Monetary Policy Review

May 2005

South African Reserve Bank

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Introduction

Despite increased uncertainty in the global environment since the publication of the previous *Monetary Policy Review* in November 2004, the inflation outlook remains favourable. Inflation has remained within the target range for the past 19 months, there has been a significant decline in inflation expectations, and it is generally expected that inflation will remain within the target range for the next two years. Primarily as a result of these favourable developments, the repurchase rate was lowered by 50 basis points at the April meeting of the Monetary Policy Committee (MPC).

The global environment has been characterised by uncertainties in recent months which require consideration. Developments in international oil markets have been of particular concern, as oil prices have reached record highs notwithstanding increases in output levels, and market conditions seem destined to be tight for some time. These higher oil prices have duly resulted in forecasts of global growth being revised downward. The imbalances in the United States (US) economy also remain, as does the uncertainty regarding the future path of the US dollar exchange rate.

Domestically, strong economic growth has been supported by robust domestic expenditure and accompanied by a welcome expansion in formal non-agricultural sector employment. However, some evidence of an exchange-rate related slowing in activity has emerged in the mining and manufacturing sectors. The view of the MPC in this regard is that a competitive and stable exchange rate is desirable for sustainable economic growth.

As usual, the *Monetary Policy Review* analyses inflation developments and the factors that have impacted on inflation, followed by an assessment of recent monetary policy developments and a discussion of the outlook for inflation. Three topical issues are focused on in the boxes. The first box discusses the long-term prospects for the international oil market, while the second reviews developments in house prices in South Africa and internationally. The final box looks at the objectives of monetary policy in inflation-targeting monetary policy frameworks.

Recent developments in inflation

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

The evolution of indicators of inflation

Figure 1 shows that the year-on-year increase in the consumer price index excluding mortgage interest cost for metropolitan and other urban areas (CPIX), the measure targeted by the Reserve Bank, extended its stay within the 3 to 6 per cent target range to 19 consecutive months in March 2005. Since the publication of the previous *Monetary Policy Review* in November 2004, when the available rate was 3,7 per cent for September, CPIX inflation initially rose to 4,6 per cent in November 2004 before slowing to 3,1 per cent in February 2005. In March, the rate increased once more to 3,6 per cent. The analysis presented in this section suggests that these fluctuations have been largely the result of movements in petrol and diesel prices.

Figure 1 Consumer price inflation: CPIX and CPI

Source: Statistics South Africa

For the calendar year 2004, average CPIX inflation was 4,3 per cent. Quarterly CPIX inflation (measured as the annualised quarter-on-quarter rate of increase in the seasonally adjusted data) accelerated from 2,7 per cent in the third quarter of 2004 to 5,0 per cent in the final quarter, and then slowed to 2,1 per cent in the first quarter of 2005.

Inflation measured year on year in terms of the headline consumer price index (CPI) for metropolitan areas increased from 1,3 per cent in September 2004 to 3,7 per cent in November 2004, before slowing to 2,6 per cent in February 2005. In March, it rose to 3,0 per cent. On a seasonally adjusted and annualised basis, the quarter-on-quarter rate of increase in the CPI accelerated from 2,5 per cent in the third quarter of 2004 to 4,9 per cent in the fourth quarter, before declining to 2,3 per cent in the first quarter of 2005.

Table 1 shows the weighted contributions of the main components of the CPIX to the year-on-year percentage changes discussed above. As can be seen, the recent movements in the CPIX inflation rate are largely attributable to developments in the transport component of the index. The contribution of this component increased from 0,6 percentage points in September 2004 to 1,1 percentage points in November, and then declined to 0,2 percentage points in February 2005 before rising once more to 0,5 percentage points in March. The corresponding movements in the inland pump price of unleaded petrol saw an increase from R4,54 per litre in September 2004 to R4,85 per litre in November, followed by a cumulative 65-cent decline to R4,20 a litre in February 2005 and increases to R4,62 per litre in March and R5,02 per litre in April (the latter includes the increase of 5 cents per litre in the Fuel Levy and 5 cents per litre in the Road Accident Fund Levy announced by the Minister of Finance in his Budget Speech in February).

The contributions of the other main components of the index remained relatively constant over the period under review. The food component contributed between 0,4 and 0,5 percentage points to overall CPIX inflation, while the contribution of the housing component increased from 0,8 percentage points during October and

November 2004 to 0,9 percentage points during the following three months before declining once more to 0,8 percentage points in March. Finally, the contribution of the medical and health care component decreased from 0,7 percentage points in September 2004 to 0,5 percentage points in January 2005 before rising once more to 0,7 percentage points in March.

Table 1 Contributions to year-on-year CPIX inflation

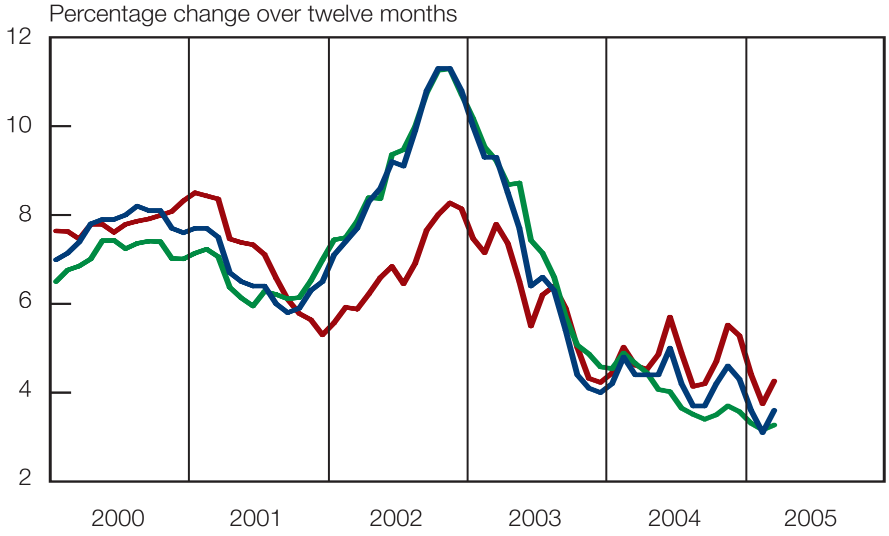
Percentage change over twelve months* and percentage points

Component	Sep 2004	Oct 2004	Nov 2004	Dec 2004	Jan 2005	Feb 2005	Mar 2005
Total*	3,7	4,2	4,6	4,3	3,6	3,1	3,6
Of which:							
Food	0,4	0,5	0,5	0,4	0,4	0,4	0,4
Housing	0,8	0,8	0,8	0,9	0,9	0,9	0,8
Medical care and health expenses	0,7	0,7	0,7	0,7	0,5	0,6	0,7
Transport	0,6	0,9	1,1	0,9	0,5	0,2	0,5
Education	0,4	0,4	0,4	0,4	0,4	0,4	0,4

Source: Statistics South Africa

Figure 2 illustrates the effect of excluding energy and food prices from the CPIX inflation measure. Energy prices have been the dominant factor determining the observed fluctuations in CPIX inflation in the period under review. Once energy prices are excluded from the overall CPIX, the rate of increase in the remaining prices increased slightly from 3,4 per cent in September 2004 to 3,7 per cent during November 2004 before declining to 3,3 per cent in March 2005. Food prices, by contrast, continued to have a moderating effect on the overall CPIX inflation rate. Excluding this component, CPIX inflation increased from 4,2 per cent in September 2004 to 5,5 per cent in November 2004 before recording 3,8 per cent in February 2005 and 4,3 per cent in March.

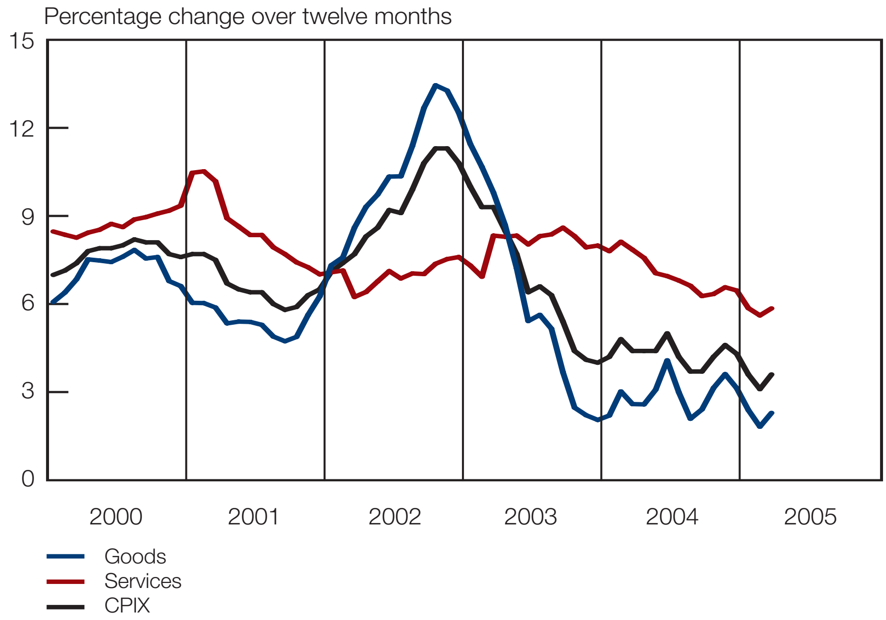
Figure 2 The effect of food and energy prices on CPIX inflation



Source: Statistics South Africa and SARB calculations

The inflation rates for the goods and services categories of CPIX are presented in Figure 3. As the graph shows, services price inflation trended downward throughout 2004 and into 2005, declining to below the upper end of the inflation target range in January 2005 for the first time since the introduction of inflation targeting. The year-on-year inflation rate for services prices increased from 6,3 per cent in September to 6,6 per cent in November 2004 before receding to 5,6 per cent in February 2005. In March, the services price inflation rate was 5,9 per cent. Goods prices, by comparison, rose by 3,6 per cent over the twelve months to November 2004 before decelerating to 2,3 per cent by March 2005.

Figure 3 CPIX: Goods and services inflation

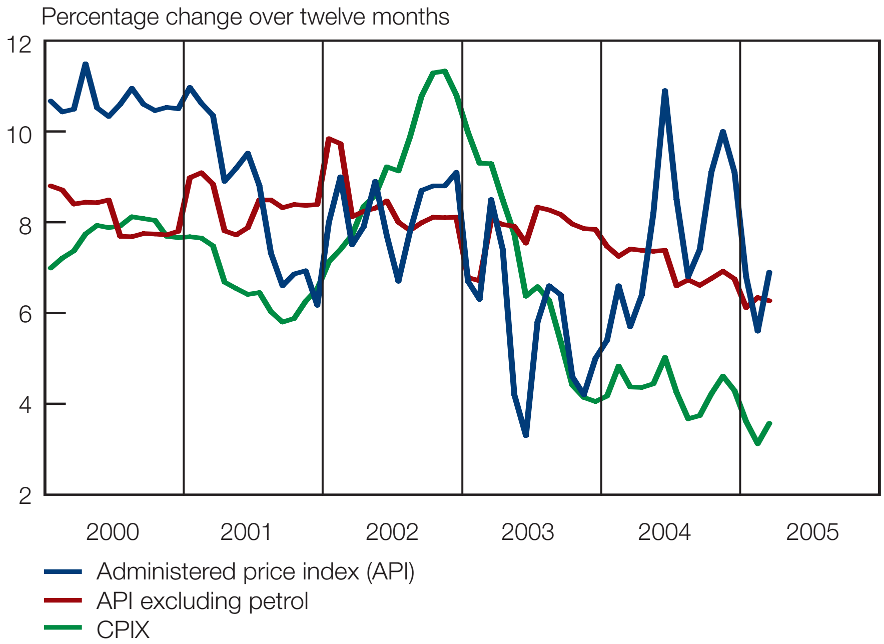


Source: Statistics South Africa

As the construction of the official index of administered prices by Statistics South Africa is still under way, the index of administered prices calculated by the Reserve Bank is presented in Figure 4 (Box 1 in the April 2002 *Monetary Policy Review* provides details). Since petrol has a weight of 20,7 per cent in this calculation (5,08 per cent in the CPIX basket), the recent fluctuations in petrol prices have had a significant influence on the index. The year-on-year inflation rate for the administered price index increased from 6,8 per cent in August 2004 to 10,0 per cent in November 2004, with petrol prices contributing 4,4 percentage points to this total. The rate then declined to reach 5,6 per cent in February 2005 before rising to 6,9 per cent in March (petrol prices contributing 0,5 and 1,8 percentage points, respectively). Excluding the petrol component, therefore, the inflation rate for the remaining administered prices continued the downward trend began in mid-2003, reaching 6,3 per cent in March 2005.

