Statement of the Monetary Policy Committee

22 October 2009

Issued by Mr T T Mboweni, Governor of the South African Reserve Bank, at a meeting of the Monetary Policy Committee (MPC) in Pretoria

Introduction

The prospects for inflation returning to within the inflation target range by the second quarter of 2010 remain promising. Domestic demand conditions continue to be subdued and currently do not pose a significant threat to the inflation outlook. Economic growth is expected to improve in the coming months, but is likely to remain below potential for some time. Domestic growth prospects are dependent to an extent on the global recovery, which appears to be uneven across countries and regions. However, the medium-term inflation outlook has been affected adversely by possible further significant adjustments to electricity tariffs.

Recent developments in inflation

There has been no publication of consumer price index (CPI) data since the previous meeting of the MPC. The most recent data showed that the year-on-year inflation rate as measured by the CPI for all urban areas declined to 6,4 per cent in August, compared with 6,7 per cent in July. The main contributors to the inflation outcome were the categories of housing and utilities, and miscellaneous goods and services.

Producer prices declined at a year-on-year rate of 4,0 per cent in August, compared with a decline of 3,8 per cent in July. Food price inflation at the producer price level continues to signal dissipating pressures on food prices at the consumer price level. Agricultural product prices declined at a year-on-year rate of 2,0 per cent, while manufactured food product prices increased at a rate of 0,1 per cent. Upside pressure on producer prices came from electricity prices, which increased by 28,6 per cent.

The outlook for inflation

The CPI inflation forecast by the South African Reserve Bank staff 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. CPI inflation is then expected to stay within the inflation target range for the rest of the forecast period until the end of 2011. Compared with the previous forecast, the outlook showed a slight improvement for 2010 and 2011, mainly as a result of the changed assumption regarding the rand exchange rate. No adjustment has been made at this stage to the central forecast for possible further increases in electricity tariffs over and above those that are already assumed in the baseline forecast.

A number of domestic and global factors have contributed to the persistent downward pressure on inflation. The global economy shows continued signs of improvement, but the recovery is not uniform across regions. The pace of recovery of most of the Asian economies has been higher than that achieved in the main industrialised economies. The timing and speed of the withdrawal of the fiscal and monetary policy stimuli may have a bearing on the nature of the recovery in these economies. Global inflation is expected to be constrained by the relatively weak demand from the industrialised countries, although the US dollar movements may provide some upward pressure to commodity prices.

There are some positive indications that the rate of contraction of the domestic economy has declined and that the economy may emerge from the recession by the end of 2009. However, the mixed picture from the published data shows that the recovery is likely to be tentative, and the output gap is likely to remain positive for some time. The physical volume of manufacturing output declined at a year-on-year rate of 15,0 per cent in August and by 2,8 per cent on a month-on-month basis. However, in the three months to August, compared with the previous three months, an increase of 0,8 per cent was recorded. The Kagiso/Bureau for Economic Research (BER) Purchasing Managers Index (PMI) increased markedly from 39,3 index points in August to 48,0 index points in September. The index shows that new sales orders have increased significantly, while manufacturers' expectations of business conditions six months ahead improved to the highest level since early 2007.

Other sectoral developments indicate that the physical volume of total mining production increased in the three months to August, but contracted on a month-on-month basis, while the real value of building plans passed continued to decline. The Rand Merchant Bank (RMB)/BER Business Confidence Indicator (BCI) declined to a ten-year low in the third quarter of 2009. The tentative nature of the domestic recovery is also reflected in the composite leading business cycle indicator compiled by the South African Reserve Bank, which declined marginally in July, following three consecutive monthly increases.

Consumption expenditure by households also remains subdued, with real retail trade sales declining at a year-on-year rate of 7,0 per cent in August. In the three months to August, there was a 1,0 per cent decline, compared with the previous three months. Wholesale trade sales also declined further in August. Total new vehicle sales are also well below their levels of a year ago. However, there are indications that the negative trend may have reached its lower turning point with zero or slightly positive rates of change being recorded on a month-on-month and quarter-on-quarter basis. The First National Bank (FNB)/BER consumer confidence index declined in the third quarter of 2009 to a relatively neutral confidence level.

Credit extension to the private sector continued to reflect both the weak household consumption expenditure and the prevailing tighter credit criteria. The Ernst & Young Financial Services Index indicates that credit standards applied by retail banks to loan applications continued to tighten in the third quarter of 2009, but at significantly lower levels. Twelve-month growth in banks' total loans and advances declined to 0,8 per cent in August 2009. Mortgage advances increased by 5,6 per cent in August, while instalment sale credit and leasing finance contracted by 4,2 per cent. Negative year-on-year growth rates were also recorded in credit card advances, bank overdrafts and general loans.

There has been some recovery in asset prices in recent months, but wealth effects do not appear to be posing an immediate threat to the inflation outlook. Domestic equity prices have increased markedly since March, but are still significantly below the levels reached in May 2008. The various house price indices indicate a moderation in the rate of decline in house prices.

The exchange rate of the rand continues to provide downside pressure on inflation and is currently trading at levels against the US dollar, similar to those prevailing at the time of the previous MPC meeting. During the past month the rand traded in a range of around R7,20 and R7,79 against the US dollar. The exchange rate of the rand has appreciated by 28 per cent against the US dollar since the beginning of 2009 and by 20 per cent on a trade-weighted basis.

The international oil price has increased in the past week, but does not pose an immediate threat to the inflation outlook. Having averaged around US$70 per barrel for a number of weeks, the price of North Sea Brent crude oil increased to current levels of around US$76 per barrel, mainly as a result of the weaker US dollar and improved global growth prospects. In October the domestic price of 95 octane petrol was reduced by 40 cents per litre as a result of both lower product prices and an appreciated rand exchange rate.

The main risks to the inflation outlook emanate from cost pressures in the economy. The trend of wage settlements still poses an upside risk to the inflation outlook. However, there appears to be some evidence that nominal wage increases are moderating, although increases have generally been above the inflation rate. According to Andrew Levy Employment Publications, the average level of wage settlements amounted to 9,4 per cent in the first nine months of 2009 compared with 9,6 per cent in the corresponding period of 2008. These increases are consistent with the Quarterly Employment Survey (QES) of Statistics South Africa, which reported that growth in average nominal remuneration per worker in the formal non-agricultural sector of the economy moderated from 11,5 per cent in the first quarter of 2009 to 8,7 per cent in the second quarter. Unit labour cost increases declined from 11,3 per cent in the first quarter to 9,3 per cent in the second quarter.

The substantial electricity tariff increases requested by Eskom are seen to be the main longer-term threat to the inflation outlook. Eskom has requested a trebling of the current electricity tariffs over the next three years, and the National Energy Regulator of South Africa (NERSA) is expected to make a decision in February 2010.

Monetary policy stance

The MPC is of the view that overall the risks to the inflation outlook have not changed markedly since the previous meeting. Accordingly, the MPC has decided to leave the repurchase rate unchanged at 7,0 per cent per annum. The MPC will continue to monitor economic and financial developments, and will not hesitate to adjust the monetary policy stance should the risks to the inflation outlook change materially.