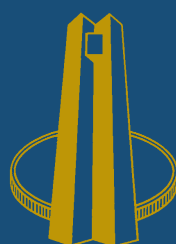
Monetary Policy Review

May 2008



South African Reserve Bank

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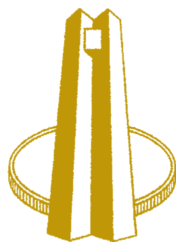

South African Reserve Bank

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Monetary Policy Review

Introduction

The South African economy continues to be impacted by a series of supply-side shocks emanating from the international energy and food markets. The effect of these shocks on the inflation environment is posing problems for economies around the world and a number of inflation-targeting countries are currently above their inflation targets. In certain advanced economies the response to these shocks has been complicated by the simultaneous effects of the banking and credit crisis that originated in the United States (US) sub-prime market.

The electricity price increase granted to Eskom in April and the possibility of further increases, together with the weakening of the exchange rate of the rand, have also worsened the domestic inflation outlook in the period since the publication of the previous *Monetary Policy Review* in November 2007. Collectively, despite signs that the economy is responding to the tighter monetary policy stance, these international and domestic developments have contributed to deteriorating inflation expectations and signs of generalised inflation pressures emerging in the economy.

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. Four topical issues are focused on in the boxes. The first box notes the recent changes announced by Statistics South Africa (Stats SA) which impact on the main inflation indices, while the second provides a global perspective on the surge in agricultural commodity prices. The third box reflects on the performance of inflation-targeting countries in the light of the global food and energy shocks, and the final box considers the impact on the global economic growth outlook of a slowdown in the US economy.

Recent developments in inflation

This section reviews recent trends in the main inflation indices and analyses developments in the main factors impacting on inflation in South Africa.

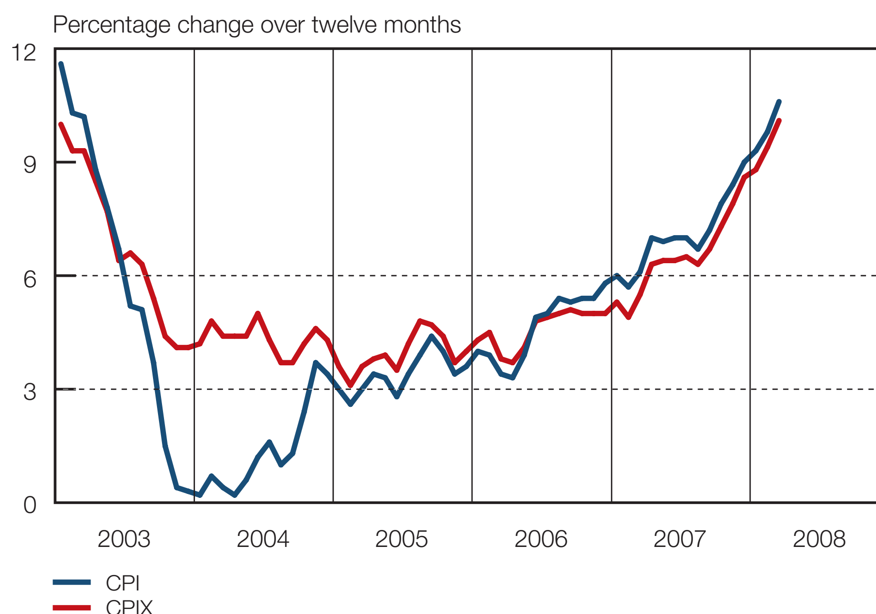
The evolution of indicators of inflation

The measure of inflation targeted by the South African Reserve Bank (the Bank), namely the year-on-year increase in the consumer price index excluding mortgage interest cost for metropolitan and other urban areas (CPIX), has remained above the inflation target range of 3 to 6 per cent since April 2007 (Figure 1). Since the publication of the previous *Monetary Policy Review*, when the latest available rate (for September 2007) was 6,7 per cent, the CPIX inflation rate has risen continuously to reach 10,1 per cent in March 2008. Developments in food and energy prices have been the most important factors driving this increase.

It is important to note that recent changes introduced by Stats SA regarding the treatment of clothing and footwear prices in the consumer price indices (discussed in greater detail in Box 1), in combination with Stats SA's policy of non-revision of these indices, have created a transitional upward bias in the aggregate indices' annual rates of change for the period from January to December 2008. For this period, Stats SA will publish a monthly estimate of the extent of upward bias. For the year-on-year CPIX inflation rates indicated

in Figure 1 this upward bias was approximately 0,17 of a percentage point in January, 0,18 of a percentage point in February and 0,20 of a percentage point in March 2008.

Figure 1 Consumer price inflation: CPIX and CPI



Source: Statistics South Africa

Figure 1 also shows the year-on-year inflation rate measured in terms of the headline consumer price index for metropolitan areas (CPI). The CPI inflation rate increased from 7,2 per cent in September 2007 to 10,6 per cent in March 2008.

The contributions of the various components of the CPIX to the overall inflation rate are presented in Table 1. As mentioned earlier, food and energy prices have been notable in this regard. The weighted contribution of food prices to the overall 12-month CPIX inflation rate, which was 3,2 percentage points in September 2007, rose to 4,4 percentage points in March 2008. The contribution of transport prices increased from 0,4 of a percentage point in September 2007 to 2,1 percentage points in March 2008.

Table 1 Contributions to CPIX inflation

Percentage change over twelve months* and percentage points

	2007				2008		
	Sep	Oct	Nov	Dec	Jan	Feb	Mar
Total*	**6,7**	**7,3**	**7,9**	**8,6**	**8,8**	**9,4**	**10,1**
Of which:							
Food	3,2	3,4	3,6	3,8	3,8	4,0	4,4
Housing	0,8	0,8	0,9	0,8	0,9	0,9	0,9
Medical care and health expenses	0,5	0,5	0,5	0,5	0,5	0,5	0,5
Transport	0,4	1,0	1,2	1,7	1,5	1,9	2,1
Education	0,4	0,4	0,4	0,4	0,4	0,4	0,4
Fuel and power	0,3	0,3	0,4	0,4	0,4	0,4	0,4
Other	1,1	0,9	0,9	1,0	1,3	1,3	1,4

Source: Statistics South Africa

Box 1 Recent changes to the main inflation indices

Statistics South Africa (Stats SA) has recently released information on changes that impact on the consumer and producer price indices that are a key input into the monetary policy process in South Africa. This box provides a brief overview of the changes and refers those readers requiring more detail to relevant publications.

The first of the releases is an explanatory note (Stats SA, 2008a) that relates to a change in the treatment of clothing and footwear prices in the CPI and CPIX, namely that the indices be compiled on the basis of clothing and footwear prices excluding items on sale. This change was mooted by Stats SA in September 2007, and first implemented in the January 2008 data (published on 27 February 2008). The change was made in order to correct a downward bias in the price changes of clothing and footwear, resulting from the inclusion of items on sale, which was identified during 2007. Stats SA points out that the bias was inconsistent with evidence available from clothing retailers and upward price pressures in other sectors, and at variance with the international best practice of not including in the CPI prices of goods with limited availability.

The introduction of the change in the treatment of clothing and footwear prices together with Stats SA's policy of not revising the CPI and CPIX indices has, however, created an upward bias in the annual rates of change of the indices for the period January – December 2008. A monthly estimate of the extent of this temporary upward bias will be provided by Stats SA during this period.

The second release provides details regarding the updating of the producer price index (PPI) (Stats SA, 2008b). From January 2008, the PPI data released by Stats SA are based on an updated set of weights. These new weights are based on updated information as well as on changes in the approach used to derive the weights at the higher industry grouping level, that is, Standard Industrial Classification (SIC) digit levels 1 to 3. A major change is that the weights used in the old PPI were based on the relative importance of sales in the higher groupings, whereas in the new PPI the higher groupings are weighted by the corresponding proportion of value added as measured in the national accounts for the purposes of calculating gross domestic product by origin. In this way the importance of each industry in the PPI is proportional to the value added. Table B1.1 compares the new and the old weights in the PPI for the higher industry grouping level.

Table B1.1: Comparison of old and new weights in the PPI

	Old weights based on sales	New weights based on value added and new information
Agriculture, forestry and fishing*	11,13	9,95
Mining and quarrying	8,92	19,41
Electricity, gas and water	4,68	8,33
Manufacturing*	75,27	62,31
Total	**100,00**	**100,00**

* Sawmilling (weight of 0,36 in old PPI) was reclassified from manufacturing to forestry

Source: Statistics South Africa (2008b)

The nature of these changes means that the new PPI is not completely comparable with its predecessor and needs to be analysed with caution. In addition to changes related to the weights in the PPI, the presentation of the headline PPI has also changed. In terms of the old PPI methodology, the headline PPI was a weighted average of the indices for domestic and imported prices, whereas the new headline PPI is based on the prices of South African output whether that output is sold in the domestic market or the export market. Import prices will have an indirect impact through the prices of imported inputs purchased by producers. The gold price, which was excluded from the old PPI in an attempt to avoid its price fluctuations dominating those of other products, is now included in the mining category of the new PPI.

According to Stats SA, these revisions are necessary to make sure that (1) the weighting pattern is not obsolete; (2) the reporting establishments continue to be the most representative of the industries surveyed; and (3) the products chosen are those that are most traded and that there is suitable representation of emerging products in the standard basket. Stats SA argues that these changes are consistent with international best practice and that they achieve a greater degree of consistency between the PPI and the system of national accounts than has been the case in the past.

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Statistics South Africa. 2008a. "Explanatory note to analysts on the method used to change the treatment of clothing and footwear prices in the Consumer Price Index (CPI)", March. Available online at: http://www.statssa.gov.za/news_archive/explannotefinal.pdf.

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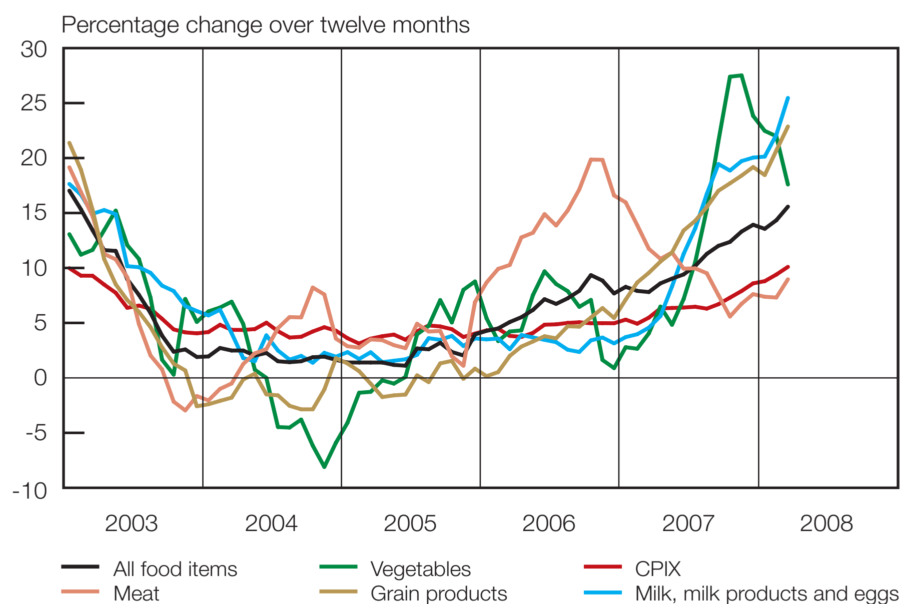
Stats SA *see* Statistics South Africa.

World agricultural commodity prices have risen sharply since late 2006, as discussed in Box 2. For South Africa, Figure 2 shows that year-on-year inflation in food prices increased from 12,0 per cent in September 2007 to 15,6 per cent in March 2008. The prices of grain products and milk, milk products, and eggs continued to accelerate strongly, with inflation rates rising from 17,0 to 22,9 per cent and 19,5 to 25,5 per cent, respectively, over this period. Vegetable prices rose at a rate of 17,6 per cent in March 2008, below their recent peak of 27,5 per cent in November 2007, and meat price inflation averaged around 7 per cent between September 2007 and March 2008.

Figure 2 CPIX and food inflation

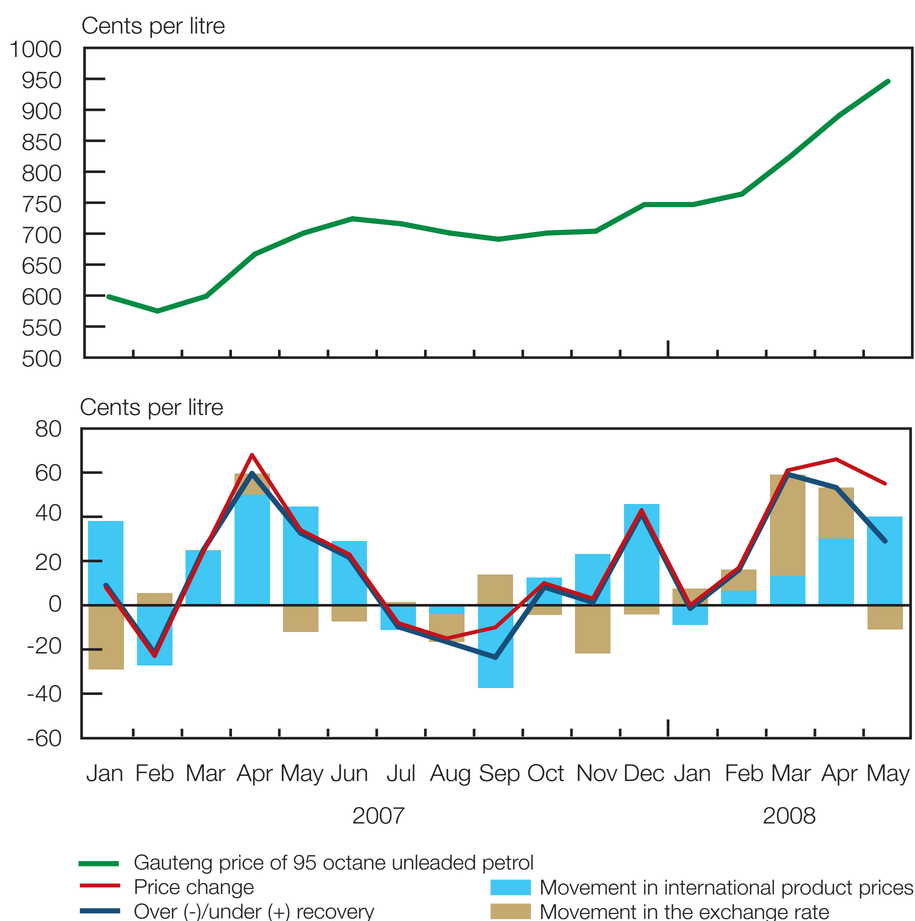


Source: Statistics South Africa

The movements in transport prices were largely the result of fluctuations in domestic petrol prices. Figure 3 examines recent developments in the price of 95 octane unleaded petrol in Gauteng Province. Since September 2007, when the price was reduced by 10 cents to R6,91 per litre, the price of petrol has increased by a cumulative R2,55 per litre to reach R9,46 per litre in May 2008. Figure 3 also decomposes the price movement for each

month, highlighting the contributions of movements in international product prices and in the exchange rate, and shows that these factors have acted together in recent months to place upward pressure on the petrol price. The net under recovery of 207,3 cents per litre since September 2007 resulted from a 162,6 cents per litre contribution from international product prices reinforced by a 44,7 cents per litre contribution from exchange-rate movements. The pump price of petrol was raised by 66 cents per litre in April (this included a combined 11 cents per litre increase in the fuel tax and Road Accident Fund levy), and by 55 cents per litre in May (this included a 20 cents per litre increase in the slate levy, a 2,5 cents per litre increase in the service differential and a 1,5 cents per litre incremental inland transport recovery levy).

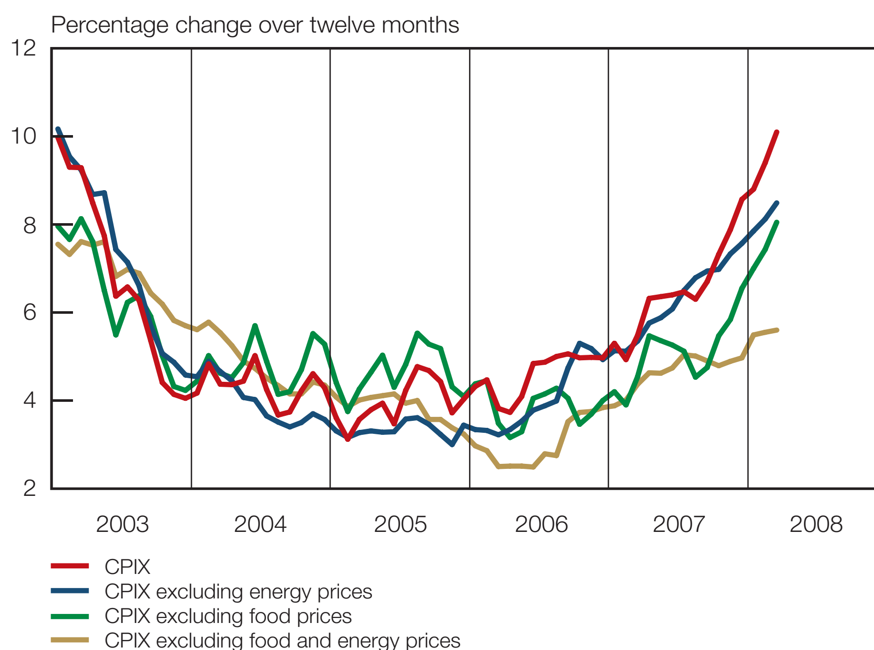
Figure 3 South African petrol price



Source: Central Energy Fund

Figure 4 shows the effect of excluding energy and food prices from the year-on-year CPIX inflation measure. Energy prices, which provided slight downward pressure on CPIX inflation between July and September 2007, have had a less benign impact since October. Excluding energy prices, CPIX inflation would have been lower, increasing from 7,0 per cent in October 2007 to 8,5 per cent in March 2008. The effect of excluding food prices from the CPIX is also to lower the resultant inflation rate, although the impact is more significant and has been more persistent than in the case of energy prices. The inflation rate for CPIX excluding food prices rose from 4,8 per cent in September 2007 to 8,0 per cent in March 2008. When both energy and food prices are excluded from the CPIX, the resulting inflation rate increased from 4,9 per cent in September 2007 to 5,6 per cent in March 2008.

