T T Mboweni: Risks to the inflation outlook – looking ahead to the August Monetary Policy Committee meeting

Address by Mr T T Mboweni, Governor of the South African Reserve Bank, to the Oxford & Cambridge Business Alumni of South Africa (OCBASA), Johannesburg, 2 August 2007.

*   *   *

Honoured guests
Ladies and Gentlemen:

1. Introduction

I would like to thank you for the opportunity to address such an illustrious gathering. I was not fortunate enough to attend either the University of Cambridge or the University of Oxford but should state that I followed the rowing competition held annually between the two universities with keen interest. I have always wondered how my Alma Mater – the University of East Anglia – would perform in this competition. I am sure the students at the University of East Anglia would relish such a challenge.

Members of the Oxford and Cambridge Business Alumni of South Africa play an important role in the economic and social life of the country. Members of the organisation include Chief Executive Officers of banks, investment bankers, investment analysts, professors, bishops and headmasters, to name a few.

My role this evening is to talk about the more mundane issues of monetary policy. I will share with you some of the issues that are of concern to the Bank. These concerns are not new and they have been raised in recent MPC statements, but I thought I would elaborate on some of them in more detail.

2. The inflation target: where do we stand?

Before highlighting these issues, let me first remind you where we stand with respect to our monetary policy objective. Our mandate is to keep CPIX inflation within the inflation target range of 3-6 per cent on a continuous basis. This we successfully achieved for 43 consecutive months between September 2003 and March 2007. In April 2007 CPIX inflation breached the upper end of the target at 6,3 per cent, and remained outside the target at 6,4 per cent in May and June. The major drivers of these developments were higher food and petrol prices. In these months, had food and energy prices been excluded, CPIX inflation would have averaged around 4,6 per cent. Nevertheless there is evidence that underlying inflation is becoming more generalised as evidenced by the fact that this narrower measure of inflation has been trending upwards in recent months from a low of 2,5 per cent in June last year. In response to these adverse inflation pressures, monetary policy has been tightened and we have increased the repo rate by a total of 250 basis points since June 2006.

It is of concern to the Bank that inflation has breached the target range. However I should emphasise that this should not be seen as a failure of monetary policy. As I noted, the main drivers of the recent surge in inflation were petrol and food price inflation. It is important to emphasise however that monetary policy reacts with a lag, and that it takes approximately 18 months to 2 years for the effects of an interest rate change to be reflected fully in inflation. This implies that there is little monetary policy can do about current inflation, which is an historical number, particularly if it has been caused by unanticipated external shocks. In setting the monetary policy stance we therefore have to focus on the medium to long term.

This does not mean that we can be complacent about near-term developments, as inflation expectations and monetary policy credibility are determined in part by these short term considerations. The challenge for monetary policy is to ensure that inflation is brought back to within the target range, and also to convince the markets that we will are serious about this. In this way we will ensure that inflation expectations remain anchored within the target range.

I should note that we are not alone in missing our targets. During the past year or so, a number of central banks have temporarily exceeded their targets, the most recent notable example being the Bank of England. Pressures emanating from oil and food prices are a global phenomenon and are posing a challenge to many central banks.

3. Dealing with inflation shocks: International oil prices

Rising international oil prices and food prices have been on the top of our list of risk factors for some time. I am often asked what monetary policy can do about oil or food prices? If we tighten monetary policy in the face of higher international oil prices, this will not cause OPEC to raise output or market prices to decline. Similarly with food prices – raising interest rates will not make it rain. Yet these are two variables that are high on our list of concerns.

Let us first consider oil prices. At the beginning of 2004, the price of North Sea Brent crude oil was around US$30 per barrel. It is now almost US$80 per barrel. In the first 5 months of this year the domestic petrol price increased by R1,34 per litre, although it has since declined by R0,23. Most of this increase has been due to higher international product prices rather than exchange rate effects. International oil prices are affected by a variety of factors ranging from higher demand in a fast-growing world economy, particularly from China; and risks to supply emanating from OPEC cutbacks, supply disruptions in a number of oil-producing countries, geopolitical tensions and adverse weather conditions. These factors have contributed to the upside risk to the oil price.

How should monetary policy react to this? The impact of a change in the international oil price is direct and relatively quick, given that domestic petrol prices are adjusted each month in terms of the formula of the Department of Minerals and Energy. Petrol has a weight of about 5 per cent in CPIX, so a 10 per cent increase in the petrol price would increase CPIX inflation by approximately 0,5 percentage points. This is the impact effect or what we call the first-round effect, and clearly there is nothing we can do about this.

