MONETARY POLICY REVIEW

October 2002

South African Reserve Bank

Enquiries relating to this *Review* should be addressed to:
The Chief Economist
Research Department
S A Reserve Bank
P O Box 427
Pretoria 0001
Tel. 27-12-3133668/3944

E-mail: sarbrsh@resbank.co.za

http://www.reservebank.co.za

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Monetary Policy Review

Introduction

Over the past few months inflation pressures in South Africa continued to increase unabatedly. Initially these pressures emanated from the sharp depreciation of the exchange rate of the rand in the second half of 2001. This fed through primarily to food prices. Earlier on in the year, therefore, the debate around monetary policy focused on the efficacy of higher interest rates in dealing with external shocks. The view of the Reserve Bank was that the main role of monetary policy under such circumstances was to guard against possible second-round effects, and to prevent the higher food price inflation from influencing inflation expectations and other wage and price decisions.

During the course of the year, it became clear that inflationary expectations were becoming increasingly entrenched and that wage settlements were trending higher. Equally disturbing was the fact that the higher inflation was no longer a food price phenomenon, and was becoming more generalised. Despite indications that the inflation environment was becoming more favourable in June, these expectations were subsequently dashed as the CPIX continued to increase, the production price index resumed its upward trend in July after a dip in June, and the exchange rate again became vulnerable. Furthermore, the threat of a United States attack on Iraq has contributed to continued high oil prices.

The result of these developments has been that since the publication of the previous *Monetary Policy Review* in April 2002, the repo rate has been increased further in June and September, on both occasions by 100 basis points. This has brought the cumulative increase for the year to 400 basis points, and demonstrates the resolve of the Bank to bring the inflation rate back within the target range for CPIX. Despite these actions, and although the forecasts show that the target for 2003 can be attained, there are nevertheless a number of factors which impart a significant upside risk to the achievement of the target.

The *Monetary Policy Review* provides an overview of recent inflation trends, as well as the factors that have impacted on inflation. This is followed by a discussion of recent monetary policy decisions, as well as a review of inflation expectations. Finally, the results of the Bank's forecasts are presented. As usual there are a number of boxes highlighting topical issues. The first box briefly touches on the question of how inflation affects different income groups. In line with the Bank's commitment to greater transparency, the second box describes the Monetary Policy Committee's decision-making process, and the third box describes the issues and process involved in setting the inflation targets.

Recent developments in inflation

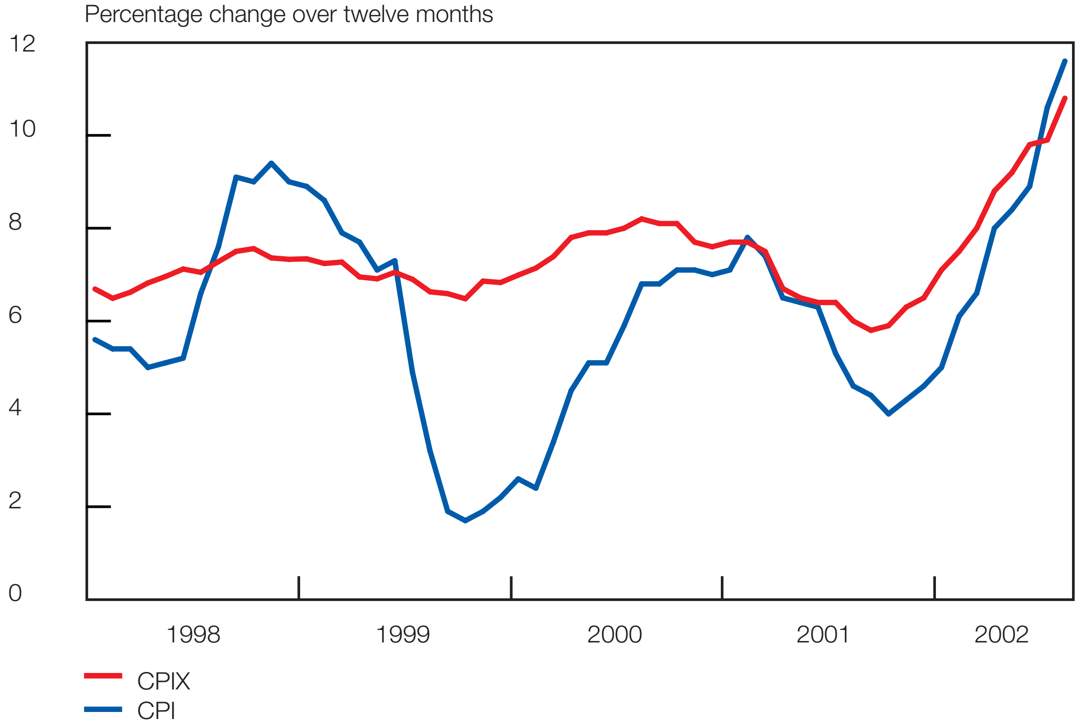
This section analyses recent trends in the main inflation indices, and reviews the developments in the main determinants of inflation in the South African economy.

The evolution of indicators of inflation

Since the April 2002 issue of the *Monetary Policy Review*, the main inflation indices have continued to rise. The depreciation in the exchange rate of the rand in the second half of 2001 and the related surge in food prices have continued to affect the various measures of year-on-year inflation in 2002. Although the impact of these initial shocks on inflation is expected to abate in the near future, there is some evidence that the pressures underlying inflation are now more broadly based than had originally been thought.

Figure 1 shows the twelve-month percentage change in the consumer price index excluding mortgage interest cost for metropolitan and urban areas (CPIX) and the headline consumer price index for metropolitan areas (CPI). From September 2001, CPIX inflation has trended upwards from 5,8 per cent to 9,9 per cent in July and 10,8 per cent in August 2002. The eight-month average rate of increase for CPIX in 2002 is 8,9 per cent.

Figure 1 Consumer price inflation: CPIX and CPI

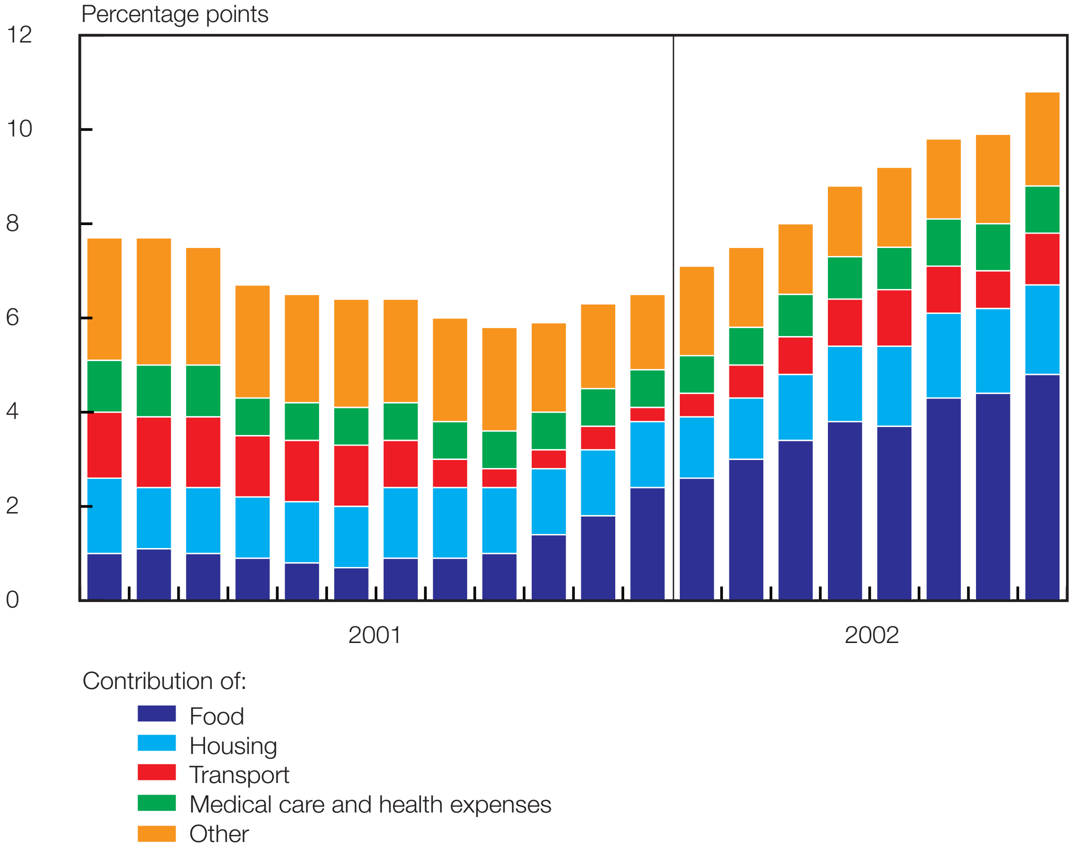


Source: Statistics South Africa

The magnitude of the increase in headline CPI inflation over the period has been slightly greater than for CPIX, as this measure incorporates the mortgage cost effect of the three 100-basis-point interest rate increases in January, March and June 2002. As Figure 1 shows, CPI inflation rose from 4,0 per cent in October 2001 to 10,6 per cent in July 2002 and 11,6 per cent in August 2002. The July increase was the first double-digit inflation figure since June 1995.

As noted above, food prices have continued to make a significant contribution to the increase in the year-on-year CPIX inflation rate in 2002. Figure 2 shows that food prices contributed 0,7 percentage points to the total CPIX inflation of 6,4 per cent in June 2001, rising strongly to a 4,8 percentage point contribution to total CPIX inflation of 10,8 per cent in August 2002.

Figure 2 Contributions to CPIX inflation



Source: Statistics South Africa and SARB calculations

The prices of most items in the food category have increased considerably. Products traded on international markets (such as grain products, fish and other seafood, sugar, and sunflower oil) whose prices were adversely affected by the sharp depreciation of the currency in 2001, serve as input factors in the production chain. The resultant knock-on effect has impacted strongly on the economy's food-pricing mechanism, and ultimately on consumers. Given the relatively higher weighting that food has in the budgets of lower income households, these developments in food prices have been a particularly severe setback to the poor. Box 1 provides a discussion of how recent inflation trends have affected the different income groups.

Besides food prices, the contributions made to CPIX inflation by transport costs, housing, and medical care and health expenses have all increased recently. After aiding the deceleration in CPIX inflation late in 2001, the contribution of transport costs rose again in 2002, fuelled by rising Brent crude oil prices which caused the inland pump price of petrol to increase from R3,75 per litre in October 2001 to R4,32 per litre in May 2002, before settling at R4,00 per litre in July and August and R4,09 per litre in September. Transport costs contributed 1,1 percentage points to the CPIX inflation rate in August 2002. The contribution of the housing component of CPIX increased from 1,3 percentage points in January and February 2002 to 1,8 percentage points in June and July, and to 1,9 percentage points in August. Medical care and health expenses, which contributed a constant 0,8 percentage points between April 2001 and February 2002, then increased to contribute 0,9 percentage points in the following three months before increasing again to contribute 1 percentage point from June to August 2002.

Box 1 Does inflation hurt the poor more?

There is often a presumption that inflation hurts the poor more than the rich. Conversely, there is a belief that monetary policy, in trying to reduce inflation, increases unemployment and therefore poverty. This box briefly outlines some of the redistributive and differential effects of inflation.

It cannot be assumed *a priori* that the poor will be hardest hit by inflation. To a significant degree this will depend on the different weights in the consumption basket, and how the relative prices in the basket change. It is also determined by the extent to which the poor can hedge against inflation.

