Monetary Policy Review

November 2009

South African Reserve Bank

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Enquiries relating to this *Review* should be addressed to:
Executive General Manager and Chief Economist
Research Department
South African Reserve Bank
P O Box 427
Pretoria 0001
Tel. 27-12-3133668

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Monetary Policy Review

Introduction

There are signs that the global economic recovery is under way, although indications are that the initial pace of recovery is likely to be slow and distributed unevenly across countries. The severe global recession saw a synchronised contraction of advanced economies and a significant slowdown in the growth of developing economies. However, recent forecasts suggest a turnaround in the second quarter of 2009, and stronger growth prospects for the second half of the year and for 2010. Nevertheless, activity levels are likely to remain well below pre-crisis levels and important policy challenges will need to be faced. Macroeconomic policies are expected to continue to focus on restoring financial sector health and supporting the recovery until it is well established, while preparing to exit the period of eased monetary conditions adopted in response to the crisis.

The domestic economy was not spared the effects of the global recession. In the second quarter of 2009 the economy recorded a third successive quarterly contraction, although the rate of contraction slowed relative to that of the previous quarter. Consistent with global growth developments, domestic economic growth is expected to improve in the coming quarters. Domestic inflation has continued to trend downwards, reaching a level just above the inflation target range in September 2009.

In this *Monetary Policy Review* the latest developments in inflation and the factors that impact on inflation are analysed. Recent monetary policy developments are reviewed, and the outlook for inflation and the inflation forecast are presented. In addition, three issues are examined in boxes. The first box examines the degree of pass-through and the speed of adjustment in banks' deposit and lending rates in response to changes in the benchmark repurchase rate in South Africa during the period since the introduction of the inflation-targeting monetary policy framework. The second box discusses asset-backed securitisation by South African banks, and the final box discusses the compilation and characteristics of the composite leading business cycle indicator for South Africa.

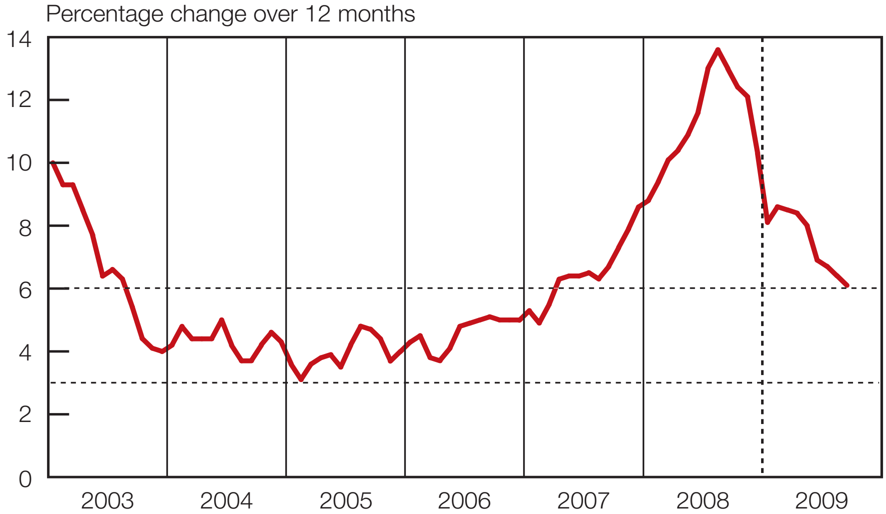
Recent developments in inflation

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

The evolution of indicators of inflation

The measure of inflation targeted by the South African Reserve Bank (Bank), the year-on-year percentage change in the headline consumer price index (CPI) for all urban areas, has declined continuously since April 2009 to marginally above the inflation target range of 3 to 6 per cent. After recording 8,4 per cent in April, the inflation rate decreased to 6,1 per cent in September (Figure 1), largely as a result of falling food price inflation and lower petrol prices.

Figure 1 Consumer price inflation: Targeted inflation*



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

Source: Statistics South Africa

Food and non-alcoholic beverages, housing and utilities, and miscellaneous goods and services have remained the highest contributing categories to the inflation rate over the period since April 2009 (Table 1). The contribution of food and non-alcoholic beverage prices decreased from 2,1 percentage points to the overall inflation rate of 8,4 per cent in April 2009, to 0,9 percentage points in September 2009 when overall inflation was 6,1 per cent. This was due to a decrease in the prices of most food categories. Except for a temporary decrease of 0,2 percentage points in June 2009 that was reversed by July, the contribution of the housing and utilities category to inflation remained at 1,8 percentage points until September, when it recorded 1,7 percentage points. Electricity prices remain a significant contributor to this category. The transport category has contributed to the fall in the inflation rate since April 2009, largely as a result of a lower petrol price. The contribution of transport to inflation declined from 0,2 percentage points in April to -0,7 percentage points in July before moderating to -0,2 percentage points in September.

Table 1 Contributions to CPI inflation

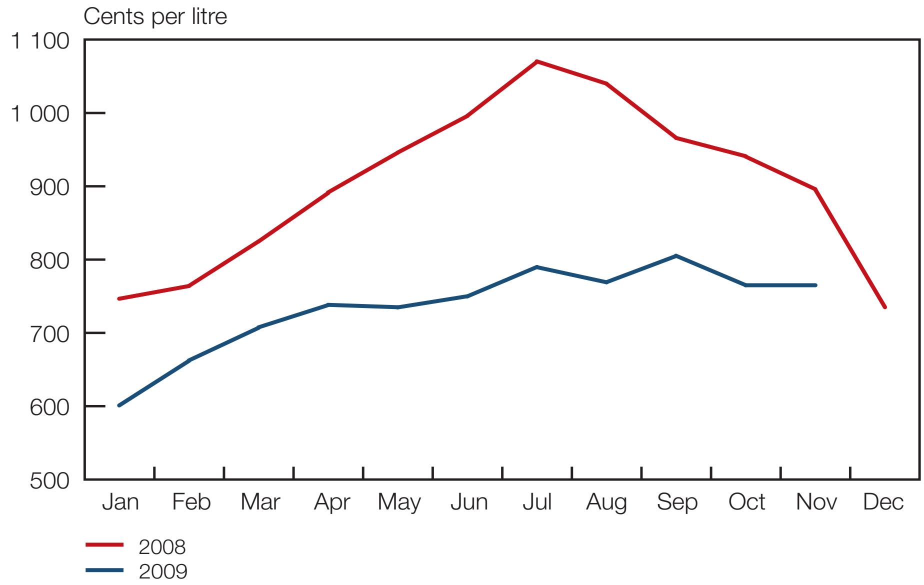
Percentage change over 12 months* and percentage points

	2009						
	Mar	Apr	May	Jun	Jul	Aug	Sep
Total*	**8,5**	**8,4**	**8,0**	**6,9**	**6,7**	**6,4**	**6,1**
Of which:							
Food and non-alcoholic beverages	2,3	2,1	1,9	1,6	1,3	1,1	0,9
Alcoholic beverages and tobacco	0,6	0,6	0,6	0,6	0,6	0,7	0,7
Housing and utilities	1,8	1,8	1,8	1,6	1,8	1,8	1,7
Health	0,2	0,2	0,2	0,2	0,2	0,2	0,2
Transport	0,2	0,2	0,1	-0,4	-0,7	-0,5	-0,2
Education	0,2	0,2	0,2	0,2	0,2	0,2	0,2
Miscellaneous goods and services	1,6	1,6	1,6	1,6	1,7	1,7	1,6
Other	1,6	1,7	1,6	1,5	1,6	1,2	1,0

Source: Statistics South Africa

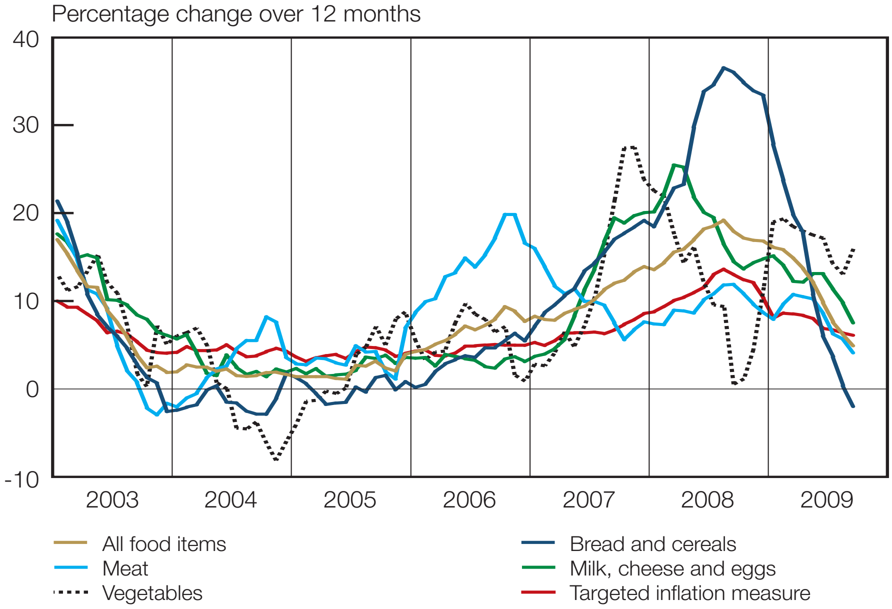
The reason for the negative contribution of the petrol price to the inflation rate is evident from Figure 2. The year-on-year inflation rate calculates the change in the price of a good compared to the price of the good in the same month of the previous year. Despite the fact that the petrol price has only decreased on four occasions in the past 11 months, the petrol price in 2009 has been consistently lower than in the corresponding months of 2008 and has, therefore, contributed negatively to the year-on-year inflation rate.

Figure 2 Comparison of monthly petrol prices for 2008 and 2009



Total food price inflation has fallen significantly from its peak in August 2008, when it recorded 19,2 per cent, to 4,9 per cent in September 2009. Figure 3 shows that the food items contributing to this continued decline include bread and cereals (for which the

Figure 3 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

inflation rate has fallen from 17,7 per cent in April 2009 to -2,0 per cent in September 2009) and meat (for which inflation declined from 10,5 per cent to 4,1 per cent over the same period). Inflation rates for vegetable prices and for milk, cheese and egg prices have remained above that of overall food prices. Vegetable price inflation increased in September for the first time since February 2009, although milk, cheese and eggs price inflation has continued to decline.

Table 2 considers the effect of excluding a number of categories from the CPI inflation rate in the period since April 2009. If petrol prices were excluded, the inflation rate for the remaining items in the CPI would have been higher than the headline rate throughout the period under review. In September 2009 the inflation rate for CPI excluding petrol prices was 7,1 per cent, compared with 6,1 per cent for the headline rate. By contrast, food and non-alcoholic beverage prices exerted upward pressure on the headline CPI inflation rate until August. However, for September, excluding this category results in a CPI inflation rate of 6,4 per cent, above the headline rate. If petrol prices, and food and non-alcoholic beverage prices are excluded from the CPI, the inflation rate for the remaining items was 7,5 per cent in September. Finally, if energy were also excluded, the inflation rate would have been lower at 7,1 per cent in September; this can be explained by the recent large year-on-year increases in the price of electricity which have placed upward pressure on the CPI inflation rate.

Table 2 The effect of food, petrol and electricity prices on headline inflation

Percentage change over 12 months

	2009						
	Mar	Apr	May	Jun	Jul	Aug	Sep
Headline CPI	**8,5**	**8,4**	**8,0**	**6,9**	**6,7**	**6,4**	**6,1**
CPI excluding petrol prices	9,5	9,4	9,2	8,3	8,2	8,0	7,1
CPI excluding food and NAB* prices	7,5	7,3	7,2	6,2	6,3	6,3	6,4
CPI excluding food, NAB and petrol prices	8,6	8,6	8,7	8,0	8,2	8,2	7,5
CPI excluding food, NAB, petrol and energy prices	8,0	8,1	8,3	7,5	7,7	7,6	7,1

* NAB: Non-alcoholic beverage

Source: Statistics South Africa

Goods inflation fell to within the inflation target range in July 2009 and continued to decline, recording a 12-month rate of 4,9 per cent in September (Table 3). This was largely due to the significant decreases in non-durable goods price inflation over the period. The inflation rates for durable and semi-durable goods have oscillated at relatively low levels since April 2009. Services inflation has remained high and has shown signs of price stickiness. It declined to 7,6 per cent in June 2009, rose to 8,1 per cent in August and then decreased once more to 7,8 per cent in September.

Overall administered price increases have remained subdued in 2009 (Table 4). The year-on-year changes in total administered prices appear to have bottomed in June 2009 (-1,2 per cent) and subsequently rose to 3,2 per cent in September 2009. Although the regulated component of administered prices has recorded significant negative inflation rates since April, mainly due to lower petrol prices, inflation for the unregulated component rose from 6,9 per cent in June to 9,3 per cent in July and 9,8 per cent in September. This was largely the result of an increase in the inflation rate of assessment rates, which doubled over the period.

Table 3 CPI: Goods and services inflation

Percentage change over 12 months

	2009						
	Mar	Apr	May	Jun	Jul	Aug	Sep
Headline CPI	**8,5**	**8,4**	**8,0**	**6,9**	**6,7**	**6,4**	**6,1**
Goods inflation	8,7	8,3	7,6	6,2	5,5	5,0	4,9
Durable goods	2,9	3,7	4,9	4,1	3,3	3,5	2,5
Semi-durable goods	6,6	5,9	5,2	4,7	5,1	4,5	4,6
Non-durable goods	11,8	10,9	9,2	7,6	6,5	5,7	6,1
Services inflation	8,4	8,4	8,4	7,6	8,0	8,1	7,8

Source: Statistics South Africa

Table 4 Administered prices

Percentage change over 12 months

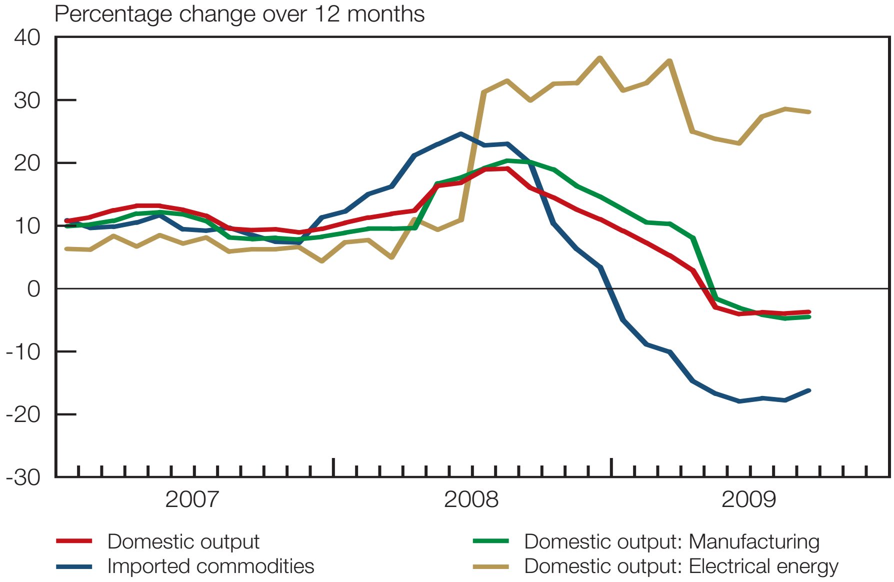
	2009						
	Mar	Apr	May	Jun	Jul	Aug	Sep
Total	2,8	1,7	0,0	-1,2	-0,4	0,2	3,2
Regulated	0,6	-1,0	-3,6	-5,3	-5,0	-4,5	-0,3
Unregulated	6,8	6,9	6,9	6,9	9,3	9,8	9,8

Source: Statistics South Africa

The year-on-year rate of inflation of domestic output measured by the producer price index (PPI) continued to decline in 2009, decreasing from 2,9 per cent in April to -3,7 per cent in September (Figure 4). The rate of decline in the PPI has been moderated

Figure 4 PPI for domestic output and imported commodities

Percentage change over 12 months



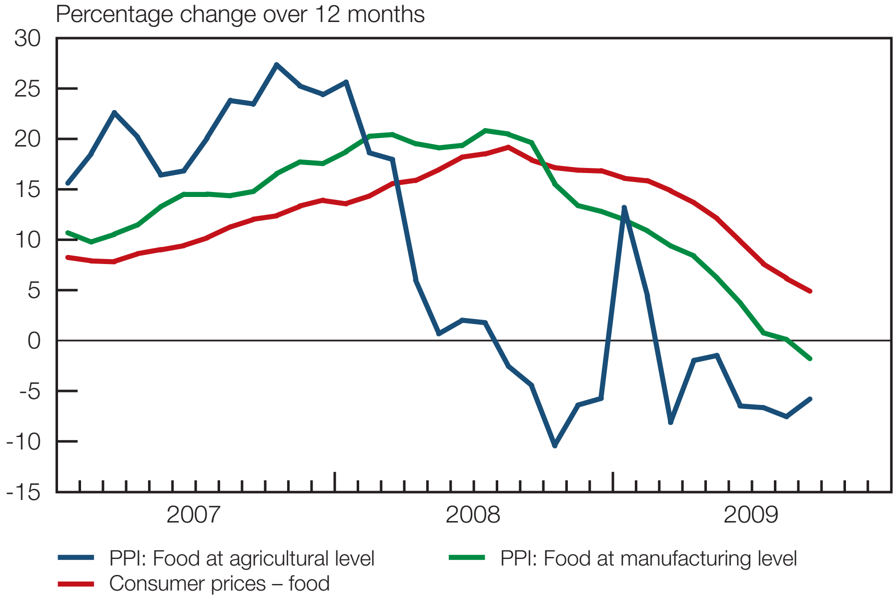
Details regarding changes to the PPI in this period are documented in Statistical Release P0142.1, February 2008, by Statistics South Africa

Source: Statistics South Africa

somewhat by large year-on-year increases in the price of electricity, which rose by 27,4 per cent in July and 28,1 per cent in September. The PPI for imported commodities inflation rate has been negative since the beginning of 2009, mainly as a result of developments in the foreign-exchange rate of the rand during this period.

The rate of change in food prices in the PPI, measured at both the agricultural and manufacturing levels, has remained below the rate of food price changes recorded in the CPI (Figure 5). The year-on-year inflation rate for food prices in the CPI was 4,9 per cent in September, compared to PPI food price inflation of -1,8 per cent at the manufacturing level and -5,8 per cent at the agricultural level.

Figure 5 Food prices in the PPI and CPI



Source: Statistics South Africa

Factors affecting inflation

Monetary policy decisions are made on the basis of current and expected developments in the wider macroeconomy. Recent developments in some of the main variables influencing inflation in South Africa are reviewed in this section, while the outlook for these variables and their likely impact on inflation are discussed in a later section.

International economic developments

The most recent International Monetary Fund (IMF) data show that global growth fell from 3,0 per cent in 2008 to a projected -1,1 per cent in 2009, the first outright contraction in the world economy since the IMF began collecting real gross domestic product (GDP) data in 1970 (Table 5). The data reflect a synchronised contraction of advanced economies and a significant slowing of the growth rates of developing economies.

The financial shocks of September and October 2008 and their aftermath clearly illustrated the effects of financial stress on real economic activity in the global economy. The United States (US) alone has lost more than 7 million jobs since the recession began in December 2007, and the unemployment rate reached a 26-year high in September 2009. Potential output growth rates were impacted negatively in all the advanced economies, and activity in the housing and financial sectors slumped. Weaker demand resulted in a noticeable increase in excess capacity that is projected to keep inflation in advanced economies close to 0 per cent in 2009. In the emerging economies, stronger disinflationary forces in some regions also prompted modest reductions in October of the IMF's April projections for inflation, notwithstanding the upward revisions to output growth for these countries. The IMF forecasts that the pace of world inflation will slow markedly in 2009 to 2,5 per cent from 6,0 per cent in 2008.