Our concern is with the broader impact of this effect, that is, the so-called second-round effects. We have to assess whether or not these increases will be passed on over time in the form of higher transport costs which will increase prices of other commodities, for example food, or through higher production costs. We also have to assess whether there will be an impact on wage and price setting, which will impact broadly on inflation. Over the past two years these second-round effects have been relatively moderate. This could be due to a number of reasons, including increasingly anchored inflation expectations as a result of enhanced monetary policy credibility; increased competitiveness in the economy; and the fact that some of these increases were in fact reversed late last year. The longer the international oil prices are subject to upward pressure, the more likely these second-round effects will feed through to generalised inflation.

The challenge for the MPC therefore is predicting not only the future course of volatile international oil prices, but also assessing how these increases will feed through to further inflation pressures over time. In deciding on the appropriate monetary policy response, it is not always easy to differentiate between first and second round effects. Some analysts have argued that we should exclude food and oil from the price index that we target. We do not believe that targeting such an index would be credible. The Economist magazine has appropriately referred to such an index as “the cold-and-hungry index”.

4. Food prices

Food prices have also become a cause for concern. Food prices have a weight of almost 26 per cent in the CPIX basket, although this proportion is much higher at around 51 per cent in the consumption basket of the lowest category of income earners.

As is the case with oil prices, there is an international dimension to the increase in food prices. Higher food inflation is an international phenomenon. This is partly weather induced, but perhaps more significantly, the increased diversion of maize and sugar to biofuels production has resulted in significant price increases in the international markets. Domestic maize and wheat prices are directly affected by these higher international prices and combined with domestic drought in some areas of the country, have caused the spot price of maize in South Africa to increase almost four-fold over the past two years.

Higher maize prices have not only increased the cost of maize products but have also affected meat prices, which last year were increasing at rates of almost 20 per cent. Meat has a weight of around 7 per cent in the CPIX basket, and in 2006 was the single biggest contributor to overall CPIX inflation. Food prices are currently increasing at rates in excess of 9 per cent per annum, and we are still feeling the effects of the maize price increases. One small consolation is that meat price increases have moderated from their peaks last year as more cattle are brought to the market during periods of drought. This trend may not persist as farmers are likely to restock at some stage.

5. Household consumption expenditure

Much has been said about the strong growth in household consumption expenditure and the associated increase in domestic credit extension. Household domestic expenditure has been increasing at a year-on-year rate of between 7 and 8 per cent for the past three years, compared to rates of growth of around 3 per cent in the preceding three years. At the same time, credit extension to the private sector has been growing at rates of around 26 per cent despite the tighter monetary policy stance. These are uncomfortably high levels and I have expressed my concern in this regard on various occasions.

Excessively high rates of expenditure growth will ultimately impact on domestic inflation, although the timing and extent of these effects are at times uncertain. These developments will remain an important focus of our monetary policy deliberations.

My concern, however, extends beyond simple monetary policy considerations. As a result of the high levels of credit extension, household indebtedness has increased to record levels, currently at around 76 per cent of disposable income. Although the debt service ratio reached a low of 6 per cent of disposable income in 2004 and 2005, this has now risen to 9 per cent.

Although part of this increased indebtedness is justified on the basis of improved household balance sheets, my concern relates to the socio-economic impact of excessive debt accumulation. As more and more people find employment or better paid employment, the temptation is to rush out and buy a bigger car and a bigger house. Very soon, we see people becoming overextended and repossessions become commonplace. Part of this development is due to excessive exuberance on the part of consumers. There is not a culture of saving in South Africa, as demonstrated by our very low savings rate, and people are happy to borrow excessively against future income in order to finance current consumption.

The problem has also been compounded on the supply side with banks and others, including retailers, falling over themselves to extend credit, resulting in a number of questionable lending practices. Perhaps the situation is not as bad as in other countries such as Australia, where it was reported a few months back that a woman successfully applied for a credit card for her cat. But some of the stories we have heard locally are not much better.

Fortunately some sanity appears to be returning to the market with the recent adoption by the banks of a voluntary code of good conduct with respect to the marketing of credit. At the same time, further constraints on lending have become evident with the introduction of the National Credit Act in June, when stricter requirements were imposed on lenders to determine the creditworthiness of borrowers. Although this may have a dampening affect on certain categories of credit extension and introduce more careful risk assessment, we do not believe that this will replace the need for monetary policy restraint.

