Statement of the Monetary Policy Committee

17 November 2009

Issued by Ms G Marcus, Governor of the South African Reserve Bank, at a meeting of the Monetary Policy Committee (MPC) in Pretoria

Introduction

There are signs that the domestic economy will continue on its recovery path, but economic growth is expected to remain below potential for some time and dependent to some extent on the pace of the global recovery, which still appears to be fragile and uneven across regions. Economic growth is also expected to be constrained by subdued domestic consumption expenditure. The domestic outlook for inflation remains favourable as a result of weak demand pressures and the main threat to the inflation outlook emanates from possible electricity price increases.

Recent developments in inflation

The year-on-year inflation rate as measured by the consumer price index (CPI) for all urban areas declined from 6,4 per cent in August 2009 to 6,1 per cent in September. The single biggest contributor to the inflation outcome was the category of housing and utilities which accounted for 1,7 percentage points. This was mainly due to the electricity component which increased at a year-on-year rate of 29,1 per cent. Food price inflation continued to moderate and at 4,9 per cent is now exerting downward pressure on overall inflation. Goods price inflation measured 4,9 per cent, compared with services price inflation of 7,8 per cent.

Producer prices declined for the fifth successive month in September, with the headline producer price inflation measuring -3,7 per cent. Most categories in the index exhibited low or negative year-on-year rates of inflation, apart from electricity, gas and water, and tobacco products.

The outlook for inflation

The CPI inflation forecast by the South African Reserve Bank (the Bank) continues to indicate that inflation is likely to return to within the inflation target range, on a sustained basis, by the second quarter of 2010. There may, however, be temporary declines to within the target range before then. CPI inflation is expected to remain within the inflation target range until the end of the forecast period in the final quarter of 2011, when it is forecast to average 5,5 per cent. Given the current uncertainty related to Eskom's tariff application to the National Energy Regulator of South Africa (NERSA), the forecast does not make provision for the higher increases requested by Eskom, and electricity price increases of 25 per cent in 2010 and 2011 are assumed. The Bank's forecast is in line with those of private-sector analysts. According to the latest Reuters consensus forecast, inflation is expected to average 5,7 per cent in 2010 and 5,85 per cent in 2011.

There are no major demand-side pressures on inflation, and the assessment of the Monetary Policy Committee (MPC) is that there are no significant upside risks to the inflation outlook emanating from this source.

Household consumption expenditure remains subdued. Real retail sales growth has been negative, but there is further evidence that motor vehicle sales may have reached their lower turning point. Although total vehicle sales in October were 12,5 per cent lower than a year ago, when the three months to October 2009 are compared with the preceding three months, an increase of 1,4 per cent was recorded. The recovery has been in passenger vehicle sales and exports. Commercial vehicle sales are still declining. Consumption expenditure is expected to remain subdued, despite the lower interest rate environment, as a result of tighter lending conditions by banks, high levels of consumer indebtedness, negative wealth effects or impaired household balance sheets, and higher levels of unemployment.

Credit extension to the private sector reflects weak demand by households and the corporate sector, and tight lending conditions by banks in response to higher perceived risk and rising impaired advances. Twelve-month growth in banks' total loans and advances declined to -0,2 per cent in September 2009. Growth in mortgage advances to the private sector declined further in September, measuring 4,8 per cent. The other main categories of loans and advances, namely instalment sale and leasing finance, credit card advances, bank overdrafts and general loans, all contracted.

Consumption expenditure is also constrained by high debt levels and negative wealth effects, although asset values have recovered somewhat from their lows earlier in the year. The all-share index on the JSE Limited is currently about 50 per cent higher than the most recent lowest point in March of 2009. House prices also appear to be recovering, with the various house price indices reflecting either small positive growth or moderate declines in October.

Labour market developments are also likely to constrain household consumption expenditure. According to the Quarterly Labour Force Survey, approximately 800 000 jobs have been lost since the beginning of the fourth quarter of 2008. The Quarterly Employment Statistics show a decline of over 200 000 formal-sector jobs between the beginning of the fourth quarter of 2008 and the end of the second quarter of 2009.

