Statement of the Monetary Policy Committee

28 May 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 downturn continues to have a negative impact on the domestic economy, which experienced two consecutive quarters of contraction. The significant widening of the domestic output gap has added further downside risk to the inflation outlook. The downward trend in inflation is expected to continue, despite inflation being subject to some inertia in the near term.

Domestic economic developments will be influenced to a large degree by the pace and magnitude of the recovery in the global economy. There are tentative signs that the global economy may have seen the worst of the downturn, but the recovery is expected to be slow and protracted.

Recent developments in inflation

The year-on-year inflation rate as measured by the consumer price index (CPI) for all urban areas declined from 8,5 per cent in March 2009 to 8,4 per cent in April. The prices of food and non-alcoholic beverages, which increased at a year-on-year rate of 13,7 per cent, contributed 2,1 percentage points to the inflation outcome. Housing and utilities contributed 1,8 percentage points. This category includes electricity and other fuels, which increased by 29,4 per cent. Petrol prices declined by 17,5 per cent, while public transport prices increased by 15,1 per cent.

The producer price index continued its downward trend in April when it increased at a year-on-year rate of 2,9 per cent. Food price pressures moderated further with manufactured food price inflation declining to 8,4 per cent, compared with 9,4 per cent in March. Prices of agricultural products increased by 2,2 per cent.

The outlook for inflation

The most recent CPI inflation forecast of the Bank shows a relatively unchanged outcome for the near-term as compared with that presented to the previous meeting of the Monetary Policy Committee. Over the longer term, there appears to be a moderate improvement. This forecast is similar to the Reuters consensus forecast of private analysts who expect inflation to average 6,9 per cent and 5,7 per cent in 2009 and 2010 respectively.

The main upside risk to the inflation outlook comes from cost-push pressures, in particular from electricity price increases. Eskom has applied to the National Energy Regulator of South Africa (NERSA) for a 34 per cent interim increase in electricity tariffs, but there is still uncertainty about the final adjustment. A number of municipalities have already budgeted for significant electricity price increases in anticipation of higher Eskom tariffs.

In line with the less-negative global outlook, there has been a moderate recovery in international oil prices. North Sea Brent crude oil has been trading at prices of around US$60 per barrel during the past days, compared with an average of around US$50 per barrel during April. These developments may result in a moderate increase in the domestic petrol price in June. The impact of the higher international prices on domestic petrol prices has been partly offset by exchange rate movements during the month.

Food price inflation remains well above average inflation, and has been lagging the favourable developments at the producer price level and in the spot prices of agricultural commodities. Food price inflation measured 17,9 per cent in August 2008 and has been moderating persistently, but slowly, since then.

In the first quarter of 2009 gross domestic product (GDP) contracted at a quarter-on-quarter annualised rate of 6,4 per cent, with mining and quarrying declining by 32,8 per cent. The manufacturing sector, which contracted at an annualised rate of 22,1 per cent, was the largest contributor to the negative GDP outcome. The weak manufacturing performance was also reflected in the utilisation of production capacity in the manufacturing sector, which declined from 82 per cent in the fourth quarter of 2008 to 79 per cent in the first quarter of 2009.

The GDP contraction was broad based, with general government services, personal services and construction being the only sectors that exhibited positive growth. Civil construction is expected to remain strong as the infrastructure programme proceeds. However, other parts of construction are expected to remain under pressure as the value of new building plans passed for both residential and non-residential construction declined by 13,4 per cent in the first quarter of this year compared with the preceding quarter.

Recent high-frequency indicators suggest that the negative trend in GDP growth is likely to continue during the second quarter of 2009, although at a more moderate pace of contraction. Most analysts expect positive, but relatively low, growth in the final half of this year. The composite leading and coincident business cycle indicators of the South African Reserve Bank (the Bank) indicate continued weakness in the economy in 2009. In March 2009 the leading indicator declined by 15,1 per cent; the largest year-on-year decline on record. The composite indicator declined at a year-on-year rate of 9,4 per cent in February. The Investec Purchasing Managers Index (PMI) declined further to 35,6 index points in April. However, expectations of business conditions six months ahead showed some improvement.

Domestic demand conditions remain subdued. Real wholesale trade sales declined by 5,9 per cent on a year-on-year basis in March 2009 and by 1,8 per cent on a month-on-month basis. Real retail sales recorded a 5,3 per cent year-on-year decline and a 1,9 per cent month-on-month decline in March. Total new vehicle sales declined at a year-on-year rate of 44 per cent in April, with commercial vehicle sales declining by 51 per cent. Vehicle exports were 31 per cent lower in April compared with the previous month.

Household consumption expenditure is expected to remain constrained by negative wealth effects and tight credit conditions. The various house price indices show that house prices have been falling in recent months. Although the All-Share Index on the JSE Limited has recovered somewhat since its recent lows, it is still significantly lower than the levels prevailing during 2008. Domestic credit extension continues to reflect the lower demand for credit, as well as the wider spreads and more stringent credit criteria being applied by banks with respect to loans to both households and companies. Year-on-year growth in total loans and advances to the private sector declined to 6,6 per cent in April. The rate of growth of instalment sale credit and leasing finance declined by 0,1 per cent, reflecting the weak demand for durable goods. Extension of bank overdrafts contracted by 6,8 per cent, while credit card advances increased marginally.

There are tentative signs that the downturn in the global economy may be bottoming out as financial market conditions appear to have become less restrictive. However, there are as yet few convincing indications that the recovery will be quick. At this stage it appears that a protracted period of slow, below-potential growth is most likely, with most analysts predicting some recovery later this year or early next year. Global inflation pressures remain subdued and have declined in a number of economies.

Since the beginning of the year the rand has appreciated by around 13 per cent on a trade-weighted basis. While the rand, along with other currencies, remains vulnerable to further possible bouts of risk aversion, the risk to the inflation outlook has been reduced by the relative strength of the rand.

Monetary policy stance

The evidence that was presented to the MPC suggests that the output gap has widened further. This is expected to contribute to an improved inflation outlook, notwithstanding some current inflation inertia. Accordingly, the MPC has decided to reduce the repurchase rate by 100 basis points to 7,5 per cent per annum with effect from 29 May 2009.