Monetary Policy Review

May 2010

South African Reserve Bank

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Introduction

The global economic recovery has progressed more rapidly than expected in the period since the previous *Monetary Policy Review* was published in November 2009. However, activity is recovering at varying speeds in different regions, and significant risks and uncertainties continue to threaten global financial markets. Concerns regarding the solvency of a number of countries in the euro area have threatened to transform the initial banking crisis into a sovereign debt crisis, which could have systemic implications for the global economy. The domestic economy, after contracting for three successive quarters, recorded consecutive quarters of positive growth in the second half of 2009, and is expected to sustain this stronger performance in 2010 and 2011.

Inflation has continued to trend downwards in recent months. Headline inflation has moved to within the inflation target range of 3 to 6 per cent for the first time since April 2007 when a year-on-year increase of 5,9 per cent was recorded in October 2009. After again breaching the upper limit of the inflation target range for technical reasons in December 2009 and January 2010, inflation has moved back to within the target range on a sustainable basis since February 2010.

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, two topical issues are addressed in boxes. The first box reproduces the clarification of the mandate of the South African Reserve Bank (the Bank) issued by the Minister of Finance, Mr P J Gordhan, in February 2010. The second box reports on research undertaken on exchange rate pass-through at the disaggregated level in South Africa using two distinct panels of data.

Recent developments in inflation

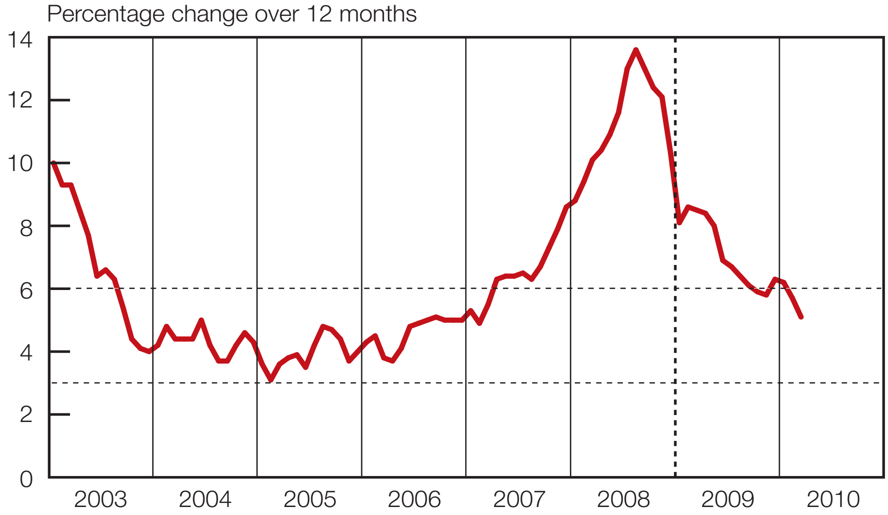
This section analyses recent trends in the main inflation indices and reviews developments in the core determinants of inflation in the South African economy.

The evolution of indicators of inflation

Figure 1 shows that the year-on-year percentage change in the headline consumer price index for all urban areas (CPI), the measure of inflation targeted by the Bank, has continued to trend downwards in the period since the previous *Monetary Policy Review* was published in November 2009. CPI inflation moved to within the inflation target range of 3 to 6 per cent for the first time since April 2007 when a rate of 5,9 per cent was recorded in October 2009. After breaching the upper limit of the inflation target range for technical reasons in December 2009 and January 2010, inflation has moved back to within the range since February 2010. The CPI inflation rate was 6,3 per cent in December 2009 and 6,2 per cent in January 2010, followed by 5,7 per cent in February and 5,1 per cent in March.

The main contributors to CPI inflation in the period since September 2009 have been the housing and utilities, and miscellaneous goods and services categories (Table 1). Housing and utilities contributed between 1,6 and 1,7 percentage points over the period, reflecting mainly electricity and other fuel price changes. The contribution of miscellaneous goods and services declined from 1,6 percentage points in September 2009 to 1,2 percentage points in March 2010. However, the main reason for the decline

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

in the overall CPI inflation rate was the contribution of the food and non-alcoholic beverages category, which decreased from 0,9 percentage points in September 2009, when CPI inflation was 6,1 per cent, to 0,2 percentage points in March 2010 when CPI inflation was 5,1 per cent. Upward pressure emerged from the contribution of the transport category, which increased from -0,3 percentage points in October 2009 to 0,7 percentage points in March 2010. This increase was largely due to higher petrol prices. On a year-on-year basis, petrol prices increased by 22,1 per cent in February and by 14,9 per cent in March.

Table 1 Contributions to CPI inflation

Percentage change over 12 months* and percentage points

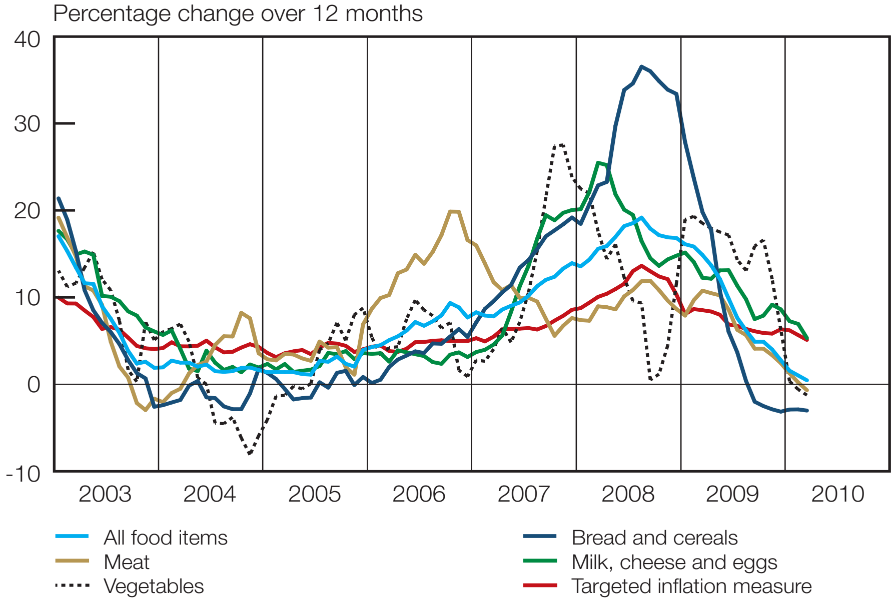
	2009				2010		
	Sep	Oct	Nov	Dec	Jan	Feb	Mar
Total*	**6,1**	**5,9**	**5,8**	**6,3**	**6,2**	**5,7**	**5,1**
Of which:							
Food and NAB**	0,9	0,9	0,8	0,6	0,4	0,3	0,2
Alcoholic beverages and tobacco	0,7	0,6	0,6	0,6	0,6	0,6	0,6
Housing and utilities	1,7	1,7	1,7	1,6	1,6	1,6	1,6
Health	0,2	0,2	0,2	0,2	0,1	0,1	0,1
Transport	-0,2	-0,3	-0,1	0,6	1,1	0,9	0,7
Education	0,2	0,2	0,2	0,2	0,2	0,2	0,1
Miscellaneous goods and services	1,6	1,5	1,5	1,5	1,3	1,3	1,2
Other	1,0	1,1	0,9	1,0	0,9	0,7	0,6

** NAB: Non-alcoholic beverage

Source: Statistics South Africa

The continued decline in food inflation is evident from Figure 2, which shows that the year-on-year inflation rate for all food items decreased from 4,9 per cent in September 2009 to 0,5 per cent in March 2010. Bread and cereals and meat products have contributed negatively to food inflation in 2010, partly as a result of a decline in the price of maize, which is an input into their production.

Figure 2 Targeted inflation* and food inflation

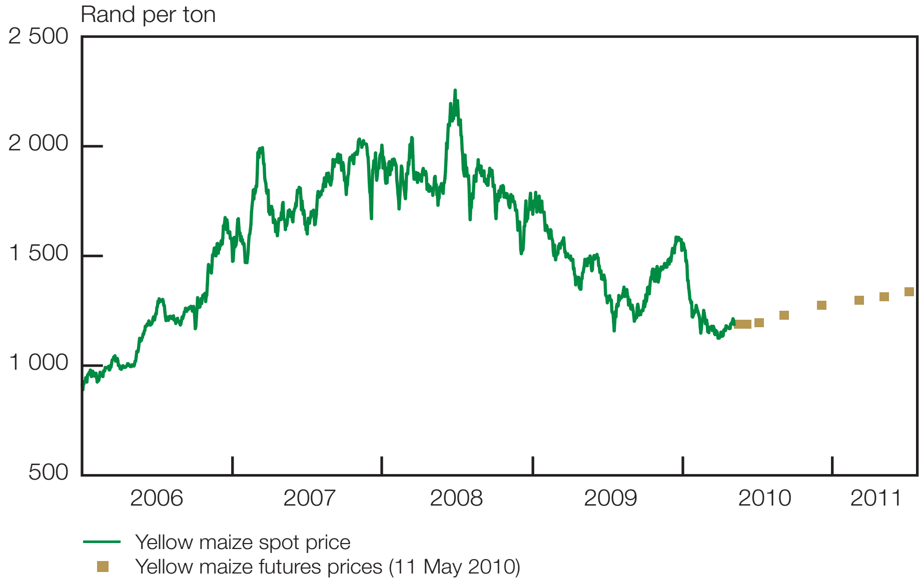


* CPIX for metropolitan and other urban areas until the end of 2008, CPI for all urban areas thereafter

Source: Statistics South Africa

Maize prices have fallen sharply in recent months, mainly driven by consecutive bumper harvests, lower international prices, an appreciation of the exchange rate of the rand, expectations that maize deliveries are likely to be close to forecast levels and good weather across South Africa's maize growing regions. The current maize harvest is projected to approach the record set in the 1981/82 season, when 14,4 million ton were harvested. The spot price of yellow maize declined from R1 549 per ton in mid-December 2009 to around R1 200 per ton in May 2010 (Figure 3). Futures prices suggest that yellow maize prices will rise slightly to around R1 277 per ton at the end of 2010.

Figure 3 Yellow maize prices



Sources: Grain South Africa and SAFEX

Table 2 considers developments in a number of measures of core inflation, calculated by excluding food, petrol and electricity prices from headline inflation. If petrol prices alone were excluded, inflation for the remaining items in the CPI was higher than headline inflation until November 2009 and lower thereafter, reflecting the upward pressure that has been exerted on inflation by petrol prices since December. The CPI excluding petrol prices recorded a year-on-year inflation rate of 4,8 per cent in March 2010, compared to the headline CPI inflation rate of 5,1 per cent. Food prices have continued to put downward pressure on CPI inflation in the period since September 2009, resulting in the inflation rate for the CPI excluding food and non-alcoholic beverage prices being consistently higher than the headline CPI rate. If both petrol prices and food and non-alcoholic beverage prices were excluded, inflation for the remaining items in the CPI was higher than headline inflation in all the months except January 2010, where the two rates were equal. Finally, if petrol, food and non-alcoholic beverage and energy prices were excluded, Table 2 reports that the resulting inflation rate was lower throughout the period under review than the rate for CPI excluding petrol and food and non-alcoholic beverage prices, reflecting the upward pressure placed on inflation by energy prices.

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

Percentage change over 12 months

	2009				2010		
	Sep	Oct	Nov	Dec	Jan	Feb	Mar
Headline CPI	**6,1**	**5,9**	**5,8**	**6,3**	**6,2**	**5,7**	**5,1**
CPI excluding petrol prices	7,1	6,9	6,6	6,2	5,5	5,1	4,8
CPI excluding food and NAB* prices	6,4	6,0	6,0	6,8	7,0	6,4	5,9
CPI excluding food, NAB and petrol prices	7,5	7,2	7,0	6,7	6,2	5,8	5,4
CPI excluding food, NAB, petrol and energy prices	7,1	6,7	6,4	6,3	5,8	5,3	5,0

* NAB: Non-alcoholic beverage

Source: Statistics South Africa

The inflation rates for goods and services prices in the CPI are reported in Table 3. Goods price inflation remained within the inflation target range throughout the period under review. This is a result of the inflation rates for durable and semi-durable goods falling to below the lower end of the inflation target range, counteracting the increase in non-durable goods inflation caused largely by increases in the petrol price. Services inflation has remained persistently above the target range, although it has been declining since September 2009.

Table 3 CPI: Goods and services inflation

Percentage change over 12 months

	2009				2010		
	Sep	Oct	Nov	Dec	Jan	Feb	Mar
Headline CPI	**6,1**	**5,9**	**5,8**	**6,3**	**6,2**	**5,7**	**5,1**
Goods inflation	4,9	4,5	4,4	5,5	5,8	4,6	4,0
Durable goods	2,5	2,0	2,0	1,5	0,4	0,0	-0,3
Semi-durable goods	4,6	4,6	3,4	4,0	3,0	1,5	1,4
Non-durable goods	6,1	5,7	5,8	7,6	8,7	7,4	6,4
Services inflation	7,8	7,4	7,4	7,2	6,8	6,8	6,5

Source: Statistics South Africa

The inflation rate for administered prices rose significantly from 3,2 per cent in September 2009 to 12,9 per cent in February 2010, before declining to 11,2 per cent in March (Table 4). The inflation rate for the regulated component of administered prices rose from -0,3 per cent in September 2009 to 14,9 per cent in February 2010 and then moderated to 12,3 per cent in March, largely due to petrol price inflation falling at a slower pace from September 2009 and rising from December 2009. The inflation rate for the unregulated component of administered prices remained almost constant over most of the period, declining marginally from 9,8 per cent in September 2009 to 9,7 per cent in February 2010, before declining to 9,1 per cent in March.

Table 4 Administered prices

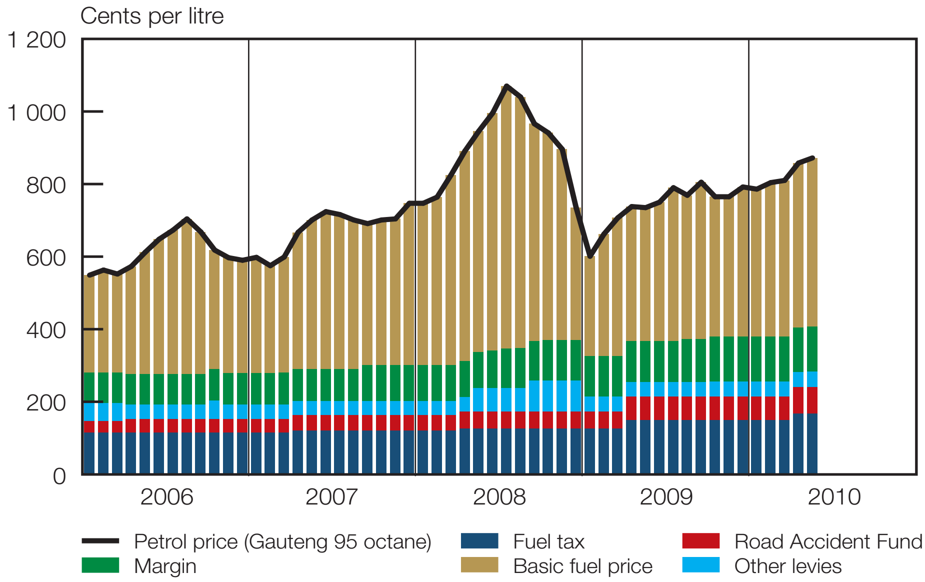
Percentage change over 12 months

	2009				2010		
	Sep	Oct	Nov	Dec	Jan	Feb	Mar
Total	3,2	2,7	4,0	9,9	14,5	12,9	11,2
Regulated	-0,3	-1,0	1,1	10,0	17,3	14,9	12,3
Unregulated	9,8	9,8	9,8	9,8	9,7	9,7	9,1

Source: Statistics South Africa

The increase in the petrol price (Figure 4) that has impacted on the CPI has, in turn, been influenced by developments in the international price of crude oil. Crude oil prices have risen since the lows experienced in December 2008, and the domestic petrol price has tracked these increases. After recording a 23-month low of 601 cents per litre in January 2009, the price of 95 octane unleaded petrol in Gauteng Province increased to 872 cents per litre in May 2010.

Figure 4 South African petrol price

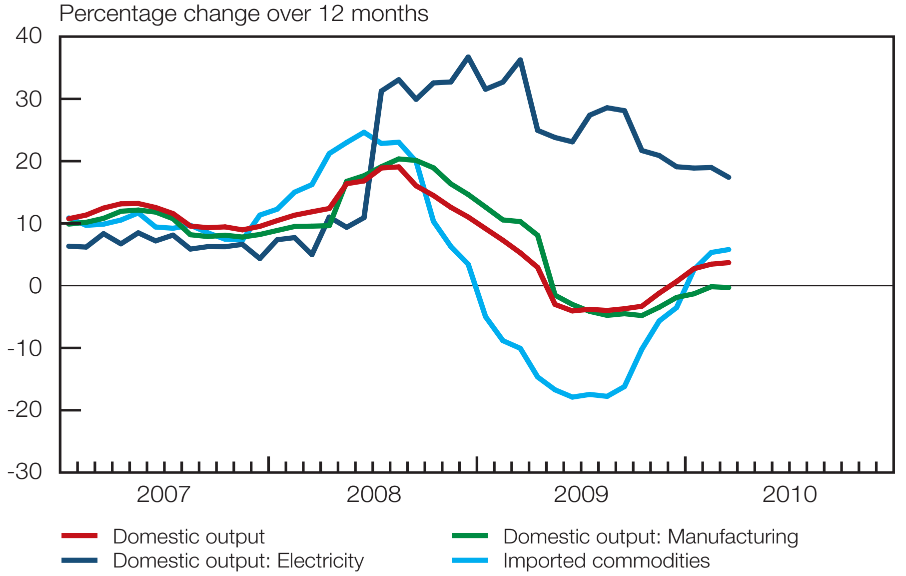


Source: Department of Minerals and Energy

Inflation measured in terms of the year-on-year change in the producer price index (PPI) for domestic output remained fairly stable from June until October 2009 at rates of between -4,1 and -3,3 per cent (Figure 5). From November 2009 there has been a slight acceleration in this measure of price changes, with the inflation rate turning positive in

December 2009 and more recently recording a level of 3,7 per cent in March 2010. The main contributors to these movements were the mining and quarrying group, basic metals and electricity. The year-on-year rate of inflation of the PPI for imported commodities has risen strongly from -16,3 per cent in September 2009 to 5,8 per cent in March 2010.

