

2008-06-13: Statement of the Monetary Policy Committee

Issued by M G Dlamini, Governor of the Central Bank of Swaziland

1. Introduction

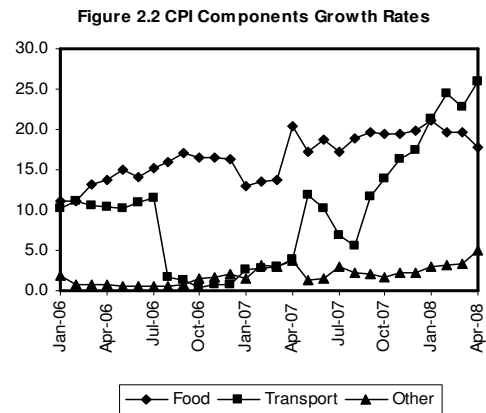
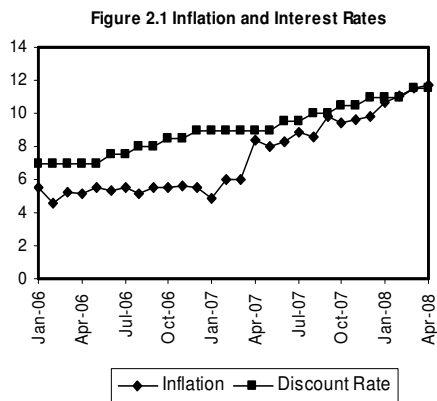
The Central Bank of Swaziland (Bank) like any other central bank has a mandate to maintain price stability on the belief that inflation is a monetary phenomenon, that is, if more money chases few goods then this will in the short to medium term result into an excess demand as output falls short of demand hence prices will increase. This type of inflation is referred to as “demand pull” inflation in as far as it originates from the demand side of the economy. Whilst different monetary tools such as interest rate (discount rate) and monetary aggregates (reserve requirements and open market operations) can be used to control inflation, the bank uses the interest rate which has proven to be more effective in combating inflation arising from the *demand side* of the economy. Higher interest rate will dampen most kinds of consumer spending and subsequently reduce the demand for goods and services thus reducing the upward pressure on prices.

However, in the case of the other type of inflation emanating from rising cost referred to as “cost push” inflation, interest rate is an inappropriate policy tool to use to control inflation. The current hike in inflation is a result of increases in oil price (mainly due to hyper demand from the emerging middle class of China and India) which translate into higher cost of production or cost of transport; and food price (due to persistent drought hence food shortage) which are both of a supply side nature and also non-interest sensitive. Interest rate will therefore be largely ineffective in alleviating these pressures on prices. The Bank alone cannot be in a position to solve this problem but a well coordinated policy approach involving monetary policy and fiscal policy is necessary to abate the escalating hike in inflation. A stimulus on production is needed and interest rates are not an ideal policy to boost production when inflation is high because of the trade-off between maintaining low inflation and high economic growth. The Government should in such situations stimulate production to complement the Central Bank policies. A proper perspective on the causes of inflation in Swaziland, which follows, is necessary to decide on an appropriate course of action.

2. Inflation and Interest Rates Developments

Despite the persistent hike in interest rates by the Bank aimed at controlling inflationary pressures, domestic inflation continued with its upward trend since the hike in interest rates began in June 2006. (See graph 2.1 below). The annual rate of inflation increased from a single digit figure of 5.3 percent in June 2006 to a double digit figure of 11.7 percent in April 2008. This raises concern whether the policy tool used to control inflation is appropriate given the current sources of inflation in Swaziland. The main sources of domestic inflationary pressures continued to be food and transport prices which together constitute 46.3 percent of the total weight of the price index with food's weight the highest at 37.7 percent. Food prices increased at an annual rate of 14.1 percent in June 2006 to 17.8 percent in April 2008 amid persistent drought which affects largely maize production in the Swazi Nation Land (SNL). The bulk of upward pressure came from items such as rice, mealie-meal, milk, cheese and eggs, oils and fats, vegetables and other cereal products, which on an annual basis increased significantly in the month of April. Food prices alone accounted for 57 percent of the overall increase in inflation in April 2008. Given also that a bulk of food stuff

are imported from South Africa, therefore, most of domestic food inflation is imported from South Africa.



