Monetary Policy Review

May 2009

South African Reserve Bank

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Contents

Tables

Monetary Policy Review

Introduction

Global output and trade have contracted sharply in the period since the previous *Monetary Policy Review* was published in November 2008. Financial markets remain under stress, despite the introduction of extensive fiscal and monetary policy measures by governments and central banks, and falling asset prices and disruptions to credit markets have impacted powerfully on consumer demand. There is growing uncertainty about the depth and duration of the economic slowdown, which is generally viewed as the most severe of the post-war period.

The South African economy has not escaped the impact of these developments. Domestic production has contracted as a result of weak domestic demand and a significant decline in export demand. Real gross domestic product (GDP) contracted at an annualised rate of 1,8 per cent in the final quarter of 2008, largely as a result of a marked slowdown in the manufacturing sector, and there is a general expectation that domestic growth will remain lacklustre in 2009. Inflation is expected to continue to trend downwards, although the volatility of developments in global markets and elevated levels of uncertainty subject inflation forecasts to higher risk than usual.

This *Monetary Policy Review* begins with an analysis of inflation developments and the factors that have impacted on inflation, followed by an assessment of recent monetary policy developments and a discussion of the outlook for inflation. Three topical issues are focused on in the boxes. The first box notes the impact on the administered prices index of the recent changes to the consumer price index (CPI) announced by Statistics South Africa (Stats SA), while the second discusses the policy measures adopted by monetary authorities in various countries in response to the global financial crisis. The third box discusses the inflation-linked bond market in South Africa with a view to facilitating the interpretation of break-even inflation rates.

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.

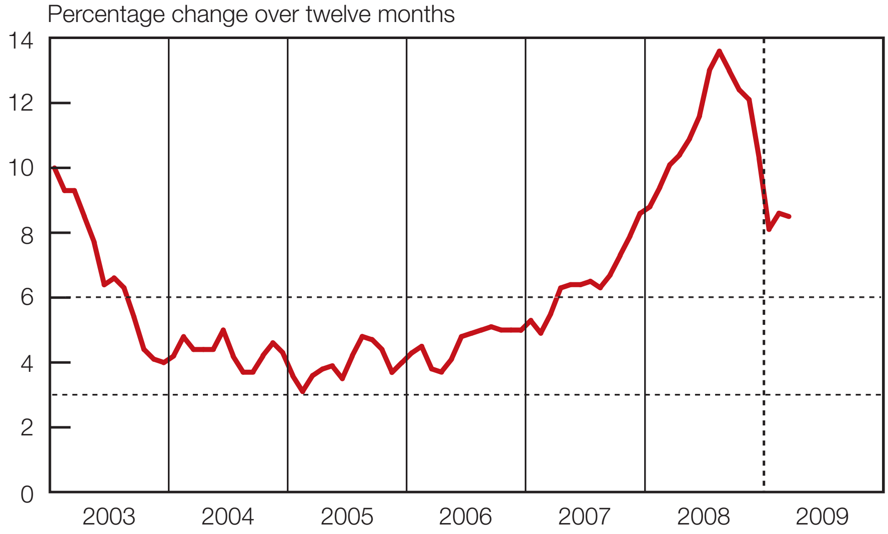
The evolution of indicators of inflation

The inflation measure targeted by the South African Reserve Bank (the Bank) until the end of 2008 was specified in terms of the consumer price index excluding mortgage interest costs for metropolitan and other urban areas (CPIX). As Figure 1 shows, the year-on-year CPIX inflation rate peaked at 13,6 per cent in August 2008 and then declined continuously to 10,3 per cent in December. The main drivers of inflation over the last quarter of 2008 were food prices, fuel and power (electricity prices), and transport (petrol prices). The upward bias included in the year-on-year CPIX as a result of the treatment of non-discounted clothing and footwear averaged 0,29 percentage points over the September–December 2008 period.[1] Average CPIX inflation for the calendar year 2008 was 11,3 per cent, with the upward bias averaging 0,24 percentage points.

1 From January 2008, Stats SA no longer included sale items in the clothing and footwear prices collected for the CPI. This change in the treatment of clothing and footwear prices, together with the policy of not revising the CPI and CPIX indices, created an upward bias in the annual rates of change of the indices for the period January–December 2008.

Figure 1 Consumer price inflation: Targeted inflation*

Percentage change over twelve months



* CPIX for metropolitan and other urban areas until the end of 2008; CPI for all urban areas thereafter

Source: Statistics South Africa

Since the release of the January 2009 CPI data, the targeted inflation measure has been the headline CPI (CPI for all urban areas). The new CPI includes a number of significant changes when compared to the previous CPI in terms of the methodology of data collection, classification and weighting (these changes were discussed in the November 2008 *Monetary Policy Review*). The year-on-year CPI inflation rate was 8,1 per cent in January 2009. It then rose to 8,6 per cent in February before declining marginally to 8,5 per cent in March (Figure 1). Inflation in the first quarter of the year was driven mainly by increases in food prices, alcoholic beverages, household maintenance and repair, electricity, and in financial services.

Table 1 Contributions to CPI inflation

Percentage change over twelve months* and percentage points

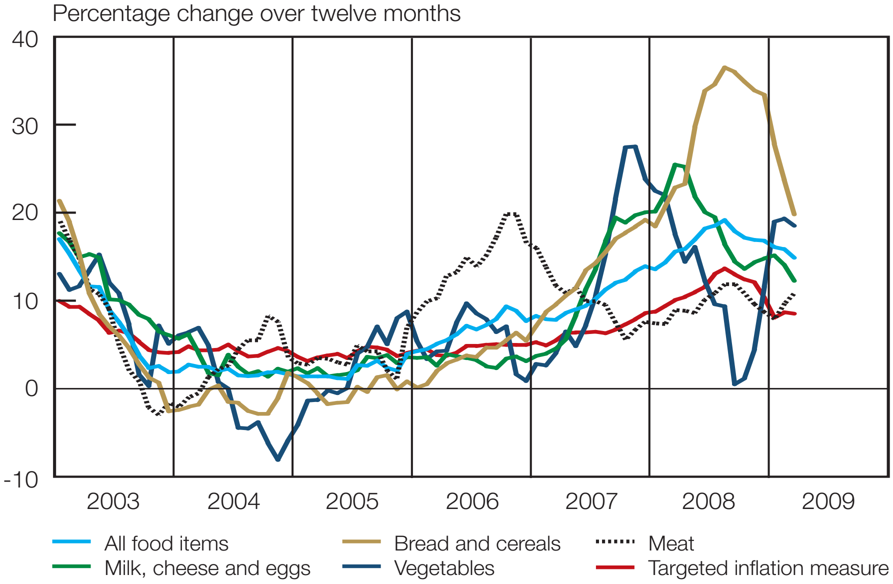
	2009		
	Jan	Feb	Mar
Total*	**8,1**	**8,6**	**8,5**
Of which:			
Food and non-alcoholic beverages	2,4	2,4	2,3
Alcoholic beverages and tobacco	0,6	0,6	0,6
Housing and utilities	2,1	2,0	1,8
Health	0,1	0,1	0,2
Transport	0,0	0,3	0,2
Education	0,2	0,2	0,2
Miscellaneous goods and services	1,4	1,6	1,6
Other	1,3	1,4	1,6

Source: Statistics South Africa

Table 1 examines the contributions to the CPI inflation rate. In January 2009 the main contributors to the year-on-year inflation rate of 8,1 per cent were food prices (2,4 percentage points), housing and utilities (2,1 percentage points), and miscellaneous goods and services (1,4 percentage points). In February a similar pattern is observed, although there were increased contributions from transport (0,3 percentage points) and from miscellaneous goods and services (1,6 percentage points), driven by increases in the insurance as well as health services components. March saw a decline in the contribution of housing and utilities (1,8 percentage points) due to lower inflation in rentals for housing and owners' equivalent rent (surveyed quarterly). The movements in the contribution of transport in Table 1 were driven by changes in the price of petrol. The Gauteng price of 95 octane unleaded petrol, which had declined from R10,70 per litre in July 2008 to R6,01 per litre in January 2009, rose to R6,61 per litre in February and R7,07 per litre in March.

The rates of increase in the prices of food items in the consumer price basket generally slowed in the period under review (Figure 2). The year-on-year inflation rate for all food items slowed from 19,2 per cent in August 2008 to 16,1 per cent in January 2009 and a still-high 14,9 per cent in March. This trend has been driven by slowly declining, albeit persistently high, inflation in bread and cereals (36,5 per cent in August 2008 to 19,9 per cent in March 2009), and meat (11,9 per cent to 10,8 per cent over the same period). Vegetable price inflation has been one of the factors limiting the decline in food price inflation, increasing sharply from a low of 0,5 per cent in September 2008 to 19,3 per cent in February 2009 before recording 18,6 per cent in March.

Figure 2 Targeted inflation* and food inflation



* CPIX for metropolitan and other urban areas until the end of 2008; CPI for all urban areas thereafter

Source: Statistics South Africa

The effect of excluding petrol, food and non-alcoholic beverages, and electricity prices from the CPI inflation measure is considered in Table 2. Since petrol prices have provided downward pressure on CPI inflation during 2009, despite rising in recent months, excluding them from the CPI results in higher inflation rates for this core measure than the 8,5 per cent recorded for headline CPI in March. Excluding petrol prices, the inflation rate for the remaining items in the headline CPI was 9,5 per cent in March. Food and non-alcoholic beverages, by contrast, have provided upward pressure on CPI inflation. If these items had been excluded, headline inflation would have been lower at 7,5 per cent in March, although notably higher than the 6,6 per cent recorded for this core measure in January. If both petrol prices and food and non-alcoholic beverages had been excluded from the CPI, inflation would have been 8,6 per cent in March. Finally, if energy had been excluded along with the other categories, an inflation rate of 8,0 per cent would have been recorded in March 2009.

Table 2 The effect of food, petrol and electricity prices on headline inflation
Percentage change over twelve months

	2009		
	Jan	Feb	Mar
Headline CPI	**8,1**	**8,6**	**8,5**
CPI excluding petrol prices	9,1	9,5	9,5
CPI excluding food and NAB* prices	6,6	7,4	7,5
CPI excluding food, NAB and petrol prices	7,8	8,2	8,6
CPI excluding food, NAB, petrol and energy prices	7,3	7,8	8,0

* NAB: Non-alcoholic beverage

Source: Statistics South Africa

The inflation rates for the goods and services categories of the CPI in 2009 are presented in Table 3. Measured over twelve months, goods prices increased by 7,9 per cent in January, and by 8,7 per cent in February and March. Within the goods category, inflation for non-durable goods has been far higher (11,8 per cent in March) than for semi-durable (6,6 per cent in March) and durable (2,9 per cent in March) goods. Services prices rose by 8,2 per cent in January, by 8,5 per cent in February and by 8,4 per cent in March.

Table 3 CPI: Goods and services inflation
Percentage change over twelve months

	2009		
	Jan	Feb	Mar
Headline CPI	8,1	8,6	8,5
Goods prices	7,9	8,7	8,7
Durable goods	1,7	2,5	2,9
Semi-durable goods	4,9	5,7	6,6
Non-durable goods	11,6	12,3	11,8
Services prices	8,2	8,5	8,4

Source: Statistics South Africa

Administered prices play a potentially important role in the inflation process. The changes to the CPI made by Stats SA have also impacted on the administered prices index, as discussed in Box 1. Table 4 shows that the year-on-year inflation rate for administered prices was 1,4 per cent in January 2009 and 2,8 per cent in February and March. The inflation rate for regulated items increased from -0,7 per cent in January to 1,5 per cent in February before slowing to 0,6 per cent in March, largely as a result of movement in the petrol price. The inflation rate for unregulated items was constant at 5,0 per cent in January and February, and then increased to 6,8 per cent in March, largely as a result of increases in the cost of schooling, tertiary education and university boarding fees.

Table 4 Administered prices
Percentage change over twelve months

	2009		
	Jan	Feb	Mar
Total	1,4	2,8	2,8
Regulated	-0,7	1,5	0,6
Unregulated	5,0	5,0	6,8

Source: Statistics South Africa

Box 1 Administered prices in the consumer price index

An ‘administered price’, as reported in the consumer price index (CPI) published by Statistics South Africa (Stats SA), is defined as “the price of a product which is set consciously by an individual producer or group of producers and/or any price, which can be determined or influenced by government, either directly or through a government agency/institution without reference to market forces”.[2] This group of prices is of particular interest to monetary policy-makers as they constitute a significant portion of the CPI that may not be influenced by monetary policy implementation.

Stats SA reports the administered price index (API) as having a total weight of 14,66 per cent in the current CPI for all urban areas. This is lower than the previous weights of 20,01 per cent in the consumer price index excluding mortgage interest costs (CPIX) for metropolitan and other urban areas and 17,91 per cent in the CPI for metropolitan and other urban areas (Table B1.1).[3] As Table B1.1 shows, most components of the API have a lower weighting in the new CPI when compared to both the previous CPI and CPIX measures that were used until the end of 2008.

2 Statistics South Africa, 2009. “Consumer price index: January 2009”, Statistical release P0141. Pretoria: Statistics South Africa, 25 February.

3 The reason for the differing weights of the API in the CPIX and CPI for metropolitan and other urban areas is the result of a reweighting that occurs in the index when the interest component is removed. This ensures that the total weight of both indices is 100 per cent and hence all components remaining in the CPIX have a higher weighting than in the CPI.

Table B1.1 Change in weights of administered prices within various inflation measures according to the classification of individual consumption by purpose

Per cent

	Weights (2000)		Weights (2008)
	CPIX for metropolitan and other urban areas	CPI for metropolitan and other urban areas	CPI for all urban areas
Administered prices	**20,01**	**17,91**	**14,66**
Housing	**7,98**	**7,17**	**5,16**
Assessment rates	1,64	1,49	2,07
Sanitary fees	0,27	0,24	0,06
Refuse removal	0,37	0,33	0,09
Water	1,81	1,63	1,10
Electricity	3,55	3,18	1,68
Paraffin	0,34	0,30	0,16
Transport	**5,42**	**4,82**	**4,16**
Petrol	5,08	4,55	3,93
Public transport: Trains	0,16	0,14	0,04
Public transport: Municipal buses	0,09	0,05	0,00
Motor licences	0,09	0,08	0,09
Motor registrations			0,10
Communication	**3,11**	**2,79**	**2,75**
Telephone fees	1,62	1,46	1,26
Telephone rent and installation	0,34	0,30	0,00
Postage	0,02	0,02	0,02
Cellular telephone calls	0,89	0,79	1,47
Cellular telephone connection fees	0,24	0,22	0,00
Recreation and culture	**0,26**	**0,23**	**0,13**
Television licences	0,26	0,23	0,13
Education	**2,97**	**2,67**	**2,18**
School fees	1,72	1,55	1,28
Universities/technikons/colleges	1,25	1,12	0,90
Restaurants and hotels	**0,16**	**0,14**	**0,28**
University boarding fees	0,16	0,14	0,28
Health	**0,11**	**0,09**	**0,00**
Public hospitals	0,11	0,09	0,00

Source: Statistics South Africa

The exceptions to this are assessment rates, motor licence and registration fees, cellular telephone call charges, and university boarding fees. These changes are largely the result of changes in spending patterns captured in the Income and Expenditure Survey conducted in 2005/06.

The API is divided into a regulated component and an unregulated component, which are both reported in the CPI publication. Regulated administered prices are those that are set according to government's policy objectives and may or may not have an economic regulator. The products and services included in regulated administered prices, as well as their weight in the CPI for all urban areas are shown in Table B1.2. Table B1.3 shows the products and services included in the unregulated portion of the API.

Table B1.2 Basket of regulated prices in the CPI for all urban areas

Per cent

Group	Products and services	Reasoning for inclusion	Weight
Housing	Total		2,94
	Water	Set by local government within Department of Water Affairs and Forestry guidelines	1,10
	Electricity	Set by local government and regulated by National Electricity Regulator	1,68
	Paraffin	Regulated by Department of Minerals and Energy	0,16
Transport	Total		3,93
	Petrol	Regulated by Department of Minerals and Energy	3,93
Communication	Total		2,75
	Telephone fees	Regulated by Independent Communications Authority of South Africa (ICASA)	1,26
	Postage	Regulated by government	0,02
	Cellular telephone calls	Regulated by Independent Communications Authority of South Africa (ICASA)	1,47
Total			**9,62**

Source: Statistics South Africa

Table B1.3 Basket of administered prices that are not regulated in the CPI for all urban areas

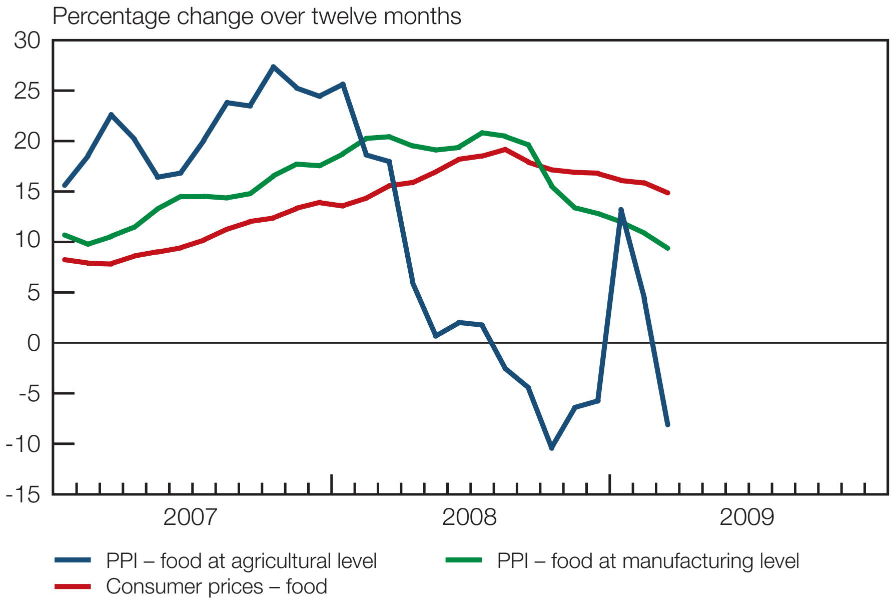
Per cent

Group	Products and services	Reasoning for inclusion	Weight
Housing	Total		**2,22**
	Assessment rates	A tax set by local government	2,07
	Sanitary fees	Set by local government	0,06
	Refuse removal	Set by local government	0,09
Transport	Total		**0,23**
	Public transport: Trains	Set by government agency	0,04
	Motor licences	Set by provincial government	0,09
	Motor registrations	Set by provincial government	0,10
Recreation and culture	Total		**0,13**
	Television licences	Set by government agency	0,13
Education	Total		**2,18**
	School fees	Set by government agencies (schools)	1,28
	Universities/technikons/ colleges	Set by government agencies (universities, technikons)	0,90
Restaurants and hotels	Total		**0,28**
	University boarding fees	Set by government agencies (universities)	0,28
Total			**5,04**

Source: Statistics South Africa

Inflation measured in terms of the year-on-year change in the headline producer price index (PPI) continued to decline in the period under review, from 14,5 per cent year on year in October 2008 to 5,3 per cent in March 2009. Focusing on the food component of the PPI, Figure 3 plots the inflation rates for the agricultural food and food at the manufacturing-level components, alongside that for food in the CPI. The figure shows that upward pressure on food price inflation at the consumer level from food production prices has been easing for some time. The inflation rate for the agricultural food PPI has declined since the end of 2007, falling below that of food in the CPI in April 2008 and PPI inflation for food at the manufacturing level has been slowing since July 2008, falling below the CPI food inflation rate in October 2008.

