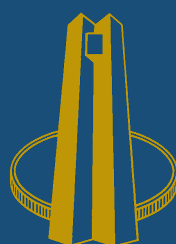
Monetary Policy Review

October 2010



South African Reserve Bank

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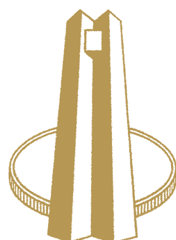

South African Reserve Bank

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Monetary Policy Review

Introduction

Domestic inflation has moderated to lower-than-expected levels in the period since the publication of the previous *Monetary Policy Review* in May 2010, restrained by the relatively weak domestic demand conditions and the further appreciation of the foreign-exchange rate of the rand. Economic growth was below expectations in the second quarter of 2010 and is projected to remain below potential for some time. Although household consumption expenditure has shown signs of recovery, it has continued to be adversely affected by high levels of household indebtedness, continued job losses and low levels of credit extension.

Growth in the domestic economy continues to take place against the backdrop of a fragile global economy, characterised by significant risks to global growth despite fears of a reversion to recession in the advanced economies having diminished somewhat. This has meant that the abnormally low policy rates in a number of advanced economies have remained in effect and emerging markets around the world have experienced increased capital inflows as investors have adjusted their portfolios to hold more emerging-market bonds. This has had implications for the exchange rate of the rand, which has appreciated despite further accumulation of foreign-exchange reserves by the South African Reserve Bank (the Bank).

The domestic inflation outlook has also improved recently, with the forecast for the targeted inflation rate being revised downwards. Inflation is expected to remain below the upper level of the 3 to 6 per cent inflation target range over the period to 2012. This improvement created sufficient space for monetary policy to provide additional stimulus to the somewhat fragile recovery of the domestic economy, allowing the repurchase rate to be reduced by 50 basis points in September 2010.

As usual, the *Monetary Policy Review* analyses inflation developments and the factors that have impacted on inflation, followed by an assessment of recent monetary policy developments and a discussion of the outlook for inflation. Three issues are focused on in the boxes. Box 1 examines the fiscal burden taken on by some of the advanced countries at the centre of the financial crisis and the key risks for the global economic recovery of synchronised fiscal consolidation, while Box 2 reports on the recently announced changes to the Bank's monetary policy operational procedures. Box 3 reports on research that examines the manner in which the policy rate in South Africa reacted to the inflation rate, the output gap, and the real exchange rate before and after the implementation of inflation targeting.

Recent developments in inflation

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

The evolution of inflation indicators

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, declined continually from 5,1 per cent in March 2010 to 3,5 per cent in August (Figure 1).

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

The main contributions to the decline in CPI inflation in the period since March 2010 (Table 1) have been the transport, and miscellaneous goods and services categories. The year-on-year percentage contribution of transport prices declined from 0,7 to 0,2 percentage points, while that of miscellaneous goods and services declined from 1,2 to 0,8 percentage points over the period. The contribution of the food and non-alcoholic beverages category increased from 0,1 percentage points in June to 0,3 percentage points in August, mainly as a result of increases in the contributions of the prices of vegetables, fish and fruit.

Table 1 Contributions to CPI inflation

Percentage change over 12 months* and percentage points

	2010					
	Mar	Apr	May	Jun	Jul	Aug
Total*	5,1	4,8	4,6	4,2	3,7	3,5
Of which:						
Food and NAB**	0,2	0,1	0,1	0,1	0,2	0,3
Alcoholic beverages and tobacco	0,6	0,6	0,6	0,6	0,6	0,4
Housing and utilities	1,6	1,5	1,5	1,5	1,5	1,4
Health	0,1	0,1	0,1	0,1	0,1	0,1
Transport	0,7	0,7	0,6	0,4	0,2	0,2
Education	0,2	0,2	0,2	0,2	0,2	0,2
Miscellaneous goods and services	1,2	1,2	1,2	1,0	0,8	0,8
Other	0,5	0,4	0,3	0,3	0,1	0,1

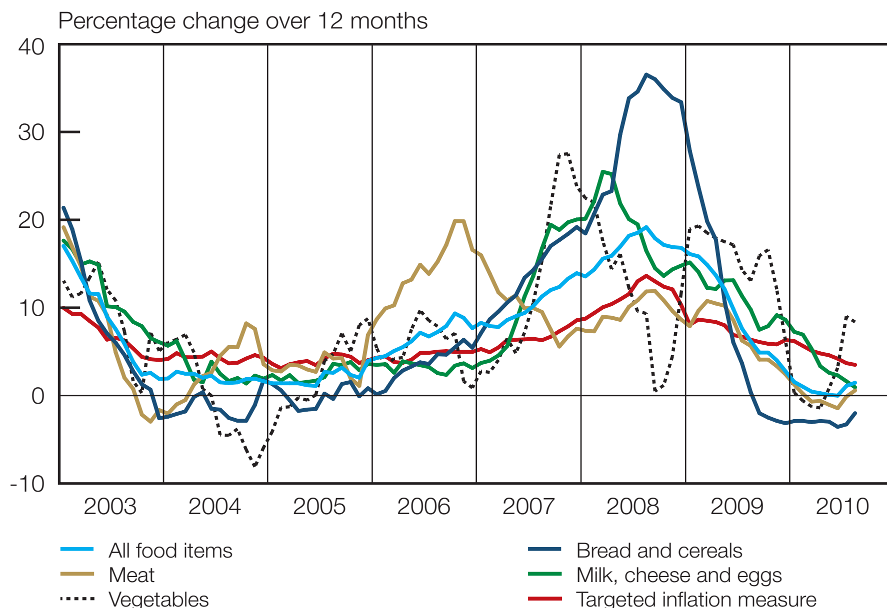
** NAB: Non-alcoholic beverages

Source: Statistics South Africa

Figure 2 shows that the year-on-year inflation rate for all food items remained low in 2010, increasing from 0,5 per cent in March to 1,5 per cent in August. Bread and cereals contributed negatively towards food inflation over the period, partly due to falling maize

prices in the first half of the year. The inflation rate for the price of vegetables increased from -0,5 per cent in February 2010 to 8,4 per cent in August. The increase recorded in recent months was mainly driven by the cold weather experienced in June, which affected the northern parts of South Africa and damaged fruit and vegetable crops.

Figure 2 Targeted inflation* and food inflation

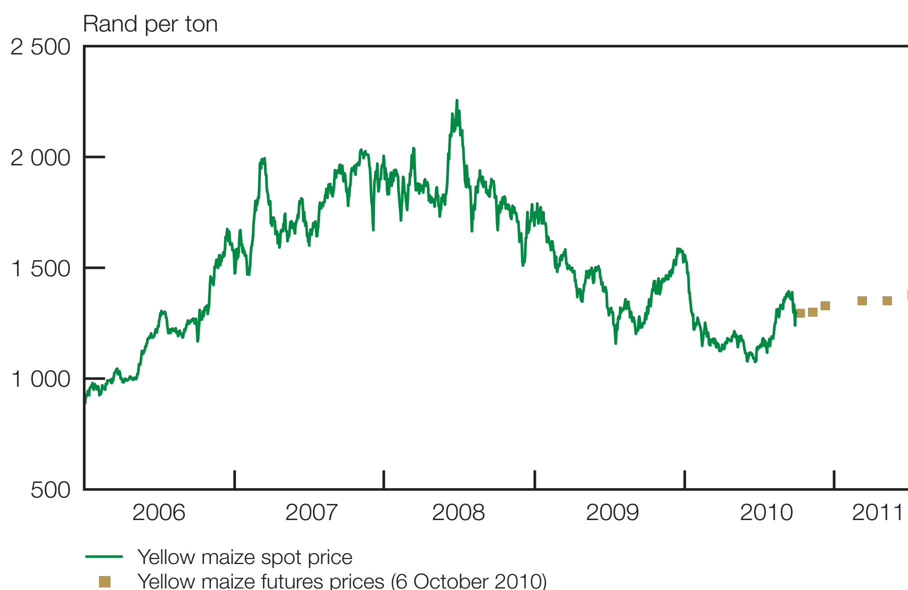


* CPIX for metropolitan and other urban areas until the end of 2008; CPI for all urban areas thereafter

Source: Statistics South Africa

The estimated maize crop in the 2009/10 season was 13,04 million tons, the largest since the 1981/82 season. Yellow maize prices declined from R1 575 per ton in January to R1 181 per ton in early August 2010 (Figure 3) as a result of the bumper maize crop, lower international prices, improved seed and technology, good weather, and the

Figure 3 Yellow maize prices

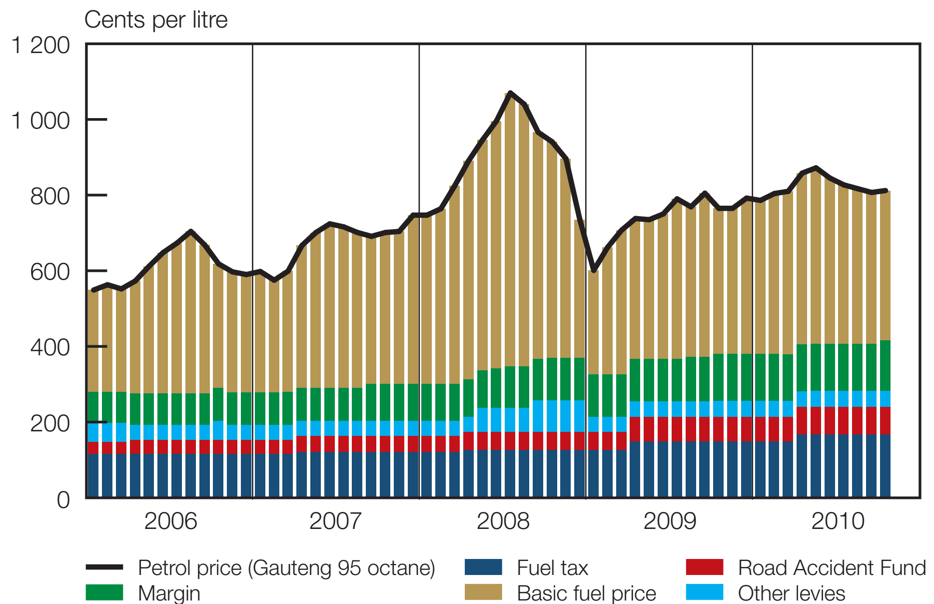


Sources: Grain South Africa and SAFEX

appreciation of the rand against the United States (US) dollar. Parity pricing in South Africa following higher US maize prices and improved prospects that the US would export yellow maize to Russia to feed livestock provided support as prices then increased to R1 390 per ton in September, before declining once more to R1 295 per ton on 6 October following favourable news regarding US grain supplies.

In April 2010 the petrol price increased to 858 cents per litre for 95 octane unleaded petrol in Gauteng Province from 810 cents per litre in March (Figure 4), largely as a result of increases in the fuel tax and Road Accident Fund levies. It then rose to 872 cents per litre in May, before declining continually to reach 807 cents per litre in September. In October the price rose by 5 cents per litre to 812 cents per litre following an increase in the retail margin that more than offset an over-recovery in the petrol price during September.

Figure 4 South African petrol price



Source: Department of Energy

Goods inflation maintained a downward trend in the period under review and has breached the lower limit of the inflation target range since June 2010 (Table 2).

Table 2 CPI: Goods and services inflation

Percentage change over 12 months

	2010					
	Mar	Apr	May	Jun	Jul	Aug
Headline CPI	**5,1**	**4,8**	**4,6**	**4,2**	**3,7**	**3,5**
Goods	4,0	3,5	3,1	2,6	2,1	1,9
Durable goods	-0,3	-1,3	-2,4	-2,6	-2,4	-3,1
Semi-durable goods	1,4	0,5	0,1	0,2	-0,4	-0,3
Non-durable goods	6,4	6,1	6,1	5,4	4,6	4,3
Services	6,5	6,5	6,4	6,1	5,4	5,4

Source: Statistics South Africa

Year-on-year percentage changes of 2,1 per cent in July and 1,9 per cent in August were recorded. The main driver of the decline in goods price inflation was the inflation rate for durable goods, which remained negative throughout the period. Semi-durable goods inflation also remained at low levels, reaching a negative level of 0,3 per cent in August 2010, while non-durable goods inflation declined to 4,3 per cent in the same month. Services inflation fell to within the 3 to 6 per cent target range in July 2010 for the first time since the publication of the new CPI had begun in January 2009. A year-on-year percentage change of 5,4 per cent was recorded in July and August 2010.

Movements in the inflation rate of the administered price index (API) have been driven by the regulated component of the index during 2010 (Table 3). The API inflation rate rose from 11,2 per cent in March to 12,1 per cent in May, before declining to 8,3 per cent in August. Inflation measured in terms of the regulated component of the index increased to 13,7 per cent in May and then slowed to 8,1 per cent in August. During this period the contribution of the year-on-year change in the petrol price rose from 3,2 percentage points in March to 4,1 percentage points in May and then declined to 1,4 percentage points in August. Electricity price increases contributed 3,8 percentage points between March and June, and 3,0 percentage points in August. The year-on-year inflation rate for electricity and other fuels prices was 24,7 per cent in June and 18,3 per cent in August. In the unregulated portion of the API large contributions were recorded by the assessment rates and school fees categories. The inflation rate for the unregulated component of the index remained between 9,3 per cent and 8,6 per cent over the period since March.

Table 3 Contributions to administered prices

Percentage change over 12 months* and percentage points

	Weights		2010					
	CPI	API	Mar	Apr	May	Jun	Jul	Aug
Regulated component								
Water	1,10	7,50	0,7	0,8	0,8	0,8	0,9	0,9
Electricity	1,68	11,46	3,8	3,8	3,8	3,8	3,2	3,0
Paraffin	0,16	1,09	-0,1	-0,1	0,0	0,0	0,0	0,0
Petrol	3,93	26,81	3,2	3,6	4,1	2,8	1,1	1,4
Telephone fees	1,26	8,59	0,3	0,3	0,3	0,3	0,3	0,0
Postage	0,02	0,14	0,0	0,0	0,0	0,0	0,0	0,0
Cellular telephone calls	1,47	10,03	-0,1	-0,1	-0,1	-0,1	-0,1	-0,1
Unregulated component								
Assessment rates	2,07	14,12	1,3	1,3	1,3	1,3	1,2	1,2
Sewage collection	0,06	0,41	0,0	0,0	0,0	0,0	0,1	0,1
Refuse collection	0,09	0,61	0,1	0,1	0,1	0,1	0,1	0,1
Train fees	0,04	0,27	0,0	0,1	0,1	0,1	0,1	0,1
Motor vehicle licences	0,09	0,61	0,0	0,0	0,0	0,0	0,0	0,0
Motor vehicle registration fees	0,10	0,68	0,1	0,0	0,0	0,0	0,1	0,1
Television licences	0,13	0,89	0,1	0,1	0,1	0,1	0,1	0,0
Primary and secondary school fees	1,28	8,73	1,0	1,0	1,0	1,0	0,9	0,9
University fees	0,90	6,14	0,5	0,5	0,5	0,5	0,5	0,5
University boarding fees	0,28	1,91	0,2	0,2	0,2	0,2	0,2	0,2
Residual			0,1	0,0	-0,1	-0,1	-0,1	-0,1
CPI for administered prices*	**14,66**	**100,00**	**11,2**	**11,6**	**12,1**	**10,8**	**8,6**	**8,3**

Source: Statistics South Africa

Table 4 shows the percentage change over 12 months in different measures of core inflation calculated by excluding petrol, food and non-alcoholic beverages (NAB), and

energy prices. The inflation rate for the CPI excluding petrol prices is lower in the period under review than that of headline CPI, except in July 2010 when the same rates were recorded, implying that petrol prices exerted upward pressure on headline CPI. By contrast, the rate for the CPI excluding food and NAB prices was higher than that for headline CPI, indicating the downward pressure from the excluded prices. Finally, inflation for the CPI excluding food, NAB and petrol prices was higher than that for the CPI excluding food, NAB, petrol and energy prices as a result of upward pressure from energy prices.

