Statement of the Monetary Policy Committee

25 March 2010

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

Introduction

The domestic economy has shown signs of moderate improvement since the previous meeting of the MPC. Inflation expectations have moderated. Inflation has returned to within the target range and is expected to remain there for the remainder of the forecast period. The risks to the inflation outlook have declined somewhat as a result of the continued appreciation of the exchange rate of the rand and greater certainty with respect to future electricity tariff increases. Household consumption expenditure is growing at positive, albeit low rates, but growth in private sector fixed capital formation remains negative.

Recent developments in inflation

The year-on-year inflation rate as measured by the consumer price index for all urban areas (CPI) returned to within the inflation target range sooner than expected, in February 2010, when it measured 5,7 per cent. The moderation in inflation was fairly broad-based. The main contributors to the inflation outcome were the categories of housing and utilities, and miscellaneous goods and services. The former category was driven mainly by electricity price increases of 26,8 per cent, while the latter category was driven by insurance costs relating to housing, health and transport. Food price inflation declined to 1,0 per cent, while communication costs declined by 22,0 per cent. Administered prices excluding petrol and paraffin increased by 10,8 per cent.

Producer price inflation increased to 3,5 per cent in February 2010, compared with 2,7 per cent in the previous month. Food price inflation at the producer level remained well contained. Agricultural food prices declined at a year-on-year rate of 13,5 per cent, while manufactured food prices declined by 1,2 per cent.

The outlook for inflation

The CPI forecast of the South African Reserve Bank (the Bank) indicates an improved inflation outlook during 2010 and a relatively unchanged outlook for 2011. Inflation is expected to average 5,3 per cent and 5,4 per cent in 2010 and 2011 respectively, and to reach a low point at an average of 4,9 per cent during the third quarter of 2010. There is now greater certainty with respect to electricity tariff increases following the decision by the National Energy Regulator of South Africa (NERSA) to grant price increases to Eskom in the order of 25 per cent per annum, which was in line with the Bank's previous assumptions. However, because lower increases were granted to municipalities, the current forecast makes provision for electricity tariff increases of 20 per cent during the third quarters of 2010 and 2011. Other factors contributing to the improved expected inflation trajectory include favourable food price developments and lower-than-expected inflation outcomes.

The Survey of Inflation Expectations published by the Bureau for Economic Research (BER) at Stellenbosch University shows a significant improvement in the first quarter of 2010, although expectations on average remain above the upper end of the target range. Average headline CPI inflation expectations in respect of 2010 declined from

7,7 per cent during the final quarter of 2009 to 6,5 per cent during the first quarter of 2010. Inflation expectations in respect of 2011 declined from 7,7 per cent to 6,7 per cent, and the expectation for 2012 is 6,8 per cent. The improved outlook was mainly due to the favourable change in the expectations of business sector and labour union respondents. The expectations of analysts remained more or less unchanged.

Inflation expectations in the financial markets also reflected a more favourable inflation outlook. The Reuters survey of financial analysts shows some improvement relative to the previous month. Inflation expectations as measured by the yield differential between conventional government bonds and inflation-linked bonds across all maturities have declined since January, and reflect expectations within the target range over longer maturities.

Growth in domestic expenditure appears to be recovering at a modest pace but does not currently pose an upside risk to the inflation outlook. Following five consecutive quarters of negative growth, real household consumption expenditure increased at an annualised rate of 1,4 per cent in the fourth quarter of 2009. While expenditure growth on non-durable and semi-durable goods contracted, expenditure on durable goods, particularly motor vehicles, increased. Wholesale and retail trade sales in January appear to confirm this trend as positive month-on-month growth was experienced. Consumer confidence, as reflected in the First National Bank/BER Consumer Confidence Index, showed a significant recovery.

The turnaround in household consumption expenditure is expected to continue at a slow pace. The improvements in the domestic equity markets appear to have reversed the negative wealth effects on consumption. Nevertheless, the recovery in household consumption expenditure is expected to be constrained by the levels of household indebtedness, which increased to 79,8 per cent of disposable income of households in the fourth quarter of 2009. Other constraining factors include the strict credit criteria applied by banks and persistently high levels of unemployment.

Growth in total loans and advances to the private sector has been negative since September 2009 and declined further at a 12-month rate of 1,2 per cent in January. Mortgage credit extension was again the only category that showed positive growth, while loans to companies declined further. The subdued credit extension data are a function of both demand and supply-side effects. The strict credit criteria applied by banks have been partly a result of the rising levels of impaired advances, which now appear to be levelling off. In January 2010 impaired advances as a percentage of total gross loans and advances declined slightly to 5,9 per cent. A significant proportion of these impairments relate to retail loans, reflecting continued pressure on the consumer.