Figure 5 PPI for domestic output and imported commodities

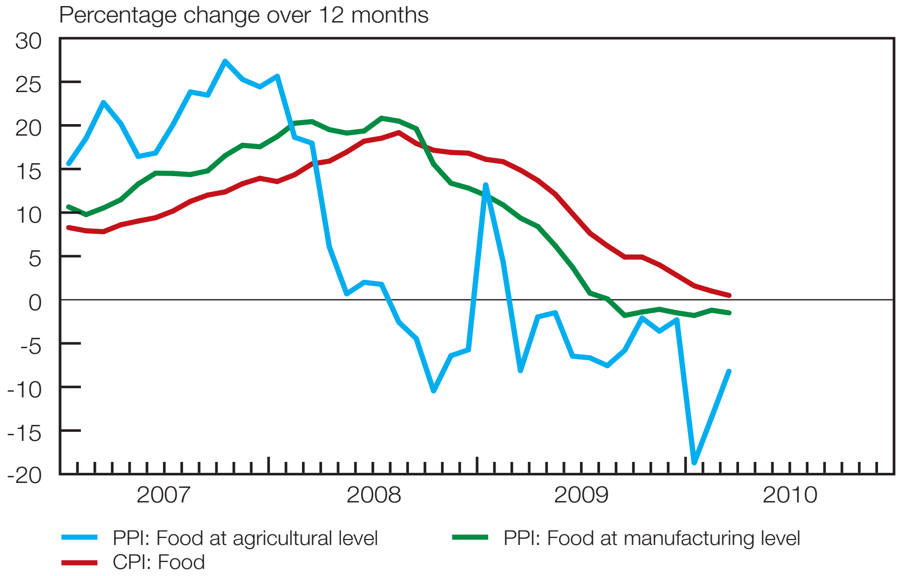


Details regarding changes to the PPI in this period are documented in statistical release P0142.1, February 2008, issued by Statistics South Africa

Source: Statistics South Africa

Figure 6 plots the year-on-year percentage changes in food prices in the domestic output PPI and the CPI. PPI food inflation at the agricultural level has remained negative and somewhat volatile since September 2009, initially rising to -2,1 per cent in October 2009, but subsequently falling to -13,5 per cent in February 2010. PPI food inflation at the manufacturing level has remained negative since the previous *Monetary Policy Review*, although it seems to have levelled off at a level above -2,0 per cent.

Figure 6 Food prices in the PPI and CPI



Source: Statistics South Africa

Box 1: Clarification of the Reserve Bank's mandate

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Ref. M3/1/1(357-10)

Ms G Marcus
Governor
South African Reserve Bank
PO Box 427
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0001

Dear Gill,

CLARIFICATION OF THE RESERVE BANK'S MANDATE

Let me once again congratulate you on your appointment! I look forward to working with you and your team at the Reserve Bank as we manage South Africa's response to the financial crisis and chart a new economic course to increase the economy's growth potential to the benefit of all South Africans.

The recession, and its negative impact on the lives of ordinary people, has taught us many lessons about the importance of pursuing policies that promote sustainable and balanced growth. It has also heightened the urgency for South Africa to chart a new growth path that allows the economy to achieve faster growth with more job creation.

To raise South Africa's growth potential, various studies – such as, the report by the International Growth and Advisory Panel and the report of the Commission on Growth and Development – have highlighted the importance of countercyclical macroeconomic policies combined with microeconomic reforms that increase competitiveness and reduce the cost of doing business. These studies acknowledge the crucial role of monetary policy and inflation management in supporting sustainable growth and employment, and in protecting real incomes. Countries set policy, whether explicitly or implicitly, to target a low and stable rate of inflation to reduce the long-term cost of borrowing and provide confidence about the future. This in turn stimulates investment, employment and competitiveness – particularly among exporters and import-competing industries. Low inflation is especially important to protect the living standards of workers and the poor.

As we move into the new fiscal year, I thought it important to reiterate the constitutional mandate of the South African Reserve Bank and indicate how the lessons of the recession and the reality of the aftermath should be taken into account:

1. Section 224 of the Constitution of the Republic of South Africa states:
   (1) *The primary objective of the South African Reserve Bank is to protect the value of the currency in the interest of balanced and sustainable economic growth in the Republic.*
   (2) *The South African Reserve Bank, in pursuit of its primary object, must perform its functions independently and without fear, favour or prejudice, but there must be regular consultation between the Bank and the Cabinet member responsible for national financial matters.*

2. Balanced and sustainable growth requires the composition of growth to be such that it does not give rise to an unsustainable balance of payments position (either surplus or deficit) or unsustainable debt burdens for the private and public sectors.

3. In exercising this mandate, the Bank should continue to pursue a target of 3 to 6 per cent for headline CPI inflation. Monetary policy should be conducted in a consistent and transparent manner within a flexible inflation targeting framework. Monetary policy acts with a lag, and for this reason should continue to focus on a medium term time horizon.

4. Notwithstanding the imperative to anchor inflation expectations, I wish to confirm that the existing framework allows for temporary deviations of inflation from the target in the event of shocks over which monetary policy has no control. While it would be important to bring inflation back to within the target range, the time frame for the adjustment should attempt to avoid unnecessary instability in output and interest rates. In such cases, the Bank is required to explain clearly to the public the policy time horizon. The policy response should have due regard to the factors that might impact on the attainment of balanced and sustainable growth. These factors include the source of the inflation shock, the size of the gap between actual and potential economic growth; credit extension and asset bubbles, employment and other labour market developments; and the stability and competitiveness of the exchange rate.

5. As government, we are fully cognizant of the fact that better alignment is needed between macroeconomic policies on the one hand, and microeconomic reforms to remove constraints to growth on the other. I can assure you the National Treasury will endeavour to manage fiscal policy in a manner that supports these aims.

6. Credible monetary policy is essential for South Africa to achieve a new growth path and more job creation. Improved communication with the public about the role of monetary policy in supporting growth will increase the effectiveness of the Bank in achieving its mandate. Ongoing assessment, discussion and commentary about our monetary policy by analysts, interested members of the public, interest groups, and the broader research community, is constructive for the emergence of a social consensus in this area over the long term.

7. The crisis has also demonstrated the importance of a stable and well-regulated financial sector. An important lesson from the crisis has been the need for central banks to have a deeper understanding of the banking sector and financial stability. This requires greater focus on both macro- and microprudential analysis, regulation and supervision. I also wish to commend the Bank for the vital role played in successfully supervising the banking sector over these difficult times, and reaffirm the role that the Bank plays in overseeing and maintaining financial stability.

In these challenging times there is a great need for our responses to be agile and dynamic. This requires vigilance, ability and strong leadership. I trust that in working together, we will be able to move closer to our goal of raising employment and living standards of all South Africans.

Yours faithfully

Pravin

PRAVIN GORDHAN
MINISTER OF FINANCE
Date: 16 - 2 - 2010

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 contraction in the global economy in 2009 was less severe than expected, largely as a result of the better-than-expected positive growth in the final quarter of the year. The International Monetary Fund (IMF) in its *World Economic Outlook (WEO) – April 2010* estimates that the global economy recorded growth of -0,6 per cent in 2009 compared with 3,0 per cent in 2008 (Table 5). The stronger recovery towards the end of 2009 was fuelled by an increase in industrial production (and hence a turn in the inventory cycle), an increase in global trade and stronger-than-expected demand in the United States (US) and a number of emerging-market economies that ultimately reflected the extraordinary fiscal and monetary policy measures implemented worldwide.

The global growth outcome for 2009 reflected contractions in most of the developed countries, countered by firmly positive growth in emerging and developing countries. For the US, negative economic growth of 2,4 per cent was recorded for the year 2009 compared with a positive rate of 0,4 per cent in 2008. However, the US experienced stronger domestic demand and an increase in industrial production, resulting in a sustained increase in real output during the second half of 2009.

The economy of Japan shrank by 5,2 per cent in 2009, compared with negative real growth of 1,2 per cent in 2008. For the euro area, negative economic growth of 4,1 per cent was recorded for the year 2009 compared with positive real growth of 0,6 per cent in 2008. Worries that Greece may default on its mounting debt, destabilising the euro and sparking a bigger debt crisis amid other vulnerable euro area member states, have weighed on markets intermittently in recent months. The fears were exacerbated in April 2010 after Greek borrowing costs spiked to an all-time high, and ratings agencies downgraded Greek sovereign debt. Standard & Poor's downgraded Greek debt in late April, which led to concerns about the euro and the status of other strained European economies. In the United Kingdom (UK), negative real gross domestic product (GDP) growth of 4,9 per cent was recorded in 2009 compared with positive real growth of 0,5 per cent in 2008, as further weakening in the housing market continued to impact negatively on the components of final demand.

Table 5 Annual percentage change in real GDP and consumer prices

	Share of global GDP*	Real GDP		Consumer prices	
	2009	2008	2009	2008	2009
World	**100,00**	**3,0**	**-0,6**	**6,0**	**2,4**
Advanced economies	**53,9**	**0,5**	**-3,2**	**3,4**	**0,1**
United States	20,5	0,4	-2,4	3,8	-0,3
Japan	6,0	-1,2	-5,2	1,4	-1,4
Euro area	15,2	0,6	-4,1	3,3	0,3
United Kingdom	3,1	0,5	-4,9	3,6	2,2
Canada	1,8	0,4	-2,6	2,4	0,3
Other advanced economies	7,3	1,7	-1,1	4,3	1,5
Emerging and developing economies	**46,1**	**6,1**	**2,4**	**9,2**	**5,2**
Sub-Saharan Africa	2,3	5,5	2,1	11,6	10,6
Central and eastern Europe	3,5	3,0	-3,7	8,1	4,7
Commonwealth of Independent States	4,3	5,5	-6,6	15,6	11,2
Developing Asia	22,5	7,9	6,6	7,4	3,1
China	12,5	9,6	8,7	5,9	-0,7
India	5,1	7,3	5,7	8,3	10,9
Middle East and North Africa	5,0	5,1	2,4	13,5	6,6
Western hemisphere	8,5	4,3	-1,8	7,9	6,0

* GDP shares based on the IMF's purchasing-power-parity valuation of country GDPs for 2009

Source: IMF *World Economic Outlook,* April 2010

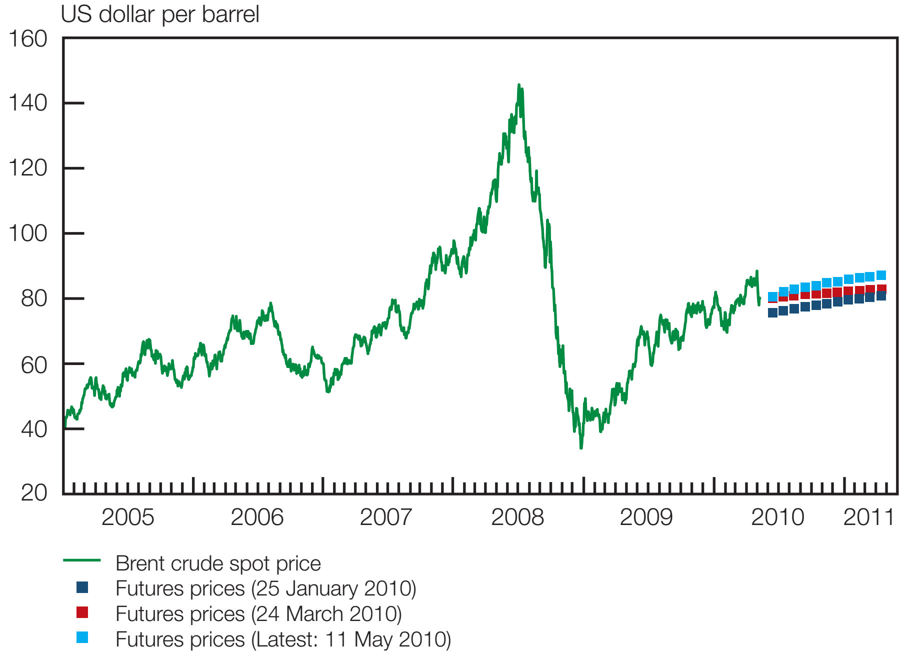
The confluence of weaker external demand and lower commodity prices led to weaker growth outcomes in most emerging economies in 2009. Average growth remained positive at 2,4 per cent, down from 6,1 per cent in 2008. For developing Asia, IMF data indicate that real output growth moderated to 6,6 per cent in 2009 from 7,9 per cent in 2008. Growth in both China and India slowed somewhat, albeit from high rates, but domestic demand continued to be supported by strong policy stimulus. The Chinese economy recorded growth of 8,7 per cent in 2009, while India's economy recorded growth of 5,7 per cent.

Growth in sub-Saharan Africa remained positive in 2009, with an expansion in real GDP of 2,1 per cent compared with 5,5 per cent in 2008. However, the inflation rate only declined slightly from 11,6 per cent in 2008 to 10,6 per cent in 2009. In the emerging and developing countries inflation moderated significantly to 5,2 per cent in 2009, while in the advanced economies there was virtually no inflation pressure – in fact, deflation was registered in Japan and the US.

Oil prices

The price of Brent crude oil, which had risen from a low of around US$34 per barrel late in December 2008 to around US$75 per barrel in early November 2009, remained relatively stable thereafter, fluctuating in a band of between US$67 and US$89 per barrel (Figure 7). Over this period the oil price was influenced largely by unexpected weather patterns in the northern hemisphere, concerns over the Iranian enrichment programme, a refinery strike in France and the volatility of the US dollar. Price pressure at the upper end of the band was capped by the recovery in global oil production from the lows recorded in the second quarter of 2009. However, by early April 2010, oil prices had settled at their highest level since October 2008, as a weaker US dollar, strong manufacturing data from China and the euro zone, as well as better-than-expected US unemployment data helped offset an increase in US crude oil inventories. Economic data reinforced expectations that a strengthening global economy would boost the demand for crude oil.

Figure 7 Price of Brent crude oil



Source: Bloomberg

At the March 2010 meeting of the Organization of the Petroleum Exporting Countries (OPEC) it was decided to keep target production at the level of 24,84 million barrels per day. This decision was taken after considering the fact that the expected increase in demand for crude oil in 2010 would be more than covered by increased production from non-OPEC oil-producing countries, that the stock levels in the Organisation for Economic Co-operation and Development (OECD) countries were comfortably above their five-year average and that there were still many perceived risks to the global recovery that could have a negative impact on the demand for oil and hence its price.

International monetary policy developments

The nascent global recovery continues to be supported by short- and long-term interest rates that have been held at their lowest levels on record in developed countries. Central bank balance sheets in developed countries expanded rapidly until recently and many central banks in emerging economies introduced special liquidity or credit facilities. The significant monetary stimulus in a number of countries is likely to continue for some time, although in some of these countries increasing emphasis is being placed on appropriate exit strategies from the extraordinary and unprecedented crisis-related intervention policies.

While global monetary conditions remain accommodative, some central banks have raised policy rates and even in countries where monetary conditions remain very accommodative crisis-related liquidity provision is winding down. There is therefore much reason for optimism about the economic outlook when comparing current developments with the global outlook scenario in 2009. Table 6 shows that since September 2009 policy rates have been reduced by central banks in a number of countries including Denmark, the Czech Republic, Hungary, Russia, Turkey and Iceland. However, Australia has led the world in raising borrowing costs partly in anticipation of a surge in investment in new mines and resources that may spark price pressures. Other countries that have raised policy rates in recent months include Norway, Israel, Malaysia, India and Brazil. As the recovery in these economies is expected to be stronger than in most advanced countries, they will probably continue to lead the tightening cycle. China has also begun tightening monetary policy in recent months in response to rapidly rising prices and concern about asset price inflation in particular.

Table 6 Selected central bank interest rates

Per cent

Countries	1 Sep 2009	13 May 2010	Latest decision (change in percentage points)	
United States	0,00–0,25	0,00–0,25	28 Apr 2010	(0,00)
Japan	0,10	0,10	10 May 2010	(0,00)
Euro area	1,00	1,00	6 May 2010	(0,00)
United Kingdom	0,50	0,50	10 May 2010	(0,00)
Canada	0,25	0,25	20 Apr 2010	(0,00)
Denmark	1,35	1,05	25 Mar 2010	(0,00)
Sweden	0,25	0,25	20 Apr 2010	(0,00)
Norway	1,25	2,00	5 May 2010	(0,25)
Switzerland	0,00–0,75	0,00–0,75	11 Mar 2010	(0,00)
Australia	3,00	4,50	4 May 2010	(0,25)
New Zealand	2,50	2,50	29 Apr 2010	(0,00)
Israel	0,75	1,50	26 Apr 2010	(0,00)
China	5,31	5,31	31 Mar 2010	(0,00)
Hong Kong	0,50	0,50	5 Nov 2009	(0,00)
Indonesia	6,50	6,50	5 May 2010	(0,00)
Malaysia	2,00	2,50	13 May 2010	(0,25)
South Korea	2,00	2,00	12 May 2010	(0,00)
Taiwan	1,25	1,25	25 Mar 2010	(0,00)
Thailand	1,25	1,25	21 Apr 2010	(0,00)
India	4,75	5,25	20 Apr 2010	(0,25)
Brazil	8,75	9,50	28 Apr 2010	(0,75)
Chile	0,50	0,50	15 Apr 2010	(0,00)
Mexico	4,50	4,50	16 Apr 2010	(0,00)
Czech Republic	1,25	0,75	6 May 2010	(-0,25)
Hungary	8,00	5,25	26 Apr 2010	(-0,25)
Poland	3,50	3,50	28 Apr 2010	(0,00)
Russia	10,75	8,00	29 Apr 2010	(-0,25)
Turkey	7,75	6,50	13 Apr 2010	(0,00)
Iceland	12,00	8,50	5 May 2010	(-0,50)

Source: National central banks

Monetary policy remains accommodative in the US and the end of the mortgage buying programme of the Federal Reserve (the Fed) was received calmly as private markets increasingly fill the void. The final Term Auction Facility and the Fed's US$1,25 trillion mortgage buying programme, with which it commenced during the worst of the credit crisis to help markets and the economy, ended in March 2010. Further action taken by the Fed was to increase the primary credit rate charged to banks on short-term loans by 25 basis points in February 2010, while the discount window was shortened to overnight in order to encourage banks to return to using this facility as a last resort when private funding is unavailable. The Fed has expressed its confidence that it will be able to drain reserves from the system effectively and shrink its balance sheet when there are appropriate signs that the worst has passed and that labour markets are headed in the right direction. The Fed has kept its benchmark rate close to zero since late 2008 and confirmed at the most recent Federal Open Market Committee (FOMC) meeting that it would maintain exceptionally low interest rates for an extended period. The Fed announced in May 2010 that it would reopen swap lines with other central banks to ensure that they had sufficient access to US dollars.

The policy rate of the European Central Bank (ECB) remains at a record low level of 1 per cent. The ECB left the policy rate unchanged at its most recent meeting and announced new collateral rules that would extend easier lending terms into 2011 to ease financial conditions for certain member countries in particular, while keeping interest rates at a record low. After the announcement of the European Union (EU) bailout plan, the ECB stated that it was willing to purchase euro zone government and private bonds “to ensure depth and liquidity” in markets.

The Bank of Japan (BOJ) kept its key interest rate unchanged at its most recent meeting. The overnight call rate has remained at 0,1 per cent since December 2008. However, policy was loosened further in March 2010 when BOJ board members boosted liquidity by expanding a low-interest loan programme in a further step to counter deflation.

The Bank of England’s (BOE) Monetary Policy Committee (MPC) held the cost of borrowing at 0,5 per cent at its most recent meeting and did not alter the £200 billion it had advanced thus far through quantitative easing to support the UK economy. The BOE warned that the road back to economic health would be slow and bumpy, given continued strains in the UK banking system, the need to reduce high levels of debt in both the public and private sectors, and the weakness of demand for UK exports in the euro area.

Denmark’s central bank reduced its main policy rate twice in January 2010. The Danmarks Nationalbank cut two of its rates on 25 March 2010 to ease pressure on the currency, but left its key lending rate unchanged at a record low 1,05 per cent. By cutting its certificate of deposit and current-account rates, the central bank aimed to curb currency strength without aligning its main rate with official euro zone borrowing costs. The central bank has cut its key lending rate 14 times since it began easing from a peak of 5,5 per cent in late 2008.

