Statement of the Monetary Policy Committee

11 December 2008

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 moderated and is expected to decline further over the coming months. At the same time, the South African economy has been affected by the significant global slowdown that has intensified recently. The domestic economy experienced negligible growth in the third quarter, while a number of sectors contracted. Moreover, while there has been some improvement in the inflation outlook, risks posed by uncertainty with regard to the exchange rate in particular, remain.

The data releases over the past weeks have shown that the international economy is slowing down faster than previously expected and that global inflation pressures are subsiding. This has resulted in the recent global interventions by policy-makers.

Domestic monetary policy remains guided by local conditions. Monetary policy always takes into consideration the possible impacts of global developments on the South African economy, in general, and on inflation, in particular.

Recent developments in inflation

CPIX inflation (headline inflation excluding mortgage interest cost) measured 13,6 per cent in August 2008 and subsequently declined to year-on-year increases of 13,0 per cent and 12,4 per cent in September and October respectively. Food, petrol and electricity prices were the main contributors to the inflation outcomes, despite the petrol price reductions in September and October. Food prices increased at a year-on-year rate of 17,2 per cent in October, while petrol and electricity prices increased by 31 per cent over the same period. If food and petrol were excluded, CPIX inflation would have measured 8,4 per cent in October, compared with 8,5 per cent in September.

Producer price inflation also showed signs of moderating in the past two months despite significant electricity price increases. Producer price inflation increased at a year-on-year rate of 19,1 per cent in August, but moderated to 14,5 per cent in October. Agricultural food prices declined for the third successive month in October when the year-on-year rate declined to 10,4 per cent. Manufactured food prices increased by 15,6 per cent in October, compared with 20,5 per cent in August.

The outlook for inflation

The most recent central forecast of the South African Reserve Bank (the Bank) shows a further improvement in the inflation outlook since the previous MPC meeting. With an unchanged stance of monetary policy, inflation is expected to continue its downward trajectory and to return to within the inflation target range in the third quarter of 2009. Inflation is then expected to breach the upper end of the target range marginally in the first quarter of 2010 as a result of technical base effects associated with the decline in petrol prices at the end of 2008. However, the downward inflation trend is forecast to continue thereafter.

Inflation is expected to average 6,2 per cent and 5,6 per cent in 2009 and 2010 respectively, and to average 5,3 per cent in the final quarter of 2010. The forecasts are subject to a greater degree of uncertainty than usual, given the highly volatile global environment, and the uncertainty related to the impact of the rebasing and reweighting of the CPI basket to be introduced by Statistics South Africa in January 2009.

Inflation expectations as measured by the yield differential between conventional government bonds and inflation-linked bonds declined from just over 9 per cent in July 2008 to around 5,1 per cent in early December. The yield curve has remained inverted at the longer end and has declined since the previous meeting, particularly in the one-to-five year maturity range.

Inflation expectations as reflected in the inflation expectations survey conducted on behalf of the Bank by the Bureau for Economic Research (BER) at Stellenbosch University deteriorated marginally for 2009, but then improved slightly for 2010. Average inflation expectations for 2009 measured 8,2 per cent compared with 8,1 per cent in the previous quarter, while inflation expectations for 2010 measured 7,2 per cent compared with 7,4 per cent in the previous survey. This was the first time since the first quarter of 2006 that expectations for any forecast year had declined.

Unit labour cost in the third quarter of 2008 increased by 12,5 per cent compared with the same quarter last year. However, the improved inflation expectations, coupled with the lower actual trend in inflation, may have a moderating impact on unit labour costs, which will most likely be influenced by the weaker state of the economy.

The exchange rate remains the most significant upside risk to the inflation outlook. Since the previous meeting of the MPC, the rand exchange rate has depreciated against the US dollar by about 11 per cent. At the time of the previous meeting, the rand was at a level of R9,15 to the United States (US) dollar. The currency subsequently depreciated to a level of R11,80 but recovered soon after, and for the past few weeks has traded in a relatively narrow range of between R10,00 and R10,50. On a trade-weighted basis, the rand has depreciated by around 7,6 per cent since the previous meeting. The rand, along with other emerging-market currencies, is influenced by the risk aversion prevailing in the uncertain global environment.