Figure 3 Food prices in the PPI and CPI



Source: Statistics South Africa

Factors affecting inflation

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

International economic developments

Worldwide economic growth slowed significantly in 2008, buffeted by the deep financial crisis, sharp run-ups in energy and food prices, and declines in many developed economies' housing markets. According to the most recent International Monetary Fund (IMF) data, the global economy recorded growth of 3,2 per cent in 2008, compared with 5,2 per cent in 2007 (Table 5). Global real GDP fell at an unprecedented annualised rate of 5 per cent in the fourth quarter of 2008.

Table 5 Annual percentage change in real GDP and consumer prices

	Share of global real GDP*	Real GDP		Consumer prices**	
	2008	2007	2008	2007	2008
World	**100,00**	**5,2**	**3,2**	**4,0**	**6,0**
Advanced economies	**55,3**	**2,7**	**0,9**	**2,2**	**3,4**
United States	20,7	2,0	1,1	2,9	3,8
Japan	6,4	2,4	-0,6	0,0	1,4
Euro area	15,7	2,7	0,9	2,1	3,3
United Kingdom	3,2	3,0	0,7	2,3	3,6
Other advanced economies	7,4	4,7	1,6	2,0	4,3
Other emerging-market and developing countries	**44,7**	**8,3**	**6,1**	**6,4**	**9,3**
Africa	3,1	6,2	5,2	6,3	10,1
Central and eastern Europe	3,5	5,4	2,9	6,1	8,0
Commonwealth of Independent States	4,6	8,6	5,5	9,7	15,6
Developing Asia	21,0	10,6	7,7	5,4	7,4
China	11,4	13,0	9,0	4,8	5,9
India	4,8	9,3	7,3	6,4	8,3
Middle East	3,9	6,3	5,9	10,5	15,6
Western hemisphere	8,6	5,7	4,2	5,4	7,9

* GDP shares based on the IMF's purchasing-power-parity valuation of country GDPs for 2008

** Zimbabwe excluded

Source: IMF *World Economic Outlook,* April 2009

The slide in global growth has proved to be far more severe than most forecasters had projected prior to the failure of Lehman Brothers and the intensification of uncertainty in its wake. The business cycle dating committee of the United States (US) National Bureau of Economic Research determined that a peak in economic activity occurred in the US economy in December 2007. The peak marked the end of the 73-month expansion that began in November 2001 and the beginning of a US recession. For the US, economic growth of 1,1 per cent was recorded for the year 2008 compared with 2,0 per cent in 2007. However, growth in the US had weakened considerably by the second half of 2008 and declined at an annualised pace of 6,3 per cent in the fourth quarter of 2008 – the largest negative value since 1982. Consumer spending, which comprises about 70 per cent of total expenditure in the economy, declined at the fastest pace in almost three decades.

Japan is in a sounder financial position than most advanced economies, but the country's growth depends heavily on exports, which have been hit hard by declining foreign demand. Thus, despite Japanese banks' lower exposure to US mortgage-backed assets, Japan slipped into a recession as international trade diminished rapidly. Japan's economy shrank in the final quarter of 2008 at an annualised rate of 12,1 per cent – the fastest since the 1974 oil shock. The sharp fall in output reflects plunging net exports and business investment, and faltering private consumption. Consequently, the economy of Japan shrank by 0,6 per cent in 2008, compared with real growth of 2,4 per cent in 2007.

For the euro area, economic growth of 0,9 per cent was recorded for the year 2008 compared with 2,7 per cent in 2007. First estimates show that real output had declined rapidly in the final quarter of 2008 – contracting the most in nearly 13 years as real GDP fell by 6,3 per cent at an annualised rate. Overall eurozone consumer price inflation of 3,3 per cent in 2008 was well above the target ceiling of the European Central Bank (ECB).

In the United Kingdom (UK), real GDP grew by 0,7 per cent in 2008 compared with 3,0 per cent in 2007 as further weakening in the housing market continued to impact negatively on the components of final demand. Inflation in the UK rose from 2,3 per cent in 2007 to 3,6 per cent in 2008.

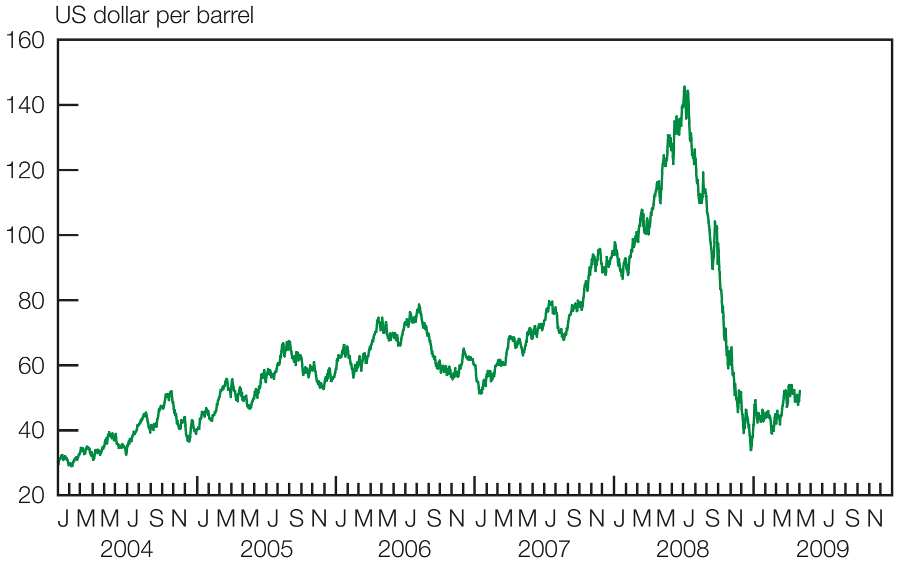
The confluence of weakening external demand, tightening financing constraints and declining commodity prices led to much weaker growth outcomes in a broad swath of emerging economies. For developing Asia, recent economic data indicate that real output growth moderated to 7,7 per cent in 2008 from 10,6 per cent in 2007. Growth in China and India is slowing, albeit from high rates, but domestic demand is being supported by a strong policy stimulus. The Chinese economy recorded growth of 9 per cent in 2008, while India's economy recorded growth of 7,3 per cent.

Growth in Africa remained relatively strong in 2008, with an expansion in real GDP of 5,2 per cent but commodity prices fell sharply in 2008 from mid-year highs, causing an especially large loss of income for commodity exporters. The severe deterioration in external growth not only reduced demand for African exports, but also began curtailing workers' remittances and the downturn was most pronounced in oil-exporting countries and other commodity-exporting countries. The 10,1 per cent inflation rate in 2008 was significantly higher than the rate of 6,3 per cent recorded the previous year.

Oil prices

Oil markets have been severely affected by the rapid slowdown in global economic activity in the second half of 2008. With supply exceeding demand, substantial inventory accumulation occurred and international oil prices declined sharply. The price of Brent crude oil fell from record highs of above US$145 per barrel in July 2008 to below US$35 by the end of the year (Figure 4). After the Organization of the Petroleum Exporting Countries (OPEC) announced in December 2008 a reduction in production quotas of 4,2 million barrels per day with effect from January 2009, oil prices fluctuated around US$45 per barrel during the period from mid-February to mid-March 2009. In recent weeks prices have risen and have fluctuated around the US$50 per barrel level.

Figure 4 Price of Brent crude oil



Source: Bloomberg

International monetary policy developments

The backdrop to international monetary policy developments in recent months was the continued weakening of the global economy and financial markets with inflation beginning to trend downwards in many countries. Consequently, central banks around the globe continued to ease their monetary policy stance aggressively. Since September 2008, policy rates have been reduced by central banks in most countries (Table 6), including Australia, Brasil, Canada, Chile, the Czech Republic, Denmark, Sweden, the euro area, Hungary, India, Indonesia, Israel, Malaysia, Mexico, Poland, South Korea, Taiwan, Thailand, Turkey and the UK.

Table 6 Selected central bank interest rates

Per cent

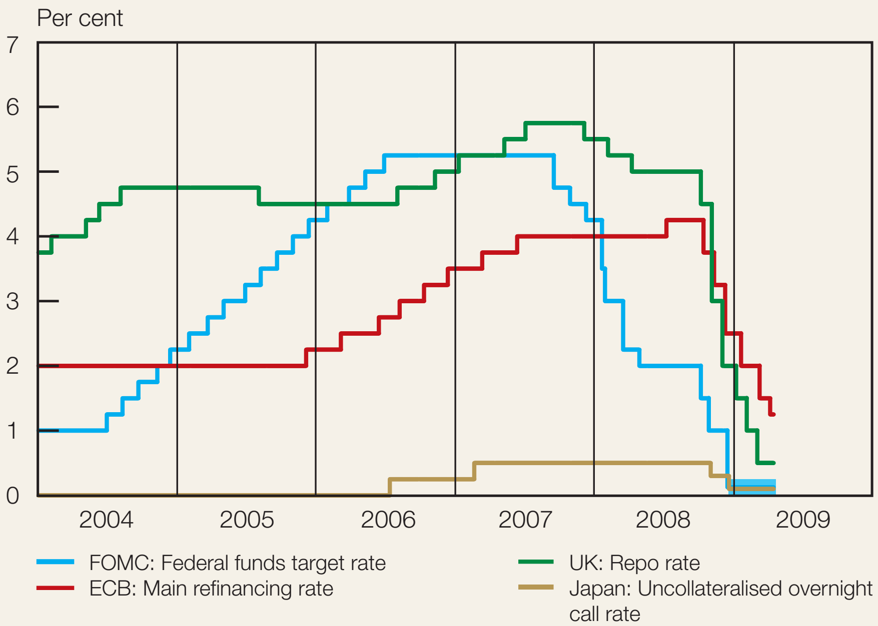
Countries	1 Sep 2008	30 Apr 2009	Latest decision (change in percentage points)	
United States	2,00	0,00–0,25	29 Apr 2009	(0,00)
Japan	0,50	0,10	30 Apr 2009	(0,00)
Euro area	4,25	1,25	02 Apr 2009	(-0,25)
United Kingdom	5,00	0,50	09 Apr 2009	(0,00)
Canada	3,00	0,25	21 Apr 2009	(-0,25)
Denmark	4,60	2,00	03 Apr 2009	(-0,25)
Sweden	4,50	0,50	21 Apr 2009	(-0,50)
Switzerland	2,75	0,00–0,75	12 Mar 2009	(-0,25)
Australia	7,25	3,00	07 Apr 2009	(-0,25)
New Zealand	8,00	2,50	30 Apr 2009	(-0,50)
Israel	4,25	0,50	27 Apr 2009	(0,00)
China	7,47	5,31	22 Dec 2008	(-0,27)
Hong Kong	3,50	0,50	30 Apr 2009	(0,00)
Indonesia	9,00	7,50	03 Apr 2009	(-0,25)
Malaysia	3,50	2,00	29 Apr 2009	(0,00)
South Korea	5,25	2,00	12 Mar 2009	(0,00)
Taiwan	3,63	1,25	26 Mar 2009	(0,00)
Thailand	3,75	1,25	08 Apr 2009	(-0,25)
India	9,00	4,75	21 Apr 2009	(-0,25)
Brazil	13,00	10,25	29 Apr 2009	(-1,00)
Chile	7,75	1,75	09 Apr 2009	(-0,50)
Mexico	8,25	6,00	17 Apr 2009	(-0,75)
Czech Republic	3,50	1,75	26 Mar 2009	(0,00)
Hungary	8,50	9,50	20 Apr 2009	(0,00)
Poland	6,00	3,75	29 Apr 2009	(0,00)
Russia	11,00	12,50	24 Apr 2009	(-0,50)
Turkey	16,75	9,75	16 Apr 2009	(-0,75)
Iceland	15,50	15,50	08 Apr 2009	(-1,50)

Source: National central banks

Box 2 Recent conventional and unconventional policy measures adopted by monetary authorities in response to the global financial crisis

With inflation concerns waning and risks to the economic outlook deepening, monetary authorities in various countries have used a range of conventional and unconventional policy tools to support their economies and ease credit market conditions. As inflation fears have receded, central bankers in many countries have been at the forefront of attempts to sustain demand in the face of severe financial disruptions. In an attempt to stabilise their financial systems, governments in many developed countries have also implemented additional policy measures.

Figure B2.1 Policy rates



Source: National central banks

Central banks in some developed countries have reacted pre-emptively to the rising threat of deflation. Policy rates in many countries are nearing the zero interest rate floor after having been cut sharply – bringing them to 0,5 per cent or less in some countries (Canada, Japan, the United Kingdom (UK) and United States (US)) and to unprecedented lows in others (including the euro area and Sweden). Central banks in developed countries have attempted to maximise relief in dislocated markets – increasing credit availability and lowering spreads – while minimising possible longer-term instability. The European Central Bank (ECB) cut the margin between its benchmark rate and the cost of borrowing from its standing facility from 100 to 50 basis points. The margin between the benchmark rate and interest paid on banks' deposits was also narrowed to 50 basis points. Furthermore, the ECB broadened the pool of eligible collateral significantly and introduced additional longer-term central bank operations. Monetary authorities in some developed countries have followed multiple strategies involving continued provision of liquidity and extended guarantees of bank liabilities. Major banks in the US, the UK and Europe were provided with new capital and guarantees against losses from holdings of legacy (formerly known as 'toxic') assets. The Federal Deposit Insurance Corporation (FDIC) in the US announced programmes to guarantee selected liabilities of FDIC-insured depository institutions and their holding companies. It later also expanded its guarantees of bank liabilities temporarily to include unsecured obligations and non-interest-bearing transaction deposits.

A number of central banks have introduced a range of new instruments, including purchases of long-term government securities and more direct measures to support intermediation. In the US the nearing zero floor has constrained room for further cutting, and lower interest rates have been supported by the use of less conventional approaches, using both the size and composition of the Federal Reserve's (the Fed) balance sheet to support credit intermediation. The "credit-easing" strategy announced by the Fed is aimed at providing direct support to credit markets by providing funding and guarantees to financial intermediaries in, for example, the US commercial paper and residential mortgage-backed securities markets. The Fed established new lending facilities and expanded existing facilities by jointly establishing with the US Treasury the Term Asset-Backed Securities Loan Facility (TALF) that lends against asset-backed securities collateralised by student loans, credit card and other loans. The Fed's programmes to purchase up to US$300 billion in longer-term Treasury securities and a combined US$1,45 trillion in agency and agency-backed mortgage-backed securities are aimed at lowering key borrowing costs for households and companies.

Central banks in the UK and Japan have also commenced purchasing long-term government securities to provide direct support to illiquid credit markets. In March 2009 the Bank of England announced that it would buy £150 billion of government and corporate bonds as part of an unprecedented attempt to revive the UK economy. The Bank indicated that it would favour buying assets from institutions other than banks, and would focus on medium and long maturities. As an additional step to increase the availability of corporate credit, the Bank of England had previously set up an asset purchase programme implemented through a specially created fund and the bank's commercial paper facility had already become operational in February 2009. As some central banks have become key intermediaries in the credit process, their balance sheets have expanded rapidly. For example, the Fed's balance sheet has expanded from less than US$1 trillion in September 2008 to over US$2 trillion at the end of March 2009. Including TALF, the Fed's balance sheet could expand to over US$3 trillion – or more than 20 per cent of GDP in the US.

To put the scale of its most recently announced quantitative easing into perspective, the US$1,25 trillion in agency mortgage-backed securities the Fed now plans to purchase in 2009 represents about one-quarter of the market. Moreover, the US$300 billion in US Treasuries the Fed plans to purchase in the next six months represents nearly 10 per cent of marketable notes and would bring its total ownership to roughly one-quarter of the market. The TALF programme is also gaining momentum and could be expanded to US$1 trillion and eventually include a wide variety of financial assets (possibly including legacy assets). Having already reduced the key interest rate that it controls to nearly zero, the central bank has increasingly turned to alternatives such as buying securities. The interventions on 18 March 2009 were the biggest to date, almost doubling all of the Fed's measures in the past year.

Central banks in emerging economies have been confronted by the need to sustain external stability in the face of highly fragile financing flows. Given the current global economic outlook, emerging-market financing is potentially more vulnerable than in the case of advanced economies due to the possibility of "sudden stops". Emerging economies that have borrowed heavily in foreign currency are also more vulnerable to exchange rate depreciation. Governments in developing countries have in general provided fiscal support on a much smaller scale than in developed countries, with China and Saudi Arabia being the important exceptions. China's central bank has ensured sufficient liquidity to sustain economic growth by implementing a moderately loose monetary policy. The government has encouraged banks to lend in support of the stimulus, implemented after the global recession had led to a collapse in exports that dragged economic growth in China to the weakest pace in seven years. In November 2008 the People's Bank of China announced that it would lend Rmb100 billion (US$14,6 billion) to banks by the end of December to stave off a slowdown in growth. In December 2009 the central bank cut its key lending rate for the fifth time in three months and, once again, lowered its reserve requirement for the country's banks.