In South Africa, Statistics SA calculates the consumption weights and inflation rates facing five different expenditure groups, namely very low (up to R8 070 per annum); low (R8 071 – R12 263); middle (R12 264 – R24 365); high (R24 366 – R55 159) and very high (R55 160 and more). Each group represents 20 per cent of the population. The weights for selected expenditure items for the different groups are shown in Table A1. As would be expected, the lower income groups have a higher weighting for food in their consumption basket. The low-income group has a weighting of 51,2 per cent for food in its consumption basket, whereas the food weighting for the high-income group is 16,7 per cent.

Table A1 Weights: Expenditure patterns for metropolitan and other urban areas

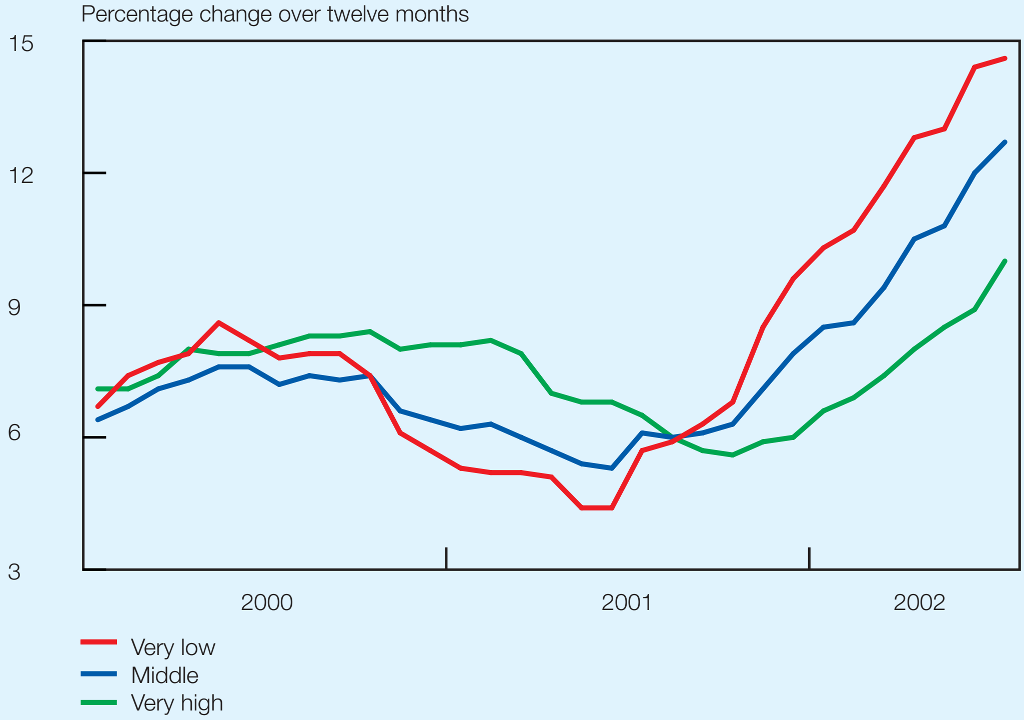
	Expenditure group category					
	Total	Very low	Low	Middle	High	Very high
Food	23,02	51,24	49,72	43,93	33,68	16,69
Non-alcoholic beverages	1,13	1,59	1,67	1,92	1,58	0,91
Alcoholic beverages	1,52	2,23	1,65	2,32	1,81	1,35
Cigarettes, cigars and tobacco	1,21	1,86	1,63	2,14	1,88	0,92
Clothing and footwear	3,64	4,17	5,22	5,78	5,70	2,84
Housing	20,70	10,04	10,11	10,69	15,88	23,51
Fuel and power	3,84	7,75	7,23	6,07	5,21	3,08
Furniture and equipment	2,82	1,06	1,62	2,53	3,55	2,76
Household operation	4,68	3,87	3,16	2,81	3,10	5,34
Medical care and health expenses	6,90	0,67	0,70	1,45	3,83	8,58
Transport	13,72	4,03	5,14	6,83	8,31	16,25
Communication	2,86	1,11	1,41	1,93	2,58	3,11
Recreation and entertainment	3,04	0,77	1,21	1,27	1,91	3,62
Reading matter	0,36	0,20	0,20	0,26	0,33	0,39
Education	3,38	1,05	1,39	2,25	3,03	3,70
Personal care	3,92	7,35	6,70	5,97	5,21	3,22
Other goods and services	3,26	1,01	1,24	1,85	2,41	3,73

Source: Statistics South Africa

The inflation rate facing the poor will depend on relative price movements. When food prices rise more than the average, the poor will be relatively more disadvantaged. Figure A1 shows that since late 2001 the inflation rate faced by the very low income groups has been significantly higher than that of the very high income group. Since 2000 the average inflation rate facing the very poor has been 8,2 per cent whereas that facing the very high expenditure group has been 7,5 per cent. This would of course differ from consumer to consumer in these groups, depending on individual preferences.

The fact that food prices have responded so quickly and significantly to exchange rate changes also emphasises the fact that it is no longer true that exchange rate changes only have an impact on the high-income groups. Since the liberalisation of agriculture, food has increasingly become a true tradeable good, subject to international prices.

Figure A1 CPIX inflation rate for various expenditure groups



Source: Statistics South Africa

Although it is not necessarily the case that the poor are most affected by inflation, there are good reasons why the poor are more vulnerable to inflation, particularly in South Africa. It is generally accepted that if inflation is anticipated, and if people have the means to protect themselves from inflation, then the impact of inflation is limited.

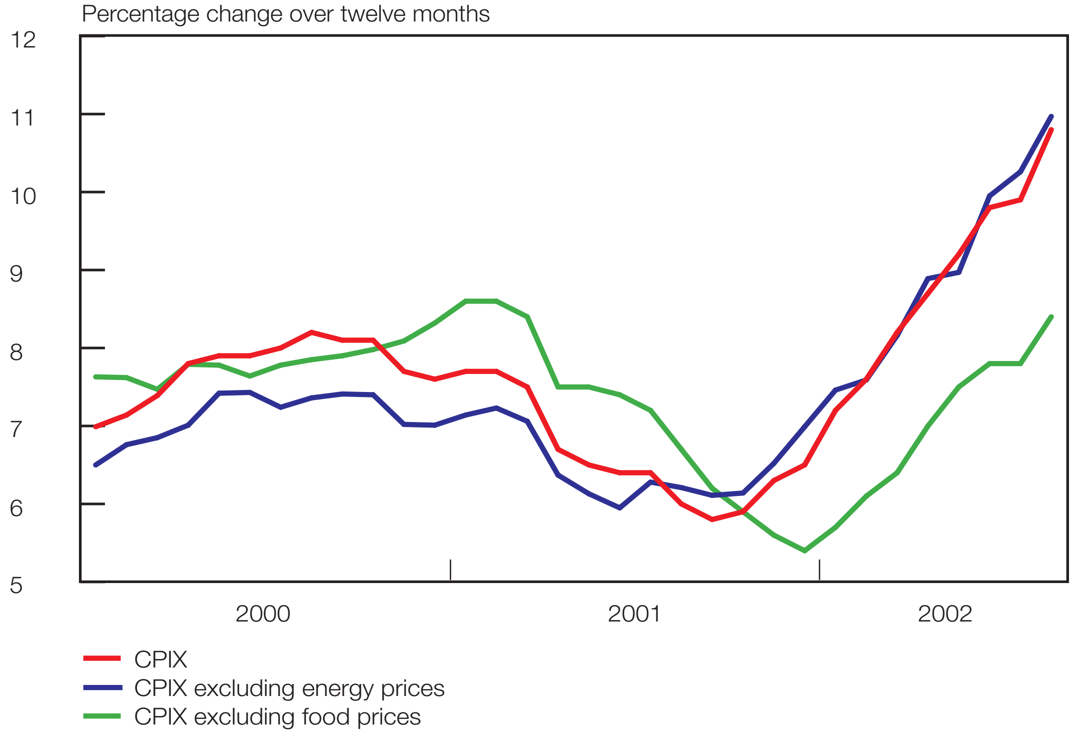
The wealthy often have assets that can more easily be protected against an expected inflation, and are better able to hedge against inflation. The ability of the working poor to protect themselves will depend on their wage-bargaining power. The non-working poor are dependent on the degree to which any social welfare benefits that they may be receiving are linked to inflation.

An important point to note is that even if the price index facing the poor does not rise significantly faster than that of other groups, the poor are more likely to suffer greater hardship than the more wealthy groups. This is because necessities typically comprise a large share of the poorer households' budgets, and they are already on or below the breadline. Consequently, the poor are less able to soften the impact of higher prices on their normal consumption purchases by either substituting lower price and lower quality items, or entirely foregoing certain types of purchases. For people living on the breadline, this is of great concern as substitution to lower quality items, or foregoing certain items can have important negative long-term dietary and health implications. In addition, the poor are less likely to have savings which will help them offset these effects.

The question about the effect of inflation on the poor must be distinguished from the related issue of whether the poor pay more in absolute terms for similar goods and services. A number of studies conducted internationally have shown that there is evidence that the poor do pay more. For example the lack of competition and high transport costs in rural areas result in higher prices paid by the rural poor. However, there is no necessary reason for the prices paid by the poor to rise faster than prices paid by the better-off.

To highlight the role that food and energy prices have played in determining the trend of CPIX inflation, Figure 3 shows the effects of excluding these prices from the main index. As expected, the exclusion of food prices lowers the recent path of CPIX inflation significantly. However, CPIX excluding food prices increased from 5,4 per cent in December 2001 to 7,8 per cent in June and July and to 8,4 per cent in August 2002, demonstrating that pressures are coming from other sources too. Excluding energy prices, by contrast, has little impact on the path and level of recent CPIX inflation.