The overall production price index (PPI) inflation rate began to rise in May 2004 but production price inflation has since remained low (Figure 5). Twelve-month PPI inflation increased to 2,5 per cent in November 2004 before declining to 1,4 per cent and 1,2 per cent during January and February 2005, respectively. In March, an inflation rate of 1,9 per cent was recorded. This subdued performance can be attributed mainly to the impact of the stronger exchange rate of the rand and low inflation rates in South Africa’s main trading partners on the production prices of imported goods. Figure 5 shows that prices of these goods increased by 0,3 per cent in January, declined by 0,7 per cent in

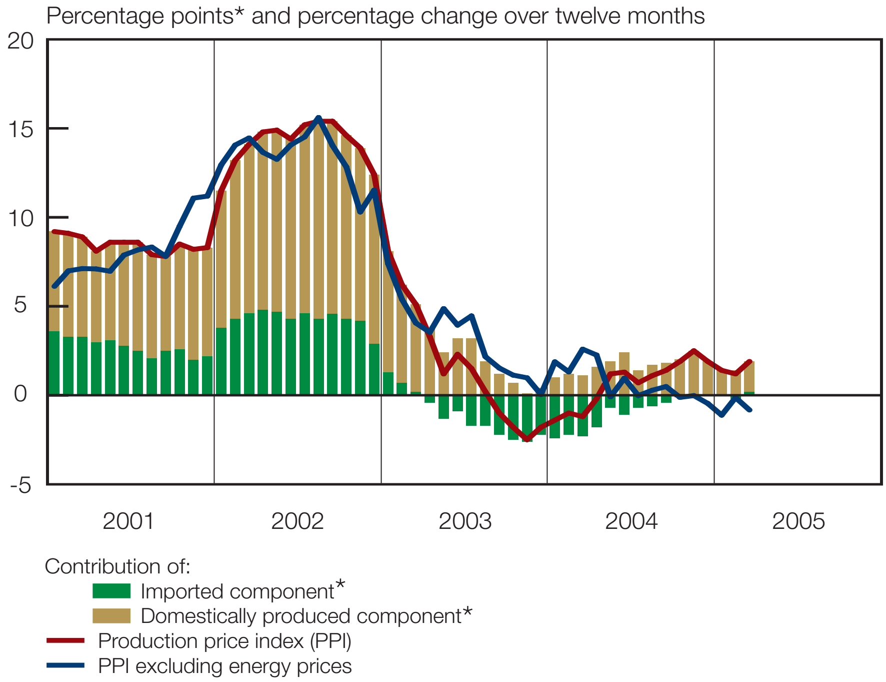
Figure 4 CPIX and administered prices



Source: Statistics South Africa and SARB calculations

February, and rose by 0,7 per cent in March 2005. The year-on-year inflation rate for domestically produced goods has also been relatively subdued, increasing from 2,4 per cent in September 2004 to 3,4 per cent in November before slowing to 2,3 per cent in March 2005. Excluding energy prices, production prices have declined on a year-on-year basis in each month since October 2004.

Figure 5 Production price inflation



Source: Statistics South Africa

Measured as the annualised quarter-on-quarter rate of increase in the seasonally adjusted data, PPI inflation slowed from 1,5 per cent in the third quarter of 2004 to 0,9 per cent in the final quarter, and then declined by 0,5 per cent in the first quarter of 2005.

Factors affecting inflation

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

International economic developments

After growing strongly in late 2003 and early 2004, global growth has moderated partly as a result of higher international oil prices. A growth rate of 5,1 per cent, the highest for the world economy in nearly 30 years, was nevertheless reported by the International Monetary Fund (IMF) for 2004 (Table 2). The expansion has, however, tended to become less balanced, although the inflation environment remained for the most part benign, with little evidence of second-round effects from higher oil prices.

Table 2 Annual percentage change in real gross domestic product and consumer prices

	Real GDP	Consumer prices
	2004	2004
World	**5,1**	**3,7**
Advanced economies	**3,4**	**2,0**
United States	4,4	2,7
Euro area	2,0	2,2
United Kingdom	3,1	1,3
Japan	2,6	0,0
Other advanced economies	3,8	1,8
Other emerging-market and developing countries	**7,2**	**5,7**
Africa	5,1	7,7
Central and eastern Europe	6,1	6,6
Commonwealth of Independent States	8,2	10,3
Developing Asia	8,2	4,2
China	9,5	3,9
India	7,3	3,8
Middle East	5,5	8,3
Western hemisphere	5,7	6,5

Source: IMF *World Economic Outlook*, April 2005

Growth of 3,4 per cent in the advanced economies in 2004 was aided by a stronger-than-expected expansion in the US which offset disappointing growth in Europe and Japan. In the US, real gross domestic product (GDP) growth accelerated from 3,0 per cent in 2003 to 4,4 per cent in 2004, although third and fourth-quarter annualised growth rates moderated to 4,0 and 3,8 per cent, respectively. The United Kingdom (UK) economy also slowed gradually through the year, as the Bank of England's Monetary Policy Committee raised the cost of borrowing by a quarter percentage point on five occasions between November 2003 and August 2004. However, growth remained robust at 3,1 per cent for 2004.

In the euro area, GDP growth for 2004 as a whole was 2,0 per cent, compared with 0,5 per cent in 2003, while growth in Japan has continued to be uneven. The growth performance was very strong from mid-2003 to early 2004, but a sharp slowdown was recorded in the latter part of last year. Consequently, although 2,6 per cent growth was recorded for 2004 as a whole, the Japanese economy registered approximately zero expansion in the last three quarters of the year.

Developing Asia generated considerable economic momentum in 2004 when GDP growth averaged 8,2 per cent, the fastest growth rate since the 1997-98 Asian financial crisis. This was aided by China's real GDP growth of 9,5 per cent, despite efforts by the Chinese government to slow the economy in 2004. India also grew strongly at 7,3 per cent. In spite of the terrible humanitarian cost of the tsunami resulting from the earthquake that occurred off the northwest coast of Sumatra on 26 December 2004, the impact of the catastrophe on growth in the region is expected to be limited.

In Latin America growth exceeded expectations in 2004, with Brazil growing at 5,2 per cent, while Central and Eastern Europe experienced their strongest growth since the beginning of the transition to more market-oriented economic systems. In the Commonwealth of Independent States higher-than-expected growth was driven largely by buoyant domestic demand and high energy and metals prices. Robust growth of 5,5 per cent was also recorded in 2004 by the oil-exporting countries of the Middle East.

Sub-Saharan Africa posted its highest GDP increase in a decade as strong global demand and prices for commodity exports, better macroeconomic policies and structural reforms in a number of countries in the region provided an encouraging boost to the poverty-reduction efforts of these countries. Economic growth in sub-Saharan Africa amounted to 5,1 per cent in 2004, with particularly impressive growth being recorded by the oil-producing countries.

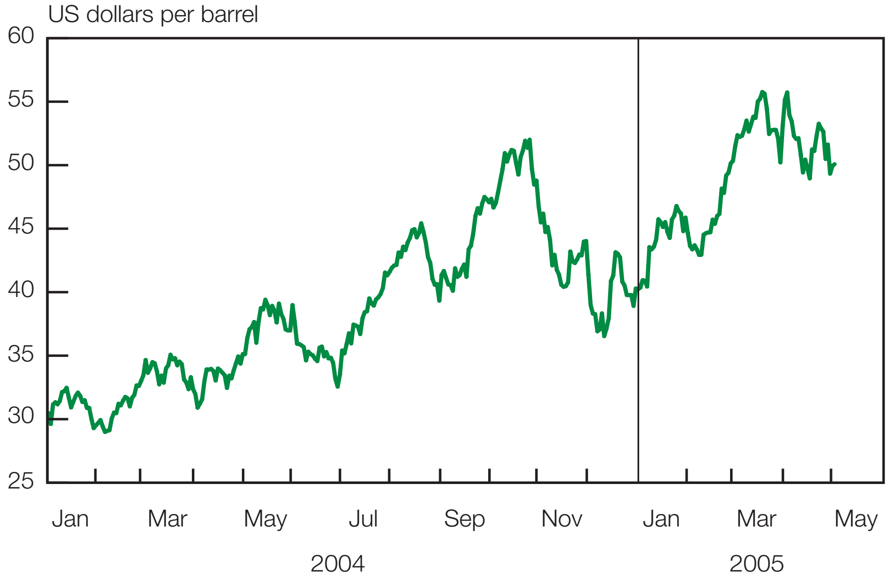
Oil prices

The strong global economic recovery has contributed to upward pressure on commodity prices and especially to a sharp increase in international crude oil prices during 2004. Excess capacity in the Organization of the Petroleum Exporting Countries (OPEC) has reached record low levels and actual oil production exceeded current output quotas during the past two years. The discussion in Box 1 suggests that conditions in the international oil market may indeed remain tight in the longer term.

The price of Brent crude oil increased significantly from around US$30 per barrel at the beginning of 2004 to US$52 per barrel in October before falling to below US$37 per barrel in early December (Figure 6). Crude oil prices began to increase once more in December after OPEC requested member countries to reduce actual production by 1 million barrels per day from January 2005 to meet the previously agreed output quota of 27 million barrels per day. OPEC decided in January to maintain the agreed output quotas but announced that the price band mechanism would be temporarily suspended, pending the completion of further studies on the subject. Crude oil prices continued to be highly volatile and reached levels of around US$47 per barrel towards the end of January before dropping below US$44 per barrel in early February after the elections in Iraq passed without disruptions to oil production.

Crude oil prices started to increase towards the end of February and accelerated further during March after the International Energy Agency (IEA) increased its estimate for global oil demand in 2005 for the third consecutive month. The IEA projected in December 2004 that global oil demand would increase to 83,7 million barrels per day in 2005. However, the March 2005 IEA projections showed oil demand in 2005 increasing to 84,3 million barrels per day. OPEC countries decided in March to increase output quotas immediately by 500 000 barrels per day and pledged an additional 500 000 barrels per day should oil prices not decline. The price of Brent crude oil, however, increased further to levels around US$55 per barrel as markets feared that global oil production might fail to keep pace with rising demand.

Figure 6 Price of Brent crude oil



Source: Bloomberg

Crude oil prices again declined to around US$50 per barrel towards the end of March but increased above US$55 per barrel in early April following a research report released by Goldman Sachs that revised its “superspike range” to US$50 – US$105 per barrel in the next several years. Crude oil prices have since declined to levels around US$50 per barrel due to favourable pronouncements regarding production levels in OPEC countries. The IEA also lowered its forecasts for global oil demand marginally by 50 000 barrels per day in its April 2005 montly report.

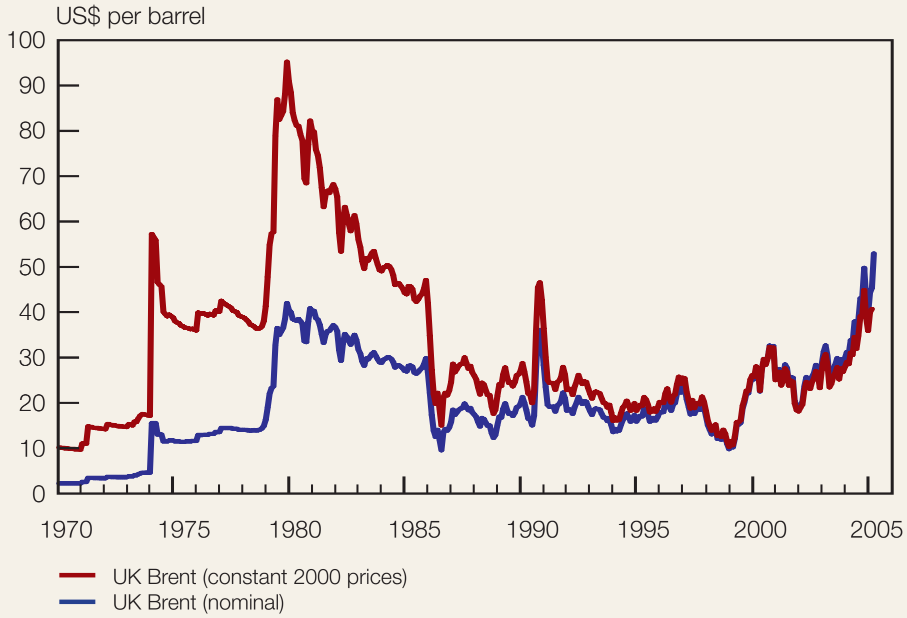
Box 1 Prospects for the world oil market

The long-term prospects for the international oil market appear to have taken a turn for the worse. Although current prices are well below the levels reached in the 1970s when measured in real terms, and the magnitude of the recent increases is limited relative to those experienced at that time, the longer-run outlook for the oil market suggests that there is a significant risk that conditions may remain tight. This is the view of the IMF [1], for example, whose analysis appears qualitatively consistent with that of other relevant institutions such as the International Energy Agency (IEA), the OPEC Secretariat and US Department of Energy (DoE). This box discusses these recent projections for the international oil market.

Although nominal oil prices have reached record highs in recent months, it is important to keep in mind the historical perspective provided by Figure B1.1. As the graph shows, and as a number of commentators have stressed, prices measured in real US dollar terms are far below the levels reached in the late 1970s and early 1980s. It is also clear from the graph that the price increases experienced in recent months are not nearly as severe as those of 1974 and 1979.

