MONETARY POLICY REVIEW

April 2003

South African Reserve Bank

Contents

Enquiries relating to this *Review* should be addressed to:
Head of Research
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

ISSN: 1609-3194

Monetary Policy Review

Introduction

Over the past few months, the world economic slowdown has continued unabated, and global geopolitical uncertainties have contributed to the turbulence in international financial markets. Although the conflict in Iraq is seen as a major cause of the continued slowdown, it is unlikely that a resolution of this conflict will solve the underlying growth problems in industrialised countries. A number of industrial country central banks, including those in the United States of America, the United Kingdom and the euro area, have responded by easing monetary policy further, and fears of deflation rather than inflation tend to predominate. Despite this low inflation international environment, uncertainties regarding the impact of the war in Iraq on the global outlook and the international oil price remain a cause for concern.

Against this turbulent international background, the South African economy has proved to be remarkably resilient. The 3 per cent growth rate achieved in 2002 was high by international comparison, and should be seen in the context of the weak international economy and the monetary policy measures taken to deal with inflationary pressures caused mainly by the weakness of the rand in late 2001. During 2002 the interest rate was increased on four occasions by 100 basis points each time. However, at the time of the Monetary Policy Committee (MPC) meeting in November, there were indications that the inflation rate had peaked and it was decided to keep the repo rate unchanged. Although the outlook for inflation improved further during the first quarter of 2003, at the March meeting of the MPC the interest rate was put on hold pending confirmation of a sustained downward trend in inflation. The MPC was particularly concerned about wage developments which could have a negative impact on inflation.

Monetary policy was also affected by the decision of the Minister of Finance to modify the inflation targets for 2004 and 2005. In 2001 the targets for these years were set at 3 – 5 per cent. However, the sharp increase in the inflation rate in 2002 meant that achieving this lower target range within the original timeframe would put excessive pressure on the economy. In October 2002 the Minister announced that the inflation target would remain at 3 – 6 per cent for 2004. Subsequently it was announced in the February 2003 Budget that the target would remain at 3 – 6 per cent for 2005 and that the target for 2006 would be announced in October 2003.

This *Monetary Policy Review* provides an analysis of recent price developments, the factors that affect inflation as well as the outlook for inflation. In addition, four focus topics are provided in boxes. The first inflation target was set for 2002, and the inflation outcome for that year was above the target range. Box 1 restates the MPC view of the reasons for the target being missed. Food prices were a significant source of inflation during 2002 and developments in this area provide a good indication of the future direction of inflation in general. Box 2 analyses recent trends in spot and futures prices of grain and their implications for food prices. The recently announced exchange control amnesty has focused attention on the possible impact of the amnesty on the exchange rate and tax revenues. Box 3 provides a brief review of international experience with such amnesties. Box 4 considers the implications of the revision of the targets for the credibility of the inflation targeting framework.

Box 1 Statement on the inflation outcome for 2002

Extract from the Statement of the Monetary Policy Committee, issued by Mr T T Mboweni, Governor of the Reserve Bank, 20 March 2003

In February 2000 an announcement was made by government that an inflation targeting framework had been adopted for monetary policy purposes. This change was made to improve the co-ordination between monetary policy and other macroeconomic policies, as well as to make monetary policy more transparent and accountable. Under this framework the Reserve Bank and more specifically the Monetary Policy Committee was given the task to achieve an average rate of increase in the overall consumer price index for metropolitan and other urban areas excluding mortgage interest costs (the CPIX) of between 3 and 6 per cent for the year 2002. The CPIX measure of inflation was chosen to ensure a wide coverage of consumer items, but without the mortgage interest cost component that would perversely fall as monetary policy was relaxed, and vice versa.

In 2002 the rate of increase in the CPIX averaged 10 per cent, or 4 percentage points above the upper limit of the target range. In the light of this outcome the Reserve Bank wishes to inform the public in general why the actual inflation rate deviated from the target. The Bank would also like to spell out what measures have been taken to bring the inflation rate within the target band in due course.

The inflation outcome for 2002

The Monetary Policy Committee is of the opinion that four factors were mainly responsible for the acceleration in the rate of increase in the general price level in 2002. First and foremost the rapid rise in the prices of consumer goods and services was related to the sharp depreciation in the external value of the rand in the second half of 2001. The nominal value of the rand on a trade-weighted basis declined by 34,3 per cent from the end of June 2001 to the end of that year. Initially the weakness of the rand was mainly linked to the contagion effects of the political situation in Zimbabwe and financial stability problems experienced in emerging-market economies such as Argentina and Turkey. Later developments in the exchange rate of the rand were characterised by typical financial market behaviour under the circumstances which prevailed at the time where further declines in the exchange rate of the rand became a self-fulfilling prophecy based on market expectations.

The increased risk aversion of international investors caused asset fund managers to withdraw portfolio investments from South Africa. These sales of South African securities increased the demand for dollars in the domestic currency market, which put downward pressure on the exchange rate of the rand. At the same time, importers made advance payments to avoid paying more in rand for foreign-currency denominated purchases of goods abroad at a later stage, while exporters delayed the repatriation of foreign-currency earnings to obtain expected higher rand proceeds from a depreciating currency. The effects of the leads and lags in foreign payments and receipts on the exchange rate of the rand were aggravated by the appearance of a deficit on the current account of the balance of payments during the second half of 2001.

A second factor leading to the acceleration in inflation during 2002 was the rise in domestic food prices which had already started from the middle of the preceding year. The prices of food increased by no less than 16,7 per cent in 2002. If the increases in food prices are excluded from the overall CPIX, the rate of increase in the prices of other goods and services averaged 7,8 per cent in 2002.

Food prices are generally a highly volatile component in consumer expenditure and can have a significant impact on other price developments in South Africa. The substantial rise in food prices during 2002 can to a large extent be attributed to the depreciated value of the rand. After the liberalisation of agricultural pricing, export and import parity prices have generally set the lower and upper bounds to the prices of domestically produced agricultural goods. The rise in international prices of grain products together with the depreciation of the rand caused the prices of food in South Africa to rise considerably. Moreover, the regional demand and supply of crops in Southern Africa shifted the prices of agricultural goods higher resulting in a movement away from export parity pricing to import parity pricing.

Thirdly, the acceleration in the prices of consumer goods and services was the result of increases in international oil prices during 2002. After the Brent price of oil had stabilised around US$20 per barrel in January and February 2002, it started to move higher and reached an average of approximately US$28 per barrel in December 2002. This increase was mainly related to concerns about a possible US-led attack on Iraq and disruptions in the supply of oil due to general strikes in Venezuela.

Fourthly, the inflation outcome in 2002 was affected by large increases in some administered prices. In particular, the prices of medical and education services and water rates continued to increase at very high rates of approximately 10 per cent or more in 2002, following on even higher increases in 2001. Assessment rates and fees for sanitary services and refuse removal also rose at a high rate in 2002. As a result, the increase in the prices of all administered goods and services averaged 8,4 per cent in 2002, or was about equal to the increase in the preceding year. High increases in administered prices, which have a weight of almost 25 per cent in the CPIX, continue to make it extremely difficult to bring inflation down to the targets set by government.

This brief exposition of the major reasons why the inflation target was not met in 2002 indicates that it was largely due to extraordinary events that could not be foreseen and which were beyond the control or influence of monetary policy. At the beginning of 2002, when it had already become apparent that the inflation target would not be met, the Reserve Bank considered whether to make use of the escape clause, which recognises circumstances which could temporarily lead to deviations from the target. In the end the Bank decided that it would be unwise to make use of this clause. Continued monetary discipline was regarded as essential for price stability and sustainable high economic growth. It was also argued at the time that the negative effect of higher interest rates on short-term economic growth would be neutralised to a large extent by the very competitive external value of the rand.

Rather than opting for a temporary increase in the inflation target, the Monetary Policy Committee decided that corrective measures should be applied. The committee affirmed that it was highly unlikely that any measures would bring the inflation rate to within the target range for 2002 because of the long lags between interest rate increases and a slowdown in inflation. The objective of the committee accordingly became focused on bringing the rate of increase in CPIX within the target range as soon as possible with the least short-term cost to economic growth and employment creation.

The first corrective step was taken at a special meeting of the Monetary Policy Committee early in January 2002. At this meeting the committee decided to increase the repurchase rate of the Bank by 100 basis points to counter rising inflation expectations. Monetary policy was tightened further at the subsequent three scheduled meetings of the Monetary Policy Committee. At all three meetings the repurchase rate was increased by 100 basis points to bring the level to 13,5 per cent in September 2002. On the basis of expected inflation, this led to a significant increase in real short-term interest rates in South Africa and therefore a tightening in monetary policy.

At the November meeting of the Monetary Policy Committee it was decided that the right dose of monetary discipline had been applied and that there were some signs that inflation pressures were abating. The committee therefore kept the repurchase rate unchanged because this level of the rate was regarded as appropriate to bring the inflation rate within the target range in due course.

Recent developments in inflation

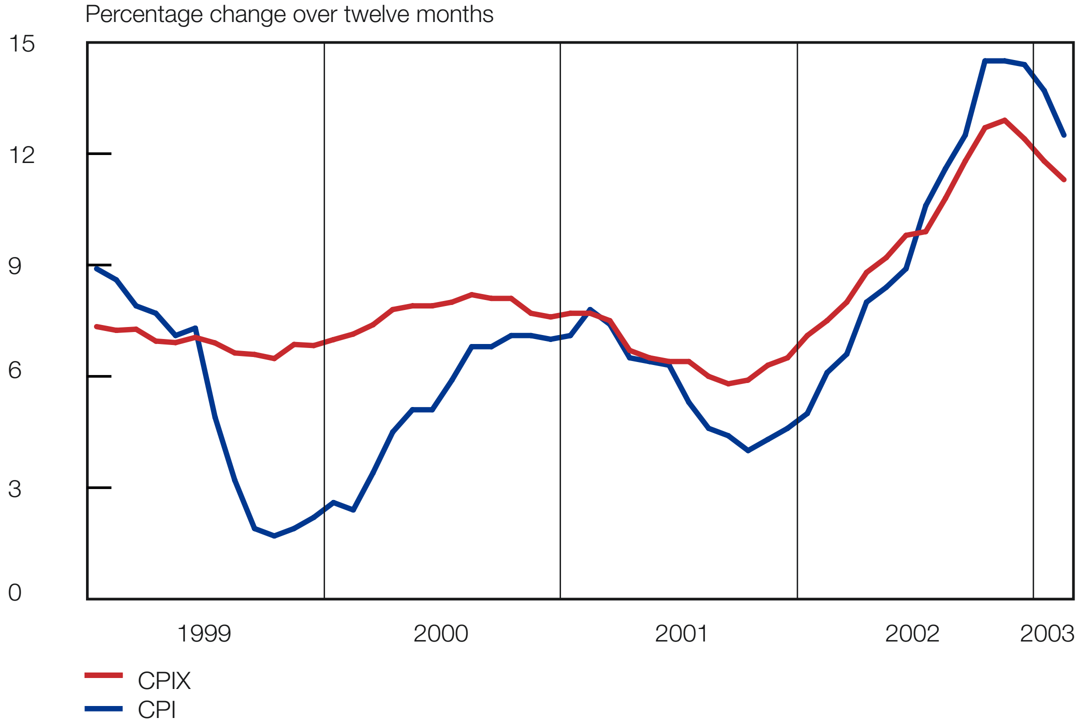
This section analyses recent trends in the main inflation indices, and reviews the developments in the primary factors impacting on inflation in the South African economy.

The evolution of indicators of inflation

The main inflation indices trended upward for most of 2002, driven mainly by the interaction of rising food prices and the effects of the large depreciation of the exchange rate in 2001. Late in the year, as the stimulus to inflation provided by these factors weakened and the effects of tighter monetary policy became apparent, the various measures of inflation reached their peaks and began moving downward into 2003.

Figure 1 depicts the twelve-month percentage change in the consumer price index for metropolitan areas (CPI) and consumer price index excluding mortgage interest cost for metropolitan and urban areas (CPIX). As the figure shows, CPIX inflation rose steadily from 7,1 per cent in January 2002 to 12,7 per cent in November, before declining to 11,3 per cent in February 2003. The annual average was 10,0 per cent, 4,0 percentage points above the upper band of the inflation target range for 2002.

