Statement of the Monetary Policy Committee

12 April 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) in February 2007, the inflation outlook has deteriorated somewhat, despite the most recent inflation outcomes. The less favourable outlook has been brought about primarily by petrol and food price increases. Domestic demand pressures and credit extension have remained strong with only tentative signs of moderation in response to the tighter monetary policy stance.

At the same time, the South African economy has been growing at a robust pace and employment growth has also been encouraging. Domestic growth prospects remain positive despite the temporary sell-off in the international markets in late February. The appetite for emerging-market assets has rebounded.

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 5,3 per cent in January 2007, following a rate of increase of 5,0 per cent in the previous three months. In February, year-on-year CPIX inflation declined to 4,9 per cent. Food and energy remained the main drivers of inflation. If these categories were excluded, CPIX inflation would have measured 3,9 per cent and 4,0 per cent in January and February, respectively.

Food prices increased at a year-on-year rate of 7,7 per cent in February this year, following an 8,1-per-cent increase in January. Meat price inflation, which was the largest contributor to overall CPIX inflation, declined from 16,0 per cent in January to 13,9 per cent in February. The elevated spot prices of maize and wheat resulted in grain product prices accelerating at a rate of 8,7 per cent in February, compared to 7,1 per cent in January. Petrol price changes over the past few months have been a reflection of the volatility in international oil prices and the exchange rate. In February 2007, year-on-year petrol price inflation measured 1,8 per cent compared to 8,2 per cent the previous month. This is, nevertheless, significantly lower than the increases in excess of 20 per cent that were experienced in the middle of last year. By contrast, the prices of a number of goods continued to decline in February. Clothing prices declined by 7,8 per cent, footwear prices by 11,0 per cent and those of furniture by 2,8 per cent.

In January and February 2007, goods price inflation measured 5,7 per cent and 5,0 per cent, respectively, compared to services price inflation of 4,6 per cent and 4,8 per cent in the same months. Administered prices increased by 6,4 per cent and 4,1 per cent in January and February, respectively, while administered prices excluding petrol increased at a year-on-year rate of 5,7 per cent in those months, compared to 3,1 per cent in June 2006.

Production price inflation continued to increase at high rates across a broad range of categories, although below the peak of 10,0 per cent seen in October and November 2006. Measured year on year, production price inflation declined to 9,5 per cent in

February, compared to 9,8 per cent in January. Imported goods inflation measured 9,7 per cent in February compared to domestically produced goods inflation of 9,4 per cent.

The outlook for inflation

The most recent central forecast of the Bank's forecasting model indicates a deterioration in the inflation outlook, mainly as a result of adverse developments in the international oil markets and administered prices. The forecast, which takes into account the petrol price increases of March and April, projects that CPIX inflation will increase to slightly below the upper level of the inflation target in the second quarter of 2007. Thereafter, apart from a technical decline in the third quarter, CPIX inflation is expected to remain at rates of around 5,9 per cent until the second quarter of 2008 and then follow a downward trajectory to reach 5 per cent by the final quarter of that year.

The latest survey of inflation expectations conducted on behalf of the Bank by the Bureau for Economic Research (BER) at the University of Stellenbosch indicates that CPIX inflation expectations in respect of both 2007 and 2008 have declined compared to the previous survey. This may indicate that inflation expectations are not always backward looking, and have remained entrenched within the inflation target range. Inflation expectations declined from 5,4 per cent to 5,2 per cent for 2007, and from 5,4 per cent to 5,1 per cent for 2008, while CPIX inflation is expected to average 5,1 per cent in 2009 . All categories of respondents lowered their expectations for 2007, while business executives and trade union officials lowered their expectations for 2008.

As usual, the MPC analysed the factors impacting on inflation and assessed the risks to the forecast. In some instances, these risks were perceived to have increased, whereas in other cases there had been no major change to our previous assessment. In particular, the risks posed by oil and food prices appeared to have increased.

International oil price developments have been dominated by heightened geopolitical tensions, supply disruptions and declining inventory levels. The price of North Sea Brent crude oil increased to around US$70 per barrel in recent weeks, compared to a level of around US$56 per barrel at the time of the February MPC meeting. As a result, the domestic petrol price increased by R0,24 per litre in March, and R0,68 per litre in April. A decomposition of the April price increase shows that of the R0,68 increase in April, about R0,09 was attributable to exchange rate changes, R0,10 to fuel taxes announced in the February Budget, and the remainder to changes in the international price of oil. International oil prices are expected to remain vulnerable to geopolitical developments and therefore continue to pose a significant risk to the outlook.