Table 5 Annual percentage change in real GDP and consumer prices

	Real GDP		Consumer prices*	
	2008	2009 (estimate)	2008	2009 (estimate)
World	**3,0**	**-1,1**	**6,0**	**2,5**
Advanced economies	**0,6**	**-3,4**	**3,4**	**0,1**
United States	0,4	-2,7	3,8	-0,4
Japan	-0,7	-5,4	1,4	-1,1
Euro area	0,7	-4,2	3,3	0,3
United Kingdom	0,7	-4,4	3,6	1,9
Other advanced economies	1,6	-2,1	4,3	1,3
Other emerging-market and developing countries	**6,0**	**1,7**	**9,3**	**5,5**
Africa	5,2	1,7	10,3	9,0
Central and eastern Europe	3,0	-5,0	8,1	4,8
Commonwealth of Independent States	5,5	-6,7	15,6	11,8
Developing Asia	7,6	6,2	7,5	3,0
China	9,0	8,5	5,9	-0,1
India	7,3	5,4	8,3	8,7
Middle East	5,4	2,0	15,0	8,3
Western hemisphere	4,2	-2,5	7,9	6,1

* Zimbabwe excluded

Source: IMF *World Economic Outlook,* October 2009

Although real growth in the largest economies in the Group of Twenty (G-20) has been severely affected during the global recession, most of them already appear to have embarked on a path to recovery. The rate of contraction in economic activity moderated in the second quarter of 2009 in the US, the euro area, Italy, Spain, the United Kingdom (UK) and Canada. Economic activity in some advanced economies stabilised towards the middle of 2009, with positive growth resuming in either the second or third quarter. Economic conditions also improved in the second quarter of 2009 in most emerging-market economies partly due to improved demand in advanced economies. However, the US economy is expected to record negative growth of 2,7 per cent in 2009, compared with positive growth of 0,4 per cent in 2008. The US is projected to record deflation of 0,4 per cent in 2009, compared with an inflation rate of 3,8 per cent in 2008.

In Japan, following a dismal first quarter of 2009, there are signs that output is stabilising. Improved consumer confidence, progress in inventory adjustment, expansionary fiscal policies, and strong performance by other Asian economies are expected to lift growth in the coming quarters. The IMF, nevertheless, forecasts another year of negative GDP growth in Japan of 5,4 per cent in 2009 following the decline of 0,7 per cent recorded in 2008. The IMF also forecasts a return to deflation of 1,1 per cent for Japan in 2009 after the inflation of 1,4 per cent recorded in 2008.

In addition to efforts to stabilise, restore and reform the banking sector, the European Economic Recovery Plan was launched in December 2008 to restore confidence and bolster demand through a co-ordinated injection of purchasing power. The overall fiscal stimulus in the euro area, including the effects of automatic stabilisers, amounts to 5 per cent of GDP. Real GDP in the euro area is, nevertheless, projected to decline by 4,2 per cent in 2009 from the 0,7 per cent real growth recorded in 2008. Inflation in the euro area is projected to fall to 0,3 per cent in 2009 from the 3,3 per cent recorded in 2008.

The IMF forecasts that the UK will record negative growth of 4,4 per cent in 2009 compared with positive real growth of 0,7 per cent recorded in 2008. Inflation in the UK is projected to decelerate from 3,6 per cent in 2008 to 1,9 per cent in 2009.

As global trade flows contracted, China suffered a ten-month decline in exports, dampening growth in the region and pulling the nationwide expansion rate down to 6,1 per cent in the first quarter of 2009 – the slowest pace in almost a decade. However, the Chinese government is using a US$586 billion stimulus package and record bank lending to build railways, roads and power plants in the country, and the IMF forecasts that China will grow by 8,5 per cent in 2009 compared with 9,0 per cent in 2008. India is expected to record growth of 5,4 per cent in 2009 compared with 7,3 per cent in 2008.

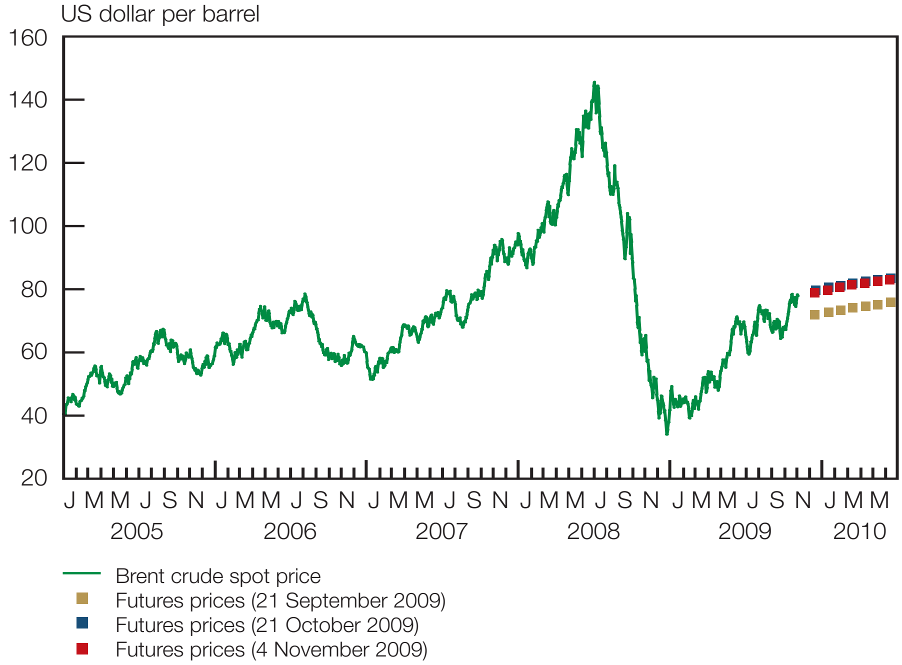
The global slowdown has had a significant impact on Africa and the continent is expected to record growth of only 1,7 per cent in 2009, compared with 5,2 per cent in 2008. The decline in global trade dampened economic expansion in all countries in sub-Saharan Africa as their terms of trade deteriorated. Inflation in Africa is expected to fall slightly from 10,3 per cent in 2008 to 9,0 per cent in 2009.

Oil prices

After falling significantly in the second half of 2008 to levels below US$35 per barrel at the end of the year, Brent crude oil prices rose in the first two quarters of 2009 to around US$70 per barrel in early June (Figure 6). Prices declined briefly in early July 2009, amid concerns about weakening energy demand and excess supply, before rising to around US$72 at the end of August and then fluctuating within a US$64–US$79 band in September and October. This was against the backdrop of contradictory projections for the global economy.

The oil market remained in contango in 2009 (where near-term oil contracts cost less than those maturing further out) as relatively large stockpiles of physical oil tended to keep a lid on near-term prices. In recent months there have also been indications that the Organization of the Petroleum Exporting Countries (OPEC) has had difficulty in ensuring that member countries adhere to output target cuts; these factors have contributed to futures prices trending lower. Other factors weighing on the oil price were the announcement in September 2009 that Russia's oil output expanded beyond 10 million barrels per day – more than that of Saudi Arabia – and in October militants in Nigeria (producer of some of the world's most sought-after grades of crude oil) appeared to accept an amnesty. However, the longer-term oil price outlook has, in general, been underpinned by an improving global economic outlook and rising equity prices. On 4 November 2009 the futures prices for Brent crude oil to be delivered in May and June 2010 were around US$82 per barrel and US$83 per barrel respectively.

Figure 6 Price of Brent crude oil



Source: Bloomberg

International monetary policy developments

Financial market turbulence and deteriorating growth prospects prompted aggressive monetary loosening in the course of the past 12 months. Decisive and concerted policy actions are yielding signs of early recovery, and G-20 countries have stated their commitment to maintaining supportive monetary, fiscal and financial sector policies until a durable recovery is assured. All the major central banks have cut policy interest rates to unusually accommodative levels to revive credit, and the IMF and the Organisation for Economic Co-operation and Development (OECD) do not expect a reversal of these policies until the second half of 2010. The challenge for policy-makers is to prepare for an orderly unwinding of the extraordinary levels of public intervention, without undermining the recovery.

Most central banks have eased official policy rates since the onset of the global financial crisis (Table 6), and a number of them have implemented unconventional monetary policy measures in response to the deteriorating economic conditions and dissipating inflationary pressures. Since the release of the May 2009 *Monetary Policy Review*, official interest rates have been reduced by central banks in Brazil, Canada, Chile, the Czech Republic, Denmark, the euro area, Hungary, Iceland, India, Indonesia, Mexico, New Zealand, Poland, Russia, Sweden, Thailand and Turkey.

Recently, the interest rate cycle has been reversed in Israel, Australia and Norway. In these countries the economic contraction was seen to be over and policy has become more focused on inflation concerns.

The United States Federal Reserve (the Fed) unanimously decided to keep the target rate unchanged at a record low of 0 to 0,25 per cent at meetings of the Federal Open Market Committee (FOMC) in August, September and November 2009, and reiterated at its most recent meeting that it would keep rates on hold for an "extended period". The FOMC opted to extend its mortgage-backed securities (MBS) and agency debt purchase programmes until the end of the first quarter of 2010, and committed itself to reducing the pace of purchases.

Table 6 Selected central bank interest rates

Per cent

Countries	1 Sep 2008	5 Nov 2009	Latest decision (change in percentage points)	
United States	2,00	0,00-0,25	04 Nov 2009	(0,00)
Japan	0,50	0,10	30 Oct 2009	(0,00)
Euro area	4,25	1,00	05 Nov 2009	(0,00)
United Kingdom	5,00	0,50	05 Nov 2009	(0,00)
Canada	3,00	0,25	20 Oct 2009	(0,00)
Denmark	4,60	1,25	25 Sep 2009	(-0,10)
Sweden	4,50	0,25	28 Oct 2009	(0,00)
Norway	5,75	1,50	29 Oct 2009	(0,25)
Switzerland	2,75	0,00-0,75	17 Sep 2009	(0,00)
Australia	7,25	3,50	04 Nov 2009	(0,25)
New Zealand	8,00	2,50	29 Oct 2009	(0,00)
Israel	4,25	0,75	26 Oct 2009	(0,00)
China	7,47	5,31	29 Sep 2009	(0,00)
Hong Kong	3,50	0,50	05 Nov 2009	(0,00)
Indonesia	9,00	6,50	04 Nov 2009	(0,00)
Malaysia	3,50	2,00	28 Oct 2009	(0,00)
South Korea	5,25	2,00	09 Oct 2009	(0,00)
Taiwan	3,63	1,25	24 Sep 2009	(0,00)
Thailand	3,75	1,25	21 Oct 2009	(0,00)
India	9,00	4,75	27 Oct 2009	(0,00)
Brazil	13,00	8,75	21 Oct 2009	(0,00)
Chile	7,75	0,50	13 Oct 2009	(0,00)
Mexico	8,25	4,50	16 Oct 2009	(0,00)
Czech Republic	3,50	1,25	05 Nov 2009	(0,00)
Hungary	8,50	7,00	20 Oct 2009	(-0,50)
Poland	6,00	3,50	28 Oct 2009	(0,00)
Russia	11,00	9,50	30 Oct 2009	(-0,50)
Turkey	16,75	6,75	16 Oct 2009	(-0,50)
Iceland	15,50	11,00	05 Nov 2009	(-1,00)

Source: National central banks

The Governing Council of the European Central Bank (ECB) left the policy rate unchanged at recent meetings and affirmed that it had no precommitment on when to withdraw the emergency measures introduced to fight the financial crisis, but that it would take the required steps at the appropriate time. The Bank of England's Monetary Policy Committee (MPC) kept the policy rate unchanged at a record low of 0,50 per cent at recent meetings and increased the stock of asset purchases in terms of the Asset Purchase Facility. It announced in October 2009 that it would give more banks access to its open-market operations and deposit facilities to help smaller institutions better manage their liquidity.

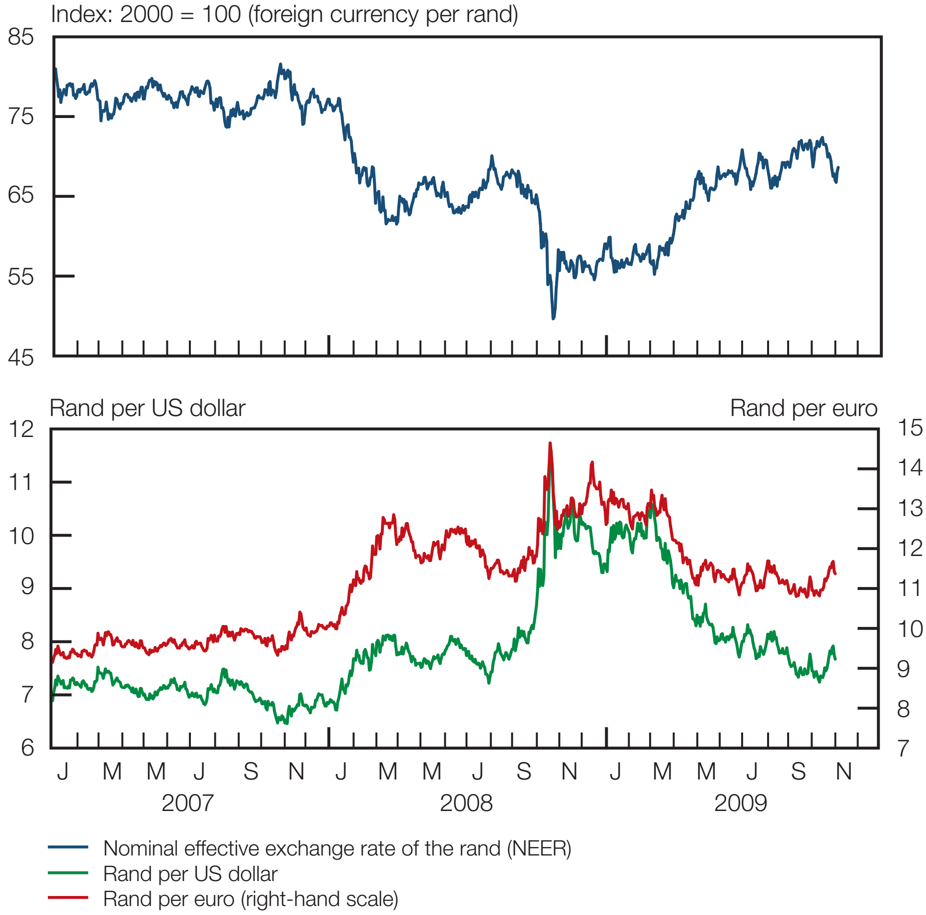
Central banks in emerging-market economies have either held policy rates steady or have lowered them further since the publication of the May 2009 *Monetary Policy Review*. The Czech National Bank held the policy rate at a record low of 1,25 per cent at its most recent meeting on signs that the outlook for inflation remained subdued. The central bank of the Republic of Turkey lowered the policy rate by 50 basis points in October 2009 after an MPC assessment that inflation was expected to remain at low levels for an extended period, and that the ongoing recovery in economic activity would be gradual and protracted.

The People's Bank of China announced a continued "moderately loose" monetary policy stance in September 2009 to cement China's economic recovery further.

Exchange rate developments

Having recovered markedly in March and April 2009 as investor sentiment improved around the world, the nominal effective exchange rate of the rand (NEER), measured against a basket of 15 currencies, rose from 67,2 index points on 1 May to 68,6 index points on 5 November 2009 (Figure 7). Over this period, the bilateral exchange rate of the rand appreciated from R8,43 to R7,67 against the US dollar, and depreciated from R11,26 to R11,37 against the euro.

Figure 7 Exchange rates of the rand

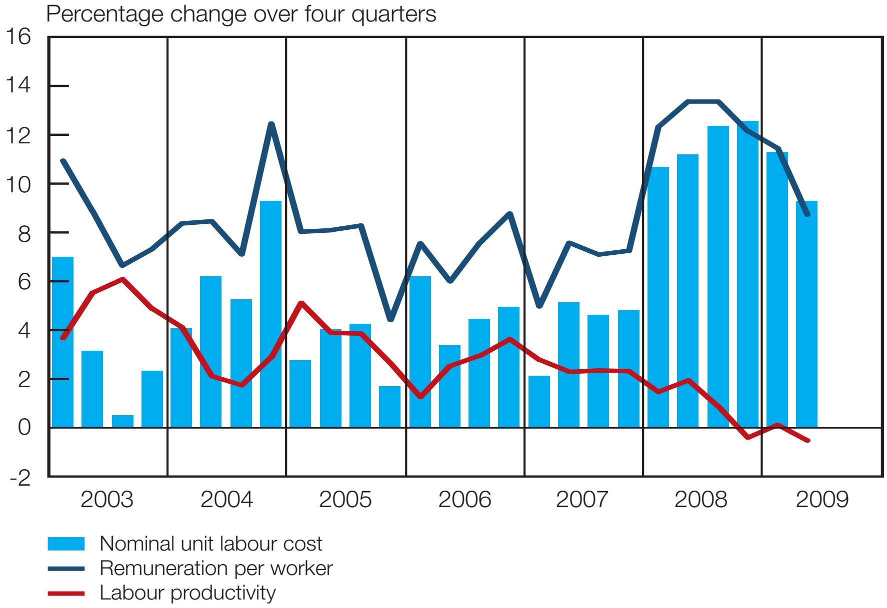


The strengthening of the rand against the US dollar is largely due to the relative weakness of the latter currency, which depreciated by approximately 12 per cent against the euro over the period. Furthermore, dollar weakness has resulted in higher commodity prices, which have supported the foreign exchange rate of the rand. This phenomenon is not unique to the rand as other commodity-based economies have experienced similar currency strength against the US dollar.

Labour markets

In recent months inflationary pressure emanating from the labour markets has been moderating (Figure 8). Wage inflation measured in terms of the year-on-year changes in nominal remuneration per worker in the formal non-agricultural sector, which recorded just over 12 per cent in each of the quarters of 2008, slowed to 11,5 per cent in the first quarter and 8,7 per cent in the second quarter of 2009. Labour productivity, measured

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



Sources: Statistics South Africa and South African Reserve Bank calculations

as the ratio of real value added to employment in the formal non-agricultural sector, rose by 0,1 per cent in the first quarter of 2009, before declining by 0,5 per cent in the second quarter. Economy-wide unit labour cost inflation, measured as wage inflation adjusted for productivity changes in the formal non-agricultural sector, therefore declined to 11,3 per cent in the first quarter of 2009 and 9,3 per cent in the second quarter, after having recorded a year-on-year increase of around 12,6 per cent in the final quarter of 2008.

The average level of wage settlements reported for the first nine months of 2009 by the *Andrew Levy Wage Settlement Survey* was 9,4 per cent (Figure 9), suggesting that wage

Figure 9 Average annual inflation and wage settlements

* Data for 2009 are for the first nine months of the year

Sources: Andrew Levy Employment Publications and Statistics South Africa settlements are falling slowly when compared to the 9,8 per cent recorded for the year 2008. Settlements have ranged from 5 per cent in the paper/printing sector to 12,3 per cent for the food/agriculture sector over the first nine months of 2009.

Demand and output

Real GDP contracted by 3 per cent on an annualised basis in the second quarter of 2009, following declines of 6,4 per cent in the first quarter of the year and 1,8 per cent in the final quarter of 2008. Real value added by the primary, secondary and tertiary sectors all continued to contract in the second quarter. The largest negative contribution came from the manufacturing sector, where real value added declined by 10,2 per cent, following a contraction of 22,1 per cent in the preceding quarter.

Real gross domestic expenditure also contracted during the second quarter of 2009 (Table 7). Inventory depletion, a contraction in final consumption expenditure by households, and slowing growth in final consumption expenditure by government and in gross fixed capital formation resulted in real gross domestic expenditure contracting at an annualised rate of 14,5 per cent during the quarter.

Table 7 Growth in real GDP and expenditure components

Per cent*

	2008					2009	
	1st qr	2nd qr	3rd qr	4th qr	Year	1st qr	2nd qr
Final consumption expenditure:							
Households	3,0	1,3	-0,9	-2,7	2,3	-4,8	-5,8
General government	12,3	-2,1	10,2	3,6	5,0	5,8	0,2
Gross fixed capital formation	10,4	5,2	7,3	3,0	10,2	12,7	0,1
Changes in inventories (R billions)**	11,1	-4,7	-11,2	-21,1	-6,5	-16,6	-52,9
Gross domestic expenditure	**12,5**	**-1,7**	**0,7**	**-3,9**	**3,1**	**2,2**	**-14,5**
Exports of goods and services	-30,1	42,5	4,0	-16,4	1,7	-55,1	-10,1
Imports of goods and services	3,9	7,9	4,7	-19,0	2,2	-27,5	-41,9
Gross domestic product	**1,7**	**5,0**	**0,2**	**-1,8**	**3,1**	**-6,4**	**-3,0**

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

Real final consumption expenditure by households contracted by 5,8 per cent in the second quarter of 2009, following a decline of 4,8 per cent in the first quarter of the year. Household expenditure on durable goods has been particularly affected, declining by 18,8 per cent in the second quarter of 2009 and having contracted in each of the preceding 6 quarters. Growth in real final consumption expenditure by general government decelerated to 0,2 per cent in the second quarter of 2009, after having increased at an annualised rate of 5,8 per cent in the first quarter. This deceleration is mainly attributable to lower spending on the Defence Procurement Programme.

