Preface

The primary mandate of the South African Reserve Bank (the Bank) is to achieve and maintain price stability in the interest of balanced and sustainable economic growth. Low inflation helps to protect the purchasing power and living standards of all South Africans, and provides a favourable environment for balanced growth, investment and employment creation. In addition, the Bank has a complementary mandate to oversee and maintain financial stability. The Bank’s Monetary Policy Committee (MPC) is responsible for monetary policy decisions and comprises the Governor as chairperson, the deputy governors and senior officials of the Bank.

Price stability is quantified by the setting of an inflation target range by Government after consultation with the Bank. The Bank has instrument independence, with the commitment to pursue a continuous target of 3 to 6 per cent for headline consumer price index inflation. The MPC conducts monetary policy within a flexible inflation-targeting framework that allows inflation to be temporarily outside the target range.

The MPC takes into account a viable medium-term time horizon for inflation and considers the time lags between policy adjustments and economic effects. This provides for interest rate smoothing over the cycle, and contributes towards more stable economic growth. The repurchase (repo) rate decision reflects the MPC’s assessment of the appropriate monetary policy stance.

The decision of the MPC, together with a comprehensive statement, is announced at a media conference at the end of each bimonthly meeting. This outlines the MPC’s assessment of prevailing global and domestic economic conditions, as well as forecasts for inflation and real economic activity.

The Monetary Policy Review (MPR) is published twice a year and is aimed at broadening the understanding of the objectives and conduct of monetary policy. The MPR reviews domestic and international developments that have affected inflation and that impact on the monetary policy stance. It also provides an assessment of the factors determining inflation and the Bank’s forecast of the future path of inflation and economic growth. The MPR is presented by the Governor and senior officials of the Bank at Monetary Policy Forums (MPFs) in various centres across South Africa, in an effort to develop a better understanding of monetary policy through direct interaction with stakeholders.
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Executive summary

Monetary policy stability in an uncertain environment

South Africa’s monetary policy has provided stability through a period of unprecedented global and domestic uncertainty. Looking beyond the recent temporary breach of the upper limit of the inflation band, the Bank’s medium-term forecast projects inflationary pressures to moderate alongside a gradual economic recovery. From 2015, the output gap – the difference between the potential growth rate of the economy and its realised rate of growth – should slowly narrow. Subdued but improving global economic growth will lend some medium-term stability to oil and commodity prices. The value of the rand is expected to remain range-bound but volatile, consistent with the ongoing high level of uncertainty in the global economy. The monetary policy stance has remained stable as reflected by the unchanged low repo rate of 5 per cent per annum. Although inflation is expected to remain within the target range, the MPC has become increasingly concerned about upside risks to the forecast.

The primary challenge to price stability lies in the volatility of food and petrol prices, which is exacerbated by exchange rate movements. Higher inflation outcomes have resulted in a gradual rise in inflation expectations, which remain uncomfortably close to the upper band of the target range. However, in line with the Bank’s forecasts, these are expected to moderate alongside headline inflation over the medium term. A sustained divergence between the Bank’s forecasts and expectations would raise concerns about the anchoring of inflation expectations.

Rand depreciation continues to be the main upside risk to the domestic inflation outlook, although the pass-through from currency movements to headline inflation has proven to be relatively muted since the onset of sustained depreciation in May 2011. Core inflation, however, has tracked higher and is the focus of heightened scrutiny. Stronger second-round effects from depreciation and sharp increases in unit labour costs would have significant and negative effects on the inflation outlook. These developments reinforce the policy dilemma amid the weaker growth outlook. A significant deterioration in the risks to the medium-term inflation outlook may necessitate appropriate action to anchor inflation expectations.

Global economic and financial conditions remain challenging

Since the publication of the previous Monetary Policy Review (MPR) in June 2013, growth momentum in the global economy has shifted to a few systemically important advanced economies. In these countries, monetary policies have remained highly accommodative and certain markets (especially labour and housing) have improved, despite ongoing fiscal consolidation that weighs on growth. In the United States (US), conflict over how best to proceed with fiscal consolidation and the need for periodic increases in the government’s borrowing limit continue to weaken confidence. Global inflation has remained largely benign, although the spectre of deflation has re-emerged in the euro area, prompting a cut in the policy rate by the European Central Bank on 7 November.

Despite slower growth, price pressures began to appear in some emerging-market and developing economies, due in part to currency weakness caused by capital flow reversals. These reversals arose owing to speculation about the timing and impact of the future reduction in the US Federal Reserve’s (the Fed) quantitative easing (QE) programme. The existing tighter financial market conditions (which are expected to persist) amplify the challenge for policymakers in key vulnerable economies to address higher inflation, slower growth and, in some cases, large current-account imbalances. The Fed might be able to mitigate the impact of QE tapering through clear forward guidance and a phased approach, but this will ultimately depend on financial market interpretation and the credibility of this guidance.
Domestic economy subdued amid uncertainty

Global conditions have had a major impact on South Africa in 2013, affecting key external variables and domestic economic outcomes. Changes in risk perceptions were apparent in reduced capital inflows and higher bond yields. Lower commodity prices and weak external demand interacted with a resurgence in labour market instability and fragile investor sentiment to constrain exports and aggregate economic growth. Subdued employment growth and household credit demand have contributed to a loss of momentum in economic activity and under-utilisation of production capacity. Short-term demand- and supply-side indicators suggest fragile and below-potential economic growth through to 2015, with the balance of risks to the downside.

South Africa’s current-account deficit persists, with sustained deficits on both the trade account and the services, income and current transfer account. The South African Revenue Service (SARS) announced revisions to its trade statistics, which will now include data on trade with Botswana, Lesotho, Namibia and Swaziland. The Bank’s revision of the current account, incorporating SARS’s new trade statistics, will be published in the December 2013 Quarterly Bulletin.

As both a cause of downward pressure on the value of the currency and a contributor to volatility when international contagion is triggered, the size of the current-account deficit remains a risk factor. A better balance between investment and saving would help to reduce risk and volatility. So too would a revival of global growth, which, together with a competitive exchange rate, should contribute towards some rebalancing of exports and imports. Risk could be further mitigated if higher global interest rates result in a build-up of South Africa’s net foreign assets.

New format of the Monetary Policy Review

This MPR is presented in a new format. It includes frequently asked questions (FAQs), technical appendices to aid the interpretation of the Bank’s forecasts, as well as a comprehensive glossary. The FAQs convey the views of the MPC on the rand exchange rate (FAQ 1), on inflation expectations (FAQ 2) and on the current-account deficit (FAQ 3). In addition, some topical issues are discussed in boxes. These include tracking of South Africa’s economic recovery (Box 1) and the impact of the global and financial crisis on South Africa’s potential output (Box 2).
Monetary policy stance and evolution of the forecast

The monetary policy stance has remained stable since July 2012, reflecting the fragility of South Africa’s recovery amid continued uncertainty and volatility. Headline consumer price inflation crossed the upper edge of the inflation target band but is forecast to remain within the band in the near term. This section reviews the evolution of the monetary policy stance since the publication of the previous MPR. It also assesses the outlook for the trajectories of domestic inflation and economic growth over the Bank’s forecast horizon.

Policy rate and inflation outcomes

The repurchase (repo) rate was left unchanged at 5 per cent at the November meeting of the MPC. The nominal repo rate remains at a historically low level set in July 2012, and followed a lengthy period (from November 2010 to July 2012) during which it was fixed at 5,5 per cent. The real repo rate1 has been negative since November 2010, and reflects a sustained period of accommodative monetary policy. Given a relatively volatile inflation rate driven primarily by exogenous factors and a negative output gap, the monetary policy stance strikes an appropriate balance between the risk of higher inflation and support for the domestic economic recovery.

Consumer price inflation

Headline consumer price index (CPI) inflation2 – the measure targeted by the Bank – remained within the inflation target range for 14 consecutive months up to June 2013. In line with other emerging-market economies, domestic consumer price inflation began to rise gradually from mid-2012, with food and petrol prices accelerating, and currency depreciation risk evident. Headline CPI inflation increased from a recent low of 4,9 per cent in July 2012 to peak at 6,4 per cent in August 2013.

CPI inflation returned to the upper end of the target range at 6,0 per cent in September and moved to within the target range at 5,5 per cent in October. Housing and utilities price inflation has remained high, sustaining CPI inflation. Recent movements in inflation were primarily driven by transport prices, which were affected by petrol price volatility. Goods inflation generally increased over 2013, but with considerable volatility. Services prices, which have risen more strongly during 2013 than goods prices and average headline CPI inflation, lost some momentum over the year.

Core inflation3 accelerated from 4,5 per cent in July 2012 to 5,3 per cent in May 2013, and has remained stable since. In the absence of obvious excess demand pressures, administered price pressures (particularly petrol), lagged effects of rand depreciation and higher unit labour costs contribute to upside risk in core inflation.

Figure 1 The repurchase rate and other short-term interest rates

Figure 2 Consumer price inflation: Targeted inflation*

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1 The real repo rate is negative when the nominal repo rate is below the expected inflation rate (12 months ahead).
2 This refers to the 12-month change in the headline CPI.
3 Core inflation in this case refers to headline CPI excluding food, non-alcoholic beverages (NAB), petrol and energy prices.
Petrol and food prices

Petrol price inflation has been volatile in 2013, ranging from a year-on-year change of 1.8 per cent in May to a high of 23.0 per cent in August. This volatility was largely driven by movements in international product prices and the rand, both of which affect the basic fuel price. The monthly contribution of petrol to CPI inflation increased to over 1.25 percentage points in July and August, more than double the average contribution of 0.56 percentage points for the first six months of 2013. By November changes in petrol prices moderated to 7.6 per cent, alleviating inflationary pressures somewhat.

Global oil prices have remained high despite the subdued global growth outlook. In August oil prices broke through the US$100 to US$105 trading range to a six-month high of US$117. These then moderated to around US$110 in response to political developments in the Middle East.

International food prices have stabilised over the year, in part due to expectations of better harvests. The level of food prices nonetheless remains high and the cost of food globally is about 75 per cent higher relative to 2005. South African consumer food price inflation re-emerged in early 2013. It peaked at 7.4 per cent in August (contributing 1.1 percentage points to CPI inflation), driven by rising bread and cereals prices and vegetable prices. Food price inflation surprised on the downside and moderated to 4.2 per cent in October.

Table 1 Contributions to targeted inflation

<table>
<thead>
<tr>
<th>Percentage change over 12 months*</th>
<th>2013</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Weights</td>
</tr>
<tr>
<td>Goods inflation**</td>
<td>49.86</td>
</tr>
<tr>
<td>Services inflation**</td>
<td>50.14</td>
</tr>
<tr>
<td>Targeted inflation**</td>
<td>100.00</td>
</tr>
</tbody>
</table>

Of which:

<table>
<thead>
<tr>
<th>Percentage change over 12 months*</th>
<th>2013</th>
</tr>
</thead>
<tbody>
<tr>
<td>Food and non-alcoholic beverages</td>
<td>15.41</td>
</tr>
<tr>
<td>Food</td>
<td>14.20</td>
</tr>
<tr>
<td>Housing and utilities</td>
<td>24.52</td>
</tr>
<tr>
<td>Transport</td>
<td>16.43</td>
</tr>
<tr>
<td>Miscellaneous</td>
<td>14.72</td>
</tr>
<tr>
<td>Other</td>
<td>28.92</td>
</tr>
</tbody>
</table>

Source: Statistics South Africa and own calculations

Evolution of the inflation outlook

Over the forecast horizon, the trajectory of South Africa’s inflation is expected to remain within but close to the upper end of the target range. The Bank’s forecasts for headline CPI inflation for 2013 reflect a moderate deterioration since the May meeting of the MPC, followed by a marginal improvement in November. Upside risks to inflation remained elevated over the review period.
Under the assumption of prolonged currency weakness, the trajectories of administered price inflation and headline CPI inflation were revised upwards for 2013 and 2014. The forecast for inflation was revised upwards for the September MPC meeting, mainly due to petrol prices. From January 2013, inflation forecasts showed consumer price inflation breaking above 6 per cent.

Table 2  The Bank’s targeted inflation forecasts

<table>
<thead>
<tr>
<th>2013 MPC meetings</th>
<th>2013 Expected peak</th>
<th>End of forecast period</th>
</tr>
</thead>
<tbody>
<tr>
<td>March .............</td>
<td>5,9 3rd quarter 2013 at 6,3 per cent</td>
<td>at 5,2 per cent in the final quarter of 2014</td>
</tr>
<tr>
<td>May ...............</td>
<td>5,8 3rd quarter 2013 at 6,1 per cent</td>
<td>at 4,9 per cent in the final quarter of 2015</td>
</tr>
<tr>
<td>July ...............</td>
<td>5,9 3rd quarter 2013 at 6,3 per cent</td>
<td>at 5,2 per cent in the final quarter of 2015</td>
</tr>
<tr>
<td>September ......</td>
<td>5,9 3rd quarter 2013 at 6,3 per cent</td>
<td>at 5,3 per cent in the final quarter of 2015</td>
</tr>
<tr>
<td>November ......</td>
<td>5,8 2nd quarter 2014 at 5,9 per cent</td>
<td>at 5,3 per cent in the final quarter of 2015</td>
</tr>
</tbody>
</table>

Source: South African Reserve Bank

Figure 5 presents an indicator of the cumulative assessed probability that inflation will exceed the upper band of the inflation target range. The indicator for the May MPC meeting pointed towards the temporary breach of the upper band of the target range in the third quarter of 2013. The subsequent notable drop in the probability indicator for May reflected the expectation of an improved outlook for inflation over the remainder of the forecast horizon. However, by November, the upside risks to inflation negatively affected the outlook, as shown by the generally higher level of this indicator relative to that of May.

The most recent inflation projections of the Bank’s core quarterly forecasting model, conditional on an unchanged repo rate assumption, are depicted in the form of a fan chart, Figure 6. The headline CPI inflation forecast reflects a more-or-less unchanged inflation outlook since September 2013. This forecast was driven by lower petrol prices as well as expectations that the value of the rand will remain range-bound and that moderate global growth would keep commodity prices muted. The longer-term inflation path remains close to 6 per cent with the balance of risks to the central projection viewed as being to the upside.

The most recent forecast for core inflation continues to show a near-term rising trend, with a higher peak of 5,6 per cent in the second half of 2014. Core inflation is projected to average 5,6 per cent in 2014, slightly higher than was indicated in the September forecast. The forecast for 2015 remained unchanged at 5,3 per cent.

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4  See Appendix 1 for a detailed discussion of this probability indicator.

5  See Appendix 2 on how the MPC uses the fan chart to assess the risks inherent in the forecast and communicates the uncertainties that lie ahead.
FAQ 1: At what point does the Monetary Policy Committee become concerned about the rand?

There is no particular level of the exchange rate that would trigger a monetary policy response by the MPC. The policy stance may be affected by the extent to which exchange rate developments impact on the medium-term inflation trajectory. In practice this means that the MPC would have to take a view on the extent and duration of the exchange rate depreciation, and the extent and duration of its impact on inflation. The latter depends on the strength of domestic demand and the pricing power of firms, which have been exceptionally muted in recent times.