1 *The discussion of this view is based on Chapter 4 of the* World Economic Outlook, *April 2005 and "Oil Market Developments and Issues", Policy Development and Review Department, IMF, 1 March 2005.*

Figure B1.1 Brent crude oil prices



Source: IMF, *International Financial Statistics*

A fundamental determinant of oil prices now and in the future is the balance between supply and demand for oil in the various markets. In the shorter term, when temporarily higher demand (e.g. as a result of a cold winter) or supply disruptions cause market conditions to tighten, the risk of price spikes increases. Provided the longer-term prospects for oil prices remain favourable, as they generally have in the 1985-2000 period, the impact of these increases on investment decisions and growth tends to be limited. When the likely evolution of the supply-demand balance over a longer horizon suggests that conditions will remain tight, however, these increases are likely to have a more significant impact on expectations and growth.

The balance between supply and demand in the oil market in the longer term is influenced by a complex set of factors which tend to act with long lags. Current oil prices are an important factor, for example. On the one hand, higher oil prices tend to encourage economies to reduce their dependence on oil, and also provide an incentive for producers to expand their production capacity and to facilitate the use of unconventional sources. As Federal Reserve Chairman Alan Greenspan recently said, "... if history is any guide, should higher prices persist, energy use will over time continue to decline, relative to GDP"[2]. The dependence of OECD economies on oil has undoubtedly declined over time, largely in response to the earlier oil price shocks of the 1970s and 1980s, although developing countries remain more energy-intensive in production. On the other hand, low current prices discourage energy conservation and investment in future production capacity. Regarding the latter, it is interesting that following the lower oil price environment of 1985-2000, OPEC's current production capacity is estimated by the IMF to be below the level of 1978.

Increases in supply are of course ultimately limited by the extent of unexploited reserves and the cost of exploiting these reserves. The distribution of reserves between the OPEC and non-OPEC countries is also a factor which will influence developments in the global oil industry. The IMF suggests that the responsiveness of non-OPEC oil supply is the key unknown in its projection of the supply-demand balance. If, as the IMF believes, supply from these countries will peak by 2010, then the importance of OPEC supply in meeting additional demand will increase after this date.

Taking these factors into account, then, what are the projections for demand and supply in the coming years? In line with the discussion of non-OPEC supply in the preceding paragraph, the baseline price path in the IMF's *World Economic Outlook* forecast is for the real price of oil (a simple average of West Texas Intermediate, Brent and Dubai prices) to decline from US$44,70 in 2005 to US$33,70 a barrel in 2010, and then to remain at this level until 2030. Table B1.1 shows the projected oil demand, non-OPEC supply and the residual "call on OPEC"[3] for the period 2010 to 2030.

2 Remarks by Chairman Alan Greenspan before the National Petrochemical and Refiners Association Conference, San Antonia, Texas, 5 April 2005.

3 This is the hypothetical amount that OPEC would need to produce to meet the shortfall between total demand and non-OPEC supply in the market.

Table B1.1 Projections: Oil demand, non-OPEC supply and call on OPEC

Millions of barrels per day

	2003 Actual	2004 Estimate	2010	2020	2025	2030
Baseline demand projection	79,8	82,4	92,0	113,5	125,5	138,5
Non-OPEC supply						
Lower bound	49,0	50,4	59,3	64,4	64,5	64,1
Upper bound	49,0	50,4	61,4	70,1	73,9	77,2
Call on OPEC						
Lower bound	30,7	32,0	30,6	43,5	51,6	61,3
Upper bound	30,7	32,0	32,7	49,2	61,0	74,4
Memorandum:						
Oil demand projection by agency						
IEA	79,8	…	90,4	106,7	…	121,3
DoE	79,8	…	91,1	110,0	120,6	…
OPEC Secretariat	79,8	…	88,7	105,8	114,6	…
Call on OPEC by agency						
IEA	30,7	…	33,3	49,8	…	64,8
DoE	30,7	…	35,7	47,8	56,0	…
OPEC Secretariat	30,7	…	34,1	48,9	58,3	…

Source: Reproduced from IMF *World Economic Outlook*, April 2005, p 170

As can be seen, the IMF's baseline projection is for global oil demand to increase to 92 million barrels per day in 2010, 113,5 million barrels per day in 2020 and eventually to 138,5 million barrels per day by 2030. Lower and upper boundaries are then provided for growth in non-OPEC supply, with the lower bound showing no increase in supply after 2020. The call on OPEC in order to meet projected demand therefore varies according to the path followed by non-OPEC supply. If this is at the lower bound, for example, the call on OPEC increases (according to the upper bound in the table) to 32,7 million barrels per day in 2010, 49,2 million barrels per day in 2020 and to 74,4 million barrels per day by 2030. The table also presents alternative oil demand projections by other agencies and corresponding estimates of the call on OPEC for comparison purposes.

The call on OPEC is projected to grow significantly over the coming years in the baseline projections presented by the IMF. After initially remaining approximately unchanged at around 32 million barrels per day until 2010, it then doubles to 61 – 74 million barrels per day in 2030. Significant investment spending will be required to meet this increase in demand, and concerns in this regard have been voiced. Since proved oil reserves are concentrated in its member countries, OPEC's response to the increase in demand will be the key determinant of future developments in the supply-demand balance and oil prices.

Although projections such as these provide important insights regarding the factors which are likely to influence the oil market, the IMF correctly stresses that long-run forecasts for oil supply and demand are subject to substantial uncertainties. Besides assumptions regarding the rate of global growth in future and the rate of growth of non-OPEC supply, more fundamental factors such as the manner in which technological progress will impact on the projections need to be considered. While this means that the risks to the projections are necessarily large, the importance of developments in the energy markets for policy-makers makes the exercise useful.

Key central bank interest rates

Table 3 presents the most recent interest rate changes made by central banks around the world. The US Federal Open Market Committee (FOMC) increased the target for the Federal Funds Rate in May 2005 to 3,0 per cent, the eighth consecutive 25-basis-point increase since the record low level of 1,0 per cent in June 2003. The FOMC noted that output was continuing to grow at a solid pace and that inflationary pressures had increased in recent months. The committee wanted to keep the upside and downside risks to sustainable growth and price stability equal, and believed that the existing monetary policy accommodation could be removed at a measured pace.

Table 3 Key central bank interest rates
Per cent

Countries	1 Jan 2004	3 May 2005	Latest change (percentage points)	
United States	1,00	3,00	3 May 2005	(+0,25)
Japan*	0,00	0,00	19 Mar 2001	(-0,15)
Euro area	2,00	2,00	6 Jun 2003	(-0,50)
United Kingdom	3,75	4,75	5 Aug 2004	(+0,25)
Canada	2,75	2,50	19 Oct 2004	(+0,25)
Denmark	2,00	2,00	6 Jun 2003	(-0,50)
Sweden	2,75	2,00	7 Apr 2004	(-0,50)
Switzerland	0 – 0,75	0,25 – 1,25	16 Sep 2004	(+0,25)
Australia	5,25	5,50	2 Mar 2005	(+0,25)
New Zealand	5,00	6,75	10 Mar 2005	(+0,25)
Israel	4,80	3,50	1 Feb 2005	(-0,20)
China	5,31	5,58	29 Oct 2004	(+0,27)
Hong Kong	2,50	4,25	23 Mar 2005	(+0,25)
Indonesia	8,31	7,70	20 Apr 2005	(+0,17)
Malaysia	**	2,70	23 Apr 2004**	
South Korea	3,75	3,25	11 Nov 2004	(-0,25)
Taiwan	1,38	1,88	24 Mar 2005	(+0,13)
Thailand	1,25	2,25	2 Mar 2005	(+0,25)
India	4,50	5,00	28 Apr 2005	(+0,25)
Brazil	16,50	19,50	20 Apr 2005	(+0,25)
Chile	2,25	3,00	7 Apr 2005	(+0,25)
Czech Republic	2,00	1,75	29 Apr 2005	(-0,25)
Hungary	12,50	7,50	26 Apr 2005	(-0,25)
Poland	5,25	5,50	27 Apr 2005	(-0,50)
Russia	16,00	13,00	15 Jun 2004	(-1,00)

* Japan eased monetary policy several times during 2003 and again in January 2004 by increasing the target range for the outstanding balance on reserve accounts at the Bank of Japan
** The central bank of Malaysia introduced a new interest rate framework on 23 April 2004

Source: National central banks

The Bank of England (BOE) raised its repo rate by 25 basis points in August 2004 to 4,75 per cent, following three similar moves earlier in 2004 to keep inflation on track and meet the inflation target in the medium term. The BOE has since left interest rates unchanged, although some members of its Monetary Policy Committee are in favour of higher interest rates due to high growth in demand in the UK economy.

The European Central Bank (ECB) has kept its official interest rate unchanged at 2 per cent since June 2003 and is satisfied that there is no significant evidence of underlying domestic inflationary pressures building up in the euro area. However, the ECB will continue to monitor the medium-term upside risks to price stability given the high level of international oil prices. Although the Bank of Japan has maintained its policy interest rate near zero since 2001, it has eased monetary policy several times during 2003 and again in January 2004 by increasing the target range for the outstanding balance on reserve accounts held by private financial institutions at the Bank of Japan. The monetary authority is currently willing to provide sufficient liquidity to the markets until the year-on-year rate of change in core consumer prices registers zero per cent or higher on a sustainable basis.

After having kept monetary policy unchanged since the end of 2003, the Reserve Bank of Australia increased its cash rate by 25 basis points to 5,5 per cent in March 2005. This increase was considered necessary due to a gradual increase in underlying inflation and limited spare capacity in the economy. The Reserve Bank of New Zealand has increased its official cash rate by a cumulative 175 basis points to 6,75 per cent since the beginning of 2004 as inflationary pressures remained strong.

Brazil's central bank raised its benchmark lending rate to 19,50 per cent in April 2005 following evidence of inflationary pressures and the increase in oil prices. The year-on-year increase of 7,5 per cent in Brazil's consumer prices in March is still higher than the inflation target of 5,1 per cent for 2005. The central bank of Chile increased its key interest rate by 25 basis points to 3,0 per cent in April 2005 due to robust domestic expenditure and a gradual increase in core inflation.

The pronounced disinflationary trends in the Czech Republic, Hungary and Poland provided the opportunity for the respective central banks to reduce their interest rates further in April 2005. The Bank of Israel also lowered its short-term interest rate by 40 basis points during January and February 2005.

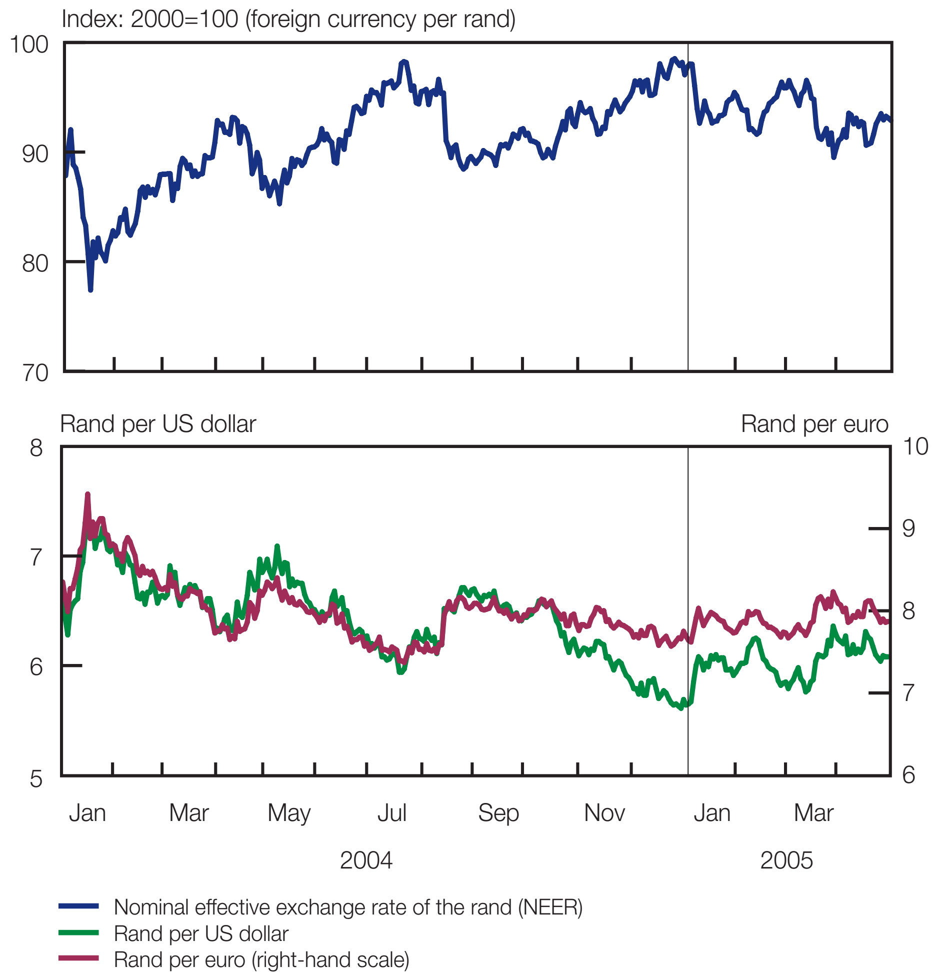
China tightened monetary policy for the first time in nine years in October 2004 due to concerns about the overheating of its economy. Interest rates in China were increased by 27 basis points to 5,58 per cent. The Bank of Thailand increased its 14-day repurchase rate by a cumulative 75 basis points in 2004 and a further 25 basis points in March 2005 to 2,25 per cent. The Bank of Thailand expects strong economic growth in the coming months as the negative impact of the tsunami disaster has been less severe than previously anticipated, although the impact of higher oil prices is expected to start feeding through to inflation. Taiwan also raised interest rates in March 2005 to 1,88 per cent. By contrast, the Bank of Korea lowered the target for the overnight call rate by a cumulative 50 basis points to 3,25 per cent during 2004 due to a slowdown in the pace of recovery and subdued consumer demand.