The spot prices of white and yellow maize have increased significantly over the past two years as a result of domestic drought conditions and increases in international prices. Grain product prices, which have a weight of 4,8 per cent in CPIX, are expected to increase further as they have not yet fully reflected these increases. The higher maize prices have also affected meat prices through their impact on cattle and chicken feed prices. However, meat price inflation could be moderated somewhat as more cattle are brought to market during periods of drought. This effect, while possibly significant, is expected to be relatively short-lived.

Despite the tighter monetary stance since June last year, household consumption expenditure growth, which measured almost 8 per cent in the fourth quarter of 2006, continues to pose a risk to inflation. In January of this year, retail sales increased at a year-on-year rate of 9,4 per cent compared to 6,7 per cent in December 2006. There is, however, some evidence of moderation in the growth of interest-sensitive durable goods consumption. In particular, a softening trend in motor vehicle sales has been observed in recent months. The seasonally adjusted number of new vehicles sold in the first quarter of 2007 declined by 2,9 per cent compared to the fourth quarter of 2006.

Consumer confidence remains at a high level. According to the latest FNB/BER Consumer Confidence Index (CCI), the CCI increased significantly during the first quarter of 2007 to reach the highest level ever recorded in the 25-year existence of the index. Factors underpinning the strong demand include the further increases in asset prices. The housing market remains buoyant and the JSE Securities Exchange has reached new highs despite the short-lived downturn in March.

Credit extension by banks to the private sector has continued at uncomfortably high levels. Twelve-month growth in banks' loans and advances extended to the private sector has grown at a rate of around 27 per cent since November 2006, and increased to 27,7 per cent in February this year. Asset-backed credit growth, however, showed a modest decline in February to 25,5 per cent. Instalment sale and leasing finance growth declined from 15,8 per cent in December to 14 per cent in February, reflecting the moderation in demand for motor vehicles. Growth in total loans and advances to households has been on a somewhat declining trend compared to the strong upward trend in credit extension to the corporate sector. Nevertheless, the ratio of household debt to disposable income increased further in the fourth quarter of 2006 to almost 74 per cent and the cost of servicing the debt has been steadily increasing.

The South African economy has grown at a rate of 5 per cent in each of the past three years, a level which we estimate to be slightly above potential. Indications are that growth rates around this level are likely to be sustained during 2007. Capacity utilisation in the manufacturing sector increased further in the fourth quarter to a new level of 86,6. The Investec Purchasing Managers Index (PMI) reflects continued buoyant conditions in the manufacturing sector, and despite a marginal decline in the RMB Business Confidence Indicator, business confidence remains high and broad based.

Underpinning this positive outlook is a strong trend in the growth of investment expenditure. Gross fixed capital formation increased at an annualised rate of 16,6 per cent in the fourth quarter of 2006, and 12,8 per cent for the year. As a ratio to gross domestic product (GDP), gross fixed capital formation has increased from around 15 per cent in the early part of the decade to over 19 per cent in the final quarter of 2006. While this bodes well for current and future growth, the concurrent decline in the savings ratio has seen the current-account deficit of the balance of payments widening to 6,4 per cent of GDP in 2006, and 7,8 per cent of GDP in the final quarter of the year.

The good growth prospects for the economy continued to ensure that the current-account deficit has been adequately financed. Since the beginning of this year, net non-resident purchases of bonds and equities have totalled R20,3 billion. The Bank has also been able to continue with its gradual build-up of international reserves. Official gross gold and other foreign exchange reserves stood at US$26,5 billion at the end of March 2007 and the international liquidity position amounted to US$24,0 billion.

Since the February meeting of the MPC, the exchange rate has been relatively stable, apart from the reaction to the transitory sell-off in international financial markets in late February. The exchange rate reached a level of R7,55 to the US dollar in response to the heightened risk in the markets, but by late March the rand had returned to levels below R7,30. The rand is currently trading at around R7,15 to the US dollar, compared to

R7,20 at the previous meeting. The trade-weighted rand exchange rate is also relatively stable compared to February. Other factors impacting on the exchange rate during this period included movements in the US dollar against other currencies and commodity price fluctuations.

The outlook for global growth appears to be positive, despite the recent market volatility. The rerating of risk, particularly in emerging markets, resulted in significant adjustments in exchange rates and stock market valuations globally. Most markets have since recovered to a large extent, including those in South Africa. Strong growth in most regions is expected to be sustained, although there is the risk of a slowdown in the United States. The continued resilience of the world economy also bodes well for commodity prices. Global inflation is expected to remain under control despite the firmer oil prices, and the international interest rate cycle appears to have peaked. However, monetary policies are unlikely to become generally more accommodating in the short term in the face of the positive growth outlook.

Monetary policy stance

The MPC has decided that despite the slight deterioration in the inflation outlook, an unchanged monetary policy stance continues to be appropriate for now. The repo rate will therefore remain at 9 per cent per annum.