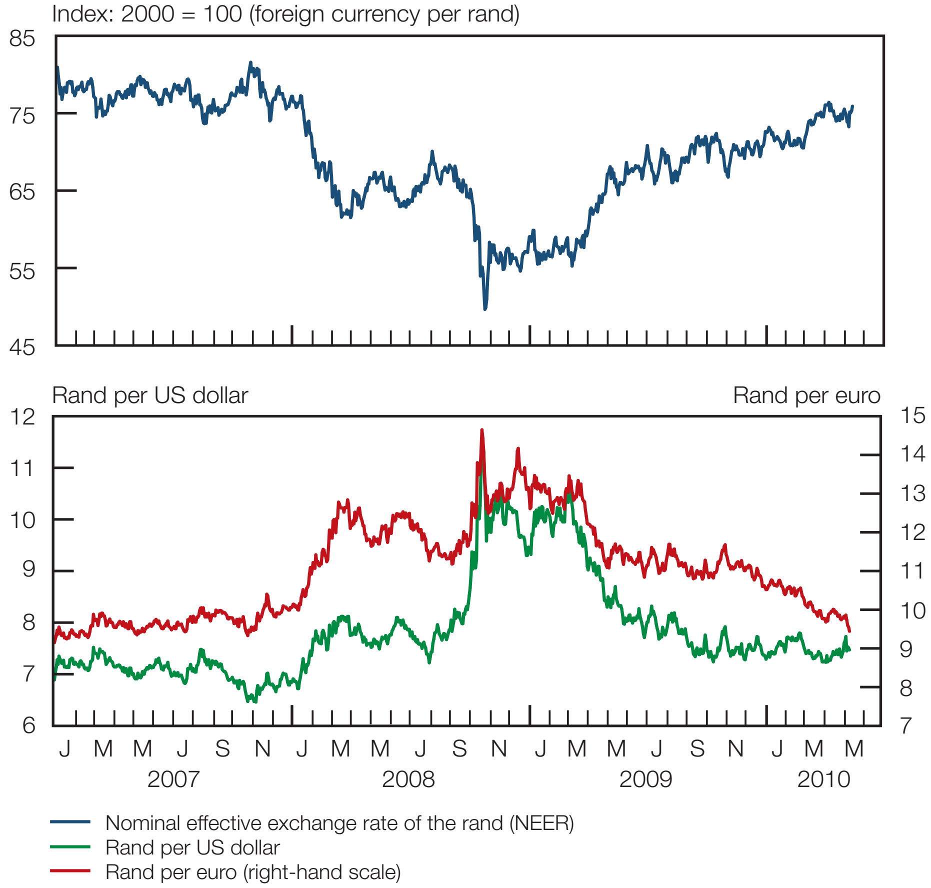
Australia’s central bank raised its benchmark interest rate to 4,50 per cent on 5 May 2010. This represented the sixth increase in borrowing costs in seven meetings, and the central bank deemed the move a further step towards ensuring a durable recovery by returning interest rates to average levels. The Reserve Bank of Australia revised its inflation forecasts upwards, with headline CPI expected to grow at 3,25 per cent in the year to June 2010, compared with the previous forecast of 3 per cent. Inflation in Australia reached 2,9 per cent in the quarter to March 2010, up from 1,3 per cent and 2,1 per cent in the previous two quarters, although it remains within the central bank’s target range of between 2 and 3 per cent over the cycle.

Policy-makers in India, China and Brazil have joined Australia in withdrawing monetary stimulus in 2010, seeking to head off asset-price bubbles as the regions lead global growth. China’s central bank is seeking to slow lending growth by 22 per cent to 7,5 trillion yuan this year. In March 2010 the World Bank cautioned that China needed to raise interest rates to help contain the risk of a property bubble and to allow a stronger yuan to dampen inflation. China’s central bank will sell three-year bills for the first time since June 2008 and has, on three occasions, ordered banks to increase the share of their assets held in reserve. India increased interest rates for the first time in almost two years in March 2010, and raised rates again in April to dampen rising inflationary pressures. Brazil increased the target Selic rate to 9,5 per cent from the end of April 2010 due to concerns about rising inflation.

Exchange rate developments

The foreign-exchange rate of the South African rand has generally strengthened in the period since the publication of the November 2009 *Monetary Policy Review*, although it has eased somewhat in recent weeks as a result of renewed risk aversion following the escalation in the Greek sovereign debt crisis (Figure 8). The trend appreciation of the rand was attributable to higher commodity prices (notably, gold and platinum prices), abnormally and persistently low interest rates in advanced economies, and inflows into the domestic bond and equity markets. To date in 2010, non-resident net purchases of South African bonds and equities have totalled around R43 billion, compared with net sales of R76 billion in the second half of 2008 and net purchases of R91 billion for 2009.

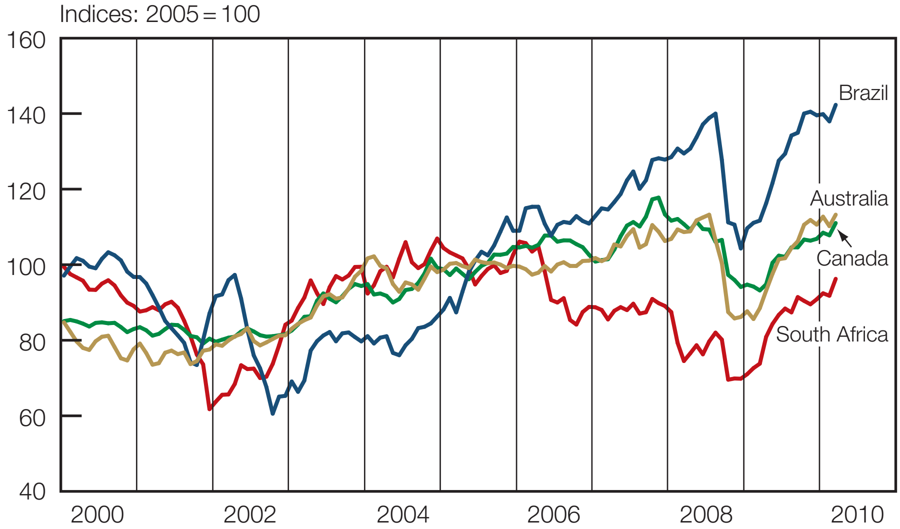
Figure 8 Exchange rates of the rand



The nominal effective exchange rate (NEER), which measures the value of the rand against a basket of 15 currencies, appreciated by 14 per cent from around 67 index points early in November 2009 to 76,4 index points on 7 April 2010. It then depreciated to 73,2 index points on 7 May, before recovering to 75,1 index points on 11 May. Measured on a bilateral basis, the rand appreciated from R11,68 to R9,59 against the euro between 3 November 2009 and 11 May 2010. Over the same period, the rand appreciated from R7,92 to R7,53 against the US dollar.

South Africa's real exchange rate has also appreciated in recent months. Measured by the Bank for International Settlements (BIS), on a consistent basis with other countries, it increased from around 70 index points at the end of 2008 to 96,3 index points in March 2010 (Figure 9). This appreciation is in line with that of other commodity-exporting countries such as Australia, Canada and Brazil, although the South African real exchange rate is the only one of this group that remains below the levels recorded, on average, in the 2005 base year.

Figure 9 Real effective exchange rates

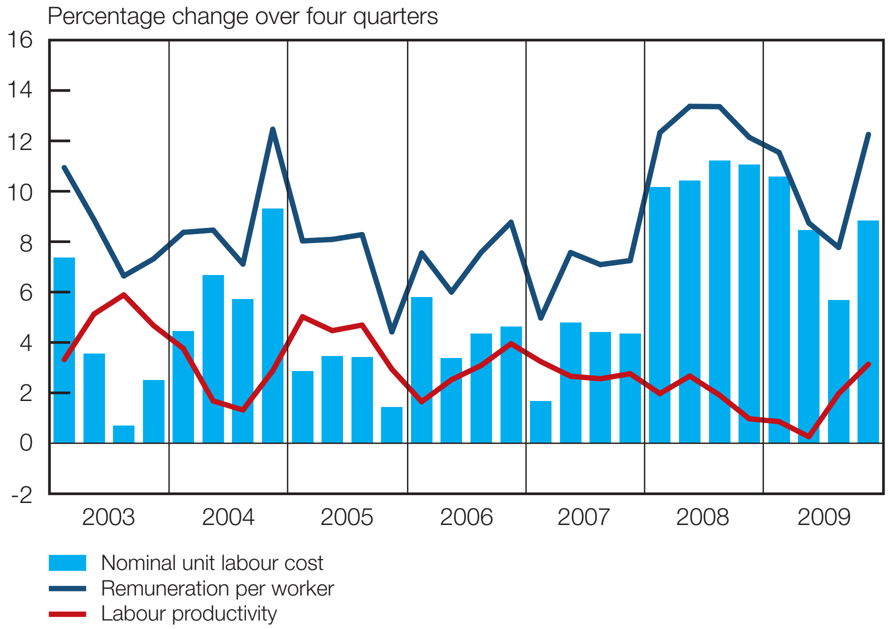


Source: Bank for International Settlements

Labour markets

Figure 10 shows that the year-on-year change in unit labour cost, which had declined from mid-2008, increased from 5,7 per cent in the third quarter of 2009 to 8,8 per cent in the fourth quarter. Wage inflation, measured by the year-on-year rate of increase in the nominal remuneration per worker in the non-agricultural sectors, rose from 7,8 per cent in the third quarter of 2009 to 12,3 per cent in the fourth quarter, largely as a result of one-off salary adjustments in the public sector. This increase was not fully offset by the improvement in the year-on-year rate of increase in labour productivity, which rose from 0,3 per cent in the second quarter of 2009 to 2,0 per cent in the third quarter and 3,1 per cent in the fourth quarter.

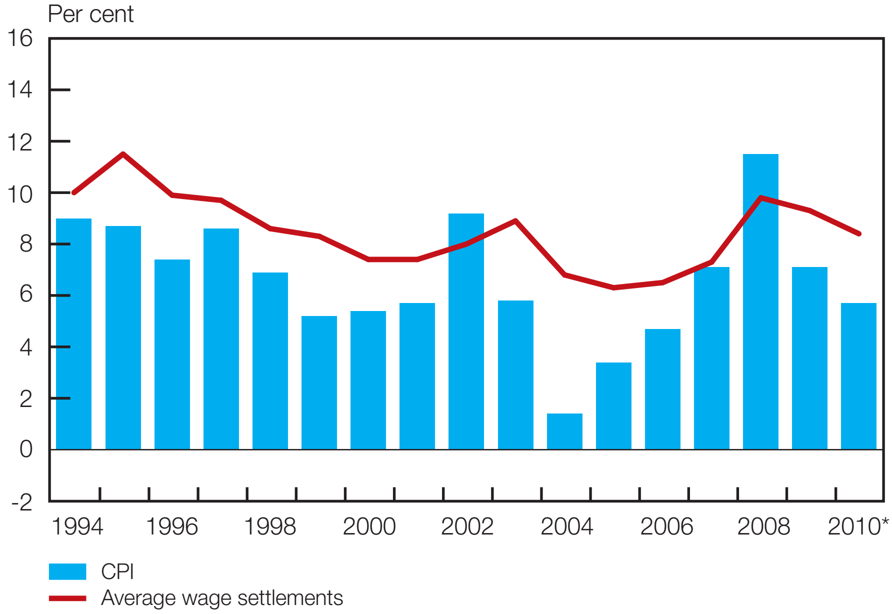
Figure 10 Remuneration per worker, labour productivity and unit labour cost in the formal non-agricultural sector



Sources: Statistics South Africa and South African Reserve Bank calculations

According to the outcome of the *Andrew Levy Wage Settlement Survey*, the level of wage settlements amounted to 8,4 per cent in the first quarter of 2010, after averaging 9,3 per cent in 2009 and 9,8 per cent in 2008. The settlements in the first quarter of 2010 ranged from 7 per cent in the health/education sector to 10 per cent in the retail sector. In 2009 the settlements ranged from 5 per cent in the paper/printing sector to 12,3 per cent in the food/agriculture sector, with 55,6 per cent of settlements falling in the 9–10,9 per cent band (Figure 11).

Figure 11 Average annual inflation and wage settlements



* Data for 2010 are for the first three months of the year

Sources: Andrew Levy Employment Publications and Statistics South Africa

Demand and output

The South African economy began to recover in the period under review. Having contracted in the previous three quarters on a quarter-on-quarter basis, real GDP increased at annualised rates of 0,9 per cent in the third quarter of 2009 and 3,2 per cent in the final quarter of the year (Table 7). For the year as a whole, real GDP nevertheless contracted by 1,8 per cent in 2009, compared with growth of 3,7 per cent in 2008.

The primary, secondary and tertiary sectors all contributed positively to the growth in real GDP in the fourth quarter of 2009. The real value added by the primary sector increased by 0,9 per cent in the fourth quarter, following a decline of 7,6 per cent in the third quarter. This was the result of positive growth in mining production and a slower rate of contraction in the agricultural sector. In the secondary sector, growth increased from 7,0 per cent in the third quarter of 2009 to 8,1 per cent in the fourth, mainly as a result of a further acceleration in growth in manufacturing output. Finally, growth in the real value added by the tertiary sector rose from 0,8 per cent in the third quarter of 2009 to 2,3 per cent in the fourth quarter, with increased activity recorded in all the subsectors of the sector.

Table 7 Growth in real GDP and expenditure components

Per cent*

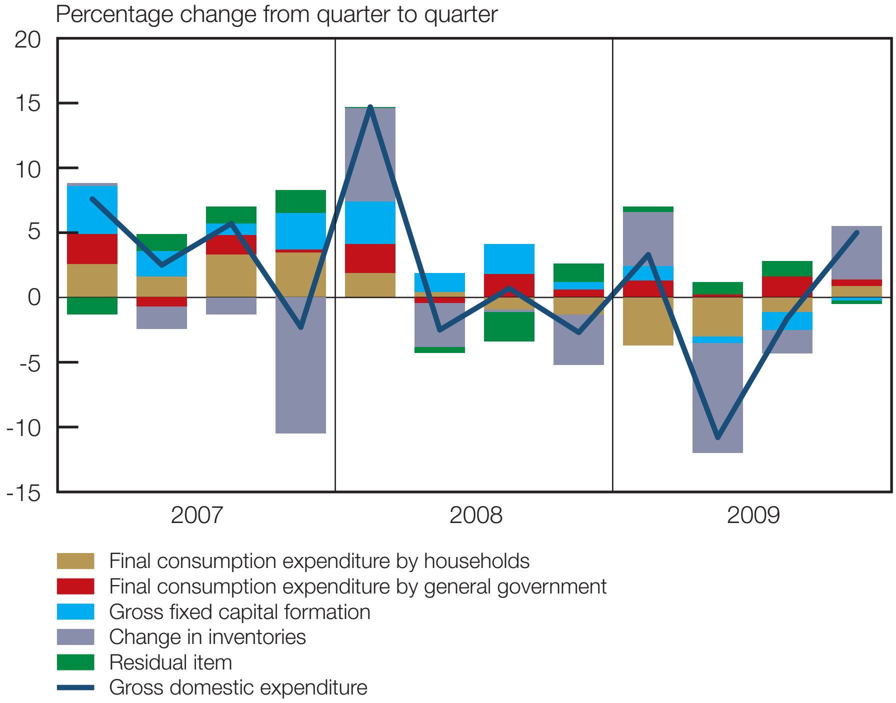
	2008	2009				
	Year	1st qr	2nd qr	3rd qr	4th qr	Year
Final consumption expenditure:						
Households	2,4	-5,8	-5,2	-1,9	1,4	-3,1
General government	4,9	6,7	0,9	8,1	2,3	4,7
Gross fixed capital formation	11,7	5,2	-2,5	-6,5	-0,9	2,3
Domestic final demand	**4,6**	**-1,3**	**-3,5**	**-1,0**	**1,1**	**-0,6**
Changes in inventories (R billions)**	-7,7	-6,8	-48,5	-56,9	-38,4	-37,6
Gross domestic expenditure	**3,3**	**3,3**	**-10,8**	**-1,6**	**5,0**	**-1,8**
Exports of goods and services	2,4	-56,9	-12,6	11,0	20,0	-19,5
Imports of goods and services	1,4	-28,7	-36,2	-1,0	26,2	-17,4
Gross domestic product	**3,7**	**-7,4**	**-2,8**	**0,9**	**3,2**	**-1,8**

* Quarterly data refer to quarter-on-quarter growth at annual rates of seasonally adjusted data
** Constant 2005 prices

Real gross domestic expenditure increased at a rate of 5,0 per cent in the final quarter of 2009, after declining by 10,8 per cent in the second quarter and 1,6 per cent in the third quarter. This performance was the result of a recovery in growth in final consumption expenditure by households over the period, and a turnaround in changes in real inventory levels and gross fixed capital formation (Figure 12). Final consumption expenditure by households increased at a rate of 1,4 per cent in the final quarter of the year, although the annual growth rate for 2009 reflected a contraction of 3,1 per cent. Growth in final consumption expenditure by general government slowed to 2,3 per cent in the fourth quarter from 8,1 per cent in the third quarter.

Figure 12 Gross domestic expenditure

Percentage change from quarter to quarter



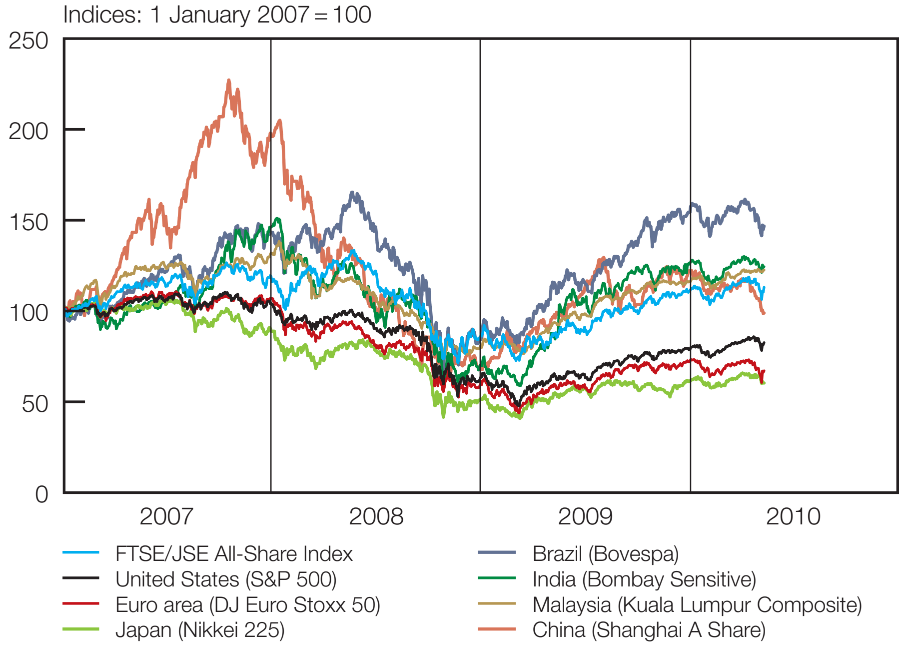
In the external sector of the economy, real exports of goods and services grew by an annualised 11,0 per cent in the third quarter of 2009 and by 20,0 per cent in the final quarter. Real imports of goods and services rose at an annualised rate of 26,2 per cent in the fourth quarter after declining by 1,0 per cent in the third quarter. South Africa's trade surplus with the rest of the world consequently widened from R22,3 billion in the third quarter of 2009 to R24,9 billion in the fourth quarter. Since net service, income and current transfer payments to non-residents remained broadly constant in the second half of 2009, the deficit on the current account of the balance of payments declined steadily from 6,7 per cent of GDP in the first quarter of 2009 to 2,8 per cent in the final quarter.

South Africa's gross gold and other foreign reserves rose from US$39,1 billion at the end of September 2009 to US$42,3 billion at the end of April 2010. The international liquidity position increased from US$37,9 billion to US$38,5 billion over the same period. The reserve positions were influenced by revaluation effects due to the stronger foreign exchange rate of the US dollar over the period, as the Bank continued to be a net purchaser of foreign currency.

