Presentation made by the South African Reserve Bank to the Portfolio and Select Committees on Finance

27 March 2007

South African Reserve Bank

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Recent international economic developments

Global economic growth remained robust in 2006, but moderated during the second half of the year. The global economic outlook, however, remains favourable ...

World Economic Outlook: Real gross domestic product

Annual percentage change in real GDP

	Actual	Projections	
	2005	2006	2007
World	**4,9**	**5,1**	**4,9**
Advanced economies	2,6	3,1	2,7
United States**	3,2	3,3	2,9
Japan**	1,9	2,2	2,1
Euro area**	1,4	2,6	2,0
United Kingdom**	1,9	2,7	2,7
Newly industrialised Asian economies*	4,5	4,9	4,4
Emerging-market and developing countries	7,4	7,3	7,2
Africa	5,4	5,4	5,9
South Africa**	5,1	5,0	4,0
Central and eastern Europe	5,4	5,3	5,0
Developing Asia	9,0	8,7	8,6
China**	10,4	10,7	10,0
India**	9,0	9,2	7,3
Western hemisphere	4,3	4,8	4,2

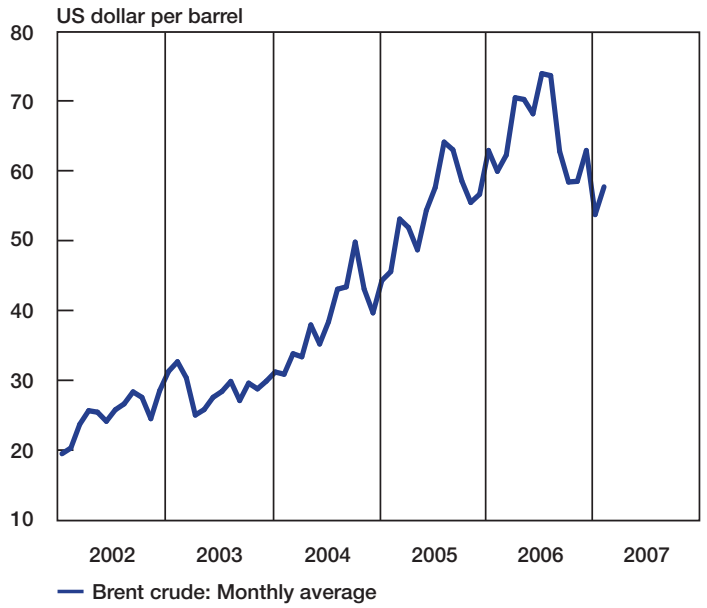
* Include Hong Kong SAR, Korea, Singapore and Taiwan Province of China
** Actual outcome for 2006
Source: IMF *World Economic Outlook*, September 2006

According to the latest IMF *World Economic Outlook*, global growth is expected to moderate slightly from 5,1 per cent in 2006 to 4,9 per cent in 2007, as the pace of economic expansion in advanced economies is expected to slow from 3,1 per cent in 2006 to 2,7 per cent in 2007.

By contrast, emerging-market and developing economies are expected to continue expanding at a faster pace than advanced economies, as robust growth in China and elsewhere continues. The IMF's view that growth in South Africa would decelerate in 2007 was informed by the view that output would be approaching potential.

... notwithstanding the high and volatile price of crude oil.

International oil price



Source: IMF *International Financial Statistics* and SA Reserve Bank

The monthly average spot price of Brent crude oil increased from US$53,72 per barrel in January 2007 to US$57,68 per barrel in February. The increase was driven by cold winter weather in the US, fund buying, rising geopolitical tensions in Iran, operational problems at US refineries and large drawdowns in US heating oil and gasoline inventories. In addition, production cutbacks from OPEC, plans to boost the US emergency crude reserves and geopolitical tensions in Nigeria and Iraq have lent support to prices. The daily spot price of Brent crude oil increased to levels above US$61 per barrel at the beginning of March, but exhibited some volatility up to the middle of the month, with the price of Brent crude oil fluctuating between US$59,90 and US$61,65 per barrel.

The generally tighter monetary policy bias …

Key central bank interest rates

Per cent

Countries	1 January 2006	19 March 2007	Latest change (Percentage points)
United States	4,25	5,25	29 Jun 2006 (+0,25)
Japan	0,00	0,50	21 Feb 2007 (+0,25)
Euro area	2,25	3,75	14 Mar 2007 (+0,25)
United Kingdom	4,50	5,25	11 Jan 2007 (+0,25)
Canada	3,25	4,25	24 May 2006 (+0,25)
Denmark	2,25	3,75	9 Mar 2007 (+0,25)
Sweden	1,50	3,25	21 Feb 2007 (+0,25)
Switzerland	0,50 – 1,50	1,75 – 2,75	15 Mar 2007 (+0,25)
Australia	5,50	6,25	8 Nov 2006 (+0,25)
New Zealand	7,25	7,50	8 Mar 2007 (+0,25)
Israel	4,50	4,00	1 Mar 2007 (-0,25)
China	5,58	6,39	18 Mar 2007 (+0,27)
Hong Kong	5,75	6,75	30 Jun 2006 (+0,25)
India	5,25	6,00	25 Jul 2006 (+0,25)
Malaysia	3,00	3,50	26 Apr 2006 (+0,25)
South Korea	3,75	4,50	10 Aug 2006 (+0,25)
Taiwan	2,25	2,75	29 Dec 2006 (+0,125)
Thailand	4,00	4,50	28 Feb 2007 (-0,25)
Brazil	18,00	12,75	8 Mar 2007 (-0,25)
Chile	4,50	5,00	11 Jan 2007 (-0,25)
Mexico	8,25	7,00	21 Apr 2006 (-0,25)
Czech Republic	2,00	2,50	29 Sep 2006 (+0,25)
Hungary	6,00	8,00	25 Oct 2006 (+0,25)
Poland	4,50	4,00	28 Feb 2006 (-0,25)
Russia	12,00	10,50	29 Jan 2007 (-0,50)
South Africa	**7,00**	**9,00**	**8 Dec 2006 (+0,50)**

Source: National central banks

In recent months several central banks across the world have steadily increased official interest rates in response to rising inflationary pressures. Since October 2006, monetary policy has been tightened in Australia, China, Denmark, the euro area, Hungary, Japan, New Zealand, Sweden, Switzerland, Taiwan and the United Kingdom. By contrast, Brazil, Chile, Israel, Russia and Thailand lowered policy rates.

… has helped to contain inflation expectations.

World Economic Outlook: Consumer prices

Annual percentage change in consumer prices

	Actual	Projections	
	2005	**2006**	**2007**
World	**3,7**	**3,8**	**3,7**
Advanced economies	2,3	2,6	2,3
United States**	3,4	3,2	2,9
Japan**	0,3	0,3	0,7
Euro area**	2,2	2,2	2,4
United Kingdom**	2,0	2,3	2,4
Newly industrialised Asian economies*	2,2	2,2	2,2
Emerging-market and developing countries	5,3	5,2	5,0
Africa	8,5	9,9	10,6
South Africa**	3,4	4,7	5,7
Central and eastern Europe	4,8	5,3	4,6
Developing Asia	3,5	3,8	3,6
China**	1,8	1,5	2,2
India**	4,2	6,3	5,3
Western hemisphere	6,3	5,6	5,2

* Include Hong Kong SAR, Korea, Singapore and Taiwan Province of China

** Actual outcome for 2006

Source: IMF *World Economic Outlook*, September 2006

Lower crude oil prices in the second half of 2006 resulted in a moderation in global headline inflation, while core inflation generally stabilised.

The latest IMF *World Economic Outlook* indicates that global headline inflation is projected to moderate slightly from 3,8 per cent in 2006 to 3,7 per cent in 2007.

Closer to home, the SADC countries' inflationary trends remain mixed.

SADC: Inflation

Annual percentage change in consumer prices

	2004	2005	Dec 2006	Jan 2007	Feb 2007
Africa	8,0	8,5	*	*	*
Angola	43,6	23,0	12,2	*	*
Botswana	6,9	8,6	8,5	7,4	*
Lesotho	4,4	4,0	6,4	*	*
Madagascar	14,0	18,4	10,8	10,8	*
Malawi	11,4	15,5	10,1	*	*
Mauritius	3,9	5,6	11,9	8,8	9,2
Mozambique	6,4	10,1	9,4	8,2	5,4
Namibia	4,1	2,4	6,1	6,0	6,0
South Africa	**1,4**	**3,4**	**5,8**	**6,0**	*
Swaziland	3,4	4,8	*	*	*
Tanzania	4,1	4,4	6,7	7,0	7,3
Zambia	18,0	18,3	8,2	9,8	12,6
Zimbabwe	350,0	237,8	1 281,1	1 593,6	1 729,9

* Not available

Source: National central banks and IMF *World Economic Outlook*, September 2006

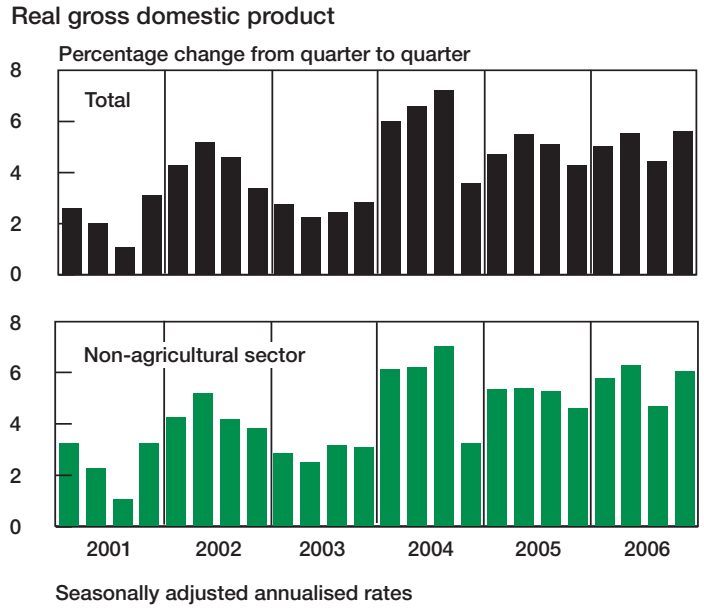
In January 2007, the twelve-month rate of change in consumer prices in the Southern African Development Community (SADC) countries ranged from 6,0 per cent in South Africa and Namibia to 9,8 per cent in Zambia, with Zimbabwe as an outlier at 1 593,6 per cent.