Figure 4 The effect of food and energy prices on CPIX inflation



Sources: Statistics South Africa and SARB calculations

Box 2 Food prices: A global perspective

In 2006 and 2007 world agricultural commodity prices rose sharply for nearly all major food and feed groups. Data from the United Nations Food and Agriculture Organization (FAO) show that in 2007 the FAO Food Price Index averaged 157, representing a 23-per-cent increase from 2006 and 34 per cent from 2005. The increases in the prices have been more pronounced for dairy products which, on average, rose by nearly 80 per cent in 2007. The prices of oilseeds increased by 50 per cent in 2007 and those of grains by 42 per cent. While the prices of wheat, maize and other agricultural commodities have surged since late 2006, the significant increases in rice prices started only in January 2008 and had doubled by the end of March after being boosted by strong Asian, Middle Eastern and African demand.

Several important supply and demand factors were the main contributors to global food inflation. On the supply side, sharp increases in dairy and wheat prices were due to a drought in Australia, and tight dairy supplies were due to low inventories in the European Union (EU). Cereal output in eight major exporting countries declined by 4 per cent in 2005 and 7 per cent in 2006, before recovering in 2007 due to higher prices. In addition, the high feed prices have raised the cost of animal production and resulted in increases in meat prices. Moreover, an outbreak of the "blue-ear disease" in China significantly reduced pork stocks and pushed up domestic meat prices by over 50 per cent in August 2007. The FAO expects a significant fall in global oilseed production, due to a shift of plantings from soya beans to maize in northern hemisphere countries. This is likely to increase the prices of soya beans and oilseeds further.

Increases in petroleum prices have raised the cost of producing and transporting agricultural commodities. Freight rates also doubled within 12 months beginning February 2006 due to stretched shipping capacity, port congestion and longer trade routes. Increases in the prices of fertilisers due to rising energy prices have also increased the cost of producing food.

According to the FAO (2007), the recent episodes of price increases differ from the past in that inventories are being kept at low levels. Global rice stocks, for example, are at their lowest level since 1976. When production shortages occur at a time when inventories are low, as happened in 2005 and 2006 for cereals, international markets tend to become tighter and the magnitude of price changes becomes magnified when unexpected events occur.

On the demand side, the biofuels market, which grew from 154,84 million barrels in 2000 to about 516,13 million barrels in 2007,[1] has become a significant source of demand for some agricultural commodities such as sugar, maize, oilseeds and palm oil. These commodities, which have traditionally been consumed as food, are now also being grown as inputs for biofuel production.

1 See Coyle (2007).

Another demand-side factor is that large, dynamic emerging markets such as China, India, Brazil and Russia have become an important source of global food demand growth. Owing to higher responsiveness of food demand to income growth, growth in per capita incomes in these countries directly translates into increased consumption, especially for high value-added food items such as meat and dairy products.

Beyond the demand and supply factors, other contributing factors to price increases are the inter-linkages and spill-over effects between various commodity markets. For instance, soaring maize markets contributed to keeping oilseed prices at high levels as maize plantings expanded at the expense of oilseed plantings (IFAD, 2008).

Table B2.1 presents a sample of countries in which in most instances[2] food inflation has been on the rise between 2006 and 2007. For instance, in emerging markets such as South Africa and developed countries such as the United States, Japan and the euro area, food inflation has been higher than headline inflation since 2006. Table B2.1 indicates that China, Indonesia and Tanzania have large food weights in their consumer price indices (CPIs) and they are therefore more sensitive to food price shocks.

2 Exceptions include Hungary, Indonesia, Japan and Tanzania.

Table B2.1: Headline and food inflation in selected countries
Per cent

Country		2004	2005	2006	2007
China:	Headline	3,9	1,8	1,5	4,8
	Food (33,6)	10,0	2,9	2,3	12,4
Euro area:	Headline	2,2	2,2	2,2	2,1
	Food* (15,6)	1,0	0,7	2,3	2,7
Hungary:	Headline	6,7	3,6	3,9	8,0
	Food (20,7)	11,6	11,6	11,5	11,5
Indonesia:	Headline	3,5	2,1	13,1	6,5
	Food (42,3)	11,0	11,2	11,6	11,4
Japan:	Headline	0,0	-0,3	0,3	0,1
	Food (27,3)	0,9	-0,9	0,5	0,3
New Zealand:	Headline	2,3	3,0	3,4	2,4
	Food (17,4)	0,8	1,4	3,0	3,9
South Africa:	Headline	1,4	3,4	4,7	7,1
	Food** (21,0)	2,3	2,2	7,2	10,3
Tanzania:	Headline	4,9	4,4	6,2	7,0
	Food (55,9)	5,9	5,9	8,0	7,0
United Kingdom:	Headline	1,3	2,0	2,3	2,3
	Food (9,0)	0,7	1,5	2,5	4,5
United States:	Headline	2,7	3,4	3,2	2,8
	Food (13,9)	3,4	2,5	2,4	4,0
Venezuela:	Headline	21,7	16,0	13,7	18,7
	Food*	25,0	25,1	25,6	26,0

Note: Weight of food prices in CPI in brackets

* Food and non-alcoholic beverages
** Food excluding soft drinks

Sources: Bloomberg and national statistical agencies

Within countries that are net food importers, poor households are likely to be hurt more by higher food prices, because they spend a higher proportion of their disposable income on food. Of particular concern to low-income countries are price increases of oilseeds and grains that constitute a large share of their citizens' diets. According to Rosen and Shapouri (2007), in low-income Asian countries, grains account for an average of 63 per cent of the diet and in North Africa about 60 per cent. In sub-Saharan Africa, grains account for nearly half of the calories consumed.

Policy responses to limit the impact of rising prices have been varied.[3] For instance, the government in China has raised subsidies for wheat and rice and has introduced export duties of 20 per cent on wheat, buckwheat, barley and oats, and 5 per cent on rice, maize, sorghum, millet and soya beans. A 36-per-cent import duty on wheat flour has been removed in India. In March the Vietnam government announced that it would cut rice exports by nearly a quarter in 2008. In the same month India effectively banned the export of all but the most expensive grades of rice. Egypt announced that it would impose a six-month ban on rice exports, starting in April 2008, and Cambodia banned all rice exports except those exported by government agencies. In Japan, authorities have announced the establishment of a department responsible for food security. In South Africa, the government made adjustments to the

3 The contents of this paragraph are based on FAO (2008).

amounts paid in social grants so as to mitigate the impact of rising food prices. In Brazil the government is considering a reduction or removal of the 10-per-cent import tax on wheat from countries other than Argentina. The Moroccan government has cut wheat import tariffs to the lowest level ever. As far as Europe is concerned, the EU has removed the 10-per-cent compulsory set-aside requirement and subsequently suspended cereal import duties (excluding oats, buckwheat and millet) as from December 2007 until the end of the current marketing season in June 2008.

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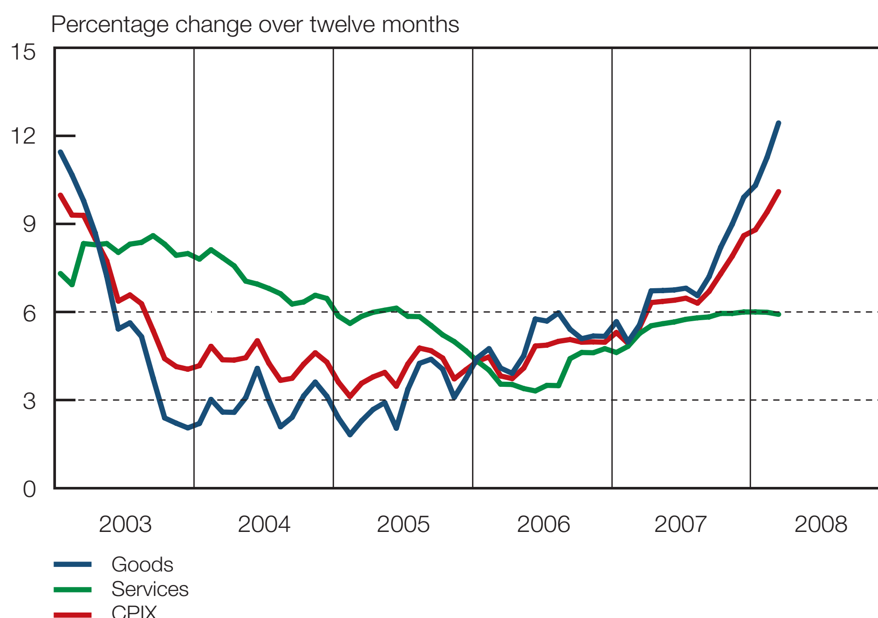
Figure 5 presents the inflation rates for the goods and services categories of CPIX inflation. Goods prices continue to place upward pressure on CPIX inflation, with the year-on-year inflation rate for goods prices rising from 7,2 per cent in September 2007 to 12,4 per cent in March 2008. The movement in goods price inflation can be attributed

Figure 5 CPIX: Goods and services inflation

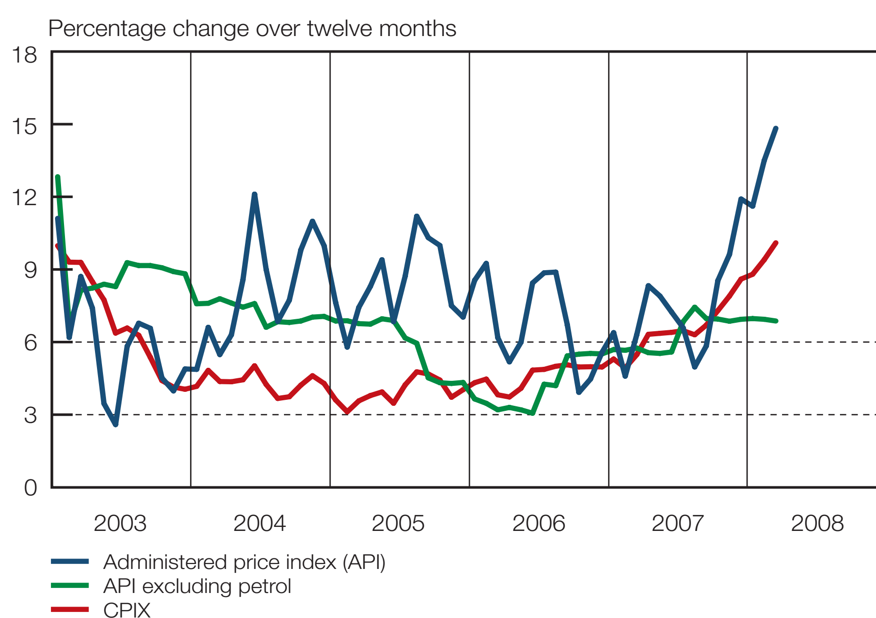


Source: Statistics South Africa

largely to the developments in the food component, which has a weight of 38,7 per cent in the goods index. Services inflation increased more modestly from 5,8 per cent to 5,9 per cent over the same period.

Administered prices have a weight of 20,01 per cent in the CPIX, with petrol prices contributing 5,08 percentage points and electricity prices 3,55 percentage points. The year-on-year inflation rate for the overall administered price index (API) amounted to 14,8 per cent in March 2008 compared with 5,8 per cent in September 2007 (Figure 6). However, excluding the petrol component, the inflation rate for the remaining administered prices remained stable at around 7 per cent between September 2007 and March 2008.

Figure 6 CPIX and administered prices



Sources: Statistics South Africa and SARB calculations

The weighted contributions of the various components to CPIX administered price inflation in the period under review are provided in Table 2, where the influence of petrol price increases is clearly evident. In September 2007, petrol prices contributed 1,0 percentage point to year-on-year administered price inflation of 5,8 per cent. By March 2008 this contribution had risen to 9,9 percentage points to an overall rate of 14,8 per cent. The recent electricity price increase of 14,2 per cent granted to Eskom from 1 April 2008 has not as yet been included in the consumer price indices.

Table 2 Contributions to administered price inflation

Percentage change over twelve months* and percentage points

	2007				2008		
	Sep	Oct	Nov	Dec	Jan	Feb	Mar
Total*	5,8	8,5	9,6	11,9	11,6	13,5	14,8
Of which:							
Petrol	1,0	3,6	4,7	6,9	6,6	8,4	9,9
Electricity	1,2	1,2	1,2	1,2	1,2	1,2	1,2
School fees	1,0	1,0	1,0	1,0	1,0	1,0	1,1
Water tariffs	0,9	0,9	0,9	0,9	0,9	0,9	0,9
Assessment rates	0,9	0,9	0,9	0,9	0,9	0,9	0,9
Other	0,8	0,9	0,9	1,0	1,0	1,1	0,8

Source: Statistics South Africa

In March 2008, Stats SA released a PPI based on a new basket and a change in methodology. The new index has a significantly lower weight for manufacturing and an approximate doubling in the weights of mining and quarrying, and of electricity, gas and water. The price of gold is now included in the mining category of the index. The new headline PPI is based on the prices of South African output sold in the domestic market or exported, whereas the previous index was a weighted index of domestic and imported prices. These changes mean that the headline PPI is likely to be a less reliable guide to future inflation trends and that focusing on particular components of the index may be more informative in this regard. The headline PPI inflation rate increased from 10,4 per cent in January 2008 to 11,8 per cent in March.

Factors affecting inflation

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

International economic developments

The recent credit turmoil centred in the US and parts of Europe began to slow the global economic expansion in the fourth quarter of 2007. According to the most recent International Monetary Fund (IMF) data, the global economy recorded growth of 4,9 per cent in 2007 (Table 3). Economic growth in the US slowed notably and growth also slowed in western Europe, while confidence indicators began deteriorating. Despite some slowing of export growth, emerging-market and developing economies have continued to expand strongly, led by China and India. These economies have benefited from the strong momentum of domestic demand, more disciplined macroeconomic policy frameworks and, in the case of commodity exporters, from higher commodity prices.

Growth in the US began to slow in the final quarter of 2007 due to a continuing sharp drop in residential construction, considerable weakness in final demand following the continued contraction in residential investment, a rundown of inventories and a deceleration in exports. In Japan, the expansion accelerated towards the end of 2007, after having lost some momentum mid-year to record an annual growth rate of 2,1 per cent on the back of improved business investment and consumer spending. For the euro area, recent economic data indicate that real output growth moderated in the final quarter of 2007, mainly due to a contraction in consumer and government expenditure. Economic growth of 2,6 per cent was recorded for the year and overall eurozone consumer price inflation of 2,1 per cent was still slightly above the European Central Bank's (ECB) target ceiling. In the United Kingdom (UK), revised estimates show that real gross domestic product (GDP) grew by 3,1 per cent in 2007. Final domestic demand was revised downwards as the negative impact of a weakening housing market on some components of final demand was greater than expected.

Developing Asia recorded sustained strong growth in 2007. The Chinese economy registered its fastest growth in 13 years, expanding by 11,4 per cent in 2007, and thereby exceeding a rate of 10 per cent for the fourth consecutive year. India's economy recorded growth of 9,2 per cent in 2007. Growth in Africa remained strong in 2007, with an expansion in real GDP of 6,3 per cent being underpinned by high commodity prices, improved economic policies and fairly limited exposure to international financial market turmoil. The 6,3 per cent inflation rate in 2007 was marginally lower than the 6,4 per cent recorded the previous year.