A depreciation that is short-lived and expected to reverse quickly is unlikely to have much impact on the medium-term inflation path. A good example of this is the petrol price, where exchange rate pass-through to consumer prices is fast and complete. Unless there are significant second-round effects, the impact on inflation will dissipate.

If inflation expectations are not anchored, or if the depreciation is significant over a sustained period (or both), inflation could be expected to rise above the target band. This could require a monetary policy reaction, depending on the extent and duration of the deviation of the inflation trajectory from the target range.

When faced with periods of currency uncertainty and volatility, as is currently the case, the MPC has to make assumptions about the path of the exchange rate over the forecast horizon. This is a difficult task given the tendency of the rand to overshoot. The MPC could change the exchange rate path assumption in the forecast, leave it unchanged and assign an upside risk to the inflation forecast, or a combination of these two.

Currently, the risk to the exchange rate posed by possible QE tapering poses a significant challenge. While tapering will happen, the MPC is uncertain as to when it will happen, how rapid it will be, and how much of this is already priced-in to the current exchange rate. Different scenarios regarding the timing and nature of tapering will result in differing inflation trajectories.

Inflation expectations

The median forecast from the Reuters survey suggests that inflation expectations for 2013 have oscillated around 6 per cent over the past six months and that a moderation in inflation will occur across 2014 and 2015. On balance, expectations of near-term inflation have increased in line with the rise in actual outcomes.
Table 4 Reuters survey of CPI forecasts*

<table>
<thead>
<tr>
<th>Per cent</th>
<th>2013</th>
<th>2014</th>
<th>2015</th>
</tr>
</thead>
<tbody>
<tr>
<td>Median</td>
<td>(5,9)</td>
<td>5,9</td>
<td>(5,6)</td>
</tr>
<tr>
<td>Mean</td>
<td>(5,9)</td>
<td>5,9</td>
<td>(5,6)</td>
</tr>
<tr>
<td>Highest</td>
<td>(6,2)</td>
<td>6,0</td>
<td>(6,2)</td>
</tr>
<tr>
<td>Lowest</td>
<td>(5,3)</td>
<td>5,7</td>
<td>(5,1)</td>
</tr>
<tr>
<td>Number of forecasters</td>
<td>(21)</td>
<td>20</td>
<td>(21)</td>
</tr>
</tbody>
</table>

*October 2013, with June forecasts in parenthesis

Source: Reuters

Inflation expectations remain stable near the upper band of the target range although the longer-term inflation trajectory is uncomfortably close to the 6 per cent level. The latest Bureau for Economic Research (BER) survey of inflation expectations for headline CPI shows that combined average expected inflation is stable around the upper end of the inflation target range.

Figure 9 shows market-determined inflation expectations associated with break-even inflation rates. Both short- and long-term break-even inflation rates have trended upwards and spiked above 7 per cent in June 2013, before declining to about 6,5 per cent.

Changes in inflation expectations have moved domestic short-term money-market rates, although the Johannesburg Interbank Agreed Rate (Jibar) remained anchored to, and tracked, movements in the repo rate. In the run-up to the May 2013 MPC meeting, the rates on forward rate agreements (FRAs) suggested a decline in short-term interest rates. However, the FRA rates reversed and increased up to August. Subsequently, money-market interest rate volatility has increased. The October results from the Reuters survey of interest rate expectations suggest that the median repo rate is expected to remain unchanged at 5,0 per cent before increasing by 50 basis points to 5,5 per cent in the first quarter of 2015.

FAQ 2: Inflation expectations and the policy stance

In an inflation-targeting regime, accountability is enhanced by the setting of a clear and measurable target. This target helps to anchor short- and long-term inflation expectations of all stakeholders. The MPC applies inflation targeting in a flexible manner, allowing for temporary deviations from the target band in the case of one-off shocks. As long as expectations are anchored, risks to inflation from temporary deviations are low.

Inflation expectations of stakeholders are influenced by the Bank’s mandate and conduct, as well as by the present level of inflation. In turn, the level and trajectory of inflation expectations, and duration above the target band, are important factors in considering any changes to the monetary policy stance.

6 The break-even inflation rate proxy for expected inflation is measured as the difference between the nominal yields on conventional South African government bonds and the real yields on CPI inflation-linked government bonds of similar maturity.

7 A forward rate is the expected future interest rate that is implied by the current interest rates. As such, it indicates the markets’ expectations about the future movements of interest rates.
The Bank gains an understanding of inflation expectations principally through a quarterly survey conducted by the BER. In this survey, economists, business people and trade unionists are asked about their expectations of inflation over a future horizon ranging from one to five years. In addition, the MPC considers market expectations of future inflation from the prices of various financial instruments that contain this information, such as the break-even rate of inflation. There are, however, challenges in interpreting expectation measures, as the processes by which various stakeholders form expectations about future inflation differ.

At present, inflation expectations as measured by the BER survey are marginally above the target band at 6.1 per cent. If these expectations rise further or stay above the upper band for a prolonged period, the MPC could consider taking steps to anchor inflation expectations to within the target band. These steps may range from a different communications strategy to actual increases in the repo rate.

Evolution of the growth outlook

The outlook for South Africa’s growth remains fragile, with modestly positive economic growth expected over the forecast horizon, Figure 11.8 The Bank lowered its forecast for real gross domestic product (GDP) growth for 2013 during the May and July 2013 MPC meetings, and again in November to 1.9 per cent. Downside risks to the domestic growth outlook persisted over the period.

Global growth

Concerted policy interventions have stimulated the global economy and supported the recovery in the wake of the contraction in world output in 2009. Global growth continues to be weak, however, and growth forecasts scaled down. Within the context of lower global growth in 2013, prospects for some advanced economies have improved this year, while emerging-market growth trends remain mixed.

Casting back to 2012, the global economy was expected to grow by 3.6 per cent in 2013. This forecast was revised downwards to 3.1 per cent in July 2013 and to 2.9 per cent by the International Monetary Fund (IMF). Global real GDP is currently projected to increase by 3.6 per cent in 2014, revised downwards from the 3.8 per cent projected earlier in 2013. Growth in 2015 is expected to be somewhat higher at 4.0 per cent.

Table 5 Global growth rates

<table>
<thead>
<tr>
<th></th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
<th>2012</th>
<th>2013*</th>
</tr>
</thead>
<tbody>
<tr>
<td>World</td>
<td>2.7</td>
<td>-0.4</td>
<td>5.2</td>
<td>3.9</td>
<td>3.2</td>
<td>2.9</td>
</tr>
<tr>
<td>Advanced economies</td>
<td>0.1</td>
<td>-3.4</td>
<td>3.0</td>
<td>1.7</td>
<td>1.5</td>
<td>1.2</td>
</tr>
<tr>
<td>Emerging-market and developing countries</td>
<td>5.8</td>
<td>3.1</td>
<td>7.5</td>
<td>6.2</td>
<td>4.9</td>
<td>4.5</td>
</tr>
<tr>
<td>Sub-Saharan Africa</td>
<td>5.7</td>
<td>2.6</td>
<td>5.6</td>
<td>5.5</td>
<td>4.9</td>
<td>5.0</td>
</tr>
</tbody>
</table>

* Figures for 2013 are estimates
Source: International Monetary Fund, World Economic Outlook, October 2013

8 See Appendix 2 on how the MPC uses the fan chart to assess the risks to the growth forecast.
Forecasts for all the BRICS countries – Brazil, Russia, India, China and South Africa – have been revised down by between 0.3 and 1.0 percentage points. The outlook for many commodity exporters (including those among the BRICS) has also deteriorated due to subdued commodity prices.

The Organisation for Economic Co-operation and Development (OECD) lowered its growth forecasts for developed economies, and now expects the combined GDP of its members to increase by only 1.2 per cent this year (down from 1.6 per cent in 2012). More muted growth forecasts align with the subdued rate of increase in the OECD industrial production index. The JPMorgan global manufacturing Purchasing Managers’ Index remained slightly above the neutral level of 50 since December 2012, before increasing to 52.1 in October 2013.

Macroeconomic policy efforts have been supportive of growth in general, with some exceptions. In the area of fiscal policy, high deficits and debt levels have severely limited policy space. Overall, macroeconomic policy efforts have had mixed global effects, with improved economic growth in the aggregate alongside considerable volatility in capital flows, currencies and asset prices for emerging markets. The latter outcomes have also increased uncertainty and depressed confidence.

Although the timing is uncertain, significant monetary accommodation in the US will abate. This QE tapering is projected alongside a more robust US economic recovery, with both accounted for in global growth forecasts. Over the forecast horizon, a stronger global recovery is expected to feed through to South Africa’s growth outcomes and provide some buoyancy that is not evident in current conditions.

The pace of growth in commodity prices is expected to remain subdued, reflecting the expectation of a gradual global economic recovery. While oil prices have increased in recent months, a reduction in geopolitical tensions and rising crude-oil output are expected to lead to a moderation in oil prices over the near term. These considerations suggest that monetary policy in many advanced economies will remain relatively expansionary for some time. Despite the high probability of short-term volatility in currencies and interest rates, improving global growth outcomes may soften the impact of QE tapering on the level of global interest rates in the long run.

**Domestic growth**

Since the previous MPR, uncertainty and fragile global growth have weighed heavily on domestic growth prospects, largely through their dampening effect on South African commodity export prices and trade volumes. Domestic factors have dragged economic growth down further. These factors include rising inflation, protracted labour unrest and electricity supply bottlenecks, all of which have constrained household consumption expenditure, investment and exports.

The pace of domestic economic activity picked up notably to 3.0 per cent in the second quarter of 2013, rebounding somewhat from the low 0.9 per cent in the first quarter. The most recent central projections, which assume an unchanged repo rate, forecast annual growth to average 1.9 per cent in 2013. Furthermore, growth is now expected to average 3.0 per cent in 2014 and 3.4 per cent in 2015, compared with the 3.3 per cent and 3.6 per cent indicated in the September forecast.
Table 6  The Bank’s real GDP growth forecasts

<table>
<thead>
<tr>
<th>MPC meetings</th>
<th>Real GDP growth</th>
</tr>
</thead>
<tbody>
<tr>
<td>2013</td>
<td>2013 Expected peak</td>
</tr>
<tr>
<td>March.............</td>
<td>2.7</td>
</tr>
<tr>
<td>May..............</td>
<td>2.4</td>
</tr>
<tr>
<td>July.............</td>
<td>2.0</td>
</tr>
<tr>
<td>September .......</td>
<td>2.0</td>
</tr>
<tr>
<td>November .......</td>
<td>1.9</td>
</tr>
</tbody>
</table>

Source: South African Reserve Bank

Business and consumer confidence have fluctuated throughout the year, indicative of often-negative short-term economic news. Low growth in disposable income and employment, as well as the current high levels of household debt, continue to strain consumer confidence. Confidence among businesses has varied across sectors, but has remained low in general.

Table 7  Domestic economic sentiment indicators

<table>
<thead>
<tr>
<th>Indicator</th>
<th>Historic range</th>
<th>Most recent</th>
<th>As at MPR*</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Low</td>
<td>High</td>
<td>Low</td>
</tr>
<tr>
<td>RMB/BER Business Confidence Index . . .</td>
<td>10</td>
<td>91</td>
<td>23</td>
</tr>
<tr>
<td>BER Manufacturing Confidence Index . . .</td>
<td>11</td>
<td>93</td>
<td>11</td>
</tr>
<tr>
<td>Ernst &amp; Young/BER Retail Confidence Index . . .</td>
<td>0</td>
<td>94</td>
<td>35</td>
</tr>
<tr>
<td>FNB Building Confidence Index . . .</td>
<td>11</td>
<td>89</td>
<td>23</td>
</tr>
<tr>
<td>Kagiso/BER Purchasing Managers’ Index . . .</td>
<td>34.6</td>
<td>63.4</td>
<td>46.6</td>
</tr>
<tr>
<td>FNB/BER Consumer Confidence Index . . .</td>
<td>-33</td>
<td>23</td>
<td>-8</td>
</tr>
</tbody>
</table>

* Improved/Worsened since previous MPR

Sources: Kagiso Securities, Rand Merchant Bank, First National Bank, Ernst & Young and the Bureau for Economic Research, Stellenbosch University

Household consumption and wealth effects

Household consumption expenditure is influenced by disposable income, asset prices and credit extension. Growth in both household consumption expenditure and disposable income edged slightly higher in the second quarter of 2013. However, these growth rates improved at a slower pace compared to the past three years, reflecting the constraints on real income of weak employment growth and elevated inflation. Consumption expenditure remains impeded by the high ratio of household debt to disposable income that has declined since its peak in 2009 but levelled off during 2013. Going forward, household consumption expenditure may be supported to some extent by wage trends.
Table 8 Growth in real expenditure components

<table>
<thead>
<tr>
<th>Per cent*</th>
<th>2011</th>
<th>2012</th>
<th>2013</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year</td>
<td>Year</td>
<td>1st qr</td>
<td>2nd qr</td>
</tr>
<tr>
<td>Final consumption expenditure</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Households</td>
<td>4.8</td>
<td>3.5</td>
<td>2.3</td>
</tr>
<tr>
<td>General government</td>
<td>4.6</td>
<td>4.2</td>
<td>3.0</td>
</tr>
<tr>
<td>Gross fixed capital formation</td>
<td>4.5</td>
<td>5.7</td>
<td>2.5</td>
</tr>
<tr>
<td>Changes in inventories (R billions)**</td>
<td>5.1</td>
<td>3.3</td>
<td>4.0</td>
</tr>
<tr>
<td>Gross domestic expenditure</td>
<td>4.6</td>
<td>4.1</td>
<td>3.5</td>
</tr>
<tr>
<td>Exports of goods and services</td>
<td>5.9</td>
<td>0.1</td>
<td>29.5</td>
</tr>
<tr>
<td>Imports of goods and services</td>
<td>9.7</td>
<td>6.3</td>
<td>32.5</td>
</tr>
</tbody>
</table>

* Quarterly data refer to quarter-on-quarter growth at seasonally adjusted annualised rates
** Constant 2005 prices

Source: South African Reserve Bank

Box 1 Tracking South Africa’s economic recovery

In 2005 South Africa achieved real economic growth above 5 per cent for the year, for the first time since 1984. This robust economic performance continued until 2007, when the financial crisis erupted.

As global demand fell in 2008 and 2009, South Africa saw a significant reduction in its real exports of goods and services. While household expenditure and gross fixed capital formation declined, the rate of growth of GDP turned negative in the final quarter of 2008 and remained negative during the first half of 2009. Subsequently, South Africa’s economic growth has been positive, although it took a further year (until the second quarter of 2010) to reach its pre-crisis level. Since 2008 the average rate of growth has been about 2.0 per cent.

