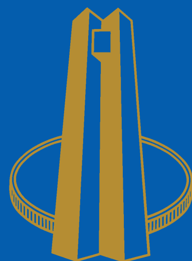
MONETARY POLICY REVIEW

November 2003



South African Reserve Bank

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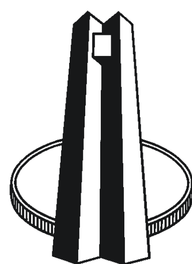

South African Reserve Bank

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Contents

Monetary Policy Review

Introduction 1

Recent developments in inflation 1
The evolution of indicators of inflation 1
Factors affecting inflation 10

Monetary policy 20

The outlook for inflation 25
International outlook 25
Outlook for domestic demand and supply 27
Indicators of inflation expectations 28
The Reserve Bank inflation forecast 29

Assessment and conclusion 30

Monetary Policy Review

Introduction

During the past six months the inflation outlook has improved significantly. The rate of inflation has declined to a level within the upper limit of the 3-6 per cent inflation target range, and it is anticipated that it will remain comfortably within the target range for the foreseeable future. The decline in inflation in 2003 has been a consequence of the monetary policy stance adopted in 2002, combined with the recovery in the exchange rate of the rand, and a favourable international inflation environment. A technical revision also resulted in Statistics South Africa (Stats SA) adjusting the inflation data downward in May.

As the inflation outlook improved, the monetary policy stance has been adjusted on four occasions in 2003. After keeping the stance unchanged at the March meeting, the repo rate was then cut by 150 basis points in June, by 100 basis points in August and September, and again by 150 basis points in October. On each occasion the Bank's forecast and other indicators suggested that the CPIX inflation rate would remain within the target range over the forecast period.

As usual, the *Monetary Policy Review* analyses developments in inflation and the factors that impact on inflation. Recent monetary policy developments are then reviewed, and the outlook for inflation as well as the inflation forecast are presented. In addition four issues are examined in boxes. The first box discusses the revision of the inflation data by Stats SA in May 2003, while the second provides an analysis of the housing component of the consumer price indices. The third box discusses the global disinflation experienced in the past two decades, and the factors that have contributed to it. The final box addresses the question of whether low inflation is sustainable in South Africa.

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.

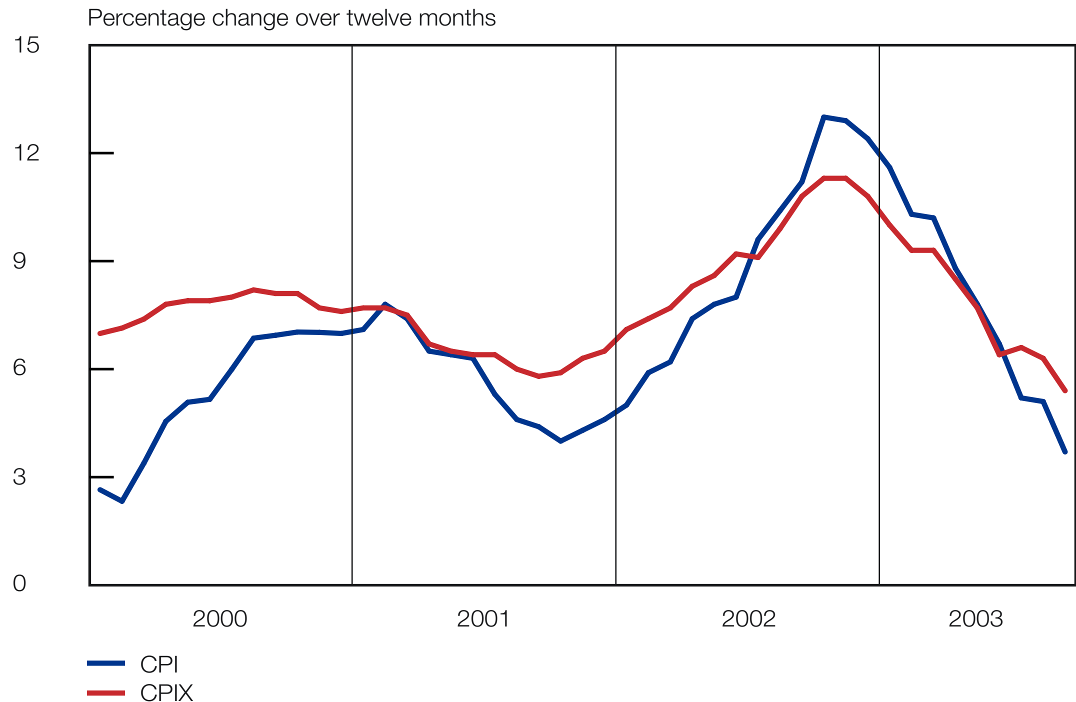
The evolution of indicators of inflation

In the last quarter of 2002, the main indicators of inflation peaked and began to follow a downward path. Furthermore, following the discovery of a statistical error in the compilation of the consumer price indices, Stats SA in May 2003 revised downward the inflation measures for January 2002 to March 2003 (Box 1 provides more detail regarding these revisions). The analysis presented here is undertaken using these new data. Figure 1 presents the twelve-month percentage changes in headline consumer price inflation for metropolitan areas (CPI) and in consumer price inflation excluding mortgage interest cost for metropolitan and urban areas (CPIX), the latter being the official measure for inflation targeting purposes.

The CPIX inflation rate which had trended upward from 5,8 per cent in September 2001 to peak at 11,3 per cent in October and November 2002, slowed to 5,4 per cent in September 2003. CPI inflation declined more sharply as a result of monetary policy-induced interest rate changes being included in this index. The inflation rate

measured in terms of the CPI rose from 4,0 per cent in October 2001 to 13,0 per cent twelve months later, before declining to 3,7 per cent in September 2003. Measured in terms of the quarter-on-quarter, seasonally adjusted and annualised changes, CPIX inflation has slowed from 12,3 per cent in the final quarter of 2002 to 2,3 per cent in the second quarter of 2003 before rising slightly to 5,1 per cent in the third quarter. The CPI inflation rate measured on this basis declined from 14,2 per cent to just 0,7 per cent in the third quarter of 2003.

Figure 1 Consumer price inflation: CPIX and CPI



Source: Statistics South Africa

Box 1 The revisions to the consumer price indices

The April 2003 consumer price inflation data, which were due for release on 20 May 2003, were not released until 30 May. The delay was attributable to a decision by Statistics South Africa (Stats SA) to conduct an internal review of the data following queries regarding their accuracy, particularly with respect to the accuracy of the housing rental component. The review revealed the existence of an error in the calculation of the rental component, and revised inflation figures were released on 30 May 2003. This box discusses the background and reasons for the revisions, and the impact they had on the country's inflation data.

The consumer price index (CPI) is a fixed-weight index of final prices paid by consumers for a representative basket of goods and services. It is published monthly by Stats SA and currently covers approximately 1 500 goods and services. Although these prices are generally collected monthly, some are collected quarterly, some annually, some at other times of the year[1] and indeed some can be collected outside the formal schedule if Stats SA deems it necessary. The *Survey of Income and Expenditure of Households*, which is conducted every five years, provides the basis for reviewing and allocating weights to the components of the basket of consumption goods and services.

1 Details of CPI components and their survey schedule are obtainable from the Stats SA website (www.statssa.gov.za) or in any of Stats SA's CPI statistical publications.

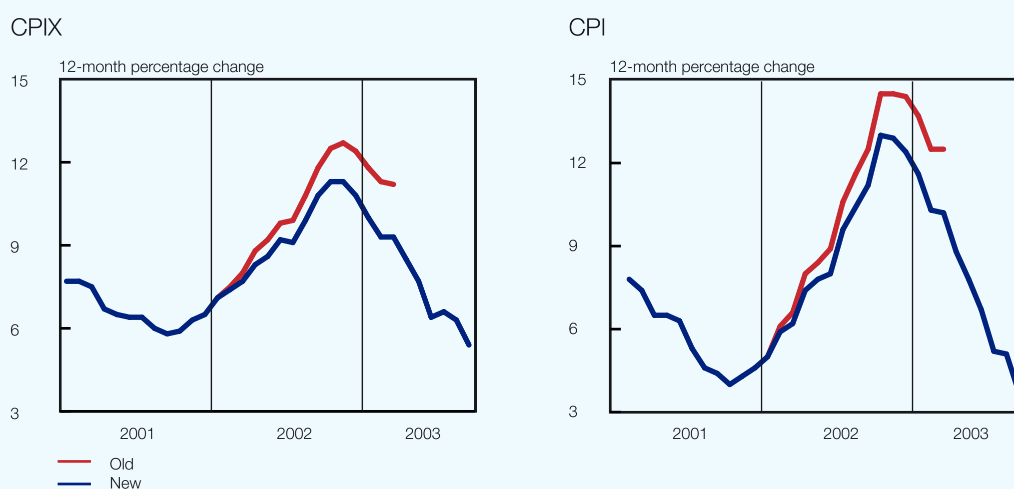
Until 1999, data on the rentals for dwellings, i.e. rental on houses, flats and townhouses, were collected annually from the *October Household Survey*. After this survey was discontinued, the only available rental data were those from the 1999 survey. These data showed an average annual increase in rents of 34,5 per cent. At a disaggregated level, the increases were 2,3 per cent,

30,4 per cent and 94 per cent for house, flat and townhouse rentals, respectively. Until the revision discussed below, these outdated growth rates were used in the calculation of the consumer price indices.

Following a series of investigations, rental information from sources external to Stats SA was obtained. This information revealed that the actual rental increases during the period under review were much smaller, necessitating Stats SA to revise their data for the period January 2002 to March 2003. Figure B1.1 shows the impact of the revisions for CPIX and CPI inflation, respectively.

As the figure reveals, the gap between the old and the new CPIX inflation measures widened from 0,1 percentage points in February 2002 to 1,9 percentage points in March 2003. Similarly, for CPI inflation, the difference increased from 0,2 to 2,3 percentage points over the same period. For March 2003, the CPIX inflation measure targeted by the Reserve Bank was revised to 9,3 per cent, compared to the 11,2 per cent published originally. Inflation measured in terms of headline CPI was revised to 10,2 per cent from the original 12,5 per cent. For the 2002 calendar year, the annual average twelve-month CPIX inflation rate was revised downward from 10,0 per cent to 9,3 per cent, and the CPI inflation rate from 10,1 per cent to 9,2 per cent.

Figure B1.1 Revisions to CPIX and CPI inflation rates

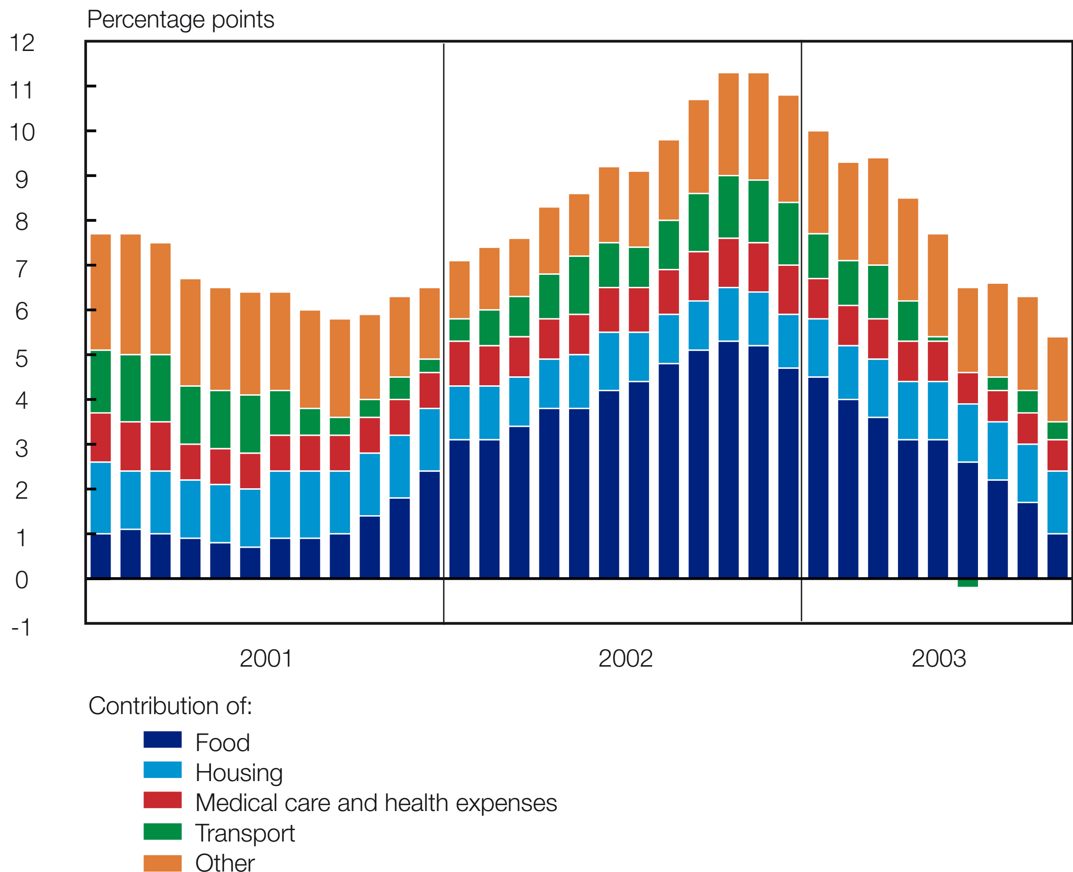


Source: Statistics South Africa

In future, rental information will be included in the *General Household Survey* which commenced in July 2003, as well as in all subsequent *Labour Force Surveys*. In the long term, it is envisaged that Stats SA will undertake special surveys to collect rental information. For the time being, however, data from external sources will continue to be used to update residential rental information on a quarterly basis until data from these surveys become available.

