Statement of the Monetary Policy Committee

15 February 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 meeting of the Monetary Policy Committee (MPC) in December 2006, the outlook for inflation has, on balance, improved. Inflation outcomes, with respect to both consumer and producer prices, have been below expectations, mainly as a result of moderating food price inflation and lower international oil prices. Nevertheless, some longer-term risks to the outlook remain. There are still only tentative signs that consumer demand growth is abating. Credit extension has continued to grow at a robust rate. The challenge for monetary policy is to weigh up the perceived medium to long-term risks against the more favourable outlook. In the past few meetings, the MPC has consistently seen these risks to be firmly on the upside.

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) remained constant at 5,0 per cent for the three months to December of 2006. In 2006 as a whole, CPIX inflation averaged 4,6 per cent compared to 3,9 per cent in 2005. In December, goods price inflation was unchanged from November at 5,2 per cent, while services price inflation increased to 4,8 per cent from 4,6 per cent in November driven mainly by higher rates of increase in housing services and medical services.

Food price inflation, which has been a major driver of CPIX inflation over the past few months, has shown some signs of moderation. In December food price inflation measured 7,7 per cent, compared to the peak of 9,4 per cent in October 2006. Meat prices, which remain the main contributor to food price inflation, increased by 16,6 per cent in December compared to rates of increase of just below 20 per cent in the previous two months. The petrol price increased at a year-on-year rate of 5,8 per cent in December, despite the R0,07 price decrease in that month. Prices of clothing and footwear fell by almost 12 per cent in December compared to the previous year.

Production price inflation also shows signs that it may have peaked. Having measured 10,0 per cent in both October and November 2006, production price inflation declined to 9,3 per cent in December. Imported goods inflation measured 9,1 per cent compared to domestically produced goods inflation of 9,4 per cent. The contribution of food to production price inflation moderated in December which suggests that pressure on food prices at the consumer level could be further contained.

The outlook for inflation

The most recent central forecast of the Bank's forecasting model indicates an improvement in the inflation outlook compared to the forecast considered at the December meeting of the MPC. CPIX inflation is no longer expected to breach the upper end of the target, but is now expected to peak at an average rate of around 5,6 per cent in the second quarter of this year and to average 4,7 per cent by the fourth quarter of

2008. In terms of the model, the improved outlook is primarily the result of the change in the monetary policy stance last year and the improved outlook with regard to expected international oil price developments.

There are a number of additional developments contributing to this positive outlook. There is some evidence of an improvement in market expectations of inflation since the previous MPC meeting. The yield curve has inverted further, reflecting in part an improvement in inflation expectations. The break-even inflation rates as suggested by the yield differential between inflation-linked bonds and conventional government bonds indicate that inflation expectations have improved significantly since September when yields at shorter maturities exceeded 6 per cent. Since then, break-even inflation rates across all maturities have declined.

Inflation expectations are also reflected to some extent in wage settlements in the economy. Recent nominal wage developments are indicative of inflation expectations remaining under control despite a slight upward trend. In the third quarter of 2006, unit labour costs increased at a year-on-year rate of 5,3 per cent, compared to a second-quarter increase of 3 per cent. According to Andrew Levy Employment Publications, nominal wage settlements averaged 6,5 per cent in 2006 compared to 6,3 per cent in 2005. Although wage settlements were slightly higher in 2006, the inflation rate was higher than in the previous year. If allowance is made for a moderate increase in labour productivity, these increases are consistent with the inflation target.

The domestic economy shows signs that the growth momentum has been maintained at rates around potential. Capacity utilisation levels remain high, particularly in construction and electricity generation, although they are below the peak reached in the second quarter of 2006. Growth in the mining and manufacturing sectors continued to display upward trends in 2006. Seasonally adjusted total mining production increased by 5,5 per cent in the three months ending December 2006, compared with the previous three months, while manufacturing sector output increased by 2,1 per cent over the same period. The positive trend in manufacturing is expected to be sustained as reflected in the Investec/BER Purchasing Managers Index which reached a level of 57,2 in January 2007.

The exchange rate of the rand has been relatively stable and averaged R7,14 to the US dollar since the previous MPC meeting when it was trading at around R7,10. During this period, it fluctuated in a range of between R6,93 and R7,40 to the US dollar. The rand is currently trading at around R7,20. On a trade-weighted basis, the rand is relatively unchanged since the previous meeting. Much of the volatility observed since the previous meeting has been due to movements of the US dollar against other currencies, fluctuations in commodity prices and generally illiquid conditions in the local foreign-exchange market at the end of the year.

