Statement of the Monetary Policy Committee

8 December 2005

Issued by Mr T T Mboweni, Governor of the South African Reserve Bank, at a meeting of the Monetary Policy Committee in Pretoria

Introduction

Inflation has remained under control and within the inflation target range, and growth in gross domestic product (GDP) has been robust. The recent revisions of the GDP data show that the economy has been growing at a faster rate than previously estimated. The most significant change was to the 2004 growth rate, which is now estimated to have been 4,5 per cent. A slightly higher growth rate is expected to be achieved this year, although there are signs that the economy might be losing some of its earlier momentum.

At the October MPC meeting, the inflation outlook had deteriorated somewhat, which was a cause for concern. Since then, however, recorded outcomes have been better than anticipated, and the outlook has changed somewhat. However a number of significant risks remain.

Recent inflation developments

Inflation as measured by the consumer price index for metropolitan and other urban areas excluding the interest cost on mortgage bonds (CPIX) declined to 4,7 per cent in September, and 4,4 per cent in October following its peak of 4,8 per cent in August. The decline occurred despite the increases in local petrol prices in September and October of R0,29 and R0,12, respectively. Since then the petrol price has been reduced by R0,31 in November and R0,30 in December. If petrol price increases were excluded from this index, CPIX inflation in September and October would have measured 3,5 per cent and 3,2 per cent, respectively, reflecting a continued absence of marked second-round effects from petrol price increases.

These more favourable outcomes have been due to a number of factors which partly offset the impact of the petrol price increases. Notable among these were the year-on-year declines in the prices of clothing and footwear, furniture and equipment, and homeowners' costs. Year-on-year food price inflation also remained low, measuring 2,5 per cent in October compared to 3,3 per cent in September. Services inflation moved further within the inflation target range, having declined to 5,2 per cent in October, compared to goods price inflation of 4,1 per cent. Of significance is the fact that administered prices excluding petrol declined to 4,5 per cent and 4,3 per cent in September and October, respectively. This can be compared to a rate of increase of 7 per cent in May. Administered price inflation including petrol amounted to 10,0 per cent in October.

Production price inflation also reversed its recent upward trend in October when it measured 4,2 per cent, compared to 4,6 per cent in September. Prices of domestically produced goods rose by 3,8 per cent and 3,5 per cent in September and October, respectively, while price increases of imported goods amounted to 6,8 per cent and 5,8 per cent. The food price category continued to exhibit price declines.

The outlook for inflation

As a result of the lower inflation outcomes as well as the changes in some of the determinants of the inflation outlook, CPIX inflation is now forecast to run at a level somewhat below the previous forecast and reach a level of around 5 per cent by the end of 2007.

There are a number of changes that have occurred since the previous meeting of the MPC which have led to this improved inflation outlook. Perhaps the most significant have been developments in the international oil market. In the aftermath of the series of hurricanes and the build-up of oil inventories in the United States, oil prices have moderated somewhat and Brent crude has averaged around US$55 since November. At the time of the previous MPC meeting, the price of Brent crude had fallen to just below US$60 per barrel, having averaged around US$64,50 per barrel in August and US$63 per barrel in September. The current levels are therefore significantly lower than they have been for some time. However given the risks and volatility in the oil markets, including uncertainties related to the Northern Hemisphere winter, this situation could change very rapidly, and will therefore be carefully monitored.

The resultant R0,61 cumulative decline in domestic petrol prices in November and December will be reflected in the CPIX outcomes for these months. Currently there is a significant overrecovery on the petrol price which, if sustained, is likely to result in a further petrol price reduction in January.

To date the overall impact of the international oil price increases on inflation and output has been far more muted than originally expected, both domestically and internationally. World growth is expected to remain relatively vigorous, particularly in the United States and Asia, and according to IMF projections, world inflation is expected to moderate next year to an average rate below 4 per cent.

According to the inflation expectations survey conducted by the Bureau for Economic Research at the University of Stellenbosch, overall CPIX inflation expectations in the fourth quarter of 2005 remained unchanged compared to the third quarter. All categories of respondents still expect inflation to remain within the target range over the next two years. CPIX inflation is expected to average 5,2 per cent in both 2006 and 2007. This represents an unchanged picture for 2006, compared to the previous survey, but the expectations for 2007 are now 0,2 percentage points lower than in the third quarter. The expectations of trade unionists and business people increased marginally for next year, but this was offset by the decline in the expectations of analysts.