Figure 2 shows the weighted contributions of the main components of CPIX inflation. Food, housing, transport, medical care and health expenses are identified here. It is clear from the figure that the food component, after providing the main impetus to the increase in year-on-year CPIX inflation in 2002, was subsequently also the main contributor to its decline in recent months. In October 2002, when CPIX inflation was 11,3 per cent, the food component contributed 5,3 percentage points to this total. By September 2003, food contributed just 1,0 percentage point to the CPIX inflation rate of 5,4 per cent. As noted in previous *Monetary Policy Reviews*, the food component is sensitive to factors such as weather conditions, the exchange rate and developments in international markets, and can be a source of considerable volatility in the CPIX inflation measure.

Figure 2 Contributions to CPIX inflation



Source: Statistics South Africa and SARB calculations

Changes in the contributions of the other components to CPIX inflation have been less dramatic. The contribution of the transport costs component declined from 1,4 percentage points in October 2002 to a negative contribution of 0,1 percentage points in June 2003, before edging up to 0,4 percentage points in September 2003. This variation can largely be attributed to oil price and exchange rate-induced fluctuations in domestic petrol prices, with the 93 octane inland petrol price falling by 38 cents per litre in May 2003, and a further 27 cents per litre in June. It then rose by 45 cents over the following three months to reach R4,06 per litre in September 2003, before declining again by 22 cents per litre in October.

The housing costs component contributed 1,3 percentage points to total CPIX inflation of 8,5 per cent in April 2003. This increased to 1,4 percentage points in September 2003. Within the housing costs component, total rental price inflation has grown consistently above the 6 per cent upper limit of the inflation target. For instance, in September 2003 year-on-year rental price inflation was 16,4 per cent, partly reflecting the robust performance of the real-estate market and price increases in related activities (e.g. assessment rates, insurance and other components). Box 2 discusses in more detail the contribution of housing to changes in the domestic consumer price indices.

Box 2 The housing component in the consumer price indices

Housing is an important component of the consumer price indices calculated by Stats SA. As Table B2.1 shows, the housing component has a weight of 22,14 per cent in the headline CPI, the largest individual component identified by Stats SA for this index, and 11,57 per cent in the CPIX for metropolitan and urban areas. These weights are obtained from the *Survey of Income and Expenditure of Households* undertaken in October 2000.

Table B2.1 Housing component weights in CPIX and CPI

	CPIX weights	Headline CPI weights
Housing	**11,57**	**22,14**
Rent	4,76	4,56
House rent	2,23	1,84
Flat rent	1,62	1,71
Townhouse rent	0,91	1,01
Home-owner's costs	**4,03**	**15,21**
Interest	0	11,43
Assessment rates	1,64	1,59
Sanitary service	0,27	0,21
Refuse removal	0,37	0,28
Insurance of building	0,12	0,11
Insurance covering mortgage debt	0,18	0,16
Repairs and maintenance	1,43	1,42
Levy (sectional title, etc)	0,02	0,01
Other	**2,78**	**2,37**
Water	1,81	1,37
Boarding		
Hostels	0,16	0,12
Holiday	0,81	0,88

Source: Statistics South Africa

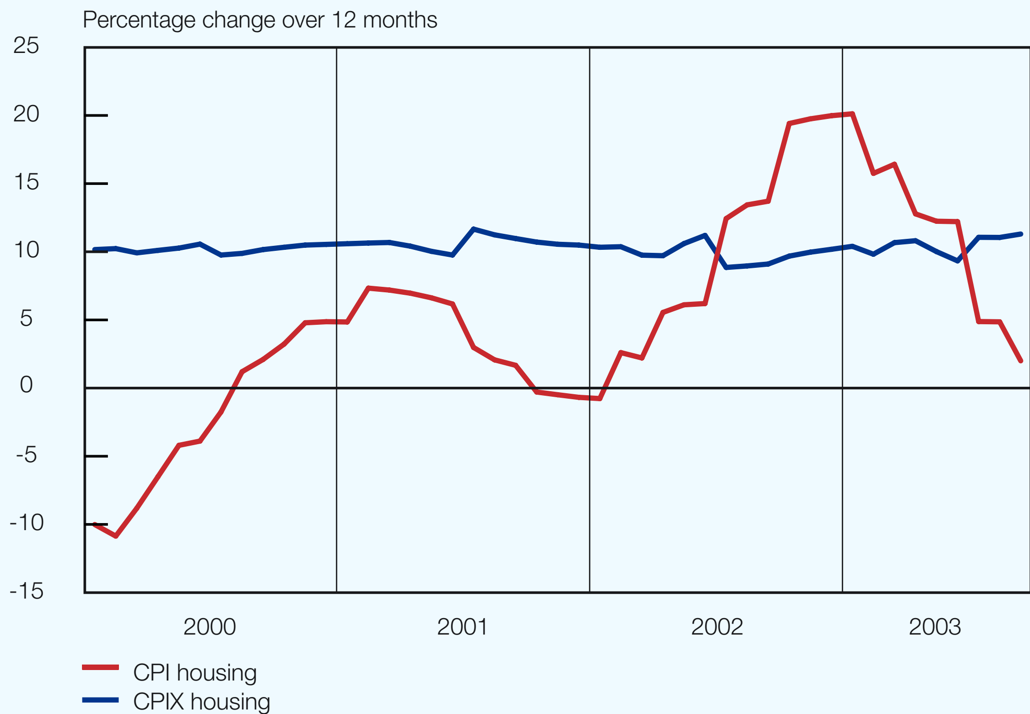
The difference between the CPI and CPIX measures is the zero weight assigned to interest costs on mortgage loans in the latter. It should be stressed that in Table B2.1 the headline CPI measure covers the metropolitan areas only, while the CPIX is for metropolitan and other urban areas, ensuring as wide a geographical coverage of price information as possible. As is well known, were these costs to be included in the index employed for inflation targeting purposes, this component would perversely fall as the Reserve Bank relaxed monetary policy, and rise as policy was tightened. Interest costs on mortgage loans are incorporated in the CPI by measuring the change in the interest rate for loans. This rate is computed as a weighted arithmetic average of the interest rates of the reporting institutions, with the weights determined by the institutions' shares of outstanding mortgages.

Figure B2.1 shows the developments in the inflation rates for total housing in the CPI and CPIX. As noted above, housing costs in the CPI are affected by monetary-policy induced changes in interest rates. The inflation rate measured for the housing component of the CPI has therefore been more variable, ranging between -11 and 21 per cent since January 2000, compared to housing costs in the CPIX, which fluctuated between 9 and 12 per cent over the same period.

The proportion of dwellings occupied by homeowners in South Africa far outweighs that which is rented. In principle, different approaches exist for measuring the price of owner-occupied housing, e.g. the acquisition approach, the user-cost approach, and the payments approach. It has been argued that the approach adopted in compiling the housing component of the South African CPI is intended as a user-cost approach. However, recent reviews of the index have suggested that this choice be reconsidered [2].

2 *For a discussion of these issues, see e.g. Haglund, M. 2000. "The South African CPI – the reliability of present practices and some potential improvements".* Report of a mission to Statistics South Africa*. Pretoria, January 24 – February 15. Version: February 15.*

Figure B2.1 Housing inflation in CPI and CPIX



Source: Statistics South Africa

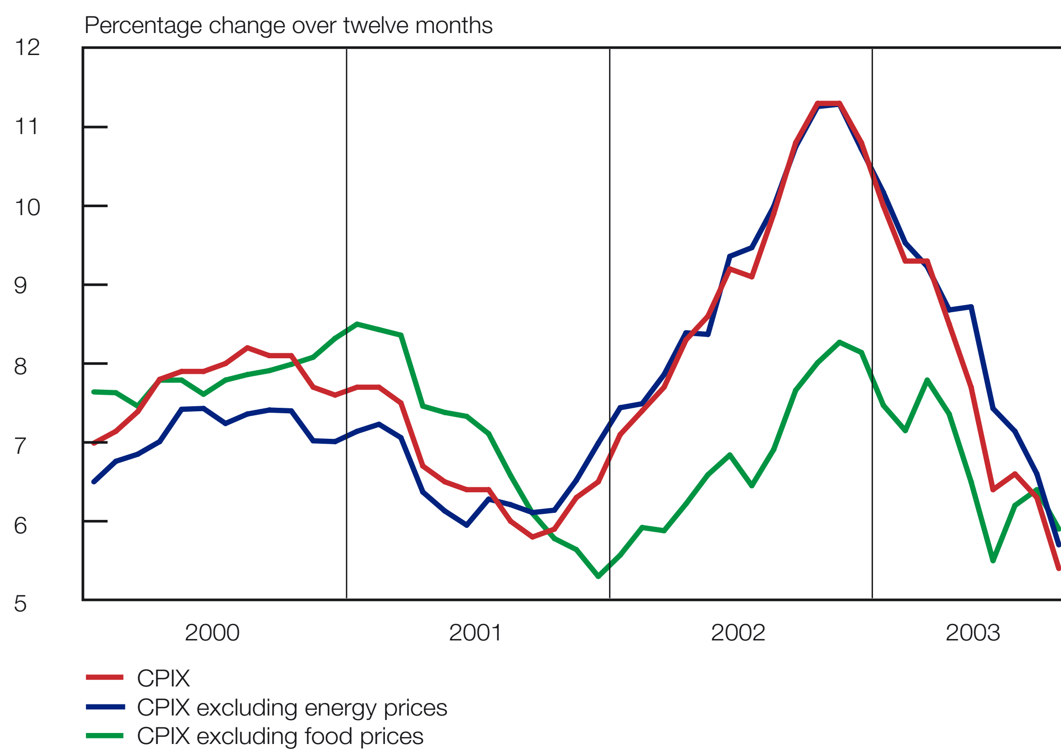
Internationally, the treatment of owner-occupied housing in the CPI remains a controversial subject. Turvey (2000) argues that much could be gained if policymakers were able to specify precisely the purpose the CPI measure is intended to serve [3]. At present, though, differences in the methods used to measure the owner-occupied housing component often make CPI measures difficult to compare across countries. For this reason, some would suggest that housing be excluded from CPI when such comparisons are to be made.

3 *Turvey, R. 2000. "Owner occupiers and the price index".* World Economics. *1(3), pp 153-59.*

Figure 3 shows the effect of excluding energy and food prices from the CPIX measure of inflation. Excluding food prices from the CPIX confirms the earlier assertion that this component was an important factor driving up CPIX inflation in 2002, and leading it down in 2003. Inflation measured by the CPIX excluding food prices declined from 8,3 per cent in November 2002 to 5,5 per cent in June 2003, before increasing to 5,9 per cent in September. Figure 3 reveals that energy prices had less impact on CPIX inflation in this period. Inflation measured in terms of the CPIX excluding energy prices coincided with overall CPIX inflation in November 2002 at 11,3 per cent, then gradually fell to reach 5,7 per cent in September 2003.

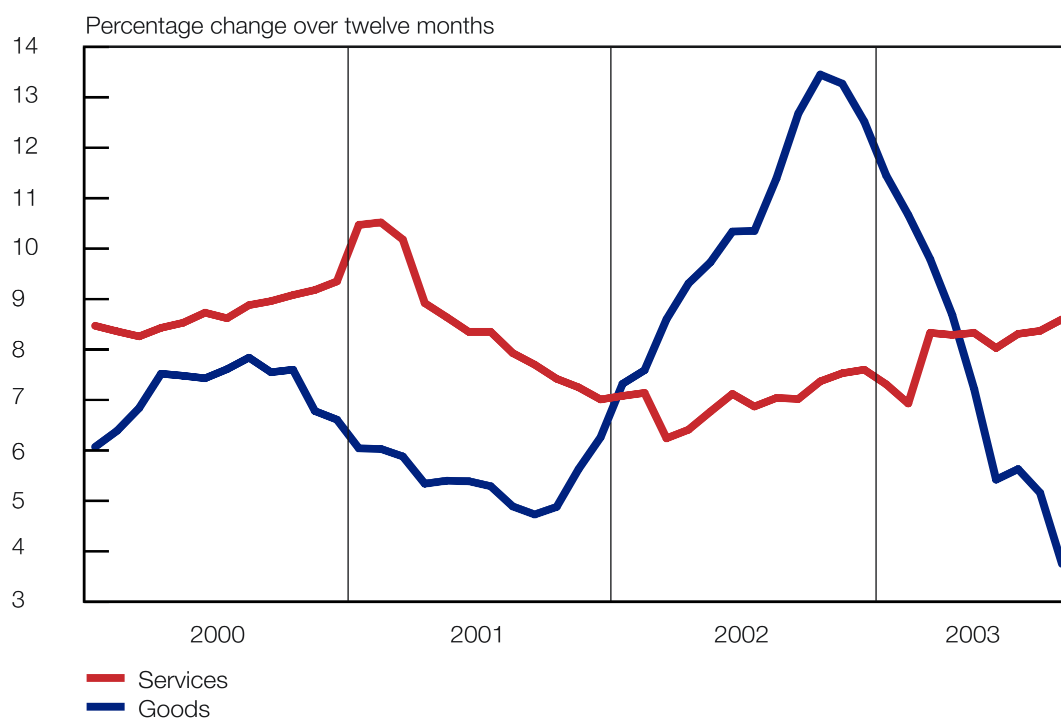
The inflation rates for the goods and services categories of the CPIX are presented in Figure 4. Goods inflation peaked at 13,4 per cent in October 2002 and declined sharply to 3,8 per cent in September 2003. This decline in goods inflation was prompted mostly by international developments; improvements in the exchange rate, food prices and oil prices were relevant here. Services inflation, which is less responsive to exchange rate developments, rose moderately from 6,2 per cent in March 2002 to 8,6 per cent in September 2003. This change in the relative price of goods and services is a typical reflection of an appreciating real exchange rate.

