Statement of the Monetary Policy Committee

7 June 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

CPIX inflation breached the upper end of the inflation target range in April 2007 for the first time since August 2003. The year-on-year increase of 6,3 per cent was higher than that expected by the Bank and most forecasters. The petrol price had increased by R0,69 per litre in April, and this was expected to contribute to an increase in the inflation rate. This was compounded by strong increases in food prices as well as generalised increases in some other categories.

The breach of the target is in the past and there is nothing that monetary policy can do about past inflation. Nevertheless, the Monetary Policy Committee (MPC) cannot ignore the possible impact of this breach on inflation expectations and the public's understanding of the monetary policy process. Monetary policy acts with a lag, and the focus of the MPC will remain, as always, on the medium-term inflation outlook which is the period over which monetary policy can be effective.

Recent developments in inflation

Year-on-year 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 6,3 per cent in April 2007 compared to 4,9 per cent in February and 5,5 per cent in March. Food and petrol price increases accounted for most of the increase, but more broad-based pressures are also becoming evident. If food and energy were excluded, CPIX inflation would have measured 4,6 per cent in April compared to 3,9 per cent in January. Although this measure is still well within the target range, the recent strong upward trend is indicative of more broadly-based price pressures.

The biggest impetus to the increase in the inflation rate in April came from the petrol price. Petrol prices increased at a year-on-year rate of 15,5 per cent in April 2007 compared to 7,9 per cent in March. Food price inflation also continued its upward trend measuring 7,8 per cent and 8,6 per cent in March and April, respectively. The higher food price inflation in April was driven mainly by grain product and meat price increases. Grain product prices increased at a year-on-year rate of 10,6 per cent compared to meat price increases of 10,8 per cent. The latter, although still high, are significantly lower than the peak increases of almost 20 per cent in October and November last year. Prices of household consumables increased by 8 per cent in April, compared to 6,1 per cent in February.

Services price inflation has also been increasing steadily, having measured 5,5 per cent on a year-on-year basis in April compared to 4,6 per cent in January. Certain components of housing services made a significant contribution to this upward trend. Pressures on inflation continue to be moderated by price declines in clothing, footwear, furniture, and recreation and entertainment.

Production price inflation increased at a year-on-year rate of 11,1 per cent in April compared to 9,5 per cent and 10,3 per cent in February and March, respectively. These developments point to further pressures on CPIX inflation in the coming months. The April increase has been the highest since December 2002. Apart from textiles, clothing and footwear, the increases were across a wide spectrum. Prices of domestically produced goods increased by 11,2 per cent in April compared to 10,5 per cent for imported goods.

The outlook for inflation

The most recent central forecast of the Bank's models indicates a further deterioration in the inflation outlook compared to the previous forecast. The forecast, which takes account of the petrol price increases of May and June, projects that CPIX inflation will remain marginally above the upper level of the inflation target range in the second quarter of 2007. After a technical decline in the third quarter, CPIX inflation is expected to marginally exceed 6 per cent in the subsequent two quarters, peaking at an average of 6,3 per cent in the first quarter of 2008. Thereafter, CPIX inflation is projected to follow a downward trajectory and to average 5,3 per cent in the fourth quarter of 2008. The higher trend of the forecast in the near term compared to the previous forecast is a result of a slightly higher oil price assumption. The committee continues to view the risks to the outlook to be strongly on the upside.

Inflation expectations are an important indicator of possible future inflation trends because of their impact on wage and price setting processes. According to the most recent inflation expectations survey conducted in May on behalf of the Bank by the Bureau for Economic Research at the University of Stellenbosch, there had been some deterioration in inflation expectations which had moved back to the levels of the fourth quarter of 2006. Nevertheless, inflation expectations still remained within the inflation target range. Respondents expected CPIX inflation to average 5,5 per cent this year, and to moderate to 5,3 per cent and 5,2 per cent, respectively, in the coming two years. Expectations of trade unionists has increased the most since the previous survey. Labour and business expectations were then significantly higher than those of analysts, but all groups were within the target range for all three survey years.

The bond markets have also shown evidence of some deterioration in expectations. In reaction to the April inflation data, long-term bond yields increased further and the yield curve shifted upwards, although it remained inverted. The break-even inflation rate, which is the difference between the yield on conventional bonds and the yield on inflation-linked bonds, increased by about 50 basis points to around 5,6 per cent from the end of May.

The MPC identified a number of upside risks to the outlook. These include food and oil prices and continued high rates of household consumption expenditure. The assessment of most of the other variables has been relatively unchanged since the previous meeting.

Oil remains an upside risk to the inflation outlook. The price of North Sea Brent crude oil has averaged US$68 per barrel since the previous MPC meeting and is currently trading above US$72 per barrel. International prices remain dominated by geopolitical tensions, fluctuating inventory levels and supply disruptions in a number of oil-producing countries. Futures prices suggest that upward pressure on oil prices is expected to persist in the near future. The domestic petrol price was increased by R0,34 and R0,23 per litre in May and June, respectively. These increases, which were due to international product price increases, were cushioned to some extent by the behaviour of the exchange rate.

