MONETARY POLICY REVIEW

March 2001

South African Reserve Bank

Contents

Foreword

Mr T T Mboweni
Governor of the South African Reserve Bank

In February 2000 formal inflation targeting was introduced in South Africa. One of the features of an inflation-targeting framework is the greater degree of transparency it requires regarding monetary policy. The inflation target gives the Bank a measurable aim in the conduct of monetary policy, and at the same time it is a yardstick against which our actions can be evaluated. A credible inflation target should provide an anchor for inflation expectations and guide forward-looking economic decision-making.

Some degree of the success of the inflation-targeting framework depends on whether the Bank's actions are fully understood by and have credibility with labour, business, and other sectors of the economy. Monetary policy transparency and openness are essential in order to enhance the understanding and credibility of our policies. The greater transparency associated with inflation targeting also means that the Bank has become more accountable for its actions to the public.

Our commitment to transparent monetary policy has resulted in several initiatives to improve the communication of our policies to the public. At the conclusion of every Monetary Policy Committee (MPC) meeting, a press conference is held where the reasons for the MPC's policy stance are explained. At the same time a detailed statement is released. We have also convened Monetary Policy Forums that provide a platform for open discussions on monetary policy and general economic developments. The MPFs are held twice a year in major centres around the country and engage with labour, business, community and other interested organisations and individuals. Finally, in line with international practice, the Bank reports regularly to Parliament on monetary policy.

This Monetary Policy Review, which will be published twice a year, is a further initiative aimed at broadening the understanding of the aims and conduct of monetary policy. In the Review we analyse the domestic and international developments that have impacted on inflation, and the monetary policy reaction to these developments. Since in an inflation-targeting framework monetary policy must be forward-looking, we also provide an assessment of the future outlook for the factors determining inflation as well as our forecast of the future path of inflation. Because such forecasts are by definition subject to a great deal of uncertainty, the forecast is presented in the form of a fan chart, which is a technique many central banks use for illustrating their forecasts.

We trust that this Monetary Policy Review will reinforce our commitment to transparency, and increase the understanding of monetary policy. Our ultimate goal and commitment is price stability on a sustainable basis. Greater understanding of our policies will speed up the achievement of this goal.

We invite you to study this Review and we would appreciate your comments and views on it.

Mr T T Mboweni
Governor of the South African Reserve Bank

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Monetary Policy Review

Introduction

Inflation targeting was formally introduced in South Africa in February 2000. The year turned out to be particularly challenging for the new monetary policy framework, given a number of developments on the international front in particular. Oil price movements and the depreciation of the rand exchange rate in the course of the year placed upward pressure on the inflation rate. Domestic economic developments, however, provided a more benign environment for countering inflation. By the beginning of 2001, the picture had changed significantly. Although the oil price appeared to have stabilised and domestic economic activity was improving, the sudden sharp decline in United States economic growth greatly increased uncertainty about the international outlook. The challenge for monetary policy has therefore been to bring about price stability in a changing economic environment.

This *Monetary Policy Review* is part of the Reserve Bank's attempt to broaden the understanding of the aims and conduct of monetary policy. As this is the first *Review,* it begins with a brief overview of some general issues relating to inflation targeting and some of the implications of this framework for monetary policy. This is followed by an analysis of the determinants of inflation and an assessment of monetary policy actions over the past year or so. The final section contains an overview of the outlook for inflation.

Inflation targeting

Inflation targeting is a monetary policy framework aimed at facilitating the reduction of the inflation rate or the maintenance of price stability. It is a framework for anchoring inflation expectations, and as can be seen in Box 1, has been successfully adopted by an increasing number of countries in recent years.

Inflation targeting, as its name suggests, implies a responsibility on the part of the central bank to achieve a predetermined inflation outcome, sometimes expressed as a range, and in some countries as a point target. The main focus of monetary policy then becomes the attainment of this target. In South Africa the inflation target has been specified as achieving an average rate of increase in the overall consumer price index, excluding mortgage interest cost (the CPIX), of between 3 and 6 per cent for the year 2002. This variant of the consumer price index was chosen because the headline or overall consumer price index is influenced directly by changes in the Reserve Bank's monetary policy. A relaxation of monetary policy through a reduction of the Reserve Bank's repurchase rate leads to lower interest rates in general, including mortgage interest costs. This in turn initially leads to lower measured inflation. Conversely, when monetary policy is tightened, for instance in order to reduce inflation, this leads to an initial increase in measured inflation through higher mortgage rates. To overcome this problem, it was decided that mortgage interest cost would be excluded from the consumer price index, for inflation targeting purposes.

A number of important implications of inflation targeting have impacted on the way monetary policy has been conducted, for example:

- Because the numerical inflation target becomes the overriding objective of monetary policy, it creates greater certainty about the Reserve Bank's policy stance and makes transparent the ultimate objective of monetary policy. Therefore this target helps discipline monetary policy and strengthens accountability of the Bank.

- Inflation targeting requires nominal exchange rate flexibility. In South Africa's case a fully flexible exchange rate regime has been adopted. This means that there is no specific target for the exchange rate. It does not however mean that the Reserve Bank is not concerned about the exchange rate, as exchange rate changes do feed into the inflation process. A depreciation of the currency directly affects the price of imports. Then there are the possible second-round effects where higher import prices feed in to wage and other price increases.

- Inflation targeting increases the co-ordination between monetary policy and other economic policies. It is more effective if there is a commitment from various quarters. At a minimum, there has to be agreement between the Reserve Bank and the government. The process would be easier if a similar commitment is obtained from the private sector as well as from the trade unions. If there is credibility that a particular target will be achieved, wages and prices will have a clear reference point, and the transition to lower rates of inflation will be far smoother.

- The pursuit of inflation targets does not mean that the Reserve Bank is not concerned about the attainment of sustained high economic growth and employment creation. Monetary policy cannot contribute directly to economic growth and employment creation in the long run. However, by creating a stable financial environment, monetary policy fulfils an important precondition for the attainment of economic development.

- In the application of inflation targeting in South Africa, allowance is made for serious supply shocks. Some discretion must be used in order to avoid costly losses in output and jobs. The Reserve Bank monitors economic developments closely to determine the origin and likely impact of such supply shocks. Although it is not possible to specify in advance all the economic shocks that could affect monetary policy, it is also important that the inherent discipline of inflation targeting is not foregone by using unconstrained discretion. The challenge facing the Reserve Bank is to apply this monetary policy framework without becoming too inflexible in its approach.

- By adopting a forward-looking approach, inflation targeting should allow monetary policy to reduce volatility in business activity and smooth out the growth trend. A feature of monetary policy internationally in the past was the 'stop-go' phenomenon where monetary policy was tightened only when inflation had clearly moved up. So, instead of being pre-emptive, monetary policy was reactive in the sense that it was only changed when inflation became entrenched in expectations and therefore in wage demands. This required a tighter monetary policy stance in terms of higher interest rates and for longer periods than might otherwise have been the case. This resulted in greater cyclical fluctuations, making it more difficult to reduce inflation.

- Finally, as mentioned above, inflation targeting is a forward-looking approach and an inflation-targeting central bank has to decide how its current policy stance will affect future price movements. The difference between inflation targeting and other frameworks is that inflation targeting makes forecasting explicit and more transparent. The fact that a definite time horizon is specified in inflation targeting makes it important for the central bank to have a reliable forecasting framework. The Reserve Bank currently makes regular inflation forecasts using a number of newly developed models. Obviously, in determining the monetary policy stance, the forecasts of these models cannot be followed blindly. Also needed is a careful analysis of the underlying economic conditions that could affect the predicted outcome of the models. The information available for the Bank's forecasting framework is enhanced by a survey of inflation expectations undertaken by the Bureau for Economic Research (BER) of the University of Stellenbosch. The results of this survey, as well as the forecast of the Bank's core model, are presented later on in this *Review*.

Box 1: Inflation targeting: the international experience

Since they were first introduced in New Zealand in 1990, inflation targets of some form have been announced by industrialised countries such as Canada (1991), the United Kingdom (1992) and Sweden (1993), and by developing countries including Chile (1991), Israel (1991), Mexico (1994), Brazil (1999), Thailand (2000) and South Africa (2000). Transition economies, namely the Czech Republic (1997) and Poland (1999), have also recently opted for inflation-targeting monetary policy frameworks.

In practice, some countries have opted for target ranges in specifying their inflation targets, while others prefer a point target or a point target combined with a range. The trade-off in this regard is essentially between the simplicity of a point target, and the degree of flexibility for absorbing shocks outside the control of the authorities, which a target range allows.

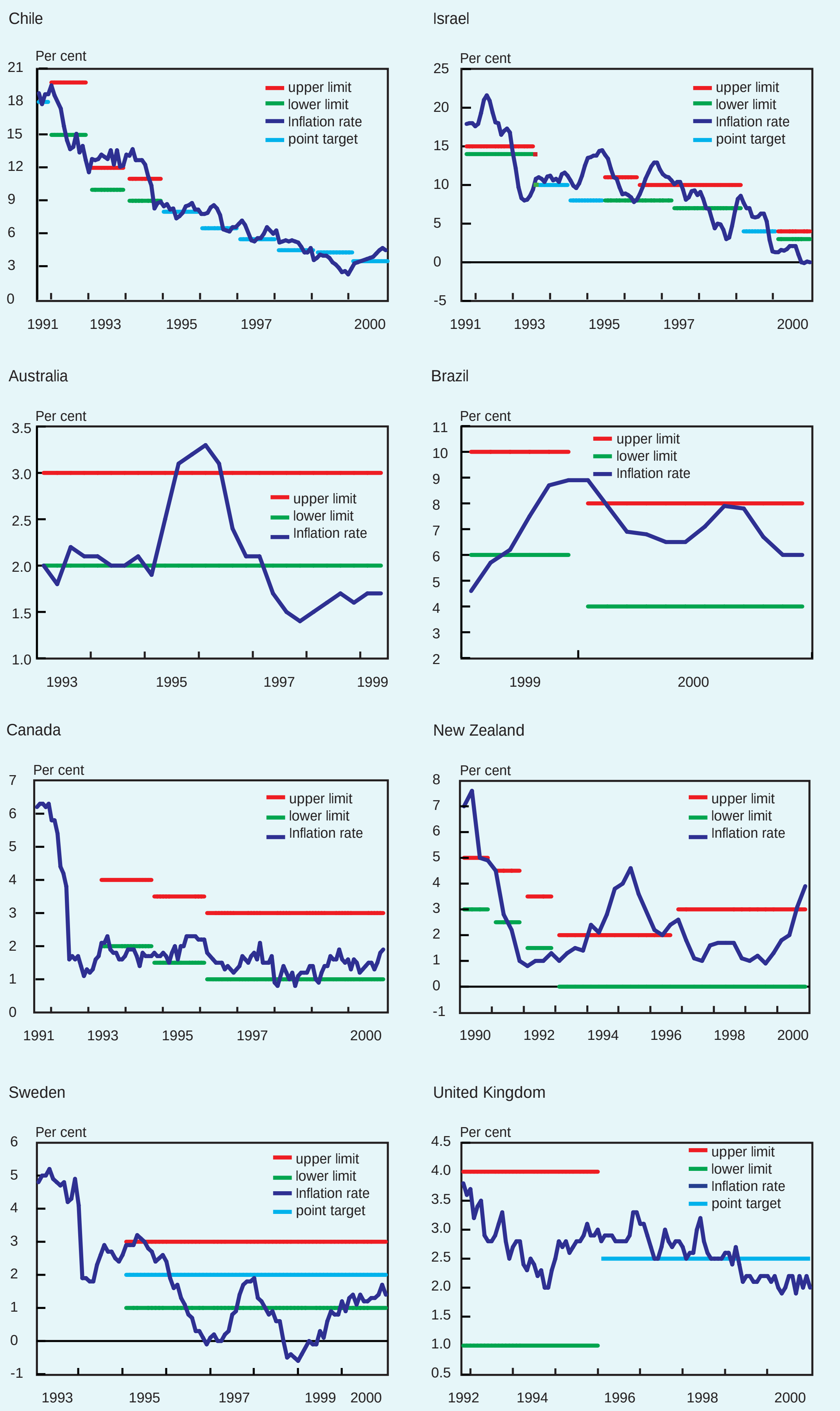
The experiences of some of the above-mentioned countries with inflation-targeting regimes are summarised in the graphs presented in Figure B1.1. These graphs indicate that when comparing the targeted indices with the announced inflation targets, experiences with inflation targeting have mostly been positive. Though no country with an inflation rate above 30 per cent has opted for this type of regime, targets have generally been met even in developing countries where inflation tended to be higher and more variable at the outset.