Table 4 The effect of food, petrol and electricity prices on headline inflation

Percentage change over 12 months

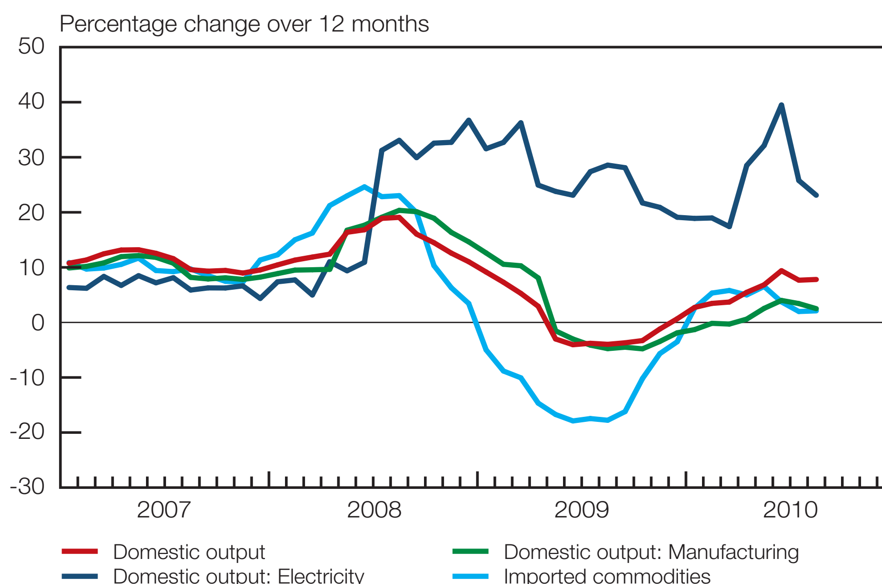
	2010					
	Mar	Apr	May	Jun	Jul	Aug
Headline CPI	**5,1**	**4,8**	**4,6**	**4,2**	**3,7**	**3,5**
CPI excluding petrol prices	4,8	4,5	4,2	4,1	3,7	3,4
CPI excluding food and NAB*	5,9	5,6	5,4	5,0	4,2	3,9
CPI excluding food, NAB and petrol prices	5,4	5,1	4,9	4,6	4,0	3,7
CPI excluding food, NAB, petrol and energy prices	5,0	4,7	4,3	4,2	3,6	3,2

* NAB: Non-alcoholic beverages

Source: Statistics South Africa

Figure 5 shows that year-on-year inflation measured in terms of the producer price index (PPI) for domestic output accelerated from 3,7 per cent in March 2010 to 9,4 per cent in June, before decreasing to 7,8 per cent in August. In August, significant contributions were made by the mining and quarrying category, which contributed 3,2 percentage points, and by electricity prices, which contributed 2,4 percentage points. Manufacturing sector inflation, by contrast, placed downward pressure on the PPI inflation rate over the period. The PPI inflation rate for imported commodities rose to 6,5 per cent in May before declining to 2,1 per cent in August.

Figure 5 PPI for domestic output and imported commodities

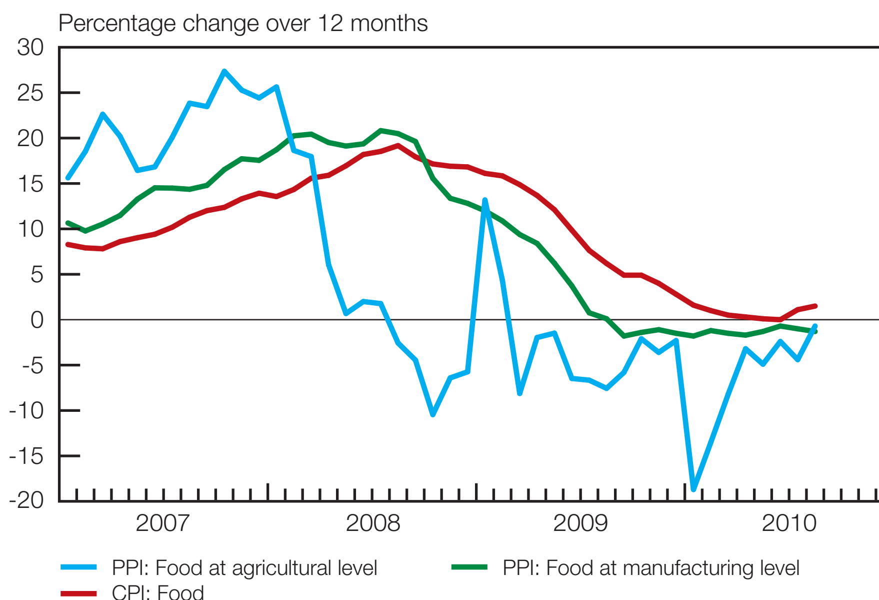


Details regarding changes to the PPI in this period are documented in statistical release P0142.1, February 2008, issued by Statistics South Africa

Source: Statistics South Africa

Year-on-year food price inflation in the PPI for domestic output has remained negative, recording -0,7 per cent in August 2010 (Figure 6). The inflation rate for food prices at the agricultural level has risen somewhat since the publication of the previous *Monetary Policy Review*, but remains subdued and has oscillated between 0 and -5 per cent. Inflation for food at the manufacturing level also remained negative at -1,3 per cent in August.

Figure 6 Food prices in the PPI and CPI



Source: Statistics South Africa

Factors affecting inflation

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

International economic developments

The most recent International Monetary Fund (IMF) data show that global growth improved from -0,6 per cent in 2009 to a projected 4,8 per cent in 2010 (Table 5). Global activity continued to strengthen during the first half of 2010 and expanded at an annual rate of almost 5 per cent – about 1 percentage point higher than forecasted in the April *World Economic Outlook (WEO)* and 0,5 percentage points higher than in the July 2010 *WEO Update*. Although lower levels of consumer confidence, and reduced household incomes and wealth have held back consumption growth in many advanced economies, a surge in inventory and fixed investment contributed to the significant rise in manufacturing and global trade.

Growth in the advanced economies nevertheless reached only about 3,5 per cent during the first half of 2010 and the recoveries in advanced economies are expected to remain fragile for as long as jobless growth prevails. Emerging-market economies, which expanded by almost 8 per cent, have experienced robust household consumption expenditure growth as investment propelled job creation. Unemployment remains at elevated levels in the US and the euro area, but has edged down in Japan and emerging Asian countries. Although the euro area's sovereign debt concerns have receded somewhat, financial markets continue to reflect concerns about fiscal sustainability

(Box 1 on page 9). The premiums investors charge to hold Greek, Spanish and Irish debt over German bunds are now wider than they were before a European Union-led rescue package was announced in May.

Global consumer price inflation has remained relatively low despite the recovery in international commodity prices. Core inflation has trended downwards in the Organisation for Economic Co-operation and Development (OECD) countries since October 2009 and inflationary pressures continued easing in emerging-market economies, except China, India and Argentina. The IMF forecasts that the pace of world inflation will accelerate to 3,7 per cent in 2010 from 2,5 per cent in 2009.

According to the official arbiter of the US business cycle, the recession that started in the US in December 2007 ended in June 2009. However, the US recovery has been moderating in the face of continued uncertainty and in the second quarter of 2010 the US economy expanded less than initially anticipated. The IMF forecasts that the US economy will record a real growth rate of 2,6 per cent in 2010 compared with the negative real growth of 2,6 per cent recorded in 2009.

Table 5 Annual percentage change in real GDP and consumer prices

	Real GDP		Consumer prices	
	2009	2010 (estimate)	2009	2010 (estimate)
World	**-0,6**	**4,8**	**2,5**	**3,7**
Advanced economies	**-3,2**	**2,7**	**0,1**	**1,4**
United States	-2,6	2,6	-0,3	1,4
Japan	-5,2	2,8	-1,4	-1,0
Euro area	-4,1	1,7	0,3	1,6
United Kingdom	-4,9	1,7	2,1	3,1
Canada	-2,5	3,1	0,3	1,8
Other advanced economies	-1,2	5,4	1,5	2,4
Emerging and developing economies	**2,5**	**7,1**	**5,2**	**6,3**
Sub-Saharan Africa	2,6	5,0	10,4	7,5
Central and eastern Europe	-3,6	3,7	4,7	5,2
Commonwealth of Independent States	-6,5	4,3	11,2	7,0
Developing Asia	6,9	9,4	3,1	6,1
China	9,1	10,5	-0,7	3,5
India	5,7	9,7	10,9	13,2
Middle East and North Africa	2,0	4,1	6,7	6,8
Latin America and the Caribbean	-1,7	5,7	6,0	6,1

Source: IMF *World Economic Outlook,* October 2010

Economic growth in Japan also lost momentum during the second quarter of 2010 as activity grew by only 0,4 per cent at an annualised rate, compared with 4,4 per cent in the previous quarter. Economic growth in the second quarter of 2010 was mainly driven by exports, but was partly offset by declining private inventory investment, government investment and a sharp increase in imports. The IMF forecasts continued deflation of 1,0 per cent for Japan in 2010.

The sovereign debt crisis that erupted in Europe in the first quarter of 2010 spread internationally, and threatened the financial system and the broader global recovery. Concerted policy action in May, comprising unprecedented liquidity and credit support, new European financing instruments and significant fiscal intervention in affected countries restored financial stability and boosted Europe's economic activity and global investor

confidence. Although buoyant domestic demand and external trade conditions in some euro area countries have subsequently underpinned growth, the fragile labour and housing markets are creating uncertainties regarding the sustainability of current economic conditions. The euro area is therefore still experiencing a gradual and uneven recovery and recorded growth of 3,9 per cent in the second quarter of 2010 compared with 0,8 per cent in the preceding quarter. Real gross domestic product (GDP) in the euro area is projected to rise by 1,7 per cent in 2010 from the negative 4,1 per cent real growth recorded in 2009. Inflation in the euro area is projected to rise to 1,6 per cent in 2010 from the 0,3 per cent recorded in 2009.

The United Kingdom (UK) economy expanded by 4,9 per cent at an annualised rate in the second quarter of 2010 as a jump in construction and stock rebuilding by businesses offset a downward revision to services growth and a drop in fixed investment, thereby underpinning the biggest growth spurt since 2001. The Bank of England nevertheless cautioned that policy-makers may need to expand emergency stimulus to support the recovery. The IMF forecasts that the UK economy will grow by 1,7 per cent in 2010 compared with negative real growth of 4,9 per cent recorded in 2009. Inflation in the UK is projected to rise to 3,1 per cent in 2010 from the 2,1 per cent recorded in 2009.

Although real GDP growth remains relatively strong across all emerging markets, particularly in Asia, the slower global growth in the second quarter of 2010 was due to a moderation in the growth rates of emerging and developing economies. The deceleration of real growth in emerging and developing countries in the second quarter of 2010 was mainly caused by slowing growth in Asian emerging-market countries. However, the IMF data show that total capital inflows to emerging Asia over the past four quarters more than quadrupled relative to 2008 levels. The size of capital inflows is still dwarfed by the region's large current-account surpluses and many of these countries have responded to balance-of-payments surpluses through significant reserve accumulation.

Commodity-exporting countries benefited from the recovery in global demand and significantly improved terms of trade. The slowdown in 2009 was brief, helped by a rapid implementation of countercyclical policies in those countries where policy space had arisen prior to the downturn. Sub-Saharan Africa's economies, whose output contracted in 2009 due to their stronger global trade linkages, are now firmly on the path to recovery. The IMF forecasts that sub-Saharan Africa will record real growth of 5 per cent in 2010 compared with 2,6 per cent in 2009. The sub-continent's inflation rate is projected to slow somewhat from 10,4 per cent in 2009 to 7,5 per cent in 2010.

Box 1 Risks for the global economic growth outlook on the road to fiscal consolidation in advanced countries

Introduction

The public finances of most countries deteriorated rapidly in the aftermath of the global financial crisis as governments acted across a broad front to bolster aggregate demand and limit the systemic consequences of the crisis.

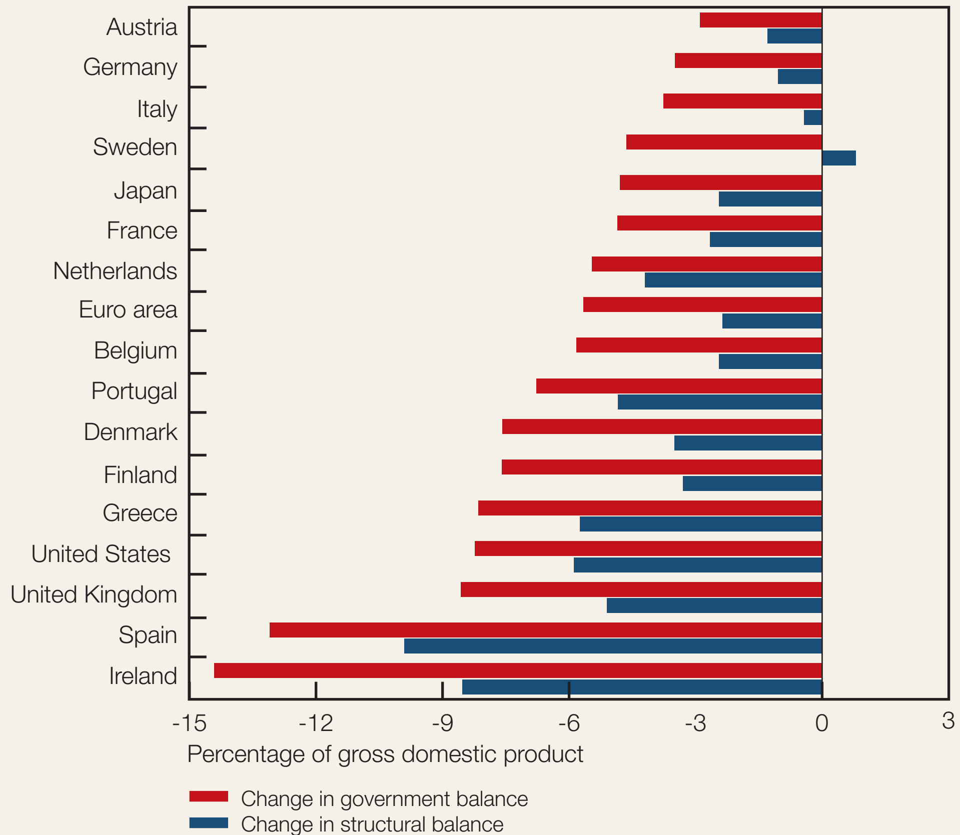
Advanced countries suffered greater deterioration in public finances than the larger emerging economies and countries such as the United Kingdom (UK), Portugal and Ireland experienced substantial deterioration of public finances, notwithstanding the fact that they had entered the global financial crisis with relatively sound fiscal positions.

