Statement of the Monetary Policy Committee

13 May 2010

Issued by Gill Marcus, 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, the outlook for domestic inflation has remained favourable, with inflation still being expected to remain within the target range over the forecast period. Domestic economic growth prospects appear to have improved and most growth forecasts have been revised upwards, despite only a modest recovery in household consumption expenditure.

The risks to this relatively favourable growth outlook have changed somewhat in the past few days as a result of recent global developments. The uncertainty related to the sustainability of fiscal deficits in a number of euro area countries, and the reaction of the financial markets to these events, has renewed fears of possible contagion that could affect the tentative recovery that has been taking place in most regions, including in South Africa. The concerted efforts by European governments, the European Central Bank (ECB) and the International Monetary Fund (IMF) have had some effect on calming the markets. However, significant risks to the global and domestic recovery remain.

Recent developments in inflation

The year-on-year inflation rate as measured by the consumer price index for all urban areas (CPI) declined to 5,1 per cent in March 2010 from 5,7 per cent in the previous month. The category of housing and utilities remained the single biggest driver of inflation, having contributed 1,6 percentage points, mainly as a result of the impact of a 26,8 per cent year-on-year increase in electricity prices. Food price inflation continued to contribute favourably to the average inflation outcome, having increased by 0,5 per cent. Administered prices excluding petrol and paraffin increased by 10,4 per cent, compared with 10,8 per cent in the previous month.

Producer price inflation increased to 3,7 per cent in March 2010, compared with 3,5 per cent in February. This upward trend was driven mainly by primary commodity price increases that do not impact directly on the CPI. Food price inflation at the producer level remained well contained and should constrain food price inflation at the consumer price level in the coming months. Agricultural food prices declined at a year-on-year rate of 6,2 per cent, while manufactured food prices declined by 1,5 per cent.

The outlook for inflation

The CPI forecast of the South African Reserve Bank (the Bank) indicates a slightly improved outlook compared with that presented at the previous meeting of the MPC, with a lower projected inflation for 2010 and 2011. CPI inflation is still expected to reach a low point in the third quarter of 2010 when it is forecast to average 4,7 per cent. Inflation is then expected to increase moderately and remain within the inflation target range until the end of the forecast period, which has been extended to the end of 2012, at 5,3 per cent.

Recent surveys indicate that analysts’ inflation expectations are within the inflation target range for most of the forecast period. According to the Reuters CPI survey, respondents expect inflation to average 5,3 per cent in 2010, and 5,8 per cent and 6,0 per cent in the following two years. Inflation expectations as indicated by inflation-linked bonds also reflect an improvement since the previous meeting of the MPC and are within the inflation target range.

According to the *World Economic Outlook* published by the IMF in April 2010, global growth is now expected to average 4,2 per cent in 2010, compared with the October 2009 forecast of 3,1 per cent. However, the recent developments in Europe have raised the possibility of a renewed crisis that could threaten the global recovery. The reaction of the financial markets to the downgrading by the rating agencies of some euro area countries was reminiscent of the aftermath of the collapse of Lehman Brothers in September 2008. Apprehension about a possible default on Greek sovereign debt sparked concerns of a contagion effect on other European economies with high fiscal deficits and debt ratios. There were also fears of a spillover to the European banking sector, which has significant exposures to the sovereign debt of these countries.

The financial markets initially reacted positively to the concerted and significant policy interventions announced on 8 May by the euro area governments and the ECB. However, the markets were subsequently less convinced that the measures taken would be sufficient to resolve the underlying solvency problem of these countries, or that the required fiscal consolidations would be politically and socially feasible. These developments demonstrate the fragility of the global environment and the related uncertainties pose a downside risk to the global recovery. The global inflation outlook, however, is expected to remain benign and is not expected to pose an upside risk to domestic inflation.

For much of the period since the previous MPC meeting, the exchange rate of the rand had remained relatively stable within a range of around R7,23 and R7,48 against the US dollar. The turbulence in the global financial markets resulted in a brief but significant depreciation of the rand against the US dollar, as risk aversion returned to the markets. Following the announcement of the proposed government interventions in Europe, the rand appreciated to current rates of around R7,50 against the US dollar.

On a trade-weighted basis, the rand has remained relatively unchanged since the beginning of the year. Over the same period the rand has depreciated by over 1 per cent against the US dollar, but has appreciated by around 11 per cent against the euro. At current levels, the rand remains a positive factor in the inflation outlook, but this is contingent on developments in the euro area and general risk aversion.