Many developing countries, especially in Asia and Latin America, have used policy buffers to alleviate pressures. In some countries exchange rates have been allowed to adjust downwards and in others stockpiles of reserves have been significantly depleted in an attempt to counter volatile exchange rate movements. In some instances reserves have been applied to augment private credit and sustain trade finance in particular. The Fed offered bilateral currency swap facilities to 14 systemically important countries and the International Monetary Fund (IMF) provided assurance to markets that external funding would be available if required by countries that had been implementing sound macroeconomic policies. In emerging Europe and the Commonwealth of Independent States countries policy responses have been complicated by greater vulnerabilities and less flexible exchange regimes. Some of these countries have been confronted by severe external financing shortages and mismatches on borrowers' balance sheets. Authorities in these countries have tightened macroeconomic policies, and have approached the IMF and other official sources for external financial support.

The rapid, and in some instances unorthodox, policy responses in many countries to the extreme financial market conditions that arose after the collapse of Lehman Brothers in the US in

September 2008 have thus far failed in aggregate to arrest the downward spiral in global economic activity. Policy responses have helped to alleviate financial market conditions, but financial markets have yet to stabilise. The additional stimulus measures announced by the G-20 in April 2009 represent a further substantial co-ordinated attempt by policy-makers to break the financial sector's negative feedback loop with the real economy.

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The US Federal Reserve (the Fed) eased its stance further in December 2008 by adopting a target range for the federal funds rate of zero to 0,25 per cent per annum. More recently, it intensified its efforts to bolster the economy. Although the Fed left the federal funds target rate unchanged at 0–25 basis points at its most recent meeting, it still eased policy, as it moved towards a quantitative easing strategy (Box 2 discusses this in more detail). On 18 March 2009 it announced that it would inject an extra US$1 trillion into the financial system by purchasing Treasury bonds and mortgage securities. The Fed announced that it would further expand its balance sheet by purchasing up to an additional US$750 billion of agency mortgage-backed securities and up to an additional US$100 billion of agency debt this year (bringing total purchases to US$1,25 trillion and US$200 billion respectively). It also decided to purchase up to US$300 billion of longer-term (2- to 10-year) Treasury securities over the next six months. Finally, the Fed anticipates that the range of eligible collateral for the Term Asset-Backed Securities Loan Facility (TALF) is likely to be expanded to include other financial assets.

The ECB is providing enhanced credit support and has allowed the interest rate it pays on its deposit facility, used by banks to place funds overnight, to become a benchmark for market rates. While the main policy rate has been cut to 1,25 per cent – the lowest ever – the deposit facility rate stands at just 0,25 per cent. The Bank of England's Monetary Policy Committee cut the official Bank Rate to a record low 0,50 per cent on 5 March 2009, and reached consensus on the adoption of a quantitative easing programme.

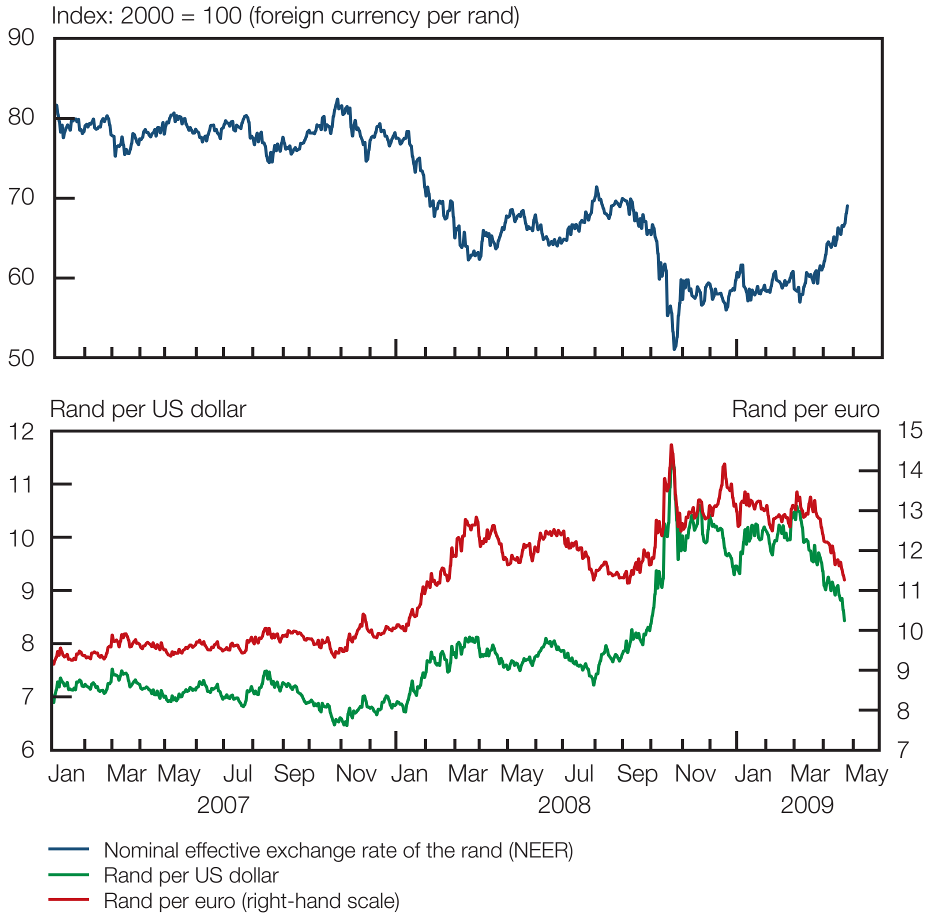
As widely anticipated, the Bank of Japan left its key policy rate unchanged at 0,10 per cent at its most recent meeting. However, it did increase the size of its monthly government bond purchases (rinban operations) from ¥1,4 trillion to ¥1,8 trillion. Moreover, it unveiled plans to provide as much as ¥1,0 trillion of subordinated loans to large commercial banks, in order to shore up the capital bases of institutions hit by portfolio losses.

Exchange rate developments

The foreign-exchange rate of the South African rand has generally strengthened in the period since the publication of the November 2008 *Monetary Policy Review* (Figure 5). The nominal effective exchange rate (NEER), which measures the value of the rand against a basket of 13 currencies, appreciated by 31 per cent; from a recent low of 52,57 on 27 October 2008 to 69,06 on 30 April 2009. Over the same period, the rand appreciated from R11,31 to R8,43 against the US dollar, and from R14,04 to R11,26 against the euro.

However, as is evident in Figure 5, the exchange rates of the rand have recovered from the sharp depreciation experienced in October 2008 that was largely due to lower commodity prices and increased global risk aversion. The risk aversion was most starkly felt in October when close to R50 billion worth of domestic bonds and shares were sold by non-residents; this was more than double the combined sales of bonds and equities by non-residents in any other month in 2008. The strengthening in the value of the rand during April 2009 was largely fuelled by improved investor sentiment around the world.

Figure 5 Exchange rates of the rand



Demand and output

The South African economy contracted at an annualised rate of 1,8 per cent in the fourth quarter of 2008 (Table 7), the first quarterly decline in aggregate real production since the third quarter of 1998. Following successive growth rates of 1,7 per cent, 5,0 per cent and 0,2 per cent in the preceding three quarters of 2008, this resulted in real GDP growth of 3,1 per cent in 2008, compared with 5,1 per cent in 2007.

The deceleration in growth in the fourth quarter of 2008 can be attributed mainly to a marked deterioration in real value added by the secondary sector, particularly by manufacturing. The real value added by the manufacturing sector contracted at an annualised rate of 21,8 per cent in the fourth quarter, having recorded a contraction of 9,4 per cent in the third quarter. By contrast, the annualised growth in real value added by the primary sector accelerated to 6,0 per cent in the final quarter of 2008 from 3,3 per cent in the third quarter, reflecting an improved growth performance by the mining sector and continued strong growth in the agriculture sector. The mining sector recorded annualised growth of 0,5 per cent in real value added in the fourth quarter after contracting by 8,8 per cent in the third quarter, while growth in real value added by the agriculture sector was 31,6 per cent in the third quarter and 16,7 per cent in the fourth quarter.

Table 7 Growth in real GDP and expenditure components
Per cent*

	2007	2008				
	Year	1st qr	2nd qr	3rd qr	4th qr	Year
Final consumption expenditure:						
Households	6,6	3,0	1,3	-0,9	-2,7	2,3
General government	4,8	12,3	-2,1	10,2	3,6	5,0
Gross fixed capital formation	16,3	10,4	5,2	7,3	3,0	10,2
Changes in inventories (R billions)**	4,2	11,1	-4,7	-11,2	-21,1	-6,5
Gross domestic expenditure	**6,0**	**12,5**	**-1,7**	**0,7**	**-3,9**	**3,1**
Exports of goods and services	7,5	-30,1	42,5	4,0	-16,4	1,7
Imports of goods and services	10,0	3,9	7,9	4,7	-19,0	2,2
Gross domestic product	**5,1**	**1,7**	**5,0**	**0,2**	**-1,8**	**3,1**

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

Real gross domestic expenditure declined at an annualised rate of 3,9 per cent in the final quarter of 2008, after increasing by a modest 0,7 per cent in the third quarter. This performance was the result of a contraction in final consumption expenditure by households over the period, a notable decline in inventory levels, and slower growth in gross fixed capital formation and final consumption expenditure by general government. Final consumption expenditure by households declined at annualised rates of 0,9 per cent in the third quarter and 2,7 per cent in the final quarter of the year. The annual growth rate for final consumption expenditure by households slowed from 6,6 per cent in 2007 to 2,3 per cent in 2008, which was the lowest rate recorded this decade.

In the external sector of the economy, real exports of goods and services grew by an annualised 4,0 per cent in the third quarter of 2008 before declining by 16,4 per cent in the final quarter. Real imports of goods and services rose by 4,7 per cent and declined by 19,0 per cent in the corresponding quarters, with the result that the trade deficit narrowed from R36,7 billion in the third quarter of 2008 to R19,6 billion in the fourth quarter. This outcome was supported by a narrowing of the shortfall on the service, income and current transfer account with the rest of the world in the fourth quarter of 2008, mainly as a result of lower interest and dividend payments to non-resident investors. As a consequence of these developments, the deficit on the current account of the balance of payments expressed as a ratio of GDP shrank from 7,8 per cent of GDP in the third quarter of 2008 to 5,8 per cent in the fourth quarter.

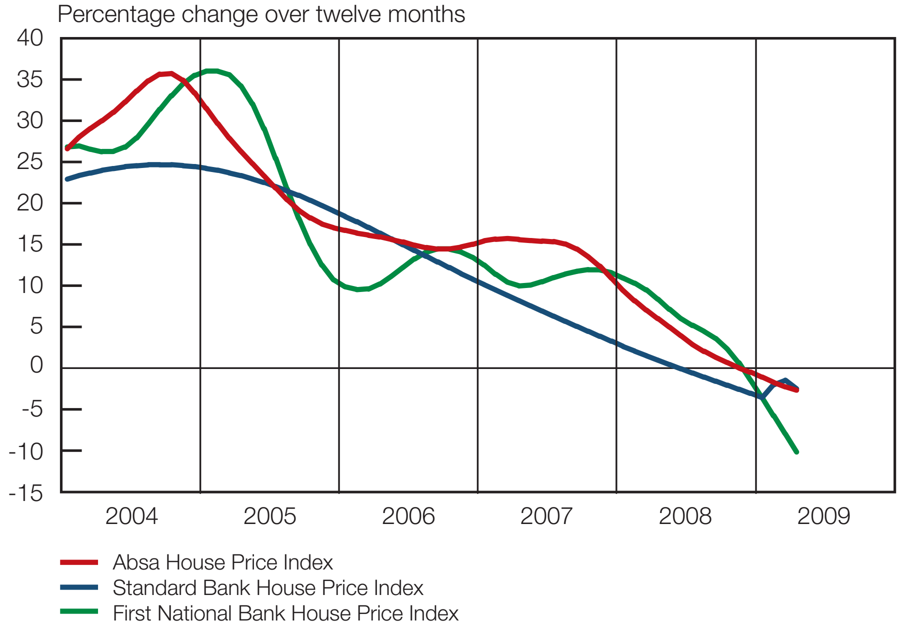
South Africa's gross gold and other foreign reserves declined marginally from US$34,4 billion at the end of September 2008 to US$34,1 billion at the end of March 2009. The international liquidity position decreased from US$33,6 billion to US$33,5 billion over the same period. The changes in the reserve positions were mainly the result of exchange rate-induced revaluation effects.

Real-estate and equity prices

The adverse economic conditions that enveloped developed countries around the globe during 2008 inevitably filtered through to developing countries such as South Africa. As in many other emerging markets, South African property and share markets weakened considerably from the second half of 2008. Negative and uncertain conditions in global markets, lower commodity prices and less favourable economic growth prospects generally contributed to the weaker performance of the South African share market, while the property market also extended its downward trend.

Measured by the Absa House Price Index (Figure 6), the year-on-year rate of change in nominal house prices continued to trend downwards from the high of 15,7 per cent reached in March 2007, reaching negative levels of growth from December 2008. This is the first occurrence of a decline in the index since 1987. The year-on-year rate of increase in the First National Bank House Price Index also continued to move downwards, recording a decline of 10,2 per cent in April 2009, while the year-on-year change in the Standard Bank House Price Index recovered from -3,6 per cent in January 2009 to -2,5 per cent in April.

Figure 6 House prices



Sources: Absa, Standard Bank and First National Bank

The declining level of economic activity in the real-estate sector is also evident from the building statistics published by Stats SA and reproduced in Table 8. While growth in the value of buildings completed decelerated during the course of 2008, the value of building plans passed recorded an even sharper deceleration, providing an indication that future construction activity may remain subdued. However, positive growth was displayed in plans passed for non-residential buildings. The real value of building plans passed for the residential sector contracted by 27,2 per cent in 2008 after decreasing by 3,2 per cent in 2007, while that for the non-residential sector expanded by 0,8 per cent in 2008 after contracting by 5,9 per cent in 2007. In the first two months of 2009, year-on-year growth in the value of buildings completed remained positive, while the value of plans passed contracted sharply for both residential and non-residential buildings.

Table 8 Real value of building plans passed and buildings completed in larger municipalities

Annual percentage change

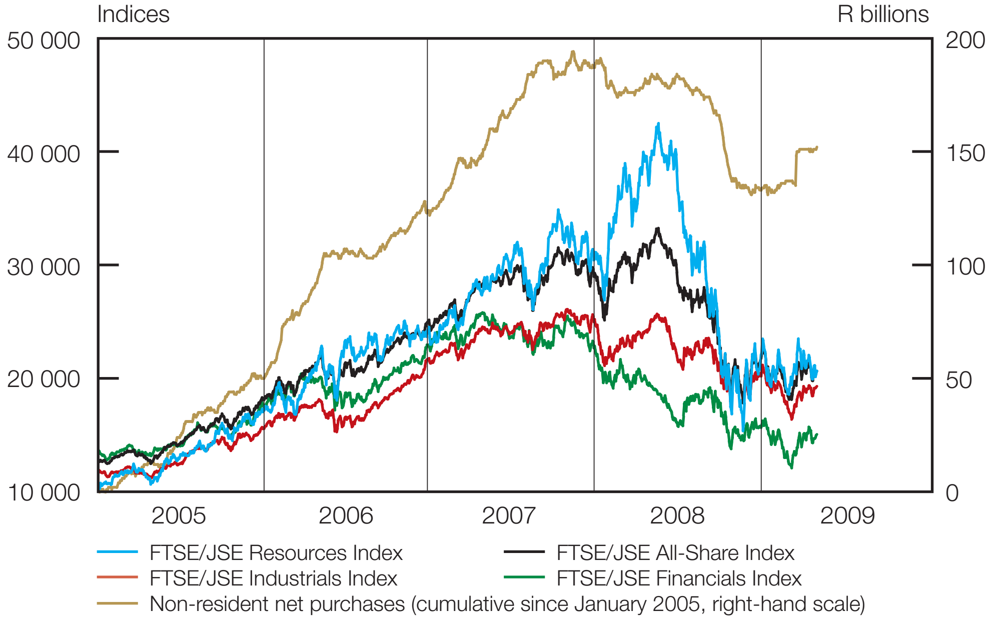
	2006	2007	2008	2009*
Building plans passed				
Total	**8,1**	**-2,4**	**-18,1**	**-48,9**
Residential	2,7	-3,2	-27,2	-53,4
Non-residential	31,7	-5,9	0,8	-41,4
Additions and alterations	5,0	1,9	-12,7	-46,4
Buildings completed				
Total	**21,5**	**9,5**	**1,2**	**10,2**
Residential	16,7	1,2	-8,8	0,2
Non-residential	30,6	48,6	18,5	26,6
Additions and alterations	34,0	6,1	15,6	19,6

* Figures for January and February 2009 compared with the corresponding months of 2008

Source: Statistics South Africa

Share prices on the JSE Limited (JSE) trended downwards during the second half of 2008, effectively mirroring developments in international markets. As Figure 7 shows, the FTSE/JSE All-Share Index (Alsi) declined by 46 per cent from a record high on 22 May 2008 to 20 November, led by a steep fall in resources shares which lost more than half their value after the commodity boom had come to an abrupt end. Similar, although somewhat less pronounced, declines were recorded by industrial and financial shares over the same period. Financial shares have been on a downward trend since the end of 2007, partly as a result of investor concerns about the impact of rising domestic interest rates on the profitability of these companies, and the negative perceptions globally regarding banking and credit markets in general.

Figure 7 Share price indices and non-resident net purchases of shares



Source: JSE Limited

The decline in domestic share prices during 2008 coincided with a sell-off of South African shares by non-resident investors. Towards the end of 2007 non-residents reassessed their investments in the light of the turbulence in global financial markets and, after four consecutive years of net purchases of South African shares, substantial net sales of R54 billion were recorded in 2008. However, early indications are that non-residents again purchased shares to the net value of R19 billion in the first four months of 2009.

