Statement of the Monetary Policy Committee

22 July 2010

Issued by Gill Marcus, Governor of the South African Reserve Bank, at a meeting of the Monetary Policy Committee (MPC) in Pretoria

Introduction

International news and discourse are currently dominated by global economic and financial market developments, which continue to weigh on domestic economic growth prospects. Although the immediate concerns relating to the sovereign debt crisis seem to have abated somewhat, significant risks remain. Furthermore, growth in a number of advanced economies appears to be losing some momentum following promising outcomes in the first quarter of the year.

The domestic inflation outlook remains favourable with inflation expected to stay within the inflation target range for some time, against the backdrop of a benign global inflation environment.

Recent developments in inflation

The year-on-year inflation rate as measured by the consumer price index (CPI) for all urban areas declined to 4,6 per cent in May 2010 from 4,8 per cent in the previous month. The main contributors to the inflation outcome were the categories of housing and utilities (mainly electricity) and miscellaneous goods and services (predominantly insurance costs) which, together, contributed almost 60 per cent to the total inflation outcome. Categories exhibiting very low inflation pressures included food and non-alcoholic beverages, communication and recreation and culture. Indicators of core inflation show that inflation is generally subdued, with CPI excluding food, petrol and energy declining to 4,3 per cent in May compared with 4,7 per cent in the previous month. Inflation excluding all administered prices measured 3,4 per cent.

Producer prices continued the upward trend seen in the past few months, and measured 6,8 per cent in May 2010, compared with 5,5 per cent in April. These increases were driven mainly by commodity and electricity price developments. Food price inflation remained low, with agricultural prices increasing by 0,3 per cent on a year-on-year basis, while manufactured food prices declined by 1,3 per cent over the same period. This suggests that food prices at the consumer level are likely to remain contained for some time.

The outlook for inflation

The CPI forecast of the Bank indicates a relatively unchanged forecast compared with that presented to the previous meeting of the Monetary Policy Committee (MPC). CPI inflation is expected to average 4,5 per cent in the third quarter of 2010, and then increase moderately thereafter. Inflation is expected to remain within the target range during the forecast period, and to measure 5,3 per cent in the final quarter of 2012.

Despite the persistent moderation of inflation within the target range, inflation expectations have remained relatively elevated, albeit with a slight downward trend. According to the survey of inflation expectations conducted by the Bureau for Economic Research (BER) at Stellenbosch University during the second quarter of 2010, average inflation expectations for both 2010 and 2011 have declined by 0,2 percentage points to 6,3 per cent and 6,5 per cent respectively, but have remained unchanged at 6,8 per cent in 2012. Financial analysts are the only category of survey respondents that expect the inflation target to be achieved during the forecast period.

Expectations derived from the markets are similar to those of the financial analysts. The break-even inflation rates, as measured by the yield differential between conventional government bonds and inflation-linked bonds, have declined since the previous meeting of the MPC, and reflect an expectation of the continued attainment of the inflation target over the medium term, although close to the upper end of the range.

The global economic growth outlook remains uncertain. In its July update of the *World Economic Outlook*, the International Monetary Fund raised the forecast for global growth from 4,2 per cent to 4,6 per cent, mainly on the basis of the higher-than-expected performance in the first quarter of the year. However, some moderation is expected in the second half of this year with a high degree of downside risk.

The sovereign debt crisis in Europe appears to have had a short-term respite, but significant longer-term risks and uncertainties persist. The planned fiscal consolidation and austerity programmes in a number of countries are expected to lead to persistently low growth for some time. The economic growth prospects in the United States (US) appear weaker than anticipated, with particular concerns about the continued weakness in the housing market, and an outlook described by US Federal Reserve Chairman Ben Bernanke as “unusually uncertain”. At the same time the Chinese authorities have taken steps to moderate the pace of economic growth. The expectation is that we are likely to see an extended period of below-potential growth in a number of regions.

Under these circumstances, global inflationary pressures are expected to remain subdued and are not seen to pose a risk to the domestic inflation environment. The weaker demand conditions are also likely to constrain global commodity price developments, including international oil prices. The price of Brent crude oil has been relatively stable for some time and has averaged around US$74 per barrel since the previous meeting of the MPC, down from the US$82 per barrel average that prevailed during the period between the March and May MPC meetings.

The continued low interest rate environment prevailing in the US and eurozone has resulted in a consistent search for yield, with a number of emerging markets being the recipients of significant capital inflows. South Africa has been no exception. Since the beginning of the year, non-residents have been net purchasers of bonds and equities to the value of around R72 billion, of which about R51 billion were bond purchases.

The rand exchange rate has been relatively volatile in the period since the previous meeting of the MPC, with the rand/dollar exchange rate fluctuating between around R8,10 and R7,43. However, since the beginning of June, the rand has been relatively stable and averaged around R7,60 per US dollar. Much of the underlying volatility can be ascribed to changes in global risk aversion related to events in Europe in particular, which saw a high degree of volatility in the US dollar/euro exchange rate. As a consequence, the rand has fluctuated against other currencies as well. Since the beginning of the year the rand has appreciated against the euro and pound sterling by 9,1 per cent and 2,9 per cent respectively, while it has depreciated by 2,9 per cent against the dollar over the same period. On a trade-weighted basis, the rand has appreciated by about 1,6 per cent since the beginning of the year.