This box examines the fiscal burden taken on by some of the advanced countries at the centre of the financial crisis and the key risks for the global economic recovery of synchronised fiscal consolidation.

The fiscal burden taken on by advanced countries due to the financial crisis

The fiscal deficit of the Organisation for Economic Co-operation and Development (OECD) countries rose from 1,3 per cent of gross domestic product (GDP) in 2007 to 8,3 per cent in 2010, the highest level in the post-World War II period. The strongest deterioration of public finances occurred in Ireland, the UK, Spain, Finland, Denmark and the United States (US) as balances worsened by around 10 percentage points on average from 2007 to 2009 (Figure B1.1).

Figure B1.1 Change in government balances, 2007–2009



Source: OECD, *Economic Outlook*, No. 87, May 2010

In the years preceding the onset of the financial crisis many advanced countries recorded sound economic growth rates but some were also incurring significant budget deficits. In a few countries, national debt-to-GDP ratios had already moved to levels deemed unsustainable and this made them more vulnerable to the subsequent downturn. Not all of the burden can, of course, be ascribed to the crisis.

In Ireland, Spain, the UK and the US in particular declining output and rising unemployment reduced tax revenue and boosted government expenditure as countries eased fiscal policy in response to the crisis. The public finances of the US and the UK were further affected by substantially reduced tax revenue from their relatively large financial sectors, and in these and other advanced countries crisis packages to the financial sectors contributed to the rising deficits (Table B1.1).

Table B1.1 shows the extent of public capital injections into the financial sectors of a number of advanced countries. This is not necessarily a permanent burden, given that, for example, 70 per cent of the funds invested by the US government have already been repaid and it expects to make an overall profit. However, three quarters of the government deficits in OECD member countries are deemed by the OECD to be structural and are therefore not expected to be reversed automatically when sustained economic growth returns.

Table B1.1 Government support during the crisis

Percentage of GDP

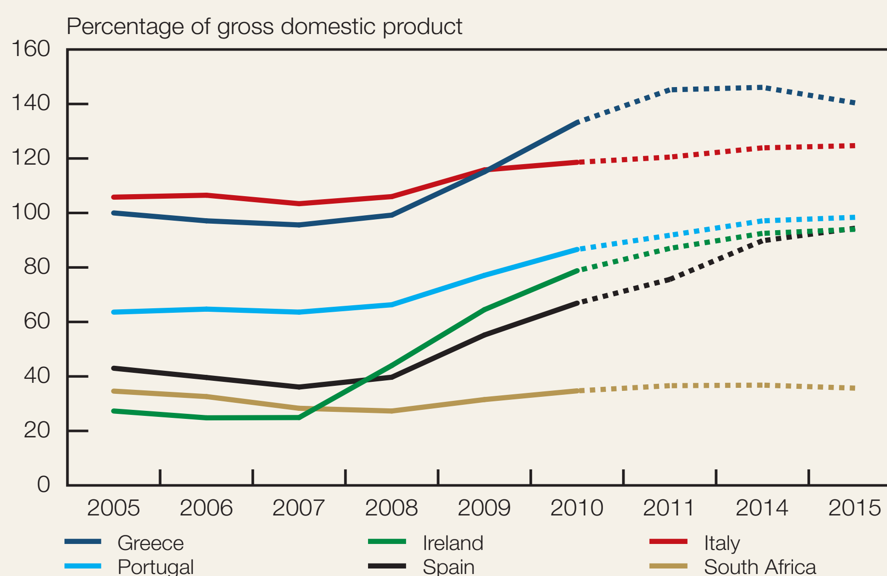
	Capital injections to financial sector	Discretionary fiscal stimulus	
	2009	2009	2010
Australia	0	2,8	1,8
Canada	0	1,8	1,7
China	0	3,1	2,7
France	1,1	1	0,5
Germany	1,2	1,5	2,1
Italy	0,3	0	0,1
Japan	0,1	2,8	2,2
United Kingdom	6,4	1,6	0,2
United States	2,9	1,8	2,9

Sources: Bloomberg, De Nederlandsche Bank, Eurostat, IMF, OECD, Thomson Reuters, and Reserve Bank of Australia

From financial crisis to sovereign debt crisis

According to the International Monetary Fund (IMF), by 2015 the ratio of public debt to GDP for the group of advanced economies in the Group of Twenty (G-20) economies will rise by almost 40 percentage points from its 2008 level. Although international financial institutions and rating agencies deem outright sovereign default in key advanced economies an unlikely outcome, by May 2010 the European Union (EU) and the IMF had created a €750 billion bailout package for Greece. Greece's experience of a sovereign debt crisis amplified investors' concerns and had a knock-on effect on global financial markets.

Figure B1.2 Debt ratio of GIIPS and South Africa



Note: Gross public debt. Broken lines indicate estimates. The IMF does not publish estimates for 2012 and 2013.

Source: IMF *Fiscal Monitor*, May 2010

Investor concerns about the rising ratio of public debt to GDP leading to a sovereign debt crisis resulted in borrowing costs for peripheral euro region countries rising significantly during the second quarter of 2010. Investors became increasingly concerned that large government debt and ageing populations would saddle some countries with inadequate fiscal space. The yield on

Greek debt rose to more than 900 basis points above that of Germany, while the credit ratings of Greece, Ireland, Portugal and Spain (GIPS) were all downgraded in subsequent months.

An analysis by Rogoff and Reinhart (2010) of advanced and emerging countries over the past 200 years shows that a large debt burden has detrimental effects on an economy. In Rogoff and Reinhart's analysis the median growth rates of the advanced countries fell by half as their debt levels moved from less than 30 per cent of GDP to 90 per cent or more. As government debt escalates, the larger interest expenditure makes public finances more vulnerable to rising interest rates and often forces countries to raise further loans or to tighten fiscal policy. However, debt as a percentage of GDP is not a complete indicator of a country's fiscal health, given that it does not reflect governments' available revenue and is backward-looking.

Even countries with a traditionally high credit standing have been reassessed in the light of the risks associated with a large government debt-to-GDP ratio. While the US government's debt as a percentage of GDP is one of the lowest among the advanced countries (53 per cent in 2009), its debt as a percentage of revenue is one of the highest (358 per cent in 2009). Japan's gross debt is equivalent to five year's tax revenue. Italy also has one of the highest debt-to-GDP ratios, at 116 per cent, but has a debt-to-revenue ratio of 188 per cent.

Risks for the global growth outlook

Long-term fiscal sustainability is a key concern for policy-makers as any perceived problems with current financing of debt could put a high-debt country's solvency under pressure. International financial institutions, including the IMF, have in the meantime called for substantial fiscal consolidation in advanced countries despite the fact that there is still considerable uncertainty about the sustainability of the global economic recovery.

The fiscal consolidation in EU member states is governed by the Stability and Growth Pact requirement that the cyclically adjusted structural budget deficit be reduced annually by at least 0,5 per cent of GDP. Some EU member states such as Greece, Ireland and Spain are deemed by the EU to require far stricter tightening measures. The bailout package arranged for Greece imposed fiscal tightening equivalent to 11 per cent of Greece's GDP until 2013. Most of the other EU member states have also received notice to correct deficits more substantively than required by the Stability and Growth Pact from 2010.

Christensen and Tommerup (2010) point to the fact that the current magnitude of fiscal consolidation being implemented has not been required in the post-World War II era of so many countries simultaneously (Table B1.2).

Table B1.2 Effects of national and simultaneous fiscal consolidation

Effect of fiscal consolidation equivalent to 1 per cent of national GDP	First-year change in GDP (per cent)				
	United States	Japan	Euro area	OECD area	Of which: Effect on own country*
Tightening in:					
United States	-0,9	-0,2	-0,1	-0,5	-0,3
Japan	0	-0,8	0	-0,2	-0,1
Euro area	-0,1	-0,1	-0,8	-0,3	-0,2
OECD area	-1,2	-1,3	-1,1	-1,1	
Effect of tightening in other countries as a percentage of effect of own tightening	33	63	38		

* GDP effect in the OECD area as a result of a decline in GDP in the country implementing the tightening.

Sources: OECD *Economic Outlook*, No. 86, Table 1.7 and Danmarks Nationalbank

Table B1.2 shows the GDP effects of isolated fiscal tightening relative to the effects of simultaneous fiscal tightening in all OECD countries as modelled by the OECD. Simultaneous fiscal consolidation will further reduce growth by 30–60 per cent relative to purely national consolidation. Some policy-makers are concerned that the global economic recovery could wane and that a recession could again ensue as stimulus measures begin to dissipate.

Koo (2008) warns of unintended consequences of synchronised fiscal consolidation in countries that are in the process of emerging from recessions brought on by the bursting of a debt-financed asset-price bubble. He points to Japan's experience in the period 1990–2005 and argues that enhanced fiscal rectitude could lead to lower fiscal revenues and higher budget deficits if the private sector focuses on debt minimisation and balance-sheet repair instead of on financial intermediation and profit maximisation. Stevens (2010) warns that increased pressure for synchronised fiscal consolidation at a time when aggregate demand remains weak means that the "least-damage path through the various competing concerns will be harder to tread".

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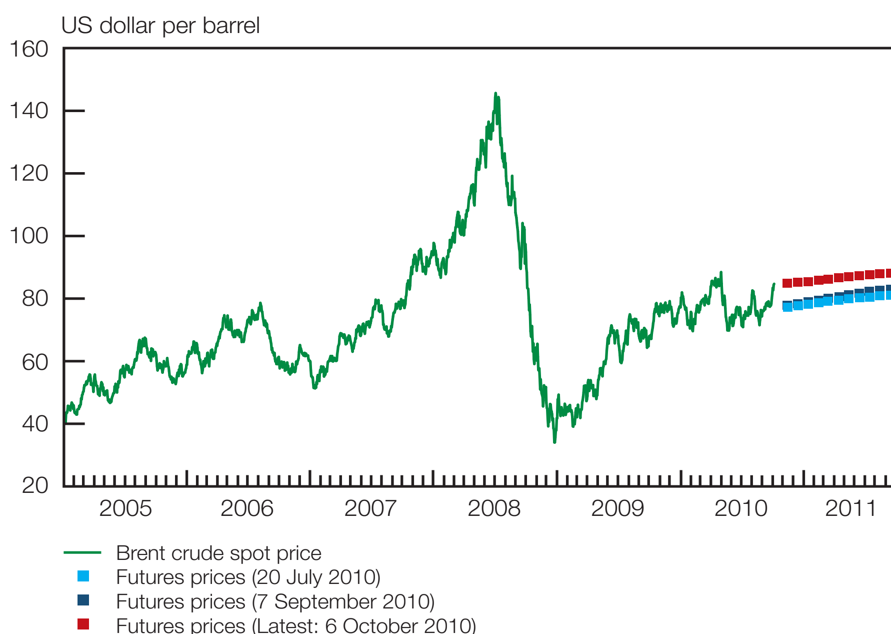
Oil prices

The oil price has remained relatively stable since the previous *Monetary Policy Review* was published in May 2010, with the price of Brent crude oil fluctuating between US$69 and US$85 per barrel (Figure 7). Prices have been contained by concerns about the global economic recovery and the effect of fiscal positions on the economic recovery of the euro zone, as well as the continued accumulation of oil stocks by the US to levels

Figure 7 Price of Brent crude oil



Source: Bloomberg

above their five-year average. The price of Brent crude oil rose to a three-month high of US$82,60 per barrel at the beginning of August driven by market sentiment, equity prices and US dollar movements. The Organization of the Petroleum Exporting Countries (OPEC) remains cautious as to the expected growth in oil demand for 2010, which it believes will be positive for the first time since 2007, but below the pre-recession average. Non-OPEC oil production remains robust with production expected to increase by 0,9 million barrels per day; a figure that has been frequently revised upwards by OPEC due to increased supply from the US, Russia and China, which has helped contain increases in the price of oil. Given improving global growth, the International Energy Agency (IEA) revised its estimate of oil demand upwards to 2,2 per cent in 2010 and 1,5 per cent in 2011.

International monetary policy developments

Monetary policy measures adopted to stem the effects of the global recession remain in place for most advanced economies, although a number of countries have begun to raise their policy rates (Table 6). Countries that have increased their interest rates since May 2010 include Canada, Sweden, New Zealand, Israel, Malaysia, South Korea, Taiwan, Thailand, India, Brazil and Chile. Russia, Turkey and Iceland have continued to reduce interest rates.

Table 6 Selected central bank interest rates

Per cent

Countries	13 May 2010	6 Oct 2010	Latest decision (change in percentage points)	
United States	0,00–0,25	0,00–0,25	21 Sep 2010	(0,00)
Japan	0,10	0,00–0,10	5 Oct 2010	(-0,10–0,00)
Euro area	1,00	1,00	2 Sep 2010	(0,00)
United Kingdom	0,50	0,50	9 Sep 2010	(0,00)
Canada	0,25	1,00	8 Sep 2010	(0,25)
Denmark	1,05	1,05	26 May 2010	(0,00)
Sweden	0,25	0,75	2 Sep 2010	(0,25)
Norway	2,00	2,00	22 Sep 2010	(0,00)
Switzerland	0,00–0,75	0,00–0,75	16 Sep 2010	(0,00)
Australia	4,50	4,50	5 Oct 2010	(0,00)
New Zealand	2,50	3,00	16 Sep 2010	(0,00)
Israel	1,50	2,00	27 Sep 2010	(0,25)
China	5,31	5,31	5 Aug 2010	(0,00)
Hong Kong	0,50	0,50	5 Nov 2009	(0,00)
Indonesia	6,50	6,50	5 Oct 2010	(0,00)
Malaysia	2,50	2,75	2 Sep 2010	(0,00)
South Korea	2,00	2,25	9 Sep 2010	(0,00)
Taiwan	1,25	1,50	30 Sep 2010	(0,125)
Thailand	1,25	1,75	25 Aug 2010	(0,25)
India	5,25	6,00	16 Sep 2010	(0,25)
Brazil	9,50	10,75	1 Sep 2010	(0,00)
Chile	0,50	2,50	16 Sep 2010	(0,50)
Mexico	4,50	4,50	24 Sep 2010	(0,00)
Czech Republic	0,75	0,75	23 Sep 2010	(0,00)
Hungary	5,25	5,25	27 Sep 2010	(0,00)
Poland	3,50	3,50	24 Aug 2010	(0,00)
Russia	8,00	7,75	31 Aug 2010	(0,00)
Turkey	6,50	6,25	16 Sep 2010	(-0,25)
Iceland	8,50	6,25	22 Sep 2010	(-0,75)

Source: National central banks

Second-quarter data for the US indicated that the recovery in output and employment had moderated, increasing domestic and global concern about the chances of a double-dip recession. In the light of this, the United States Federal Reserve (the Fed) announced

that it was willing to assist the economy further, with the first steps being to reinvest the proceeds from expiring mortgage-backed securities into long-term treasury securities and keeping the target for the federal funds rate low for an extended period of time.