Following a revised annualised increase of 12,7 per cent in the first quarter of 2009, growth in real gross fixed capital formation slowed to 0,1 per cent in the second quarter. This deceleration mainly reflected substantially slower growth in real capital outlays by public corporations, while those by private business enterprises declined at a similar rate to that recorded in the first quarter of 2009. Real inventories declined by R52,9 billion in the second quarter of 2009 compared with a decline of R16,6 billion in the first quarter.

Inventory depletion in the second quarter of 2009 was mainly evident in the manufacturing and agricultural sectors.

Developments in the external sector of the economy resulted in the ratio of the deficit on the current account of the balance of payments to GDP declining from 7,0 per cent in the first quarter of 2009 to 3,2 per cent in the second quarter. The decline in the volume of imports of goods and services outweighed a smaller decline in the volume of exports of goods and services, resulting in the smaller deficit on the trade account in the second quarter of 2009. Lower net income and other service-related payments to non-residents meant that the shortfall in the country's net services, income and current transfer account with the rest of the world also narrowed significantly.

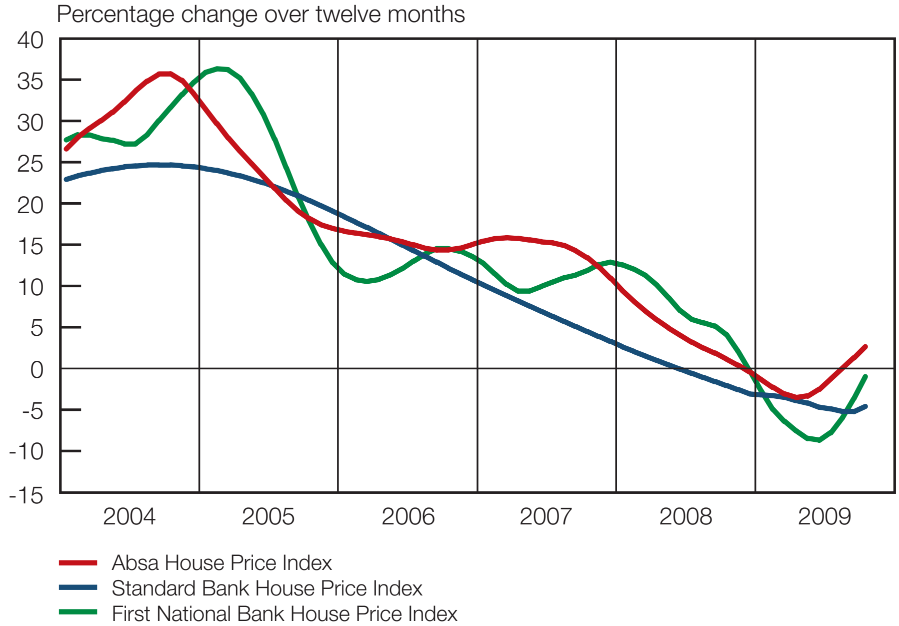
South Africa's gross international reserve position strengthened from US$35,7 billion at the end of July 2009 to US$39,8 billion at the end of October, partly due to a general allocation of SDR 1,385 billion from the IMF in August and a special allocation of SDR 179,9 million in September. The international liquidity position also improved from US$34,7 billion at the end of July to US$38,8 billion at the end of October.

Real-estate and equity prices

A general easing in risk aversion became evident during the second half of 2009 as financial markets globally displayed signs of cautious optimism regarding a recovery in growth. The South African share market followed the upward movement in international markets, benefiting from a recovery in commodity prices, the lowering of domestic interest rates and continued non-resident interest. By contrast, the property market remained in the doldrums, although there are some indications of a return to positive growth.

The year-on-year changes in nominal house prices (Figure 10) have generally been negative since the end of 2008, declining to rates last recorded more than 20 years ago. The rate of change in the average price of residential property in the middle segment of

Figure 10 House prices



Sources: Absa, Standard Bank and First National Bank the market, as measured by the Absa House Price Index, reached a recent low at a negative rate of 3,5 per cent in April 2009, before improving to 2,6 per cent in October. This was mirrored by the First National Bank House Price Index which recorded a similar improvement from a negative year-on-year rate of 8,7 per cent in June 2009 to -1,0 per cent in October. The change over 12 months in the Standard Bank median house price recorded a decline of 4,6 per cent in October 2009.

Building statistics published by Statistics South Africa, summarised in Table 8, indicate the deteriorating level of activity in the real-estate sector during 2009, while suggesting bleak prospects for future construction activity. The real value of building plans passed by larger municipalities during the first eight months of 2009, which provides insight into future construction activity, decreased by 29,5 per cent compared with the period January to August 2008. The real value of building plans passed for residential buildings recorded a decline of 46,5 per cent measured on this basis, with less pronounced decreases of 13,6 per cent recorded in the category for additions and alterations, and 10,3 per cent in plans for 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	-17,4	-29,5
Residential	2,7	-3,2	-26,5	-46,5
Non-residential	31,7	-5,9	2,0	-10,3
Additions and alterations	5,0	1,9	-12,5	-13,6
Buildings completed				
Total	21,5	9,5	1,8	-11,7
Residential	16,7	1,2	-8,2	-25,2
Non-residential	30,6	48,6	19,4	1,0
Additions and alterations	34,0	6,1	15,9	10,0

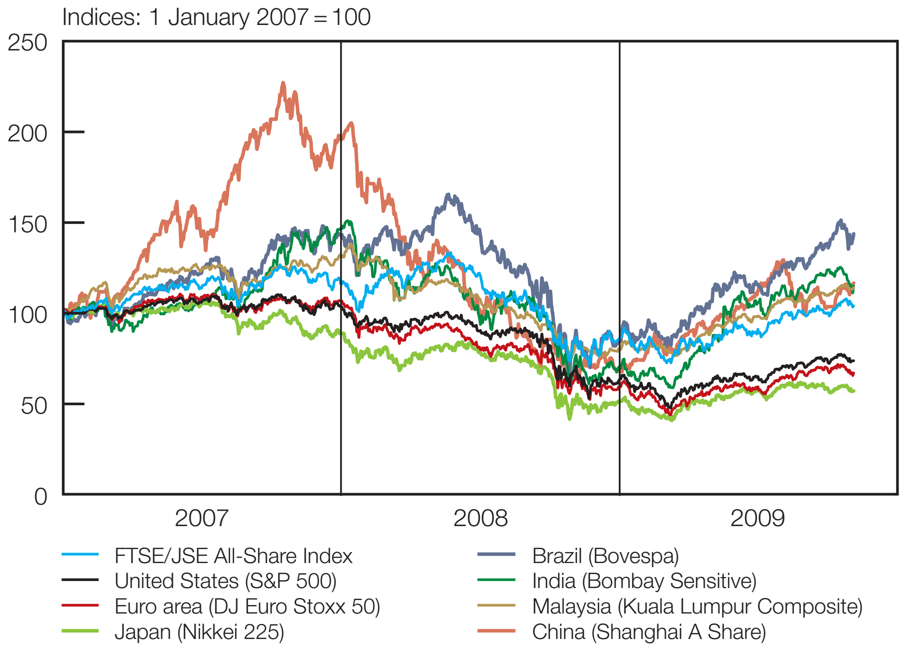
* Data for 2009 are for the first eight months of 2009 compared with the same period of the previous year

Source: Statistics South Africa

The real value of buildings reported as completed in larger municipalities during the first eight months of 2009 decreased by 11,7 per cent when compared with the same period a year earlier. Measured on this basis, the real value of residential buildings completed declined by 25,2 per cent, while increases of 1,0 per cent for non-residential buildings and 10,0 per cent for additions and alterations were reported.

Following global trends share prices on the JSE Limited (JSE) recorded a notable recovery during 2009 (Figure 11). From its recent low of 18 121 index points on 3 March 2009 the FTSE/JSE All-Share Index (Alsi) increased by 43 per cent to 25 925 on 4 November 2009. The trend was consistent with international markets becoming increasingly confident of a global economic recovery. Continued non-resident interest, improvements in commodity prices and lower domestic interest rates ensured that the buoyant share market conditions in the first ten months of 2009 were spread fairly widely across the various sectors. The daily average price level of shares listed in the resources sector increased by 40 per cent from 3 March to 4 November 2009. Over the same period the industrial index recorded a gain of 44 per cent while the financial index rebounded by 48 per cent as the lower interest rates and the appreciating exchange value of the rand weighed favourably on the profitability prospects of companies in these sectors.

Figure 11 Share price indices



Sources: JSE Limited and I-Net Bridge

Fiscal policy

The *Medium Term Budget Policy Statement* (MTBPS) was presented by the Minister of Finance on 27 October 2009. The revised budget balance for 2009/10 is a deficit of R183,8 billion, which represents 7,6 per cent of GDP (Table 9). This revised budget balance is twice the deficit of 3,8 per cent of GDP projected in the *Budget Review 2009.* Consolidated government revenue reflects the impact of lower earnings and reduced consumption and imports on tax revenues, and is now expected to be R657,5 billion in 2009/10, significantly lower than the estimate of R740,4 billion made in February. Consolidated government expenditure in 2009/10 is expected to be slightly higher than projected in February, rising from R834,3 billion to R841,4 billion. In the medium term, projected deficits as a percentage of GDP are 6,2 per cent for 2010/11, declining to 5,0 per cent for 2011/12, and to 4,2 per cent for 2012/13.

The estimated public-sector borrowing requirement (PSBR), reflecting the higher financing requirements of government and the non-financial public enterprises, increased from R88,9 billion in 2008/09 (3,8 per cent of GDP) to a revised R284,5 billion for 2009/10 (11,8 per cent of GDP). The PSBR is projected to remain relatively high over the medium term as a result of the infrastructure programmes of the non-financial public enterprises, declining to 11,2 per cent of GDP in 2010/11, to 9,4 per cent of GDP in 2011/12 and to 8,4 per cent of GDP in 2012/13. Net loan debt as a share of GDP has been revised upwards from 25,6 per cent of GDP in the February *Budget Review 2009* to 29,2 per cent, and is projected to increase to 41,1 per cent of GDP by 2012/13.

Table 9 Public finance data

	2008/09	2009/10		2010/11	2011/12	2012/13
	Outcome	Budget	Revised estimates	Medium-term estimates		
Consolidated government* (R billions)						
Revenue	692,0	740,4	657,5	743,5	833,4	921,3
Expenditure	715,4	834,3	841,4	905,6	975,6	1 052,8
Budget balance	-23,4	-94,0	-183,8	-162,1	-142,1	-131,5
As a percentage of GDP						
Budget balance	-1,0	-3,8	-7,6	-6,2	-5,0	-4,2
Total net loan debt	22,6	25,6	29,2	34,2	37,8	41,1
PSBR**	3,8	8,0	11,8	11,2	9,4	8,4

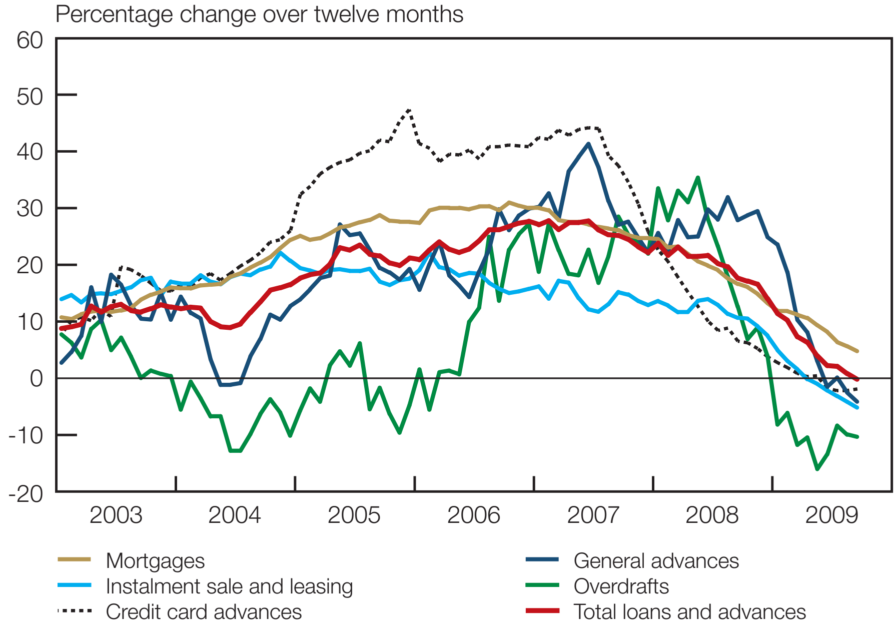
* Includes national government, provinces, social security funds and selected public entities
** PSBR: Public-sector borrowing requirement

Source: National Treasury *Medium Term Budget Policy Statement 2009*

Monetary conditions

Growth in total loans and advances extended to the private sector remained lacklustre in 2009, despite the cumulative effect of decreases in lending rates as monetary policy eased in successive steps from December 2008 (Figure 12). The sluggish response in the quantity of credit demanded to decreases in lending rates partly reflected the low levels of consumer and business confidence associated with concerns over prospects for income and employment, and impaired balance sheets on account of asset market declines. The supply of credit has also been affected by stricter lending criteria

Figure 12 Banks' loans and advances by type



applied by banks. Box 1 provides an analysis of banks' deposit and lending rates over the inflation targeting period.

Box 1 Analysis of banks' deposit and lending rates over the inflation-targeting period

Credit extension to both households and companies has been slow to react to the easier monetary policy stance adopted since December 2008 as weaker macroeconomic conditions continue to affect the South African economy. Year-on-year growth in banks' total loans and advances extended has declined significantly from near record levels of around 25 per cent, on average, in 2007 to single-digit growth in 2009. Growth in money supply followed a similar downward trajectory due to deteriorating growth in household and corporate income and declining household wealth.

This box briefly examines the degree of pass-through and the speed of adjustment in banks' deposit and lending rates in response to changes in the benchmark repurchase rate in South Africa during the period since the introduction of the inflation-targeting monetary policy framework in 2000. The data are obtained from Banks Act BA returns (DI returns prior to 2008), submitted to the Registrar of Banks.

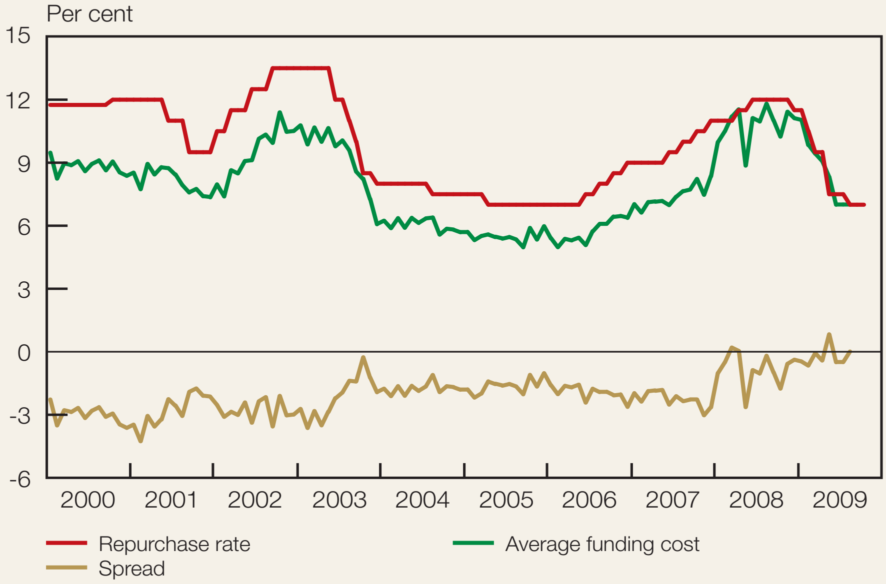
The lending and deposit rates offered by banks are affected by their cost of funding which, *inter alia*, is impacted by the money-market yield curve and, ultimately, the repurchase rate. Variable deposit and lending rates, therefore, fluctuate along with changes in the repurchase rate – lending rates at a margin above, and deposit rates at a margin below to slightly above the repurchase rate, depending on maturity, risk, liquidity and prevailing economic conditions.

Deposit rates

An average calculated deposit rate or funding cost is derived by analysing banks' interest outlays against deposit liabilities[1] (Figure B1.1).

1 Calculated as the ratio of total rand-denominated interest expenses to total rand-denominated deposits.

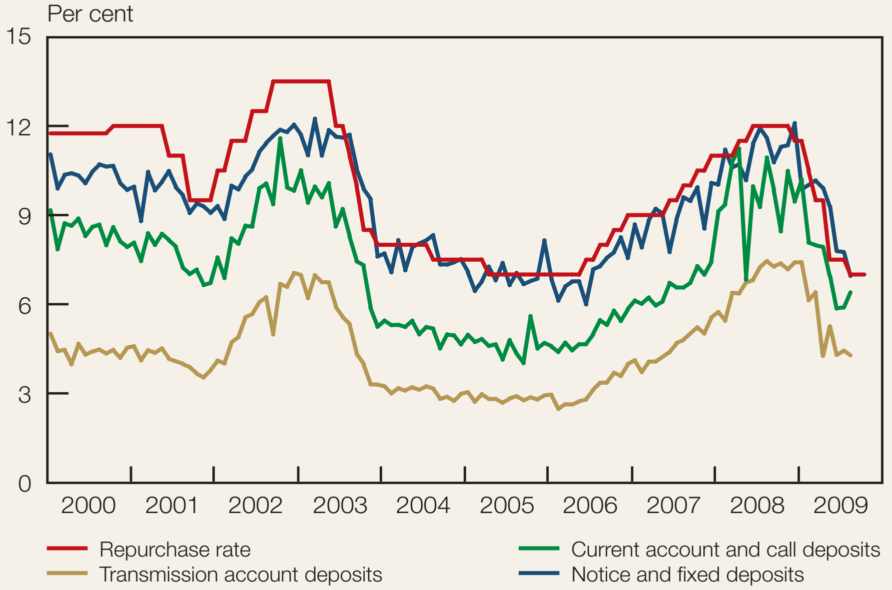
Figure B1.1 Calculated average funding cost and the repurchase rate



The spread between deposit rates and the repurchase rate narrowed during the initial phases of the previous and current monetary policy easing cycles, while adjustments to deposit rates also tended to lag during policy tightening phases. Depositors, therefore, tended to receive a relatively smaller interest benefit during monetary policy tightening phases, but received a relatively larger interest benefit during monetary easing cycles. A much narrower spread between banks' deposit rates and the repurchase rate was maintained in 2008[2] and early 2009 as banks probably attempted to attract deposits during a period of decelerating real economic growth. The beneficial rates that banks offered are especially evident in rates on longer term deposits, such as fixed deposits (Figure B1.2).

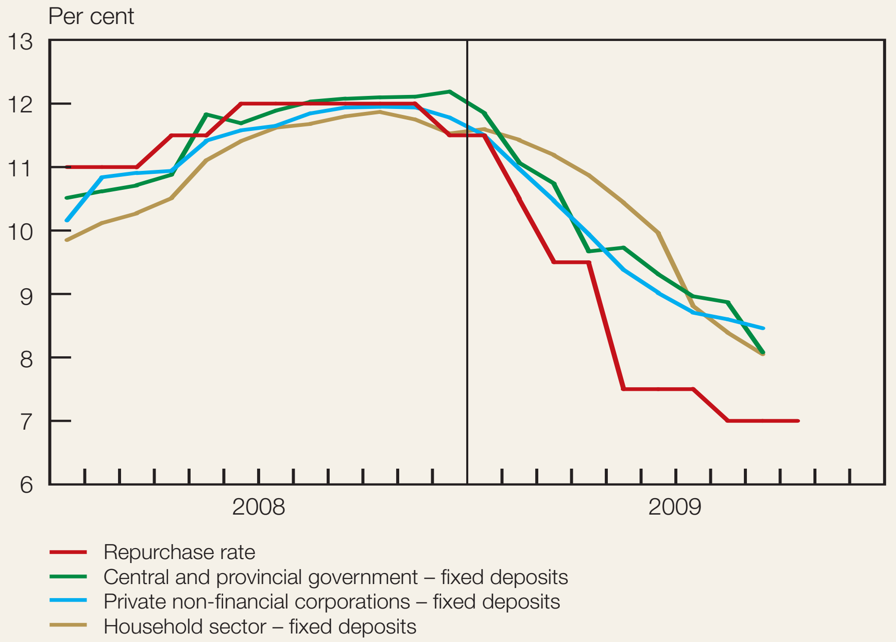
2 The implementation of the Basel II accounting framework in January 2008 may have influenced the comparability of data over the period of analysis.