Figure 3 The effect of food and energy prices on CPIX inflation

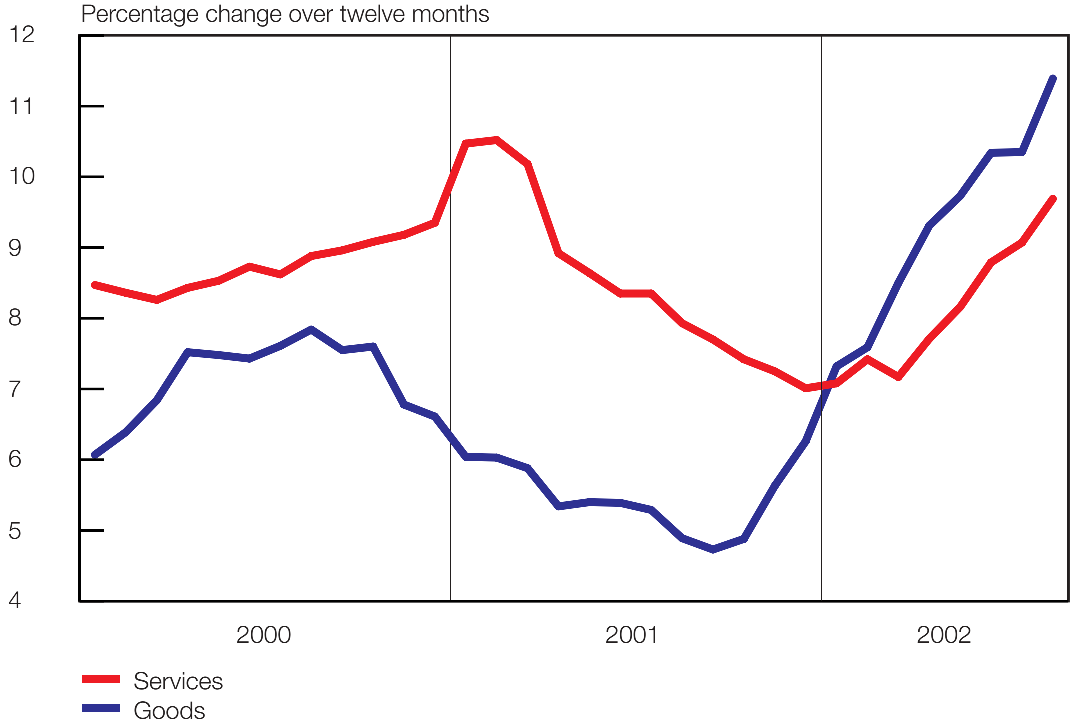


Source: Statistics South Africa

Figure 4 provides a breakdown of CPIX inflation into the more aggregated ‘goods’ and ‘services’ categories. Broadly speaking, the goods component of the CPIX comprises a relatively larger proportion of the tradeable items that are significantly affected by the rand’s exchange rate and foreign competition, than the services component which contains a significant proportion of non-tradeables (primarily affected by internal factors such as wage-cost factors). An examination of developments in these two components in Figure 4 reveals that inflation in the goods component increased sharply from 4,7 per cent in September 2001 to 11,4 per cent in August 2002, which was the expected response of traded goods to the exchange rate shock experienced in 2001. Potentially more important, however, is the response of inflation in the services component. This has followed but lagged the upward trend of goods-component inflation. After hovering just above 7 per cent in the first quarter of 2002, the inflation rate for this component rose to 9,7 per cent in August.

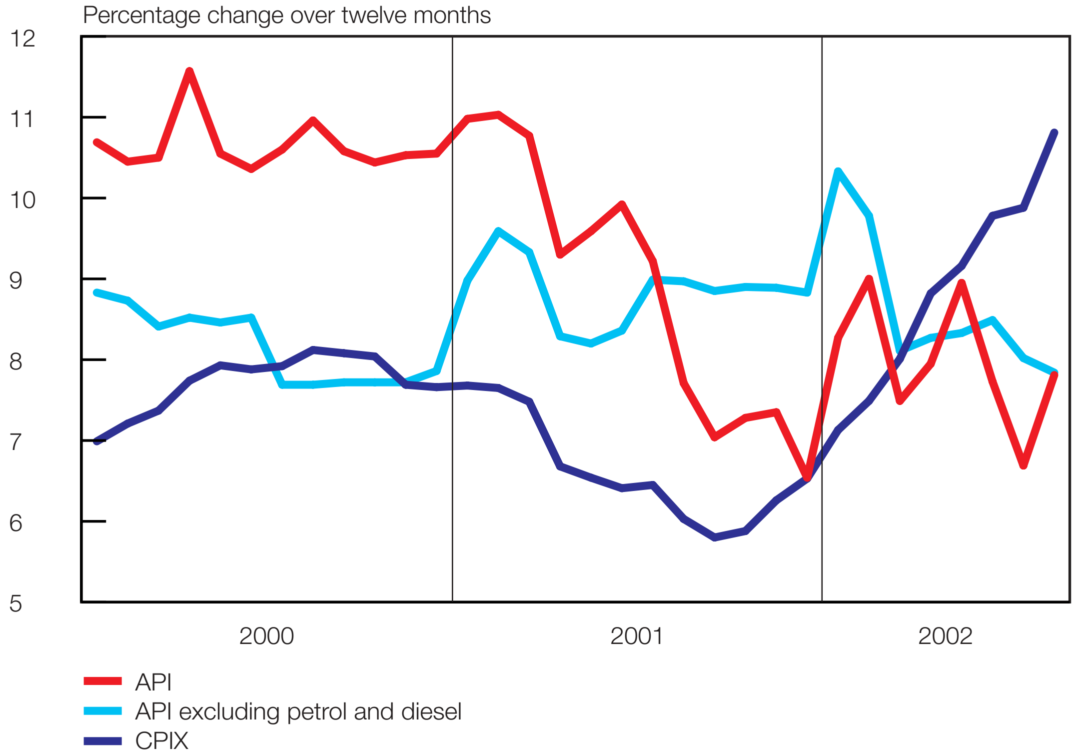
Administered prices carry a weight of 24,55 per cent in the CPIX, and therefore play an important role in determining the level of prices in South Africa. As Figure 5 shows, this sector of the economy recorded double-digit inflation rates until March 2001,

Figure 4 CPIX: Goods and services inflation



Source: Statistics South Africa

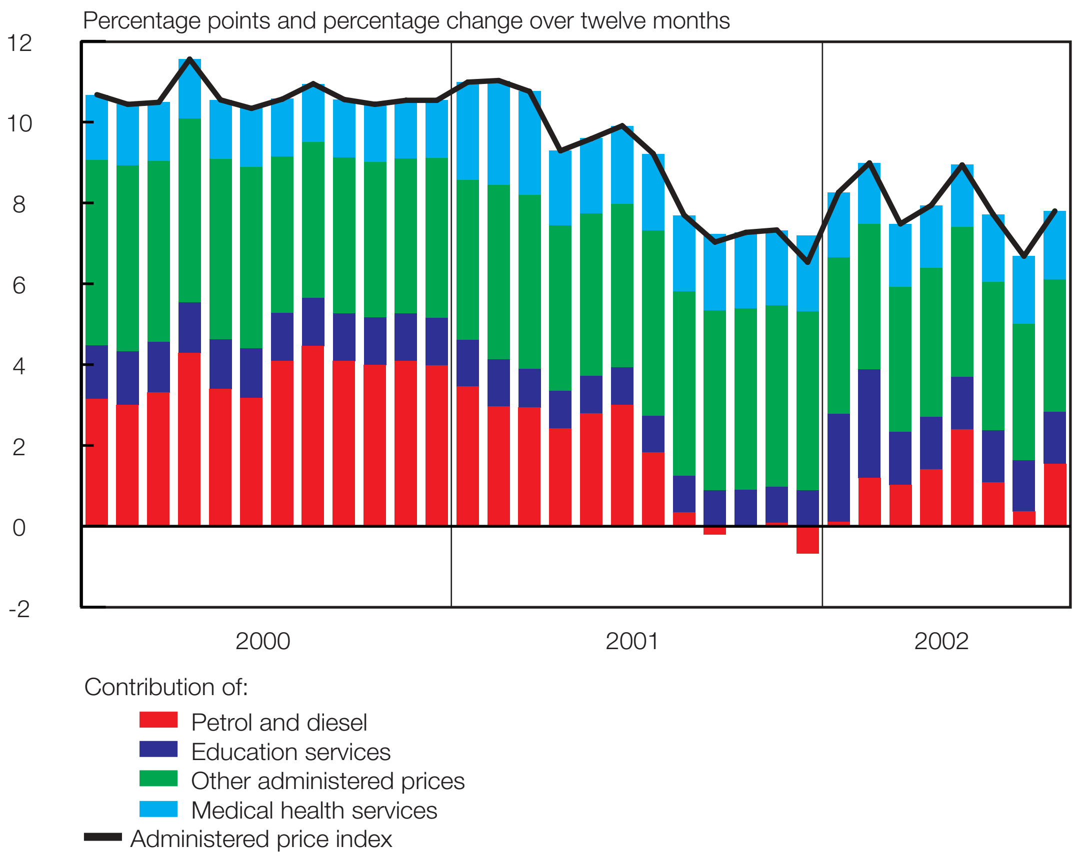
Figure 5 CPIX and administered prices



Source: Statistics South Africa and SARB calculations before gradually declining to the level of overall CPIX in December 2001. More recently, as the impact of the exchange rate and food shocks have impacted on the tradeables in the CPIX, inflation in the index of administered prices (API) has been slightly below that for CPIX, although still at high rates. In August 2002 the inflation rate for the API was 7,8 per cent.

The contributions of the various components to the inflation rate of the API are shown in Figure 6. Significant contributions to the overall inflation rate of 7,8 per cent in August 2002 were made by *medical health services* (1,7 percentage points) and *education* (1,3 percentage points). The contribution of *petrol and diesel prices* declined from 2,4 percentage points in May 2002 to 0,4 percentage points in July, before increasing once more to 1,6 percentage points in August as a result of base effects from August 2001 price decreases.

Figure 6 Contributions to the administered price index



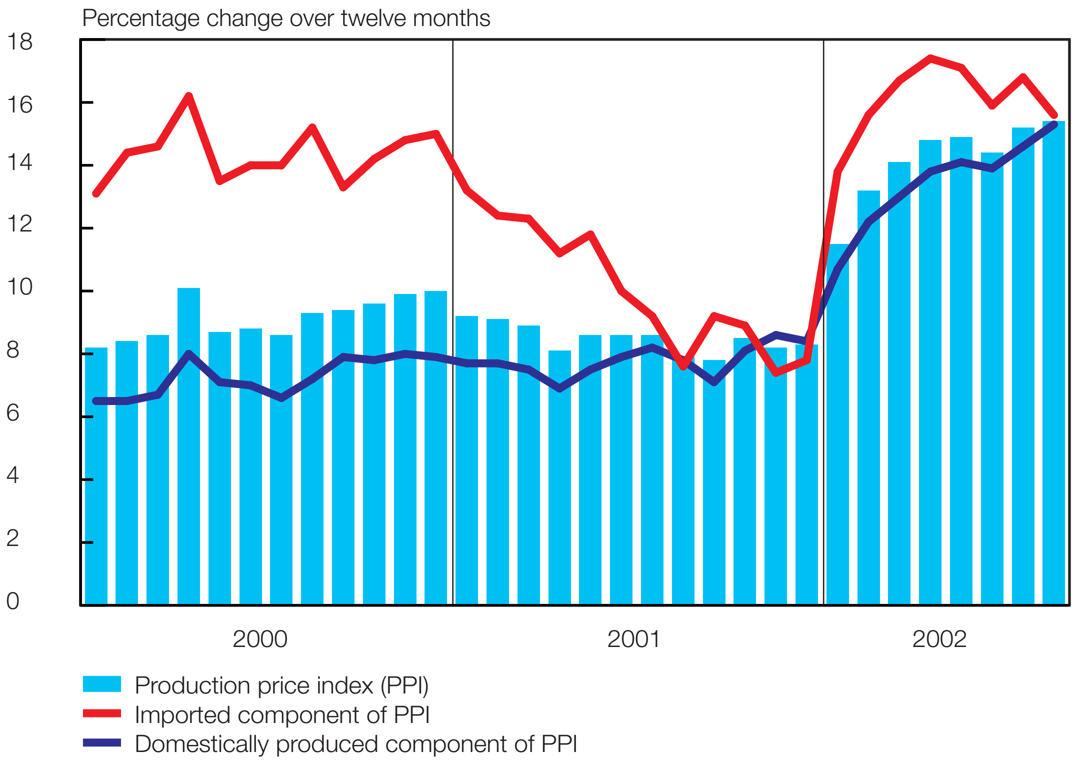
Source: Statistics South Africa and SARB calculations

Developments in year-on-year production price inflation are shown in Figure 7. After signs of a peak in the rate of increase in the overall production price index (PPI), when inflation declined from 14,9 per cent in May to 14,4 per cent in June 2002, PPI inflation rose to 15,2 per cent in July and to 15,4 per cent in August.