The Governing Council of the European Central Bank (ECB) determined at its meeting in August that the policy rate, at 1 per cent per annum, remains at an appropriate level for the euro area given the council's assessment of the economic outlook for the area as well as for the global economy. The council viewed the economic outlook to be favourable, but with much uncertainty both for the euro area and the global economy.

The target for the uncollateralised overnight call rate in Japan was changed from a point target of 0,1 per cent to a range of between 0 and 0,1 per cent in October 2010. Further monetary easing had been added at the end of August, following a decision taken at an unscheduled monetary policy meeting, in the form of a new six-term fixed-rate funds-supplying operation against pooled collateral. This was extended by the Policy Board of the Bank of Japan in October by committing to pursue a "virtually zero interest rate policy" until price stability returned. This commitment was supported by the establishment of an asset purchase programme.

The Bank of England has maintained its policy rate at 0,5 per cent and its holdings under the asset purchase programme at £200 billion. While the second quarter of 2010 seems to have been positive for the UK, there are concerns about the path of the recovery that have resulted in the Bank of England remaining cautious.

In Canada the interest rate was raised by 25 basis points in June, July and September 2010. The Bank of Canada noted on each occasion that further tightening of monetary policy would have to be considered carefully given the uncertainty surrounding the economic outlook. The Bank of Canada's view is that domestic monetary conditions remain stimulative despite these measures, consistent with achieving the 2 per cent inflation target in an environment of significant excess supply and an uneven global recovery.

Sweden was another industrialised nation that saw monetary tightening based on a relatively strong recovery from the global recession. However, the Riksbank indicated that its view was that the interest rate would not rise as much as previously expected due to the subdued global recovery. The Riksbank has increased the interest rate on two occasions since May 2010, most recently to 0,75 per cent in early September, and further monetary tightening has occurred in that two of the three fixed interest rate loans extended to banks during 2009 have not been renewed or replaced. Such changes are viewed by the Riksbank as returning monetary policy to a more normal state.

Australia kept its interest rates stable at recent meetings, partly due to the fragility of the global economic recovery, although New Zealand has begun to tighten policy by raising interest rates twice since May. The economic recovery in New Zealand seems to be proceeding at an acceptable pace, albeit sensitive to the global economic recovery, and with inflation remaining near to the target, it was deemed to be appropriate to start removing monetary stimulus as the economy returned to normality.

In Asia, South Korea has started to raise rates, joining India and Malaysia. Taiwan and Thailand have also increased their policy rates since May. The reasons cited in all cases are the global economic recovery and stronger domestic economic growth.

In South America, Brazil has continued tightening by increasing its interest rate by 125 basis points in the period under review. Chile has also increased rates by 200 basis points over the period. In both cases the global recovery is cited as a factor in the decision, although policy-makers are mindful of the fragility of the recovery.

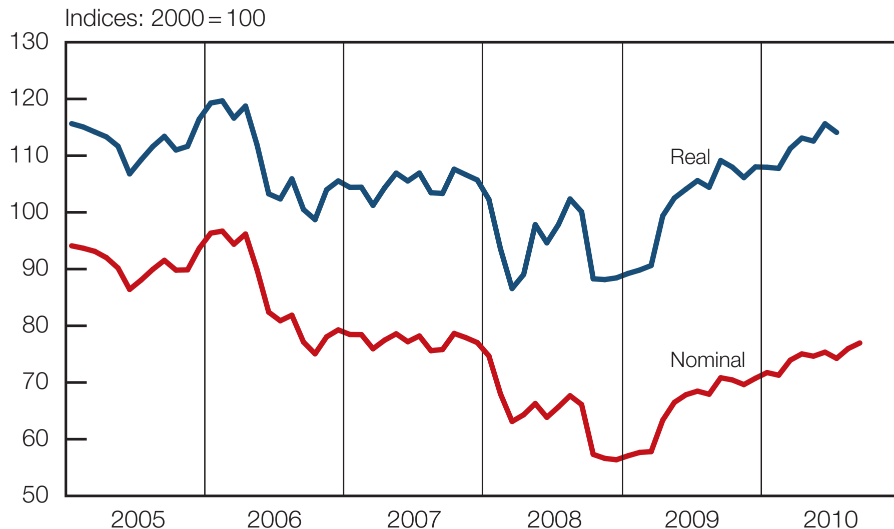
Exchange rate developments

After depreciating to R7,97 against the US dollar late in May 2010 due to an increase in global risk aversion following concerns over the public debt levels experienced by some European countries, the foreign exchange rate of the rand recovered to below R7,40 to the US dollar towards the end of July following news that HSBC and Standard Chartered banks were considering purchasing the South African bank, Nedbank (Figure 8). The currency continued to strengthen in line with other emerging-market economies, moving below R7 to the US dollar since late September. Between May and 6 October 2010 the rand appreciated from R9,93 to R9,54 against the euro.

Figure 8 Exchange rates of the rand

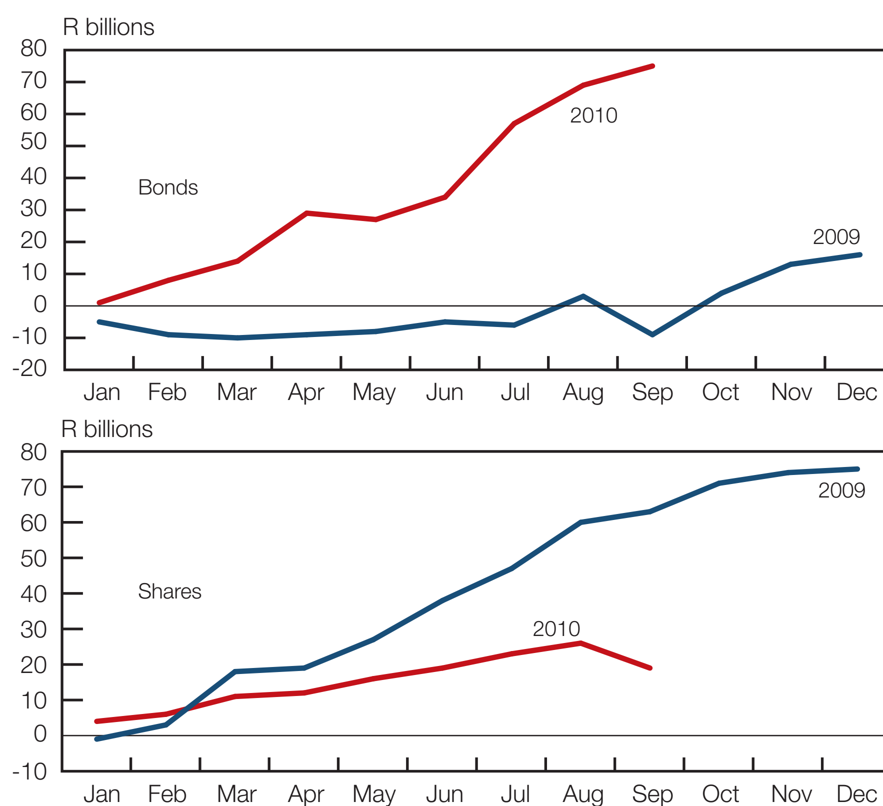
The nominal effective exchange rate of the South African rand measured on a monthly basis against a basket of 15 currencies appreciated by 8,8 per cent between the end of 2009 and September 2010 (Figure 9). Similarly, the real effective exchange rate measured against the same basket of currencies appreciated by 5,6 per cent in the year to July 2010.

Figure 9 Nominal and real effective exchange rates of the rand



Cumulative non-resident net purchases in the bond market increased dramatically in 2010 (Figure 10), totalling R71,8 billion by 6 October compared with net sales of R9,5 billion in the same period in 2009. By contrast, cumulative non-resident net share purchases have been relatively subdued in 2010, amounting to R20,4 billion in the year to date. Over the same period in 2009, cumulative non-resident net share purchases amounted to R66,1 billion. Emerging markets around the world have experienced increased capital inflows as pension funds and global institutional investors have adjusted their portfolios to hold more emerging-market bonds. South Africa comprises about 10 per cent of one of the more popular emerging-market bond indices in which institutional investors are investing. These inflows have been an important factor in the persistent rand strength in recent months.

Figure 10 Cumulative net purchases of bonds and shares by non-residents in 2009 and 2010

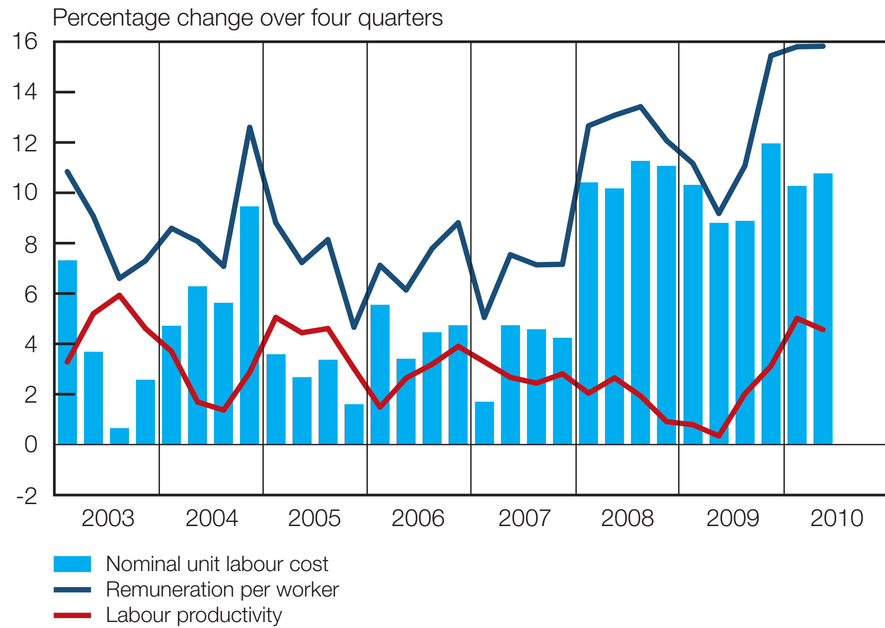


Source: JSE Limited

Labour markets

The year-on-year increase in nominal unit labour cost in the non-agricultural sectors rose from 10,2 per cent in first quarter of 2010 to 10,8 per cent in the second quarter (Figure 11). This was due to growth in labour productivity decreasing from 5,0 per cent to 4,6 per cent, while the rate of increase in remuneration per worker remained at 15,8 per cent.

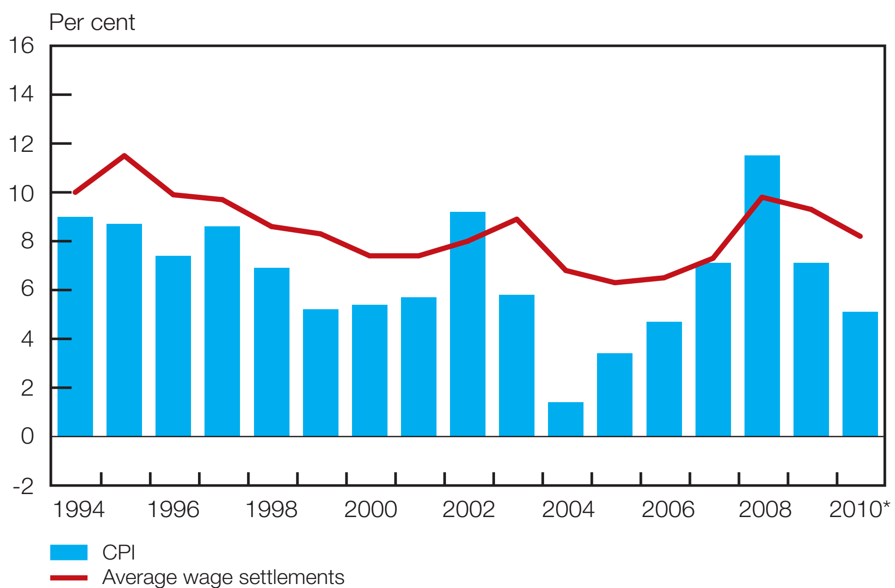
Figure 11 Remuneration per worker, labour productivity and unit labour cost in the formal non-agricultural sector



Sources: Statistics South Africa and South African Reserve Bank calculations

According to the Andrew Levy Employment Publications survey, the average level of wage settlements in the South African economy declined from 8,4 per cent in the first quarter of 2010 to 8,2 per cent in the second quarter (Figure 12). Although these settlements are lower than the average increase of 9,3 per cent recorded in 2009, they have to be compared to the lower inflation outcomes and the improved inflation outlook in 2010. Unless accompanied by higher productivity, settlements in excess of inflation could put upward pressure on domestic inflation dynamics, and impact negatively on

Figure 12 Average annual inflation and wage settlements



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

Sources: Andrew Levy Employment Publications and Statistics South Africa

international competitiveness and employment trends. The average levels of wage settlements in the second quarter of 2010 ranged from 5 per cent in the food/agriculture sector to 10 per cent in the retail sector.

Table 7 shows total employment by industry in the formal non-agricultural sector in the fourth quarter of 2008 and the first two quarters of 2010. In the second quarter of 2010, employment in the formal non-agricultural sector had increased by 41 000 since the first quarter of 2010, but had contracted by 385 000 since the fourth quarter of 2008. The finance, insurance, real-estate and business services sector has shed the most jobs since the fourth quarter of 2008, and the wholesale and retail trade, manufacturing and construction sectors also reported significant losses over this period. Most sectors reported small net gains in the most recent quarter. The community, social and personal services sector created jobs in all three periods.

Table 7 Employment in formal non-agricultural industries

Thousands

	Total employment		
	2008 4th qr	2010 1st qr	2010 2nd qr
Mining and quarrying	518	491	494
Manufacturing	1 275	1 187	1 170
Electricity, gas and water supply	59	56	57
Construction	474	418	413
Wholesale and retail trade	1 747	1 630	1 635
Transport, storage and communication	366	359	360
Finance, insurance, real-estate and business services	1 914	1 742	1 767
Community, social and personal services	2 159	2 203	2 231
Total	8 512	8 086	8 127

Source: Statistics South Africa *Quarterly Employment Survey*

Demand and output

Real GDP increased by 3,2 per cent on an annualised basis in the second quarter of 2010, following annualised increases of 4,6 per cent in the first quarter of the year and 3,2 per cent in the final quarter of 2009. Lower mining activity in the second quarter partially offset the improved growth performance by manufacturing and the boost provided to retail and other services subsectors by the FIFA World Cup™ tournament.

The only significant negative contribution in the second quarter of 2010 came from the mining sector, with real value added declining by 20,8 per cent, partly due to stoppages resulting from industrial action and routine maintenance. This more than offset the 11,6 per cent annualised growth recorded in the agricultural sector in the second quarter, and the real value added in the primary sector consequently declined by 12,5 per cent following an increase of 11,8 per cent in the first quarter. Real value added by the tradeables sectors showed continued substantive growth in the second quarter of 2010. In the secondary sector strong growth was recorded in various divisions of manufacturing including petroleum, chemical products, rubber and plastic products, food and beverages, as well as the motor vehicle, parts and accessories and other transport equipment divisions. Growth in real value added by the tertiary sector gained momentum in the first half of 2010 and rose from 2,7 per cent in the first quarter to 4 per cent in the second quarter.