Table 3 Annual percentage change in real gross domestic product and consumer prices

	2007		
	Share of global real GDP*	Real GDP	Consumer prices
World	**100,0**	**4,9**	**4,0****
Advanced economies	**56,3**	**2,7**	**2,2**
United States	21,4	2,2	2,9
Japan	6,6	2,1	0,0
Euro area	16,1	2,6	2,1
United Kingdom	3,3	3,1	2,3
Other advanced economies	8,9	4,6	2,0
Other emerging-market and developing countries	**43,7**	**7,9**	**6,3****
Africa	3,0	6,3	6,3**
Central and eastern Europe	4,1	5,8	5,6
Commonwealth of Independent States	4,5	8,5	9,7
Developing Asia	20,0	9,7	5,3
China	10,8	11,4	4,8
India	4,6	9,2	6,4
Middle East	3,8	5,8	10,4
Western hemisphere	8,3	5,6	5,4

* GDP shares based on the IMF's purchasing-power-parity valuation of country GDPs for 2007

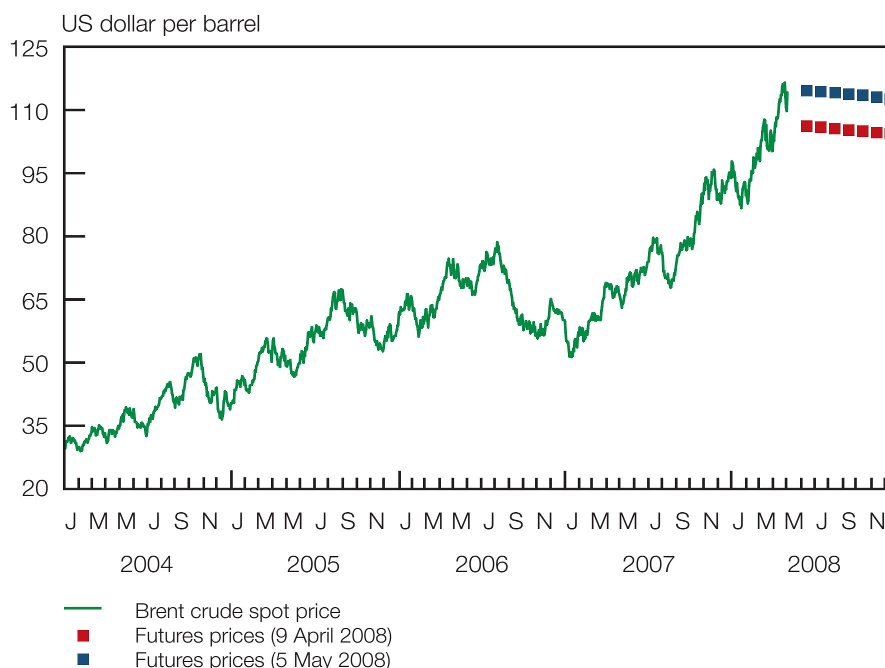
** Zimbabwe excluded

Source: IMF *World Economic Outlook,* April 2008

Oil prices

International crude oil prices continued to rise in the period under review. From around US$90 per barrel at the beginning of November 2007, Brent crude oil prices remained volatile throughout December 2007 and reached levels of around US$98 per barrel in early January 2008 (Figure 7). After declining thereafter in January and at the beginning

Figure 7 Price of Brent crude oil



Source: Bloomberg

of February, the second week of February saw the start of a renewed upward trend. The oil price initially increased due to concerns about supplies from Venezuela, following threats by the country's president to cease oil supplies to the US, and later on due to statements made by Iran's oil minister that the Organization of the Petroleum Exporting Countries (OPEC) would consider reducing production. Reports of increased violence in Nigeria and speculative oil demand were also responsible for keeping the oil price at levels between US$98 and US$100 per barrel in the second half of February. Supply disruptions in Ecuador and the UK also contributed to the rise in the oil price in late February.

The oil price remained volatile in March 2008. It rose initially on the announcement of unexpectedly low US crude-oil inventories and OPEC's decision on 5 March 2008 to keep its output targets unchanged, and subsequently on a weaker US dollar and projections that global oil demand for 2008 would remain robust. After reaching levels of around US$108 per barrel in mid-March, the oil price then declined due to heightened uncertainty regarding the overall economic outlook after the US Federal Reserve decided to mediate the purchase of Bear Stearns and then reduced its policy rate. The price of Brent crude oil continued to retreat to end the month at around US$100 per barrel, despite a brief rally on lower-than-expected fuel inventories, geopolitical concerns and resumed dollar weakness.

In late April, Brent crude oil prices rose significantly to reach US$116 per barrel, as further US dollar weakness and rumours of an attack on an oil pipeline in Nigeria stoked speculative oil demand, but retreated once more to end the month around US$110 per barrel.

Central bank interest rate developments

Headline inflation has increased since mid-2007 in both advanced and emerging-market economies. Core inflation has also generally drifted upwards, but in the US the Federal Reserve has been cutting interest rates in response to increasing downside risks to activity, while policy has been on hold in the euro area and Japan (Table 4).

Since the beginning of 2007, a group of the world's biggest banks have recorded asset writedowns and credit losses of US$232 billion, and the Federal Reserve has continued to cut its policy rate in an attempt to forestall losses in the credit and equity markets. On 16 March 2008, the Federal Reserve decided to lend to investment banks from the discount window, a privilege previously reserved for more tightly regulated commercial banks. It also expanded the types of eligible collateral in an effort to provide liquidity to strained markets such as mortgage-backed securities. The Federal Reserve's Term Securities Lending Facility that lends out US Treasury bills against collateral to primary dealers in an effort to improve liquidity in repurchase markets was also expanded. The US Federal Open Market Committee lowered its target for the federal funds rate by a further 25 basis points on 30 April 2008 – a cumulative reduction of 325 basis points since August 2007. The Bank of England cut its key interest rate by a quarter of a percentage point to 5 per cent on 10 April 2008 amid falling house prices and tightening credit standards as the continuing money-market turmoil looked set to dent UK economic growth. Official interest rates were also lowered in Canada, Hong Kong, Israel and Turkey. However, annual consumer price inflation continued to accelerate in most countries, including emerging-market economies in general, and recent data suggest that price pressures will remain strong in the coming months.

In many countries where food and energy represent a higher share of consumption baskets and/or capacity constraints have been more of a concern, central banks have continued to tighten their policy stances. Monetary policy has been tightened in Australia, the Czech Republic, Hungary, Poland, Russia, Sweden, Taiwan, Iceland and

Brazil since November 2007. The Central Bank of Iceland raised its key rate by 50 basis points to a record 15,5 per cent to support its depreciating currency and tame persistent inflation pressures. The decision follows a 1,25 percentage-point rate increase on 25 March. Brazil's central bank raised its benchmark interest rate more than expected by 50 basis points to 11,75 per cent from a record-low 11,25 per cent (the first increase in three years) as quickening economic growth threatened to stoke inflation. A surge in food prices and rising consumer demand have pushed annual inflation in Brazil from an eight-year low of 3 per cent in March 2007 to a two-year high of 4,7 per cent in March, above policy-makers' year-end target for a third month.

Table 4 Selected central bank interest rates

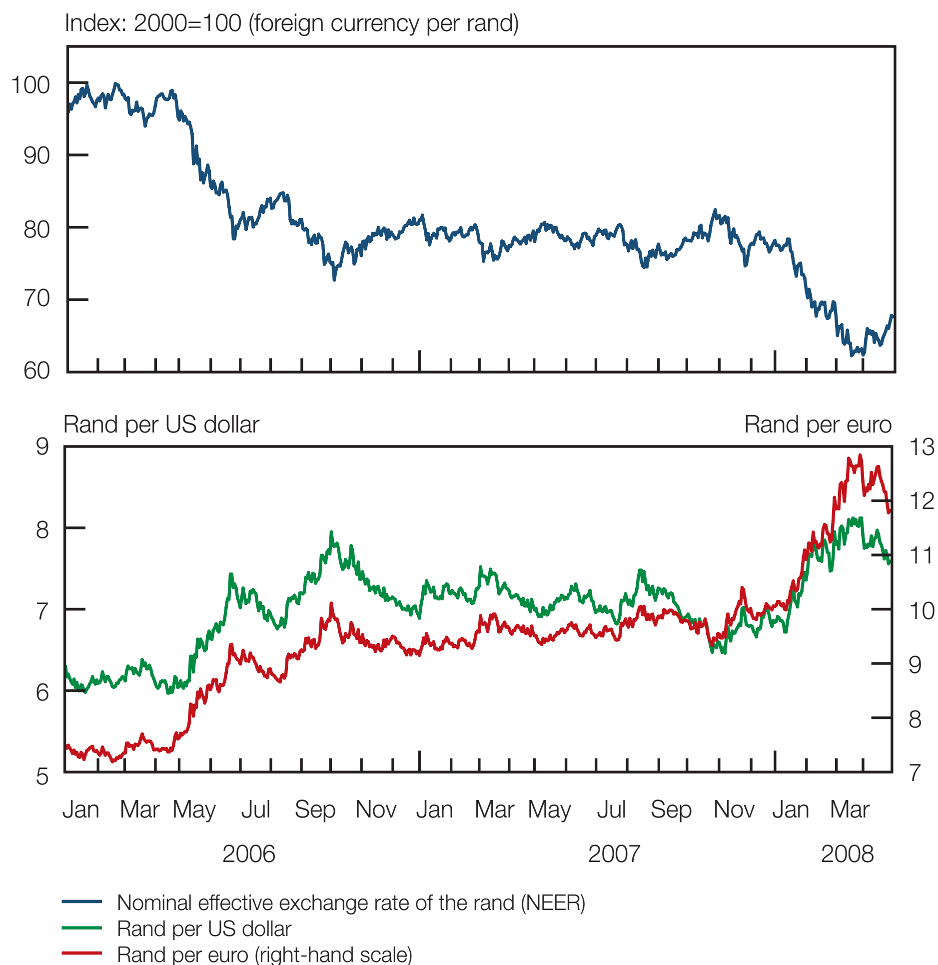
Per cent

Countries	1 Jan 2007	5 May 2008	Latest decision (change in percentage points)	
United States	5,25	2,00	30 Apr 2008	(-0,25)
Japan	0,25	0,50	30 Apr 2008	(0,00)
Euro area	3,50	4,00	10 Apr 2008	(0,00)
United Kingdom	5,00	5,00	10 Apr 2008	(-0,25)
Canada	4,25	3,00	22 Apr 2008	(-0,50)
Denmark	3,50	4,00	6 Jun 2007	(+0,25)
Sweden	3,00	4,25	24 Apr 2008	(+0,25)
Switzerland	1,50 – 2,50	2,25 – 3,25	13 Mar 2008	(0,00)
Australia	6,25	7,25	1 Apr 2008	(0,00)
New Zealand	4,50	8,25	24 Apr 2008	(0,00)
Israel	4,50	3,25	28 Apr 2008	(0,00)
China	6,12	7,47	20 Dec 2007	(+0,18)
Hong Kong	6,75	3,50	2 May 2008	(-0,25)
Indonesia	9,75	8,00	3 Apr 2008	(0,00)
Malaysia	3,50	3,50	29 Apr 2008	(0,00)
South Korea	4,50	5,00	7 Mar 2008	(0,00)
Taiwan	2,75	3,50	27 Mar 2008	(+0,125)
Thailand	5,00	3,25	9 Apr 2008	(0,00)
India	7,25	7,75	29 Apr 2008	(0,00)
Brazil	13,25	11,75	16 Apr 2008	(+0,50)
Chile	5,25	6,25	13 Mar 2008	(0,00)
Mexico	7,00	7,50	18 Apr 2008	(0,00)
Czech Republic	2,50	3,75	8 Feb 2008	(+0,25)
Hungary	8,00	8,25	28 Apr 2008	(+0,25)
Poland	4,00	5,75	30 Apr 2008	(0,00)
Russia	11,00	3,75	29 Apr 2008	(+0,25)
Turkey	17,50	15,25	17 Apr 2008	(0,00)
Iceland	13,30	15,50	10 Apr 2008	(+0,50)

Source: National central banks

Exchange rate developments

The South African rand has depreciated markedly since the publication of the previous *Monetary Policy Review* in November 2007 (Figure 8). Despite the US dollar having weakened against a range of currencies, the rand depreciated against the US dollar by approximately 16 per cent from R6,53 on 1 November 2007 to R7,59 on 30 April 2008. During the same period, the rand depreciated by around 25 per cent against the euro, weakening from R9,43 to R11,82 to the euro. When measured against a basket of 13 currencies, that is, the nominal effective exchange rate of the rand (NEER), the rand depreciated from 81,6 index points on 1 November 2007 to 67,6 index points on 30 April 2008, representing a decline of 17,1 per cent.



The exchange-rate movements in this period may partly reflect increased risk aversion by investors towards emerging markets in the wake of the sub-prime crisis. Electricity supply constraints may also have affected investor perceptions regarding South Africa's growth prospects. In addition, there appears to be an increased risk premium that investors require for holding the rand, given its volatility and increasing concerns about the size of the South African current-account deficit, notwithstanding the fact that the deficit has so far been comfortably financed by capital inflows on the financial account of the balance of payments.

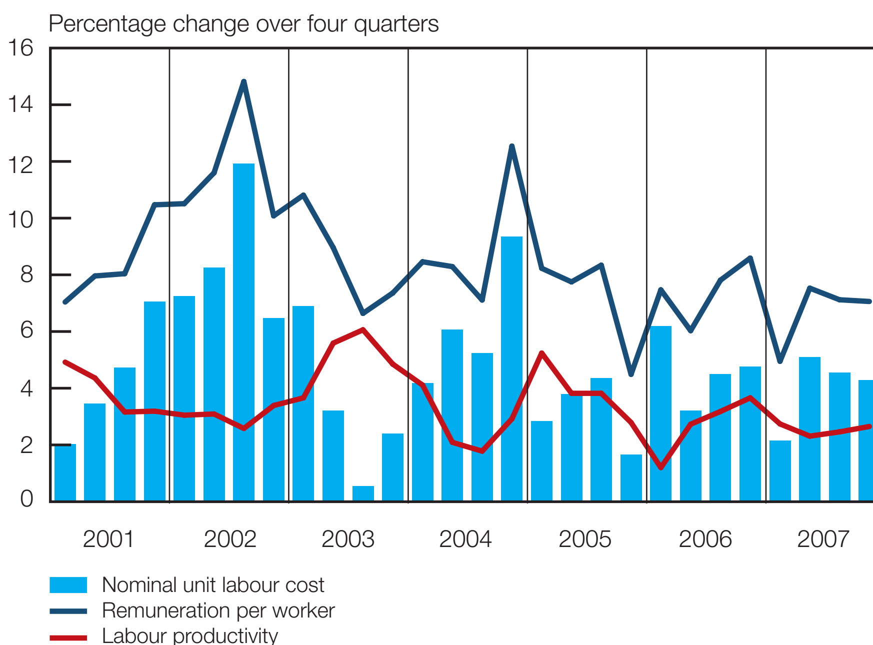
The net inflow of capital in the fourth quarter of 2007 amounted to R54,2 billion, bringing the cumulative net inflow of capital to R192,8 billion for 2007 as a whole. Foreign direct investment into South Africa recorded an inflow of R40,2 billion in 2007, following an outflow of R3,6 billion in 2006. Increased risk aversion by international investors, however, has significantly lowered foreign portfolio inflows to R2,9 billion in the fourth quarter of 2007 from an inflow of R33,7 billion in the third quarter.

Labour markets

Figure 9 shows that wage inflation, measured by the year-on-year rate of increase in the nominal remuneration per worker in the non-agricultural sectors, remained relatively flat between the third and fourth quarters of 2007, slowing slightly from 7,5 per cent to 7,1 per cent. The combination of this decline in wage inflation and a slight increase in the growth in

labour productivity during the same period resulted in a marginal decline in the growth in unit labour cost from 4,6 per cent to 4,3 per cent between the third and fourth quarters of 2007.

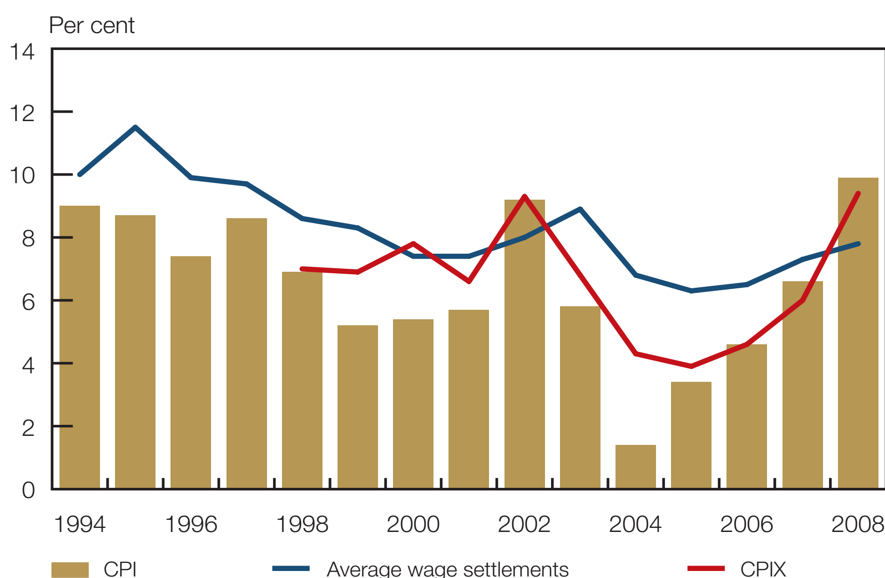
Figure 9 Remuneration per worker, labour productivity and unit labour cost in the formal non-agricultural sector



Sources: Statistics South Africa and SARB calculations

According to Andrew Levy Employment Publications, wage settlements averaged 7,3 per cent in 2007 compared with 6,5 per cent a year before (Figure 10). In the first quarter of 2008, wage settlements increased to 7,8 per cent. Given the recent increase in inflation expectations, it is expected that wage settlements will move upwards during 2008.

Figure 10 Average annual inflation and wage settlements



* Data for 2008 are for the first quarter
Sources: Andrew Levy Employment Publications and Statistics South Africa

Demand and output

The South African economy recorded an annualised rate of growth of 5,3 per cent in the fourth quarter of 2007, compared with a revised annualised rate of 4,8 per cent in the third quarter (Table 5). For 2007, the real GDP growth rate was 5,1 per cent, compared with 5,4 per cent in 2006. This represented the fourth consecutive year in which growth was either close to or above 5 per cent.

