

Statement of the Monetary Policy Committee

13 August 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

There are encouraging signs that the global slowdown may have reached its lower turning point, although the speed and extent of the recovery are still subject to a high degree of uncertainty. The South African economy appears to be lagging behind these international developments and it is likely that the domestic economy contracted in the second quarter of this year. The domestic economy remains constrained by weak global and domestic demand.

Targeted inflation declined materially in June, but is still outside the inflation target range. Expectations are that it will take some time before inflation returns to within the target range on a sustainable basis. Cost-push pressures appear to be the main source of upside risk to the inflation outlook.

Recent developments in inflation

The year-on-year inflation rate as measured by the consumer price index (CPI) for all urban areas declined from 8,0 per cent in May 2009 to 6,9 per cent in June. The main contributors to the inflation outcome were food and non-alcoholic beverages, housing and utilities, and miscellaneous goods and services. Each of these categories contributed 1,6 percentage points to CPI inflation. Petrol prices declined at a year-on-year rate of 25 per cent, despite the 17 cents per litre increase in the petrol price in June. Administered price inflation, excluding petrol prices, measured 9,1 per cent in June, with electricity prices increasing by 28,6 per cent.

Producer prices declined at a year-on-year rate of 4,1 per cent in June, compared with a decline of 3,0 per cent in May. Prices of mining and chemical products were the main contributors to this trend, but there was also further moderation in food price inflation. Prices of agricultural products declined at a year-on-year rate of 1,7 per cent, while prices of manufactured food products increased at a rate of 3,7 per cent, compared with a rate of 6,2 per cent in the previous month.

The outlook for inflation

The most recent CPI inflation forecast by the staff of the South African Reserve Bank remained more or less unchanged compared with the previous forecast. However, CPI inflation is still expected to continue its moderate downward trend, to enter the target range during the second quarter of 2010 and to remain within the target range for the rest of the forecast period ending in 2011.

These projections are broadly in line with the Reuters consensus survey of private-sector analysts. The most recent survey for July indicates that analysts expect inflation to decline to within the inflation target range during the second quarter of 2010, and to average 5,8 per cent and 5,6 per cent in 2010 and 2011 respectively. Expectations derived from the yield differential between conventional government bonds and inflation-linked bonds have remained within the inflation target range over the short- to medium-term maturities.

The outlook for the international economy appears to have improved. The cautious optimism that the bottom of the cycle may have been reached continues to prevail, although some analysts still doubt the strength and sustainability of this recovery. The recovery is also not expected to be uniform across countries or regions. According to the July 2009 *World Economic Outlook* of the IMF, global output is expected to contract by 1,4 per cent in 2009 before recovering to 2,5 per cent in 2010. The developed economies are expected to grow by 0,6 per cent, while growth in emerging economies is expected to average 4,7 per cent in 2010. At this stage, global inflation appears to be under control despite the significant monetary accommodation in a number of advanced economies.

Domestic economic conditions remain subdued amid indications that the economy contracted further in the second quarter of 2009, although at a slower rate of contraction than in the previous quarter. Manufacturing production declined at a year-on-year rate of 17,1 per cent in June, and by 3 per cent in the three months to June 2009 compared with the previous three months. The utilisation of production capacity in manufacturing in May 2009 was 78 per cent; down from 84,4 per cent a year ago. The Kagiso/Bureau for Economic Research Purchasing Managers' Index (PMI) declined in July, indicating that the difficult conditions in the manufacturing sector are likely to persist. However, according to the PMI, expectations of business conditions six months ahead continued to improve. Similarly, the Bank's composite leading business cycle indicator increased for a second consecutive month in May 2009, indicating the possibility of a recovery later in the year.

Household consumption expenditure growth continued to contract during the past few months. New vehicle sales declined again in July, with total vehicle sales declining by 4,5 per cent in July compared with the previous month. Total vehicle exports declined by 12 per cent on a month-on-month basis, and by 60,3 per cent on a year-on-year basis. Real retail trade sales contracted at a seasonally adjusted rate of 3,6 per cent in the second quarter of 2009 compared with the first quarter. On a year-on-year basis, retail sales declined by 6,7 per cent in June. The First National Bank/Bureau for Economic Research Consumer Confidence Index increased moderately in the second quarter of 2009, although it is still at low levels.

The weak state of domestic demand is reflected in the rate of credit extension to the private sector. Year-on-year growth in total loans and advances of banks to the private sector declined from 6,3 per cent in April 2009 to 2,2 per cent in June. On a quarter-on-quarter basis, negative growth of 1,8 per cent was measured in the second quarter of 2009. Year-on-year growth in mortgage advances moderated to 8,2 per cent in June, while instalment sales credit and leasing finance, as well as other loans and advances, experienced negative year-on-year growth. These declines are due, in part, to stricter lending criteria being applied by banks.

The impact of negative wealth effects on domestic consumption expenditure may have dissipated somewhat with the partial recovery of equity prices in the local and global markets. Since the beginning of the year, the All-Share Index on the JSE Limited has increased by about 14 per cent. However, the index is still significantly below the levels reached in 2008. The various house price indices all show that house prices continued to decline in July, but the pace of decline appears to be moderating.

The exchange rate of the rand has remained relatively volatile, but within a range that has prevailed since May 2009 with the decline in global risk aversion. The exchange rate of the rand has fluctuated between approximately R7,68 to the US dollar and R8,32 to the US dollar since the previous meeting of the MPC. Since the beginning of the year, the nominal effective exchange rate of the rand has appreciated by about 13 per cent.

As noted above, food price developments continue to be a major factor in the overall inflation outcomes. After months of relative stickiness, food price inflation at the consumer price level appears to be responding to the favourable trends at the producer price level. In June 2009 food price inflation declined to 9,8 per cent compared with a rate of 16,1 per cent in January 2009.

The main upside risks to the inflation outlook emanate from cost-push pressures. The international oil price has continued its stronger upward trend, as the outlook for the global economy improves. The price of North Sea Brent crude oil has remained above US\$70 per barrel for most of the period since the previous meeting. Although domestic petrol prices were reduced by 21 cents per litre in July, the current under-recovery indicates that a further petrol price increase is likely in August.

Other adverse cost pressures include administered price increases, particularly electricity prices, and wage increases that have generally been in excess of inflation. According to Andrew Levy Employment publications, wage settlements in the first six months of 2009 averaged 9,7 per cent. In the first quarter of 2009 the increase in unit labour cost over four quarters amounted to 11,2 per cent.

Monetary policy stance

The MPC is of the view that, notwithstanding upside cost pressures, the adverse economic conditions appear to tilt the balance of risks to the inflation outlook towards the downside over the medium term. The MPC has, therefore, decided to reduce the repurchase rate by 50 basis points to 7 per cent per annum with effect from 14 August 2009.