Real gross domestic expenditure increased at a rate of 2,3 per cent in the second quarter of 2010 (Table 8). This was a result of the continued strong recovery in final consumption expenditure by households over the period, and sustained robust growth in final consumption expenditure by general government. Final consumption expenditure by households increased at a rate of 4,8 per cent in the second quarter of 2010, compared with growth of 5,7 per cent in the first quarter. Favourable wage settlements, lower interest rates and positive wealth effects related to further share and house price recoveries underpinned improving consumer sentiment and robust growth in expenditure by households on durable and semi-durable goods in the first half of 2010. Final consumption expenditure by general government increased at a rate of 7,2 per cent in the second quarter of 2010, a similar rate to that achieved in the first quarter. Growth in gross fixed capital formation rose slightly to 0,8 per cent in the second quarter of 2010 from 0,2 per cent in the first quarter. Real fixed capital formation by the private sector contracted further in the first half of 2010, while real capital expenditure by the public sector increased due mainly to expenditure on infrastructure. The rate of inventory depletion slowed further in the second quarter of 2010. Real inventories declined by R7,2 billion in the second quarter of 2010 compared with a decline of R8,7 billion in the first quarter. Inventory depletion in the second quarter of 2010 continued to reflect a still relatively tight business environment.

Table 8 Growth in real GDP and expenditure components

Per cent*

	2009					2010	
	1st qr	2nd qr	3rd qr	4th qr	Year	1st qr	2nd qr
Final consumption expenditure:							
Households	-5,8	-5,2	-1,9	1,6	-3,1	5,7	4,8
General government	6,7	0,8	8,2	2,1	4,7	7,3	7,2
Gross fixed capital formation	5,2	-2,5	-6,5	-0,9	2,3	0,2	0,8
Changes in inventories (R billions)**	-6,8	-48,5	-56,9	-38,4	-37,6	-8,7	-7,2
Gross domestic expenditure	3,3	-10,8	-1,6	4,9	-1,8	12,1	2,3
Exports of goods and services	-56,9	-12,6	11,0	20,0	-19,5	-15,3	18,0
Imports of goods and services	-28,7	-36,2	-1,0	26,2	-17,4	14,2	11,4
Gross domestic product	-7,4	-2,8	0,9	3,2	-1,8	4,6	3,2

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

In the external sector of the economy, real exports of goods and services grew at an annualised rate of 18 per cent in the second quarter of 2010 after declining by 15,3 per cent in the first quarter. South Africa's exports benefited from increased trade with key trading partners including China, India and countries in the euro area. Real imports of goods and services reflected the continued recovery in domestic expenditure and rose at an annualised rate of 14,2 per cent in the first quarter of 2010 and by 11,4 per cent in the second quarter. South Africa's trade balance with the rest of the world reverted from a deficit of R12,9 billion in the first quarter of 2010 to a surplus of R13,2 billion in the second quarter. Since net service, income and current transfer payments to non-residents narrowed significantly, the deficit on the current account of the balance of payments declined from 4,6 per cent of GDP in the first quarter of 2010 to 2,5 per cent in the second quarter.

South Africa's gross international reserve position declined marginally from US$43,2 billion at the end of July 2010 to US$43,1 billion at the end of August, before rising again to US$44,1 billion at the end of September. The international liquidity position improved from US$38,7 billion at the end of July 2010 to US$39,2 billion at the end of August and to US$40,1 billion at the end of September. The forward position at the end of September 2010 amounted to US$1,1billion compared with US$0,5 billion at the end of August. The Bank began conducting longer-term foreign exchange swaps in August to manage money-market liquidity (Box 2 provides more detail in this regard).

Real-estate and equity prices

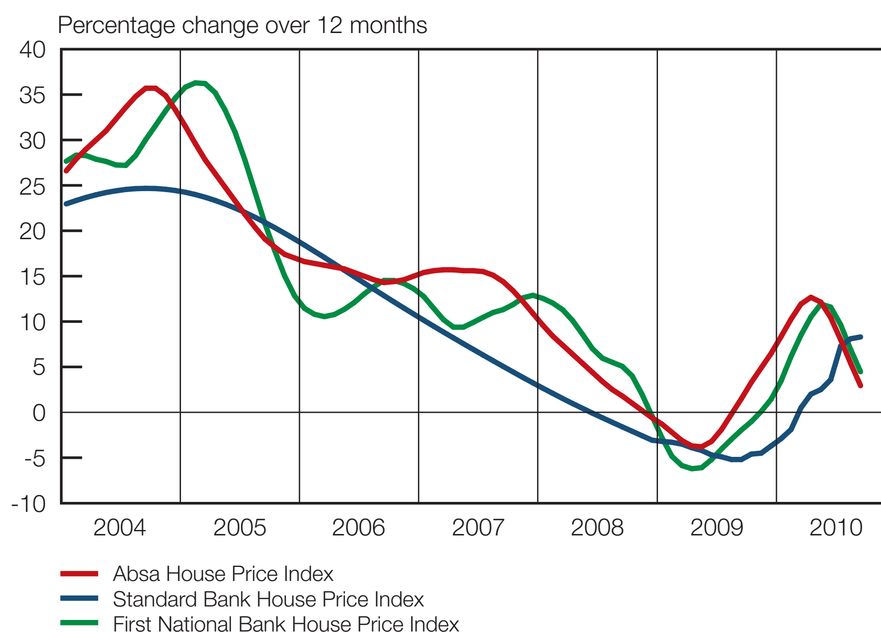
The FTSE/JSE All-Share Index (Alsi), which had trended upwards from early in 2009, reached 29 565 index points in mid-May 2010 (Figure 13). Since then, it has fluctuated between a low of 26 009 index points and a high of 29 698 index points, recorded on 6 October 2010. Over this period, the Alsi was buoyed by the performance of the Industrial Index and held back by that of the Financial Index.

Figure 13 Share price indices

Sources: JSE Limited and I-Net Bridge

Figure 14 shows that house prices continued to recover in 2010 as household circumstances improved, optimism regarding further easing of credit standards increased and the positive lagged effects of the 600-basis-point reduction in interest rates since late 2008 began to materialise. The 12-month rates of change for the house price indices published by Absa and First National Bank (FNB) remained positive, although both declined slightly in recent months, and the Standard Bank Median House Price Index accelerated to positive territory. Between June and September 2010 the 12-month rate of change decreased from 11,6 per cent to 4,5 per cent in the case of the FNB House Price Index, and from 10,4 per cent to 2,9 per cent for the Absa House Price Index. The 12-month rate of change for the Standard Bank Median House Price Index increased from 3,6 per cent to 8,3 per cent over the same period.

Figure 14 House prices



Sources: Absa, Standard Bank and First National Bank

The real value of total building plans passed and total buildings completed in larger municipalities contracted in the first 7 months of 2010 compared to the same period in 2009 (Table 9). The largest percentage decrease in both real building plans passed and buildings completed over this period was in the non-residential category. The real value of building plans passed in the non-residential component decreased by 39,6 per cent, while the real value of non-residential buildings completed contracted by 27,3 per cent.

Table 9 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	-22,2	-13,1
Residential	-3,2	-26,3	-36,9	-0,8
Non-residential	-5,9	2,0	-9,4	-39,6
Additions and alterations	1,9	-12,5	-8,3	-1,2
Buildings completed				
Total	9,5	1,8	-14,6	-22,3
Residential	1,2	-8,2	-25,0	-20,5
Non-residential	48,6	19,4	-7,0	-27,3
Additions and alterations	6,1	15,9	3,1	-19,5

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

Source: Statistics South Africa

Fiscal policy

In April–August 2010 national government revenue amounted to R247,4 billion, representing a year-on-year rate of increase of 21,9 per cent compared with the same period a year earlier. The strong increase in revenue stemmed from higher collections in

all major tax categories, and mirrored improvements in domestic economic activity. Taxes on income, profits and capital gains increased by 8,1 per cent compared with the same period a year earlier, driven mainly by relatively strong growth in personal income tax. Taxes on property increased by 6,3 per cent during the period, reflecting signs of recovery in real-estate market activity. Collections from taxes on goods and services recorded significant growth of 35,9 per cent, owing to higher value-added tax (VAT) collections. A recovery in consumer spending and lower VAT refunds contributed to the substantial increase in VAT collections. Proceeds from taxes on international trade and transactions increased considerably on account of brisk collections from customs duties, alongside a recovery in imports.

Spending by national government totalled R320,4 billion in the first five months of fiscal 2010/11, or an increase of 10,9 per cent compared with the same period a year earlier. The *Budget Review 2010* projected that national government expenditure would increase by 11,9 per cent to amount to R797,3 billion in fiscal 2010/11. Growth in spending was underpinned by transfers and subsidies, together with current payments by various departments. Interest paid on national government debt equalled R20,7 billion during April–August 2010, or an increase of 11,4 per cent compared with the same period of the previous fiscal year. Interest payments rose sharply from higher issuances of Treasury bills and domestic government bonds to finance higher expenditure. Transfers to provinces increased by 11,8 per cent in April–August 2010 compared with the same period a year earlier. The growth in transfers was to extend and improve service delivery outcomes in health and education.

The net result of national government revenue and expenditure was a cash-book deficit before borrowing and debt repayment of R73 billion in the first five months of fiscal 2010/11. This was R12,9 billion lower than the cash-book deficit recorded in April–August 2009 and is consistent with government's projections. The narrowing in the national government deficit resulted from strong growth in revenue collections, which far outweighed slower-than-budgeted growth in expenditure. The *Budget Review 2010* projects that the cash-book deficit would amount to R154,0 billion for fiscal 2010/11 as a whole.

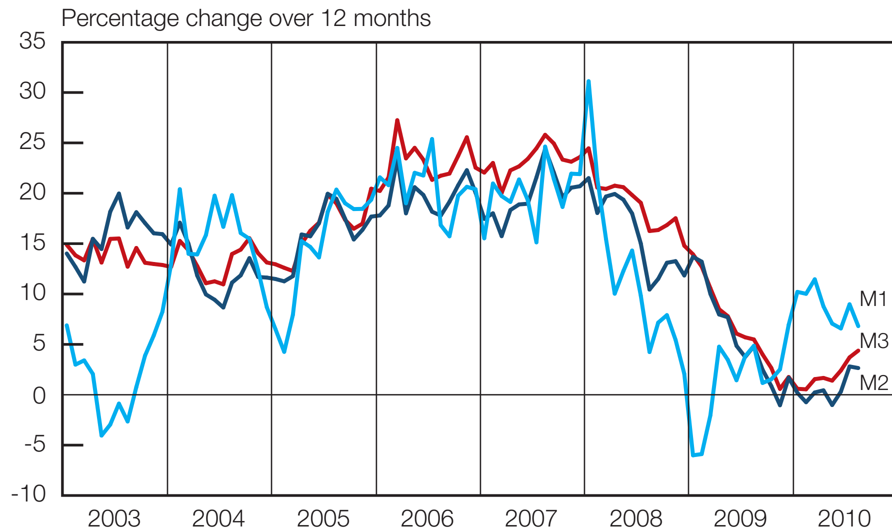
The net borrowing requirement almost equalled the cash-flow deficit and can be compared with a net borrowing requirement of R85,2 billion recorded in the first five months of fiscal 2009/10. The net borrowing requirement was financed through the issuance of debt instruments in the domestic capital market. During the period under review, national government raised R24,6 billion from Treasury bills and recorded net issues of R49,9 billion in domestic long-term and retail bonds. Net redemptions of foreign long-term bonds of R1,0 billion were recorded over this period compared with net issues of R6,0 billion in April–August 2009.

Monetary conditions

The year-on-year growth in the M2 and M3 monetary aggregates has been trending downwards since January 2009, with growth in M2 bottoming out in November 2009 at -1,0 per cent and then recovering to 2,7 per cent in August 2010 (Figure 15). By comparison, M3 growth bottomed in February 2010 at 0,5 per cent, and then recovered to 4,4 per cent in August 2010.

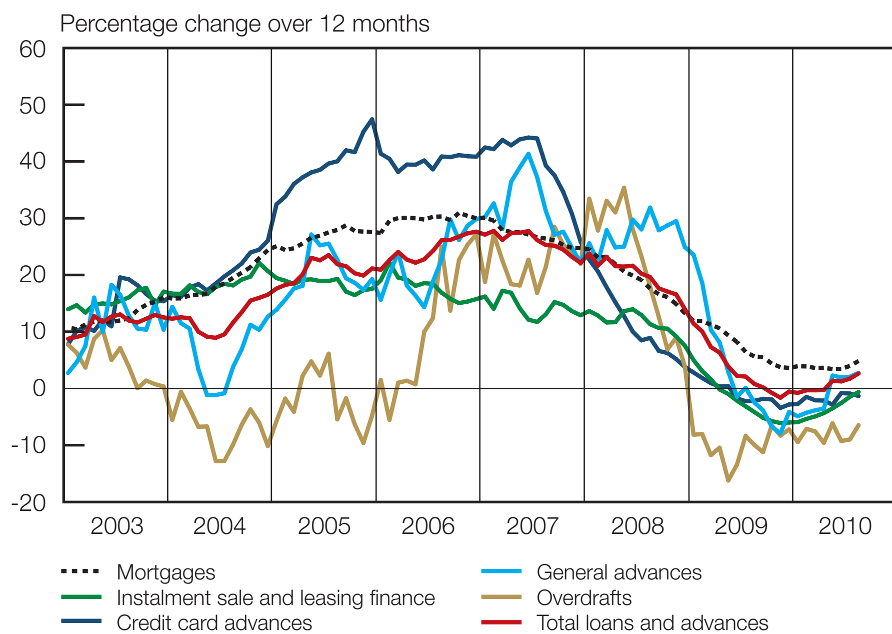
Banks' credit extension remained subdued. Year-on-year growth in the total loans and advances aggregate remained negative from October 2009 to April 2010, reaching a low of -1,6 per cent in November 2009. In August 2010 growth of 2,6 per cent was recorded

Figure 15 Growth in monetary aggregates



(Figure 16). Mortgage advances grew by 4,8 per cent in August, up from 4,0 per cent in July. Year-on-year growth for other categories such as instalment sale and leasing, overdrafts and credit cards remained in negative territory in August, but the general trend is one of gradual improvement.

Figure 16 Banks' loans and advances by type



Monetary policy

At the beginning of 2010 there were signs that the global recovery was well underway, and in many countries there was a focus on the appropriate exit strategies to return both monetary and fiscal policies to their normal settings. However, growth in advanced economies was revised downwards in the face of disappointing outcomes, and it appeared that growth was going to remain low for longer. This was against the backdrop of fiscal consolidation in a number of countries, particularly in Europe, and it became

clear that the burden of adjustment would fall on monetary policy to try and prevent a collapse of growth rates. At the same time, emerging-market growth was more pronounced and, in some instances, monetary policy became more restrictive.

In South Africa, growth was relatively slow compared with that of emerging-market peers and, at the same time, inflation was declining at a faster-than-expected pace, partly as a result of the sustained strength in the rand exchange rate and an improved inflation outlook. As a consequence, during the period under review there was a further decline in the repurchase rate of 50 basis points at the September meeting of the Monetary Policy Committee (MPC) (Figure 17). This brought the repurchase rate (repo) to a level of 6 per cent, which is the lowest policy rate since 1980. The real repurchase rate is also at lower levels than the average of around 3,5 per cent observed during the past decade. This relatively low real policy rate, however, should be seen in the context of the weak state of the economy, low real interest rates globally and a strong exchange rate, which contributes to a tightening of overall monetary conditions.