In Chile and Israel, for example, where inflation targets were initially combined with crawling peg exchange rate regimes, gradual disinflation has been achieved. Chile in the 1990s reduced its targets (initially specified as ranges and later as points) and its measured inflation rate by 1 or 2 percentage points a year to an average rate of 3,8 per cent in 2000. Israel managed to reduce inflation from around 18 per cent in 1991 to about 1 per cent in 1999 and to zero in 2000, despite episodes of inflationary pressure. In Brazil, which only adopted an inflation-targeting regime in June 1999 when the Russian crisis forced it to abandon its crawling peg exchange rate, the early signs are promising. Inflation was 8,9 per cent at the end of 1999, and the first inflation target was met.

The more developed countries have also had success with their inflation-targeting regimes. New Zealand reduced its inflation rate rapidly until 1992. Despite a hiccup in 1995, when the authorities underestimated the strength of inflationary pressures in the economy and then widened their target range to 0-3 per cent, inflation returned to this range until recently. Canada, too, managed to reduce inflation rapidly after implementing inflation targeting in February 1991, and after undershooting its target in 1993-94, has kept inflation in the lower half of its target range ever since. The United Kingdom initially remained within its target range and has since fluctuated close to its point target, while Sweden has achieved its inflation target since it became operational in 1995 with the exception of two periods when inflation was below the lower limit of its tolerance range. Australian inflation was at or just below the lower end of its 'thick point' target until 1995, after which it breached first the upper and then the lower limit of this target.

To date, the international experience with the inflation-targeting monetary policy framework has been favourable, and inflation has generally been in line with the targets that have been set.

Figure B1.1 Inflation targets and realised inflation rates



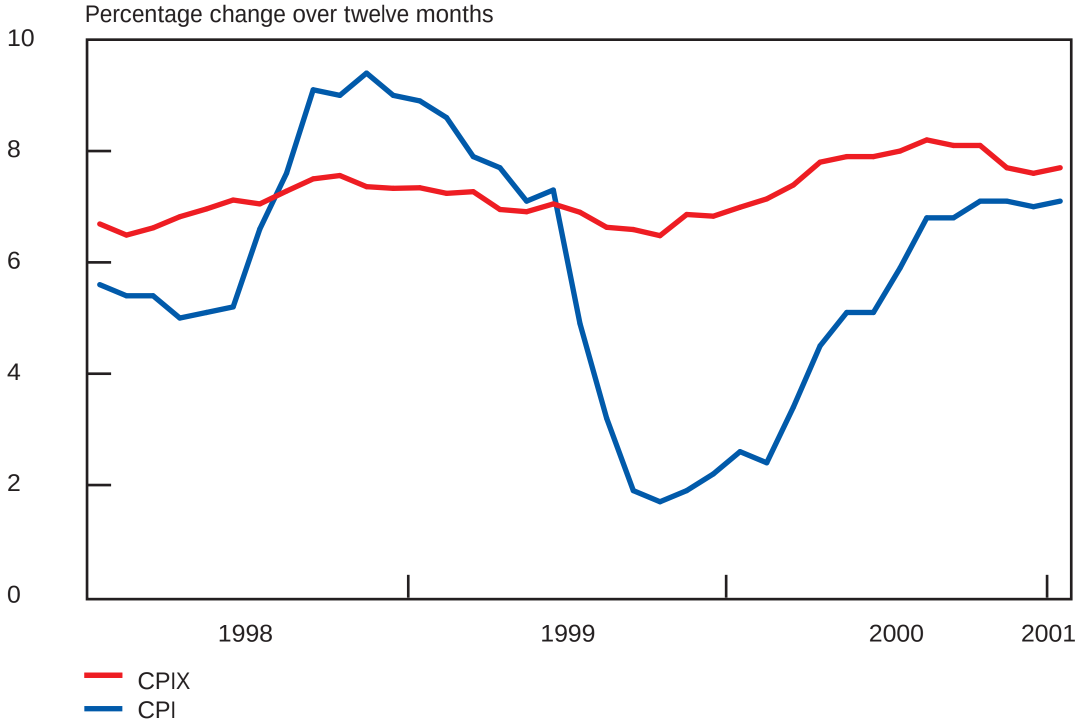
Recent developments in inflation

This section analyses recent trends in the main inflation indices, and reviews developments in the main factors affecting inflation in the South African economy.

The evolution of indicators of inflation

CPIX (for metropolitan and urban areas) inflation, selected as the appropriate measure for inflation-targeting purposes, was 7,7 per cent for the twelve-month period to January 2001. As Figure 1 shows, CPIX inflation increased from 6,5 per cent in October 1999 to 8,2 per cent in August 2000. It then fell to 7,6 per cent in December 2000, before rising slightly again in January.

Figure 1 Consumer price inflation: CPIX and CPI

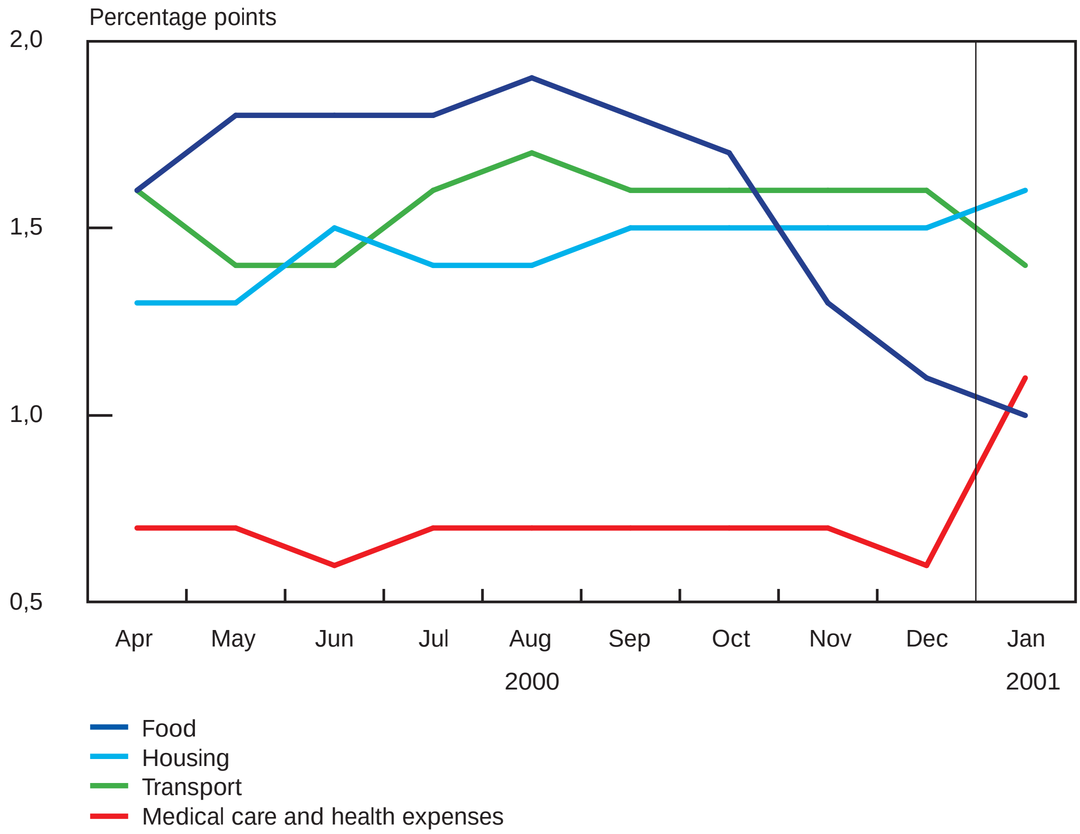


Source: Statistics South Africa

Important causes of the upward trend in CPIX inflation until August 2000 were higher food prices, and a rise in transport prices related to the surge in crude oil prices experienced in world markets between early 1999 and late 2000. Box 2 provides a more detailed discussion of the impact of higher oil prices on domestic inflation. Figure 2 reveals that the food and transport components contributed 1,9 and 1,6 percentage points, respectively, to overall CPIX inflation of 8,2 per cent in August 2000. Pressure from food prices then declined rapidly, and by January 2001 this component contributed only 1 percentage point to overall CPIX inflation. Transport price increases, too, have moderated since August, and contributed 1,4 percentage points in January 2001. Figure 2 also shows that the contribution of housing costs increased gradually from 1,4 to 1,6 percentage points between August 2000 and

January 2001, while medical care and health expenses increased sharply from 0,6 percentage points in December 2000 to 1,1 percentage points in January 2001.