Figure 1 Consumer price inflation: CPIX and CPI



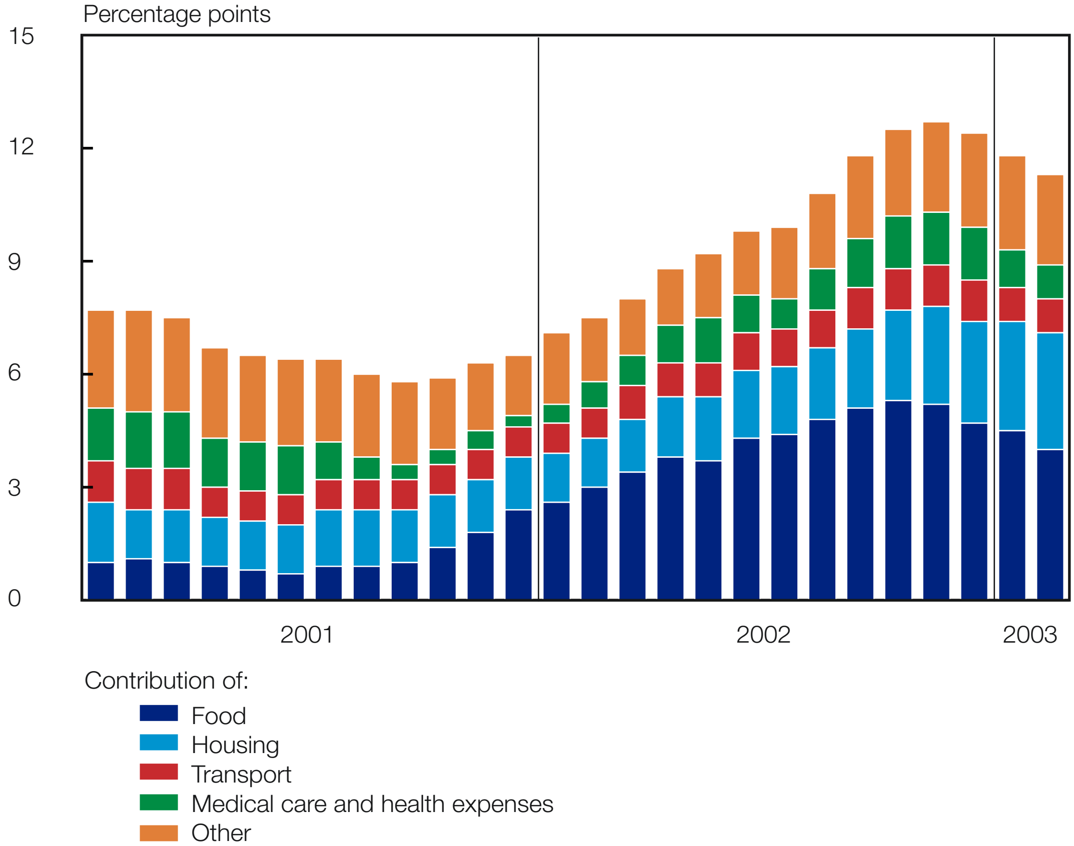
Source: Statistics South Africa

Headline CPI inflation increased at a faster pace than CPIX in 2002, reflecting the impact of the four 100-basis-point repo rate increases in the course of the year. CPI inflation rose from 5,0 per cent in January 2002 to peak at 14,5 per cent in October and November. Inflation measured by this index then slowed to 13,7 per cent in January 2003 and to 12,5 per cent in February.

Food prices were the dominant factor determining the observed trend in CPIX inflation in 2002. Figure 2 shows that, after contributing 1,0 percentage point when the total CPIX inflation rate was at its recent low of 5,8 per cent in September 2001, its contribution then rose sharply to 5,3 percentage points in October 2002 when total CPIX inflation was 12,5 per cent. As noted earlier, food price inflation then moderated, and the contribution of this component to CPIX inflation declined to 4,5 percentage points in January 2003 and further to 4,0 percentage points in February. In these months total CPIX inflation was 11,8 and 11,3 per cent, respectively. The outlook for food prices is discussed further in Box 2.

Of the other components of the CPIX, the contribution of housing to inflation increased from 1,3 percentage points in January and February 2002 (when total CPIX inflation was 7,1 and 7,5 per cent, respectively) to 3,1 percentage points in February 2003. The contribution of transport costs fluctuated in line with movements in oil prices and the exchange rate, declining to 0,8 percentage points in July 2002 before increasing to 1,4 percentage points in October – December, and then declining again to 0,9 percentage points in February 2003. The contribution of this component will be watched closely in the coming months, with the war in Iraq, coupled with the very low levels of international oil reserves, impacting on oil prices. Already the impact has been felt domestically with the 30 cents per litre increase in the petrol price in March.

Figure 2 Contributions to CPIX inflation



Source: Statistics South Africa and SARB calculations

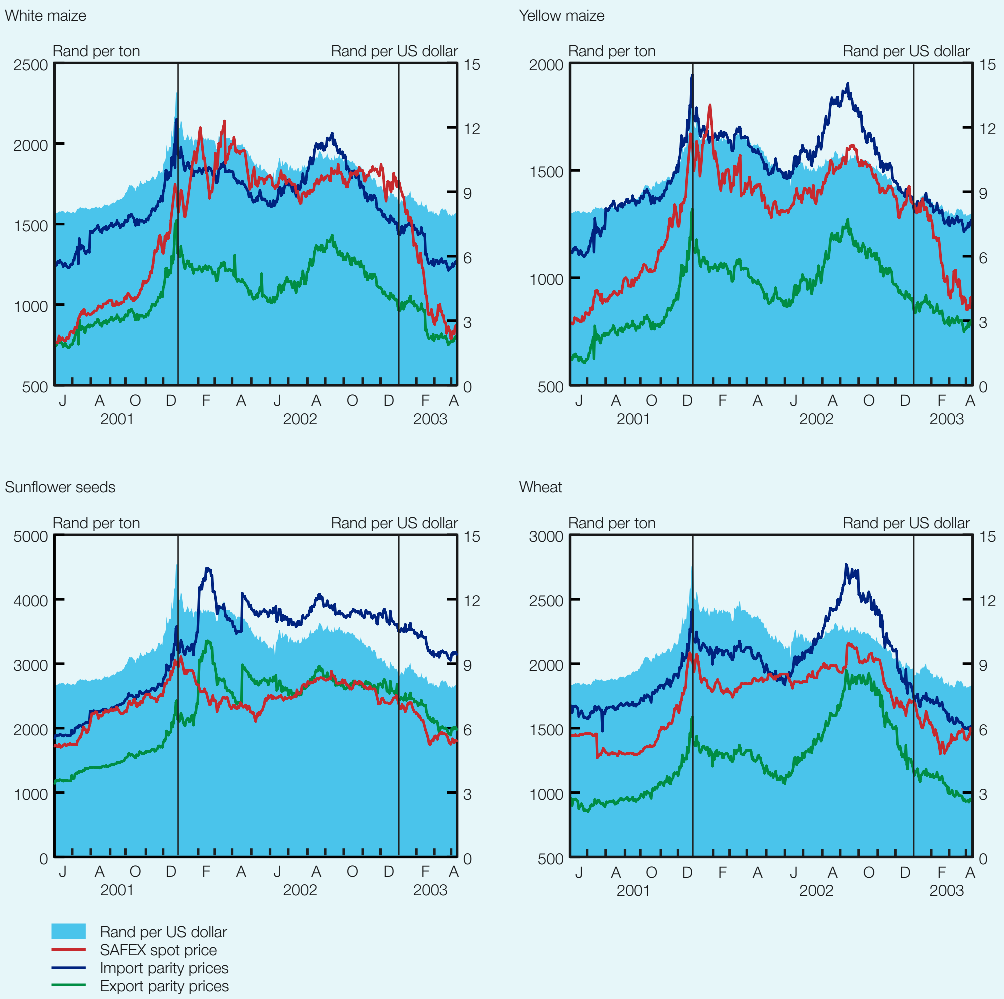
Box 2 Food price inflation: a view from the grain markets

Food price inflation has eased recently. After rising from 3,2 per cent in June 2001 to peak at 20,9 per cent in October 2002, the inflation rate for food prices in the CPIX has since declined to 15,3 per cent in February 2003. This box considers developments in the grain market and the outlook for grain prices, which play a significant role in determining food prices, both directly, and indirectly as an input cost to livestock and dairy operators. An earlier discussion, which dealt with the determination of prices in the grain market and the reasons for the sharp increases experienced in 2002, was presented as Box 2 in the April 2002 *Monetary Policy Review.*

Grains (white and yellow maize, sunflower seeds and wheat) are tradeable commodities and their prices are derived from dollar-based export and import parity prices. In 2001 and 2002, a combination of demand-pull and cost-push factors adversely affected domestic grain prices (evident in Figure B2.1). Over this period, poor weather conditions, regional shortages and the effects of the fall in the value of the rand in 2001 resulted in prices in the various grain markets moving up to, and sometimes briefly beyond, the import parity price level. During the planting season in 2002, for example, when rainfall and stock levels were low and fears of El Niño were widespread, prices were substantially above import parity pricing even though the rand was strengthening.

Since late in 2002, grain prices have been falling. Maize prices, in particular, have declined sharply. The price of white maize fell to a three-year low of R790 per ton at the end of March 2003, close to the export parity price of R770 per ton which is the breakeven price for the export of surplus maize. Yellow maize, the main feed for livestock in South Africa, is currently also trading below R900 per ton.

Figure B2.1 Selected grain prices



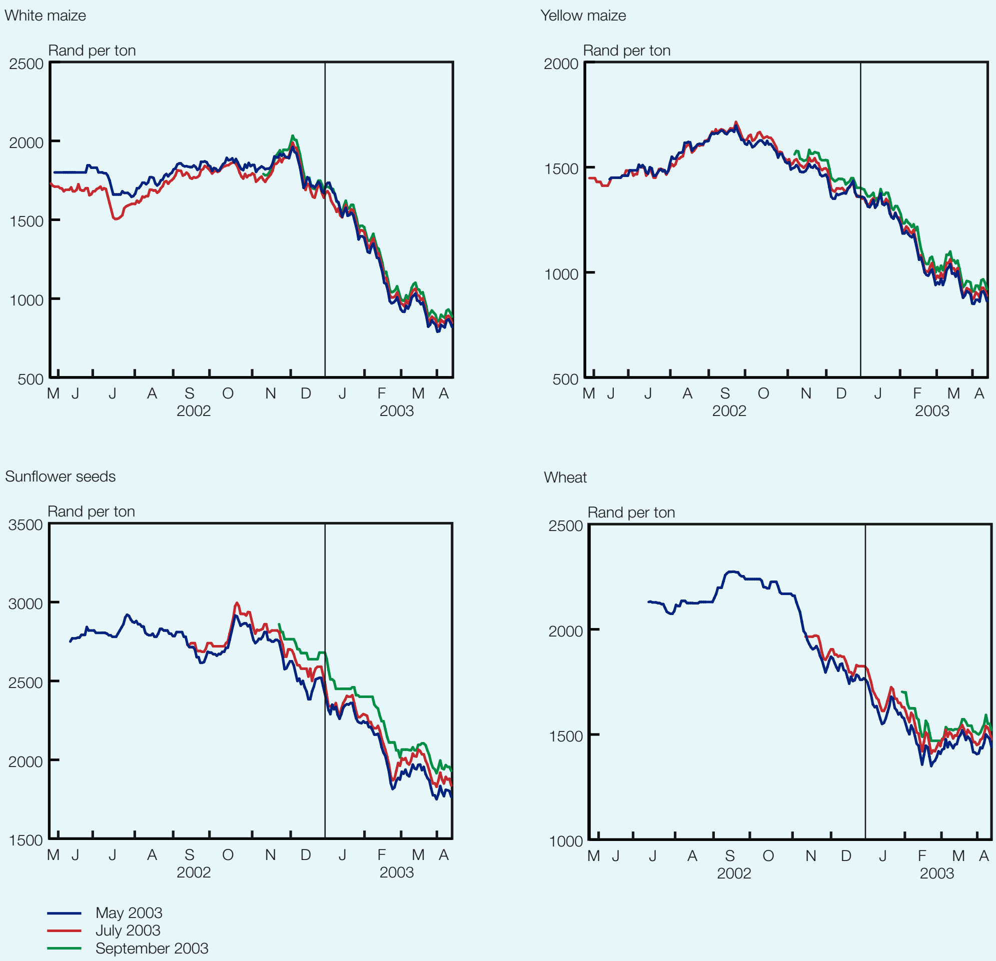
Source: Grain South Africa

Futures prices, which play an important role in the price discovery process, have also adjusted downward as new information has become available to market participants. Figure B2.2 shows that the price of white maize for delivery in July 2003 on South African Futures Exchange (SAFEX), for example, more than halved from R1 989 per ton at the beginning of December 2002 to R821 per ton at the end of March 2003. The figure shows that the SAFEX prices of futures contracts for yellow maize, wheat and sunflower seeds for delivery in May, July and September 2003 have all adjusted to developments in the grain markets in a similar way in recent months.