There are indications that the decline in employment in the formal non-agricultural sector appears to have slowed. According to the *Quarterly Employment Survey*, 18 000 jobs were created in the final quarter of 2009. However, on a seasonally adjusted basis, employment declined by 0,7 per cent, following the 5,1 per cent decline in the previous quarter. Cyclical employment trends tend to lag the upturn in the economy and the impact of the recession on employment will take some time to be reversed.

A countercyclical fiscal policy stance has been maintained. The national government deficit is projected to equal 7,2 per cent of gross domestic product (GDP) in the 2009/10 fiscal year, then to narrow over the next three years as the economy recovers and to measure 4,7 per cent in the 2012/13 fiscal year. The public sector borrowing requirement is expected to reach 11,8 per cent of GDP, and the overall government debt-to-GDP ratio is expected to peak at 43 per cent in the medium term. Should this fiscal trajectory be maintained, the MPC does not foresee a possible conflict with monetary policy objectives.

The economic growth outlook has improved somewhat over the past few months, although the output gap is expected to remain positive for some time. The 3,2 per cent annualised growth rate recorded in the fourth quarter of 2009 confirmed that the economy has emerged from the recession and the latest forecast of the Bank is that growth is likely to average 2,6 per cent in the current year. Although this compares favourably with the growth experienced in 2009, it is nevertheless still low.

The manufacturing sector in particular grew relatively strongly in the last two quarters of 2009, although off a low base, following four consecutive quarters of negative growth. The Kagiso/BER Purchasing Managers Index indicates that this trend is likely to continue. Business confidence, as measured by the Rand Merchant Bank/BER Business Confidence Index also showed an improvement, but remains negative.

The sustainability of the recovery in domestic growth will be influenced to a significant degree by the global growth trends. The pattern of the global economic recovery has remained unchanged, with strong growth being recorded in Asia in particular, and more moderate growth in a number of countries in Latin America and Africa. The outlook for the United States (US) and Europe is less positive, with increased concerns about the sustainability of burgeoning fiscal deficits and government debt ratios. In the US the weak housing market also remains a constraint on household consumption expenditure. Although a number of countries have begun to normalise their policy rates, monetary and fiscal stimuli still remain in place in most industrialised economies, and indications are that there will not be an early reversal of these accommodative policies. Against this backdrop, the benign global inflation environment is expected to persist and the risk of imported inflation is relatively low.

While an appreciated rand exchange rate is a positive factor in the inflation outlook, an excessively strong exchange rate is a cause for concern from the perspective of overall macroeconomic balance. It is difficult to determine with precision an appropriate level of the exchange rate, but at recent levels the exchange rate may contribute to constraints in the recovery of export- and import-competing sectors of the economy.

Since the previous meeting of the MPC, the rand has appreciated from levels of around R7,60 against the US dollar to current levels of around R7,35. On a trade-weighted basis, the rand has appreciated by about 6 per cent since the previous meeting and by 3 per cent since the beginning of the year. The trade-weighted exchange rate was also influenced by the recent weakness in the euro and pound sterling against the US dollar. Since the previous meeting, the rand has appreciated by about 8 per cent and 11 per cent against the euro and pound sterling respectively.

A number of factors continue to impact on the exchange rate of the rand. These include the sustained capital inflows into emerging markets, in general, in response to abnormally low interest rates in advanced economies, investor sentiment and the recovery in commodity prices. The recovery in commodity prices contributed to the narrowing of the deficit on the current account of the balance of payments in the final quarter of 2009 to 2,8 per cent of GDP.

Other supply-side or exogenous factors are not expected to impart a significant upside risk to the inflation forecast. International oil prices have remained relatively stable in the

US$70 to US$80 dollar range, and moderate increases over the forecast period have been incorporated into the inflation forecast. Nevertheless, an increase in the order of 50 cents per litre has been assumed for April; about half of which is due to increased fuel levies announced in the budget.

Domestic food prices, which for most of last year were one of the main sources of upside risk to the inflation outlook, have recently contributed favourably to the inflation outlook. In the past few weeks maize prices have declined significantly, despite an upward trend in other food prices globally. While it is not clear at this stage to what extent these price declines will be passed on to the consumer, these developments should at least constrain food price increases for some time.

Wage settlements continue to indicate some moderation, but remain positive in real terms. The ratio of total compensation of employees to real GDP declined from 10,1 per cent in the year to the third quarter of 2009 to 9,2 per cent in the year to the fourth quarter. Nominal unit labour costs increased from 5,7 per cent in the third quarter to 8,8 per cent in the fourth quarter of 2009, but this figure was distorted by significant one-off adjustments to some public-sector pay scales.

Despite the reduced uncertainty associated with the electricity tariff increases, electricity and other administered price increases remain a threat to the inflation outlook. Of concern is the apparent trend towards greater reliance on high tariff increases to finance long-term infrastructural expenditure projects. These increases are, in effect, relative price changes or implicit tax increases. However, they contribute to the general inflation environment and remain a challenge for monetary policy.