Figure 2 Contributions to CPIX inflation

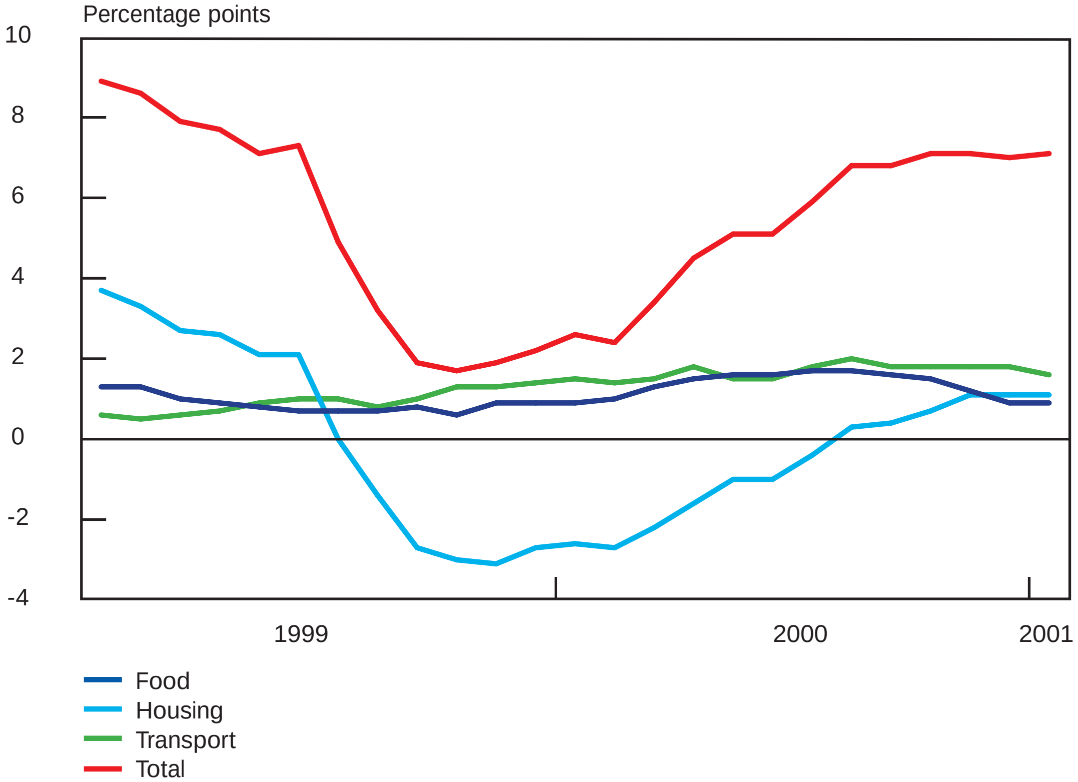


Source: Statistics South Africa

Figure 1 shows the divergence between CPIX and CPI (for metropolitan areas) inflation and this illustrates the problems associated with using the latter in an inflation-targeting context. Figure 3 reveals that the initial low level of CPI inflation in late 1999 reflected the impact of monetary policy-induced interest rate changes on the housing component of the index. From August 1999 to July 2000 this component made a negative contribution to the CPI that was largely responsible for the low inflation measured by this index. This negative contribution was the result of falling payments on mortgage loans as interest rates declined from the high levels reached at the time of the Asian crisis in late 1998. As interest rates stabilised at lower levels early in 2000, changes in other housing-related prices assumed greater importance, and placed upward pressure on the index.

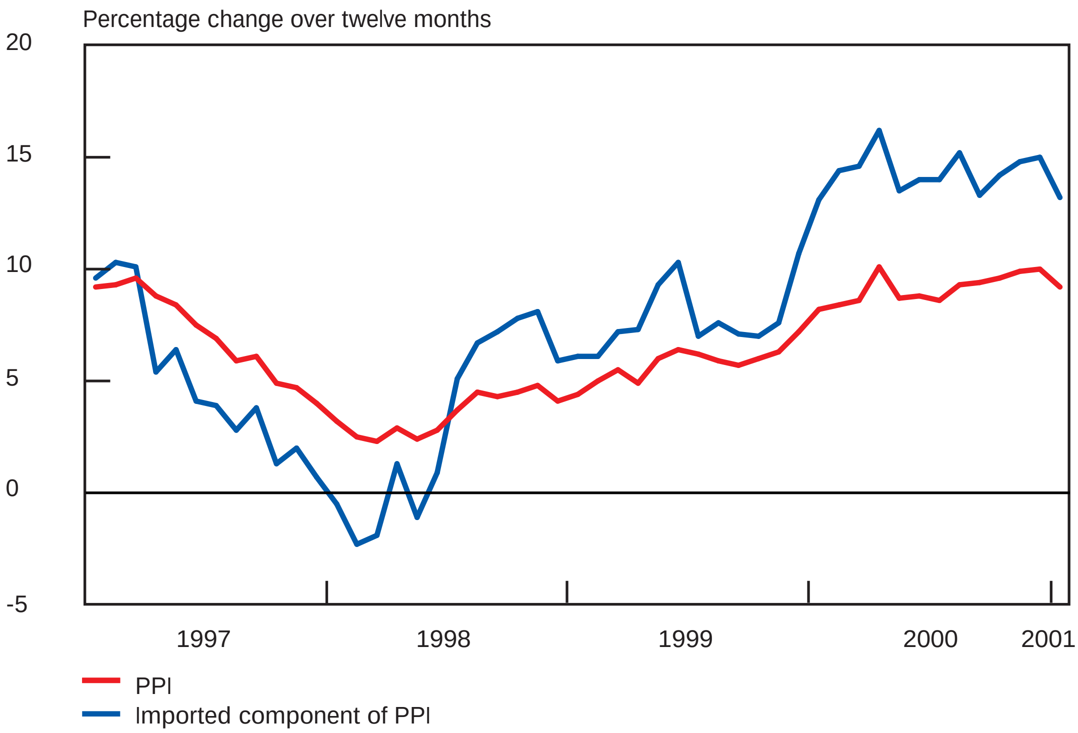
Inflation measured by production prices has generally trended upward since early in 1998, as shown in Figure 4. Annual inflation measured by the production price index (PPI) increased from 2,3 per cent in March 1998 to 10,0 per cent in December 2000, with a spike to 10,1 per cent in April 2000, before declining slightly to 9,2 per cent in January 2001. As is clear from Figure 4, the upward trend was driven by higher inflation in the imported component of the index. The rand price of imported goods included in the PPI began to rise faster than the overall index midway through 1998,

Figure 3 Contributions to CPI inflation



Source: Statistics South Africa

Figure 4 Production price inflation



Source: Statistics South Africa

when the rand depreciated significantly in the wake of the Asian and Russian crises, and continued to place upward pressure on the index as a result of the increase in international oil prices and the further weakness of the rand in 2000.

Production prices have historically provided some indication of future trends in consumer prices. Recently, however, this relationship has not been clearly evident in the data. Though annual CPIX inflation turned down after August 2000, for example, inflation measured by the PPI continued to rise in December before declining to 9,2 per cent in January 2001.

The reasons for this temporary breakdown in the relationship lie in the interaction of technical factors related to the compilation of the indices and the factors currently impacting upon inflation in South Africa, which have been identified in the discussion so far. Particularly important in this regard is the relative treatment of the increase in food prices, the surge in crude oil prices and the weakening of the exchange rate in the compilation of the indices.

In the case of the PPI, which measures only changes in goods prices, imported goods have a weight of 27 per cent in the index, as opposed to an estimated weight of around 6 per cent in the CPIX. It may be expected therefore that factors such as the weakening of the exchange rate and increases in imported energy prices have a relatively larger impact on the PPI.

Furthermore, changes in international crude oil prices are directly reflected in the imported component of the PPI. The moderating effect of specific taxes on the petrol price included in the CPIX does not operate on the PPI. For this reason, too, the recent oil price increases will have a larger effect on production prices than on consumer prices.

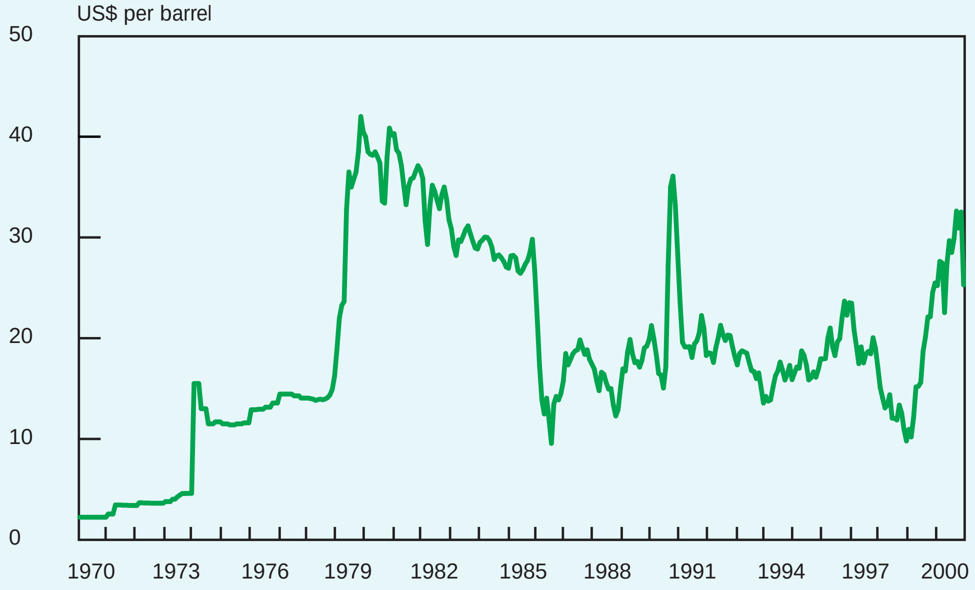
Another reason advanced for the current divergence between the two indices is the relative treatment of food prices. This component has a weight of almost 22 per cent in the CPIX, compared with around 16 per cent in the PPI. The recent moderation in food price inflation therefore impacts more on the CPIX than on the PPI. Also, it is often argued that changes in the production prices of food lead those in consumer prices. Since production prices stabilised in late 2000 after earlier declines, it may be expected that the moderating influence of the food component of the CPIX evident in Figure 2 will end in the coming months.

Box 2: Oil prices and inflation

World crude oil prices have fluctuated significantly in recent years (Figure B2.1). After falling in late 1998 to their lowest levels in 25 years, they rose strongly from early 1999 following production cuts by the Organisation of Petroleum Exporting Countries (OPEC) and growing world demand. By the second half of 2000, they had reached their highest levels since the Gulf War price spike in 1990. Prices remained high despite repeated sets of co-ordinated production increases by OPEC, intended to maintain prices in a range of US$22-US$28, and it was only in December 2000 that prices fell into this target range.

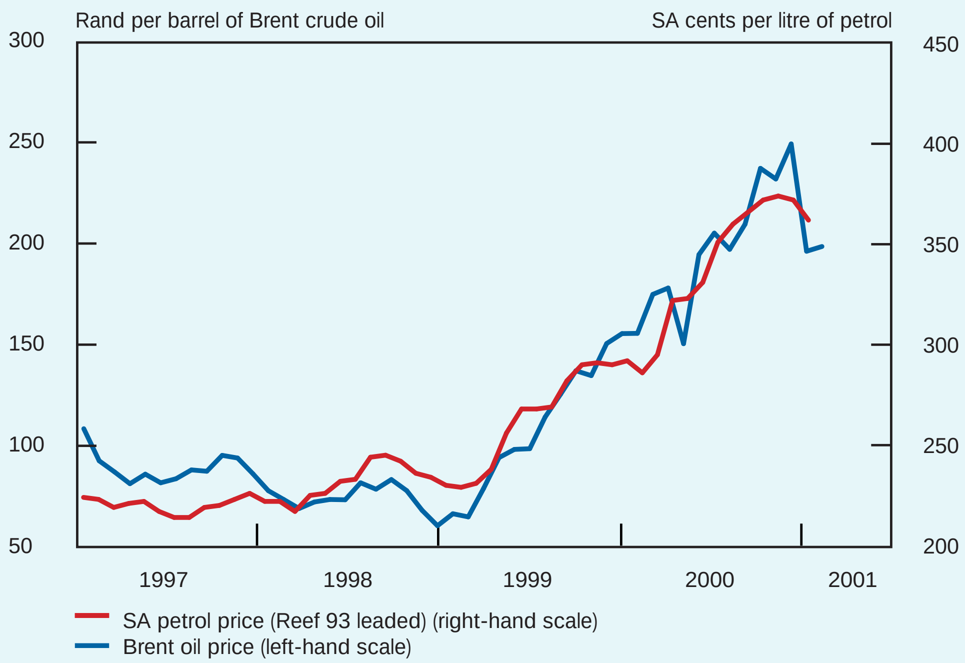
The impact of these changes in global oil prices on domestic prices is difficult to measure with precision, as both direct and indirect effects have to be taken into account. Complicating factors such as changes in the exchange rate and the state of the economy can also moderate or exacerbate these effects.