As Figure 7 shows, the imported and domestic components of the PPI both trended upward in 2002. The imported component of PPI increased at a faster rate, with inflation rising steeply from 7,4 per cent in November 2001 to 17,4 per cent in

April 2002, before declining to 15,6 per cent in August. The inflation rate for the domestic component of the PPI, which has a weighting of 73 per cent in the overall index, rose from 7,1 per cent in September 2001 to 14,1 per cent in May 2002, before slowing to 13,9 per cent in June. Inflation in this component of the PPI then rose once more, reaching 15,3 per cent in August.

Figure 7 Production price inflation



Source: Statistics South Africa

Factors affecting inflation

Recent developments in some of the main drivers of inflation are reviewed in this section. These include domestic and international factors. In a later section the outlook for these variables and, therefore, for inflation, is presented.

International economic developments

At the beginning of 2002 the global economy was emerging from what many analysts viewed as one of the shortest and most moderate downturns of the post-war era. According to the International Monetary Fund (IMF), the moderating factors included the general pre-emptive and aggressive response of policy-makers to the downturn, and the progress made with reducing vulnerabilities and the strengthening of economic fundamentals in advanced and in developing countries. The recent revisions to the US national accounts, however, show that the recession of 2001 was worse than originally estimated, and that there was in fact a contraction during the first three quarters of the year.

In the first quarter of 2002 there were indications that a recovery had begun. First-quarter growth in the United States was 5 per cent and there were expectations that the upswing would be even stronger than many had anticipated. The US stock markets also responded positively and there were signs that the recovery was spreading to the rest of the world. However, these hopes were dashed with the succession of corporate accounting scandals which shook the US markets and, ultimately, the major markets around the world as well.

Second-quarter growth in the US declined considerably to 1,1 per cent and the IMF estimates that output growth for 2002 will be 2,2 per cent (Table 1). The decline in growth reflected in part a decline in consumer expenditure growth, probably as a result of the weaker stock markets. Consumer expenditure, which had held up well during the recession, increased by 1,9 per cent in the second quarter, compared with 3,1 per cent in the first quarter. The weakness in the US markets also resulted in a decline in capital inflows, leading to a significant weakening of the US dollar since May.

The weaker second-quarter performance in the United States led to generalised downward revisions of growth forecasts, not only in the United States but also in many other regions. In the euro area, the initial recovery in the first quarter was not as strong as in the US but there were signs that the downturn had bottomed out. Real gross domestic product (GDP) in the euro area increased at an annualised rate of 1,2 per cent in the first quarter and 1,4 per cent in the second quarter. This followed a contraction of 1,0 per cent in the final quarter of 2001. However, at the recent meeting of European Union finance ministers in Copenhagen, growth estimates for the second half of 2002 were halved by the European Commission to 0,3 per cent, and growth for the year is not expected to exceed 1,0 per cent in line with the IMF estimate of 0,9 per cent (Table 1).

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

Per cent

	Real GDP		Inflation rates	
	2001	2002 (estimate)	2001	2002 (estimate)
World	2,2	2,8	4,3	3,6
Advanced economies	0,8	1,7	2,2	1,4
USA	0,3	2,2	2,8	1,5
Japan	-0,3	-0,5	-0,7	-1,0
Euro area	1,5	0,9	2,6	2,1
United Kingdom	1,9	1,7	2,1	1,9
Developing countries	3,9	4,2	5,7	5,6
Africa	3,5	3,1	13,1	9,6
Asia	5,6	6,1	2,6	2,1
Western hemisphere	0,6	-0,6	6,4	8,6
Countries in transition	5,0	3,9	15,9	11,3

Source: *IMF World Economic Outlook,* September 2002

The Japanese economy remains weak. The revisions to the method of calculating GDP in Japan meant that the economy contracted by 0,1 per cent in the first quarter as against initial estimates of 5,7 per cent positive growth, though second-quarter growth recovered to 2,6 per cent. However, the weaker performance of the US and

European economies is already beginning to affect Japanese exports. The East Asian economies had more robust performances during the first half of the year, buoyed by increased exports and higher consumer expenditure.

Not all emerging markets followed the Asian recovery. Crises in a number of Latin American countries resulted in uncertainty and increased risk perceptions. Argentina continues to be in one of its deepest recessions, and the contagion effects of this on the region have impacted on Uruguay and Ecuador in particular. The Brazilian economy has been faced with increased uncertainty in the run up to its October elections, although recent IMF assistance has helped to stabilise the situation. Nevertheless, the volatile situation in Latin America has been negative for emerging-market risk in general.

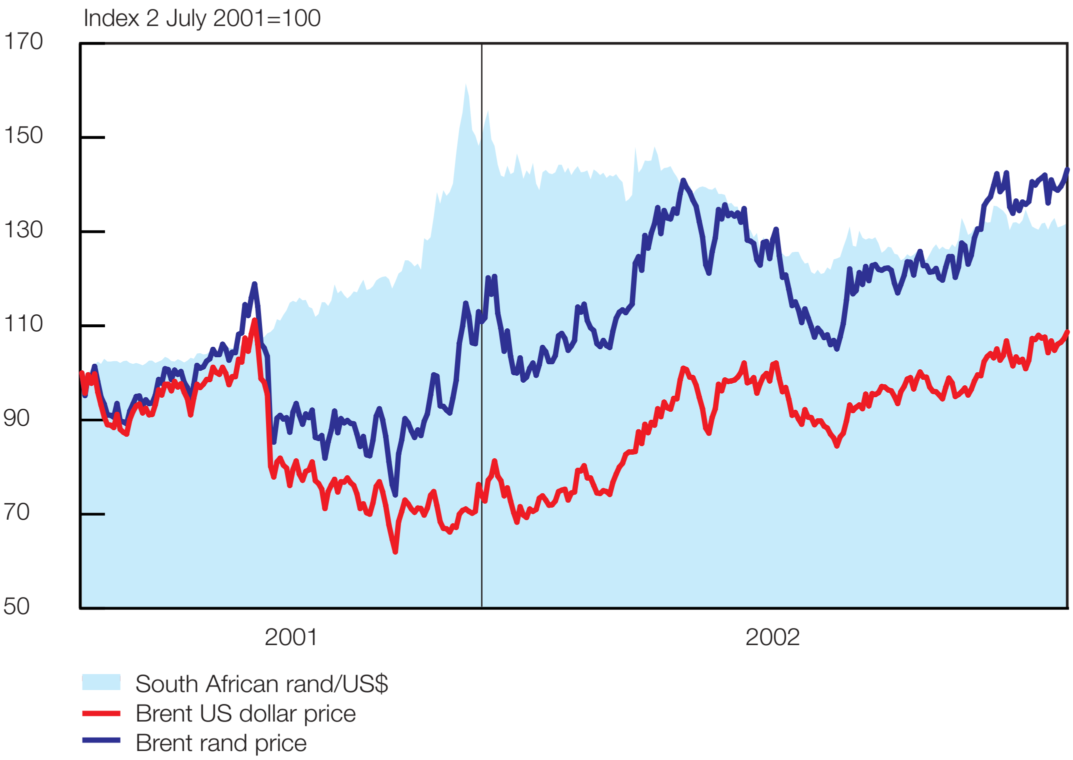
Despite the downturn in 2002 and the weak recovery, South Africa managed to avoid a significant decline in growth. Although export volume growth declined in the second half of 2001, the depreciation in the external value of the rand in the second half of 2001 helped reverse this trend in the first half of 2002. However, the weaker pace of recovery could adversely affect exports as well as commodity prices.

The slower pace of global recovery has meant that inflation has not been a major cause for concern in most countries. Lower real growth rates meant that firms still had limited pricing power. As Table 1 shows, it is estimated that world inflation will average 3,6 per cent in 2002 compared with 4,3 per cent in 2001.

Oil prices

International oil prices have remained relatively high since the second quarter of this year, despite lower-than-anticipated demand. During the course of the year, the Organisation of Petroleum Exporting Countries (OPEC) has maintained quotas at the lower levels introduced in January. Since April, the monthly average Brent price has been above the

Figure 8 Brent crude oil price and rand/US dollar exchange rate



level of US$25 per barrel (apart from June when it was marginally lower). More recently, oil prices moved sharply higher amid concerns of a possible US-led attack on Iraq. OPEC has recently reaffirmed its commitment to maintain the benchmark price within a range of US$22 and US$28 per barrel for a basket of crude oil. The price of the OPEC basket has remained marginally below the ceiling of US$28 per barrel.

World interest rates

The delayed recovery in the world economy has resulted in differing monetary policy stances in advanced economies. Some countries have pursued tighter policies and others have left them unchanged since the end of 2001 (Table 2). Canada, Sweden, Australia and New Zealand have tightened monetary policy between May and July in response to stronger growth and inflationary pressures, whereas the United States, the euro area, Denmark and the United Kingdom, for example, have left monetary policy unchanged since the end of last year. Initially, it was widely expected that most economies would be adopting a tighter monetary policy stance during the course of this year. Such increases are now expected to be delayed, and some expect that US rates could decline even further. Several emerging markets including Thailand, Brazil, Mexico, Indonesia, and Chile have eased their monetary policy stances since the beginning of the year. South Korea moved against this trend with an increase in May.