In January 2007 annual consumer price inflation accelerated in South Africa, Tanzania, Zambia and Zimbabwe, while it decelerated in Botswana, Mauritius, Mozambique and Namibia.

Available data for February 2007 indicate that annual consumer price inflation accelerated further in Mauritius, Tanzania, Zambia and Zimbabwe, while it decelerated further in Mozambique.

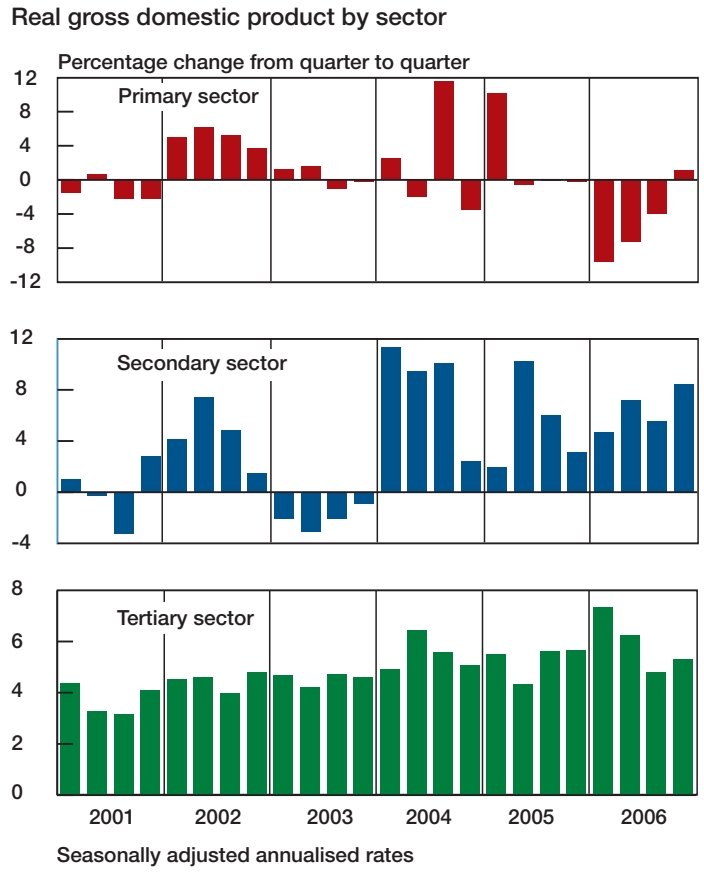
Recent domestic economic developments

The South African economy expanded rapidly in the fourth quarter of 2006 ...



Growth in South Africa's real gross domestic product increased from an annualised rate of 4½ per cent in the third quarter of 2006 to 5½ per cent in the fourth quarter. The acceleration in the aggregate economic growth in the fourth quarter of 2006 resulted from stronger growth in the real value added by all the main sectors of the economy. Subsequent to six consecutive quarters of negative growth, real value added in the primary sector also increased in the final quarter of 2006.

... as the primary, secondary and tertiary sectors of the economy all recorded stronger growth momentum.

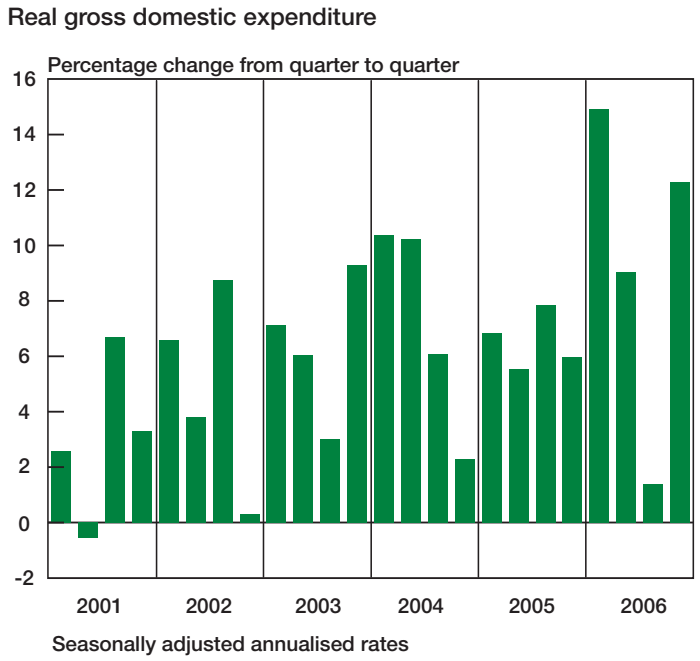


The real value added by the primary sector rebounded from a decline of 4 per cent in the third quarter to an increase at an annualised rate of 1 per cent in the fourth quarter of 2006. This was the result of an increase in the real value added by the mining sector which more than offset the decline registered in agricultural output in the fourth quarter of 2006.

Following growth at an annualised rate of 5½ per cent in the third quarter of 2006, the real value added by the secondary sector increased further at a rate of 8½ per cent in the fourth quarter. This acceleration was especially due to the improved fortunes of the manufacturing sector.

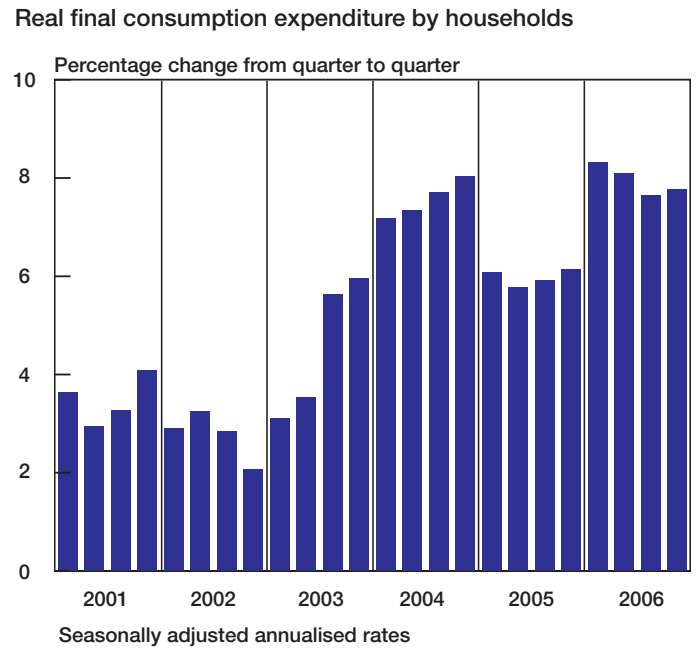
Growth in real value added by the tertiary sector rose from 4¾ per cent in the third quarter of 2006 to 5¼ per cent in the fourth quarter. The higher growth was a reflection of marginally higher growth rates posted by all the subsectors of the tertiary sector with the exception of the trade sector over this period.

Gross domestic expenditure accelerated further ...



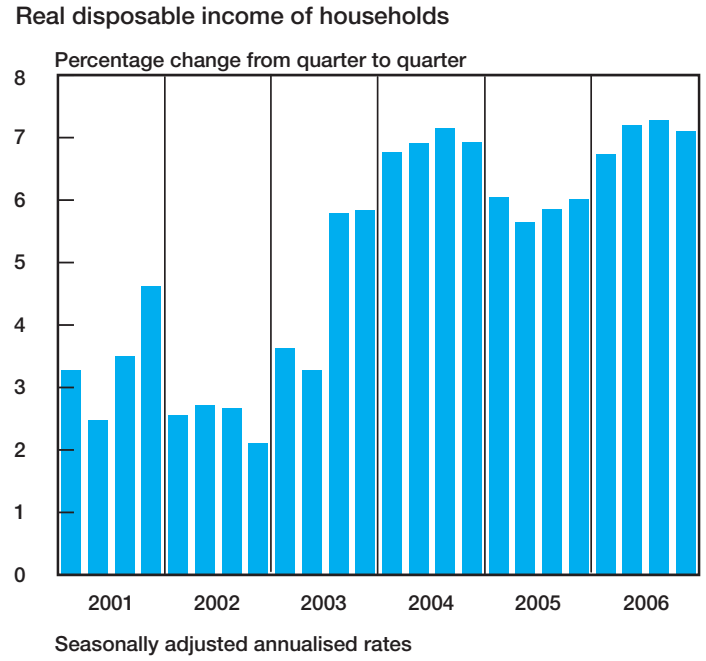
Growth in aggregate real gross domestic expenditure accelerated from an annualised rate of 1½ per cent in the third quarter of 2006 to 12¼ per cent in the fourth quarter. All the expenditure components contributed to this acceleration. However, it was especially due to a turnaround in real final consumption expenditure by general government and strong inventory accumulation during the fourth quarter.

... as real final consumption expenditure by households increased ...



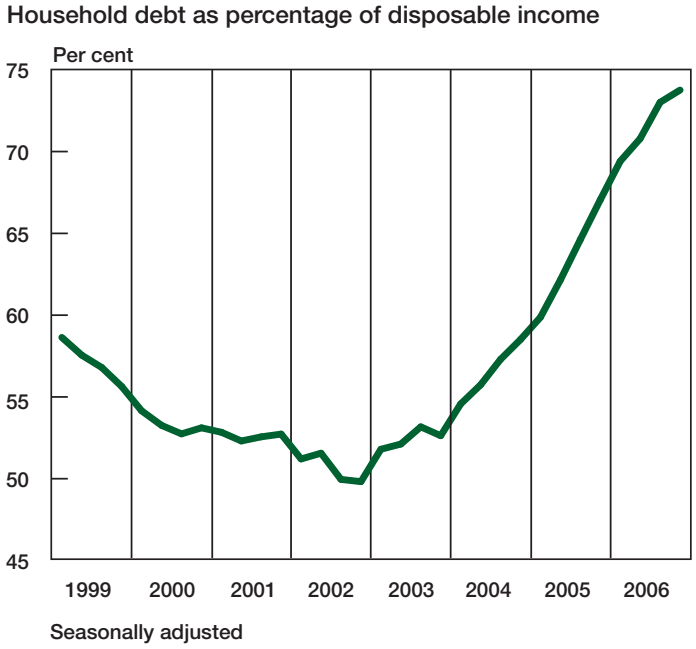
Real final consumption expenditure by households increased at an annualised rate of 7¾ per cent in the fourth quarter of 2006 compared with a rate of 7½ per cent in the third quarter. The sustained robust expansion in household spending was broad based and proceeded at a roughly similar pace in all the spending categories.