Table 5 Growth in real gross domestic product and expenditure components
Per cent*

	2006	2007				
	Year	1st qr	2nd qr	3rd qr	4th qr	Year
Final consumption expenditure:						
Households	8,2	7,2	4,9	4,4	3,8	7,0
General government	5,2	14,0	-3,8	8,7	1,2	5,0
Gross fixed capital formation	13,8	17,2	11,2	12,9	14,1	14,8
Change in inventories (R billions)**	16,5	12,9	9,1	6,5	-8,7	4,9
Gross domestic expenditure	**9,2**	**6,4**	**3,2**	**5,4**	**0,2**	**6,0**
Exports of goods and services	5,6	-11,6	4,4	-3,4	21,6	8,3
Imports of goods and services	18,8	-4,8	1,0	0,1	1,1	10,4
Gross domestic product	**5,4**	**5,1**	**4,4**	**4,8**	**5,3**	**5,1**

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

The robust growth in the fourth quarter of 2007 can be attributed to a marked acceleration in growth in real value added by the secondary sector. This sector grew at an annualised rate of 8,1 per cent in the fourth quarter, compared with only 0,6 per cent in the third quarter of 2007. The strong growth in the secondary sector reflected the improved performance of the manufacturing sector, which contributed about 1 percentage point to real economic growth in the fourth quarter of 2007. This was mainly the result of a strong recovery subsequent to industrial action in the third quarter in the subsector that manufactures motor vehicles, parts and accessories. However, measured on a calendar-year basis, growth in real value added by the manufacturing sector still decelerated from 5,2 per cent in 2006 to 3,9 per cent in 2007.

A solid increase in agricultural production in the fourth quarter of 2007 was partly neutralised by a contraction in the mining sector during the same quarter. Growth in real value added by the primary sector accordingly slowed from an annualised rate of 4,5 per cent in the third quarter of 2007 to 1,6 per cent in the fourth quarter. Real output in the mining sector declined at an annualised rate of 1,7 per cent in the fourth quarter of 2007, mainly due to a contraction in output volumes of gold and diamonds, as well as a slowdown in platinum production. However, real value added by the agricultural sector accelerated from an annualised rate of 5,8 per cent in the third quarter of 2007 to 10,5 per cent in the fourth quarter. Whereas agricultural production improved from a decline of 7,9 per cent in 2006 to an increase of 0,3 per cent in 2007, mining production contracted by 0,1 per cent in 2006 and by 0,6 per cent in 2007.

Growth in aggregate real gross domestic expenditure decelerated from an annualised rate of 5,4 per cent in the third quarter of 2007 to 0,2 per cent in the fourth quarter. The simultaneous slowdown in growth in final consumption expenditure by households and government over this period, as well as a notable decline in inventory levels, more than

neutralised sustained vigorous growth in gross fixed capital formation. The growth in final consumption expenditure by households slowed throughout 2007, recording 4,4 per cent in the third quarter and 3,8 per cent in the final quarter of the year. The ratio of gross fixed capital formation to GDP was 20,6 per cent in 2007 – its highest level since 1985.

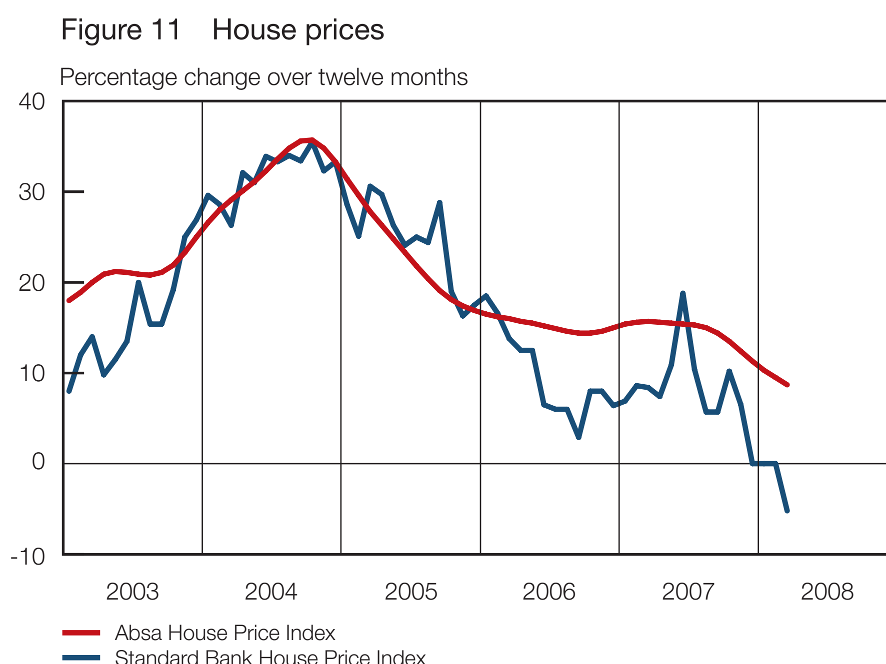
In the external sector of the economy, real exports of goods and services surged by an annualised 21,6 per cent in the fourth quarter of 2007. Export proceeds were boosted by an increase in the physical quantity of exports and higher international commodity prices during the fourth quarter of 2007. Real imports of goods and services rose moderately by 1,1 per cent in the corresponding quarter, with the result that South Africa's trade deficit almost halved. This outcome outweighed a further widening of the shortfall on the service, income and current transfer account with the rest of the world over the same period. Consequently, the deficit on the current account of the balance of payments shrank from 8,1 per cent of GDP in the third quarter of 2007 to 7,5 per cent in the fourth quarter. The deficit was more than covered by net financial inflows from the rest of the world in the fourth quarter. South Africa's reserve position continued to strengthen with the gross gold and other foreign reserves increasing from US$30,5 billion at the end of September 2007 to US$34,4 billion at the end of March 2008. The international liquidity position increased from US$28,4 billion to US$33,1 billion over the same period.

Real-estate and equity prices

Figure 11 shows that the rate of increase in house prices has continued to slow since September 2007. After pausing after mid-2006, the year-on-year rate of increase in the nominal Absa House Price Index declined once more, from 14,4 per cent in September 2007 to 8,7 per cent in March 2008.[4] The year-on-year change in the Standard Bank House Price Index fell sharply from 10,2 per cent in October 2007 to -5,2 per cent in March 2008. The median house price measured by this index was R550 000 in March 2008, compared with R580 000 in March 2007.

4 The Absa House Price Index records the total purchase price of houses in the 80 – 400 m² size category, valued at R2,9 million or less in 2007 and for which loan applications were approved by Absa. The Standard Bank House Price Index is based on the median price of the full spectrum of recorded house prices.

Figure 11 House prices



Sources: Absa and Standard Bank

Table 6 presents building statistics published by Stats SA, which suggest that economic activity in the real-estate sector continued to moderate in 2007. The real value of buildings completed increased by 9,8 per cent in 2007 compared with 21,4 per cent in 2006, mainly due to a significant slowdown in the growth of the real value of buildings completed in the residential sector, which declined from 16,7 per cent to 1,5 per cent. By contrast, the growth in the real value of buildings completed in the non-residential sector was 48,8 per cent in 2007, up from 30,6 per cent in 2006.

Table 6 Real value of building plans passed and buildings completed in larger municipalities

Annual percentage change

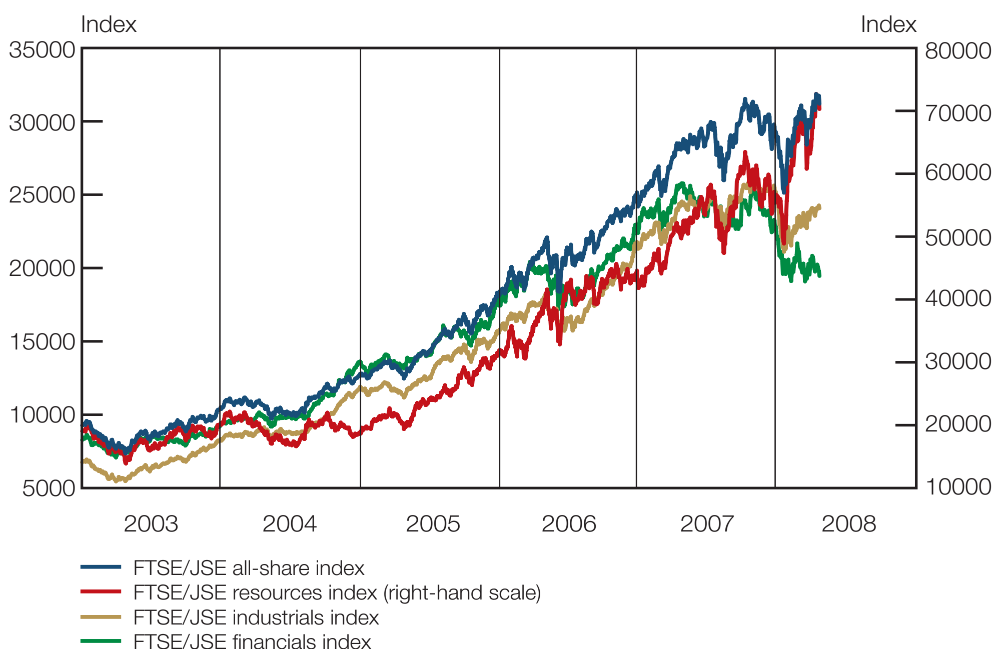
	2004	2005	2006	2007
Building plans passed				
Total	**35,7**	**36,3**	**8,1**	**-2,7**
Residential	42,0	29,8	2,7	-3,5
Non-residential	23,8	53,6	31,7	-5,9
Additions and alterations	29,1	41,6	5,0	1,4
Buildings completed				
Total	**26,2**	**25,7**	**21,4**	**9,8**
Residential	38,4	32,7	16,7	1,5
Non-residential	8,2	6,7	30,6	48,8
Additions and alterations	7,9	18,1	33,1	6,6

Source: Statistics South Africa

The total real value of building plans passed, which provides an indication of future construction activity, declined by 2,7 per cent in 2007. This was the result of declines in the real value of building plans passed for both the residential and non-residential sectors. The real value of building plans passed for the residential sector contracted by 3,5 per cent in 2007 after increasing by 2,7 per cent in 2006, and that for the non-residential sector declined by 5,9 per cent in 2007 after increasing by 31,7 per cent in 2006.

Share prices on the JSE Limited (JSE) followed global trends in the period under review by initially moving lower before recovering lost ground (Figure 12). The all-share index

Figure 12 Share price indices



(Alsi) traded above the 31 000 level in mid-October 2007 before declining in tandem with global markets on concerns regarding the US sub-prime market to just above 25 000 late in January 2008. The Alsi was then buoyed by high commodity prices and the recovery in global markets following the US Federal Reserve's interest rate reductions to trade around 31 000 once more in April. The record-high commodity prices resulted in the JSE resources index increasing from around 59 000 at the beginning of November 2007 to above 72 000 in mid-April 2008.

Fiscal policy

Notwithstanding the anticipated moderation in the pace of economic growth, the South African Minister of Finance was able to present a surplus budget on 20 February 2008 (Table 7). According to the 2008 *Budget Review*, the estimated budget balance for 2007/08 remains in surplus at R15,8 billion (or 0,8 per cent of GDP), an amount of R5,1 billion more than what was estimated at the time of the 2007 Budget. The medium-term budget balance is projected to be surpluses of 0,6, 0,5 and 0,5 per cent of GDP in 2008/09, 2009/10 and 2010/11, respectively. In terms of the structural or cyclically adjusted budget balance introduced in the 2007 *Medium Term Budget Policy Statement*, which factors in estimates of cyclical or one-off revenues, the budget is broadly stable with a deficit averaging 1,2 per cent of GDP over the next three years.

Table 7 Public finance data

R billions and per cent

	2005/06	2006/07	2007/08		2008/09	2009/10	2010/11
	Actual	Actual	Budget	Revised estimates	Medium-term estimates		
National government							
Deficit(-)/surplus(+)	-4,9	+11,0	+10,7	+15,8	+14,3	+11,3	+14,3
Revenue	411,7	481,2	544,6	558,0	625,4	692,9	759,0
Expenditure	416,7	470,2	533,9	542,1	611,1	681,6	744,7
As percentage of GDP:							
Deficit(-)/surplus(+)	-0,3	+0,6	+0,6	+0,8	+0,6	+0,5	+0,5
State debt cost	3,2	2,9	2,7	2,6	2,2	2,0	1,9
Total net loan debt	29,7	26,4	24,3	22,3	19,7	17,7	15,9
PSBR*	-0,7	-0,3	0,3	-0,1	1,2	1,4	1,4

* PSBR: Public-sector borrowing requirement

Source: National Treasury *Budget Review 2008*

The continued robust growth in tax revenue resulted in a revised main budget revenue total of R558 billion for fiscal 2007/08, representing 2,5 per cent more than originally budgeted. Expenditure was also revised upwards by about 1,5 per cent to R542,1 billion for the same period. Debt service costs are projected to continue decreasing over the medium term, declining from 2,6 per cent of GDP in 2007/08 to 1,9 per cent in 2010/11. The public-sector borrowing requirement (PSBR), which represents the funds needed by the public sector to cover any deficit in financing its own activities, has moved from a negative requirement to an average of 1,3 per cent of GDP over the medium term.

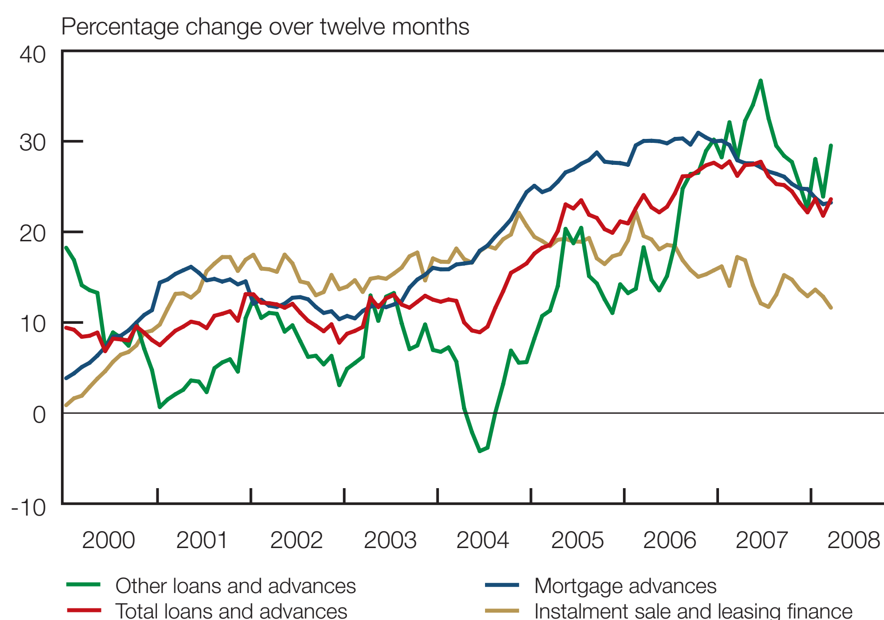
Monetary conditions

The growth in monetary aggregates slowed over the period under review, despite having moved higher in January 2008. The 12-month growth rate of the broad monetary aggregate (M3) slowed from 25,8 per cent in August 2007 to 23,2 per cent in November, then increased to 24,9 per cent in January 2008, before declining to 21,0 per cent in March. The movements in the growth rates for the narrower aggregates followed a similar pattern, with the M2 aggregate slowing to 20,0 per cent in March from 21,8 per cent in January, and the M1 aggregate declining to 15,5 per cent from 31,4 per cent over the same period.

Growth in total loans and advances to the private sector[5] declined between September 2007 and March 2008 (Figure 13). The year-on-year growth in total loans and advances to the private sector slowed from 25,2 per cent in September 2007 to 23,6 per cent in March 2008. Adjusted for securitisation transactions, growth in this aggregate was 24,8 per cent in March. The growth in the other loans and advances category, reflecting the usage of general loans and overdraft facilities by the corporate and household sectors, has been the main contributor to total loans and advances in recent months, although growth has slowed from its peak of 36,7 per cent in June 2007 to 29,5 per cent in March 2008. Mortgage advances slowed in tandem with total loans and advances, declining from 26,1 per cent in September 2007 to 23,2 per cent in March 2008, while the growth in instalment sale credit and leasing finance slowed from 15,2 per cent to 11,6 per cent over this period.

5 Total loans and advances to the private sector consist of instalment sale credit, leasing finance, mortgage advances, overdrafts, credit card and general advances. The first three categories are referred to as asset-backed credit, while the last three are referred to as other loans and advances.