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



Source: Statistics South Africa

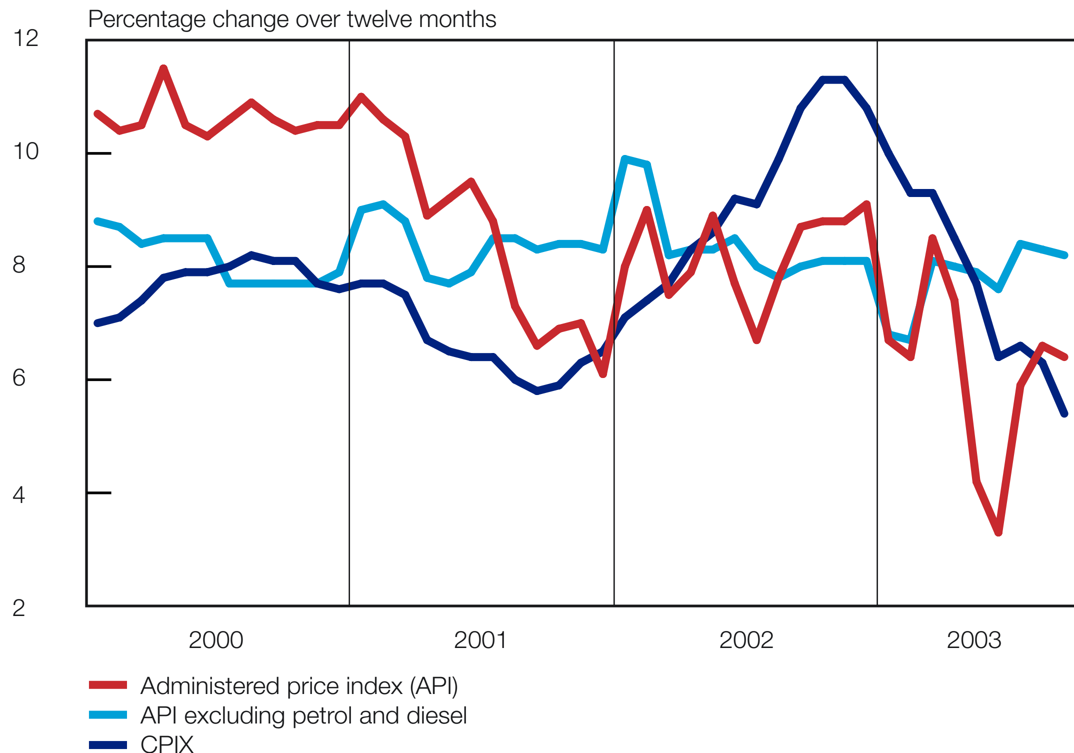
Figure 4 CPIX: goods and services inflation



Source: Statistics South Africa

Fluctuations in administered prices were caused mainly by changes in petrol and diesel prices, as Figure 5 shows. Inflation measured by the overall administered price index (API) constructed by the Bank declined steeply from 8,5 per cent in March 2003 to 3,3 per cent in June before rising again to 6,4 per cent in September. However, if petrol and diesel prices are excluded, the increase in the remaining administered prices (which are predominantly services) moved in a relatively narrow range of 7,6 to 8,4 per cent. Since the beginning of 2003, the communication services, electricity, water, assessment rates, education services and medical health services components have all grown at rates exceeding the upper limit of the inflation target range.

Figure 5 CPIX and administered prices

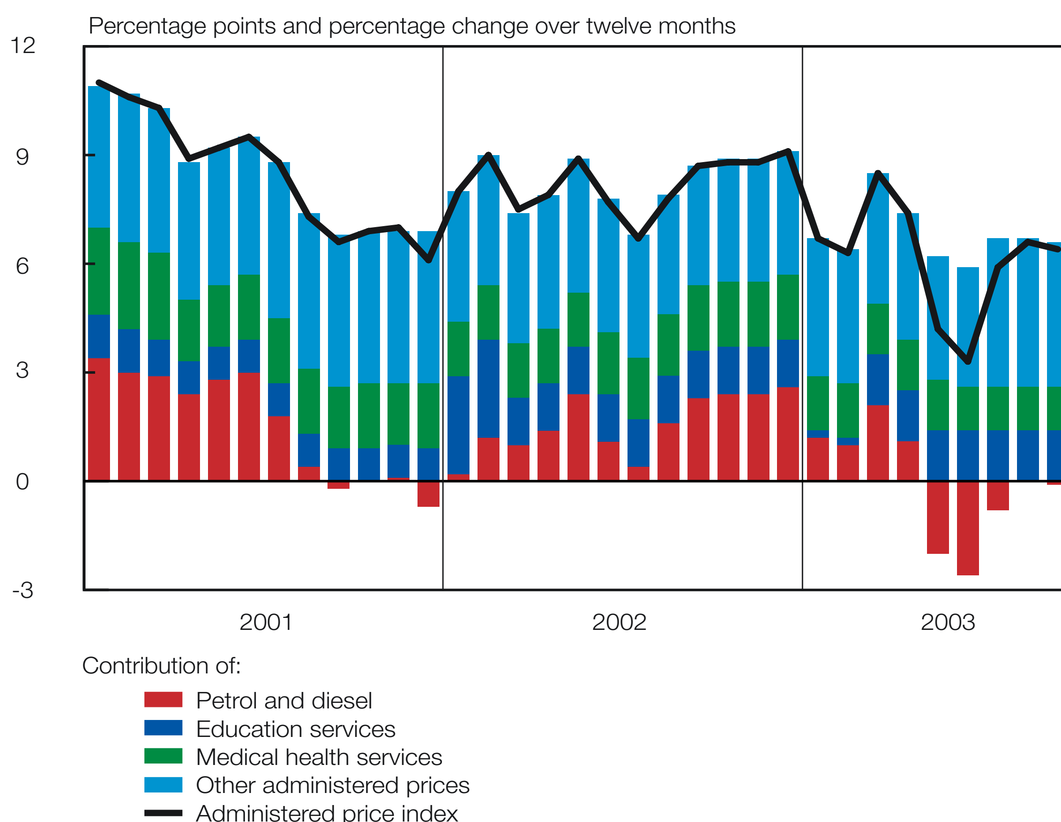


Source: Statistics South Africa and SARB calculations

Figure 6 shows the contribution of the various API components to the overall API inflation rate. Once again it is clear that petrol and diesel prices contributed significantly to the variability in API inflation. In February 2003, petrol and diesel contributed 1,0 percentage point to overall API inflation of 6,4 per cent. Its contribution doubled to 2,1 percentage points in March, then fell to -2,6 percentage points in June 2003 before shrinking to -0,1 percentage points in September.

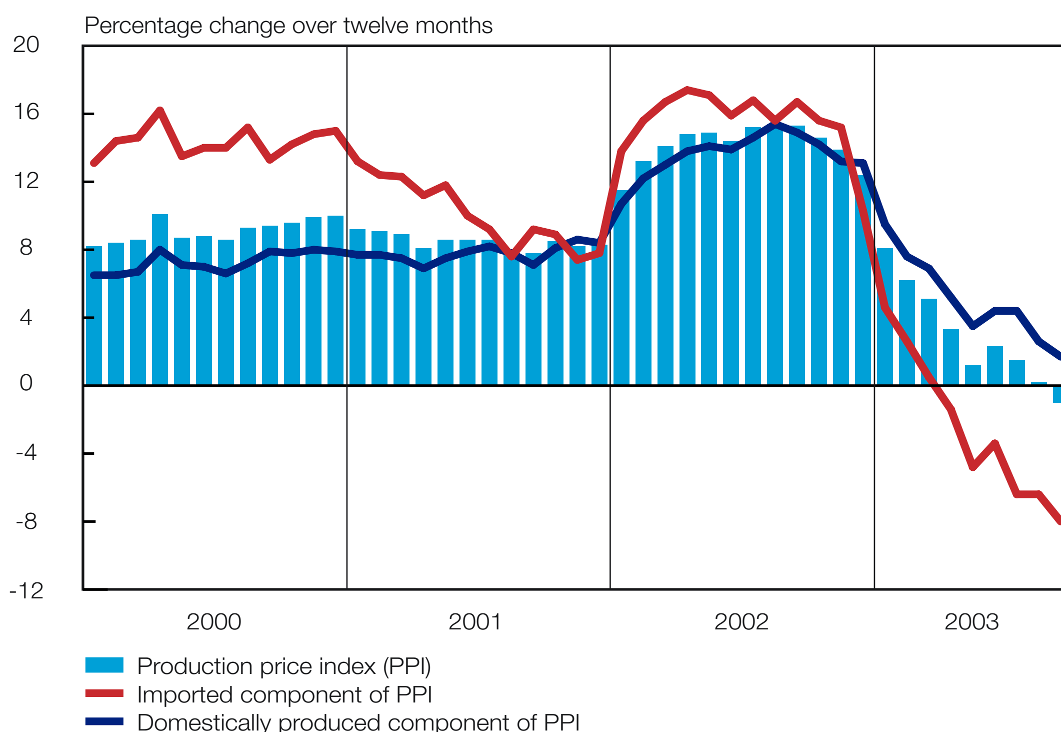
Developments in production price inflation are shown in Figure 7. The overall production price index (PPI) inflation rate averaged 14,2 per cent in 2002, resulting from annual average inflation rates of 15,5 per cent and 13,5 per cent in the imported PPI and domestic PPI components, respectively. Total PPI inflation peaked at 15,4 per cent in August and September 2002, before dropping sharply to decline by 1,0 per cent in September 2003. This is the lowest producer inflation rate recorded since 1959.

Figure 6 Contributions to the administered price index



Source: Statistics South Africa and SARB calculations

Figure 7 Production price inflation



Source: Statistics South Africa

The imported component of the PPI was the main driving force behind the decline in overall PPI inflation. The weight assigned to imports in the PPI, at 27 per cent, is larger than that estimated for imports in the consumer price indices, and import prices therefore have a larger impact on PPI inflation. The strengthening of the rand in the past twelve months has consequently contributed to imported PPI inflation dropping from 16,7 per cent in September 2002 to -8,0 per cent in September 2003. However, inflation measured by the domestic component of the PPI also fell from a peak of 15,3 per cent in August 2002 to just 1,7 per cent in September 2003.

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

The first half of 2003 was marked by disappointing global economic developments partly due to the continued after-effects of the bursting of the bubble in international equity markets, uncertainties created by the war in Iraq, high oil prices and concerns regarding Severe Acute Respiratory Syndrome (SARS), particularly in the Asian region. It is estimated that world growth will register a modest improvement in 2003, rising from 3,0 per cent in 2002 to 3,2 per cent in 2003 (Table 1).

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

	Real GDP		Inflation rates	
	2002	2003 (estimate)	2002	2003 (estimate)
World	3,0	3,2	3,5	3,9
Advanced economies	1,8	1,8	1,5	1,8
USA	2,4	2,6	1,6	2,1
Japan	0,2	2,0	-0,9	-0,3
Euro area	0,9	0,5	2,3	2,0
United Kingdom	1,9	1,7	2,2	2,8
Developing countries	4,6	5,0	5,3	5,9
Africa	3,1	3,7	9,3	10,6
Asia	6,4	6,4	2,0	2,5
Western hemisphere	-0,1	1,1	8,7	10,9
Countries in transition	4,2	4,9	11,1	9,7

Source: IMF *World Economic Outlook,* September 2003

The recovery in the United States (US) has been gaining momentum recently, with real gross domestic product (GDP) increasing at a rate of 3,3 per cent in the second quarter of 2003 following an increase of 1,4 per cent in the previous quarter. Consumer spending continued to increase in the first half of 2003, though not as strongly as in the previous few years. Although consumer confidence bounced back significantly after the war in Iraq ended, it has started to deteriorate again recently partly due to the lack of improvement in the US labour market conditions. The unemployment rate,

however, remained unchanged at 6,1 per cent in September 2003, suggesting a possible turnaround in the labour market. Core inflation (measured in terms of the all-items consumer price index excluding food and energy) recorded an annual rate of 1,3 per cent in August 2003, the lowest rate since February 1966. According to the United States Federal Open Market Committee (FOMC), the risk of inflation becoming undesirably low in the US remains a concern.