Transport inflation, which is mainly influenced by international crude oil prices, remains relatively high at 26 percent during April 2008. The higher transport inflation is directly related to the increase in fuel prices since February this year. Since the beginning of this year, petrol prices have risen by over 30 percent and diesel prices by over 40 percent. International oil prices on the other hand have risen from about \$107 a barrel in April to around \$135 per barrel as demand grew for a hedge against a weakening dollar and fuel consumption by Asian countries accelerated. Speculations around supply have to a large extent have been the key driver of the price and OPEC's dithering on increasing production has not helped matters. Transport prices contributed about 18 percent to the overall increase in inflation during April 2008.

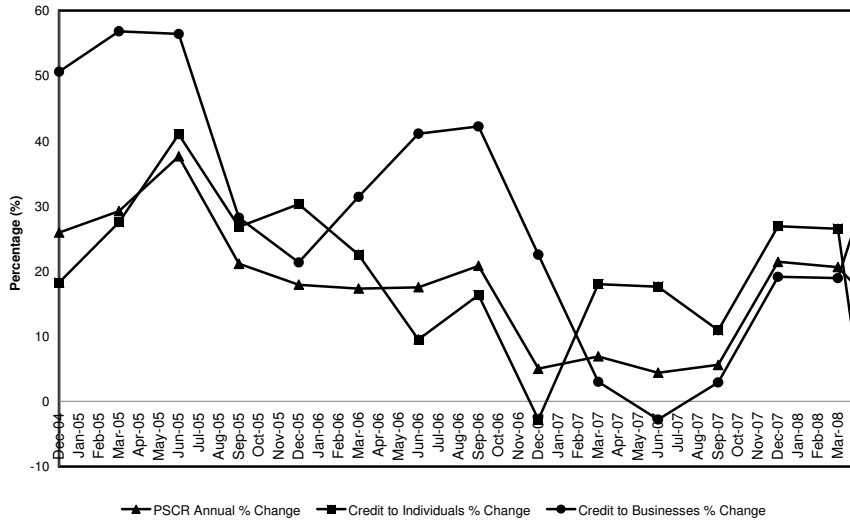
Looking ahead, food and oil prices still pose an upside risk to domestic inflation but government through the Ministry of Agriculture and Co-operatives is doing everything possible to bring food shortage such as maize under control by coming out with proposal for mitigation on the food price crisis in Swaziland.

3. Interest Rates and Monetary Aggregates

Since the interest rates hike in June 2006, credit extension to the private sector is showing moderation although at still relatively high levels. Growth in private sector credit extended by local banking institutions eased from a high of 20.8 percent in September 2006 to 17.4 percent in April 2008. The graph below (figure 3.1) illustrates the private sector credit and a further breakdown of credit to businesses and individuals.

According to the graph, private sector credit is trending downwards in the period under review. The slowdown in private sector credit growth was mainly reflected in credit extended to individuals and credit extended to businesses also showed a decline during the same period. At an annual rate, growth in credit extended to individuals slowed to 5 percent at the end of April 2008 from 30.3

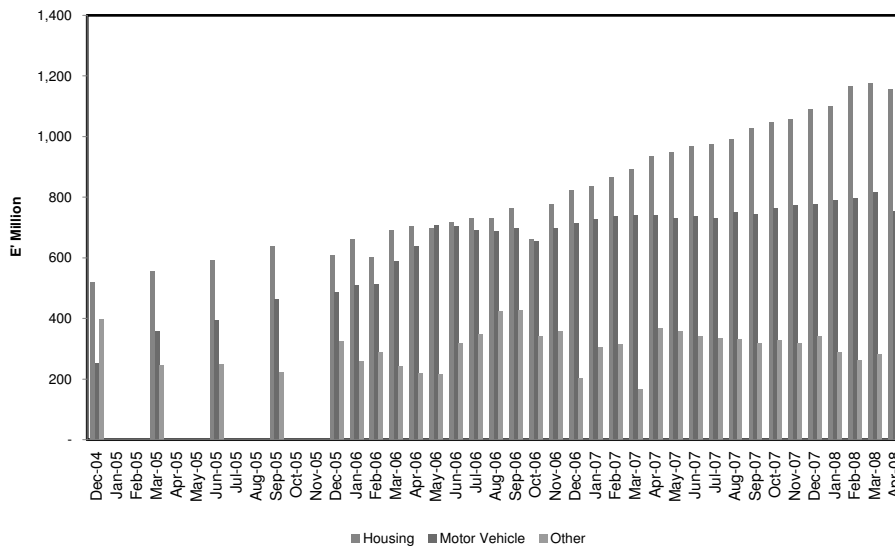
Figure 3.1 Private Sector Credit to Businesses and Individuals for the period December 2004 to April 2008



percent at the end of 2005. In the same vein growth in credit extended to businesses also decreased from 42.2 percent in September 2006 to 28.2 percent at the end of April 2008.