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

During the period under review, as outlined in earlier sections of this review, the targeted headline inflation continued to decline and surprise on the downside despite significant administered price increases. It also became apparent that the impact of the 2010 FIFA World Cup™ tournament on inflation was very limited and mostly reversed soon after the event. At the July meeting, the latest CPI outcome (for March) was 4,6 per cent and by the September meeting the latest outcome had declined to 3,7 per cent. However, monetary policy is not made on the basis of the latest inflation figure. Because of the lags between monetary policy changes and their impact on inflation, monetary policy has to be forward-looking and based on expected inflation. The inflation forecast of the Bank's macroeconomic model is therefore an important factor in the decision-making process. During the past few months, the inflation forecast has been revised down significantly, partly as a result of revised assumptions for the model's exogenous variables, but also because the more favourable outcomes lowered the starting point of the more recent forecasts. At the time of the May meeting, the low point for inflation was

expected to occur in the third quarter of 2010 at a rate of 4,7 per cent. By September, this forecast was revised down to 3,7 per cent. At the May meeting, inflation was expected to average 5,1 per cent in 2011, but by September this forecast had declined to 4,6 per cent. The latest forecast is discussed in more detail in a later section of this review.

Despite the better inflation outcomes, inflation expectations remained relatively elevated, but a more pronounced downward trend was observed in the survey of inflation expectations conducted by the Bureau for Economic Research (BER) at Stellenbosch University. Nevertheless, average inflation expectations for both labour and business respondents remained above the inflation target range for all three forecast years, ending 2012. Financial analysts were more positive about improved future inflation outcomes and they expect inflation to remain within the target range for the forecast period. The MPC also noted at both the July and September meetings that expected inflation, as proxied by the break-even inflation rates, had declined and by the latter meeting the decline was to levels significantly below 6 per cent.

Global economic developments continued to impact on the domestic economic outlook and therefore on the thinking of the MPC. At the July meeting, there was an expectation that the strong global economic performance observed in the first half of the year would not be sustained and some moderation was expected, with a high degree of downside risk. There were particular concerns about the impact of fiscal consolidation in a number of countries and the outlook for US growth, particularly in the light of continued weakness in the US housing market. The policy-induced slowdown in China was also noted. Similar concerns were expressed in the September MPC statement.

The global outlook had a number of implications for monetary policy. Not only did slow growth impact negatively on domestic growth prospects through trade links with advanced economies, it also implied that the inflationary pressures emanating from the advanced economies were likely to remain benign. This was true not only for manufactured goods, but for some commodity prices as well. In particular, the MPC noted the relative stability of the international oil price, which remained within a range of about US$70–80 per barrel over most of this period.

A further implication of the global slow-growth scenario was that monetary policy in the advanced economies was likely to remain accommodative for an extended period of time. The committee noted the implication for the rand exchange rate, which was characterised by persistent strength over this period, particularly in the period between the two meetings when the trade-weighted rand exchange rate appreciated by a further 4 per cent, bringing the cumulative appreciation since the beginning of the year to almost 6 per cent. In September the exchange rate was seen to be the main downside risk to the inflation outlook.

In the July statement the MPC expressed concern about the continued strength and volatility of the currency, particularly for the manufacturing, export and import-competing sectors of the economy. While noting the difficulties and high costs relating to achieving a weaker range for the currency, the MPC committed itself to playing its part in a considered manner with respect to ongoing discussions with the National Treasury related to the options available to address these issues and the availability of resources to do so.

The MPC also noted that there appeared to be a structural change taking place with respect to international capital flows, which made the rand exchange rate more sensitive to interest rate differentials. Whereas in previous years bond flows appeared to be mainly speculative in nature, there were now indications that the inflows into the bond market, which had amounted to R75 billion for the nine months to September 2010, were more

long term in nature as foreign pension funds sought higher yields in emerging markets. The implications are that these flows are likely to persist as long as interest rates in advanced economies remain abnormally low.

The domestic economy emerged from recession during 2009, but in 2010 the outlook appeared increasingly fragile, partly as a result of the uncertain global recovery. Although the forecast for growth for 2010 was revised down only marginally between the two meetings – from 2,9 per cent to 2,8 per cent – the downward revisions for 2011 and 2012 were more significant. Growth was now expected to average 3,2 per cent and 3,5 per cent in these two years, compared with the previous forecast of 3,6 per cent and 4,0 per cent respectively. The lower projected growth was consistent with the decline in the Bank's leading business cycle indicator. The weaker trend was particularly evident in the construction, manufacturing and mining sectors. The MPC also expressed concern about the weak state of private-sector gross fixed capital formation. Although the Rand Merchant Bank (RMB)/BER Business Confidence Index recovered somewhat in the third quarter, it was nevertheless still below the neutral level of 50, and confidence in the manufacturing and construction sectors remained particularly low. Under these circumstances the output gap was expected to remain negative for some time.

A central concern of the MPC was the outlook for household consumption expenditure. Following five quarters of negative growth, expenditure recovered in the final quarter of 2009 and then grew at an annualised rate of 5,7 per cent in the first quarter of 2010. In the second quarter expenditure growth had moderated to 4,8 per cent. The committee was of the view that the 2010 FIFA World Cup™ tournament may have given a temporary boost to consumption and there was an expectation that a further moderation in expenditure growth could be expected going forward. Motor vehicle sales were particularly buoyant, although off a low base.

The outlook for household consumption expenditure was seen to be affected by contradictory forces. The main negative factors included low levels of credit extension, high levels of household indebtedness, high levels of unemployment and continued job losses.

Credit extension to the private sector remained weak over the period and most categories, apart from mortgage credit advances, continued to exhibit negative growth. However, there were signs of a reversal of these negative trends and overall year-on-year growth in total loans and advances had become positive during this period. The committee's view was that this weak trend was related to both supply and demand factors. On the supply side, there was some evidence of a loosening of the credit criteria applied by banks. However, bank lending appeared to be constrained by persistently relatively high levels of impaired advances, particularly retail loans. There were also indications that the banks' pricing for risk was still higher than was the case before the crisis. On the demand side, consumers were seen to be constrained by high levels of debt.

Consumption expenditure was also seen to be constrained by the continued unfavourable unemployment trends. During the period, job losses persisted, albeit at a slower rate. Employment insecurity was also seen as a constraining factor. Job shedding was most marked in the construction and manufacturing sectors.

There were a number of factors that were seen to provide a positive stimulus to consumption expenditure. These included lower nominal interest rates, lower inflation, positive wealth effects and high levels of real wage increases for those in employment. Wealth effects have been positive due to increases in house prices, but there were indications that the rate of increase may have tapered off by September. The bond market rally had continued and equity prices had recovered significantly from their lows in the first quarter of 2009, although they remained below their pre-crisis levels.

The trend of wage settlements was also seen to provide a positive impetus to domestic expenditure. Nevertheless, the MPC saw these developments to be the main upside risk to the inflation outlook. Of concern was the level of wage settlements that was well in excess of inflation outcomes. Such settlements, if not accompanied by higher productivity, could put pressure on domestic prices and impact negatively on South Africa's international competiveness, as well as on employment trends.

In both meetings the other main upside risk to the inflation outlook was seen to emanate from administered prices, although there was more certainty with respect to the scale of the electricity price increases granted to Eskom. At the July meeting the risks to the inflation outlook were assessed to be relatively evenly balanced, and the MPC kept the monetary policy stance unchanged. By September, the committee viewed the improved outlook to have allowed sufficient room to provide additional stimulus to the fragile recovery of the domestic economy, which remained vulnerable to the uncertain global environment. Against this background the MPC reduced the repurchase rate to 6 per cent with effect from 10 September 2010. These actions were seen to be consistent with the continued attainment of the inflation target. The committee also noted that the current monetary policy stance was deemed to be appropriate for the prevailing circumstances and that the scope for further downward movement was seen to be limited. However, this would be reassessed on an ongoing basis in a forward-looking manner.

Box 2 Changes to the South African Reserve Bank's monetary policy operational procedures

The South African Reserve Bank's (the Bank) monetary policy operational framework is continuously reviewed and assessed for efficiency and effectiveness. The most recent review also took into account some challenges occasionally encountered in the conduct of open-market operations. A lower level of participation in the auctions for SARB debentures and longer-term reverse repos had resulted in a decline in the money-market shortage, which had affected the efficiency of the monetary policy operational framework. After consultation with market participants, a number of refinements to the monetary policy implementation framework were identified, including new measures aimed at streamlining the daily monetary policy operations. It is important to note that these changes are operational in nature and do not in any way reflect on the monetary policy stance of the Bank.

With effect from 30 August 2010 the following changes to the Bank's monetary policy operations were implemented:

1. The Bank discontinued its practice of announcing the estimated ranges of the weekly liquidity requirement. In the current framework only the daily average of the estimated weekly liquidity requirement is announced to the market when the weekly main repo auction is conducted. There is also a daily announcement to the market of the actual liquidity requirement of the previous day, made at 09:00 on every business day.
2. The use of Category 2 assets as eligible collateral in the Bank's refinancing operations is being phased out. Maturing Category 2 assets will not be replaced with bonds from the All-Bond Index (Albi). With effect from 1 March 2011 Category 2 assets will no longer be accepted as collateral for the Bank's refinancing operations. The future use of assets other than prescribed liquid assets as collateral for refinancing purposes will be determined by prevailing exceptional market conditions.
3. A new automated final end-of-day square-off process at prevailing standing facility rates will replace current manual auctions. This change will affect the South African Multiple Option Settlement (SAMOS) penalty facility, which is abolished as a consequence.
4. The spread between the rates for standing facilities and the repo rate has been widened from the current 50 basis points to 100 basis points below and above the prevailing repo rate. During August the Bank started to use longer-term foreign exchange swaps with maturities of up to 12 months as an instrument to manage money market liquidity more effectively. The consequence of conducting longer-term foreign exchange swap transactions to drain liquidity from the market is that the Bank will reflect an overbought forward position on its monthly releases of official gold and foreign exchange reserves.

The transition to these new operational procedures has so far proceeded without any problems, although the Bank will continue to monitor closely the impact of the changes on the functioning of the interbank market.

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

According to the latest IMF *WEO* forecasts for 2011 are broadly in line with earlier forecasts and show global activity expanding by 4,2 per cent, although downside risks continue to dominate (Table 10). Growth is projected at only 2,2 per cent in advanced economies, with some economies slowing noticeably during the second half of 2010 and the first half of 2011, before a reacceleration of activity. With only a few exceptions among the emerging economies, growth is forecasted by the IMF to remain below potential with unemployment persistently high, while inflation is projected to stay generally low amid continued excess capacity and high unemployment. The IMF's *WEO* output projections show emerging-market and developing economies expanding at a rate of 6,4 per cent in 2011. According to the IMF the probability of a sharp global slowdown, including stagnation or contraction in advanced economies, still appears low. However, risks to the growth projections are mainly to the downside as financial and macroeconomic conditions are expected to remain unsettled while economic weaknesses in certain regions persist.

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

Per cent

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

Source: IMF *World Economic Outlook*, October 2010

Recent data suggest that growth in the US economy is slowing and there are rising concerns that joblessness will weaken consumer spending, which accounts for 70 per cent of the economy. The economy has slowed to relatively anaemic growth, and high-frequency indicators suggest a weak recovery in coming quarters. The US housing market also shows few signs of recovery. The IMF projects a slow recovery for the US economy, with growth far weaker than in previous recoveries. GDP growth is projected to decrease from 2,6 per cent in 2010 to 2,3 per cent in 2011 with risks to the outlook remaining elevated and tilted to the downside.

Japan's economy appears to be running out of steam as exports to Asia are slowing and the effects of government incentives dissipate. The Japanese government unveiled an economic plan at the end of August 2010 that includes extending incentive programmes to buy energy-saving electronic appliances and to support home improvements, measures to help graduates to find jobs, and support for small and mid-sized businesses affected by the yen's strength.

European confidence in the economic outlook improved to the highest level in more than two years in August 2010 after surging exports helped the economy expand at the fastest pace in four years in the second quarter. While Germany's economy grew briskly in the second quarter, there was little evidence of a revival in the countries of southern Europe, keeping debt concerns in these countries alive. The recovery in the euro area is therefore expected to be moderate and uneven, as there are pronounced differences in economic prospects across the region related to the extent to which macroeconomic policies can support the recovery. The euro area's GDP is projected by the IMF to grow at 1,7 per cent in 2010 and 1,5 per cent in 2011.

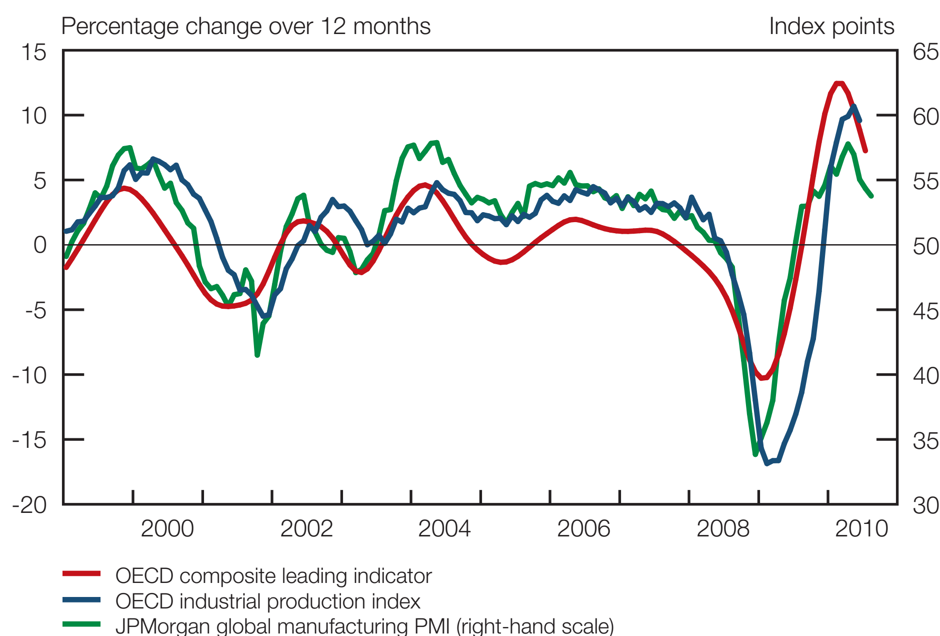
In some advanced economies such as the UK, household-sector deleveraging and the re-allocation of resources away from the construction sector are expected to act as a drag on economic activity. Domestic demand is expected to remain subdued, particularly following the recent measures to cut the budget deficit. Although these problems have been serious enough to raise concerns about the durability of the recovery, UK consumer confidence unexpectedly rose in August 2010 for the first time in six months, a sign that rebounding economic growth has improved consumer sentiment.

Although emerging and developing countries that did not experience major financial excesses just prior to the financial crisis have been recording relatively strong growth, the IMF's view is that a sustained, healthy recovery rests on two rebalancing acts. The IMF deem internal rebalancing (with a strengthening of private demand in advanced economies while allowing for fiscal consolidation) and external rebalancing (with an increase in net exports in deficit countries, such as the US, and a decrease in net exports in surplus countries, notably emerging Asia) as key requirements for a sustained recovery.