Figure B2.1 The price of Brent crude oil



For consumer prices, the initial impact is evident in the petroleum products included in the CPI and CPIX. Petrol and fuel prices are highly sensitive to international crude oil prices once allowance is made for the effect of specific taxes, so these direct effects appear with a relatively short time lag (Figure B2.2). Given a share of petrol and diesel prices of around 4,1 per cent in the CPI and CPIX baskets, the direct effect of a rise in oil prices which causes an increase of say 10 points in the index for these items over their base period, would add 0,41 percentage points to overall measured inflation.

Figure B2.2 Brent crude and South African petrol prices



In the case of production prices, both crude oil and downstream petrol products are included in the index. The measure employed by Statistics SA includes crude oil prices as a part of the 'other minerals' component of mining and quarrying ('other minerals' having a weight of 3,18 per cent), and 'products of petroleum and coal' in the manufacturing sector (with a weight of 2,75 per cent). In addition to these weights, the moderating effect of specific taxes does not operate on the crude oil component. It may be expected therefore that the direct effect of an oil price rise on production prices will be larger than in the case of consumer prices.

These direct effects are fairly easily discernible, but the indirect effects present more of a challenge. Although some of the effects on downstream sectors, such as transportation, and on alternative energy sources can be identified, the aggregate impact is not easily measured. Past experience suggests that these effects will only appear gradually, and depend to some extent on the cyclical and competitive state of the economy.

Excluding energy prices from the calculation of the price indices gives some indication of the impact of these indirect effects on inflation. The impact to date of excluding energy prices from the CPIX and PPI is evident in Figures B2.3 and B2.4, respectively. The CPIX measure of annual inflation in 2000, which peaked at 8,2 per cent in August and was down to 7,6 per cent in December, would only have measured 7,2 and 6,7 per cent, respectively. As the discussion above suggests, excluding energy prices from the PPI has a larger influence on inflation measured in this way. The all-goods PPI inflation trended upward, with the oil price, from 4,4 per cent in January 1999 to reach an annual rate of 10,0 per cent in December 2000 (with a spike to 10,1 per cent in April). If energy prices are excluded, however, PPI inflation would have fallen from 5,8 per cent in February 1999 to 3,4 per cent in October and November of that year, and would still have been at 3,6 per cent in March 2000. After the increases experienced since then, annual PPI inflation excluding energy prices rose to 6,3 per cent in December 2000.

From a policy perspective, it is primarily the indirect effects that occupy decision makers. In particular, if the direct price effects feed into wages and other prices, and if inflation expectations are hiked upward, then a policy response would be warranted. For this reason, central banks will keep a close watch on the second-round effects of the recent oil price rise.

Figure B2.3 CPIX consumer price inflation and the oil price

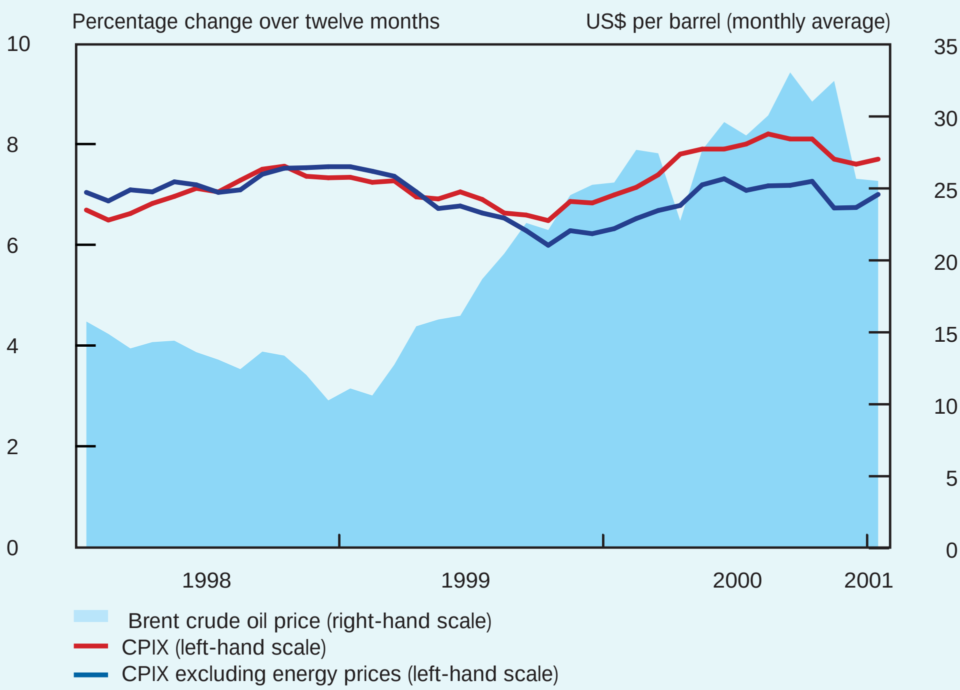
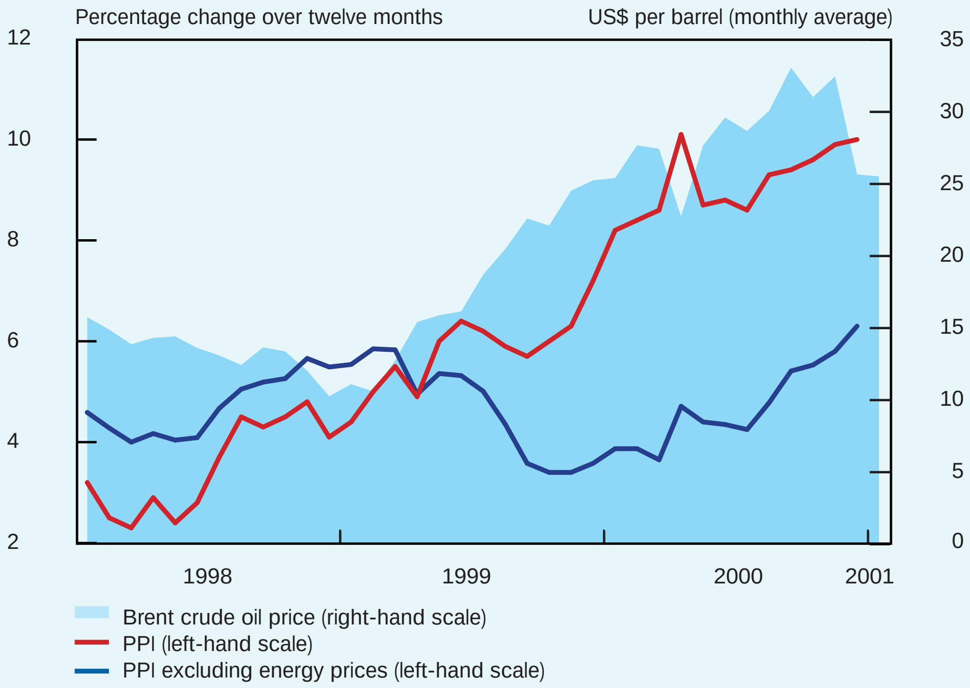


Figure B2.4 Production price inflation



Factors affecting inflation

The inflation environment is affected by several factors, and in order to apply monetary policy effectively, these factors have to be assessed. These factors include the external environment and exchange rate developments, labour market conditions, the state of domestic demand and output, fiscal policy and monetary conditions. The impact of administered prices on inflation is also considered.

The external environment

The external environment was an important factor determining the path and the outlook for inflation in 2000. A major factor was the oil price, as discussed above. The rising oil price had a direct impact on domestic prices and was a key consideration in the monetary policy decisions.

Another key factor is the general state of the international economy and world inflation, which is summarised in Table 1. During the first half of 2000, the United States economy continued its unprecedented economic expansion. In the second quarter of 2000, GDP growth of 5,6 per cent was recorded, following first-quarter growth of 4,8 per cent. This strong growth performance caused the US Federal Reserve to raise its target for the federal funds rate on six occasions from 4,75 per cent to 6,5 per cent between June 1999 and May 2000.

The upward trend of world interest rates was also observed in the euro area where the European Central Bank (ECB) raised interest rates on seven occasions between November 1999 and October 2000. The ECB was primarily concerned about the rising inflation rate which was spurred on by rising oil prices and the weak euro that depreciated from just over US$1,02 per euro at the beginning of 2000 to below US$0,83 in November. Growth in the euro area was generally around 3 per cent.

Table 1 Annual percentage change in real gross domestic product and inflation rates

	Real GDP		Inflation rates	
	1999	2000 (estimate)	1999	2000 (estimate)
World	3.4	4,7	5,4	4,6
Advanced economies	3,2	4,2	1,4	2,3
USA	4,2	5,2	2,2	3,2
Japan	0,2	1,4	-0,3	-0,2
Euro area	2,4	3,5	1,2	2,1
Developing countries	3,8	5,6	6,6	6,2
Africa	2,2	3,4	11,8	12,7
Asia	5,9	6,7	2,4	2,4
Western Hemisphere	0,3	4,3	9,3	8,9
Countries in transition	2,4	4,9	43,8	18,3

Source: IMF *World Economic Outlook* (October 2000)

In the United Kingdom, interest rates were raised by 25 basis points in January and again in February 2000, but the fact that inflation remained below the target of 2,5 per cent for the rest of the year meant that there were no further rate increases. However, the fairly robust growth rates in the UK meant that interest rates were not reduced during the year. In Japan, economic recovery has continued to be slow and fragile, and prices have continued to fall. Despite this, the Bank of Japan moved away from its zero interest rate policy and raised the overnight call rate by 0,25 per cent in August.