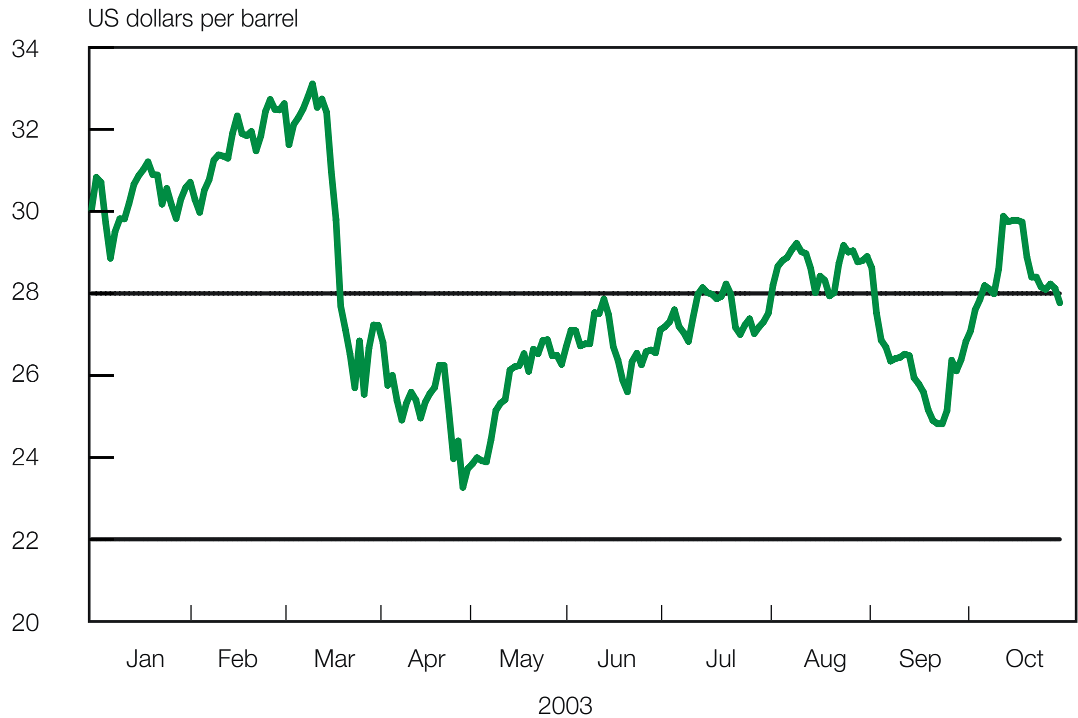
Real GDP in Japan increased at a stronger than anticipated rate of 3,9 per cent in the second quarter of 2003, following an increase of 2,4 per cent in the preceding quarter. The Bank of Japan is expecting Japanese exports and production to benefit from increased global growth in the second half of this year and to provide the momentum for an economic recovery in Japan. The deflationary pressure in the Japanese economy is easing, with the core CPI (consumer prices excluding fresh food) declining by 0,1 per cent in the year to August 2003. In the euro area, economic activity was weaker than expected in the second quarter of 2003. Real GDP contracted by 0,3 per cent, following an increase of 0,1 per cent in the previous quarter. However, recent monthly data have indicated that economic activity might have firmed somewhat in the third quarter.

Concerns over the spread of the SARS virus appear to have affected economic performance in the first half of 2003 in several Asian developing countries. These concerns are, however, fading and growth is expected to pick up in the second half of 2003. The Latin American economies are expected to grow by 1,1 per cent in 2003, recovering only modestly from the contraction experienced in 2002. Rising net exports reflecting the substantial real exchange rate depreciations that took place in 2002 are the primary factor driving the improved situation in Latin America.

Oil prices

Crude oil prices rose sharply in late 2002 and early 2003 due to increased expectations of a war in Iraq and disruptions in oil supplies from Venezuela and Nigeria. However, as Figure 8 shows for the Organisation of Petroleum Exporting Countries (OPEC) crude oil basket, prices fell below US$24 a barrel after the war ended, before returning towards US$30 per barrel in August 2003 as a result of low levels of Organisation for Economic Cooperation and Development (OECD) crude oil inventories and delays in restoring Iraq's oil production to pre-war levels. Crude prices again fell below US$25 per barrel in mid-September due to higher US oil inventories and lower demand for fuel following the end of the US summer travel season. Crude oil prices have since increased to levels around US$30 per barrel after OPEC decided on 24 September to reduce oil production quotas by 900 000 barrels to 24,5 million barrels per day, starting in November 2003. Further upward pressure on oil prices also resulted following calls by Venezuelan President Hugo Chavez for the cartel to target a basket price range of between US$25 and US$32 per barrel instead of the current target of US$22 – US$28 per barrel (shown in Figure 8). Since the end of the war, oil prices have remained within the OPEC target range except for brief periods. From the South African perspective, however, the appreciation of the exchange rate of the rand against the US dollar has moderated the inflationary impact that developments in the oil market have had in the period under review.

Figure 8 OPEC* basket price of crude oil



* Organisation of Petroleum Exporting Countries

Source: Bloomberg

World interest rates

Interest rates were eased in most advanced and developing economies during 2003, against a backdrop of declining inflation and subdued economic conditions (Table 2). The FOMC cut the target for the federal funds rate by 25 basis points to 1 per cent in June 2003 to provide further support to the US economy. The FOMC has indicated its preparedness to maintain a highly accommodative monetary policy stance in the light of low inflation and subdued growth. The European Central Bank (ECB) also reduced official interest rates in June by 50 basis points to 2 per cent, taking into account favourable price developments in the euro area and what it perceived as downside risks to economic growth. The weaker-than-expected foreign and domestic economic activity and the consequent reduction in prospective inflationary pressure allowed the Bank of England to lower the official interest rate in July by 25 basis points to 3,5 per cent. Although most central banks have reduced official rates this year, very few have done so since July. The already low levels of interest rates and nascent global recovery suggest that the likelihood of further aggressive cuts is low.

Table 2 Key central bank interest rates
Per cent

Countries	1 Jan 2003	28 Oct 2003	Latest change (percentage points)	
United States	1,25	1,00	25 Jun 2003	(-0,25)
Japan	0,00	0,00	19 Mar 2001	(-0,15)
Euro area	2,75	2,00	5 Jun 2003	(-0,50)
United Kingdom	4,00	3,50	10 Jul 2003	(-0,25)
Canada	2,75	2,75	3 Sep 2003	(-0,25)
Denmark	2,75	2,00	6 Jun 2003	(-0,50)
Sweden	3,75	2,75	9 Jul 2003	(-0,25)
Switzerland	0,25 – 1,25	0 – 0,75	6 Mar 2003	(-0,50)
Australia	4,75	4,75	5 Jun 2002	(+0,25)
New Zealand	5,75	5,00	24 Jul 2003	(-0,25)
Israel	8,90	6,10	1 Oct 2003	(-0,40)
Hong Kong	2,75	2,50	26 Jun 2003	(-0,25)
Indonesia	12,93	8,53	22 Oct 2003	(-0,02)
Malaysia	5,00	4,50	21 May 2003	(-0,50)
South Korea	4,25	3,75	10 Jul 2003	(-0,25)
Taiwan	1,63	1,38	26 Jun 2002	(-0,25)
Thailand	1,75	1,25	27 Jun 2003	(-0,50)
India	6,25	6,00	29 Apr 2003	(-0,25)
Brazil	25,00	19,00	22 Oct 2003	(-1,00)
Chile	3,00	2,75	9 Jan 2003	(-0,25)
Czech Republic	2,75	2,00	31 Jul 2003	(-0,25)
Hungary	8,50	9,50	19 Jun 2003	(+2,00)
Poland	6,75	5,25	25 Jun 2003	(-0,25)
Russia	21,00	16,00	21 Jun 2003	(-2,00)

Source: National central banks

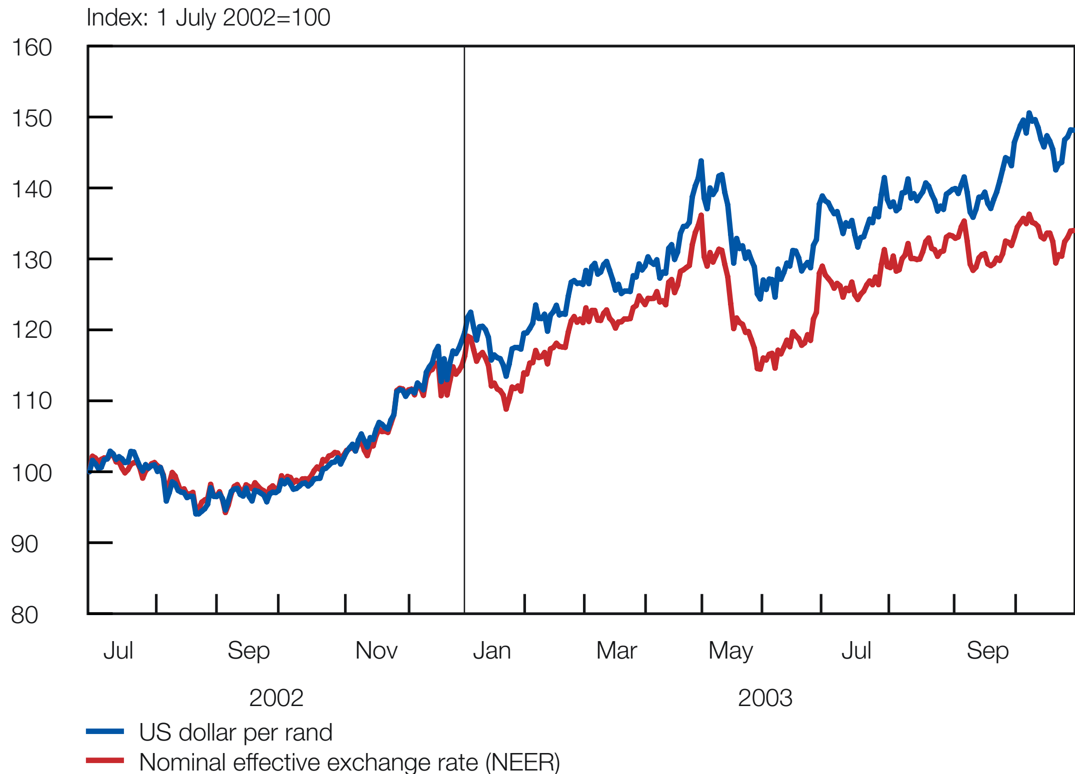
Exchange rate developments

One of the most significant factors influencing inflation in South Africa over the past few years has been the behaviour of the exchange rate of the rand. As Figure 9 shows, the recovery of the currency that was evident in 2002 continued in 2003, with the rand generally appreciating both against the US dollar and against a basket of trading-partner currencies. The nominal exchange rate strengthened more against the US dollar, appreciating from over R10,50 to the US dollar in October 2002 to below R6,90 in October 2003. Over the same period the nominal effective exchange rate appreciated by approximately 38 per cent.

The US dollar has weakened against a range of currencies in the period under review. However, the exchange rates of currencies such as the euro and the Australian and New Zealand dollars have not appreciated against the US dollar to the extent that the rand has. This recovery of the rand may be attributed to a number of factors. The negative net open foreign currency position (NOFP) of the Reserve Bank, which was widely regarded as a source of exchange rate weakness and instability, has moved into positive territory since May 2003. The rating agencies have also continued to upgrade their assessments of the South African economy. In May, Standard and Poor's raised its long-term foreign currency ratings on South Africa from BBB- to BBB, and its local currency ratings from A-/A-2 to A/A-1, and confirmed South Africa's A-3 short-term foreign currency ratings. A week earlier, Fitch

Ratings had upgraded South Africa's long-term foreign currency rating from BBB- to BBB. In addition, commodity prices have provided support to the exchange rate. In US dollar terms, for example, the *Economist's* all-items commodity price index increased by almost 24 per cent between October 2001 and August 2003. Finally, the interest rate differential between South Africa and its major trading partners has also had an impact.

Figure 9 The nominal effective exchange rate of the rand and the US dollar per rand exchange rate

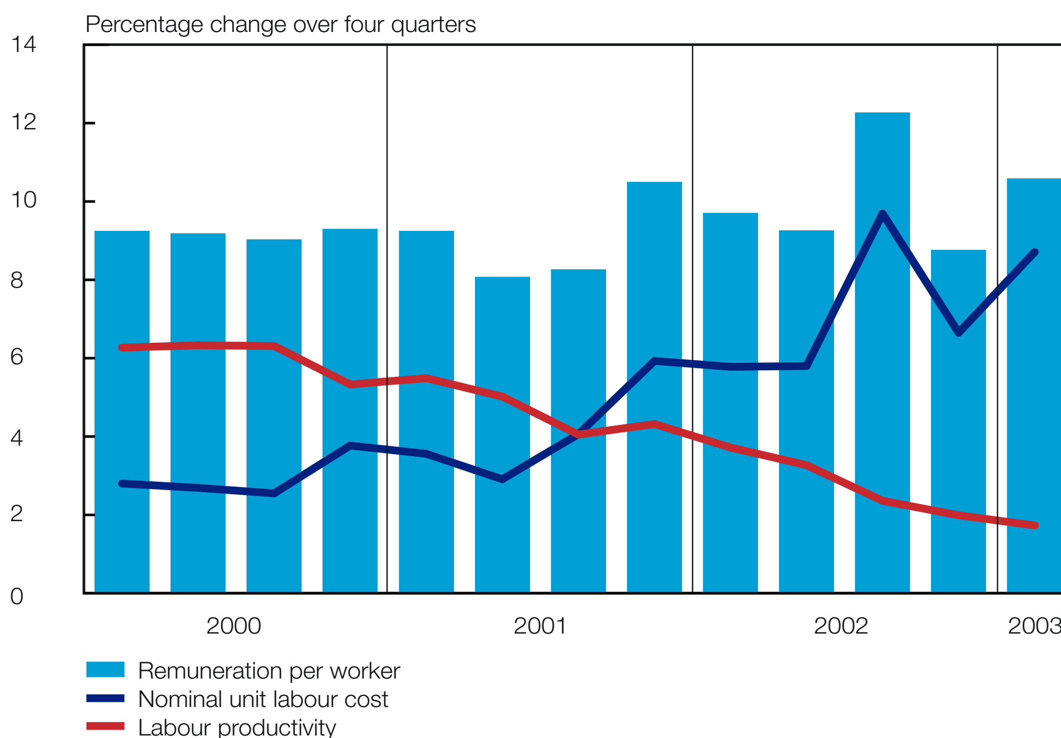


Labour markets

Unit labour cost, measured as the ratio of remuneration per worker to output per worker, is an important indicator of potential inflationary pressures. After slowing to a year-on-year increase of 6,7 per cent in the fourth quarter of 2002 from a high of 9,7 per cent in the preceding quarter, unit labour cost increased by 8,7 per cent in the first quarter of 2003 (Figure 10). Note that the labour market data discussed in this section are based on revised time series following the publication of the new *Survey of Employment and Earnings* reporting expanded data from the third quarter of 2002.