Real-estate and equity prices

Both real-estate prices and the prices of shares on the JSE Limited (JSE) have recovered from the low levels seen in early 2009. Since the first quarter of 2009, JSE share prices have risen strongly, driven by the recovery in global markets and the improving global economic outlook, improved investor sentiment towards South Africa by overseas investors and firmer commodity prices. The FTSE/JSE All-Share Index (Alsi) increased by 63 per cent from a low of 18 121 index points on 3 March 2009 to a peak of 29 565 index points on 15 April 2010, before declining in line with international markets to 26 515 on 7 May following concerns about Greece's sovereign debt. By 11 May it had recovered to 27 514 index points. The index performed similarly to those of

Figure 13 Share price indices

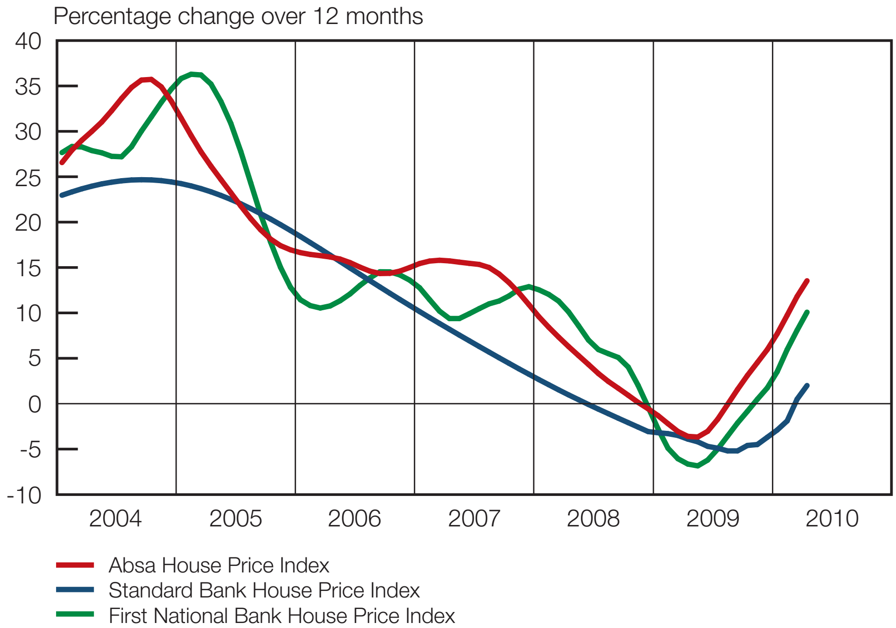


Sources: JSE Limited and I-Net Bridge

other emerging-market economies such as Malaysia, China and India, increasing less than the Brazilian Bovespa Index but outperforming the S&P 500, Dow Jones Euro Stoxx50 and the Nikkei indices (Figure 13).

The year-on-year percentage changes in nominal house prices have returned to positive territory, after recording negative rates in most of 2009 (Figure 14). Factors contributing to the upward trend include the lagged effect of the cumulative 550 basis point reduction in interest rates since 2009, the easing of lending conditions to consumers by banks and growing optimism about the impact of improving economic growth on household disposable income. The 12-month change in the First National Bank (FNB) National Average House Price Index improved from -6,9 per cent in May 2009 to 10,1 per cent in April 2010, and a similar upward trend is evident in the Absa House Price Index, which improved from a rate of -3,7 per cent in May 2009 to 13,5 per cent in April 2010. The 12-month change in average house prices measured by the Standard Bank Median House Price Index improved from -5,2 per cent in September 2009 to 2,0 per cent in April 2010.

Figure 14 House prices



Sources: Absa, Standard Bank and First National Bank

Building statistics published by Statistics South Africa summarised in Table 8 show a deterioration in the total real values of both building plans passed and buildings completed in the past three years. The pace of contraction measured by the annual percentage changes of the total real value of building plans passed deteriorated from -2,4 per cent in 2007 to -21,6 per cent in 2009. Similarly, the growth in the total real value of buildings completed and in residential buildings completed deteriorated from positive rates in 2007 to negative rates in 2009. The deterioration in the residential components of both building plans passed and completed was more intense in 2009 than in 2008.

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

Annual percentage change

	2007	2008	2009	2010*
Building plans passed				
Total	**-2,4**	**-17,3**	**-21,6**	**-8,2**
Residential	-3,2	-26,3	-36,7	-13,3
Non-residential	-5,9	2,0	-7,0	-29,2
Additions and alterations	1,9	-12,5	-8,1	20,4
Buildings completed				
Total	**9,5**	**1,8**	**-15,8**	**-38,0**
Residential	1,2	-8,2	-25,1	-40,5
Non-residential	48,6	19,4	-10,8	-35,9
Additions and alterations	6,1	15,9	2,8	-34,9

* Data for 2010 are for the first two months of 2010 compared with the same period of the previous year

Source: Statistics South Africa

Fiscal policy

The fiscal space that was created in the years preceding the financial crisis allowed a concerted response to the crisis in line with government's stated intention to manage public finances along a trajectory that will return the fiscus to a sustainable position. The 2010 Budget that was presented by the Minister of Finance on 17 February 2010 maintains public spending levels, while revenue is projected to recover over the forecast period to 2012/13. The deficit is therefore projected to continue trending downwards as spending growth moderates and revenue continues to rise. Over the next three years public spending is projected to grow by about 2 per cent on average in real terms compared with average real growth of 7,2 per cent in the preceding three years. Non-interest expenditure is projected to decline over the forecast period and rising budget revenue will lead to a narrowing primary budget deficit over the next three fiscal years.

The revised budget balance for 2009/10 is a deficit of R177,8 billion, which represents 7,3 per cent of GDP (Table 9). This revised budget balance is almost double 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 expected to have amounted to R657,6 billion in 2009/10, significantly lower than the estimate of R740,4 billion made in February 2009. Consolidated government expenditure in 2009/10 was expected to have been approximately as projected in February 2009, rising marginally from R834,3 billion to R835,3 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 4,1 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, is expected to widen to 11,8 per cent of GDP in 2009/10. While the deficits of government and the non-financial public enterprises are projected to moderate in subsequent years – declining to 11,1 per cent of GDP in 2010/11, to 8,8 per cent of GDP in 2011/12 and to 7,1 per cent of GDP in 2012/13 – total borrowing of the public sector remains high over the medium term. Net loan debt as a share of GDP in 2009/10 has been revised to 28,2 per cent and is projected to increase to 39,8 per cent of GDP by 2012/13. Based on National Treasury's GDP growth estimates, the central forecast is for net loan debt to rise to 44 per cent of GDP in 2015/16 and to decline gradually thereafter. While the assumptions produce a reasonably favourable fiscal outlook, lower economic growth outcomes and higher fiscal deficits pose significant risks to the outlook.

Table 9 Public finance data

	2008/09	2009/10		2010/11	2011/12	2012/13
	Outcome	Budget	Revised estimates	Medium-term estimates		
Consolidated national government* (R billions)						
Revenue	689,7	740,4	657,6	738,4	827,7	922,3
Expenditure	713,9	834,3	835,3	907,0	977,0	1 058,6
Budget balance	-24,2	-94,0	-177,8	-168,6	-149,6	-136,3
As a percentage of GDP						
Budget balance	-1,0	-3,8	-7,3	-6,2	-5,0	-4,1
Total net loan debt	22,7	25,6	28,2	33,2	37,3	39,8
PSBR**	4,0	8,0	11,8	11,1	8,8	7,1

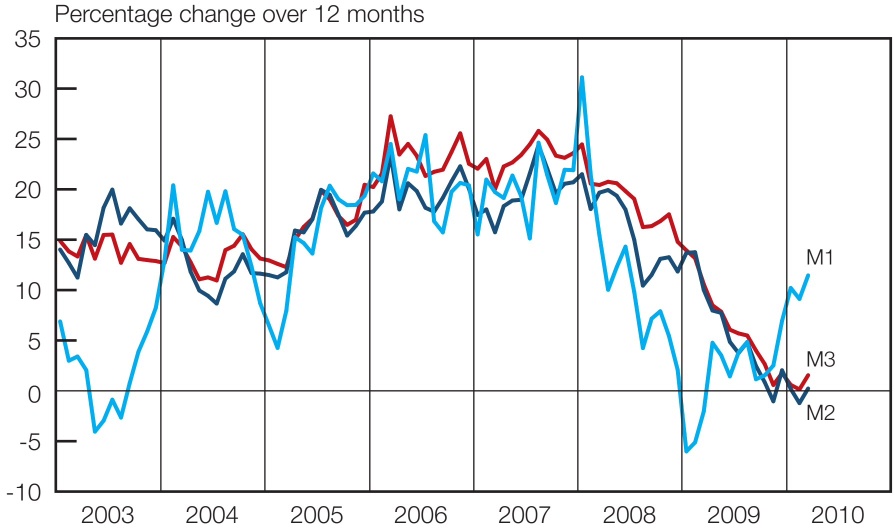
* Includes national government, provinces, social security funds and selected public entities
** PSBR: Public-sector borrowing requirement

Source: National Treasury *Budget Review 2010*

Monetary conditions

Growth in broad money has generally declined since September 2009, with growth in the M3 aggregate recording a record-low year-on-year rate of 0,1 per cent in February 2010, before rising to 1,6 per cent in March (Figure 15). The growth rate of M2 has been somewhat volatile, recovering to 0,2 per cent in January 2010, contracting by 1,2 per cent in February and recording 0,2 per cent in March. Conversely, the growth rate of M1 has continued to rise since previously reported in the November 2009 *Monetary Policy Review*. The growth rate increased from 1,2 per cent in September 2009 to 11,5 per cent in March 2010.

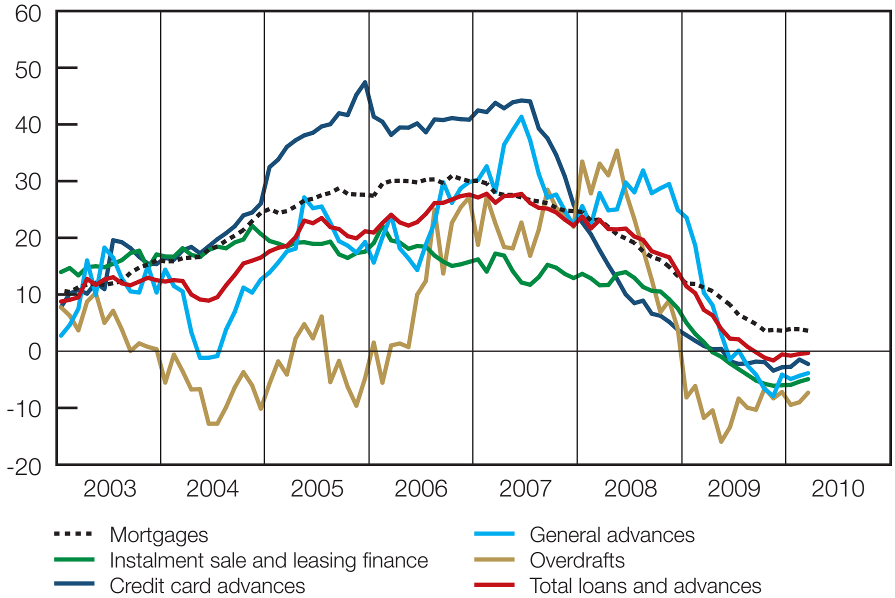
Figure 15 Growth in monetary aggregates



As Figure 16 shows, year-on-year growth in the total loans and advances aggregate has remained negative since September 2009, reaching a low of -1,6 per cent in November 2009 and most recently contracting by 0,3 per cent in March 2010. Mortgage advances, which grew by 3,9 per cent in January and February 2010, have levelled off since October 2009. All other categories of loans and advances to the private sector remain in negative growth territory, although there are some signs that the trajectory of the growth paths may have changed in line with continued lower interest rates, increased economic activity, and improving consumer and business confidence.

Figure 16 Banks' loans and advances by type

Percentage change over 12 months



Box 2 Exchange rate pass-through in South Africa: Panel evidence from individual goods and services

Exchange rate pass-through is broadly defined as the percentage change in prices as a result of a change in the exchange rate. However, this definition contains a considerable amount of ambiguity, and there are a number of issues that complicate the measurement of exchange rate pass-through. The prices considered, the lag between exchange rate changes and prices changes, the source of the exchange rate change, the presence of simultaneity biases and possible changes in aggregate price indices are all potentially important. Recent work undertaken at the Bank contributes to this literature by studying exchange rate pass-through in South Africa at a disaggregated level.[1] Two distinct panels of disaggregated data are employed. The first data set, obtained from the Economist Intelligence Unit (EIU), contains annual prices of 158 individual goods and services at the consumer level from 1990 to 2009. The second panel contains quarterly average import unit values for 26 eight-digit import categories from ten of South Africa's top trading partners from the first quarter of 1998 to the second quarter of 2009. Estimates of pass-through to both sets of prices are reported in the study.

1 Parsley D. 2010. "Exchange Rate Pass-through in South Africa: Panel Evidence from Individual Goods and Services". Forthcoming, South African Reserve Bank Working Paper.

Focusing first on pass-through to prices in the EIU data set, a number of specifications are estimated. The basic specification is a first-differenced log linear specification of the standard exchange rate pass-through equation:

$$\Delta p^{*}_{it} = \Sigma^{1}_{j=0}\, \beta_j\, \Delta s_{t-j} + \gamma \Delta c_t + \delta \Delta rgdp_t + \varpi \Delta G7gap_t + goods\ dummies$$

where Δ is the first-difference operator, p^{*}_{it} is the natural log of the rand price of the good or service i at time t, s_{t-j} is the log of the bilateral rand/US dollar exchange rate at time t-j, c_t is the log of the world export price index – an indicator of costs of production, *rgdp* is log real gross domestic product – an indicator of changes in domestic demand conditions, and the G7 output gap is indicated by *G7gap*. Since the goods are pooled into a single regression, product dummies are included.

The second specification builds on this by including lags of exogenous variables and a lag of the dependent variable, the third specification includes an error correction term to capture reversion to purchasing power parity (PPP)[2], and the final specification includes interaction terms of the trend with the error correction term and the change in the exchange rate term.

2 The PPP relationship is obtained from a regression of South African consumer prices on United States prices, the nominal rand/dollar exchange rate and a constant.

Each specification is estimated separately for those items designated as goods (113 items) and for those items designated as services (45 items), a unique aspect of the study. The main results are summarised in Table B2.1. As can be seen, short-run pass-through is statistically significant for all specifications using the goods data set, and all but one specification for the services data set. Short-run pass-through is quite low, ranging between 11 and 23 per cent for goods and between 10 and 37 per cent for services. It can also be seen that pass-through from the change in the foreign prices of goods is somewhat higher than the exchange rate pass-through for both goods and services. These results confirm that the law of one price does not hold. The error correction term is significant in both specifications for the goods data set and for the third specification for the services data set. While this indicates long-run reversion to PPP, the long run is particularly long, which suggests that either prices are sticky in South Africa or that there is significant local value-added content in goods and services sold to the consumer in South Africa. The finding that there is no significant trend in exchange rate pass-through may explain why there has been less of a downward trend in inflation in South Africa relative to the results of studies for other countries.

Table B2.1 Pass-through to final goods and services

	1	2	3	4
	Goods			
Δ*ln*(exchange rate)	0,0901**	0,0426	0,1120***	0,1655***
Δ*ln*(exchange rate (-1))	0,1433***	0,1084***		
Sum	0,2334***	0,1509***		
Trend*Δ*ln*(exchange rate)				0,0067
Δ*ln*(world export prices)	0,4561***	0,4793***	0,7042***	0,7845***
Δ*ln*(world export prices (-1))		-0,1858	-0,0251	-0,1076
Δ*ln*(real income)	-0,0141***	-0,0123***	-0,0192***	-0,0205***
Δ*ln*(real income (-1))		0,0059	0,0042	-0,0006
G7 gap	0,0027	-0,0033	0,0246***	0,0256***
G7 gap (-1)		-0,0046	-0,0207**	-0,0363***
Dependent variable (-1)		-0,2796*		
Error correction term			-0,1019***	-0,1494***
Trend*Ecm				0,0036***
	Services			
Δ*ln*(exchange rate)	0,1515**	0,1838**	0,1048**	0,1182
Δ*ln*(exchange rate (-1))	0,1423**	0,1835*		
Sum	0,2938***	0,3673***		
Trend*Δ*ln*(exchange rate)				0,0027
Δ*ln*(world export prices)	0,2357	0,2414	0,5083**	0,5176*
Δ*ln*(world export prices (-1))		0,1542	0,1355	0,0999
Δ*ln*(real income)	-0,0098	-0,0160**	-0,0175**	-0,0158*
Δ*ln*(real income (-1))		0,0025	0,0063	-0,0075
G7 gap	0,0146	0,0249	0,0329***	0,0340***
G7 gap (-1)		-0,0159	-0,0085	-0,0056
Dependent variable (-1)		-0,1188		
Error correction term			-0,0777**	-0,0559
Trend*Ecm				-0,0015

***, **, * indicate significance at the 1, 5 and 10 per cent levels respectively

Pass-through to import prices is estimated using the import unit values of 26 products imported into South Africa, from the ten largest suppliers, that is, using a three-dimensional panel of goods (26), countries (10) and time (46 quarters). Following Knetter (1989), the following general empirical specification is used:

$$ln\ p^*_{ijt} = \theta_t + \lambda_j + \gamma_i + \beta_j\, ln\ s_{jt} + \nu_{ijt}$$

According to this specification, the rand price of import *i*, is determined by good, time and source country fixed effects, plus a random error. Augmenting the equation with country specific (log) exchange rates allows an estimate of the country-specific pass-through elasticities, which is presented in Table B2.2.

Table B2.2 Pass-through to South African imports

	1	2
Brazil	0,7526***	0,7131***
China	0,2327	0,2648**
Germany	0,5816***	0,5012***
Great Britain	0,6055***	0,5619***
India	0,6211*	0,8068***
Japan	0,3767**	0,4365***
Sweden	0,0741	-0,0461
Switzerland	0,6328*	0,4694**
Taiwan	0,6418***	0,5911***
United States	0,7357***	0,6692***

***, **, * indicate significance at the 1, 5 and 10 per cent levels respectively

The first set of results reported in Table B2.2 is based on the entire data set, while the second set of results is from regressions run after dropping the top and bottom 5 per cent of the residuals. These results suggest that pass-through from Brazil and the US is quite high, at over 70 per cent (column 1). Furthermore, pass-through from Germany, Great Britain, India, Switzerland and Taiwan is clustered around 60 per cent, while Japan exhibits a much lower level of pass-through at about 38 per cent. The results for China and Sweden report low levels of pass-through, although the coefficients are not significantly different from zero. The results reported in column 2 are quite similar to those reported in column 1, except that pass-through from China becomes statistically significant at the 5 per cent level.

Finally, two additional specifications were estimated using this data set. The first constrains all pass-through coefficients to be the same (excluding China and Sweden) and the second investigates if the level of the pass-through has changed over time. The results suggest that the average pass-through to South African import prices over the period 1998 to 2009 is about 60 per cent and that there is no evidence that the level of pass-through to import prices has changed over time.