Although share prices remained somewhat volatile during the first months of 2009, the Alsi rebounded by 16 per cent from 20 November 2008 to the end of April following a modest recovery in commodity prices, the lowering of the repurchase rate and improved conditions on global equity markets.

Fiscal policy

The adverse developments in the global economy impacted markedly on the budget presented by the Minister of Finance on 11 February 2009 (Table 9). According to the *Budget Review 2009*, the estimated budget balance for 2008/09 is a deficit of R22,8 billion (or 1,0 per cent of GDP), a significant revision to the surplus of R14,3 billion that was estimated at the time of the 2008 budget. As a percentage of estimated GDP, the medium-term budget balances are projected to be deficits of 3,9 per cent in 2009/10, 3,1 per cent in 2010/11 and 2,3 per cent in 2011/12. The structural budget balance, which adjusts for the effects of the economic cycle, averages -3,2 per cent of GDP over the next three fiscal years.

Table 9 Public finance data

R billions and per cent

	2006/07	2007/08	2008/09		2009/10	2010/11	2011/12
	Actual	Actual	Feb 2008 budget	Revised estimates	Medium-term estimates		
National government							
Deficit (–)/surplus (+)	+11,0	+18,3	+14,3	-22,8	-95,6	-83,3	-67,7
Revenue	481,2	559,8	625,4	611,1	643,0	709,1	781,2
Expenditure	470,2	541,5	611,1	633,9	738,6	792,4	849,0
As a percentage of GDP							
Deficit (–)/surplus (+)	+0,6	+0,9	+0,6	-1,0	-3,9	-3,1	-2,3
State debt cost	2,9	2,6	2,2	2,4	2,2	2,2	2,3
Total net loan debt	26,4	23,4	19,7	22,6	25,6	27,1	27,4
PSBR*	-0,3	-0,6	1,2	3,9	7,5	6,5	5,3

* PSBR: Public-sector borrowing requirement

Source: National Treasury *Budget Review 2009*

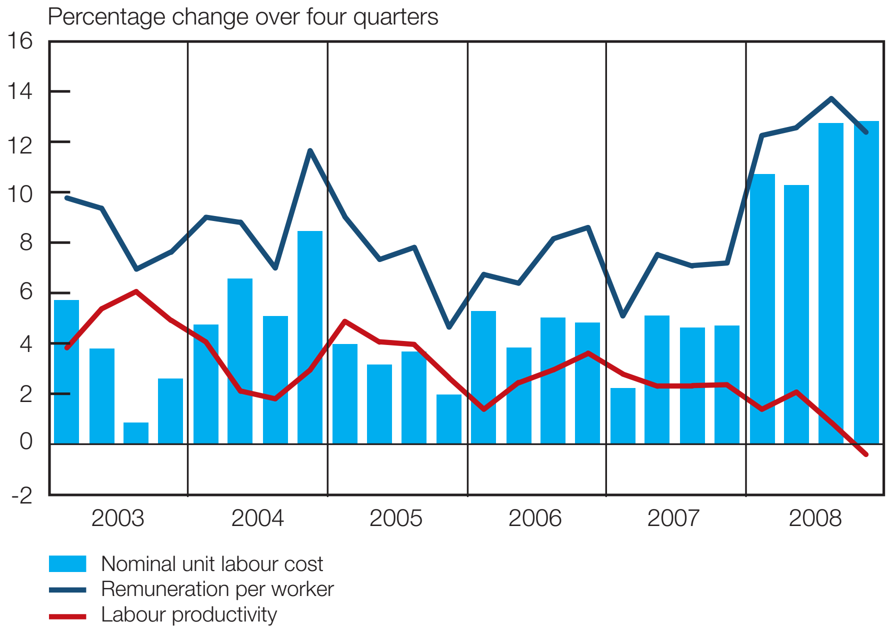
The weaker economic environment has resulted in a revised main budget revenue total of R611,1 billion for fiscal 2008/09, representing R14,3 billion less than originally budgeted. Expenditure has been revised upwards by R22,8 billion to R633,9 billion for the same period. Debt-service costs as a percentage of GDP are projected to decline slightly over the medium term, from 2,4 per cent in 2008/09 to 2,2 per cent in 2009/10 and 2010/11, and 2,3 per cent in 2011/12.

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 -0,6 per cent of GDP in 2007/08 to a revised estimate of 3,9 per cent of GDP in 2008/09. The PSBR, bolstered by the public corporations' and governments' capital expenditure, is projected at 7,5 per cent of GDP in 2009/10, before contracting slightly to reach 5,3 per cent of GDP in 2011/12.

Labour markets

Figure 8 shows that wage inflation, measured by the year-on-year rate of increase in the nominal remuneration per worker in the non-agricultural sectors, accelerated from 7,1 per cent in the third quarter of 2007 to 13,7 per cent in the third quarter of 2008, before slowing to 12,4 per cent in the fourth quarter. The combination of these changes in wage inflation and generally declining labour productivity growth resulted in the growth in unit labour cost rising from 4,6 per cent to 12,8 per cent during the same period.

Figure 8 Remuneration per worker, labour productivity and unit labour cost in the formal non-agricultural sector

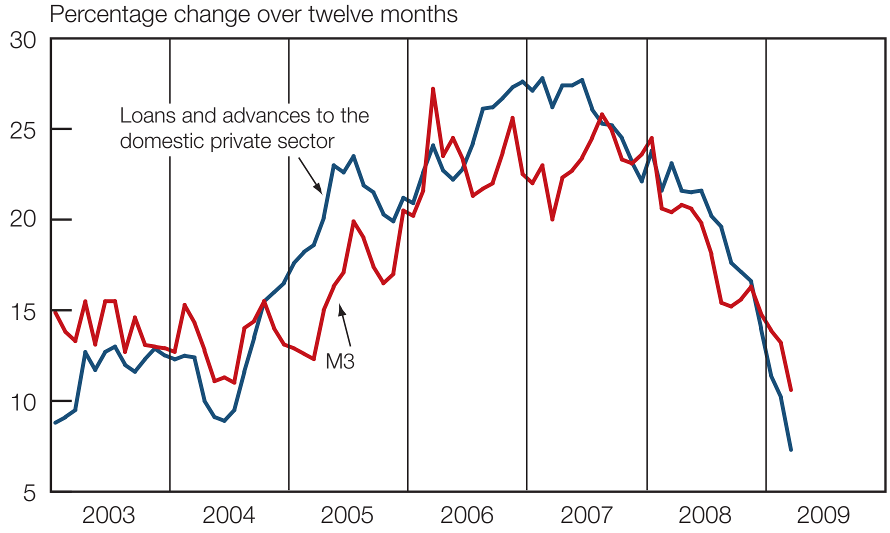


According to the outcome of the *Andrew Levy Wage Settlement Survey*, the average level of wage settlements amounted to 10,2 per cent in the first quarter of 2009, after recording 9,8 per cent in 2008 and 7,3 per cent in 2007. The settlements in the first quarter of 2009 ranged from 7 per cent in the metal/manufacture sector to 12,3 per cent in the food/agriculture sector.

Monetary conditions

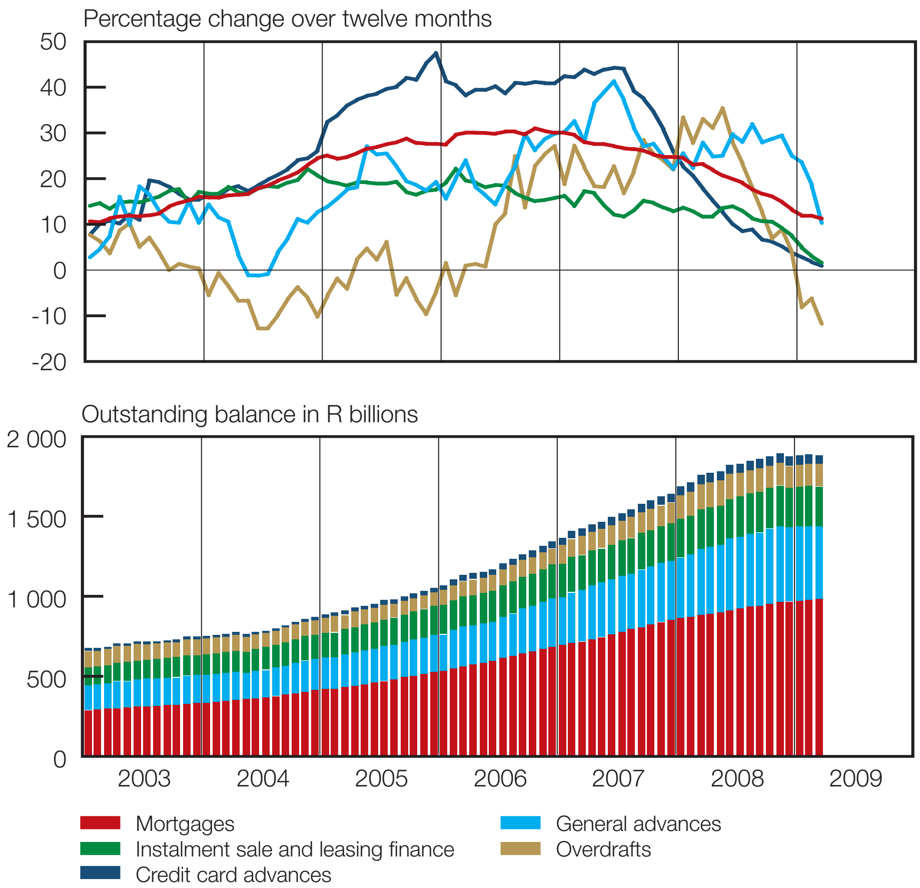
Monetary data, and particularly growth in credit extension, continued to reflect tighter conditions in the period under review, affected by higher interest rates, decelerating economic activity and tighter lending criteria applied by banks (Figure 9). Year-on-year growth in banks' loans and advances to the private sector decelerated from 23,8 per cent in January 2008 to 14,0 per cent in December and 7,3 per cent in March 2009. Similarly, growth in broad money supply (M3) decelerated from 24,5 per cent in January 2008 to 14,8 per cent in December and further to 10,6 per cent in March 2009.

Figure 9 Growth in money supply and credit extension



Mortgage advances dominate the bank loans and advances aggregate, with more than 50 per cent of outstanding loans falling in this category (Figure 10). Of the remaining categories, approximately one-quarter consists of general loans, while overdrafts (7 per cent), credit card advances (3 per cent) and instalment sales and leasing finance (13 per cent) make up the remainder. Growth in all the loan categories decelerated during 2008 and the early months of 2009. Year-on-year growth in mortgage advances decelerated from, on average, 27 per cent in 2007 to 19 per cent

Figure 10 Banks' loans and advances by type



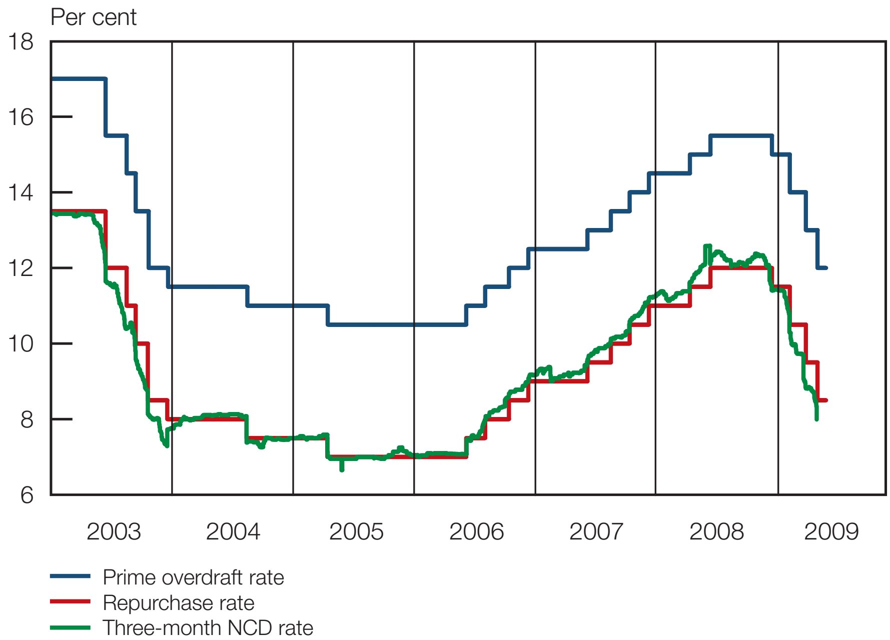
in 2008 and 12 per cent in the first three months of 2009. Growth in other loans and advances, which include general loans, overdrafts and credit card advances, decelerated from 30 per cent in 2007 to 24 per cent in 2008 and 9 per cent in the first three months of 2009.

Monetary policy

Since the publication of the previous *Monetary Policy Review* there have been four meetings of the Monetary Policy Committee (MPC). The severe downturn in the global economy in the final months of 2008, and the speed with which it spread to virtually all parts of the world, created new challenges for monetary policy-makers generally. It was decided that, in the light of these developments, it would be appropriate for the time being to meet more frequently in order to assess these rapidly changing circumstances in a timeous manner and to be able to act appropriately when necessary. Accordingly, the MPC is scheduled to meet every month, apart from July, for the remainder of 2009.

For much of 2008, the MPC had been concerned about the more generalised nature of the inflation dynamics that were brought about primarily by the succession of supply-side shocks such as food and oil price increases. As outlined in this *Review*, the global economic landscape changed dramatically in the later part of the year, and these global developments have had a significant impact on the South African economy and on monetary policy in particular. The economy has experienced a marked slowdown and a consequent widening of the output gap, while pressures on inflation have subsided as a result of declining demand and lower commodity prices. These developments allowed for a change in the monetary policy stance. As Figure 11 shows, the repurchase rate was reduced by 50 basis points in December and by a further 100 basis points at each of the subsequent three meetings.

Figure 11 The repurchase rate and other short-term interest rates



These interest rate reductions were effected despite the fact that inflation was still above the upper end of the inflation target range. As explained in previous *Reviews*, given the lag in the reaction of inflation to interest rate changes, the focus of monetary policy is on the medium- to longer-term expected trajectory of inflation, rather than on the current outcomes. It is also the case that an inflation-targeting framework allows for flexibility in the time horizon for achieving the inflation target. The MPC also has to assess the risks to the inflation outlook, as the forecast is not followed mechanistically. During the past months, the view of the committee was that the balance of risks to the outlook, which for most of 2008 had been viewed as being on the upside as a result of oil and food price developments, had changed significantly. The widening output gap was increasingly seen as a downside risk to the inflation outlook. While the exchange rate was initially seen as a source of upside risk, the recent appreciation of the rand reduced this risk somewhat.

At the December MPC meeting the inflation forecast generated by the Bank's forecasting model showed an improvement in the inflation outlook, with inflation expected to return to within the target range by the third quarter of 2009. Although inflation was forecast to increase again in the first quarter of 2010 as a consequence of base effects, it was expected to remain within the target range for the remainder of the forecast period. The forecast presented to the February 2009 meeting was similar, but both these forecasts were subject to heightened uncertainty as a result of the reweighting and rebasing of the CPI that was due to be implemented by Stats SA in January 2009.

The new CPI measure for January was available at the March 2009 MPC meeting and it revealed that the previous forecasts had slightly overestimated the degree to which the inflation rate would decline. This then resulted in a near-term deterioration in the inflation outlook, but a more favourable trend was forecast for the medium term, with inflation expected to average 5,3 per cent in the final quarter of 2010. At the April meeting, the forecast again deteriorated slightly, with inflation now expected to average 5,4 per cent at the end of the forecast period. The most recent forecast is discussed in more detail later on in this *Review*. The MPC, however, emphasised the fact that the higher levels of uncertainty and the pace of change of global developments made these forecasts subject to higher risk than was usually the case.

Inflation expectations, which had been deteriorating in the course of the year, appeared to have improved somewhat in the longer term in the fourth quarter of 2008. According to the inflation expectations survey conducted on behalf of the Bank by the Bureau for Economic Research (BER) at Stellenbosch University, inflation expectations for 2009 as measured in the fourth quarter of 2008 reflected a slight deterioration when compared with those measured in the previous quarter. However, expectations for 2010 improved, with average expected inflation of 7,2 per cent, compared with 7,4 per cent in the previous survey. In the survey conducted in the first quarter of 2009, average inflation expectations for 2009 showed an improvement, but there was a marked deterioration for 2010 with CPI inflation now expected to average 8 per cent. However, the survey was characterised by divergent views between the different groups of respondents.

During the review period, international developments had an impact on the domestic inflation outlook. At each MPC meeting, the international economy was characterised by progressively worse outcomes as the advanced economies experienced negative growth, and emerging-market economies also showed signs of slowing. The forecasts for global growth were also revised downwards over time. The falling global demand and declining commodity prices meant that world inflation pressures eased, despite significant monetary and fiscal policy stimuli in many countries.

Food and petrol prices continued to warrant special attention. At the time of the December meeting North Sea Brent crude oil was trading at around US$40 per barrel, compared with a peak of almost US$150 per barrel in August 2008. A similar level was recorded at the time of the February meeting, but by the April meeting international prices had risen to above the US$50 per barrel level. The impact on the domestic petrol price was also affected by exchange rate developments and domestic tax increases. Whereas domestic petrol prices declined by around R4,40 per litre between September 2008 and February 2009, successive increases in the following months resulted in a cumulative increase in petrol prices of R1,37 per litre. The committee nevertheless noted that under conditions of low global growth the risk posed to domestic inflation by international oil prices had subsided to a large extent.

The committee also concluded that the risk posed by food prices had moderated somewhat. The price of a number of agricultural commodities had declined in global and domestic markets, and this was reflected in price declines in some of the agricultural food categories in the PPI. However, up to the April 2009 meeting food price increases at the consumer price level, although declining, had remained stubbornly high and the MPC noted that the expected decline in inflation might be delayed by the continued high rates of increase in food prices, despite marked declines in producer price food inflation.