The upward trend in nominal unit labour cost is attributable to declining growth in labour productivity accompanied by stronger growth in remuneration per worker. Nominal remuneration per worker increased by 12,3 per cent year on year in the third quarter of 2002 and slowed to 8,8 per cent in the fourth quarter of 2002 before accelerating to 10,6 per cent in the first quarter of 2003. Labour productivity, conversely, continued to decelerate, increasing by only 1,7 per cent year on year in the first quarter of 2003, down from 3,7 per cent in the first quarter of 2002.

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



Source: Statistics South Africa

Recent data from *Andrew Levy Employment Publications* reveal that the average level of wage settlements for the nine months ending 30 September 2003 was 8,9 per cent, compared with 7,7 per cent for the same period in 2002. At a disaggregated level, the settlements ranged from 12 per cent in the Municipal/Utility sector to 6 per cent in the Food/Manufacturing sector.

Demand and output

Weakening global economic growth and the appreciation of the rand resulted in a deceleration in domestic economic growth in four consecutive quarters up to the second quarter of 2003. Although gross domestic expenditure (GDE) growth remained fairly robust, Table 3 indicates that growth in South Africa's real GDP slowed from a rate of almost 4 per cent in the second quarter of 2002, to only 1,5 per cent in the first quarter and 1,1 per cent in the second quarter of 2003.

Agricultural output fell sharply in the second quarter of 2003 due to unfavourable weather conditions resulting in a poor field crop harvest. The real value added by manufacturing also declined in the second quarter mainly as a result of diminishing price competitiveness of South African products and inadequate global economic growth. Given the fairly mild winter and the fact that manufacturing is such a significant user of electricity, growth in electricity generation also remained weak in the second quarter of 2003. Output growth in most other sectors was positive but slowing, with clear signs of increased economy-wide surplus production capacity.

Growth in real GDE accelerated from an annualised rate of 3,7 per cent in the first quarter of 2003 to 5,7 per cent in the second quarter. While inventory accumulation

and growth in real fixed capital formation by general government and by the private sector accelerated significantly, growth in real fixed capital formation by public corporations slowed during the second quarter of 2003.

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

	2002 2nd qr	2002 3rd qr	2002 4th qr	2002 Year	2003 1st qr	2003 2nd qr
Final consumption expenditure (households)	3,8	3,0	2,5	3,2	2,5	2,7
Final consumption expenditure (government)	3,5	3,7	4,2	3,7	3,8	3,9
Gross fixed capital formation	7,8	8,7	11,6	6,5	7,8	5,7
Change in inventories (R billion)	0,4	4,5	6,2	4,4	4,2	6,4
Gross domestic expenditure	**-0,6**	**7,4**	**5,0**	**4,2**	**3,7**	**5,7**
Exports of goods and services	26,8	-23,4	28,1	-1,4	-19,7	-8,4
Imports of goods and services	7,8	-11,3	47,5	3,1	-13,8	10,7
Gross domestic product	**3,8**	**2,9**	**2,4**	**3,0**	**1,5**	**1,1**

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

Real final consumption expenditure by general government continued to increase at a relatively brisk annualised rate of 3,9 per cent in the second quarter of 2003. Real final consumption expenditure by households also maintained its recent growth momentum, recording 2,7 per cent in the second quarter of 2003 on an annualised basis, with spending on all goods and services categories holding firm.

In the external sector, export volumes remained subdued during the second half of 2002 and the first half of 2003, while firm real domestic expenditure and rising capital formation drove import volumes somewhat higher. Given the continued relatively robust growth in real GDE, the slowdown in domestic economic growth can therefore be ascribed to weak net exports to the rest of the world.

Fiscal policy

Fiscal policy has become relatively more expansionary, with the government budget deficit projected at 2,4 per cent of GDP in the 2003 Budget (Table 4). However, the fiscal stance remains supportive of the monetary policy objective of price stability.

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

	2001/ 2002	2002/ 2003	April to June 2002	April to June 2003	2003/ 2004	2004/ 2005	2005/ 2006
	Actual	Actual	Actual	Actual	Budget estimate*	Medium-term estimates*	
National government:							
Revenue	24,8	24,6	25,0	23,5	24,7	24,6	24,6
Expenditure	26,3	26,1	25,6	25,3	27,1	27,0	27,0
Deficit (-)	1,5	1,4	0,6	1,8	2,4	2,4	2,3
Total loan debt	43,3	39,4	44,0	38,9	37,8	37,6	37,3
PSBR**	0,5	1,4	1,1	1,1	3,1	2,9	2,7

* These figures will be revised in the National Treasury's *Medium Term Budget Policy Statement*.
** PSBR: Public-sector borrowing requirement
Source: SARB and National Treasury *Budget Review* 2003

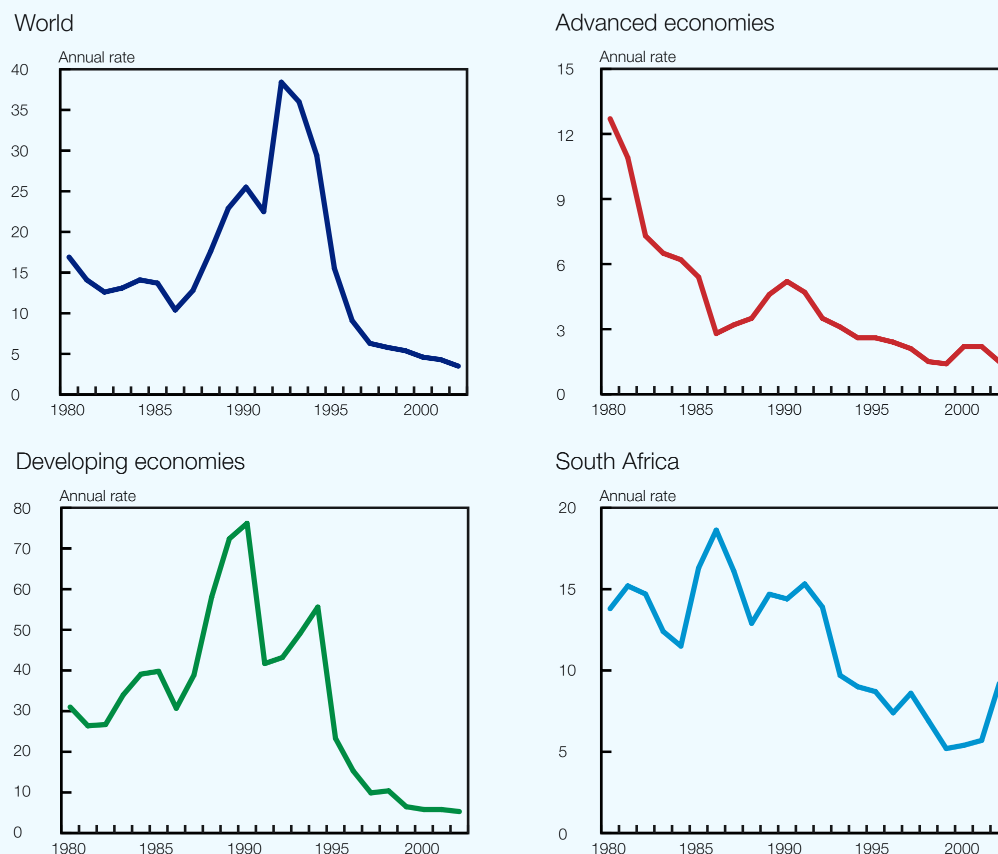
The *Statement of the National Revenue, Expenditure and Borrowing* as at 31 August 2003 shows that for the first five months of this fiscal year revenue collected was R113,6 billion, up by 6,9 per cent on the same period in 2002/03, compared to a budgeted increase of 9,4 per cent for the year. Taxes from income and profits increased by 3,5 per cent reflecting declining corporate profits, but VAT collections remained strong as a consequence of sustained expenditure growth. National government expenditure increased to R135,3 billion in the same period, an increase of 10,6 per cent on the same period in 2002/03 (the budgeted increase for the fiscal year is 14,7 per cent). The National Treasury will be publishing up-to-date projections in its *Medium Term Budget Policy Statement* on 12 November 2003.

Box 3 Trends in global inflation

After averaging around 30 per cent per annum in the early 1990s, current projections by the IMF are that global inflation will be just 3,9 per cent in 2003. In a recent paper [4], then Economic Counsellor and Director of the IMF, Kenneth Rogoff, considered the reasons for this significant turnaround. This box provides a brief overview of Rogoff's discussion of the global disinflation experienced in the past two decades, and the factors that have contributed to it [5].

Although the shift toward lower inflation has not progressed uniformly amongst groups of countries, this trend in inflation is not confined to the advanced economies. As Figure B3.1 shows, the average annual inflation rate in the advanced economies[6] declined sharply from 12,7 per cent in 1980 to 2,8 per cent in 1986. With inflation then averaging 2,9 per cent in the 1990s, and being projected at 1,8 per cent for 2003, Rogoff argues that disinflation in this group of countries has run its full course.

Figure B3.1 Trends in CPI inflation



Source: IMF *World Economic Outlook* and Statistics South Africa

4 Rogoff, K. 2003. "Globalization and Global Disinflation". Paper prepared for the Federal Reserve Bank of Kansas City conference on "Monetary Policy and Uncertainty: Adapting to a Changing Economy". Jackson Hole, WY, 29 August.

5 It is important to distinguish between the terms used here. Inflation (deflation) is a sustained increase (decrease) in the general price level. Disinflation, by contrast, refers to a decline in the rate of inflation.

6 The classification of countries into advanced economies, developing countries and transition economies is taken from the IMF's World Economic Outlook, *2003 (Statistical Appendix, pp 163-69).*

7 These are the formerly centrally planned economies in Eastern Europe.

By contrast, average inflation in the group of developing countries first increased from 30,9 per cent in 1980 to 76,2 per cent in 1990, before declining sharply to 5,4 per cent in 2002. Whereas in 1990-94 inflation averaged over 230 per cent in Latin America, over 360 per cent in the so-called transition economies[7] and around 40 per cent in Africa, the IMF's inflation projection for 2003 is around 6 per cent for this group of countries.

A further significant fact is that in 1992, 44 countries had inflation rates over 40 per cent, whereas for 2003 only 3 countries (Angola, Myanmar and Zimbabwe) are expected to remain in this category. Only 11 countries currently have an inflation rate exceeding 20 per cent.

Inflation in South Africa, measured in Figure B3.1 by the change in the annual average CPI, peaked at 18,6 per cent in 1986, before declining to 5,6 per cent in 1999. After the recent exchange rate related rise in inflation in 2002, 12-month changes in CPI inflation are at present again below 6 per cent.

One aspect of the recent behaviour of global inflation rates that has attracted attention concerns changes in the persistence of inflation. Persistence here refers to the influence that a variable's history has on its current value. Most measures focus on the long-run effects of a shock to the variable – in other words, if a shock raises inflation by 10 per cent then by how much will inflation rise over time and how long will it take to return to its previous level? In this sense, a decline in inflation persistence is consistent with inflation expectations becoming better anchored in the lower inflation environment. As the Bank for International Settlements (72nd *Annual Report,* p 26) comments:

> *"there is some evidence that, following the impressive decline in both the level and volatility of inflation in the 1990s, inflation expectations appear to be better anchored. More specifically, in the new environment of low and stable inflation, economic agents appear to have become more forward-looking and seem to be gearing their expectations of inflation more to monetary policy than to past rates of inflation. In particular, short-term persistence of changes in inflation has noticeably diminished during the last decade. This change, which has been particularly evident in many countries with inflation targeting regimes, implies that past inflation has become less important in explaining today's inflation".*

Rogoff (2003) reports results that are broadly consistent with the view that inflation expectations have become better anchored, particularly in the industrialised countries.

There are a number of factors that have contributed to global disinflation. Improvements in the conduct of monetary policy, such as increased central bank independence, explicit inflation targeting, transparency and accountability, have been important. However, Rogoff argues that other factors have also played a part. Some of these tend to be specific to periods and regions. For example, more prudent fiscal policies have been significant particularly in regions such as Latin America and Africa, and stronger productivity growth linked to improvements in technology is often cited as a factor for the US in the 1990s.

Possibly the most important factors supporting the episode of global disinflation, though, have been the increasingly competitive markets, expanding international trade, accelerating technological development and rising productivity that have characterised increased globalisation and deregulation. Rogoff argues that these factors have been relevant to a broad range of countries and that the interaction between them, together with a tendency to reduce the size and role of government, has increased competition and lowered monopoly pricing power around the world. This, in turn, has the once-off effect of lowering prices, and also impacts on long-term trend inflation. To quote Rogoff, "as economies become more competitive, prices become more flexible, reducing the impact of unanticipated inflation on output. At the same time, any incentive the monetary authorities might have to try to systematically raise output falls as well. As a result, the central bank's anti-inflation credibility is enhanced, and trend inflation falls".

To sum up, although the inflation rates in different groups of countries have followed different paths, the past two decades have been characterised by a nearly universal disinflation episode. Associated with the reduction in both the level and volatility of inflation, there is also some evidence that inflation expectations are better anchored. A number of factors help to explain this trend in global inflation, including institutional changes to monetary policy formulation, regional and time-specific factors, and more universal factors such as the interaction of globalisation and deregulation in the economies of the world. This suggests that a global recovery will not necessarily lead to a resurgence of inflation.