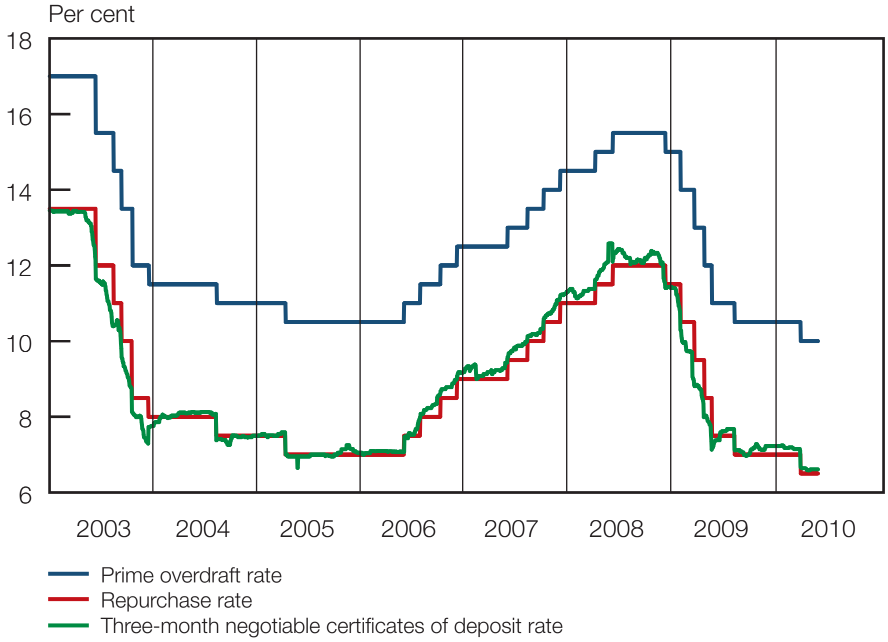
Results from this study suggest that pass-through to prices estimated using the EIU data set is low in South Africa (between 15 and 25 per cent) and that there is very slow convergence to long-run purchasing power parity. No evidence of a decline in pass-through to these prices over the past twenty years was found in this study. Furthermore, pass-through to import prices is somewhat higher at around 60 per cent and no evidence of decline over the estimation period was found.

Monetary policy

In the wake of the global financial crisis, many central banks have loosened their monetary policy significantly. Most of these adjustments occurred during late 2008 and the first half of 2009. South Africa generally followed this trend, and between December 2008 and August 2009 the repurchase rate was reduced by a total of 500 basis points. The stance of monetary policy subsequently remained unchanged until March 2010. During this period, the MPC was of the view that the repurchase rate was consistent with the expected inflation trajectory and with the projected recovery in the domestic economy. Since the publication of the previous *Monetary Policy Review* (November 2009), the repurchase rate was reduced by a further 50 basis points in March, which brought it to a level of 6,5 per cent per annum (Figure 17). This further reduction in the rate was implemented against the backdrop of a more favourable inflation outlook and continued weakness in domestic household consumption expenditure in particular.

In 2009, against the backdrop of heightened volatility and uncertainty in international financial markets, and the severe global economic downturn, the decision was taken to increase the frequency of MPC meetings to monthly, given the pace at which global

Figure 17 The repurchase rate and other short-term interest rates



events were unfolding. This allowed for a more timely assessment of, and appropriate reaction to, new information and changing circumstances. However, as the intensity of the crisis declined and it appeared that the global economy was on the road to recovery, the Bank reverted to a bimonthly schedule, although it was noted that this schedule could be reconsidered if the situation called for it. During the period under review, there have been three meetings of the MPC: in January, March and May 2010.

At the time of the January 2010 meeting, the most recent inflation outcomes were within the inflation target range. Year-on-year CPI inflation rates for October and November 2009 measured 5,9 per cent and 5,8 per cent respectively, although there was an expectation that inflation would temporarily breach the upper end of the target range as a result of adverse technical base effects related to petrol prices in particular. At that stage, it was expected that inflation would increase to around 6,5 per cent in December 2009 and January 2010, before returning on a sustained basis to within the inflation target range by March 2009. The MPC emphasised that the forward-looking nature of monetary policy meant that the focus remained on the longer-term expected trend of inflation and, at that stage, inflation was expected to remain within the inflation target range until the end of the forecast period in the final quarter of 2011, when it would measure around 5,4 per cent.

Inflation declined to within the inflation target range sooner than expected. In February 2010 inflation measured 5,7 per cent and declined further to 5,1 per cent in March. In March the Bank's forecast indicated an improved inflation outlook for 2010, compared with the previous forecast, while the forecast for 2011 was relatively unchanged.

At the May 2010 meeting, there was further improvement in the forecast, with inflation expected to reach a low point of 4,7 per cent in the third quarter of 2010. Inflation was then expected to increase moderately and remain within the inflation target range until the end of the forecast period, which had been extended to the end of 2012, at 5,3 per cent. This forecast is discussed in more detail in a later section.

Inflation expectations, as reflected in the survey conducted by the Bureau for Economic Research (BER) at Stellenbosch University had remained persistently high during 2009 despite the decline in inflation. The 2009 fourth quarter survey continued this trend, but by March, with the publication of the 2010 first quarter survey, it was evident that there was a significant improvement and expectations for 2010 inflation declined from 7,7 per cent to 6,5 per cent, while expectations for the subsequent two years moderated to 6,7 per cent and 6,8 per cent respectively. Despite the improvement, average expectations remained outside the inflation target range. Expectations of financial analysts, both in the BER survey, as well as those reflected in the Reuters surveys, were more positive and indicated that the expectations of this category were anchored at the upper end of the target range.

Domestic economic prospects are strongly influenced by the global economic outlook. During the period under review, the global economy initially showed signs of a strong recovery, although this improvement was uneven across regions. The global growth recovery was driven by emerging markets, particularly in Asia, but the MPC expressed concern about the low growth and risks in the euro area and, to a lesser extent, in the US. The committee noted that the relatively slow pace of recovery in advanced economies implied that the pace at which accommodative monetary policy was reversed was likely to be slow, while the need to reverse unsustainable fiscal positions posed a risk to the global outlook. By May, as the crisis in the euro area intensified, these risks increased, and the MPC noted the possibility of a renewed crisis that could threaten the global recovery. Despite the massive interventions of European governments, the ECB and the IMF, risks and uncertainties still prevailed. The global inflation outlook was assessed as being benign and did not appear to pose a risk to the domestic inflation outlook.

The domestic economy emerged from the recession during this period. By the time of the January meeting, it was evident that positive growth was being experienced, with GDP growth of 0,9 per cent recorded in the third quarter of 2009. At that stage, the Bank's forecast was that growth in 2010 would average 2,0 per cent. By March, the growth performance and outlook had improved, following the 3,2 per cent growth rate recorded in the final quarter of 2009. The Bank's growth forecast for 2010 also showed a marked improvement to 2,6 per cent. By May the forecast had improved further to 2,7 per cent and to 3,6 per cent for 2011. The GDP forecasts are discussed in more detail in a later section. The output gap, which is the difference between actual and potential output growth, nevertheless remained relatively wide and was expected to remain positive for some time.

During the period under review, most of the short-term indicators reflected a continuation of the positive growth trend. The South African Reserve Bank composite leading indicator confirmed the sustained nature of the upswing and the Kagiso Purchasing Managers' Index was also consistent with the observed recovery in the manufacturing sector, which showed consistent improvement during this period.

Despite the improved growth outlook, the MPC noted the continued weakness in domestic expenditure and expressed the view that demand conditions did not pose a risk to the inflation outlook. In the January meeting the committee noted that real household consumption expenditure was still contracting in the third quarter of 2009, but by the fourth quarter this trend was reversed when positive, but low, growth was recorded. There was also evidence that the negative trend in the consumption of durable goods had reversed. This was reinforced by the strong recovery in motor vehicle sales that was evident in the first few months of 2010. Retail sales data, despite some signs of improvement, reflected continued weakness of household consumption expenditure. In May it was noted that although retail sales declined on a year-on-year basis in February, when the three months to February were compared with the previous three months, a positive increase was recorded.

Throughout most of this period, the committee was of the view that the subdued consumption expenditure was likely to persist as a result of a number of factors. These included trends in credit extension, the need to repair impaired household balance sheets and elevated rates of unemployment.

Credit extension by banks to the private sector contracted in most of the categories. However, these trends were not only a result of strict credit criteria applied by banks, but also due to constrained demand for credit. The MPC pointed to evidence of some relaxation of these credit criteria, yet most categories of private-sector credit extension contracted consistently during this period. Mortgage advances was the only category to exhibit year-on-year growth, but even this growth was negative in real terms. The decline in credit extension did help to retard the pace of increase in household debt. The ratio of household debt to disposable income appeared to have levelled out during this period after sustained increases in previous years, but remained at historically high levels.

There were, however, some positive developments with respect to wealth effects. Equity prices continued their steady recovery, but reacted adversely to the global financial market turbulence in the first week of May. House prices, which had been generally declining for some time, began to exhibit positive growth.

In January the MPC noted that adverse employment trends and employment insecurity were likely to constrain household expenditure. During the third quarter of 2009, the Quarterly Employment Statistics Survey showed further employment losses, despite the turnaround in the economy. At the March meeting, by which time the fourth quarter data had been released, a more favourable picture was evident and it appeared that the decline in employment had slowed. However, the *Quarterly Labour Force Survey* released ahead of the May meeting indicated that the unemployment rate had increased further and that employment trends were likely to lag the recovery.

Fiscal policy has a potentially significant impact on monetary policy. For a number of years fiscal policy had been supportive of monetary policy and was therefore not a concern. In response to the crisis, however, the fiscal deficit was allowed to widen as the automatic stabilisers took effect. The MPC deemed this an appropriate countercyclical policy and expressed the view that if the proposed fiscal consolidation over the coming years were to be maintained, it did not foresee a possible conflict with monetary policy objectives.

A major contributor to the favourable inflation outlook was the behaviour of the rand exchange rate. During the period under review, the rand exchange rate was generally in a range of around R7,20 to R7,60 against the US dollar. The uncertainty in the global financial markets in May resulted in a brief, but significant, depreciation of the rand against the US dollar. The MPC was, however, cognisant of the fact that a strong rand could impact adversely on some sectors of the economy and be a cause for concern from the perspective of overall macroeconomic balance. However, the rand exchange rate was influenced by a number of exogenous factors, including improved commodity prices and the sustained capital inflows into emerging markets in general, in response to abnormally low interest rates in advanced economies. These low interest rates were expected to persist for some time. Whereas previously the exchange rate was seen as an upside risk to the inflation outlook, during this period it was generally regarded as a downside risk. However, the reaction of the rand to the developments in the euro area demonstrated the vulnerability of the rand to changes in global sentiment, and the MPC noted that the positive impact of the rand on the inflation outlook was contingent on developments in the euro area and general risk aversion.

Supply-side factors no longer imparted a major upside risk to the inflation outlook. During 2008 and much of 2009, food price inflation was generally the most significant contributor to the inflation outcomes. However, during 2009 food price inflation moderated significantly. In January 2010 the MPC noted that pressures from food prices had subsided despite higher international prices. By the March meeting, food price inflation had declined to below the average CPI inflation rate and the significant decline in the price of maize in the early months of 2010, and continued price declines at the producer price level improved the outlook for favourable food price inflation trends in the medium term.

International oil prices recovered somewhat in the course of 2009, but the impact on domestic inflation was cushioned to some extent by the appreciation of the rand exchange rate. The petrol price was therefore not regarded as a major upside risk to the inflation outlook during the period under review, although by the May meeting, international oil prices had increased somewhat compared with the relatively stable trading range of US$70 to US$80 that had prevailed for some months.

The trend in wage settlements is also an important focus of the MPC. During this period the committee noted that the risk to the inflation outlook emanating from wage developments had subsided somewhat. Although wage settlements were, on average, still in excess of inflation, indications were that they were declining in nominal terms. However in May the MPC noted that while nominal wage settlement rates had been declining, a number of wage negotiations were at levels well above the current and expected inflation rate. It was noted that should a general upward trend in wage settlement rates transpire, in the absence of compensating increases in productivity, it could pose an upside risk to the inflation outlook.

The main risk to the inflation outlook remained administered prices, particularly electricity price increases. During this period, Eskom had applied for multi-year electricity tariff increases of 35 per cent per annum. The Bank's forecasts made provision for 25 per cent and this imparted an upside risk to the inflation forecast. However, once the determination of 25 per cent was announced, the upside risk from this source was reduced. Nevertheless, these tariff increases will remain a source of upside pressure in the inflation outlook. The committee also noted with concern the apparent trend toward greater reliance on high tariff increases to fund long-term infrastructure projects.

At the January meeting, the risks to the inflation forecast were assessed as being fairly balanced. Given that the inflation trajectory was relatively close to the upper end of the inflation target range, the MPC decided that it would be prudent to keep the repurchase rate unchanged. By the March meeting, the inflation forecast had improved somewhat and the risks to the outlook had moved to the downside. This was mainly a result of the further strengthening of the rand exchange rate and the fact that there was now greater certainty with respect to electricity tariff increases, which had previously been the main source of upside risk. In the absence of significant demand pressures and in the light of this reduced risk, the MPC decided that there was some space for an additional monetary policy stimulus to reinforce the sustainability of the upswing without jeopardising the achievement of the inflation target. Accordingly, the repurchase rate was reduced by a further 50 basis points to 6,5 per cent per annum.

At the May meeting, the risks to the inflation forecast were more evenly balanced. The main risks to the forecast were seen to emanate from administered prices and the risks emanating from the global economy. The MPC was of the view that the current stance of monetary policy was appropriate for the prevailing inflation outlook and associated risks. The committee accordingly kept the repurchase rate unchanged at 6,5 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 seem to point towards an improving global economic recovery. Although projected medium-term growth in the global economy may be somewhat lower than in previous expansions, the IMF has, in its April 2010 *WEO*, forecasted a recovery that is slightly more robust than previously expected. The current upturn in global economic growth is still largely driven by strong output growth in emerging-market economies, especially Developing Asia, but the contribution from advanced economies has improved significantly in recent quarters. The support provided by inventory rebuilding could, however, soon begin to wane and the sustainability of the global recovery would then depend, to a large extent, on domestic final demand components such as consumption expenditure and gross fixed capital formation.

In response to the downturn, monetary policy has been highly expansionary and has been supported by unconventional liquidity provision, while fiscal policy has provided a major stimulus in most countries. While financial systems are being repaired in some countries, the economic recovery will remain fragile in many advanced economies. This exposes governments to substantial execution risk in the implementation of their exit strategies. Governments face a delicate balancing act with respect to the timing of these adjustments and tightening fiscal policy too soon risks undermining the recovery. However, the IMF notes that postponing fiscal consolidation for much longer is no less risky as it would test the patience of the market and could force central banks to commence with pre-emptive monetary policy tightening.

In most developed countries, the negative feedback loops between consumer demand and financial markets have reversed and pent-up demand has begun to filter through to the real sector. However, the largest economies plan to maintain the fiscal stimulus provided in 2009, at least through 2010, as it is expected that the recovery under way in these countries will be relatively sluggish compared with recoveries from previous recessions. Although the recoveries in real and financial activity are mutually supportive, access to credit remains difficult in many countries. According to the IMF, international policy co-ordination is essential in ensuring a durable recovery and it projects that global growth will reach 4,2 per cent in 2010 (an upward revision of about 1 percentage point from the October 2009 estimate) and 4,3 per cent in 2011 (Table 10).

The increase in real GDP in advanced economies during recent quarters was largely driven by positive contributions from inventory investment and by net exports. Personal consumption expenditure also contributed significantly to growth in key advanced economies in the fourth quarter of 2009. The IMF's April 2010 *WEO* projects growth of 3,1 per cent for the US economy in 2010, before declining to 2,6 per cent in 2011. Although the recovery of the US economy gained momentum in the fourth quarter of 2009 with real GDP advancing by 5,6 per cent, private final demand was still subdued and remained well below pre-crisis levels.

Economic growth in the euro area slowed to 0,2 per cent in the final quarter of 2009 as consumption remained subdued, while investment contracted. The weakening financial situation of many euro area countries, in particular Greece, is deemed to be hampering growth prospects for the region. The IMF projects growth of 1,0 per cent for the euro area in 2010 and 1,5 per cent in 2011. In May 2010 the EU agreed on a significant €750 billion bailout plan in an effort to counter a burgeoning sovereign debt crisis that began in Greece, but subsequently threatened the stability of financial markets worldwide. The plan consists of €440 billion of loans from euro zone governments, €60 billion from an EU emergency fund, and €250 billion from the IMF.

Table 10 IMF projections of world growth and inflation for 2010 and 2011*

Per cent

	Real GDP		Consumer prices	
	2010	2011	2010	2011
World	**(3,1) 4,2**	**4,3**	**(2,9) 3,7**	**3,0**
Advanced economies	**(1,3) 2,3**	**2,4**	**(1,1) 1,5**	**1,4**
United States	(1,5) 3,1	2,6	(1,7) 2,1	1,7
Japan	(1,7) 1,9	2,0	(-0,8) -1,4	-0,5
Euro area	(0,3) 1,0	1,5	(0,8) 1,1	1,3
United Kingdom	(0,9) 1,3	2,5	(1,5) 2,7	1,6
Canada	(2,1) 3,1	3,2	(1,3) 1,8	2,0
Other advanced economies	(2,6) 3,7	3,9	(1,7) 2,2	2,2
Emerging-market and developing countries	**(5,1) 6,3**	**6,5**	**(4,9) 6,2**	**4,7**
Sub-Saharan Africa	(4,1) 4,7	5,9	(7,3) 8,0	6,9
Central and eastern Europe	(1,8) 2,8	3,4	(4,2) 5,2	3,6
Commonwealth of Independent States	(2,1) 4,0	3,6	(9,4) 7,2	6,1
Developing Asia	(7,3) 8,7	8,7	(3,4) 5,9	3,7
China	(9,0) 10,0	9,9	(0,6) 3,1	2,4
India	(6,4) 8,8	8,4	(8,4) 13,2	5,5
Middle East and North Africa	4,5	4,8	6,5	6,4
Western hemisphere	(2,9) 4,0	4,0	(5,2) 6,2	5,9

* IMF projections for 2010 as at October 2009 in parenthesis

Source: IMF *World Economic Outlook*, April 2010

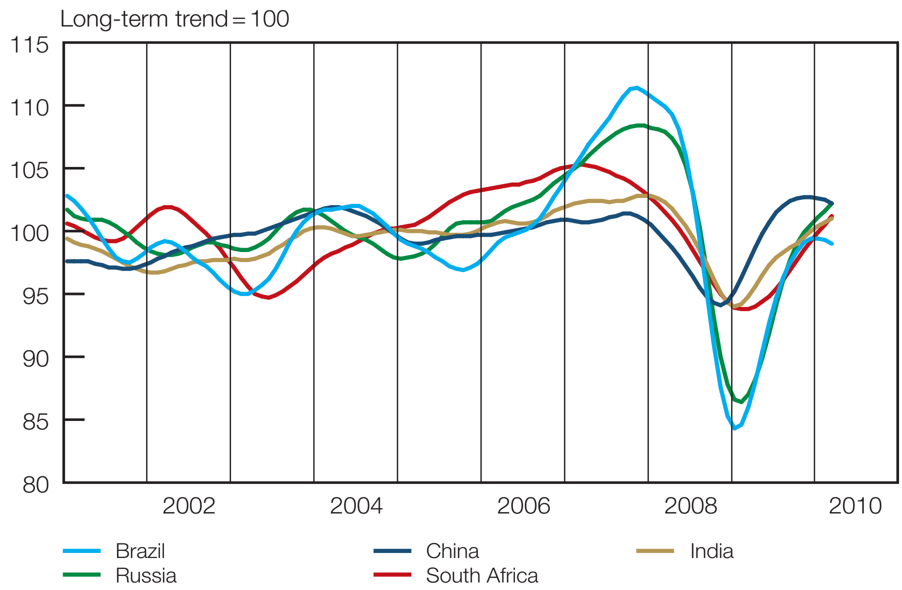
Real output in Japan rebounded and expanded at a revised rate of 3,8 per cent in the fourth quarter of 2009. The BOJ's quarterly Tankan survey of business sentiment showed improving sentiment among the nation's biggest firms for the fourth straight quarter amid growing faith in the global recovery. The IMF projects growth of 1,9 per cent for Japan in 2010 and 2,0 per cent in 2011. This improvement in growth is projected to be relatively broad-based with a strong positive contribution from exports. Deflationary pressures are expected to continue to pose a significant challenge to policymakers in Japan in 2010 and 2011.