The MPC paid particular attention to the output gap that had been widening over the past quarters. The output gap, measured as the difference between actual and potential output growth, is an important determinant of inflation. At the time of the December meeting, the committee noted that the 0,2 per cent GDP growth rate recorded in the third quarter of 2008 represented a significant widening of the output gap. Other high-frequency data, observed at the December 2008 and February 2009 meetings, indicated that the fourth-quarter growth outcome was likely to be lower than that recorded in the third quarter. By the March meeting the fourth-quarter contraction of 1,8 per cent was confirmed, and the outlook for the first quarter of 2009 remained bleak in the light of contractions in mining, manufacturing and retail sales as observed in the monthly data releases. The RMB/BER Business Confidence Index and the Investec/BER Purchasing Managers Index (PMI) also indicated that growth, particularly in the manufacturing sector, was likely to remain under pressure in the coming months.

Expenditure in the economy also remained subdued over the period under review, in part due to the tighter stance of monetary policy that had been adopted until the middle of 2008, but also due to the impact of other factors related to the global financial crisis. At all the meetings of the MPC during this period, the sharp decline in real household consumption expenditure was noted, particularly with respect to durable goods consumption. In the fourth quarter of 2008, household consumption expenditure declined at an annualised rate of 2,7 per cent, mainly as a result of a 20 per cent contraction in consumption of durable goods.

The weak trends in global and domestic demand were also seen to have an impact on the current account of the balance of payments. The lower international price of oil, along with declining demand for goods and services generally, allowed for a decline in imports in the final quarter of 2008. This trend, coupled with lower net income and dividend payments to non-residents, more than offset the decline in the volume and value of exports during that quarter. Consequently, the deficit on the current account of the balance of payments narrowed to 5,8 per cent of GDP in the final quarter of 2008, compared with a deficit of 7,8 per cent in the previous quarter.

Trends in credit extension also exhibited a steady deceleration over the period. Credit extension to households continued to moderate in line with the lower levels of consumption expenditure, while credit extension to firms also decelerated. The committee also noted that the downward trend in the growth of credit extension was not only a result of lower demand, but also of the more stringent lending criteria applied by banks. Asset prices also remained under pressure: by April the various house price indices showed that house prices were falling and equity prices on the JSE had declined substantially in the wake of the global credit crisis since September 2008. These factors were seen by the committee as factors constraining a near-term increase in expenditure. Evidence that households were rebuilding their impaired balance sheets was also seen in the declines in the ratio of household debt to disposable income that were observed in the final two quarters of 2008.

While the above factors generally contributed to the moderation in inflation and in some instances were seen to impart a downside risk to the inflation outlook, a number of upside risks were also observed. In particular, the behaviour of the rand exchange rate in the wake of the financial crisis was a cause for concern for the committee, because of the potential impact of the exchange rate on inflation. At the December 2008 and February 2009 meetings, the rand was seen to pose the main upside risk to the inflation outlook. The rand had been trading at levels of around R8,00 to the US dollar in early September 2008. However, as risk aversion increased following the collapse of Lehman Brothers in mid-September, the rand depreciated against the US dollar along with most other emerging-market currencies. At the time of the December meeting, the rand was trading at around R10,20 to the US dollar, having reached a level of R11,80 at one stage. The rand remained volatile during the subsequent months, but by the March 2009 meeting it had appreciated to levels of around R9,45 to the US dollar and to around R8,50 in April. While the risk to the inflation outlook emanating from the exchange rate had subsided somewhat, the committee recognised that the volatile and uncertain international environment meant that the outlook for the rand remained uncertain.

At the March and April meetings, the main upside risks to the inflation outlook were identified as emanating mainly from cost-push pressures, particularly from administered prices. These included possibly higher-than-expected electricity tariff increases.

The improved outlook for inflation, in part a result of the declining economic growth, and the change in the balance of risks to the outlook have allowed for a 350 basis point reduction in the repurchase rate by the MPC since December 2008. Unlike in a number of other countries, monetary policy in South Africa has not had to focus directly on financial stability issues as the domestic banking system has remained sound. Monetary policy, which continues to be conducted within a flexible inflation-targeting framework, has remained focused on bringing inflation down to within the inflation target range over a reasonable time period, while being sensitive to growth variability issues.

The outlook for inflation

The outlook and uncertainties relating to some of the international and domestic factors that are considered by the MPC in setting monetary policy, including indicators of inflation expectations and the fan chart representation of the Bank's forecast, are discussed below.

International outlook

The global economy has continued to weaken significantly in recent months and the decline in global demand has resulted in a marked contraction in international trade. There is growing uncertainty about the depth and duration of the economic slowdown. The IMF, which in January 2009 was forecasting global growth to average 0,5 per cent in 2009, has downgraded its outlook for the global economy for the third time in five months and now expects a contraction of 1,3 per cent in 2009 (Table 10). This would be the first decline in the nearly 40-year history of the series.

Table 10 IMF projections of world growth and inflation for 2009 and 2010*

Per cent

	Real GDP			Inflation rates**		
	2009		2010	2009		2010
World	**(3,0)**	**-1,3**	**1,9**	**(4,6)**	**2,5**	**2,4**
Advanced economies	**(0,5)**	**-3,8**	**0,0**	**(2,0)**	**-0,2**	**0,3**
United States	(0,1)	-2,8	-0,1	(1,8)	-0,9	-0,1
Japan	(0,5)	-6,2	0,5	(0,9)	-1,0	-0,6
Euro area	(0,2)	-4,2	-0,4	(1,9)	0,4	0,6
United Kingdom	(-0,1)	-4,1	-0,4	(2,9)	1,5	0,8
Other advanced economies	(2,5)	-4,1	0,6	(3,3)	0,6	1,5
Other emerging-market and developing countries	**(6,1)**	**1,6**	**4,0**	**(7,8)**	**5,7**	**4,7**
Africa	(6,0)	2,0	3,9	(8,3)	9,0	6,3
Central and eastern Europe	(3,4)	-3,7	0,8	(5,8)	4,6	4,2
Commonwealth of Independent States	(5,7)	-5,1	1,2	(12,6)	12,6	9,5
Developing Asia	(7,7)	4,8	6,1	(6,2)	2,8	2,4
China	(9,3)	6,5	7,5	(4,3)	0,1	0,7
India	(6,9)	4,5	5,6	(6,7)	6,3	4,0
Middle East	(5,9)	2,5	3,5	(14,4)	11,0	8,5
Western hemisphere	(3,2)	-1,5	1,6	(7,3)	6,6	6,2

* IMF projections for 2009 as at October 2008 in parenthesis
** Zimbabwe excluded

Source: IMF *World Economic Outlook*, April 2009

The IMF projects a severe 3,8 per cent contraction in the advanced economies and relatively meagre growth of just 1,6 per cent in the emerging economies. Moreover, it projects an anaemic recovery in 2010 with global growth of only 1,9 per cent. The IMF's April 2009 *World Economic Outlook* economic growth projections for all countries are lower than their September 2008 counterparts due to the sudden and steep declines in global production and world trade. Notwithstanding these significant downward revisions to the IMF forecast, risks to the growth outlook are heavily skewed to the downside. Consumer price inflation also continues to trend downwards in most countries and world inflation is projected to be restrained by declining demand and lower commodity prices, which are expected to remain subdued under conditions of negative or low growth.

The IMF has warned that the US recession may last into 2010 unless policy-makers can stabilise the financial system. For the US economy, the IMF projects contractions of 2,8 per cent in 2009 and 0,1 per cent in 2010. The contraction in economic activity is expected to push the output gap to levels reached in the early 1980s. Growth in the US is only expected to turn positive in the third quarter of 2010, based on the assumptions that financial market conditions improve relatively rapidly in the second half of 2009 and that sustained policy support bolsters domestic demand.

The economy of the 16-nation euro region is expected to contract by 4,2 per cent in 2009, worse than the 2 per cent slump that the IMF forecast in its January 2009 update. Record declines in exports and production in the first half of this year are expected to shrink the economy significantly and a further marginal contraction of 0,4 per cent is projected for the region in 2010. The projected decline in economic activity in 2009 reflects the significant contraction in external demand, the corrections in housing markets in certain member states and increasing financing constraints.

Japan is expected to experience the sharpest contraction among the G-7 economies in 2009, with real GDP projected to fall by no less than 6,2 per cent as net exports, business investment and private consumption weaken simultaneously. The financial sector in Japan has also begun to weigh on growth prospects.

In Africa regional growth is expected to slow sharply to 2,0 per cent this year, less than half the rate of the past five years, but the IMF warns that the projection may be too optimistic. Even though the crisis has been slow in reaching Africa's shores, the IMF expects the combined impact of economic and financial shocks to be severe. Financial flows have become scarce, trade financing even scarcer and more expensive, and foreign investment in Africa's stock and bond markets has fallen. As growth around the world declines, demand for Africa's products is expected to fall significantly further and commodity export prices to remain lacklustre. Tourism revenue is also expected to decline further as consumers around the world tighten their belts.

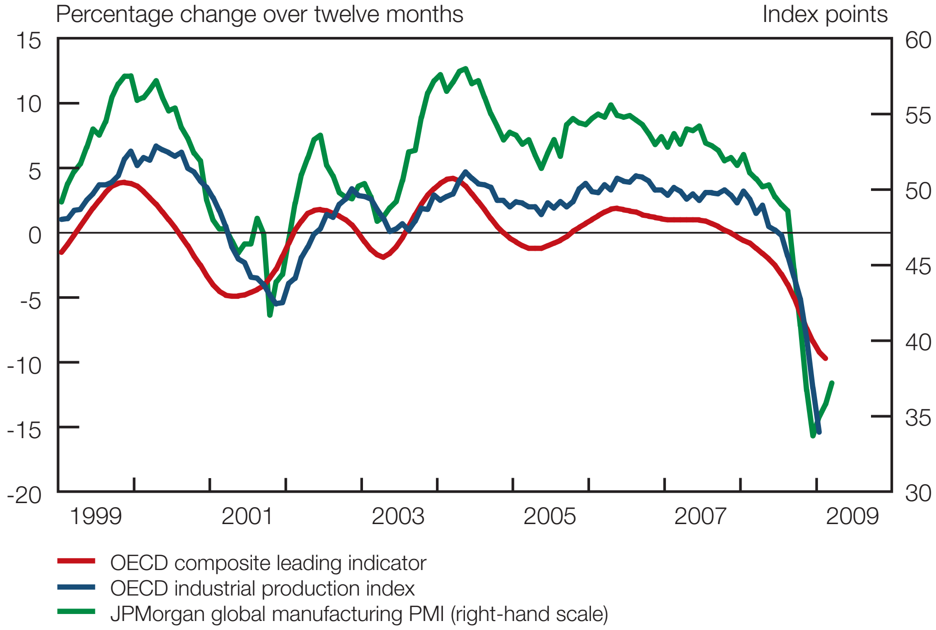
Among major emerging economies, China appears to be best positioned to weather the global slowdown. Although export growth has weakened substantially, China has a large budget surplus that gives the government considerable flexibility to boost consumer and business spending. China's financial system has a limited connection to foreign banks and the country's foreign-exchange reserves are approaching US$2 trillion. India's banking system is also relatively insulated from international financial turmoil and the country's economic growth has generally relied more on domestic demand than on exports.

The IMF warns that a further deterioration in the financial markets in advanced economies could lead to a deeper and longer downturn, and that the deflation risk in advanced economies could reinforce such an outcome. Emerging economies may also find it increasingly difficult to secure external financing, and the spectre of trade and financial protectionism is also a concern for the overall global economic outlook. However, the global growth outlook could improve significantly once the monetary and fiscal policy measures announced in various countries begin to bear fruit, especially if policy measures are strengthened credibly.

The composite leading indicator compiled by the Organisation for Economic Co-operation and Development (OECD) projects a continuing slowdown in economic activity in the major OECD countries (Figure 12). The OECD composite leading indicator continued to fall, recording a decline of 9,7 per cent in February 2009 compared with the same month of the previous year. The percentage change over twelve months in the OECD industrial production index declined further to a negative 15,4 per cent in January 2008, compared with a decline of 12,0 per cent recorded on the same basis for the previous month. Although the JPMorgan global manufacturing PMI increased for a third straight month to 37,2 in March 2009 from 33,7 in December 2008, it is still at a level that is indicative of continued broad contraction in global manufacturing.

Whereas inflation is expected to remain subdued due to lower commodity prices and weakening economic growth, deflation risks have arisen in some of the advanced countries. Headline inflation in the advanced economies fell below 1 per cent in February 2009. Inflation has also moderated significantly across the emerging economies, although in some cases falling exchange rates have dampened the downward momentum. Sustained deleveraging and tight credit availability are likely to continue to weigh heavily on the global economy in 2009. The world economy is therefore expected to stagnate for most of 2009, with a slow recovery commencing only during 2010.

Figure 12 Selected indicators of global economic activity



Sources: OECD and JPMorgan

The magnitude of the global slowdown in 2009 will, to a large degree, depend on the severity of the financial crisis and the effectiveness of government policy initiatives around the world. Considerable time could pass before financial institutions' losses are fully recognised, leverage is reduced and market confidence recovers. A decisive commitment to multilateral concerted and co-ordinated efforts is therefore deemed crucial by the IMF to achieving a nearer-term global recovery. The colossal global stimulus package has continued to expand in recent months and President Obama's US programme began taking effect in April 2009. The US Congressional Budget Office estimates that the programme will add up to 4 percentage points to US real GDP growth rates in the second and third quarters of 2009. Stimulus programmes are also expected to bolster a number of other major economies across the world. However, overall, the global economic situation for 2009 remains extremely uncertain and significant downside risks remain a palpable threat to the global growth outlook.

Outlook for domestic demand and supply

There is a general expectation that domestic growth will be quite disappointing in the first two to three quarters of 2009 due to weaker domestic and international economic conditions, before improving moderately in 2010 and 2011. Although annual growth in final consumption expenditure by government remained relatively unchanged, growth in gross final expenditure by households and in gross fixed capital formation decelerated between 2007 and 2008. In particular, growth in households' real disposable income, which fell from a seasonally adjusted and annualised rate of -0,8 per cent in the third quarter of 2008 to -1,9 per cent in the fourth quarter, is expected to remain subdued, with recovery only expected later in 2009. The main source of growth in 2009/10 from the demand side is likely to be the increased public-sector investment in infrastructure that will be supported by a deficit of 3,8 per cent deficit of GDP, as announced in the National Treasury's 2009 *Budget Review*.

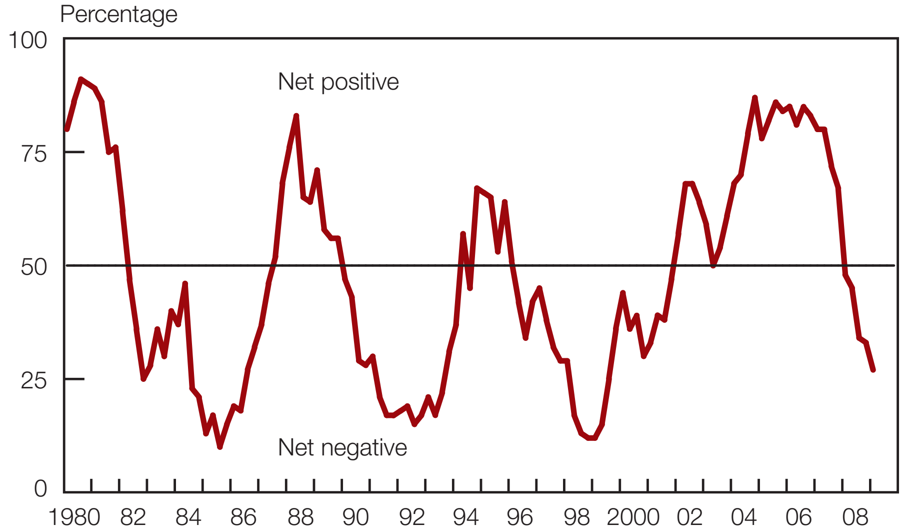
According to the latest Reuters consensus forecasts surveyed in March 2009, the South African economy is expected to contract by 0,3 per cent in 2009, with the second quarter of the year expected to show an annualised contraction of 0,8 per cent, followed by positive growth of 0,7 per cent in the third quarter and 1,8 per cent in the fourth quarter. Growth in 2010 and 2011 is expected to recover to 2,7 per cent and 3,9 per cent respectively.

As far as the quarterly analysis of manufacturing activity is concerned, the first-quarter 2009 BER survey revealed that the net majority of respondents rating current business conditions worse than those of a year ago increased from 50 per cent to 56 per cent. On the supply side, production volumes have declined sharply due to declining sales volumes and high levels of finished goods inventories. In addition, the net majority of respondents expecting a deterioration in business conditions in the coming twelve months increased from 28 per cent to 34 per cent. On the demand side, net majorities of 41 per cent reported declines in domestic order volumes and 25 per cent reported declines in export order volumes.

Surveys of consumer and business confidence indicate that confidence levels in the economy remain at low levels. 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, rose from -4 in the fourth quarter of 2008 to +1 during the first quarter of 2009. Improvement in the consumer confidence was supported by, among other factors, significant declines in petrol and diesel prices between November 2008 and February 2009, a 150 basis point cut in official interest rates up to the time the survey was conducted, the easing of CPI inflation, and a positive response to the national budget announced in the 2009 *Budget Review*.

The level of business confidence, measured in terms of the Rand Merchant Bank/Bureau for Economic Research (RMB/BER) Business Confidence Index, declined to its lowest level in a decade, registering 27 index points in the first quarter of 2009, which was preceded by 33 points in the fourth quarter of 2008 (Figure 13). 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. The decline in business confidence occurred in the midst of the deteriorating global landscape. Manufacturers' confidence declined from 31 to 16 index points on the back of declining domestic and

Figure 13 RMB/BER Business Confidence Index



Sources: Rand Merchant Bank and Bureau for Economic Research export orders, and of slow-moving inventories. Wholesaler confidence registered 31 index points, following 44 index points registered in the fourth quarter of 2008. Building contractor confidence declined from 42 to 33 index points due to a sharp contraction in building activity. Retailers' confidence rose marginally from 49 to 52 index points on the back of strong sales of non-durable goods such as food and beverages. However, the high confidence among retailers was limited to dealers in non-durable goods.

