Statement of the Monetary Policy Committee

9 October 2008

Issued by Mr T T Mboweni, Governor of the South African Reserve Bank, at a meeting of the Monetary Policy Committee (MPC) in Pretoria

Introduction

Since the previous meeting of the MPC the turmoil on global financial markets has intensified. This development has impacted negatively on the outlook for the international economy. As the banking crisis has deepened, global markets have been characterised by declining equity prices, exchange rate volatility and widening spreads on emerging-market debt. The prices of many commodities, including oil, have also declined, although gold is a notable exception by virtue of its safe-haven status.

Governments and central banks have undertaken various actions, both individually and in concert. The South African banking and financial system remains stable. However, domestic financial markets have experienced the impact of these developments. The domestic equity market has suffered losses in line with international markets, and the exchange rate of the rand has been negatively affected by increased global risk aversion, resulting in higher volatility and a significant depreciation. The South African Reserve Bank (the Bank) is monitoring developments closely.

The inflation outlook remains uncertain, as the risk profile has changed somewhat. The outlook has improved on account of the lower oil prices, but the exchange rate has emerged as a significant risk factor.

Recent developments in inflation

CPIX inflation increased from 13,0 per cent in July 2008 to 13,6 per cent in August. Food and petrol price increases were again the main contributors to this rising trend. Food prices increased at a year-on-year rate of 19,2 per cent in August, driven to a significant extent by grain product prices which increased by 36,5 per cent. Petrol prices increased at a year-on-year rate of 45,9 per cent in August, despite the 30 cent per litre reduction in the petrol price in that month. If food and petrol were excluded, CPIX inflation would have measured 8,1 per cent in August, compared with 7,4 per cent and 6,3 per cent in the prior two months. The significant upward trend in this measure was mainly due to electricity price increases of 23,9 per cent and 28,2 per cent in July and August respectively, but it also reflects continued generalised inflation pressures.

Producer price inflation also remained strong. Producer prices increased at a year-on-year rate of 19,1 per cent in August. The rate of increase in agricultural food prices declined to 2,3 per cent, but manufactured food price inflation remained elevated at over 20 per cent.

The outlook for inflation

The most recent central forecast of the Bank shows a moderate improvement in the inflation outlook since the previous MPC meeting, although the peak is slightly higher. As was the case at the previous meeting, some assumptions were made to try to account for the rebasing and reweighting of the CPI basket that will be introduced by Statistics South Africa in January 2009. Inflation is expected to peak at an average rate of 13,3 per cent in the third quarter of this year, and to average 6,9 per cent in 2009, after a significant decline in the first quarter of that year. Consumer price inflation is still expected to return to within the inflation target range only in the second quarter of 2010, and to reach a level of 5,5 per cent in the final quarter of that year.

According to the most recent inflation expectations survey conducted on behalf of the Bank by the Bureau for Economic Research (BER) at Stellenbosch University, CPIX inflation is expected to average 10,2 per cent in 2008 and 8,1 per cent and 7,4 per cent in 2009 and 2010 respectively. The increases in respect of 2009 and 2010 were significantly smaller than the increases observed in the previous survey. However, only the financial analysts expect inflation to return to within the target range by 2010. This is similar to the Reuters consensus survey conducted in August which indicates that inflation is expected to average 7,5 per cent in 2009 and 5,9 per cent in 2010.

Inflation expectations as measured by the yield differential between conventional government bonds and inflation-linked bonds indicated some improvement in expectations over the longer term. The break-even inflation expectation declined from just over 9 per cent in July 2008 to around 6,3 per cent at the end of September. The yield curve has remained inverted but has moved down since the previous meeting.

The continued upward trend in wage settlements also indicates that inflation expectations are not well anchored. According to the Quarterly Economic Survey of Statistics South Africa, year-on-year growth in unit labour cost measured 10,5 per cent in the second quarter of 2008, compared with 10,7 per cent in the previous quarter. The most recent Wage Settlement Survey of Andrew Levy Employment Publications shows that the average wage settlement rate increased to 9,6 per cent in the nine months to September 2008 compared with 8,3 per cent in the six months to June 2008.

The turmoil in international financial markets has resulted in some changes in the balance of risks as perceived by the MPC. The most significant of these changes relate to oil price and exchange rate developments.