Monetary conditions

The rate of increase in the monetary aggregates slowed from the second half of 2002, as inflation and real GDP growth rates declined. This, in turn, was a reflection of the effects of a relatively tight monetary policy stance, the recovery in the international exchange value of the rand and weak global demand. However, having recorded only 2,3 per cent growth during the first quarter of 2003, Table 5 shows that growth in the broadly defined money supply (M3) rebounded to 13,1 per cent during the second quarter before declining to 4,3 per cent in the third quarter. The twelve-month growth in M3 was 5,5 per cent in September.

Table 5 Percentage change in monetary and credit aggregates
Per cent

Period	M1A	M1	M2	M3	Total loans and advances **
Quarterly change*					
2002: 1st qr	14,4	54,2	40,2	32,1	14,0
2nd qr	16,2	21,8	15,4	18,2	9,3
3rd qr	22,5	-1,0	0,2	8,9	6,3
4th qr	-2,1	0,3	11,2	6,9	7,2
2003: 1st qr	-0,4	-1,5	7,3	2,3	12,4
2nd qr	0,8	-3,6	16,5	13,1	22,3
3rd qr	12,9	1,1	7,7	4,3	8,3
Twelve-month change:					
2003: January	11,4	6,3	10,3	10,2	8,8
February	8,1	2,9	8,9	9,0	9,1
March	4,0	2,8	5,2	5,7	9,5
April	7,2	2,8	10,6	9,8	12,8
May	2,2	-3,9	8,9	7,0	11,7
June	4,6	-2,5	11,9	9,1	12,7
July	3,2	-0,2	11,5	7,3	13,1
August	1,0	-2,0	8,7	5,1	12,0
September	2,9	-1,4	8,6	5,5	11,6
Average	4,9	0,5	9,4	7,6	11,2

* Quarterly data refer to quarter-on-quarter growth at annual rates of seasonally adjusted data
** Total loans and advances to the domestic private sector (excluding investments and bills discounted)

Whereas the growth trend displayed by the narrow monetary aggregates (M1A and M1) reflected the deceleration in price inflation and slower growth in domestic production and income over this period, the growth rate in M2 accelerated from 7,3 per cent in the first quarter of 2003 to 16,5 per cent in the second quarter before declining to 7,7 per cent in the third quarter. During this period, fixed and notice deposits with maturities of six months or less rose fairly briskly as considerable uncertainty in the financial markets and relatively attractive interest returns probably supported the precautionary and speculative demand for such deposits.

Responding to the higher level of short-term interest rates, growth in the monetary sector's loans and advances to the domestic private sector (excluding the investments category of claims on the private sector) decelerated markedly in the course of 2002 and reached twelve-month rates of increase of less than 10 per cent in late

2002 and early 2003. However, quarter-on-quarter growth turned around and started accelerating well ahead of the first reduction in the Reserve Bank's repurchase rate in June 2003. This was a reflection of a more favourable environment for bank lending and the sustained growth in domestic final demand for goods and services. Quarter-on-quarter growth in loans and advances accelerated from annualised rates below 10 per cent during the last three quarters of 2002 to 12,4 per cent in the first quarter of 2003 and further to 22,3 per cent in the second quarter before declining to 8,3 per cent in the third quarter.

A large share of credit extension during the second quarter of 2003 was in the form of other loans and advances to the corporate sector. This is consistent with the continued growth in fixed capital formation and increased tempo of inventory accumulation. Growth in mortgage advances also held up well throughout the first three quarters of 2003 reflecting, among other things, the brisk pace of transactions in real estate evidenced by the growth in transfer duty collected. Reflecting relatively strong consumer demand and capital formation, the twelve-month growth in instalment sale and leasing finance credit fluctuated between 13,4 per cent and 17,3 per cent during the first nine months of 2003. Although there was substantial disintermediation as companies borrowed on the corporate bond market, the acceleration in the twelve-month growth rate of other loans and advances in the first half of 2003 was probably the result of importers speeding up payment for their import commitments and exporters delaying the repatriation of export proceeds, thus resorting to the use of credit as working capital.

Monetary policy

Since the publication of the previous *Monetary Policy Review*, there have been four meetings of the Monetary Policy Committee (MPC). Although the original schedule was for quarterly meetings to coincide with the release of quarterly data, it was felt that this led to excessively long lags between meetings. Following an MPC strategic planning session in May 2003, a new schedule was announced which allowed for meetings in alternate months. As in the past, the MPC reserved the right to hold unscheduled meetings if it was felt that circumstances warranted it, as was the case on 10 September when a special meeting was held. Although the monetary policy stance is generally set at the MPC meetings that are scheduled on alternate months, there is in fact a continuous process of keeping the monetary policy stance under review, taking account of any new information or developments. Special meetings are, however, expected to remain the exception rather than the rule.

Although there were clear signs that the inflation rate was moving towards the inflation target at the March 2003 meeting, it was still felt that the upside risks limited the possibilities for action on the part of the MPC. The fact that the war in Iraq commenced on the day of the meeting made the outlook particularly uncertain. Furthermore, the Bank's inflation forecast showed a projected inflation rate just below the upper end of the target range in 2004 and 2005 with an unchanged monetary policy stance.

The situation changed significantly by the time of the next meeting in June and at the subsequent meetings. An important factor in June was the revision of the CPIX inflation data which were revised down by almost 200 basis points. This had a considerable impact not only on current inflation but also on the expected future path of inflation. According to the forecasts presented to the MPC in June, CPIX inflation was expected to decline to reach the mid-point of the target by the

fourth quarter of 2003 and remain in that vicinity for the remainder of the forecast period to 2005. At the subsequent meetings the updated forecasts, based on revised assumptions, continued to indicate that inflation would remain comfortably within the target range, despite successive reductions in interest rates.

The Bank's forecast is an important part of the monetary policy decision-making process. In principle, the inflation targeting policy rule suggests that interest rates should be set on the basis of the divergence of the central forecast from the inflation target. Thus if the forecast for inflation up to the policy horizon (around 18 months to two years) is above the inflation target, interest rates should be raised and if it is below, interest rates should be reduced. However, in reality, although this rule does guide policy formulation, the MPC does not follow it in a mechanical way. The models and the forecast are part of the process but not the overriding consideration.

As conditions in the economy change and as expectations change, the assumptions of the forecast will be continuously changing, so the forecasts themselves are continuously reassessed. Because the future cannot be perfectly predicted, the MPC can never be certain about the forecasts, and the further into the future, the more uncertain things are. Uncertainty will always be greatest around the end of the forecast period and this makes it difficult to apply any rule mechanistically. However, a forward-looking policy does require an assessment of the expected future path of inflation.

It was not only the revision of the data that allowed for the more favourable outlook. A number of factors that determine the inflation outlook had improved since the previous meeting. As seen earlier, production price inflation, which is generally a good indicator of future trends in consumer price inflation had declined to 3,3 per cent in April, mainly as a result of the recovery in the rand and moderating food price inflation. By the time of the October meeting, PPI inflation had fallen to 0,2 per cent.

International factors that contributed to the improvement in the domestic inflation outlook included the low global inflation which meant that there was little threat from imported inflation. As shown in Box 3, low inflation has become the norm, even in regions which as recently as a decade ago were suffering from triple digit inflation. There are also good reasons to believe that this low inflation environment can be sustained through the impending global recovery. Other positive external factors included the ending of the war in Iraq which resulted in a decline in oil prices to within the OPEC target range. Although by October these prices had risen to the upper end of the OPEC target, they are still lower than during the first few months of this year.

Domestically, inflation expectations continued to subside, as reflected in the Bureau for Economic Research (BER) survey and various other expectations measures in the bond markets. This is covered in more detail below. There were also no signs of supply constraints and the increasing gap between actual output growth and potential growth was clearly illustrated by the fall in the capacity utilisation rate for manufacturing to 79 per cent in the second quarter of 2003 from 80,3 per cent in the first quarter.

As already indicated, growth in M3 had declined progressively from a peak of 20,6 per cent in May 2002. In August M3 growth was 5,1 per cent, down from 9,1 per cent in June, reflecting conditions conducive to a low inflation environment. Credit extension, although more buoyant than M3 growth, was also under control. Furthermore continued fiscal prudence underpinned the positive environment.

The behaviour of the exchange rate of the rand was an important factor influencing the inflation outlook. By the October meeting the nominal effective exchange rate was 16 per cent better than at the beginning of the year. Although much of this was a result of dollar weakness, the rand improved over the year against other currencies as well, although not by as much as against the dollar.

There were nevertheless risks attached to the inflation outlook. The main risk identified by the MPC was the high pay increases, with recent wage settlement rates of around 10 per cent. At the same time, growth in labour productivity declined, resulting in an increase in unit labour cost of 8,7 per cent in the first quarter of 2003. Although high unit labour costs can put the inflation target at risk, the Committee felt that because wages tend to be negotiated in a backward-looking manner in order to compensate for past inflation, the decline in inflation should lead to a decline in nominal wage settlements going forward. In other words, if nominal wage settlements follow inflation down, it will retard the speed of disinflation but not prevent it. This issue is discussed in Box 4.

Box 4 Is low inflation sustainable in South Africa?

The question is often asked whether South Africa is able to achieve permanently lower inflation rates. Some local analysts argue that there are structural impediments to low inflation or what can perhaps be termed a ‘natural rate of inflation’ that is above the upper end of the inflation target range. If this were true, the cost of bringing inflation below this level could indeed be costly. So the important question is: Can inflation get lower, and can it stay lower?

The Bank’s view is that there is nothing inherently structural about the inflation rate that cannot be changed. In fact it could be argued that inflation inertia is often a question of psychology. Although structural impediments to low inflation could include factors such as monopolistic pricing structures, a significant amount of the inflation inertia or persistence that is observed in various countries, as well as in South Africa, can be ascribed to backward-looking wage and price setting.

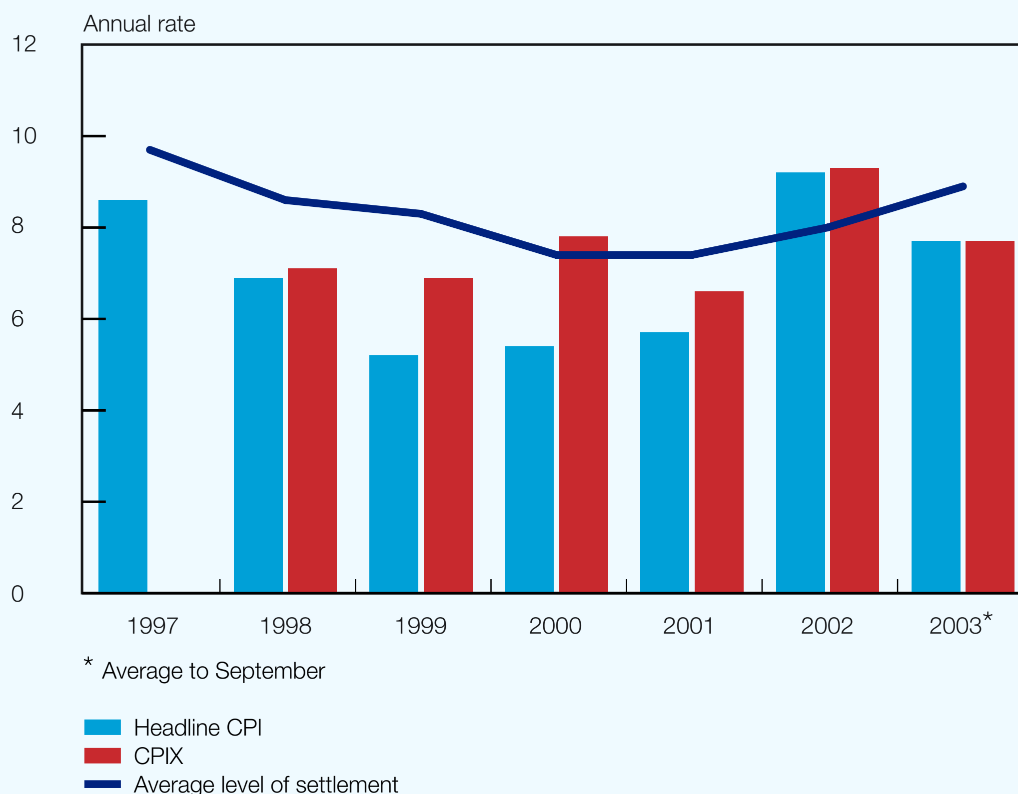
Backward-looking behaviour, where wage and price setters assume that inflation will be similar to what it was in the previous period, arises when there is a lack of credibility in monetary policy. Simply put, in the absence of strong credibility, if people do not see inflation falling, they will not believe it will fall. This will result in inflation inertia if the central bank accommodates these higher wages and prices. Inflation targeting tries to influence inflation expectations directly. The easiest way to do this successfully is to actually achieve low inflation to change the mindset. This requires tough-minded policies on the part of the Bank, but once the commitment to low inflation is demonstrated and low inflation is actually achieved, there is no reason to believe that low inflation cannot be sustained. As credibility builds, the process becomes easier.