Domestic output appears to be recovering and the leading business cycle indicator of the Bank has continued its positive trend. There are still some doubts about the speed of recovery, and the output gap remains relatively wide. Most forecasts suggest that positive growth will have resumed by the fourth quarter of 2009, but there is less unanimity about the third quarter outcome.

The outlook is also not even across sectors. The monthly data suggests that the mining sector contracted further in the third quarter, but the manufacturing sector performance on a quarter-on-quarter basis was relatively robust. According to Statistics South Africa, the physical volume of mining production declined by 7,5 per cent in the three months to September compared with the previous three months. However, a more positive trend may be expected in the fourth quarter.

The physical volume of manufacturing production increased by 2,6 per cent over the same period. This outcome is consistent with the Kagiso/Bureau for Economic Research Purchasing Managers Index which, although still reflecting a contraction in manufacturing, has rebounded significantly and the forward-looking indicators in the index are generally positive. There is a risk, however, that this recovery could be affected by low consumption expenditure growth. The outlook for the construction sector appears to be less favourable. The real value of building plans passed declined by 18,5 per cent on a year-on-year basis in August, while in the three months to August, compared with the previous three months, a decrease of 27,7 per cent was recorded. The First National Bank Civil Construction Index also declined significantly in the third quarter of 2009.

Fiscal policy developments are not seen to be a threat to the inflation outlook. The revised budgeted deficit of 7,6 per cent of gross domestic product announced in the Medium Term Budget Policy Statement is to a significant extent due to lower tax revenues – a result of low economic growth – and is therefore part of the workings of the automatic stabilisers. The previous fiscal prudence has provided sufficient space for increased borrowing to fund the shortfall. The deficit is expected to narrow as growth gains momentum.

No significant upside risks to the inflation outlook are expected from food prices. Food price inflation has declined to below 5 per cent, and this favourable trend is expected to continue. Consumer food prices tend to lag food price developments at the producer price level, and the latter have been either declining or rising marginally over the past months. In October, manufactured food prices declined at a year-on-year rate of 1,8 per cent, while agricultural product prices declined by 2,4 per cent. The current spot and future prices of agricultural commodities indicate that no significant upward pressures are expected in the near future.

For the past year petrol prices have exerted downward pressure on inflation as a result of the appreciation of the rand and relatively low international product prices compared to the previous year. However, these favourable base effects are not expected to continue. Over the past few months the international oil prices have remained relatively stable, but some account is taken in the forecast of possible increases in the international oil price should the global recovery accelerate. In November the domestic petrol price remained unchanged and, should current trends continue, a modest increase in the petrol price is possible in December.

The rand has remained a positive factor in the inflation outlook, notwithstanding some volatility during the month. Since the previous MPC meeting, the rand has traded in a range of between R7,30 and R7,90 against the US dollar. The rand's movements have been influenced, to a large extent, by exogenous factors, in particular movements in the dollar, a resumption in global capital flows to emerging markets and a recovery in commodity prices. Since the beginning of the year the rand has appreciated by 20 per cent on a trade-weighted basis.

The global economic recovery has been led by the emerging Asian economies. However, the turnaround in the advanced economies is less certain. While there are positive signs, the recent higher growth rates have been driven by a turn in the inventory cycle, and the continued weakness in consumption expenditure in the United States in particular, and rising levels of unemployment pose risks to the recovery. The nature and speed of exit strategies from the previous stimulus packages also remain a risk to the outlook.

The global environment remains benign from an inflation perspective. Despite moderately higher commodity prices, there are no significant risks to the global inflation outlook.

As in the past few meetings, the main risks to the inflation outlook are seen to emanate from electricity price increases and the possible second-round effects thereof. In addition, the trend of wage settlements continues to pose an upside risk to the inflation outlook.

Monetary policy stance

The MPC, having reviewed the global and domestic economic and financial developments, has decided to maintain the current stance of monetary policy and to leave the repurchase rate unchanged at 7 per cent per annum.