Monetary policy stance

The assessment of the MPC is that despite clear signs that the economy has emerged from the recession, the pace of recovery is expected to remain slow. The improved inflation environment has provided some space for an additional monetary stimulus to reinforce the sustainability of the upswing without jeopardising the achievement of the inflation target. The MPC has therefore decided to reduce the repurchase rate by 50 basis points to 6,5 per cent per annum with effect from 26 March 2010. The MPC will continue to assess developments and will adjust the monetary policy stance when necessary in order to achieve the inflation target.

Statement of the Monetary Policy Committee

13 May 2010

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

Introduction

Since the previous meeting of the MPC, the outlook for domestic inflation has remained favourable, with inflation still being expected to remain within the target range over the forecast period. Domestic economic growth prospects appear to have improved and most growth forecasts have been revised upwards, despite only a modest recovery in household consumption expenditure.

The risks to this relatively favourable growth outlook have changed somewhat in the past few days as a result of recent global developments. The uncertainty related to the sustainability of fiscal deficits in a number of euro area countries, and the reaction of the financial markets to these events, has renewed fears of possible contagion that could affect the tentative recovery that has been taking place in most regions, including in South Africa. The concerted efforts by European governments, the European Central Bank (ECB) and the International Monetary Fund (IMF) have had some effect on calming the markets. However, significant risks to the global and domestic recovery remain.

Recent developments in inflation

The year-on-year inflation rate as measured by the consumer price index for all urban areas (CPI) declined to 5,1 per cent in March 2010 from 5,7 per cent in the previous month. The category of housing and utilities remained the single biggest driver of inflation, having contributed 1,6 percentage points, mainly as a result of the impact of a 26,8 per cent year-on-year increase in electricity prices. Food price inflation continued to contribute favourably to the average inflation outcome, having increased by 0,5 per cent. Administered prices excluding petrol and paraffin increased by 10,4 per cent, compared with 10,8 per cent in the previous month.

Producer price inflation increased to 3,7 per cent in March 2010, compared with 3,5 per cent in February. This upward trend was driven mainly by primary commodity price increases that do not impact directly on the CPI. Food price inflation at the producer level remained well contained and should constrain food price inflation at the consumer price level in the coming months. Agricultural food prices declined at a year-on-year rate of 6,2 per cent, while manufactured food prices declined by 1,5 per cent.

The outlook for inflation

The CPI forecast of the South African Reserve Bank (the Bank) indicates a slightly improved outlook compared with that presented at the previous meeting of the MPC, with a lower projected inflation for 2010 and 2011. CPI inflation is still expected to reach a low point in the third quarter of 2010 when it is forecast to average 4,7 per cent. Inflation is then expected to increase moderately and remain within the inflation target range until the end of the forecast period, which has been extended to the end of 2012, at 5,3 per cent.

Recent surveys indicate that analysts' inflation expectations are within the inflation target range for most of the forecast period. According to the Reuters CPI survey, respondents expect inflation to average 5,3 per cent in 2010, and 5,8 per cent and 6,0 per cent in the following two years. Inflation expectations as indicated by inflation-linked bonds also reflect an improvement since the previous meeting of the MPC and are within the inflation target range.

According to the *World Economic Outlook* published by the IMF in April 2010, global growth is now expected to average 4,2 per cent in 2010, compared with the October 2009 forecast of 3,1 per cent. However, the recent developments in Europe have raised the possibility of a renewed crisis that could threaten the global recovery. The reaction of the financial markets to the downgrading by the rating agencies of some euro area countries was reminiscent of the aftermath of the collapse of Lehman Brothers in September 2008. Apprehension about a possible default on Greek sovereign debt sparked concerns of a contagion effect on other European economies with high fiscal deficits and debt ratios. There were also fears of a spillover to the European banking sector, which has significant exposures to the sovereign debt of these countries.

The financial markets initially reacted positively to the concerted and significant policy interventions announced on 8 May by the euro area governments and the ECB. However, the markets were subsequently less convinced that the measures taken would be sufficient to resolve the underlying solvency problem of these countries, or that the required fiscal consolidations would be politically and socially feasible. These developments demonstrate the fragility of the global environment and the related uncertainties pose a downside risk to the global recovery. The global inflation outlook, however, is expected to remain benign and is not expected to pose an upside risk to domestic inflation.

For much of the period since the previous MPC meeting, the exchange rate of the rand had remained relatively stable within a range of around R7,23 and R7,48 against the US dollar. The turbulence in the global financial markets resulted in a brief but significant depreciation of the rand against the US dollar, as risk aversion returned to the markets. Following the announcement of the proposed government interventions in Europe, the rand appreciated to current rates of around R7,50 against the US dollar.