If various periods in recent history are reviewed, South Africa’s inflation experience in the 1980s was characterised by inertia around the 15 per cent level. It took a sustained tough monetary policy stance on the part of the Bank to break this cycle, and inflation and expectations thereof came down to below the 10 per cent level by the beginning of the 1990s. More recently, around the time of the introduction of inflation targeting, expectations had crept lower, and before the sudden reversal in late 2001 there was evidence that nominal wage settlements were trending lower in line with the declining inflation trends, and that inflation expectations in general were becoming more focused on the target range. Figure B4.1 shows the relationship between inflation and wage settlements. Unfortunately the reversal in late 2001 was a setback, but the speed with which inflation has come down again suggests that monetary policy has an increased degree of credibility. Lower inflation will eventually bring about lower expectations of inflation.

However, expectations are often extremely difficult to change. As Glenn Stevens, Deputy Governor of the Reserve Bank of Australia, recently lamented, even after 10 years of inflation of 2,5 per cent in Australia, there are still household respondents to their inflation expectations survey who believe that inflation will be 10 per cent or more in the year ahead [8].

8 Stevens, G. 2003. “Inflation targeting – a decade of Australian experience”. Address to South Australian Centre for Economic Studies April 2003 Economic Briefing. Adelaide, 10 April.

Figure B4.1 CPIX, CPI and average level of settlement



Source: *Andrew Levy Employment Publications* and Statistics South Africa

The most recent Bureau for Economic Research inflation expectations survey has shown that inflation expectations, although still above the target range for business and labour respondents, have declined significantly. This indicates that the lower inflation trend is influencing inflation expectations.

Although forward-looking wage setting will help accelerate the decline in inflation, it does not necessarily follow that lower inflation cannot be achieved in the absence of such expectations. What it does mean is that the process will take longer and have a higher cost. Once lower inflation expectations are entrenched and the credibility of monetary policy is increased, the Bank's job will be that much easier. Monetary policy responses to shocks will be more subdued and the impact on output will also be reduced.

The prevalence of administered prices is also a problem common to emerging markets. Such prices are not necessarily responsive to monetary policy, and are perhaps an important structural impediment to a sustainable low inflation rate in South Africa. It is easier to credibly sustain low inflation in a competitive economy than in one characterised by monopolistic structures such as administered price setting.

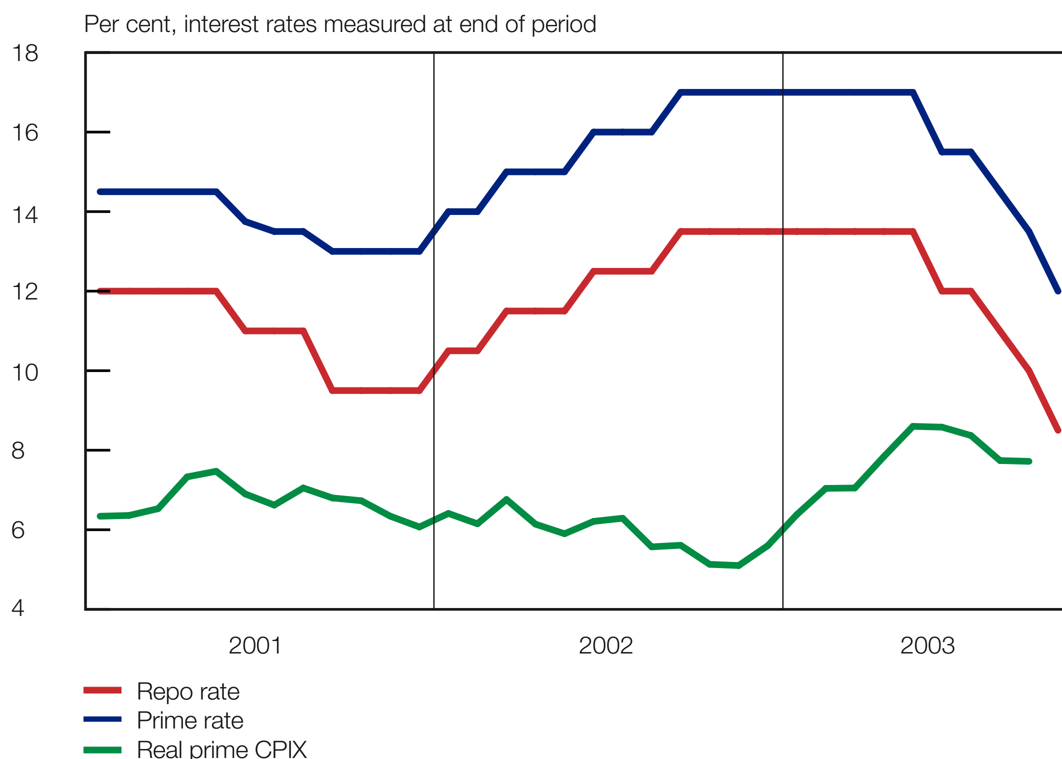
The challenge will also be to change the way administered prices are set. Here again there is reason for optimism. As competition is introduced, monopolistic pricing power will diminish. For example, the introduction of a second network operator will hopefully constrain the price increases in the telecommunications sector. Furthermore the moderate 2,5 per cent price increase granted to Eskom by the National Electricity Regulator is also a positive development.

Ultimately the Bank would like to see a strengthening of forward-looking inflation expectations and a weakening of the weight of past inflation in wage and price setting. Some sectors in the South African economy remain stubbornly backward looking and continue to predict the monetary policy stance on the back of the most recent CPIX or PPI data. The existence of administered prices and the prevalence of backward-looking inflation expectations will affect the speed of disinflation, but should not prevent the attainment of sustained lower inflation.

The Committee also noted the sustained growth in domestic final demand, which was running at 3½ per cent in the first half of 2003. At the same time the slowdown in economic activity in the first two quarters meant that the current account of the balance of payments had moved into deficit, albeit at still manageable levels.

The MPC's decision to cut the repo rate in June by 150 basis points was therefore based on a positive outlook for inflation that was enhanced by the data revision, as well as general monetary and real-sector conditions. As inflation and inflation expectations continued to decline, this meant that real interest rates were rising significantly (Figure 11). This, coupled with the continued recovery of the rand meant that monetary conditions were tightening considerably. Given the rapid decline of actual and expected inflation, the reduction of the repo rate still meant that real interest rates remained high, particularly when compared to other countries.

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 September 2003 (i.e. this excludes the October rate decrease).

At the subsequent three meetings of the MPC, the inflation outlook facing the Committee continued to improve and this allowed the MPC to reduce interest rates by 100 basis points in the August and September meetings, and by 150 basis points in the October meeting. On each occasion the Bank's forecast continued to indicate that CPIX inflation would continue to remain within the target range of 3-6 per cent over the forecast period, despite the successive reductions in interest rates. The level of real interest rates also gave the Committee room to manoeuvre.

By October the repo rate had therefore declined to 8,5 per cent, the lowest nominal level for this interest rate or its predecessor, the Bank rate, since 1980. However, historical comparisons of nominal rates can be misleading. In 1980 the

inflation rate was around 14 per cent, implying a strongly negative real interest rate. Currently, although real interest rates have come down with the successive reductions in nominal rates, they are still significantly positive.

The recent monetary policy actions of the Bank have been interpreted in some quarters as being directed to weakening the exchange rate of the rand. The Bank's position on the exchange rate is unchanged. However, the Bank has recently stated that its objective to gradually build up the level of foreign exchange reserves will result in limited purchases of foreign currency from the market. However, such purchases will continue to be carried out in a way that should not have any significant impact on the foreign exchange market. It is clear from the behaviour of the exchange rate in recent months that these modest activities have not been negative for the exchange rate.

The outlook for inflation

The view of the MPC is that the year-on-year CPIX inflation rate will decline towards the midpoint of the 3-6 per cent target range, and remain around this point in 2004 before rising slightly in 2005. Factors affecting the outlook for inflation, as well as indicators of inflation expectations and the Bank's forecast, are discussed below.

International outlook

The world economic recovery appears to be gathering momentum and the US economy in particular seems poised for a more sustained recovery. Although the IMF's baseline forecast for global growth is basically unchanged from a few months ago, the balance of risks has improved significantly. The quick end to the war in Iraq has reduced the likelihood of worst-case scenarios evolving, while monetary and fiscal policies overall have been eased further. In the *World Economic Outlook* published in September, the IMF nevertheless left its forecast for global growth at 4,1 per cent for 2004 but upgraded its growth forecast for the US economy to 3,9 per cent (Table 6). Similarly, the Congressional Budget Office (CBO) anticipates that the US GDP will grow at a rate of 3 per cent in the second half of this year and 4 per cent in 2004.

Table 6 IMF projections of world growth and inflation
Per cent

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

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

Despite a weak labour market and considerable excess capacity, current US data have shown the greatest signs of improvement amongst industrialised countries, forward-looking indicators are strongest, and there is a large policy stimulus in the pipeline. Although the FOMC perceives roughly equal upside and downside risks to the attainment of sustainable growth in the US, the most significant risk to world growth remains the fact that both the federal government and US trade deficits are at record levels. However, partly because of the projected economic growth, the CBO's baseline projections show federal budget deficits that diminish and then give way to surpluses near the end of their ten-year forecast period. The large US current-account deficit far exceeds the peak level of the 1980s and absorbs the bulk of global net capital outflows. Fortunately a number of forces are converging to stabilise the deficit as a percentage of GDP, including the weaker dollar, projected lower energy prices and, importantly, stronger foreign growth. Support will also come from the fact that the destination of US exports has shifted toward faster growing emerging-market economies.

The growth prospects of the euro area are of concern to South Africa's manufacturing exporters in particular. Although the latest IMF projection for growth in the euro area in 2003 has again been revised downwards, there are now clearer signs that the euro area may embark on a long-awaited recovery. The lower IMF forecast probably reflects continued disappointing private domestic demand, the appreciation of the euro and a slow tempo in structural adjustments. However, both euro area business and consumer confidence are improving and some indicators have also begun to point upwards. Corporate balance sheet constraints have eased and financial conditions appear supportive of growth. The risks to a positive euro area outlook have not disappeared but they are more balanced than a few months ago.

Although the Japanese economy and financial system are still burdened with a number of difficulties, the improved global outlook has led to the first signs of recovery being observed. Business fixed investment is expected to continue recovering gradually against the background of an upturn in corporate performance, particularly among large manufacturers. Furthermore, business and household sentiment have received a boost from the substantial rise in stock prices from their low levels earlier this year.

In emerging markets in Asia, growth is expected to pick up in the second half of 2003 and remain strong in 2004, aided by continued robust growth in China. The IMF's growth forecast for Asia depends on a prompt rebound in domestic demand, as well as the eventual pace of the global recovery and an assumed continuation of the recovery in the information technology sector.

In most emerging markets, financing conditions have eased significantly, aided by low industrial country interest rates and improved sentiment toward a number of key emerging markets. Activity in much of Latin America appears to be stabilising and external confidence in the region has improved markedly. Nonetheless, the recovery remains fragile and, with a number of countries facing significant debt problems and political uncertainties, the region remains vulnerable to a reversal in financial market sentiment.

Prospects for stronger growth in Africa have been improving. However, the positive effects of improved macroeconomic policies, rising commodity prices and debt relief could be partly offset by continued political instability and adverse weather conditions in certain regions. The IMF's growth forecast for Africa has been revised downwards slightly to 4,8 per cent for 2004.

International inflationary pressures remain very low (see Box 3). The IMF's inflation forecast for advanced countries is below 2 per cent in 2003 for the second year in suc-

cession and is projected to fall to 1,3 per cent in 2004, the lowest level for 30 years. Inflation in developing countries is expected to fall to slightly more than 5 per cent. Although there has in recent years only been overt deflation in Japan, the fact that inflation in a number of advanced countries is projected at below 1 per cent in 2004 has attracted increased concern about the possibility of deflation in these countries. However, as a result of recent policy measures coupled with expectations of a robust recovery, inflationary expectations have edged up, making the risk of a global deflationary spiral appear remote.

With oil prices near the top of the OPEC price range, further significant price increases are not expected. With global inflationary pressures still very moderate, macroeconomic policies in most countries are expected to remain supportive of a recovery.

Outlook for domestic demand and supply

Whilst a number of sectors still displayed a reasonable growth performance in the first quarter of 2003, overall real GDP growth slowed down despite firm domestic demand growth. Manufacturers supplying the domestic market have been facing increased import competition while many of those with significant export markets are also experiencing difficulties as a result of the recovery in the exchange value of the rand. The slowdown in growth continued into the second quarter of 2003 but some preliminary indicators began pointing firmly upward towards the end of the second quarter while others appeared to have either stagnated somewhat or weakened further. On balance however, the favourable developments in leading variables were probably indicative of an imminent turnaround as the composite leading indicator of economic activity of the Reserve Bank picked up strongly in May, June and July 2003. The latest Reuters consensus forecast for real GDP growth, surveyed in September 2003, is for growth of 2,1 per cent in 2003 rising to 3,0 per cent in 2004. The forecast for 2003 is the mean of 14 individual forecasts ranging between 1,7 and 2,5 per cent, and that for 2004 is the mean of 14 individual forecasts with a low of 2,3 per cent and a high of 3,8 per cent.

The relatively robust growth in real government expenditure continued in the second quarter of 2003. Consumer demand is expected to remain firm given the decline in interest rates and the growth in personal disposable income. Gross fixed capital formation has shown strong growth over the last seven quarters, rising to an annualised average of almost 8 per cent (compared to about 3 per cent previously). Consequently, the potential growth rate of the South African economy has been rising and GDP growth can now be sustained at a slightly higher level without inflationary pressures being generated in the economy as quickly as in the past.

