating further food price pressures at the retail level in the near term. Agricultural food prices increased at a year-on-year rate of 22,9 per cent in August, while manufactured food prices increased by 14,9 per cent.

The outlook for inflation

The most recent central forecast of the Bank indicates a modest deterioration in the inflation outlook, particularly in the short term, when compared to the forecast considered at the previous MPC meeting. CPIX inflation is now expected to remain above the upper level of the inflation target range and to peak in the first quarter of 2008 at an average of 6,8 per cent before declining to the upper end of the inflation target range in the following quarter. Thereafter CPIX is expected to continue its downward path and reach around 5,2 per cent by the end of 2009. The higher trend is a result of a higher-than-expected second-quarter inflation outcome and revised administered price assumptions.

Inflation expectations increased in the third quarter of 2007. According to the survey conducted by the Bureau for Economic Research (BER) at the University of Stellenbosch, CPIX inflation is expected to average 5,9 per cent in 2007 and 5,8 per cent and 5,6 per cent in the next two years. These expectations are 0,5 percentage points higher for 2007 and 2008 than those measured in the second quarter, and 0,4 percentage points higher for 2009. Although expectations are generally still within the inflation target range, the upward trend of expectations is of concern given the significant role that these expectations play in wage and price-setting decisions.

Despite the upward drift in expectations, the view is still that inflation will decline over time. This is confirmed in part by the inverted yield curve and also by the medium-term inflation expectations indicated in the break-even inflation rates, as measured by the yield differential between conventional bonds and inflation-linked bonds of similar maturity. This measure has recently declined to just below 5,2 per cent compared to 5,8 per cent in July.

The higher inflation expectations are also reflected in wage trends. According to Andrew Levy Employment Publications, the average level of wage settlements for the nine months ending 30 September 2007 was 7,2 per cent compared to 6,4 per cent at the end of September 2006. Unit labour cost increases, which adjust for labour productivity changes, measured 5,5 per cent in the second quarter which is consistent with the inflation target range.

The MPC identified a number of risks to the inflation outlook and is of the view that these risks remain on the upside.

Exogenous factors, namely oil and food prices, continue to cloud the inflation outlook. International oil prices have increased since the previous MPC meeting when North Sea Brent crude oil was trading at around US$72 per barrel. After declining to US$68 per barrel in August, the upward trend was resumed and the price reached levels in excess of US$80 per barrel in September. At present the price is around US$78 per barrel. The appreciation of the rand against the dollar in September moderated the impact of the international price on the domestic petrol price. In October, the domestic price of 95-octane petrol increased by 10 cents per litre, following a reduction by the same amount the previous month. While a possible moderation of global growth could take some pressure off the oil prices, at this stage the risks to inflation emanating from this source are still considered to be on the upside.

Food price developments also remain a risk. Domestic food prices have been influenced by adverse domestic supply conditions and international developments, including the impact of biofuel demand. Over the past two years maize and wheat prices have increased significantly. The longer-term outlook for food prices as reflected in lower futures prices appears more promising. However, as indicated earlier, prices are expected to remain elevated as a result of pressure from production prices.

One of the key inflation risks identified in previous meetings has been the strong growth of household consumption expenditure. More recently there has been evidence of some moderation. After increasing at an annualised rate of 7,4 per cent in the first quarter of 2007, household consumption expenditure increased at a rate of 5,5 per cent in the second quarter. This was the lowest quarterly increase since the second quarter of 2003. The main contributor to this slowdown was an annualised 10-per-cent decline in durable goods expenditure.

Retail sales have lost some momentum in recent months, having increased by 0,3 per cent in the three months to July compared to the previous three months. On a year-on-year basis, retail sales increased by 4,9 per cent in real terms in July 2007 compared to 7,1 per cent in June. The subdued trend in motor vehicle sales also continued, particularly with respect to passenger car sales. New commercial vehicle sales have also declined recently. The FNB/BER Consumer Confidence Index, which reached an historically high level in the first quarter of 2007, declined in the second and third quarters.

The moderation observed in the growth of household consumption expenditure is not reflected to the same extent in the credit extension data. Nevertheless, tentative signs of restraint are evident. Twelve-month growth in the banks' loans and advances extended to the private sector has continued at a brisk pace. This rate declined from 27,7 per cent in June 2007 to 25,0 per cent in August. This trend is also observed if securitisation transactions are adjusted for, although at a higher level. Twelve-month growth in loans and advances to the household sector has continued its downward trend, measuring 20,9 per cent in August compared to 21,7 per cent in June. Growth in loans and advances to the corporate sector also showed signs of moderating from high levels when it increased by 30,1 per cent in August compared to 35,4 per cent in July.

There has also been some moderation in output growth, with gross domestic product (GDP) growing at an annualised rate of 4,5 per cent in the second quarter of 2007. This rate is in line with the Bank's estimates of potential output growth. The slowdown was mainly a result of slower growth momentum in the manufacturing sector which grew at an annualised rate of 0,5 per cent. The Investec/BER Purchasing Managers Index, which declined in August and September, indicates that this sector is likely to remain under pressure in the coming months. This overall trend is also confirmed by the RMB/BER Business Confidence Index which, although still high, has declined to its lowest level in three-and-a-half years. Despite evidence of a slowdown, growth is expected to be sustained at levels around potential, underpinned by continued strong investment expenditure.

The exchange rate of the rand has continued to display a degree of resilience. The rand had initially depreciated in the wake of the turbulence in international financial markets. At the previous MPC meeting the rand was at a level of around R7,45 against the United States (US) dollar compared to a level of around R6,80 in July. The depreciation of the US dollar against a number of major currencies, particularly the euro, resulted in the rand exchange rate returning to levels prevailing in July. On a trade-weighted basis, the rand has depreciated by about 2,3 per cent since the beginning of the year, but has appreciated by 6 per cent since the previous meeting of the MPC.

Developments in the exchange rate of the rand can be ascribed in part to capital inflows, strong commodity prices and the favourable outlook for the South African economy. During August, at the height of the global financial market turbulence, non-resident net purchases of South African bonds and shares totalled R32 billion, although in

September the net purchases were negligible. The deficit on the current account of the balance of payments which had measured 6,5 per cent of GDP in the second quarter of 2007 continued to be financed comfortably. Furthermore, the Bank was able to increase the level of official gross gold and other foreign-exchange reserves to US$30,5 billion at the end of September, while the international liquidity position improved to US$28,4 billion.

On the international front, although uncertainties still remain, financial market turbulence appears to have subsided somewhat. The longer-term impact on the global growth outlook is still unclear, but some slowdown in the US economy, in particular, can be expected. Nevertheless, continued robust growth in Asia is expected to underpin commodity prices. World inflation is expected to remain under control despite a slight upward adjustment in inflation expectations.

Monetary policy stance

Having considered the above developments and in particular the risks which are on the upside, the MPC has decided to adjust the repurchase rate by 50 basis points to 10,5 per cent per annum with effect from Friday, 12 October 2007. The MPC is determined to ensure that inflation returns to within the target range.