… alongside sustained growth in real disposable income of households.



Growth in real disposable income of households continued in the fourth quarter of 2006, albeit at a slightly slower rate than in the third quarter. The moderation in growth could partly be ascribed to lower farm income recorded over this period.

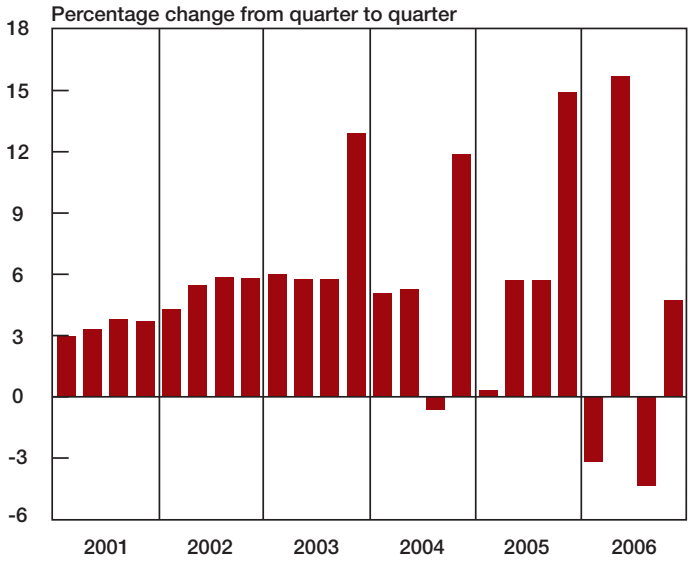
However, household debt as a percentage of households' disposable income continued to rise ...



Household debt as a percentage of household disposable income increased from 73 per cent in the third quarter of 2006 to 73¾ per cent in the fourth quarter. Apart from some consumption expenditure being financed on credit, the acquisition and construction of housing also bolstered the level of household debt.

... while real final consumption expenditure by general government recovered in the fourth quarter ...

Real final consumption expenditure by general government

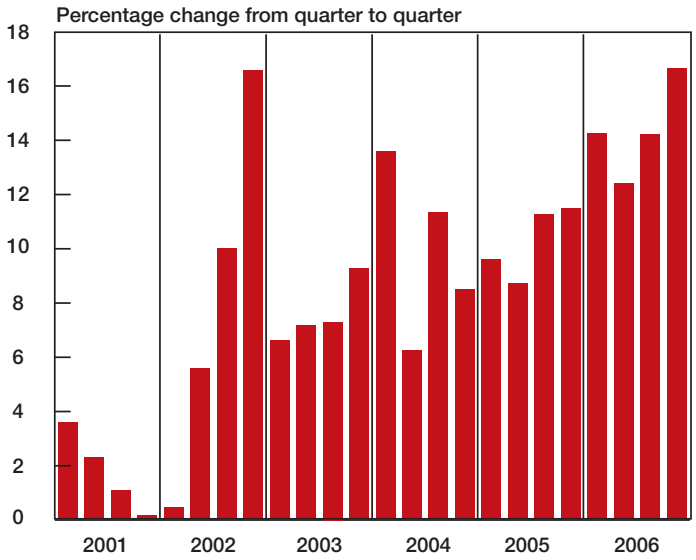


Seasonally adjusted annualised rates

Real final consumption expenditure by general government increased at a rate of 4¾ per cent in the fourth quarter of 2006, recovering from a broadly similar rate of decline in the third quarter. The strong increase reflected expenditure on goods and non-wage services. Growth in real expenditure on compensation of employees remained stable from the third to the fourth quarter of 2006.

… and growth in real gross fixed capital formation accelerated strongly.

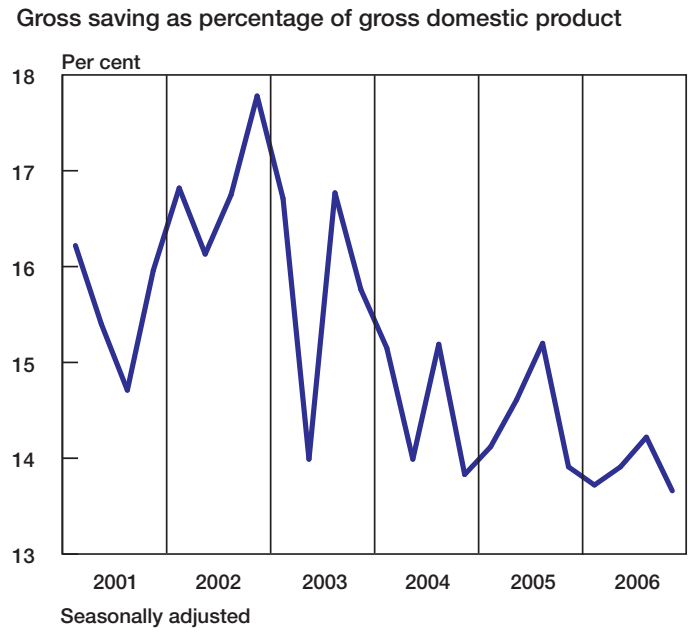
Real gross fixed capital formation



Seasonally adjusted annualised rates

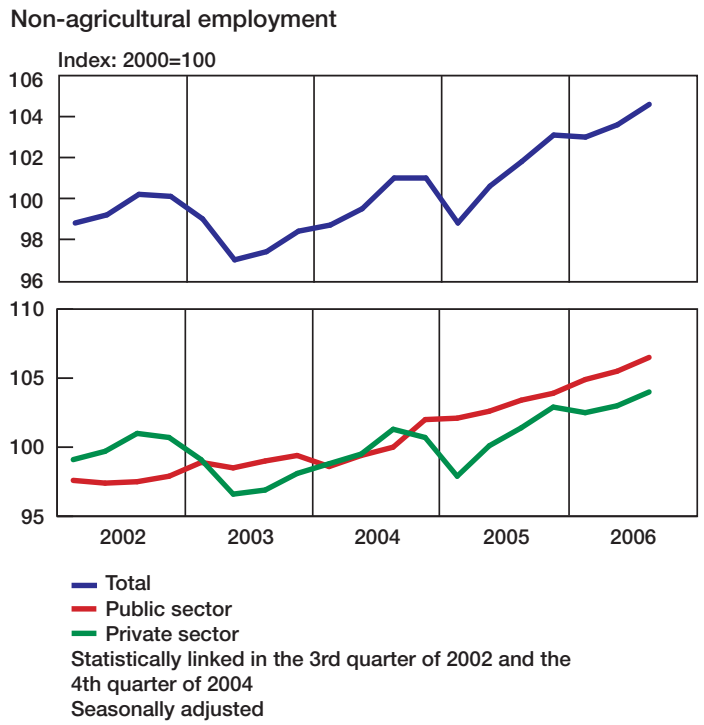
Growth in real gross fixed capital formation accelerated from 14¼ per cent in the third quarter of 2006 to 16½ per cent in the fourth quarter. The increase in the fourth quarter could be attributed to the continued growth in real capital outlays across all institutional sectors – private business enterprises, public corporations and the general government. This lifted the ratio of gross fixed capital formation to gross domestic product from 18½ per cent in the third quarter of 2006 to 19¼ per cent in the fourth quarter.

However, national saving deteriorated.



The ratio of gross saving to gross domestic product declined from 14¼ per cent in the third quarter of 2006 to 13¾ per cent in the fourth quarter. The deterioration in gross saving was mainly due to marginally weaker savings by the corporate sector and general government. Consequently, the annual saving ratio fell back to a historical low of 14 per cent in 2006.

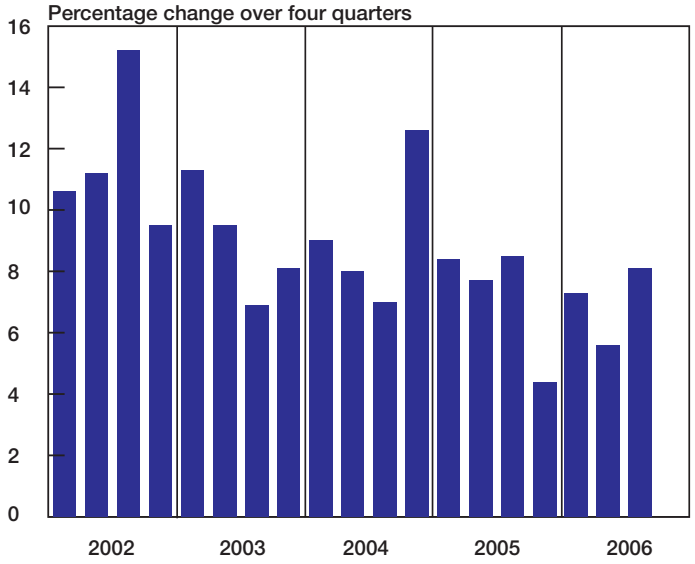
The robust domestic economic growth supported a continued increase in employment in both the private and public sectors in the third quarter of 2006.



According to Statistics South Africa's *Quarterly Employment Statistics* (QES), employment growth regained momentum during the second and third quarters of 2006, following a slight decrease in employment during the first quarter. In the third quarter employment growth took place at an annualised rate of 3,9 per cent in both the public and private sector. Measured over a period of four quarters, employment increased by 2,7 per cent in the third quarter of 2006, or by around 200 000 employees. Private-sector employment increased by 2,6 per cent over this four-quarter period while public-sector employment increased by 3,0 per cent.

Nominal wages per worker accelerated in a number of sectors of the economy, with some sectors reaching double-digit rates of increase.

