T T Mboweni: Monetary and economic trends in South Africa

Statement of the Monetary Policy Committee by Mr T T Mboweni, Governor of the South African Reserve Bank, at the South African Reserve Bank, Victoria, 13 October 2005.

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Introduction

For the past two years, CPIX inflation has been within the inflation target range of 3-6 per cent. In recent months, however, oil price developments have posed an increasing risk to the continued attainment of the inflation target and since the last meeting of the Monetary Policy Committee, CPIX inflation has risen by 1,3 percentage points. These increases were in line with expectations, and our current forecasts show that we should remain within the target range over the forecast period. More recently there has been some respite in the oil market, and prices have moderated from recent peaks caused by hurricanes Katrina and Rita. However, oil prices remain at high levels and continue to be of concern.

Despite the petrol price increases, the economy continues to perform at a robust pace, domestic demand remains strong, and formal sector employment has increased.

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) reached a low of 3,1 per cent in February and then began to increase, mainly as a result of petrol price movements. After measuring 3,5 per cent in June, CPIX inflation increased to 4,2 per cent and 4,8 per cent in July and August respectively. During these two months, the petrol price increased by a total of R0,56. Excluding petrol and diesel costs, CPIX inflation measured 3,6 per cent in both July and August having averaged 3,4 per cent for the previous 12 months. This indicates that thus far there has been limited pass-through from petrol prices to prices of other goods and services.

Other categories of goods and services that have shown significant price increases are tobacco products, domestic workers' wages, medical costs and education. In contrast, prices of clothing and footwear have continued to fall, while most other categories show very subdued price increases. Despite recent increases in the maize price, food price inflation has remained low, measuring 2,7 per cent in August. Administered prices excluding petrol rose at 5,9 per cent, marginally below the upper limit of the inflation target range. However if the petrol price is included, administered prices increased by 11,2 per cent.

Production price inflation has also displayed a marked upward trend, reflecting to a significant degree the higher energy prices. Having measured 2,4 per cent in May 2005, production price inflation increased steadily, reaching 4,2 per cent in August. Imported goods inflation increased from an annual rate of 1,8 per cent in May to 6,2 per cent in August, while domestically produced goods inflation increased from 2,6 per cent to 3,6 per cent over the same period.

The outlook for inflation

Owing mainly to the adverse oil price developments, the Bank's inflation forecast has deteriorated somewhat since the last MPC meeting. However CPIX inflation is expected to remain within the target range of 3-6 per cent over the forecast period. The upper turning point is expected to occur in the first two quarters of 2006 at a level just below 6 per cent. Thereafter, CPIX inflation is expected to resume a moderate downward trajectory. Although there are no clear signs of second-round effects, the longer the upward trend and volatility of oil prices persist, the more likely the price increases will continue to impact on expectations and feed through to other prices. Monetary policy has to remain vigilant in anticipating such developments.

Since the last meeting of the MPC, the international crude oil prices reached new record levels of almost US$70 per barrel in the wake of the hurricanes in the United States. The price of Brent crude averaged around US$64.50 per barrel in August and US$63 in September, compared to US$58 in July. These developments resulted in further increases in the domestic petrol price of R0,29 and

R0,12 per litre in September and October respectively, and will contribute to further upward pressure on CPIX in those months. More recently crude oil prices have declined to below US$60 per barrel and if this trend continues, we could see a moderate decline in petrol prices in November. However the volatility of international oil prices means that significant upside risk remains.

There are a number of other developments that also pose risks to the inflation outlook. The latest inflation expectations survey conducted by the Bureau for Economic Research at the University of Stellenbosch indicates that there has been a marginal deterioration in inflation expectations which may be a result of the impact of the higher petrol prices. CPIX inflation is now expected to average 5,2 per cent next year, and 5,4 per cent in 2007, up 0,3 per cent and 0,4 per cent respectively. The deterioration in inflation expectations was also reflected in the increase in the breakeven inflation rates, measured by the spreads between the yields on South African CPI inflation-linked bonds and conventional nominal bonds of the same maturity. If the deterioration in inflation expectations were to continue, it would be a cause for concern given the critical role of expectations in the price and wage formation process.