After the creation of about two million jobs in the period 2004 to 2008, the financial crisis and the ensuing global recession led to one million jobs being lost and a worsening rate of unemployment. The mining sector’s employment levels remained fairly stable since the beginning of the crisis, with a brief dip in 2008–2009 but reaching peak levels during 2012. Although the volume of manufacturing production experienced a slow and steady recovery, employment in the manufacturing sector fell after the crisis and has remained low ever since. A range of factors contributed to this, including increasing mechanisation in the face of tense labour relations and uncertainty about the expected path of the global recovery (and hence demand for manufactured goods). Consistently positive annual output growth in the tertiary sector throughout the financial crisis was accompanied by a stable level of employment in this sector, supported by continued job growth in the public sector.

The global financial crisis did not have a direct and lasting impact on South African financial markets. The rate of credit extension to households and the private sector did ebb for a while after the crisis struck, as banks and policymakers adapted to global developments. Growth in mortgage advances remains muted. This may indicate the reluctance of banks and borrowers to take on large and longer-term debt contracts. However, most other types of credit have recovered.

Asset prices

Household income remains strongly supported by developments in domestic share prices, which in rand terms continued along a strong upward trend in 2013. The FTSE/JSE All-Share Price Index (Alsi) continued to scale new all-time highs to 46 193 index points on 6 November 2013. At these levels, share prices may incentivise listed companies to raise more capital, which may in turn support fixed capital formation.
A comparison of the Alsi, in rand and US dollar terms since the beginning of 2012, shows the impact of the rand’s depreciation on domestic share prices (mainly through repatriated earnings, rand-hedges, and pricing of dual-listed shares). In US dollar terms, South Africa’s share prices closely followed those of commodity-producing Canada and Australia.

The moderate pace of growth in the residential real-estate market seen earlier in the year lost some momentum. This can be seen in growth in Absa’s nominal house price index, which decelerated somewhat from a high 11.9 per cent in April 2013 to 8.1 per cent in October. Growth in real house prices remained positive from December 2012, but decelerated from 5.7 per cent in April 2013 to 2.4 per cent in October. Although a marginal expansion in real house prices is expected, the real-estate market remains constrained by muted growth in mortgage finance.

Credit conditions

Since November 2010, the low and stable interest rate environment has supported real growth in overall credit extension. Credit extension by banks remained broadly in line with money-supply and nominal GDP growth.

More recently, growth in banks’ total loans and advances to the private sector moderated since the recent peak of 10.0 per cent in December 2012 to 8.4 per cent in September 2013. Mortgage lending, which prior to the crisis comprised the largest component of credit extended, has remained quite low. In contrast, instalment sale credit and leasing finance for the acquisition of vehicles has grown relatively strongly. Support from another main driver, other loans and advances,9 moderated mainly due to a slowdown in general loans to 14.7 per cent in September. Slower growth in general loans reflected weaker household credit demand and increased caution on the part of lenders who were faced with increased regulatory scrutiny regarding unsecured loans.10 Credit extension to households is likely to constrain consumption expenditure in the short- to medium term.

Government expenditure

In real terms, government consumption expenditure grew by 3.3 per cent in the first half of 2013, compared to 4.0 per cent over the same period of 2012. Non-interest expenditure is expected to grow by an annual average of 2.2 per cent over the medium-term expenditure framework (MTEF). The Medium Term Budget Policy Statement maintained the countercyclical fiscal stance, providing support to close the output gap, while setting out a consolidation path to reduce the budget deficit over time. The public-sector wage bill is estimated to decline as a share of total expenditure, contributing towards fiscal consolidation and the rebuilding of fiscal space to fund new priorities.

As a ratio of GDP, total net loan debt is expected to stabilise at 44 per cent in 2017/18. Interest payments, consisting on average of 9.1 per cent of total expenditure annually over the MTEF, is the fastest-growing item of expenditure in the consolidated budget. Over the longer term, government has set itself the objective of rebuilding fiscal space by stabilising and then reducing the ratio of public debt to GDP.

9 The category other loans and advances consists of general loans and advances, credit card advances and overdrafts.

10 To manage risk and limit impairments.
Capacity utilisation

Capacity utilisation – a measure of resource use in the economy – has trended upwards since its low in 2009, rising from 77 per cent to almost 83 per cent late in 2012. It has since fallen, declining in the first quarter of 2013 but then improved marginally in subsequent quarters.

The main contributor to under-utilisation of production capacity is insufficient demand. The shortage of resources remained broadly unchanged with skilled labour and raw material shortages the major contributors, underscoring the need for policies to bring about structural changes.

The output gap

The sizeable deceleration in the pace of economic activity in the first and third quarters of 2013 contributed to a wider output gap, which is expected to deteriorate further in 2014. The output gap will narrow slightly at a slow pace towards the end of the forecast horizon, in line with gradual domestic economic recovery. The current size of the output gap suggests an absence of significant demand pressures in the domestic economy and softens upside pressures on inflation.

11 Generally, a sustained negative output gap (i.e., where actual output is lower than potential output) is associated with weak demand conditions and subdued inflationary pressures. In contrast, a positive output gap (i.e., where actual output is higher than potential output) implies robust demand conditions and is indicative of rising inflationary pressures. See Appendix 3 on how the Bank derives the output gap.

Box 2 The impact of the global financial and economic crisis on South Africa’s potential output

Potential output is the highest level of non-inflationary sustainable GDP that the productive capacity of an economy is able to deliver. This concept remains unobservable and needs to be estimated. The Bank uses several methodologies to estimate potential output, which can then be combined into an equally-weighted aggregate measure, focusing on the longer-term average trend growth of potential output. The output gap is defined as the difference between the actual level of real output and the estimated potential level of real output. The change in the output gap is an indicator of price and wage pressures in an economy.

Figure B2.1 shows how the level of real actual output and the aggregate measure of real potential output have changed in South Africa since the onset of the global crisis. The impact of the 2008–2009 slowdown in economic activity is clear with actual real output remaining below the potential output measure since 2009. For the period 1998 to 2011, annual average real growth in potential output was estimated at 3.5 per cent. The size of the negative output gap was estimated at between 1.5 per cent and 2.0 per cent from 2009 to 2011. Closing this output gap will require real actual output growth in excess of real potential output growth.

The IMF has recently considered why output growth in the BRICS countries has weakened following the global financial crisis, separating out structural (with significant negative implications for the global economy) and cyclical (i.e., transitory) factors.

2 These methodologies produce outcomes that are not materially different and include de-trending smoothing techniques (Hodrick-Prescott filter), as well as structural and semi-structural techniques (the Bank’s potential GDP model, general equilibrium models and multivariate Hodrick-Prescott filter).
3 See IMF World Economic Outlook (WEO), October 2013, pp.41–44, Box 1.2. “What Explains the Slowdown in the BRICs?”
Risks to the outlook

The Bank bases its projections on a set of key assumptions about the future behaviour of the main macroeconomic variables. These assumptions inform the baseline scenario. However, due to risks associated with macroeconomic variables, the MPC also considers alternative scenarios. This section discusses global and domestic risks to the Bank’s baseline scenario.

Global risks

Economic growth and policy risk

A key set of risks concern the trajectory of the global economy. Over the course of the financial crisis, sharply higher global uncertainty and volatility resulted in the systematic downward revision of global growth forecasts as expected growth rates were not realised. These projections depend on a gradual strengthening of the global economy, driven by better performance in key advanced economies, stabilisation in the euro area and improving emerging-market outcomes.

Policy settings in major world economies continue to support the recovery. In June 2013, the Fed signalled a potential moderation in the pace of asset purchases and stated that the current low level of the federal funds rate will remain appropriate even after asset purchases (QE) are concluded. The October policy meeting concluded with accommodative policy intact and no clear signal about when this tapering would begin, in part due to conflicting economic outcomes.

In July, the European Central Bank (ECB) committed to keeping its monetary policy stance accommodative for as long as necessary to support growth. This was followed by a 25 basis point cut to its policy rate in November. The Bank of England (BOE) in August linked changes in the interest rate and asset sales to an unemployment threshold of 7 per cent, although a 2 per cent inflation target remains its primary objective.12

12 In its most recent statement, the BOE indicated that the unemployment rate may fall to 7 per cent sooner than previously projected, leading to speculation that the benchmark interest rate may be raised earlier than previously anticipated.
The Bank of Japan has indicated the open-ended continuation of its quantitative and qualitative easing programme. Inflationary pressures have prompted monetary policy responses in a number of countries, including Brazil, Indonesia and India, all of which have raised policy rates.

Fiscal policy uncertainty has proved to be a major challenge to the world economy. However, in advanced countries, fiscal consolidation is being calibrated to reduce risks to near-term economic activity while enhancing long-term growth prospects. In the euro area, government borrowing costs have returned to more sustainable levels in recent months as intra-euro area bond spreads narrowed sharply. Furthermore, some emerging-market economies have started rebuilding fiscal space.

### Table 9  Selected central bank interest rates

<table>
<thead>
<tr>
<th>Countries</th>
<th>23 May 2013</th>
<th>21 Nov 2013</th>
<th>2013 Cumulative</th>
</tr>
</thead>
<tbody>
<tr>
<td>South Africa</td>
<td>5,00</td>
<td>5,00</td>
<td>0,00</td>
</tr>
<tr>
<td>United States</td>
<td>0,00–0,25</td>
<td>0,00–0,25</td>
<td>0,00</td>
</tr>
<tr>
<td>Japan*</td>
<td>0,30</td>
<td>0,30</td>
<td>0,00</td>
</tr>
<tr>
<td>Euro area</td>
<td>0,50</td>
<td>0,25</td>
<td>-0,50</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>0,50</td>
<td>0,50</td>
<td>0,00</td>
</tr>
<tr>
<td>Canada</td>
<td>1,00</td>
<td>1,00</td>
<td>0,00</td>
</tr>
<tr>
<td>China</td>
<td>6,00</td>
<td>6,00</td>
<td>0,00</td>
</tr>
<tr>
<td>India</td>
<td>7,25</td>
<td>7,75</td>
<td>-0,25</td>
</tr>
<tr>
<td>Russia**</td>
<td></td>
<td>5,50</td>
<td></td>
</tr>
<tr>
<td>Brazil</td>
<td>7,50</td>
<td>9,50</td>
<td>2,25</td>
</tr>
<tr>
<td>Australia</td>
<td>2,75</td>
<td>2,50</td>
<td>-0,50</td>
</tr>
<tr>
<td>New Zealand</td>
<td>2,50</td>
<td>2,50</td>
<td>0,00</td>
</tr>
<tr>
<td>South Korea</td>
<td>2,50</td>
<td>2,50</td>
<td>-0,25</td>
</tr>
<tr>
<td>Indonesia</td>
<td>5,75</td>
<td>7,50</td>
<td>1,75</td>
</tr>
<tr>
<td>Chile</td>
<td>5,00</td>
<td>4,50</td>
<td>-0,50</td>
</tr>
<tr>
<td>Mexico</td>
<td>4,00</td>
<td>3,50</td>
<td>-1,00</td>
</tr>
<tr>
<td>Turkey</td>
<td>4,50</td>
<td>4,50</td>
<td>-1,00</td>
</tr>
</tbody>
</table>

* The Bank of Japan announced a change in its monetary target from the uncollateralised overnight call rate to the monetary base (to increase by ¥60–70 trillion annually) on 4 April 2013, thus the basic loan rate is now used in the table

** The Bank of Russia announced a transition to inflation targeting on 13 September 2013, hence the one-week liquidity provision interest rate (the key policy rate) is now used in the table

** Tapering of quantitative easing and financial risks

An important external risk arises from the unwinding of unconventional monetary policies in advanced economies, in particular QE tapering in the US. Tapering could threaten growth prospects through spillover effects, especially where buoyant global financial asset prices do not reflect underlying economic fundamentals. QE tapering should reflect a stronger US economy, which is favourable for both global and domestic growth. However, tapering also implies less monetary accommodation to financial markets, potential losses as prices of emerging-market assets fall, and higher borrowing costs for emerging markets that will increase macroeconomic risk.
Improved growth prospects in advanced economies have had an effect on the behaviour of investment in asset markets. Domestic bond yields rose and became more volatile from May following the announcement of the possible tapering of QE. In South Africa, non-resident net sales of shares of R3,4 billion in 2012 changed to net purchases of R4,8 billion in 2013 year-to-date. Net purchases of bonds fell from R88,6 billion in 2012 to only R12,6 billion in 2013 year-to-date along with increased volatility in the demand for bonds. This outcome was driven by a significant net sell-off of domestic bonds and equities in November.

EMBI13 spreads suggest that despite unique domestic challenges and heightened financial market volatility in the emerging-market universe, South Africa has managed to remain favourably positioned relative to other emerging-market economies. The relatively orderly adjustment in the bond market suggests continued non-resident portfolio inflows and adequate funding of the budget deficit.

**Currency and balance-of-payments risks**

Emerging-market currencies are vulnerable to the longer-term adjustment in global bond yields. Part of the risk lies in the interaction between global developments, such as QE tapering, and domestic vulnerabilities. Downward pressure on currencies has been the result for a range of emerging-market economies, including South Africa.

The rand has depreciated by 20,3 per cent against the US dollar since the beginning of the year, of which 6,6 per cent was recorded since the May 2013 MPC. Sharply weaker non-resident portfolio inflows, lower international commodity prices14 (and therefore lower terms of trade) and perceived current-account vulnerability have contributed to these movements. On a bilateral basis the rand weakened to its lowest post-crisis level of R10,44 to the US dollar on 27 August.

Since the nominal effective exchange rate's (NEER) post-crisis peak in December 2010, it has weakened persistently by 33,9 per cent, of which 15,7 per cent was recorded since the beginning of 2013. On a trade-weighted basis, the rand remained more or less unchanged since June 2013. The close co-movement between the real effective exchange rate (REER)15 of the rand and the REERs of developed commodity-exporting countries and emerging markets has broken down since mid-2011.

Currency depreciation and its pass-through into domestic prices is likely to remain a key risk to the inflation outlook. Despite a fairly sustained depreciation since May 2011, the pass-through has nonetheless been unusually muted, deviating from previous episodes of currency weakness. This may be due to the weak global recovery and South Africa’s negative output gap, both of which tend to reduce the pricing power of firms.

Trend movements in the currency can help to reduce macroeconomic imbalances. The flexibility of the exchange rate acts as a shock absorber and helps to manage vulnerabilities. Since May 2011, the rand has depreciated in real terms by 20,5 per cent. Over time, this is expected to lower import growth and strengthen export growth, and contribute to an improvement

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13 The EMBI+ is a US dollar emerging-market debt benchmark that tracks returns for actively traded external emerging-market debt.
14 The TRJ/CRB Total Return Index reflects a long-only, broadly diversified investment in commodities.
15 The REER in this case is produced by the Bank for International Settlements (BIS).
in the trade balance. Thus far, the response of exports and imports to depreciation has been weak.

Despite stronger growth in advanced economies and further rand depreciation, the trade deficit widened in the first half of 2013, owing to weak second-quarter trade figures. Although export growth by volume was slightly higher than that of imports in the second quarter of 2013, the terms of trade deteriorated due to falling commodity prices. Overall, export volumes did not improve sufficiently to offset this fall. The current-account deficit widened to 6.5 per cent of GDP in the second quarter of 2013, as both the trade deficit and services, income and current transfer account deficit increased. Lagged effects from rand movements may take shape only over the longer run.

