Statement of the Monetary Policy Committee

24 March 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 global economy has continued to weaken significantly in recent months as a result of the turmoil in the financial markets. There is growing uncertainty regarding the depth and duration of the economic slowdown. The South African economy has not escaped the impact of these developments, and domestic production has contracted as a result of weak domestic demand and a significant decline in export demand. Against this backdrop of widening domestic and global output gaps, the balance of risks to the inflation outlook has changed somewhat.

Recent developments in inflation

Inflation as measured by the reweighted and reconstituted consumer price index (CPI) for all urban areas (which is the new target measure) measured 8,1 per cent in January 2009. Food and non-alcoholic beverages prices, which increased at year-on-year rates of 15,7 per cent in January, contributed 2,4 percentage points to total inflation. The housing and utilities category contributed 2,1 percentage points, and together with food accounted for more than half of the measured inflation increase. The transport component had a minimal impact on the overall CPI as a result of the 20,3 per cent reduction in petrol prices during January. Producer price inflation, which reached 19,1 per cent in August 2008, continued its downward trend, measuring 9,2 per cent in January 2009. Despite the depreciation of the rand during 2008, producer prices of imported goods declined at a year-on-year rate of 5 per cent in January.

The outlook for inflation

The most recent central forecast of the Bank shows a near-term deterioration in the inflation outlook, but a more favourable trend is forecast for the medium term, which is the relevant time frame for monetary policy. Consumer price inflation is expected to average 8,1 per cent in the first quarter of 2009 and then to decline to below 6 per cent in the third quarter of the year. As a result of technical base effects, inflation is then expected marginally to exceed the upper end of the inflation target range, before returning back to within the range in the second quarter of 2010 and to remain there until the end of the forecast period in the fourth quarter of 2010, when it is expected to average 5,3 per cent. The heightened levels of uncertainty and the rate of change of global developments make these forecasts subject to higher risk than is usually the case.

Expectations by analysts are similar to those of the Bank, with the Reuters consensus forecast showing a moderate upward revision of inflation in 2009 and a relatively unchanged forecast in 2010, when inflation is expected to average 5,5 per cent in the final quarter. Most forecasters expected inflation to have increased moderately in February 2009 before resuming its downward trend. Inflation expectations, as reflected in the yield differential between inflation-linked bonds and conventional government bonds, have increased slightly since the previous meeting of the MPC, but remain within the inflation target range.

The inflation outlook has been dominated by the continued weakening of the global economy and financial markets, notwithstanding significant monetary and fiscal measures introduced by central banks and governments. The decline in global demand has resulted in a marked contraction in international trade. The International Monetary

Fund, which in January was forecasting global growth to average 0,5 per cent in 2009, now expects the global economy to contract by up to 1 per cent in 2009. Numerous industrialised and developing countries are already experiencing negative growth. World inflation is being restrained by declining demand and lower commodity prices, which are expected to remain subdued under these conditions of negative or low growth.

The weak global demand has been reflected in the export performance of the South African economy. However, the decline in the value of exports in the final quarter of 2008 was more than offset by a lower value of imports, mainly due to declining international oil prices. Combined with a narrowing of the deficit on the services, income and current transfer account of the balance of payments, this resulted in a narrowing of the deficit on the current account from 7,8 per cent of GDP in the third quarter of 2008 to 5,8 per cent in the final quarter. However, the published January trade data, which showed a further considerable decline in the value of merchandise exports, suggest that the improvement in the trade deficit may not be sustained to the same extent seen in the fourth quarter. The deficit on the current account of the balance of payments measured 7,4 per cent of GDP for the 2008 calendar year.

Domestic demand conditions have also deteriorated further. In the fourth quarter of 2008, gross domestic expenditure and domestic final demand contracted by 3,9 per cent and 0,4 per cent respectively. Final consumption expenditure by households declined by 2,7 per cent, mainly as a result of a 20 per cent contraction in consumption of durable goods. The growth in gross fixed capital formation moderated further, recording an annualised growth rate of 3 per cent. Motor vehicle sales, which have been under pressure for some time, declined at a year-on-year rate of 35,6 per cent in February. In January real retail sales increased at a year-on-year rate of 1,7 per cent – the first year-on-year increase in 9 months – while wholesale trade sales declined by 4,5 per cent over the same period.

Domestic demand conditions are expected to remain under pressure as a result of declining disposable incomes, tighter credit conditions and negative wealth effects. Credit extension to the private sector has continued its downward trend as a result of lower demand and more stringent lending criteria being applied by banks. In January 2009 growth in total loans and advances to the private sector measured 11,4 per cent. The slower rate of credit extension has resulted in a further moderation of the ratio of household debt to disposable income to 76,4 per cent in the fourth quarter of 2008, compared with a peak of 78,2 per cent in the first quarter of that year.

Domestic output has been impacted appreciably by these external and domestic demand developments, resulting in a further widening of the domestic output gap. In the final quarter of 2008 GDP contracted at an annualised rate of 1,8 per cent, mainly due to a 22 per cent decline in manufacturing-sector output. The high frequency data indicate that these adverse conditions may have persisted in the first quarter of 2009. Manufacturing and mining output contracted at year-on-year rates of 11,1 cent and 8,7 per cent respectively in January, while the Investec/Bureau for Economic Research (BER) Purchasing Managers Index reached a new low in February, reflecting continued strain on the manufacturing sector. The latest BER manufacturing survey indicates extreme and broad-based weakness in this sector in the first quarter of 2009. The RMB/BER Business Confidence Index surveyed in the first quarter of 2009 reached its lowest level since 1999, particularly in the manufacturing, wholesale and construction sectors. The confidence of retailers of non-durable goods increased somewhat.

On a trade-weighted basis, the rand has been relatively stable since the beginning the year and has appreciated by about 2,5 per cent since the previous meeting. Movements in the rand exchange rate in recent weeks have been mainly reflecting volatile international currency developments. After the previous meeting of the MPC, the rand first depreciated to around R10,60 against the US dollar, as the dollar strengthened against most currencies. Since then the US dollar has weakened somewhat and the rand is currently trading at levels of around R9,45 per US dollar.

The upside risks to the inflation outlook emanate primarily from cost-push pressures, particularly from administered prices. These include possible higher-than-expected electricity tariff increases. The decline in inflation may also be delayed by continued high rates of increases in food prices, despite marked declines in producer price food inflation.

Monetary policy stance

Against the background of a slowing global and domestic economy and an improved medium-term outlook for inflation, the MPC has decided to reduce the repurchase rate by 100 basis points to 9,5 per cent per annum with effect from 25 March 2009.