Balance-of-payments developments suggest that the deficit on the current account might have widened significantly in the fourth quarter of 2006 following an increase in the trade deficit. Preliminary estimates indicate that the deficit on the trade account of the balance of payments more than doubled from the third to the fourth quarter of 2006. In the fourth quarter, the value of merchandise imports increased by about 17 per cent from the third quarter, while the value of merchandise exports increased by about 8,5 per cent. Much of the import momentum in the fourth quarter, however, can be ascribed to the 140-per-cent increase in the volume of oil imports compared to the third quarter. This inventory build-up appears to be exceptional and oil imports are unlikely to be sustained at these levels.

We have emphasised on a number of occasions that the MPC does not have a target for the current account, nor does the MPC view deficits on the current account to be inflationary in themselves. The mandate of the Bank is to maintain inflation within the target range of 3 to 6 per cent. The risk to inflation arises if the market perceives a particular level of the current account to be unsustainable, which could have implications for the exchange rate and, consequently, for the inflation rate. To date the current-account deficit, including that in the fourth quarter, has been adequately financed. Current developments appear to indicate that the current-account deficit will continue to be adequately financed given the coherent macroeconomic policy framework of the country and positive growth prospects. Non-resident purchases of South African bonds and equities totalled R108 billion in 2006 as a whole, compared to R41 billion for 2005. This year to date, the non-residents have been net buyers of bonds and equities to the value of around R5,1 billion. Official gross gold and other foreign-exchange reserves stood at US$25,9 billion at the end of December 2006 and the international liquidity position amounted to US$23,3 billion.

Fiscal policy has remained supportive of monetary policy. International factors also provide a benign backdrop to the inflation outlook. Global growth prospects generally remain positive, with most regions expected to experience sustainable growth rates. The global interest rate cycle appears to have peaked in most regions, and world inflation is expected to remain under control.

International oil price developments have impacted positively on inflation outcomes. The price of North Sea Brent crude oil, which was above US$62 per barrel at the time of the December meeting, reached a 20-month low of around US$51 per barrel in January following the unseasonably warm winter in the northern hemisphere. However, a further reduction in output quotas by OPEC, effective from 1 February 2007, and colder weather in Europe and the US resulted in prices rising again towards US$60 per barrel. In the past few days the price of Brent crude has declined to around US$56 per barrel as fears of further OPEC cuts abated. Domestic petrol prices increased by R0,06 per litre in January, but were reduced by R0,23 cents per litre in February. This recent relative stability in the oil market has reduced the risk posed to inflation from this source. Nevertheless, given the tight supply and demand conditions in the market, oil prices remain vulnerable to geopolitical developments.

As has been the case at the past few meetings, the central concern of the MPC was the continued strong pace of household consumption expenditure growth and its potential impact on inflation. It is recognised that there are lags in the adjustment to interest rate changes, and the question facing the Committee was the extent to which further reactions to interest rate changes can still be expected. This is a difficult judgement call to make in the light of the inevitable lags in data collection. Consumer demand, however, still appears to be growing robustly despite the 200-basis-point increase in the repo rate last year. Real retail sales growth increased at a year-on-year rate of 12,3 per cent in November but moderated somewhat to 7,2 per cent in December. On a seasonally adjusted month-on-month basis a decline of 2,1 per cent was recorded. It is still premature to tell whether this is the beginning of a new trend. There are also tentative signs that demand for motor vehicles may be declining.

Household consumption expenditure has been underpinned by the continued asset price growth which has contributed to the sustained strength in household balance sheets. Share prices on the JSE Securities Exchange have continued to reach new highs. The all-share index increased by 38 per cent during 2006 and, since the previous meeting of the MPC, has increased by 9 per cent. House prices have also continued to increase at a brisk pace. According to the Absa house price index, house prices are still growing at year-on-year rates of almost 15 per cent.

Twelve-month growth in banks' loans and advances extended to the private sector increased by almost 28 per cent in December, although the annualised quarterly growth showed some sign of moderation, declining from 28,6 per cent in the third quarter to 26,6 per cent in the fourth quarter. Mortgage advances grew at rates of around 30 per cent for much of 2006, while instalment sale credit and leasing finance recorded year-on-year growth of 15,8 per cent in December. These increases were despite further securitisation transactions on the part of the banks. Of significance is the fact that growth in total loans and advances to the corporate sector increased from 27,6 per cent in October to 31,8 per cent in December, whereas growth of credit extended to the household sector declined from 26,1 per cent in October to 24,3 per cent in December.

Monetary policy stance

On the basis of the foregoing analysis, the MPC is satisfied that the inflation outlook has improved somewhat and expects inflation to remain within the target range for the forecast period. As the mandate of the Bank is to keep inflation within the inflation target range, the MPC has decided to leave the repo rate unchanged for now at 9 per cent per annum. However, risks to the inflation outlook remain and the MPC will continue to closely monitor developments with a view to adjusting the monetary policy stance as and when required.