Statement of the Monetary Policy Committee

07 December 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

Inflation has continued its upward trend but is still within the inflation target range. Credit extension and domestic demand remain strong, and there are only tentative signs that household consumer demand may be responding to the tighter monetary policy stance. The recent revisions of the gross domestic product (GDP) data show that the economy has been growing at a faster rate than previously estimated. Reflecting the strong economy, the equity market has reached new highs.

The outlook for the international economy remains somewhat mixed with good growth performances in Europe and Asia, and some weakness in the United States economy. The resultant weakening of the US dollar against some of the major currencies and the rebounding of investor confidence in emerging markets has influenced the rand and other currencies.

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) declined to 5,0 per cent in October 2006 from 5,1 per cent in September. The outcome, however, was higher than expected following the R0,50-per-litre reduction in the petrol price in October. Petrol and diesel prices increased at a year-on-year rate of 0,2 per cent in October, compared to 22,1 per cent in August. The lower petrol price inflation, combined with continued sizeable declines in the prices of clothing and footwear, contributed to the moderation in goods price inflation from 6,0 per cent in August to 5,1 per cent in October. However, this favourable development was offset by the increase in services inflation from 3,5 per cent in August to 4,6 per cent in October.

The food category remained the main inflation driver. Food price inflation increased from a year-on-year rate of 7,2 per cent in August 2006 to 7,9 per cent and 9,4 per cent in September and October, respectively. Meat prices increased at a year-on-year rate of almost 20 per cent in October, while the prices of fish and other seafood increased by 11,0 per cent. The significance of the meat price developments is illustrated by the fact that if this subcategory were excluded, CPIX inflation would have measured approximately 3,8 per cent in October. Housing services were primarily responsible for the increase in services inflation in September and October. Administered prices excluding energy increased at a year-on-year rate of 5,5 per cent in October, up from 4,2 per cent in August.

Production price inflation continued to increase markedly and across a broad spectrum of categories. Measured year on year, production price inflation had declined to 9,0 per cent in September 2006 from 9,2 per cent the previous month. However, in October the year-on-year increase was 10,0 per cent. Imported goods inflation measured 10,4 per cent in October compared to 8,2 per cent in September. Domestically produced goods inflation increased to 9,9 per cent compared to 9,2 per cent in the previous month. The categories displaying the highest year-on-year increases included agricultural products, manufactured food and electricity, gas and water.

The outlook for inflation

The most recent central forecast of the Bank's forecasting model indicates a moderate improvement in the inflation outlook compared to the forecast considered at the October meeting of the Monetary Policy Committee (MPC). CPIX inflation is expected to breach the upper level of the inflation target range in the second quarter of 2007. Thereafter, CPIX inflation is expected to follow a downward path to just above 5 per cent at the end of the forecast period in 2008. The more favourable outlook is as a result of the previous monetary adjustments, and a consolidation of oil prices at around US$60 per barrel.

Inflation expectations have shown a slight deterioration in the fourth quarter of 2006. According to the latest survey conducted on behalf of the Bank by the University of Stellenbosch-based Bureau for Economic Research (BER), expectations increased marginally by 0,1 percentage points in respect of both 2006 and 2007. However, the forecast for 2008 shows a significant upward adjustment of 0,4 percentage points. The survey results indicate that CPIX inflation is now expected to average 5,4 per cent in both 2007 and 2008. In the previous survey the forecasts were 5,3 per cent and 5,0 per cent, respectively. Although expectations for all forecast years are within the inflation target range, the upward trend in expectations observed over the past two quarters is a source of some concern to the MPC.

The yield curve became more inverted in October and November 2006. Rather than necessarily reflecting expectations of a drastic slowing in the economy, technical factors are partly responsible for the inversion of the curve. The shorter end of the curve reflects expectations of higher interest rates, while the longer end of the curve is influenced by among other things, demand and supply conditions in the bond market and positive expectations regarding future inflation outcomes.

Notwithstanding the slight improvement in the forecast, the MPC still views the risks to the outlook to be on the upside, with continued pressures on inflation emanating from a number of sources.

There is a mixed picture with respect to the responsiveness of household consumer demand to the cumulative 150-basis-point increase in the repo rate since June. The growth in household consumption expenditure declined moderately from 7,8 per cent in the second quarter of 2006, to 7,2 per cent in the third quarter, with a marked decline in the growth of spending on durable and non-durable goods. Motor vehicle sales trends may indicate a possible impact of the increased interest rates on sales. In November, new motor vehicle sales increased at a modest year-on-year rate of 2,3 per cent, and declined by 3 per cent on a month-on-month basis. The FNB/BER Consumer Confidence Index, however, rose marginally in the fourth quarter following a decline in the third quarter, indicating continued resilience in consumer demand.