Table 2 Key central bank interest rates
Per cent

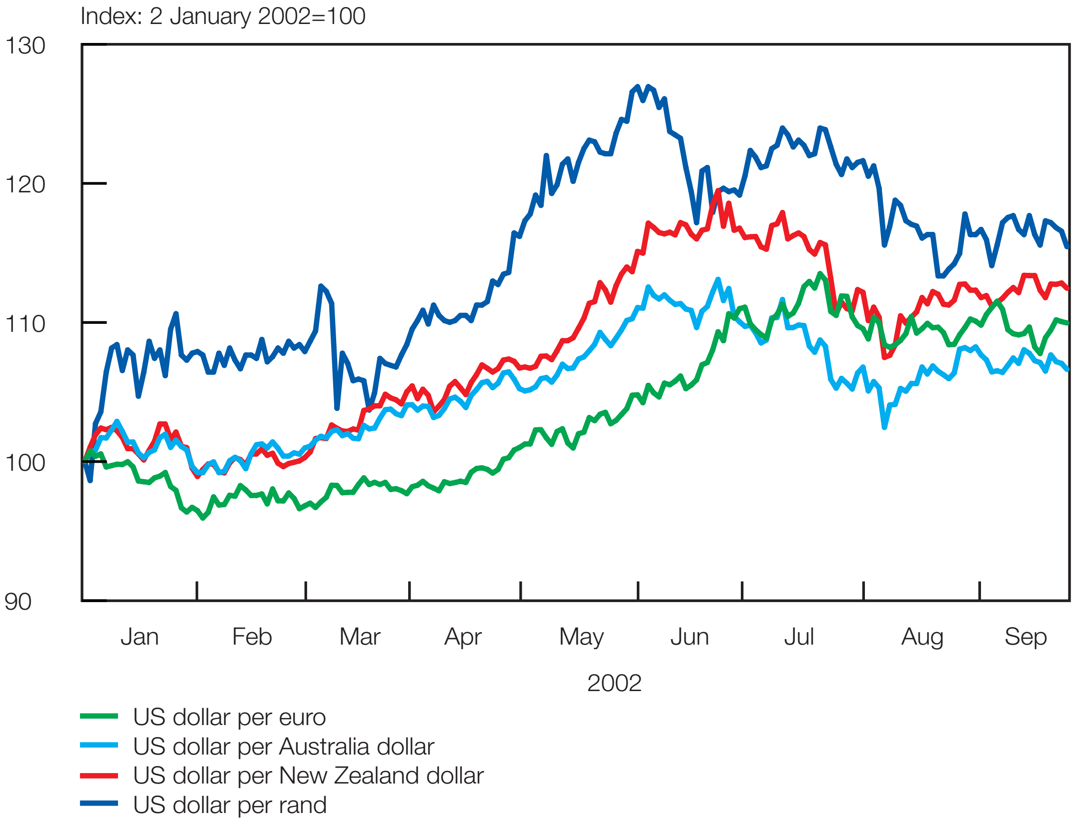
Countries	1 January 2002	26 September 2002	Latest change (Percentage points)	
USA	1,75	1,75	11 Dec 2001	(-0,25)
Japan	0,00	0,00	19 Mar 2001	(-0,15)
Euro area	3,25	3,25	8 Nov 2001	(-0,50)
United Kingdom	4,00	4,00	8 Nov 2001	(-0,50)
Canada	2,25	2,75	16 Jul 2002	(+0,25)
Denmark	3,25	3,25	9 Nov 2001	(-0,50)
Sweden	3,75	4,25	2 May 2002	(+0,25)
Switzerland	1,25–2,25	0,25–1,25	26 Jul 2002	(-0,50)
Australia	4,25	4,75	5 Jun 2002	(+0,25)
New Zealand	4,75	5,75	3 Jul 2002	(+0,25)
Israel	3,80	9,10	24 Jun 2002	(+2,00)
Hong Kong	3,25	3,25	12 Dec 2001	(-0,25)
Indonesia	17,62	13,50	12 Jun–18 Sep 2002	(-1,66)
Malaysia	5,00	5,00	20 Sep 2001	(-0,50)
South Korea	4,00	4,25	7 May 2002	(+0,25)
Taiwan	2,13	1,88	27 Jun 2002	(-0,25)
Thailand	2,25	2,00	21 Jan 2002	(-0,25)
India	6,50	6,50	22 Oct 2001	(-0,50)
Brazil	19,00	18,00	17 Jul 2002	(-0,50)
Chile	6,50	3,00	8 Aug 2002	(-0,25)
Czech Republic	4,75	3,00	26 Jul 2002	(-0,75)
Hungary	9,75	9,50	8 Jul 2002	(+0,50)
Poland	11,50	8,00	29 Aug 2002	(-0,50)
Russia	25,00	21,00	7 Aug 2002	(-2,00)

Source: National central banks

Exchange rate developments

Despite losing ground after May, the rand has remained one of the better performing currencies this year. Following the 37 per cent depreciation against the US dollar in 2001, it went through a period of consolidation in January and early February, followed by a strong rally from February to mid-June 2002. During April it appreciated sharply from R11,28 per US dollar to reach R9,74 per US dollar at the end of May. Part of the appreciation can be ascribed to exporters' repatriation of export earnings, declining pressure on emerging-market currencies, the weakening of the US dollar following the corporate governance and accounting scandals in the US, and the gold price rally accompanied by an improved outlook for commodities. The latter factor led to a general strengthening of the currencies of commodity-producing countries, including Australia, as shown in Figure 9.

Figure 9 US dollar per rand, euro, Australian and New Zealand dollar



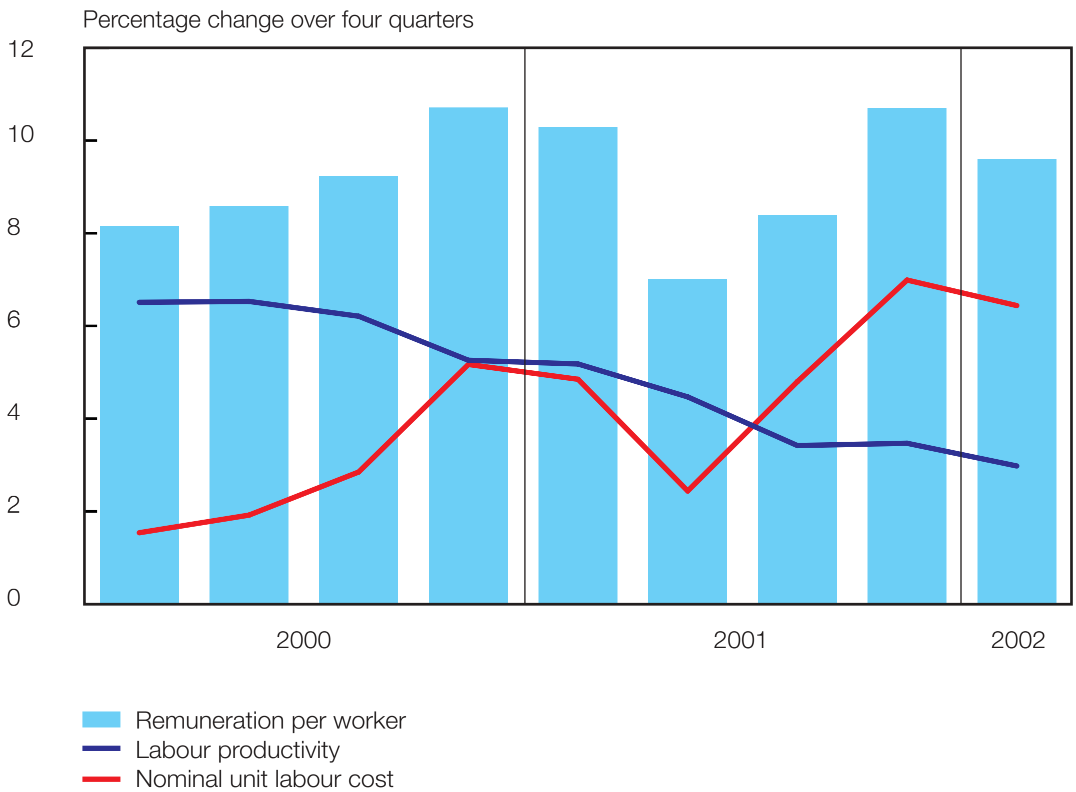
Since June the rand has come under increased pressure and followed a weaker trend. By late September it was around R10,60 per US dollar. Factors contributing to this decline were the disappointing inflation figures; the increasingly uncertain outlook for the global economy and commodities; deteriorating political and economic developments in the region, particularly in Zimbabwe; emerging-market jitters stemming from the crisis in Argentina and the threat of debt default in Brazil; and what was probably most significant, the leaking of the draft mining charter. Despite reassurances by government that this did not reflect government policy, large-scale selling of bonds and equities by non-residents at times pushed the rand to levels close to R11 per US dollar. In July and August, non-residents reduced their holdings of domestic securities by almost R12 billion.

Labour markets

The labour market developments detailed in Figure 10 reveal that increases in economy-wide unit labour cost (i.e. wage increases adjusted for productivity changes in the formal non-agricultural sector), have risen to levels above the targeted inflation rate for the economy. The year-on-year growth in unit labour cost accelerated from 2,4 per cent in the second quarter of 2001 to 7,0 per cent in the fourth quarter, before moderating to 6,4 per cent in the first quarter of 2002. Growth in unit labour cost for the manufacturing sector alone was well below these levels, measuring 3,6 per cent in the first quarter of 2002 largely as a result of improved growth in labour productivity.

As Figure 10 shows, the increase in unit labour cost in the formal non-agricultural sectors of the economy was the result of rising rates of increase in nominal remuneration per worker and the continued downward trend in the measured growth in labour productivity per worker. The annual increase in remuneration per worker rose from 7,0 per cent in the second quarter of 2001 to 10,7 per cent in the final quarter, while growth in labour productivity per worker declined from 4,5 per cent in the second quarter of 2001 to 3,4 per cent in the third quarter, before levelling off to 3,5 per cent in the last quarter of the year. In the first quarter of 2002, the growth in labour productivity per worker declined once more to 3,0 per cent, but the impact of this on growth in unit labour cost was more than offset by the moderation in the rate of increase in remuneration per worker to 9,6 per cent.

Figure 10 Remuneration per worker, labour productivity and unit labour cost in the formal non-agricultural sectors



Source: Statistics South Africa

Demand and output

The South African economy continues to perform relatively well in a global context. Table 3 shows that real GDP grew at a modest 2,2 per cent in the first quarter of 2002, before accelerating to 3,1 per cent in the second quarter. A wide range of productive sectors played a role in increasing output growth in the second quarter, including a strong contribution from export-oriented sectors which show signs of having benefited from the exchange rate depreciation in 2001 despite fairly weak global growth.

Table 3 Growth in real gross domestic product and expenditure components
Per cent

	2001 Q3	2001 Q4	2001 Year	2002 Q1	2002 Q2
Final consumption expenditure (households)	2,6	3,4	2,8	3,0	3,0
Final consumption expenditure (government)	2,6	2,8	1,4	2,8	3,0
Gross fixed capital formation	3,0	5,7	3,3	6,0	7,5
Change in inventories (R billion)	5,3	6,2	3,0	8,8	0,9
Gross domestic expenditure	**6,2**	**3,2**	**1,8**	**6,1**	**-0,9**
Exports of goods and services	-30,1	-4,4	2,4	7,1	23,1
Imports of goods and services	20,1	-3,0	0,4	27,2	6,6
Gross domestic product	**1,2**	**2,5**	**2,2**	**2,2**	**3,1**

Quarterly data refer to quarter-on-quarter growth at annual rates of seasonally adjusted data

As Table 3 shows, there was solid growth in aggregate final demand in 2002. Final consumption expenditure by households and by government was buoyant, and fixed capital formation increased relatively strongly. A sharp slowdown in the rate of inventory accumulation, however, resulted in a decline in real gross domestic expenditure by 0,9 per cent in the second quarter.

Fiscal policy

Although a mildly expansionary budget was announced for the 2002/03 fiscal year, the fiscal accounts for the first quarter of the year show that the deficit before borrowing and debt repayment shrank on a year-on-year basis. The surplus of revenue over expenditure for the non-financial public sector for the first three months of fiscal 2002/03 amounted to R2,9 billion (1,1 per cent of GDP), compared with the R1,3 billion recorded in the same period in fiscal 2001/02 (0,5 per cent). This increase in the surplus in government accounts has been largely the result of exceptionally high government revenue growth. Government revenue of R66,7 billion was collected in the first quarter (25,0 per cent of GDP), an increase of 25,8 per cent on the same quarter of 2001/02 and well above the 7,1 per cent forecast for 2002/03 as a whole. Higher revenue receipts were recorded across-the-board, including increased corporate tax payments arising from the depreciation of the rand and better collection of domestic taxes on goods and services. Government expenditure, by contrast, grew by 11,8 per cent year on year to R68,3 billion (25,6 per cent of GDP).

Table 4 Public finance: ratios to gross domestic product (fiscal years)
Per cent

	1999/2000	2000/01	2001/02	2002 April to June	2002/03	2003/04	2004/05
					Medium-term estimates		
National government							
Revenue	24,2	23,7	24,8	25,0	24,5	24,5	24,5
Expenditure	26,4	25,7	26,3	25,6	26,6	26,4	26,2
Deficit (-)	-2,2	-2,0	-1,5	-0,6	-2,1	-1,9	-1,7
Total loan debt	46,4	43,7	43,3	44,0	40,7	39,9	37,4
PSBR*	1,1	1,3	0,5	-1,1	1,4	1,6	1,7

Source: SARB and National Treasury, *Budget Review 2002*
* PSBR: Public-sector borrowing requirement

Monetary conditions

The year-on-year rates of increase in all of the monetary aggregates in Table 5 have been disturbingly high in 2002. To the extent that these aggregates represent sources of funding for future expenditure on goods and services, they are an indication of possible spending that may exceed the economy's production potential, and hence of inflationary pressures in the economy.