The UK finally returned to positive growth with real GDP increasing by 1,8 per cent in the fourth quarter of 2009, following six consecutive quarters of contraction – the longest and deepest recession in the UK in the post-war period. The IMF projects growth of 1,3 per cent for the UK in 2010 and 2,5 per cent in 2011.

Emerging-market economies have continued to experience stronger economic growth since the second half of 2009. Much of the improvement has been the result of increased trade, robust private consumption expenditure and, for some economies, the commodity price recovery. Since rebounding in the first quarter of 2009, real GDP growth in emerging-market economies has continued to strengthen following the recovery in the global economy. However, domestic structural rigidities coupled with the uncertainties surrounding economic developments in advanced countries pose the major risks to growth prospects in emerging countries. Some concern has also been expressed as to the risk carried by emerging economies as a result of the exceptional growth of capital inflows into their economies.

In several Asian, including certain BRIC (Brazil, Russia, India and China) economies, output already exceeds pre-crisis levels by a wide margin and actual output growth in some is already outpacing potential output growth estimates. The IMF expects China's economy, for example, to expand by about 10 per cent in 2010 and 2011. There are concerns that China might curb credit more comprehensively in an effort to restrain its inflation, which now looks set to be 3,1 per cent in 2010, up from a previous estimate of 0,6 per cent. China's growth momentum might slow in the coming quarters as the central bank implements monetary tightening. The government also announced that it would nullify all local government loan guarantees that have supported a substantial part of the investment projects undertaken. In India growth is projected to be 8,8 per cent in 2010 and 8,4 per cent in 2011, supported by rising private demand. Consumption in India is expected to strengthen, while investment is expected to be boosted by strong profitability. The upward revisions to the IMF's 2010 growth projections in BRIC countries is underscored by the significant improvement in the leading indicators in these countries during the course of 2009 (Figure 18).

Figure 18 Composite leading indicators



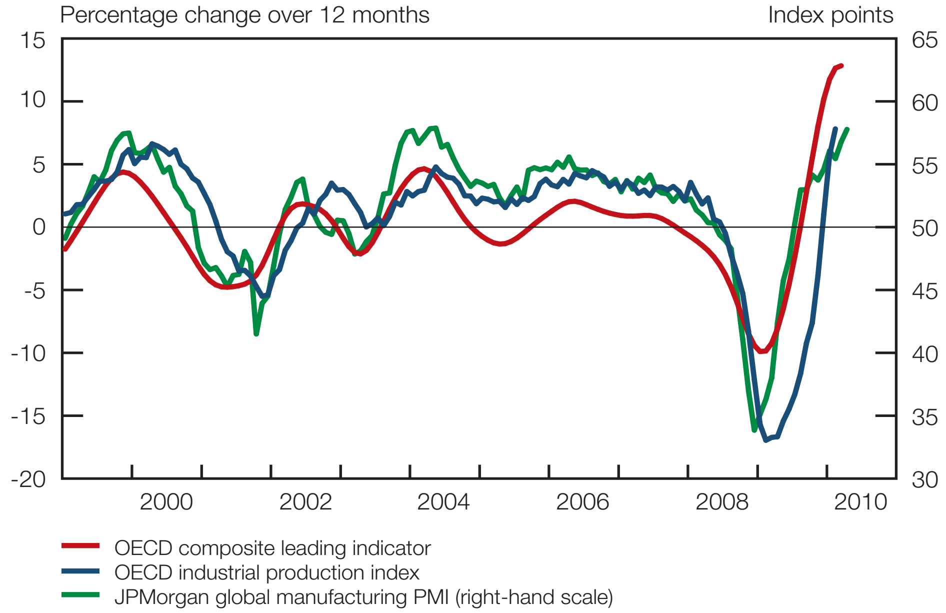
Source: OECD

Although the financial turbulence struck Africa through many different channels, all across the continent there have subsequently been significant rebounds in trade, export earnings, bank credit and commercial activity. The IMF expects growth in sub-Saharan Africa of 4,7 per cent in 2010, but cautions that this is incumbent upon the global recovery. Those African countries that had undertaken good policies in years prior to the financial crisis were less affected by the downturn in economic activity. This was the result of strengthened fiscal positions, lower inflation and comfortable reserve cushions. Those countries with improved debt positions were able to use their budgets to dampen the impact of the crisis, including preserving social spending. However, Africa remains very vulnerable to commodity price volatility, instability in neighbouring countries, significant reliance on remittances, aid and financial flows and the ever-present possibility of natural disasters.

The composite leading indicator compiled by the OECD projects strong signs of economic expansion in the OECD area after increasing by 12,8 per cent in March 2010, compared with the corresponding month of the previous year (Figure 19). The JPMorgan global manufacturing Purchasing Managers' Index (PMI) remains high by historical standards, continuing its upward trend in April 2010 when it increased by 1 point to 57,8 (the highest level since May 2004). The global manufacturing PMI has been indicating sustained expansion in recent months. The year-on-year rate of change in the OECD industrial production index accelerated to 7,8 per cent in February 2010, following a protracted contraction from July 2008 to December 2009. Real output growth in the

OECD area accelerated from 2,4 per cent in the third quarter of 2009 to 3,2 per cent in the fourth quarter. The improved performance in the OECD area was mainly due to rapid growth in the US and Japan. By contrast, GDP growth in the euro area slowed in the fourth quarter of 2009. The UK also recorded positive GDP growth in the fourth quarter after six consecutive quarters of contraction.

Figure 19 Selected indicators of global economic activity



Sources: OECD and JPMorgan

The euro-zone manufacturing PMI rose to 57,6 in April 2010 from 56,6 in March. A weakened euro and rising global demand helped boost export growth to the highest level in 10 years in April 2010. Leading indicators of manufacturing activity in the euro zone have improved significantly in recent months, linked to robust manufacturing activity around the globe, as the sector recovers following an extraordinarily deep collapse during the financial crisis. Germany, Europe's largest economy, benefited from rising global demand, which pushed the country's PMI reading to 61,5 in April 2010 from 60,2 in March, the highest level since the series commenced in April 1996. The manufacturing PMI reading for France, the euro-zone's second-largest economy, also rose to 56,6 from 56,5 in March, boosted by a sharp rise in new order volumes. Italy's data also showed accelerated activity, with the PMI rising to 54,3 from 53,7 in March. Data showed that activity in Spain expanded at its strongest rate in 3 years, but continues to lag that of other big economies in the region. The nation's manufacturing PMI reached 53,3 in April from 51,8 in March. National divergences in April marked a survey record, ranging from record output growth in Germany to a steep and accelerating rate of contraction in Greece, where output is falling at a rate not far off the one seen at the very height of the financial crisis.

The global economic recovery that commenced in 2009 was based on an average crude oil price of US$67 per barrel from the second to the fourth quarter of the year, and there is mounting concern that higher oil prices could hinder the recovery. Although the oil price has risen significantly in recent weeks, the medium-term outlook is for upward price pressure to remain moderate for some time and that recent price pressure has been mainly the result of speculative transactions based on the improving global outlook. OPEC spare capacity and OECD inventories are still well above recent historical averages and, although the oil futures curve has not yet returned to the usual state of backwardation, the spread between futures and spot prices has narrowed significantly.

Futures markets foresee modest oil price increases in the medium term, with prices rising to just above US$83 at the end of 2010.

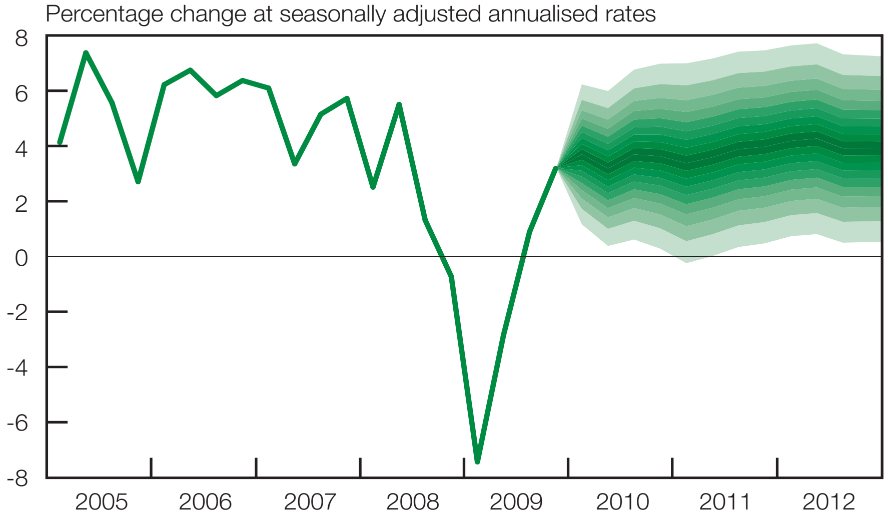
Inflation expectations have generally remained well anchored worldwide despite extraordinarily accommodative monetary and fiscal policies, and this, together with still-low levels of capacity utilisation, should serve to keep inflation in check in most countries. However, further falls in inflation were slowed or inhibited by nominal downward rigidities becoming more binding at very low inflation rates in a number of advanced economies. In some countries, unit costs rose due to a reluctance to lay off existing employees despite the slowdown in economic activity. In the face of weak revenues and deteriorating financial conditions, some countries' firms resisted lowering prices and margins in order to rebuild working capital. The decline in inflation pressure at the global level has been limited by the strong cyclical position of key emerging economies. This has provided a strong boost to commodity prices and is an important reason why both excess capacity in commodity production and excess inventories in a number of commodities markets are lower than is usual for this stage of the global cycle. Inflation in many emerging economies has continued to be higher than in the advanced economies and quite variable from year to year. Inflation slowed but remained quite high throughout the cycle in various Latin American, Middle Eastern and Commonwealth of Independent States economies. In India inflation rose strongly due significantly to one-time factors, while in Russia it fell appreciably. Inflation fell moderately in Brazil, while in China prices actually declined for a while, but are now rebounding quickly.

Outlook for domestic demand and supply

After three consecutive quarters of improvement, GDP growth is expected to sustain its stronger performance in 2010 and 2011. According to the Bank's latest quarterly projections, real output is expected to grow at annual average rates of 2,7 and 3,6 per cent in 2010 and 2011 respectively (Figure 20). Quarter-on-quarter annualised real GDP growth is expected to be 3,7 per cent in the first quarter of 2010 and 3,2 per cent in the second quarter.

Figure 20 Real GDP growth forecast

Percentage change at seasonally adjusted annualised rates

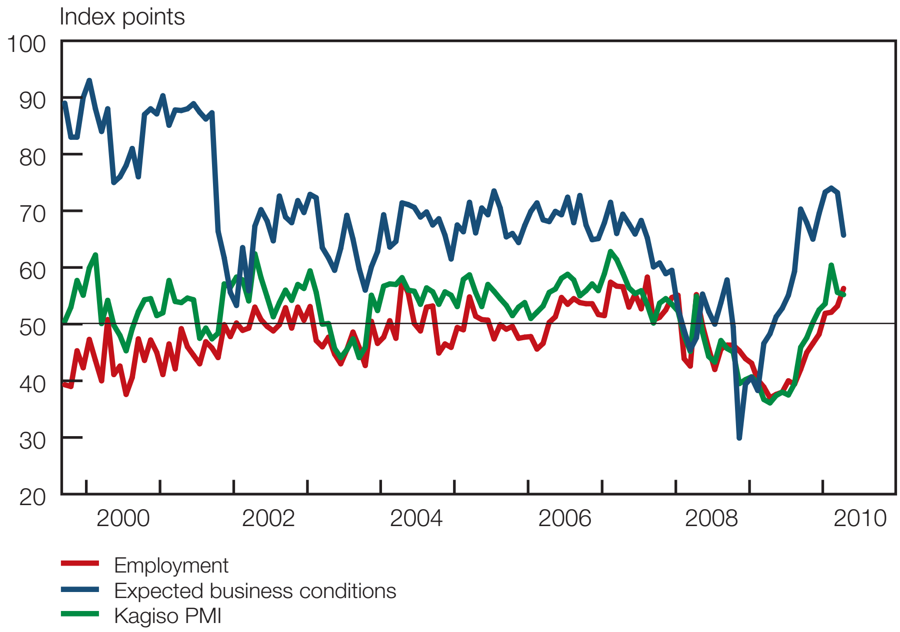


Note: The fan chart uses confidence bands to depict varying degrees of certainty. The darkest band of the fan chart covers the most likely 10 per cent of probable outcomes foreseen for growth, including the central projection. Each successive band, shaded slightly lighter and added on either side of 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).*

According to the March 2010 Reuters survey of long-term forecasts for the South African economy, analysts expect real GDP to grow by 2,88 and 3,52 per cent in 2010 and 2011 respectively, and reach 3,86 per cent in 2012. By comparison, the National Treasury's February 2010 *Budget Review* expected real output growth to register 2,3 and 3,2 per cent in 2010 and 2011, and reach 3,6 per cent in 2012. On the demand side, sources of growth during this forecast period are expected to be final consumption by households and government, gross fixed capital formation and net exports. On the supply side, the secondary and services sectors are expected to be the main sources of growth.

The continuing momentum in economic growth is supported by the seasonally adjusted Kagiso PMI, which measures domestic manufacturing activity. Figure 21 shows that this indicator rose from 50,3 index points in November 2009 to 55,2 index points in April 2010. The April PMI employment index posted an above-50 reading of 56,3 index points, while the expected business conditions index registered 65,7 index points. These trends point to the manufacturing sector's positive contribution to output growth in the first quarter of 2010.

Figure 21 Kagiso PMI



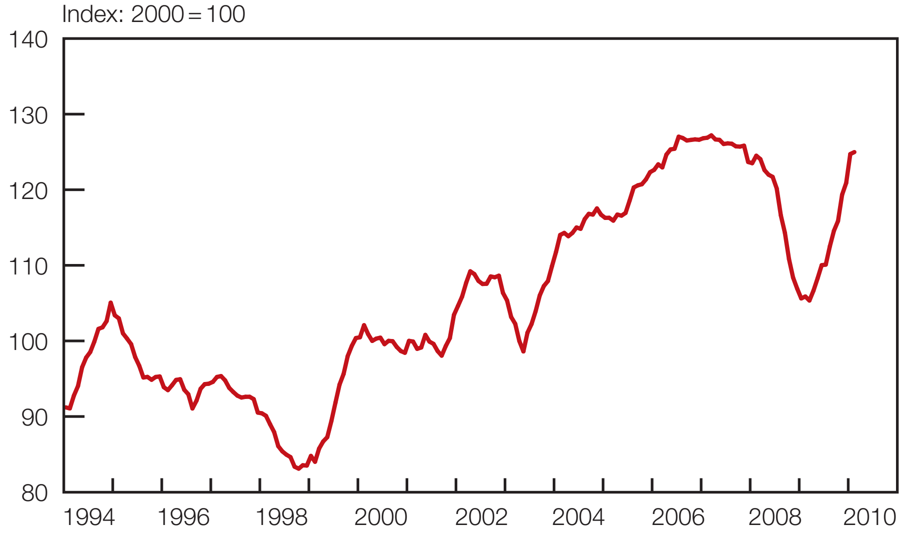
Source: Kagiso Securities and Bureau for Economic Research, Stellenbosch University

The Bank's composite leading indicator has increased by close to 19 per cent in the 12-month period ending February 2010 (Figure 22). The increase in the leading indicator was evenly spread, with five of the eleven component time series assessed increasing and six decreasing.

As far as the quarterly analysis of manufacturing activity is concerned, the first quarter 2010 BER survey revealed that manufacturing business confidence increased from 19 index points in the fourth quarter of 2009 to reach 28 in the first quarter of 2010. According to Statistics South Africa data, manufacturing production for March 2010 rose by 6,3 per cent compared with March 2009.

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 28 in the fourth quarter of 2009 to 30 in the first quarter of 2010. Four out

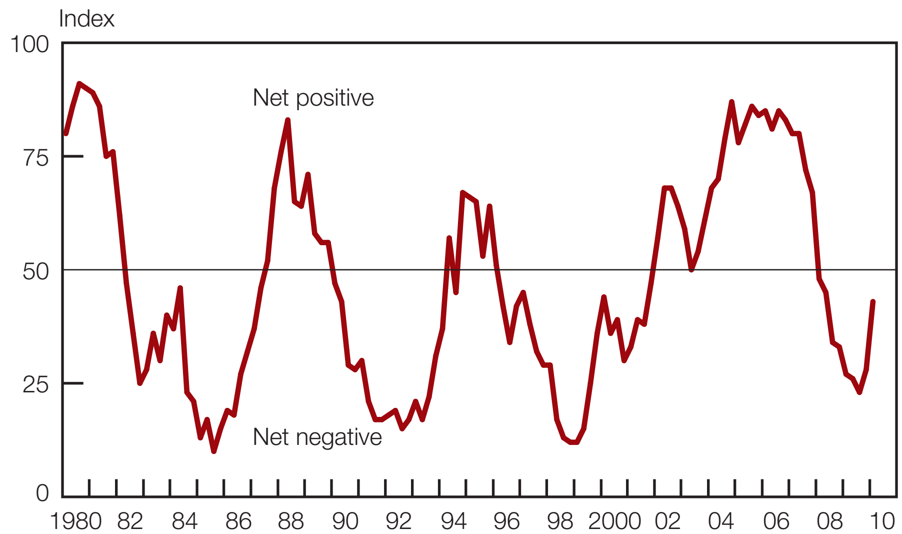
Figure 22 Composite leading business cycle indicator



of six subcomponents of the index registered increases. Improvements in confidence levels were recorded among building contractors (+2), subcontractors (+7), architects (+16) and retailers of building materials (+2). Declines occurred in the case of manufacturers of building materials and quantity surveyors. As far as short-term prospects for the residential sector are concerned, survey respondents expect business conditions to improve in the second quarter of 2010.

Although it is currently below the net-positive level of 50, the RMB/BER Business Confidence Index rose sharply from 28 index points in the fourth quarter of 2009 to reach a level of 43 during the first quarter of 2010 (Figure 23); this is the single biggest increase between two consecutive quarters in 16 years. New vehicle dealer confidence rose sharply from an index level of 29 in the fourth quarter of 2009 to 60 in the first quarter of 2010. The surge in confidence was due to sales that surpassed expectations. Wholesaler confidence increased from 27 to 50.