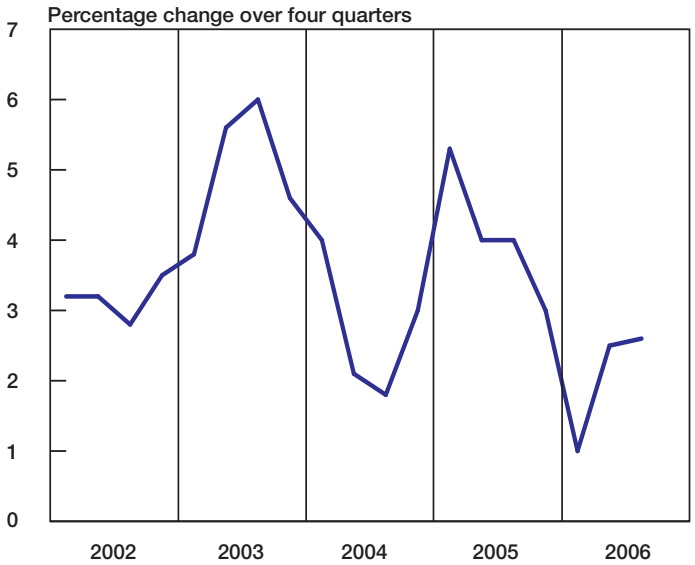
Non-agricultural nominal remuneration per worker



The year-on-year rate of increase in the average nominal renumeration per worker picked up markedly from 4,4 per cent in the fourth quarter of 2005 to 7,3 per cent in the first quarter of 2006 and 8,1 per cent in the third quarter of 2006. The nominal rate of wage growth per worker in the manufacturing, construction, non-gold mining and trade, catering and accommodation services sectors was below the upper limit of the inflation target range. The year-on-year rate of increase in nominal renumeration per worker in the public sector accelerated from 2,9 per cent in the second quarter of 2006 to 8,2 per cent in the third quarter. The highest remuneration increases were recorded at the national government level with a rate of 12,5 per cent.

Economy-wide labour productivity growth accelerated.

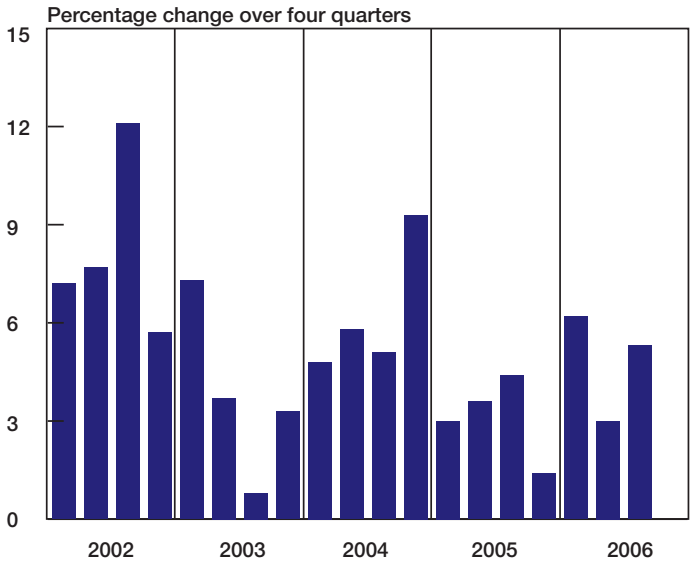
Non-agricultural labour productivity



Following solid output growth in the economy which outpaced increases in the overall level of employment, economy-wide labour productivity growth accelerated from a year-on-year rate of 1,0 per cent in the first quarter of 2006 to 2,6 per cent in the third quarter. However, labour productivity in the manufacturing sector slowed from an average annual rate of 5,0 per cent in 2005 to year-on-year rates of around 3 per cent in the first three quarters of 2006.

An acceleration in remuneration growth in excess of that in productivity led to a significant increase in nominal unit labour cost.

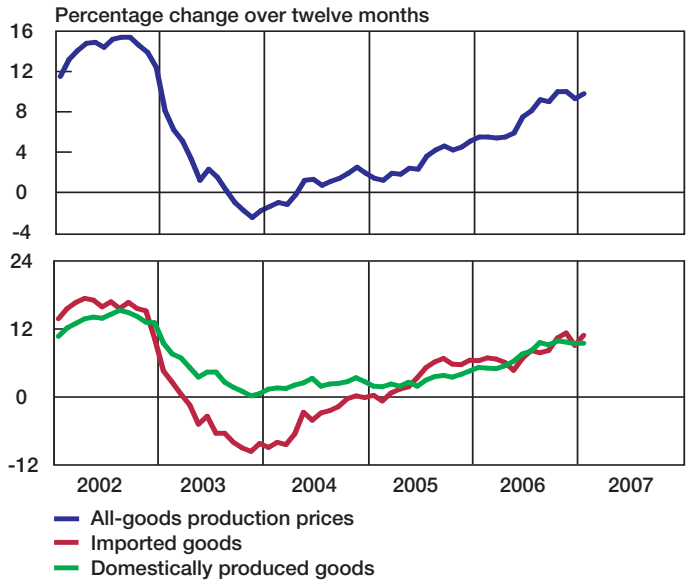
Non-agricultural nominal unit labour cost



Given the acceleration in the rate of increase in average nominal renumeration per worker from 5,6 per cent in the second quarter of 2006 to 8,1 per cent in the third quarter, as well as the broadly unchanged growth in labour productivity over this period, the rate of increase in nominal unit labour cost in the formal non-agricultural sector accelerated from 3,0 per cent in the second quarter of 2006 to 5,3 per cent in the third quarter.

Production price inflation lost some of its upward momentum, having accelerated for approximately three years ...

All-goods production prices

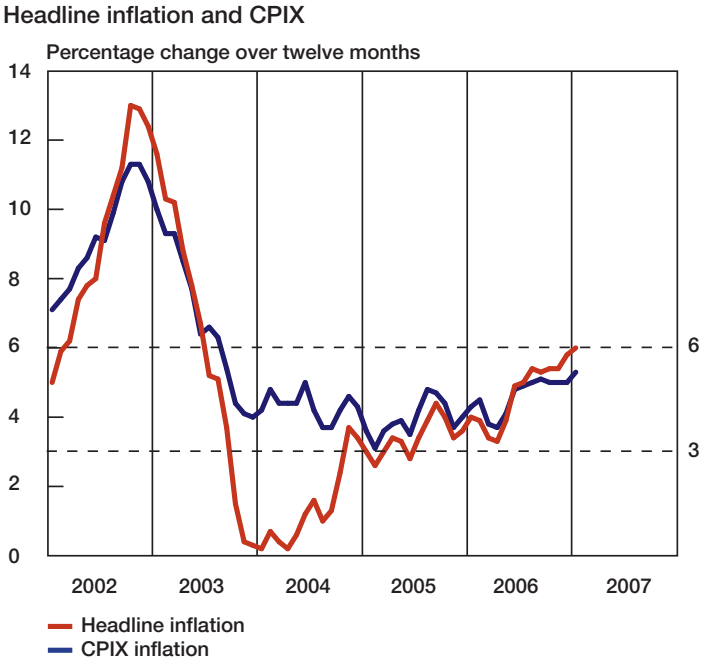


Year-on-year imported goods price inflation almost doubled from the opening months of 2006 to 11,3 per cent in November, but receded to 9,1 per cent in December following a decline in mineral product prices, basic metal prices and agricultural food prices. In January 2007 it edged up to 10,9 per cent following increases in mining product prices and manufacturing food prices.

Domestically produced goods price inflation accelerated markedly to 9,9 per cent in November from a level of around 5 per cent in the first four months of 2006. Subsequently, this rate of increase moderated to 9,5 per cent in January 2007, supported by decreases in the price of fuel.

Consequently, all-goods production price inflation moderated from a year-on-year rate of 10,0 per cent in November 2006 to 9,3 per cent in December before picking up to 9,8 per cent in January 2007.

… while CPIX inflation remained within the inflation target range.



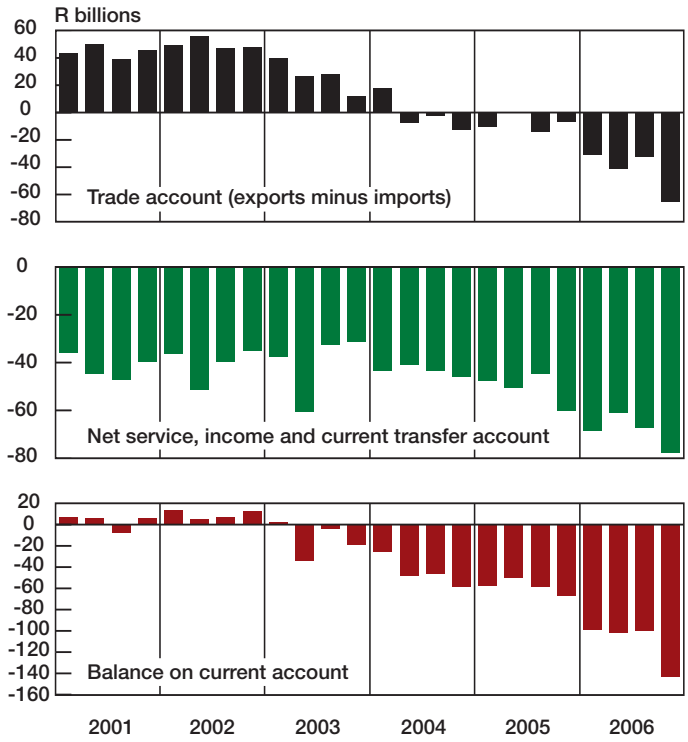
Year-on-year CPIX inflation has remained within the inflation target range since September 2003. However, in the second half of 2006 it accelerated considerably and came to 5 per cent from October to December 2006. It accelerated to a year-on-year rate of 5,3 per cent in January 2007.

Higher rates of increase in CPIX services prices were fairly widespread in recent months, led by increases in domestic workers' wages, home owners' costs and transport services.

In August 2006, year-on-year CPIX goods price inflation rose to 6 per cent – the upper limit of the inflation target range – driven by higher petrol prices. Petrol price decreases in the final months of 2006 offset the rapid acceleration in consumer food prices, notably meat, fish and other sea foods. On balance, this lowered CPIX goods price inflation to 5,2 per cent in December. However, it has since increased to 5,7 per cent in January 2007.