The broad M3 monetary aggregate increased by 17,4 per cent in July 2002. Although the trend in this aggregate appears to be downward from the 20,6 per cent growth recorded in May, the decline is largely due to increased tax collections, which transferred a portion of the private sector's deposits in M3 to government deposits which are not included in M3. The growth in the more narrowly defined aggregates slowed noticeably from the first to the second quarter of 2002, but nevertheless remained stubbornly high.

Table 5 Percentage change in monetary aggregates
Twelve-month change

		M1A	M1	M2	M3
2002:	January	18,1	21,9	18,6	19,7
	February	17,9	23,4	18,3	19,4
	March	28,1	24,7	17,8	18,1
	April	18,5	20,9	16,6	17,6
	May	21,3	25,2	19,6	20,6
	June	18,0	21,5	17,1	18,1
	July	18,0	18,3	14,6	17,3
	Average	**20,0**	**21,6**	**17,1**	**18,4**

Credit extension to the private sector, which had risen sharply to a three-year high of 15,6 per cent in January 2002, has since declined steadily to 11,7 per cent in July. This reduction was mainly the result of reversals in the leads and lags associated with foreign transactions, with earlier borrowing in this regard apparently being repaid as the currency strengthened in the first five months of the year. The corporate sector was affected most by this trend, and the share of households in total credit extended to the private sector duly increased over the period.

Monetary policy

Monetary policy continues to be dominated by the response to the sharp depreciation of the rand in November and December 2001. The Monetary Policy Committee decision-making process is described in Box 2, and Box 3 discusses issues relating to the setting of the targets.

Box 2 Making monetary policy decisions

One of the questions often raised in the context of monetary policy regards the monetary policy decision-making process. This box describes the practical aspects of this process.

The Monetary Policy Committee (MPC) was reconstituted at the beginning of 2002 and currently comprises seven members: the Governor, two deputy governors and four senior officials of the Reserve Bank. The MPC will increase to eight members when the vacant position of deputy governor is filled.

Previously, meetings were held every six to eight weeks, but since the beginning of this year quarterly meetings have been scheduled to coincide with the release of key quarterly data. However, provision is made for unscheduled meetings if the need arises, as was the case with the unscheduled meeting in January 2002.

Although the meetings are held quarterly, there is an almost continuous monitoring of economic developments, particularly those that impact on inflation and monetary policy. Members receive briefing updates and analysis and research output from various units in the Bank, as well as material from various external domestic and international sources, including financial institutions, academic economists, and international organisations such as the IMF and the Bank for International Settlements.

The MPC cycle begins in earnest approximately two to three weeks prior to the scheduled meeting, when members meet with the Macro Models Unit. By then the modellers will have consulted various other units regarding the assumptions made about the exogenous variables of the models. The assumptions are presented to the committee and, in the ensuing discussions, changes may be suggested to the assumptions or requests made for alternative scenarios to be considered during the forecasting process. This process ensures that there is ‘ownership’ of the forecast by the committee.

The first day of the scheduled MPC meeting starts with presentations on special items of topical interest that are prepared on an *ad hoc* basis, usually at the prior request of the MPC. In the past, such topics have included analyses of food prices, international oil prices and the role of monetary aggregates in the inflation process. This is followed by a review of economic developments which entails presentations on different aspects of the economy, prepared by various departments in the Bank and presented by the respective unit or departmental heads. The members of the committee will have received a full set of documentation the previous week. The standard agenda for the economic developments is as follows:

- International economic conditions: prepared by the International Economy Unit of the Research Department.
- International financial markets: prepared by the International Banking Department.
- Domestic money and capital markets: prepared by the Money and Capital Market Department.
- Financial and fiscal developments: prepared by the Financial Analysis and Public Finance Unit of the Research Department.
- National economic conditions: prepared by the National Economy Unit of the Research Department.
- Economic projections: the forecasts of the various Bank econometric models as developed by the Macro Models Unit of the Research Department are presented, along with surveys of inflation expectations.

Each presentation is followed by a discussion. These presentations usually continue until late afternoon, and up to that point the monetary policy stance is not discussed. In the evening there is a working dinner where some of the issues raised during the course of the day are discussed further, with a focus on the implications for the monetary policy stance.

The following morning begins with a summary of the discussion of the previous evening. A discussion of the monetary policy stance ensues. Committee members are then asked in turn to express their views on the appropriate monetary policy stance and on any interest rate changes that may be deemed appropriate. In general, decisions are made by consensus or with a majority view, without a formal vote being taken.

Once the decision is taken, the statement to be issued is finalised. To ensure that the embargo on the release of the decision is not broken, the statement is released to the press at the same time that the Governor reads the statement live on national television at 15:00.

An important implication of the introduction of inflation targeting is that monetary policy has become more forward looking. Monetary policy decisions are made on the basis of current and expected developments in a number of variables, which are also the main drivers of the Bank's forecasting models. As described above, the MPC monitors a number of factors that influence inflation, including money supply and credit extension; changes in wages and productivity and unit labour cost; the output gap; exchange rate developments and import prices, oil prices and other administered prices. There is no target for any of these variables other than for CPIX, which is the benchmark for monetary policy decisions.

This implies that greater emphasis is given to the forecast than in the past. However, it is important to stress that there is not a mechanical relationship between the forecast and monetary policy decisions. Because of the uncertainties inherent in the forecast (as illustrated in the fan chart), the models and forecasts are aids to policy-making, but the final decision has to be a judgement call based not only on the forecast but also on other information.

Although output is not specifically targeted, it is an important factor in monetary policy decisions as it enters the model through the output gap. The future path of output can determine the extent of expected inflationary pressures. Similarly, although there is no specific target for the exchange rate, the expected future path of the exchange rate could have an important impact on monetary policy decisions.

The explicit forward-looking nature of monetary policy has resulted in far greater stability in the real and nominal interest rates. This is reflected in the less vigorous response to events such as the oil price shock in 2000, the exchange rate developments in 2000 and 2001 and the money supply developments in the second half of 2001. Excessive focus on or targeting of these variables would probably have resulted in greater variability in interest rates.

Following the 100-basis-point increase in the repo rate at the unscheduled meeting in January 2002, monetary policy was tightened further in the subsequent three meetings of the Monetary Policy Committee. In all cases the repurchase rate was increased by a further 100 basis points (Figure 11). By March it was clear that inflation expectations had been adversely affected by the depreciation, and that the impact of the depreciation on prices would not be limited to a one-off unavoidable first-round effect. In addition, there was concern about the continued high rate of growth in the money supply and credit extension, the state of the balance of payments, and the beginning of an acceleration in unit labour cost. This was against the backdrop of a world economy recovering from the downturn, with anticipated acceleration in the recovery. It was felt that tightening monetary policy at that stage, if successful in dampening wage and price increases, would avert the need for more drastic increases in the future.

By June, the upward trends of inflation and inflation expectations had maintained their momentum, and unit labour cost trends and money supply developments remained unfavourable. By that time, CPIX inflation had moved above the 9 per cent level and PPI inflation had reached almost 15 per cent. There were, however, some positive indications that could have signalled a reduction in pressure on inflation, and that appeared to signal the peak of the interest rate cycle at the time. These included the partial recovery of the rand from its lows in December, the surplus on both the current and financial accounts of the balance of payments, the continued low level of capacity utilisation and the fact that fiscal discipline was being maintained.

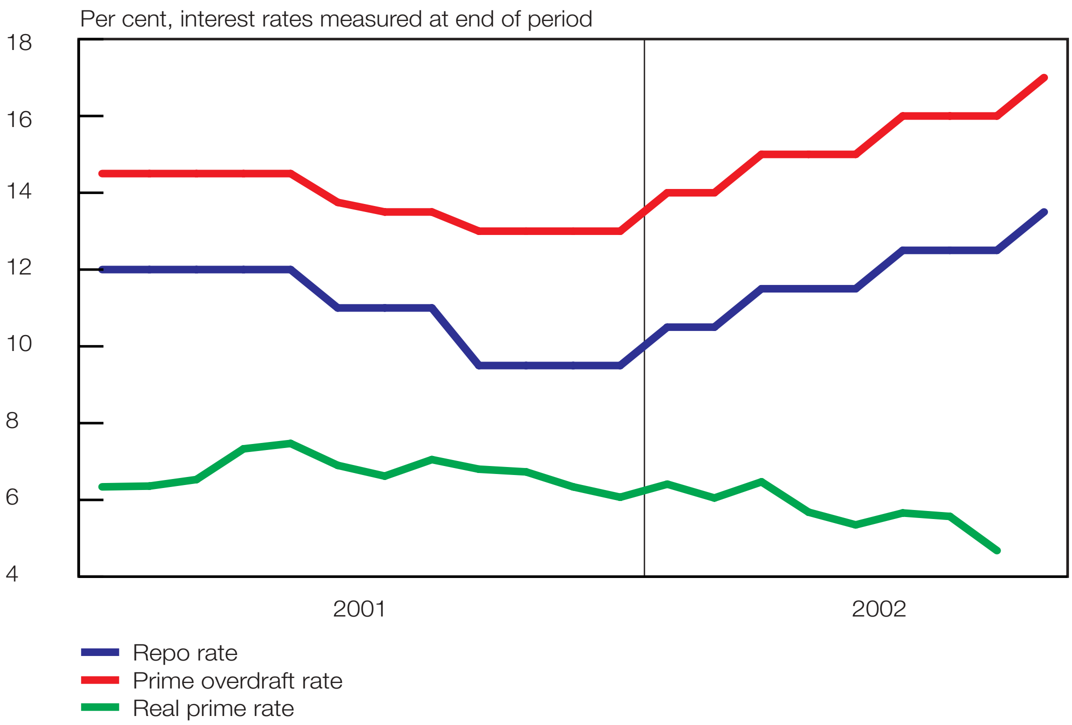
This relatively positive outlook appeared to be confirmed with the release of the PPI figures for June, which showed that production price inflation had declined. It was hoped that this would mark the turning point of the PPI and feed in with a lag to the CPIX. This appeared to bode well for the inflation outlook. Unfortunately, as discussed earlier, in the subsequent month production prices resumed their upward trend. Apart from this setback, a number of factors contributed to the increasingly negative outlook for inflation when the MPC met in September.

At the September meeting, the MPC had to take cognisance of the fact that not only was inflation rising at a faster rate than expected, but inflation pressures were also becoming more broadly based. It was no longer a case of rising food prices but, as seen earlier in the *Review*, the price increases were becoming more generalised and had also spread to services. Furthermore, quarter-on-quarter CPIX inflation was even more pronounced. Apart from this, the oil price was keeping petrol prices high, and the risk of an attack on Iraq by the United States is likely to keep these prices at higher levels, with a risk of further acceleration. The weaker exchange rate since June has also clouded the inflation outlook. The leaking of the draft mining charter contributed to substantial net sales of securities in the bond and equity markets.

Inflation expectations (discussed more fully below) remained high, and there was increasing evidence that wage settlements were significantly higher in the third quarter than had been the case in the first half of the year. However, there is evidence that an inflation spiral is not anticipated, and that inflation will begin to trend downwards later this year.