A number of factors have played a role in easing the inflationary pressures in the grain markets. The impact of the stronger rand on the import and export parity prices in the markets, the generally favourable prospects for the domestic 2002/03 crops, relatively stable international grain markets, and the improvement of the food supply situation in the Southern African region are all important in this regard.

The domestic maize crop has benefited from good rains in early December 2002, which provided relief after a dry November, and again in late February. The National Department of Agriculture estimates that the total domestic maize crop for the 2002/03 season will be 9,1 million tons (the second production forecast as at 19 March 2003), slightly down from the 10,0 million tons produced in 2001/02. In the case of wheat, which is a winter grain (and a lower volume, higher value product), some uncertainty has arisen over domestic output levels, related to the land area planted. This helps explain the spike observed in recent spot prices (Figure B2.1). Although wheat producers and millers experienced some difficulties during the 2002/03 season, the domestic wheat crop is projected at 2,1 million tons and imports at between 250 000 and 300 000 tons. Last year, 2,4 million tons of wheat were produced domestically and 600 000 tons were imported.

Figure B2.2 Prices of SAFEX futures for 2003 delivery



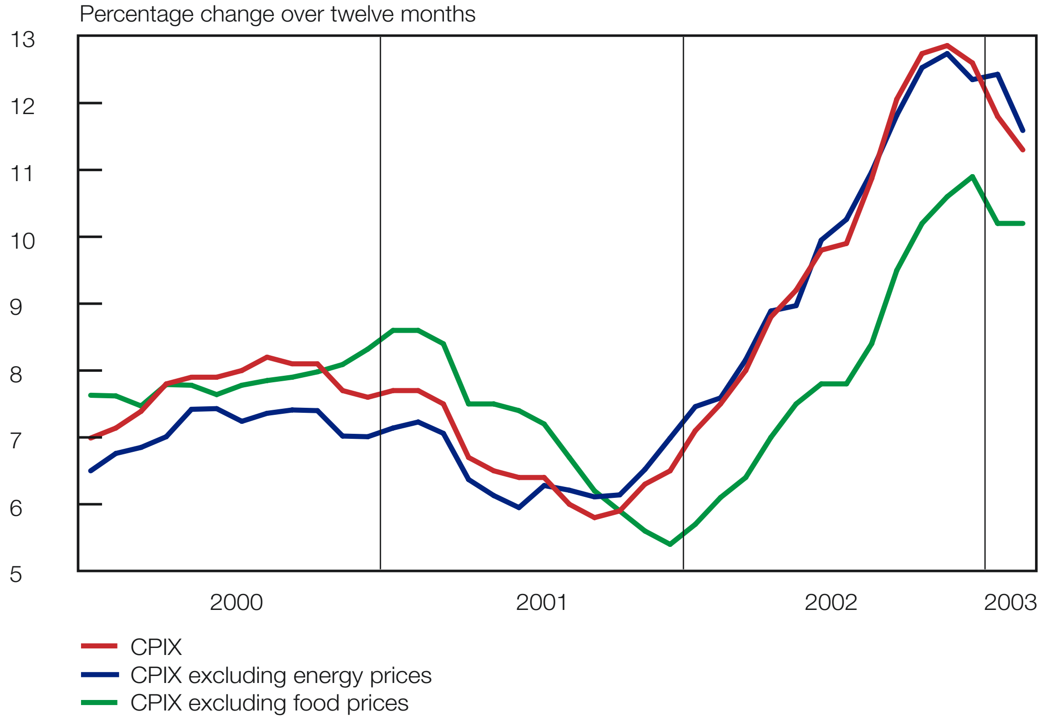
Source: SAFEX

On the international front, grain prices have receded in recent months as global supplies appear sufficient to meet demand. The US Department of Agriculture's March forecast was that world trade in maize in 2002/03 would be unchanged from 2001/02 at nearly 102 million tons, although stock levels are expected to decline to relatively low levels. World wheat trade in 2002/03 is forecast at 104,8 million tons, down 5,3 million tons from 2001/02, with lower production and higher consumption expected.

The recent decline in grain prices has contributed to a decrease in the inflation rate of agricultural products measured at the production level. Agricultural prices in the production price index (PPI) actually fell by 1,1 per cent in the twelve months to February 2003, after increasing by as much as 30,1 per cent when measured on the same basis in September 2002. As the benefits of lower production prices only impact on consumer prices with a lag, reflecting the relative stages of the production process and the time taken to deplete existing stocks, this sharp decline is not yet fully evident in the CPIX. So far, as noted earlier in the box, the inflation rate for food prices in the CPIX has fallen from 20,9 per cent in October 2002 to 15,3 per cent in February 2003. On the basis of production price data, food prices at the consumer price level should continue to fall in the coming months, and assist in bringing the overall rate of inflation down in 2003.

The role that food and energy prices have played in determining the trend of CPIX inflation is revealed by Figure 3, which shows the effect of excluding these prices from the main index. It is clear from the graph that food has been the main determinant of both the timing and magnitude of CPIX increases. The exclusion of food price inflation, which peaked at 20,9 per cent in October 2002 before declining to 15,3 per cent in February 2003, delays the turning points and lowers the recent path of CPIX inflation significantly. CPIX inflation excluding food prices increased from 5,7 per cent in January 2002 to 10,9 per cent in December before falling to 10,2 per cent in February 2003. The exclusion of energy prices, by contrast, has little impact on the path of CPIX inflation.

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



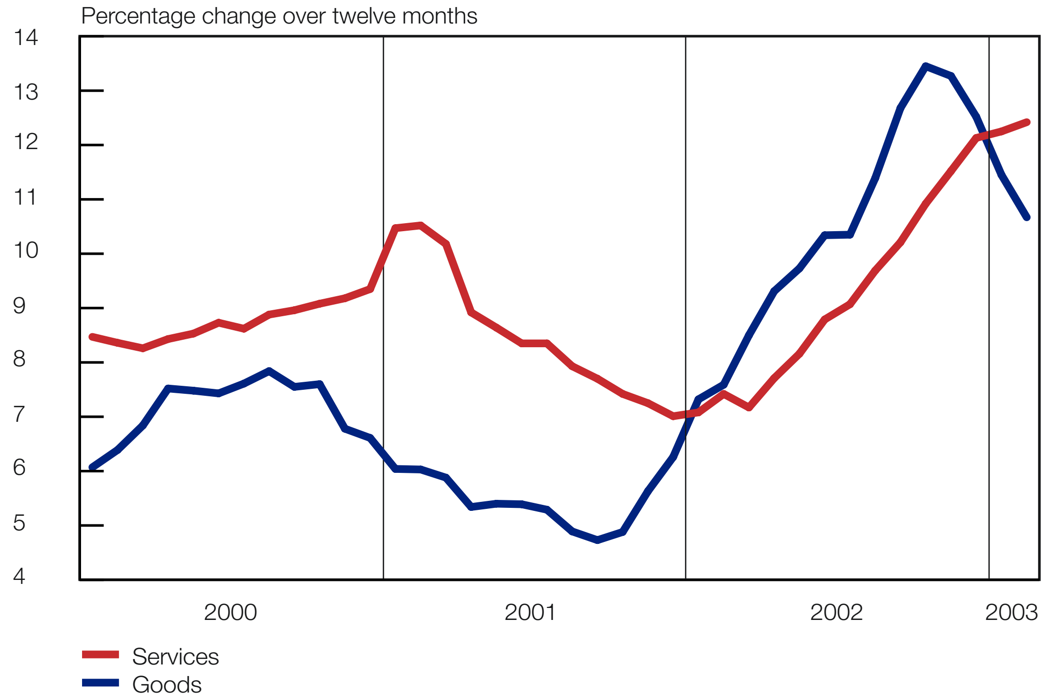
Source: Statistics South Africa

Figure 4 presents a breakdown of CPIX inflation into the broad ‘goods’ and ‘services’ categories. The goods category, containing relatively more items that are tradeable on international markets than the services category, is more susceptible to changes in the global environment and the exchange rate. This is evident in Figure 4, where the path of goods price inflation reflects the effects of the depreciation of the rand in late 2001 and the impact of the regional demand for grains. Goods inflation rose from 4,7 per cent in September 2001 to 10,3 per cent in June and July 2002, and gained further momentum to peak at 13,4 per cent in October 2002. The stronger rand and slower rate of food price inflation then aided a fairly sharp decline to 11,4 per cent in January and 10,7 per cent in February 2003.

The services category, by contrast, has been less variable, and has followed goods price inflation with a lag. Services inflation trended upwards from just over 7 per cent in January – March 2002 to 12,4 per cent in February 2003. The inflation rate for this category, which is primarily affected by internal factors such as wage-cost relationships and administered prices, is currently above that of the goods category and is slowing the decline in CPIX inflation. However the rate of increase appears to be slowing down and the index is expected to moderate over the coming months.

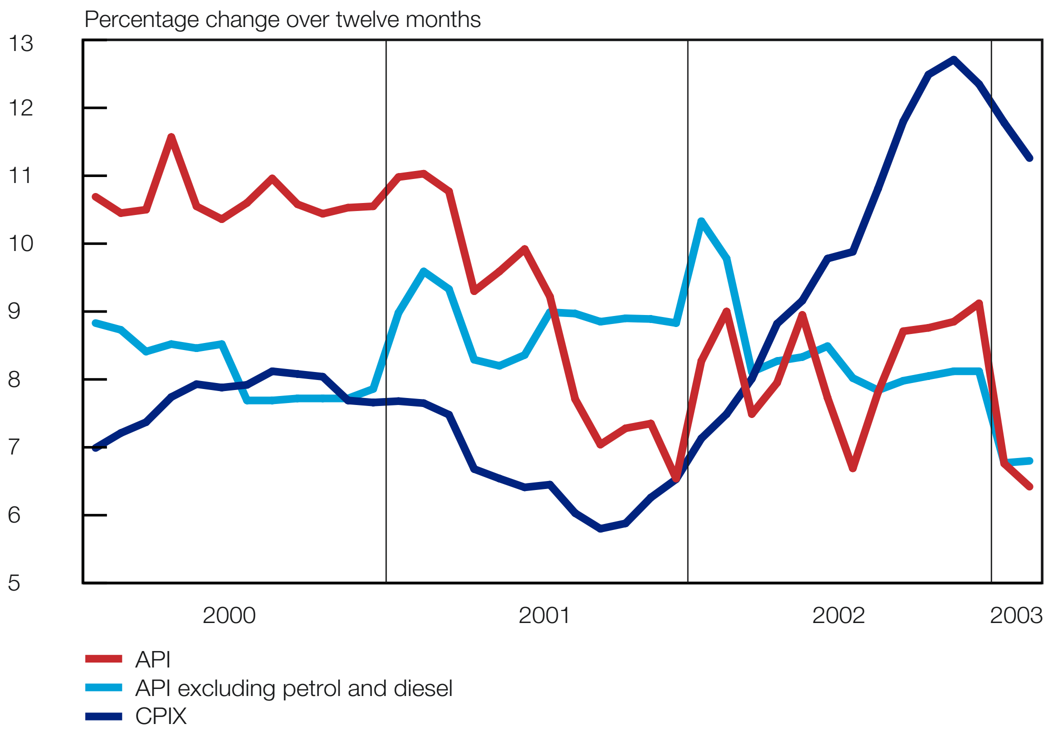
Administered prices have a significant weight in the CPIX basket, and therefore play an important role in determining the overall inflation outcome. As Figure 5 shows, the inflation rate for the South African Reserve Bank’s (the Bank’s) administered price index (API) displayed no clear trend in 2002, tracking the fluctuations in the domestic petrol price to average 8,3 per cent for the year. However, stripping out petrol and diesel prices, over which the least control is arguably exercised, the inflation rate for the index declined from an average of 8,9 per cent in 2001 to 8,5 per cent in 2002. The inflation rate for both the all-inclusive API and the index excluding petrol and diesel prices declined further to below 7 per cent in the first two months of 2003.