Pressure on inflation emanating from food price increases is expected to persist for some time. This may be attributed to international food price developments which have seen the diversion of grain products to biofuel production and increased food demands as a result of higher global real incomes.

Household consumption expenditure has remained strong although preliminary estimates suggest that there has been a slight moderation in the first quarter. Growth in new passenger motor vehicle sales has been declining since late last year, but the most recent trend has been distorted by problems related to the teething challenges during the introduction of a new electronic licensing system. Sales of commercial and heavy vehicles remain strong, reflecting the strong state of the economy. Growth in retail sales declined to a year-on-year rate of 8,0 per cent in February compared to 9,9 per cent the previous month, but accelerated to a year-on-year rate of 10,1 per cent in March.

The continued underlying strength in household consumption expenditure is reflected in the high rates of domestic credit extended to the private sector. Twelve-month growth in banks' loans and advances extended to the private sector measured 26,2 per cent in March before increasing to 27,4 per cent in April. Adjusted for the cumulative effect of securitisation transactions, growth has remained at around 29 per cent. Growth in mortgage advances, which had previously exhibited a slight declining trend, increased at a year-on-year rate of 27,6 per cent in April. In line with the declining trend in passenger motor vehicle sales, instalment sale and leasing finance increased by 17,2 per cent and 16,9 per cent in March and April, respectively. Consistent with the growth in fixed capital formation, advances to the corporate sector accounted for the strongest increases in bank lending.

The sustained strength in consumer demand has been underpinned by higher levels of employment, higher real incomes and improved household balance sheets. Higher equity and house prices contributed to this positive wealth effect. The all-share index on the JSE Limited reached new heights in the past weeks, in tandem with strong equity market performances in a number of countries. According to the Absa and Standard Bank house price indices, house prices continue to increase although at moderately slower rates.

South Africa's economic growth rate declined moderately in the first quarter of 2007 to an annualised quarter-on-quarter rate of 4,7 per cent. The decline is attributable mainly to a contraction in the mining sector and slower manufacturing-sector growth. The construction sector grew at over 21 per cent mainly as a result of non-residential construction and civil engineering projects. This strong performance is indicative of the continuing domestic investment boom which has been given further impetus by the investment activities of public corporations. The economy is still growing at a rate of around estimated potential and the higher rate of fixed capital formation, which is now in excess of 20 per cent of gross domestic product (GDP), is expected to sustain economic growth going forward as well as increase the growth potential of the economy. The utilisation of production capacity in manufacturing increased by a further 0,3 percentage points in the first quarter of 2007 to 86,5 per cent. However, growth in the manufacturing sector appears to have moderated somewhat. Manufacturing output declined between March and April of this year, and the most recent Investec Purchasing Managers Index (PMI) also indicates a slowdown of the manufacturing sector's growth momentum.

According to the most recent Wage Settlement Survey by Andrew Levy Employment Publications, wage settlements averaged 6,5 per cent in 2006 and remained at this rate in the first quarter of 2007. These increases are consistent with the inflation target if positive changes in labour productivity are taken into account.

The exchange rate of the rand is trading at levels similar to those prevailing at the time of the previous MPC meeting. The volatility observed since the last meeting can be attributed mainly to movements of the US dollar against other currencies.

The deficit on the trade account of the balance of payments narrowed as a result of an expected decline in the volume of imported oil. Preliminary data suggest that the deficit on the current account of the balance of payments in the first quarter of 2006 was narrower than that experienced in the final quarter. As before, this deficit was comfortably financed by net financial inflows. In the year to date, non-resident net purchases of bonds and equities have totalled around R45 billion. The bulk of this has been equity investments, reflecting continued confidence in South Africa's macroeconomic policy framework and the related growth prospects. This is also illustrated further by the revision of the outlook from stable to positive of South Africa's external sovereign debt rating by Moody's rating agency. Further progress was also made with international reserve accumulation. As at the end of May, official gross gold and other foreign exchange reserves had increased to US$ 27,9 billion, while the international liquidity position had risen to US$ 25,5 billion.

Aside from oil and food price developments, the international economic environment remains relatively favourable. World growth is expected to remain strong although slightly lower than that achieved last year. The main risk to growth is seen to emanate from the housing market in the United States, although this risk appears to have dissipated somewhat. In general, international interest rates are not expected to decline in the near future, while further increases may still occur in some regions. The generally tighter monetary policy stance is expected to keep inflation contained despite pressures from rising oil and food prices. Growth prospects in the CMA region remain positive, although member countries are also experiencing inflationary pressures from food and oil prices.

Monetary policy stance

The MPC has decided that in view of the further deterioration in the inflation outlook, the monetary policy stance needs to be adjusted to ensure that CPIX inflation returns to within the inflation target range over time. Accordingly, the repo rate will be increased by 50 basis points to 9,5 per cent per annum with effect from Friday 8 June 2007. The MPC will continue to monitor developments which have a bearing on inflation outcomes and will not hesitate to adjust the policy stance as may be appropriate.