International crude oil prices have declined further. North Sea Brent crude oil is currently trading at around US$40 per barrel, compared with US$83 per barrel at the time of the previous meeting of the MPC. The lower international oil price has resulted in a cumulative decline in domestic petrol prices of R3,35 per litre since August, and by R2,06 since the previous MPC meeting. If current levels of international oil prices and exchange rates persist, a further sizeable decline in the domestic petrol price can be expected in January.

The trend in international food prices has also followed that of other commodities, and since June 2008 there has been a 30 per cent decline in the *Economist* Food Price Index. These developments have contributed to the year-on-year declines in the agricultural food component of the producer price index mentioned above, and to the significant fall in domestic spot prices of maize and wheat, despite the depreciation of the rand over the past weeks. Food price increases at the consumer price level remain elevated, but the spot price developments are expected to impact on these prices in the coming months.

South Africa's economic growth rate also declined significantly in the third quarter of 2008 when real gross domestic product (GDP) increased at an annualised rate of 0,2 per cent. This represented a significant widening of the output gap. The slowdown was a result of contractions in mining, manufacturing and the retail and wholesale trade sectors. Manufacturing output declined further in October. The Bank's leading indicator of economic activity has been trending downward for some time, and more recently the coincident indicator has followed this trend. The Investec/BER Purchasing Managers'

Index declined to its lowest level since its inception to reach a level of 39,5 – a level similar to that prevailing in a number of other countries. The RMB/BER Business Confidence Index also reflects a negative outlook.

Gross fixed capital formation held up relatively well in the third quarter when it grew at a rate of 10,0 per cent, mainly as a result of investment by public corporations and general government. However, growth in private-sector gross fixed capital formation declined to 2,6 per cent. This was particularly the case in investment in private residential buildings where the real value of residential and non-residential building plans continued to decline.

Household consumption expenditure contracted in the third quarter for the first time since 1998. Consumption of durable goods in particular declined by almost 10 per cent, while non-durable goods consumption also contracted. Motor vehicle sales continued to decline in October and November, while real retail trade sales declined further in October. The FNB/BER Consumer Confidence Index showed a further deterioration in the fourth quarter of 2008.

The rate of growth of credit extension to the private sector continued to moderate. Year-on-year growth in total loans and advances to the private sector declined to 17,1 per cent in October, while growth in mortgage advances and instalment sale credit and leasing financed decline to 16,1 per cent and 10,5 per cent respectively. There are also indications of tighter credit standards being applied by banks to both households and the corporate sector. The lower rate of credit extension to households contributed to the further moderation of household indebtedness. Household debt as a percentage of disposable income measured 75,3 per cent in the third quarter, compared with 78,5 per cent in the first quarter of 2008.

The current-account deficit, which measured 7,9 per cent of GDP in the third quarter of 2008, is likely to moderate in the coming months as a result of the lower international oil price and lower dividend payments to non-residents, among other factors.

The turmoil in the international financial markets has also been reflected as well in domestic asset prices. The all-share index on the JSE Limited has followed global equity market trends and has exhibited a high degree of volatility over the past months. Since the previous meeting, the index has declined by about 1,5 per cent, but at one stage it had declined by about 15 per cent. The housing market remains subdued, with prices falling in real terms, and in some instances in nominal terms as well. These negative wealth effects are likely to weigh on household expenditure in the coming months.

Global developments are also expected to contribute to downward inflation pressures. Apart from sharply declining commodity prices, the decline in the volume of world trade has also lowered transport costs significantly. Growth forecasts have been revised down significantly, particularly in the advanced economies, and the expected protracted slowdown is likely to lower prices of other goods as well, as the pricing power of firms dissipates. The possible stimulus to growth provided by more accommodative monetary policies and fiscal stimuli are likely to take some time to filter through, given the fragile state of the banking systems and the marked declines in business and consumer sentiment.

Monetary policy stance

The Monetary Policy Committee considered recent developments in the South African economy and the risks to the inflation outlook against the backdrop of conditions prevailing in the global economy and international financial markets. The MPC has noted improvements in the inflation outlook in South Africa since its previous meeting in October 2008. However, risks to the inflation outlook remain and will be monitored closely. The MPC has therefore decided to reduce the repurchase rate by 50 basis points to 11,5 per cent per annum with effect from 12 December 2008.