Figure 23 RMB/BER Business Confidence Index



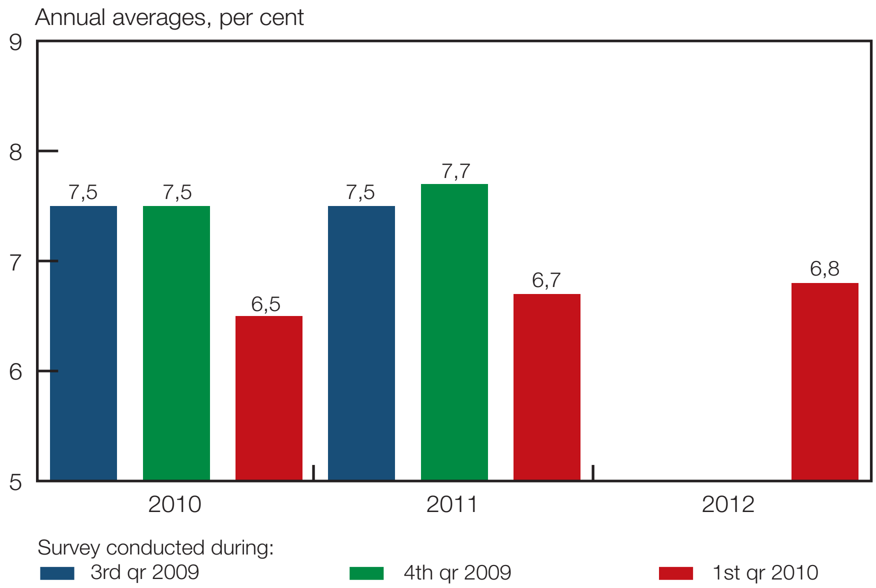
Sources: Rand Merchant Bank and Bureau for Economic Research, Stellenbosch University

During the first quarter of 2010 the FNB/BER Consumer Confidence Index increased by 9 index points to reach +15, the highest reading since the fourth quarter of 2007. Consumers rating the present period as an appropriate time to buy durable goods increased on a net basis by 11 index points to -4. In addition, the net percentage of consumers expecting an improvement in South Africa's economic performance during the next 12 months rose from +16 in the fourth quarter of 2009 to +23 index points in the first quarter of 2010.

Indicators of inflation expectations

Estimates of inflation expectations for the forecast period from 2010 to 2012 obtained from the BER survey conducted during the first quarter of 2010 show that average annual CPI inflation is expected to decline over the forecast years, although it is expected to remain above the inflation target range of 3 to 6 per cent. Inflation expectations in the first quarter of 2010 are lower at all time horizons than those surveyed in the preceding quarter. As depicted in Figure 24, average CPI inflation expectations for 2010 are 6,5 per cent, followed by 6,7 per cent for 2011 and 6,8 per cent for 2012. The inflation expectations of business and trade unions were above the inflation target range, while those of financial analysts were either at the upper level of, or within, the range.

Figure 24 BER surveys of headline CPI inflation expectations



Source: Bureau for Economic Research, Stellenbosch University

The April 2010 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 be consistent with the official target range of 3 to 6 per cent from 2010 until the end of the forecast period in 2012 (Table 11). It is expected that CPI inflation will average 5,3 per cent in 2010 and 5,8 per cent in 2011, and be at the upper level of the inflation target range at 6,0 per cent in 2012.

Table 11 Reuters survey of CPI inflation forecasts: April 2010*

Per cent

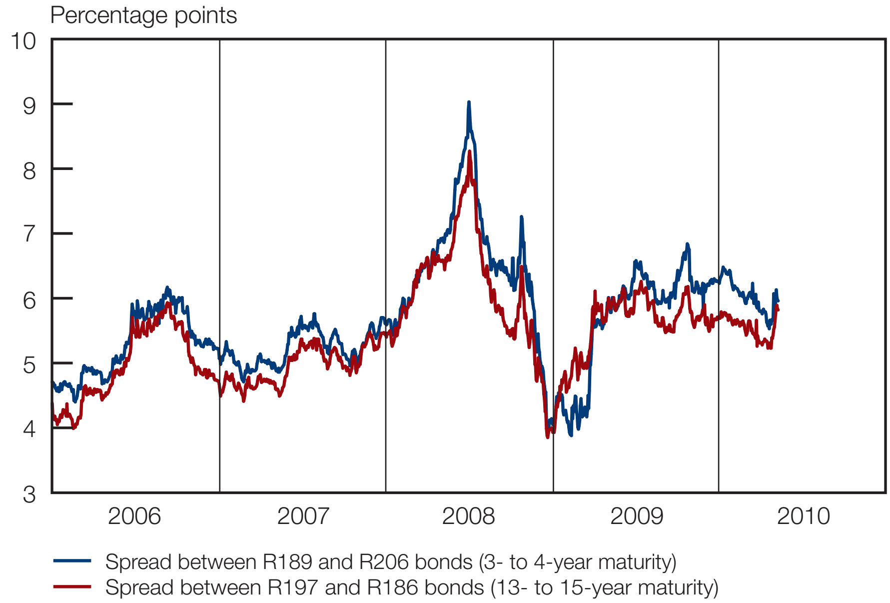
	2010		2011		2012	
1. Mean	(5,5)	5,3	(5,8)	5,8	(6,0)	6,0
2. Median	(5,4)	5,2	(5,8)	5,8	(5,8)	5,8
3. Highest	(6,5)	6,5	(7,6)	6,7	(7,4)	6,9
4. Lowest	(5,0)	5,0	(5,2)	5,2	(5,0)	5,3
Number of forecasters	(23)	21	(23)	24	(17)	18

* March 2010 survey results in parentheses

Source: Reuters

Inflation expectations as proxied by 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, trended lower from the beginning of the year until the end of April 2010 (Figure 25). From the beginning of May break-even inflation rates began rising due to increases in nominal bond yields which were likely triggered by risk premia associated with developments in sovereign bonds in Europe. The break-even rate for the 3–4 year maturity range was 6,0 per cent on 11 May 2010, while that for the 13–15 year maturity range was 5,8 per cent.

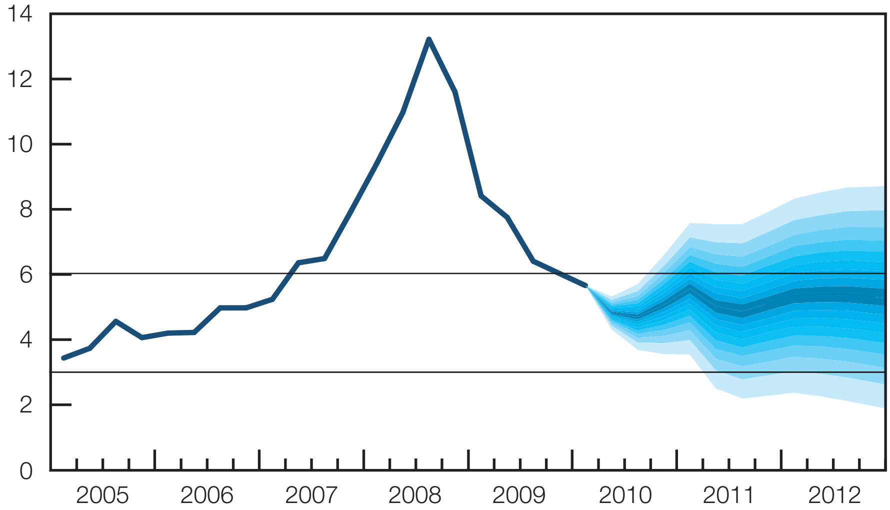
Figure 25 Break-even inflation rates



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 11–13 May 2010, are reproduced in the form of a fan chart in Figure 26. According to these projections, the targeted inflation rate is expected to remain within the inflation target range of 3 to 6 per cent until the end of 2012. The projections for 2010 and 2011 are slightly below those presented in the previous *Monetary Policy Review* in November 2009.

Figure 26 Targeted inflation* forecast



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

Note: The fan chart uses confidence bands to depict varying degrees of certainty. The darkest band of the fan chart covers the most likely 10 per cent of probable outcomes foreseen for inflation, including the central projection. Each successive band, shaded slightly lighter and added on either side of the central band, adds a further 10 per cent to the probability, until the whole shaded area depicts a 90 per cent confidence interval (see Box 4 "Understanding the fan chart" on p. 27 of the March 2001 *Monetary Policy Review).*

The central projection, conditional on an unchanged repurchase rate, is for the average quarterly CPI inflation rate to decelerate further to 4,7 per cent in the third quarter of 2010. It will then fluctuate between 4,9 and 5,6 per cent until the end of the forecast period in the final quarter of 2012, when it will be 5,3 per cent. This forecast includes an increase of 20 per cent in the electricity price to accommodate the increase approved by the National Electricity Regulator of South Africa (NERSA). The main risks to the inflation outlook are from the risks emanating from the global economy and from administered price developments. Outcomes for the exchange rate of the rand, commodity prices or electricity prices that differ from those assumed in the model will impact on the central projection.

Assessment and conclusion

During the second half of 2009, the world economy emerged from the global recession. In the course of the year, the pace of recovery accelerated and by the beginning of 2010 most global growth forecasts were being revised upwards. In some countries the authorities were beginning to reverse some of the extraordinary measures that were put in place during the crisis. Nevertheless, there were still some concerns that an excessively rapid reversal of these policies, and normalisation of fiscal and monetary policy stances would delay or even reverse the recovery. It was also becoming evident that the pace of recovery was very uneven across economies and regions. The recovery was being led by the emerging markets, particularly those in Asia, while the outlook for the euro area was far less favourable. During this period, there were increasing concerns about the solvency of a number of countries in the euro area, as fiscal deficits widened and debt rose considerably. There was an increased danger that the initial banking crisis could transform into a sovereign debt crisis, which could also have systemic implications for the global economy. The global financial markets became increasingly nervous and volatile, until decisive action was taken by European governments, the ECB and the IMF in early May 2010. While the immediate threat to global growth and stability appears to have dissipated somewhat, risks remain that the required fiscal adjustment in these countries may not be possible.

The South African economy has also emerged from the recession, although the recovery has not only lagged that of some of the emerging-market economies, but the rate of growth has also been slower. This has been partly due to the continued slow revival of domestic household consumption expenditure and a continued contraction in private-sector fixed capital formation. The manufacturing sector, however, appears to have recovered somewhat in the past few months. Despite the more favourable growth outlook, the output gap is expected to remain positive for some time. The growth performance will also be affected by the performance of the global economy and the risks posed by developments in the euro area.

Despite an upward trend in some international commodity prices over the past months, the global inflation environment remains benign and is not a threat to the domestic inflation outlook. Inflation has returned to within the inflation target range and it is expected to remain within the range during the forecast period. The positive outlook allowed for an additional 50 basis point reduction in the repurchase rate in March 2010. At that time the favourable inflation trajectory and lower perceived risks to the inflation forecast gave space for an additional monetary policy stimulus to reinforce the sustainability of the domestic growth upswing, without jeopardising the achievement of the inflation target. More recently, as the risks to the outlook became more evenly balanced, the MPC assessed the current monetary policy stance to be appropriate for the achievement of the inflation target and a sustainable growth recovery.

Statement of the Monetary Policy Committee

26 January 2010

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

Introduction

The longer-term inflation outlook remains relatively favourable, notwithstanding some base effects that are likely adversely to affect the inflation outcomes in the short term. Domestic consumption expenditure remains under stress and there are no perceived risks to the inflation outlook from this source. Despite the continued contraction of private-sector gross fixed capital formation, the domestic economic growth outlook appears to have improved, but is expected to remain below the potential output growth for some time. The global economy is characterised by an uneven recovery across regions and some risks persist, while the global inflation outlook appears to be contained.

Recent developments in inflation

The year-on-year inflation rate as measured by the consumer price index for all urban areas (CPI) declined from 6,1 per cent in September 2009 to 5,9 per cent and 5,8 per cent in October and November respectively. The categories of housing and utilities, and miscellaneous goods and services remained the single biggest contributors to the inflation outcome in November, having contributed 1,7 and 1,5 percentage points respectively. These categories were mainly driven by electricity and insurance cost increases. Food price inflation continued to moderate and measured 4,0 per cent in November, while administered prices excluding petrol and paraffin increased by 11,0 per cent, primarily as a result of electricity price increases.

Producer prices declined at year-on-year rates of 3,3 per cent and 1,2 per cent in October and November respectively. The underlying producer price trends in the food sector remained favourable for further moderation in food price inflation at the consumer level. In November agricultural prices increased at a year-on-year rate of 0,9 per cent, while manufactured food prices declined by 1,1 per cent.

The outlook for inflation

CPI inflation is expected to increase to above the target range in the coming three months, due to technical base effects related to petrol price changes. Current forecasts indicate that inflation could measure around 6,5 per cent in December and January, before moderating in the subsequent months. Because of the forward-looking nature of monetary policy, the focus of the Monetary Policy Committee (MPC) is on the longer-term expected trend of inflation. The CPI inflation forecast by the South African Reserve Bank (the Bank) is predominantly unchanged since the November forecast. In line with market forecasts, inflation is expected to return to within the inflation target range on a sustained basis in March 2010, and remain within the target range until the end of the forecast period in the final quarter of 2011, when it is forecast to average 5,4 per cent.

Since the previous MPC meeting, Eskom has modified its tariff application to the National Energy Regulator of South Africa (NERSA). Given the continued uncertainty related to the electricity tariff increases, the forecast does not make provision for the full multi-year increases of 35 per cent requested by Eskom, and electricity price increases of 25 per cent in 2010 and 2011 are assumed. The outcome of the Eskom application is expected to be announced in February.

The most recent inflation expectations survey conducted by the Bureau for Economic Research (BER) at Stellenbosch University shows that in the fourth quarter of 2009 there were no significant changes in expectations compared with the previous survey. According to the survey, inflation is expected to average 7,5 per cent in 2010 and 7,7 per cent in 2011. While both business and trade union respondents continued to expect inflation to remain outside the target range, the forecasts of financial analysts deteriorated moderately but remained within the target range. The latter forecasts were in line with the Reuters survey, which in January showed that market analysts expect inflation to average 5,7 per cent and 5,8 per cent in 2010 and 2011 respectively.

The demand-side pressures on inflation have been persistently weak, and the MPC remains of the view that there are no significant upside risks to the inflation outlook emanating from this source.

Real final consumption expenditure by households has contracted on a quarter-on-quarter annualised basis since the third quarter of 2008. In the third quarter of 2009 household consumption expenditure declined by 2,0 per cent. This weak trend appears to have continued in the final quarter of 2009. Real retail trade sales declined at a year-on-year rate of 6,6 per cent in November 2009 and by 5,9 per cent in the three months to the end of November compared with the same period in 2008. Wholesale trade sales also declined in November. New vehicle sales continue to show some signs of improvement, but nevertheless contracted by 7,2 per cent in December on a year-on-year basis. Consumer confidence appears to have improved, however, as reflected in the First National Bank (FNB)/BER Consumer Confidence Index which recorded its highest reading since the first quarter of 2008.

Adverse employment trends and employment insecurity are likely to constrain household consumption expenditure. According to Statistics South Africa's Quarterly Employment Statistics, employment levels decreased further during the third quarter of 2009, despite a more favourable growth performance. Formal non-agricultural employment declined by 4,2 per cent in this quarter, representing almost 110 000 jobs. Employment is expected to lag the growth recovery.

Credit extension to the private sector reflects the weak demand and tight credit supply conditions, and is also seen as a constraint on spending. There are, however, indications that the strict lending criteria applied by banks in response to higher perceived risk and rising impaired advances may be easing. In November 2009 impaired advances as a percentage of total gross loans and advances increased to 5,9 per cent from 5,8 per cent the previous month. Total loans and advances to the private sector contracted by 2,0 per cent in November compared with the previous year. This was the third consecutive month of credit contraction. The only component of credit extension that recorded positive nominal growth was mortgage advances, which grew at a 12-month rate of 3,0 per cent. These developments were also reflected in the level of household debt, where the ratio of household debt to disposable income declined from 80,1 per cent in the second quarter of 2009 to 79 per cent in the third quarter. This relatively high level of debt is expected to continue to constrain consumption expenditure.

While the combination of increased unemployment, the lack of access to credit and the need to repair impaired household balance sheets is expected to dominate consumption trends in the coming quarters, there have been some positive developments with respect to wealth effects. House prices have shown signs of improvements, with the Absa and FNB house price indices showing positive but moderate growth. Equity prices have recovered somewhat since their lows in March of 2009, but the recent equity market decline both domestically and abroad shows that some volatility may persist in line with uncertainty relating to the sustainability of the global recovery.

There are continued signs that the domestic economic recovery is under way following the 0,9 per cent annualised gross domestic product (GDP) growth rate measured in the third quarter of 2009. However, the recovery is expected to remain relatively subdued and below the potential growth rate of the economy for some time. The forecast of the Bank is that GDP growth will average 2,0 per cent in 2010 and 3,0 per cent in 2011. Nonetheless, it could take some time until pre-recession levels of output are reached. The more positive outlook is in line with the continued positive trends seen in the composite leading business cycle indicator of the Bank, which increased strongly again in November. The coincident indicator also exhibited a slight upward movement. These trends are in line with the more positive outlook seen in the Rand Merchant Bank (RMB)/BER business confidence index during the fourth quarter of 2009.

The manufacturing sector has also shown signs of some recovery and is expected to contribute positively to the 2009 fourth quarter growth outcome. The physical volume of manufacturing production declined at a year-on-year rate of 4,7 per cent in November, but increased by 3,9 per cent in the three months to November compared to the previous three months. The Kagiso Purchasing Managers Index (PMI) also reflected a positive outlook in November and December. However, the manufacturing sector may be constrained by weak domestic demand, while external demand will be impacted by the strength of the global recovery as well as, in part, by exchange rate developments.

The rand has remained a positive factor from an inflation perspective. However, the MPC is cognisant of the negative impact of the rand's movements during the past year on some sectors of the economy. Since the previous MPC meeting, the rand/dollar exchange rate has fluctuated between around R7,28 and R7,73. On a trade-weighted basis, the rand has remained more or less unchanged since the previous meeting. Much of the volatility of the exchange rate during this period can be explained by general volatility in the international foreign exchange markets where the US dollar fluctuated in a range of US$1,41 and US$1,51 against the euro.

With the decline of risk aversion in global markets, emerging markets in general, including South Africa, have also had to deal with significant capital inflows. These inflows have put upward pressure on a number of emerging market currencies. Intervention to prevent these appreciations is often costly and not always effective. At the same time, the possibility of reversals of these flows, should global sentiment change, poses a risk to the exchange rate outlook in these countries.

The global recovery has continued with relatively strong performances in some of the emerging-market economies. However, risks and vulnerabilities still remain, particularly in a number of countries in the euro area, and the recovery is expected to remain relatively slow in some economies that are important export destinations for South African goods. Unsustainable fiscal positions, as well as the need to reverse previous unconventional monetary policy interventions, may also pose a risk to the global growth 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.

Other supply-side or exogenous factors are not expected to impart a significant upside risk to the inflation forecast. International oil prices appear to have stabilised somewhat over the past months and moderate increases have been assumed over the forecast period. The outlook for food price inflation, as reflected in producer prices and futures prices, is favourable and these prices are unlikely to pose an upside risk to the inflation outlook for some time despite higher food prices in international markets.

The risk to the inflation outlook emanating from wage developments appears to have subsided somewhat. Wage settlements are still in excess of inflation, but have been declining in nominal terms. Average nominal remuneration per worker in the formal non-agricultural sector moderated to 7,6 per cent in the third quarter of 2009, while the nominal unit labour cost increase in the third quarter compared with the same quarter the previous year measured 5,7 per cent.

Electricity price increases remain the single biggest risk to the inflation outlook. There is the risk that increases granted to Eskom could be markedly higher than those assumed in the Bank's forecast, and there is also the risk that the second-round effects of these increases may be underestimated by the forecasting model.

Monetary policy stance

The MPC noted that inflation is likely to remain close to the upper end of the target range over the forecast period and is of the view that the risks to this outlook are fairly evenly balanced. Electricity price increases pose the biggest upside risk, counteracted by the weak state of domestic demand. Against this background the MPC has decided to keep the repurchase rate unchanged at 7,0 per cent per annum.