Despite tentative signs of moderation in consumer demand, private-sector credit extension remains at high levels. Growth in total loans and advances extended to the private sector has maintained a rate of around 26 per cent since August 2006 despite some securitisation transactions. Mortgage advances remained the main source of credit growth. The higher rates of credit extension have contributed to the further increase in household indebtedness which in the third quarter of this year rose to 73 per cent of household disposable income, while the cost of servicing this debt has also increased marginally. Insolvencies have remained at low levels.

Food price inflation continues to pose a threat to the inflation outlook and is likely to maintain its strong trend in the coming months. Wheat and maize price increases have fed through to food prices at the production price level and a further pass-through to CPIX can be expected. Prices of grain products in CPIX have increased further, and in October, grain product inflation had risen to 5,5 per cent. The futures prices of maize suggest that some respite could be on the way during the first half of next year.

The risk to the inflation outlook arising from oil price developments appears to have abated somewhat. For most of October and November, North Sea Brent crude oil traded at prices between US$55 and US$60 per barrel in the international market. Towards the end of November, prices began to edge up amid fears of further OPEC quota cuts. The oil prices displayed a far lower degree of volatility than was the case during the earlier parts of 2006. The current international oil price levels, and the more recently appreciated rand exchange rate, have led to a R1,14-per-litre decline in domestic petrol prices during the past four months. Nevertheless, the oil price is still considered to pose an upside risk to the inflation outlook, given the sensitivity of oil prices to geopolitical events and the continued tight supply and demand conditions in the oil market.

During the period since the previous meeting of the MPC, the exchange rate of the rand has displayed a degree of volatility. The related uncertainty therefore also poses a risk to the inflation outlook. The rand is currently trading at around R7,10 to the US dollar compared to R7,70 at the time of the October meeting of the MPC. Part of the recent appreciation of the rand against the US dollar can be attributed to the recent 6-per-cent decline in the value of the US dollar against the euro and pound sterling. Against the euro, the rand is currently trading at levels similar to those at the previous MPC meeting. On a trade-weighted basis, the rand has therefore appreciated by about 2,8 per cent since 12 October.

Balance-of-payments developments indicate that the deficit on the trade account narrowed in the third quarter of this year, and has contributed to the decline in the ratio of the current-account deficit to GDP from a revised 5,7 per cent in the second quarter of 2006 to 5,2 per cent in the third quarter. The current-account deficit continues to be adequately financed by capital inflows which are largely attracted by the positive growth prospects of the South African economy. This year to date, non-resident purchases of South African bonds and equities have exceeded R100 billion, compared to R41 billion for 2005 as a whole. Official gross gold and other foreign-exchange reserves stood at US$25 billion at the end of November 2006 and the international liquidity position amounted to US$22,2 billion.

The South African economy has sustained its strong growth momentum and grew at revised annualised rates of 5,0 and 5,5 per cent in the first two quarters of this year, respectively. Growth in the third quarter, however, moderated to 4,7 per cent. This decline is not viewed as being indicative of a widening of the output gap, and there are few signs of significant underutilisation of capacity in the economy. The forward-looking indicators also remain favourable. The Investec/BER Purchasing Managers Index declined in November, but nevertheless still indicates a strong performance in the manufacturing sector. Similarly, in the fourth quarter of this year, the RMB/BER Business Confidence Index remained at the high levels seen over the past two years, while the BER manufacturing survey showed a marked improvement in manufacturing business confidence in the fourth quarter of this year.

On the positive side from an inflation-outlook perspective, wage settlement levels appear to be moderate, although there is evidence of a slight upward trend. According to Andrew Levy Employment Publications, the average level of wage settlements in collective bargaining agreements increased marginally from 6,2 per cent in the nine months ending September 2005 to 6,4 per cent over the same period in 2006. Settlements ranged from 4,6 per cent in the retail sector to 8,9 per cent in the mining sector. These settlements remain in line with the inflation target if allowance is made for a moderate increase in labour productivity over time.

Fiscal policy continues to be supportive of monetary policy. In the October *Medium Term Budget Policy Statement*, the government has continued to demonstrate its commitment to prudent fiscal management.

International inflation developments are generally seen to be relatively favourable. Global inflation fears appear to have subsided somewhat in the wake of tighter monetary policies by a number of central banks. However, in recent weeks there have been indications of a possible slowdown in the United States economy which have contributed to the uncertainties and volatility in the international financial markets. It is still too early to tell how these developments will play themselves out in the coming months.

Monetary policy stance

The MPC has decided to adjust the existing monetary policy stance by increasing the repo rate by 50 basis points to 9,0 per cent per annum with effect from Friday, 8 December 2006. As always, the MPC will continue to monitor all relevant developments in the economy and will not hesitate to act to ensure that the monetary policy stance remains consistent with achieving the inflation target.