The global developments also highlight the current focus of the financial markets on the sustainability of fiscal deficits and debt ratios. The South African national government deficit measured an estimated 6,7 per cent of GDP in the 2009/10 fiscal year, compared with the projected 7,2 per cent announced in the February budget. The deficit is expected to narrow over the next three years as the economy recovers and to measure 4,7 per cent in the 2012/13 fiscal year. The overall government debt-to-GDP ratio is expected to peak at 43 per cent in the medium term. This fiscal trajectory is consistent with fiscal sustainability and the MPC does not foresee a possible conflict with monetary policy objectives should this trend be maintained.

The moderate recovery in domestic economic growth appears to be sustained. Both the composite leading and coincident business cycle indicators of the Bank continued their upward trend in the first two months of 2010, confirming the positive short-term outlook for domestic economic activity. The various business confidence indices are also relatively favourable. The most recent GDP forecast of the Bank is for growth of 2,7 per cent in 2010 and 3,6 in 2011. At these rates of growth, the output gap is not viewed as an upside risk to the inflation outlook. The main risks to the growth outlook are seen to emanate from possible adverse global economic developments.

The growth outlook is underpinned by the continued recovery in the manufacturing sector, which grew at a broad-based year-on-year rate of 6,3 per cent in March. The Kagiso/BER Purchasing Managers Index declined in April, but still reflects a continued expansion of this sector. Total mining production increased at a year-on-year rate of 11,0 per cent in March.

Private-sector demand pressures remain benign from an inflation perspective. There is some evidence of an improvement in household consumption expenditure. Real retail sales declined on a year-on-year basis in February, but the shorter-term trends were more positive. When the three months to February are compared with the previous three months, an increase of around 3 per cent was recorded. New vehicle sales also maintained their favourable trends, increasing at a year-on-year rate of 36 per cent in April.

Domestic bank credit extension to the private sector continues to reflect weak demand conditions despite evidence of some loosening of credit supply constraints. Twelve-month growth in loans and advances contracted by 0,3 per cent in March 2010. Growth in mortgage advances declined from 3,9 per cent in February to 3,6 per cent in March, but nevertheless remained the only category of credit extension to register positive growth. The most recent Ernst & Young/BER Financial Services Index shows that the banks have moved to a more neutral position with respect to credit standards applied to new loans.

Consumption is also determined to some extent by the wealth effects in the economy. House prices appear to have recovered somewhat, and the various indices now all reflect positive house price growth. The equity markets have also improved significantly since their lows in March 2009. However, in the five trading days to 7 May, the JSE All-Share Index declined by almost 10 per cent, demonstrating the vulnerability of the market to changes in sentiment.

Despite the more favourable growth outlook, employment trends appear to be lagging the domestic recovery. The *Quarterly Labour Force Survey* indicates that 171 000 jobs were lost in the first quarter of 2010. These adverse trends are expected to constrain household consumption expenditure somewhat and offset, to some extent, the positive impact on consumption of higher real wage increases.

Notwithstanding these job losses, there is a concern about the possible impact of the level of wage increases in the economy. According to Andrew Levy Employment Publications, the average wage settlement rate in the first quarter of 2010 moderated to 8,4 per cent, compared with the 9,3 per cent increase measured in 2009. However, the MPC noted that a number of wage negotiations are at significantly higher levels, and well above the current and expected inflation rate. Should a general upward trend in wage settlement rates transpire, in the absence of compensating increases in productivity, it could pose an upside risk to the inflation outlook.

Other factors that have a significant impact on the inflation outlook include food and petrol prices. As noted earlier, food price inflation is expected to remain subdued as a result of the recent decline in the domestic maize price. The international oil price, having remained in the range of US$70 to US$80 per barrel for some time, appeared to have resumed its upward trend since late April. However the recent uncertainty in the financial markets, which cast doubts about the sustainability of the global recovery, resulted in a decline in the international price of Brent crude oil to below the US$80 per barrel level.

Monetary policy stance

The assessment of the MPC is that inflation is likely to remain within the inflation target range over the forecast period, and that the economy is expected to continue on a recovery path. The risks to the inflation forecast are seen to be more evenly balanced than at the previous meeting of the MPC. The main risks to the inflation outlook emanate from administered price developments and from the risks emanating from the global economy. The domestic growth outlook will continue to be affected by the global developments. The MPC will continue to monitor these developments closely.

For these reasons, the MPC deems it appropriate to maintain the current stance of monetary policy. Accordingly, the repurchase rate remains unchanged at 6,5 per cent per annum.