Statement of the Monetary Policy Committee

16 August 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

The Monetary Policy Committee (MPC) met and evaluated domestic and international economic developments as well as the prospects for inflation going forward. In this context the MPC noted that recent financial market developments in some of the developed economies have had spill-over effects on emerging markets including South Africa.

A number of central banks have responded by injecting significant amounts of liquidity into their banking systems to ensure an orderly adjustment to the liquidity squeeze that was being experienced. The focus of the South African Reserve Bank (the Bank) remains to ensure a return of the inflation rate to within the target range.

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 6,4 per cent in both May and June 2007, following an increase of 6,3 per cent in April. CPIX inflation has exceeded the upper end of the inflation target range of 6 per cent for the past three months. The main causes of the upward trend in inflation remain food and energy, but broader underlying pressures are also evident. If food and energy prices were excluded, CPIX inflation would have measured 4,6 per cent in May and 4,7 per cent in June, compared to 3,8 per cent in December 2006. This indicator has been rising consistently since the middle of 2006 when it measured 2,5 per cent.

Food prices increased at year-on-year rates of 9,0 per cent and 9,4 per cent in May and June 2007, respectively, with grain product prices increasing by 13,4 per cent in June. Meat price inflation has been declining steadily since it peaked late last year, but nevertheless recorded an increase of 9,9 per cent in June. Petrol prices increased at year-on-year rates of 13,7 per cent in May and 11,1 per cent in June as a result of a cumulative increase of R0,57 per litre in these two months.

Prices of services, which tend to adjust more slowly than those of goods, have also been displaying an upward trend, having increased at a year-on-year rate of 5,7 per cent in June compared to 4,6 per cent in January 2007. The higher inflation trend is also observed in administered prices excluding petrol which have increased at rates of around 5,5 per cent since October 2006. Price declines in clothing, footwear and furniture continue to moderate pressures on inflation.

Production price inflation remains high, but declined to a year-on-year rate of 10,4 per cent in June following rates in excess of 11 per cent in the previous two months. The prices of agricultural goods have been increasing at year-on-year rates of almost 20 per cent since March 2007, whereas manufactured goods prices increases moderated to 6,4 per cent in May and June. Imported goods inflation declined from 11,7 per cent in May 2007 to 9,4 per cent in June.

The outlook for inflation

The most recent central forecast of the Bank indicates a slight deterioration in the inflation outlook, particularly in the short term, when compared to the previous forecast. CPIX inflation is now expected to remain above the upper level of the inflation target range at an average of around 6,3 per cent before declining to within the inflation target range in the second quarter of 2008. Thereafter it is expected to follow a downward path, to reach around 5,1 per cent by the end of 2009. The higher trend results from a higher-than-expected second quarter outcome which raised the starting point of the forecast, and a revised assumption for international oil prices.

The MPC identified a number of upside risks to the inflation outlook. These include oil and food prices, and high rates of household consumption expenditure. The assessment of most of the other variables was relatively unchanged, although there is some uncertainty about the potential impact of international financial market developments.

Food prices remain a threat to the inflation outlook despite the declining trend in meat price increases. High rates of increase in the spot prices of maize and wheat during the first half of this year are expected to sustain the higher food inflation. Of further concern are the year-on-year increases in June in the prices of agricultural products and manufactured food at the producer price level measuring 18,7 per cent and 15,0 per cent, respectively. These indicate possible further pressures on food prices at the retail level in coming months.

North Sea Brent crude oil is currently trading at around US$72 per barrel, which is similar to prices prevailing at the time of the previous MPC meeting. During July, however, the price rose to levels slightly below US$80 per barrel. More recently, prices have moderated partly as a result of concerns about the growth outlook in the United States and the sell-off in financial markets. The domestic petrol price declined in July and August by a total of R0,23, reflecting exchange rate and product price movements. Despite this recent respite, risks to inflation emanating from this source are still considered to be on the upside.

There is little evidence of a sustained slowdown in household consumption expenditure growth. The FNB/BER Consumer Confidence Index still remains near record levels despite a moderate decline in the second quarter of 2007. Retail sales growth remains robust, although the most recent data show that the year-on-year increase in June declined to 6,4 per cent compared to rates of growth of 5,9 per cent and 9,2 per cent in April and May, respectively. Retail sales of household furniture, appliances and equipment declined by 13,5 per cent in June compared to a year ago. Sales of private motor vehicles have also continued to decline. The seasonally adjusted number of new passenger vehicles sold in the three months to July 2007 reflected a decrease of 5,4 per cent compared to the previous three months.