Figure 4 CPIX: goods and services inflation



Source: Statistics South Africa

Figure 5 CPIX and administered prices

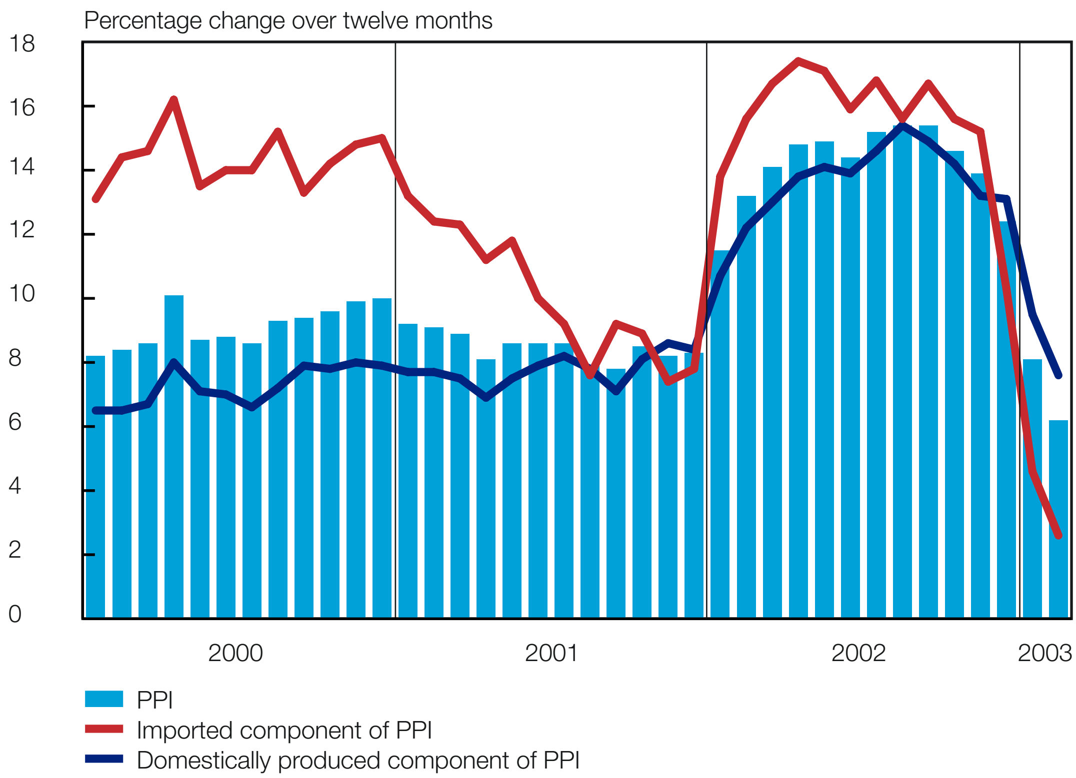


Source: Statistics South Africa and SARB calculations

Although administered price inflation is currently below the overall CPIX inflation, the concern of the Bank is that these prices tend to be relatively inflexible and therefore may not follow the downward trend of the overall inflation rate. Secondly, there have been a number of highly publicised administered price increases or proposed price increases (for example those announced by Telkom and Eskom) that are above the current inflation rate. The danger is that these increases could have a disproportionate impact on inflation expectations, and make the task of monetary policy more difficult.

Developments in production prices often precede those in the downstream consumer price indices. Figure 6, which plots the year-on-year change in the production price index (PPI), and that of its imported and domestic components, shows that these measures are presently signalling lower consumer price inflation in 2003. The overall PPI inflation rate, which rose from a low of 8,3 per cent in December 2001 to reach 15,4 per cent in August and September 2002, fell gradually to 12,4 per cent in December before rapidly halving to 6,2 per cent by February 2003. The inflation rate for the imported PPI component, which has a weight of 27 per cent in the total PPI, has fallen particularly quickly recently. As the effects of the stronger exchange rate of the rand and the sharp increase in the index in the December 2001 to April 2002 period have been incorporated into the calculation of the inflation rate for this component, it declined from 15,2 per cent in November 2002 to only 2,6 per cent in February 2003. The domestically produced component of the PPI has followed a similar path, albeit at a slower rate, falling from 15,4 per cent in August 2002 to 7,6 per cent in February 2003.

Figure 6 Production price inflation



Source: Statistics South Africa

Factors affecting inflation

This section reviews recent developments in some of the main drivers of inflation in South Africa. These include the external environment and the exchange rate, as well as domestic demand and output, fiscal policy and monetary conditions. A discussion of the outlook for these variables and their likely impact on inflation is presented later.

International economic developments

The global economy showed signs of recovery in early 2002 after the worldwide slowdown in 2001. It is estimated that world growth registered a modest improvement in 2002, rising to 3,0 per cent from 2,3 per cent in 2001 (Table 1). The economic recovery was, however, uneven in both timing and geographical distribution.

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

	Real GDP		Inflation rates	
	2001	2002 (estimate)	2001	2002 (estimate)
World	2,3	3,0	4,4	3,6
Advanced economies	0,9	1,8	2,2	1,5
USA	0,3	2,4	2,8	1,6
Japan	0,4	0,3	-0,7	-0,9
Euro area	1,4	0,8	2,6	2,3
United Kingdom	2,0	1,6	2,1	2,2
Developing countries	3,9	4,6	5,8	5,4
Africa	3,6	3,4	13,0	9,3
Asia	5,7	6,5	2,7	1,9
Western hemisphere	0,6	-0,1	6,4	8,7
Countries in transition	5,1	4,1	16,3	11,1

Source: *IMF World Economic Outlook,* April 2003

The pattern of US growth during 2002 was uneven as concerns about economic, political and corporate governance issues weighed heavily on an economy already adjusting to a succession of shocks from previous years. Real gross domestic product (GDP) growth was 2,4 per cent for the year as a whole compared with 0,3 per cent in 2001. Measured at seasonally adjusted and annualised rates, growth fluctuated quite considerably, registering 5,0 per cent, 1,3 per cent, 4,0 per cent and 1,4 per cent, respectively, during the successive quarters of 2002. Consumer confidence has deteriorated in recent months as a result of worsening labour market conditions, concerns surrounding the war with Iraq, warnings of possible terrorist attacks and high oil prices. While the increase in oil prices has already translated into higher consumer price inflation, core inflation remains low.

The export-led recovery in Japan during the first half of 2002 turned out to be short-lived. Real GDP increased by 0,3 per cent in 2002 as a whole, compared with an increase of 0,4 per cent in 2001. Deflation persisted mainly due to sluggish domestic demand, declining consumer confidence and record unemployment levels. Economic performance in the euro area, which is an important destination for South African exports, deteriorated during 2002 as the economy expanded by 0,8 per cent compared to 1,4 per cent in 2001. The German economy contracted by 0,1 per cent in the fourth quarter of 2002.

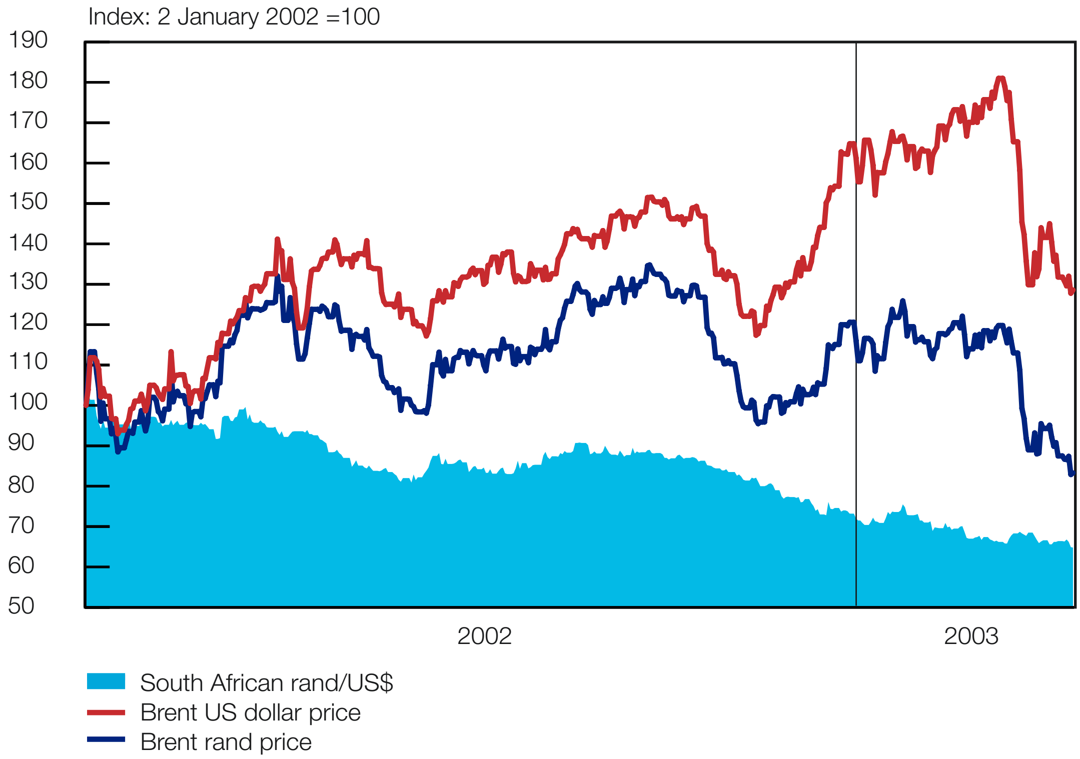
Emerging Asia grew more than twice as fast as the global average in 2002, but there were significant differences between the countries in the region. The Chinese economy once again outperformed the rest of the region with 8,0 per cent GDP growth in 2002, underpinned by growth in government spending, foreign investment and exports. The Asian recovery, however, contrasts with a disappointing performance in Latin America. The crises in Argentina and Venezuela and mounting concerns about prospects for Brazil contributed to the decline in regional output during 2002.

The low growth environment contributed to the continued moderation of world inflation which declined from 4,4 per cent in 2001 to 3,6 per cent in 2002 (Table 1). Inflationary pressures have, however, increased in several Latin American countries, especially Argentina.

Oil prices

The strengthening of the rand during 2002 meant that rand oil price movements were more muted than dollar price developments (Figure 7). The spot price of Brent crude oil increased significantly from $19 per barrel in January 2002 to almost $35 in the beginning of March 2003. Oil prices initially rose after global economic activity began to improve in May 2002. Upward pressure on crude oil prices also came from increased political tensions in the Middle East and Venezuela. The pressure intensified late last year as a strike in Venezuela almost shut down that country's oil industry. The increasing prospects of a war with Iraq, along with a very low level of crude oil inventories, especially in the United States, also kept oil prices high in the first months of 2003.

Figure 7 Brent crude oil price and rand/US dollar exchange rate



Source: Bloomberg

Crude oil prices began to fall after the US-led war on Iraq became a certainty. Brent crude prices fell to almost $25 per barrel after the attacks began, mainly as a result of speculation that the war would be short, with limited disruption of Middle East oil supplies.

World interest rates

Poor growth prospects have dominated monetary policy decisions in many developed countries (Table 2). Interest rates were reduced in a number of European economies in March to address concerns regarding the slowdown in economic growth. The Bank of Canada, however, increased interest rates prompted by higher core and total CPI inflation over the past few months due to an increase in domestic demand and crude oil prices.