The Investec/BER PMI, a barometer of manufacturing activity, registered a historical low of 35,6 index points in April 2009, marginally down from 36,0 index points in March. On a seasonally adjusted basis, the inventories index fell to 28,7 points in April, and the purchasing commitments index declined to a record low of 29,9 points. The business activity index showed a slight improvement in April to 32,8 from 31,2 points in March, and new sales orders increased to 33,7 from 32,6 points. Business expectations regarding economic conditions six months ahead adjusted upwards from 46,6 index points in March 2009 to 48,3 points in April. Since the index is still below 50, this indicates that the manufacturing sector continues to expect unfavourable conditions in the short term due to the weak domestic and global economy, but that some improvement is expected in the second half of the year.

The FNB Building Confidence Index, which measures the business confidence of the major role players and suppliers involved in the building industry, dropped from an index value of 40 in the last quarter of 2008 to 28 in the first quarter of 2009. All sub-components of the index showed significant generalised deterioration in the first quarter of 2009. The business confidence of residential contractors slipped from an index value of 34 in the fourth quarter of 2008 to an index value of 26 in first quarter of 2009. The business confidence of non-residential building contractors dropped from an index value of 59 in the fourth quarter of 2008 to 51 in the first quarter of 2009.

Indicators of inflation expectations

Estimates of inflation expectations for the forecast period from 2009 to 2011 obtained from the BER survey conducted during the first quarter of 2009 show that average annual CPI inflation expectations are expected to decline over the forecast years, although they are expected to remain above the upper limit of 6 per cent of the CPI inflation target. As depicted in Table 11, average CPI inflation expectations for 2009 are 8,3 per cent, followed by 8,0 per cent for 2010, and 7,8 per cent for 2011. Among the groups surveyed, only the financial analysts expect CPI inflation to fall within the target range during 2010 and 2011. By contrast, business and labour expect CPI inflation to exceed the upper end of the target range by a considerable margin.

Table 11 BER survey of CPI inflation expectations: First quarter 2009

Per cent

	2009	2010	2011
1. Financial analysts	6,1	5,4	5,5
2. Business	9,2	8,6	8,3
3. Trade unions	9,7	10,1	9,6
Average 1–3	8,3	8,0	7,8

Source: Bureau for Economic Research, Stellenbosch University

The March 2009 Reuter's survey of long-term forecasts for the South African economy, which surveys a group of financial market analysts, reports that targeted CPI inflation is expected to fall within the official target range of 3 to 6 per cent from the third quarter of 2009 and is expected to stay within the target range until the end of the forecast period in 2011 (Table 12). It is expected that CPI inflation will average 6,7 per cent in 2009, decline to 5,6 per cent in 2010, and reach 5,3 per cent in 2011.

Table 12 Reuters survey of CPI forecasts: March 2009*
Per cent

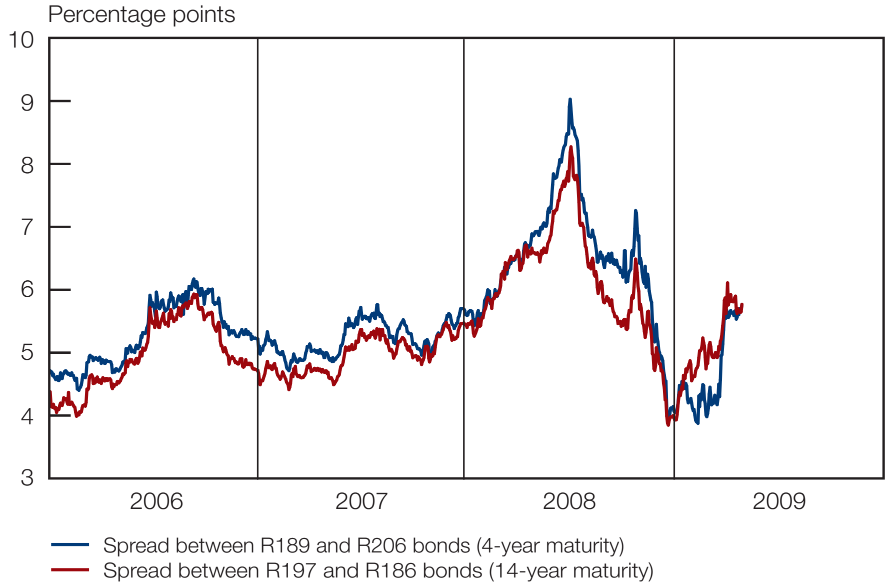
	2009		2010		2011	
1. Mean	(6,4)	6,7	(5,7)	5,6	(5,5)	5,3
2. Median	(6,5)	6,7	(5,7)	5,7	(5,5)	5,5
3. Highest	(7,0)	7,4	(6,5)	6,6	(6,7)	6,8
4. Lowest	(5,5)	6,0	(4,7)	4,0	(4,3)	4,1
Number of forecasters	(21)	20	(21)	20	(15)	14

* February 2009 survey results in parentheses

Source: Reuters

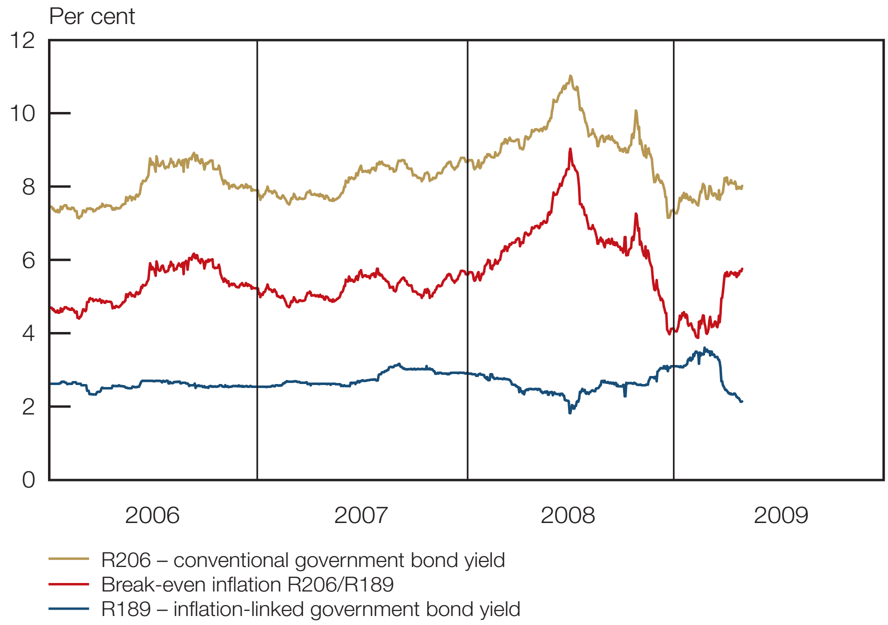
Expectations derived from break-even inflation rates, measured as the difference between the yields on South African CPI inflation-linked bonds and conventional nominal bonds of similar maturity, suggest that inflation expectations trended downward from the beginning of July 2008 until the end of the year (Figure 14). In 2009 break-even inflation rates obtained from the R189 inflation-linked bond maturing in 2013 show that short-term market inflation expectations initially fell below longer-term break-even rates associated with the R197 bond maturing in 2023. In the second week of March 2009 the R189 spread was around 4,2 per cent, down from a high of 9,0 per cent at the beginning of July 2008. During the same period the R197 break-even rate was 5,0 per cent, down from 8,3 per cent in the first week of July 2008.

Figure 14 Break-even inflation rates



More recently, break-even inflation rates have again moved higher. This is partly the result of the rally in the inflation-linked bond market, particularly the shorter-term inflation-linked bonds, which resulted from the windfall effect of the revised base index values (Figure 15). Box 3 provides more detail regarding this. On 30 April 2009 break-even inflation at the four-year maturity had risen to 5,8 per cent, a level similar to that at the fourteen-year maturity.

Figure 15 Nominal, inflation-linked and break-even yields



Box 3 The South African inflation-linked bond market and break-even inflation rates

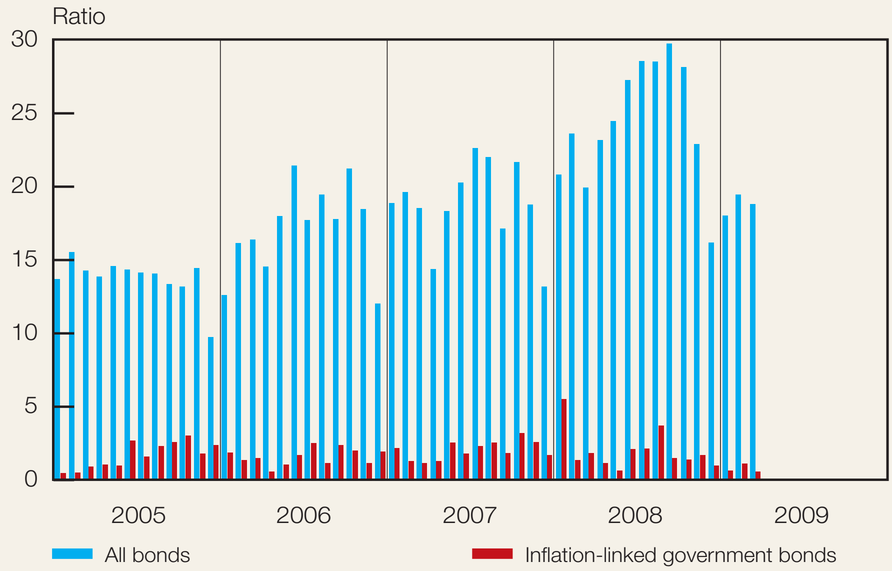
Inflation-linked bonds are bonds that have their redemption value and coupon payments linked to a price index. They provide investors with an inflation hedge, while reducing uncertainty about the real cost of borrowing. In South Africa, inflation-linked bonds were first issued by the South African government during March 2000, when the R189 bond with a coupon rate of 6,250 per cent maturing in March 2013 was launched. In the subsequent years government issued inflation-linked bonds of various maturities with the intention of developing a yield curve of inflation-linked bonds of up to 30 years. There are currently four inflation-linked government bonds in issue, varying from the R189 to the R202, with a coupon rate of 3,450 per cent and maturing in December 2033. As at the end of 2008, the total value outstanding of government inflation-linked bonds comprised approximately 15 per cent of the overall government bond market. In recent years inflation-linked bonds have also been issued by various public and private-sector institutions (mostly banks).

Prices of inflation-linked financial securities are often used to infer market-based measures of expectations of future inflation and attitudes to inflation risk. The difference in the yield between conventional and index-linked bonds of similar maturity, referred to as the 'break-even inflation rate', provides information about market participants' views regarding average expected inflation for the reference price index over the period to maturity of the bonds. This measure is a useful supplement to surveys and econometric forecasts of future inflation. However, as is regularly noted in this *Review*, movements in break-even inflation rates may be affected by factors such as inflation risk premiums, the liquidity of the bonds, the demand and supply balance, and other market developments. Since these factors may influence their reliability, break-even rates should be used cautiously in the assessment of capital market players' inflation expectations. This box provides information about the South African inflation-linked bonds market that facilitates the interpretation of break-even inflation rates.

Liquidity

South African inflation-linked bonds are generally not very liquid instruments, as they are traditionally bought as long-term investments by investors. As a ratio of the nominal value of inflation-linked bonds in issue, the turnover in the secondary market for inflation-linked bonds is far lower than that of conventional bonds. In 2008 the annualised liquidity ratio of all listed bonds on the Bond Exchange of South Africa (BESA) averaged around 24, that is, in a year bonds generally traded 24 times their amount in issue. By comparison, inflation-linked bonds traded at an average ratio of only twice their amount in issue. In the first three months of 2009 the annualised liquidity ratio of all bonds came to 19, while that of inflation-linked bonds came to 1.

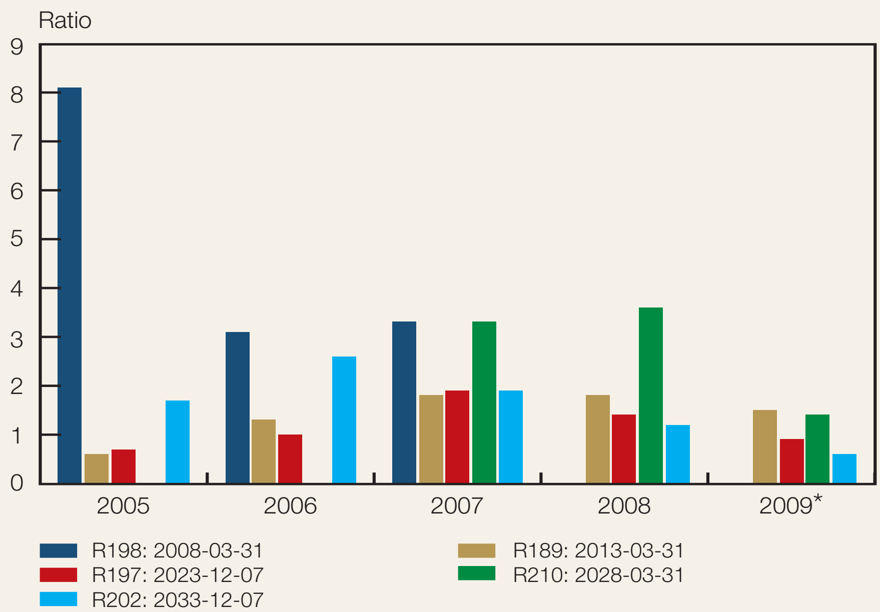
Figure B3.1 Liquidity ratios (annualised)



Source: BESA and own calculations

Of the different inflation-linked bonds in issue, the R210, issued in 2007 and expiring in 2028, has been the most liquid inflation-linked bond since 2007, trading at around three times per year its nominal value in issue. Prior to that, the R198 was the most liquid of the inflation-linked

Figure B3.2 Liquidity of inflation-linked government bonds in issue



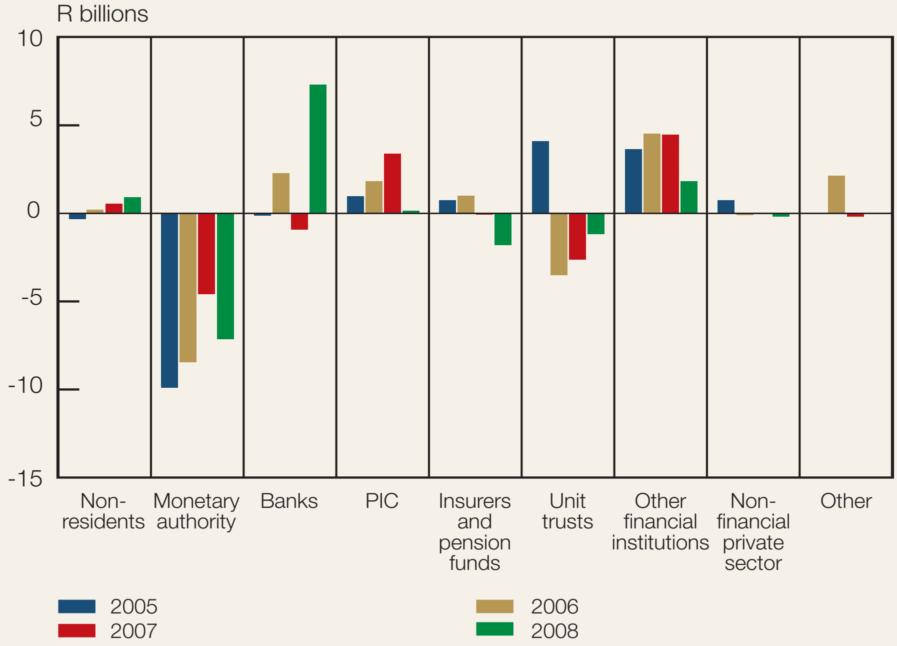
* January to March, annualised

Source: BESA and own calculations

bonds in issue, before it expired in 2008. In recent years the liquidity of the longer-term R202 bond, first issued in 2003, has dwindled.

Figure B3.3 indicates the more active participants in secondary market trading of inflation-linked bonds. The South African Reserve Bank (the Bank), acting as an agent on behalf of the National Treasury, is generally the net supplier or seller of inflation-linked bonds. The main buyers are banks and other financial institutions. The Public Investment Corporation (PIC) is also usually a net buyer, while insurers and pension funds, who generally buy to hold, are less active participants in the secondary market. To try and promote greater liquidity in inflation-linked bonds, the National Treasury initiated a Reverse Repurchase Agreement Transactions Facility, operated by the Bank, from 31 August 2006. However, thus far this measure has had a very limited impact on liquidity.

Figure B3.3 Net purchases and sales on BESA by sector



Source: BESA and own calculations

Demand and supply

New issuances of inflation-linked government bonds declined from around R22 billion in 2005 and R17 billion in 2006, to around R8 billion and less in 2007 and 2008. This coincided with a general decline in goverment bond issuance as well as a decline in demand as the bid-to-cover ratio[4] declined from, on average, four times the amounts auctioned in 2005 to twice the amounts auctioned in 2007 and 2008. However, this ratio has since improved in the early part of 2009.