Figure 13 Growth in loans and advances

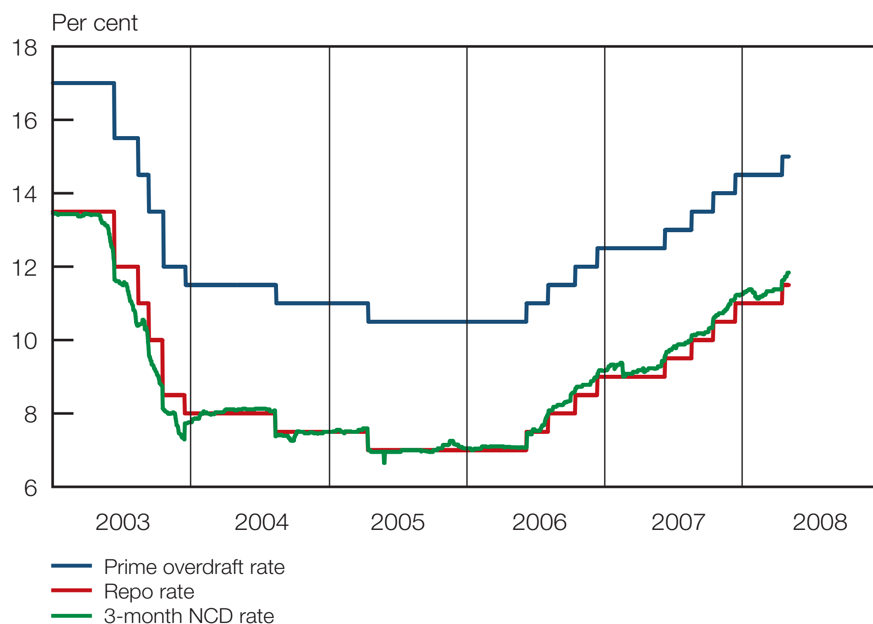


Monetary policy

In recent months, monetary policy has been facing a number of challenges. Inflation has been rising relentlessly despite the tighter stance of monetary policy, and by February CPIX inflation had reached 9,4 per cent. By the final quarter of 2007 there were clear signs that monetary policy was beginning to have the expected impact on domestic demand, but at the same time the economy was faced with a number of exogenous

supply-side shocks that were impacting on the inflation outlook. Initially, these shocks were confined to oil and food prices, but, more recently, electricity price developments also compounded the problems. The higher trend of inflation outcomes has contributed to a significant increase in inflation expectations and further increases in the repurchase rate of 50 basis points in December 2007 and in April 2008 (Figure 14).

Figure 14 The repo and other short-term interest rates



In general, there is little that monetary policy can do to avoid the first-round, or impact effects of supply-side shocks. The standard response is for the monetary authorities to allow for these one-off increases, but to react to any second-round or generalised effects that may come through. If inflation expectations are well anchored, the required monetary policy response could be relatively restrained. Similarly, the extent and duration of the shock or relative price change would also have a bearing on the intensity of the policy response. The problem facing the Monetary Policy Committee (MPC) is that it has not been facing a single shock of limited duration. The MPC has had to deal with a multiplicity of shocks of extended duration. For example, there has not been a sudden one-off increase in oil prices. Rather, what has been seen is a significant and extended upward trend in prices, which has almost consistently surprised on the upside. This has necessitated significant upward revisions to forecasts of future oil-price developments on numerous occasions. The severity of these developments has, in turn, adversely affected inflation expectations which, in turn, contributes to more generalised inflation.

During the past three meetings of the MPC, there was a consistent deterioration of the inflation forecast of the Bank, primarily as a result of upward revisions to the assumptions relating to exogenous variables of the model. At the December 2007 meeting, it was expected that inflation would peak at around 7,8 per cent in the first quarter of 2008 and then decline to within the inflation target range by the end of 2008, and reach 5,2 per cent by the final quarter of 2009. By January, the near-term forecast had deteriorated slightly, with inflation expected to peak at 8,5 per cent in the first quarter of 2008. Although CPIX inflation was still expected to return to within the target range by the end of 2008, the trajectory for 2009 was flatter around the 5,6-per-cent level. The forecast presented to the MPC at the April 2008 meeting showed a significant deterioration. This forecast is reproduced later on

in this *Review*. Not only was the peak expected to exceed 9 per cent, but inflation was now expected to return to within the inflation target range only by the end of 2009.

The forecasts of the Bank were broadly in line with those of the private sector. Although at the time of the April meeting the general consensus in the private sector was that inflation would return to within the inflation target range during the first half of 2009, subsequent revisions have also seen a more pessimistic outlook for inflation. The forecasts are also complicated by the uncertainty relating to the extent of the additional electricity price increase to be granted to Eskom.

At the December meeting, the committee noted that there was increasing evidence that previous monetary policy actions were having a dampening effect on household consumption expenditure. However, the MPC was concerned about the possible impact of the higher inflation outcomes on inflation expectations. At that time, inflation expectations, as reflected in the Inflation Expectations Survey conducted by the Bureau for Economic Research (BER) at Stellenbosch University, had exhibited a slight deterioration in the fourth quarter of 2007. Of significance was the fact that expectations for 2009 had remained unchanged at 5,6 per cent. Indicators from the bond markets also indicated that expectations appeared to be anchored within the target range, but following an upward trend.

The main concerns of the MPC at the December 2007 meeting were the petrol, food and electricity price prospects. The price of North Sea Brent crude oil was around US$90 per barrel, and domestic petrol prices had increased by 43 cents per litre in December. At that time there was still uncertainty relating to the outcome of Eskom's application for an 18-per-cent electricity price increase. Food was still a major contributor to inflation trends, although futures prices indicated that some respite could be expected during 2008. These factors contributed to the MPC's decision to increase the repurchase (repo) rate by a further 50 basis points in December.

Other developments were either seen to be neutral or favourable with respect to the containment of inflation pressures. Household consumption expenditure continued to show signs of moderation, and this was reflected mainly in motor vehicle and retail sales. Credit extension to the private sector remained high, but appeared to be showing signs of moderation. Asset-price growth also appeared to be restrained at that time, particularly in the wake of global developments, which had a negative impact on domestic financial and capital markets. House price increases were still positive but declining. The supportive role of fiscal policy was confirmed by the renewed commitment to fiscal prudence with the projection of fiscal surpluses in the coming years.

Domestic output growth appeared to be consistent with the potential growth rate of the economy, while the exchange rate, although more volatile, was relatively unchanged. The deficit on the current account of the balance of payments, which had widened to 8,1 per cent of GDP in the third quarter, continued to be adequately financed by capital inflows. The global outlook at that time remained uncertain, although world inflation appeared to be under control.

At the January 2008 meeting, the MPC decided to leave the repo rate unchanged, despite the continued upward trend in inflation. As noted earlier, the central forecast of the Bank had only shown a slight deterioration in the short term, and the longer-term projection, which is of more concern to monetary policy, was relatively unchanged. The main upside risks were the same as at the previous meeting, although the MPC's assessment was that the degree of upside risk had abated somewhat. International oil

prices had reached US$100 per barrel, but there was some expectation that the impending global downturn could restrain the degree of upside price risk. Food prices also remained a risk to the outlook, with some respite expected from the more favourable weather conditions. Although the electricity price increase of 14,2 per cent had been announced by the regulator, uncertainty still prevailed in this respect. An important adverse development from an inflation perspective since the previous meeting was the 7-per-cent depreciation of the trade-weighted rand exchange rate.

Despite these developments, the MPC felt there were sufficient offsetting developments that would have a restraining impact on the inflation trend. Most significant was the continued decline of household consumption expenditure growth, which was also being dampened by negative wealth effects as evidenced in the 16-per-cent decline in the Alsi on the JSE since October 2007 and the continued moderation in house-price increases. Growth in credit extension also maintained its downward trend and wage growth appeared to be consistent with the inflation target range. Risks to output growth were seen to be on the downside, particularly in the light of emerging electricity supply constraints. At the same time, the downside risks to global growth had increased.

By April, the risks to the inflation outlook had increased again, and the MPC decided to raise the repo rate by a further 50 basis points. The prospect for a near-term return to within the inflation target range had receded considerably. Furthermore, there were signs that pressures on inflation were becoming more generalised, implying the emergence of second-round effects. Oil prices had continued their upward trend and, combined with a further 10-per-cent depreciation of the South African rand against most currencies, resulted in a R1,27 cumulative increase in the domestic price of petrol in March and April. Food price pressures were also exacerbated by the rand depreciation. The prospect of a doubling of electricity prices by the middle of 2009 also had a marked impact on the risk profile of the inflation outlook. Adding to these negative prospects was the most recent inflation expectations survey which showed that expectations had deteriorated significantly since the previous survey. Of particular concern was the deterioration in expectations for the 2009 and 2010 periods, which indicates that respondents, on average, do not expect inflation to return to within the target range over the medium term. These trends were also evident in the increasingly higher wage settlements.

The MPC did highlight a number of factors counteracting these unfavourable trends, but did not consider them to be sufficient to offset the upside risk to the forecast. These factors were similar to those considered at the previous meeting. Of major significance was the further slowdown in household consumption expenditure growth and evidence of a moderation of output growth to rates below potential, as evidenced in a number of surveys. The global growth scenario was also subject to further downward revisions, while global inflation, while rising somewhat, appeared to be under control despite oil and food price pressures.

When the MPC initially started on its tightening cycle in June 2006, the main concern was the potential impact of high levels of domestic demand on inflation. Monetary policy clearly has a direct role to play under such circumstances. The dilemma facing the MPC more recently was that a succession of supply-side shocks had come to dominate the inflation landscape. The discussion in Box 3 suggests that a number of inflation-targeting countries currently face a similar challenge. While monetary policy cannot do much to prevent these shocks from having first-round effects, the lack of a monetary policy response could impact adversely on inflation expectations, which would then reinforce the emergence of generalised price increases.

6 However, these trends were observable worldwide in the 1990s, and critics point out that inflation targeters did not perform better in this regard than non-IT industrialised countries such as Germany and the US.

Box 3 Monetary policy challenges in uncertain times

The South African Reserve Bank is one of some 20 countries that have adopted the inflation-targeting (IT) framework since New Zealand became the first inflation targeter in 1990. The IT framework has generally been found to have performed well. After countries had adopted IT, the levels and volatility of inflation, and of interest rates, tended to decline, output volatility did not worsen, and exchange rate pass-through moderated.[6] More recently, however, there have been challenges that have resulted in a number of inflation targeters missing their targets, raising questions about the success of the framework.

As Tables B3.1 and B3.2 show, inflation outcomes in 2005 were within the targets of the vast majority of IT countries. In January 2005, for example, all of the 7 industrialised countries in Table B3.1 were within their targets, as were 8 of the 16 emerging-market inflation targeters in Table B3.2 (including South Africa).

Table B3.1: IT adoption dates and targets: Industrial countries
Per cent and percentage points (pp)

Country	IT adoption date	Target range* (per cent and pp)	Point (per cent)	Inflation as at January 2005 (per cent)	Inflation as at March 2008 (per cent)
New Zealand	Mar 1990	1 – 3	-	2,8	3,4
Canada	1991	1 – 3	-	1,9	1,4
United Kingdom	Oct 1992	+/- 1pp	2	1,5	2,5
Sweden	Jan 1993	+/- 1pp	2	0,0	3,4
Australia	Apr 1993	2 – 3	Thick point	2,4	4,2
Iceland	Mar 2001	+/- 1,5pp	2,5	4,0	8,7
Norway	Mar 2001	+/- 1pp**	2,5	1,1	3,2

* A number preceded by a (+/-) indicates the tolerance level for a point target (in percentage points)
** "Particular emphasis will be placed on any deviations outside the interval +/- 1 percentage point"

Sources: International Financial Statistics, various central banks' inflation reports and websites

Table B3.2: IT adoption dates and targets: Emerging-market economies
Per cent and percentage points (pp)

Country	IT adoption date	Target range* (per cent and pp)	Point (per cent)	Inflation as at January 2005 (per cent)	Inflation as at March 2008 (per cent)
Israel	1992	1 – 3	-	1,2	3,7
Czech Republic	Jan 1998	+/- 1pp	3	1,7	7,1
Poland	1999	+/- 1pp	2,5	4,0	4,1
Brazil	Jun 1999	+/- 2pp	4,5	7,4	4,7
Chile	Sep 1990	+/- 1pp	3	2,3	8,5
Colombia	Sep 1999	3,5 – 4,5 (2008)	-	5,4**	5,9
South Africa	Feb 2000	3 – 6	-	3,6	10,1
Thailand	May 2000	0 – 3,5	-	0,7	1,7
Korea	1998	+/- 0,5pp	3	3,1	3,9
Mexico	Jan 2001	+/- 1pp	3	4,5	4,3
Hungary	Jun 2001	+/- 1pp	3	4,1	6,7
Peru	Jan 2002	+/- 1pp	2	3,0	5,5
Philippines	Jan 2002	+/- 1pp	4	8,4	6,4
Indonesia	Jul 2005	+/- 1pp	5	7,3	8,2
Romania	Aug 2005	+/- 1pp	4	9,0	8,6
Turkey	Jan 2006	+/- 2pp	4	9,5	9,2

* A number preceded by a (+/-) indicates the tolerance level for a point target (in percentage points)
** Colombia's target for 2005 was 4,5 – 5,5 per cent

Sources: International Financial Statistics, various central banks' inflation reports and websites

This situation has altered dramatically in recent months. Primarily as a result of inflationary pressures emanating from the supply-side effects of developments in international energy and food markets, many IT countries are currently in breach of their targets. As the tables show, according to the most recent inflation data, 4 out of 7 industrialised country and 14 out of 16 emerging-market inflation targeters are in breach of the upper end of their inflation target range or tolerance limit.

Does this mean that the IT framework has failed? The answer is no, although the current situation provides an important test. Ideally, inflation targeters would prefer to keep inflation on target at all times. However, the framework recognises that there may be instances when supply-side shocks cause inflation to diverge from the target. The appropriate response of monetary policy in such instances would be to ensure that second-round effects are minimised. The more anchored expectations are, the more restrained the response will need to be. The success or failure of IT depends on whether it allows IT countries to anchor expectations and facilitates a return to a low and stable inflation environment over time, with as little cost to output as possible.

The outlook for inflation

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

International outlook

Growth in world economic activity is projected to slow notably in 2008 in the wake of ongoing financial market turbulence and increased risk aversion. After expanding by 4,9 per cent in 2007, the global economy is expected to expand by 3,7 per cent in 2008 (revised downwards from the forecast of 4,8 per cent made by the IMF in September 2007), and by 3,8 per cent in 2009 (Table 8). The risks to growth have become more skewed to the downside than at the beginning of the year, predicated on the fallout from sub-prime mortgages, weakness in consumer spending and lower productivity growth.

Table 8 IMF projections of world growth and inflation for 2008 and 2009*
Per cent

	Real GDP			Inflation rates		
	2008		2009	2008		2009
World	**(4,8)**	**3,7**	**3,8**	**(3,6)**	**4,8****	**3,7****
Advanced economies	**(2,2)**	**1,3**	**1,3**	**(2,0)**	**2,6**	**2,0**
United States	(1,9)	0,5	0,6	(2,3)	3,0	2,0
Japan	(1,7)	1,4	1,5	(0,5)	0,6	1,3
Euro area	(2,1)	1,4	1,2	(2,0)	2,8	1,9
United Kingdom	(2,3)	1,6	1,6	(2,0)	2,5	2,1
Other advanced economies	(3,8)	3,3	3,4	(2,3)	3,0	2,6
Other emerging-market and developing countries	**(7,4)**	**6,7**	**6,6**	**(5,3)**	**7,4****	**5,6****
Africa	(6,5)	6,3	6,4	(6,0)	7,5**	5,9**
Central and eastern Europe	(5,2)	4,4	4,3	(4,1)	6,4	4,3
Commonwealth of Independent States	(7,0)	7,0	6,5	(8,3)	13,1	9,5
Developing Asia	(8,8)	8,2	8,4	(4,4)	5,9	4,1
China	(10,0)	9,3	9,5	(3,9)	5,9	3,6
India	(8,4)	7,9	8,0	(4,4)	5,2	4,0
Middle East	(5,9)	6,1	6,1	(9,2)	11,5	10,0
Western hemisphere	(4,3)	4,4	3,6	(5,8)	6,6	6,1

* IMF projections for 2008 as at September 2007 in parenthesis
** Zimbabwe excluded

Source: IMF *World Economic Outlook*, April 2008

The growth projections for the US and some advanced economies have been reduced significantly. Box 4 discusses the impact of a slowdown in the US on the global economy. However, although growth forecasts have been lowered across the board, with import growth of OPEC and other oil exporters soaring and the oil and commodity investment boom continuing apace, the global expansion is projected to better withstand the credit crisis-induced demand weakness in the US and a few other developed countries than during previous crises.

Real GDP growth in the advanced economies is forecast at 1,3 per cent in 2008 and 2009 after having amounted to 2,7 per cent in 2007, while consumer prices are projected to rise 2,6 per cent this year. This would be the highest inflation rate since 1995. The US economy faces increasing headwinds from a downturn in the housing sector and US growth is projected to slow to 0,5 per cent in 2008, having been revised downwards from the 1,9 per cent forecasted by the IMF in September 2007. Rising prices for food, energy and other raw materials account for much of the pick-up in inflation rates. Inflation in the US is expected to average 3 per cent in 2008, before decelerating to 2 per cent in 2009.

In Japan, consumer and business sentiment has weakened. Japan's growth is projected to decelerate to 1,4 per cent in 2008 before rising slightly to 1,5 per cent in 2009. Inflation of 0,6 per cent is projected for 2008 and 1,3 per cent for 2009.

For the euro area, the growth forecast for 2008 has been revised downwards by the IMF to 1,4 per cent from the 2,1 per cent forecast in September 2007. Growth in 2009 is projected to decline further to 1,2 per cent. Inflation in the euro area is expected to average 2,8 per cent in 2008, well above the ECB's preferred range.

In the UK growth is projected to decline to 1,6 per cent in 2008, having been revised downwards from the 2,3 per cent forecasted by the IMF in September 2007. Inflation in the UK is projected to accelerate to 2,5 per cent in 2008 before declining to 2,1 per cent in 2009.