The deficit on the current account widened significantly during the fourth quarter of 2006, partly as a result of the trade deficit which more than doubled in line with brisk domestic expenditure.

Balance of payments: Current account

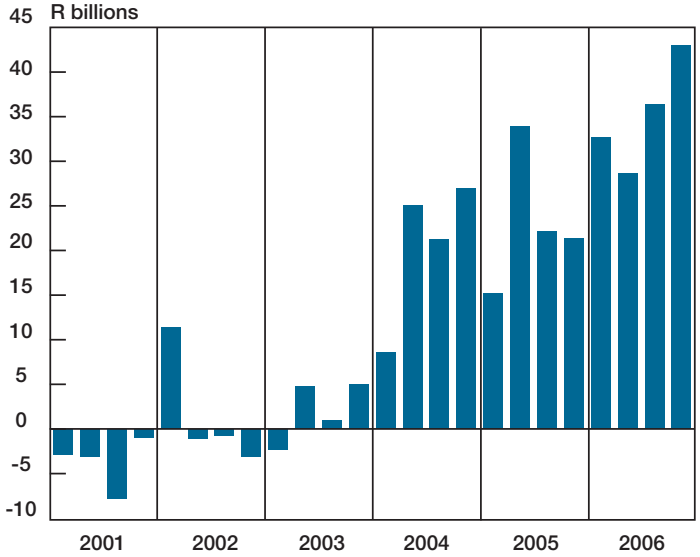


Seasonally adjusted and annualised

There was a substantial increase in the value of total merchandise imports in the fourth quarter of 2006 which more than offset an increase in the value of merchandise exports. Consequently, South Africa's trade deficit more than doubled from the third quarter to the fourth quarter of 2006. The large trade deficit recorded in the final quarter lifted the deficit for 2006 to R42,5 billion, compared with R7,7 billion recorded in 2005. The sizable trade deficit occurred alongside a significant increase in net service payments to the rest of the world. As a result, the deficit on the current account widened further from the third to the fourth quarter of 2006. The current-account deficit increased from R100 billion in the third quarter of 2006 to R143 billion in the fourth quarter. As a percentage of gross domestic product, this latter deficit amounted to 7,8 per cent. For 2006 as a whole the deficit came to 6,4 per cent of gross domestic product.

However, the largest surplus ever recorded on the financial account of the balance of payments was sufficient to finance the current-account deficit ...

Balance of payments: Financial account

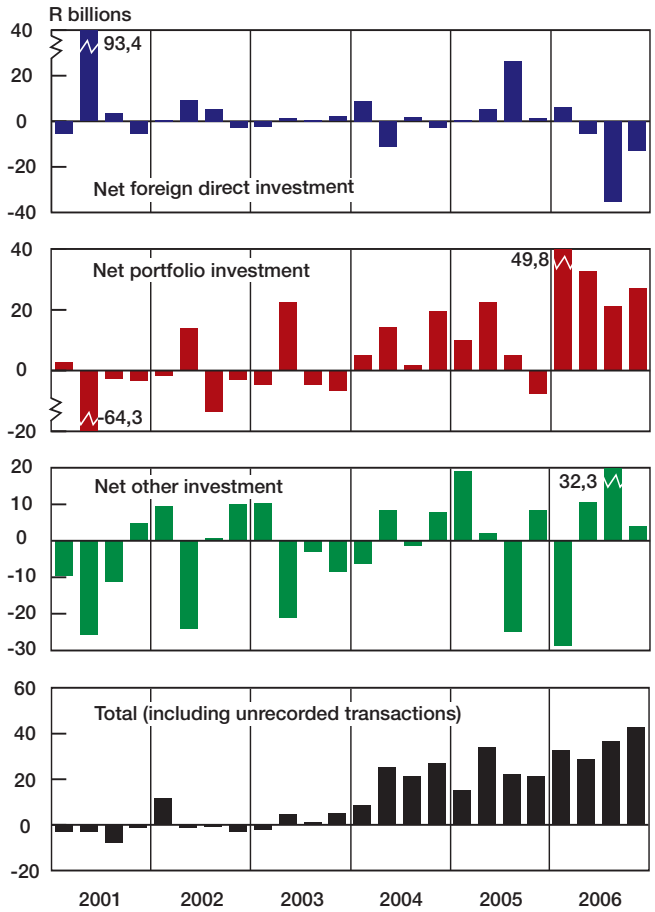


Including unrecorded transactions

Excess liquidity and low yields in industrialised countries benefited South Africa during 2006 when the country registered its largest net annual inflow of capital to date, amounting to R140,7 billion. Although sizeable inflows were recorded in each of the first three quarters of 2006, the financial account registered the largest inflow of R43 billion in the fourth quarter. The inflow of capital in 2006 was the fifth consecutive annual inflow and has brought the accumulated inflow to R330 billion since the start of 2002.

... with portfolio investment once again contributing most to the surplus on the financial account.

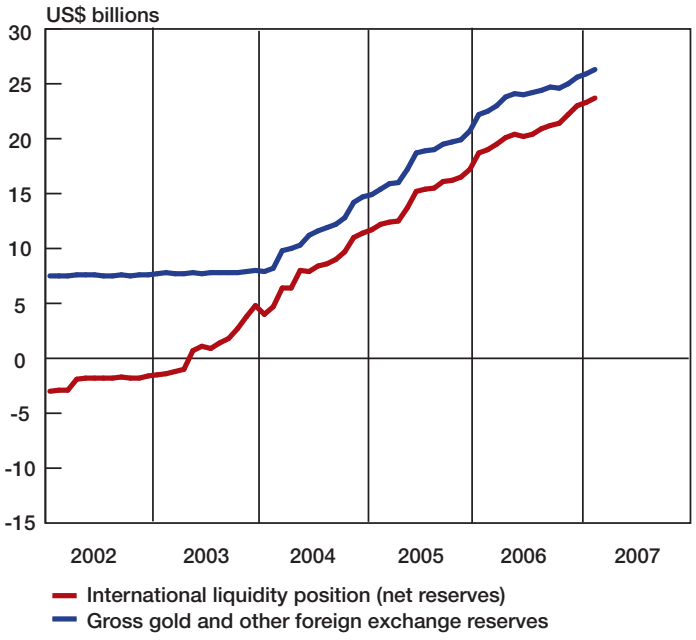
Financial account



The surplus on the financial account increased further in the fourth quarter of 2006 as net portfolio investment increased to R27 billion from R21 billion in the third quarter. For 2006 as a whole, net portfolio investment recorded an inflow of R131 billion, constituting about 93 per cent of total inflows recorded on the financial account. These inflows were partly offset by an outflow of net direct investment capital of R13 billion in the final quarter. The sale of a non-resident direct investor's equity stake in a domestic gold-mining company to a South African company was mainly responsible for this outflow. As a percentage of gross domestic product the surplus on the financial account of the balance of payments increased to 8,2 per cent in 2006 from 6 per cent in 2005.

Notwithstanding the substantial deficit on the current account during the fourth quarter of 2006, South Africa's gold and foreign exchange reserves rose further ...

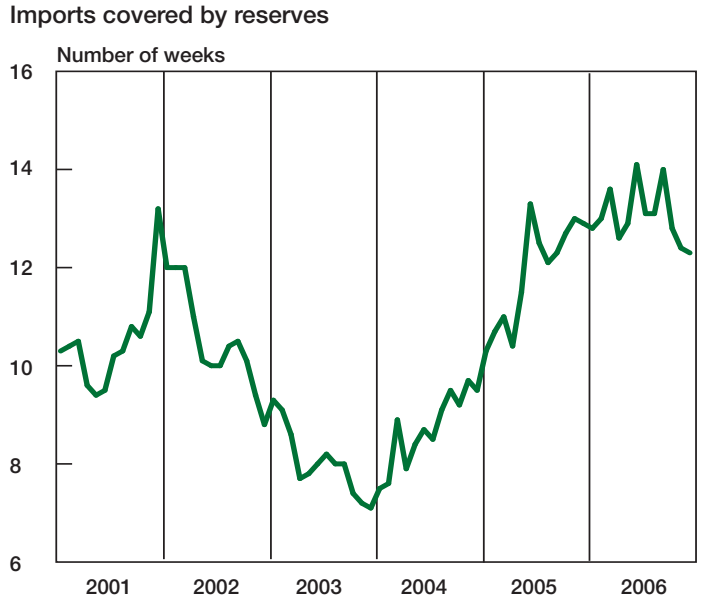
Gross gold and other foreign reserves and international liquidity position of the South African Reserve Bank



South Africa's overall balance-of-payments position (i.e. the change in the country's international reserves owing to balance-of-payments transactions) recorded a surplus of R7,7 billion in the fourth quarter of 2006 compared to a surplus of R7,1 billion in the third quarter. For 2006 as a whole, the surplus on the country's overall balance of payments was R29,8 billion compared with a surplus of R34,3 billion in 2005.

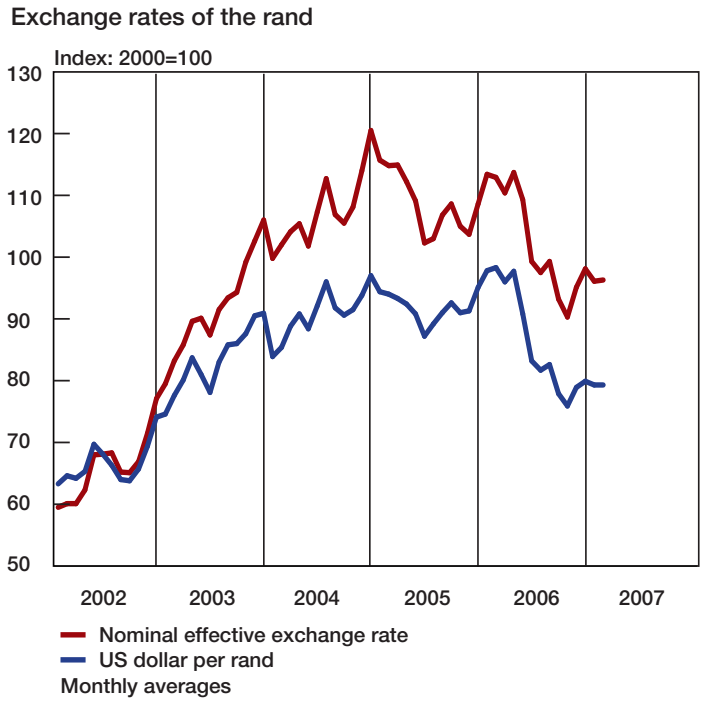
South Africa's gross international reserves increased from US$24,7 billion at the end of September 2006 to US$25,6 billion at the end of December and further to US$ 26,3 billion at the end of February 2007. The Bank's outstanding foreign liabilities declined further to US$2,8 billion at the end of December when the Bank prepaid US$500 million on a 3-year US$1 billion syndicated loan entered into in 2004.