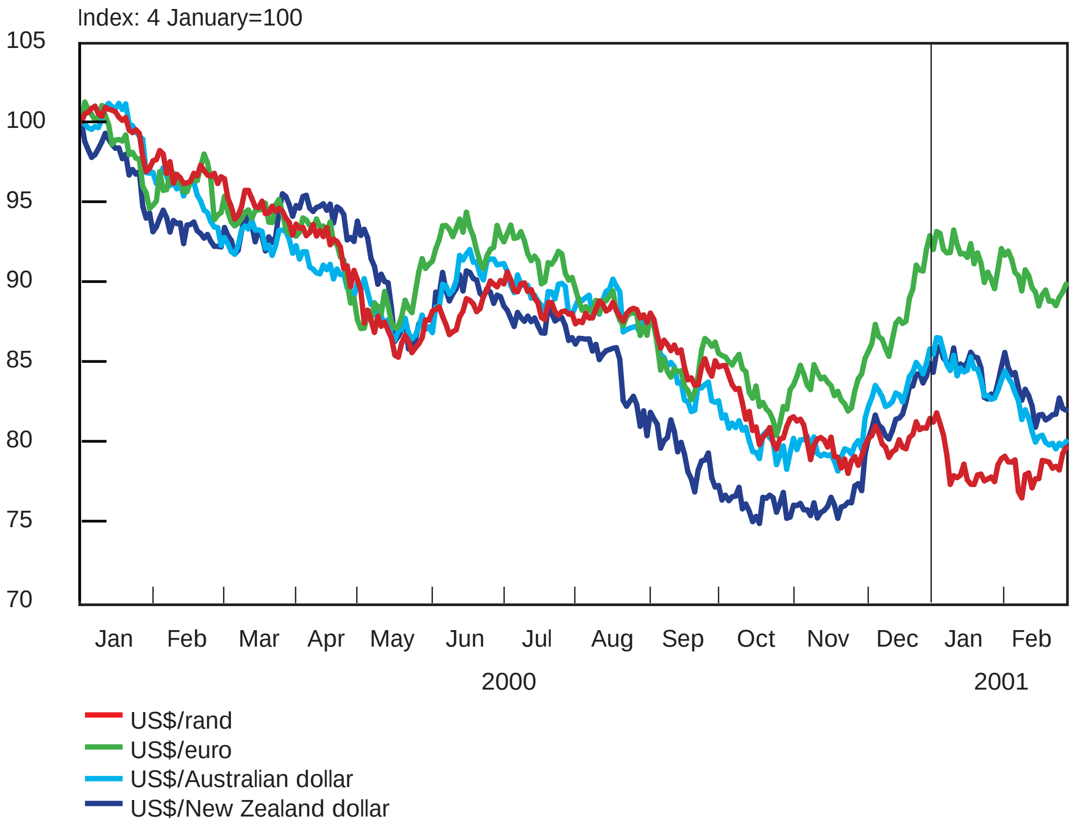
In the emerging markets of Latin America (apart from Argentina) and Asia in particular, the first half of 2000 was characterised by strong recovery from the Asian crisis. Inflation rates in Asia remained low, and Latin American inflation rates, although generally higher than in Asia and the advanced economies, remained under control and on a downward trend.

The second half of 2000 saw a dramatic change in the growth rate in the United States, although the full extent was only evident at the end of the year. Third-quarter growth was 2,2 per cent followed by 1,1 per cent in the fourth quarter, well below expectations. In an attempt to prevent the United States economy from sliding into a recession, the federal funds rate was reduced by 50 basis points on 3 January 2001, and by a further 50 basis points on 31 January. This contributed to a general decline in official interest rates internationally, including the United Kingdom, Japan, Canada and Australia. Therefore the general pressure on world interest rates and world inflation rates abated during the last few months of 2000 and the beginning of 2001, with the downturn in US growth and the decline in the oil price to within the OPEC target range.

Exchange rate developments

The expected path of the rand exchange rate figures prominently in monetary policy decisions given its direct and indirect impact on domestic prices. The exchange rate came under consistent pressure during 2000. Having started the year on a promising note, it fell sharply against the US dollar during the year. A major factor was the exceptional strength of the US dollar against the euro and most other currencies. As shown in Figure 5, the US$/rand exchange rate moved broadly in line with the movement of the US dollar against the euro. The Australian dollar and the New Zealand dollar followed a similar pattern. This reflected the capital flowing out of Europe and emerging markets into the United States. There were times when country-specific events caused divergences from the pattern of co-movement. Thus for example events in Zimbabwe in April/May 2000 resulted in a greater depreciation in the rand than in the other currencies. In late October when the euro started to gain ground against the dollar, the rand did not follow suit, although the Australian and New Zealand currencies did but to a lesser extent. This was caused by a number of factors, including sustained outflows of capital from South Africa in the fourth quarter, and unsubstantiated rumours about the relaxation of exchange controls and delays in the implementation of the government's privatisation programme.

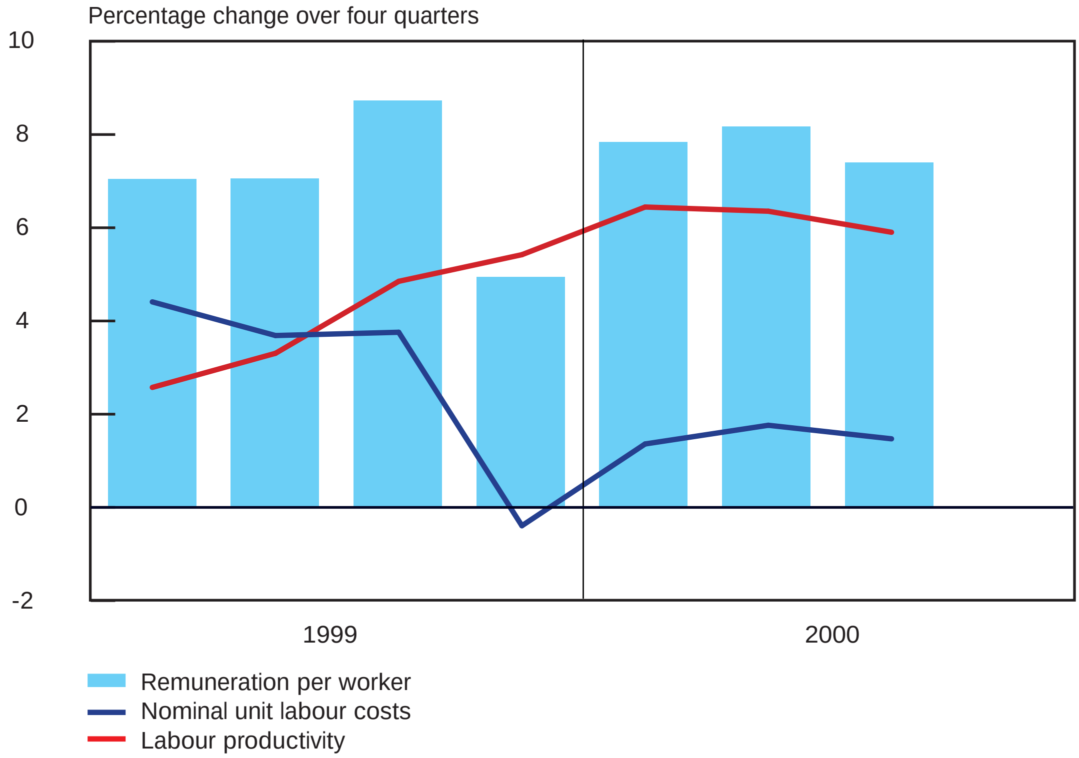
Figure 5 US dollar per rand, euro, Australian and New Zealand dollar



Labour markets

Wage developments are an important element in the inflation process, and therefore labour market developments are closely monitored for monetary policy purposes. From an inflation perspective, it is the increase in unit labour costs that is important, that is, the increase in wages adjusted for changes in productivity. As shown in Figure 6 annual growth in labour productivity in the non-agricultural sectors increased from 2,6 per cent in the first quarter of 1999 to 6,3 per cent in the second quarter of 2000, before falling slightly to 5,9 per cent in the third quarter. This was a result of growth in real output and the decline in formal-sector employment. Given the fairly moderate increases in nominal remuneration per worker in this period, this improvement in labour productivity resulted in the inflationary pressures associated with unit labour costs falling sharply. The annual change in unit labour costs was just 1,5 per cent in the third quarter of 2000. As a result, pressures on inflation emanating from the labour market have been subdued.

Figure 6 Remuneration per worker, labour productivity and unit labour costs

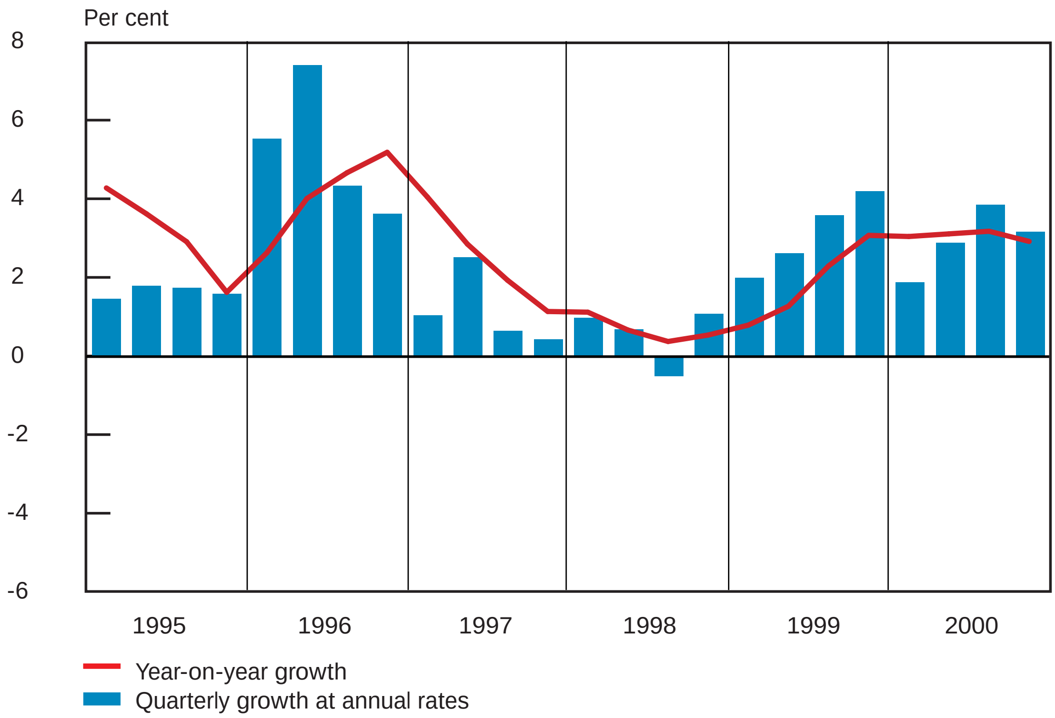


Demand and output

Domestic demand and supply conditions are also important determinants of inflation. Growth in the domestic economy has recovered steadily from the slowdown resulting from the Asian financial crisis of 1997-98. Figure 7 shows that real growth, measured as the annual change in constant 1995 price GDP, improved from a low of 0,7 per cent in the second quarter of 1998 to 3,1 per cent in the fourth quarter of 1999. Some of the momentum gained in 1999 was lost in the first quarter of 2000, as regional floods and capital outflows eroded the growth impetus. However, growth for the full year was marginally above 3 per cent.

On the demand side, real gross domestic expenditure rose by 2,7 per cent in 2000. Private consumption expenditure grew consistently throughout the year at around 3 per cent. This was driven by lower interest rates and higher real disposable income which in turn was affected by demutualisation receipts and the tax relief announced in the 2000 Budget. Gross fixed capital formation which had contracted sharply in 1999, recovered in 2000, increasing by 1,3 per cent for the year but increasing at a faster rate each quarter. These increases were partially offset by the decline of 2,4 per cent in the real consumption expenditure of general government, which continued on the downward trend that had begun in the last quarter of 1997.

