Statement of the Monetary Policy Committee

10 April 2008

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 South African economy continues to respond to the less accommodative monetary policy stance. Domestic expenditure is responding to our current policy settings. Various high frequency and survey data point to the economy growing at a rate below potential, but nevertheless underpinned to some extent by strong investment expenditure by the private sector and public corporations.

The inflation outlook is being influenced by a series of supply-side shocks emanating from the international oil and food prices which are posing challenges for inflation-targeting countries in general. Domestically, there is evidence of generalised price pressures and the prospect of further substantial electricity price increases will also delay the return to within the inflation target range. In the light of these developments, inflation expectations have deteriorated.

Recent developments in inflation

CPIX inflation has maintained its upward trend, reaching 9,4 per cent in February 2008. Petrol and food prices were again the main drivers of inflation and increased at year-on-year rates of 29,5 per cent and 14,3 per cent, respectively. If food and energy prices were excluded, CPIX inflation would have measured 5,6 per cent. Further impetus to inflation came from the change in methodology for calculating clothing and footwear prices. Whereas clothing and footwear prices were previously shown to have declined persistently since October 2003, these prices increased at year-on-year rates of 7,9 per cent and 8,4 per cent in January and February 2008, respectively.

Year-on-year producer price inflation measured 11,3 per cent in February compared to 10,4 per cent in January. Agricultural food prices increased at a year-on-year rate of 23,5 per cent in February, while manufactured food prices increased by 20,9 per cent.

The outlook for inflation

The most recent central forecast of the Bank indicates a further deterioration in the inflation outlook when compared to the previous forecast. Inflation is now expected to peak at an average of around 9,3 per cent in the first quarter of this year, and thereafter to follow a downward trajectory. However, CPIX inflation is now expected to return to within the inflation target range by the fourth quarter of 2009. The deterioration in the outlook is a result of higher-than-expected recent quarterly inflation outcomes, and further upward revisions of oil and administered price assumptions for 2008 and 2009. The possibility of an electricity price increase in excess of that recently granted to Eskom has not been factored into the central forecast, although the Monetary Policy Committee (MPC) has considered various alternative scenarios.

Most private-sector forecasts have also been revised upwards in recent weeks, although the majority predict inflation will return to within the target range before the final quarter of next year. The Reuters consensus forecast also expects inflation to peak in the first quarter of this year, and to return to within the target range during the second quarter of 2009.

The current inflation trends are having a significant impact on inflation expectations, particularly those of business executives and trade union officials. According to the inflation expectations survey conducted on behalf of the Bank by the Bureau for Economic Research (BER) at the University of Stellenbosch, average CPIX inflation expectations for 2008 have increased from 5,9 per cent at the time of the previous survey to 7,8 per cent, and for 2009 from 5,6 per cent to 7,0 per cent. CPIX inflation is expected to average 6,7 per cent in 2010. Whereas financial analysts expect inflation to moderate to 5,9 per cent in 2009 and 5,4 per cent in 2010, business executives and trade union officials expect inflation to average 7,5 per cent and 7,4 per cent in those years respectively.

Break-even inflation rates, measured as the yield differential between conventional government bonds and inflation-linked bonds, also indicate a deterioration of inflation expectations.

The trend of wage settlements is a critical variable in determining whether inflation expectations do in fact translate into higher inflation. There is evidence that nominal wage settlements have been trending higher. According to Andrew Levy Employment Publications, wage settlements in the first quarter of 2008 averaged 7,8 per cent compared to 7,3 per cent in 2007 and 6,5 per cent in 2006.

A number of factors continue to pose an upside risk to the inflation outlook. The most serious risk emanates from the possibility of additional electricity price increases. If granted, the electricity price will have doubled by the middle of 2009. A final determination will be made by the National Energy Regulator of South Africa in June.

International oil prices have remained at elevated levels. The price of North Sea Brent crude oil was US$92 per barrel at the time of the previous MPC meeting and is currently trading at around US$107 per barrel. The impact on CPIX has been aggravated by the depreciation of the rand against the dollar, and in the past 2 months, the rand price of 95 octane petrol has increased by a total of R1,27 per litre. Of this increase, 43 cents was due to international product price increases and 69 cents was due to exchange rate changes. The remainder was accounted for by tax and other levy adjustments. Despite the slowdown in the global economy, international oil price developments continue to pose an upside risk to the inflation outlook.