The lagged impact of higher interest rates during 2002, the recovery in the exchange value of the rand and weak global growth had a dampening effect on economic activity during the first half of 2003. The effect of the rand appreciation has been softened to an extent by declining fuel prices, rising commodity prices, positive influences resulting from tax cuts in the 2003/04 Budget, lower inflation and lower interest rates. Notwithstanding the problems being experienced in the manufacturing and mining sectors, the general business climate (as measured by the September 2003 Business Confidence Index of the South African Chamber of Business) has improved. The net effect of these forces and the fact that the global economic recovery appears to be gaining momentum are likely to ensure an acceleration of GDP growth towards year-end.

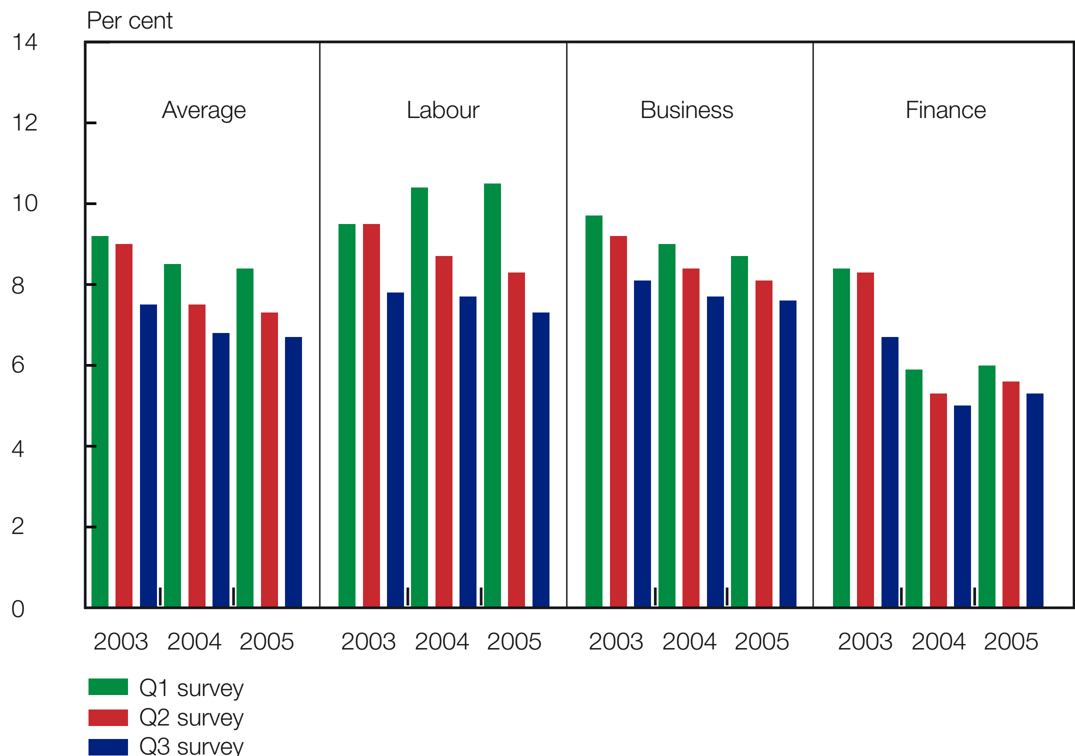
Higher growth is likely to result in increased imports. However, positive influences on exports, including strong commodity prices and a recovery in the global economy, will help to keep the current-account deficit at sustainable levels.

Indicators of inflation expectations

The most recent quarterly surveys of CPIX inflation expectations in the South African economy, conducted by the Bureau for Economic Research at the University of Stellenbosch, are reproduced in Figure 12. The survey undertaken in the third quarter of 2003 found that the CPIX inflation rate is expected to average 7,5 per cent in 2003, before declining to 6,8 per cent in 2004 and 6,7 per cent in 2005. Inflation expectations measured by the survey have, however, declined continuously through the year as measured inflation has slowed. Comparing the results of the survey for the third quarter with those undertaken in the first and second quarters of 2003, it can be seen that the inflation expectations of each group has declined for each period.

Figure 12 reveals that the financial analysts once again have lower expectations for inflation than business and trade union officials. Financial analysts expect CPIX inflation to be within the target range of 3 – 6 per cent in 2004 and in 2005. Surveyed in the third quarter of 2003, their expectations for these years are 5,0 per cent and 5,3 per cent, respectively. The expectations of business and labour are still above the target range at this stage, although the trade union respondents in particular have revised their expectations sharply downward in the course of the year, from 10,4 per cent to 7,7 per cent for 2004, and from 10,5 per cent to 7,3 per cent in 2005.

Figure 12 BER surveys of CPIX inflation expectations

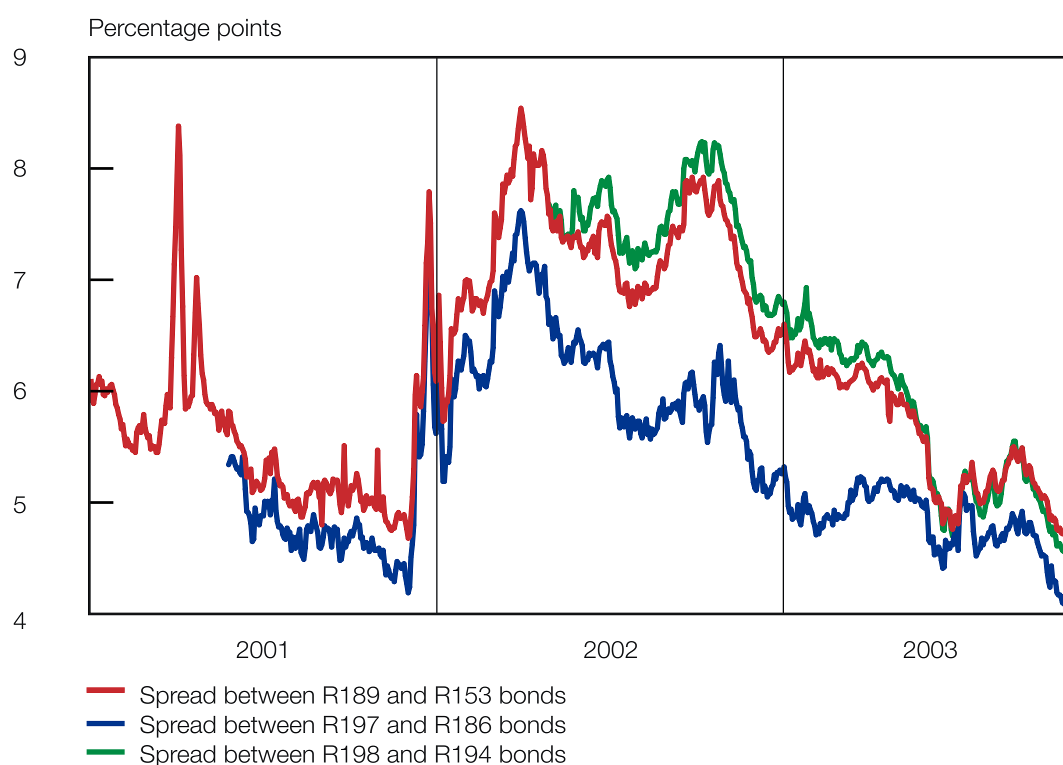


The inflation expectations obtained from the Reuters monthly survey of long-term forecasts for the South African economy are similar to those reported by the BER for financial analysts in Figure 12. The Reuters September survey reports that CPIX inflation is expected to average 6,8 per cent in 2003. This is the mean of 14 individual forecasts ranging between 6,2 per cent and 7,2 per cent. CPIX inflation is then expected to

decline to average 4,9 per cent in 2004 (14 forecasts ranging between 4,2 and 5,6 per cent) and 5,3 per cent in 2005 (13 forecasts ranging from 3,3 to 6,0 per cent).

The decline in inflation expectations is also evident in the spreads between the yields on South African government CPI inflation-linked bonds and conventional nominal bonds of similar maturity, or breakeven inflation rates. Assuming no differences in the liquidity of the bonds and their payment patterns and no changes to the risk premium associated with future inflation, these spreads provide an indication of expected inflation over the period until the bond matures. As Figure 13 shows, inflation expectations obtained this way declined steadily from October 2002 until June 2003, then rose slightly until the end of August before moving downward once more. The breakeven inflation rates calculated from the R189 (maturing 2013) and R198 (maturing 2008) inflation-linked bonds have been below 5 per cent in October 2003, while the longer-dated R197 (maturing 2023) has been just above 4 per cent.

Figure 13 Breakeven inflation rates



The Reserve Bank inflation forecast

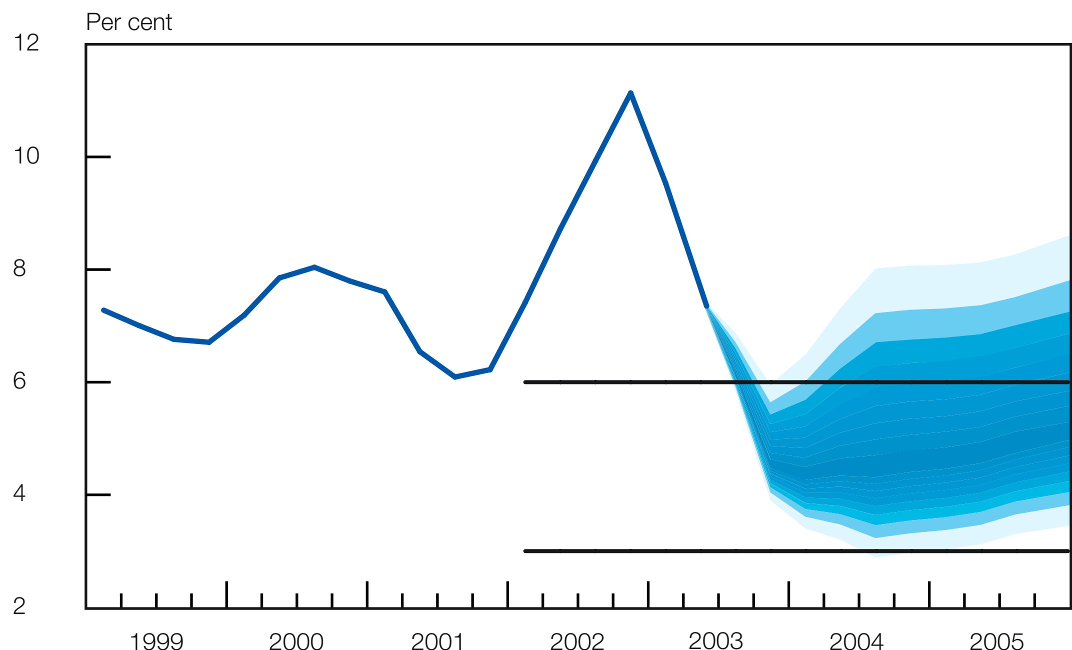
The Bank's latest forecast for CPIX inflation, presented to the MPC at the October 2003 meeting, is reproduced in Figure 14. The fan chart technique is again employed to indicate the uncertainties surrounding the central projection (the March 2001 *Monetary Policy Review* provides a discussion of this technique). As usual, the forecast is based on the assumption of an unchanged repo rate over the forecast period.

The central forecast projects that CPIX inflation will move to within the 3 to 6 per cent target range by the final quarter of this year, and remain at around the midpoint of this range in 2004. Inflation is then projected to edge up in 2005 but to

remain within the target range for the forecast period. The probability distribution for this forecast implies that there is approximately a 55 per cent probability that the CPIX inflation rate will be between 3 and 6 per cent in the final quarter of 2004.

The fan chart attempts to convey the risks underlying these probability intervals. Factors contributing to the risk that inflation will be below the central projection include the possibility that the exchange rate of the rand will appreciate further, and combine with low rates of domestic producer price inflation and subdued foreign inflationary pressures to push the CPIX inflation rate lower in the short term. The factors contributing to the risk that inflation will be above the central projection include inflation expectations in some quarters remaining above the upper limit of the target range, domestic demand pressures which may become stronger than currently anticipated and rates of administered price inflation and salary and wage settlements which are above the target range.

Figure 14 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 inflation environment has changed substantially during the course of the year. It has become apparent that the inflationary spike of last year, a consequence of the depreciation of the rand in late 2001, has dissipated, and that CPIX inflation will sustain its softer trend. This positive outlook has enabled the Reserve Bank to reduce rates significantly over the past few months. Nominal rates are at levels last seen in the 1980s, but the difference is that the current and expected inflation rates are significantly lower than those observed in the 1980s.

Whether or not these lower interest rate levels can be maintained will depend on the sustainability of the positive factors that underpin the inflation outlook. Although the global economy is expected to continue its recovery, world inflation is not likely to accelerate significantly. Oil prices are at the upper end of the OPEC target range, but they are not expected to increase appreciably. At the same time the stronger world economy will help domestic exports in the form of increased demand and stronger commodity prices.

Domestically, the inflation outlook will be influenced by three main factors. Firstly the exchange rate is an important factor. The expunging of the negative NOFP has contributed to a more stable and more two-way market. Secondly the behaviour of administered prices could undermine the sustainability of low inflation. Hopefully announcements such as the limiting of electricity price increases for next year to 2,5 per cent will become more commonplace. Finally the most serious threat to the inflation targets and therefore to the sustainability of lower nominal interest rates is the trend of wage settlements. Excessively high settlements could undermine the attainment of the inflation targets. There is reason to believe that nominal wage settlements will follow the downward trend in inflation, and once low inflation expectations become entrenched, then wages should increasingly be set on a forward-looking basis.

The evolution of these internal and external factors and their impact on the future path of inflation will determine the future direction of monetary policy adjustments. Although conditions have allowed the MPC to reduce nominal interest rates significantly, the overriding objective remains the attainment of the inflation target.