Figure 7 Real gross domestic product (seasonally adjusted and annualised)



Growth in the volume of exports of goods and services levelled off in the first two quarters of 2000, and then grew strongly in the second half of the year. Import volumes also rose strongly in the same period.

Overall, demand and output were relatively subdued in the earlier part of the year, and although there was a recovery in the latter part of the year, there were no strong indications of inflationary pressures emanating from excess demand or excessive capacity utilisation.

Fiscal policy

A major cause of inflation, particularly in developing countries, is excessive government expenditure, and in the most extreme cases the printing of money to finance government budget deficits. In recent years, fiscal policy in South Africa has managed to bring government expenditure and the deficit under control, thus eliminating a significant potential source of inflationary pressure. As mentioned above, the growth of government consumption expenditure has been decelerating. Over the past few years, revenue levels have improved, largely owing to more efficient tax collection. The objectives of the 2001 Budget were *inter alia* to promote a stronger economic performance within a prudential fiscal framework and maintain firm growth in real capital expenditure.

The steady decline in the fiscal deficit has translated into a decline in the public-sector borrowing requirement. The national government deficit on the main budget is projected to reach 2,5 per cent of GDP in 2001/02, falling to 2,1 per cent of GDP in 2003/04. The public-sector borrowing requirement is projected to reach 2,0 per cent of GDP over the same period. These measures will reduce government's dependence on borrowing from the primary markets, thus reducing interest costs. Lower public debt and deficits will also contribute to lower interest rates. In 2001/02, in particular, the proceeds from the restructuring of government assets such as Telkom, are projected to enable government to reduce its long-term debt.

BOX 3: Administered prices and inflation

The public sector administers the prices of certain goods and services in the economy, and to the extent that it has discretion over the setting of these prices, it directly influences the inflation process. A working definition of administered prices is presented in this box, followed by a discussion of the relationship between these prices and consumer prices.

The administered price index (API) consists of a subset of the components of the CPI and CPIX baskets whose prices are directly determined by government departments or other public-sector agencies. The API excludes the prices of commodities previously determined by bodies that have been deregulated and goods which have only their final market prices influenced by indirect taxes.

Table B3.1 shows that the API constitutes 21,64 per cent of the overall CPI and 23,9 per cent of CPIX. In the CPI, medical services, petrol and diesel, and communication services account for 54,6 per cent of total weight assigned to the API. The main components in the CPIX are medical services, petrol and diesel, and electricity; together they contribute 53,6 per cent of the total weight of administered prices.

Table B3.1 Administered prices and their weights in the CPI and CPIX

Per cent

Component	CPI weight	CPIX weight
Public transport services	1,98	1,98
Petrol and diesel	4,10	4,06
Communication services	3,06	3,61
Electricity	2,93	3,67
Paraffin	0,06	0,11
Licences	0,25	0,30
Water	1,27	1,58
Education	2,04	2,05
Medical services	4,65	5,07
Medical care goods	1,30	1,47
Total	21,64	23,90

An analysis of annual changes between 1980 and 1999 in the CPI and API suggests that the CPI increased on average by 12,1 per cent, and the API by 11,8 per cent. This implies that administered prices were not a dominant factor in the inflation determination process over this period. Individually, the components of administered prices increased at different rates; for instance, education services rose fastest, whereas petrol and diesel rose the slowest.

Between 1980 and 1991, the ratio of the API to the overall CPI indicates that administered prices rose slower than consumer prices. This trend was reversed from 1991 partly because of a continued decline in CPI inflation. The average annual change in the CPI fell from 14,7 per cent in 1980-91 to 8,6 per cent in 1991-99, while that of the API slowed from 12,6 per cent to 10,9 per cent. Though inflation declined, three elements of the administered prices accelerated: water tariffs, paraffin prices and licences.

The recent changes in administered prices are perhaps more topical. Changes for the year ending December 2000 are examined in Table B3.2.

As the table shows, overall administered prices increased by 11,1 per cent in this period. A significant portion of this increase, however, was generated by the petrol and diesel component, where price increases were largely beyond the control of administrators. An index of these prices rose by 28,4 per cent in 2000, and the API excluding petrol and diesel increased by 8,0 per cent. In comparison, the overall CPI rose by 7,0 per cent.

Table B3.2 Changes in administered prices in 2000

Annual percentage change

Component of consumer price index	
Administered prices	11,1
Public transport	4,0
Petrol and diesel	28,4
Communication services	6,2
Electricity	6,0
Paraffin	40,3
Licences	8,3
Water	9,1
Education	14,8
Medical services	7,2
Medical care goods	9,1
Administered prices excluding petrol and diesel	8,0
Overall consumer prices	7,0
Overall consumer prices excluding administered prices	5,4

In addition to the petrol and diesel component, a number of administered prices increased by more than the rise in headline inflation. Paraffin, a derivative of petroleum and a source of domestic fuel for low-income households, was also directly affected by the increase in oil prices and rose by 40,3 per cent. Increases in education costs, licences, water tariffs, medical services and medical care goods also exceeded 7,0 per cent. By contrast, public transport costs, electricity and communication services increased by less than the headline inflation rate.

Viewed another way, the change in the API contributed 2,9 percentage points to the 7,0 per cent increase in the CPI in 2000. Petrol and diesel accounted for 1,4 percentage points of this, and education and medical services for 0,4 percentage points each. The remaining 0,7 percentage points were apportioned among the other subcomponents of administered prices.

Monetary conditions

During 2000, the growth in monetary aggregates was relatively subdued, although monetary growth tended to accelerate toward the latter part of the year, reflecting more buoyant conditions in the real economy. The average growth rate for 2000 of broad money supply (M3) was 7,6 per cent. However, as shown in Table 2, the quarterly growth figures reveal a strong surge of 14,7 per cent in the fourth quarter. Faster fourth-quarter growth is also evident in the other monetary aggregates. Although monetary conditions, for the most part, have not been a cause for concern for monetary policy, recent developments will be closely monitored.

Table 2 Percentage change in monetary aggregates

Quarterly at seasonally adjusted annual rates

2000	M1A	M1	M2	M3
1st qr	13,9	17,6	7,8	10,3
2nd qr	-1,8	5,2	-1,0	-1,7
3rd qr	-13,5	-8,3	0,5	4,9
4th qr	9,4	6,6	15,5	14,7

The upturn in activity was also reflected in credit extension which accelerated in the fourth quarter, with total domestic credit extension increasing at 15,0 per cent in this quarter, as opposed to the 10,6 per cent average for the year. The growth rate of bank credit extended to the private sector increased from 4,5 per cent in the second quarter to 17,9 per cent in the fourth quarter.

Monetary policy

With the introduction of inflation targeting in February 2000, monetary policy was given a clear and unambiguous target. Although the Bank's primary objective before the implementation of inflation targeting was to reduce inflation and maintain financial stability, inflation targeting provided a clear numerical basis for measuring the Reserve Bank's success.

Over the past year the inflation rate measured by the CPIX rose consistently until October, afterwards declining slowly until January 2001 when it increased marginally. Given that the concern of the Monetary Policy Committee (MPC) is the target range in 2002, it is more important to react to expected inflation rather than to current inflation. In deciding on the monetary policy stance, the MPC has to consider the factors that are likely to affect the inflation rate in future, and therefore the attainment of the inflation target. In addition, monetary policy actions are also informed by the results of the econometric forecasts obtained from the new suite of models developed at the Reserve Bank.

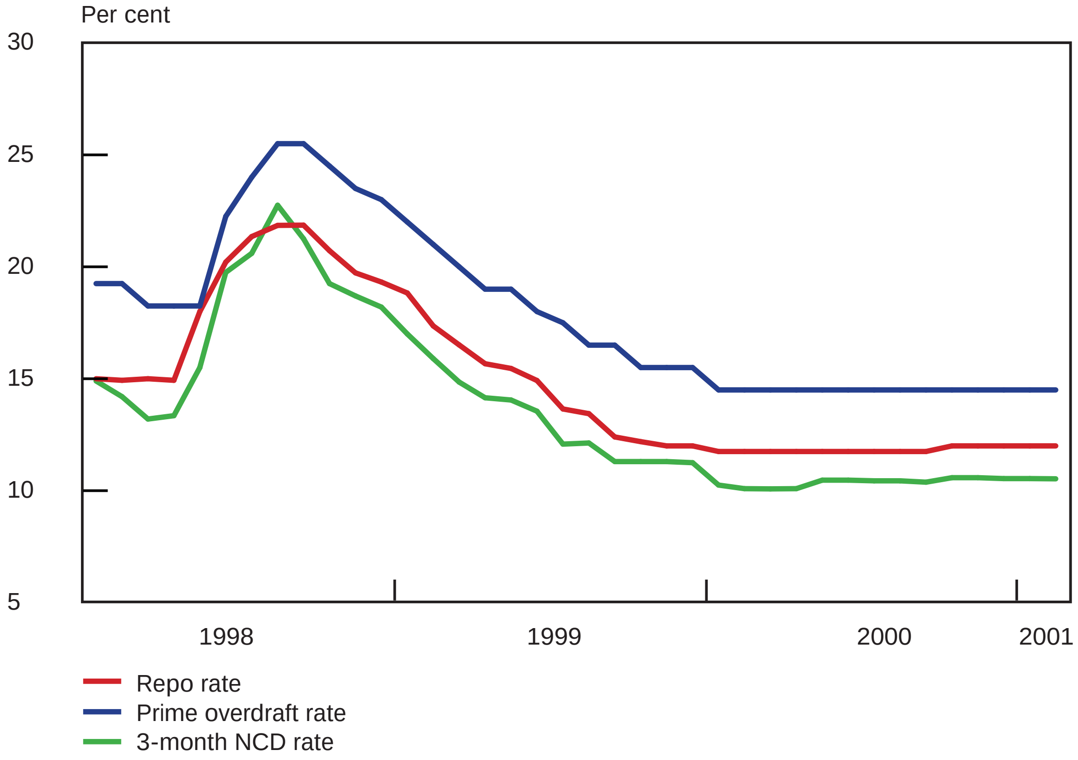
The Reserve Bank's main instrument of monetary policy is the repurchase rate or repo rate as it is more commonly known. The repo rate is effectively the rate at which the Bank lends to the commercial banks. If the Bank decides to tighten monetary policy, it is announced in an MPC statement, and the increase is effected by underproviding liquidity at the daily auction. More expensive borrowing from the Bank means that the commercial banks eventually pass this on to their customers in the form of not only higher prime rates and mortgage rates, but also higher deposit rates. In this way the Bank influences a whole range of interest rates. The relationship between the repo rate and selected short-term rates is shown in Figure 8. Rates in the money market may at times lead the repo rate to the extent that monetary policy actions are anticipated.

The repo rate was reduced steadily following the highs in the wake of the Asian crisis in 1998. In November 1999 the MPC froze the repo rate in order to provide some certainty during the transition to the new millennium. Following the smooth change, the MPC announced a reduction in the repo rate of 25 basis points in January, which in turn resulted in a reduction of 100 basis points in the commercial banks' prime lending rate.