Exchange rate developments

The exchange rate of the rand measured against a basket of currencies is currently around its average level for the past 10 months. As the graphs in Figure 7 show, the nominal effective exchange rate of the rand appreciated in the period between August and December 2004 partly as a result of US dollar weakness, and then trended downward once more in 2005. As usual, the performance of the rand in the period since the publication of the previous *Monetary Policy Review* in November 2004 has been influenced by both international and domestic factors.

Movements in the exchange rate of the US dollar against a broad spectrum of currencies have been an important factor affecting the rand in this period. The dollar initially strengthened from the end of 2004 to mid-February 2005 as a result of favourable pronouncements and economic data releases, and the 25-basis-point increase in the Federal Funds Rate on 2 February. The currency then weakened on international markets until early March, influenced by continued concerns about the increasing US trade deficit and speculation about possible central bank diversification of foreign exchange reserves from US dollars into alternative currencies. Subsequently, however, the dollar strengthened once more, supported by a further 25-basis-point increase in the Federal Funds Rate on 23 March and positive consumer and producer data released for February.

Figure 7 Exchange rates of the rand

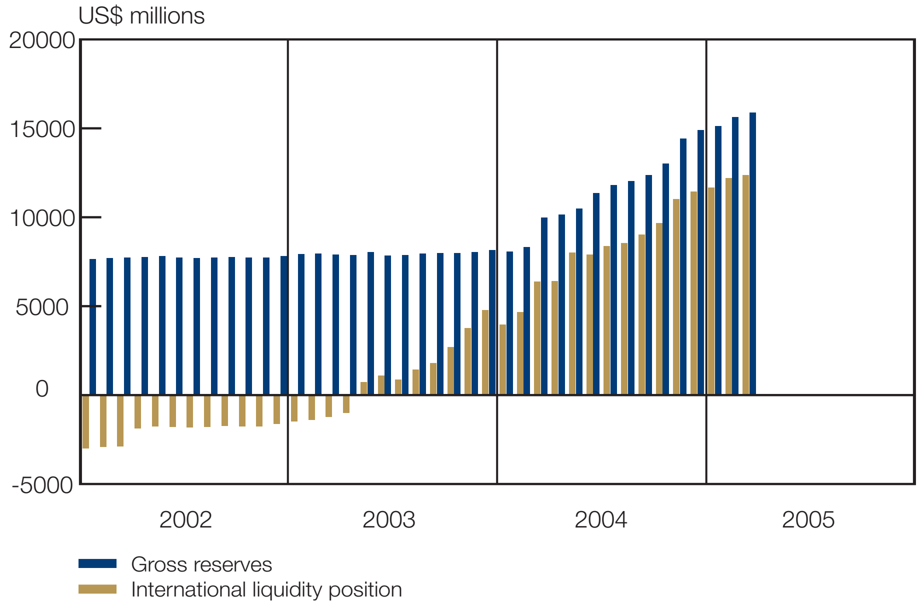


Various other factors have also contributed to the recent performance of the rand. International perceptions of South Africa's economic fundamentals continued to improve, influenced by factors such as a more favourable growth performance, an improved foreign-exchange reserve position, continued sound fiscal management and better inflation performance. A ratings upgrade was consequently received from Moody's Investor Services in January 2005. The period under review also saw a significant inflow of capital. The last quarter of 2004 saw net purchases of about R24 billion worth of bonds and equities by foreign investors, followed by a further R7,8 billion from January to March 2005. Partly absorbing these flows, the deficit on the current account of the balance of payments widened once more in the fourth quarter of 2004 as increases in the value of imports and net service and income payments more than offset the growth in export values.

Reserve accumulation

Figure 8 reveals that the South African Reserve Bank has continued to purchase foreign exchange in order to build up reserves in a gradual manner. The Bank's gross reserves increased from US$12,4 billion at the end of September 2004 to US$15,9 billion at the end of March 2005, while the international liquidity position (net reserves) improved from US$9,0 billion to US$12,4 billion over the same period.

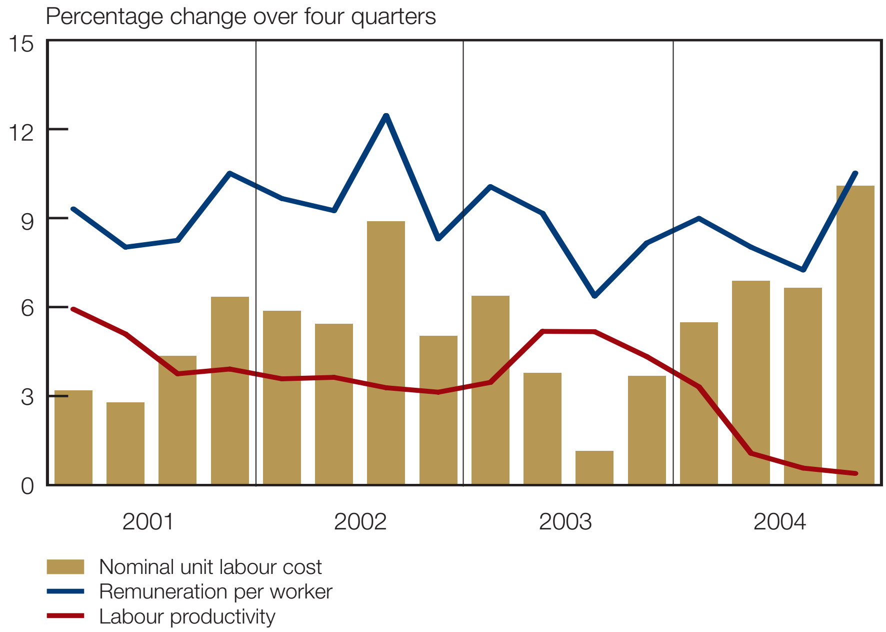
Figure 8 Official reserve position of the South African Reserve Bank



Unit labour cost

Developments in unit labour cost, measured as the ratio of remuneration per worker to output per worker in the formal non-agricultural sector of the economy (Figure 9), require careful consideration in the period under review. Revisions to the Survey of Employment and Earnings by Statistics South Africa now show nominal remuneration per worker

Figure 9 Renumeration per worker, labour productivity and unit labour cost in the formal non-agricultural sector



Source: Statistics South Africa

growing by 7,3 and 10,5 per cent year on year in the third and fourth quarters of 2004, respectively, although the latter increase in particular is well above the annual average results obtained from surveys of wage settlements. Average nominal wage settlements are reported by Andrew Levy Employment Publications to be 6,8 per cent for 2004, and 6 per cent in the first quarter of 2005. With the downward trend in labour productivity growth continuing, year-on-year unit labour cost duly increased by 6,6 per cent in the third quarter and by 10,1 per cent in the fourth quarter of 2004.

The growth in labour productivity has declined continuously from 5,2 per cent in the third quarter of 2003 to 0,4 per cent in the final quarter of 2004. Measured here as the ratio of real value added to employment in the formal non-agricultural sector, this decline is largely attributable to increases in employment more than offsetting increases in real value added.

Demand and output

Since the November 2004 *Monetary Policy Review*, Statistics South Africa and the South African Reserve Bank have published a revised set of national accounts data for the post-1997 period. The exercise resulted in level adjustments to the data and also involved changing the base year from 1995 to the year 2000. Table 4 examines the recent growth in real GDP using these data.

Table 4 Growth in real gross domestic product and expenditure components

Per cent

	2003			2004				
	3rd qr	4th qr	Year	1st qr	2nd qr	3rd qr	4th qr	Year
Final consumption expenditure by households	5,6	5,9	3,4	6,2	6,4	6,6	7,1	6,1
Final consumption expenditure by government	6,4	13,9	6,4	6,0	6,2	0,2	13,2	7,2
Gross fixed capital formation	7,2	10,1	9,0	11,6	10,1	7,4	9,1	9,4
Changes in inventories (R billions)*	9,2	9,2	9,2	9,6	14,9	13,6	7,6	11,4
Gross domestic expenditure	**6,0**	**8,6**	**5,3**	**5,4**	**8,8**	**2,6**	**4,4**	**6,3**
Exports of goods and services	-0,2	-0,9	-0,9	-10,8	15,9	11,4	23,8	2,9
Imports of goods and services	14,3	20,6	8,5	-4,2	34,1	-0,5	23,3	12,9
Gross domestic product	**2,3**	**3,1**	**2,8**	**3,8**	**4,4**	**5,7**	**4,0**	**3,7**

Quarterly data refer to quarter-on-quarter growth at annual rates of seasonally adjusted data
* Constant 2000 prices

Buoyed by sustained strong growth in domestic demand, the growth rate of real GDP accelerated to 5,7 per cent in the third quarter of 2004 before easing to 4,0 per cent in the final quarter of the year. For 2004 as a whole, real GDP growth increased to 3,7 per cent from 2,8 per cent in 2003.

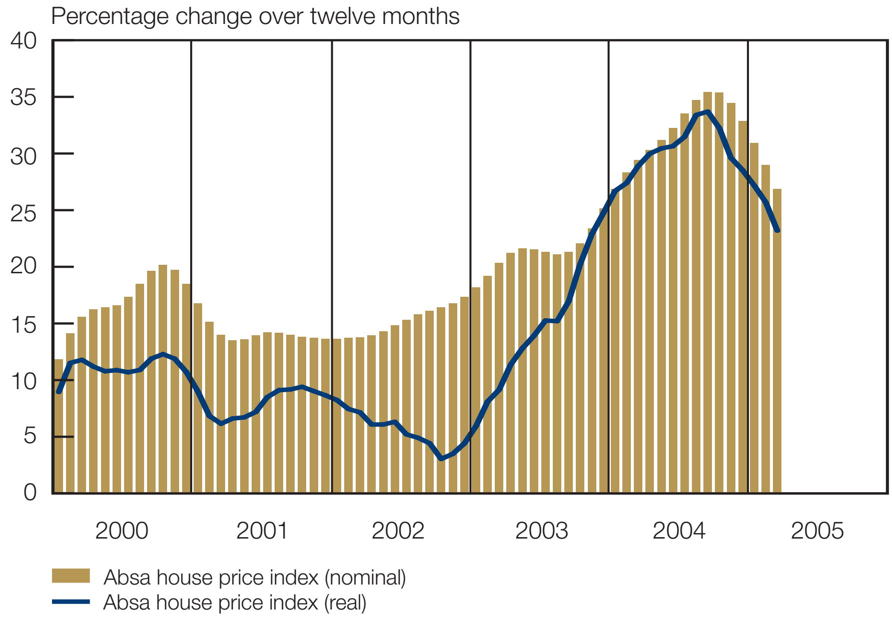
Domestic spending has generally been the main driver of this expansion, supported by growth in disposable income, buoyant real-estate and securities markets, and a favourable interest rate environment. Despite slowing to 2,6 per cent in the third quarter of 2004 largely as a result of weak final consumption expenditure by government, real domestic expenditure increased by 4,4 per cent in the fourth quarter and by 6,3 per cent overall in 2004. The three main components of real final demand all contributed strongly in this regard. Final consumption expenditure by private households and general government increased by 6,1 per cent and 7,2 per cent, respectively, in 2004 and growth in gross fixed capital formation was even higher at 9,4 per cent. The increase in domestic demand coupled with the stronger exchange rate also stimulated growth in expenditure on imports of goods and services, which after slowing to 0,5 per cent in the third quarter jumped to 23,3 per cent in the final quarter, contributing to overall growth of 12,9 per cent for the year. Exports of goods and services, having contracted in 2003 and in the first quarter of 2004, increased once more in the last three quarters of the year to record growth of 2,9 per cent overall.

Real output growth tended to be strongest in those sectors primarily oriented towards the domestic market in response to the expansion in expenditure. The slower growth recorded in the final quarter of the year was mainly the result of weakness in the primary and secondary sectors, and especially in the mining and manufacturing sectors which are most exposed to the effects of the stronger currency. However, in 2004 as a whole, the primary sector was able to expand real value added by 3,3 per cent, the secondary sector by 2,9 per cent, and the tertiary sector by 4,1 per cent.

Real-estate and equity prices

Robust growth has been a striking feature of the South African real-estate market in recent years, although house price increases have slowed in recent months. Figure 10 presents the year-on-year increases in house prices measured by the Absa house price index. This index records the total purchase price of houses in the 80 – 400 m^2 size category which are priced at less than R2,2 million and for which loan applications were approved by Absa. After peaking at just over 35 per cent in September 2004, growth in nominal house prices declined to reach 26,9 per cent in March 2005. In real terms, the corresponding rates are 33,7 per cent in September 2004 and 23,2 per cent in March 2005. Box 2 provides an international perspective on these developments.