Figure B1.2 Deposit categories: Calculated average yields



Information on the *actual reported* interest rates on existing deposits offered by banks, illustrated in Figure B1.3, also tends to paint a similar picture. While deposit rates vary depending on the client and term of deposit, the rates on fixed deposits of less than one year for different economic sectors displayed a close alignment with the repurchase rate. Interest rates on existing deposits lagged the downward movement in the repurchase rate during 2009, with households receiving a somewhat larger benefit relative to other client categories.

Figure B1.3 Client categories: Average 0–1-year fixed-deposit rates (top five banks)



3 Calculated as the ratio of total rand-denominated interest income to total rand-denominated loans and advances.

Lending rates

The average calculated yield on banks' total rand-denominated loans and advances was found to fluctuate at around 240 basis points above the repurchase rate from 2001 to 2009. Some narrowing occurred during 2002 and from 2006 to 2008 during the tightening phases of monetary policy, suggesting that lending rates lagged the increases in the repurchase rate. Similarly, the gap between lending rates and the repurchase rate widened when policy eased in 2003 and 2009. The lagged response of lending rates probably contributed to the slowdown experienced in the growth of credit extension in the wake of the monetary policy easing cycle. The repurchase rate and an implied average lending rate[3] are shown in Figure B1.4.

Figure B1.4 Calculated average interest rate on total loans and advances, and the repurchase rate

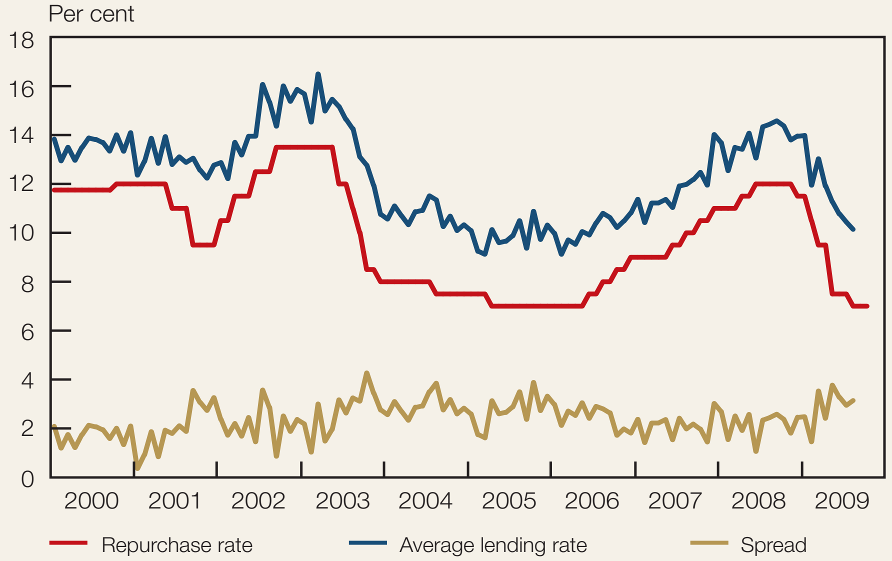
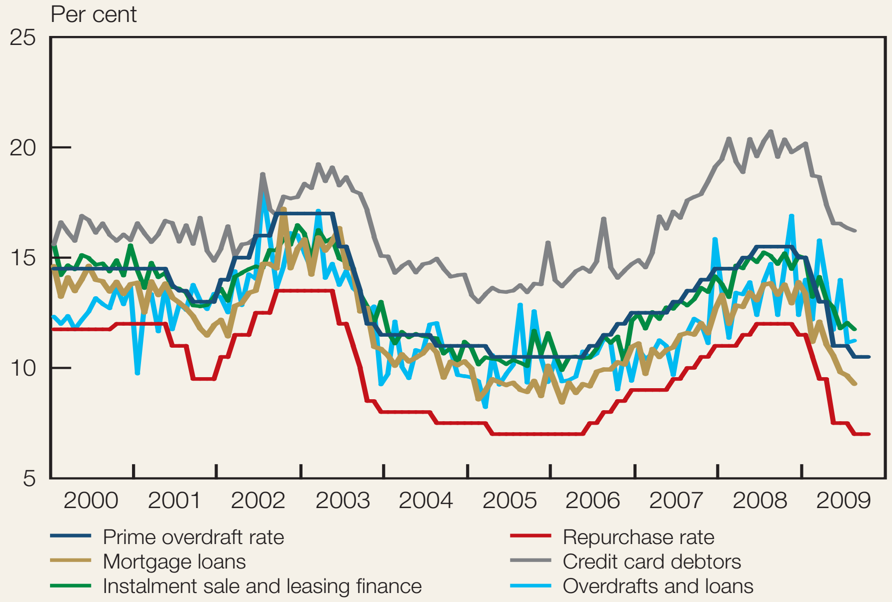


Figure B1.5 shows that most of the lending rates of the different loan categories fluctuated between the repurchase rate and the prime rate (benchmarked at the repurchase rate plus 350 basis points). Mortgage rates, a lower risk product due to its term and collateral requirements, fluctuated

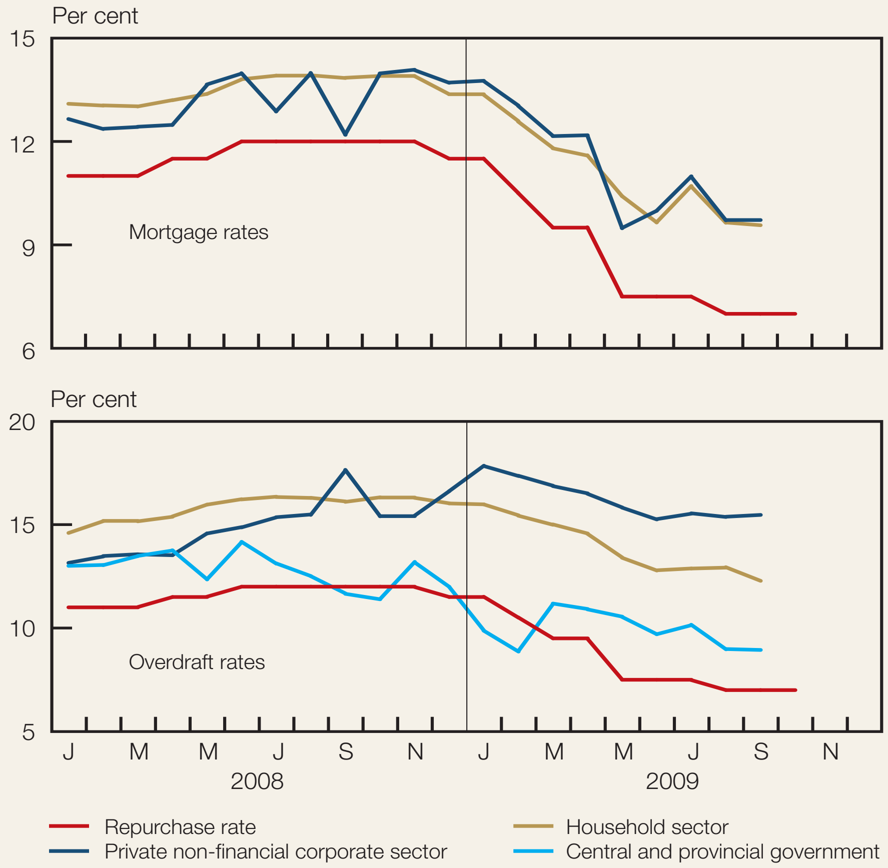
Figure B1.5 Calculated average interest rates on categories of loans and advances compared to the repurchase and prime rates



around mid-way between the repurchase and prime rates, while interest rates on instalment sales fluctuated closer to the prime rate. Overdrafts are generally subject to greater variation in lending rates, while credit card debtors are charged a significantly higher premium for the privilege of having access to a more flexible credit facility.

When comparing *actual reported* lending rates for households and companies, the interest rates vary according to the loan category (Figure B1.6). In the case of mortgage loans, the rates for households and companies appeared to be quite similar, while overdraft rates displayed a greater variance between different economic sectors. Rates on overdrafts to the public sector are generally substantially lower than those available to the private and household sectors.

Figure B1.6 Average lending rates (top five banks)



Conclusion

This analysis suggests a complete long-term pass-through for most lending rates, but incomplete immediate short-term pass-through of the policy rate to bank lending rates. However, there is no evidence of an asymmetric response of lending rates to changes in the repurchase rate. Although banks' lending and deposit rates appear to have reacted in a broadly consistent way during the period under review, there is some evidence of heterogeneity in the adjustments across lending categories. Furthermore, there is evidence of a somewhat more lagged response of banks' interest rate adjustments over the most recent monetary policy cycle. While this may constrain lending during an easing phase of the cycle, the relatively more favourable deposit rates that have prevailed in the recent period should encourage renewed growth in money supply over the longer term.

Sources

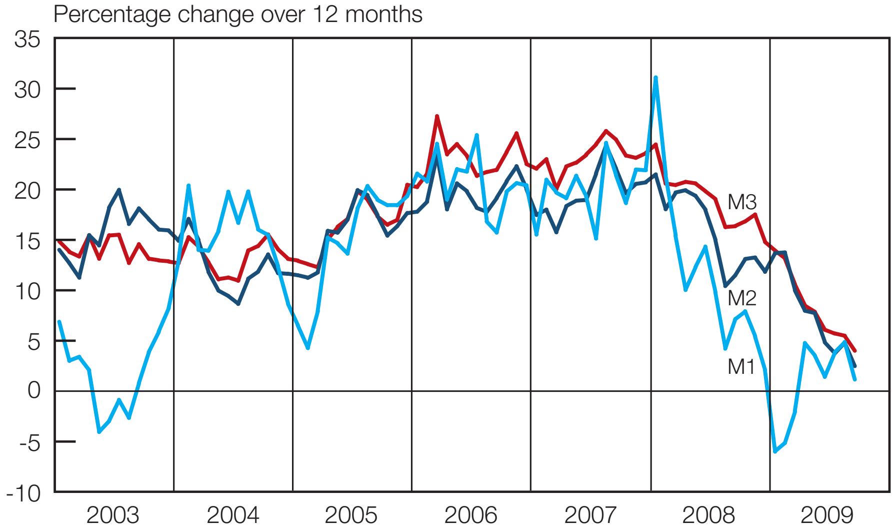
Implied average interest rates were calculated from the aggregated information of bank returns:
BA100 Balance sheet (DI100 prior to January 2008)
BA120 Income statement ((DI200 prior to January 2008)

Average actual interest rates were extracted from:
BA930 Interest rates on deposits, loans and advances

Year-on-year growth in banks' total loans and advances to the private sector fell back from average growth of around 20 per cent in 2008 to a negative 0,2 per cent in September 2009 – the slowest growth on record. Negative year-on-year rates of change in total loans and advances were last recorded in May 1966. Growth over 12 months in mortgage advances, which dominate the bank loans and advances aggregate, declined notably from 24,5 per cent at the start of 2008 to 4,8 per cent in September 2009. Growth in other loans and advances, which include general loans, overdrafts and credit card advances, followed a similar downward trajectory, declining to negative growth rates from May 2009. The securitisation of loans and advances by banks, a phenomenon that gathered pace in South Africa before contracting sharply in the wake of the turmoil in international markets in 2008, is discussed in Box 2.

Similar to the deceleration in credit extension, the year-on-year growth in broad money supply (M3) fell back from average growth of 19,0 per cent in 2008 to 4,0 per cent in September 2009 (Figure 13). During the same period a decline of similar magnitude was recorded by the narrower M2 monetary aggregate. The M1 monetary aggregate, which represents cash, cheque and other demand deposits, declined to negative growth in the first three months of 2009, before improving to year-on-year growth of 1,2 per cent in September.

Figure 13 Growth in monetary aggregates



Box 2 Asset-backed securitisation by South African banks

The United States (US) sub-prime-related credit crisis placed renewed emphasis on the issuance and use of financial derivatives and financing vehicles globally as securitisation of risky assets served to amplify the extent of the crisis. Securitisation provides an avenue whereby non-marketable loans and/or cash flows are replaced by negotiable securities issued in the capital markets. By issuing such debt instruments, future cash inflows are turned into present cash.

Internationally, and especially in the US market, the securitisation of risky mortgage loans and the use of financial derivatives and financing vehicles helped to transfer and spread the risk in an increasingly leveraged global financial system. Securitisation transactions in these markets accelerated after 2004 when the Basel II[4] Accord on international bank regulation was published. The second Basel Accord opened an arbitrage opportunity for banks through its recognition of the

4 **Basel Accord:** A set of recommended common banking standards agreed to by the Basel Committee on Bank Supervision in 1988, with the focus on capital adequacy and risk. The second Basel Accord, known as Basel II, became effective from 2008. It focuses on three main areas, namely minimum capital requirements, supervisory review and market discipline.

transfer of assets, or the risks related to them, and allowing for the exclusion of these assets from risk-based calculations. This essentially enabled banks to reduce their capital requirements through securitisation and contributed towards the acceleration in off-balance-sheet activity.

In South Africa the scale and extent of securitisation were limited by, *inter alia*, market size, lack of demand and prudent supervision. The first issuance in the present decade of a mortgage-backed securitisation to the value of R1 billion occurred in 2002. This was followed by the securitisation of vehicle receivables, and other types of collateralised loans and advances in subsequent years. Activity picked up from 2005 with securitisations amounting to around R10 billion for that year. Issuance doubled in 2006 and increased further to over R30 billion in 2007. The issuance of securitised bank assets virtually dried up in early 2008, when turmoil in international markets led to risk aversion and a general tightening in credit conditions. An independent review of all securitisation schemes affecting banks was commissioned by the Bank Supervision Department of the South African Reserve Bank (the Bank) during April 2008.

Figure B2.1 Asset-backed securitisations by private-sector banks – new issues

Source: Bond Exchange of South Africa

Following the recommendations made by a large international locally based auditing firm, the supervisory authority stated its intent to consider the proposals in order to ascertain the need to revise the legislative framework. The report also noted that securitisation in South Africa was not as complicated as in the US and in European countries, and that the assets housed in South African schemes tended to have a high level of transparency. Risks related to securitisation schemes were found to have been managed appropriately by the banks reviewed. Furthermore, top-tier South African banks, on average, sourced only 4 per cent of their total funding from securitisation, which was significantly less than that of international banks that struggled during the liquidity crisis.

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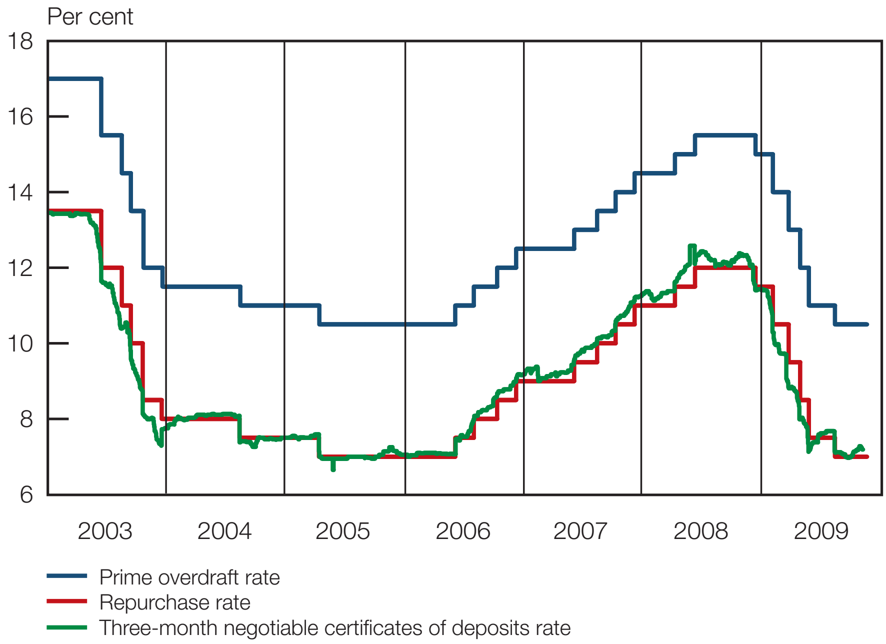
Monetary policy

The global financial crisis resulted in the widespread adoption of more accommodating monetary policy stances globally. South Africa's monetary policy easing began in December 2008, and in the four MPC meetings between then and April 2009 the repurchase rate was reduced by 350 basis points (Figure 14). Since then, and following the publication of the previous *Monetary Policy Review*, there were six meetings of the MPC, and the repurchase rate was reduced by a further 150 basis points – by 100 basis points in May and a further 50 basis points in August. The repurchase rate declined to a level of 7 per cent per annum, which was the same as the low point of the interest rate cycle reached in 2005, and the lowest nominal policy rate since the late 1970s. However, the inflation rate in 2009 was significantly higher than that which prevailed in 2005.

Figure 14 The repurchase rate and other short-term interest rates



The adjustment in the repurchase rate offset the 500 basis point monetary policy tightening implemented between June 2006 and June 2008, and was over a considerably shorter period. This decisive response reflected the severity of the global and domestic downturn, and the consequent dissipation of inflationary pressures. However, during the period under review, it appeared that the global and domestic recessions were reaching their lower turning points, and, given the lag in the impact of monetary policy actions on demand and inflation, the need for further stimulus was reduced.

During this period, the inflation rate remained outside the inflation target range, but the inflation forecasts of the staff of the Bank consistently showed that the inflation rate was expected to follow a persistent downward trend to within the target range. By the time of the November 2009 meeting the latest inflation outcome (September) was 6,1 per cent, only marginally outside the range. Although there were slight changes to the forecast in the various meetings, as a result of changing assumptions of the exogenous variables, the pattern remained relatively stable. The forecasts consistently showed that CPI inflation was expected to enter the inflation target range on a sustained basis in the second quarter of 2010 and to remain within the target range until the end of the forecast period in the final quarter of 2011. However, the changing electricity price assumptions reversed this favourable trend somewhat in the later part of the forecast period. The most recent forecast presented to the MPC is discussed in greater detail later in this review. Of concern to the committee was the fact that the central forecast remained close to the upper end of the target, so that relatively small shocks to inflation could result in a breach of the upper end of the target. During the period under review, the main changes to exogenous assumptions related to the exchange rate and administered prices, particularly petrol and electricity prices.

Inflation expectations are an important determinant of inflation outcomes, as they impact on price and wage setting. During the past period, inflation expectations have been a concern for the committee, as they did not appear to reflect fully the actual decline in the inflation that had been taking place. According to the inflation expectations survey conducted by the Bureau for Economic Research (BER) at Stellenbosch University, inflation expectations for 2009 deteriorated during the second quarter of 2009. While a downward trend for the subsequent two years remained, only the financial analysts expected that inflation would be within the target range in 2010 and 2011. The survey conducted in the third quarter of 2009 showed some improvement, but, on average, remained above the upper end of the inflation target range, with inflation expected to average 7,5 per cent in both 2010 and 2011. Again, only the financial analysts expected that inflation would be within the target range in these years.

The outlook for the global economy featured prominently in the deliberations of the committee, because of the linkages to the domestic economy. Whereas in the first few months of the year the global economy was characterised by progressively worse outcomes, by the May 2009 MPC meeting there were tentative signs that the global recession was bottoming out as financial market conditions had become less restrictive. During the subsequent months, there was greater optimism concerning the global outlook, but there were some doubts about the strength and the sustainability of the recovery. By September forecasts were generally being revised upwards, and the risks to the global growth prospects were generally assessed to be on the upside. There were, however, still concerns about the timing and extent of reversals of monetary and fiscal policy stimuli, which could retard the rate of recovery. The pace of recovery was also expected to be uneven across regions, with faster growth expected in emerging markets, particularly those in Asia. As a result of weak demand and lower commodity prices, global inflation pressures remained subdued and were not expected to place significant pressures on domestic inflation despite the generally loose monetary conditions.

The domestic recession and the associated widening of the domestic output gap resulted in downward pressure on domestic inflation. The output gap, which is calculated as the difference between actual and potential output growth, is an important determinant of inflation. While potential output is difficult to calculate with precision and may also have declined over the past months, the output gap nevertheless remains wide. By the time of the May meeting, the extent of the GDP growth contraction in the first quarter was apparent. GDP had contracted at a quarter-on-quarter annualised rate of 6,4 per cent, and capacity utilisation in the manufacturing sector had declined to 79 per cent in the same period. At that time it was expected that negative growth would persist into the second quarter, but the pace of contraction was expected to moderate. This was confirmed by the quarter-on-quarter decline of 3,0 per cent, published in August.