Inflation expectations as indicated in the long-term break-even inflation rates, measured as the yield differential between conventional bonds and inflation-linked bonds, point to some improvement in inflation expectations. The break-even inflation rate in the five-to-eight year maturity range decreased from a recent high of 5,1 per cent in mid-October to 4,8 per cent at the end of November.

Exchange rate developments have reinforced the impact of the lower international oil prices on the domestic petrol prices. The rand initially depreciated against the dollar after the previous MPC meeting, but in recent weeks it has appreciated against most currencies. Since the previous meeting the nominal effective exchange rate of the rand has appreciated by almost 7 per cent. This recent rand strength is explained in part by improved international perceptions of South Africa's growth prospects and higher commodity prices. In recent days the platinum price has breached the US$1 000 level, and the gold price has exceeded US$500.

Wage growth has remained moderate with unit labour cost increases in the first half of the year being well within the inflation target range. Revised year-on-year increases in unit labour costs in the formal non-agricultural sector measured 3,8 per cent and 4,5 per cent in the first two quarters of this year respectively, while unit labour cost increases in the manufacturing sector measured 4,4 per cent and 0,2 per cent in these quarters. Surveys by Andrew Levy Employment Publications show that wage settlements for the first 9 months of this year averaged 6,2 per cent, down from 6,7 per cent in the same period of 2004.

Regarding fiscal policy, the October *Medium Term Budget Policy Statement* indicated that the budget deficit for the current fiscal year is now expected to be approximately one per cent of GDP compared to an initial budgeted estimate of 3,1 per cent. Furthermore, the projected deficits for the forthcoming two fiscal years are expected to be around 2 per cent of GDP.

Output and expenditure trends, however, are likely to be a source of upward pressure on inflation. According to the recently revised data, the economy grew at an annualised rate of 5,2 per cent in the first two quarters of 2005 before slowing to 4,2 per cent in the third quarter. Manufacturing capacity utilisation also remained high in the third quarter and the composite leading business cycle indicator has continued its rising trend. Although growth is expected to continue at a robust pace, there are also some indications of a slowdown in manufacturing-sector growth as seen in the significant decline in the Investec/BER Purchasing Managers Index over the past four months, and the 4,9 per cent decrease in real manufacturing production in October.

Expenditure also remains robust with real gross domestic final demand growing at a rate of around 6 per cent in the first three quarters of this year. Real household expenditure has been growing at a similar rate. Motor vehicle sales continued to reach new highs, but the rate of increase has declined. In October, the number of new motor vehicles sold decreased by 1,7 per cent compared to September sales. The strong demand is underpinned by the current level of interest rates and strong asset prices, with the JSE Securities Exchange reaching new record highs in November. Although house prices continue to rise, the rate of increase has declined significantly. These favourable conditions have resulted in household debt as a percentage of disposable income rising to 63,5 per cent in the third quarter of 2005.

Money supply and credit extension growth remain at high rates consistent with expenditure growth, but there may be some signs of moderation. M3 money supply decelerated from a year-on-year rate of 19,0 per cent in August 2005 to 16,8 per cent and 16,4 per cent in September and October, respectively. Growth in total loans and advances, driven mainly by asset-backed credit, declined marginally from 21,9 per cent in August to 20,5 per cent in October. Part of this could be due to increased securitisation. Mortgage advances in particular remained strong, reflecting continued buoyancy in the housing market.

The increasing deficit on the current account of the balance of payments is a potential concern. The latest data show that the current account deficit increased to 4,7 per cent of GDP in the third quarter, up from a revised deficit of 3,7 per cent in the second quarter. These deficits are a reflection of higher domestic expenditure and are not in themselves inflationary. To date the deficits have been more than adequately financed by capital inflows which, in turn, are being attracted by the improved growth prospects in the economy. The overall balance of payments has remained in surplus, and the level of gross gold and foreign exchange reserves increased slightly above the US$20 billion level to date.

Monetary policy stance

Taking the above factors into consideration, the Monetary Policy Committee has decided to leave the repo rate unchanged at 7 per cent per annum. The MPC will, as is usually the case, remain vigilant in order to ensure that CPIX inflation stays within the inflation target range. Should the outlook deteriorate, the MPC will not hesitate to adjust the repo rate in the appropriate direction.