Statement of the Monetary Policy Committee

14 August 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

The outlook for inflation remains uncertain. Food and oil price increases continue to cloud the inflation outlook, but there are tentative signs that these pressures may be moderating. Domestic consumption expenditure also remains subdued. However, electricity price increases are set to have an impact on inflation going forward, and there is evidence that underlying inflation has maintained some of its upward momentum. Conflicting pressures are being felt from the global economy, which is experiencing slower growth and higher inflation.

While there are clear signs that the economy is responding to the less accommodative monetary policy stance, the MPC had to assess whether recent monetary policy actions are sufficient to bring inflation back to within the inflation target range over the medium term.

Recent developments in inflation

CPIX inflation increased at a year-on-year rate of 11,6 per cent in June 2008, compared with 10,9 per cent in May. Food price inflation accelerated from 16,9 per cent in May to 18,2 per cent in June, mainly as a result of significant increases in the prices of grain products, as well as fats and oils. Petrol prices increased by almost 36 per cent in June, and together with food prices accounted for about 56 per cent of the increase in CPIX. However, if food and petrol were excluded, CPIX inflation would have measured 6,3 per cent. Services price inflation has been increasing consistently over the past few months and reached a level of 6,7 per cent in June.

Producer price inflation increased at a year-on-year rate of 16,8 per cent in June, driven mainly by petroleum products and mining output prices. Food price increases at the producer price level continue to show some moderation. Agricultural food price increases measured 2,0 per cent in June, while manufactured food price increases, while still high, measured 19,4 per cent, compared with a peak of 20,4 per cent in March 2008.

The outlook for inflation

The central forecast of the Bank has been complicated by the impending rebasing and reweighting of the CPI basket, to be implemented by Statistics South Africa from January 2009. In trying to account for these changes, certain assumptions have to be made, and the central forecast is therefore subject to additional uncertainty.

The central forecast generated on the above basis indicates a near-term deterioration of the inflation outlook when compared with the previous forecast. CPIX inflation is expected to peak at an average rate of around 13 per cent in the third quarter of 2008, compared with 12 per cent. Thereafter, inflation is expected to decline significantly in the first quarter of 2009, partly as a result of the reweighting and rebasing effects. Inflation is then expected to decline gradually, and to fall below the upper end of the inflation target range in the second quarter of 2010. Inflation is expected to average about 7,2 per cent in 2009 and 5,9 per cent in 2010. The forecast takes account of the additional electricity price increases granted to Eskom in June. However, there is some uncertainty about the timing of these increases, or the full extent of the increases that will be passed on to household consumers by the municipalities.

Forecasts by private-sector economists have also been influenced by the coming technical adjustments to the inflation basket. Between June and July, the Reuters consensus CPIX forecast for 2009 declined from 8,2 per cent to 7,5 per cent, while the forecast for 2010 declined from 6 per cent to 5,9 per cent. Since July, the break-even inflation rates, measured as the yield differential between conventional government bonds and inflation-linked bonds, have also reflected some improvement in medium-term inflation expectations. The yield curve moved down markedly, particularly at the long end of the curve, with the R157 having declined by about 100 basis points since the previous MPC meeting.

The higher inflation outcomes and expectations have had an impact on wage settlements. According to the Wage Settlement Survey of Andrew Levy Employment Publications, the average level of wage settlements for the first half of 2008 was 8,3 per cent, compared with 6,8 per cent in the same period in 2007. Unit labour costs increased by 10,2 per cent in the first quarter of 2008, compared with the same quarter in the previous year, while unit labour cost increases in manufacturing measured 6,6 per cent. These trends, while not unexpected, were noted by the MPC.

Significant risks to the inflation outlook remain, although there are tentative signs that some of the risk factors may have moderated somewhat. International oil prices are well below the levels reached in early July 2008 when the price of North Sea Brent crude oil was around US$145 per barrel. Currently oil is trading at around US$112 per barrel, compared with around US$140 per barrel at the time of the previous MPC meeting. These price developments were reflected in domestic petrol price adjustments. In July the price of 95 octane petrol in Gauteng increased by 74 cents per litre, but in August the price declined by 30 cents per litre. If current oil price and exchange rate levels are maintained, a further sizeable decline can be expected in September. It is still too early to tell if the lower international oil price is a temporary phenomenon.

