Statement of the Monetary Policy Committee

12 June 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 outlook for inflation remains bleak in an environment of sustained increases in international oil and food prices. An increasing number of countries are experiencing intensified inflation pressures and the risk to both global and domestic inflation is seen to be firmly on the upside against the backdrop of a slowing international and domestic economy. Domestically, price increases have become more broad-based, and inflation expectations have deteriorated further. Adding to the inflation uncertainty is the impending announcement of the electricity price increases to be granted to Eskom.

Recent developments in inflation

CPIX inflation measured 10,4 per cent in April 2008, compared with 10,1 per cent in the previous month. Sustained food and petrol price pressures were primarily – but not only – responsible for this trend. Petrol prices increased at a year-on-year rate of 30,5 per cent, while food prices increased by 15,9 per cent. Together these two categories accounted for over half of the increase in CPIX. Broad-based pressures are also intensifying. If food and energy were excluded, CPIX inflation would have measured 6,1 per cent. The stronger underlying inflation trend has been driven by price increases in a range of categories, notably clothing and footwear, water, household consumables, and fuel and power.

Year-on-year producer price inflation measured 12,4 per cent in April, compared with 11,9 per cent in March. Agricultural food output price increases declined to a year-on-year rate of 6 per cent in April, compared with a recent peak of 27 per cent in October 2007. Manufactured food price increases remained elevated at around recent highs of around 20 per cent.

The outlook for inflation

The most recent central forecast of the South African Reserve Bank (Bank) indicates a further deterioration in the inflation outlook when compared with the previous forecast. CPIX inflation is now expected to peak at around 12 per cent in the third quarter of 2008 and to return to within the inflation target range by the third quarter of 2010. The previous forecast was for a peak of 9,3 per cent in the first quarter of 2008. The deterioration in the forecast is a result of higher-than-expected inflation outcomes, a more depreciated exchange rate of the rand, as well as further upward revisions in international oil price projections over the forecast period. As with the previous forecast, the possibility of an electricity price increase in excess of that granted to Eskom in December 2007 has not been factored into the central forecast.

The forecasts made by private-sector analysts have also deteriorated since the previous MPC meeting. According to the May 2008 Reuters consensus forecast, CPIX inflation is expected to peak at 11,3 per cent in the third quarter of 2008. Most respondents see inflation back within the target range during 2010. Break-even inflation rates, measured as the yield differential between conventional government bonds and inflation-linked bonds, also indicate a deterioration of inflation expectations and are now firmly above the upper end of the target range.

Deteriorating inflation expectations are also evident in the survey conducted on behalf of the Bank by the Bureau for Economic Research (BER) at the University of Stellenbosch. During the second quarter of 2008, CPIX inflation expectations in respect of all forecast years increased further. CPIX inflation is now expected to average 8,9 per cent in 2008, up from 7,8 per cent in the previous survey. Some moderation is then forecast for 2009 and 2010 when CPIX inflation is expected to average 7,9 per cent and 7,2 per cent, respectively.

The main risks to the inflation outlook emanate from the possibility of further electricity price increases, which will be announced next week by the National Energy Regulator of South Africa (Nersa); petrol and food price increases; and the exchange rate.

There has been no respite from the acceleration in the international oil prices which has continued to surprise on the upside. In recent days North Sea Brent crude oil prices reached levels of almost US$140 per barrel, compared with US$107 per barrel at the time of the previous MPC meeting. Domestic petrol prices increased by 55 cents and 50 cents per litre in May and June, respectively, bringing the cumulative increase in the petrol price since January 2008 to about R2,50 per litre. A further increase is possible in July.

Food prices still pose an upside risk to the inflation outlook although some positive domestic developments may partially offset the global trends. Despite higher international maize prices, the domestic spot price of maize declined in response to the release of the domestic crop estimates. Nevertheless, the depreciation of the rand exchange rate in recent weeks limited this decline. International wheat and rice prices are still high, but wheat prices have declined from their recent record levels. As noted earlier, agricultural producer price inflation declined significantly in April, but it is still too early to know if this trend will be sustained.

The exchange rate of the rand against the US dollar is little changed from the levels prevailing at the time of the previous MPC meeting, when it was trading at around R7,90 to the US dollar. However, the rand has been relatively volatile and the related uncertainty poses a risk to the inflation outlook. In May the rand appreciated to around R7,50 to the US dollar, to a large extent as a result of speculation relating to a sizeable FDI transaction which did not subsequently materialise.