The IMF expects China's economy to expand by 10,5 per cent in 2010 and by 9,6 per cent in 2011. IMF data show that the Middle East and North Africa region is recovering strongly and average growth rates among oil exporters are projected to be higher over the next two years, compared with 2009. The IMF expects strong macroeconomic fundamentals through much of sub-Saharan Africa to also leave the region well positioned to benefit from the global recovery now underway. Output growth is projected to accelerate to 5 per cent in 2010 and 5,5 per cent in 2011, supported by the recovery in exports and commodity prices, as well as robust domestic demand in a number of countries.

The composite leading indicator compiled by the OECD has continued to project economic expansion in the OECD and increased by 7,3 per cent in July 2010 compared with the corresponding month of the previous year (Figure 18). The JPMorgan global manufacturing Purchasing Managers' Index (PMI) fell back slightly to 54,3 in July 2010 from 55,0 in June, but has remained comfortably above the neutral level of 50 for more than a year. The year-on-year rate of change in the OECD industrial production index accelerated to 9,6 per cent in June 2009. Manufacturers in advanced OECD member countries have relied on faster-growing emerging economies to fuel production and earnings as households in most domestic markets held back on spending.

Figure 18 Selected indicators of global economic activity



Sources: OECD and JPMorgan

Although the recovery of commodity prices has raised the level of consumer prices during 2010, inflation is projected, in general, to remain relatively low worldwide amid continued excess capacity and high unemployment. Headline and core inflation is projected by the IMF to converge to about 5 per cent in 2011 in emerging economies compared with 1,3 per cent in advanced economies. Capacity constraints and rising food prices are beginning to boost prices among some major emerging economies. Brazil and China have experienced gradual increases in inflation pressure, while India has seen a sharp rise in inflation.

Box 3 Monetary policy responses to inflation, the output gap and the real exchange rate in South Africa

Introduction

After a decade of inflation targeting, it seems appropriate to assess how monetary policy in South Africa reacted to some key macroeconomic variables. This box reports on research that utilises the generalised autoregressive conditional heteroskedasticity (GARCH) framework combined with an augmented Taylor-type monetary policy function to examine the manner in which the policy rate in South Africa reacted to the inflation rate, the output gap, and the real exchange rate before and after the implementation of inflation targeting.

The mean equation for the GARCH modelling extends the specification of the policy reaction function appearing in Sergi and Hsing (2010):

$$(1)\ R_t = \beta_0 + \beta_1 \pi_t + \beta_2 \pi_t D_t + \beta_3 D_t + \beta_4 YG_t + \beta_5 D_t YG_t + \beta_6 E_t + \beta_7 D_t E_t + \beta_8 E_{t-1} + \beta_9 D_t E_{t-1} + \varepsilon_t$$

where

R_t = the policy rate
π_t = inflation rate
D_t = dummy variable equal to 1 after adopting inflation targeting and 0 otherwise
YG_t = the output gap
E_t = the real effective exchange rate (REER), and
ε_t = the error term.

The effect of the inflation rate on the policy rate is $dR / d\pi = \beta_1$ before the adoption of inflation targeting and is $dR / d\pi = \beta_1 + \beta_2$ after adopting inflation targeting. This applies to the other variables.

The variance equation is of the exponential GARCH (EGARCH) form:

$$log\sigma_t^{\,2} = \alpha_0 + \alpha_1 \frac{|\varepsilon_{t-1}|}{\sigma_{t-1}} + \alpha_2 \frac{\varepsilon_{t-1}}{\sigma_{t-1}} + \alpha_3\, log\sigma^2_{t-1} + \alpha_4\, log\sigma^2_{t-2} + \alpha_5 D_t \quad (2)$$

The log transformation guarantees a positive variance. Asymmetry exists when $\alpha_2 \neq 0$. When α_2 is negative, this implies that negative shocks will have larger effects on volatility than positive shocks of the same magnitude. The coefficient α_3 measures the persistence of shocks in the conditional variance before and after inflation targeting. The coefficient α_5 captures the impact of inflation targeting on the conditional variance. A negative α_5 implies that the conditional variance of the interest rate has been lower under inflation targeting than in the pre-inflation-targeting period.

Monthly data for the period from January 1990 to December 2009 were used in the study. The policy rate is represented by the repurchase rate and its predecessor the bank rate. Since the data are of a monthly frequency, the Hodrick-Prescott filter with a smoothing parameter of 14400 was used to extract the trend and output gap. The output gap was calculated as the percentage deviation of the actual real industrial production index from the potential industrial index. An increase in the real effective exchange rate implies a real appreciation. The dummy for inflation targeting has a value of one from February 2000.

Estimation was undertaken using different assumptions regarding the error term (Table B3.1). Model 1 was estimated under the assumption of a normal error distribution using the Berndt-Hall-Hall-Hausman (BHHH) method, Bollerslev-Wooldridge robust standard errors and covariance with backcast parameter equal to 0,8. Model 2 was estimated under the assumption of a normal error distribution using the BHHH method, Bollerslev-Wooldridge robust standard errors and covariance with backcast parameter equal to 0,6. Model 3 was estimated under a generalised error distribution assumption using the BHHH method, with backcast parameter equal to 0,2.

The β_3 coefficient measures the impact of inflation targeting in the mean equations of the three models. In all cases the coefficient is negative and significant at the 1 per cent significance level. This implies that the level of the interest rate has decreased under inflation targeting.

Table B3.1 The model under different assumptions

	Model 1	Model 2	Model 3
β_0	13,7202	13,8666	13,8395
β_1	0,2533	0,2433	0,2461
β_2	0,0652	0,0578	0,0733[b]
β_3	-6,0358	-5,9835	-6,1676
β_4	-0,0134[a]	-0,0097[a]	-0,0126[a]
β_5	0,0431[b]	0,0368[c]	0,0422[c]
β_6	-0,0584	-0,0474[b]	-0,0595
β_7	0,0542	0,0445[b]	0,0555
β_8	-0,0418[b]	-0,0320[c]	-0,0441
β_9	0,0446[b]	0,0338[c]	0,0466
R^2	0,9431	0,9433	0,9412
Adjusted R^2	0,9403	0,9405	0,9384
AIC	1,9099	1,9104	1,9104
SC	2,1725	2,1731	2,1876

All models were corrected for autocorrelation using two moving average terms that were statistically significant across all three models. All coefficients are significant at the 1 per cent level except [a] which is not significant at the 10 per cent level and [b] and [c] which are significant at the 5 per cent and 10 per cent levels respectively.

Table B3.2 Marginal change of the variable before and after inflation targeting

	Model 1		Model 2		Model 3	
	Before inflation targeting	After inflation targeting	Before inflation targeting	After inflation targeting	Before inflation targeting	After inflation targeting
$dR/d\pi_t$	0,2533	0,3185	0,2433	0,3011	0,2461	0,3193
dR/dYG_t	-0,0134[a]	0,0431	-0,0097[a]	0,0368	-0,0126[a]	0,0422
dR/dE_t	-0,0584	-0,0042	-0,0474	-0,0030	-0,0595	-0,0040
dR/dE_{t-1}	-0,0418	0,0028	-0,0320	0,0018	-0,0441	0,0026
Intercept	13,7202	7,6845	13,8666	7,8831	13,8395	7,6719

All coefficients are significant at the 10 per cent level except [a] which is not significant at the 10 per cent level.

The main inferences that can be gleaned from Table B3.2 are as follows. There is a smaller role for exchange rates in the policy rule under the inflation-targeting framework than during the pre-inflation-targeting period. This finding is consistent with that of Ortiz and Sturzenegger (2007). In addition, the study finds that the responsiveness of the policy rate towards other variables has changed significantly and has become more aggressive towards the output gap and inflation.

Table B3.3 Variance equation results

	Model 1	Model 2	Model 3
α_0	-0,4165	-0,4298	-0,4136
α_1	0,4569	0,4702	0,4701
α_2	-0,0519[c]	-0,0527[c]	-0,0467[a]
α_3	1,6772	1,6706	1,6305
α_4	-0,7529	-0,7449	0,6986
α_5	-0,0958[b]	-0,0959[b]	-0,1071[c]

All coefficients are significant at the 1 per cent level except [a] which is not significant at the 10 per cent level, [b] which is significant at the 5 per cent level, and [c] which is significant at the 10 per cent level.

In the variance equation, the test of asymmetry is represented by α_2. The estimates of α_2 are significant in models 1 and 2 at the 10 per cent significance level, implying that asymmetry is not rejected (Table B3.3). In model 3 asymmetry is rejected. Hence, the evidence is mixed on asymmetry. The α_5 coefficient measures the impact of inflation targeting in the variance equations of the three models. In all cases the coefficient is negative and significant at the 10 per cent significance level. This implies that the variance of the interest rate has decreased under inflation targeting.

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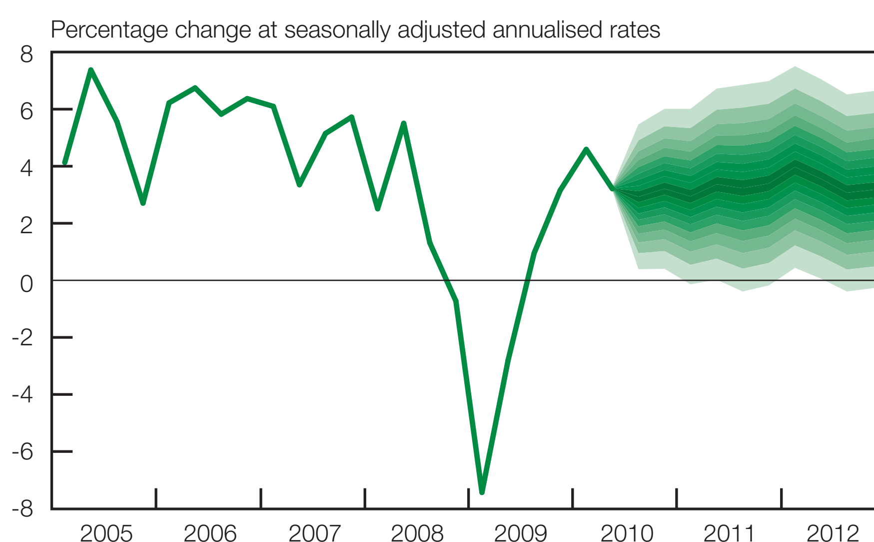
Outlook for domestic demand and supply

According to the Bank's forecast presented at the MPC meeting in September 2010, real GDP growth is expected to average 2,8 per cent in 2010, rising to 3,2 per cent in 2011 and 3,5 per cent in 2012 (Figure 19). The latest Reuters consensus forecasts, surveyed in September 2010, expect real output growth to register 3,0 and 3,5 per cent in 2010 and 2011 respectively, and to reach 3,9 per cent in 2012. On the demand side, the main influences on growth during this forecast period are expected to be the acceleration in final consumption expenditure by households and government, and the expected moderation in growth in gross fixed capital formation. On the supply side, the secondary and tertiary sectors are expected to be the main contributors to domestic growth.

Figure 19 Real GDP growth forecast

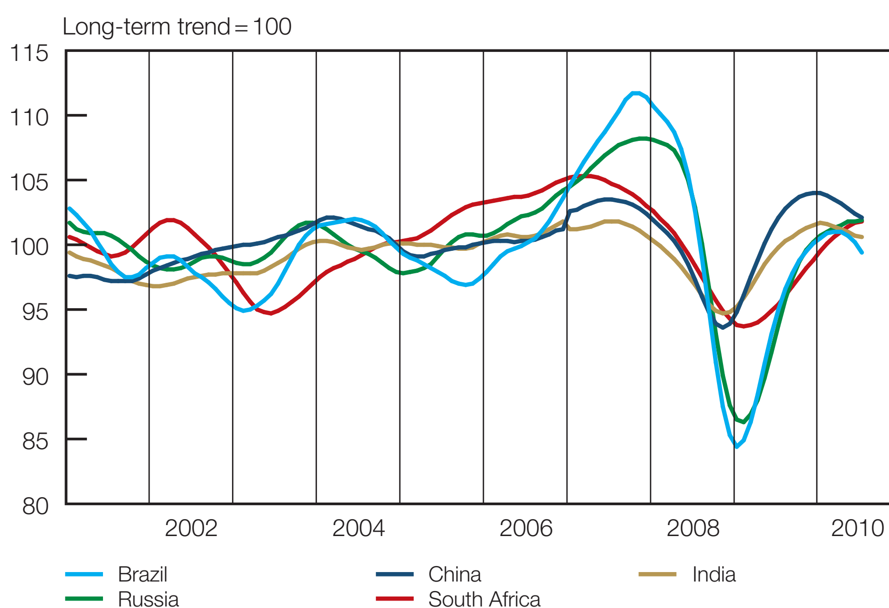


Note: The fan chart uses confidence bands to depict varying degrees of certainty. The darkest band of the fan chart covers the most likely 10 per cent of probable outcomes foreseen for growth, including the central projection. Each successive band, shaded slightly lighter and added on either side of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

The Bank's composite leading business cycle indicator increased in July 2010 following declines in May and June (Figure 20). Recent movements in the leading indicator point to a continuation of the recovery in economic activity, although at a somewhat more moderate pace. A comparison of the Bank's composite business cycle indicator with those of other emerging markets such as Brazil, Russia, India and China reveals convergence towards July 2010.

According to the seasonally adjusted Kagiso PMI (Figure 21), the PMI broke the critical level of 50 to reach 50,3 index points in August 2010, but experienced a setback in September when it registered 48,4 index points. In September all five of the sub-indices

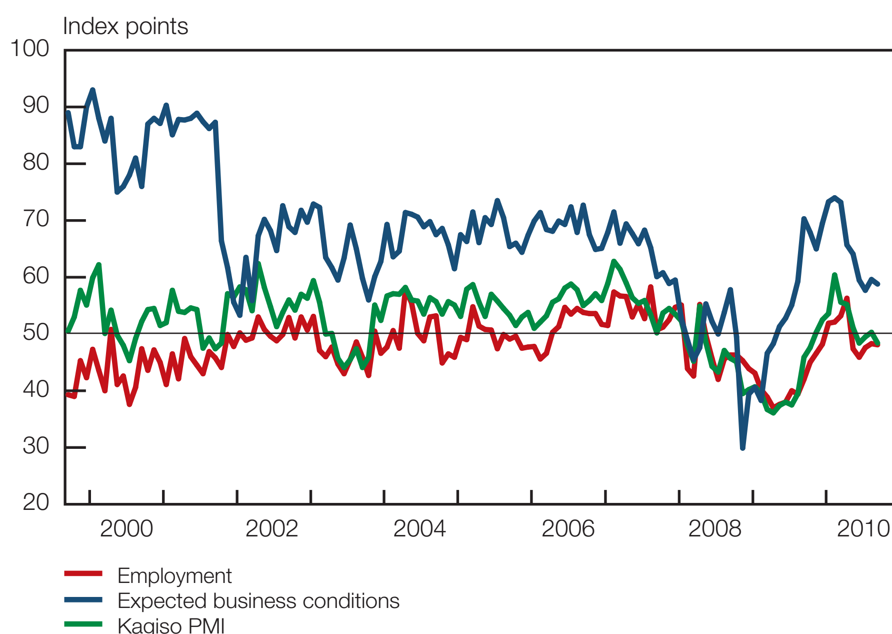
Figure 20 Composite leading indicators



Sources: OECD and South African Reserve Bank

used to calculate the overall PMI declined. Owing to work stoppages in August and September 2010, the business activity index declined by 1,1 index points to register 45,8 index points. The employment index registered the fifth consecutive below-50 reading at 48,1 index points. The new sales orders index decreased by 1,8 points, but managed to stay above 50 index points.