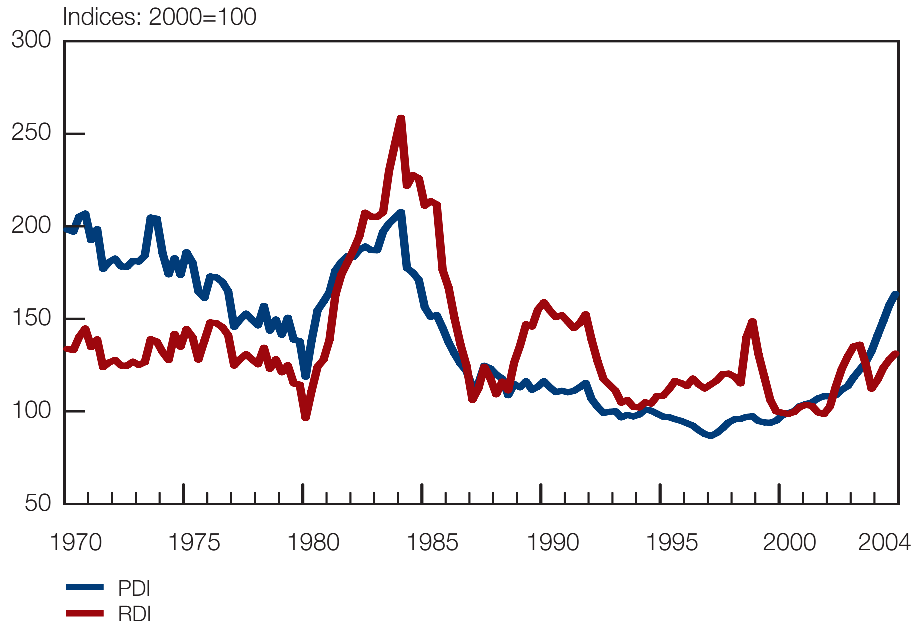
Figure 10 House prices



Source: Absa

A factor which may help explain the slower growth in house prices is the impact of buoyant market conditions on the affordability of houses. Figure 11 presents two indices which serve as proxies of affordability. In both cases an increase in the index represents a decline in affordability. The first (PDI) is simply the ratio of the indices of Absa nominal house prices to per capita disposable income. This broad measure shows that affordability has been deteriorating since 1997 as house prices have risen faster than increases in disposable income. The second measure (RDI), which is calculated as the ratio of mortgage repayments on an average priced house to per capita disposable income suggests, however, that there has been limited deterioration in affordability in recent years. Since this measure takes into account both house prices and the mortgage interest rate, increases in house prices which exceed increases in disposable income may be offset by lower interest cost.

Figure 11 Housing affordability indices



Source: Absa and SARB calculations

Note: A down payment of 20 per cent is assumed in the calculation of RDI. The mortgage rate is proxied by the predominant rate of banks for dwelling units, and the monthly repayment is calculated over a period of 20 years.

The values of building plans passed and completed are important indicators of real-estate sector activity. Table 5 shows that the values of both building plans approved and completed remain strong, particularly in the residential real-estate sector. The growth in the real value of buildings completed increased from 6,8 per cent in 2003 to 22,5 per cent in 2004, while the real value of building plans passed, a measure of future construction activity, increased by 33,0 per cent in 2004 compared with 11,3 per cent in 2003. The increases recorded in January – February 2005 relative to the corresponding months of 2004 were 9,9 per cent for the real value of building plans passed, and 20,4 per cent for the real value of buildings completed.

South African Reserve Bank

Box 2 Housing price dynamics: An international perspective

The behaviour of house prices is attracting attention in the media and from policy-makers in a number of countries around the world, in part due to the growing realisation of their importance for both monetary policy and financial stability in general. This box briefly discusses why house prices may matter, and reviews developments in these prices in South Africa and internationally. An analysis of trends in inflation-adjusted house prices in the post-1980 period is presented, and the factors which drive these trends are considered.

Why are developments in house prices important?

1 *Case K E, J M Quigley and R J Shiller. 2001. "Comparing Wealth Effects: The Stock Market Versus the Housing Market",* Cowles Foundation Discussion Paper No. 1335, *Yale University, October.*

A house is typically the most valuable asset a household owns. For financial intermediaries, the mortgages raised to finance the ownership of residential real estate constitute a significant portion of their portfolios. Fluctuations in house prices are therefore important to both groups, and by extension to the wider economy. Research suggests that changes in housing wealth influences consumption behaviour, for example[1], and that house prices play a potentially important role in the transmission of monetary policy via wealth and balance sheet effects (see Box 3, May 2004 *Monetary Policy Review*). In addition, the importance of mortgages in the asset-backed finance portfolios of banks and other financial intermediaries means that house prices also influence the performance of these institutions and of the financial system itself.

Trends in house prices

2 *For example Tsatsaronis K and H Zhu. 2004. "What drives housing price dynamics: cross-country evidence".* BIS Quarterly Review, *March; and Sutton G D. 2002. "Explaining changes in house prices".* BIS Quarterly Review, *September.*

Figure B2.1 presents inflation-adjusted house price indices for South Africa, Australia, the United Kingdom, Ireland, Canada and the United States. Although these indices may not be fully comparable between countries, given differences in measurement, they do provide a sense of the general trends – the long swings which are evident in the prices. Consistent with the findings of other studies[2], two periods of rapid growth can be observed in the graphs. The first of these is in the 1980s, followed first by a slowdown in the early 1990s as the global economy slowed, and then by a second period of growth which is most notable from the mid-1990s.

These broad trends disregard important differences in the experiences of the countries, however. Growth in house prices in Canada and the US, for example, has tended to be less volatile than in the other countries in Figure B2.1, although real house prices are nevertheless at historic highs in the US at present. Also, the more recent upswing appears to have begun earlier in the UK, Australia and the US than in South Africa, where prices accelerated late in the decade.

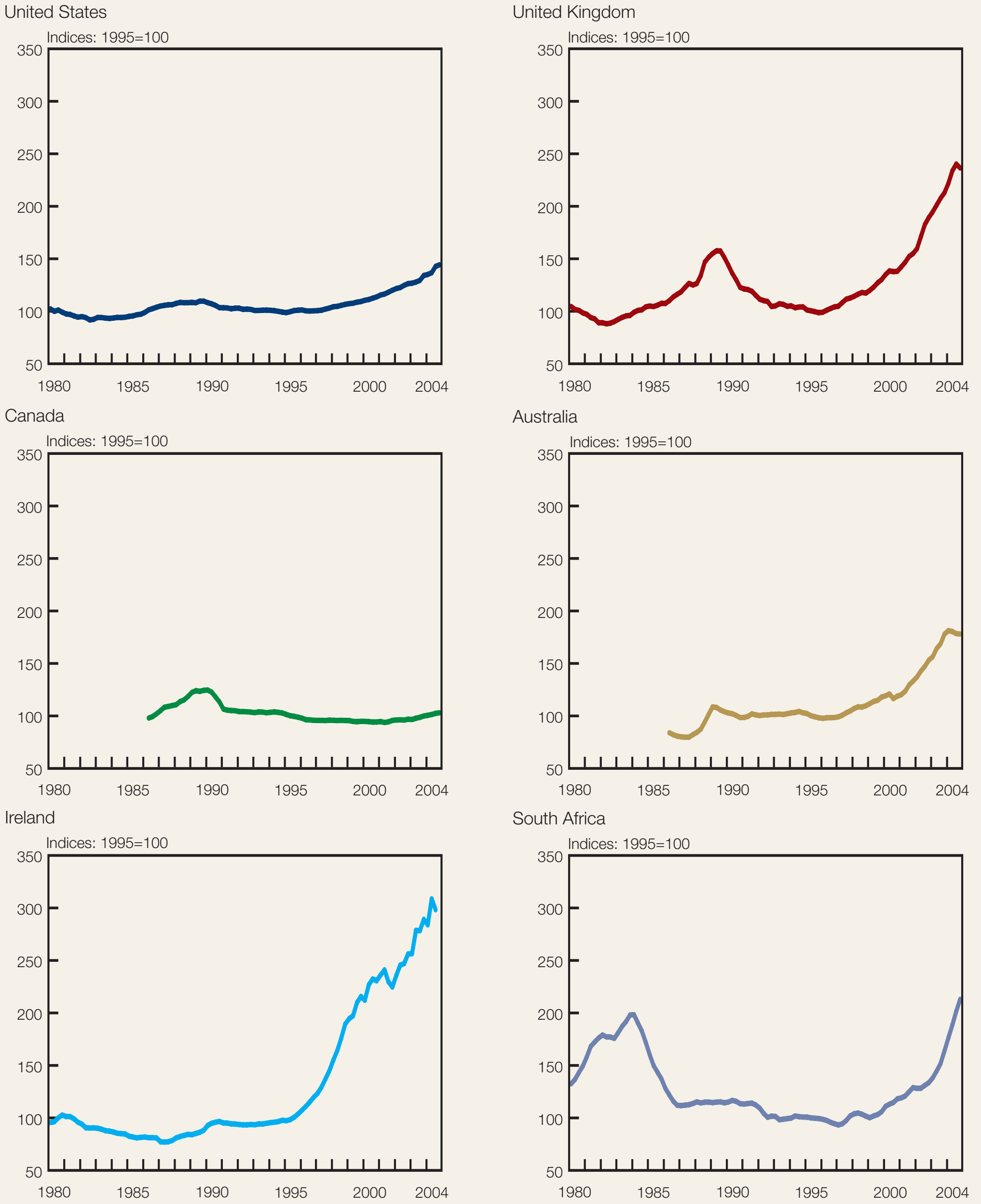
What drives house prices?

House prices, like other prices, are determined by demand and supply factors. Tsatsaronis and Zhu (2004), for example, distinguish between factors that operate in the longer term, and those that impact on the shorter-term dynamics of house prices. Furthermore, differences in the characteristics of national housing markets mean that these factors may affect house prices differently in different countries. In fact, this is the case even within countries.

In the longer term, the demand for housing would tend to be positively related to household income and wealth (both current and expected). Moreover, since a house is a long-lived asset that provides services over an extended period, the current and future interest rates used to discount this stream of services is an important determinant of its price. It follows, therefore, that a shift to a lower inflation environment that reduces these interest rates would tend to boost house prices. Shifts in demographics (e.g. population movements or changes in the age profile which impacts on the number of potential new buyers), amendments to the tax system that favour home ownership or changes in the financial service markets that promote ownership would also impact on demand. The supply of housing is influenced in the longer term by factors such as the availability of land, the existing stock of housing and the cost of adding to this housing stock.

Supply factors tend to be relatively inflexible in the shorter term, while the planning and construction phases involved in expanding the housing stock occur. Consequently, movements in house prices at this horizon may be attributed largely to demand factors. Demand factors which have received attention in the literature include the prevailing conditions relating to the financing of house purchases, the transaction cost framework and the general level of confidence in the housing market (which may remain low, e.g. following a period of volatility; Tsatsaronis and Zhu, 2004).

Figure B2.1 Inflation-adjusted house prices*



* Deflated using CPI data. For Ireland, quarterly house price data for the period 1980–98 are derived from annual data using the quadratic match average interpolation method.

Sources: Bloomberg, Absa, Nationwide, Irish Department of Environment and Local Government, Office of Federal Housing Enterprise Oversight and IFS.

Even though houses are not physically transferable, factors such as stronger global growth and the structural shift to lower inflation and interest rates in the 1990s are universal drivers of rising house prices. To the extent that the various demand and supply factors are national in character, however, the dynamics of house prices may differ across countries. In South Africa, declines in inflation and interest rates have been bolstered by a number of idiosyncratic factors which have supported the positive momentum in housing demand. There have been gradual reductions in both personal income taxes and transfer costs, and the growing economy has generated not only increases in income but has begun to modify its distribution. Greater access to the mainstream housing markets by previously excluded communities has contributed to the increased demand for housing. South Africa has also seen changes in the financial sector that have impacted on the dynamics of house prices, such as the emergence of securitisation of mortgage assets and the extension of the duration of mortgages. Collectively, these global and national factors explain the recent trends in house prices in South Africa.