The volatility of the rand is also explained by fluctuations of the US dollar against other major currencies, commodity price movements, domestic growth concerns and expectations regarding any further monetary policy actions in South Africa. The rand also remains vulnerable to possible negative perceptions related to the further widening of the current-account deficit of the balance of payments in the first quarter of 2008. This development was a result of higher crude oil prices and strong demand for capital goods imports related to infrastructural investment projects. The volume of mining exports declined as a result of electricity load-shedding to the mines. To date, the current-account deficit, including that in the first quarter, has been adequately financed.

Despite these upside risks, there are a number of offsetting effects which confirm the responsiveness of the economy to the less accommodative monetary policy stance of the Bank.

Growth in household consumption expenditure has continued to decline in response to higher interest rates and slower growth in households' real disposable income. Real final consumption expenditure by households grew at an annualised rate of 3,3 per cent in the first quarter of 2008 compared with 3,8 per cent in the previous quarter, having peaked at around 9 per cent in the final quarter of 2006. The recent quarter-on-quarter moderation was due to an 8,1 per cent contraction in spending on durable goods. The total number of new vehicles sold in May 2008 was 24,6 per cent lower than in May 2007. Both commercial and passenger vehicle sales registered significant declines.

Retail sales growth has also continued to moderate. On a year-on-year basis, real retail sales declined by 1,7 per cent in March, while growth in the first quarter of 2008 compared with the same quarter in 2007 measured 0,6 per cent.

Reflecting these expenditure trends, growth in credit extension to the private sector also showed some signs of moderation, although still at relatively high levels. Twelve-month growth in banks' total loans and advances extended to the private sector declined to 21,5 per cent in April 2008, compared with 23,6 per cent in March. Year-on-year growth in mortgage advances declined to 21,9 per cent in April, while growth over the same period in instalment sale credit and leasing finance declined to 11,8 per cent, reflecting the downward trend in motor vehicle and other durable goods consumption. Household debt as a ratio of disposable income increased to 78,2 per cent from 77,6 per cent, while the ratio of debt service cost to disposable income increased from 10,9 per cent to 11,3 per cent.

The economy has shown signs of slowing down following a number of years of growth above the estimated potential growth rate. In the first quarter of 2008, growth in real gross domestic product was an annualised rate of 2,1 per cent compared with 5,3 per cent in the previous quarter. Despite a strong performance by the agricultural sub-sector, the primary sector contracted by 13,0 per cent, mainly as a result of electricity supply constraints. The slowdown was fairly broad-based, with growth in the secondary sector declining to 1 per cent. The utilisation of production capacity in manufacturing declined in the first quarter of 2008, while the Investec/BER Purchasing Managers Index (PMI) shows that the manufacturing sector continues to face low growth in new sales orders and strong pressure on input costs, despite an improvement in manufacturing output growth in April. Overall business confidence, as measured by the RMB/BER Business Confidence Index declined further in the second quarter of 2008. Gross fixed capital formation, however, has remained relatively robust.

The all-share index on the JSE Limited reached new highs in recent weeks, but has moderated since then. However, while the all-share index has increased by about 6 per cent since the beginning of 2008, this has been due primarily to the resources sector which has increased by about 26 per cent as a result of high commodity prices. The industrial index is almost unchanged while the financial index has declined by over 23 per cent over the same period. There is evidence that house prices are beginning to decline. According to the Absa House Price Index, house prices in the middle segment of the market have been declining marginally in nominal terms on a month-on-month basis since February 2008. The Standard Bank index shows that the median house price declined by 13,3 per cent in May on a year-on-year basis.

The outlook for the global economy remains uncertain although there is some tentative evidence that the worst of the banking and credit crisis may be over. Global growth is also expected to remain subdued, but there is uncertainty regarding the extent and duration of the slowdown. Many countries are experiencing increasing inflationary pressures and are facing the challenge of dealing with higher inflation and slowing growth. As the inflation pressures have intensified, monetary policy is becoming more focused on this threat, and an increasing number of central banks have adopted a tighter monetary policy stance.

Monetary policy stance

In the light of the further deterioration in the inflation outlook, but mindful that the economy is responding to a less accommodative monetary policy stance, the Monetary Policy Committee has decided that at this stage further tightening of monetary policy is warranted. Accordingly the repurchase rate will be increased by 50 basis points to 12 per cent per annum with effect from 13 June 2008. The MPC remains committed to bringing inflation back to within the target range over a reasonable time period.