In September 2009 the committee indicated that the lower turning point of the cycle may have been reached, but that recovery in the short term would be relatively slow and tentative. The South African Reserve Bank's composite leading indicator indicated that the economy was likely to resume positive growth by the end of the year. This was consistent with other high-frequency indicators, including the Kagiso/BER Purchasing Managers' Index (PMI). By the October meeting, the three-month-on-three-month growth rates in manufacturing and mining had become positive, further reinforcing the positive growth outlook.

The subdued domestic expenditure was a persistent theme during the period under review, and there were no signs that the easier stance of monetary policy was likely to have imminent demand-led inflationary impacts. Wholesale and retail trade sales contracted during this period, as did overall household consumption expenditure. Expenditure on durable goods was particularly weak over the period. In October the MPC noted that real retail trade sales had declined at a year-on-year rate of 7,0 per cent in August, while in the three months to August there was a 1,0 per cent decline. However, there were some signs that the negative trend of motor vehicle sales may have reached its lower turning point in September 2009 with zero or slightly positive rates of change being recorded on a month-on-month and quarter-on-quarter basis.

Trends in domestic credit extension reflected the weak state of domestic consumption expenditure. The committee noted that supply-side developments may also have contributed to these pressures, with the generally tighter credit criteria applied by banks to both household and corporate sector borrowers. However, in October it was noted that the Ernst & Young Financial Services Index had indicated that credit standards applied by retail banks to loan applications continued to tighten in the third quarter of 2009, but at significantly lower levels.

Domestic expenditure was also constrained by negative wealth effects over the period. Although equity prices had recovered significantly since their lows in March, they were still significantly below the peaks reached in 2008. House prices also declined further over the period, but the various house price indices indicated that there appeared to be a moderation in the rate of decline in house prices. These factors, along with indications that consumers were attempting to reduce their overall debt and repair impaired balance sheets, were seen to be a constraint on consumption expenditure in the near term.

In the early stages of the global financial crisis, the rand exchange rate had depreciated significantly, and the exchange rate was seen as one of the main upside risk factors to inflation. However, during the period under review, as global risk aversion subsided and commodity prices recovered somewhat, the rand appreciated along with a number of emerging-market and commodity-producing currencies. The exchange rate, while still relatively volatile, strengthened significantly and by October had appreciated since the beginning of the year by about 20 per cent on a trade-weighted basis. The committee recognised the vulnerability of the rand to changes in sentiment or risk aversion, and felt that the risk to inflation from this source had declined over the period.

The risks posed to the inflation outlook by a number of other variables were also perceived to have moderated somewhat. For most of 2008 and the early part of 2009, food prices had posed an upside risk to the inflation outlook. Although food prices at the producer price level had been moderating for some time, this was not initially reflected at the consumer price level. At the May meeting the committee noted that although manufactured food price inflation had declined to 8,4 per cent in April and agricultural price inflation to 2,2 per cent, the moderation at the consumer price level was stubbornly slow. At that time consumer food price inflation measured almost 18 per cent. Since then the rate of deceleration of consumer food price inflation has increased and by

September it had declined to 4,9 per cent; below the average headline inflation rate of 6,1 per cent. Inflation at the producer price level continued to indicate that this favourable trend was likely to continue.

International oil prices had been one of the main upside risk factors for the first part of 2008, but this changed later in the year when the oil price declined to a low of around US$35 per barrel in the wake of the global downturn. Since then oil prices have doubled, as global prospects improved and the US dollar depreciated, but are still well below the peaks reached in 2008. However, the impact on domestic petrol prices was relatively modest as the higher international oil prices were largely offset by the appreciation of the rand exchange rate. Since May 2009 the domestic petrol price had increased by about 30 cents per litre.

While demand pressures remained benign, the committee consistently identified cost-push pressures as being the main threat to the inflation outlook. Of particular concern were wage settlements and administered price increases. During the period, nominal wage increases were generally in excess of inflation. However, by October 2009 the committee noted that there was evidence that nominal wage increases had been moderating. The substantial electricity tariff increases requested by Eskom were seen as the main longer-term threat to the inflation outlook. The request by Eskom for a trebling of current electricity tariffs over the next three years will be decided upon by the National Energy Regulator of South Africa (NERSA) in February 2010.

During this period the MPC continued to implement monetary policy within a flexible inflation-targeting framework. While focusing on bringing inflation down to within the target range over a reasonable time frame, the committee remained sensitive to cyclical growth considerations. At the MPC meeting in May the risks to the inflation outlook were still seen to be on the downside and the committee decided to reduce the repurchase rate by 100 basis points. The view of the committee was that the widening output gap contributed to an improved inflation outlook despite the relatively slow pace of disinflation. The committee's assessment of the downside risks was such that the additional reduction in the repurchase rate would provide a stimulus to the economy without creating significant additional inflationary pressures. At the subsequent meeting, in June 2009, the repurchase rate was kept unchanged. The committee was cognisant of the fact that there had been significant monetary accommodation since December 2008, and felt it prudent to pause and assess the impact of previous interest rate reductions.

By August 2009 the MPC had decided that the balance of risks to the inflation outlook had tilted to the downside again as a result of the continued adverse output and expenditure trends, along with favourable exchange rate and food price developments. Accordingly, the committee decided to reduce the repurchase rate by a further 50 basis points, bringing the cumulative decrease since December 2008 to 500 basis points.

At the subsequent meetings in September and October 2009 the risks to the outlook were seen to be more balanced than before, particularly in the light of positive indications that the economy was likely to emerge from the recession later in the year. At the same time, the Eskom request for further electricity tariff increases imparted additional upside risk to the outlook. This rebalancing of the perceived risks prompted an unchanged monetary policy stance. At the November 2009 meeting the risks were assessed as having remained more or less unchanged and so the repurchase rate was kept unchanged at 7 per cent per annum.

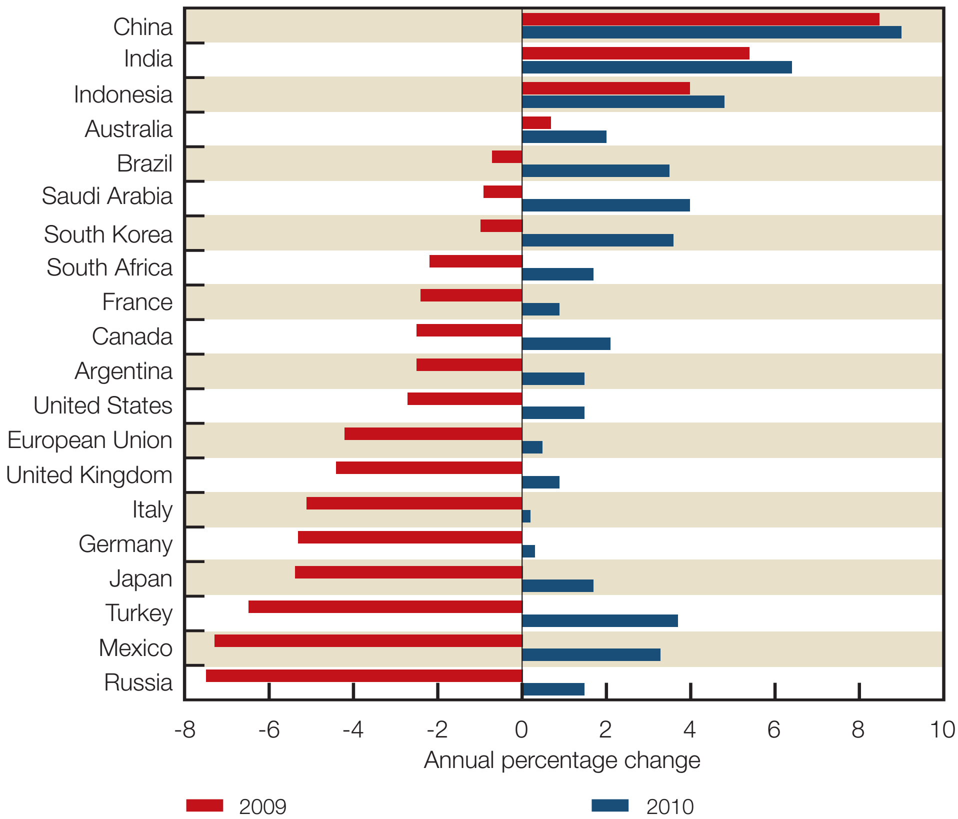
The outlook for inflation

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

International outlook

Recent data suggest that aggressive policy action by central banks and governments in a large number of countries has provided the impetus for the global economy to bottom out and regain traction. The huge policy responses by various governments have enabled an incipient economic recovery, restored confidence, and allayed fears of global financial collapse and deflation. The latest projections for growth in the G-20 countries, published in the IMF's October 2009 *World Economic Outlook* and incorporated in Figure 15, show a marked turnaround in the forecasts for 2010 relative to the growth rates achieved in 2009.

Figure 15 IMF forecasts for real GDP: G-20 countries



Sources: IMF *World Economic Outlook* database, October 2009

A similar reversal is foreseen for the global economy. After contracting by about 1,1 per cent in 2009, world growth is projected by the IMF to reaccelerate to 3,1 per cent in 2010 (Table 10). This is comfortably above recent growth rates, but still well below the rates achieved before the crisis. According to the latest projections, inflation in advanced economies is expected to ease to 0,1 per cent in 2009 due to the contraction of global economic activity, before accelerating to 1,1 per cent in 2010. Owing to moderation in energy and food prices, annual consumer price inflation continued to decelerate in emerging markets as a group during 2009. Inflation in emerging-market and developing economies is projected to decelerate further from 5,5 per cent in 2009 to 4,9 per cent in 2010. Despite upward pressure from recovering commodity prices, global inflation is expected to remain subdued through 2010, held back by significant excess capacity. Risks for sustained deflation appear small, as core inflation and inflation expectations in most major economies are still holding in the 1 to 2 per cent range.

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

Per cent

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

* IMF projections for 2009 as at April 2009 in parenthesis
** Zimbabwe excluded

Source: IMF *World Economic Outlook*, October 2009

The US economy appears to be stabilising after contracting for four consecutive quarters. It expanded at a higher-than-expected 3,5 per cent seasonally adjusted and annualised rate in the third quarter of 2009 thanks to a recovery in consumer spending. Financial markets have shown signs of improvement, and interbank lending has largely returned to normal. Companies appear to be done with their cost cutting and this could have laid the groundwork for economic growth in the third quarter of 2009. The US$787 billion stimulus bill was also expected to have given GDP a boost in the third quarter. High-frequency indicators point to a diminishing rate of deterioration, and industrial production may be close to bottoming out; the inventory cycle is turning; and business and consumer confidence has improved. These developments are consistent with stabilisation of output during the second half of 2009 and with a gradual recovery emerging in 2010.

Japan's economy emerged from recession by improving significantly in the second quarter of 2009, after a second significant double-digit rate of decline in GDP in the first quarter of the year. Japan's US$275 billion stimulus package was largely credited with the rebound. The plan included massive public works projects, a "cash-for-clunkers" programme to promote the replacement of old vehicles with new ones, and sending consumers cheques amounting to about US$130 each. These initiatives helped drive consumer spending up, but analysts have been cautious about labelling Japan's economic turnaround as a true recovery, as businesses cut inventories very low in prior quarters. The increasing rate of deflation, unemployment rising to a record high in September and jobless rates that are projected to rise above the 6 per cent level in 2010 are growing sources of concern. Another concern is that Japan's fiscal stimulus has grown the debt-to-GDP ratio to an all-time-high of 200 per cent.

Consumer and business survey indicators have been recovering in the euro area, but data on real activity show few signs of stabilisation and thus activity is projected to strengthen more slowly than elsewhere. Macroeconomic policies are providing support, but much adjustment in the labour market still needs to be done. Rising unemployment will weigh on consumption and activity, as will the region's heavy dependence on the banking sector. However, the two largest economies in the euro area recorded positive growth in the second quarter of 2009. Germany rebounded from four straight quarters of decline to grow at an annualised pace of 1,3 per cent in the second quarter of 2009. A US$120 billion stimulus package, a US$25,9 billion business lending programme and extensions of government-subsidised labour contracts helped Germany to emerge from the recession. Business confidence in Germany rose to a one-year high, and consumer confidence is at a 15-month high. France's US$37 billion economic stimulus programme helped bring the French economy back to positive growth in the second quarter of 2009 for the first time in more than a year. However, the fiscal deficit is forecast to rise to between 7 per cent and 7,5 per cent of GDP in 2010, which is more than double the 3 per cent limit set by the European Union.

The OECD expects the UK's real GDP to fall by 4,7 per cent in 2009, having previously forecast it would shrink by 4,3 per cent. The UK is the only major economy for which the OECD has forecast a larger contraction than previously, although the country has shown signs that it is beginning to recover. In August the services sector grew at the fastest pace in almost two years, while factory output has begun to rebound after significant declines throughout the downturn. The latest business and consumer confidence surveys show a slight improvement, and the UK government announced plans to continue the nation's stimulus efforts at least through next year.

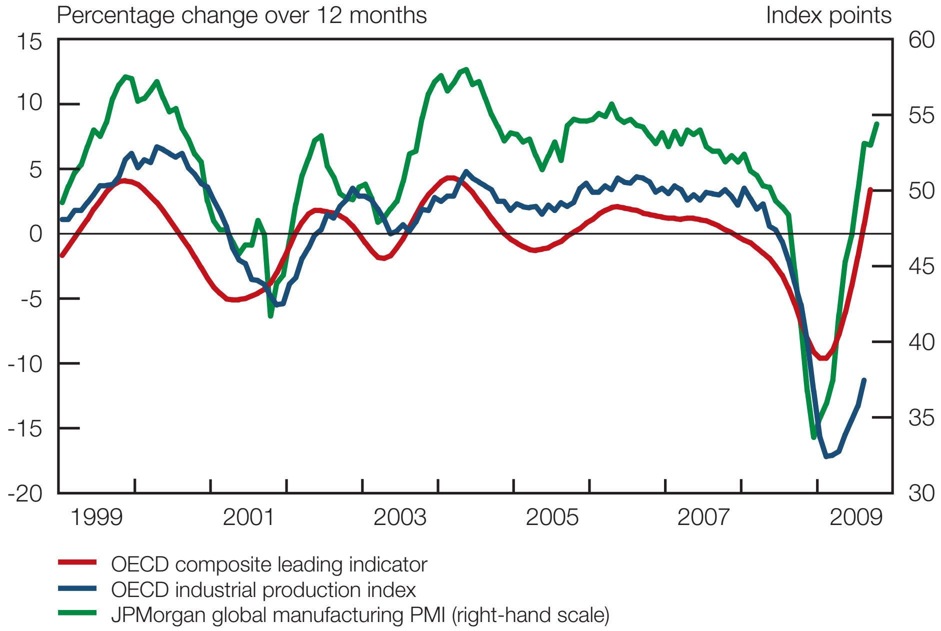
Many developing countries posted growth in their GDP during the second quarter of 2009, benefiting from China's strength, as well as unprecedented global stimulus and following a sharp decline in economic activity in the first quarter of 2009. Estimates for many developing economies were revised upwards by the IMF and the positive feedback loop, launched by government stimulus, is expected to continue.

China has weathered the global downturn better than any other G-20 nation and the Chinese economy has responded to reflationary measures. China's GDP rebounded well in the second quarter of 2009 as the economy was aided by a US$586 billion stimulus package, increased bank lending and government support for exports. According to a recent report from the Asian Development Bank, China's state-controlled banking system lent US$1,2 trillion more to Chinese businesses and consumers in the first seven months of 2009 than during the same period a year ago. As a result, factory output, construction and auto sales grew rapidly in the second quarter. Although the global downturn resulted in a slowdown in China's GDP growth to an annualised rate of 6,5 per cent in the first half of 2009, the IMF has forecasted real growth of 8,5 per cent for 2009 and 9 per cent for 2010.

The IMF expects African economies to recover fairly quickly once the global economy gains momentum. Debt levels in most countries on the continent are not a source of concern, and fiscal and monetary policies are expected to remain supportive of recovery in these countries. Both China and India have sharply increased trade with, and investments in, Africa, which could further aid the region's recovery. The strength of the recovery would, nevertheless, be determined by the extent of the rebound in global trade, favourable commodity prices and a pick-up in worker remittances.

Improving signs of recovery in a number of OECD countries resulted in the composite leading indicator compiled by the OECD recording year-on-year increases of 0,7 per cent in August and 3,4 per cent in September 2009 (Figure 16). These are the first positive changes since November 2007. The JPMorgan Global Manufacturing PMI remained above the neutral level of 50 for a third consecutive month in October 2009 at 54,4 after a reading of 53 was recorded in September. The year-on-year rate of decline in the OECD industrial production index decelerated to 11,3 per cent in August 2009.

Figure 16 Selected indicators of global economic activity



Sources: OECD and JPMorgan

Among leading advanced economies, only the UK, Italy, and Canada were still in recession in the third quarter of 2009. The outlook for emerging economies is even brighter, but some parts of the developing world are still experiencing difficult conditions – notably parts of central and eastern Europe and Africa. The re-emergence of relatively strong growth in parts of Asia and Latin America means that these regions are leading the West out of recession. At the G-20 Summit in the US held in September 2009 steps were announced to help the global economy transition to sustained growth and G-20 leaders gave the assurance that policy stimulus would continue until a durable recovery is secured. However, the first tentative signs are emerging that some central banks are scaling back their supportive policies and that the risks to growth are more balanced.

Outlook for domestic demand and supply

Although real GDP growth has been negative in the past three quarters, there is a general expectation among economists surveyed by Reuters in October that growth in South Africa will improve moderately in the fourth quarter of 2009 and continue on a positive trajectory in 2010 and 2011. With the exception of July, the Bank's composite leading indicator (discussed in Box 3) has increased each month since April 2009, pointing to a probable recovery in economic conditions towards the end of 2009. In August 2009 components such as average hours worked per factory worker in manufacturing, the volume of domestic orders in manufacturing and the annual percentage change in the number of new passenger vehicles sold have shown improvements. In addition, commodity price and share price indices, as well as leading trading-partner indicators, all point to economic recovery and an improved export climate.

According to the latest Reuters consensus forecasts surveyed in October 2009, the South African economy is expected to contract by 1,91 per cent in 2009, with the fourth quarter of the year expected to show an annual increase of 1,94 per cent, followed by positive growth of 2,83 and 2,91 per cent in the first and second quarters of 2010. Growth in 2010 is expected to recover to 2,33 per cent and to 3,50 per cent in 2011. In its October 2009 *Forecast of Key Economic Variables*, the BER projected a calendar year real economic growth rate of -1,7 per cent in 2009 and 2,7 per cent in 2010, followed by 3,7 per cent in 2011. According to the *MTBPS* released on 27 October 2009, real GDP is expected to contract by 1,9 per cent in 2009. However, the growth rate is projected to be 1,5 per cent in 2010 and 2,7 per cent in 2011.

Box 3 The composite leading business cycle indicator

In monitoring the South African economy, the Bank regularly compiles and continuously analyses three composite business cycle indicators – leading, coincident and lagging. The composite leading business cycle indicator is a key indicator of the domestic economic outlook presented in this *Monetary Policy Review* and this box briefly discusses the compilation and characteristics of the composite leading business cycle indicator.

The Bank first published composite business cycle indicators in 1983. Composite business cycle indicators are compiled by integrating various economic indicators into a single index. Various factors, such as structural changes in the economy or the identification of new economic indicators, necessitate the frequent reassessment of the constituent time series of the composite business cycle indicators. For this reason the composite leading business cycle indicator was last revised for in 2007. With every revision, a range of economic indicators is evaluated for possible inclusion and all the time series are subjected to an appraisal system that rates business cycle indicators according to the

- economic significance of the process represented by the indicator;
- statistical adequacy of the data;
- historical conformity to, and timing relationship with, the business cycle;
- smoothness of the time series; and
- timeliness of the data.

The composite leading business cycle indicator currently comprises 12 economic indicators, which have historically preceded turning points in the business cycle (Table B3.1).

The Bank determines the official reference turning points in South Africa's business cycle in terms of the growth cycle definition of business cycles and, according to this methodology, the most recently identified peak in the business cycle occurred in November 2007. Therefore, the Bank's business cycle chronology, published regularly in its *Quarterly Bulletin*, represents reference turning-point dates that distinguish between upward phases when the pace of growth in aggregate economic activity exceeds its long-term growth trend, and downward phases when aggregate economic activity either contracts or increases at a slower rate than its long-term growth trend.