4 The ratio of the number of bids received in a security auction compared to the number of accepted bids.

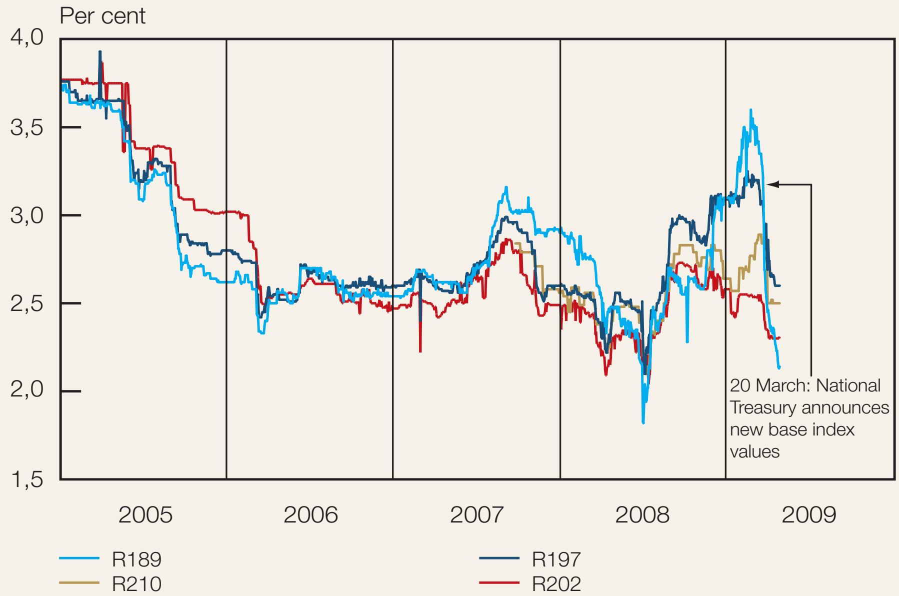
Holders of inflation-linked bonds in issue

A substantial portion of inflation-linked bonds in issue is held by the PIC, which acts as the asset manager for the government pension funds. As at the end of 2008, the PIC held more than 80 per cent of the inflation-linked government bonds in issue. The retirement funds managed by the PIC would, understandably, show a preference for holding long-term inflation-hedged instruments.

The impact of the new headline CPI

The reference inflation measure used for South African inflation-linked bonds is the headline CPI. This was the CPI for metropolitan areas until January 2009, when it became the CPI for all urban areas as a result of the changes implemented by Statistics South Africa. On 20 March 2009 the National Treasury clarified the pricing of inflation-linked bonds based on the new headline CPI for all urban areas. In essence, the holders of inflation-linked bonds may receive higher returns than the official inflation rate due to base effects in the changeover to the new index for 2009. This resulted in a rally in the yields in all the categories of inflation-linked bonds, with sharper declines recorded in the yields on shorter-term inflation-linked bonds (Figure B3.4).

Figure B3.4 Yields on inflation-linked government bonds



In addition to the beneficial impact of the new index values, the decline in inflation-linked bond yields also resulted from higher demand due to rising inflation expectations. The downward trend in interest rates has also improved the relative return on inflation-linked bonds compared to that of term bank deposits.

The rally in the inflation-linked bond market, which resulted from the windfall effect of the revised base index values, exaggerated the upward movement in break-even rates towards the end of March 2009. At the same time the short-term break-even rate realigned itself with movements in longer-term rates. On 30 April 2009 break-even inflation in the four-year maturity range had risen to 5,76 per cent, while that over fourteen years indicated expectations of 5,77 per cent. The break-even rate for the nineteen-year maturity range stood at 5,87 per cent, while that of the twenty-four-year-maturity range, at 6,07 per cent, exceeded the upper band of the inflation target range. It is possible that break-even rates over the different categories would have been significantly lower, were it not for the recent revision in the base index values that followed from the implementation of the new headline CPI.

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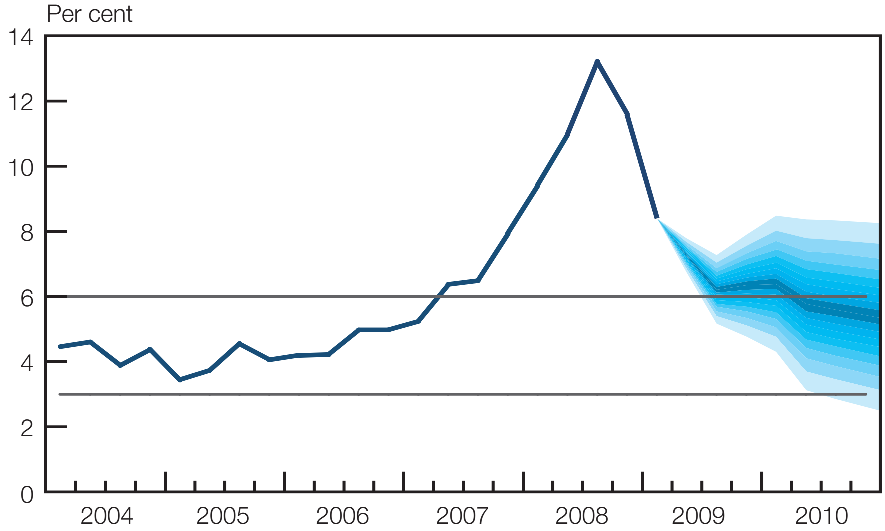
The South African Reserve Bank inflation forecast

The most recent projections of the Bank's quarterly inflation forecasting model, presented to the MPC meeting on 29 and 30 April 2009 are reproduced in the form of a fan chart in Figure 16. According to these projections, the inflation outlook for 2009 has deteriorated since the forecast presented to the previous MPC meeting, largely as a result of a higher administered price inflation outlook and the higher-than-anticipated February inflation outcome, but the forecast for 2010 remains fundamentally the same.

The central projection, conditional on an unchanged repurchase rate, is for the average quarterly CPI inflation rate to decelerate further to 6,2 per cent in the third quarter of 2009. Thereafter inflation is expected to increase marginally to 6,4 per cent in the first quarter of 2009, before resuming its downward trajectory to reach 5,4 per cent by the end of the forecast period in the fourth quarter of 2010.

Figure 16 Targeted inflation* forecast



* CPIX for metropolitan and other urban areas until the end of 2008; CPI for all urban areas thereafter

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 inflation, including the central projection. Each successive band, shaded slightly lighter and added on either side of the central band, adds a further 10 per cent to the probability, until the whole shaded area depicts a 90 per cent confidence interval (see Box 4 "Understanding the fan chart" on p. 27 of the March 2001 *Monetary Policy Review).*

The heightened levels of uncertainty and the rate of change in global developments make recent forecasts subject to higher risk than is usually the case. Alternative scenarios for movements in the foreign-exchange rate of the rand and oil prices generate more optimistic or pessimistic outcomes than the central projection. Larger-than-anticipated electricity price increases and their second-round effects pose an upside risk to the forecast, as do higher-than-expected salary and wage settlements. Conversely, the risks arising from the possibilities of a deeper and more prolonged global slowdown or a more significant moderation in domestic growth generally tend to exert a downward bias on the forecast.

Assessment and conclusion

The turmoil that erupted in the financial markets in the later part of 2008 has had a profound impact on the growth prospects in many countries. Most economies are either contracting or slowing significantly and these adverse conditions are likely to persist for some time. Financial markets are likely to remain volatile as risk aversion and optimism about growth prospects fluctuate in response to emerging data and conflicting signals. The uncertainty created by these developments makes it a difficult environment for monetary policy-making. Most countries have responded to the banking and real-sector crisis with monetary and fiscal policy stimuli, in order to offset the decline in demand and encourage new demand.

The South African economy has also been impacted by these developments and in the final quarter of 2008 the economy experienced its first quarter of negative growth since 1998. Recent indicators suggest that the economy, and the manufacturing sector in particular, is likely to remain under pressure for some time. While the prospects for the economy are linked to global developments, the infrastructural expenditure programme that is currently under way will go some way towards underpinning investment expenditure.

The global and domestic economic slowdown has had a significant moderating impact on the inflation outlook. The widening output gap, weak domestic demand and lower commodity prices have all contributed to the revised outlook, although administered price developments and, to a lesser extent, uncertainties relating to the exchange rate provided some countervailing pressure. Nevertheless, the improvement in the overall inflation outlook and the perceived downside risk to the medium-term inflation outlook has allowed for a more accommodative stance, and the repurchase rate has been reduced by 350 basis points since December 2008. The continued stability of the domestic banking system meant that the MPC could maintain its focus on its mandate to achieve price stability within a flexible inflation-targeting framework.

Statement of the Monetary Policy Committee

11 December 2008

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

Since the previous meeting of the MPC, domestic inflation has moderated and is expected to decline further over the coming months. At the same time, the South African economy has been affected by the significant global slowdown that has intensified recently. The domestic economy experienced negligible growth in the third quarter, while a number of sectors contracted. Moreover, while there has been some improvement in the inflation outlook, risks posed by uncertainty with regard to the exchange rate, in particular, remain.

The data releases over the past weeks have shown that the international economy is slowing down faster than previously expected and that global inflation pressures are subsiding. This has resulted in the recent global interventions by policy-makers.

Domestic monetary policy remains guided by local conditions. Monetary policy always takes into consideration the possible impacts of global developments on the South African economy, in general, and on inflation, in particular.

Recent developments in inflation

CPIX inflation (headline inflation excluding mortgage interest cost) measured 13,6 per cent in August 2008 and subsequently declined to year-on-year increases of 13,0 per cent and 12,4 per cent in September and October respectively. Food, petrol and electricity prices were the main contributors to the inflation outcomes, despite the petrol price reductions in September and October. Food prices increased at a year-on-year rate of 17,2 per cent in October, while petrol and electricity prices increased by 31 per cent over the same period. If food and petrol were excluded, CPIX inflation would have measured 8,4 per cent in October, compared with 8,5 per cent in September.

Producer price inflation also showed signs of moderating in the past two months despite significant electricity price increases. Producer price inflation increased at a year-on-year rate of 19,1 per cent in August, but moderated to 14,5 per cent in October. Agricultural food prices declined for the third successive month in October when the year-on-year rate declined to 10,4 per cent. Manufactured food prices increased by 15,6 per cent in October, compared with 20,5 per cent in August.

The outlook for inflation

The most recent central forecast of the South African Reserve Bank (the Bank) shows a further improvement in the inflation outlook since the previous MPC meeting. With an unchanged stance of monetary policy, inflation is expected to continue its downward trajectory and to return to within the inflation target range in the third quarter of 2009. Inflation is then expected to breach the upper end of the target range marginally in the first quarter of 2010 as a result of technical base effects associated with the decline in petrol prices at the end of 2008. However, the downward inflation trend is forecast to continue thereafter.

Inflation is expected to average 6,2 per cent and 5,6 per cent in 2009 and 2010 respectively, and to average 5,3 per cent in the final quarter of 2010. The forecasts are subject to a greater degree of uncertainty than usual, given the highly volatile global environment, and the uncertainty related to the impact of the rebasing and reweighting of the CPI basket to be introduced by Statistics South Africa in January 2009.

Inflation expectations as measured by the yield differential between conventional government bonds and inflation-linked bonds declined from just over 9 per cent in July 2008 to around 5,1 per cent in early December. The yield curve has remained inverted at the longer end and has declined since the previous meeting, particularly in the one-to-five year maturity range.

Inflation expectations as reflected in the inflation expectations survey conducted on behalf of the Bank by the Bureau for Economic Research (BER) at Stellenbosch University deteriorated marginally for 2009, but then improved slightly for 2010. Average inflation expectations for 2009 measured 8,2 per cent compared with 8,1 per cent in the previous quarter, while inflation expectations for 2010 measured 7,2 per cent compared with 7,4 per cent in the previous survey. This was the first time since the first quarter of 2006 that expectations for any forecast year had declined.

Unit labour cost in the third quarter of 2008 increased by 12,5 per cent compared with the same quarter last year. However, the improved inflation expectations, coupled with the lower actual trend in inflation, may have a moderating impact on unit labour costs, which will most likely be influenced by the weaker state of the economy.

The exchange rate remains the most significant upside risk to the inflation outlook. Since the previous meeting of the MPC, the rand exchange rate has depreciated against the US dollar by about 11 per cent. At the time of the previous meeting, the rand was at a level of R9,15 to the United States (US) dollar. The currency subsequently depreciated to a level of R11,80 but recovered soon after, and for the past few weeks has traded in a relatively narrow range of between R10,00 and R10,50. On a trade-weighted basis, the rand has depreciated by around 7,6 per cent since the previous meeting. The rand, along with other emerging-market currencies, is influenced by the risk aversion prevailing in the uncertain global environment.

International crude oil prices have declined further. North Sea Brent crude oil is currently trading at around US$40 per barrel, compared with US$83 per barrel at the time of the previous meeting of the MPC. The lower international oil price has resulted in a cumulative decline in domestic petrol prices of R3,35 per litre since August, and by R2,06 since the previous MPC meeting. If current levels of international oil prices and exchange rates persist, a further sizeable decline in the domestic petrol price can be expected in January.

The trend in international food prices has also followed that of other commodities, and since June 2008 there has been a 30 per cent decline in the *Economist* Food Price Index. These developments have contributed to the year-on-year declines in the agricultural food component of the producer price index mentioned above, and to the significant fall in domestic spot prices of maize and wheat, despite the depreciation of the rand over the past weeks. Food price increases at the consumer price level remain elevated, but the spot price developments are expected to impact on these prices in the coming months.

South Africa's economic growth rate also declined significantly in the third quarter of 2008 when real gross domestic product (GDP) increased at an annualised rate of 0,2 per cent. This represented a significant widening of the output gap. The slowdown was a result of contractions in mining, manufacturing and the retail and wholesale trade sectors. Manufacturing output declined further in October. The Bank's leading indicator of economic activity has been trending downward for some time, and more recently the coincident indicator has followed this trend. The Investec/BER Purchasing Managers' Index declined to its lowest level since its inception to reach a level of 39,5 – a level similar to that prevailing in a number of other countries. The RMB/BER Business Confidence Index also reflects a negative outlook.

Gross fixed capital formation held up relatively well in the third quarter when it grew at a rate of 10,0 per cent, mainly as a result of investment by public corporations and general government. However, growth in private-sector gross fixed capital formation declined to 2,6 per cent. This was particularly the case in investment in private residential buildings where the real value of residential and non-residential building plans continued to decline.

Household consumption expenditure contracted in the third quarter for the first time since 1998. Consumption of durable goods in particular declined by almost 10 per cent, while non-durable goods consumption also contracted. Motor vehicle sales continued to decline in October and November, while real retail trade sales declined further in October. The FNB/BER Consumer Confidence Index showed a further deterioration in the fourth quarter of 2008.

The rate of growth of credit extension to the private sector continued to moderate. Year-on-year growth in total loans and advances to the private sector declined to 17,1 per cent in October, while growth in mortgage advances and instalment sale credit and leasing financed decline to 16,1 per cent and 10,5 per cent respectively. There are also indications of tighter credit standards being applied by banks to both households and the corporate sector. The lower rate of credit extension to households contributed to the further moderation of household indebtedness. Household debt as a percentage of disposable income measured 75,3 per cent in the third quarter, compared with 78,5 per cent in the first quarter of 2008.

The current-account deficit, which measured 7,9 per cent of GDP in the third quarter of 2008, is likely to moderate in the coming months as a result of the lower international oil price and lower dividend payments to non-residents, among other factors.

The turmoil in the international financial markets has also been reflected as well in domestic asset prices. The all-share index on the JSE Limited has followed global equity market trends and has exhibited a high degree of volatility over the past months. Since the previous meeting, the index has declined by about 1,5 per cent, but at one stage it had declined by about 15 per cent. The housing market remains subdued, with prices falling in real terms, and in some instances in nominal terms as well. These negative wealth effects are likely to weigh on household expenditure in the coming months.

Global developments are also expected to contribute to downward inflation pressures. Apart from sharply declining commodity prices, the decline in the volume of world trade has also lowered transport costs significantly. Growth forecasts have been revised down significantly, particularly in the advanced economies, and the expected protracted slowdown is likely to lower prices of other goods as well, as the pricing power of firms dissipates. The possible stimulus to growth provided by more accommodative monetary policies and fiscal stimuli are likely to take some time to filter through, given the fragile state of the banking systems and the marked declines in business and consumer sentiment.

Monetary policy stance

The Monetary Policy Committee considered recent developments in the South African economy and the risks to the inflation outlook against the backdrop of conditions prevailing in the global economy and international financial markets. The MPC has noted improvements in the inflation outlook in South Africa since its previous meeting in October 2008. However, risks to the inflation outlook remain and will be monitored closely. The MPC has therefore decided to reduce the repurchase rate by 50 basis points to 11,5 per cent per annum with effect from 12 December 2008.

Statement of the Monetary Policy Committee

5 February 2009

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

Since the previous meeting of the MPC, domestic inflation has continued on its downward trend. A further decline is expected in the January data when the reweighting and rebasing of the consumer price index (CPI) implemented by Statistics South Africa (Stats SA) comes into effect. With respect to economic growth, the domestic economy is being adversely affected by the continuing turbulence in the global economy. The widening domestic output gap and declining international commodity prices are expected to exert further downward pressure on inflation going forward. Nevertheless, some risks to the inflation outlook remain and the MPC had to assess these conflicting risks against the backdrop of a highly uncertain and volatile international environment.

Recent developments in inflation

CPIX inflation (headline inflation excluding mortgage interest cost) has been moderating consistently since August 2008 when it measured 13,6 per cent. In November and December 2008 inflation had declined to 12,1 per cent and 10,3 per cent respectively. Electricity, food, and clothing and footwear prices were the main contributors to the inflation outcomes in these months, having increased at year-on-year rates in excess of 15 per cent. Petrol prices increased by 25,8 per cent in November, but declined by 1,8 per cent in December. If food and petrol were excluded, CPIX inflation would have measured 8,7 per cent in December.

Producer price inflation also moderated in the past two months, declining to a year-on-year rate of 11,0 per cent in December. Food price increases continued to moderate: agricultural product prices were unchanged in December, while manufactured food price inflation declined to a year-on-year rate of 12,8 per cent in the same month.

The outlook for inflation

The most recent central forecast of the South African Reserve Bank (the Bank) is similar to that presented to the MPC in December. Partly as a result of the reweighting and rebasing of the new targeted inflation index, CPI inflation is expected to decline further and average 7,5 per cent in the first quarter of 2009, and to decline to below the upper end of the inflation target range during the third quarter of the year when it is expected to average 5,2 per cent. Inflation is then forecast to increase again and to breach the upper end of the target range in the first quarter of 2010, mainly as a result of technical base effects. Thereafter, inflation is expected to return to within the target range and remain there until the end the forecast period when it is expected to average 5,5 per cent. The simulation results of the model make provision for the most recent trends of actual and preliminary data that have become available from Stats SA since the previous MPC meeting.

Market indicators also reflect a moderation in expected inflation. Inflation expectations as measured by the yield differential between conventional government bonds and inflation-linked bonds have remained within the inflation target range. The Reuters consensus survey conducted in December indicates that analysts expect inflation to average 6,4 per cent in 2009 and 5,8 per cent in 2010.