Table 2 Key central bank interest rates
Per cent

Countries	1 Jan 2002	11 April 2003	Latest change (percentage points)	
United States	1,75	1,25	6 Nov 2002	(-0,50)
Japan	0,00	0,00	19 Mar 2001	(-0,15)
Euro area	3,25	2,50	6 Mar 2003	(-0,25)
United Kingdom	4,00	3,75	6 Feb 2003	(-0,25)
Canada	2,25	3,00	4 Mar 2003	(+0,25)
Denmark	3,25	2,50	7 Mar 2003	(-0,25)
Sweden	3,75	3,50	18 Mar 2003	(-0,25)
Switzerland	1,25 – 2,25	0 – 0,75	6 Mar 2003	(-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	8,70	1 Apr 2003	(-0,20)
Hong Kong	3,25	2,75	7 Nov 2002	(-0,50)
Indonesia	17,62	11,31	9 Apr 2003	(-0,09)
Malaysia	5,00	5,00	20 Sep 2001	(-0,50)
South Korea	4,00	4,25	7 May 2002	(+0,25)
Taiwan	2,13	1,63	12 Nov 2002	(-0,25)
Thailand	2,25	1,75	19 Nov 2002	(-0,25)
India	6,50	6,25	29 Oct 2002	(-0,25)
Brazil	19,00	26,50	19 Feb 2003	(+1,00)
Chile	6,50	2,75	9 Jan 2003	(-0,25)
Czech Republic	4,75	2,50	31 Jan 2003	(-0,25)
Hungary	9,75	6,50	17 Jan 2003	(-1,00)
Poland	11,50	6,00	26 Mar 2003	(-0,25)
Russia	25,00	18,00	17 Feb 2003	(-3,00)

Source: National central banks

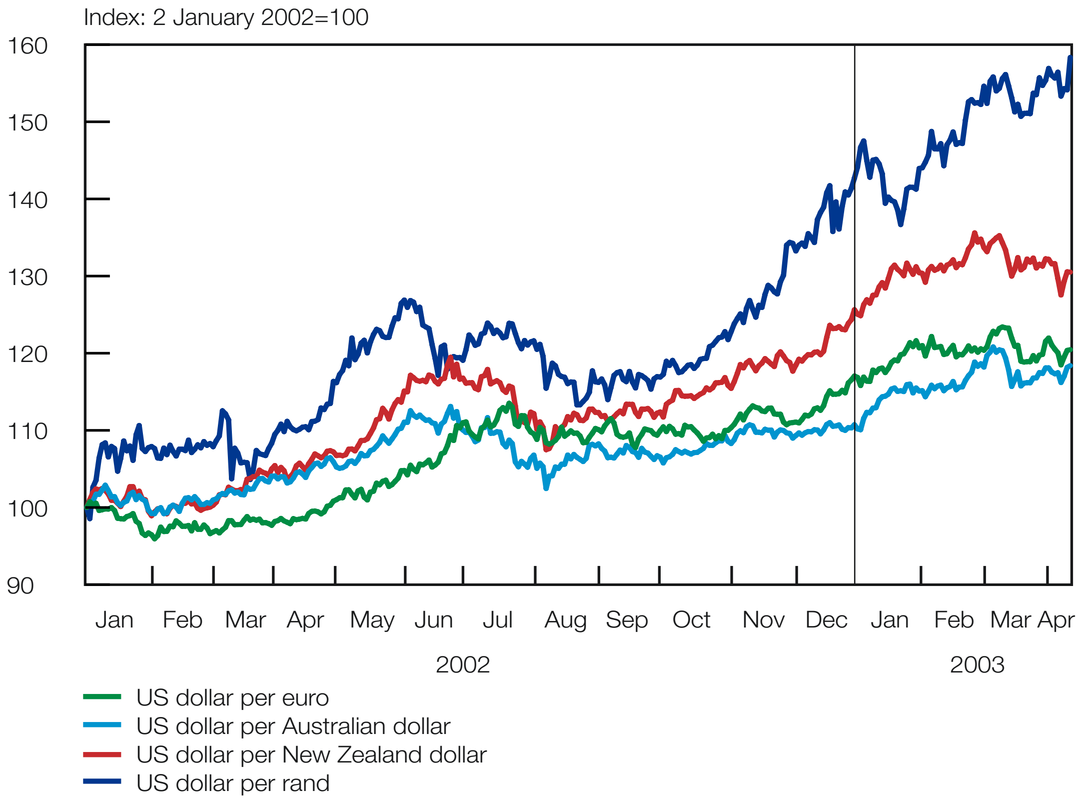
A number of Latin American central banks tightened monetary policy as a result of the inflationary impact of weakening currencies. In Brazil, for example, the central bank increased the Selic overnight rate for the fifth time since October 2002 to 26,5 per cent on 19 February 2003. This decision was aimed at slowing inflation that has accelerated after the Brazilian currency, the real, lost a third of its value in the past 12 months. By contrast, Chile, whose growth rate outpaced that of the rest of the region in 2002, unexpectedly cut its benchmark lending rate in January by 25 basis points to 2,75 per cent. This action was taken in the light of weak domestic demand and slowing inflation.

Certain European emerging economies' monetary authorities (including those of the Czech Republic, Hungary and Poland) also cut interest rates as there was little evidence of excessive demand inflation pressures, and some concern about excessive currency appreciation.

Exchange rate developments

While the previous year's large depreciation of the rand adversely affected inflation in 2002, the exchange rate recovered and generally performed strongly through 2002 and into 2003 (Figure 8). Despite coming under pressure between June and late August 2002 when it depreciated from R9,74 to R10,90 against the US dollar, and again briefly in January 2003, the exchange rate nevertheless appreciated to levels below R8,00 to the US dollar in March and April 2003.

Figure 8 US dollar per rand, euro, and Australian and New Zealand dollar



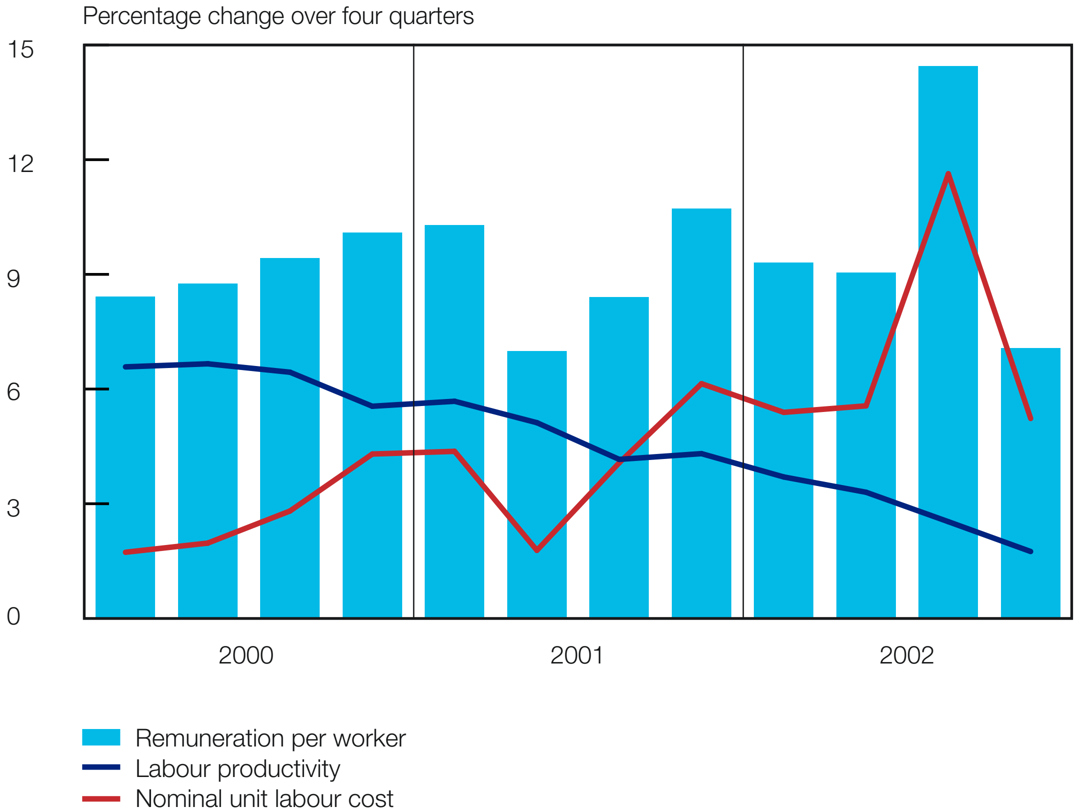
The strong appreciation of the rand since September 2002 has been influenced by a number of factors. The uncertain state of the US economy and the associated weakness of the US dollar against a range of currencies is certainly important in this regard. However, it is also clear from the figure that the rand has strengthened more against the US dollar than have the euro and Australian and New Zealand currencies. Between the end of August 2002 and the end of March 2003 the trade weighted index of the rand appreciated by 28 per cent. Additional factors that help to explain this relative strengthening include the steady growth performance of the economy in 2002, the wider nominal interest rate differentials that resulted from the four interest rate increases in 2002, an improvement in the country's terms of trade and current-account position, and a generally more positive perception, including from the rating agencies, of the outlook for the South African economy.

Labour markets

Labour cost developments play an important role in the inflation process in South Africa and are watched closely for monetary policy purposes. The rate of increase in unit labour cost (i.e. the increase in wages adjusted for changes in productivity), has been trending upward since 2001, and at times in 2002 has been growing faster than the upper limit of the inflation target. Between the second half of 2001 and the corresponding period in 2002, growth in nominal unit labour cost increased by 8,4 per cent.

As Figure 9 shows, the higher growth rate in unit labour cost in the formal non-agricultural sectors of the economy was driven by rates of increase in nominal remuneration per worker that were not matched by growth in labour productivity. Growth in remuneration per worker increased from just over 9 per cent in the first and second quarters of 2002 to 14,5 per cent in the third quarter before moderating to just over 7 per cent in the final quarter. Survey results from *Andrew Levy Employment Publications,* which found that the increase in average wage settlements rose from 7,4 per cent for the year to December 2001 to 8 per cent for the same period in 2002, provide supporting evidence for this increase in remuneration per worker in 2002. Growth in labour productivity, by contrast, continued to trend downward throughout the year.

Figure 9 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 weathered the difficult international environment relatively well in 2002. Until the end of the year, domestic economic growth remained robust despite losing some momentum during the second half of the year. Table 3 indicates that annual real growth in GDP for 2002 was 3 per cent, marginally above the rate that was achieved in 2001.

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

	2001	2002 1st qr	2002 2nd qr	2002 3rd qr	2002 4th qr	2002
Final consumption expenditure by households	3,1	3,4	3,5	2,9	2,3	3,1
Final consumption expenditure by government	3,3	3,5	3,5	3,7	4,2	3,7
Gross fixed capital formation	3,2	6,9	7,8	8,7	11,5	6,5
Change in inventories (1995 R billion)	1,7	6,4	0,4	4,5	6,2	4,4
Gross domestic expenditure	**2,3**	**5,4**	**-0,6**	**7,4**	**5,0**	**4,2**
Exports of goods and services	2,5	6,2	26,8	-23,4	28,1	-1,4
Imports of goods and services	0,3	18,4	7,8	-11,3	47,5	3,1
Gross domestic product	**2,8**	**3,0**	**3,8**	**2,9**	**2,4**	**3,0**

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

On a quarterly basis, real GDP growth declined from 3,8 per cent in the second quarter to 2,9 per cent in the third quarter and 2,4 per cent in the last quarter of 2002. This slowdown in growth was due to slower growth in the real value added by the secondary sectors of the economy, and virtually no growth in the primary sectors of the economy. Activity in the tertiary sectors remained lively in 2002. There is still considerable surplus production capacity in the economy, which lessens the likelihood of inflationary pressure emerging from supply constraints.

Aggregate real gross domestic expenditure demonstrated strong growth in 2002, increasing by 4,2 per cent during the year after recording 2,3 per cent growth in 2001. Contributing to this growth in 2002 was a strong increase in gross fixed capital formation, at a year-on-year rate of 11,5 per cent in the fourth quarter and 6,5 per cent for 2002 as a whole. This was due to increases in capital expenditure by the private and public sectors. In the public sector, Transnet took delivery of the first two of South African Airways' new Airbus aircraft, while further progress was made with the Coega project.