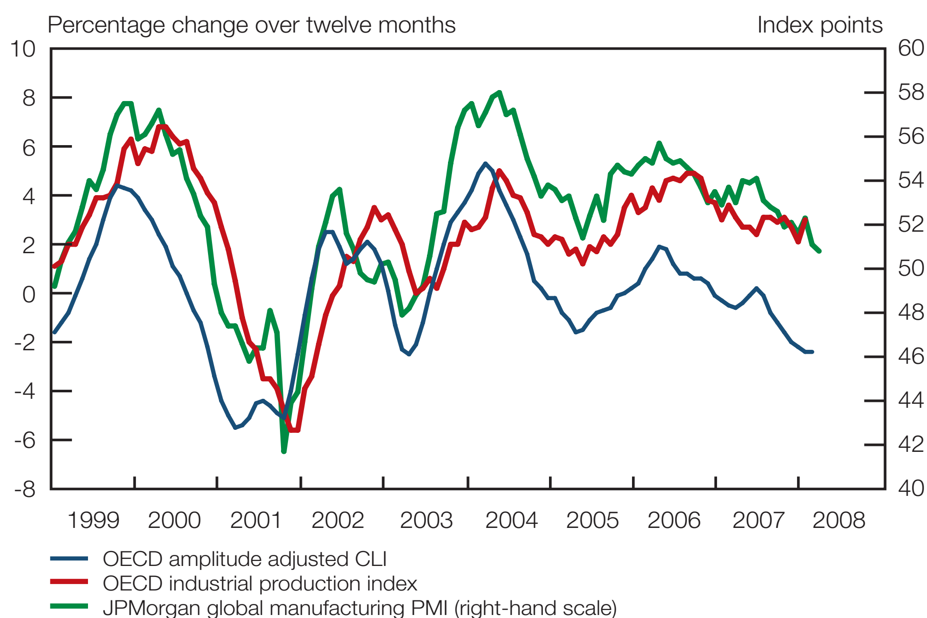
Outside the US and a few developed countries, growth is expected to generally hold up well as a rotation in the source of global demand from credit-driven activity in the borrowing countries to revenue-financed spending by the commodity exporters occurs. Given the recent surge in commodity prices and continued problems in credit markets, this rotation appears not to have run its course yet. A good indicator of this is Asian exports which have remained robust overall, but are now decelerating to the US while booming to the oil and commodity exporting countries. Consequently, global economic activity continues to be supported by robust economic conditions in emerging-market countries in general. However, weaker external demand, a further deterioration in financing conditions and the tightening of monetary policy in a number of countries pose downside risks to the growth outlook for these countries. Developing Asian nations have also been adopting measures to ease the burden of mounting food and fuel prices on the region's poor, and inflation poses a greater challenge to the region's economies than the current financial turmoil.

China's real GDP growth is projected to slow somewhat from the 11,4 per cent expansion in 2007 to around 9,3 per cent in 2008. Inflation is projected to average 5,9 per cent in 2008 and 3,6 per cent in 2009. India is expected to record 7,9 per cent growth in 2008 and 8,0 per cent 2009, while inflation is projected to decline to 5,2 per cent in 2008 and 4,0 per cent in 2009. Growth of 8,2 per cent in 2008 would be the lowest for developing Asia since 2002, down from 9,7 per cent in 2007.

Africa's economic outlook remains positive given the continued favourable commodity price outlook, regional macroeconomic stability, rising oil production and continued capital inflows. The most important downside risks for growth in the region would comprise heightened risk aversion by investors as a result of the tensions flowing from the Zimbabwe elections and a worse-than-expected foreign demand outcome due to spill-over effects flowing from the international financial turmoil.

The outlook summarised in Table 8 on page 25 is also reflected in other indicators. The Global Manufacturing Purchasing Managers Index (PMI), produced by JPMorgan in association with research and supply management organisations, continued its declining trend during January 2008 (Figure 15). The January outcome was the lowest since July 2003 and was caused by a record fall of 8,3 points in the index of services production, which more than offset a surprise increase in the index of manufacturing output. The year-on-year rate of change in the Organisation for Economic Co-operation and Development (OECD) amplitude-adjusted composite leading indicator was a negative 2,4 per cent in January 2008 after declining 2,1 per cent in the previous month, suggesting a slowdown in economic activity in the major OECD economies. January data for individual countries also suggest a slowdown in economic activity in the US, Japan, the euro area, Canada and the UK. January 2008 data for non-OECD countries point to a possible downturn in China and India, while continued expansions are expected in Russia and Brazil. The year-on-year rate of change in the OECD industrial production index increased slightly from 2,7 per cent in November 2007 to 3,0 per cent in January 2008.

Figure 15 OECD composite leading indicators



Sources: OECD and JPMorgan

Overall, the balance of risks to the global outlook is tilted to the downside, mainly due to the continued turmoil in financial markets that could further reduce domestic demand in advanced economies. Not only could ongoing financial market turbulence further reduce domestic demand in advanced economies, but it could also spill over into emerging-market and developing economies. Although banks have already taken most of the writedowns needed on US sub-prime loans, the IMF has warned that as the US economy weakens, the deterioration in credit will move up and across the credit spectrum leading to slowing credit growth. The IMF expects Europe to also experience

tightening conditions and slowing credit growth as its banks have experienced losses and securitisation markets have contracted. Emerging markets are projected to show continued resilience in the credit crisis although several countries that rely on international markets and international bank borrowing to fund sizeable current-account deficits and rapid credit growth will be at greater risk of economic contraction.

A number of factors continue to place upward pressure on oil prices, with little relief expected until later this year. Oil demand continues to grow apace in China, India and Russia, where fuel prices are heavily subsidised. In the Middle East, soaring energy needs and shortfalls in natural gas supplies mean major exporters such as Saudi Arabia and the United Arab Emirates must use more oil in their own region. The US Energy Information Administration (EIA) predicts that even with falling consumption being projected in the US, oil demand worldwide will jump by 1,2 million barrels a day this year. The fact that the oil market currently has little spare capacity to tap in a crisis (i.e. the fact that the 13-member OPEC now has just over two million barrels a day in excess production capacity, almost all of it in Saudi Arabia) has also attracted greater speculative interest in the market. Futures prices as at 5 May 2008 project Brent crude oil prices of around US$114 per barrel for delivery in the third quarter of 2008.

Box 4 The impact of a US slowdown on the global economy

The US Conference Board's leading business cycle indicator decreased sharply in November 2007 – its second consecutive monthly decline – having been down in four of the previous six months. The leading composite index fell by 1,2 per cent from May to November 2007, the largest six-month decrease in the index in six years (a three-month decline in the leading index is deemed by some observers to signal a recession but few economists actually use such a simple and inflexible rule). Meanwhile, industrial production and real personal income less transfer payments peaked in September 2007, real manufacturing and trade sales peaked in October, and, most recently, employment peaked in December. After five years of strong global economic growth, an increasingly important question for policy-makers in many countries is how hard the landing of the US economy will be and how this will impact on the global economic growth outlook.

In 2007 there were expectations that strong sources of growth outside the US would prove resilient to a consumer-led US recession. Decoupling, the notion that the rest of the world can weather the effects of a slowing US economy, was expected by some analysts to ensure sustained global growth in 2008 and beyond in the event of a US recession. Decoupling proponents backed their claims with data available during 2007 that showed sustained strong growth in the economies of important US trading partners. However, what had begun in 2006 as the cooling of the US housing market and turned at the beginning of 2007 into a US sub-prime mortgage dilemma had expanded by the middle of 2007 into a more severe reduction in the availability of credit. The financial turmoil then began moving from the US to Europe, in part because of European banks' exposure to the US mortgage sector and in part because of corrections in real-estate markets, most notably in the United Kingdom (UK) and Spain. As both banks and private households in affected countries had to write off non-performing assets, the outlook for investment and consumption in these countries darkened somewhat in the latter part of 2007. Towards the end of January 2008, another round of broad-based turmoil in credit markets commenced. However, in contrast to the bank liquidity problems experienced in 2007, the most recent problems were related to solvency at leveraged institutions that had used borrowed money to purchase assets that had subsequently fallen in value. Banks became increasingly concerned about their solvency and called in part of their loans. This resulted in leveraged institutions in a number of countries being forced to sell assets in a falling market. It was becoming increasingly apparent that powerful forces of globalisation could make substantial decoupling unlikely and international financial institutions began to revise their global growth forecasts downwards. However, the fallout from slowing growth in the US thus far has been limited as global growth recorded in 2007 rounded off the best global four-year period in more than 30 years. Even the International Monetary Fund's latest estimate projects global growth of 3,7 per cent in 2008.

By lowering their policy rates, policy-makers in the US and the UK have striven to widen the gap between short-term and long-term rates. Such a steeper yield curve should allow banks to restore profitability by increasing the margin between their interest income from longer-term lending and

their own costs from short-term borrowing. This should ensure that credit remains available to the rest of the economy at lower costs, and complementary measures such as the recent concerted liquidity management by the US and European central banks as well as help for troubled bond insurers can foster the proper functioning of the financial system by facilitating balance-sheet adjustments in the banking and private household sectors. If aggressively looser monetary policy and the monetary transmission mechanism do not succeed in bringing about a steeper yield curve, the feedback from the financial market turmoil to the real economy could be substantial. The credit squeeze will have a stronger negative real economy impulse if tighter liquidity conditions, lower asset values, impaired capital resources, reduced capital supply and slower aggregate demand feed back on each other. A longer and deeper recession could then ensue as more expensive and rationed mortgages result in house prices in the US and other industrial countries falling further and for longer.

Decoupling proponents point out that global economic growth has increasingly been driven by emerging markets and developing countries in recent years. These economies have largely abstained from excessive credit extension and are less exposed to present international financial turmoil than some of the industrial countries. According to World Bank estimates, emerging-market and developing countries contributed almost 70 per cent to global economic growth in 2007. China added more than twice as much to growth as the US, while India accounted for as much as the euro area. The world economy's boom in the past five years has reflected a fundamental shift in the prime drivers of growth. Even if the US and some other industrial countries were to suffer a mild recession, output in emerging-market and developing countries could still keep global growth substantially above 2 per cent – the rate that was seen to divide global expansions from recessions in the past. However, in the event of a more prolonged US recession, European and Asian banks would become less immune to the US credit squeeze if the market value of higher-quality US mortgage debt to which these banks are exposed continues to fall. There are still no signs of significant spillover from the US to China, India and key emerging-market countries. Countries with current-account surpluses, well-capitalised banking systems and commodity exports should continue to perform well, and this could generate a degree of reverse coupling, thereby dampening a US slowdown.

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Outlook for domestic demand and supply

Domestic growth is set to moderate during 2008 on the back of weakened consumer and business confidence, as well as capacity and skills constraints in certain sectors. The impact of electricity supply constraints is particularly important in this regard. Measures of domestic trade and manufacturing activity have decelerated further although fixed investment has shown renewed resilience.

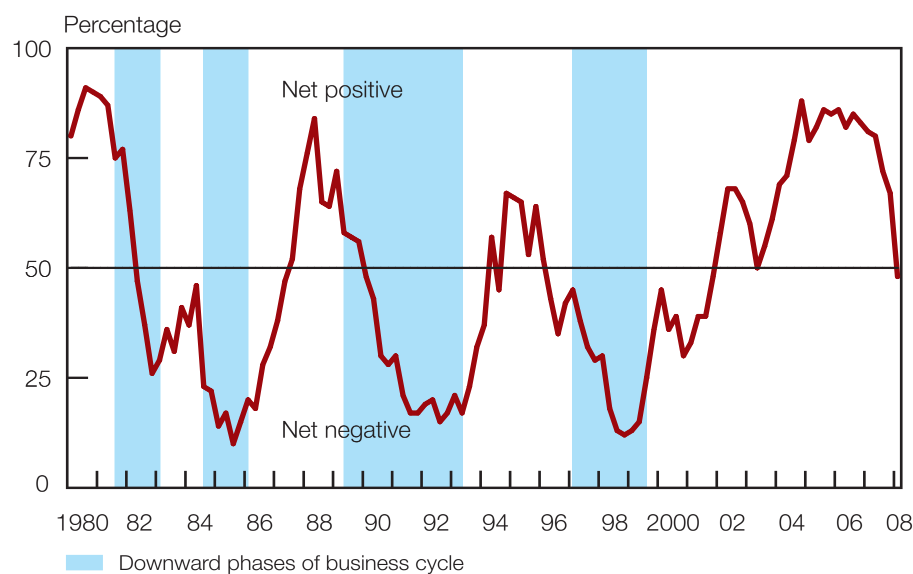
In its February 2008 *Budget Review*, the National Treasury expects economic growth to slow to 4,0 per cent in 2008 before increasing to 4,2 per cent in 2009. Economic growth is projected to increase to 4,6 per cent in 2010, partly in response to stimulus from the 2010 FIFA World Cup. According to the latest Reuters consensus forecasts surveyed in March 2008, the South African economy is expected to grow by 3,7 per cent in 2008, 4,2 per cent in 2009 and 4,9 per cent in 2010. These forecasts represent the mean of 22 individual forecasts for 2008 and 2009 and the mean of 16 forecasts for 2010. They range from 1,8 to 4,4 per cent for 2008, from 1,8 to 5,3 per cent for 2009, and from 3,9 to 5,5 per cent for 2010.

Consumer confidence, measured by the First National Bank/Bureau for Economic Research (FNB/BER) Consumer Confidence Index (CCI) as the percentage of

respondents expecting an improvement in conditions less the percentage expecting deterioration, declined from +22 in the final quarter of 2007 to a four-year low of +12 in the first quarter of 2008. The previous occasion consumer confidence fell by such a big margin was during the third quarter of 2004 when the index declined by 14 index points. Although the CCI is currently at its lowest level in four years and although overall consumer confidence has declined sharply during the first quarter of 2008, it nevertheless remains relatively high as a reading of +12 indicates that the majority of consumers is still optimistic about the future. The sharp decline in the first quarter was mainly the result of a number of adverse developments since the previous survey, such as rising capacity constraints.

The level of business confidence, measured in terms of the Rand Merchant Bank (RMB)/BER Business Confidence Index, declined to its lowest level in six years (Figure 16). The index measures business confidence on a scale of 0 to 100, with 0 indicating an extreme lack of confidence, 50 neutrality and 100 extreme confidence. It declined from 67 in the fourth quarter of 2007 to 48 in the first quarter of 2008, with all subcomponents declining in the quarter. The largest declines occurred among wholesalers and manufacturers, declining by 35 and 23 index points, respectively, with new vehicle dealers' confidence declining by a further 4 index points to a level of 30. Building contractors' confidence declined from 83 to a level of 69 and retailers' confidence declined by 19 index points to a level of 52 in the first quarter of 2008. The net negative sentiment that prevailed can be attributed to a contraction in business volumes, reduced profitability, declining household spending as well as electricity supply disruptions. The fieldwork for the first-quarter survey took place between 4 February and 4 March 2008.

Figure 16 RMB/BER Business Confidence Index



Sources: Rand Merchant Bank and Bureau for Economic Research

The South African Chamber of Commerce and Industry's Trade Activity Index, which is a composite index of sales volumes, new orders, supplier deliveries, inventory levels and employment, rose by 2 index points from 48 in January to 50 in February 2008. However, the index is still 8 index points lower than the level of 58 reported in March 2007. The latest survey results point towards a possible bottoming of trade conditions that had slowed substantially towards the end of last year. The Trade Expectations Index, which has remained in the 66 – 68 range since March 2007, was at 67 index points in February 2008.

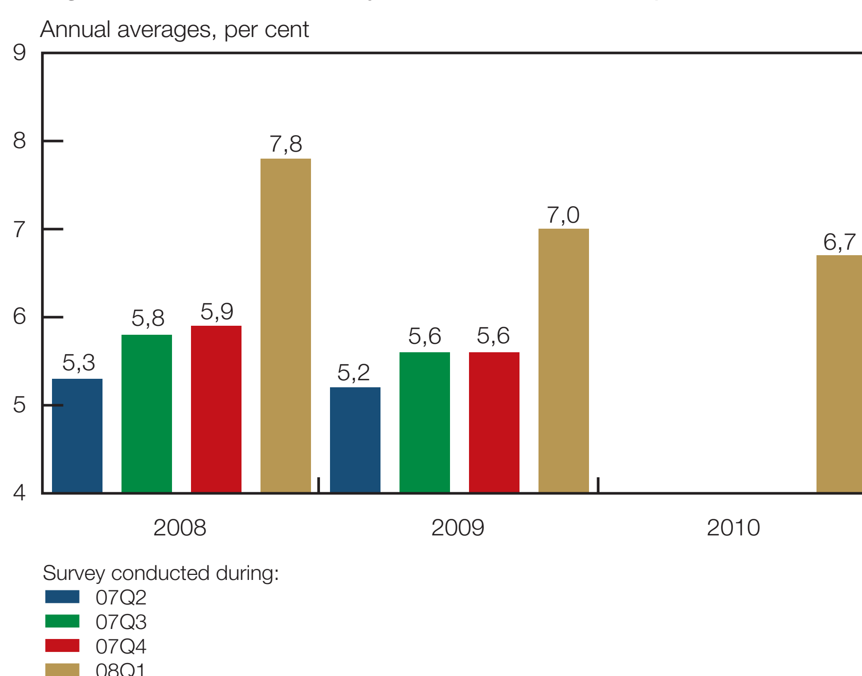
The Investec/BER PMI, a barometer of manufacturing activity, increased to 54,1 in April 2008, after dropping to 43,7 in March. The timing of Easter during 2008 would have artificially depressed the March reading and probably explains the concomitant sharp increase in April. Business activity and new sales orders were somewhat firmer in April, and a more appropriate average March and April reading, while still showing a slight improvement on February, remains under the critical level of 50 indicating continued pressure on the sector. The combined March and April employment number of 48,1 also showed a slight improvement on February, but at a level below 50 is consistent with a moderate decline in employment. Pressure on input prices continued to mount, with the PMI input price sub-index increasing from 90,7 in March to 93,1 in April 2008.