… but an increase in imports resulted in a decline in the level of import cover.



The level of import cover (i.e. the value of gross international reserves relative to the value of imports of goods and services) declined from 15 weeks at the end of September 2006 to 12 weeks at the end of December. This was due to the exceptionally strong imports towards the end of the year.

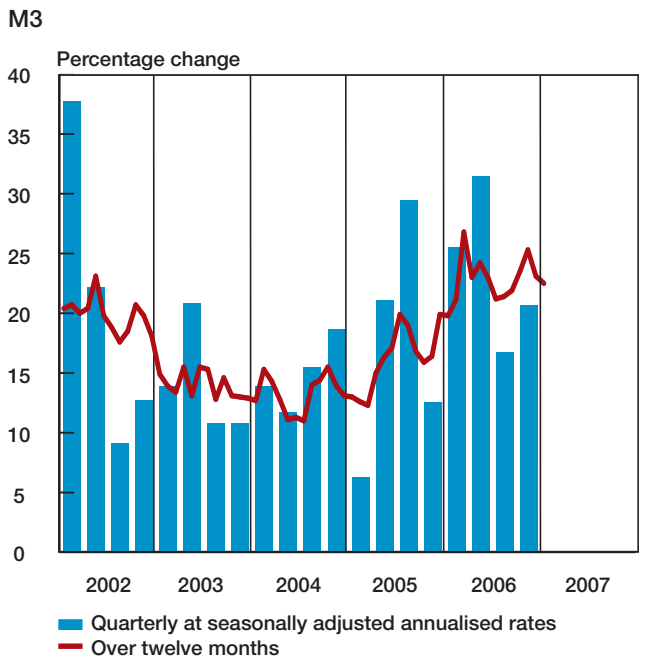
The exchange rate of the rand recovered during the fourth quarter of 2006, following declines in the second and third quarters.



On balance, the nominal effective exchange rate of the rand appreciated by 7,7 per cent during the fourth quarter of 2006 as a result of a sizable inflow of capital on the financial account of the balance of payments. The macroeconomic factors which supported the movement in the rand were, among other things, the higher gold price, weaker US dollar, widening of the interest rate differential and the rise in global equity markets. However, for 2006 as a whole, the weighted average exchange rate of the rand declined by 15,4 per cent compared to a decline of 2,0 per cent in 2005. This was the largest annual decline since 2001. During the first 2½ months of 2007 the nominal effective exchange rate declined by 1,0 per cent.

The real effective exchange rate of the rand depreciated by 10,7 per cent over the twelve months to December 2005, strengthening the competitiveness of South African exporters.

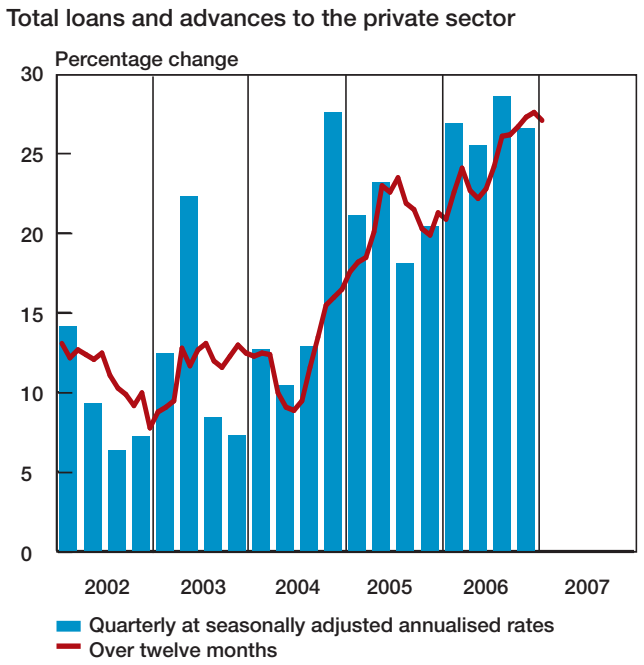
Growth in M3 accelerated further in the fourth quarter of 2006 ...



The seasonally adjusted and annualised quarter-to-quarter growth in the broadly defined money supply (M3) accelerated from 16,7 per cent in the third quarter of 2006 to 20,6 per cent in the fourth quarter. The acceleration in M3 was also evident in its twelve-month growth which accelerated, on balance, from 21,2 per cent in July 2006 to 23,1 per cent in December. A growth rate of 22,5 per cent was registered in January 2007.

The corporate sector remained the main driver of the strong growth in M3, consistent with the precautionary and yield-seeking motives for holding monetary assets. Positive wealth effects and robust turnover in the financial markets during the fourth quarter of 2006 also supported robust growth in M3.

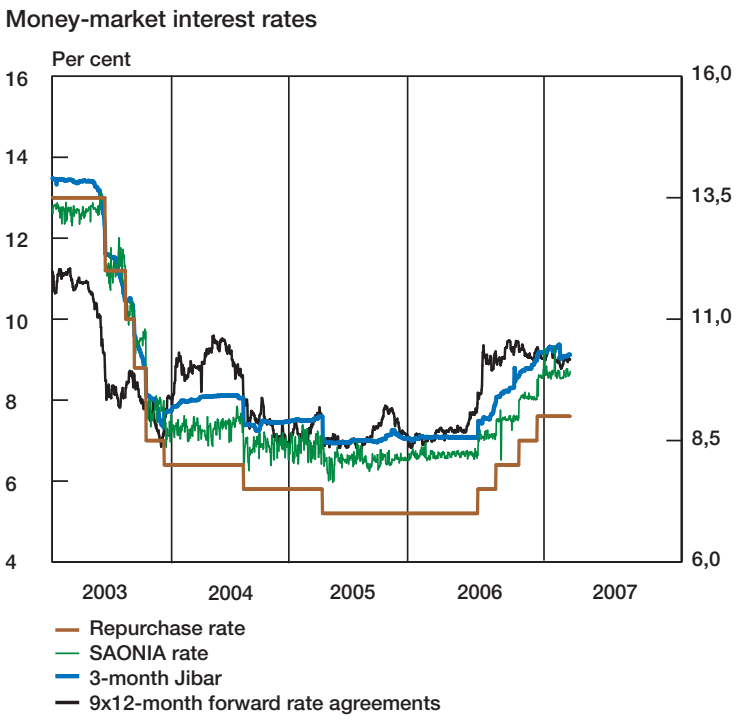
... while growth in banks' total loans and advances continued at a robust pace. However, there were signs of a slowdown in the early months of 2007.



Banks' loans and advances extended to the private sector continued to grow robustly in the fourth quarter of 2006, underpinned by strong domestic expenditure and income as well as positive wealth effects. Quarter-to-quarter annualised growth accelerated to 28,6 per cent in the third quarter of 2006 and 26,6 per cent in the fourth quarter.

Twelve-month growth accelerated from 24,2 per cent in July 2006 to rates of around 27 per cent since October. All credit categories recorded significant increases in recent months despite securitisation transactions to the value of R15,1 billion in the second half of 2006.

Money-market interest rates generally increased during the monetary policy tightening phase of 2006, but subsequently moved sideways.

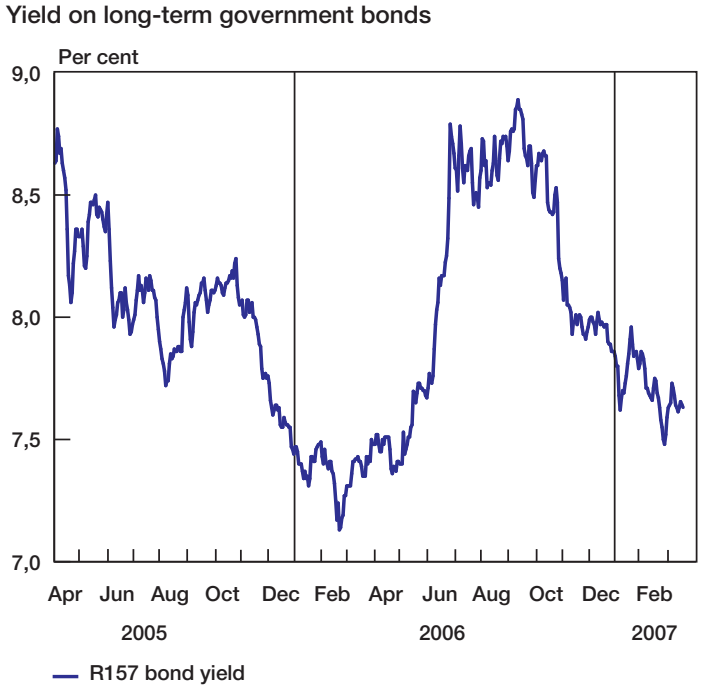


The Monetary Policy Committee (MPC) raised the repurchase rate by 50 basis points on each occasion at four consecutive meetings from June 2006 to December 2006. This was amid a deterioration in the risks to the inflation outlook.

The MPC subsequently left the repurchase rate unchanged at its February 2007 meeting as the outlook for inflation had improved since the December 2006 meeting.