Table B3.1 Component series of the composite leading business cycle indicator and their contribution to the August 2009 data point

Component series	Contribution
BER: Average hours worked per factory worker in manufacturing (half weight)	Positive
Job advertisements: The *Sunday Times* (percentage change over 12 months)	Negative
BER: Volume of orders in manufacturing (half weight)	Positive
BER: Business confidence index	Negative
Number of building plans approved: Flats, townhouses and houses larger than 80 m^2	Positive
Number of new passenger vehicles sold (percentage change over 12 months)	Positive
Gross operating surplus as a percentage of GDP	N/A
Interest rate spread: 10-year government bonds minus 91-day Treasury bills	Negative
Index of prices of all classes of shares traded on the JSE	Positive
Real M1 (six-month smoothed growth rate)	Negative
Commodity price index for South Africa's main export commodities (US dollar based)	Positive
Composite leading business cycle indicator of South Africa's major trading-partner countries (percentage change over 12 months)*	Positive

* The international business cycle indicator comprises the composite leading business cycle indicators of eight of South Africa's main trading-partner countries, weighted according to the value of South Africa's exports to each country

Periodic revisions of the composite leading business cycle indicator have ensured that this indicator remains as reliable as possible in predicting movements in the business cycle. The leading business cycle indicator exhibits a lead time of about 10 months, on average, on business cycle turning points. The timing relationship of the composite leading business cycle indicator is shown in Table B3.2 along with the reference turning points of the business cycle for the period since August 1981.

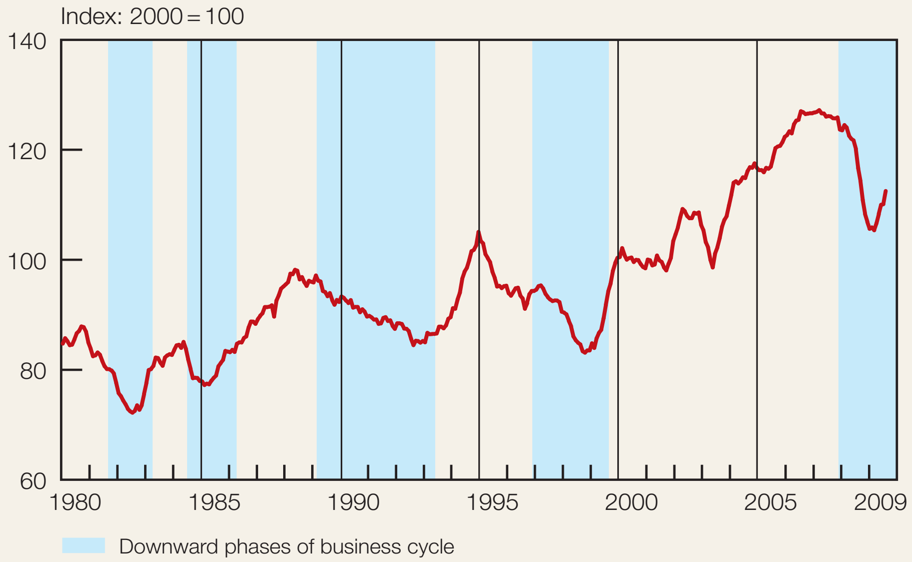
Table B3.2 Timing relationship between the composite leading indicator and the reference turning points of the business cycle*

Reference turning points		Timing relationship in months	
Peak	Trough	Peak	Trough
August 1981		-11	
	March 1983		-8
June 1984		-1	
	March 1986		-13
February 1989		-9	
	May 1993		-9
November 1996		-23	
	August 1999		-10
November 2007		-8	
Average:		-10½	-10
Median:		-9	-9½

* The minus sign means that this indicator leads the reference turning point

As is the case in other countries, there is a fairly large dispersion in the number of months by which the leading indicator leads the reference turning points of various cycles. Although the composite leading and other business cycle indicators provide invaluable information in this regard, a reference turning point in the business cycle can only be determined accurately ex post. Various other macroeconomic indicators, together with significant economic events and developments occurring near a turning point, are subjected to comprehensive analysis to identify the reference turning point accurately. Figure B3.1 shows the composite leading business cycle indicator over the officially identified cycle from 1980.

Figure B3.1 Composite leading business cycle indicator



The recent relatively consistent upward trend in the composite leading business cycle indicator provides significant evidence that a reference trough in the business cycle should arrive towards the end of 2009 or early 2010. The declining trend in the leading indicator that has persisted since April 2007 appears to have been reversed. The composite leading indicator increased significantly in August 2009, the fifth consecutive increase in the indicator since it reached a most recent low in March 2009. Seven of the eleven component time series that were available for August 2009 increased, while four decreased (Table B3.1).

Countercyclical monetary and fiscal policy measures have paved the way for the domestic economic recovery, but the ultimate outcome will depend in large measure on the sustainability of the global recovery that is currently under way. South Africa's business cycle has a relatively low contemporaneous concordance with certain trading-partner growth cycles. However, given the synchronised nature of the current global recession, the resumption of sustainable growth in the domestic economy will be largely determined by a return to sustained global growth and the associated strong rebound in global trade and commodity prices. Encouragingly, the International Monetary Fund (IMF) has forecast a reacceleration of global growth to 3,1 per cent in 2010 in the October 2009 *World Economic Outlook*.

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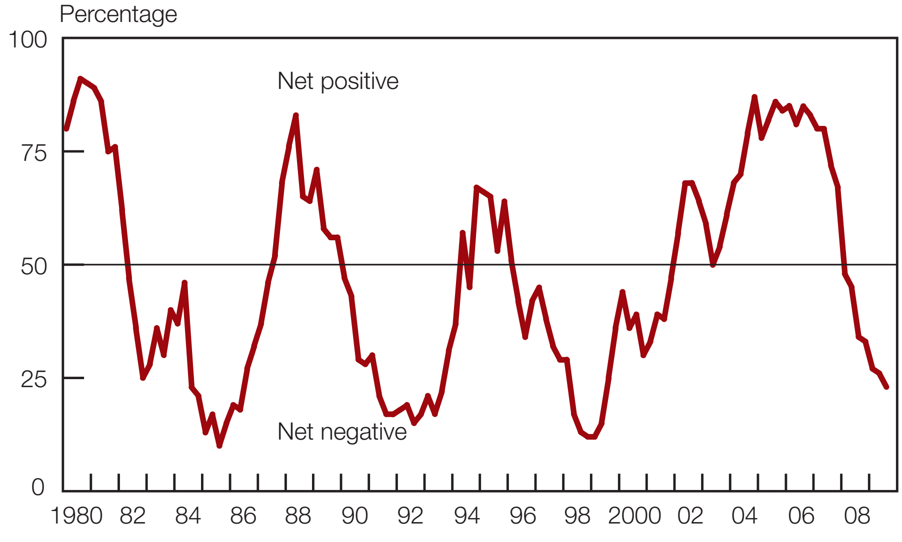
As far as the quarterly analysis of manufacturing activity is concerned, the third quarter 2009 BER survey revealed that the net majority of respondents rating current business conditions worse than those of a year ago decreased from 70 per cent to 53 per cent, with 20 per cent of respondents expecting business conditions to improve in 12 months' time. On the supply side, the pace of contraction in production volumes is slowing, while fixed investment is expected to increase in a year's time. On the demand side, net majorities reporting lower sales and order volumes declined from 51 per cent to 47 per cent.

The seasonally adjusted Kagiso PMI, a barometer of domestic manufacturing activity, increased from 45,9 index points in September to 47,6 index points in October 2009. The October results showed continued signs of increased activity in the domestic manufacturing sector, even though the index has not yet reached the break-even level of 50. Both the business activity and the forward-looking new sales orders indices increased, reaching 48,4 and 48,9 index points respectively. After rising uninteruptedly for seven months, the index for expected business conditions declined slightly from 70,3 points in September to 67,9 index points in October. The backlog of sales orders index increased from 34,4 to 41,6 points, while that of purchasing commitments rose from 44,3 to 50,0 points. The inventories index decreased moderately to 42,9 in October from 45,5 points in September 2009.

The level of business confidence, measured in terms of the Rand Merchant Bank (RMB)/BER Business Confidence Index, declined to its lowest level in a decade, registering 23 index points in the third quarter of 2009, which was preceded by 26 points in the second quarter of 2009 (Figure 17). 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 due to declines in all but one of the retail subsectors, with overall confidence decreasing from 47 to 35 index points. On the positive side, business confidence accretion in new vehicle trade occurred for three consecutive quarters, climbing from 12 index points in the second quarter to 19 in the third quarter of 2009. By contrast, confidence among wholesalers dropped to 17 points in the third quarter, down from 36 index points in the second quarter of 2009. Although still low, manufacturers' confidence rose from 11 to 22 index points due to improvements in both domestic and foreign sales volumes. Building contractor confidence changed slightly, registering 24 index points in the third quarter, up from 23 in the second quarter.

Figure 17 RMB/BER Business Confidence Index



Sources: Rand Merchant Bank and Bureau for Economic Research

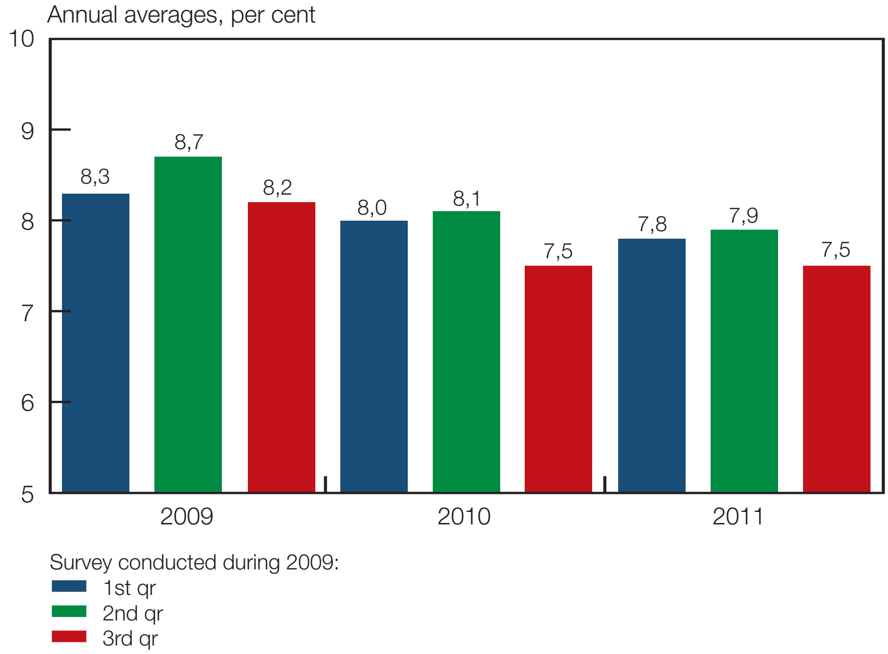
The FNB Building Confidence Index, which measures the business confidence of all the major role players and suppliers involved in the building industry, rose marginally from an index value of 30 in the second quarter to 32 in the third quarter of 2009. Three out of six sub-components of the index registered increases. Improvements in confidence levels were recorded among building contractors (+1), manufacturers (+23) and retailers of building materials (+13). Declines occurred in the case of architects (-7), quantity surveyors (-4) and building sub-contractors (-15). However, survey respondents do not expect business conditions to deteriorate significantly in the fourth quarter of 2009.

During the third quarter of 2009 all consumer confidence sub-indices of the the FNB/BER Consumer Confidence Index deteriorated. The economic performance sub-component saw the largest decline, with the index falling by 6 index points to +11 during the same quarter. The net percentage of consumers expecting their own finances to improve declined by two index points, from +17 to +15 during the third quarter of 2009, while the net percentage of consumers rating the present as an appropriate time to buy durable goods declined by two index points, from -21 to -23.

Indicators of inflation expectations

Estimates of inflation expectations for the forecast period from 2009 to 2011 obtained from the BER survey conducted during the third quarter of 2009 show that average annual CPI inflation is expected to decline over the forecast years, although it is expected to remain above the upper limit of the CPI inflation target range. Inflation expectations in the third quarter are lower at all horizons than those surveyed in the preceding quarter. As depicted in Figure 18, the average CPI inflation expectation for 2009 is 8,2 per cent, and 7,5 per cent for 2010 and 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 at least 2,2 percentage points.

Figure 18 BER surveys of headline CPI inflation expectations



Source: Bureau for Economic Research, Stellenbosch University

The October 2009 Reuters 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 second quarter of 2010 and is expected to stay within the target range until the end of the forecast period in 2011 (Table 11). It is expected that CPI inflation will average 7,2 per cent in 2009, decline to 5,8 per cent in 2010, and record 5,9 per cent in 2011.

Table 11 Reuters survey of CPI forecasts: October 2009*

Per cent

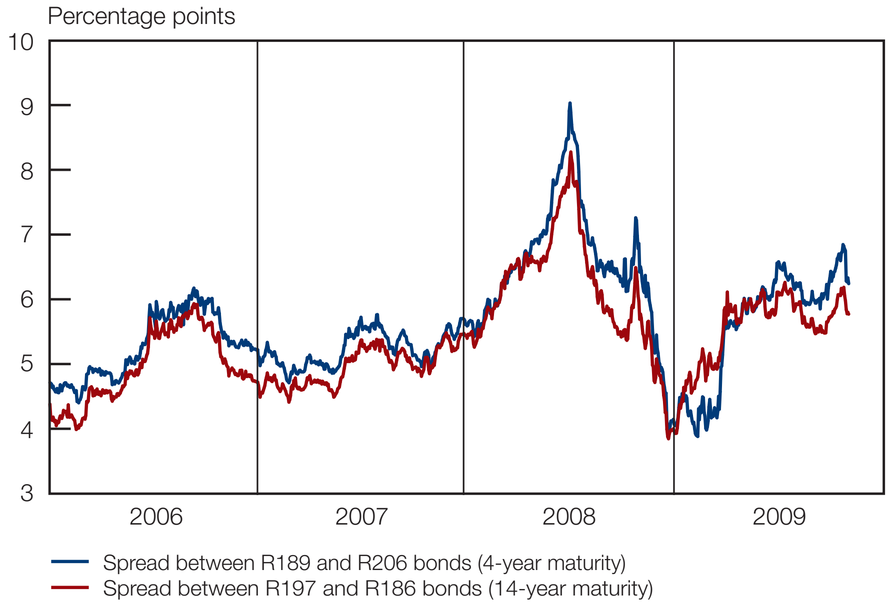
	2009		2010		2011	
1. Mean	(7,2)	7,2	(5,7)	5,8	(5,6)	5,9
2. Median	(7,2)	7,2	(5,8)	5,8	(5,5)	5,7
3. Highest	(7,4)	7,3	(6,4)	7,5	(6,6)	7,0
4. Lowest	(7,0)	7,0	(4,5)	4,8	(4,6)	4,6
Number of forecasters	(20)	19	(20)	19	(17)	17

* September 2009 survey results in parentheses

Source: Reuters

Inflation expectations as 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, initially trended somewhat higher from the middle of April 2009 to mid-July, rising to levels just exceeding the upper limit of the inflation target range. The upward momentum was mainly the result of rising yields on conventional bonds. Subsequently, break-even inflation over the different maturities consolidated at lower levels as inflation prospects improved. On 4 November 2009 break-even inflation in the four-year maturity range stood at 6,24 per cent, while that over 14 years indicated expectations of 5,77 per cent. The slight widening of the gap between short- and longer-term break-even inflation rates suggests that market participants have slightly better inflation expectations over the long term than over the short term.

Figure 19 Break-even inflation rates



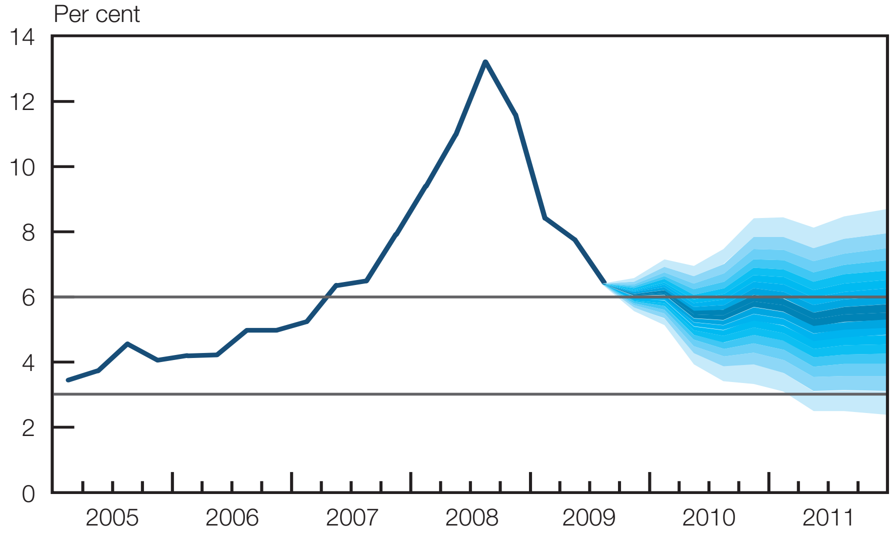
The South African Reserve Bank inflation forecast

The most recent projections of the Bank's quarterly inflation forecasting model, presented to the MPC meeting on 16 and 17 November 2009, are reproduced in the form of a fan chart in Figure 20. According to these projections, the targeted inflation rate is expected to continue to trend downwards, moving below the upper level of the inflation target range in the second quarter of 2010 and remaining within the target range for the remainder of the forecast period.

The central projection, conditional on an unchanged repurchase rate, is for the average quarterly CPI inflation rate to decelerate further to 6,1 per cent in the fourth quarter of 2009, then increase marginally in the first quarter of 2010, before moving below the upper level of the inflation target range in the second quarter of 2010. It is then expected to remain within the inflation target range, fluctuating between 5,3 per cent and 5,9 per cent, until the end of the forecast period in the fourth quarter of 2011. The projections for 2010 and 2011 are slightly higher than those presented to the previous MPC meeting in October 2009.

Movements in oil prices, commodity prices, electricity prices and the exchange rate of the rand that differ from those assumed in the model will impact on the central projection, with alternative scenarios for movements in these variables generating more optimistic or pessimistic outcomes for targeted inflation. The forecast makes provision for electricity price increases of 25 per cent per annum for the next two years, which is below the 45 per cent per annum proposed by Eskom. On balance, there is deemed to be a neutral risk to the forecast of targeted inflation in Figure 20.

Figure 20 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 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).*

Assessment and conclusion

There are positive signs that the worst of the global recession may be over. A number of industrialised economies have experienced positive growth in the third quarter of 2009, while growth in some emerging market economies has been robust. The recovery is not expected to be smooth and even across countries and regions, and a number of risks and concerns persist. While the global downturn was deep, the duration was probably shorter than initially feared at the height of the financial crisis. Part of the reason was the decisive intervention undertaken by governments in the form of significant monetary and fiscal stimuli. However, these actions will have to be reversed at some point, and the nature and timing of these exit strategies could impact on the speed and extent of the recovery. There are also concerns that while global financial markets have become less restrictive, it is not clear that the financial markets and banking systems, particularly in the industrialised countries, have dealt fully with the toxic assets that were at the root of the crisis. Furthermore, the global recovery will be dependent to a certain extent on the recovery of consumption expenditure in the advanced economies. The housing market in the US is still under pressure, and this may constrain consumption expenditure as households attempt to rebuild their impaired balance sheets.

The recovery in the South African economy appears to be lagging that of the global economy. Nevertheless, there are convincing signs that the low point of the current growth cycle has been reached and that positive growth will resume by the fourth quarter of this year. The global recovery has already been reflected in an improved export performance in the past months. However, the domestic recovery is expected to be hesitant, driven by the inventory cycle and fixed investment projects. Consumption expenditure is expected to take a while longer to recover.

The global inflation environment remains benign. The relatively wide output gaps and lower commodity prices have contributed to this outcome. Domestic inflation has also responded to the weak demand conditions, and the inflation rate has reached a level marginally above the inflation target range. This has allowed for a significant 500 basis point reduction in the repurchase rate since December 2008. By adopting a forward-looking flexible approach, the MPC was able to provide some stimulus to the slowing economy, while maintaining the focus on its price stability objective. Even though some risks to the inflation outlook remain, the current monetary policy stance is deemed adequate to moderate inflation further to within the target range, while simultaneously allowing for the resumption of a positive growth trajectory.

Statement of the Monetary Policy Committee

28 May 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 downturn continues to have a negative impact on the domestic economy, which experienced two consecutive quarters of contraction. The significant widening of the domestic output gap has added further downside risk to the inflation outlook. The downward trend in inflation is expected to continue, despite inflation being subject to some inertia in the near term.

Domestic economic developments will be influenced to a large degree by the pace and magnitude of the recovery in the global economy. There are tentative signs that the global economy may have seen the worst of the downturn, but the recovery is expected to be slow and protracted.