The MPC also had to consider the fact that despite the previous increases in interest rates, growth in the monetary aggregates and credit extension had remained stubbornly high. On the positive side, despite fairly robust growth in demand, it was acknowledged that there was no sign of excess spending or production capacity

Figure 11 The repo, prime and real prime interest rates*



* The real prime overdraft rate is measured *ex post* using the CPIX inflation rate, and is available only to August 2002 (i.e. this excludes the September rate increases)

constraints. Although inflation was being driven primarily by cost-push factors, it was felt that this, combined with accommodating monetary developments, required a monetary policy response from the Bank.

Although the cumulative rate increases have amounted to 400 basis points for the year, the banks' real prime overdraft rate measured *ex post* deflating by the CPIX inflation rate, will be similar to that prevailing at the end of 2001 (Figure 11). On the basis of *expected* inflation, it can be argued that real rates have risen somewhat. However, monetary policy responses to inflation shocks do require increases in real interest rates. In addition, the increase should be seen in conjunction with the stimulus given to the economy from the depreciation in the real exchange rate of the rand over the past year. Considered in this way, monetary conditions are not as tight as suggested by looking solely at the level of interest rates. Growth and expenditure levels have remained relatively robust. The MPC is aware of the fact that excessively high real interest rates will have a negative effect on the economy. The challenge facing the Bank is to increase real rates sufficiently to achieve its inflation objectives at a minimum cost to the real economy. Such costs, however, cannot be avoided over the short term, and are necessary in order to reap the longer-term benefit of lower inflation.

Box 3 How are inflation targets determined?

A number of countries have adopted inflation targeting in situations where their inflation rates were significantly above the long-run targeted level. In such situations, deciding on the rate and path of disinflation becomes critical. According to a study by Mahadeva and Stern, most countries in such instances have used the introduction of inflation targeting as part of the disinflation mechanism. This makes the inflation target endogenous to the inflation outcome. As these authors suggest, "...during disinflation it is difficult to separate decisions about target-setting from implementation. Short-term targets on a disinflation path may be more akin to conditional forecasts than policy rules, but their publication may nevertheless increase transparency and hence help policymakers to achieve lower inflation." (Mahadeva and Stern, 2001:1)

The setting of inflation targets in South Africa can be seen in this context – that the introduction of inflation targeting would help with the process of bringing down inflation to its long-run level, by increasing the credibility of the Bank's anti-inflation objectives and commitment. To initiate this process, the first target had to be below the prevailing CPIX inflation rate of around 7 per cent. However, it also had to be feasible or achievable, and credible. Because of lags in monetary policy, it also had to have a reasonable time horizon, i.e. it had to have a time horizon of longer than about eighteen months, as this is the estimated lag between a change in interest rates and its full impact on inflation. (Using a time horizon that is too short is likely to result in frequent misses of the inflation target even when monetary policy is being conducted optimally.) The result was that the target range was set in February 2000 at 3-6 per cent, to be achieved on average for 2002.

Subsequent to the introduction of the inflation-targeting framework, a joint Treasury/Reserve Bank Inflation Targeting Technical Committee was established to maintain regular contact and to consult on technical issues relating to the framework. This is an advisory committee and the final decisions are taken by the Minister of Finance and the Governor. Decisions relating to the implementation of monetary policy remain the preserve of the Reserve Bank. In other words, full instrument independence is maintained.

An important decision that had to be taken in deciding on subsequent targets was whether a target for one year should be announced, or whether a multi-year path should be specified. Specifying a path has the advantage of allowing for better forward planning in wage and price setting by the private sector. It also helps with the process of disinflation by providing credibility and transparency.

An alternative approach is to continue to announce only one medium-term annual inflation target. This could be accompanied by an announcement of a long-run target which in turn may or may not have a specified target date for its achievement.

The advantage of not announcing the full path is that it does allow for some flexibility if there are problems with attaining the target, i.e. an annual target can leave more room to absorb short-run inflationary shocks and dampen output fluctuations.

On the one hand, announcing a disinflation path may influence inflation expectations more than the announcement of only a short-term target would. On the other hand, if the detailed path is missed, credibility may be undermined. The decision taken in South Africa was to have some combination of the two, where the full path has not been specified, but the annual targets for 2003-2005 have been.

The basis for the decision was that South Africa would want a reduction in the inflation rate at a speed which would not unduly affect the real sector of the economy. The decision was based on what the forecasts indicated was feasible, given the monetary policy stance. The objective remains the reduction of inflation but implicit in this is a recognition that an excessively fast reduction in inflation will have high costs.

At the time when the new targets were set, there was a general belief that the targets for 2002 would be attained. For example in September 2001, at the time that the targets were being decided upon, the Reuters consensus forecast for CPIX average for 2002 was 5,8 per cent and 5,4 per cent for 2003. In October the consensus forecast for 2002 was 5,7 per cent and 5,4 per cent in 2003. The Reserve Bank and Treasury forecasts were in line with these forecasts.

Ultimately, the Bank's objective is to bring the inflation rate down to the level of its major trading partners. No time frame has been set at this stage, nor has the exact long-term target level for inflation.

Reference

Mahadeva, L. and Sterne, G. 2001. Inflation Targets as a Stabilisation Device. *Bank of England Mimeograph*.

The outlook for inflation

The outlook, risk and uncertainties relating to some of the factors that determine the outlook for inflation and that are embodied in the forecast, are presented in this section.

The international context

At the time of publication of the previous *Monetary Policy Review*, there were positive signs that the recovery in the United States was progressing well. Nevertheless, there was uncertainty about the strength and duration of the recovery, while some commentators were predicting a double dip recession. Since then, there has been a slew of bad news from the international markets. It has become increasingly clear that if a general recovery does take place, it will not be as strong as many had originally predicted. This includes the IMF which, in its recent *World Economic Outlook,* has downgraded its projections for the second half of 2002 and 2003, with the risks of the outlook primarily on the downside. As can be seen in Table 6 world growth projections for 2003 have been revised downward from 4,0 per cent to 3,7 per cent. Most significantly, US growth has been revised down to 2,6 per cent from 3,4 per cent.

Private-sector forecasters have also engaged in continuous downward revisions of the strength of the world recovery. The widely held view is that, although the recovery will continue, there is a likelihood of a prolonged period of low world growth. The weakness in international stock markets, led by the United States, has negative implications for consumer expenditure growth, which had underpinned the initial recovery in the US and which had mitigated the extent of the recession in 2001. As US corporations and households rebuild their balance sheets, real growth is expected to be subdued.

Table 6 IMF projections of world growth and inflation for 2003

	Real GDP		Inflation	
	April	September	April	September
World	4,0	3,7	3,5	3,8
Advanced economies	3,0	2,5	1,8	1,7
USA	3,4	2,6	2,4	2,3
Japan	0,8	1,1	-0,5	-0,6
Euro area	2,9	2,3	1,6	1,6
United Kingdom	2,8	2,4	2,5	2,1
Developing countries	5,5	5,2	5,1	6,0
Africa	4,2	4,2	6,1	9,5
Asia	6,4	6,3	3,0	3,2
Western hemisphere	3,7	3,0	7,4	9,3
Countries in transition	4,4	4,5	8,7	8,8

Source: *IMF World Economic Outlook,* September 2002.

Growth in the euro area has also been lower than anticipated, and is expected to continue on a weaker path. The outlook in Germany in particular has deteriorated as negative consumer and producer sentiment persists. A number of forecasters have recently downgraded their forecasts for the euro area, and the IMF projection for 2003 has been revised downward to 2,3 per cent from 2,9 per cent in April.

Although the Japanese economy showed promising signs of a strong recovery earlier in the year, these hopes appear to have been premature as the stronger yen and faltering recovery in the US and Europe have negatively affected Japanese growth prospects. The continued recovery in the rest of Asia, however, could help support Japanese growth over the coming months. Although lower world growth and higher oil prices will undermine growth in Asia, domestic demand is expected to maintain a steady growth momentum.

The Latin American region is expected to remain turbulent during the coming months. Although prospects in Brazil have improved following IMF assistance, the uncertainties surrounding the upcoming elections continue to influence the perceptions of risk in the region. This is compounded by continued and unresolved problems, particularly in Argentina.

In March it appeared that the world had seen the end of the downward trend in the interest rate cycle and there was an expectation of an imminent reversal of that trend. Not only has this reversal been put on hold, but there are expectations of a renewed round of rate cuts, especially in the US, and cuts are not ruled out in the euro area and the United Kingdom, particularly as the outlook for the real economy is becoming increasingly negative. Given the current low levels of rates, the scope for aggressive cutting is more limited than in 2001. However, macroeconomic policy in general is likely to remain supportive of a global recovery. Interest rates in the industrialised countries are therefore likely to remain stable or decline. International inflation pressures have become even more subdued, and some analysts have been forecasting deflation in the United States. Therefore, an increase in world inflation is unlikely.

The international oil price remains a threat to the domestic inflation environment. Despite the higher oil price in recent months, OPEC has not bowed to the pressure to increase the output quotas. There does, however, seem to be a commitment to maintaining the oil price within the OPEC range of US$22-28 per barrel. Although the bottom of the range has been successfully defended in the past, the resolve to prevent prices from breaching the top of the range has yet to be tested.

A major factor clouding the oil market is the continued threat of a US attack on Iraq. This has kept the oil price at high levels. If an attack does occur, a further spike in the price would be likely. However, a number of factors could keep prices from rising excessively. Firstly, the tepid recovery in the US and the euro area would moderate demand for oil. Secondly, as prices rise, non-OPEC oil output is expected to increase, reducing OPEC market share. This could result in more pressure from within OPEC to increase quotas. Overall, however, it is expected that the risks to the oil price remain on the upside.

Apart from oil, the international maize price has been rising since mid-July and this is likely to start filtering through to domestic production and consumer prices.

Outlook for domestic demand and supply

The deteriorating outlook for the global economy is likely to have a negative impact on South African exports. Although this will be mitigated somewhat by a favourable competitive position as a result of a depreciated real exchange rate of the rand, lower demand for exports, less favourable commodity prices, and higher emerging-market risk aversion than originally expected will make the outlook on this front less favourable for South Africa.

The less favourable export performance could be detrimental to the current account of the balance of payments, and, if imports do not decline, the current-account surplus could decline significantly and move into deficit as there is unlikely to be a substantial fall in dividend outflows. To the extent that domestic economic growth persists at current levels, imports are unlikely to decline significantly. However, higher interest rates are expected to influence expenditure, including imports. Although the second-quarter GDP growth was encouraging, it is not clear whether it can be sustained at those levels. Domestic investment growth has been rising at a healthy rate and consumption expenditure has remained buoyant. As the global recovery falters, the growth outlook is likely to be less optimistic as export demands are curtailed. Capacity constraints are not expected to be a problem, although the higher expected wage demands could start putting upward pressure on unit labour cost.

The exchange rate of the rand continues to be undervalued but, as seen in the past, such a situation may persist for extended periods. As the global economy is weaker than anticipated, the rand is not expected to make a strong recovery in the near future. With rising uncertainty about the world economy, emerging-market risk premiums could rise and reduce flows to emerging markets, and the foreign exchange markets could be characterised by increased volatility. In the South African region, developments in Zimbabwe continue to affect foreign perceptions negatively.