The Bank is very aware of the impact of both the level and volatility of the rand on the economy, particularly the manufacturing, export and import-competing sectors. We are ready to continue to play our part in a considered manner, and discussions with the National Treasury about the various options available to address these issues, as well as the availability of resources to do so are ongoing.

While a range of levels has been proposed by various interest groups or analysts as desired or equilibrium levels – anything from R10,50 to R8,50 against the US dollar – we reiterate that we do not have a target level for the rand. It is very difficult to define with precision the degree of over- or undervaluation of an exchange rate. The approach when assessing this should be guided by a sense of when the value is clearly not consistent with equilibrium, which itself changes from time to time. Moreover, it is important not to underestimate how difficult it is to achieve a particular range of a weaker currency, or how costly this can be. Any actions would also have to be consistent with the inflation target, as there is no point in having a weaker currency if the benefits are simply eroded by inflation.

The recovery in domestic economic growth has continued. Real gross domestic product (GDP) grew at an annualised rate of 4,6 per cent in the first quarter of 2010, driven mainly by the recovery in the manufacturing and mining sectors. However, indications are that second quarter growth was likely to have been less favourable, and the negative output gap is expected to persist for some time. The Bank forecasts economic growth to average around 2,9 per cent during 2010, with the uncertainties emanating from the global economy posing the main downside risks.

The relatively unfavourable outlook can be ascribed in part to an expected slowdown in the manufacturing sector. Growth in this sector in the three months to May 2010 compared with the previous three months measured 1,2 per cent. The Kagiso/BER Purchasing Managers Index has been moderating consistently since its peak in February 2010, and in July the index reflected an expectation of a contraction in the sector. The construction sector also remains under pressure, as evidenced in the 29,9 per cent year-on-year decline in total building plans passed in May. Civil construction is also showing declining activity and, according to the First National Bank (FNB) civil construction survey, the industry is experiencing unsatisfactory business conditions. The Rand Merchant Bank (RMB)/BER Business Confidence Index also declined during the second quarter of 2010. Private sector gross fixed capital formation continued to decline in the first quarter of 2010, albeit at a slower rate of contraction.

There are signs of recovery in domestic household consumption expenditure. In the first quarter of 2010 consumption expenditure grew at a higher-than-expected annualised rate of 5,7 per cent. The recovery was fairly broad-based except for expenditure on services, which remained relatively subdued. The positive trend is expected to have been maintained in the second quarter. Retail trade sales increased at a year-on-year rate of 4,6 per cent in May. However when comparing the three months to May with the preceding three months, an increase of 0,3 per cent was recorded. Consumption expenditure is expected to have received a boost from the 2010 FIFA World Cup™. New vehicle sales increased by 20,7 per cent on a year-on-year basis in June, although they declined by 9,7 per cent relative to the previous month.

The BER retail survey suggests that the outlook for the sector remains fragile. After two consecutive positive quarters, retail business confidence declined in the second quarter of 2010, and overall business conditions, sales volumes and profitability performed worse than expected.

The outlook for household consumption expenditure is being affected by contradictory forces. Positive factors include lower interest rates, lower inflation, positive wealth effects arising from favourable house price and equity market developments, and high levels of real wage increases for those in employment. In the first quarter of 2010 unit labour costs increased by 9,6 per cent compared with the same quarter a year ago. According to Andrew Levy Publications, the average wage settlement rate amounted to 8,2 per cent in the first half of 2010, compared with 9,3 per cent for 2009 as a whole. Wage expectations also remain elevated, according to the BER inflation expectations survey.

Factors constraining consumption expenditure include continued job losses and high levels of household debt and low levels of credit extension to the private sector. According to the Quarterly Employment Statistics survey of Statistics South Africa, employment levels declined further in the first quarter of 2010, as private-sector employment contracted for the seventh consecutive quarter. Youth unemployment is particularly evident.

Growth in bank credit extension to the private sector turned positive in May when growth over twelve months in total loans and advances measured 1,4 per cent, mainly as a result of an increase in credit extension to the corporate sector. Twelve-month growth in mortgage advances has remained stable at levels around 3 per cent since November 2009. There are some indications, as evidenced in the most recent Ernst & Young/BER financial services survey, that in the second quarter of 2010 retail banks loosened their credit criteria somewhat. However, bank lending to consumers may be constrained by the persistently relatively high levels of impaired advances, particularly in relation to retail loans. Demand for loans may also have been negatively affected by the continued high levels of household debt, which measured 78,4 per cent of disposable income in the first quarter of 2010.

The main upside risks to the inflation outlook continue to emanate from cost-push pressures, particularly recent wage settlements and high levels of administered price increases.

Monetary policy stance

The MPC assesses the risks to the inflation outlook as being evenly balanced and views the current monetary policy stance as appropriate. Therefore, the MPC decided to keep the repurchase rate unchanged at 6,5 per cent per annum. The committee is aware of the fragilities and vulnerabilities to the domestic economy, driven in part by global uncertainties. The committee will continue to assess economic and financial developments, and should circumstances warrant it, the appropriate response will be taken, consistent with the Bank's inflation-targeting mandate.