On a trade-weighted basis, the rand has remained relatively unchanged since the beginning of the year. Over the same period the rand has depreciated by over 1 per cent against the US dollar, but has appreciated by around 11 per cent against the euro. At current levels, the rand remains a positive factor in the inflation outlook, but this is contingent on developments in the euro area and general risk aversion.

The global developments also highlight the current focus of the financial markets on the sustainability of fiscal deficits and debt ratios. The South African national government deficit measured an estimated 6,7 per cent of GDP in the 2009/10 fiscal year, compared with the projected 7,2 per cent announced in the February budget. The deficit is expected to narrow over the next three years as the economy recovers and to measure 4,7 per cent in the 2012/13 fiscal year. The overall government debt-to-GDP ratio is expected to peak at 43 per cent in the medium term. This fiscal trajectory is consistent with fiscal sustainability and the MPC does not foresee a possible conflict with monetary policy objectives should this trend be maintained.

The moderate recovery in domestic economic growth appears to be sustained. Both the composite leading and coincident business cycle indicators of the Bank continued their upward trend in the first two months of 2010, confirming the positive short-term outlook for domestic economic activity. The various business confidence indices are also relatively favourable. The most recent GDP forecast of the Bank is for growth of 2,7 per cent in 2010 and 3,6 in 2011. At these rates of growth, the output gap is not viewed as an upside risk to the inflation outlook. The main risks to the growth outlook are seen to emanate from possible adverse global economic developments.

The growth outlook is underpinned by the continued recovery in the manufacturing sector, which grew at a broad-based year-on-year rate of 6,3 per cent in March. The Kagiso/BER Purchasing Managers Index declined in April, but still reflects a continued expansion of this sector. Total mining production increased at a year-on-year rate of 11,0 per cent in March.

Private-sector demand pressures remain benign from an inflation perspective. There is some evidence of an improvement in household consumption expenditure. Real retail sales declined on a year-on-year basis in February, but the shorter-term trends were more positive. When the three months to February are compared with the previous three months, an increase of around 3 per cent was recorded. New vehicle sales also maintained their favourable trends, increasing at a year-on-year rate of 36 per cent in April.

Domestic bank credit extension to the private sector continues to reflect weak demand conditions despite evidence of some loosening of credit supply constraints. Twelve-month growth in loans and advances contracted by 0,3 per cent in March 2010. Growth in mortgage advances declined from 3,9 per cent in February to 3,6 per cent in March, but nevertheless remained the only category of credit extension to register positive growth. The most recent Ernst & Young/BER Financial Services Index shows that the banks have moved to a more neutral position with respect to credit standards applied to new loans.

Consumption is also determined to some extent by the wealth effects in the economy. House prices appear to have recovered somewhat, and the various indices now all reflect positive house price growth. The equity markets have also improved significantly since their lows in March 2009. However, in the five trading days to 7 May, the JSE All-Share Index declined by almost 10 per cent, demonstrating the vulnerability of the market to changes in sentiment.

Despite the more favourable growth outlook, employment trends appear to be lagging the domestic recovery. The *Quarterly Labour Force Survey* indicates that 171 000 jobs were lost in the first quarter of 2010. These adverse trends are expected to constrain household consumption expenditure somewhat and offset, to some extent, the positive impact on consumption of higher real wage increases.

Notwithstanding these job losses, there is a concern about the possible impact of the level of wage increases in the economy. According to Andrew Levy Employment Publications, the average wage settlement rate in the first quarter of 2010 moderated to 8,4 per cent, compared with the 9,3 per cent increase measured in 2009. However, the MPC noted that a number of wage negotiations are at significantly higher levels, and well above the current and expected inflation rate. Should a general upward trend in wage settlement rates transpire, in the absence of compensating increases in productivity, it could pose an upside risk to the inflation outlook.

Other factors that have a significant impact on the inflation outlook include food and petrol prices. As noted earlier, food price inflation is expected to remain subdued as a result of the recent decline in the domestic maize price. The international oil price, having remained in the range of US$70 to US$80 per barrel for some time, appeared to have resumed its upward trend since late April. However the recent uncertainty in the financial markets, which cast doubts about the sustainability of the global recovery, resulted in a decline in the international price of Brent crude oil to below the US$80 per barrel level.

Monetary policy stance

The assessment of the MPC is that inflation is likely to remain within the inflation target range over the forecast period, and that the economy is expected to continue on a recovery path. The risks to the inflation forecast are seen to be more evenly balanced than at the previous meeting of the MPC. The main risks to the inflation outlook emanate from administered price developments and from the risks emanating from the global economy. The domestic growth outlook will continue to be affected by the global developments. The MPC will continue to monitor these developments closely.

For these reasons, the MPC deems it appropriate to maintain the current stance of monetary policy. Accordingly, the repurchase rate remains unchanged at 6,5 per cent per annum.