FAQ 3: Why has the current account of the balance of payments been slow to adjust to the exchange rate depreciation?

Currency depreciation can narrow the current-account deficit as the relative price of imports to domestically produced goods rises, squeezing imports; and as domestically produced goods become relatively cheaper in international markets, raising demand for exports. The rand (NEER) has depreciated by 30.4 per cent since May 2011, but the current-account deficit has not yet responded significantly to this depreciation. Possible reasons for the slow adjustment of the current account include the following:

- Slow adjustment in trade volumes after exchange rate depreciation. Exchange rate depreciation implies higher domestic prices of imported goods. If import volumes are slow to adjust, the value (volume multiplied by price) of imports can rise.
- Around 80 per cent of merchandise imports in South Africa are intermediate goods (including fuel) and capital goods that support gross fixed capital formation. This imparts some rigidity to import volumes, limiting downward adjustment.
- Partly because of the weak domestic economy, the pass-through to inflation from the weaker exchange rate has been more muted than usual, implying that retailers are reducing their profit margins. While this is positive for the inflation rate, it reduces the incentive for consumers either to switch to locally manufactured goods or to reduce their purchases of imported goods.
- There are normal lags in the adjustment by local manufacturers to a depreciated exchange rate. Breaking into new markets takes time, and producers would want to be sure that the improvement in competitiveness will be sustained.
- Labour disputes and strikes in a number of key sectors of the economy have impacted negatively on exports over this period.
- Prices for agricultural and mineral commodities have declined in global markets. Exchange rate depreciation helps to cushion the impact of lower US dollar prices on domestic producers. However, it does not provide an impetus to export more in volume terms.
- Continued slow growth in some of our major trading partners, particularly in Europe, has constrained demand for our manufactured exports.
Domestic risks

The Bank’s forecast is clouded by domestic risks. South Africa’s economic growth rate is sensitive to changes in household expenditure, which in turn is affected by administered prices, high consumer debt levels and service costs, and tighter lending standards. Real household incomes are further eroded by rising inflation and in particular petrol and electricity prices. As aggregate growth slows, real incomes also rise more slowly, limiting growth in consumption expenditure.

Low consumer and business confidence, as well as protracted supply constraints continue to dampen growth in gross fixed capital formation. Private fixed capital formation is expected to grow only modestly over the medium term, and appears to be sensitive to tense labour relations and work stoppages, as well as to global events.

The increase in electricity supply was delayed and remains inadequate to date, with costs to firms and households rising. This creates disincentives for fixed capital formation and growth that could lead to deeper downside risks to the forecast. Stronger growth in cost-push pressures and unit labour costs would tend to worsen the trade-off between wage growth and weak productivity relative to employment outcomes.

The exchange rate of the rand remains an increasingly upside risk to the inflation outlook against the backdrop of a possible further depreciation of the currency, notwithstanding relatively slow pass-through to consumer prices to date. Wage pressures and increases in unit labour costs also negatively affect the inflation outlook.

Conversely, a stronger global economic recovery implies positive risks for the economic growth outlook in South Africa. This recovery could result from better outcomes in advanced economies, a quicker rebound in emerging markets or a combination of the two. Similarly, a number of domestic risks could be alleviated through actions that would improve South Africa’s real GDP forecast. These actions include a more rapid pace of job creation, improved infrastructure and greater certainty about the cost and supply of intermediate inputs.

Review of global and domestic inflation

This section reviews recent trends in global and domestic inflation. Whereas price pressures in advanced economies have softened, emerging-market economies face somewhat stronger inflationary pressures. In South Africa, exogenous prices remain the key drivers of headline inflation outcomes, with core inflation trending upwards.

Global inflation

Global inflation in 2013 remained broadly contained due to modest global growth and soft commodity prices. Inflation declined in advanced economies, especially in the euro area. In Japan, deflation eased as inflation expectations increased. Sustained negative output gaps in major economies underscore low inflation forecasts for much of the world economy. Consumer price inflation in emerging-market and developing countries is projected to
decelerate from 6,2 per cent in 2013 to 5,7 per cent in 2014 and 5,2 per cent in 2015. As 2013 progressed, significant currency weakness in a wide range of emerging-market and developing economies led to increased inflation.

Table 10 IMF projections of world inflation*

<table>
<thead>
<tr>
<th>Consumer prices</th>
<th>2013</th>
<th>2014</th>
<th>2015</th>
</tr>
</thead>
<tbody>
<tr>
<td>World</td>
<td>(3,8)</td>
<td>3,8</td>
<td>(3,7)</td>
</tr>
<tr>
<td>Advanced economies</td>
<td>(1,7)</td>
<td>1,4</td>
<td>(1,9)</td>
</tr>
<tr>
<td>United States</td>
<td>(1,8)</td>
<td>1,4</td>
<td>(1,9)</td>
</tr>
<tr>
<td>Japan</td>
<td>(0,1)</td>
<td>0,0</td>
<td>(2,3)</td>
</tr>
<tr>
<td>Euro area</td>
<td>(1,7)</td>
<td>1,5</td>
<td>(1,5)</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>(2,7)</td>
<td>2,7</td>
<td>(2,3)</td>
</tr>
<tr>
<td>Canada</td>
<td>(1,5)</td>
<td>1,1</td>
<td>(1,9)</td>
</tr>
<tr>
<td>Other advanced economies</td>
<td>(2,1)</td>
<td>1,5</td>
<td>(2,5)</td>
</tr>
<tr>
<td>Emerging-market and developing countries</td>
<td>(5,9)</td>
<td>6,2</td>
<td>(5,3)</td>
</tr>
<tr>
<td>Sub-Saharan Africa</td>
<td>(7,2)</td>
<td>6,9</td>
<td>(5,7)</td>
</tr>
<tr>
<td>South Africa</td>
<td>(5,8)</td>
<td>5,9</td>
<td>(5,5)</td>
</tr>
<tr>
<td>Central and eastern Europe</td>
<td>(4,4)</td>
<td>4,1</td>
<td>(3,5)</td>
</tr>
<tr>
<td>Commonwealth of Independent States</td>
<td>(6,8)</td>
<td>6,5</td>
<td>(6,6)</td>
</tr>
<tr>
<td>Developing Asia</td>
<td>(5,0)</td>
<td>5,0</td>
<td>(4,7)</td>
</tr>
<tr>
<td>China</td>
<td>(3,0)</td>
<td>2,7</td>
<td>(3,0)</td>
</tr>
<tr>
<td>India</td>
<td>(10,8)</td>
<td>10,9</td>
<td>(9,5)</td>
</tr>
<tr>
<td>Middle East and North Africa</td>
<td>(9,6)</td>
<td>12,3</td>
<td>(8,1)</td>
</tr>
<tr>
<td>Latin America and the Caribbean</td>
<td>(6,1)</td>
<td>6,7</td>
<td>(5,4)</td>
</tr>
</tbody>
</table>

* IMF projections as at April 2013 ( ) in parenthesis

Source: International Monetary Fund, World Economic Outlook, October 2013

**Domestic inflation**

**Consumer prices**

Both headline and core inflation have gradually accelerated along a similar trend since the middle of 2012. Food and petrol price pressures were the main drivers of this acceleration, with currency depreciation risk evident. Administered prices have had a strong influence on inflation outcomes, specifically through electricity, education, petrol and water price changes.

The 12-month change in the administered price index (API) remained significantly above 6,0 per cent and accelerated noticeably through to July and August before moderating somewhat in September and October. In terms of their contribution, changes in petrol prices had a major effect on the API over the period under review. This is evident from the gap between inflation of the API excluding petrol and paraffin and total API inflation. By August 2013 the full effect of the new electricity price as set by municipalities resulted in a decrease of 0,5 percentage points in the contribution of electricity to administered prices.16

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16 Municipalities change electricity prices once a year, with a majority effecting this change as at July each year; however, a few do so in August. As a result, the 0,5 percentage point change in the contribution of electricity to the API has been calculated using the June 2013 and August 2013 contributions.
Table 11 Contributions to administered prices

<table>
<thead>
<tr>
<th>Weights 2013</th>
<th>CPI</th>
<th>API</th>
<th>Apr</th>
<th>May</th>
<th>Jun</th>
<th>Jul</th>
<th>Aug</th>
<th>Sep</th>
<th>Oct</th>
</tr>
</thead>
<tbody>
<tr>
<td>CPI for administered prices*</td>
<td>18,48</td>
<td>100,00</td>
<td>8,9</td>
<td>6,3</td>
<td>7,5</td>
<td>11,1</td>
<td>11,1</td>
<td>8,9</td>
<td>7,8</td>
</tr>
<tr>
<td>CPI for administered prices excluding petrol and paraffin*</td>
<td>12,75</td>
<td>68,99</td>
<td>7,8</td>
<td>7,8</td>
<td>8,1</td>
<td>7,3</td>
<td>7,0</td>
<td>7,0</td>
<td>7,1</td>
</tr>
<tr>
<td>Regulated component</td>
<td></td>
<td></td>
<td></td>
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<td></td>
<td></td>
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<td></td>
<td></td>
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<tr>
<td>Water</td>
<td>1,55</td>
<td>8,39</td>
<td>0,9</td>
<td>0,9</td>
<td>0,9</td>
<td>0,9</td>
<td>0,8</td>
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<tr>
<td>Electricity</td>
<td>4,13</td>
<td>22,35</td>
<td>2,1</td>
<td>2,1</td>
<td>2,1</td>
<td>1,8</td>
<td>1,6</td>
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<tr>
<td>Petrol</td>
<td>5,68</td>
<td>30,74</td>
<td>3,3</td>
<td>0,6</td>
<td>1,9</td>
<td>6,4</td>
<td>6,6</td>
<td>3,9</td>
<td>2,9</td>
</tr>
<tr>
<td>Other regulated administered prices</td>
<td>2,34</td>
<td>12,66</td>
<td>0,2</td>
<td>0,2</td>
<td>0,3</td>
<td>0,4</td>
<td>0,5</td>
<td>0,4</td>
<td>0,5</td>
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<tr>
<td>Unregulated component</td>
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<td></td>
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<td></td>
<td></td>
</tr>
<tr>
<td>Assessment rates</td>
<td>1,30</td>
<td>7,03</td>
<td>0,5</td>
<td>0,5</td>
<td>0,5</td>
<td>0,5</td>
<td>0,4</td>
<td>0,4</td>
<td>0,4</td>
</tr>
<tr>
<td>Primary and secondary school fees</td>
<td>1,72</td>
<td>9,31</td>
<td>0,9</td>
<td>0,9</td>
<td>0,9</td>
<td>0,9</td>
<td>0,9</td>
<td>0,9</td>
<td>0,9</td>
</tr>
<tr>
<td>University fees</td>
<td>1,23</td>
<td>6,66</td>
<td>0,6</td>
<td>0,6</td>
<td>0,6</td>
<td>0,6</td>
<td>0,6</td>
<td>0,6</td>
<td>0,6</td>
</tr>
<tr>
<td>Other unregulated administered prices</td>
<td>0,53</td>
<td>2,87</td>
<td>0,1</td>
<td>0,1</td>
<td>0,2</td>
<td>0,2</td>
<td>0,1</td>
<td>0,1</td>
<td>0,1</td>
</tr>
</tbody>
</table>

Source: Statistics South Africa

Domestic food prices, with a significant weight of 14,2 per cent in the CPI, have increased since June 2013. At the same time, international food price inflation has been negative. The contrasting trends in the measures of international and domestic food prices are partly the result of the stage of production at which prices are measured and the different compositions of the two indices. For example, the Food and Agriculture Organization (FAO) food price index measures grains and cereals at an earlier stage of production than they are measured in South Africa’s CPI. During 2013, processed food inflation, as measured in South Africa’s headline inflation, has averaged 7,2 per cent, higher than unprocessed food inflation at 5,5 per cent. The weighting also differs substantially as the different components in the FAO food price index are trade weighted while South Africa’s CPI is consumption weighted.

Over the review period, petrol prices trended upwards, rising to multiple highs. Changes in the petrol price are influenced by the changes in the international oil price and movements of the rand. Figure 28 shows the relationship between changes in the spot and futures prices of Brent crude oil in both US dollar and rand terms, together with the lagged changes in the South African petrol price.

**Producer prices**

The producer price indices provide an indication about price changes along the value chain. The headline producer price index (PPI) is the PPI for final manufactured goods, measured at the factory gate. Headline PPI gives an early indication about price changes in locally produced goods that may, in the future, be consumed domestically.
Headline PPI increased to above 6,0 per cent from July 2013, reflecting high food and fluctuating petrol prices. Recent movements in intermediate manufactured goods price inflation have been driven by the effect of rand weakness on import prices. This is evidenced by steep increases in inflation for rubber products and basic precious and non-ferrous metals.

Table 12 Measureds of producer price inflation

<table>
<thead>
<tr>
<th>Percentage change over 12 months</th>
<th>2013</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Apr</td>
</tr>
<tr>
<td>Final manufactured goods</td>
<td>5,4</td>
</tr>
<tr>
<td>Excluding:</td>
<td></td>
</tr>
<tr>
<td>Petroleum products</td>
<td>5,4</td>
</tr>
<tr>
<td>Food</td>
<td>5,3</td>
</tr>
<tr>
<td>Intermediate manufactured goods</td>
<td>7,2</td>
</tr>
<tr>
<td>Electricity and water</td>
<td>12,9</td>
</tr>
<tr>
<td>Mining</td>
<td>4,8</td>
</tr>
<tr>
<td>Agriculture, forestry and fishing</td>
<td>1,7</td>
</tr>
</tbody>
</table>

Source: Statistics South Africa

Wages and unit labour costs

Rising labour costs and above-inflation wage agreements indicate higher inflationary pressures going forward, some of which may be offset by job losses or slower employment growth. These settlements, rising from 7,6 per cent in 2012 to 7,9 per cent in the first nine months of 2013, reflect the influence of last year’s labour disputes on current wage negotiations and higher realised inflation. In June 2013, the majority of settlements were expected to fall within the 7,5 to 8,5 per cent range, but the emergence of rival unions has introduced an element of unpredictability.

Wage increases in excess of output growth (indicating muted productivity gains) resulted in nominal unit labour costs rising from 5,2 per cent in the fourth quarter of 2012 to 6,8 per cent in the second quarter of 2013. Average real wage settlements levelled off at 1,9 per cent from 2012 despite sluggish economic growth and weak job creation. Real unit labour costs also increased as nominal unit labour costs grew by more than inflation.

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18 As reported in the September 2013 Andrew Levy Wage Settlement Survey.
Appendices

The following appendices are intended to assist in interpreting the indicator of the probability that inflation will be above the target, the growth and inflation fan charts, and the output gap.