Final consumption expenditure by government grew at 3,7 per cent in 2002, an increase from the 3,3 per cent growth recorded in 2001. On a quarterly basis, the rate of increase rose over the course of the year from 3,5 per cent in the first and second quarters to 4,2 per cent in the final quarter of 2002. Growth in consumption expenditure by households remained constant at 3,1 per cent in 2002, although on a quarterly basis it declined from 3,5 per cent in the second quarter to reach 2,3 per cent by the fourth quarter of the year. Consumer demand for durable goods slowed down, reflecting the negative effect of the four increases in lending rates during 2002.

In the external sector of the economy, exports of goods and services declined by 1,4 per cent in 2002 while imports grew by 3,1 per cent, reflecting the slowdown in world economic activity, the effect of the appreciation of the exchange rate and the growth performance of the South African economy.

Fiscal policy

Although fiscal policy continues to provide a mildly expansionary stimulus to the economy, this is not a cause for concern for monetary policy. The 2003 Budget, presented to parliament by the Minister of Finance on 26 February 2003, projects a deficit of 2,4 per cent of GDP for the 2003/04 fiscal year (Table 4). This is slightly above the February 2002 Budget estimate of 2,1 per cent for 2002/03, but more significantly above the latest estimated outcome of 1,4 per cent of GDP. This lower anticipated deficit to GDP ratio is the result of larger-than-expected revenue collections over the period. The medium-term estimates presented in the 2003 Budget suggest that this measure of fiscal pressure will remain stable for the next two years, with deficits of 2,4 and 2,3 per cent of GDP being forecast for 2004/05 and 2005/06, respectively.

Table 4 Public finance: ratios to gross domestic product
Per cent

	2002/03		2003/04	2004/05	2005/06
	Budget estimate	Revised estimate	Budget estimate	Medium-term estimates	
National government:					
Revenue	24,5	24,6	24,7	24,6	24,6
Expenditure	26,6	26,1	27,1	27,0	27,0
Deficit (-)	2,1	1,4	2,4	2,4	2,3
Total loan debt	40,7	39,4	37,8	37,6	37,3
PSBR*	1,4	1,4	3,1	2,9	2,7

* PSBR: Public-sector borrowing requirement
Source: National Treasury, *Budget Review 2003*

The public-sector borrowing requirement (PSBR), which takes into account borrowing by central government, provinces and municipalities as well as by non-financial public enterprises such as Eskom, Telkom and the Post Office, is expected to increase from 1,4 per cent of GDP in 2002/03 to 3,1 per cent in 2003/04. This is the result of expected increases in capital expenditure both within the main Budget and by the non-financial public enterprises, and also provision for extraordinary payments and receipts. In the medium term, the National Treasury projects that the PSBR will decline to 2,9 per cent in 2004/05 and to 2,7 per cent in 2005/06. Fiscal pressure from the government gross debt position also remains under control, with the ratio of total national government loan debt to GDP estimated in the *Budget Review* at 39,4 per cent at the end the 2002/03 fiscal year. This is projected to fall to 37,3 per cent at the end of 2005/06.

In his Budget Speech, the Minister also announced further steps regarding the liberalisation of exchange controls. Besides allowing institutional investors and South African companies increased offshore investment opportunities, these included the freeing of emigrants' blocked funds and the introduction of an exchange control amnesty with accompanying special tax provisions.

The amnesty is aimed at encouraging the repatriation of assets held abroad in contravention of the foreign exchange and tax regulations, and the broadening of the tax base. At this stage it is difficult to assess the extent to which the tax base will be affected, or the possible impact on the exchange rate. The value of assets abroad is unknown, as is the amount that will be repatriated. The Reserve Bank does, however, have some discretion in regulating the rate of outflow of blocked rand balances. Box 3 provides a discussion of the international experience with amnesties.

Box 3 Foreign exchange and tax amnesty: an international perspective

Countries that have experienced capital flight often consider using exchange control or tax amnesties. Two broad motivations which emerge from the international experience with amnesties are briefly discussed here. The first case is where the intention is to use an amnesty to repatriate flight capital for the purpose of fostering national development, and the second is where the intention is to 'regularise' assets held abroad and include them in the tax base.

Underlying the first motivation is the perception that flight capital is an unutilised reserve of funds that can be retrieved to promote national development. Capital flight results in the exportation of domestic savings and foreign exchange from countries where they are generally in short supply, with negative consequences for investment and growth (and for debt levels if financed externally). Proponents of amnesties see the repatriation of flight capital as necessary to reverse this process. Proposals for amnesties to repatriate capital in certain Latin American countries and more recently in Russia have emphasised this view.

The foundations of this argument require closer scrutiny, however. If the concern is the enhancement of investment and growth then, as Buiter and Szegvari (2002: 7) argue in the Russian context, it does not matter in principle whether the necessary capital inflows are repatriated flight capital rather than foreign direct or portfolio investment by non-residents. Unless economic arguments for specifically targeting past flight capital can be made, the appropriate response is to attempt to attract flows from all potential investors by improving the investment climate. Evidence suggests that improved macroeconomic stability and governance encourage the return of flight capital (for example Ajayi, 1997 cited in World Bank, 2002: 71).

The second and perhaps less controversial motivation for an amnesty is what might be termed the regularisation of undisclosed offshore investments. In this case, even if the funds for these investments were acquired legitimately, the manner in which they were transferred abroad criminalised them. This provides a barrier to repatriation, even when the circumstances that encouraged capital flight have changed. Furthermore, since the investments are not reported, they remain outside the tax net in residence-based tax systems. The intention of the amnesty in this context is to regularise these investments by decriminalising them and bringing them into the tax net. Repatriation may or may not be required in order to qualify for the amnesty.

The recent Italian 'tax shield' is an example of this type of mechanism. In late 2001, the Italian government approved legislation to encourage the repatriation of capital and the regularisation of assets held abroad. The measures allowed natural persons who were in violation of tax and foreign exchange regulations a 'one-off' opportunity to regularise (with or without repatriation) their offshore assets by paying a 'substitute tax' equal to 2,5 per cent of the amount declared, or by investing a sum equal to 12 per cent of the amount in special government securities.

To qualify for the amnesty, a confidential disclosure of assets needed to be lodged with an intermediary. Only in the case where assets were not repatriated was it required that the taxpayer be named to the tax authorities. By making the declaration, the taxpayer was permitted to create a protective shield against future tax audits relating to the period prior to their making the declaration.

At the same time as the amnesty was introduced, the level of penalties for not declaring offshore assets was increased, and the Ministry of Economics and Finances announced that the fight against the illegal holding of offshore assets would become a priority in the 2002 programme of tax assessments.

The magnitude of the amounts involved when amnesties are discussed is notoriously difficult to determine. In the Italian case, the Banca d'Italia estimated that around €500 billion was illegally held offshore. Government budget revenue estimates of €50 million for 2001 and €1 billion for 2002 implied an expected repatriation or regularisation of more than €40 billion (Banca d'Italia *Annual Report* for 2001). More recent reports estimate that the Italian amnesty in the period to 2002 resulted in repatriation of roughly 10 per cent of the capital held abroad.[1]

Indications are that the German government is also considering a tax amnesty and a reduced savings tax on interest income to lure tax evaders back to the country. The proposed amnesty calls for self-incrimination before the end of 2003 (with a penalty rate of 25 per cent) or before July 2004 (penalty rate 35 per cent), following which immunity from prosecution will not be granted. Savings income will then be taxed at a flat rate of 25 per cent in future, decoupling this from the income tax

1 Although an initial deadline of 15 May 2002 was set, with a special extension to 1 July 2002, the Italian tax shield scheme was renewed in 2003, with the rate payable being increased to 4 per cent and the alternative of subscription to government bonds no longer permitted. Budget estimates are that revenue of €2 billion will be raised from the measure in 2003.

regime which has a top marginal rate of 48,5 per cent. Estimates from the finance ministry are that the amnesty would result in repatriation of €100 billion (⅓ of estimated capital flight of €300 billion) and therefore for additional tax revenues of €25 billion.

References

Banca d'Italia *Economic Bulletin*, various.

Buiter, W.H. and Szegvari, I. 2002. Capital flight and capital outflows from Russia: symptom, cause and cure. European Bank for Reconstruction and Development. *Working Paper No 73*, June.

Paternollo, R. and Salvadori di Wisenhoff, V. 2002. Italy's tax shield: shedding light on offshore investments? *Tax Notes International,* 11 March.

World Bank. 2002. Global Development Finance: Financing the Poorest Countries. Washington, DC.

Monetary conditions

The growth in the broad money supply (M3) slowed down to relatively low rates in the second half of 2002 while narrow money holdings (M1A) – usually accumulated to finance spending – actually declined in the fourth quarter of 2002 after rising rapidly in the first three quarters of the year. The demand for M1A money during the first three quarters of 2002 was probably influenced by rapidly rising nominal income and expenditure. From early 2002 the demand for M3 money balances was also strengthened by heightened stock market uncertainty and concerns that global economic weakness might spill over to South Africa. Exporters repatriated export earnings more rapidly than before, further adding to the demand for money balances.

After bank lending rates were increased in January 2002, monetary growth accelerated initially but was thereafter reined in significantly by the Reserve Bank's progressive tightening of its monetary policy stance during the year. The growth rate of M3 – measured over twelve months as well as from one quarter to the next – had decelerated significantly by the end of 2002 and the early months of 2003. Although broad money supply growth averaged 15,4 per cent for 2002, the annualised quarterly growth rate had slowed to 7,1 per cent by the fourth quarter.

Table 5 Percentage change in monetary aggregates
Per cent

Period	M1A	M1	M2	M3	Private-sector credit extension
Quarterly change*					
2001: 1st qr	9,5	18,8	21,0	19,5	2,8
2nd qr	7,9	18,7	11,3	16,4	5,0
3rd qr	27,3	10,5	9,8	16,8	14,1
4th qr	27,0	8,2	9,0	9,0	19,4
2002: 1st qr	14,4	54,2	40,2	32,1	19,7
2nd qr	16,2	21,8	15,3	18,2	1,9
3rd qr	22,5	-1,0	0,2	8,9	4,2
4th qr	-2,1	0,3	11,2	7,1	6,7
Twelve-month change					
2002: Dec	8,9	11,9	12,2	12,8	4,4
2003: Jan	12,5	6,3	10,1	9,9	12,4
Feb	14,1	2,8	8,7	8,7	13,8

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

The rising cost of credit during 2002 helped to put a brake on the growth of aggregate nominal spending and contributed to an appreciable slowdown in aggregate credit growth. Aggregate credit growth fell to very low levels in the middle quarters of 2002 but strengthened in the fourth quarter due to technical reasons. Banks commenced fully reporting on their balance sheets all assets and liabilities arising from their involvement in repurchase and other similar transactions. Since a sizeable portion of repurchase transactions involves government securities, the wider implementation of these accounting procedures led to a sharp increase in banks' claims on the government sector. Underlying credit demand by private-sector businesses and households continued to grow at a modest rate in the fourth quarter of 2002.

In the early months of 2003, the twelve-month growth rate in domestic private-sector credit extension showed a strong increase, moving from 4,4 per cent in December 2002 to 12,4 and 13,8 per cent in January and February 2003. This can be ascribed to technical factors related to the reporting of mark-to-market positions in derivatives on a gross rather than a net basis, in line with developments in accounting practice and bank regulation. Adjusting for these factors, the twelve-month growth in credit extension in January and February would have been 8,8 and 9,1 per cent, respectively.

Monetary policy

After the September 2002 MPC meeting the outlook for inflation was still uncertain. Although inflation was expected to peak by the end of the year, factors such as higher wage settlements, high money supply growth figures, stubbornly high producer prices and questions over the sustainability of the exchange rate recovery cast doubt on the strength of the expected downturn in the inflation rate. The outlook for a relaxation of the monetary policy stance was also influenced by the fact that the targets for 2004 and 2005 were to decline to 3 – 5 per cent, which added to the pressures on monetary policy.