Indicators of inflation expectations

The findings of the inflation expectations survey undertaken in the third quarter of 2002 by the Bureau for Economic Research (BER) at the University of Stellenbosch, are reported in Table 7. The table shows that in the third quarter of 2002, the average expectation for CPIX inflation in 2002 was 8,5 per cent. Financial analysts' expectations were the highest at 9,2 per cent and those of trade union officials the lowest at 7,9 per cent. Looking further ahead, the average expectation was that CPIX inflation would decline to 7,6 per cent in 2003 and to 7,0 per cent in 2004.

Table 7 BER survey of CPIX inflation expectations: 3rd quarter 2002*
Per cent

	2002	2003	2004
1. Finance	9,2 (8,5)	7,1 (7,0)	6,2 (6,0)
2. Business	8,3 (8,4)	7,9 (8,2)	7,5 (7,9)
3. Labour	7,9 (7,6)	7,9 (7,4)	7,3 (7,4)
Average 1 - 3	8,5 (8,2)	7,6 (7,5)	7,0 (7,1)

Source: Bureau for Economic Research, University of Stellenbosch
* Second-quarter results in parentheses

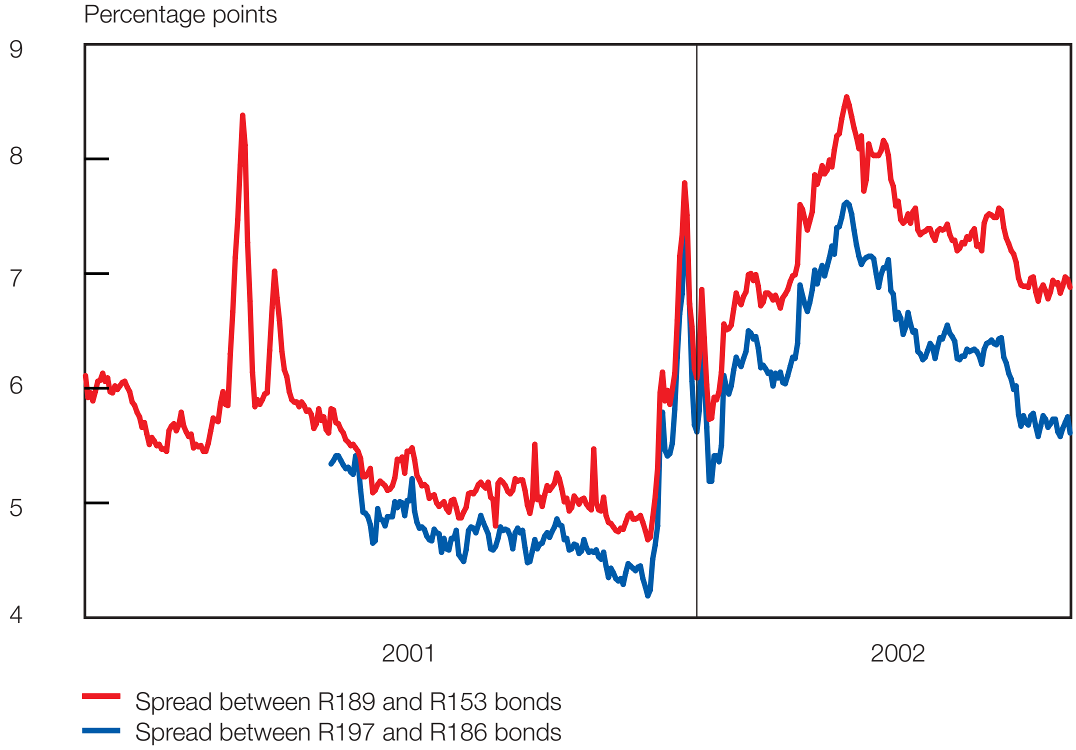
When these results are compared with those from the survey undertaken in the second quarter of 2002 (Table 7) it is clear that the increase in inflation expectations relates largely to 2002 (expected 2002 CPIX inflation averaged 8,2 per cent in the second quarter and 8,5 per cent in the third). For 2003 and 2004, the average expectations are roughly unchanged from the previous survey. The BER contrasts this with the second-quarter survey that reported large increases in expected inflation in all forecast years, and argues that this indicates that the increase in inflation expectations may be slowing down. Although the results show that the Reserve Bank is expected at this stage to miss its inflation targets in the coming years, the BER interprets these results as suggesting that the increase in CPIX inflation expectations may be slowing down and that the jump in inflation expectations which followed the exchange rate depreciation and surge in food prices, may have been contained.

The consensus CPIX forecasts produced from the Reuters August survey of long-term forecasts for the South African economy reveal that inflation is expected to average 9,4 per cent in 2002 (this is the mean of 11 individual forecasts ranging between 8,8 per cent and 9,7 per cent). CPIX inflation is then expected to decline to 6,9 per cent in 2003 and 5,4 per cent in 2004. An analysis of the Reuters consensus forecasts over time confirms the BER's finding that most of the increase in inflation expectations has been restricted to the 2002 forecast, which rose from 5,7 per cent in October 2001 to 9,4 per cent in August 2002. The increase in the mean 2003 forecast was initially moderate (from 5,4 per cent in October 2001 to 6,2 per cent in June 2002), although it then rose to 6,9 per cent in August 2002 – perhaps as expectations of a later turning point in the inflation surge took hold. By contrast, the average forecast for CPIX inflation in 2004 has declined from 5,7 per cent in the December 2001 survey to 5,4 per cent in August 2002.

Another indicator of trends in longer-term inflation expectations may be obtained from the spread between the yields on South African CPI inflation-linked bonds and conventional nominal bonds of similar maturity. Disregarding the risk premium associated with future inflation and differences in the liquidity of the bonds and their payments patterns, these spreads or break-even inflation rates provide an indication of expected inflation over the period until the bond matures. Figure 12 reveals that inflation expectations obtained in this way from the R189 (maturing 2013) and

R197 (maturing 2023) inflation-linked bonds resumed their downward trend at the end of March 2002 after increasing sharply since December 2001. More recently there appears to have been a slight reversal of this downward trend.

Figure 12 Breakeven inflation rates

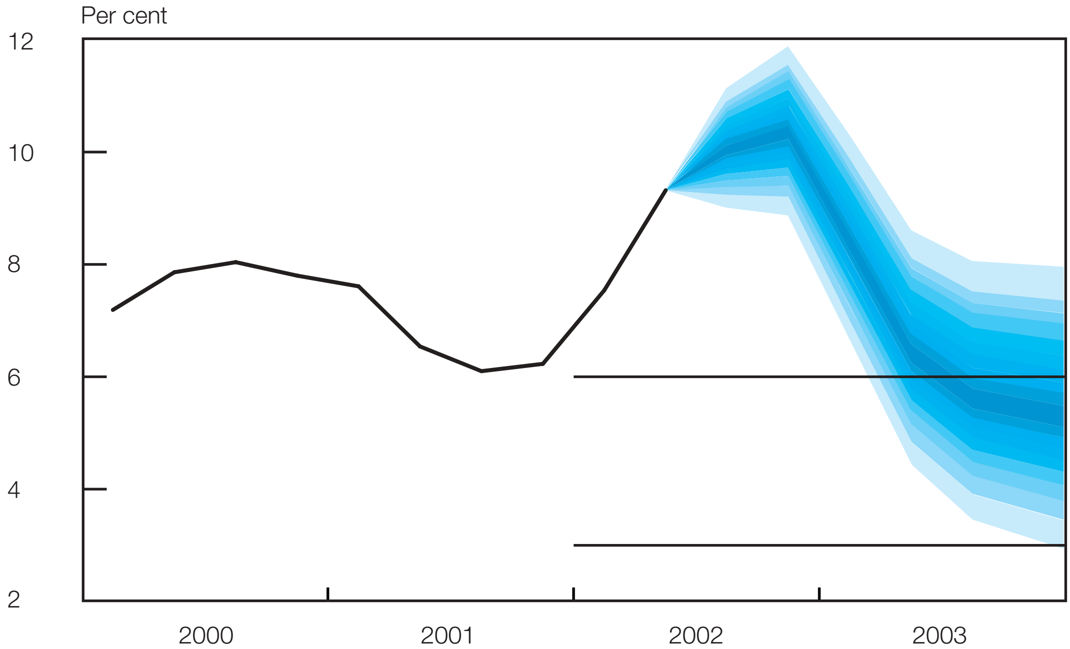


The Reserve Bank inflation forecast

The Reserve Bank's latest projection for CPIX inflation over the forecast period from the third quarter of 2002 to the end of 2003 is presented in Figure 13. The forecast again employs the fan chart technique to indicate the uncertainties surrounding the central projection (the March 2001 *Monetary Policy Review* provides a discussion of this technique). The forecast incorporates the projected effects of the 100-basis-point increase in the repo rate announced on 12 September 2002.

Figure 13 shows that the central projection for the CPIX inflation rate is forecast to peak at over 10 per cent in the fourth quarter of 2002 before declining to within the 6 per cent upper limit of the target range in the second half of 2003. As is always the case with forecasts, risks were foreseen which could result in the actual inflation outcome missing the central projection on either side. Factors that may be detrimental in this regard include the possibility that the oil price will increase substantially as a result of the current tensions surrounding Iraq, causing the oil price to be higher than was assumed when compiling the forecast, and that administered prices and unit labour cost may rise at rates which are not consistent with the inflation targets. A stronger or weaker than expected performance of the exchange rate would also add to the risk that the actual CPIX inflation outcome may be below or above the central projection.

Figure 13 CPIX forecast



Note: The fan chart uses confidence bands to depict varying degrees of certainty. The darkest band of the fan chart covers the most likely 10 per cent of probable outcomes foreseen for CPIX inflation, including the central projection. Each successive band, shaded slightly lighter and added on either side of the central band, adds a further 10 per cent to the probability until the whole shaded area depicts a 90 per cent confidence interval (see Box 4 "Understanding the fan chart" on p 27 of the March 2001 *Monetary Policy Review*).

Assessment and conclusion

Over the past few months the Bank has shown its determination to prevent the external shocks that have hit South Africa from turning into an uncontrolled inflation spiral. It is recognised that the action taken so far has been unpopular in some quarters where it is argued that monetary policy has little role to play in dealing with temporary external shocks. However, as seen above, the impact of the shocks has not been temporary, and far from being isolated to limited categories, price increases have become more generalised, and have also influenced inflation expectations. In such circumstances the monetary authorities have no option but to react. It has often been stressed in the past that failure to act sooner would result in more drastic action later.

The next few months will be critical for the monetary policy outlook. As seen above, despite the actions of the Reserve Bank, there are a number of factors which impart upside risk to the achievement of the inflation target in 2003. On the international front, the pace and extent of the global recovery will have an important effect on the prospects for the rand. Also of importance will be developments between the United States and Iraq. Not only would this conflict affect the oil price, but it could have a significant impact on the speed of the global recovery. Clearly these events are not something that monetary policy can counter directly, but their effects on inflation cannot be ignored.

Domestically, what will be critical is the extent to which prices begin to react to the monetary policy actions taken during the course of the year. It is well known that monetary policy has a lagged effect, and steps taken earlier in the year should begin to show results. The Bank's forecasts, along with those of most other private-sector forecasters, indicate that the turning point in the inflation rate is expected at some time during the last quarter of 2002. Should this indeed occur, the previous actions combined with base effects should culminate in a consistent downward trend in the inflation rate. The sooner this happens, the quicker the reversal in negative inflation expectations is likely to occur. The longer the postponement of this turning point, the greater the difficulty in reducing inflation, and monetary policy may have to adjust accordingly.