Asset-backed credit displayed a downward trend, suggesting that there is not much inflationary pressure coming from this component. The graph below (figure 3.2) presents the households' credit by products for the period December 2004 to April 2008.

Figure 3.2 Households Credit by Products for the period December 2004 to April 2008



For instance, growth in mortgage loans, which accounts for the bulk of credit extended to individuals (54 percent), decelerated from 34.5 percent at the end of February 2008 to 23.3 percent at the end of April 2008. Similarly, growth in credit extended for the purchase of vehicles by individuals (comprises 35 percent of total credit extended to individuals) slowed down to 2.1

percent in April 2008 from 10.2 percent in March 2008. Other credit extended to individuals, mainly comprising personal and education loans as well as loans for non-profit institutes serving households, contracted by 44 percent at the end of April after growing by 70.8 percent in March.

4. Concluding Remarks

It is clear from the forgone analysis that the sources of the current increase in inflation in Swaziland are less of demand pull inflation but more of a cost push inflation which therefore makes interest rate as a policy tool to control inflation inefficient. This is evident from the continuous upward trend in inflation despite several hikes in interest rate by the Bank. It was further confirmed that indeed domestic inflation stem largely from food and transport prices (due to increase in oil prices) which are supply phenomenon. With regard to monetary aggregates, whilst the hike in interest rates dampened credit extension to the private sector it did not translated into lower inflation and therefore further confirming the ineffectiveness of interest rate to control inflation through the credit channel transmission.

5. Monetary Policy Decision

The Bank, at its meeting held on the 12th June 2008, decided that, for now, it will not adjust its discount rate upwards. Although concerned with the spiralling of inflation in recent months, the effect of continued interest rates increases on the domestic economy was a major factor in influencing the decision by the Bank to adopt a cautionary stance. In taking this stance, the Bank noted with concern the slowing of the global economy, underpinned by the recent financial market turmoil and a weakening of the US growth performance and other developments within the region which are a threat to the economic development of Swaziland. The Bank was also concerned with the effect of the past hikes in interest rates on overall growth in terms of making credit expensive through increased borrowing costs.

The Bank is also of the view that the accommodative monetary policy stance taken within the auspices of the CMA agreement, which allows for free flow of funds within the member states, would not result in arbitrage as long as Swaziland maintains an insignificant interest rate differential with its major partner, South Africa.

The decision to keep interest rates unchanged has also been taken in order to assess the effectiveness of the increase in interest rates in terms of curbing the major components of our local consumer price index. Inflation has continued its upward trend since the last monetary policy meeting in April. The annual rate of inflation increased moderately from 11.6 percent in March 2008 to 11.7 percent in April 2008. Evidence has shown that despite the past upward adjustments in interest rates the country is still experiencing growth in food and transport prices. Food prices increased at an annual rate of 17.8 percent and accounted for 57 percent of the overall increase in inflation during the same month. Transport inflation, which is mainly influenced by international crude oil prices, remained relatively high at 26 percent during April 2008. The higher transport inflation is directly related to the increase in fuel prices since February this year.

Available demand indicators, such as private sector credit extension, show some signs of moderation, although at a relatively high levels. Twelve-month growth in banks' total loans and advances extended to the private sector eased from 20.6 percent in March 2008 to 17.4 percent in April 2008. Year-on-year growth in mortgage advances declined to 23.3 percent compared to 31.9

percent in March. In contrast, growth in loans and advances extended to the business sector increased to 28.2 percent from 18.9 percent in March.

The Bank would like to have an opportunity to weigh the effect of the restrictive monetary policy stance on the low domestic economic growth rate particularly given that Swaziland's growth rate is the lowest in the CMA. Latest official estimates put real GDP growth at 2.8% in 2007 which is the same growth rate recorded in 2006. Growth in economic activity will be largely propelled by growth of services and construction activities as well as improved performance of some major industries in the manufacturing sector.

Despite the fact that local banks are free to exercise their desire to this decision the Bank would like to emphasise that the benefit of leaving the discount rate unchanged should be passed on to the customers.

The Bank remains, nevertheless, concerned about the rising inflation, and will not hesitate to adjust its policy stance should monetary policy conditions so demand in the interest of price stability.

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(GOVERNOR)