In October 2002 the Minister of Finance announced a revision of the targets for 2004 and 2005. In his *Medium Term Budget Policy Statement* (MTBPS) he announced that he and the Governor of the Reserve Bank had decided to modify the targets by maintaining the target at 3 – 6 per cent for 2004, and that the target of 3 – 5 per cent would be suspended until further notice. Subsequently, in the February Budget Speech, it was announced that the target for 2005 would also be maintained at 3 – 6 per cent, and that the target for 2006 would be announced concurrent with the October 2003 MTBPS. Box 4 assesses the changing of the target in more detail.

The November MPC meeting was the first meeting in 2002 where interest rates were not increased. This decision was taken despite the fact that CPIX inflation was still rising, having reached a year-on-year rate of 12,5 per cent in October, and an even higher quarter-on-quarter annualised rate of 12,7 per cent in the third quarter. However, the prices of non-food goods appeared to be levelling off, although services prices, which are traditionally more sticky, were still accelerating.

Monetary policy is set on a forward-looking basis, so despite the fact that the inflation figures still disappointed on the upside, there was sufficient evidence to suggest that the turning point in inflation had either been reached or was imminent. There were a number of fundamental factors that convinced the MPC not to raise rates further at that stage. These factors, discussed earlier in this review, included the significant slowdown in production price inflation; the strengthening of the external value of the rand; the decline in international oil prices; slower growth in bank credit extension; and a deceleration in the pace of growth in the more broadly defined money supply aggregates. These factors had been a major cause for concern earlier in the year. In addition, there were other factors which continued to be conducive to a lower inflation environment, including continued excess production capacity in the economy, the lack of signs of excess spending, and continued fiscal discipline on the part of government.

Box 4 The changing of the targets: what does it mean for the inflation targeting framework?

In October 2002 the Minister of Finance announced that the target of 3 – 5 per cent for 2004 and 2005 had been suspended until further notice, and that the target for 2004 would remain at 3 – 6 per cent. Subsequently the target for 2005 was also set at 3 – 6 per cent. Although the change has generally been received favourably, it has been criticised by some as representing a lack of commitment to the inflation target. It should, however, be emphasised that whereas the goal of inflation targeting is to achieve the target, the objective is not to hit it as quickly as possible or at all costs.

Most central banks would regard themselves as flexible inflation targeters. This does not necessarily mean that they have dual or multiple objectives, but rather that they are mindful of the costs of attaining the target or getting back to the target when they are knocked off course. It is generally the case that central banks, when they find themselves outside the target, do not try to get back to the target as quickly as possible. Most central banks choose a policy horizon within which to influence inflation outcomes. The horizon is determined by various factors including the time lags between a change in monetary policy and its impact on inflation, the behaviour of inflation expectations and the importance a central bank may attach to other policy objectives.

In Canada, for example, a policy horizon of six to eight quarters is specified for getting back to the target. Other countries have greater flexibility. The Swedish framework specifies a horizon of one to two years, although departures from this general rule may be warranted. According to Sweden's central bank, the Riksbank, a mechanical approach that invariably attempts to bring inflation back to the targeted level within the next one to two years could, in certain cases, lead to unduly large and undesirable fluctuations in economic activity. Such extensions to the horizon should not represent a change in the fundamental commitment to long-term price stability.

In the UK, the Monetary Policy Committee of the Bank of England is given the flexibility to propose the horizon over which a deviation from the target will be rectified. This will depend on the nature and severity of the initial shock which caused inflation to deviate from the target.

The Australian approach recognises the fact that responses to monetary policy actions may differ depending on the phase of the business cycle. The target is therefore specified as keeping underlying inflation between 2 and 3 per cent on average over the cycle, which allows for short-run variations and deviations from target. Recently the New Zealand system has adopted a similar approach whereby the inflation target is specified over the medium term to give the Reserve Bank greater flexibility in deciding how to respond to shocks to the economy and inflation variations around the target.

In South Africa, the issue is complicated by the fact that inflation has not yet come down to its target level. When inflation gets thrown off course, the question is not only how quickly to get it back to where it was before the shock, but also whether the original disinflation path and timeframe should be maintained. The original targets were set on the basis of what was believed to be an attainable and sustainable disinflation path. This path and speed of disinflation were chosen as it was felt to be the optimal rate of disinflation that would not unduly affect the real economy. Subsequent to the setting of the targets, the unexpected increase in inflation made the target for 2002 unattainable unless draconian monetary policy measures were adopted. A policy of strict inflation targeting would have required getting back to the target as quickly as possible, irrespective of the cost. However, the higher level of inflation that had ensued meant that to try and achieve the original targets within the same time period would clearly not be optimal.

Under such circumstances, maintaining the target at 3 – 6 per cent for 2004 does not mean that the authorities have reduced their commitment to lower inflation. Rather, it is a recognition that there are long lags in monetary policy; trying to achieve a target too quickly may not be technically feasible; and achieving a target too quickly may come at an unacceptably high price, particularly if the reason for the deviation from the disinflation path is not the result of Reserve Bank policy in the first place. Missing or changing a target does not necessarily undermine the inflation targeting framework as a whole, as long as there is a sustained commitment to low inflation.

There were, however, a number of upside risks highlighted by the MPC. The committee was particularly concerned about high inflationary expectations, the high increases in some administered prices as well as the faster growth in nominal unit labour cost. This latter factor was of particular concern given the strong relationship between unit labour cost increases and inflation, and the possibility of a wage/price spiral, combined with higher inflation expectations.

The relatively long gap between the November 2002 meeting and the meeting in March 2003 gave the committee a better chance to assess the sustainability of the improved inflation climate. By the time of the meeting there were more positive signs that the downward trend in inflation was sustainable. As seen above, apart from the fact that the CPIX inflation rate itself had appeared to be on a downward trajectory, production price inflation, as a leading indicator of future trends in consumer prices, had declined significantly. Most of the factors that had shown some improvement at the time of the November MPC meeting continued to give cause for optimism. The rand's recovery proved to be sustained, and money supply and underlying bank credit extension growth continued to moderate. Apart from a decrease in capacity utilisation, the committee noted that although fiscal policy was expected to be more expansionary in the coming year, the projected levels for the budget deficit over the next three years would not present any difficulties for monetary policy. Two other factors that had improved the inflation outlook since the previous meeting were the fact that the current account recorded a surplus in the fourth quarter and the fact that food price increases, a major driver of inflation in the recent past, had shown signs of moderating. Although food price inflation was still at a higher level than the average inflation rate, indications were that the downward trend would continue.

Despite this positive outlook, the MPC felt that it would be premature to be too complacent about inflation and left the repo rate unchanged. The committee was reluctant to reverse the policy stance because certain risks were identified that could prevent or slow down the expected decline in the inflation rate. The major risk identified was that of the rate of increase in unit labour cost which, as seen above, had risen considerably in the third quarter of 2003. Furthermore, it was felt that the publicity surrounding a number of recently announced increases in administered prices could have a negative impact on inflation expectations in general. Finally, the uncertainty surrounding the outcome and impact of the war in Iraq made it difficult to predict the short to medium-term outlook for the recovery in the world economy and the behaviour of oil prices.

Although the projections of the Bank's forecasting models are not followed in a mechanistic manner, a further restraining element was that although the central forecast of the model is for inflation to drop within the target range of 3 – 6 per cent by the fourth quarter of 2003, the central forecast for 2004 (which is the relevant period for current policy) shows that the inflation rate is expected to settle slightly below the top end of the target range. This also assumes an unchanged policy stance. Given the uncertainties inherent in the forecast, at this stage there is still an uncomfortably high probability that the outcome for 2004 will be above the target range. The forecast is presented in more detail below.

The outlook for inflation

The view of the MPC is that year-on-year CPIX inflation will move to within the target range towards the end of 2003. The outlook and uncertainties relating to some of the factors that are incorporated in this projection are discussed below.

International outlook

Although the international outlook is overshadowed by the developments in Iraq, the resolution of this crisis is not expected to result in an early, high-growth global scenario because of underlying problems in the industrialised economies. The dependence of the global recovery on the US has become increasingly apparent and, as the prospects for US growth have deteriorated, an increasing number of analysts have downgraded their forecasts for global growth. In the latest *World Economic Outlook,* for example, the IMF has downgraded its forecast for world growth from 3,7 per cent to 3,2 per cent, and for the advanced economies from 2,5 per cent to 1,9 per cent. World growth is expected to recover to 4,1 per cent in 2004 (Table 6).

Table 6 IMF projections of world growth and inflation
Per cent

	Real GDP			Inflation		
	2003*		2004	2003*		2004
World	3,2	(3,7)	4,1	3,8	(3,8)	3,3
Advanced economies	1,9	(2,5)	2,9	1,9	(1,7)	1,7
USA	2,2	(2,6)	3,6	2,3	(2,3)	2,3
Japan	0,8	(1,1)	1,0	-0,7	(-0,6)	-0,6
Euro area	1,1	(2,3)	2,3	2,0	(1,6)	1,5
United Kingdom	2,0	(2,4)	2,5	2,8	(2,1)	2,7
Developing countries	5,0	(5,2)	5,8	5,8	(6,0)	5,1
Africa	3,9	(4,2)	5,2	10,1	(9,5)	7,6
Asia	6,3	(6,3)	6,5	2,3	(3,2)	3,3
Western hemisphere	1,5	(3,0)	4,2	11,0	(9,3)	6,9
Countries in transition	4,0	(4,5)	4,1	9,4	(8,8)	7,4

* IMF projections for 2003 as at September 2002 in parentheses
Source: IMF *World Economic Outlook,* April 2003

Although consumption in the US is still holding up relatively well, consumer sentiment has seen marked declines. It is possible that a continued worsening in labour market conditions and weaker equity prices may further affect consumption, especially given the relatively high indebtedness of the household sector. Meanwhile, capacity utilisation rates in manufacturing remain low, acting as a drag on new investment. The risk of weaker consumption, combined with question marks about whether business fixed investment will pick up significantly in 2003 given the outbreak of the Iraq war, has increased uncertainty about US growth prospects. Supportive monetary policy and the recent fiscal stimulus are, however, expected to limit the extent of the downturn.

According to the latest preliminary indicators, the euro area has continued to expand in the first quarter of 2003 but at a slower rate than last year and at only about half the euro area's estimated long-run trend growth rate of between 2 and 2½ per cent a year. A recently published National Bank of Belgium business confidence index for the euro area fell to its weakest level in 18 months. The latest IMF projection for growth in 2003 has been revised down significantly to 1,1 per cent from the 2,3 per cent forecast in September 2002, similar to the European Commission's revised forecast of 1 per cent. The outlook in Germany in particular remains weak, with growth of 0,5 per cent projected by the IMF for 2003.

In Japan, deflation continues apace indicating the stubbornness of the problem, and suggesting the need for still more policy action. The faltering recovery in the US and Europe has continued to constrain Japanese growth prospects.

The prospects for the major emerging-market countries have become increasingly diverse. Vulnerabilities are seen in a number of countries in Latin America, and the IMF forecast for 2003 growth has been halved to 1,5 per cent. In emerging Asia, by contrast, the recovery has so far proved stronger than expected, and there are signs of domestic demand growth becoming established more broadly, not only in China and South Korea. However, the relatively positive outlook may be tempered by the recent outbreak of Severe Acute Respiratory Syndrome (SARS).

Growth in Africa, which has been better sustained than in many other regions during the downturn, is expected to be resilient this year, with the outlook for much of the region continuing to depend heavily on favourable commodity market developments and political stability.

The low world growth prospects mean that world inflation is expected to remain low, including in the high growth areas of Asia (Table 6). The lower inflation environment suggests that as long as the rand remains stable or strengthens, non-oil imported inflation will not be a cause for concern. Higher oil prices in recent months have contributed to the resurgence in energy price pressures in oil importing countries although these are expected to abate. Although the oil price will probably remain volatile until the cessation of hostilities in Iraq, the concern of oil-producing export countries (OPEC) is now to prevent prices from falling too low as a result of increased crude oil output.

Interest rates in most industrialised countries have declined with the deteriorating economic conditions, amidst little evidence of non-oil price pressures. Macroeconomic policies in the industrialised countries are expected to remain supportive of a global recovery.