The risks to inflation posed by food price developments remain. Grain product prices in particular appear to have gained some momentum at both the producer price and consumer price levels. As noted earlier, however, manufactured food producer price inflation remains high, but agricultural food inflation has declined to low levels, indicating the possibility of some price relief in the future. The spot price of yellow maize declined in early August following the release of local crop estimates. Wheat prices have also declined on international markets, but nevertheless remain high.

The exchange rate of the rand has exhibited some volatility since the previous meeting of the MPC when it was trading at around R8,00 per US dollar. In late July the rand began to appreciate and reached a level of around R7,20 against the US dollar, but has since depreciated to current levels of around R7,85 per US dollar. On a trade-weighted basis the rand has appreciated by about 4 per cent since the previous meeting.

The outlook for most of the other determinants of inflation has been relatively unchanged since the previous meeting.

Growth in household consumption expenditure appears to have remained subdued. Real retail sales declined on a year-on-year basis in the four consecutive months to June 2008. In May and June retail sales declined by 3,4 per cent and 2,6 per cent respectively. Motor vehicle sales also remain under pressure with the total number of vehicles sold in July declining by over 20 per cent when compared with the same time last year. In the second quarter of 2008, the FNB/BER Consumer Confidence Index experienced its largest quarter-on-quarter decline in 24 years.

Credit extension to the private sector exhibited further moderation, although it still remained at relatively high levels. Growth over twelve months in mortgage advances measured 19,9 per cent in June 2008, while growth in instalment sale credit and leasing finance grew by 14 per cent. Growth in credit extension to households remains on a downward trend.

Real growth in gross domestic product also appears to be lower than the rates achieved in the past few years, although growth in the second quarter is expected to exceed the first quarter growth rate of 2,1 per cent. This improvement will be a result of base effects and improved performances of mining and manufacturing in the second quarter. The expected subdued trend in output growth is evident in a number of indicators. The South African Reserve Bank composite leading business cycle indicator, which has been declining since March 2007, continued its downward trend in May 2008, while the RMB/BER Business Confidence Index also declined significantly in the second quarter of 2008. The Investec/BER Purchasing Managers Index also points to continued slow growth in the manufacturing sector, primarily due to sluggish new sales orders. The utilisation of production capacity in manufacturing declined in both of the first two quarters of 2008. The real value of building plans passed and approved also declined in the past three months.

The lower growth trend has also been reflected in asset prices, and the associated negative wealth effects could moderate consumption expenditure growth further. Equity prices have declined in recent weeks as a result of a weaker economy and lower commodity prices. The all-share index on the JSE Limited has declined by 7 per cent since the beginning of the year, and by about 13 per cent since the previous MPC meeting. All the major sub-indices are lower than they were at the beginning of 2008. The housing market is also subdued, with both the Absa and Standard Bank indices reflecting negative real house price growth.

The global economy is characterised by slowing growth, particularly in the industrialised countries, and intensified inflationary pressures. Growth prospects in the US are being clouded by the persistent weakness in the local housing market and continued financial market uncertainty. Growth in emerging markets also shows some signs of moderation, but nevertheless remains relatively strong. Most central banks have recently either adopted a tighter monetary policy stance or have kept their policy rates unchanged.

The MPC also noted economic developments in Lesotho, Namibia and Swaziland – South Africa's Common Monetary Area (CMA) partners. Food and energy price developments have also intensified in these countries, raising inflation to high levels. Recent developments in real sector indicators have been mixed. Government financial balances are supported by high import duty revenue, and government debt levels are well contained. While interest rates throughout the CMA increased significantly over the past two years, it was noted that most recently not all of the countries have tightened monetary policy.

Monetary policy stance

The MPC has considered recent economic developments and the outlook for inflation and has concluded that, notwithstanding certain risks to future inflation outcomes, the current monetary policy stance is appropriate. Consequently, the repurchase rate will for now remain unchanged at 12 per cent per annum. The MPC will continue to monitor developments closely and will not hesitate to act to deliver on its mandate.