6. Economic growth and inflation

Excessively high economic growth brings with it potential inflationary pressures to which monetary policy has to be sensitive. In each of the past three years, the economy has been growing at a rate of 5 per cent, which is high compared to our experience of the past 25 years or so. Capacity utilisation in the manufacturing sector has also reached record high levels. While we in the Bank are pleased by this strong growth performance, we have to ensure that this growth does not affect inflation adversely.

In economic terminology this refers to the concept of potential output, which at a simplified level is the rate at which the economy can grow without generating inflationary pressures. From a monetary policy perspective we have to consider whether our current growth experience is inflationary. In other words, are we growing in excess of our potential output?

Unfortunately, estimating potential output is not a simple task and the estimates are subject to a high degree of uncertainty. Current research in the Bank estimates that the potential output of the economy is now at least around 4,5 per cent per annum. This can be compared to estimates of around 3 per cent or less during the 1990s. If this estimate is correct, it implies we are currently growing at a rate above potential. This is not necessarily a threat to inflation if this growth entails the necessary microeconomic reforms which will allow for a higher potential growth rate. However if the growth rate does not improve the productive capacity of the economy, there could be inflationary consequences. These considerations are not easily observable, which makes our job that much more difficult.

7. Wage settlements

In recent weeks, following the publicity emanating from the public servants strike, much attention has been focused on the risk to inflation from higher wage settlements. From an inflation perspective, higher real wage settlements may increase domestic demand pressures. There also may be a cost-push effect as producers pass on the higher wage costs in terms of higher prices. The latest consolidated data for the economy as a whole are not yet available but there does appear to be a worrying trend towards higher nominal wage settlements. However we should also bear in mind that at this stage real wage settlements do not appear to be significantly higher than in the recent past. In other words, higher nominal wage settlements are simply compensating workers for the higher trend in inflation. It is therefore important that we reverse this inflation trend.

Furthermore, we also need to focus on the increases in unit labour costs, that is, the nominal wage increases adjusted for increases in labour productivity. The latest data indicate that in the first quarter of this year unit labour costs in the non-agricultural sector increased by 2,2 per cent compared to the first quarter of last year of 2006. So although wage growth poses an increasing threat to the inflation outlook, it does not appear to be out of control.

8. Administered prices

When we initially adopted the inflation targeting framework, one of the constant laments we had at that time was the challenge posed to us by the range of administered or regulated prices in the economy which remained stubbornly high. Administered price setting by the regulators eventually became more market-related, and from around 2003 till recently this category did not feature among the list of our concerns. Unfortunately this situation is changing. The administered price index (excluding petrol) has been increasing steadily in recent months. The API excluding petrol increased at a year-on-year rate of 5,6 per cent in June this year, compared to 4,3 per cent a year ago. Top of our list of concerns are the proposed electricity price increases requested by Eskom. These increases are of the order of 18 per cent for the next two years.

While we fully appreciate the need to expand electricity generating capacity in the country as a matter of urgency, it is essential that alternative financing options be carefully considered as these will have significant implications for inflation and monetary policy. A similar argument can be made for other areas where infrastructure expansion will take place. It is accepted that increases in tariffs or indeed excise or fuel taxes should not be regarded as "true" inflation. However if they are a regular annual feature of the economic landscape they become an integral part of the inflation process which we have to take account of. We are mandated to achieve a particular inflation outcome, but to achieve this, government and other regulators need to take account of this in their price setting.

9. Conclusion

I have attempted to outline some of the major concerns currently facing the MPC. This does not mean that other issues are not concerning us, or that we see no positive developments. I should also emphasise that we do not have a target for any particular variable – our focus is on the overall inflation outcome, which is the outcome of the interaction of a number of variables. In other words, we cannot say what the appropriate growth of household consumption spending should be, as it would need to be seen in the context of the behaviour of the other factors that determine the inflation rate.

Monetary policy-making is not a simple matter of adjusting an interest rate lever in an automatic way. Because monetary policy has to be forward-looking, and because the future is inherently uncertain, we have to make decisions on the basis of our best estimates of the most likely outcomes. Despite these difficulties, we will continue to strive to achieve our mandate and bring inflation back to within the inflation target range. This will be the true test of the success of monetary policy.

Thank you.