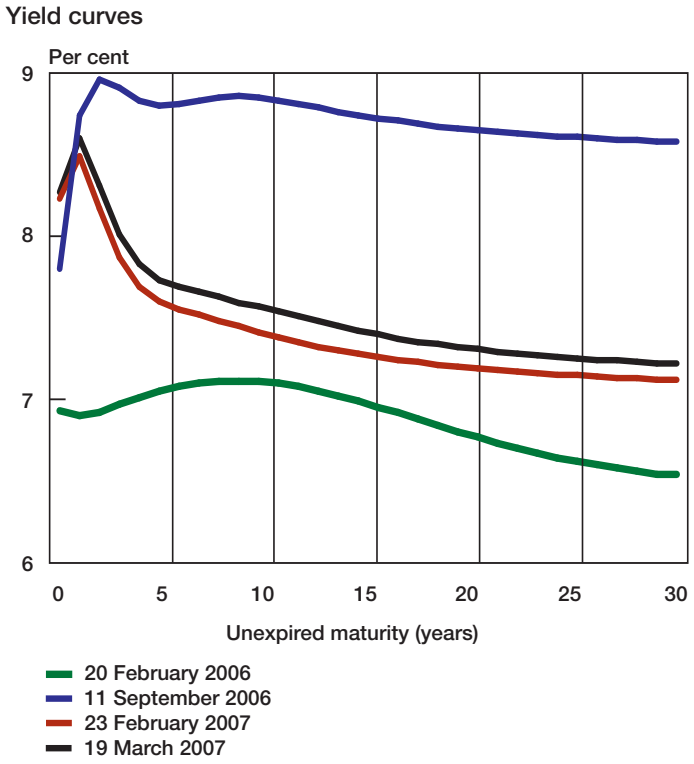
Interest rates on three-month instruments mirrored the trend of the repurchase rate. For instance, the three-month Johannesburg Interbank Agreed rate (Jibar) increased by a total of 196 basis points to 9,04 per cent over the recent six-month monetary policy tightening phase. The rate thereafter fluctuated broadly sideways.

From mid-September 2006, the yield on long-term government bonds declined significantly …



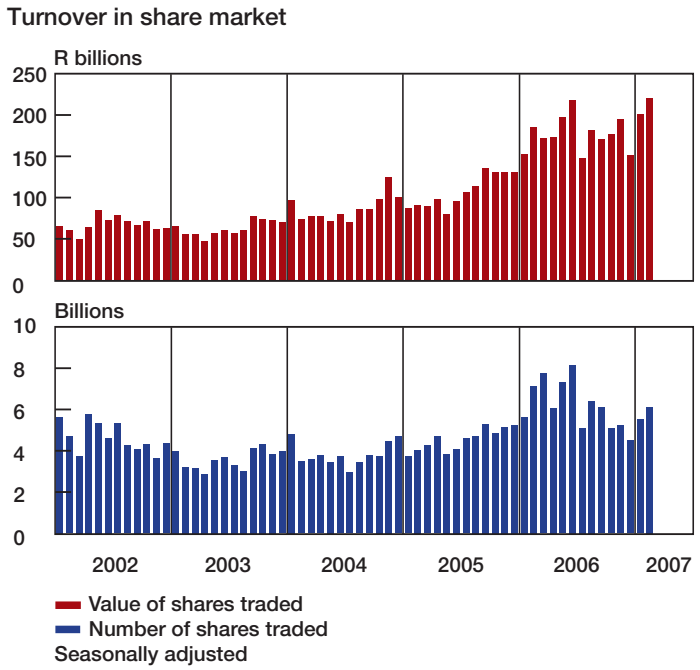
From a recent high of 8,89 per cent on 11 September 2006, the daily average yield on the long-term R157 government bond (maturing in 2015) fluctuated along a declining trend in response to the projections of lower bond supply and the appreciation in the exchange value of the rand. The yield on long-term government bonds reached a low of 7,48 per cent on 23 February 2007, before trending higher to 7,63 per cent on 19 March alongside the weaker exchange value of the rand.

… and the yield curve moved downwards and became inverted.



The level of the yield curve became inverted from mid-October 2006 as the short end of the curve increased in accordance with the tighter monetary policy stance, while the medium to longer end of the curve moved lower, probably as a result of projected lower bond supply, the appreciation in the exchange value of the rand and expectations that inflation will remain within the target range over the longer term. From a low on 23 February 2007 the yield curve moved higher in response to the weaker exchange value of the rand.

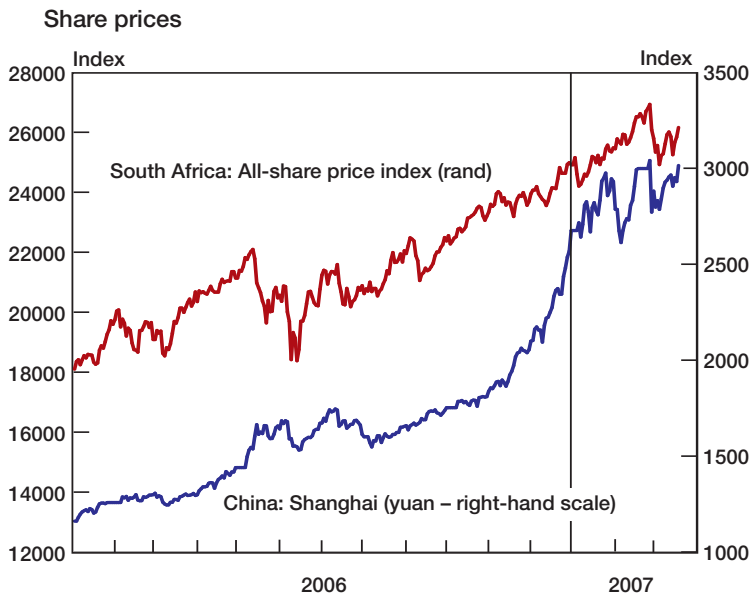
Trading activity in the secondary share market reached new highs …



The highest ever annual turnover of R2,1 trillion in 2006 was 66 per cent higher than the value traded in 2005. The seasonally adjusted value of shares traded on the JSE Limited reached an all-time monthly high of R220 billion in February 2007, contributing towards a turnover of R420 billion for the first two months of 2007.

Market liquidity, measured by the annualised turnover as a percentage of market capitalisation, declined from a record high of 65 per cent in June 2006 to 33 per cent in December, before increasing to 51 per cent in February 2007.

… but share prices receded from late February 2007, led by a decline in the Chinese share market.

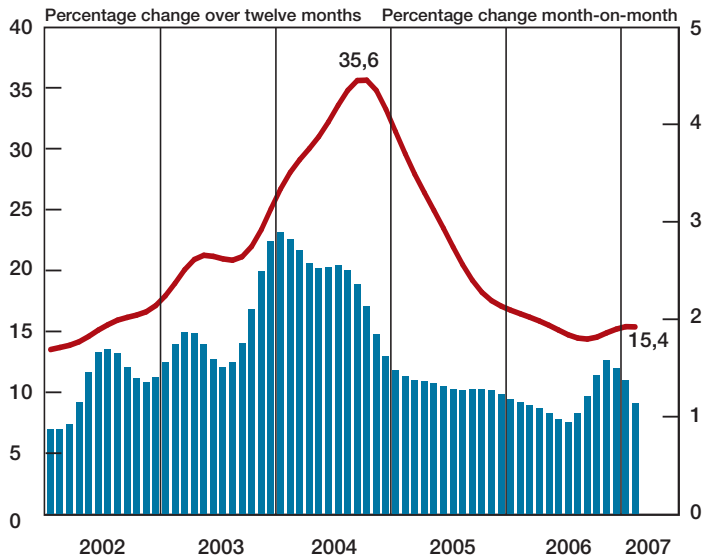


After declining from early May 2006 to mid-June, share prices increased considerably to 26 February 2007, buoyed by the robust economy, higher commodity prices and stronger global equity markets. Share prices, however, corrected downwards as international commodity prices and share markets deteriorated.

The daily closing level of the all-share price index increased by 47 per cent from 13 June 2006 to an all-time high on 26 February 2007. Subsequently, the all-share price index declined by 7 per cent to 5 March, before recovering by 5 per cent to 19 March as developed and emerging equity markets rebounded.

In the real-estate market, house price increases regained some momentum towards the end of 2006.

House prices



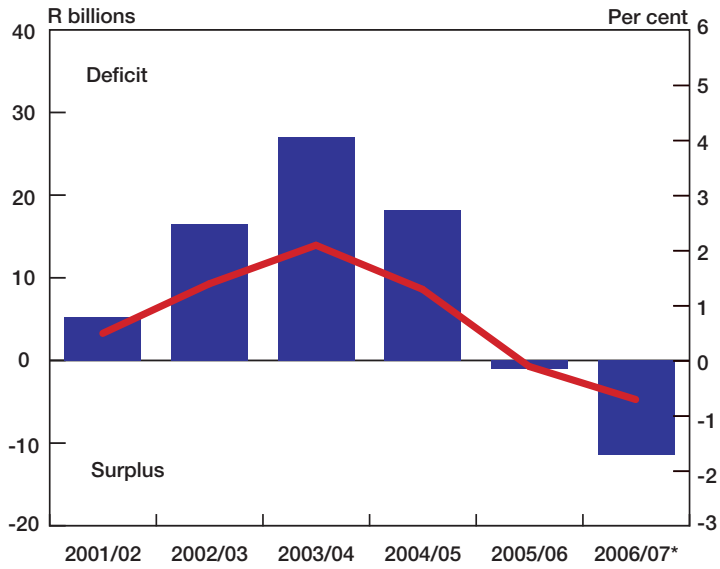
Percentage change in nominal house prices
Over twelve months
Month-on-month (right-hand scale)
Source: Absa

The deceleration in the rate of increase in residential real-estate prices of the past two years paused towards the end of 2006. The year-on-year increase in the average price of residential property in the middle segment of the market, as measured by Absa, decelerated from 35,6 per cent in September 2004 to 14,4 per cent in September 2006, before accelerating to 15,4 per cent in February 2007.

Similarly, month-on-month growth in house prices decelerated to a low of 0,9 per cent in July 2006, before accelerating to 1,1 per cent in February 2007. The general slowdown in growth in property prices could partly be explained by the progressively higher monthly repayments on new mortgage bonds, due to rising house prices and increases in mortgage rates from June 2006.

Government finances continued to be supportive of a disciplined monetary policy environment.

