Statement of the Monetary Policy Committee

5 February 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

Since the previous meeting of the MPC, domestic inflation has continued on its downward trend. A further decline is expected in the January data when the reweighting and rebasing of the consumer price index (CPI) implemented by Statistics South Africa (Stats SA) comes into effect. With respect to economic growth, the domestic economy is being adversely affected by the continuing turbulence in the global economy. The widening domestic output gap and declining international commodity prices are expected to exert further downward pressure on inflation going forward. Nevertheless, some risks to the inflation outlook remain and the MPC had to assess these conflicting risks against the backdrop of a highly uncertain and volatile international environment.

Recent developments in inflation

CPIX inflation (headline inflation excluding mortgage interest cost) has been moderating consistently since August 2008 when it measured 13,6 per cent. In November and December 2008 inflation had declined to 12,1 per cent and 10,3 per cent respectively. Electricity, food, and clothing and footwear prices were the main contributors to the inflation outcomes in these months, having increased at year-on-year rates in excess of 15 per cent. Petrol prices increased by 25,8 per cent in November, but declined by 1,8 per cent in December. If food and petrol were excluded, CPIX inflation would have measured 8,7 per cent in December.

Producer price inflation also moderated in the past two months, declining to a year-on-year rate of 11,0 per cent in December. Food price increases continued to moderate: agricultural product prices were unchanged in December, while manufactured food price inflation declined to a year-on-year rate of 12,8 per cent in the same month.

The outlook for inflation

The most recent central forecast of the South African Reserve Bank (the Bank) is similar to that presented to the MPC in December. Partly as a result of the reweighting and rebasing of the new targeted inflation index, CPI inflation is expected to decline further and average 7,5 per cent in the first quarter of 2009, and to decline to below the upper end of the inflation target range during the third quarter of the year when it is expected to average 5,2 per cent. Inflation is then forecast to increase again and to breach the upper end of the target range in the first quarter of 2010, mainly as a result of technical base effects. Thereafter, inflation is expected to return to within the target range and remain there until the end the forecast period when it is expected to average 5,5 per cent. The simulation results of the model make provision for the most recent trends of actual and preliminary data that have become available from Stats SA since the previous MPC meeting.

Market indicators also reflect a moderation in expected inflation. Inflation expectations as measured by the yield differential between conventional government bonds and inflation-linked bonds have remained within the inflation target range. The Reuters consensus survey conducted in December indicates that analysts expect inflation to average 6,4 per cent in 2009 and 5,8 per cent in 2010.

The volatile exchange rate of the rand continues to pose the main upside risk to the inflation outlook. The rand is currently trading against the United States (US) dollar at levels similar to those prevailing at the time of the previous MPC meeting. During December 2008 the rand appreciated against the US dollar and reached a level of R9,30 in the first week of January. This move was mainly a result of a weaker US dollar, which depreciated to US$1,47 against the euro. Renewed risk aversion in international markets and a stronger US dollar in January resulted in the rand returning to current levels of around R10,00. The rand has appreciated marginally on a trade-weighted basis since the previous meeting.

The risks to the inflation outlook posed by oil and food prices appear to have subsided somewhat. Food prices continued to moderate at the production price level, but these favourable developments have not yet been seen at the consumer price level. Spot and futures prices of maize and wheat remained well below the average price level in 2008 and some relief at the consumer price level is expected in the coming months.

The price of Brent crude oil, which reached a low of US$34 per barrel during December 2008, averaged around US$41 for the month. This, along with the termination of the slate levy, allowed for a further reduction in domestic petrol prices of R1,34 per litre in January. However, international oil prices recovered somewhat in January and averaged almost US$45 per barrel during that month. As a consequence, the domestic price of petrol was increased by 61 cents per litre in February. The outlook for oil prices remains uncertain, but prices are expected to remain relatively subdued as a result of weakening global growth.

The domestic economy continues to show signs of slowing, following the 0,2 per cent annualised growth recorded in the third quarter of 2008. The composite leading and coincident business cycle indicators of the Bank point to a continuation of this trend. Other high-frequency indicators are consistent with this outlook. The physical volume of manufacturing production declined at a year-on-year rate of 4,4 per cent in November 2008, while the latest Investec/BER Purchasing Managers Index indicates that the outlook for the manufacturing sector remains negative. The utilisation of production capacity in manufacturing declined by 3,4 percentage points in the fourth quarter of 2008 to 82 per cent. Mining output contracted by 6,1 per cent in November compared with the previous year, while the real value of total building plans approved declined by 25,3 per cent over the same period.

Household consumption expenditure also remains under pressure. Real wholesale trade sales increased slightly in the year to November 2008, but real retail sales declined by 4 per cent over the same period. Motor vehicle sales contracted at a year-on-year rate of 35,4 per cent in January, with commercial vehicle sales declining by 41 per cent. Motor vehicle exports, which remained strong in 2008, also moderated and the industry expects larger declines in the coming months. Exports in general are expected to remain under pressure, given the adverse global conditions. However, preliminary data indicates that the deficit on the trade account of the balance of payments probably contracted during the final quarter of 2008.

Household consumption expenditure may also be affected by remuneration trends and employment growth. According to Andrew Levy Employment Publications, the level of wage settlements for the year 2008 amounted to 9,8 per cent, compared with an average inflation rate of 11,3 per cent. Nominal unit labour cost increases in the third quarter of 2008 measured 12,4 per cent. Employment growth has also been impacted by the slowing economy. In the third quarter of 2008 non-agricultural employment increased by one per cent, compared with 3,9 per cent in the first quarter of that year. Private-sector employment contracted in the second and third quarters.

The subdued trend in household consumption expenditure and the stricter credit criteria applied by banks to both households and corporates have been reflected in a further moderation in the growth of credit extension to the private sector. Growth over 12 months in total loans and advances by banks to the private sector declined to 14,4 per cent in December 2008. Most categories of loans have exhibited declines in growth.

High consumption expenditure is expected to remain under pressure from negative wealth effects resulting from adverse asset price developments. The all-share index on the JSE Limited remained volatile in line with global market turbulence. The housing market has also remained subdued, with the various house price indices indicating real price declines.

The outlook for the world economy has deteriorated further as a result of the continued difficulties being experienced by the global financial system. The International Monetary Fund significantly downgraded its forecast for global growth in 2009 to 0,5 per cent. Many of the advanced economies are expected to experience negative growth rates in the coming months, while growth prospects of emerging market and developing economies have also deteriorated. As a result of these widening output gaps and declining commodity prices, world inflation pressures have subsided.

Monetary policy stance

The MPC has decided to reduce the repurchase rate by 100 basis points to 10,5 per cent per annum with effect from 6 February 2009. The MPC will continue to monitor domestic and global developments in order to decide on the most appropriate monetary policy stance going forward.