Table 5 The real value of building plans passed and buildings completed

Percentage change

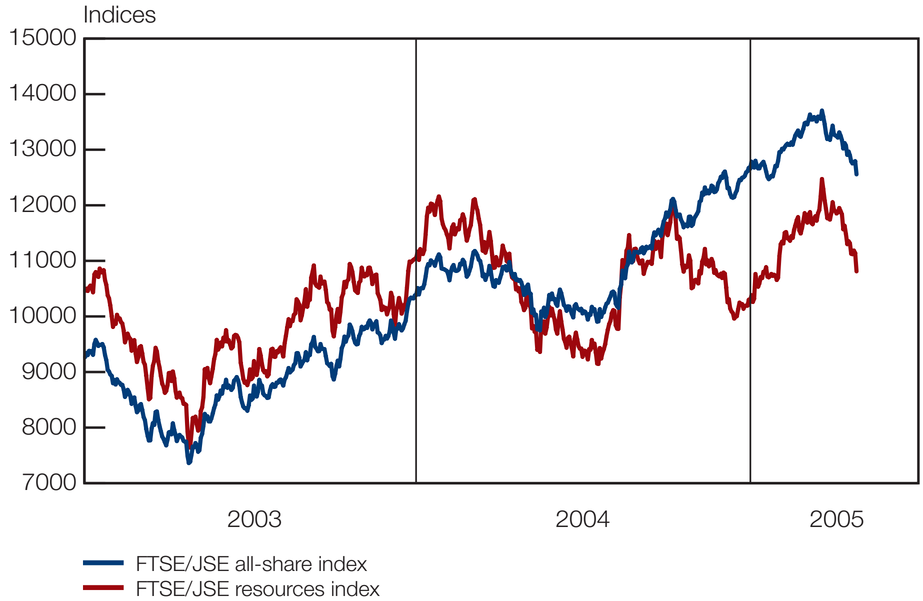
	2003	2004	2005*
Building plans passed			
Total	**11,3**	**33,0**	**9,9**
Residential	16,3	39,6	-3,2
Non-residential	3,5	18,1	40,0
Additions and alterations	6,3	27,6	30,4
Buildings completed			
Total	**6,8**	**22,5**	**20,4**
Residential	8,1	33,8	35,7
Non-residential	8,7	6,2	-5,1
Additions and alterations	1,4	5,8	4,3

* These figures are for January – February 2005 compared to the corresponding months of 2004

Source: Statistics South Africa

The lower domestic inflation and interest rate environment, good corporate performance, high international commodity prices and stronger global equity markets provided support to equity prices on the JSE Securities Exchange SA (JSE) until mid-March 2005. The closing level of the daily all-share price index as depicted in Figure 12 shows a continued upward trend in share prices from mid-2004, reaching a record high of 13 761 on 17 March 2005. The index then fell to below 12 500 at the end of April as world markets weakened. The resources index, which performed sluggishly between October and mid-December 2004, in part due to the strengthening of the exchange rate, then rose to reach a historic high level of 12 473 on 17 March 2005, before declining to around 10 650 at the end of April.

Figure 12 Share price indices



Fiscal policy

Government's fiscal policies remain supportive of monetary policy. The Budget presented on 23 February 2005 estimates total revenue for the 2005/06 fiscal year at R369,9 billion and makes provision for total expenditure of R417,8 billion, resulting in an estimated budget deficit of R48,0 billion (Table 6). This represents 3,1 per cent of GDP. The budget deficit as a proportion of GDP is projected to decline to 3,0 and 2,7 per cent, respectively, in the subsequent two fiscal years.

Table 6 Public finance data

	2002/03	2003/04	2004/05	2004/05	2005/06	2006/07	2007/08
	Actual	Actual	MTBPS Oct 2004	Revised estimates	Medium-term estimates		
National government (R billions)							
Revenue	278,5	299,4	328,2	338,0	369,9	405,4	444,6
Expenditure	291,5	328,7	371,7	370,1	417,8	456,4	494,9
Deficit (-)	13,0	29,2	43,5	32,2	48,0	51,0	50,3
As a percentage of GDP:							
Deficit (-)	1,1	2,3	3,2	2,3	3,1	3,0	2,7
Total gross loan debt	35,8	35,7	37,6	35,7	36,0	36,7	36,6
PSBR*	1,0	2,4	4,1	2,8	3,9	3,8	3,8

* PSBR: Public-sector borrowing requirement

Source: National Treasury *Budget Review* 2005 and *Medium Term Budget Policy Statement* 2004

The deficit to GDP ratio for 2004/05 has been revised to 2,3 per cent in the 2005/06 *Budget Review* from the 3,2 per cent envisaged in the 2004 *Medium Term Budget Policy Statement* (MTBPS). This is a consequence of revisions to historical GDP data, an increase in revenue collection and a slightly lower revised expenditure estimate. Indeed, higher than expected tax revenues suggest that the actual deficit for 2004/05 may be even lower than the revised 2,3 per cent of GDP.

The public-sector borrowing requirement (PSBR) for 2004/05 has also been revised downward from the 4,1 per cent of GDP presented in the 2004 MTBPS to 2,8 per cent in the 2005/06 *Budget Review*. The PSBR is estimated at 3,9 per cent of GDP in the fiscal year 2005/06, declining slightly to 3,8 per cent in the medium term.

Monetary conditions

Monetary aggregates have grown at a brisk rate in 2004 and early 2005 (Table 7), in line with the growth in domestic expenditure. The average monthly year-on-year growth rate in 2004 for the broad monetary aggregate, M3, was 13,3 per cent, although the rate decelerated from a high of 14,9 per cent in October to 11,9 per cent in March 2005. The movements in the year-on-year growth in the narrower aggregates were more pronounced than those in M3, with M1A and M1 growing at 16,6 per cent and 15,2 per cent, respectively, in 2004. Measured from quarter to quarter and at an annualised rate, M3 increased by 17,6 per cent in the final quarter of 2004 and by 6,0 per cent in the first quarter of 2005.

The total loans and advances credit aggregate accelerated in the period under review, driven mainly by growth in asset-backed finance (mortgage advances, leasing finance and instalment sale credit). On a year-on-year basis, the rate of increase in total loans and advances accelerated from 8,8 per cent in June 2004 to 17,8 per cent in March 2005, with growth in asset-backed finance increasing from 17,7 per cent to 22,9 per cent over the same period. Growth in mortgage advances recorded 24,2 per cent in March, while leasing finance and instalment sales credit grew by 15,2 and 21,0 per cent, respectively. Quarter-on-quarter annualised growth in total loans and advances accelerated from 10,1 per cent in the second quarter of 2004 to 27,0 per cent in the fourth quarter, before slowing to 20,0 per cent in the first quarter of 2005.

Table 7 Percentage change in monetary and credit aggregates
Per cent

Period		M1A	M1	M2	M3	Total loans and advances **
Quarterly change*						
2003	1st qr	-0,4	-1,4	14,7	11,6	12,4
	2nd qr	0,8	-3,7	23,5	19,8	22,3
	3rd qr	13,0	3,0	15,9	9,8	8,4
	4th qr	16,9	25,7	11,9	10,0	7,3
2004	1st qr	40,6	37,3	10,2	15,0	12,5
	2nd qr	8,1	-1,2	5,9	13,0	10,1
	3rd qr	0,7	10,0	13,8	13,0	12,5
	4th qr	10,6	14,0	19,1	17,6	27,0
2005	1st qr	17,0	-0,4	7,0	6,0	20,0
Twelve-month change						
2004	Jan	15,5	13,0	14,8	12,6	12,2
	Feb	22,1	19,3	16,6	14,9	12,5
	Mar	14,9	14,1	14,7	14,2	12,3
	Apr	16,9	13,0	11,5	12,6	9,9
	May	21,6	16,0	10,6	11,9	9,0
	Jun	18,3	18,9	9,7	11,8	8,8
	Jul	15,0	15,2	8,9	11,3	9,3
	Aug	16,7	17,6	10,2	13,3	11,4
	Sep	16,6	17,4	12,1	14,7	13,2
	Oct	14,9	14,9	12,3	14,9	15,2
	Nov	13,8	13,9	11,5	14,2	15,6
	Dec	12,3	9,0	11,0	12,8	16,1
Average		**16,6**	**15,2**	**12,0**	**13,3**	**12,1**
2005	Jan	10,1	5,7	10,5	12,0	17,0
	Feb	6,2	4,2	11,3	12,2	17,6
	Mar	13,4	8,4	12,6	11,9	17,8

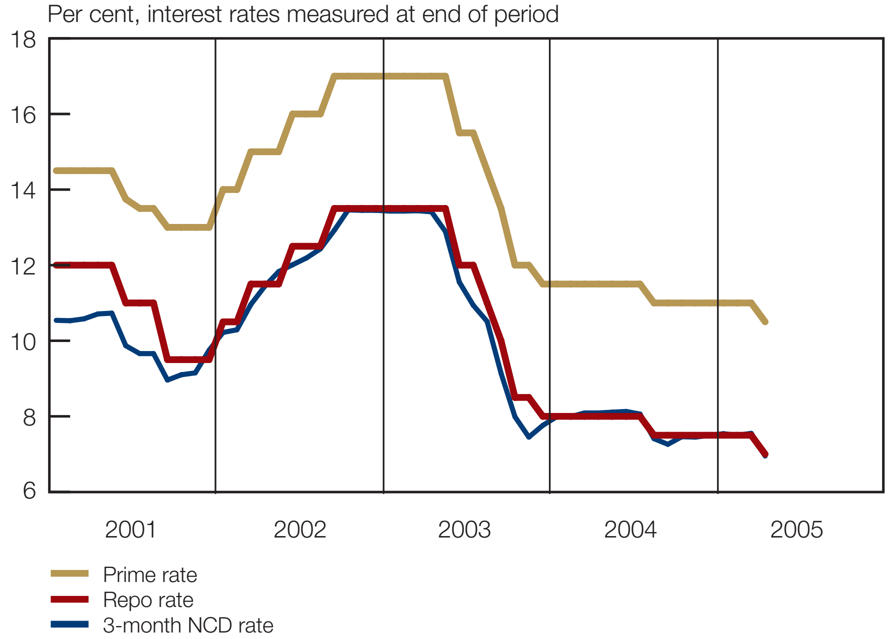
* Quarter-on-quarter growth at annual rates of seasonally adjusted data
** Total loans and advances to the domestic private sector excluding investments and bills discounted

Monetary policy

Since the publication of the previous *Monetary Policy Review* there have been three meetings of the MPC. At the December 2004 and February 2005 meetings the monetary policy stance was left unchanged. At the April meeting, the MPC decided to reduce the repo rate by 50 basis points (Figure 13) in view of an improvement in inflation expectations and a favourable expected inflation outcome in the next two years. Developments in the international oil markets and associated uncertainty dominated discussions not only of the threat to domestic inflation but also to world inflation and growth. However, despite the threat that looms over the market, the actual impact on world and domestic inflation has been far less marked than was the case during previous oil crises.

An important factor in determining the stance of monetary policy is the forecast generated by the Bank's macroeconomic models. As has been explained in previous

Figure 13 The repo and short-term interest rates



Monetary Policy Reviews, monetary policy is not set mechanistically according to the outcome of the central forecast. Some judgement is required as well. But the model does attempt to incorporate in a systematic way the combined impact of the different inflation determinants on the inflation outcome. In addition, forecasts presented at different meetings are subject to change, either because of a change in the assumptions about the exogenous variables (for example the international oil price) or forecast errors. In addition, the forecast is constructed on the assumption of an unchanged monetary policy stance. If the stance changes one would expect to see a change in the forecast.

The forecasts presented to the MPC in October 2004 showed that inflation was expected to peak at around 5,8 per cent in the third quarter of 2005 and then decline moderately. Since then the forecasts have predicted more benign inflation outcomes. In February 2005, the central forecast showed that inflation was expected to peak in the first quarter of 2006 at a level slightly above 5 per cent and to then decline towards the mid-point of the target. In April, the forecasts showed a similar pattern, although a slightly lower inflation path was predicted as a result of the unexpectedly low inflation outcome in the first month of this year. This was despite higher oil price assumptions factored into the forecast. The forecast presented to the MPC in April is reproduced later in this Review. The MPC's views on the outlook for some of the determinants of inflation are highlighted below.

A theme that dominated all three meetings was the developments in international oil prices. At the time of the December 2004 meeting, oil prices had receded from their October highs of over US$52 per barrel following the Iraqi elections. In November Brent crude oil averaged US$43,45, although the MPC acknowledged that the daily fluctuations clearly illustrated the nervousness in the market. By February 2005 the average oil price had risen slightly, although the combination of the lower prices in November and December, combined with a firm rand, resulted in a lowering of domestic petrol prices in January and February. Since then, international prices have resumed their upward movement, averaging just below US$55 per barrel in the two weeks before the April MPC meeting. The implications for domestic prices were a reversal of the petrol price reductions seen in previous months, and the likelihood that these increases would ensure that the 3,1 per cent CPIX inflation measured in February would represent the low point of the inflation outcomes for the time being.

At the time of the April meeting, uncertainty regarding the future course of the oil price had increased, with suggestions of high upside risk. However, the MPC had to consider a number of issues. First, although there is no doubt that higher oil prices do impact negatively on measured inflation, it is generally accepted that monetary policy should not respond to these first-round effects. In any event, as mentioned above, the forecasts showed that despite the higher oil price assumptions, inflation should remain well contained. In the event of an unexpectedly high “superspike”, monetary policy would have to remain vigilant of the second-round effects. Furthermore, in such an event, the impact on the real economy is likely to be contractionary, which could offset in part the impact of the higher oil prices on inflation. Precipitate tightening of monetary policy under such circumstances could intensify this contractionary effect. Second, there is the impact of higher oil prices on the international economy. Although there has been a significant increase in prices, the impact has been far more muted than in previous rounds of price increases. Despite the higher prices, the IMF still forecasts inflation to be well contained, and the latest *World Economic Outlook* projects world inflation to be marginally lower in 2005 than in 2004. This continued subdued world inflation has been one of the considerations in the setting of domestic monetary policy. The higher oil prices have, however, resulted in a downward revision of world economic growth of about 0,5 per cent.