Non-financial public-sector borrowing requirement



Fiscal years
* *Budget Review 2007* estimate
R billions
Per cent of gross domestic product (right-hand scale)

National government revenue grew strongly in the first ten months of fiscal 2006/07, with all the major categories of tax revenue exceeding the original budgetary expectation.

With government expenditure remaining below revenue during the period April 2006 to January 2007, a cash book surplus before borrowing and debt repayment of R3,8 billion was recorded.

The non-financial public sector recorded a cash surplus of R1,0 billion, or 0,1 per cent of gross domestic product, in fiscal 2005/06 as a whole. The *Budget Review 2007* indicates a public-sector surplus of R11,4 billion, or 0,7 per cent of gross domestic product, for fiscal 2006/07.

Statement of the Monetary Policy Committee

15 February 2007

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

Introduction

Since the meeting of the Monetary Policy Committee (MPC) in December 2006, the outlook for inflation has, on balance, improved. Inflation outcomes, with respect to both consumer and producer prices, have been below expectations, mainly as a result of moderating food price inflation and lower international oil prices. Nevertheless, some longer-term risks to the outlook remain. There are still only tentative signs that consumer demand growth is abating. Credit extension has continued to grow at a robust rate. The challenge for monetary policy is to weigh up the perceived medium to long-term risks against the more favourable outlook. In the past few meetings, the MPC has consistently seen these risks to be firmly on the upside.

Recent developments in inflation

Year-on-year inflation as measured by the consumer price index for metropolitan and other urban areas excluding the interest cost on mortgage bonds (CPIX) remained constant at 5,0 per cent for the three months to December of 2006. In 2006 as a whole, CPIX inflation averaged 4,6 per cent compared to 3,9 per cent in 2005. In December, goods price inflation was unchanged from November at 5,2 per cent, while services price inflation increased to 4,8 per cent from 4,6 per cent in November driven mainly by higher rates of increase in housing services and medical services.

Food price inflation, which has been a major driver of CPIX inflation over the past few months, has shown some signs of moderation. In December food price inflation measured 7,7 per cent, compared to the peak of 9,4 per cent in October 2006. Meat prices, which remain the main contributor to food price inflation, increased by 16,6 per cent in December compared to rates of increase of just below 20 per cent in the previous two months. The petrol price increased at a year-on-year rate of 5,8 per cent in December, despite the R0,07 price decrease in that month. Prices of clothing and footwear fell by almost 12 per cent in December compared to the previous year.

Production price inflation also shows signs that it may have peaked. Having measured 10,0 per cent in both October and November 2006, production price inflation declined to 9,3 per cent in December. Imported goods inflation measured 9,1 per cent compared to domestically produced goods inflation of 9,4 per cent. The contribution of food to production price inflation moderated in December which suggests that pressure on food prices at the consumer level could be further contained.

The outlook for inflation

The most recent central forecast of the Bank's forecasting model indicates an improvement in the inflation outlook compared to the forecast considered at the December meeting of the MPC. CPIX inflation is no longer expected to breach the upper end of the target, but is now expected to peak at an average rate of around 5,6 per cent in the second quarter of this year and to average 4,7 per cent by the fourth quarter of 2008. In terms of the model, the improved outlook is primarily the result of the change in the monetary policy stance last year and the improved outlook with regard to expected international oil price developments.

There are a number of additional developments contributing to this positive outlook. There is some evidence of an improvement in market expectations of inflation since the previous MPC meeting. The yield curve has inverted further, reflecting in part an improvement in inflation expectations. The break-even inflation rates as suggested by the yield differential between inflation-linked bonds and conventional govern-

ment bonds indicate that inflation expectations have improved significantly since September when yields at shorter maturities exceeded 6 per cent. Since then, break-even inflation rates across all maturities have declined.

Inflation expectations are also reflected to some extent in wage settlements in the economy. Recent nominal wage developments are indicative of inflation expectations remaining under control despite a slight upward trend. In the third quarter of 2006, unit labour costs increased at a year-on-year rate of 5,3 per cent, compared to a second-quarter increase of 3 per cent. According to Andrew Levy Employment Publications, nominal wage settlements averaged 6,5 per cent in 2006 compared to 6,3 per cent in 2005. Although wage settlements were slightly higher in 2006, the inflation rate was higher than in the previous year. If allowance is made for a moderate increase in labour productivity, these increases are consistent with the inflation target.

The domestic economy shows signs that the growth momentum has been maintained at rates around potential. Capacity utilisation levels remain high, particularly in construction and electricity generation, although they are below the peak reached in the second quarter of 2006. Growth in the mining and manufacturing sectors continued to display upward trends in 2006. Seasonally adjusted total mining production increased by 5,5 per cent in the three months ending December 2006, compared with the previous three months, while manufacturing sector output increased by 2,1 per cent over the same period. The positive trend in manufacturing is expected to be sustained as reflected in the Investec/BER Purchasing Managers Index which reached a level of 57,2 in January 2007.

The exchange rate of the rand has been relatively stable and averaged R7,14 to the US dollar since the previous MPC meeting when it was trading at around R7,10. During this period, it fluctuated in a range of between R6,93 and R7,40 to the US dollar. The rand is currently trading at around R7,20. On a trade-weighted basis, the rand is relatively unchanged since the previous meeting. Much of the volatility observed since the previous meeting has been due to movements of the US dollar against other currencies, fluctuations in commodity prices and generally illiquid conditions in the local foreign- exchange market at the end of the year.

Balance-of-payments developments suggest that the deficit on the current account might have widened significantly in the fourth quarter of 2006 following an increase in the trade deficit. Preliminary estimates indicate that the deficit on the trade account of the balance of payments more than doubled from the third to the fourth quarter of 2006. In the fourth quarter, the value of merchandise imports increased by about 17 per cent from the third quarter, while the value of merchandise exports increased by about 8,5 per cent. Much of the import momentum in the fourth quarter, however, can be ascribed to the 140-per-cent increase in the volume of oil imports compared to the third quarter. This inventory build-up appears to be exceptional and oil imports are unlikely to be sustained at these levels.

We have emphasised on a number of occasions that the MPC does not have a target for the current account, nor does the MPC view deficits on the current account to be inflationary in themselves. The mandate of the Bank is to maintain inflation within the target range of 3 to 6 per cent. The risk to inflation arises if the market perceives a particular level of the current account to be unsustainable, which could have implications for the exchange rate and, consequently, for the inflation rate. To date the current- account deficit, including that in the fourth quarter, has been adequately financed. Current developments appear to indicate that the current-account deficit will continue to be adequately financed given the coherent macroeconomic policy framework of the country and positive growth prospects. Non-resident purchases of South African bonds and equities totalled R108 billion in 2006 as a whole, compared to R41 billion for 2005. This year to date, the non-residents have been net buyers of bonds and equities to the value of around R5,1 billion. Official gross gold and other foreign-exchange reserves stood at US$25,9 billion at the end of December 2006 and the international liquidity position amounted to US$23,3 billion.

Fiscal policy has remained supportive of monetary policy. International factors also provide a benign backdrop to the inflation outlook. Global growth prospects generally remain positive, with most regions expected to experience sustainable growth rates. The global interest rate cycle appears to have peaked in most regions, and world inflation is expected to remain under control.

International oil price developments have impacted positively on inflation outcomes. The price of North Sea Brent crude oil, which was above US$62 per barrel at the time of the December meeting, reached a 20-month low of around US$51 per barrel in January following the unseasonably warm winter in the northern hemisphere. However, a further reduction in output quotas by OPEC, effective from 1 February 2007, and colder weather in Europe and the US resulted in prices rising again towards US$60 per barrel. In the past few days the price of Brent crude has declined to around US$56 per barrel as fears of further OPEC cuts abated. Domestic petrol prices increased by R0,06 per litre in January, but were reduced by R0,23 cents per litre in February. This recent relative stability in the oil market has reduced the risk posed to inflation from this source. Nevertheless, given the tight supply and demand conditions in the market, oil prices remain vulnerable to geopolitical developments.

As has been the case at the past few meetings, the central concern of the MPC was the continued strong pace of household consumption expenditure growth and its potential impact on inflation. It is recognised that there are lags in the adjustment to interest rate changes, and the question facing the Committee was the extent to which further reactions to interest rate changes can still be expected. This is a difficult judgement call to make in the light of the inevitable lags in data collection. Consumer demand, however, still appears to be growing robustly despite the 200-basis-point increase in the repo rate last year. Real retail sales growth increased at a year-on-year rate of 12,3 per cent in November but moderated somewhat to 7,2 per cent in December. On a seasonally adjusted month-on-month basis a decline of 2,1 per cent was recorded. It is still premature to tell whether this is the beginning of a new trend. There are also tentative signs that demand for motor vehicles may be declining.

Household consumption expenditure has been underpinned by the continued asset price growth which has contributed to the sustained strength in household balance sheets. Share prices on the JSE Securities Exchange have continued to reach new highs. The all-share index increased by 38 per cent during 2006 and, since the previous meeting of the MPC, has increased by 9 per cent. House prices have also continued to increase at a brisk pace. According to the Absa house price index, house prices are still growing at year-on-year rates of almost 15 per cent.

Twelve-month growth in banks' loans and advances extended to the private sector increased by almost 28 per cent in December, although the annualised quarterly growth showed some sign of moderation, declining from 28,6 per cent in the third quarter to 26,6 per cent in the fourth quarter. Mortgage advances grew at rates of around 30 per cent for much of 2006, while instalment sale credit and leasing finance recorded year-on-year growth of 15,8 per cent in December. These increases were despite further securitisation transactions on the part of the banks. Of significance is the fact that growth in total loans and advances to the corporate sector increased from 27,6 per cent in October to 31,8 per cent in December, whereas growth of credit extended to the household sector declined from 26,1 per cent in October to 24,3 per cent in December.

Monetary policy stance

On the basis of the foregoing analysis, the MPC is satisfied that the inflation outlook has improved somewhat and expects inflation to remain within the target range for the forecast period. As the mandate of the Bank is to keep inflation within the inflation target range, the MPC has decided to leave the repo rate unchanged for now at 9 per cent per annum. However, risks to the inflation outlook remain and the MPC will continue to closely monitor developments with a view to adjusting the monetary policy stance as and when required.