Growth in credit extension to the private sector remains high although it is premature to assess the impact on credit extension due to the introduction of the National Credit Act in June. Twelve-month growth in banks' loans and advances extended to the private sector increased at a rate of 27,9 per cent in June. Adjusted for securitisation transactions, the increase would have been 30,3 per cent. Growth in loans and advances to the corporate sector measured 36,2 per cent in June compared to 33,3 per cent in May, while growth in credit extended to the household sector moderated from 22,8 per cent in May to 21,5 per cent in June. Year-on-year growth of asset-backed credit has been declining steadily over the past few months, recording a growth rate of 23,6 per cent in June.

Wage settlements have been trending upwards. According to Andrew Levy Employment Publications the average level of wage settlements measured 6,5 per cent in 2006. In the first half of 2007 wage settlement rates have averaged 6,8 per cent, but a growing number of recent settlements have been closer to 8 per cent. This may still be consistent with the inflation target if labour productivity growth is accounted for. Nevertheless, the upward trend is of some concern given the importance of wage developments in the price formation process.

As a result of the uncertainties in the international financial markets and the strengthening of the US dollar, the rand exchange rate has depreciated somewhat, particularly over the past few days. Before the onset of the current round of global financial market volatility, the rand had appreciated due to, among other factors, the weakness in the US dollar against other currencies and anticipated capital inflows related to possible merger and acquisition activity. At one stage the rand had reached levels slightly below R6,80 at a time when the US dollar had reached an historic low against the euro. However, the increased global risk aversion and a recovery in the US dollar reversed this trend and the rand is currently trading at a level of around R7,45 compared to R7,22 at the time of the previous meeting. Since the beginning of the year the nominal effective exchange rate of the rand has declined by 6,2 per cent.

Despite the global financial market developments noted above, non-resident interest in South African assets, in particular equities, has remained positive. Since 20 July when emerging-market spreads started to widen, non-residents have been net purchasers of equities totalling in excess of R11 billion, although in the past few days they have been moderate net sellers to the value of around R150 million. The sustainability of these inflows will depend in part on global liquidity conditions as well as domestic growth prospects.

Conditions in the local foreign-exchange market during July allowed for further accumulation of foreign-exchange reserves. At the end of July gross gold and foreign-exchange reserves had increased by US$1,06 billion to US$29,33 billion, while the international liquidity position had increased to US$26,97 billion.

The domestic economy continues to grow at a brisk pace but there are some signs of moderation. Gross domestic product (GDP) grew at an annualised rate of 4,7 per cent in the first quarter of 2007, down from 5,6 per cent in the final quarter of 2006. Mining production has continued to disappoint despite favourable commodity prices. In the second quarter of 2007 the physical volume of mining production remained under pressure, declining by 1,4 per cent compared to the previous quarter. The physical volume of manufacturing production also came under pressure in the second quarter when it grew by only 0,1 per cent. Nevertheless, the index of utilisation of productive capacity in the manufacturing sector increased to 86,8 per cent in the second quarter. The RMB/BER Business Confidence Index declined marginally in the second quarter of 2007. A more positive outlook is provided by the Investec/BER Purchasing Managers Index which increased in July 2007 following three consecutive monthly declines. Despite some negative indications, growth is expected to be underpinned in the coming months by the continued acceleration in the growth of real gross fixed capital formation which increased at a year-on-year rate of almost 22 per cent in the first quarter of 2007 and brought the ratio of fixed capital formation to GDP to over 20 per cent.

At this stage there is no evidence that the recent turbulence in the international financial markets will have marked effects on the domestic growth outlook, although this will depend to some extent on the impact of these developments on the United States' growth performance. To date the impact has been felt in the exchange rate and, to a greater extent, on the capital market. Although the prices of equities on the JSE Limited declined from their recent elevated levels, at the end of trade on 15 August the all-share index was still over 8 per cent higher than that prevailing at the beginning of the year. This suggests that the possible impact on consumption via the wealth effect and on investment is likely to be limited.

The international environment has become increasingly volatile and uncertain. The updated IMF *World Economic Outlook* forecasts published in July this year show a 0,3-per-cent increase in expected world GDP growth for both 2007 and 2008. World inflation is expected to remain more or less unchanged and average 3,5 per cent for 2007 and 2008. This forecast was made before the recent turmoil on the international financial markets and it is too early to assess the risks that these developments may pose to the global growth and inflation outlook.

Monetary policy stance

Having considered recent developments, the MPC has decided that a further adjustment in the monetary policy stance is required to ensure that CPIX inflation returns to within the target range. Accordingly, the repo rate is adjusted by 50 basis points to 10,0 per cent per annum with effect from 17 August 2007. The MPC will continue to monitor the relevant economic and financial developments to ensure that its mandate is fulfilled.