Appendix 1: Indicator of the probability that inflation will be above the target

The indicator of the probability that inflation will be above target is derived from the probability distribution around the inflation fan chart’s median projection. It indicates the assessed cumulative probability of inflation being above the 6 per cent upper band of the 3 to 6 per cent inflation target range in each quarter of the forecast period. The line is purposefully wide to show the 5 per cent level of uncertainty around the central projection and more precise probability of the forecast, but should not be interpreted as a confidence interval.

Appendix 2: The Bank’s fan charts

The MPC uses fan charts to focus the discussion of risks lying ahead and their impact on the inflation and growth forecasts.

Fan chart projections are based on assumptions and are subject to uncertainty. These graphical representations reflect the MPC’s collective judgement (a single view of the probability) of the most likely path of inflation and growth outcomes in the future. However, there is no mechanical link between either the central projection or the distribution at the forecast horizon and the setting of monetary policy.

Fan charts reflect the MPC’s view of uncertainty associated with the projections at different horizons through a range of confidence intervals. The mode – darkest band at the centre of the fan chart – represents the most likely 10 per cent of the probable outcomes, including the central projection. Moving away from the central projection, the area covered by each successive band, shaded slightly lighter and added on either side of the central band, adds a further 10 per cent to the probability, until the whole shaded area depicts a 90 per cent confidence interval. The width of the coloured confidence bands is an indication of the estimated uncertainty. The fan becomes progressively wider and flatter as the projection extends into the future, reflecting increased uncertainty.

The MPC also takes a view on the balance of risks. The probability distribution will be symmetrical if risks are viewed as evenly spread. If risks are viewed as not evenly spread then the probability distribution will be asymmetrical and skewed. A skewed probability distribution reflects a higher likelihood of outcomes in one direction (above or below the central projection). An upward bias is reflected by a slightly larger shaded area covered by the upper bands and a downward bias by a slightly larger shaded area covered by the lower bands.

19 Actual inflation and growth outcomes are therefore expected to be somewhere within the fan on 90 out of 100 occasions. For the remaining 10 out of 100 occasions inflation and growth can be anywhere in the area outside the shaded range.
Appendix 3: The Bank’s estimate of the output gap

The output gap (both its size and changes to it) is an important measure of under- or over-utilisation of resources. It enhances the analysis of demand pressures in the economy and serves as an indicator of inflationary pressure in the current period and over the forecast horizon.\(^{20}\)

The output gap is the difference between actual output (GDP) and potential output. Potential output reflects the level of sustainable output that is consistent with stable inflation and is an unobserved variable.\(^{21}\) As a result, the output gap is not directly measurable and must therefore be estimated.\(^{22}\) Changes in the output gap over time occur because of variations in the level of actual GDP and the level of potential output. The variation in the former is a reflection of the business cycle and shocks, while the variation in the latter is a function of factors that affect the productive capacity in the economy. These factors include productivity and labour force developments, as well as economic shocks.

The estimation of the output gap is a technical exercise that relies on statistical and structural methodologies to produce an aggregate measure that satisfies certain criteria. These criteria include economic consistency, specification robustness, flexibility in incorporating additional judgment, and the ability to reduce and quantify uncertainty.\(^{23}\) Potential output can be estimated in several ways. The Bank bases its calculations on the following methodologies:\(^{24}\)

- **Hodrick–Prescott filter.** This is a purely statistical method, which assumes that output can be decomposed into a long-term (trend) component and a component that captures the short-term deviation of output from the trend.

- **Production function method.** This method incorporates the structural information from a production function specification to obtain an estimate of potential output. Information on capital stock, labour trends and developments in total factor productivity is used for this purpose.

- **Multivariate Hodrick–Prescott filter.** This semi-structural method augments the statistical properties of the Hodrick–Prescott filter with structural relationships relating to production constraints, goods and labour markets, as well as capacity utilisation.

- **General equilibrium approach.** This approach entails the use of “gap models” and incorporates actual output, inflation (both actual and expected), unemployment and capacity utilisation data in order to estimate potential output. It uses a multivariate Kalman filter for this purpose.

\(^{20}\) For example, if actual output exceeds potential output then the output gap is positive, resources are over-utilised and prices tend to rise. Conversely, if actual output is below potential output, the output gap is negative, resources are under-utilised and prices tend to fall.

\(^{21}\) Stable inflation refers to the absence of inflationary pressures and excessive price fluctuations.

\(^{22}\) In addition to the uncertainty surrounding the unobserved potential output, regular revisions to the GDP figures present further uncertainty in the estimation of the output gap.


\(^{24}\) Refer to Ehlers et al. (2013) for more detail on these methodologies.
The Bank uses equal weights\textsuperscript{25} to aggregate the estimates of potential output produced by the methodologies listed above. Figure A3.1 presents the Bank’s different potential output estimates and shows how they relate to actual output. The output gap is calculated by subtracting the aggregate measure of potential output (red line in Figure A3.1) from actual GDP (dark blue line in Figure A3.1) and expressing the difference as a percentage of potential output.

Although the output gap is a useful indicator of inflationary pressure, it is important to recognise that it is an aggregate measure of resource utilisation and that there are uncertainties involved in its calculation. As such, the Bank uses the output gap as only one in a range of indicators that it considers in its policymaking process.

\textsuperscript{25} Use of equal weights is justified because none of the methods of estimating potential output is superior to the others.
Statement of the Monetary Policy Committee

18 July 2013

Issued by Gill Marcus, Governor of the South African Reserve Bank, at a meeting of the Monetary Policy Committee (MPC) in Pretoria

The period since the previous meeting of the Monetary Policy Committee (MPC) has been dominated by the reaction of the global financial markets to statements by the United States (US) Federal Reserve that a slowdown in quantitative easing may begin sooner than previously anticipated. The news impacted on capital flows to emerging markets, with outflows from bond markets in particular, but yields on long-term bonds of advanced economies were also affected. While some of the initial fears have been addressed by further guidance from the Fed, this episode gives some insight into the difficulties that could be faced in fine-tuning exit strategies from highly accommodative monetary policies, particularly at a time when global growth remains weak.

These events had a significant impact on the exchange rate of the rand, creating further upside risks to the inflation outlook at a time when the domestic economy has shown increased signs of vulnerability. There has consequently been no let-up in the policy dilemma faced by monetary policy: that of a widening output gap in a worsening inflation environment.

The year-on-year inflation rate as measured by the consumer price index (CPI) for all urban areas surprised on the downside at 5,6 per cent in May 2013, having measured 5,9 per cent for the previous three consecutive months. However, this decline is likely to have been temporary as it was due in part to a 73 cent per litre decrease in the petrol price in May, which has since been reversed by an 84 cent per litre increase in July. Food price inflation increased further from 6,3 per cent in April to 6,7 per cent, and accounted for 1,0 percentage point of CPI inflation. The other main contributors to the inflation outcome were housing and utilities, and miscellaneous goods and services which contributed 1,4 and 1,1 percentage points respectively. Administered price inflation declined to 6,3 per cent from 8,9 per cent in April due to the petrol price decline. Excluding petrol, administered price inflation was unchanged at 7,8 per cent. Core inflation, which excludes food, petrol and electricity, measured 5,3 per cent, marginally up from 5,2 per cent in April. The headline producer price inflation for final manufactured goods measured 4,9 per cent in May, compared with 5,4 per cent in April.

Despite the lower starting point, the inflation forecast of the Bank has deteriorated since the previous meeting of the MPC. Inflation is now expected to average 0,1 and 0,3 percentage points higher in 2013 and 2014 at 5,9 per cent and 5,5 per cent respectively, while the forecast for 2015 has been raised from 5,0 per cent to 5,2 per cent. A temporary breach of the upper end of the target range is still expected in the third quarter of 2013, but at a higher average level of 6,3 per cent (6,1 per cent previously), followed by a return to within the target range by the final quarter of the year. The deterioration is mainly due to continued currency weakness and higher-than-expected petrol price increases.

The forecast for core inflation for 2013 is unchanged at an average of 5,3 per cent in 2013 and is now expected to peak at 5,5 per cent in the fourth quarter. This measure is then expected to moderate and to average 5,2 per cent and 5,0 per cent in the coming two years, compared with the previous forecasts of 5,0 per cent and 4,6 per cent respectively. This upward drift in the forecast in the absence of obvious excess demand pressures suggests that there may be emerging underlying pressures, possibly due to the lagged effects of the depreciation of the rand exchange rate.

Inflation expectations appear to have remained anchored around the upper end of the inflation target range. According to the survey conducted by the Bureau for Economic Research at Stellenbosch University during the second quarter of 2013, inflation expectations
of all the categories of respondents remained almost unchanged compared with those of the previous quarter. Overall, the survey found that inflation is expected to average 6,0 per cent in 2013 and 6,1 per cent in the next two years, with financial analysts’ expectations below those of the business executives and trade union officials over the whole forecast period and within the target range. The former category is consistent with the Reuters survey which reflects expectations of an average of 5,9 per cent in 2013, and moderating to 5,6 per cent and 5,4 per cent in the following two years respectively.

The global economic growth outlook has remained fragile due to the continuing deeper recession in the eurozone and a slowdown in a number of systemically important emerging-market economies. Several forecasters, including the International Monetary Fund (IMF), have downgraded eurozone growth forecasts against the backdrop of a slowdown in Germany, and continued risks emanating from Portugal, Italy and Spain. In its recent World Economic Outlook update, the IMF reduced its 2013 forecast for eurozone growth by 0,2 percentage points to -0,6 per cent, with a weaker recovery than previously forecast in 2014. Although the US economic recovery appears to be gaining some traction, headwinds from the fiscal contraction remain, and first quarter economic growth, at an annualised 1,8 per cent, was weaker than the initial estimate of 2,5 per cent. The sustainability of the recovery is also at risk from rising long-term bond and mortgage interest rates in response to expectations of a tapering off of asset purchases by the Fed. There are tentative signs of stronger growth in Japan, but the sustainability of the recovery remains uncertain.

The slowing growth in various emerging-market economies including China, Brazil and Russia illustrate the difficulties of decoupling from the advanced economies, with the IMF revising its forecasts for 2013 for China from 7,8 per cent to 7,5 per cent; Russia from 3,4 per cent to 2,5 per cent; and Brazil from 3,0 per cent to 2,5 per cent. The deteriorating outlook for emerging markets has been compounded by the recent capital flow reversals that impacted adversely on domestic bond and currency markets in particular. While financial markets have stabilised somewhat, the risks posed to emerging economies in general, including South Africa, by normalisation of monetary policy in the US in the future, are evident.

The combination of slower growth in China and the stronger US dollar has also impacted negatively on commodity prices, although oil prices have been underpinned by risks related to recent events in Egypt. Global inflation remains benign and monetary policy is expected to remain accommodative in the advanced economies for some time, as indicated in the forward guidance provided by the ECB, the Bank of England and the Fed, notwithstanding a possible slower pace of quantitative easing in the US. By contrast, a general tightening bias is evident in a number of emerging markets in response to recent capital flow and exchange rate developments.

Movements in the exchange rate of the rand continue to pose the main upside risk to the inflation outlook. Since the previous meeting of the MPC exchange rate volatility has increased and the rand generally traded in a range between R9,60 and R10,36 against the US dollar. Since the beginning of the year the rand has depreciated by 14,2 per cent against the US dollar and by 11,1 per cent on a trade-weighted basis. Much of the recent volatility and weakness have been in line with the reaction of a number of other emerging-market currencies to fears of US monetary policy tightening. The rand has also been negatively impacted by lower commodity prices.

Domestic bond yields increased significantly in response to capital outflows and higher bond yields in the advanced economies. The yield on the 10-year government bond, for example, increased by more than 100 basis points since the financial market turbulence in late May. Net sales of domestic government bonds by non-residents amounted to R17,4 billion in May and June. In July non-residents became net buyers again with net purchases of R3,0 billion, bringing the year-to-date net total to R5,2 billion. Having been net sellers of South African equities in both 2011 and 2012, non-residents have returned to the market, with year-to-date net purchases of R23,3 billion.
Despite a 15,5 per cent nominal effective depreciation of the rand exchange rate since January 2012, the pass-through to inflation has been relatively muted, particularly when compared with previous episodes of currency weakness. This is probably a reflection of the weak pricing power in some sectors of the economy in a low growth environment. Nevertheless, the risk remains that these pricing pressures may intensify at some stage, particularly if the exchange rate depreciates further from current levels.

Market expectations are for a moderate appreciation of the rand in the coming months, although these expectations have been tempered in recent surveys. According to the Reuters Econometer survey conducted in June, analysts on average expect a rand/dollar exchange rate of R9,70 at the end of 2013, and R9,40 at the end of 2014. There is, however, a wide dispersion between the forecasters, reflecting a high degree of uncertainty. Despite a slight narrowing of the current-account deficit in the first quarter of 2013 to 5,8 per cent of GDP, the depreciated currency reflects this deficit against a backdrop of declining terms of trade and more uncertain global capital flows.

The outlook for domestic economic growth has weakened further, following the first quarter annualised growth rate of 0,9 per cent. While more favourable outcomes can be expected in the subsequent quarters of this year, overall annual growth is likely to be lower than the 2,5 per cent growth rate recorded in 2012. The Bank’s growth forecast for 2013 has again been revised down from 2,4 per cent to 2,0 per cent, and from 3,5 per cent to 3,3 per cent for 2014. Growth is expected to accelerate to 3,6 per cent in 2015, compared with 3,8 per cent previously. The risks to the outlook are still assessed to be on the downside, particularly in the face of further delays in overcoming electricity supply constraints. In line with these subdued growth prospects, the RMB/BER Business Confidence Index declined from 52 in the first quarter of 2013 to 48 in the second quarter, consistent with the continued sideways movement of the Bank’s leading indicator of economic activity.

The outlook for the mining sector remains bleak following a 0,7 per cent year-on-year contraction in May. Although production showed positive month-to-month growth for the first time in four months, on a three-month-to-three-month basis the sector contracted by 1,4 per cent. There are indications that the manufacturing sector will make a positive contribution to growth in the second quarter following the annualised 7,9 per cent contraction in the first quarter. In May the sector expanded by 2,2 per cent on a year-on-year basis, and by 0,9 per cent on a three-month-to-three-month basis. This more positive trend is also indicated in the Kagiso PMI which increased by 1,2 index points to 52,6 in July.

The real value of building plans passed remains on a moderately upward trend despite a decline in May. The FNB construction confidence index reflects some improvement, having increased by 4 points to 41 in the second quarter of 2013, although the civil construction index declined somewhat over the same period.

Underlying the sluggish economic growth outlook is the low growth in real gross fixed capital formation, which moderated from an annualised 4,3 per cent in the fourth quarter of 2012 to 2,5 per cent in the first quarter of 2013. Private-sector fixed investment growth slowed from 3,8 per cent to 2,8 per cent over this period, and reflected lower outlays in all sectors apart from agriculture, construction and finance. Work stoppages at Eskom’s Medupi plant also impacted negatively on investment by state-owned enterprises in the quarter. Fixed investment expenditure is likely to remain affected by low business confidence and prolonged electricity supply constraints.