Recent developments in inflation

The year-on-year inflation rate as measured by the consumer price index (CPI) for all urban areas declined from 8,5 per cent in March 2009 to 8,4 per cent in April. The prices of food and non-alcoholic beverages, which increased at a year-on-year rate of 13,7 per cent, contributed 2,1 percentage points to the inflation outcome. Housing and utilities contributed 1,8 percentage points. This category includes electricity and other fuels, which increased by 29,4 per cent. Petrol prices declined by 17,5 per cent, while public transport prices increased by 15,1 per cent.

The producer price index continued its downward trend in April when it increased at a year-on-year rate of 2,9 per cent. Food price pressures moderated further with manufactured food price inflation declining to 8,4 per cent, compared with 9,4 per cent in March. Prices of agricultural products increased by 2,2 per cent.

The outlook for inflation

The most recent CPI inflation forecast of the Bank shows a relatively unchanged outcome for the near-term as compared with that presented to the previous meeting of the Monetary Policy Committee. Over the longer term, there appears to be a moderate improvement. This forecast is similar to the Reuters consensus forecast of private analysts who expect inflation to average 6,9 per cent and 5,7 per cent in 2009 and 2010 respectively.

The main upside risk to the inflation outlook comes from cost-push pressures, in particular from electricity price increases. Eskom has applied to the National Energy Regulator of South Africa (NERSA) for a 34 per cent interim increase in electricity tariffs, but there is still uncertainty about the final adjustment. A number of municipalities have already budgeted for significant electricity price increases in anticipation of higher Eskom tariffs.

In line with the less-negative global outlook, there has been a moderate recovery in international oil prices. North Sea Brent crude oil has been trading at prices of around US$60 per barrel during the past days, compared with an average of around US$50 per barrel during April. These developments may result in a moderate increase in the domestic petrol price in June. The impact of the higher international prices on domestic petrol prices has been partly offset by exchange rate movements during the month.

Food price inflation remains well above average inflation, and has been lagging the favourable developments at the producer price level and in the spot prices of agricultural commodities. Food price inflation measured 17,9 per cent in August 2008 and has been moderating persistently, but slowly, since then.

In the first quarter of 2009 gross domestic product (GDP) contracted at a quarter-on-quarter annualised rate of 6,4 per cent, with mining and quarrying declining by 32,8 per cent. The manufacturing sector, which contracted at an annualised rate of 22,1 per cent, was the largest contributor to the negative GDP outcome. The weak manufacturing performance was also reflected in the utilisation of production capacity in the manufacturing sector, which declined from 82 per cent in the fourth quarter of 2008 to 79 per cent in the first quarter of 2009.

The GDP contraction was broad based, with general government services, personal services and construction being the only sectors that exhibited positive growth. Civil construction is expected to remain strong as the infrastructure programme proceeds. However, other parts of construction are expected to remain under pressure as the value of new building plans passed for both residential and non-residential construction declined by 13,4 per cent in the first quarter of this year compared with the preceding quarter.

Recent high-frequency indicators suggest that the negative trend in GDP growth is likely to continue during the second quarter of 2009, although at a more moderate pace of contraction. Most analysts expect positive, but relatively low, growth in the final half of this year. The composite leading and coincident business cycle indicators of the South African Reserve Bank (the Bank) indicate continued weakness in the economy in 2009. In March 2009 the leading indicator declined by 15,1 per cent; the largest year-on-year decline on record. The composite indicator declined at a year-on-year rate of 9,4 per cent in February. The Investec Purchasing Managers Index (PMI) declined further to 35,6 index points in April. However, expectations of business conditions six months ahead showed some improvement.

Domestic demand conditions remain subdued. Real wholesale trade sales declined by 5,9 per cent on a year-on-year basis in March 2009 and by 1,8 per cent on a month-on-month basis. Real retail sales recorded a 5,3 per cent year-on-year decline and a 1,9 per cent month-on-month decline in March. Total new vehicle sales declined at a year-on-year rate of 44 per cent in April, with commercial vehicle sales declining by 51 per cent. Vehicle exports were 31 per cent lower in April compared with the previous month.

Household consumption expenditure is expected to remain constrained by negative wealth effects and tight credit conditions. The various house price indices show that house prices have been falling in recent months. Although the All-Share Index on the JSE Limited has recovered somewhat since its recent lows, it is still significantly lower than the levels prevailing during 2008. Domestic credit extension continues to reflect the lower demand for credit, as well as the wider spreads and 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 6,6 per cent in April. The rate of growth of instalment sale credit and leasing finance declined by 0,1 per cent, reflecting the weak demand for durable goods. Extension of bank overdrafts contracted by 6,8 per cent, while credit card advances increased marginally.

There are tentative signs that the downturn in the global economy may be bottoming out as financial market conditions appear to have become less restrictive. However, there are as yet few convincing indications that the recovery will be quick. At this stage it appears that a protracted period of slow, below-potential growth is most likely, with most analysts predicting some recovery later this year or early next year. Global inflation pressures remain subdued and have declined in a number of economies.

Since the beginning of the year the rand has appreciated by around 13 per cent on a trade-weighted basis. While the rand, along with other currencies, remains vulnerable to further possible bouts of risk aversion, the risk to the inflation outlook has been reduced by the relative strength of the rand.

Monetary policy stance

The evidence that was presented to the MPC suggests that the output gap has widened further. This is expected to contribute to an improved inflation outlook, notwithstanding some current inflation inertia. Accordingly, the MPC has decided to reduce the repurchase rate by 100 basis points to 7,5 per cent per annum with effect from 29 May 2009.

Statement of the Monetary Policy Committee

25 June 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 domestic economy continues to show signs of stress in the wake of the global economic downturn. Output growth remains negative, while trends in household consumption expenditure have continued to deteriorate. There are, however, signs that the downturn, both globally and domestically, may be nearing the lower turning point, but the recovery is expected to be slow and protracted.

The inflation rate has continued its downward trend, which has been constrained by relatively sticky services price inflation. While the widening output gap and weak domestic demand pose a downside risk to the inflation outlook, these risks are increasingly being offset by various cost-push and exogenous factors that are impacting on the economy, as well as by deteriorating inflation expectations.

Recent developments in inflation

The year-on-year inflation rate as measured by the consumer price index (CPI) for all urban areas declined from 8,4 per cent in April 2009 to 8,0 per cent in May. Food price inflation declined from 13,6 per cent in April to 12,1 per cent in May, but remains the main contributor to the inflation outcome, having contributed 1,9 percentage points. Housing and utilities inflation contributed 1,8 percentage points, mainly as a result of the 29,6 per cent increase in electricity prices and the 15,1 per cent increase in the cost of maintenance and repairs. Services price inflation has remained unchanged at 8,4 per cent since March 2009, while goods price inflation declined from 8,7 per cent to 7,6 per cent over the same period.

Producer prices declined at a year-on-year rate of 3 per cent in May 2009. Nonetheless, agricultural product prices increased at a year-on-year rate of 1,5 per cent, while manufactured food product prices increased by 6,2 per cent.

The outlook for inflation

The most recent CPI inflation forecast by the staff of the South African Reserve Bank (the Bank) shows that CPI inflation is still expected to continue its moderate downward trend, to enter the target range during the second quarter of 2010, and to remain within the target range for the rest of the forecast period ending 2011. A more favourable exchange rate assumption has been offset by higher-than-expected petrol price increases and inflation outcomes.

CPI inflation expectations, as measured by the Bureau for Economic Research (BER) at Stellenbosch University deteriorated during the second quarter of 2009. Average inflation expectations for 2009 increased from 8,3 per cent in the first quarter to 8,7 per cent in the second quarter, mainly as a result of upward revisions by financial analysts. While a downward trend for the subsequent two years remains, only the financial analysts predict inflation to be within the inflation target range in the coming two years. Overall, CPI inflation is expected to average 8,1 per cent and 7,9 per cent in 2010 and 2011 respectively.

Inflation expectations, as measured by the yield differential between conventional and inflation-linked bonds, also showed a moderate increase over the past weeks. However, the break-even rate has generally remained within the inflation target range over the short- to medium-term maturities.

The growth prospects for the economy remain a downside risk to the inflation outlook. The output gap, which is the difference between actual and potential output growth, has widened over the past few quarters. Following the 6,4 per cent contraction of gross domestic product (GDP) in the first quarter of 2009, the most recent high frequency data and indicators suggest that the negative trend in GDP growth is likely to have continued during the second quarter of 2009. Mining production declined at a year-on-year rate of 10,6 per cent in April, but increased by 7,2 per cent on a month-on-month basis. Total manufacturing production declined by 3,3 per cent in April 2009, compared with the previous month, and by 21,6 per cent on a year-on-year basis.

The composite leading indicator as compiled by the staff of the Bank increased slightly in April. The indicator suggests that the lower turning point in the cycle could be reached later in the year. The Kagiso Securities/Bureau for Economic Research Purchasing Managers' Index remains at low levels, but recorded a slight increase in May, also indicating an expectation that the economy may be approaching its lower turning point. This is consistent with the Rand Merchant Bank/Bureau for Economic Research Business Confidence Indicator, which declined further in the second quarter, but the rate of decline has slowed.

The domestic growth prospects will be determined, to an important degree, by international developments. The global downturn has resulted in a significant decline in South Africa's exports in the first quarter of 2009, leading to a wider deficit on the current account of the balance of payments compared with the previous quarter. The outlook for the global economy remains uncertain, but there is a general sense of cautious optimism that the lower turning point of the cycle might have been reached. The general view appears to be that the global economy will remain under pressure for most of this year before beginning a slow recovery. Global inflation remains well contained.

Growth in domestic expenditure has remained subdued, with real domestic final demand contracting by 1,5 per cent in the first quarter of 2009. Real final consumption expenditure by households declined at a quarter-on-quarter annualised rate of 4,9 per cent. Contractions in consumption were experienced in all broad categories of goods, but there was a rebound in the growth of expenditure on services. Growth in real gross fixed capital formation moderated to 2,6 per cent during the same period. The main contributor to the 2,2 per cent increase in gross domestic expenditure was final consumption expenditure by general government, which increased by 5,9 per cent.

Household consumption expenditure appears to have remained under pressure in the second quarter of 2009. In April, real retail trade sales declined by 1,1 per cent compared with the previous month, and by 6,7 per cent on a year-on-year basis. Real wholesale trade sales increased by 0,7 per cent on a month-on-month basis, but declined by 15,1 per cent on a year-on-year basis. While new vehicle sales in May increased marginally compared with the previous month, the year-on-year decline measured 32,9 per cent.

Household consumption expenditure is expected to remain constrained by tighter credit criteria of banks and negative wealth effects. The various house price indicators all show that house prices have continued to decline. The All-Share Index on the JSE Limited has recovered somewhat from its lows in March, but is still substantially below the levels recorded during the first half of 2008.

Growth in expenditure may also be affected negatively by the adverse trends in employment growth. According to the Quarterly Employment Survey of Statistics South Africa, 179 000 jobs were lost in the formal non-agricultural sector during the first quarter of 2009.

The exchange rate of the rand has fluctuated against the US dollar between a range of about R7,85 and R8,25 since the previous meeting of the MPC. As global risk aversion has declined, a number of emerging-market economy currencies have appreciated and since the beginning of the year, the rand has appreciated by approximately 15 per cent on a trade-weighted basis.

As noted above, food price inflation remains the main contributor to the inflation outcome, but the downward trend has continued, although at a slow pace. The spot price of yellow maize has declined by about 40 per cent since June 2008, and is now at levels last seen in the final quarter of 2006.

The main upside risk to the inflation outlook comes from cost-push pressures, particularly from electricity price increases and other administered prices, as well as nominal wage increases, which have generally been in excess of inflation. In the first quarter of 2009 the increase in unit labour cost over four quarters amounted to 11,2 per cent.

The international oil price has re-emerged as a potential upside risk to the inflation outlook. The price of North Sea Brent crude oil reached levels in excess of US$70 per barrel in the past week, before declining to current levels of around US$67 per barrel. As a result of the higher international product prices, a further petrol price increase is likely in July.

Monetary policy stance

The MPC has decided to keep the repurchase rate unchanged at 7,5 per cent per annum. This decision is based on the economic and inflation analysis provided above. The committee is fully cognisant of the fact that there has been significant monetary accommodation since December 2008. The MPC remains fully committed to its mandate of achieving and maintaining price stability.

Statement of the Monetary Policy Committee

13 August 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

There are encouraging signs that the global slowdown may have reached its lower turning point, although the speed and extent of the recovery are still subject to a high degree of uncertainty. The South African economy appears to be lagging behind these international developments and it is likely that the domestic economy contracted in the second quarter of this year. The domestic economy remains constrained by weak global and domestic demand.

Targeted inflation declined materially in June, but is still outside the inflation target range. Expectations are that it will take some time before inflation returns to within the target range on a sustainable basis. Cost-push pressures appear to be the main source of upside risk to the inflation outlook.

Recent developments in inflation

The year-on-year inflation rate as measured by the consumer price index (CPI) for all urban areas declined from 8,0 per cent in May 2009 to 6,9 per cent in June. The main contributors to the inflation outcome were food and non-alcoholic beverages, housing and utilities, and miscellaneous goods and services. Each of these categories contributed 1,6 percentage points to CPI inflation. Petrol prices declined at a year-on-year rate of 25 per cent, despite the 17 cents per litre increase in the petrol price in June. Administered price inflation, excluding petrol prices, measured 9,1 per cent in June, with electricity prices increasing by 28,6 per cent.

Producer prices declined at a year-on-year rate of 4,1 per cent in June, compared with a decline of 3,0 per cent in May. Prices of mining and chemical products were the main contributors to this trend, but there was also further moderation in food price inflation. Prices of agricultural products declined at a year-on-year rate of 1,7 per cent, while prices of manufactured food products increased at a rate of 3,7 per cent, compared with a rate of 6,2 per cent in the previous month.

The outlook for inflation

The most recent CPI inflation forecast by the staff of the South African Reserve Bank remained more or less unchanged compared with the previous forecast. However, CPI inflation is still expected to continue its moderate downward trend, to enter the target range during the second quarter of 2010 and to remain within the target range for the rest of the forecast period ending in 2011.

These projections are broadly in line with the Reuters consensus survey of private-sector analysts. The most recent survey for July indicates that analysts expect inflation to decline to within the inflation target range during the second quarter of 2010, and to average 5,8 per cent and 5,6 per cent in 2010 and 2011 respectively. Expectations derived from the yield differential between conventional government bonds and inflation-linked bonds have remained within the inflation target range over the short- to medium-term maturities.

The outlook for the international economy appears to have improved. The cautious optimism that the bottom of the cycle may have been reached continues to prevail, although some analysts still doubt the strength and sustainability of this recovery. The recovery is also not expected to be uniform across countries or regions. According to the July 2009 *World Economic Outlook* of the IMF, global output is expected to contract by 1,4 per cent in 2009 before recovering to 2,5 per cent in 2010. The developed economies are expected to grow by 0,6 per cent, while growth in emerging economies is expected to average 4,7 per cent in 2010. At this stage, global inflation appears to be under control despite the significant monetary accommodation in a number of advanced economies.

Domestic economic conditions remain subdued amid indications that the economy contracted further in the second quarter of 2009, although at a slower rate of contraction than in the previous quarter. Manufacturing production declined at a year-on-year rate of 17,1 per cent in June, and by 3 per cent in the three months to June 2009 compared with the previous three months. The utilisation of production capacity in manufacturing in May 2009 was 78 per cent; down from 84,4 per cent a year ago. The Kagiso/Bureau for Economic Research Purchasing Managers' Index (PMI) declined in July, indicating that the difficult conditions in the manufacturing sector are likely to persist. However, according to the PMI, expectations of business conditions six months ahead continued to improve. Similarly, the Bank's composite leading business cycle indicator increased for a second consecutive month in May 2009, indicating the possibility of a recovery later in the year.

Household consumption expenditure growth continued to contract during the past few months. New vehicle sales declined again in July, with total vehicle sales declining by 4,5 per cent in July compared with the previous month. Total vehicle exports declined by 12 per cent on a month-on-month basis, and by 60,3 per cent on a year-on-year basis. Real retail trade sales contracted at a seasonally adjusted rate of 3,6 per cent in the second quarter of 2009 compared with the first quarter. On a year-on-year basis, retail sales declined by 6,7 per cent in June. The First National Bank/Bureau for Economic Research Consumer Confidence Index increased moderately in the second quarter of 2009, although it is still at low levels.

The weak state of domestic demand is reflected in the rate of credit extension to the private sector. Year-on-year growth in total loans and advances of banks to the private sector declined from 6,3 per cent in April 2009 to 2,2 per cent in June. On a quarter-on-quarter basis, negative growth of 1,8 per cent was measured in the second quarter of 2009. Year-on-year growth in mortgage advances moderated to 8,2 per cent in June, while instalment sales credit and leasing finance, as well as other loans and advances, experienced negative year-on-year growth. These declines are due, in part, to stricter lending criteria being applied by banks.

The impact of negative wealth effects on domestic consumption expenditure may have dissipated somewhat with the partial recovery of equity prices in the local and global markets. Since the beginning of the year, the All-Share Index on the JSE Limited has increased by about 14 per cent. However, the index is still significantly below the levels reached in 2008. The various house price indices all show that house prices continued to decline in July, but the pace of decline appears to be moderating.

The exchange rate of the rand has remained relatively volatile, but within a range that has prevailed since May 2009 with the decline in global risk aversion. The exchange rate of the rand has fluctuated between approximately R7,68 to the US dollar and R8,32 to the US dollar since the previous meeting of the MPC. Since the beginning of the year, the nominal effective exchange rate of the rand has appreciated by about 13 per cent.

As noted above, food price developments continue to be a major factor in the overall inflation outcomes. After months of relative stickiness, food price inflation at the consumer price level appears to be responding to the favourable trends at the producer price level. In June 2009 food price inflation declined to 9,8 per cent compared with a rate of 16,1 per cent in January 2009.

The main upside risks to the inflation outlook emanate from cost-push pressures. The international oil price has continued its stronger upward trend, as the outlook for the global economy improves. The price of North Sea Brent crude oil has remained above US$70 per barrel for most of the period since the previous meeting. Although domestic petrol prices were reduced by 21 cents per litre in July, the current under-recovery indicates that a further petrol price increase is likely in August.

Other adverse cost pressures include administered price increases, particularly electricity prices, and wage increases that have generally been in excess of inflation. According to Andrew Levy Employment publications, wage settlements in the first six months of 2009 averaged 9,7 per cent. In the first quarter of 2009 the increase in unit labour cost over four quarters amounted to 11,2 per cent.

Monetary policy stance

The MPC is of the view that, notwithstanding upside cost pressures, the adverse economic conditions appear to tilt the balance of risks to the inflation outlook towards the downside over the medium term. The MPC has, therefore, decided to reduce the repurchase rate by 50 basis points to 7 per cent per annum with effect from 14 August 2009.

Statement of the Monetary Policy Committee

22 September 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

There are signs that the global economic recovery is under way, but the indications are that the pace of recovery is likely to be slow and uneven, particularly in the industrialised economies where banking sector concerns still persist. Domestic economic growth, which has been negative in each of the past three quarters, is expected to improve in the coming quarters. However, the domestic recovery is likely to be influenced by global growth developments and is subject to a relatively high degree of uncertainty. Domestic inflation has continued its downward trend, but some risks to the outlook remain.

Recent developments in inflation

The year-on-year inflation rate as measured by the consumer price index (CPI) for all urban areas declined to 6,4 per cent in August, compared with 6,7 per cent in July. The main contributors to the inflation outcome were the categories of housing and utilities, and miscellaneous goods and services. Food price inflation moderated further, with food and alcoholic beverages increasing at a year-on-year rate of 6,8 per cent; down from 8,3 per cent in July.

Producer prices have continued their negative trend and declined at a year-on-year rate of 3,8 per cent in July, compared with a decline of 4,1 per cent in June. Food price inflation at the consumer level can be expected to abate as agricultural product prices declined at a year-on-year rate of 1,7 per cent, while manufactured food product prices increased at a rate of 0,8 per cent. Upside pressure on producer prices came from electricity prices which increased by 27,4 per cent.

The outlook for inflation

The CPI inflation forecast by the South African Reserve Bank staff continues to indicate that inflation is likely to return on a sustained basis to within the inflation target range by the second quarter of 2010. CPI inflation is then expected to remain within the inflation target range for the remainder of the forecast period until the end of 2011. Compared with the previous forecast, the outlook is unchanged for 2009 and 2010, although there is a slight improvement for 2011. The exchange rate of the rand has provided downside pressure, which has more or less offset higher oil price assumptions and higher unit labour costs over the period.