The economy has continued to grow at a robust pace, with quarter-on-quarter annualised real GDP growth accelerating from 3,5 per cent in the first quarter of 2005 to 4,8 per cent in the second quarter. This acceleration was attributed in part to the strong increase in the real value added by the manufacturing sector, which appears to have recovered from the contraction in the first quarter. The utilisation of production capacity in manufacturing, having fallen back in the previous two quarters, picked up again in the second quarter of 2005. The physical volume of manufacturing production continued on an upward trend in the third quarter and the most recent value of the Investec/BER Purchasing Manager's Index (PMI) also indicates that the recovery in this sector has continued, although at a more moderate pace. Most other sectors have also remained buoyant and the composite leading business cycle indicator shows a favourable growth outlook.

This positive growth performance had a positive effect on employment. According to the Quarterly Employment Statistics survey, formal non-agricultural employment increased at an annualised quarter-on-quarter rate of 7,6 per cent in the second quarter of this year. Over the past year this reflects an increase of 84,000 employees.

Domestic demand shows few signs of significant moderation and all components of final demand grew at a healthy rate in the second quarter. New motor vehicle sales reached new record highs in September, although there was a moderate slowdown in the growth of motor vehicle sales which increased by 25,3 per cent over the year. The strong domestic demand has been underpinned by low nominal interest rates, higher real incomes and increases in asset prices. Share prices on the JSE Limited, for example, reached new record highs, and since the previous MPC meeting the all-share price index increased by 4 per cent.

The vigorous demand was financed in part by increased borrowing, and the household debt ratio continued to rise in the second quarter. Household debt as a percentage of disposable income rose from 60 per cent in the first quarter to 62 per cent in the second quarter of 2005. However, because of the low nominal interest rate environment, debt servicing cost as a percentage of disposable income remained unchanged at a relatively low level of 6½ per cent.

The monetary and credit aggregates have also been increasing at rates consistent with strong domestic demand. Year-on-year growth in M3 picked up from 17,1 per cent in June 2005 to 19,9 per cent in July and 19,0 per cent in August. Total domestic credit extension grew by 18,0 per cent in July and 18,3 per cent in August. Twelve-month growth in bank loans and advances to the private sector remained above 20 per cent, with increases in mortgage advances reaching 26 per cent in August. The latter reflects continued buoyancy in the housing market, although the rate of increase in house prices has fallen steadily since September 2004.

Strong domestic demand and high international crude oil prices have impacted on the current account of the balance of payments. Although the deficit on the current account of the balance of payments as a percentage of GDP contracted to 3,4 per cent in the second quarter of 2005, data for July and August indicate a possible widening of the trade deficit in the third quarter. The current account however remains financed by capital inflows, and the international liquidity position of the Bank increased to a level of US$16,1 billion at the end of September.

World inflation is expected to be negatively affected by higher oil prices. The IMF now predicts that world inflation in 2006 will average 3,7 per cent, compared to the April forecast of 3,1 per cent for the same period. Nevertheless this is lower than the revised 3,9 per cent average expected for 2005 and indicates that world inflation appears to be well contained. World growth is expected to be sustained at a robust rate of 4,3 per cent in 2006 although it has moderated somewhat since last year.

Not all developments have been negative from an inflation perspective. Although inflation expectations have deteriorated moderately, there is no evidence that this has impacted on wage settlements. Unit labour costs in the first half of this year increased at rates within the inflation target range, measuring 4,6 per cent and 5,3 per cent in the first two quarters of this year.

The nominal effective exchange rate of the rand depreciated by 0,3 per cent since the last meeting of the MPC, but it has been relatively stable over the period. The volatility that did occur was to a large extent a reflection of movements between the euro and the US dollar. Positive international perceptions of South Africa were further confirmed with the recent sovereign credit rating upgrade by the Fitch rating agency.

Monetary policy stance

The deterioration in the inflation outlook cannot be ignored. The increased risk of possible pass-through leading to pronounced second-round effects on CPIX inflation must inform policy going forward. Although there is no conclusive evidence of pass-through at present, and the Monetary Policy Committee has not judged it necessary to change the monetary policy stance at this meeting, these developments will be closely monitored. The Committee stands ready to take the appropriate action in order to ensure that the inflation target mandate continues to be achieved. At this meeting the MPC has decided therefore that the repurchase rate will remain unchanged at 7 per cent per annum.