Developments in wage settlements and unit labour cost were also closely monitored by the MPC. In February 2005, the committee commented on the favourable unit labour cost data, which showed that in the third quarter of 2004 unit labour cost had increased by 4,9 per cent compared to the third quarter of the previous year. At the time of the subsequent meeting, this figure had been revised up to 6,6 per cent, and the figure for the fourth quarter was 10,1 per cent. These figures appear to be a threat to the inflation outlook. However, the surveys on wage settlements continue to reflect a downward trend, with the latest figures for the first quarter of 2005 indicating settlements averaging 6 per cent. The MPC has in the past commented on the fact that wages tend to be set on the basis of past inflation, and therefore these settlements are likely to lag, but eventually follow, the downward trend in inflation. This pattern appears to be continuing, but the committee did raise a cautionary note.

Domestic expenditure trends continued to be carefully analysed in these meetings. As seen earlier, domestic expenditure remained robust and was sustained by higher consumer confidence, the stronger rand, lower interest rates, higher real incomes and high asset prices. There was, however, evidence that the rate of increase in house prices was slowing. Nevertheless, the strong consumer demand continued over the period but there was little evidence of inflationary pressure emanating from this. The strong domestic pressure was also reflected in the money supply and credit extension figures. Although M3 money supply growth has remained fairly stable at around 12 per cent on a year-on-year basis, credit extension has been growing at a much faster rate. Much of this was related to mortgage loans, reflecting the buoyant conditions in the property market, and the purchase of new motor vehicles which have reached near record highs.

Although output was also relatively robust it declined moderately in the fourth quarter of 2004 in line with the expectations of the MPC. In the April 2005 meeting, the committee was concerned about the slackening pace of growth in a number of sectors, in particular the manufacturing and gold-mining sectors. The outlook for growth in these sectors would be affected by world economic growth as well as the rand exchange rate.

The MPC also noted the fact that the current-account deficit has been increasing as a result of the higher levels of imported goods. In 2004 the current-account deficit as a percentage of GDP averaged 3,2 per cent for the year, and around 4 per cent in the fourth quarter. The MPC was, however, confident that deficits around these levels would continue to be financed comfortably through capital inflows.

The rand exchange rate, which has had an important impact on the inflation outcome in South Africa, has been a source of uncertainty. At the time of the December 2004 meeting, the rand had strengthened mainly as a result of dollar weakness, but subsequently the dollar recovered somewhat as US monetary policy was tightened. However, the continued imbalances in the US economy implied that the outlook for the US dollar, and therefore for the rand exchange rate, remained uncertain.

In the April meeting the MPC expressed concern about the fact that since the middle of 2004 the rand had been in a trading range significantly higher than was the case since the beginning of 2003. This was not only true against the US dollar. The average effective (trade-weighted) exchange rate index was approximately 10 per cent higher than its level between the beginning of 2003 and mid-2004. The MPC expressed concern regarding the impact of this development on certain sectors of the economy which were beginning to show signs of stress in the face of the stronger rand.

This concern has been interpreted in some quarters as a signal that there has been a change in the objective of monetary policy. However, it should be emphasised that achieving the inflation target remains the primary and overriding objective of monetary policy. The purpose of achieving this objective is not to achieve low inflation for its own sake, but to provide a stable platform for sustainable economic growth. When inflation is comfortably within the inflation target range, monetary policy has a greater degree of freedom to focus on other factors as well. Being concerned with the impact of developments in the rand exchange rate on the growth prospects of the economy is therefore entirely consistent with the inflation-targeting framework, where the control of inflation remains the overriding objective. These issues are discussed further in Box 3.

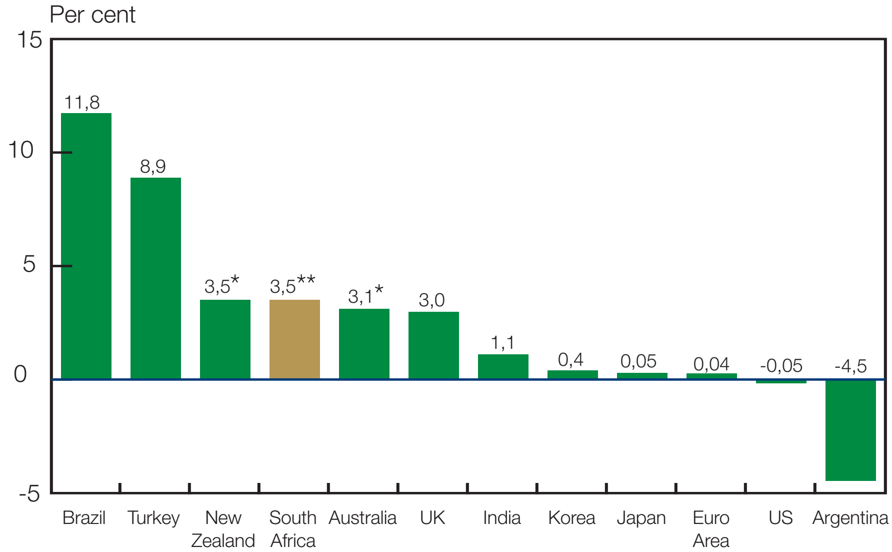
In the December meeting the committee noted that the increase in the price of consumer services had remained consistently above the upper level of the inflation target. By the April meeting, however, this measure had fallen below the 6-per-cent level for two consecutive months, measuring 5,6 per cent in February 2005. This was viewed as a positive development, as these prices are generally less affected by exchange rate developments than are goods prices. This reflected in part progress made by the public authorities in the containment of administered price increases. Fiscal policy also continued, and is expected to continue, to be supportive of monetary policy during this period, with the MPC highlighting the lower-than-expected budget deficit outturn for the 2004/05 fiscal year.

Other favourable developments over the period included the continued low levels of production price inflation, which indicate few pressures coming through on consumer prices in the short term and continued low levels of food price increases.

Finally, a further important positive development has been the evolution of inflationary expectations which are discussed in more detail later in this Review. All the recent surveys showed a progressive decline in inflation expectations. The results of the latest survey by the Bureau for Economic Research (BER) showed that all categories of respondents expected CPIX inflation to remain in the target range over the next three years. These improved expectations are seen as an illustration of the improved credibility of monetary policy and an important signal that low inflation is sustainable.

From the discussion above it is clear that the MPC was cognisant of the risks to the inflation forecast. However it was felt that, on balance, and given the favourable inflation outcome and expected outcomes, the factors supporting a further rate reduction outweighed the risks. Accordingly, the MPC decided at its April meeting that a further 50-basis-point reduction in the repo rate was justified. This brought the repo rate down to 7 per cent. Although this is low in nominal terms, real rates remain in line with those in a number of other countries including Australia, New Zealand and the UK, and are still significantly higher than those in the US and the euro area (Figure 14).

Figure 14 Real money-market interest rates in April 2005



* December 2004
** Calculated using CPIX inflation
3-month money-market interest rates adjusted using latest 12-month inflation in consumer prices

Source: Bloomberg and *The Economist*

Box 3 Inflation targeting and the objectives of monetary policy

Within an inflation-targeting framework, achieving and maintaining inflation at or around the target is the primary objective of monetary policy. The question that is often raised is whether or not monetary policy should have or does have other objectives as well. In South Africa, when interest rates were raised in 2002 in response to exchange rate developments, the Bank was accused of being indifferent to economic growth and of having exchange rate targets. More recently, the Bank's decision to lower interest rates has been met with criticism that the Bank is now targeting output and/or the exchange rate. Maintaining the inflation rate within the 3-6 per cent target range remains the overriding objective of monetary policy. However, to suggest that monetary policy does not take other developments into consideration in reaching a decision on interest rate changes is to misunderstand the nature of the inflation-targeting framework.

There are three main reasons for wanting to achieve low inflation. Firstly, there are good distributional and efficiency reasons. It is generally the case that the poor are affected most by inflation as they are least able to hedge against the ravages of high inflation. In addition, inflation can result in a misallocation of resources across sectors of the economy. Secondly, low inflation or price stability provides an anchor for inflation expectations. If inflation expectations are well anchored, this makes price stability easier to maintain in the long term. Finally, low inflation makes an important contribution to growth by providing a stable environment for sustainable economic growth. This is in line with the constitutional mandate of the Bank to protect the value of the currency in the interest of balanced and sustainable economic growth. In the long run, therefore, low inflation contributes to economic growth by providing a stable macroeconomic environment. This does not, however, imply that there is a long-run trade-off between growth and inflation. The Bank does not believe that higher long-run growth can be achieved through higher inflation. On the contrary, it believes that higher long-run growth will be achieved against a background of low inflation. Low inflation brings about lower interest rate variability and lower nominal interest rates on a sustainable basis which contribute to growth. More recently, with inflation remaining well contained within the inflation target range, higher levels of economic growth have been achieved on a sustainable basis which is indeed the reason monetary policy is directed at maintaining low inflation.

Achieving low inflation may incur short-run real costs, and there may be a trade-off between inflation variability and output variability in the short run. It is perhaps instructive to distinguish here between what is usually referred to as strict and flexible inflation targeting. Strict inflation targeting is when only inflation enters the central bank's objective function, while flexible inflation targeting is when other variables, such as output, have a positive weight in the objective function. The fact that most central banks to some extent have secondary objectives means that flexible inflation targeting is the general case.

The question then becomes how flexible inflation targeting is applied, or what weight is assigned to output? It is often the case that in the early phase of inflation targeting, a greater weight is assigned to inflation as credibility is built up. Monetary policy characterised by strict inflation targeting will try to hit the target as quickly as possible under all circumstances. Under flexible targeting, monetary policy will gradually push inflation towards the target. Most inflation-targeting models show that the stricter inflation targeting is, the more variable output will be. Too narrow a focus on inflation will result in interest rate and output instability. By contrast, too much of a focus on the cyclical growth issues will result in greater inflation variability and lower credibility for the whole inflation-targeting framework. The issue then is the appropriate trade-off between rigid adherence to the inflation target on the one hand and a steady path of output on the other, bearing in mind credibility considerations.

Even if a central bank does not have output variability or the size of the output gap as a specific objective of monetary policy, it is the case that in most models of inflation, the output gap is one of the determinants of inflation. A widening output gap (i.e. lower current or expected growth) implies less pressure on inflation, and therefore room for further monetary accommodation. Conversely, as the output gap closes, a tighter monetary policy stance is more likely.

Similarly, current or expected exchange rate developments will feed into the monetary policy decision-making process. An appreciating currency will be reflected in a more benign inflation forecast because of the direct price effect of import prices on domestic prices. Furthermore, an appreciating currency results in a contraction in output and an effective tightening of monetary conditions, and this impact on economic growth could be offset by lower interest rates. Furthermore, although monetary policy does not target the exchange rate, the valuation of the exchange rate could be cause for concern.

This does not mean that responses to exchange rate or output developments happen mechanically, i.e. that every time the exchange rate appreciates or output declines there will be an easing of monetary policy. The inflation outlook is impacted on by a number of concurrent and often contradictory forces, and the forecasting model will take this into account. In addition, the MPC will have to use its judgement as to the likely evolution of these variables. As long as the inflation target remains the overriding objective of monetary policy, it is appropriate that monetary policy takes cognisance of other variables that impact on inflation.

The outlook for inflation

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

International outlook

Having moderated as 2004 progressed, global growth looks set to continue at sustainable, though still robust, rates in 2005 and 2006. The IMF projects world growth at 4,3 per cent in 2005 and at 4,4 per cent in 2006 (Table 8). Global inflation is expected to remain subdued at 3,6 and 3,1 per cent in 2005 and 2006, respectively. Although macroeconomic policies and financial conditions remain generally supportive of growth, there are a number of threats and challenges to this outlook.

Table 8 IMF projections of world growth and inflation for 2005 and 2006

Per cent

	Real GDP		Inflation rates	
	2005	2006	2005	2006
World	**4,3**	**4,4**	**3,6**	**3,1**
Advanced economies	**2,6**	**3,0**	**2,0**	**1,9**
United States	3,6	3,6	2,7	2,4
Japan	0,8	1,9	-0,2	-0,0
Euro area	1,6	2,3	1,9	1,7
United Kingdom	2,6	2,6	1,7	2,0
Other advanced economies	3,1	3,4	2,0	2,1
Other emerging-market and developing countries	**6,3**	**6,0**	**5,5**	**4,6**
Africa	5,0	5,4	7,7	5,9
Central and eastern Europe	4,5	4,5	5,2	4,0
Commonwealth of Independent States	6,5	6,0	11,4	8,8
Developing Asia	7,4	7,1	3,9	3,4
China	8,5	8,0	3,0	2,5
India	6,7	6,4	4,0	3,6
Middle East	5,0	4,9	8,6	8,3
Western hemisphere	4,1	3,7	6,0	5,2

Source: IMF *World Economic Outlook*, April 2005

The projections in Table 8 indicate that US GDP will grow by 3,6 per cent in both 2005 and 2006. Inflationary pressures remain relatively benign as inflation is projected to slow from 2,7 per cent in 2005 to 2,4 per cent in 2006. However, uncertainties regarding the large deficits in the US and the future path of the US dollar exchange rate, which increase the risk associated with global imbalances, suggest that there are threats to these projections. The US budget proposals for the fiscal year 2006, which aim to halve the budget deficit in 4 years, will be an important step towards sustainability.