The volatile exchange rate of the rand continues to pose the main upside risk to the inflation outlook. The rand is currently trading against the United States (US) dollar at levels similar to those prevailing at the time of the previous MPC meeting. During December 2008 the rand appreciated against the US dollar and reached a level of R9,30 in the first week of January. This move was mainly a result of a weaker US dollar, which depreciated to US$1,47 against the euro. Renewed risk aversion in international markets and a stronger US dollar in January resulted in the rand returning to current levels of around R10,00. The rand has appreciated marginally on a trade-weighted basis since the previous meeting.

The risks to the inflation outlook posed by oil and food prices appear to have subsided somewhat. Food prices continued to moderate at the production price level, but these favourable developments have not yet been seen at the consumer price level. Spot and futures prices of maize and wheat remained well below the average price level in 2008 and some relief at the consumer price level is expected in the coming months.

The price of Brent crude oil, which reached a low of US$34 per barrel during December 2008, averaged around US$41 for the month. This, along with the termination of the slate levy, allowed for a further reduction in domestic petrol prices of R1,34 per litre in January. However, international oil prices recovered somewhat in January and averaged almost US$45 per barrel during that month. As a consequence, the domestic price of petrol was increased by 61 cents per litre in February. The outlook for oil prices remains uncertain, but prices are expected to remain relatively subdued as a result of weakening global growth.

The domestic economy continues to show signs of slowing, following the 0,2 per cent annualised growth recorded in the third quarter of 2008. The composite leading and coincident business cycle indicators of the Bank point to a continuation of this trend. Other high-frequency indicators are consistent with this outlook. The physical volume of manufacturing production declined at a year-on-year rate of 4,4 per cent in November 2008, while the latest Investec/BER Purchasing Managers Index indicates that the outlook for the manufacturing sector remains negative. The utilisation of production capacity in manufacturing declined by 3,4 percentage points in the fourth quarter of 2008 to 82 per cent. Mining output contracted by 6,1 per cent in November compared with the previous year, while the real value of total building plans approved declined by 25,3 per cent over the same period.

Household consumption expenditure also remains under pressure. Real wholesale trade sales increased slightly in the year to November 2008, but real retail sales declined by 4 per cent over the same period. Motor vehicle sales contracted at a year-on-year rate of 35,4 per cent in January, with commercial vehicle sales declining by 41 per cent. Motor vehicle exports, which remained strong in 2008, also moderated and the industry expects larger declines in the coming months. Exports in general are expected to remain under pressure, given the adverse global conditions. However, preliminary data indicates that the deficit on the trade account of the balance of payments probably contracted during the final quarter of 2008.

Household consumption expenditure may also be affected by remuneration trends and employment growth. According to Andrew Levy Employment Publications, the level of wage settlements for the year 2008 amounted to 9,8 per cent, compared with an average inflation rate of 11,3 per cent. Nominal unit labour cost increases in the third quarter of 2008 measured 12,4 per cent. Employment growth has also been impacted by the slowing economy. In the third quarter of 2008 non-agricultural employment increased by one per cent, compared with 3,9 per cent in the first quarter of that year. Private-sector employment contracted in the second and third quarters.

The subdued trend in household consumption expenditure and the stricter credit criteria applied by banks to both households and corporates have been reflected in a further moderation in the growth of credit extension to the private sector. Growth over 12 months in total loans and advances by banks to the private sector declined to 14,4 per cent in December 2008. Most categories of loans have exhibited declines in growth.

High consumption expenditure is expected to remain under pressure from negative wealth effects resulting from adverse asset price developments. The all-share index on the JSE Limited remained volatile in line with global market turbulence. The housing market has also remained subdued, with the various house price indices indicating real price declines.

The outlook for the world economy has deteriorated further as a result of the continued difficulties being experienced by the global financial system. The International Monetary Fund significantly downgraded its forecast for global growth in 2009 to 0,5 per cent. Many of the advanced economies are expected to experience negative growth rates in the coming months, while growth prospects of emerging market and developing economies have also deteriorated. As a result of these widening output gaps and declining commodity prices, world inflation pressures have subsided.

Monetary policy stance

The MPC has decided to reduce the repurchase rate by 100 basis points to 10,5 per cent per annum with effect from 6 February 2009. The MPC will continue to monitor domestic and global developments in order to decide on the most appropriate monetary policy stance going forward.

Statement of the Monetary Policy Committee

24 March 2009

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 global economy has continued to weaken significantly in recent months as a result of the turmoil in the financial markets. There is growing uncertainty regarding the depth and duration of the economic slowdown. The South African economy has not escaped the impact of these developments, and domestic production has contracted as a result of weak domestic demand and a significant decline in export demand. Against this backdrop of widening domestic and global output gaps, the balance of risks to the inflation outlook has changed somewhat.

Recent developments in inflation

Inflation as measured by the reweighted and reconstituted consumer price index (CPI) for all urban areas (which is the new target measure) measured 8,1 per cent in January 2009. Food and non-alcoholic beverages prices, which increased at year-on-year rates of 15,7 per cent in January, contributed 2,4 percentage points to total inflation. The housing and utilities category contributed 2,1 percentage points, and together with food accounted for more than half of the measured inflation increase. The transport component had a minimal impact on the overall CPI as a result of the 20,3 per cent reduction in petrol prices during January. Producer price inflation, which reached 19,1 per cent in August 2008, continued its downward trend, measuring 9,2 per cent in January 2009. Despite the depreciation of the rand during 2008, producer prices of imported goods declined at a year-on-year rate of 5 per cent in January.

The outlook for inflation

The most recent central forecast of the Bank shows a near-term deterioration in the inflation outlook, but a more favourable trend is forecast for the medium term, which is the relevant time frame for monetary policy. Consumer price inflation is expected to average 8,1 per cent in the first quarter of 2009 and then to decline to below 6 per cent in the third quarter of the year. As a result of technical base effects, inflation is then expected marginally to exceed the upper end of the inflation target range, before returning back to within the range in the second quarter of 2010 and to remain there until the end of the forecast period in the fourth quarter of 2010, when it is expected to average 5,3 per cent. The heightened levels of uncertainty and the rate of change of global developments make these forecasts subject to higher risk than is usually the case.

Expectations by analysts are similar to those of the Bank, with the Reuters consensus forecast showing a moderate upward revision of inflation in 2009 and a relatively unchanged forecast in 2010, when inflation is expected to average 5,5 per cent in the final quarter. Most forecasters expect inflation to have increased moderately in February 2009 before resuming its downward trend. Inflation expectations, as reflected in the yield differential between inflation-linked bonds and conventional government bonds, have increased slightly since the previous meeting of the MPC, but remain within the inflation target range.

The inflation outlook has been dominated by the continued weakening of the global economy and financial markets, notwithstanding significant monetary and fiscal measures introduced by central banks and governments. The decline in global demand has resulted in a marked contraction in international trade. The International Monetary Fund, which in January was forecasting global growth to average 0,5 per cent in 2009, now expects the global economy to contract by up to 1 per cent in 2009. Numerous industrialised and developing countries are already experiencing negative growth. World inflation is being restrained by declining demand and lower commodity prices, which are expected to remain subdued under these conditions of negative or low growth.

The weak global demand has been reflected in the export performance of the South African economy. However, the decline in the value of exports in the final quarter of 2008 was more than offset by a lower value of imports, mainly due to declining international oil prices. Combined with a narrowing of the deficit on the services, income and current transfer account of the balance of payments, this resulted in a narrowing of the deficit on the current account from 7,8 per cent of GDP in the third quarter of 2008 to 5,8 per cent in the final quarter. However, the published January trade data, which showed a further considerable decline in the value of merchandise exports, suggest that the improvement in the trade deficit may not be sustained to the same extent seen in the fourth quarter. The deficit on the current account of the balance of payments measured 7,4 per cent of GDP for the 2008 calendar year.

Domestic demand conditions have also deteriorated further. In the fourth quarter of 2008, gross domestic expenditure and domestic final demand contracted by 3,9 per cent and 0,4 per cent respectively. Final consumption expenditure by households declined by 2,7 per cent, mainly as a result of a 20 per cent contraction in consumption of durable goods. The growth in gross fixed capital formation moderated further, recording an annualised growth rate of 3 per cent. Motor vehicle sales, which have been under pressure for some time, declined at a year-on-year rate of 35,6 per cent in February. In January real retail sales increased at a year-on-year rate of 1,7 per cent – the first year-on-year increase in 9 months – while wholesale trade sales declined by 4,5 per cent over the same period.

Domestic demand conditions are expected to remain under pressure as a result of declining disposable incomes, tighter credit conditions and negative wealth effects. Credit extension to the private sector has continued its downward trend as a result of lower demand and more stringent lending criteria being applied by banks. In January 2009 growth in total loans and advances to the private sector measured 11,4 per cent. The slower rate of credit extension has resulted in a further moderation of the ratio of household debt to disposable income to 76,4 per cent in the fourth quarter of 2008, compared with a peak of 78,2 per cent in the first quarter of that year.

Domestic output has been impacted appreciably by these external and domestic demand developments, resulting in a further widening of the domestic output gap. In the final quarter of 2008 GDP contracted at an annualised rate of 1,8 per cent, mainly due to a 22 per cent decline in manufacturing-sector output. The high frequency data indicate that these adverse conditions may have persisted in the first quarter of 2009. Manufacturing and mining output contracted at year-on-year rates of 11,1 cent and 8,7 per cent respectively in January, while the Investec/Bureau for Economic Research (BER) Purchasing Managers Index reached a new low in February, reflecting continued strain on the manufacturing sector. The latest BER manufacturing survey indicates extreme and broad-based weakness in this sector in the first quarter of 2009. The RMB/BER Business Confidence Index surveyed in the first quarter of 2009 reached its lowest level since 1999, particularly in the manufacturing, wholesale and construction sectors. The confidence of retailers of non-durable goods increased somewhat.

On a trade-weighted basis, the rand has been relatively stable since the beginning the year and has appreciated by about 2,5 per cent since the previous meeting. Movements in the rand exchange rate in recent weeks have been mainly reflecting volatile international currency developments. After the previous meeting of the MPC, the rand first depreciated to around R10,60 against the US dollar, as the dollar strengthened against most currencies. Since then the US dollar has weakened somewhat and the rand is currently trading at levels of around R9,45 per US dollar.

The upside risks to the inflation outlook emanate primarily from cost-push pressures, particularly from administered prices. These include possible higher-than-expected electricity tariff increases. The decline in inflation may also be delayed by continued high rates of increases in food prices, despite marked declines in producer price food inflation.

Monetary policy stance

Against the background of a slowing global and domestic economy and an improved medium-term outlook for inflation, the MPC has decided to reduce the repurchase rate by 100 basis points to 9,5 per cent per annum with effect from 25 March 2009.

Statement of the Monetary Policy Committee

30 April 2009

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 global economy continues to be in the midst of a severe synchronised downturn with a number of countries already experiencing recession. The G-20 countries, including South Africa, have committed themselves to a programme of action in order to contribute towards the earliest possible global economic recovery. Despite a generally positive response to the G-20 summit in April, it has become increasingly accepted that the slowdown is likely to be severe and protracted, and that the global recovery is likely to be gradual.

Domestic output and expenditure growth are declining or negative, and the growth outlook is dependent to a significant extent on a broader global recovery. Despite the widening domestic output gap, inflation remains sticky, but is expected to continue on its downward path.

Recent developments in inflation

The year-on-year inflation rate as measured by the consumer price index (CPI) for all urban areas increased to 8,6 per cent in February 2009 and then moderated to 8,5 per cent in March. Food price inflation continued its downward trend, increasing at a year-on-year rate of 14,7 per cent in March, compared with 15,8 per cent in the previous month. Food prices remained the largest contributor to the inflation outcome, contributing 2,3 percentage points. The largest price increase was recorded by electricity and other fuels, which increased by 30,1 per cent. Significant increases were also recorded in the prices of tobacco, housing maintenance and repairs, health, recreation and culture, and education. Countervailing pressure came from petrol prices, which declined by 14,9 per cent, despite the petrol price increase of 45 cents per litre in March.

Producer price inflation, which reached 19,1 per cent in August 2008, continued its downward trend, measuring 7,3 per cent and 5,3 per cent in February and March 2009 respectively. Prices of agricultural food products declined at a year-on-year rate of 2,1 per cent in March, while manufactured food price inflation moderated to 9,4 per cent.

The outlook for inflation

The most recent central forecast of the Bank shows a near-term deterioration in the inflation outlook, but inflation is expected to follow a downward trend and to average 5,4 per cent at the end of the forecast period in the final quarter of 2010. The slightly higher expected trend is a result of revised assumptions about administered prices and the higher-than-anticipated inflation outcome for February.

Inflation expectations show a mixed picture. The inflation expectations survey, which is conducted on behalf of the Bank by the Bureau for Economic Research (BER) at Stellenbosch University, reflects somewhat divergent inflation expectations between the different groups of respondents. In the survey conducted in the first quarter of 2009, average CPI inflation expectations for 2009 declined from 8,6 per cent to 8,3 per cent. Expectations ranged from 6,1 per cent for analysts, to 9,7 per cent for trade unionists. Inflation is expected to average 8,0 per cent in 2010, up from the 7,5 per cent measured in the previous survey. While analysts expect inflation to average 5,4 per cent in 2010, business executives and trade union officials expect inflation to average 8,6 per cent and 10,1 per cent respectively. Inflation is expected to moderate to 7,8 per cent in 2011.

Wage settlements, which generally follow inflation trends with a lag, have also edged up slightly. According to Andrew Levy Employment Publications, the level of wage settlements increased by 10,2 per cent in the first quarter of 2009, compared to the 2008 average of 9,8 per cent. Nominal unit labour cost increased over four quarters by 12,8 per cent in the final quarter of 2008. Nominal wage settlements are expected to moderate somewhat as the inflation rate declines. According to the Quarterly Employment Statistics Survey conducted by Statistics South Africa, in the fourth quarter of 2008 employment levels showed their first decline in four years.

The risks to the inflation outlook as assessed by the MPC have remained relatively unchanged since the previous meeting of the committee, although the recent appreciation of the rand exchange rate, if sustained, may have reduced the degree of the upside risk to the inflation outlook. The rand exchange rate remains affected by changes in global risk aversion, but there has been a decline in the degree of volatility. Since the positive market reaction to the G-20 summit in early April, sentiment towards emerging-market economies in general has improved and most emerging market currencies have appreciated against the US dollar.

As noted earlier, the global economy remains under pressure despite fiscal and monetary stimuli in many countries. In January 2009 the International Monetary Fund (IMF) forecasted global growth of 0,5 per cent and 3,0 per cent for 2009 and 2010 respectively. The IMF now expects global output to contract by 1,3 per cent in 2009, before recovering gradually to 1,9 per cent in 2010. The advanced economies are expected to contract by 3,8 per cent, while the emerging and developing economies are expected to experience positive growth of 1,6 per cent, with China and India expected to grow by 6,5 per cent and 4,5 per cent respectively. The growth forecast for Africa has been reduced from 3,4 per cent to 2,0 per cent. The risks to these forecasts are seen to be on the downside, given the current heightened levels of uncertainty. World trade has also declined and is expected to contract by a further 9,5 per cent in 2009.

World inflation is expected to remain subdued as a result of these growth trends and lower commodity prices. World inflation is expected to average 2,5 per cent in 2009 and 2,4 per cent in 2010. Although a number of commodity prices have recovered somewhat from their lows in the fourth quarter of 2008, they are expected to be restrained by the weak global demand. The price of North Sea Brent crude oil declined to around US$35 per barrel in late December 2008, but has been trading at around the US$50 per barrel level for most of April 2009. During this month, the higher international oil product prices have been more or less offset by the appreciation of the rand against the US dollar, and the domestic price of petrol is expected to remain relatively unchanged in May.

The outlook for domestic economic growth remains subdued, with no indications of a quick recovery. The high-frequency data continue to suggest that the negative conditions recorded in the final quarter of 2008 persisted in the first quarter of 2009. The physical volume of manufacturing production declined at a year-on-year rate of 15,0 per cent in February, following an 11,1 per cent contraction in the previous month. The outlook for manufacturing remains negative, with the Investec/BER Purchasing Managers Index declining further in March. Total mining production declined at a year-on-year rate of 12,8 per cent in February, while the real value of building plans approved declined by 42,7 per cent over the same period.

The sluggish domestic demand conditions also appear to have persisted. Wholesale trade sales declined at a year-on-year rate of 8,9 per cent in February, while retail sales declined by 4,5 per cent following a modest increase in January. Total new vehicle sales declined by 30,3 per cent in March, reflecting the continued weak demand for durable goods. However, the FNB/BER Consumer Confidence Index, while still at low levels, showed an increase in the first quarter of 2009. Falling house prices and weak asset markets are also expected to restrain consumption expenditure.

Domestic credit extension continues to reflect the declining trend in domestic expenditure, as well as more stringent credit criteria being applied by banks with respect to loans to both households and companies. Year-on-year growth in total loans and advances to the private sector declined to 10,2 per cent in February and 7,3 per cent in March 2009. The quarterly growth declined from 6,2 per cent in the fourth quarter of 2008 to 0,1 per cent in the first quarter of 2009. Instalment sale credit and leasing finance reflected the weak demand for durable goods, with increases of 3,1 per cent in February and 1,6 per cent in March.

In line with the previous MPC statement, the committee assesses the main risks to the inflation outlook to emanate from cost-push pressures, particularly administered prices, which include the risk of higher-than-expected electricity tariff increases. Food price inflation at the consumer price level, which has remained relatively unresponsive to lower inflation at the producer price level, appears to show signs of moderation. Should this downward trend accelerate, it could have a significant downward impact on the inflation trajectory.

Monetary policy stance

The MPC considered the severe synchronised downturn in international and domestic economic conditions and noted their potential future downward impact on inflation, notwithstanding the higher-than-expected recent domestic inflation outcomes. The committee is of the view that the adverse economic conditions continue to tilt the balance of risks to the inflation outlook to the downside over the medium term and has therefore decided to reduce the repurchase rate by 100 basis points to 8,5 per cent per annum with effect from 4 May 2009.