Since the previous meeting of the MPC, the rand exchange rate has depreciated further. On a trade-weighted basis, the rand has now depreciated by around 16 per cent since the beginning of 2008. In March the rand depreciated to almost R8,26 against the US dollar, but is currently trading at around R7,90. The currency has been affected by various factors including movements in the dollar, perceptions that the current-account deficit on the balance of payments could widen, and increased risk aversion in global financial markets since the previous MPC meeting. Firm international commodity prices, however, continue to provide some support to the currency.

Food price inflation has shown few signs of moderating and trends at the producer level indicate further pipeline pressures. International food price developments are particularly worrisome with a number of food-producing countries restricting exports in recent weeks. International wheat prices have also reached new highs. Domestic spot prices of maize have been volatile around an upward trend, partly as a result of the depreciated exchange rate. Futures prices suggest that maize prices are expected to remain high in the coming months despite the improved crop forecast for this year.

There are a number of factors that are expected to have a moderating effect on the inflation outlook.

Household consumption expenditure has continued to respond to the tighter monetary policy stance. Real final consumption expenditure growth declined consistently during

2007, and grew at an annualised rate of 3,8 per cent in the fourth quarter. This softer trend appears to have continued in the first quarter of 2008 as evidenced by the negative retail sales trends in the past few months. Motor vehicle sales have declined further, with new passenger vehicle sales being particularly affected. When comparing the first three months of 2008 with the same period last year, a decrease of 19,1 per cent was recorded. The latest FNB/BER Consumer Confidence Index shows a distinct break with recent trends. Although still at relatively high levels, the index declined to its lowest level in 3,5 years in the first quarter of this year.

This slower household consumption expenditure growth is reflected to some extent in the declining trend of bank credit extension to the private sector. Twelve-month growth in banks' total loans and advances extended to the private sector, which has exhibited a downward trend, slowed to 21,8 per cent in February. Growth in all categories of credit extension declined in February. The ratio of household debt to disposable income increased marginally to 77,6 per cent in the fourth quarter of 2007. The cost of servicing this debt has increased significantly, in line with higher interest rates.

The domestic economy has shown signs of moderation following a robust annual growth rate of 5,1 per cent in 2007. A number of indicators suggest that output growth will be below potential in the coming quarters, although infrastructural investment programmes are likely to underpin the overall growth rate. At this stage it is still unclear what the impact of electricity supply disruptions will be on output growth. The composite leading business cycle indicator has been declining significantly since November 2007, while in the first quarter of this year the RMB/BER Business Confidence Index declined to its lowest level in seven years. The significant decline in the Investec/BER Purchasing Managers Index in March may be pointing to a marked slowdown in the manufacturing sector despite the improved performance in February when real output increased at a month-on-month rate of 2,4 per cent. Mining output declined by 5,2 per cent during the three months ended February 2008.

Asset prices have also been subdued since the previous meeting of the MPC. The Absa house price index shows that year-on-year growth in prices of residential property in the middle segment of the market declined to 8,7 per cent in February 2007, while the median house price, as measured by Standard Bank, declined by 5,2 per cent in March. The all-share index on the JSE Limited has increased by about 15 per cent since the end of January, driven primarily by the impact of strong commodity prices on the resources sector.

The international economic and financial environment remains uncertain and volatile. The sustained weakness in the US housing market has resulted in downward revisions of US growth forecasts, while the IMF has revised downwards its forecast for global growth in 2008 to 3,7 per cent from 4,1 per cent forecast in January. Global inflation forecasts have been revised upwards in the wake of higher food and energy prices. Nevertheless global inflation appears to be relatively contained. The turmoil in financial markets is expected to persist for some time as banks keep writing down more financial assets and experience losses. As a consequence, global foreign exchange and financial markets are likely to remain volatile.

Monetary policy stance

In view of the deteriorating inflation outlook, and especially evidence of more generalised inflation pressures, the MPC has decided to increase the repo rate by 50 basis points to 11,5 per cent per annum with effect from 11 April 2008. The MPC remains committed to bringing CPIX inflation back to within the inflation target range.