Between January and October 2000, the repo rate remained constant, and accordingly most short-term interest rates remained constant too. For example, the three-month bankers' acceptances rate moved in a narrow range of 9,83 per cent and 10,93 per cent. This spread of 1,1 percentage points can be compared with spreads of 6,6 percentage points in 1999 and 8,85 percentage points in 1998. Most market short-term rates rose in October, from concern about the inflationary consequences of higher oil prices and the depreciation of the rand. However, this rise was short-lived and by the end of October rates declined to their previous levels. The predominant rate on mortgages has remained unchanged since February 2000.

The constant repo rate between January and October could be interpreted as an indication of a passive monetary policy stance. However, as seen in the earlier discussion, this was a volatile period from a monetary policy perspective. Despite various

Figure 8 The repo and short-term interest rates



shocks that had to be accounted for, positive as well as negative factors impacted on inflation, and a number of these factors offset one another. The discipline imposed by an inflation-targeting framework meant that, because the MPC was focusing on the longer-term outcome, disruptive stop-go policies would be less likely. With inflation targeting, monetary policy becomes a case of looking at the projected inflation rate relative to the target. If it is above the target, monetary tightening is required, and vice versa.

During 2000 it was generally the case that international developments were a negative factor for the inflation outlook and therefore for short-term interest rates. As outlined above, these major international developments included rising oil prices, rising international interest rates reflecting the monetary policy stance of other central banks, and high real growth rates in the US resulting in some upward pressure on the US inflation rate. Thus the international environment made it difficult to reduce South African interest rates too quickly.

The exchange rate was a further factor negatively affecting the inflation rate. Although the year 2000 started promisingly for the economy and the exchange rate, the latter soon came under pressure. As with the oil price, there are first-round effects that are generally unavoidable. However, the concern of the MPC was not these first-round effects but rather the second-round effects resulting mainly from the spill-over of first-round effects on inflation expectations. As emphasised earlier, the MPC does not have a target for the exchange rate, but clearly the path of the exchange rate is a factor that has to be taken into account in determining the stance of monetary policy.

Although international conditions tended to boost inflation during most of 2000, domestic conditions moved in the opposite direction. As seen above, the low growth in unit labour costs throughout the year reduced the domestic cost pressure on inflation. Similarly the fairly subdued state of domestic demand, particularly in the early part of the year, had a dampening effect on inflation. These conditions were reflected in the money and credit markets. Credit extension remained fairly low and there was no undue increase in any of the monetary aggregates before the final months of 2000.

Overall therefore, monetary policy for most of 2000 can be characterised as having been influenced by domestic and international factors moving in opposite directions, with different intensities at different points in time. In general it was felt that the target rate of inflation would be achieved given these conditions and expected future developments. This resulted in an unchanged repo rate until October.

On 16 October 2000 the MPC held an unscheduled meeting to discuss developments in the international economy. At that stage, tensions were rising in the Middle East, worsening the medium-term outlook for international oil prices. At the same time the exchange rate was coming under renewed pressure, having depreciated to a level of around R7,50 against the US dollar. The MPC was concerned that these factors would increase the upward pressure on inflation through second-round effects, particularly since there were indications that domestic economic activity was beginning to pick up more strongly. Given these concerns, the MPC effected an increase of 25 basis points in the repo rate. It was not expected that the private banks would follow this adjustment by raising their prime lending rates. The small adjustment was more a signal of a tightening monetary policy stance, in an attempt to forestall second-round effects.

At this time there was pressure on the Bank from a number of quarters to use the higher oil price as a justification for missing the target, rather than raising interest rates. In one sense, the whole inflation-targeting framework was being put to its first real test. In the case of the early inflation-targeting countries, the international climate was relatively stable when the framework was introduced, and in many cases the actual rate was not far off the target. Inflation targeting was therefore a case of trying to maintain a low rate of inflation. In South Africa's case, the challenge was to maintain a downward trend in the inflation rate in the face of a significant real external shock in the form of the higher oil price.

This was a potential dilemma for monetary policy. On the one hand, an excessive tightening of monetary policy to contain the inflationary effects of the oil price shock could have had negative short-term consequences for domestic economic activity at a time when conditions were still subdued. On the other hand, there was pressure on the Bank from outside to revise or abandon the target. Following the latter course precipitately would have put the Bank's credibility at risk, and would have complicated future monetary policy implementation. The Bank was able to steer an appropriate course that did not negatively affect the real sector of the economy and at the same time demonstrate its commitment to achieving the target for 2002.

Towards the end of the year there was a sudden and significant change in the factors influencing the inflation rate. Firstly, the oil price declined significantly, falling to levels of around US$25 per barrel. This filtered through quickly to a decline in the pump price of petrol. At the same time the US economy slowed down rapidly, resulting in a swift reaction from the US Federal Reserve with a reduction of 50 basis points in the federal funds rate in early January and a further reduction of 50 basis points at the end of January. The Bank of England lowered interest rates in February, and although inflation in the euro area is still at a 7-year high, the stronger euro and the weaker oil prices will probably reverse this trend, and therefore put downward pressure on the ECB interest rate.

In South Africa, there were signs of a domestic recovery, the exchange rate remained under pressure, and developments on the balance of payments were mildly unfavourable for foreign capital flows. In addition, although CPIX inflation was falling moderately, PPI inflation continued to rise in December. These potentially unfavourable developments (from an inflation perspective) led to the MPC decision in January that it would not follow the international trend of lower interest rates, but maintain the repo rate at 12 per cent. Although there had been significant changes in the determinants of inflation, on balance it was felt that until future trends were more certain, it would be premature to lower the repo rate.

The outlook for inflation

The view of the MPC is that CPIX inflation will move to the target of 3 to 6 per cent inflation in 2002 provided that the oil price and exchange rate behave as anticipated, and that there is not excessive overheating in the domestic economy. As with all projections, however, there are several key uncertainties.

International context

The international environment is expected to differ greatly from that prevailing in 2000. The strong world growth experienced in 2000 is expected to moderate substantially, resulting in further easing of monetary policies, particularly in the advanced economies. Furthermore, oil prices are not expected to put the same pressures on world inflation rates as in 2000. Therefore a benign inflationary environment internationally is expected. This does not mean that lower interest rates in South Africa will necessarily follow. A severe downturn internationally could negatively influence commodity prices and South Africa's exports in general. If this is combined with a lack of capital inflows, and if domestic expenditure is rising, upward pressure on interest rates could occur.

It is generally expected that growth in the US will be low if not negative in the first half of 2001. The outlook beyond that is more uncertain. Some forecasters see a recovery in the second half of 2001, though others argue that the US will move into a longer recession. There are a number of arguments pointing to a relatively speedy recovery in the United States. Firstly, there has been a significant loosening of monetary policy by the US Federal Reserve, with indications that further interest rate cuts would be considered, if necessary. Secondly, inflation pressures in the US are relatively benign, allowing room for further interest rate reductions, and finally the proposed tax cuts could be a strong fiscal stimulus to economic activity. The impact of this factor will depend on how quickly the tax proposals can pass through the US Congress and Senate.

The speed and severity of the US downturn meant that most forecasts of global growth for 2001 have had to be revised downwards. Late last year, most forecasts already provided for lower world growth in 2001, given the expected downturn in the United States. Since then, most of these forecasts have been revised down further. For example the *World Economic Outlook* of the IMF had in September forecast world growth of 4,2 per cent for 2001, and US growth of 3,2 per cent. In February the IMF announced that these forecasts were being revised down to 3,4 per cent and 1,7 per cent respectively. These projections appear in Table 3.

Table 3 IMF projections of world growth and inflation for 2001

	Real GDP		Inflation
	Oct 2000	Feb 2001 (Revised)	Oct 2000
World	4,2	3,4	3,8
Advanced economies	3,2		2,1
USA	3,2	1,7	2,6
Japan	1,8		0,5
Euro area	3,4		1,7
Developing countries	5,7		5,2
Africa	4,4		8,6
Asia	6,6		3,3
Western Hemisphere	4,5		7,0
Countries in transition	4,1		12,5

Source: IMF *World Economic Outlook* (October 2000)

The impact of the US economic downturn on the rest of the world will largely depend on the duration of the slowdown. Euro area growth is not expected to be unduly affected by the US downturn unless there is a sustained recession. Generally, euro area growth is expected to be between 2,5 and 3 per cent. The major impact is expected to be on the exports of Asian economies, and to a lesser extent those of Latin America, apart from Mexico which has stronger ties with the US. A downturn in emerging-market exports could also result in further capital outflows from emerging markets, including South Africa. Furthermore a strong recession in Asia could affect South Africa's exports to that region, as was the case during the Asian crisis. World inflation, however, is expected to remain low.

Outlook for domestic demand and supply

Growth in GDP in 2001 and 2002 is expected to continue on an upward path. Forecasts are that growth will moderately exceed that achieved in 2000, as a more stable economic environment and a recovery in consumer and business confidence stimulate demand, and planned increases in government capital expenditure and tax cuts are implemented. Increases in private and public consumption and investment expenditure are expected to result in a moderate deterioration in the current account of the balance of payments, although exports should remain firm on account of the competitive real exchange rate of the rand. Capacity utilisation rates still indicate scope for increases in output without running into bottlenecks, and labour resources are also clearly underutilised.

Real final consumption expenditure by households is expected to increase over the next two years as consumer confidence improves. After falling to its lowest level in seven years in the fourth quarter of 2000 according to the BER index, consumer confidence is forecast to recover. Allied to this, disposable income is likely to receive a boost from lower petrol prices, and from further tax cuts.

The forecast increase in consumption expenditure by households is supported by a similar forecast for government expenditure. Real final government consumption expenditure is planned to increase by 2,5 per cent in 2001 and by 2,75 per cent in 2002 according to the Treasury's Medium Term Expenditure Framework (MTEF).

Investment expenditure by both the private and public sectors is also set to rise over the next two years. From the low base in 2000, business confidence and real gross fixed capital formation by the private sector are expected to increase as a result of lower inflation and a better outlook for economic growth. Capital expenditure by government, in terms of the MTEF, is projected to rise in real terms over the next three years.

Although exports of goods and services are likely to increase as a result of the competitive real exchange rate level, it is expected that this increase will be more than offset by rising expenditure on the import side. Exports could also be negatively affected by a prolonged US recession. Merchandise imports are set to increase with the faster growth forecast for the economy. Capital inflows are expected to be boosted later on in the year by the planned Telkom initial public offering, as well as by the purchase of De Beers by Anglo American, which is expected to result in an inflow of US$2,9 billion in 2001.

Surveys of inflation expectations

Inflation expectations play an important role in determining the actual inflation outcome. The Bank therefore commissioned the BER at the University of Stellenbosch to conduct quarterly surveys of inflation expectations in the South African economy. The findings of the BER surveys will provide an ongoing source of valuable information about future inflation and the credibility of monetary policy in South Africa.