Statement of the Monetary Policy Committee

25 March 2010

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

Introduction

The domestic economy has shown signs of moderate improvement since the previous meeting of the MPC. Inflation expectations have moderated. Inflation has returned to within the target range and is expected to remain there for the remainder of the forecast period. The risks to the inflation outlook have declined somewhat as a result of the continued appreciation of the exchange rate of the rand and greater certainty with respect to future electricity tariff increases. Household consumption expenditure is growing at positive, albeit low rates, but growth in private sector fixed capital formation remains negative.

Recent developments in inflation

The year-on-year inflation rate as measured by the consumer price index for all urban areas (CPI) returned to within the inflation target range sooner than expected, in February 2010, when it measured 5,7 per cent. The moderation in inflation was fairly broad-based. The main contributors to the inflation outcome were the categories of housing and utilities, and miscellaneous goods and services. The former category was driven mainly by electricity price increases of 26,8 per cent, while the latter category was driven by insurance costs relating to housing, health and transport. Food price inflation declined to 1,0 per cent, while communication costs declined by 22,0 per cent. Administered prices excluding petrol and paraffin increased by 10,8 per cent.

Producer price inflation increased to 3,5 per cent in February 2010, compared with 2,7 per cent in the previous month. Food price inflation at the producer level remained well contained. Agricultural food prices declined at a year-on-year rate of 13,5 per cent, while manufactured food prices declined by 1,2 per cent.

The outlook for inflation

The CPI forecast of the South African Reserve Bank (the Bank) indicates an improved inflation outlook during 2010 and a relatively unchanged outlook for 2011. Inflation is expected to average 5,3 per cent and 5,4 per cent in 2010 and 2011 respectively, and to reach a low point at an average of 4,9 per cent during the third quarter of 2010. There is now greater certainty with respect to electricity tariff increases following the decision by the National Energy Regulator of South Africa (NERSA) to grant price increases to Eskom in the order of 25 per cent per annum, which was in line with the Bank's previous assumptions. However, because lower increases were granted to municipalities, the current forecast makes provision for electricity tariff increases of 20 per cent during the third quarters of 2010 and 2011. Other factors contributing to the improved expected inflation trajectory include favourable food price developments and lower-than-expected inflation outcomes.

The Survey of Inflation Expectations published by the Bureau for Economic Research (BER) at Stellenbosch University shows a significant improvement in the first quarter of 2010, although expectations on average remain above the upper end of the target range. Average headline CPI inflation expectations in respect of 2010 declined from 7,7 per cent during the final quarter of 2009 to 6,5 per cent during the first quarter of 2010. Inflation expectations in respect of 2011 declined from 7,7 per cent to 6,7 per cent, and the expectation for 2012 is 6,8 per cent. The improved outlook was mainly due to the favourable change in the expectations of business sector and labour union respondents. The expectations of analysts remained more or less unchanged.

Inflation expectations in the financial markets also reflected a more favourable inflation outlook. The Reuters survey of financial analysts shows some improvement relative to the previous month. Inflation expectations as measured by the yield differential between conventional government bonds and inflation-linked bonds across all maturities have declined since January, and reflect expectations within the target range over longer maturities.

Growth in domestic expenditure appears to be recovering at a modest pace but does not currently pose an upside risk to the inflation outlook. Following five consecutive quarters of negative growth, real household consumption expenditure increased at an annualised rate of 1,4 per cent in the fourth quarter of 2009. While expenditure growth on non-durable and semi-durable goods contracted, expenditure on durable goods, particularly motor vehicles, increased. Wholesale and retail trade sales in January appear to confirm this trend as positive month-on-month growth was experienced. Consumer confidence, as reflected in the First National Bank/BER Consumer Confidence Index, showed a significant recovery.

The turnaround in household consumption expenditure is expected to continue at a slow pace. The improvements in the domestic equity markets appear to have reversed the negative wealth effects on consumption. Nevertheless, the recovery in household consumption expenditure is expected to be constrained by the levels of household indebtedness, which increased to 79,8 per cent of disposable income of households in the fourth quarter of 2009. Other constraining factors include the strict credit criteria applied by banks and persistently high levels of unemployment.

Growth in total loans and advances to the private sector has been negative since September 2009 and declined further at a 12-month rate of 1,2 per cent in January. Mortgage credit extension was again the only category that showed positive growth, while loans to companies declined further. The subdued credit extension data are a function of both demand and supply-side effects. The strict credit criteria applied by banks have been partly a result of the rising levels of impaired advances, which now appear to be levelling off. In January 2010 impaired advances as a percentage of total gross loans and advances declined slightly to 5,9 per cent. A significant proportion of these impairments relate to retail loans, reflecting continued pressure on the consumer.

There are indications that the decline in employment in the formal non-agricultural sector appears to have slowed. According to the Quarterly Employment Survey, 18 000 jobs were created in the final quarter of 2009. However, on a seasonally adjusted basis, employment declined by 0,7 per cent, following the 5,1 per cent decline in the previous quarter. Cyclical employment trends tend to lag the upturn in the economy and the impact of the recession on employment will take some time to be reversed.

A countercyclical fiscal policy stance has been maintained. The national government deficit is projected to equal 7,2 per cent of gross domestic product (GDP) in the 2009/10 fiscal year, then to narrow over the next three years as the economy recovers and to measure 4,7 per cent in the 2012/13 fiscal year. The public sector borrowing requirement is expected to reach 11,8 per cent of GDP, and the overall government debt-to-GDP ratio is expected to peak at 43 per cent in the medium term. Should this fiscal trajectory be maintained, the MPC does not foresee a possible conflict with monetary policy objectives.

The economic growth outlook has improved somewhat over the past few months, although the output gap is expected to remain positive for some time. The 3,2 per cent annualised growth rate recorded in the fourth quarter of 2009 confirmed that the economy has emerged from the recession and the latest forecast of the Bank is that growth is likely to average 2,6 per cent in the current year. Although this compares favourably with the growth experienced in 2009, it is nevertheless still low.

The manufacturing sector in particular grew relatively strongly in the last two quarters of 2009, although off a low base, following four consecutive quarters of negative growth. The Kagiso/BER Purchasing Managers Index indicates that this trend is likely to continue. Business confidence, as measured by the Rand Merchant Bank/BER Business Confidence Index also showed an improvement, but remains negative.

The sustainability of the recovery in domestic growth will be influenced to a significant degree by the global growth trends. The pattern of the global economic recovery has remained unchanged, with strong growth being recorded in Asia in particular, and more moderate growth in a number of countries in Latin America and Africa. The outlook for the United States (US) and Europe is less positive, with increased concerns about the sustainability of burgeoning fiscal deficits and government debt ratios. In the US the weak housing market also remains a constraint on household consumption expenditure. Although a number of countries have begun to normalise their policy rates, monetary and fiscal stimuli still remain in place in most industrialised economies, and indications are that there will not be an early reversal of these accommodative policies. Against this backdrop, the benign global inflation environment is expected to persist and the risk of imported inflation is relatively low.

While an appreciated rand exchange rate is a positive factor in the inflation outlook, an excessively strong exchange rate is a cause for concern from the perspective of overall macroeconomic balance. It is difficult to determine with precision an appropriate level of the exchange rate, but at recent levels the exchange rate may contribute to constraints in the recovery of export- and import-competing sectors of the economy.

Since the previous meeting of the MPC, the rand has appreciated from levels of around R7,60 against the US dollar to current levels of around R7,35. On a trade-weighted basis, the rand has appreciated by about 6 per cent since the previous meeting and by 3 per cent since the beginning of the year. The trade-weighted exchange rate was also influenced by the recent weakness in the euro and pound sterling against the US dollar. Since the previous meeting, the rand has appreciated by about 8 per cent and 11 per cent against the euro and pound sterling respectively.

A number of factors continue to impact on the exchange rate of the rand. These include the sustained capital inflows into emerging markets, in general, in response to abnormally low interest rates in advanced economies, investor sentiment and the recovery in commodity prices. The recovery in commodity prices contributed to the narrowing of the deficit on the current account of the balance of payments in the final quarter of 2009 to 2,8 per cent of GDP.

Other supply-side or exogenous factors are not expected to impart a significant upside risk to the inflation forecast. International oil prices have remained relatively stable in the

US$70 to US$80 dollar range, and moderate increases over the forecast period have been incorporated into the inflation forecast. Nevertheless, an increase in the order of 50 cents per litre has been assumed for April; about half of which is due to increased fuel levies announced in the budget.

Domestic food prices, which for most of last year were one of the main sources of upside risk to the inflation outlook, have recently contributed favourably to the inflation outlook. In the past few weeks maize prices have declined significantly, despite an upward trend in other food prices globally. While it is not clear at this stage to what extent these price declines will be passed on to the consumer, these developments should at least constrain food price increases for some time.

Wage settlements continue to indicate some moderation, but remain positive in real terms. The ratio of total compensation of employees to real GDP declined from 10,1 per cent in the year to the third quarter of 2009 to 9,2 per cent in the year to the fourth quarter. Nominal unit labour costs increased from 5,7 per cent in the third quarter to 8,8 per cent in the fourth quarter of 2009, but this figure was distorted by significant one-off adjustments to some public-sector pay scales.

Despite the reduced uncertainty associated with the electricity tariff increases, electricity and other administered price increases remain a threat to the inflation outlook. Of concern is the apparent trend towards greater reliance on high tariff increases to finance long-term infrastructural expenditure projects. These increases are, in effect, relative price changes or implicit tax increases. However, they contribute to the general inflation environment and remain a challenge for monetary policy.

Monetary policy stance

The assessment of the MPC is that despite clear signs that the economy has emerged from the recession, the pace of recovery is expected to remain slow. The improved inflation environment has provided some space for an additional monetary stimulus to reinforce the sustainability of the upswing without jeopardising the achievement of the inflation target. The MPC has therefore decided to reduce the repurchase rate by 50 basis points to 6,5 per cent per annum with effect from 26 March 2010. The MPC will continue to assess developments and will adjust the monetary policy stance when necessary in order to achieve the inflation target.

Statement of the Monetary Policy Committee

13 May 2010

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

Introduction

Since the previous meeting of the Monetary Policy Committee (MPC), the outlook for domestic inflation has remained favourable, with inflation still being expected to remain within the target range over the forecast period. Domestic economic growth prospects appear to have improved and most growth forecasts have been revised upwards, despite only a modest recovery in household consumption expenditure.

The risks to this relatively favourable growth outlook have changed somewhat in the past few days as a result of recent global developments. The uncertainty related to the sustainability of fiscal deficits in a number of euro area countries, and the reaction of the financial markets to these events, has renewed fears of possible contagion that could affect the tentative recovery that has been taking place in most regions, including in South Africa. The concerted efforts by European governments, the European Central Bank (ECB) and the International Monetary Fund (IMF) have had some effect on calming the markets. However, significant risks to the global and domestic recovery remain.

Recent developments in inflation

The year-on-year inflation rate as measured by the consumer price index for all urban areas (CPI) declined to 5,1 per cent in March 2010 from 5,7 per cent in the previous month. The category of housing and utilities remained the single biggest driver of inflation, having contributed 1,6 percentage points, mainly as a result of the impact of a 26,8 per cent year-on-year increase in electricity prices. Food price inflation continued to contribute favourably to the average inflation outcome, having increased by 0,5 per cent. Administered prices excluding petrol and paraffin increased by 10,4 per cent, compared with 10,8 per cent in the previous month.

Producer price inflation increased to 3,7 per cent in March 2010, compared with 3,5 per cent in February. This upward trend was driven mainly by primary commodity price increases that do not impact directly on the CPI. Food price inflation at the producer level remained well contained and should constrain food price inflation at the consumer price level in the coming months. Agricultural food prices declined at a year-on-year rate of 6,2 per cent, while manufactured food prices declined by 1,5 per cent.

The outlook for inflation

The CPI forecast of the South African Reserve Bank (the Bank) indicates a slightly improved outlook compared with that presented at the previous meeting of the MPC, with a lower projected inflation for 2010 and 2011. CPI inflation is still expected to reach a low point in the third quarter of 2010 when it is forecast to average 4,7 per cent. Inflation is then expected to increase moderately and remain within the inflation target range until the end of the forecast period, which has been extended to the end of 2012, at 5,3 per cent.

Recent surveys indicate that analysts' inflation expectations are within the inflation target range for most of the forecast period. According to the Reuters CPI survey, respondents expect inflation to average 5,3 per cent in 2010, and 5,8 per cent and 6,0 per cent in the following two years. Inflation expectations as indicated by inflation-linked bonds also reflect an improvement since the previous meeting of the MPC and are within the inflation target range.

According to the *WEO* published by the IMF in April 2010, global growth is now expected to average 4,2 per cent in 2010, compared with the October 2009 forecast of 3,1 per cent. However, the recent developments in Europe have raised the possibility of a renewed crisis that could threaten the global recovery. The reaction of the financial markets to the downgrading by the rating agencies of some euro area countries was reminiscent of the aftermath of the collapse of Lehman Brothers in September 2008. Apprehension about a possible default on Greek sovereign debt sparked concerns of a contagion effect on other European economies with high fiscal deficits and debt ratios. There were also fears of a spillover to the European banking sector, which has significant exposures to the sovereign debt of these countries.

The financial markets initially reacted positively to the concerted and significant policy interventions announced on 8 May by the euro area governments and the ECB. However, the markets were subsequently less convinced that the measures taken would be sufficient to resolve the underlying solvency problem of these countries, or that the required fiscal consolidations would be politically and socially feasible. These developments demonstrate the fragility of the global environment and the related uncertainties pose a downside risk to the global recovery. The global inflation outlook, however, is expected to remain benign and is not expected to pose an upside risk to domestic inflation.

For much of the period since the previous MPC meeting, the exchange rate of the rand had remained relatively stable within a range of around R7,23 and R7,48 against the US dollar. The turbulence in the global financial markets resulted in a brief but significant depreciation of the rand against the US dollar, as risk aversion returned to the markets. Following the announcement of the proposed government interventions in Europe, the rand appreciated to current rates of around R7,50 against the US dollar.

On a trade-weighted basis, the rand has remained relatively unchanged since the beginning of the year. Over the same period the rand has depreciated by over 1 per cent against the US dollar, but has appreciated by around 11 per cent against the euro. At current levels, the rand remains a positive factor in the inflation outlook, but this is contingent on developments in the euro area and general risk aversion.

The global developments also highlight the current focus of the financial markets on the sustainability of fiscal deficits and debt ratios. The South African national government deficit measured an estimated 6,7 per cent of GDP in the 2009/10 fiscal year, compared with the projected 7,2 per cent announced in the February budget. The deficit is expected to narrow over the next three years as the economy recovers and to measure 4,7 per cent in the 2012/13 fiscal year. The overall government debt-to-GDP ratio is expected to peak at 43 per cent in the medium term. This fiscal trajectory is consistent with fiscal sustainability and the MPC does not foresee a possible conflict with monetary policy objectives should this trend be maintained.

The moderate recovery in domestic economic growth appears to be sustained. Both the composite leading and coincident business cycle indicators of the Bank continued their upward trend in the first two months of 2010, confirming the positive short-term outlook for domestic economic activity. The various business confidence indices are also relatively favourable. The most recent GDP forecast of the Bank is for growth of 2,7 per cent in 2010 and 3,6 in 2011. At these rates of growth, the output gap is not viewed as an upside risk to the inflation outlook. The main risks to the growth outlook are seen to emanate from possible adverse global economic developments.

The growth outlook is underpinned by the continued recovery in the manufacturing sector, which grew at a broad-based year-on-year rate of 6,3 per cent in March. The Kagiso/BER Purchasing Managers Index declined in April, but still reflects a continued expansion of this sector. Total mining production increased at a year-on-year rate of 11,0 per cent in March.

Private-sector demand pressures remain benign from an inflation perspective. There is some evidence of an improvement in household consumption expenditure. Real retail sales declined on a year-on-year basis in February, but the shorter-term trends were more positive. When the three months to February are compared with the previous three months, an increase of around 3 per cent was recorded. New vehicle sales also maintained their favourable trends, increasing at a year-on-year rate of 36 per cent in April.

Domestic bank credit extension to the private sector continues to reflect weak demand conditions despite evidence of some loosening of credit supply constraints. Twelve-month growth in loans and advances contracted by 0,3 per cent in March 2010. Growth in mortgage advances declined from 3,9 per cent in February to 3,6 per cent in March, but nevertheless remained the only category of credit extension to register positive growth. The most recent Ernst and Young/BER Financial Services Index shows that the banks have moved to a more neutral position with respect to credit standards applied to new loans.

Consumption is also determined to some extent by the wealth effects in the economy. House prices appear to have recovered somewhat, and the various indices now all reflect positive house price growth. The equity markets have also improved significantly since their lows in March 2009. However, in the five trading days to 7 May, the JSE All-Share Index declined by almost 10 per cent, demonstrating the vulnerability of the market to changes in sentiment.

Despite the more favourable growth outlook, employment trends appear to be lagging the domestic recovery. The Quarterly Labour Force Survey indicates that 171 000 jobs were lost in the first quarter of 2010. These adverse trends are expected to constrain household consumption expenditure somewhat and offset, to some extent, the positive impact on consumption of higher real wage increases.

Notwithstanding these job losses, there is a concern about the possible impact of the level of wage increases in the economy. According to Andrew Levy Employment Publications, the average wage settlement rate in the first quarter of 2010 moderated to 8,4 per cent, compared with the 9,3 per cent increase measured in 2009. However, the MPC noted that a number of wage negotiations are at significantly higher levels, and well above the current and expected inflation rate. Should a general upward trend in wage settlement rates transpire, in the absence of compensating increases in productivity, it could pose an upside risk to the inflation outlook.

Other factors that have a significant impact on the inflation outlook include food and petrol prices. As noted earlier, food price inflation is expected to remain subdued as a result of the recent decline in the domestic maize price. The international oil price, having remained in the range of US$70 to US$80 per barrel for some time, appeared to have resumed its upward trend since late April. However the recent uncertainty in the financial markets, which cast doubts about the sustainability of the global recovery, resulted in a decline in the international price of Brent crude oil to below the US$80 per barrel level.

Monetary policy stance

The assessment of the MPC is that inflation is likely to remain within the inflation target range over the forecast period, and that the economy is expected to continue on a recovery path. The risks to the inflation forecast are seen to be more evenly balanced than at the previous meeting of the MPC. The main risks to the inflation outlook emanate from administered price developments and from the risks emanating from the global economy. The domestic growth outlook will continue to be affected by the global developments. The MPC will continue to monitor these developments closely.

For these reasons, the MPC deems it appropriate to maintain the current stance of monetary policy. Accordingly, the repurchase rate remains unchanged at 6,5 per cent per annum.

Abbreviations

Alsi	All-Share Index
BER	Bureau for Economic Research (Stellenbosch University)
BIS	Bank for International Settlements
BOE	Bank of England
BOJ	Bank of Japan
CPI	consumer price index
ECB	European Central Bank
EIU	Economist Intelligence Unit
EU	European Union
FNB	First National Bank
FOMC	Federal Open Market Committee
GDP	gross domestic product
IMF	International Monetary Fund
JSE	JSE Limited
MPC	Monetary Policy Committee
NAB	non-alcoholic beverage
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
PPP	purchasing power parity
PSBR	public-sector borrowing requirement
RMB	Rand Merchant Bank
the Bank	South African Reserve Bank
the Fed	Federal Reserve System
UK	United Kingdom
US	United States
WEO	*World Economic Outlook*