# X P Guma: Low domestic inflation in an environment of high oil prices, vigorous household spending and credit demand and a widening current account deficit; and the outlook for interest rates in South Africa

Luncheon address by Dr X P Guma, Deputy Governor of the South African Reserve Bank, at Investec, Pretoria, 4 July 2006.

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Inflation in the world economy has declined significantly in recent years and has remained relatively subdued over the past few years despite a significant rise in commodity prices and strong economic growth. Chart 1, based on World Bank data illustrates the trend in world inflation, clearly showing the peak that occurred at a rate in excess of 35 percent per annum in the early 1990s and the rapid deceleration to rates around 5 per cent per annum thereafter.

South Africa's inflation performance began to improve during the 1990s, as the next chart indicates; and subsequent to the adoption of the inflation targeting framework, inflation as measured by CPIX entered and has remained within the target range since September 2003.

Oil prices have risen sharply since 2003 (as the next chart indicates), on account of various determinants. During this year, the spot price of Brent crude oil has increased dramatically from approximately US$59.9 per barrel in February to levels around US$70.5 per barrel towards the end of April and an average of US$68.15 per barrel in June.

Continued brisk expansion in final consumption expenditure by households has been underpinned by a steady increase in household disposable income, continued buoyancy in the real estate and securities markets and what some describe as an accommodative interest rate environment. Overall household debt as a percentage of annualised disposable income increased to a record level of 68 percent in the first quarter of 2006.

Robust growth in gross domestic expenditure and a concomitant strong increase in the value of merchandise imports resulted in a sizeable deficit on the trade account of the balance of payments in the first quarter of 2006. Given the larger shortfall on the services and income account with the rest of the world and the somewhat subdued performance of South Africa's exports – notwithstanding the buoyancy of international commodity prices, the current account of the balance of payments registered a deficit equivalent to 6.4 percent in the first quarter of 2006.

Interestingly, as others have observed, despite the sell-off in emerging markets since May, non-residents have remained net buyers of South African financial assets and there have been significant investment flows into South Africa over the past year. Non-resident investors bought a net R13 billion worth of South African equities during May 2006 and R460 million the first half of June 2006. Despite generally negative sentiment towards emerging market-market assets, they continued to buy R768 million worth of bonds in May and R4.5 billion in June.

About this there can be little argument, for all that I have done is to summarise the facts. It is also not in dispute that the repo rate, the rate at which the South African Reserve Bank will lend to the banks, was increased recently, primarily on account of deteriorating risks to the outlook for inflation.

What we can debate, and what I look forward to hearing your views about, is the nature of the conflict regarding the outlook for interest rates in South Africa. The South African Reserve Bank Monetary Policy Review (May 2006) states it as follows: "On the one hand the inflation outlook, as reflected in the recent inflation forecasts of the Bank, has improved significantly… "on the other hand, there a number of developments that have led the MPC to remain vigilant". This was before the last meeting of the MPC. Does a dilemma remain and how would you characterise it?

Let me have your views.