Confidence levels in the civil construction industry, which provide an insight into trends in fixed investment, declined slightly in the first quarter of 2008, despite the continued robust performance of fixed investment growth in the economy. The FNB Civil Construction Confidence Index, which reflects the proportion of managers expressing satisfaction with current conditions in the industry, decreased from an index value of 83 in the fourth quarter of 2007 to 79 in the first quarter of 2008. Tendering competition increased during the first quarter of 2008, reflecting the moderation in the current level of construction activity reported by respondents to the survey. Notwithstanding the rise in tendering competition, margins of respondents and therefore the growth in the profitability of companies responding to the survey was not unduly impeded. However, expectations are that business conditions in the civil construction sector are unlikely to deteriorate further.

Indicators of inflation expectations

Inflation expectations have increased significantly in recent months. A survey of inflation expectations, undertaken by the BER in the first quarter of 2008, reports that inflation expectations registered the largest increase between consecutive quarters in the survey's eight-year history (Figure 17).

Figure 17 BER surveys of CPIX inflation expectations



Source: Bureau for Economic Research, University of Stellenbosch

According to the first quarter of 2008 survey, CPIX inflation is expected to average 7,8 per cent in 2008, before declining to 7,0 per cent in 2009 and 6,7 per cent in 2010. As Figure 17 shows, these results are notably higher than those obtained in the previous three surveys. Disaggregated according to different survey groups as shown in Table 9, business people and trade union leaders expect CPIX to remain at around 7,5 per cent over the forecast period. However, financial analysts expect CPIX inflation to decline from 8,1 per cent in 2008 to 5,9 per cent in 2009 and 5,4 per cent in 2010.

Table 9 BER survey of CPIX inflation expectations: First quarter 2008*
Per cent

	2008	2009	2010
1. Financial analysts	(6,0) 8,1	(5,1) 5,9	(-) 5,4
2. Business	(5,8) 7,6	(5,7) 7,5	(-) 7,4
3. Trade unions	(6,0) 7,5	(6,0) 7,5	(-) 7,4
Average 1 – 3	(5,9) 7,8	(5,6) 7,0	(-) 6,7

* Fourth-quarter 2007 results in parentheses

Source: Bureau for Economic Research, University of Stellenbosch

Deteriorating inflation expectations are also evident from the March 2008 Reuters survey of long-term forecasts for the South African economy (Table 10). According to this survey, the mean CPIX inflation rate is expected to reach 8,8 per cent in 2008, before slowing to 6,0 per cent in 2009 and 5,4 per cent in 2010. Consistent with the BER survey, the March 2008 Reuters forecasts represent a significant upward revision to the results of the February survey.

Table 10 Reuters survey of CPIX forecasts: March 2008*
Per cent

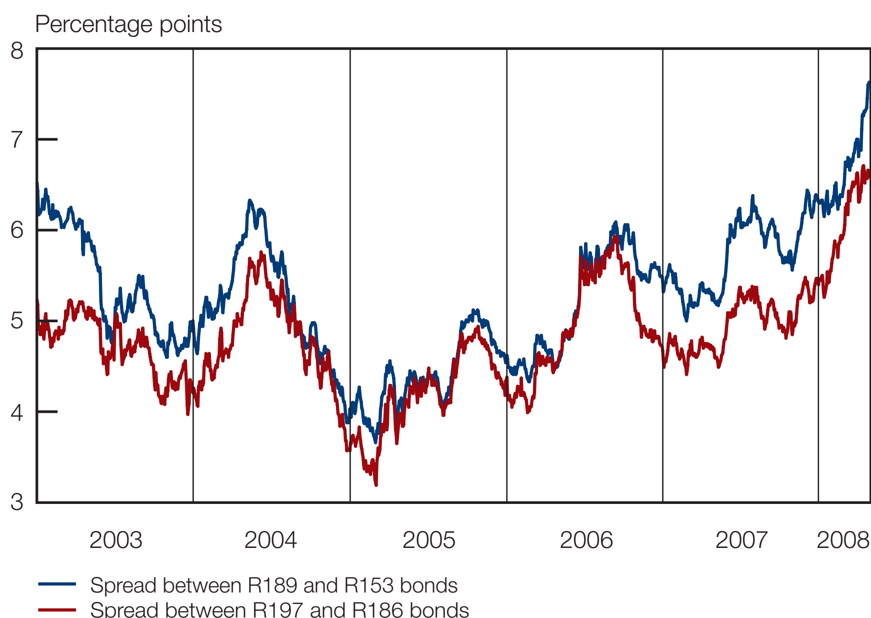
	2008	2009	2010
1. Mean	(8,1) 8,8	(5,6) 6,0	(5,2) 5,4
2. Median	(8,2) 8,7	(5,6) 6,1	(5,1) 5,3
3. Highest	(8,8) 9,5	(7,3) 8,0	(7,3) 8,0
4. Lowest	(6,8) 7,8	(4,9) 4,9	(4,5) 4,4
Number of forecasters	(17) 22	(17) 22	(12) 16

* February 2008 survey results in parentheses

Source: Reuters

Expectations derived from break-even inflation rates, measured as the difference between the yields on South African CPI inflation-linked bonds and conventional nominal bonds of similar maturity, also suggest that inflation expectations have moved higher in the period under review (Figure 18). Break-even inflation rates obtained from the R197 (maturing 2023) inflation-linked bond rose from 4,94 per cent at the beginning of November 2007 to 6,59 per cent on 29 April 2008, while those from the R189 (maturing 2013) inflation-linked bond increased from 5,64 per cent to 7,63 per cent over the same period.

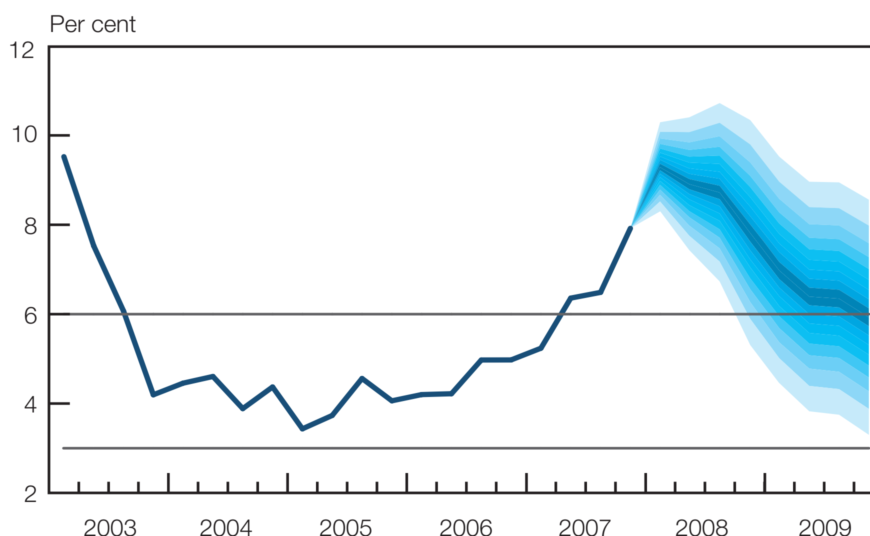
Figure 18 Break-even inflation rates



The South African Reserve Bank inflation forecast

The most recent projections of the Bank's quarterly inflation-forecasting model, presented to the MPC meeting on 9 and 10 April 2008, are reproduced in the form of a fan chart in Figure 19. According to these projections, the inflation outlook has deteriorated since the publication of the previous *Monetary Policy Review* in November 2007. This deterioration is ascribed to recent inflation outcomes being higher than

Figure 19 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).*

expected, and to further upward revisions to the oil and administered prices assumptions for 2008 and 2009. The administered prices assumption makes provision for the National Energy Regulator of South Africa's (NERSA) approved 14,2 per cent electricity price increase as well as the 2c/kWh electricity levy announced in the Budget Speech of February 2008. The central projection, conditional on an unchanged repurchase rate, is for the average CPIX inflation rate to peak at 9,3 per cent in the first quarter of 2008, and then decline to within the inflation target range in the final quarter of 2009.

A number of factors currently pose risks to the inflation outlook. The possibility of further electricity price increases appears the most significant and immediate upside risk. Eskom has applied for a revision of the increase for 2008/09 from 14,2 per cent to 60 per cent, and for a further increase of a similar magnitude in the following year. International oil prices also continue to pose a threat in this regard despite the slowdown in global economic growth, and food prices show few signs of moderating internationally. The threat from oil and food price developments is itself partly dependent on developments in the rand exchange rate. Increased risk aversion in global markets and negative perceptions regarding the size of the current-account deficit are factors that increase the risk to the inflation outlook arising from the exchange rate.

Balancing these upside risks are factors that are expected to have a moderating effect on the inflation outlook. Slower growth in overall economic activity, reflected particularly in household consumption expenditure and in bank credit extension to the private sector, is an important factor in this regard. Asset prices are also providing less encouragement for inflation, with house-price increases moderating in recent months.

Assessment and conclusion

The monetary policy environment remains particularly challenging. While South Africa has unique challenges, other inflation-targeting countries are also having to deal with similar significant food and oil-price shocks. Indications are currently that food price increases are becoming more entrenched globally, and are being compounded by the restriction of food exports by a number of countries. The situation is further aggravated by the diversion of food production to biofuels in response to high and rising international energy prices. Unusually, despite the economic slowdown in the US, commodity prices in general have not only remained strong but have risen, adding to the challenges faced by monetary policy. International financial market volatility and uncertainty have not subsided, and against this background, many inflation-targeting countries have found it increasingly difficult to remain within their target ranges. The challenge for these countries, including South Africa, is to ensure that inflation returns to within the inflation target range within a reasonable period of time.

Domestically, the possibility of further electricity price increases poses an additional risk to the inflation outlook. At the same time, the economy has been responding to the previous monetary policy actions taken by the MPC, and household consumption expenditure is moderating. However, inflation expectations have increased and are no longer clearly anchored within the inflation target range over time.

Monetary policy will continue to focus on the medium-term outcomes because of the lagged response to monetary policy actions. The Bank's current expectation is for inflation to peak in the near term and then to follow a downward trend to return to within the target range by the end of 2009. There are, however, a number of upside risks to this outlook, and the MPC remains committed to bringing inflation back to within the target range over a reasonable time horizon.

Statements issued by
Mr T T Mboweni,
Governor of the South African Reserve Bank

Statement of the Monetary Policy Committee

6 December 2007

Issued by Mr T T Mboweni, Governor of the South African Reserve Bank, at a meeting of the Monetary Policy Committee (MPC) in Pretoria

Introduction

The short-term inflation outlook has deteriorated since the previous meeting of the Monetary Policy Committee (MPC). Food and energy prices have maintained pressure on inflation and these pressures are expected to persist in the coming months. At the same time, previous monetary policy actions are probably beginning to have an impact on household consumption expenditure and this is expected to help moderate inflation pressures over time. The MPC, however, has to ensure that the short-term impact of higher inflation does not allow inflation expectations to become entrenched at higher levels.

Recent developments in inflation

CPIX inflation remained outside the target range for the seventh consecutive month, reaching a four-and-a-half-year high of 7,3 per cent in October 2007. Food price inflation has continued to accelerate, measuring 12,4 per cent in October. Most of the food categories in CPIX recorded double-digit rates of increase, with the main contributions emanating from grain products, milk, cheese and eggs, and vegetables. Meat price inflation, however, declined to 6,6 per cent. Petrol prices increased at a year-on-year rate of 12,0 per cent in October following moderate increases in the previous three months. Administered prices excluding petrol continued their upward trend and measured 8,5 per cent in October.

There is, however, some evidence that upward pressure on other components of inflation may be moderating. If food and petrol were excluded, CPIX inflation would have measured 4,8 per cent in October, compared to 5,0 per cent in July and August 2007. Low or negative rates of inflation are still being recorded in the following categories: clothing and footwear, furniture, recreation, and communication.

Production price inflation in October 2007 remained high at 9,5 per cent, which was marginally above that in the previous two months. Imported goods inflation declined to 7,5 per cent, while the prices of domestically produced goods increased by 10,2 per cent. Prices of agricultural and manufactured foods increased by 26,1 per cent and 17,5 per cent, respectively, which suggests that further pressures on retail food prices can be expected in the coming months.

The outlook for inflation

The most recent central forecast of the Bank indicates a further deterioration in the inflation outlook, particularly in the short term, when compared to the previous forecast. CPIX inflation is now expected to peak at around 7,8 per cent in the first quarter of next year. Thereafter, CPIX inflation is expected to decline to below the upper end of the target range by the final quarter of 2008. A gradual downward trend is expected to persist and to measure 5,2 per cent in the final quarter of 2009. The higher trend is a result of higher administered price assumptions, particularly for petrol and electricity, over the forecast period.

Despite the higher short-term trend in inflation, expectations remain contained within the inflation target range. According to the inflation expectations survey that is conducted on behalf of the Bank by the Bureau for Economic Research (BER) at the University of Stellenbosch, there was only a slight deterioration in expectations in the fourth quarter compared to those in the third quarter when a significant increase in expectations was recorded. CPIX inflation in 2008 is now expected to average 5,9 per cent, compared to the 5,8 per cent expected in the previous survey. Significantly, CPIX inflation expectations for 2009 remained unchanged at 5,6 per cent.

Expectations as reflected in the break-even inflation rates, which is the yield differential between conventional and inflation-linked bonds, reflect some deterioration. Break-even inflation rates over different maturities decreased between the August and October meetings of the MPC. Since the October meeting, break-even inflation has increased somewhat over all maturities, but still remains below the 6 per cent level.

The main risks to the inflation outlook emanate from food, petrol and electricity price prospects. International oil prices have continued to remain an upside risk factor. At the time of the October meeting of the MPC, North Sea Brent crude oil prices were trading at around US$78 per barrel. Since then, prices have increased to peak at almost US$100 per barrel, although in recent days prices have declined to around US$90 per barrel. Domestic petrol prices have been adversely affected by these international trends, and the local price of 93 octane petrol increased by 3 cents per litre in November 2007 and by 43 cents per litre in December.

The degree of upside risk from food price increases may have subsided over time, but food prices nevertheless remain the main contributors to inflation. As noted, production prices indicate that further pressures can be expected on CPIX in the short term. However there are expectations of some moderation during the course of next year as a result of base effects, more favourable weather conditions and higher crop estimates. Futures prices generally reflect an expectation of lower prices, particularly for maize, during 2008. Global food price pressures are nevertheless expected to persist for some time.

Electricity prices in particular pose a significant risk to the inflation outlook. The National Energy Regulator of South Africa is due to make a decision on the application by Eskom to raise electricity tariffs by 18 per cent in 2008 and 17 per cent in 2009 in order to help finance its capital expenditure programme.

Despite these risks and pressures, not all the recent developments have been negative from an inflation perspective. In particular, there is evidence of a lagged response by the economy to the previous monetary policy tightening. Household consumption expenditure continues to show some signs of moderation in response to the changed monetary policy stance and lower household disposable income growth. Final consumption expenditure by households grew by 4,5 per cent in the third quarter of 2007, compared to a revised 4,9 per cent growth in the second quarter. This third quarter moderation was a result of a marked deceleration in real expenditure on semi-durable goods in particular. The real value of retail sales remained broadly unchanged from the second quarter to the third quarter. Sales of new vehicles also remained subdued. Despite these developments, the FNB/BER Consumer Confidence Index reflected an increase in consumer confidence during the fourth quarter.

Reflecting the slowdown in household consumption expenditure, credit extension to the private sector has shown some signs of moderation, but nevertheless remains at high

levels. Twelve-month growth in total loans and advances had declined gradually over the past few months. Growth over 12 months in loans and advances extended to the household sector declined to 20,1 per cent in October 2007, having peaked at 28,2 per cent in February 2006. The growth rate of loans and advances to the corporate sector declined to 29,7 per cent in October. Household debt as a percentage of household disposable income increased to 77,4 per cent in the third quarter.

Asset price growth, which in the past has helped to underpin domestic demand, appears to be somewhat restrained. Having recovered from the initial impact of the subprime developments in the United States (US) and euro area, the JSE Limited has been fairly volatile, in line with the uncertainties that prevailed in the global equity markets. In addition, according to Absa Bank, the year-on-year rate of increase in house prices in the middle segment has declined further to 13,6 per cent in October.

Fiscal policy continues to be supportive of monetary policy. In the October *Medium Term Budget Policy Statement*, the commitment to fiscal prudence was confirmed with the projection of fiscal surpluses for the coming three years.

Output growth remained strong, with gross domestic product (GDP) growth measuring 4,7 per cent in the third quarter of 2007 compared to a revised 4,4 per cent in the second quarter. Economic growth therefore continues to be at around rates consistent with the potential growth rate of the economy. Growth in gross fixed capital formation remained strong in the third quarter, and this is expected to underpin growth going forward.

