Statement of the Monetary Policy Committee
31 January 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

Since the previous meeting of the Monetary Policy Committee (MPC) in December 2007, the international environment has become increasingly uncertain and volatile. It appears that the continued fall-out from the United States (US) sub-prime crisis has not been confined to financial markets only and there has been a general downward revision to forecasts of global growth.

The slowdown in global growth could have spill-over effects on the South African economy which is also being affected adversely by electricity supply constraints. The economy has continued to respond to the tighter monetary policy stance and inflation is expected to peak in the first quarter of 2008. Nevertheless, there are still significant risks to the inflation outlook.

Recent developments in inflation

CPIX inflation has continued its upward trend, measuring 8,6 per cent in December 2007. The main drivers were again petrol and food. Petrol prices increased at a year-on-year rate of 23,8 per cent in December, while food prices increased at a rate of 13,9 per cent. Excluding food and petrol, CPIX inflation would have measured 5,0 per cent. Prices of clothing and footwear declined significantly, while modest declines were measured in recreation and entertainment, and textiles.

Production price inflation measured 10,3 per cent in December compared to 9,1 per cent in November. Prices of imported goods increased at a year-on-year rate of 11,3 per cent compared to 7,3 per cent the previous month. Manufactured food inflation increased to 18,7 per cent from 18,3 per cent in November while agricultural products inflation declined to 24,0 per cent from 26,8 per cent.

The outlook for inflation

The most recent central forecast of the Bank indicates a further deterioration in the inflation outlook in the short term when compared to the previous forecast. CPIX inflation is still expected to peak in the first quarter of 2008 but at an average of around 8,5 per cent. In line with the previous forecast, CPIX inflation is then expected to decline to below the upper end of the target range by the final quarter of 2008 and to remain at around the 5,6-per-cent level for most of 2009. The higher near-term projections are a result of slightly higher inflation outcomes and further revisions to assumptions about administered prices.

This central forecast of the Bank is broadly consistent with market expectations. The Reuters consensus forecast also expects inflation to peak during the first quarter of 2008 and to fall below the upper level of the target range in the fourth quarter. CPIX inflation is expected to average 6,8 per cent and 5,3 per cent in 2008 and 2009, respectively. The longer-term inflation expectations, as reflected in the break-even inflation rates, have remained relatively unchanged at below the 6-per-cent level since the previous MPC meeting.

The main upside risks to the inflation outlook remain food and energy price prospects, although the extent of the upside risk may have moderated somewhat. The price of North Sea Brent crude oil, which peaked at around US$100 per barrel in December, is currently trading at around US$92 per barrel. Domestic petrol prices remained unchanged in January and the current average under-recovery for January is approximately 15 cents per litre. Oil prices remain vulnerable to supply disruptions, although the adverse global growth outlook may restrain the degree of upside price risk.

Food prices remain one of the main short-term risks to inflation. Production prices continue to indicate that sustained food price pressure can be expected in the coming months. However, the more favourable weather conditions and lower futures prices for maize have reinforced a general expectation of some moderation of food price inflation during the course of this year. However, future trends will be dominated by global supply and demand conditions.

The threat posed to the inflation outlook by higher electricity prices remains. Eskom has been granted an average tariff increase of 14,2 per cent from July. The precise increase that will be faced by households may be higher, and will only be known during the coming months. Furthermore, there is a risk that the increases granted to Eskom over the forecast period could be higher than currently anticipated.

The rand exchange rate has depreciated in recent weeks following a period of relative stability. The currency has been affected by movements in the dollar and, more recently, by increased risk aversion towards emerging markets. The currency has been given some support from commodity prices which have remained firm, and in the case of gold and platinum, have reached new highs. On a trade-weighted basis, the rand has depreciated by around 7 per cent since the beginning of 2008.

Despite these pressures and risks to the outlook, there have been a number of developments which are likely to have a restraining impact on the inflation trend. The moderation of household consumption expenditure highlighted at the previous meeting appears to have continued. Real retail sales have trended downwards since the middle of 2007 and in November sales decreased by 0,7 per cent compared to October. Sales of household furniture, appliances and equipment have contracted the most. Motor vehicle sales also continued their downward trend. Sales of passenger vehicles declined by almost 10 per cent in 2007 compared to 2006 although commercial vehicle sales remained relatively strong.

Growth in household consumption expenditure is also expected to be dampened by negative wealth effects. The global financial market turbulence has been reflected in the volatility on the JSE Limited. Since its peak in October 2007, the all-share index has fallen by approximately 16 per cent. House price increases have also moderated somewhat. According to the Absa house price index, house price increases declined to 11,2 per cent in December 2007, while the month-on-month increase in December was 0,3 per cent. The Standard Bank median house price index was unchanged on a year-on-year basis in December.

Credit extension to the private sector has moderated further. Growth over twelve months in loans and advances extended to the private sector declined from 25,2 per cent in September 2007 to 22,2 per cent in December. The quarterly growth declined from

23,5 per cent in the third quarter to 18,1 per cent in the fourth quarter. Growth in all the subcategories, namely mortgage advances, instalment sales and leasing, and other loans and advances, has displayed a persistent downward trend. The growth in loans and advances to households declined to 18,9 per cent in December, down from 20,1 per cent in November 2007.

According to the *Wage Settlement Survey* by Andrew Levy Employment Publications, the average wage settlement for 2007 was 7,3 per cent compared to 6,5 per cent in 2006. This appears to be consistent with the 7,7 per cent year-on-year increase in average nominal remuneration per worker measured in the third quarter of 2007. Once productivity increases are adjusted for, year-on-year growth in nominal unit labour costs in the formal non-agricultural sector measured 4,8 per cent in the third quarter of 2007 compared to 5,0 per cent the previous quarter. These unit labour cost developments are consistent with the inflation target range.

The risks to output growth appear to be on the downside and this is likely to be reinforced by the electricity supply disruptions. Growth in the construction sector also appears to be moderating with a decline in residential and non-residential plans approved. In November the real value of building plans passed decreased by 16,5 per cent on a year-on-year basis. The volume of cement sales has also shown a significant decline in recent months.

The turbulence in international financial markets has not subsided, and losses suffered by financial institutions with exposure to the US sub-prime market continue to be reported. Fears of a slowdown in some of the advanced economies, and in the US in particular, have also been weighing on the markets. Although the emerging-market economies are expected to sustain relatively strong growth, there are indications of some moderation in growth in China, albeit still at high levels. Global inflation appears to be under control.

Monetary policy stance

There are still considerable risks to the inflation outlook. In light of, *inter alia*, heightened economic uncertainties, both domestically and globally, and some evidence of moderation in domestic consumption expenditure, the MPC has decided that it is appropriate at this time to leave the repo rate unchanged at 11 per cent per annum. The MPC remains committed to bringing inflation back to within the inflation target range.