Statement of the Monetary Policy Committee
6 December 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 short-term inflation outlook has deteriorated since the previous meeting of the Monetary Policy Committee (MPC). Food and energy prices have maintained pressure on inflation and these pressures are expected to persist in the coming months. At the same time, previous monetary policy actions are probably beginning to have an impact on household consumption expenditure and this is expected to help moderate inflation pressures over time. The MPC, however, has to ensure that the short-term impact of higher inflation does not allow inflation expectations to become entrenched at higher levels.

Recent developments in inflation

CPIX inflation remained outside the target range for the seventh consecutive month, reaching a 4-and-a-half-year high of 7,3 per cent in October 2007. Food price inflation has continued to accelerate, measuring 12,4 per cent in October. Most of the food categories in CPIX recorded double-digit rates of increase, with the main contributions emanating from grain products, milk, cheese and eggs, and vegetables. Meat price inflation, however, declined to 6,6 per cent. Petrol prices increased at a year-on-year rate of 12,0 per cent in October following moderate increases in the previous three months. Administered prices excluding petrol continued their upward trend and measured 8,5 per cent in October.

There is, however, some evidence that upward pressure on other components of inflation may be moderating. If food and petrol were excluded, CPIX inflation would have measured 4,8 per cent in October, compared to 5,0 per cent in July and August 2007. Low or negative rates of inflation are still being recorded in the following categories: Clothing and footwear, furniture, recreation and communication.

Production price inflation in October 2007 remained high at 9,5 per cent, which was marginally above that in the previous two months. Imported goods inflation declined to 7,5 per cent while the prices of domestically produced goods increased by 10,2 per cent. Prices of agricultural and manufactured foods increased by 26,1 per cent and 17,5 per cent, respectively, which suggests that further pressures on retail food prices can be expected in the coming months.

The outlook for inflation

The most recent central forecast of the Bank indicates a further deterioration in the inflation outlook, particularly in the short term, when compared to the previous forecast. CPIX inflation is now expected to peak at around 7,8 per cent in the first quarter of next year. Thereafter CPIX inflation is expected to decline to below the upper end of the target range by the final quarter of 2008. A gradual downward trend is expected to persist and to measure 5,2 per cent in the final quarter of 2009. The higher trend is a result of higher administered price assumptions, particularly for petrol and electricity, over the forecast period.

Despite the higher short-term trend in inflation, expectations remain contained within the inflation target range. According to the inflation expectations survey that is conducted on behalf of the Bank by the Bureau for Economic Research (BER) at the University of Stellenbosch, there was only a slight deterioration in expectations in the fourth quarter compared to those in the third quarter when a significant increase in expectations was recorded. CPIX inflation in 2008 is now expected to average 5,9 per cent, compared to the 5,8 per cent expected in the previous survey. Significantly, CPIX inflation expectations for 2009 remained unchanged at 5,6 per cent.

Expectations as reflected in the break-even inflation rates, which is the yield differential between conventional and inflation-linked bonds, reflect some deterioration. Break-even inflation rates over different maturities decreased between the August and October meetings of the MPC. Since the October meeting, break-even inflation has increased somewhat over all maturities, but still remains below the 6 per cent level.

The main risks to the inflation outlook emanate from food, petrol and electricity price prospects. International oil prices have continued to remain an upside risk factor. At the time of the October meeting of the MPC, North Sea Brent crude oil prices were trading at around US$78 per barrel. Since then prices increased to peak at almost US$100 per barrel, although in recent days prices have declined to around US$90 per barrel. Domestic petrol prices have been adversely affected by these international trends, and the local price of 93 octane petrol increased by 3 cents per litre in November 2007 and by 43 cents per litre in December.

The degree of upside risk from food price increases may have subsided over time, but food prices nevertheless remain the main contributors to inflation. As noted, production prices indicate that further pressures can be expected on CPIX in the short term. However there are expectations of some moderation during the course of next year as a result of base effects, more favourable weather conditions and higher crop estimates. Futures prices generally reflect an expectation of lower prices, particularly for maize, during 2008. Global food price pressures are nevertheless expected to persist for some time.