The exchange rate of the rand has displayed a higher degree of volatility in recent weeks, but nevertheless has remained relatively unchanged since the previous meeting of the MPC. The relative strength of the rand has been underpinned by sustained capital inflows which financed an expanding current-account deficit in the third quarter of 2007. The deficit, which measured approximately 8,1 per cent of GDP, was driven mainly by increased imports of manufactured goods, as well as by a marked acceleration in service payments to non-residents. Despite this, capital inflows were sufficient to allow for a further accumulation of foreign-exchange reserves by the Bank. At the end of November, the official gross gold and other foreign-exchange reserves had increased to US$32,3 billion, and the international liquidity position to US$30,7 billion.

The outlook for the international economy remains uncertain, with continued turbulence in international financial markets. The reported losses of institutions with exposure to the US sub-prime mortgage market have exceeded expectations and there are concerns that the downturn in some of the advanced economies may be more severe than originally anticipated. Global inflation appears to be contained although oil and food prices continue to pose a risk to the outlook.

Monetary policy stance

The assessment of the MPC is that the balance of risks to the inflation outlook continues to be on the upside. Therefore, the MPC has decided to adjust the repurchase rate by 50 basis points to 11,0 per cent per annum with effect from Friday, 7 December 2007. The MPC will continue to monitor relevant developments and take the necessary steps to ensure that inflation returns to within the target range.

Statement of the Monetary Policy Committee

31 January 2008

Issued by Mr T T Mboweni, Governor of the South African Reserve Bank, at a meeting of the Monetary Policy Committee in Pretoria

Introduction

Since the previous meeting of the Monetary Policy Committee (MPC) in December 2007, the international environment has become increasingly uncertain and volatile. It appears that the continued fall-out from the United States (US) sub-prime crisis has not been confined to financial markets only and there has been a general downward revision to forecasts of global growth.

The slowdown in global growth could have spill-over effects on the South African economy which is also being affected adversely by electricity supply constraints. The economy has continued to respond to the tighter monetary policy stance and inflation is expected to peak in the first quarter of 2008. Nevertheless, there are still significant risks to the inflation outlook.

Recent developments in inflation

CPIX inflation has continued its upward trend, measuring 8,6 per cent in December 2007. The main drivers were again petrol and food. Petrol prices increased at a year-on-year rate of 23,8 per cent in December, while food prices increased at a rate of 13,9 per cent. Excluding food and petrol, CPIX inflation would have measured 5,0 per cent. Prices of clothing and footwear declined significantly, while modest declines were measured in recreation and entertainment, and textiles.

Production price inflation measured 10,3 per cent in December compared to 9,1 per cent in November. Prices of imported goods increased at a year-on-year rate of 11,3 per cent compared to 7,3 per cent the previous month. Manufactured food inflation increased to 18,7 per cent from 18,3 per cent in November while agricultural products inflation declined to 24,0 per cent from 26,8 per cent.

The outlook for inflation

The most recent central forecast of the Bank indicates a further deterioration in the inflation outlook in the short term when compared to the previous forecast. CPIX inflation is still expected to peak in the first quarter of 2008, but at an average of around 8,5 per cent. In line with the previous forecast, CPIX inflation is then expected to decline to below the upper end of the target range by the final quarter of 2008 and to remain at around the 5,6-per-cent level for most of 2009. The higher near-term projections are a result of slightly higher inflation outcomes and further revisions to assumptions about administered prices.

This central forecast of the Bank is broadly consistent with market expectations. The Reuters consensus forecast also expects inflation to peak during the first quarter of 2008 and to fall below the upper level of the target range in the fourth quarter. CPIX inflation is expected to average 6,8 per cent and 5,3 per cent in 2008 and 2009, respectively. The longer-term inflation expectations, as reflected in the break-even inflation rates, have remained relatively unchanged at below the 6-per-cent level since the previous MPC meeting.

The main upside risks to the inflation outlook remain food and energy price prospects, although the extent of the upside risk may have moderated somewhat. The price of North Sea Brent crude oil, which peaked at around US$100 per barrel in December, is currently trading at around US$92 per barrel. Domestic petrol prices remained unchanged in January and the current average under-recovery for January is approximately 15 cents per litre. Oil prices remain vulnerable to supply disruptions, although the adverse global growth outlook may restrain the degree of upside price risk.

Food prices remain one of the main short-term risks to inflation. Production prices continue to indicate that sustained food price pressure can be expected in the coming months. However, the more favourable weather conditions and lower futures prices for maize have reinforced a general expectation of some moderation of food price inflation during the course of this year. However, future trends will be dominated by global supply and demand conditions.

The threat posed to the inflation outlook by higher electricity prices remains. Eskom has been granted an average tariff increase of 14,2 per cent from July. The precise increase that will be faced by households may be higher and will only be known during the coming months. Furthermore, there is a risk that the increases granted to Eskom over the forecast period could be higher than currently anticipated.

The rand exchange rate has depreciated in recent weeks following a period of relative stability. The currency has been affected by movements in the dollar and, more recently, by increased risk aversion towards emerging markets. The currency has been given some support from commodity prices, which have remained firm, and in the case of gold and platinum, have reached new highs. On a trade-weighted basis, the rand has depreciated by around 7 per cent since the beginning of 2008.

Despite these pressures and risks to the outlook, there have been a number of developments that are likely to have a restraining impact on the inflation trend. The moderation of household consumption expenditure highlighted at the previous meeting appears to have continued. Real retail sales have trended downwards since the middle of 2007 and in November sales decreased by 0,7 per cent compared to October. Sales of household furniture, appliances and equipment have contracted the most. Motor vehicle sales also continued their downward trend. Sales of passenger vehicles declined by almost 10 per cent in 2007 compared to 2006, although commercial vehicle sales remained relatively strong.

Growth in household consumption expenditure is also expected to be dampened by negative wealth effects. The global financial market turbulence has been reflected in the volatility on the JSE Limited. Since its peak in October 2007, the all-share index has fallen by approximately 16 per cent. House price increases have also moderated somewhat. According to the Absa House Price Index, house price increases declined to 11,2 per cent in December 2007, while the month-on-month increase in December was 0,3 per cent. The Standard Bank House Price Index was unchanged on a year-on-year basis in December.

Credit extension to the private sector has moderated further. Growth over 12 months in loans and advances extended to the private sector declined from 25,2 per cent in September 2007 to 22,2 per cent in December. The quarterly growth declined from 23,5 per cent in the third quarter to 18,1 per cent in the fourth quarter. Growth in all the subcategories, namely mortgage advances, instalment sales and leasing, and other loans and advances, has displayed a persistent downward trend. The growth in

loans and advances to households declined to 18,9 per cent in December 2007, down from 20,1 per cent in November.

According to the Wage Settlement Survey by Andrew Levy Employment Publications, the average wage settlement for 2007 was 7,3 per cent compared to 6,5 per cent in 2006. This appears to be consistent with the 7,7 per cent year-on-year increase in average nominal remuneration per worker measured in the third quarter of 2007. Once productivity increases are adjusted for, year-on-year growth in nominal unit labour costs in the formal non-agricultural sector measured 4,8 per cent in the third quarter of 2007, compared to 5,0 per cent the previous quarter. These unit labour cost developments are consistent with the inflation target range.

The risks to output growth appear to be on the downside and this is likely to be reinforced by the electricity supply disruptions. Growth in the construction sector also appears to be moderating with a decline in residential and non-residential plans approved. In November 2007 the real value of building plans passed decreased by 16,5 per cent on a year-on-year basis. The volume of cement sales has also shown a significant decline in recent months.

The turbulence in international financial markets has not subsided and losses suffered by financial institutions with exposure to the US sub-prime market continue to be reported. Fears of a slowdown in some of the advanced economies, and in the US in particular, have also been weighing on the markets. Although the emerging-market economies are expected to sustain relatively strong growth, there are indications of some moderation in growth in China, albeit still at high levels. Global inflation appears to be under control.

Monetary policy stance

There are still considerable risks to the inflation outlook. In the light of, *inter alia*, heightened economic uncertainties, both domestically and globally, and some evidence of moderation in domestic consumption expenditure, the MPC has decided that it is appropriate at this time to leave the repo rate unchanged at 11 per cent per annum. The MPC remains committed to bringing inflation back to within the inflation target range.

Statement of the Monetary Policy Committee

10 April 2008

Issued by Mr T T Mboweni, Governor of the South African Reserve Bank, at a meeting of the Monetary Policy Committee in Pretoria

Introduction

The South African economy continues to respond to the less accommodative monetary policy stance. Domestic expenditure is responding to the Bank's current policy settings. Various high-frequency and survey data point to the economy growing at a rate below potential, but nevertheless underpinned to some extent by strong investment expenditure by the private sector and public corporations.

The inflation outlook is being influenced by a series of supply-side shocks emanating from the international oil and food prices, which are posing challenges for inflation-targeting countries in general. Domestically, there is evidence of generalised price pressures and the prospect of further substantial electricity price increases will also delay the return to within the inflation target range. In the light of these developments, inflation expectations have deteriorated.

Recent developments in inflation

CPIX inflation has maintained its upward trend, reaching 9,4 per cent in February 2008. Petrol and food prices were again the main drivers of inflation and increased at year-on-year rates of 29,5 per cent and 14,3 per cent, respectively. If food and energy prices were excluded, CPIX inflation would have measured 5,6 per cent. Further impetus to inflation came from the change in methodology for calculating clothing and footwear prices. Whereas clothing and footwear prices were previously shown to have declined persistently since October 2003, these prices increased at year-on-year rates of 7,9 per cent and 8,4 per cent in January and February 2008, respectively.

Year-on-year producer price inflation measured 11,3 per cent in February compared to 10,4 per cent in January. Agricultural food prices increased at a year-on-year rate of 23,5 per cent in February, while manufactured food prices increased by 20,9 per cent.

The outlook for inflation

The most recent central forecast of the Bank indicates a further deterioration in the inflation outlook when compared to the previous forecast. Inflation is now expected to peak at an average of around 9,3 per cent in the first quarter of this year, and thereafter to follow a downward trajectory. However, CPIX inflation is now expected to return to within the inflation target range by the fourth quarter of 2009. The deterioration in the outlook is a result of higher-than-expected recent quarterly inflation outcomes, and further upward revisions of oil and administered price assumptions for 2008 and 2009. The possibility of an electricity price increase in excess of that recently granted to Eskom has not been factored into the central forecast, although the Monetary Policy Committee (MPC) has considered various alternative scenarios.

Most private-sector forecasts have also been revised upwards in recent weeks, although the majority predict inflation will return to within the target range before the final quarter of next year. The Reuters consensus forecast also expects inflation to peak in the first quarter of this year, and to return to within the target range during the second quarter of 2009.

The current inflation trends are having a significant impact on inflation expectations, particularly those of business executives and trade union officials. According to the inflation expectations survey conducted on behalf of the Bank by the Bureau for Economic Research (BER) at the University of Stellenbosch, average CPIX inflation expectations for 2008 have increased from 5,9 per cent at the time of the previous survey to 7,8 per cent, and for 2009 from 5,6 per cent to 7,0 per cent. CPIX inflation is expected to average 6,7 per cent in 2010. Whereas financial analysts expect inflation to moderate to 5,9 per cent in 2009 and 5,4 per cent in 2010, business executives and trade union officials expect inflation to average 7,5 per cent and 7,4 per cent in those years respectively.

Break-even inflation rates, measured as the yield differential between conventional government bonds and inflation-linked bonds, also indicate a deterioration of inflation expectations.

The trend of wage settlements is a critical variable in determining whether inflation expectations do, in fact, translate into higher inflation. There is evidence that nominal wage settlements have been trending higher. According to Andrew Levy Employment Publications, wage settlements in the first quarter of 2008 averaged 7,8 per cent compared to 7,3 per cent in 2007 and 6,5 per cent in 2006.

A number of factors continue to pose an upside risk to the inflation outlook. The most serious risk emanates from the possibility of additional electricity price increases. If granted, the electricity price will have doubled by the middle of 2009. A final determination will be made by the National Energy Regulator of South Africa in June.

International oil prices have remained at elevated levels. The price of North Sea Brent crude oil was US$92 per barrel at the time of the previous MPC meeting and is currently trading at around US$107 per barrel. The impact on CPIX has been aggravated by the depreciation of the rand against the dollar, and in the past two months, the rand price of 95 octane petrol has increased by a total of R1,27 per litre. Of this increase, 43 cents was due to international product price increases and 69 cents was due to exchange-rate changes. The remainder was accounted for by tax and other levy adjustments. Despite the slowdown in the global economy, international oil price developments continue to pose an upside risk to the inflation outlook.

Since the previous meeting of the MPC, the rand exchange rate has depreciated further. On a trade-weighted basis, the rand has now depreciated by around 16 per cent since the beginning of 2008. In March the rand depreciated to almost R8,26 against the US dollar, but is currently trading at around R7,90. The currency has been affected by various factors, including movements in the dollar, perceptions that the current-account deficit on the balance of payments could widen and increased risk aversion in global financial markets since the previous MPC meeting. Firm international commodity prices, however, continue to provide some support to the currency.

Food price inflation has shown few signs of moderating and trends at the producer level indicate further pipeline pressures. International food price developments are particularly worrisome with a number of food-producing countries restricting exports in recent weeks. International wheat prices have also reached new highs. Domestic spot prices of maize have been volatile around an upward trend, partly as a result of the depreciated exchange rate. Futures prices suggest that maize prices are expected to remain high in the coming months despite the improved crop forecast for this year.

There are a number of factors that are expected to have a moderating effect on the inflation outlook.

Household consumption expenditure has continued to respond to the tighter monetary policy stance. Real final consumption expenditure growth declined consistently during 2007, and grew at an annualised rate of 3,8 per cent in the fourth quarter. This softer trend appears to have continued in the first quarter of 2008 as evidenced by the negative retail sales trends in the past few months. Motor vehicle sales have declined further, with new passenger vehicle sales being particularly affected. When comparing the first three months of 2008 with the same period last year, a decrease of 19,1 per cent was recorded. The latest FNB/BER Consumer Confidence Index shows a distinct break with recent trends. Although still at relatively high levels, the index declined to its lowest level in 3,5 years in the first quarter of this year.

This slower household consumption expenditure growth is reflected to some extent in the declining trend of bank credit extension to the private sector. Twelve-month growth in banks' total loans and advances extended to the private sector, which has exhibited a downward trend, slowed to 21,8 per cent in February. Growth in all categories of credit extension declined in February. The ratio of household debt to disposable income increased marginally to 77,6 per cent in the fourth quarter of 2007. The cost of servicing this debt has increased significantly, in line with higher interest rates.

The domestic economy has shown signs of moderation following a robust annual growth rate of 5,1 per cent in 2007. A number of indicators suggest that output growth will be below potential in the coming quarters, although infrastructural investment programmes are likely to underpin the overall growth rate. At this stage it is still unclear what the impact of electricity supply disruptions will be on output growth. The composite leading business cycle indicator has been declining significantly since November 2007, while in the first quarter of this year the RMB/BER Business Confidence Index declined to its lowest level in seven years. The significant decline in the Investec/BER Purchasing Managers Index in March may be pointing to a marked slowdown in the manufacturing sector, despite the improved performance in February when real output increased at a month-on-month rate of 2,4 per cent. Mining output declined by 5,2 per cent during the three months ended February 2008.

Asset prices have also been subdued since the previous meeting of the MPC. The Absa House Price Index shows that year-on-year growth in prices of residential property in the middle segment of the market declined to 8,7 per cent in February 2007, while the median house price, as measured by Standard Bank, declined by 5,2 per cent in March. The all-share index on the JSE Limited has increased by about 15 per cent since the end of January, driven primarily by the impact of strong commodity prices on the resources sector.

The international economic and financial environment remains uncertain and volatile. The sustained weakness in the US housing market has resulted in downward revisions of US growth forecasts, while the IMF has revised downwards its forecast for global growth in 2008 to 3,7 per cent, from 4,1 per cent forecast in January. Global inflation forecasts have been revised upwards in the wake of higher food and energy prices. Nevertheless, global inflation appears to be relatively contained. The turmoil in financial markets is expected to persist for some time as banks keep writing down more financial assets and experience losses. As a consequence, global foreign-exchange and financial markets are likely to remain volatile.

Monetary policy stance

In view of the deteriorating inflation outlook, and especially evidence of more generalised inflation pressures, the MPC has decided to increase the repo rate by 50 basis points to 11,5 per cent per annum with effect from 11 April 2008. The MPC remains committed to bringing CPIX inflation back to within the inflation target range.

Abbreviations

Alsi	all-share index
API	administered price index
BER	Bureau for Economic Research (Stellenbosch University)
CCI	Consumer Confidence Index
CLI	composite leading indicator
CPI	consumer price index for metropolitan areas
CPIX	consumer price index excluding mortgage interest cost for metropolitan and other urban areas
ECB	European Central Bank
EIA	Energy Information Administration
EU	European Union
FAO	Food and Agriculture Organization
FNB	First National Bank
GDP	gross domestic product
IFAD	International Fund for Agricultural Development
IMF	International Monetary Fund
IT	inflation targeting
JSE	JSE Limited
MPC	Monetary Policy Committee
NEER	nominal effective exchange rate of the rand
NERSA	National Energy Regulator of South Africa
OECD	Organisation for Economic Co-operation and Development
OPEC	Organization of the Petroleum Exporting Countries
PMI	Purchasing Managers Index
PPI	producer price index
PSBR	public-sector borrowing requirement
repo	repurchase
RMB	Rand Merchant Bank
SARB	South African Reserve Bank
SIC	Standard Industrial Classification
Stats SA	Statistics South Africa
UK	United Kingdom
US	United States