The euro area and Japan, which together account for nearly one quarter of global output, have performed disappointingly recently. Given strong economic ties, economic developments in these countries have a significant impact on growth prospects for South Africa. Growth in the euro area is projected at 1,6 per cent for 2005 improving to 2,3 per cent for 2006, and in Japan at 0,8 and 1,9 per cent for 2005 and 2006, respectively. The projections for inflation in Table 8 suggest that inflationary pressures are well contained in both cases. The UK economy is projected to grow by 2,6 per cent in both 2005 and 2006, with inflation rates of 1,7 and 2,0 per cent, respectively.

In Developing Asia growth is expected to be slightly slower in 2005 and 2006 at 7,4 and 7,1 per cent, respectively, compared with the 8,2 per cent growth rate achieved in 2004. China's economy grew by more than 9 per cent for the second straight year in 2004, and is expected to slow only slightly to 8,5 per cent in 2005 and 8,0 per cent in 2006. Despite slowing markedly in recent months, inflation in China remains a concern. The consumer price index registered a 3,9-per-cent increase in 2004, although this is projected to slow in 2005 and 2006. Latin America is expected to grow robustly this year, as is the oil-rich Middle East region, and prospects for growth in sub-Saharan Africa remain generally favourable.

Solid global growth is therefore expected in 2005 and 2006. However, there are important risks to the outlook which are perhaps tilted slightly to the downside. Some of the key risks cited by the IMF are the increasingly unbalanced nature of the global expansion, the possibility of a sudden tightening of financial conditions and further sharp increases in the oil price. The IMF forecasts are based on the assumption of an average price of oil of US$46,50 per barrel in 2005, and US$43,75 per barrel in 2006 (a simple average of the spot prices of UK Brent, Dubai, and West Texas Intermediate crude oil).

Outlook for domestic demand and supply

The domestic economy looks set to sustain the growth momentum which was established in 2004. The latest Reuters consensus forecast, based on surveys undertaken in late March 2005, is for real GDP growth of 4,1 per cent in 2005 and 3,8 per cent in 2006. The forecasts are the means of 13 individual forecasts ranging between 3,7 and 4,6 per cent for 2005, and between 3,4 and 4,5 per cent for 2006.

Domestic demand is likely to remain the most important force behind economic growth in 2005. Consumer confidence remains high, as is borne out by the near-record levels of the First National Bank/BER consumer confidence index in the first quarter of 2005. The improvement in this index in recent quarters has been broad-based as confidence increased across all population and income groups. The factors that pushed consumer confidence higher last year remained in place, including the lowest nominal interest rates in over two decades, low inflation, a surge in house and share prices, favourable personal tax rates, increased social grants and a moderate improvement in employment.

Economic activity on the supply side has also shown signs of expansion. The tertiary sector has contributed substantially to economic growth and remains resilient, and the extended period of growth in domestic demand has helped to offset the adverse impact of the exchange rate and disappointing export growth of the secondary sector. There is evidence, however, of a slackening of activity in parts of the manufacturing and primary sectors which is related to the stronger external value of the rand in the past six months.

Many companies have seen their profits soar, with the First National Bank/BER business confidence index recording a recent high in March 2005. Businesses also deemed this year's Budget and the amendment to the company tax rate as complementing the present favourable financial environment and ensuring continued momentum for medium-term economic growth. The South African Chamber of Business (Sacob) business confidence index registered 127,5 in March 2005, its highest level since reaching a record level of 130,9 in September 2004. However, the Standard Bank/Sacob Trade Conditions Survey, which appraises overall trading conditions in South Africa on a monthly basis, indicated that trade conditions had been slightly weaker in the first three months of 2005. The medium-term (six months ahead) outlook nevertheless continues to be quite optimistic according to the trade expectations index for March.

Indicators of inflation expectations

Expectations for CPIX inflation in 2005 have declined to the midpoint of the target range, according to the results of the most recent BER quarterly survey of inflation expectations for South Africa. The latest survey of financial analysts, business executives and representatives of the trade union movement was conducted early in March 2005. Table 9 shows that the average expectation for 2005 regarding the CPIX inflation measure targeted by the Reserve Bank is 4,5 per cent, rising slightly to 4,8 per cent for 2006 and to 5,0 per cent for 2007. Since the survey undertaken in the fourth quarter of 2004, the average expectations for CPIX inflation in 2005 and 2006 have declined by a full percentage point in each case.

Table 9 BER survey of CPIX inflation expectations: 1st quarter 2005*

Per cent

	2005		2006		2007	
1. Finance	(4,7)	4,0	(5,2)	4,7	( )	4,8
2. Business	(6,3)	4,7	(6,6)	5,1	( )	5,4
3. Labour	(5,6)	4,8	(5,7)	4,6	( )	4,8
Average 1 – 3	(5,5)	4,5	(5,8)	4,8	( )	5,0

* Fourth-quarter 2004 results in parentheses

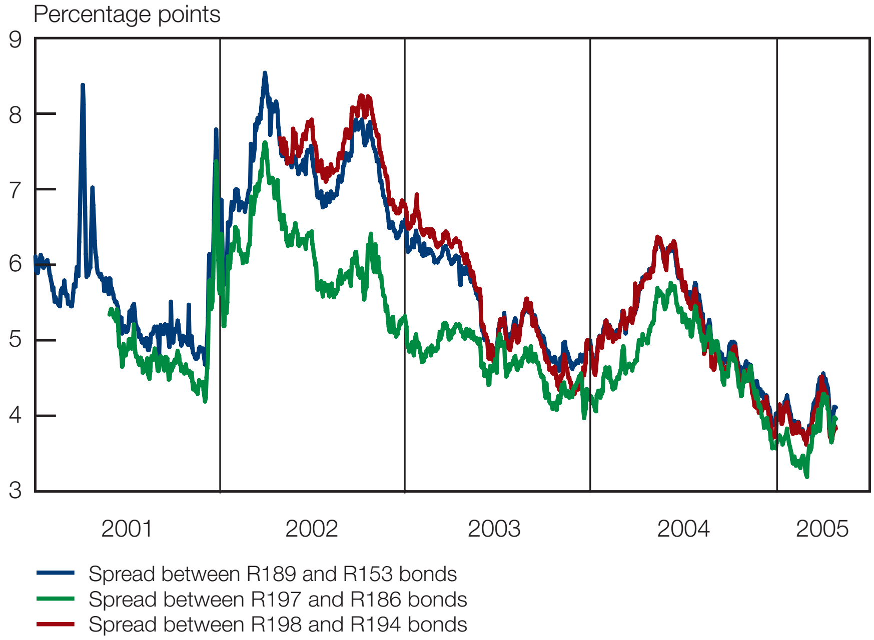
Source: Bureau for Economic Research, University of Stellenbosch

The decline in overall CPIX inflation expectations between the fourth quarter of 2004 and first quarter of 2005 was primarily the result of a downward shift in the expectations of business executives. Their expectation for inflation in 2005 declined by 1,6 percentage points and for inflation in 2006 by 1,5 percentage points. By contrast, labour representatives' expectations for 2005 and 2006 declined by 0,8 and 1,1 percentage points, and those financial analysts by 0,7 and 0,5 percentage points, respectively.

The Reuters survey of economists based in South Africa, the UK and the US published on 7 April reports a similar trend in consensus forecasts for 2005-07. CPIX inflation is expected to average 4,1 per cent in 2005, representing the mean of 15 individual forecasts ranging from 3,4 to 4,7 per cent. The expectation is that CPIX inflation will then rise to average 4,8 per cent in 2006, and 5,0 per cent in 2007. The consensus forecast for 2006 is the mean of 16 forecasts ranging between 3,6 and 5,8 per cent, and for 2007 it is the mean of 10 forecasts ranging between 4,1 and 6,0 per cent.

Evidence of inflation expectations being anchored in the target range is also provided by the breakeven inflation rates, measured by the spreads between the yields on South African CPI inflation-linked bonds and conventional nominal bonds of similar maturity. 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. As Figure 15 shows, these breakeven inflation rates declined steadily between mid-2004 and the end of February 2005, rose slightly in March, and then declined once more in April. The inflation expectations obtained from the R197 (maturing 2023), R189 (maturing 2013) and R198 (maturing 2008) inflation-linked bonds have remained within the target range since mid-2004 and were around 4 per cent at the end of April 2005.

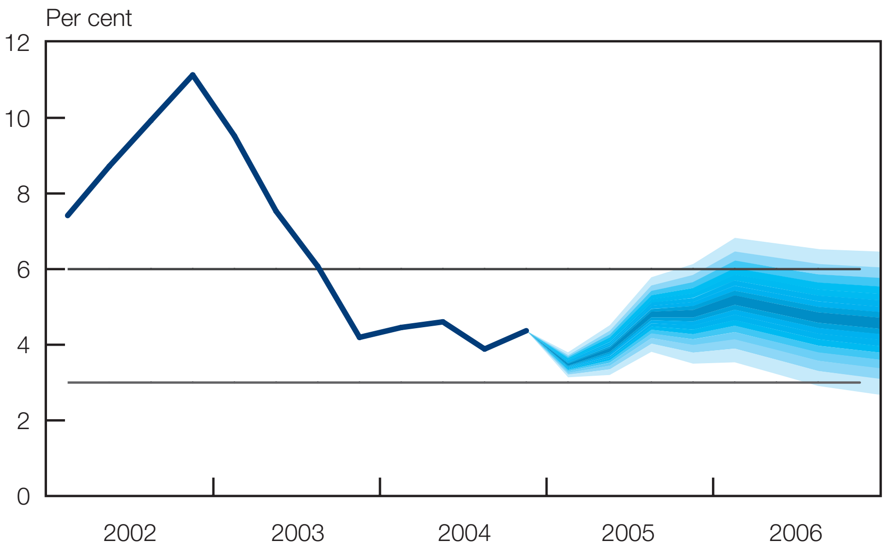
Figure 15 Breakeven inflation rates



The Reserve Bank inflation forecast

Figure 16 reproduces the Reserve Bank's quarterly forecast for CPIX inflation presented at the MPC meeting on 13 and 14 April 2005. The latest observed value for CPIX was for the fourth quarter of 2004, although January 2005 data were incorporated in the forecast for

Figure 16 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*).

the first quarter of 2005. The forecast is based on the assumption of an unchanged repo rate at 7,5 per cent over the forecast period, which runs from the first quarter of 2005 to the final quarter of 2006.

The central projection of the forecast is for the CPIX inflation rate to reach a lower turning point in the first quarter of 2005 and then to increase to 5,2 per cent in the first quarter of 2006, before gradually declining to around 4,5 per cent by the end of the forecast period. The probability distribution for this forecast suggests that there is approximately an 80 per cent probability that the CPIX inflation rate will be between 3 and 6 per cent in the final quarter of 2006.

With regard to the risks to the forecast, there are a number of factors that increase the possibility of outcomes that deviate from the central projection. Important among these is the threat of international crude oil price spikes, which would increase the upside risks associated with the forecast. Additional factors such as high rates of growth in asset-backed credit extension and administered price increases above the upper limit of the target range are also relevant in this regard. The low rates of production price inflation and agricultural futures suggest that future pressure from these sources will be limited. Overall, the balance of risks associated with the forecast is deemed to be neutral.

Assessment and conclusion

Against a background of an uncertain international economic environment, monetary policy in South Africa has contributed to maintaining inflation within the inflation target of 3 – 6 per cent. Although the inflation rate appears to have reached a lower turning point in February, the increase in March to a year-on-year rate of 3,6 per cent was attributable mainly to the higher international oil prices. Of significance is the fact that despite the higher oil prices, inflation is expected to remain comfortably within the target range over the forecast period of two years. This view is confirmed not only by the Bank's forecasts, but also by the fact that inflation expectations have continued to improve considerably over time.

The lower actual and forecasted inflation resulted in more room for the Bank to reduce interest rates at the April meeting of the MPC. This move was justified not only on the basis of the improved inflation outlook but also on the basis of evidence of a slackening of activity in some sectors of the economy. These sectors have been negatively affected by the continued strength of the exchange rate which has in effect resulted in an involuntary tightening of monetary conditions. On a weighted basis, the rand has been trading over the past few months at a range higher than for the main part of 2004.

Monetary policy will continue to be forward looking and will remain focused on the expected trend of inflation. As usual, there are a number of upside and downside risks and uncertainties relating to the determinants of the inflation trend. On the international front, there are the oil prices and their impact on global growth and prices, as well as the uncertain outlook for the US dollar which has implications for the exchange rate of the rand. Domestically, monetary policy will have to take cognisance of the risks and uncertainties relating *inter alia* to the continued high levels of expenditure, the outlook for the output gap and trends in wage settlements. Monetary policy will be guided by the MPC's assessment of the future developments in these and other variables, and their expected impact on the outlook for inflation.