The most recent study of inflation expectations undertaken on behalf of the Bank by the Bureau for Economic Research (BER) at Stellenbosch University indicates that inflation expectations have improved somewhat, but remain, on average, above the upper end of the inflation target range. Inflation is expected to average 7,5 per cent in both 2010 and 2011. This represents declines of 0,6 per cent and 0,4 per cent in these years respectively, compared with the previous survey. Only the financial analysts expect inflation to be within the target range in the coming two years. Since the previous meeting of the MPC, the break-even inflation rates, as measured by the yield differential between conventional government bonds and inflation-linked bonds, declined across all maturities to within the inflation target range.

Overall, the risks to the inflation outlook appear to be fairly evenly balanced. The main upside risks continue to emanate from high increases in some administered prices, particularly electricity prices, and increases in nominal unit labour costs well in excess of the current inflation rate. Nominal unit labour cost increased over four quarters by 9,3 per cent in the second quarter of 2009, compared with 11,3 per cent in the previous quarter.

International oil prices, which remain an upside inflation risk factor, have moderated slightly since the previous meeting of the MPC and appear to have stabilised around current levels of about US$70 per barrel. Domestic petrol prices increased by 36 cents per litre in September, but the current over-recovery indicates that this increase may be offset, to a large extent, in October, as a result of lower product prices and the recent appreciation of the rand.

Growth in domestic final demand declined at an annualised rate of 3,5 per cent in the second quarter of 2009. Household consumption expenditure contracted by 5,8 per cent, compared with a decline of 4,8 per cent in the previous quarter. Durable goods consumption was the most affected sub-category, declining by 18,8 per cent. New vehicle sales declined at a year-on-year rate of 23 per cent in August, but there are signs that the decline is levelling out. In July real retail and wholesale trade sales contracted at year-on-year rates of 3,8 per cent and 13,8 per cent respectively, although retail sales increased on a month-on-month basis.

Consumption expenditure is expected to remain constrained by negative wealth effects, although there has been a marked recovery in the equity markets, which may relieve these effects somewhat. Since the beginning of the year, the all-share index on the JSE Limited has increased by about 20 per cent. House prices, however, have continued their downward trend. The various house price indices, while still indicating negative price trends, show that prices are declining at a slower rate.

Credit extension to the private sector continued to reflect both the weak household consumption expenditure and the prevailing tighter credit criteria. Twelve-month growth in banks' total loans and advances declined to 2,1 per cent in July. Mortgage advances declined to a year-on-year rate of growth of 6,4 per cent in July, while instalment sale credit and leasing finance contracted by 3,2 per cent over the same period, as a result of subdued demand for motor vehicles and other durable goods. Other loans and advances, comprising credit card advances, bank overdrafts and general loans, declined by 2,0 per cent. Lower levels of credit extension have resulted in a slight decline in household debt as a percentage of household disposable income to 76,3 per cent in the second quarter of 2009. The ratio of debt-service cost to household disposable income declined from 10,9 per cent in the first quarter to 9,5 per cent in the second quarter.

Domestic output contracted by 3,0 per cent in the second quarter of 2009, but there are early indications that the lower turning point may have been reached. However the recovery is expected to be slow. The South African Reserve Bank composite leading indicator increased for the third consecutive month in June and continues to predict a recovery by the end of the year.

The rate of contraction in the manufacturing sector also shows signs of slowing down. On a year-on-year basis, manufacturing output declined by 13,7 per cent in July, but it increased at an annualised month-on-month rate of 3,0 per cent. The Kagiso/BER

Purchasing Managers Index (PMI) increased in July, although still at levels that indicate negative growth. Mining production increased at a year-on-year rate of 4,8 per cent in July. However, the real value of all building plans passed declined by 43,2 per cent in July, with the slowdown in residential building plans being the main contributor.

The exchange rate of the rand continues to provide downside pressure on inflation and has appreciated further since the previous meeting of the MPC when it was at a level of around R8,10 to the US dollar. Since the beginning of the year, the rand has appreciated by 26 per cent against the US dollar, and by 20 per cent on a trade-weighted basis.

The global economy appears to be recovering in response to concerted fiscal and monetary packages that have been put in place. A number of industrialised economies have experienced positive growth rates in the second quarter, while others have shown a moderation in the rate of contraction. Many forecasts for the second half of the year and for 2010 have been revised upward, but remain well below pre-crisis levels. However, there are risks that the recovery may be short-lived should consumer demand not improve further in the industrialised economies. While there have been some improvements in financial market conditions, more still remains to be done. Global inflation remains relatively subdued and poses no immediate risk to the domestic inflation outlook.

Monetary policy stance

The MPC is of the view that the risks to the inflation outlook appear to be fairly evenly balanced. Given the current policy stance, inflation is expected to continue moderating and return to within the inflation target range during the forecast period. Accordingly, the MPC has decided to leave the repurchase rate unchanged at 7 per cent per annum.

Statement of the Monetary Policy Committee

22 October 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 prospects for inflation returning to within the inflation target range by the second quarter of 2010 remain promising. Domestic demand conditions continue to be subdued and currently do not pose a significant threat to the inflation outlook. Economic growth is expected to improve in the coming months, but is likely to remain below potential for some time. Domestic growth prospects are dependent to an extent on the global recovery, which appears to be uneven across countries and regions. However, the medium-term inflation outlook has been affected adversely by possible further significant adjustments to electricity tariffs.

Recent developments in inflation

There has been no publication of consumer price index (CPI) data since the previous meeting of the MPC. The most recent data showed that the year-on-year inflation rate as measured by the CPI for all urban areas declined to 6,4 per cent in August, compared with 6,7 per cent in July. The main contributors to the inflation outcome were the categories of housing and utilities, and miscellaneous goods and services.

Producer prices declined at a year-on-year rate of 4,0 per cent in August, compared with a decline of 3,8 per cent in July. Food price inflation at the producer price level continues to signal dissipating pressures on food prices at the consumer price level. Agricultural product prices declined at a year-on-year rate of 2,0 per cent, while manufactured food product prices increased at a rate of 0,1 per cent. Upside pressure on producer prices came from electricity prices, which increased by 28,6 per cent.

The outlook for inflation

The CPI inflation forecast by the South African Reserve Bank staff continues to indicate that inflation is likely to return to within the inflation target range, on a sustained basis, by the second quarter of 2010. CPI inflation is then expected to stay within the inflation target range for the rest of the forecast period until the end of 2011. Compared with the previous forecast, the outlook showed a slight improvement for 2010 and 2011, mainly as a result of the changed assumption regarding the rand exchange rate. No adjustment has been made at this stage to the central forecast for possible further increases in electricity tariffs over and above those that are already assumed in the baseline forecast.

A number of domestic and global factors have contributed to the persistent downward pressure on inflation. The global economy shows continued signs of improvement, but the recovery is not uniform across regions. The pace of recovery of most of the Asian economies has been higher than that achieved in the main industrialised economies. The timing and speed of the withdrawal of the fiscal and monetary policy stimuli may have a bearing on the nature of the recovery in these economies. Global inflation is expected to be constrained by the relatively weak demand from the industrialised countries, although the US dollar movements may provide some upward pressure to commodity prices.

There are some positive indications that the rate of contraction of the domestic economy has declined and that the economy may emerge from the recession by the end of 2009. However, the mixed picture from the published data shows that the recovery is likely to be tentative, and the output gap is likely to remain positive for some time. The physical volume of manufacturing output declined at a year-on-year rate of 15,0 per cent in August and by 2,8 per cent on a month-on-month basis. However, in the three months to August, compared with the previous three months, an increase of 0,8 per cent was recorded. The Kagiso/Bureau for Economic Research (BER) Purchasing Managers Index (PMI) increased markedly from 39,3 index points in August to 48,0 index points in September. The index shows that new sales orders have increased significantly, while manufacturers' expectations of business conditions six months ahead improved to the highest level since early 2007.

Other sectoral developments indicate that the physical volume of total mining production increased in the three months to August, but contracted on a month-on-month basis, while the real value of building plans passed continued to decline. The Rand Merchant Bank (RMB)/BER Business Confidence Indicator (BCI) declined to a ten-year low in the third quarter of 2009. The tentative nature of the domestic recovery is also reflected in the composite leading business cycle indicator compiled by the South African Reserve Bank, which declined marginally in July, following three consecutive monthly increases.

Consumption expenditure by households also remains subdued, with real retail trade sales declining at a year-on-year rate of 7,0 per cent in August. In the three months to August, there was a 1,0 per cent decline, compared with the previous three months. Wholesale trade sales also declined further in August. Total new vehicle sales are also well below their levels of a year ago. However, there are indications that the negative trend may have reached its lower turning point with zero or slightly positive rates of change being recorded on a month-on-month and quarter-on-quarter basis. The First National Bank (FNB)/BER consumer confidence index declined in the third quarter of 2009 to a relatively neutral confidence level.

Credit extension to the private sector continued to reflect both the weak household consumption expenditure and the prevailing tighter credit criteria. The Ernst & Young Financial Services Index indicates that credit standards applied by retail banks to loan applications continued to tighten in the third quarter of 2009, but at significantly lower levels. Twelve-month growth in banks' total loans and advances declined to 0,8 per cent in August 2009. Mortgage advances increased by 5,6 per cent in August, while instalment sale credit and leasing finance contracted by 4,2 per cent. Negative year-on-year growth rates were also recorded in credit card advances, bank overdrafts and general loans.

There has been some recovery in asset prices in recent months, but wealth effects do not appear to be posing an immediate threat to the inflation outlook. Domestic equity prices have increased markedly since March, but are still significantly below the levels reached in May 2008. The various house price indices indicate a moderation in the rate of decline in house prices.

The exchange rate of the rand continues to provide downside pressure on inflation and is currently trading at levels against the US dollar, similar to those prevailing at the time of the previous MPC meeting. During the past month the rand traded in a range of around R7,20 and R7,79 against the US dollar. The exchange rate of the rand has appreciated by 28 per cent against the US dollar since the beginning of 2009 and by 20 per cent on a trade-weighted basis.

The international oil price has increased in the past week, but does not pose an immediate threat to the inflation outlook. Having averaged around US$70 per barrel for a number of weeks, the price of North Sea Brent crude oil increased to current levels of around US$76 per barrel, mainly as a result of the weaker US dollar and improved global growth prospects. In October the domestic price of 95 octane petrol was reduced by 40 cents per litre as a result of both lower product prices and an appreciated rand exchange rate.

The main risks to the inflation outlook emanate from cost pressures in the economy. The trend of wage settlements still poses an upside risk to the inflation outlook. However, there appears to be some evidence that nominal wage increases are moderating, although increases have generally been above the inflation rate. According to Andrew Levy Employment Publications, the average level of wage settlements amounted to 9,4 per cent in the first nine months of 2009 compared with 9,6 per cent in the corresponding period of 2008. These increases are consistent with the Quarterly Employment Survey (QES) of Statistics South Africa, which reported that growth in average nominal remuneration per worker in the formal non-agricultural sector of the economy moderated from 11,5 per cent in the first quarter of 2009 to 8,7 per cent in the second quarter. Unit labour cost increases declined from 11,3 per cent in the first quarter to 9,3 per cent in the second quarter.

The substantial electricity tariff increases requested by Eskom are seen to be the main longer-term threat to the inflation outlook. Eskom has requested a trebling of the current electricity tariffs over the next three years, and the National Energy Regulator of South Africa (NERSA) is expected to make a decision in February 2010.

Monetary policy stance

The MPC is of the view that overall the risks to the inflation outlook have not changed markedly since the previous meeting. Accordingly, the MPC has decided to leave the repurchase rate unchanged at 7,0 per cent per annum. The MPC will continue to monitor economic and financial developments, and will not hesitate to adjust the monetary policy stance should the risks to the inflation outlook change materially.

Statement of the Monetary Policy Committee

17 November 2009

Issued by Ms G Marcus, Governor of the South African Reserve Bank, at a meeting of the Monetary Policy Committee (MPC) in Pretoria

Introduction

There are signs that the domestic economy will continue on its recovery path, but economic growth is expected to remain below potential for some time and dependent to some extent on the pace of the global recovery, which still appears to be fragile and uneven across regions. Economic growth is also expected to be constrained by subdued domestic consumption expenditure. The domestic outlook for inflation remains favourable as a result of weak demand pressures and the main threat to the inflation outlook emanates from possible electricity price increases.

Recent developments in inflation

The year-on-year inflation rate as measured by the consumer price index (CPI) for all urban areas declined from 6,4 per cent in August 2009 to 6,1 per cent in September. The single biggest contributor to the inflation outcome was the category of housing and utilities which accounted for 1,7 percentage points. This was mainly due to the electricity component which increased at a year-on-year rate of 29,1 per cent. Food price inflation continued to moderate and at 4,9 per cent is now exerting downward pressure on overall inflation. Goods price inflation measured 4,9 per cent, compared with services price inflation of 7,8 per cent.

Producer prices declined for the fifth successive month in September, with the headline producer price inflation measuring -3,7 per cent. Most categories in the index exhibited low or negative year-on-year rates of inflation, apart from electricity, gas and water, and tobacco products.

The outlook for inflation

The CPI inflation forecast by the South African Reserve Bank (the Bank) continues to indicate that inflation is likely to return to within the inflation target range, on a sustained basis, by the second quarter of 2010. There may, however, be temporary declines to within the target range before then. CPI inflation is expected to remain within the inflation target range until the end of the forecast period in the final quarter of 2011, when it is forecast to average 5,5 per cent. Given the current uncertainty related to Eskom's tariff application to the National Energy Regulator of South Africa (NERSA), the forecast does not make provision for the higher increases requested by Eskom, and electricity price increases of 25 per cent in 2010 and 2011 are assumed. The Bank's forecast is in line with those of private-sector analysts. According to the latest Reuters consensus forecast, inflation is expected to average 5,7 per cent in 2010 and 5,85 per cent in 2011.

There are no major demand-side pressures on inflation, and the assessment of the Monetary Policy Committee (MPC) is that there are no significant upside risks to the inflation outlook emanating from this source.

Household consumption expenditure remains subdued. Real retail sales growth has been negative, but there is further evidence that motor vehicle sales may have reached their lower turning point. Although total vehicle sales in October were 12,5 per cent lower than a year ago, when the three months to October 2009 are compared with the preceding three months, an increase of 1,4 per cent was recorded. The recovery has been in passenger vehicle sales and exports. Commercial vehicle sales are still declining. Consumption expenditure is expected to remain subdued, despite the lower interest rate environment, as a result of tighter lending conditions by banks, high levels of consumer indebtedness, negative wealth effects or impaired household balance sheets, and higher levels of unemployment.

Credit extension to the private sector reflects weak demand by households and the corporate sector, and tight lending conditions by banks in response to higher perceived risk and rising impaired advances. Twelve-month growth in banks' total loans and advances declined to -0,2 per cent in September 2009. Growth in mortgage advances to the private sector declined further in September, measuring 4,8 per cent. The other main categories of loans and advances, namely instalment sale and leasing finance, credit card advances, bank overdrafts and general loans, all contracted.

Consumption expenditure is also constrained by high debt levels and negative wealth effects, although asset values have recovered somewhat from their lows earlier in the year. The all-share index on the JSE Limited is currently about 50 per cent higher than the most recent lowest point in March of 2009. House prices also appear to be recovering, with the various house price indices reflecting either small positive growth or moderate declines in October.

Labour market developments are also likely to constrain household consumption expenditure. According to the Quarterly Labour Force Survey, approximately 800 000 jobs have been lost since the beginning of the fourth quarter of 2008. The Quarterly Employment Statistics show a decline of over 200 000 formal-sector jobs between the beginning of the fourth quarter of 2008 and the end of the second quarter of 2009.

Domestic output appears to be recovering and the leading business cycle indicator of the Bank has continued its positive trend. There are still some doubts about the speed of recovery, and the output gap remains relatively wide. Most forecasts suggest that positive growth will have resumed by the fourth quarter of 2009, but there is less unanimity about the third quarter outcome.

The outlook is also not even across sectors. The monthly data suggests that the mining sector contracted further in the third quarter, but the manufacturing sector performance on a quarter-on-quarter basis was relatively robust. According to Statistics South Africa, the physical volume of mining production declined by 7,5 per cent in the three months to September compared with the previous three months. However, a more positive trend may be expected in the fourth quarter.

The physical volume of manufacturing production increased by 2,6 per cent over the same period. This outcome is consistent with the Kagiso/Bureau for Economic Research Purchasing Managers Index which, although still reflecting a contraction in manufacturing, has rebounded significantly and the forward-looking indicators in the index are generally positive. There is a risk, however, that this recovery could be affected by low consumption expenditure growth. The outlook for the construction sector appears to be less favourable. The real value of building plans passed declined by 18,5 per cent on a year-on-year basis in August, while in the three months to August, compared with the previous three months, a decrease of 27,7 per cent was recorded. The First National Bank Civil Construction Index also declined significantly in the third quarter of 2009.

Fiscal policy developments are not seen to be a threat to the inflation outlook. The revised budgeted deficit of 7,6 per cent of gross domestic product announced in the Medium Term Budget Policy Statement is to a significant extent due to lower tax revenues – a result of low economic growth – and is therefore part of the workings of the automatic stabilisers. The previous fiscal prudence has provided sufficient space for increased borrowing to fund the shortfall. The deficit is expected to narrow as growth gains momentum.

No significant upside risks to the inflation outlook are expected from food prices. Food price inflation has declined to below 5 per cent, and this favourable trend is expected to continue. Consumer food prices tend to lag food price developments at the producer price level, and the latter have been either declining or rising marginally over the past months. In October, manufactured food prices declined at a year-on-year rate of 1,8 per cent, while agricultural product prices declined by 2,4 per cent. The current spot and future prices of agricultural commodities indicate that no significant upward pressures are expected in the near future.

For the past year petrol prices have exerted downward pressure on inflation as a result of the appreciation of the rand and relatively low international product prices compared to the previous year. However, these favourable base effects are not expected to continue. Over the past few months the international oil prices have remained relatively stable, but some account is taken in the forecast of possible increases in the international oil price should the global recovery accelerate. In November the domestic petrol price remained unchanged and, should current trends continue, a modest increase in the petrol price is possible in December.

The rand has remained a positive factor in the inflation outlook, notwithstanding some volatility during the month. Since the previous MPC meeting, the rand has traded in a range of between R7,30 and R7,90 against the US dollar. The rand's movements have been influenced, to a large extent, by exogenous factors, in particular movements in the dollar, a resumption in global capital flows to emerging markets and a recovery in commodity prices. Since the beginning of the year the rand has appreciated by 20 per cent on a trade-weighted basis.

The global economic recovery has been led by the emerging Asian economies. However, the turnaround in the advanced economies is less certain. While there are positive signs, the recent higher growth rates have been driven by a turn in the inventory cycle, and the continued weakness in consumption expenditure in the United States in particular, and rising levels of unemployment pose risks to the recovery. The nature and speed of exit strategies from the previous stimulus packages also remain a risk to the outlook.

The global environment remains benign from an inflation perspective. Despite moderately higher commodity prices, there are no significant risks to the global inflation outlook.

As in the past few meetings, the main risks to the inflation outlook are seen to emanate from electricity price increases and the possible second-round effects thereof. In addition, the trend of wage settlements continues to pose an upside risk to the inflation outlook.

Monetary policy stance

The MPC, having reviewed the global and domestic economic and financial developments, has decided to maintain the current stance of monetary policy and to leave the repurchase rate unchanged at 7 per cent per annum.

Abbreviations

Alsi	All-Share Index
BER	Bureau for Economic Research (Stellenbosch University)
BESA	Bond Exchange of South Africa
CPI	consumer price index
CPIX	consumer price index excluding mortgage interest costs
ECB	European Central Bank
FNB	First National Bank
FOMC	Federal Open Market Committee
G-20	Group of Twenty
GDP	gross domestic product
IMF	International Monetary Fund
JSE	JSE Limited
MBS	mortgage-backed security
MPC	Monetary Policy Committee
MTBPS	Medium Term Budget Policy Statement
NAB	non-alcoholic beverage
NCD	negotiable certificates of deposit
NEER	nominal effective exchange rate of the rand
NERSA	National Energy Regulator of South Africa
OECD	Organisation for Economic Co-operation and Development
OPEC	Organization of the Petroleum Exporting Countries
PMI	Purchasing Managers Index
PPI	producer price index
PSBR	public-sector borrowing requirement
RMB	Rand Merchant Bank
Stats SA	Statistics South Africa
the Bank	South African Reserve Bank
the Fed	Federal Reserve System
UK	United Kingdom
US	United States