The recent depreciation in the rand exchange rate poses a significant upside risk to the inflation outlook. Following the initial rejection by the US Congress of the Troubled Asset Relief Program (TARP), there was significant volatility in foreign-exchange markets as the dollar strengthened against a number of major currencies, particularly against those in emerging-market economies. The domestic foreign-exchange market was also affected, and the rand is currently trading at around R9,12 against the US dollar, compared with R8,00 at the previous MPC meeting. On a trade-weighted basis, the rand has depreciated by around 20 per cent since the beginning of the year and by almost 9 per cent since the previous meeting. The impact of the exchange rate on the inflation outlook will depend, to a significant degree, on the extent to which these new levels are sustained.

In most other instances the risks to the outlook have declined or remained unchanged. International oil prices have declined considerably over the past few weeks. Having peaked at around US$145 per barrel in July 2008, the price of North Sea Brent crude oil (Brent) has declined to current levels of around US$83 per barrel. At the time of the previous MPC meeting Brent was trading at US$112 per barrel. In line with these oil market developments, the price of 95 octane petrol in Gauteng has declined by a total of R1,29 per litre since August. The impact of the lower international oil prices on domestic petrol prices will be offset to some extent by the recent depreciation of the rand against the dollar.

As noted, food price inflation remains elevated, although agricultural price inflation at producer price level has declined further. International rice prices appear to have peaked and both maize and wheat prices are currently below the peaks reached earlier in 2008 in the global and domestic markets. Favourable base effects are also expected to contribute to a declining trend in food price inflation. However, food prices are expected to remain elevated in the short term, as evidenced by high increases in processed food prices at the producer level.

Household consumption expenditure has remained subdued in line with declining growth in disposable income and the less accommodative monetary policy stance. Growth in household consumption expenditure declined to 1,2 per cent in the second quarter of 2008 as expenditure on durable goods contracted by almost 15 per cent. This is reflected in the further decline in motor vehicle sales in September at a year-on-year rate of almost 20 per cent. Retail and wholesale trade sales growth have continued their negative trends. The latest FNB/BER Consumer Confidence Index shows an improvement relative to the second quarter, but remains at levels last seen in 2004.

Credit extension to the private sector exhibited further moderation. Growth over twelve months in total loans and advances to the private sector declined from 21,3 per cent in June 2008 to 19,7 per cent in August. Growth in mortgage advances moderated to 17,6 per cent in August 2008 while instalment sale credit and leasing finance grew by 11,3 per cent. The slower growth in credit extension to households is reflected in the ratio of debt to disposable income which declined in the second quarter of 2008 to 76,7 per cent.

Asset prices have been significantly affected by the recent global market turmoil and the softer trend in commodity prices. The associated negative wealth effects could contribute to a further moderation in consumption expenditure growth. The all-share index on the JSE Limited has declined by about 27 per cent since the beginning of the year, and by about 25 per cent since the previous MPC meeting. The housing market is also subdued with the Absa and Standard Bank House Price indices continuing to record negative real house price growth.

Domestic economic growth appears to be moderating, despite the rebound in the second quarter of 2008 when GDP growth of 4,9 per cent was recorded. This improvement was mainly the result of base effects following the 2,1 per cent growth rate recorded in the first quarter of 2008. Short-term indicators suggest that growth in the third quarter is likely to be subdued and that growth will remain below its estimated potential rate. The composite leading indicator of the Bank declined further in July and the RMB/BER Business Confidence Index also declined further in the third quarter of this year. The manufacturing sector remains under pressure as seen in the weaker trend in the volume of manufacturing production, as well as in the Investec/BER Purchasing Managers Index. Growth in real gross fixed capital formation remained relatively robust, despite declining from 16,9 per cent in the first quarter to 9,1 per cent in the second quarter. Investment expenditure is expected to underpin a positive growth rate.

Developments in the international markets have already had a negative impact on growth in a number of regions and global growth forecasts are being revised down further, particularly in the OECD countries. The slowing world economy is also likely to have an adverse effect on domestic growth prospects. The continuing crisis has led to a generally more accommodative monetary policy stance in a number of countries, and some governments and central banks are taking unprecedented steps to help stabilise the situation. At this stage it is unclear how the crisis will unfold, but heightened risk and uncertainty are likely to persist for some time.

Monetary policy stance

The MPC considered recent developments in the South African economy and the risks to the inflation outlook against the backdrop of conditions prevailing in the international financial markets. The MPC is of the view that an unchanged monetary policy stance is appropriate at this stage. Accordingly, the repurchase rate remains at 12 per cent per annum. The MPC remains committed to, and focused on, the achievement of the Bank's mandate.