Employment growth remains subdued, particularly in the private sector. In the year from March 2012 to March 2013, employment grew by 1,0 per cent, or 80 000 workers, of which 65 000 were in the public sector, although this number was inflated by temporary appointments relating to municipal by-elections in the first quarter of the year. Employment contracted in the mining and manufacturing sectors during this period. The official
unemployment rate increased from 24,9 per cent in the fourth quarter of 2012 to 25,2 per cent in the first quarter of 2013. Of particular concern is the increase in the youth unemployment rate to 52,9 per cent in the first quarter.

Slower growth in real consumption expenditure by households is indicative of declining consumer confidence and the relative lack of excessive demand pressures in the economy. Household consumption expenditure growth moderated to 2,3 per cent in the first quarter of 2013, driven mainly by more subdued demand for durable goods, particularly motor vehicles. Real retail trade sales surprised on the upside in May with year-on-year growth of 6,2 per cent. Nevertheless, retail trade sales increased by 0,5 per cent in the three months ending May compared with the previous three months, suggesting a continuation of the moderate growth in sales.

Consumption expenditure is expected to be constrained by high petrol and electricity costs, high consumer debt levels and declining growth in credit extension to households. Despite a moderation in the growth of household debt in the first quarter of 2013, the ratio of household debt to disposable income was unchanged at 75,4 per cent, as growth in real disposable income also slowed.

Twelve-month growth in total loans and advances extended to the private sector increased by 9,3 per cent in May, but excluding mortgage advances the increase was 16,8 per cent. In the first five months of 2013, general loans (mainly unsecured lending) continued to account for the bulk of the increase in credit extension, but at a slower pace, particularly to households. Twelve-month growth in general loans to households declined from a recent peak of 35,4 per cent in September 2012 to 24,4 per cent in May 2013. The slowdown is more pronounced when measured over three months. In the three months to the end of May 2013, annualised growth was 11,3 per cent, compared with rates of increase in excess of 30 per cent during 2012.

One of the upside risks to inflation remains wage and salary increases. In the first quarter of 2013, a stronger upward trend was observed with growth in nominal remuneration per worker increasing from 6,6 per cent in the fourth quarter of 2012 to 7,5 per cent. With slower productivity growth, this implied an increase in unit labour cost growth from 5,2 per cent to 6,7 per cent. These increases are consistent with the overall average wage settlement rate in collective bargaining agreements published by Andrew Levy Employment Publications, which increased from 7,6 per cent in 2012 to 7,9 per cent in the first quarter of 2013.

Other upside risks to the inflation outlook emanate from food prices, which have been accelerating over the past few months following a low of 4,6 per cent in September 2012. Food price pressures are intensifying at the producer price level, with manufactured food product prices increasing by 6,9 per cent in May. Although agricultural product inflation remained subdued at 2,6 per cent, this was mainly due to the 13,0 per cent decline in live animal prices which offset the 10,4 per cent increase in cereal and other crop prices. More favourably, global food prices have declined as a result of expectations of bumper crops in some of the main grain producing countries. The FAO international cereals price index decreased by 10,1 per cent since September 2012.

Global oil prices have broken out of their recent trading range of between US$100 and US$105, mainly due to political developments in the Middle East.

However, the relatively subdued global growth outlook, particularly in China, is likely to restrain these price increases. The current under-recovery of around 36 cents per litre on the domestic petrol price is mainly due to international price developments, and indicates that a further petrol price increase can be expected in August.
The MPC continues to face conflicting policy choices relating to rising inflation and slowing
growth. Inflation is expected to resume its upward trajectory following the brief respite in
May. However, despite the upward trend in core inflation, there are no strong signs of excess
demand pressures and the forecast for headline inflation suggests that the breach of the
target may be short-lived. The main upside risk to the inflation outlook is the exchange rate
and much will depend on the strength of the pass-through to inflation, which to date has
been relatively muted. However, the risk remains that these pressures could be mounting,
particularly if further currency weakness occurs and affects inflation expectations, which
are currently anchored at the upper end of the target range. In addition, the outcome of the
present round of wage bargaining will be critical in determining the extent of wage pressure
on the inflation outlook.

The output gap has widened, and is only anticipated to begin to narrow during 2015, when
growth is expected to be more or less in line with potential. The downside risk to growth has
already resulted in the Bank being more tolerant of inflation at the upper end of the target
range than would normally have been the case, an approach that is consistent with a flexible
inflation-targeting framework.

While the upside risks to the inflation outlook reduce the scope for further accommodation,
a tightening of the monetary policy stance does not automatically follow. This will be
highly dependent on how we see the inflation trajectory unfolding in this very uncertain
environment. In other words, it has become even more data dependent. At this stage a
sustained breach of the inflation target is not our central forecast. However, we are concerned
about the revised higher trajectory of core inflation and macroeconomic vulnerabilities
that are increasingly evident. The MPC is mindful of these conflicting pressures and the
challenging domestic and global environment, and will continue to monitor developments
closely and act appropriately to achieve its mandate. The MPC has decided to keep the
repurchase rate unchanged at 5.0 per cent per annum.
Statement of the Monetary Policy Committee

19 September 2013

Issued by Gill Marcus, Governor of the South African Reserve Bank, at a meeting of the Monetary Policy Committee (MPC) in Pretoria

Since the previous meeting of the Monetary Policy Committee (MPC), domestic inflation has breached the upper end of the target range. This development was in line with our forecast and we continue to expect inflation to moderate somewhat in the final quarter of this year. While the outlook for the domestic economic growth environment remains unchanged, it has been overshadowed by protracted work stoppages. Where wage agreements have been reached, these have generally been above the headline inflation rate, contributing to the upside risk to the inflation outlook.

During this period, global financial markets have been dominated by continued speculation about the speed and timing of tapering of quantitative easing by the United States (US) Fed. The uncertainty related to this event resulted in a high degree of volatility and weakening in a number of emerging-market economies’ foreign-exchange and bond markets since May. The decision by the Fed to delay tapering surprised the markets and emerging-market currencies in particular responded strongly, with many seeing significant overnight currency appreciation. The Fed emphasised the data-dependent nature of its decision, indicating that this respite could prove to be temporary, as speculation regarding the timing of future tapering is likely to continue whenever positive data emerges from the US.

The year-on-year inflation rate as measured by the consumer price index (CPI) for all urban areas increased to 6,3 per cent in July and 6,4 per cent in August. Food and non-alcoholic beverages inflation measured 7,1 per cent in August, up from 6,8 per cent in July, while petrol prices increased at a year-on-year rate of 23 per cent. Core inflation, which excludes food, petrol and electricity, measured 5,1 per cent, down from 5,2 per cent in July, while administered prices excluding petrol moderated to 7,0 per cent. The headline producer price inflation for final manufactured goods accelerated to 6,6 per cent in July, up from 5,9 per cent in June.

The inflation forecast of the Bank has deteriorated further since the previous meeting of the MPC. The forecast for 2013 is unchanged at an average of 5,9 per cent, but inflation is now expected to average 5,8 per cent in 2014 compared with 5,5 per cent in the previous forecast. The forecast for 2015 has been raised from 5,2 per cent to 5,4 per cent, and inflation is expected to average 5,3 per cent in the final two quarters of that year. The current breach of the inflation target is still expected to be temporary, and the peak was possibly reached in August. The deterioration in the forecast is mainly due to changes in assumptions related to the exchange rate of the rand and petrol prices, but given the overnight developments these assumptions will be revisited on an ongoing basis.

The forecast for core inflation for 2013 is 0,1 percentage point lower, at an average of 5,2 per cent. This measure is then expected to average 5,4 per cent and 5,3 per cent in the coming two years, compared with the previous forecasts of 5,2 per cent and 5,0 per cent respectively, and to measure 5,1 per cent in the final quarter of 2015. This upward drift of underlying inflation is due to the lagged effects of the depreciation of the rand exchange rate and the impact of higher unit labour costs.

Inflation expectations, as measured in the survey conducted in the third quarter of 2013 by the Bureau for Economic Research, have remained stable around the upper end of the target range. It is of concern to the MPC that inflation is expected to average 6,0 per cent in 2013 and 6,2 per cent and 6,1 per cent in the subsequent two years respectively. Business respondents expect inflation to average 6,4 per cent in both 2014 and 2015, slightly lower
than in the previous forecast, while expectations of trade unionists are unchanged from the previous survey, at 6,2 per cent and 6,3 per cent for these respective years. The expectations of economic analysts have deteriorated slightly since the previous survey but still expect inflation to average below 6,0 per cent over the period, and to average 5,8 per cent and 5,5 per cent in 2014 and 2015 respectively.

Global economic prospects have improved in a number of the advanced economies, but downside risks remain. Growth in the US appears to be gradually improving, despite fiscal headwinds, and most forecasts are for growth in excess of 2,5 per cent in 2014. There are, however, a number of downside risks to the outlook which were also highlighted by the Fed. Financial conditions have tightened since the initial tapering announcement, and there are fears that the significantly higher mortgage rates and the observed downturn in mortgage applications could derail the nascent recovery in the housing market, posing a risk to household consumption expenditure. Fiscal policy is also seen as a source of downside risk, with the debt ceiling issue expected to resurface in mid-October. Failure to find a resolution could result in further unplanned fiscal expenditure cuts.

The eurozone emerged from its protracted recession in the second quarter of 2013 led by Germany, but economic growth is expected to remain weak and below trend for some time. This negative outlook is compounded by fragile political environments in a number of countries, including uncertainty regarding the ability of some of the peripheral countries to meet the conditions of their bail-out clauses amid stringent fiscal consolidation measures and deteriorating debt dynamics, and slow progress towards a banking union. The Japanese economy appears to be responding to the stimulus packages and the weaker yen, but it is still too early to assess the sustainability of the recovery.

Fears of a marked slowdown in China have abated somewhat following strong growth in industrial production in August, amid easing liquidity and bank lending conditions. While there are some concerns that the recent improvement is based on an unsustainable credit boom, growth in excess of 7 per cent in 2014 is generally expected.

The expectation of an end to US quantitative easing prompted a sell-off of emerging-market assets, which has the risk of further undermining the weaker growth outlook that has been apparent for some time. While financial markets in these countries have reacted positively to the Fed’s decision not to begin tapering at this stage, the underlying weaknesses are expected to persist.

Monetary policy in the advanced economies remains highly accommodative, and forward guidance suggests that low policy rates will be maintained for some time. Inflation in the advanced economies remains very low but there is speculation that a faster-than-expected decline in the US unemployment rate could prompt an earlier start to normalisation of monetary policy in the US. Some emerging markets, notably Brazil, Indonesia, Turkey and India have either tightened monetary policy in response to currency depreciation, implemented a range of direct controls on capital flows or engaged in direct intervention in the foreign-exchange markets.

The exchange rate of the rand has been highly volatile since the previous meeting of the MPC, against the backdrop of a widening current-account deficit, domestic labour disputes, and the reversal of capital flows to emerging-market economies. The rand’s strong co-movement with other emerging-market currencies suggests that external factors predominated over this period. Since the previous MPC meeting, the rand has fluctuated in a range between around R9,55 and R10,50 against the US dollar and appreciated by 2,3 per cent against the dollar, but is more or less unchanged on a trade-weighted basis.

The uncertainties related to possible changes in US monetary policy have been reflected in the volatile non-resident activity in the domestic bond and equity markets. Following net sales of domestic bonds to the value of R17,9 billion between May and August in reaction
to the Fed tapering announcement, non-residents have been net purchasers of bonds in September to the value of R9.3 billion, bringing the cumulative total since the beginning of the year to R14.9 billion. Non-resident appetite for domestic equities has remained strong following net sales in 2011 and 2012, with year-to-date net purchases of R28.3 billion.

The risks to the inflation outlook from the exchange rate remain elevated and dependent on its future trend. A sustained depreciation trend could pose a significant risk to the inflation outcome. While there are some signs of generalised price pressures evident in the producer price index, to date the pass-through to consumer price inflation has been relatively muted, given the weak pricing power in the current low growth environment.

The rand is expected to remain sensitive to global sentiment as well as to the current-account deficit, which widened to 6.5 per cent of gross domestic product (GDP) in the second quarter of 2013. The deficit is expected to narrow in the coming months in response to the depreciated currency. However, this response is expected to be slow, given the import-intensive nature of capital expenditure by the state-owned enterprises in particular. Furthermore, export revenues are hampered by weak external demand, strike activity in the mining and motor vehicles sectors in particular, and declining terms of trade. The stepping up of exports is critical to address the current account deficit. While the rand has appreciated significantly in the last few days, the experience of the past few months is indicative of its vulnerability to future changes in US monetary policy.

The domestic growth outlook is unchanged since the previous MPC meeting. The real GDP growth rate of 3.0 per cent recorded in the second quarter of 2013 was driven mainly by a recovery in the manufacturing sector, following the marked contraction in the first quarter. Despite the rebound, growth was below the estimated potential of around 3.5 per cent and the negative output gap widened further. The Bank’s forecast of GDP growth is unchanged: we still expect growth to average 2.0 per cent in 2013, and 3.3 per cent and 3.6 per cent in the next two years respectively. The composite leading business cycle indicator of the Bank declined slightly in June, continuing its broadly sideways movement, confirming the subdued growth outlook. Business sentiment remains weak: the RMB/BER Business Confidence Index declined from 48 index points in the second quarter to 42 index points in the third quarter.

There are, however, tentative signs of improvement in the manufacturing sector. The Kagiso PMI increased to its highest level in 6 years, and in July the physical volume of manufacturing production increased by 3.5 per cent on a month-to-month basis, and 5.4 per cent year on year. Capacity utilisation also increased marginally in the second quarter of 2013 to 81.3 per cent. Despite these positive trends, manufacturing output is expected to be adversely affected by protracted strikes, particularly in the motor vehicle sector. Mining output, which contracted in the second quarter, is expected to contribute positively to growth in the third quarter, following strong increases in production in July and a relatively quick resolution of the strikes in the gold-mining sector.

Growth in real gross fixed capital formation remains relatively weak, at an annualised rate of 2.7 per cent in the second quarter of 2013. A positive feature is the acceleration in the growth of private-sector fixed investment expenditure to 4.4 per cent, which more than offset the decline in outlays by the public corporations, mainly due to unplanned construction delays. Gross fixed capital formation as a percentage of GDP increased marginally to 19.5 per cent in the second quarter, still well below the levels of around 24 per cent reached in 2008 and the National Development Plan target of 30 per cent by 2030.

Employment trends remain extremely subdued, consistent with the slow pace of economic growth. According to the Quarterly Employment Statistics (QES) of Statistics South Africa (Stats SA), formal non-agricultural employment increased by a mere 7,000 employees or 0.1 per cent between the quarters ended June 2012 and June 2013. Of great concern is
the loss of jobs in the tradeable sectors of the economy. Over this period there was a loss of 23 000 employees in the mining sector and a total of 7 000 in the manufacturing and construction sectors, while there was an increase of 26 000 employees in the community, social and personal services industry.