Electricity prices in particular pose a significant risk to the inflation outlook. The National Electricity Regulator is due to make a decision on the application by Eskom to raise electricity tariffs by 18 per cent in 2008 and 17 per cent in 2009 in order to help finance its capital expenditure programme.

Despite these risks and pressures, not all the recent developments have been negative from an inflation perspective. In particular, there is evidence of a lagged response by the economy to the previous monetary policy tightening. Household consumption expenditure continues to show some signs of moderation in response to the changed monetary policy stance and lower household disposable income growth. Final consumption expenditure by households grew by 4,5 per cent in the third quarter of 2007, compared to a revised 4,9 per cent growth in the second quarter. This third quarter moderation was a result of a marked deceleration in real expenditure on semi-durable goods in particular. The real value of retail sales remained broadly unchanged from the second quarter to the third quarter. Sales of new vehicles also remained subdued. Despite these developments, the FNB/BER Consumer Confidence Index reflected an increase in consumer confidence during the fourth quarter.

Reflecting the slowdown in household consumption expenditure, credit extension to the private sector has shown some signs of moderation, but nevertheless remains at high levels. Twelve-month growth in total loans and advances had declined gradually over the past few months. Growth over twelve months in loans and advances extended to the household sector declined to 20,1 per cent in October 2007, having peaked at 28,2 per cent in February 2006. The growth rate of loans and advances to the corporate sector declined to 29,7 per cent in October. Household debt as a percentage of household disposable income increased to 77,4 per cent in the third quarter.

Asset price growth, which in the past has helped to underpin domestic demand, appears to be somewhat restrained. Having recovered from the initial impact of the sub-prime developments in the United States (US) and euro area, the JSE Limited has been fairly volatile, in line with the uncertainties that prevailed in the global equity markets. In addition, according to Absa Bank, the year-on-year rate of increase in house prices in the middle segment has declined further to 13,6 per cent in October.

Fiscal policy continues to be supportive of monetary policy. In the October *Medium Term Budget Policy Statement*, the commitment to fiscal prudence was confirmed with the projection of fiscal surpluses for the coming three years.

Output growth remained strong, with GDP growth measuring 4,7 per cent in the third quarter of 2007 compared to a revised 4,4 per cent in the second quarter. Economic growth therefore continues to be at around rates consistent with the potential growth rate of the economy. Growth in gross fixed capital formation remained strong in the third quarter, and this is expected to underpin growth going forward.

The exchange rate of the rand has displayed a higher degree of volatility in recent weeks, but nevertheless has remained relatively unchanged since the previous meeting of the MPC. The relative strength of the rand has been underpinned by sustained capital inflows which financed an expanding current-account deficit in the third quarter of 2007. The deficit, which measured approximately 8,1 per cent of GDP, was driven mainly by increased imports of manufactured goods, as well as by a marked acceleration in service payments to non-residents. Despite this, capital inflows were sufficient to allow for a further accumulation of foreign-exchange reserves by the Bank. At the end of November, the official gross gold and other foreign-exchange reserves had increased to US$32,3 billion, and the international liquidity position to US$30,7 billion.

The outlook for the international economy remains uncertain, with continued turbulence in international financial markets. The reported losses of institutions with exposure to the US sub-prime mortgage market have exceeded expectations, and there are concerns that the downturn in some of the advanced economies may be more severe than originally anticipated. Global inflation appears to be contained although oil and food prices continue to pose a risk to the outlook.

Monetary policy stance

The assessment of the MPC is that the balance of risks to the inflation outlook continues to be on the upside. Therefore the MPC has decided to adjust the repurchase rate by 50 basis points to 11,0 per cent per annum with effect from Friday, 7 December 2007. The MPC will continue to monitor relevant developments and take the necessary steps to ensure that inflation returns to within the target range.