The surveys provide quantitative information obtained from households, business people in the non-financial sector, representatives of the financial sector (including economists), and representatives of trade unions and employer organisations. After trial runs in the first half of 2000, the first official survey was conducted in the third quarter of the year. The findings of the most recent survey, for the first quarter of 2001, are reproduced in Table 4.

As is evident from Table 4, the BER survey reports CPIX inflation expectations (excluding household expectations) declining from an arithmetic average of 7,3 per cent in 2001 to 7,1 per cent in 2002 and 7,0 per cent in 2003. At this early stage, therefore, the findings of the survey indicate that the average expectation is for the inflation target to be missed in 2002. The 5,5 per cent inflation expected by the financial sector for that year is within the target range, however, and the average expectation for inflation has declined from the 7,3 per cent reported in the survey for the fourth quarter of 2000. Furthermore, the BER has noted that this finding is consistent with the initial experience in other countries that adopted inflation targeting. Inflation expectations gradually moved within the target range as the central banks' credibility increased.

Table 4 BER survey of inflation expectations (1st quarter 2001)

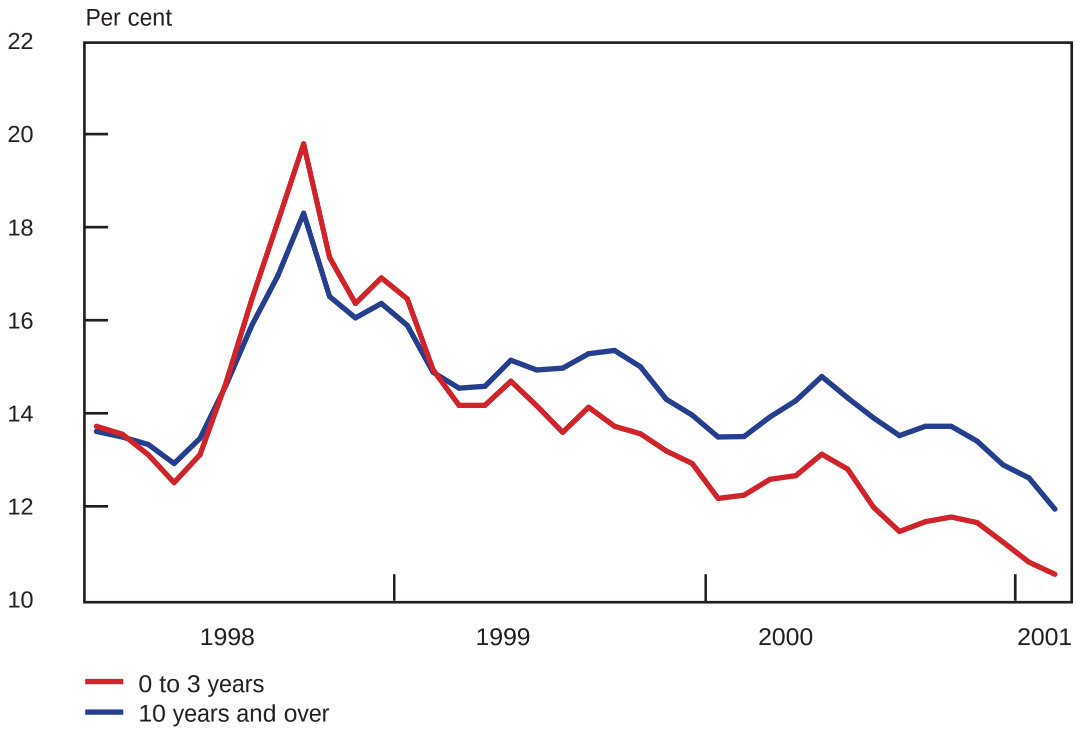
	Headline CPI inflation			CPIX inflation		
	2001	2002	2003	2001	2002	2003
Finance	6,0	5,1	4,9	6,1	5,5	5,1
Business	6,3	6,5	6,6	7,9	8,0	8,0
Labour	6,5	6,7	6,3	7,9	7,7	7,7
Average	6,3	6,1	5,9	7,3	7,1	7,0
Households	7,3	-	-	-	-	-
Grand average	6,5	-	-	-	-	-

Source: Bureau for Economic Research, University of Stellenbosch

The expectations of the financial sector for inflation are confirmed by the consensus forecast produced from the Reuters monthly survey of long-term forecasts for the South African economy. This survey of economists based in South Africa, the US and the UK, solicits forecasts of key South African economic indicators for the current and subsequent seven quarters, and for the current and next two calendar years. The recent survey published on 1 February reports that the mean forecast for CPIX inflation in 2002 is 5,7 per cent. This represents a mean of 13 forecasts ranging between 5,1 per cent and 6,4 per cent. The consensus forecast for 2001 is 6,2 per cent.

Lower inflation expectations are also implicit in the long-term bond rates. The yield curve has become progressively flatter since May 2000, as shown in Figure 9. The yields on bonds with an outstanding maturity of twenty-five years have declined, on balance, by 375 basis points from 10 May 2000 to 5 March 2001. Similarly, declines in the yield differential between the conventional ten-year bond and the inflation-linked bond reflect expectations of lower inflation.

Figure 9 Yield on government bonds

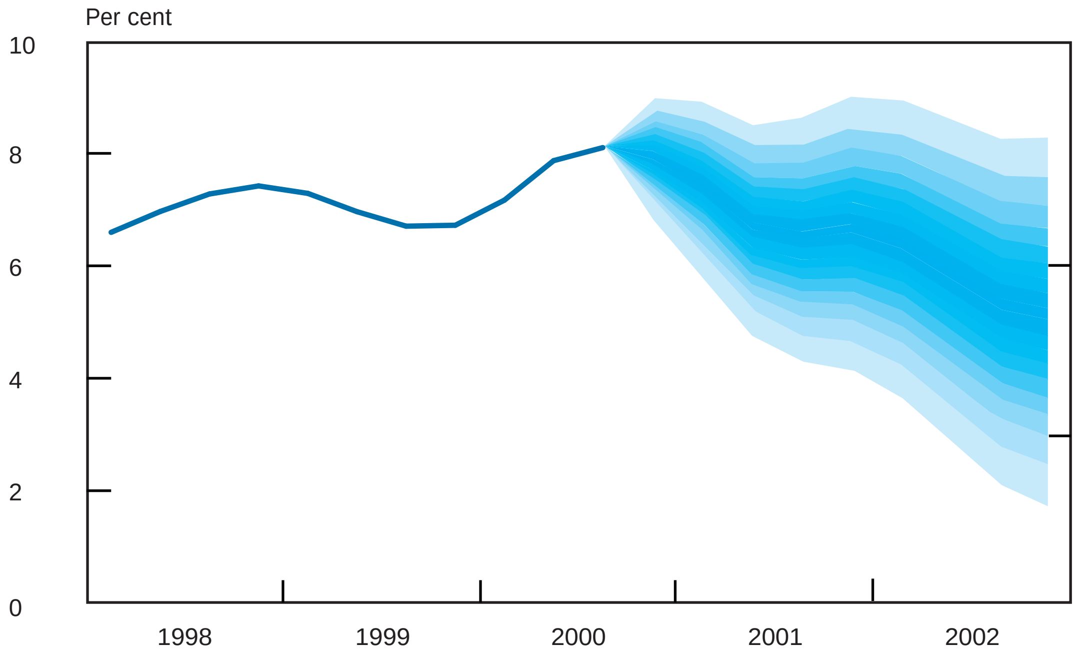


The Reserve Bank inflation forecast

The Bank's projection for CPIX inflation over the period to 2002 is presented in graphical form in Figure 10. As with any forecast, a number of uncertainties have to be considered. Given these uncertainties, the fan chart technique is used. Box 4 explains the construction of the fan chart employed in Figure 10 to indicate the uncertainties around the forecast.

The projection shows that CPIX passed through its upper turning point in the third quarter of 2000, and that it is expected to decline steadily over the forecast horizon. The most probable outcome foreseen for the inflation rate for 2002 falls within the target range of 3 to 6 per cent.

Figure 10 CPIX forecast



Box 4: Understanding the fan chart

An inflation forecast is subject to a large degree of uncertainty. Many central banks use fan charts to illustrate this, using confidence bands to depict varying degrees of certainty. The following inputs are required for constructing the fan chart:

- The outlook for inflation (central projection, based on the outcome of the models).
- The degree of uncertainty surrounding the projection, which also determines the width of the bands.
- The degree of skewness in this uncertainty, determined by the balance of risks (e.g. upside or downside risk).

The bands of the fan are drawn around the central projection. The central projection is contained in the darkest band, which covers 10 per cent of the probable outcomes foreseen for inflation. Therefore there is a 10 per cent chance that actual inflation will be in the central and darkest band. Two more bands are added to each side of this central band, increasing the size of the band and the probability to 20 per cent. Then another two bands are added and the probability increases by another 10 per cent and so on until the whole shaded area depicts a 90 per cent confidence interval – i.e. there is a 90 per cent chance that future inflation will be somewhere in this area.

The total area may seem large but this is because of the significant risks present in the forecast owing to the uncertain future as well as to the large (90 per cent) degree of certainty. If a narrower area is chosen the certainty that inflation will be in that area will deteriorate accordingly.

The MPC uses the fan chart to assess the risks inherent in the forecast and also to communicate the uncertainties that lie ahead. If the future economic developments are deemed to be particularly volatile, the bands will be wider. If a fairly stable future is foreseen, the bands will in turn be narrower. The fan chart allows policy makers to focus their discussion on the risks lying ahead as well as on the possible effect of these risks on inflation.

Assessment and conclusion

During 2000, inflation pressures in the South African economy emanated primarily from external sources, whereas domestic pressures were relatively subdued. For most of the year the external pressures tended to push the CPIX away from the target. Despite a slight upward trend in inflation, the repo rate was raised only by 25 basis points in October. In the latter part of the year, with the decline in the oil price and the slowdown in the US economy, these external pressures subsided. At the same time, however, domestic expenditure picked up, increasing the possibility of greater pressure from domestic sources. The possible second-round effects of the continued depreciation of the rand also remain a cause for concern.

The outlook for the next few months is uncertain. Stronger domestic growth is forecast and, if overdone, this could eventually put some upward pressure on capacity and on the inflation rate. However, there is no evidence that wage settlements or other cost increases have begun to adversely affect the inflation rate, nor that capacity constraints are likely to create bottlenecks. No inflationary pressure is expected from fiscal policy. A major uncertainty, however, is the extent and duration of the United States downturn, and the extent to which this would influence the world economy in general. A prolonged recession in the United States will have a negative impact on commodity prices and exports, and therefore put pressure on South Africa's balance of payments and exchange rate, particularly if domestic expenditure continues to rise at a strong pace.

With respect to monetary policy, a volatile year has passed and the advantages of inflation targeting are becoming clearer. The nature of the inflation-targeting framework has meant that monetary policy has become more forward-looking than in the past, and there has been less reaction to short-term changes in the variables that affect inflation. This has led to a more stable real interest rate outcome. Eventually, as the inflation rate continues to fall and expectations permanently adjust accordingly, this will allow for further reductions in the nominal interest rate. In the meantime monetary policy will remain cautious in order to ensure that the inflation target will be achieved without large and potentially damaging fluctuations in interest rates.