Growth in final consumption expenditure by households has been on a declining trend since the first quarter of 2012, but may have bottomed out, having increased from 2,3 per cent in the first quarter to 2,5 per cent in the second quarter. There was a notable increase in the consumption of durable goods, which could include pre-emptive buying ahead of possible exchange rate-induced price increases, as reflected in the sharp decline in new vehicle sales in August. The moderate trend in consumer demand is also reflected in the 2,8 per cent year-on-year increase in retail trade sales in July, and the month-on-month decline of 0,5 per cent.

The FNB/BER Consumer Confidence Index increased significantly in the third quarter and expenditure is expected to be positively affected by high wage settlements and positive wealth effects. Nevertheless, consumption expenditure growth is expected to be constrained by low employment creation, high household debt levels, declining rates of credit extension to households, and high petrol and electricity price increases, all of which are likely to curtail discretionary spending.

The trend of wage settlements remains an upside risk to inflation and job creation. The current wage bargaining round has seen a wide range of settlements, generally above the current inflation rate. According to Andrew Levy Employment Publications, the overall average wage settlement rate in collective bargaining agreements was 7,9 per cent in the first half of 2013 and this is likely to have increased in the third quarter. According to data derived from the QES, average salary and wages per worker over four quarters increased by 8,7 per cent in the quarter ending June 2013, but when accounting for productivity increases, the unit labour cost increase amounted to 6,8 per cent. The ultimate impact on inflation will depend in part on the increase in the total wage bill, as the impact of higher wages may be offset by job losses or slower employment creation. We are concerned that the increase in productivity, although relatively low, reflects job losses and a switch to more capital intensive production.

The moderate pace of bank credit extension to the private sector has been maintained with twelve-month growth of 8,7 per cent in total loans and advances recorded in July. Instalment sale credit and leasing finance remained robust, while growth in general loans to households, which is mainly unsecured lending, declined to 20,2 per cent in July, the lowest rate of growth since August 2010. The shorter-term trends for unsecured lending are more marked, with growth in the three months to July measuring 11,0 per cent and negative growth in loans of less than R30 000. Growth in mortgage credit extension has remained subdued. Twelve-month growth in credit extension to the corporate sector declined from 10,5 per cent in June to 8,7 per cent in July, with some indications that this reflects a lack of demand by corporates. They remain relatively cash flush and have also placed increasing reliance on corporate bond issues.

Food prices are a risk to the inflation outlook, although the continued downward trend of international food prices has helped to offset the impact of the weaker rand on maize and wheat prices. Consumer food inflation measured 7,4 per cent in August, while at the producer price level, manufactured food price inflation measured 7,5 per cent in July. Price increases of agricultural products, by contrast, were muted at 0,5 per cent in July, with year-on-year declines in the prices of cereals and meat, but strong increases, of 21,4 per cent, in fruit and vegetable prices.

The immediate risks to inflation from international crude oil prices appear to have abated for now following a decline in the political risk premium, but prices remain highly sensitive to developments in the Middle East in particular. Having increased to a level of around
US$118 per barrel in response to events in Egypt and Syria, the price has since moderated to around US$110 as the risk of US military action in Syria has subsided. Petrol prices increased at a year-on-year rate of 23,0 per cent in August, but favourable base effects and the small decline in the price in September are likely to result in a far lower rate of petrol price inflation in that month. The combination of a lower oil price and a stronger exchange rate observed in recent days is likely to result in a further moderate price decline in October, reversing the expectation earlier in the month of a further significant increase.

The MPC assesses the risks to the inflation outlook to be on the upside, mainly due to exchange rate and wage pressures. The decision of the Fed to delay tapering has provided a temporary reprieve to the exchange rate. However, the continued uncertainty relating to the timing of the inevitable slowdown in bond purchases and its data-dependent nature imply that emerging-market currencies, including the rand, are likely to experience a protracted period of volatility. In the short run these developments may have moderated the risk to inflation from the exchange rate, but medium- to longer-term risks remain, which will be assessed on an ongoing basis.

The MPC remains mindful of the conflicting policy choices that it faces. The breach of the upper end of the inflation target is expected to be temporary, but the longer-term trajectory is uncomfortably close to the upper end of the target range. At the same time, there are still no significant demand-side pressures in the economy and consumption expenditure growth is subdued. The output gap continues to widen, and the employment data show that there is very little net employment creation in the economy, while employment in the manufacturing and mining sectors has been declining. Consumers remain under pressure with persistently high debt-to-disposable income ratios, further exacerbated by the rising cost of petrol and other administered prices.

Currently, a sustained breach of the inflation target is not our central forecast, but the upside risks to the inflation outlook require careful monitoring. Should the risks to the medium-term inflation outlook deteriorate significantly the MPC will not hesitate to take appropriate action in order to maintain the integrity of the inflation-targeting framework and to anchor inflation expectations at a lower level. At this stage, however, given the global uncertainties and downside growth risks, the MPC has decided to keep the repurchase rate unchanged at 5,0 per cent per annum.
Since the previous meeting of the Monetary Policy Committee (MPC), the headline inflation rate has returned to within the inflation target range. Despite this favourable development, inflation is expected to remain uncomfortably close to the upper end of the target band. Moreover, the upside risks to the inflation outlook remain elevated, dominated by uncertainties primarily relating to both the timing and the speed of the tapering of the United States (US) Fed’s bond purchasing programme.

The domestic growth outlook remains fragile, with third-quarter growth expected to have been adversely affected by the protracted work stoppages in the motor vehicle sector in particular, which also contributed to a decline in exports. Both business and consumer confidence remain at low levels. The MPC therefore continues to face the dilemma of upside risks to inflation, against a backdrop of a weaker growth outlook and a possible further depreciation of the currency.

Having breached the upper end of the inflation target range in July and August, the year-on-year inflation rate, as measured by the consumer price index (CPI) for all urban areas, declined to 6,0 per cent in September and 5,5 per cent in October. Food and non-alcoholic beverages inflation surprised on the downside, moderating to 4,3 per cent from 6,0 per cent in September, and contributing 0,6 percentage points to the annual CPI increase, compared with 0,9 percentage points in the previous month. Petrol prices increased at a year-on-year rate of 9,3 per cent, down from 12,8 per cent in September. Core inflation, which excludes food, petrol and electricity, was unchanged at 5,3 per cent, while administered price inflation excluding petrol increased marginally to 7,1 per cent. The headline producer price inflation for final manufactured goods was unchanged in September at 6,7 per cent.

The headline inflation forecast of the Bank is more or less unchanged since the previous meeting of the MPC. The forecast average inflation rates for 2013 and 2014 are 5,8 per cent and 5,7 per cent respectively, both years 0,1 percentage point lower than in the previous forecast. The forecast for 2015 is unchanged at 5,4 per cent, with inflation expected to average 5,3 per cent in the final quarter of that year. Inflation is expected to remain within the target range for the entire forecast period, with a peak of 5,9 per cent in the second quarter of 2014.

The forecast for core inflation for 2013 is unchanged at an average of 5,2 per cent, but has deteriorated for 2014 when it is expected to average 5,6 per cent compared with the forecast of 5,4 per cent previously. The forecast for 2015 remains at 5,3 per cent, ending the year at 5,1 per cent. This upward drift of the underlying inflation measure continues to be driven by the lagged effects of the depreciation of the rand exchange rate and the impact of higher unit labour costs.

The global economy is characterised by a hesitant multispeed recovery. The outlook for the US remains positive following third-quarter growth of 2,8 per cent, notwithstanding the fiscal headwinds and the unresolved budget and fiscal cliff issues, which remain downside risks. The employment data have generally been positive, prompting speculation that the Fed may begin cutting back on its programme of bond purchases sooner than previously anticipated. There is a great deal of uncertainty around the timing and pace of tapering. The timing is likely to be highly sensitive to labour market developments, and we expect the pace to be gradual to avoid undue impacts on financial markets. However, as evidenced earlier this year, the financial markets’ reaction will be key to the process and to spillover effects.
While the United Kingdom (UK) economy also appears to be growing relatively strongly, with annualised growth of 3,2 per cent in the third quarter of 2013, hopes for a rebound in the eurozone have been undermined by weak growth in the third quarter. Having emerged from a prolonged recession in the second quarter, the region recorded an annualised growth rate of 0,4 per cent in the third quarter, with contractions in a number of countries, including France and Italy, and a slowdown in Germany. The Japanese economy shows signs of a sustained recovery, but growth moderated to 1,9 per cent in the third quarter, from around 4 per cent in the previous two quarters.

The slowdown in emerging markets remains broad-based but there are signs that some countries, particularly in emerging Asia, may be responding to the recovery in the advanced economies. The outlook for China has also improved and it is expected to maintain its growth rate of around 7,5 per cent, amid recent moves towards further structural reforms. Subdued growth is expected in most of the larger Latin American economies, including Brazil and Mexico.

Monetary policy in the advanced economies is expected to remain highly accommodative for some time against the backdrop of subdued headline and core inflation, as well as persistently high rates of unemployment. Despite the expected reversal of quantitative easing, the US policy rate is expected to remain at the zero bound for much longer, while slow growth and the risk of deflation prompted the recent further easing of monetary policy by the European Central Bank. Inflation in the UK has declined to below the upper threshold of 2,5 per cent. Emerging-market economies are facing generally higher inflation dynamics, due in part to exchange rate reactions to expectations of Fed tapering. Inflation pressures have prompted monetary policy responses in a number of countries including Brazil, India and Indonesia, who have all raised rates.

Speculation regarding tapering has been the main driver of rand exchange rate volatility since the previous meeting of the MPC. The rand appreciated to around R9,55 against the US dollar following the September decision by the Fed to delay tapering, and then reached a level of around R10,45 following the November Federal Open Market Committee meeting when market expectations were for an earlier start to tapering. More recently the rand has appreciated somewhat as the expected timing was pushed back by the markets, and also in response to the South African Revenue Service (SARS) release of new trade data. The rand has depreciated by 17 per cent against the US dollar since the beginning of the year, and by 15 per cent on a trade-weighted basis.

The exchange rate of the rand remains an increasingly upside risk to the inflation outlook, notwithstanding the relatively slow pass-through to consumer prices to date. The challenge facing the MPC is not only to anticipate the timing and speed of Fed tapering, but also to try to assess the extent to which tapering is already priced into the exchange rate. There is a risk that, should there be a stronger or more disorderly response by the markets to actual Fed tapering, the reaction of the exchange rate could be more extreme.

These developments have been reflected in the non-resident activity in the domestic bond and equity markets. In September and October, when expectations of Fed tapering were modified, non-residents were net buyers of bonds to the value of R17 billion, more or less reversing the net sales that followed the initial reaction in May. Since early November, however, when risk aversion returned, net sales of bonds have amounted to R9,7 billion. At the same time, net sales of equities have amounted to R14,5 billion. Year to date, non-resident purchases of bonds and equities have totalled R12,8 billion and R4,8 billion respectively.

A further risk is the deficit on the current account of the balance of payments, which makes the exchange rate more sensitive to possible capital flow slowdowns or reversals. In the second quarter of 2013 the deficit amounted to 6,5 per cent of GDP, and the published trade
data suggest that a further deterioration of the trade account can be expected following the temporary collapse of motor vehicle exports and significantly higher imports in the third quarter. The actual outcome may be ameliorated to some extent by the recent inclusion by SARS of South Africa’s merchandise trade data with its Southern African Customs Union (SACU) partners in the trade statistics, made possible by the modernisation of the customs data collections systems. The new inclusive data have resulted in a significant adjustment to the trade statistics published by SARS.

However, in compiling the balance-of-payments accounts in the past, the Bank made estimates of South Africa’s trade with Botswana, Lesotho, Namibia and Swaziland, based on various sources. The historical trade data in the balance-of-payments accounts will be revised to account for the differences between the new data and our own previous estimates. These revisions will be published in the December Quarterly Bulletin on 3 December, and may also result in minor revisions to the gross domestic product (GDP) data. Nevertheless, the underlying trend of the current account is not expected to change significantly.

The domestic economic growth outlook remains fragile. Following a rebound of growth to an annualised 3,0 per cent in the second quarter of 2013, the third-quarter outcome is expected to be significantly lower, and more in line with the 0,9 per cent recorded in the first quarter of this year. The Bank’s forecast for growth in 2013 has been revised down from 2,0 per cent to 1,9 per cent, while the forecasts for 2014 and 2015 have been revised down to 3,0 per cent and 3,4 per cent respectively, from 3,3 per cent and 3,6 per cent. This is consistent with the Bank’s composite leading business cycle indicator which continues to trend sideways, while the RMB/BER Business Confidence Index at 43 points was more or less unchanged in the fourth quarter, indicative of a subdued outlook.

The adverse third-quarter growth outcome is largely due to a quarter-to-quarter contraction of 2,1 per cent in the manufacturing sector, in part a consequence of the protracted strikes that resulted in a 27,9 per cent decline in the production of motor vehicles, parts and accessories in that quarter. Reflecting these developments, the Kagiso PMI declined to 50,0 index points in September from 55,6 points in August, but recovered somewhat to 50,7 index points in October. Industrial action and safety-related stoppages also impacted negatively on mining output, but despite negative growth in August and September, a positive quarter-to-quarter growth rate of 1,4 per cent was recorded.

Encouragingly, the construction sector is showing signs of recovery with a generally steady upward trend in the value of real building plans passed, and the confidence of building contractors in the business confidence index increasing to its highest level in almost six years.

The moderating trend in the growth of consumption expenditure by households that has been evident for some time appears to have continued into the third quarter. Retail trade sales recorded a quarter-to-quarter increase of only 0,4 per cent in that quarter, and a month-to-month contraction of 0,7 per cent in September, although wholesale trade was more robust. This is consistent with the FNB/BER Consumer Confidence Index which had reached a ten-year low in the third quarter of 2013, with only a marginal improvement in the fourth quarter.

The trends in credit extension are likely to constrain consumption expenditure in the short to medium term. Twelve-month growth in total loans and advances measured 8,4 per cent in September, down from 9,0 per cent in August, while the quarterly growth rate was 5,3 per cent in the third quarter. There are clear indications of a sharp decline in lending to households. Twelve-month growth in general loans to households, mostly unsecured lending, declined to 14,2 per cent in September, the lowest rate of growth since February 2010, while annualised growth over three months was 2,8 per cent. In August and September a contraction was recorded in this category. Growth in mortgage lending, at below 3 per cent,
remained subdued despite a small acceleration in September, mainly driven by commercial mortgages. By contrast, instalment sale credit remained buoyant, while twelve-month growth in total loans and advances to companies increased to 10.6 per cent.

Household consumption expenditure is, however, expected to be supported to some extent by wage trends. According to Andrew Levy Employment publications, the overall average wage settlement rate in collective bargaining agreements was 7.9 per cent in the first nine months of 2013, compared with 7.6 per cent for 2012 as a whole. Although a number of these settlements are generally well below the initial demands, they are considerably above the upper band of the inflation target, and pose a potential risk to the inflation outlook.

