Statement of the Monetary Policy Committee

25 June 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 domestic economy continues to show signs of stress in the wake of the global economic downturn. Output growth remains negative, while trends in household consumption expenditure have continued to deteriorate. There are, however, signs that the downturn, both globally and domestically, may be nearing the lower turning point, but the recovery is expected to be slow and protracted.

The inflation rate has continued its downward trend, which has been constrained by relatively sticky services price inflation. While the widening output gap and weak domestic demand pose a downside risk to the inflation outlook, these risks are increasingly being offset by various cost-push and exogenous factors that are impacting on the economy, as well as by deteriorating inflation expectations.

Recent developments in inflation

The year-on-year inflation rate as measured by the consumer price index (CPI) for all urban areas declined from 8,4 per cent in April 2009 to 8,0 per cent in May. Food price inflation declined from 13,6 per cent in April to 12,1 per cent in May, but remains the main contributor to the inflation outcome, having contributed 1,9 percentage points. Housing and utilities inflation contributed 1,8 percentage points, mainly as a result of the 29,6 per cent increase in electricity prices and the 15,1 per cent increase in the cost of maintenance and repairs. Services price inflation has remained unchanged at 8,4 per cent since March 2009, while goods price inflation declined from 8,7 per cent to 7,6 per cent over the same period.

Producer prices declined at a year-on-year rate of 3 per cent in May 2009. Nonetheless, agricultural product prices increased at a year-on-year rate of 1,5 per cent, while manufactured food product prices increased by 6,2 per cent.

The outlook for inflation

The most recent CPI inflation forecast by the staff of the South African Reserve Bank (the Bank) shows that 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 2011. A more favourable exchange rate assumption has been offset by higher-than-expected petrol price increases and inflation outcomes.

CPI inflation expectations, as measured by the Bureau for Economic Research (BER) at Stellenbosch University deteriorated during the second quarter of 2009. Average inflation expectations for 2009 increased from 8,3 per cent in the first quarter to 8,7 per cent in the second quarter, mainly as a result of upward revisions by financial analysts. While a downward trend for the subsequent two years remains, only the financial analysts predict inflation to be within the inflation target range in the coming two years. Overall, CPI inflation is expected to average 8,1 per cent and 7,9 per cent in 2010 and 2011 respectively.

Inflation expectations, as measured by the yield differential between conventional and inflation-linked bonds, also showed a moderate increase over the past weeks. However, the break-even rate has generally remained within the inflation target range over the short- to medium-term maturities.

The growth prospects for the economy remain a downside risk to the inflation outlook. The output gap, which is the difference between actual and potential output growth, has widened over the past few quarters. Following the 6,4 per cent contraction of gross domestic product (GDP) in the first quarter of 2009, the most recent high frequency data and indicators suggest that the negative trend in GDP growth is likely to have continued during the second quarter of 2009. Mining production declined at a year-on-year rate of 10,6 per cent in April, but increased by 7,2 per cent on a month-on-month basis. Total manufacturing production declined by 3,3 per cent in April 2009, compared with the previous month, and by 21,6 per cent on a year-on-year basis.

The composite leading indicator as compiled by the staff of the Bank increased slightly in April. The indicator suggests that the lower turning point in the cycle could be reached later in the year. The Kagiso Securities/Bureau for Economic Research Purchasing Managers' Index remains at low levels, but recorded a slight increase in May, also indicating an expectation that the economy may be approaching its lower turning point. This is consistent with the Rand Merchant Bank/Bureau for Economic Research Business Confidence Indicator, which declined further in the second quarter, but the rate of decline has slowed.

The domestic growth prospects will be determined, to an important degree, by international developments. The global downturn has resulted in a significant decline in South Africa's exports in the first quarter of 2009, leading to a wider deficit on the current account of the balance of payments compared with the previous quarter. The outlook for the global economy remains uncertain, but there is a general sense of cautious optimism that the lower turning point of the cycle might have been reached. The general view appears to be that the global economy will remain under pressure for most of this year before beginning a slow recovery. Global inflation remains well contained.

Growth in domestic expenditure has remained subdued, with real domestic final demand contracting by 1,5 per cent in the first quarter of 2009. Real final consumption expenditure by households declined at a quarter-on-quarter annualised rate of 4,9 per cent. Contractions in consumption were experienced in all broad categories of goods, but there was a rebound in the growth of expenditure on services. Growth in real gross fixed capital formation moderated to 2,6 per cent during the same period. The main contributor to the 2,2 per cent increase in gross domestic expenditure was final consumption expenditure by general government, which increased by 5,9 per cent.

Household consumption expenditure appears to have remained under pressure in the second quarter of 2009. In April, real retail trade sales declined by 1,1 per cent compared with the previous month, and by 6,7 per cent on a year-on-year basis. Real wholesale trade sales increased by 0,7 per cent on a month-on-month basis, but declined by 15,1 per cent on a year-on-year basis. While new vehicle sales in May increased marginally compared with the previous month, the year-on-year decline measured 32,9 per cent.

Household consumption expenditure is expected to remain constrained by tighter credit criteria of banks and negative wealth effects. The various house price indicators all show that house prices have continued to decline. The All-Share Index on the JSE Limited has recovered somewhat from its lows in March, but is still substantially below the levels recorded during the first half of 2008.

Growth in expenditure may also be affected negatively by the adverse trends in employment growth. According to the Quarterly Employment Survey of Statistics South Africa, 179 000 jobs were lost in the formal non-agricultural sector during the first quarter of 2009.

The exchange rate of the rand has fluctuated against the US dollar between a range of about R7,85 and R8,25 since the previous meeting of the MPC. As global risk aversion has declined, a number of emerging-market economy currencies have appreciated and since the beginning of the year, the rand has appreciated by approximately 15 per cent on a trade-weighted basis.

As noted above, food price inflation remains the main contributor to the inflation outcome, but the downward trend has continued, although at a slow pace. The spot price of yellow maize has declined by about 40 per cent since June 2008, and is now at levels last seen in the final quarter of 2006.

The main upside risk to the inflation outlook comes from cost-push pressures, particularly from electricity price increases and other administered prices, as well as nominal wage increases, which have generally been in excess of inflation. In the first quarter of 2009 the increase in unit labour cost over four quarters amounted to 11,2 per cent.

The international oil price has re-emerged as a potential upside risk to the inflation outlook. The price of North Sea Brent crude oil reached levels in excess of US$70 per barrel in the past week, before declining to current levels of around US$67 per barrel. As a result of the higher international product prices, a further petrol price increase is likely in July.

Monetary policy stance

The MPC has decided to keep the repurchase rate unchanged at 7,5 per cent per annum. This decision is based on the economic and inflation analysis provided above. The committee is fully cognisant of the fact that there has been significant monetary accommodation since December 2008. The MPC remains fully committed to its mandate of achieving and maintaining price stability.