Outlook for domestic demand and supply

As noted earlier, by the fourth quarter of 2002 there were already some signs of a slowdown in domestic growth. Activity in the primary and secondary sectors may also have stagnated somewhat in the first quarter of 2003 as a result of weaker foreign demand and the strengthening of the value of the rand. The latest Reuters consensus forecast for real GDP growth, surveyed in March 2003, is for growth of 2,8 per cent in 2003 rising to 3,4 per cent in 2004. The forecast for 2003 is the mean of 14 individual forecasts ranging between 2,2 and 3,5 per cent, and that for 2004 is the mean of 14 individual forecasts with a low of 3,0 per cent and a high of 3,8 per cent.

Although substantial unemployment characterises the labour market, certain skills remain in short supply and higher wage demands resulted in nominal unit labour cost increasing significantly in the second half of last year. Rising wage demands may continue putting upward pressure on unit labour cost, and thus affect inflation.

The rate of growth in real government expenditure is expected to remain robust given the average annual increase published in the National Treasury's *Budget Policy Statement* for February 2003. These increased levels of real government expenditure make provision for increased expenditure on non-interest items such as health, education, social grants, municipal infrastructure and housing, improved police and justice services and the speeding up of electrification services to rural areas.

Consumer demand appears to have slowed down somewhat in early 2003 through the cumulative effect of higher interest rates and higher inflation levels, but the recently announced personal income tax relief should mitigate against this.

Importantly, the growth in real outlays on gross fixed capital formation by the private sector and public corporations accelerated significantly over the past two years and further relatively robust growth in capital formation by these sectors is projected for 2003. The recent real exchange rate appreciation coupled with less robust foreign demand will probably serve to dampen export volume growth during the first half of 2003, but foreign demand and dollar-denominated commodity prices are expected to improve during the latter half of 2003.

Indicators of inflation expectations

The Bureau for Economic Research (BER) at the University of Stellenbosch conducts quarterly surveys of inflation expectations in the South African economy. The survey of CPIX inflation expectations undertaken in the first quarter of 2003 found that this inflation rate is expected to average 9,2 per cent in 2003, before declining to 8,5 per cent in 2004 and 8,4 per cent in 2005. Comparing these results with those from the survey undertaken in the fourth quarter of 2002, presented in parentheses in Table 7, and with earlier surveys, it is evident that inflation expectations have tended to follow the upward movement in actual inflation through 2002.

Table 7 BER survey of CPIX inflation expectations: 1st quarter 2003*
Per cent

	2003	2004	2005
1. Finance	8,4 (8,2)	5,9 (6,4)	6,0
2. Business	9,7 (8,7)	9,0 (8,1)	8,7
3. Labour	9,5 (8,7)	10,4 (8,8)	10,5
Average 1 – 3	9,2 (8,6)	8,5 (7,7)	8,4

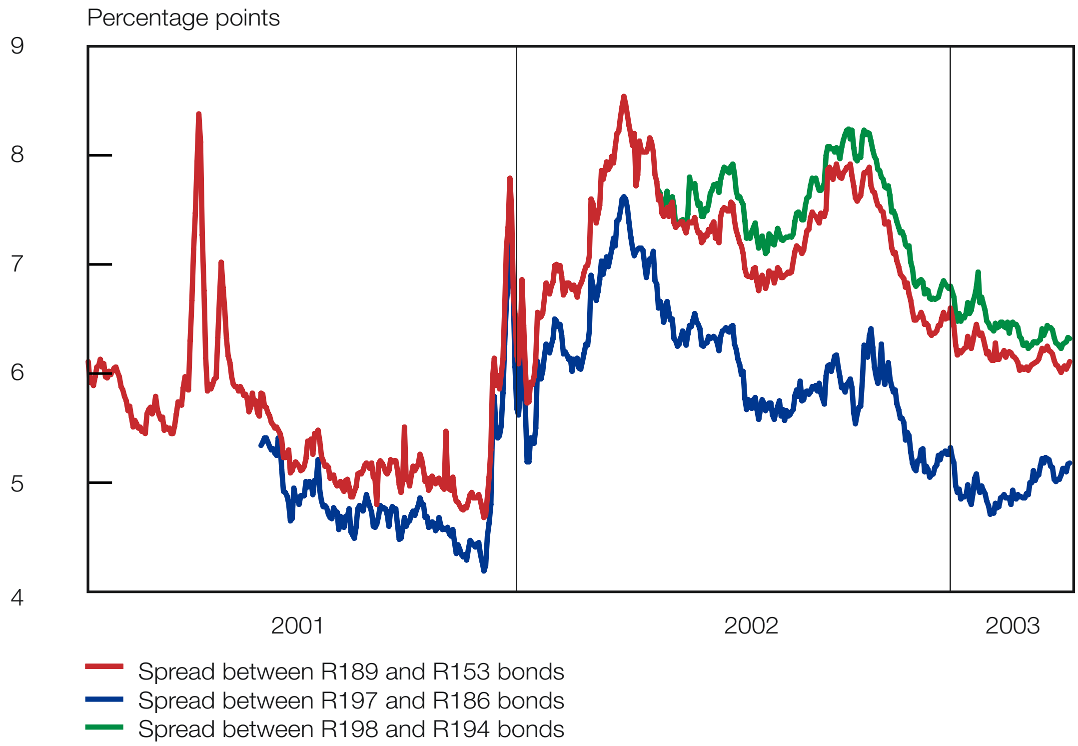
* Fourth-quarter 2002 survey results in parentheses
Source: Bureau for Economic Research, University of Stellenbosch

The expectations of the financial analysts reported in Table 7 are lower than those of business and trade union officials for each year in the 2003-05 period. Financial analysts expect CPIX inflation to move to the upper end of the target range in 2004 and to remain at that level in 2005 (averaging 5,9 per cent and 6,0 per cent, respectively). Business expectations are for inflation to fall only gradually over the period, from 9,7 per cent in 2003 to 8,7 per cent in 2005, while trade union officials expect inflation to increase from 9,5 per cent in 2003 to around 10½ per cent thereafter.

The BER-surveyed expectations of the financial sector analysts are above those obtained from the Reuters monthly survey of long-term forecasts for the South African economy, although a similar medium-term downward trend is evident. The Reuters March survey of economists based in South Africa, the UK and the US reports that CPIX inflation is expected to average 8,3 per cent in 2003. This is the mean of 14 individual forecasts ranging between 7,5 per cent and 8,7 per cent. The expectation is that CPIX inflation will then decline to average 5,3 per cent in 2004 (14 forecasts ranging from 4,5 – 6,0 per cent) before rising to 5,4 per cent in 2005 (8 forecasts ranging between 4,9 and 6,0 per cent).

Lower inflation expectations are also evident in the longer term. As Figure 10 shows, the spreads between the yields on South African CPI inflation-linked bonds and conventional nominal bonds of similar maturity, or breakeven inflation rates, have declined steadily since October 2002. These spreads provide an indication of expected inflation over the period until the bond matures, assuming no changes to the risk premium associated with future inflation and differences in the liquidity of the bonds and their payment patterns. The inflation expectations obtained in this way from the R189 (maturing 2013) and R198 (maturing 2008) inflation-linked bonds moved from around 8 per cent in October 2002 to just above 6 per cent in April 2003, while the spread on the longer-dated R197 (maturing 2023) is currently slightly above 5 per cent.

Figure 10 Breakeven inflation rates



The Reserve Bank inflation forecast

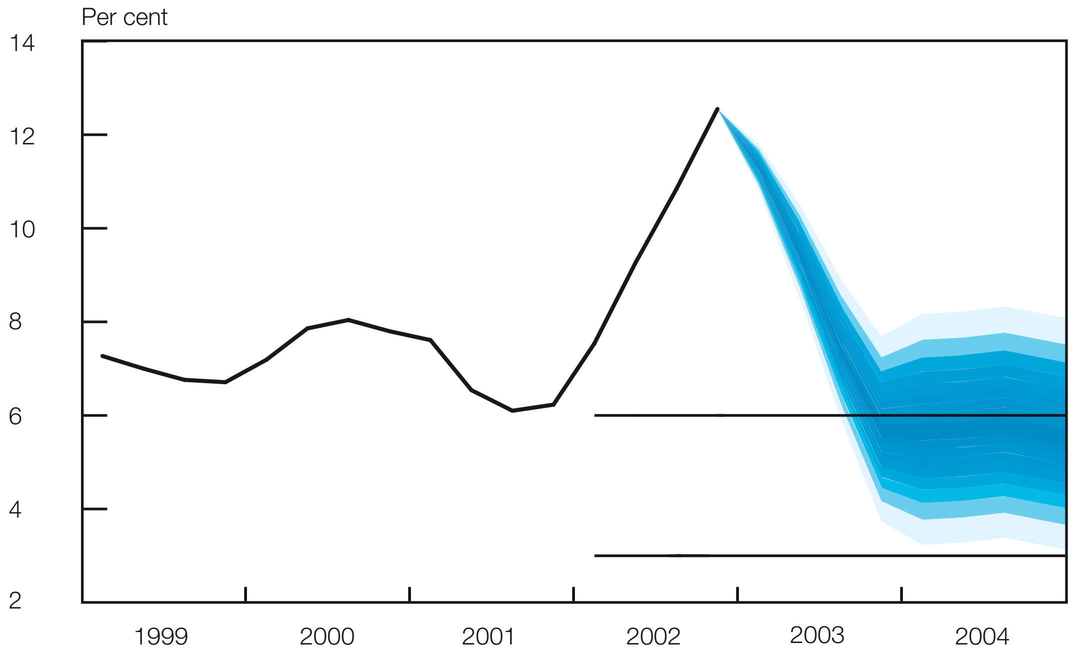
The Bank's latest forecast for CPIX inflation is presented in Figure 11. This is the forecast that was presented to the MPC at the March meeting, and being produced from a quarterly model it means that the latest observed value for CPIX was for the fourth quarter of 2002, and the CPIX for the first quarter of 2003 is the first value that is forecasted. As usual, the forecast is based on the assumption of an unchanged repo rate over the forecast period. The fan chart technique is again employed to indicate the uncertainties surrounding the central projection (the March 2001 *Monetary Policy Review* provides more details regarding this technique).

The central forecast projects a similar time path to that presented in the October 2002 edition of this review. The central projection of the forecast is for the CPIX inflation rate to dip below the upper level of the target to 5,7 per cent in the final quarter of 2003, and then to remain at around this level in 2004. The probability distribution for this forecast implies that there is approximately a 60 per cent probability that the CPIX inflation rate will be below 6 per cent in the final quarter of 2003.

With regard to the risks underlying these confidence intervals, a number of factors might slow the expected decline in inflation and result in actual inflation above the central projection. These include the possibility that the war in Iraq will have a worse than anticipated impact on oil prices, and the risk that the stubbornly high level of inflation expectations by business and trade unions will result in salary and wage increases being negotiated above the rate that can be justified on the basis of productivity changes and the inflation target. In addition to these risks, there is also the possibility that administered prices will be allowed to rise at rates which are not consistent with the inflation targets.

A slightly lesser risk exists that the actual CPIX inflation outcome will be below the central projection. A stronger than anticipated performance of the exchange rate would add to the likelihood of this occurring, as would the contractionary impact of a weaker-than-expected world economy in 2003.

Figure 11 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

The outlook for inflation has improved considerably over the past few months, and there are indications that the downward trend in inflation may be sustained, particularly against the backdrop of a weak international economy. Since the MPC meeting in March, further confirmation of this trend has been provided by lower than expected PPI and CPIX figures as well as subdued money supply data. In addition the rand has maintained its stronger levels. Although the international oil price is expected to remain volatile, threats to inflation from this source are receding. Critical to the inflation outlook will be the extent to which inflation expectations adjust to the lower trend in inflation as well as the future course of wage settlements in the economy.

There is no doubt that the tightening of monetary conditions has contributed to the improved outlook for inflation. The MPC came under considerable criticism in the course of 2002 for the measures taken to combat the surge in inflation. It would appear, however, that the monetary policy actions taken in 2002 have prevented an uncontrolled inflation spiral. In achieving this, the MPC acted cautiously in order to avoid a destabilising impact on the real economy. The result was that despite the increase in the repo rate over the year, economic growth and domestic expenditure remained relatively resilient. Similarly, a premature or excessively fast move on the downside could also be destabilising. Monetary policy will continue to be focused on bringing the inflation rate to within the target range of 3 – 6 per cent as soon as possible, while being mindful of the possible short-term consequences for economic growth.