According to the Quarterly Labour Force Survey of Statistics South Africa (Stats SA), the official unemployment rate moderated to 24.7 per cent in the third quarter of 2013, from 25.5 per cent a year earlier. This follows an increase in employment of 2.8 per cent or 383,000 jobs over that period. This implies that the economy has only now returned to the same levels of employment attained before the crisis. These figures, however, are in contrast to the Quarterly Employment Statistics of Stats SA which showed a 0.1 per cent growth in the formal non-agricultural sector from June 2012 to June 2013, and which correlates more closely with GDP trends.

Fiscal policy, as outlined in the Medium Term Budget Policy Statement, continues to be countercyclical, attempting to balance the need to support the economy and the need for fiscal consolidation. A deficit of 4.2 per cent is projected for the current fiscal year, and is expected to narrow to 3.0 per cent by 2015/16. Non-interest real expenditure growth is capped at an average of 2.2 per cent over the next three years, and the three-year agreement with civil service unions, due to expire in 2015, is expected to limit the growth in the public sector wage bill. This pace of consolidation should stabilise the net national debt at 44 per cent in 2017/18.

Food price inflation moderated to 4.2 per cent in October, from 6.0 per cent in September, with the deceleration in price increases being broad-based. Final manufactured producer food price inflation declined from 7.5 per cent peak in July to 6.8 per cent in September. Agricultural product prices increased by 4.3 per cent at the producer price level in September, with cereals and other crop prices declining by 6.8 per cent. This was in line with lower international food commodity prices, which offset the impact of the weaker exchange rate to some extent. While food price inflation may continue to moderate in the short term, upside pressures can be expected from the exchange rate and the fact that meat price declines, due in part by drought-induced culling, are unlikely to persist.

International oil prices have remained relatively contained below the US$110 per barrel level since the previous MPC meeting. These prices continue to be dominated by political developments in the Middle East, and the global growth outlook. Should international oil prices and the exchange rate remain at current levels, a small increase in the domestic petrol price is likely in December following a cumulative 48 cents decrease in October and November. It is important to note, however, that further weakness in the exchange rate will pass through quickly into these prices.

Despite the better-than-expected October inflation outcome, the MPC continues to assess the risks to the inflation outlook to be on the upside, mainly as a result of further potential exchange rate pressures. Tapering by the Fed is inevitable, but until a decision is taken financial markets globally are likely to experience heightened volatility. There is a high degree of uncertainty regarding the extent to which US policy actions are already priced in to the exchange rate.

Compounding the risks to the exchange rate is the stubbornly wide current-account deficit, notwithstanding recent revisions to the trade data. The deficit increases South Africa’s sensitivity to global spillover effects. The MPC is mindful of the adjustment lags
and will be watching carefully for signs of a positive current-account response. We need to take advantage of the depreciated exchange rate and not allow the benefits to be eroded through higher wage and other input prices. Action will be required should the adjustment mechanism not operate effectively.

While the exchange rate impact on CPI is increasingly evident in the core inflation measure, to date the pass-through has been relatively muted. But this is unlikely to persist should there be a significant further depreciation.

At the same time the policy dilemma is underlined by the deterioration in the growth outlook. The committee assesses the risks to be on the downside, amid continued supply disruptions and low business and consumer confidence. The downward trend of household consumption expenditure is indicative of relatively weak demand conditions in the economy, and slower bank credit extension to households is likely to reinforce this trend.

The inflation forecast remains uncomfortably close to the upper level of the inflation target range but our central forecast remains within the target. Given the increased upside risks to the outlook, we do not see room for further monetary accommodation. We will continue to monitor developments carefully on an ongoing basis and remain committed to act as required. The MPC has decided to keep the repurchase rate unchanged at 5.0 per cent per annum at this stage.

The MPC meeting dates for 2014 are as follows:

27–29 January 2014 (Monday–Wednesday)
25–27 March 2014 (Tuesday–Thursday)
20–22 May 2014 (Tuesday–Thursday)
15–17 July 2014 (Tuesday–Thursday)
16–18 September 2014 (Tuesday–Thursday)
18–20 November 2014 (Tuesday–Thursday)
Abbreviations

Alsi  All-Share Price Index
API  administered price index
BER  Bureau for Economic Research [Stellenbosch University]
BIS  Bank for International Settlements
BOE  Bank of England
BRICS  Brazil, Russia, India, China and South Africa
CPI  consumer price index
CPIX  consumer price index excluding mortgage interest cost for metropolitan and other urban areas
CRB  Commodity Research Bureau
ECB  European Central Bank
EMBI+  [JPMorgan] Emerging Markets Bond Index Plus
FAO  Food and Agriculture Organization of the United Nations
FAQ  frequently asked questions
FRA  forward rate agreement
GDE  gross domestic expenditure
GDP  gross domestic product
IMF  International Monetary Fund
Jibar  Johannesburg Interbank Agreed Rate
JSE  Johannesburg Securities Exchange Limited
MPC  Monetary Policy Committee
MPF  Monetary Policy Forum
MPR  Monetary Policy Review
MTEF  medium-term expenditure framework
NAB  non-alcoholic beverages
NEER  nominal effective exchange rate
OECD  Organisation for Economic Co-operation and Development
PMI  Purchasing Managers’ Index
PPI  producer price index
QE  quantitative easing
REER  real effective exchange rate
repo  repurchase [rate]
SARS  South African Revenue Service
S&P  Standard & Poor’s
Stats SA  Statistics South Africa
the Bank  South African Reserve Bank
the Fed  United States Federal Reserve
TRJ  Thompson Reuters/Jefferies
US  United States
VIX®  Chicago Board Options Exchange Market Volatility Index
WEO  World Economic Outlook
Glossary

**Accommodative monetary policy**: Monetary policy-related actions intended to stimulate economic activity by lowering interest rates, increasing the quantity of money or by keeping already low interest rates stable in the economy.

**Administered prices**: Prices that are set according to government’s policy rather than determined by market supply and demand forces (usually because the product is related to social welfare). These prices may or may not have an economic regulator.

**Advanced economies**: Advanced economies are highly industrialised countries with high levels of GDP per capita.

**Balance of payments**: A record of transactions between the home country and the rest of the world over a specific period. It includes the current and financial accounts. See also current account.

**Bond yield**: The return on an interest-bearing instrument accruing to its owner. The yield-to-maturity takes into account the price of the bond, all coupon cash flows and the remaining term to maturity.

**Break-even inflation**: This is calculated as the difference between nominal yields on a conventional government bond and real yields on an inflation-linked government bond of similar maturity. It is used as a proxy of market-determined inflation expectations.

**Budget deficit**: The extent to which government expenditure exceeds government revenue (a budget surplus occurs when revenue exceeds expenditure).

**Business/consumer confidence**: Economic indicators measuring the state of optimism about the economy and its prospects among business managers and consumers.

**Capacity utilisation**: The percentage utilisation of production capacity in the manufacturing industry is a measure of the use of manpower, plant and machinery in manufacturing. The degree of capacity constraint experienced in the manufacturing industry is determined by obtaining indications from large manufacturing enterprises regarding skills shortages, and other reasons such as downtime due to maintenance, changes in productivity and seasonal factors. The measure is used to assess the degree of capacity constraint experienced in the manufacturing industry.

**Capital flow reversals**: The movement of portfolio investment in bonds and equity from the receiving country back to the country of origin.

**Central projection**: The most likely outcome for the variable of interest over the period, according to South African Reserve Bank forecasts.

**Collective bargaining system**: A system within which labour market-related issues are resolved by groups representing labour (trade unions) and groups representing employers (representatives from individual organisations or chambers representing industries).

**Commodity prices**: Commodities can refer to food, oil or precious metals. Major South African-produced commodities include platinum and gold.

**Consumer price index (CPI)**: CPI provides an indication of aggregate price changes in the domestic economy. It is calculated using a number of categories forming a representative set of goods and services bought by consumers.

**Core quarterly forecasting model**: The South African Reserve Bank’s primary forecasting model, used to project (core) inflation values on a quarterly basis.

**Core inflation**: Inflation excluding food and energy (including petrol) prices, which is considered a better reflection of the trend underlying inflation.
Crude oil price: The price in US dollars per barrel of unrefined (North Sea) oil.

Currency spread: A measure of the market-perceived risk embedded in the rand. It is calculated as the difference in yields between rand-denominated domestic government bonds and US dollar-denominated domestic government bonds of a similar maturity.

Current account: The current account of the balance of payments consists of net exports (exports less imports) in the trade account, as well as the services, income and current transfer account.

Demand pressures: Demand pressures refer to price pressures from increased consumption in the domestic or foreign economy.

Developing economies: Developing economies have not reached a significant level of industrialisation, have less developed infrastructure and have lower standards of living and literacy compared to developed nations.

Emerging-market economies: Emerging-market economies are those with low to middle income per capita, which are advancing rapidly and are integrating with global (product and capital) markets.

Exchange rate depreciation (appreciation): Exchange rate depreciation (appreciation) refers to a decrease (increase) in the value of a currency relative to another currency.

Exchange rate pass-through: The effect of exchange rate changes on domestic inflation (i.e., percentage change in domestic CPI due to a 1 per cent change in the exchange rate). Changes in the exchange rate affect import prices, which in turn affect domestic consumer prices and inflation.

Exogenous prices: Exogenous prices are prices of goods that are set outside the influence of domestic policy. These prices are often influenced by market dominance (e.g., cartels and monopolies) as well as supply and demand considerations globally. A prime example of a good whose price is exogenous in the domestic context is crude oil. Most commodities are priced exogenously.

Fiscal consolidation: Government policies that are aimed at reducing budget deficits through decreases in government spending, increases in taxation or a combination of the two. Other terms used to refer to fiscal consolidation include fiscal austerity and fiscal reform.

Flexible inflation targeting: Refers to inflation-targeting regimes that consider changes in inflation and other variables affecting the real economy in the short term. Hence, where under strict inflation targeting only inflation matters, flexible inflation targeting takes into account other variables, such as output.

Forecast horizon: The future period over which the Bank generates its forecasts. Typically, between two and three years.

Forward rate agreement (FRA): A contract that determines the rate of interest to be paid or received on an obligation beginning at a future start date.

Gross domestic expenditure (GDE): Total value of expenditure on goods and services within the country plus expenditure on imports less exports.

Gross domestic product (GDP): Total market value of all goods and services produced in a country. It includes total consumption expenditure, capital formation, government consumption expenditure and the value of exports less the value of imports.

Gross fixed capital formation: The value of acquisitions of capital goods (e.g., machinery, equipment and buildings) by firms, adjusted for disposals constitutes gross fixed capital formation.

Headline consumer price index (CPI): CPI for all urban areas that is released monthly by Stats SA. Headline CPI is a measure of price levels in all urban areas. The 12-month percentage change in headline CPI is referred to as headline CPI inflation and reflects changes in the cost of living. This is the official inflation measure for South Africa.
Household final consumption expenditure: The amount of money spent by households on consumer goods and services.

Household disposable income: Household disposable income is defined as primary income, net current transfers and social benefits, less taxes on income and wealth.

House price index: Measure of the prices at which residential dwellings are bought and sold over time.

Inflation (growth) outlook: The evolution of future inflation (growth) over the forecast horizon.

Inflation targeting: Monetary policy framework that is used by central banks to steer actual inflation towards an inflation target level or range.

Interest rate smoothing: The gradual decrease (increase) of the policy rate over the business cycle. Policymakers target the medium term, thus they will allow time for previous changes to have an effect before making further changes (if necessary). Gradual interest rate changes also permit economic stakeholders to adapt their expectations about future interest rate changes.

Median: A statistical term used to describe the observed number that separates ordered observations in half.

Mortgage: A form of secured loan extended for the purchase of real estate.

Nominal effective exchange rate (NEER): An index that expresses the value of a country’s currency relative to a basket of other currencies. An increase (decrease) in the effective exchange rate indicates a strengthening (weakening) of the domestic currency with respect to the selected basket of currencies. The weighted average exchange rate of the rand is calculated against 15 currencies. The weights of the five major currencies are in brackets: euro (34,82), US dollar (14,88), Chinese yuan (12,49), British pound (10,71) and Japanese yen (10,12). Index: 2000 = 100.

Net exports: See current account.

Nominal variables: Nominal variables are stated in current prices and represent the cost of an item.

Output gap/potential growth (GDP): Potential growth is the rate of GDP growth that could theoretically be achieved if all productive assets in the economy are employed in a stable inflation environment. The output gap is the difference between actual growth and potential growth. If this is negative, then the economy is viewed to be underperforming and demand pressures on inflation low. If the output gap is positive, the economy is viewed to be overheating and demand pressures inflationary in nature.

Producer price index (PPI): The PPI is an index that measures changes in prices of goods at the factory gate. Stats SA currently produces five different indices that measure price changes at different stages of production. Headline PPI is the index for final manufactured goods. PPI measures indicate potential pressure on consumer prices.

Productivity: The amount of goods and services produced in relation to the resources utilised in the form of labour and capital. The most common measure is labour productivity.

Purchasing Managers’ Index (PMI): An index that shows the sentiment of purchasing managers in the manufacturing sector, indicating the broader economic health of the sector.

Quantitative easing (QE): An unconventional monetary policy tool, implemented largely in the US, the UK, the euro area and Japan. QE involves the central bank purchasing bonds on the open market so as to inject liquidity into the economy. This also leads to a markedly higher level of money supply in the economy.

Range-bound: When a variable (e.g., the exchange rate) moves within a relatively narrow range for a certain period.
Real effective exchange rate (REER): The Bank for International Settlements’ REER indices include a total of 61 entities, including individual euro area countries and the euro area as a separate entity. The base year for the indices is 2010 and the REERs are geometric-weighted averages of bilateral exchange rates adjusted by relative consumer prices.

Real variables: Variables that are adjusted for inflation and hence are expressed in constant prices (of some base year) and represent the volume of an aggregate.

Real repo rate: The nominal repurchase (repo) rate, as set by the Monetary Policy Committee, adjusted for inflation.

Repurchase rate (repo rate): The rate that commercial banks pay to borrow money from the South African Reserve Bank.

Second-round effects: This describes the indirect effect of price shocks (first round) on other prices (second round). For example, should the petrol price rise sharply, not only does it affect the cost of transport for the consumer, but also for producers who will then increase the price of their goods to cover the transport cost.

Sovereign spread: The risk attached to the probability that a country will default on its debt. The sovereign spread (a proxy for sovereign credit ratings) is calculated by comparing the yield on a dollar-denominated South African bond with that of US Treasuries.

Terms of trade: Ratio of the value (in price terms) of exports to the value (in price terms) of imports. If this ratio is below 1 then the value of imports exceeds that of exports.

Unit labour costs: The labour cost of production of one “unit” of output. This is calculated as the total wages and salaries in the non-agricultural sector divided by the real value added at basic prices in the non-agricultural sector of the economy.

Unsecured loans: Loans extended without any collateral (guarantees/underlying assets) as security to protect the value of the loan.

VIX®: The Chicago Board Options Exchange Market Volatility Index (VIX®) measures the implied volatility of S&P 500 index options and serves as a popular indicator of investors’ perception of risk.