Statement of the Monetary Policy Committee

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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

There are signs that the global economic recovery is under way, but the indications are that the pace of recovery is likely to be slow and uneven, particularly in the industrialised economies where banking sector concerns still persist. Domestic economic growth, which has been negative in each of the past three quarters, is expected to improve in the coming quarters. However, the domestic recovery is likely to be influenced by global growth developments and is subject to a relatively high degree of uncertainty. Domestic inflation has continued its downward trend, but some risks to the outlook remain.

Recent developments in inflation

The year-on-year inflation rate as measured by the consumer price index (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. Food price inflation moderated further, with food and alcoholic beverages increasing at a year-on-year rate of 6,8 per cent; down from 8,3 per cent in July.

Producer prices have continued their negative trend and declined at a year-on-year rate of 3,8 per cent in July, compared with a decline of 4,1 per cent in June. Food price inflation at the consumer level can be expected to abate as agricultural product prices declined at a year-on-year rate of 1,7 per cent, while manufactured food product prices increased at a rate of 0,8 per cent. Upside pressure on producer prices came from electricity prices which increased by 27,4 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 on a sustained basis to within the inflation target range by the second quarter of 2010. CPI inflation is then expected to remain within the inflation target range for the remainder of the forecast period until the end of 2011. Compared with the previous forecast, the outlook is unchanged for 2009 and 2010, although there is a slight improvement for 2011. The exchange rate of the rand has provided downside pressure, which has more or less offset higher oil price assumptions and higher unit labour costs over the period.

The most recent study of inflation expectations undertaken on behalf of the Bank by the Bureau for Economic Research (BER) at Stellenbosch University indicates that inflation expectations have improved somewhat, but remain, on average, above the upper end of the inflation target range. Inflation is expected to average 7,5 per cent in both 2010 and 2011. This represents declines of 0,6 per cent and 0,4 per cent in these years respectively, compared with the previous survey. Only the financial analysts expect inflation to be within the target range in the coming two years. Since the previous meeting of the MPC, the break-even inflation rates, as measured by the yield differential between conventional government bonds and inflation-linked bonds, declined across all maturities to within the inflation target range.

Overall, the risks to the inflation outlook appear to be fairly evenly balanced. The main upside risks continue to emanate from high increases in some administered prices, particularly electricity prices, and increases in nominal unit labour costs well in excess of the current inflation rate. Nominal unit labour cost increased over four quarters by 9,3 per cent in the second quarter of 2009, compared with 11,3 per cent in the previous quarter.

International oil prices, which remain an upside inflation risk factor, have moderated slightly since the previous meeting of the MPC and appear to have stabilised around current levels of about US$70 per barrel. Domestic petrol prices increased by 36 cents per litre in September, but the current over-recovery indicates that this increase may be offset, to a large extent, in October, as a result of lower product prices and the recent appreciation of the rand.

Growth in domestic final demand declined at an annualised rate of 3,5 per cent in the second quarter of 2009. Household consumption expenditure contracted by 5,8 per cent, compared with a decline of 4,8 per cent in the previous quarter. Durable goods consumption was the most affected sub-category, declining by 18,8 per cent. New vehicle sales declined at a year-on-year rate of 23 per cent in August, but there are signs that the decline is levelling out. In July real retail and wholesale trade sales contracted at year-on-year rates of 3,8 per cent and 13,8 per cent respectively, although retail sales increased on a month-on-month basis.

Consumption expenditure is expected to remain constrained by negative wealth effects, although there has been a marked recovery in the equity markets, which may relieve these effects somewhat. Since the beginning of the year, the all-share index on the JSE Limited has increased by about 20 per cent. House prices, however, have continued their downward trend. The various house price indices, while still indicating negative price trends, show that prices are declining at a slower rate.

Credit extension to the private sector continued to reflect both the weak household consumption expenditure and the prevailing tighter credit criteria. Twelve-month growth in banks' total loans and advances declined to 2,1 per cent in July. Mortgage advances declined to a year-on-year rate of growth of 6,4 per cent in July, while instalment sale credit and leasing finance contracted by 3,2 per cent over the same period, as a result of subdued demand for motor vehicles and other durable goods. Other loans and advances, comprising credit card advances, bank overdrafts and general loans, declined by 2,0 per cent. Lower levels of credit extension have resulted in a slight decline in household debt as a percentage of household disposable income to 76,3 per cent in the second quarter of 2009. The ratio of debt-service cost to household disposable income declined from 10,9 per cent in the first quarter to 9,5 per cent in the second quarter.

Domestic output contracted by 3,0 per cent in the second quarter of 2009, but there are early indications that the lower turning point may have been reached. However the recovery is expected to be slow. The South African Reserve Bank composite leading indicator increased for the third consecutive month in June and continues to predict a recovery by the end of the year.

The rate of contraction in the manufacturing sector also shows signs of slowing down. On a year-on-year basis, manufacturing output declined by 13,7 per cent in July, but it increased at an annualised month-on-month rate of 3,0 per cent. The Kagiso/BER Purchasing Managers Index (PMI) increased in July, although still at levels that indicate negative growth. Mining production increased at a year-on-year rate of 4,8 per cent in July. However, the real value of all building plans passed declined by 43,2 per cent in July, with the slowdown in residential building plans being the main contributor.

The exchange rate of the rand continues to provide downside pressure on inflation and has appreciated further since the previous meeting of the MPC when it was at a level of around R8,10 to the US dollar. Since the beginning of the year, the rand has appreciated by 26 per cent against the US dollar, and by 20 per cent on a trade-weighted basis.

The global economy appears to be recovering in response to concerted fiscal and monetary packages that have been put in place. A number of industrialised economies have experienced positive growth rates in the second quarter, while others have shown a moderation in the rate of contraction. Many forecasts for the second half of the year and for 2010 have been revised upward, but remain well below pre-crisis levels. However, there are risks that the recovery may be short-lived should consumer demand not improve further in the industrialised economies. While there have been some improvements in financial market conditions, more still remains to be done. Global inflation remains relatively subdued and poses no immediate risk to the domestic inflation outlook.

Monetary policy stance

The MPC is of the view that the risks to the inflation outlook appear to be fairly evenly balanced. Given the current policy stance, inflation is expected to continue moderating and return to within the inflation target range during the forecast period. Accordingly, the MPC has decided to leave the repurchase rate unchanged at 7 per cent per annum.