Figure 21 Kagiso PMI



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

The RMB/BER Business Confidence Index rose from a low of 23 in the third quarter of 2009 to a level of 36 in the second quarter of 2010 and to 47 in the third quarter, this being the highest level in two and a half years. Sectors that saw the biggest increases were new vehicles and retail trade. New vehicle dealers' confidence rose sharply from 49 in the second quarter to 79 in the third quarter. Retail confidence also surged by 14 index points to reach 52. The confidence level of building contractors recovered to 25, but is still in net-negative territory, while that of wholesalers rose to 50, up from 47 in the second quarter. Manufacturing confidence rose marginally from an index value of 28 in the second quarter to 30; its highest level since the end of 2008.

The FNB/BER Consumer Confidence Index (CCI) remained largely unchanged, increasing by 1 index point from +14 in the second quarter of 2010 to +15 in the third quarter. Consumers remained optimistic about the year-ahead prospects for the economy as a whole and their own finances, but were somewhat hesitant to commit to the purchase of durable goods.

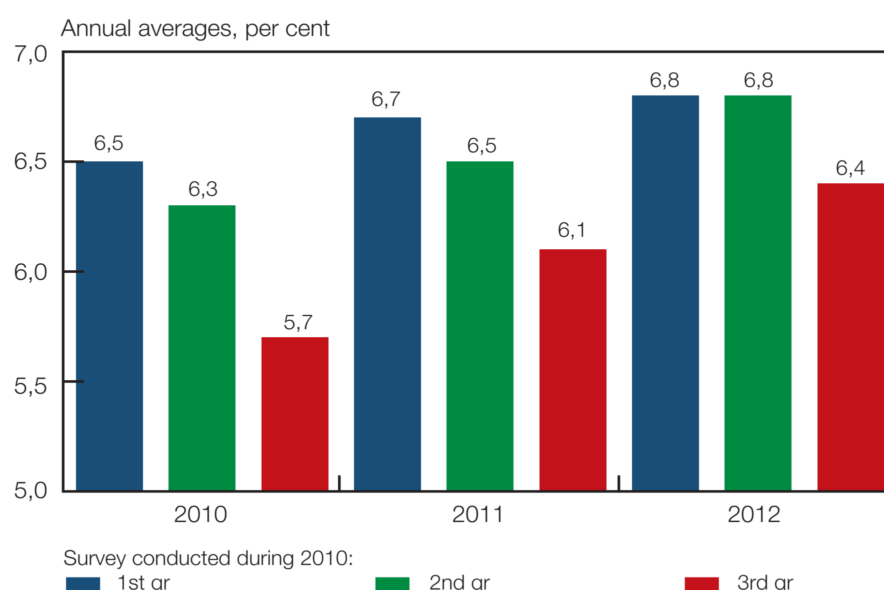
The BER third quarter 2010 manufacturing survey, which was released in September, showed that manufacturing business confidence rose from 28 index points in the second quarter to 30 index points in the third quarter. The rise in confidence was supported by improvements in domestic sales, orders received and production volumes.

The FNB Building Confidence Index, which measures the business confidence of all the major role-players and suppliers involved in the building industry, declined from a value of 30 in the first quarter of 2010 to 24 in the second quarter, before recovering to 29 in the third quarter. Both residential and non-residential building activity declined in the third quarter.

Indicators of inflation expectations

Estimates of inflation expectations for the period from 2010 to 2012, obtained from the BER survey conducted during the third quarter of 2010, are shown in Figure 22. These results show that average annual CPI inflation is expected to remain below the upper level of the 3 to 6 per cent inflation target range in 2010, but to rise above the target band in 2011

Figure 22 BER surveys of headline CPI inflation expectations

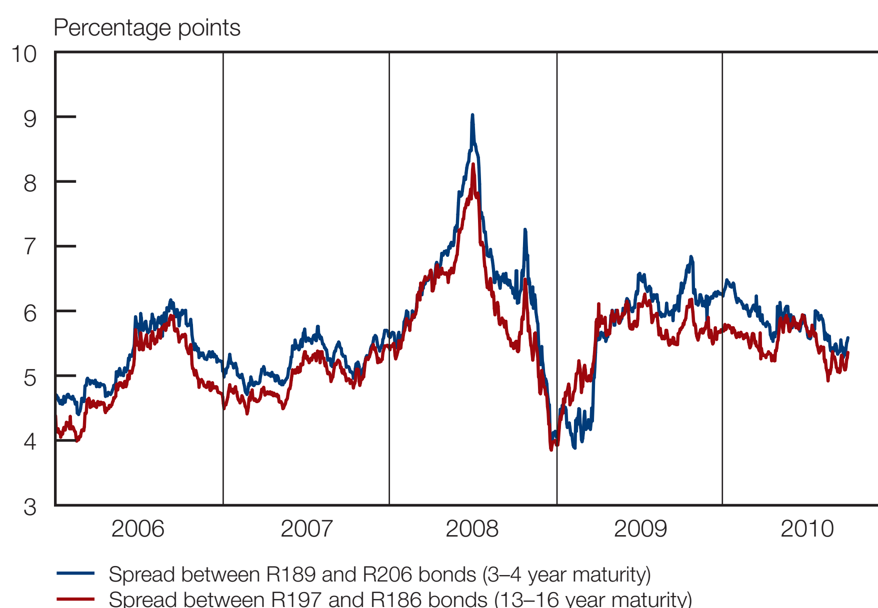


Source: Bureau for Economic Research, Stellenbosch University

and 2012. Inflation expectations in the third quarter of 2010 were lower at all horizons than those surveyed in the preceding quarter. Average CPI inflation expectations for 2010 are 5,7 per cent, rising to 6,1 per cent for 2011 and 6,4 per cent for 2012.

Inflation expectations derived from break-even inflation rates, measured as the difference between the yields on South African CPI inflation-linked bonds and conventional nominal bonds of similar maturity, have been trending lower from the beginning of the year (Figure 23). On 1 January 2010 the 13–16 year maturity break-even inflation rate was 5,46 per cent, while the 3–4 year maturity break-even rate was 6,26 per cent. On 5 October 2010 the long-maturity break-even registered 5,36 per cent, while the short-end break-even was at 5,59 per cent.

Figure 23 Break-even inflation rates



The latest estimates of inflation expectations for the period from 2010 to 2012 obtained from the Reuters survey conducted in September 2010 show that average annual CPI inflation is expected to decline over the forecast years, and is expected to remain below the upper level of 6 per cent of the CPI inflation target range. Inflation expectations for the period 2010–2012 are lower at all horizons than those surveyed in the preceding months. As depicted in Table 11, average CPI inflation expectations for 2010 are 4,4 per cent, followed by 4,9 per cent for 2011 and 5,7 per cent for 2012.

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

Per cent

Forecast survey	2010		2011		2012	
Mean	(4,9)	4,4	(5,2)	4,9	(5,9)	5,7
Median	(4,5)	4,4	(5,3)	4,9	(5,8)	5,7
Highest forecast	(5,1)	5,0	(5,7)	5,6	(6,7)	6,5
Lowest forecast	(4,3)	4,2	(4,6)	3,8	(5,5)	4,3
Number of forecasters	(22)	23	(22)	23	(19)	20

* August 2010 survey results in parentheses

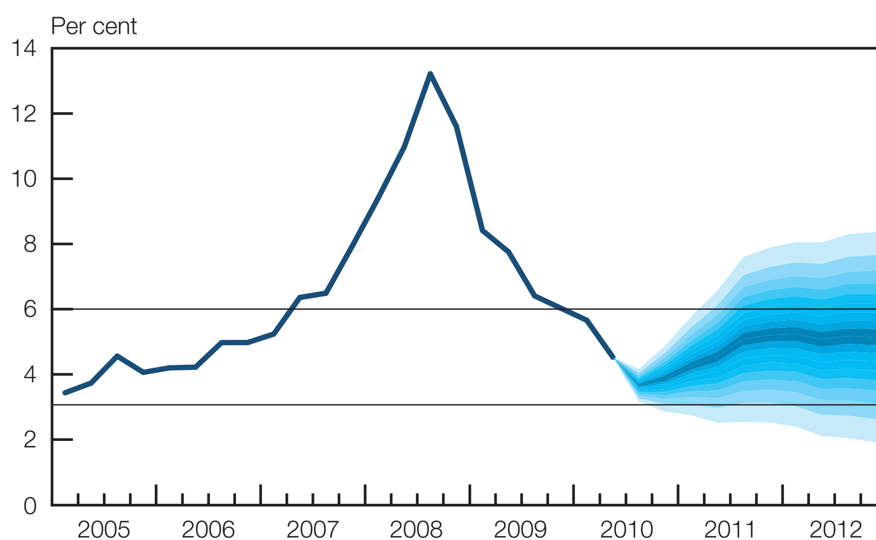
Source: Reuters

The South African Reserve Bank inflation forecast

The quarterly inflation projections of the core inflation forecasting model of the Bank, presented to the MPC from 7 to 9 September 2010, are reproduced in Figure 24. The central projection of the baseline forecast shows that at this time targeted inflation was expected to reach a low point of 3,7 per cent, on average, in the third quarter of 2010. Inflation was expected to remain within the inflation target range until the end of the forecast period, averaging 4,8 per cent in 2011 and measuring 5,1 per cent in the final quarter of 2012. When compared to the forecast presented to the previous MPC meeting, the outlook for the annual rate of targeted inflation is lower over the entire forecast period from 2010 to 2012. The forecast makes provision for electricity price increases of 20 per cent per annum at the consumer level in the third quarter of each of the three consecutive forecast years.

The main downside risks to the inflation outlook were viewed as emanating from the foreign exchange rate of the rand, while wage settlements in excess of inflation were the main upside risk. Risks from cost–push pressures remained relatively unchanged, although administered price increases are, on average, at elevated levels and therefore continue to place upside pressure on the inflation outlook. Inflationary pressures emanating from the global economy remain muted, although there are potential risks from food price increases, particularly related to wheat prices.

Figure 24 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).*

Assessment and conclusion

The global economy has continued to recover in a hesitant and uneven manner. While the threat of a reversion to recessionary conditions in the advanced economies has receded somewhat, the downside risks to growth remain elevated. This is partly due to the weak consumption expenditure developments, as well as the withdrawal and in some instances the significant reversal of fiscal stimuli. At the beginning of 2010 there had been much focus on the exit strategies that were expected to be implemented as part of the normalisation of both monetary and fiscal policy stances. However, the sovereign debt crisis in some European countries focused attention on the sustainability of fiscal deficits, and a number of countries adopted severe fiscal austerity measures. This left monetary policy to assume the burden of underpinning growth. Market expectations that monetary policy in the US would start tightening by mid-2010 were revised substantially, and current expectations are for interest rates in the US and other advanced economies to remain lower for longer against the backdrop of relatively weak growth prospects. These interest rate developments have changed the pattern of global capital flows, as funds seeking higher yields have flowed in large volumes to emerging markets' capital markets.

By contrast to most of the industrialised economies, emerging-market economies, particularly in Asia and Latin America, have been experiencing relatively robust growth and, in some instances, monetary policy tightening has begun. South Africa has been somewhat of an outlier and domestic economic growth has remained below potential, the growth outlook remains subdued and unemployment remains high. There are indications that consumption expenditure is recovering, but the impact of the FIFA World Cup™ is still unclear at this stage, which raises doubts about the sustainability of expenditure, particularly in the light of weak credit extension. Growth in private-sector gross fixed capital formation has been lagging and is also seen to be a constraint on growth.

The inflation outlook remains benign: headline CPI increased by 3,5 per cent in August, the lowest rate of increase in 5 years. Inflation is expected to remain in the target range for the remainder of the forecast period, although significant further downside potential is constrained by high levels of administered price increases. The major downside risk to the inflation outlook remains the exchange rate, which has been impacted significantly by the capital inflows responding to the low interest rate climate in the advanced economies. These pressures are likely to persist as long as monetary policy remains extremely accommodative in these countries.

The favourable inflation developments have allowed for further domestic monetary policy loosening. The nominal repurchase rate is the lowest it has been for 30 years, while the real repurchase rate is well below its long-run average. While the MPC at its most recent meeting viewed the current monetary policy stance as being appropriate for the current environment, this view is conditional upon no significant changes in the variables that impact on inflation. Policy will continue to be conducted in a flexible inflation-targeting framework, mindful of the state of the economy and financial stability considerations.

Statement of the Monetary Policy Committee

22 July 2010

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

Introduction

International news and discourse are currently dominated by global economic and financial market developments, which continue to weigh on domestic economic growth prospects. Although the immediate concerns relating to the sovereign debt crisis seem to have abated somewhat, significant risks remain. Furthermore, growth in a number of advanced economies appears to be losing some momentum following promising outcomes in the first quarter of the year.

The domestic inflation outlook remains favourable with inflation expected to stay within the inflation target range for some time, against the backdrop of a benign global inflation environment.

Recent developments in inflation

The year-on-year inflation rate as measured by the consumer price index (CPI) for all urban areas declined to 4,6 per cent in May 2010 from 4,8 per cent in the previous month. The main contributors to the inflation outcome were the categories of housing and utilities (mainly electricity) and miscellaneous goods and services (predominantly insurance costs) which, together, contributed almost 60 per cent to the total inflation outcome. Categories exhibiting very low inflation pressures included food and non-alcoholic beverages, communication and recreation and culture. Indicators of core inflation show that inflation is generally subdued, with CPI excluding food, petrol and energy declining to 4,3 per cent in May compared with 4,7 per cent in the previous month. Inflation excluding all administered prices measured 3,4 per cent.

Producer prices continued the upward trend seen in the past few months, and measured 6,8 per cent in May 2010, compared with 5,5 per cent in April. These increases were driven mainly by commodity and electricity price developments. Food price inflation remained low, with agricultural prices increasing by 0,3 per cent on a year-on-year basis, while manufactured food prices declined by 1,3 per cent over the same period. This suggests that food prices at the consumer level are likely to remain contained for some time.

The outlook for inflation

The CPI forecast of the Bank indicates a relatively unchanged forecast compared with that presented to the previous meeting of the Monetary Policy Committee (MPC). CPI inflation is expected to average 4,5 per cent in the third quarter of 2010, and then increase moderately thereafter. Inflation is expected to remain within the target range during the forecast period, and to measure 5,3 per cent in the final quarter of 2012.

Despite the persistent moderation of inflation within the target range, inflation expectations have remained relatively elevated, albeit with a slight downward trend. According to the survey of inflation expectations conducted by the Bureau for Economic Research (BER) at Stellenbosch University during the second quarter of 2010, average

inflation expectations for both 2010 and 2011 have declined by 0,2 percentage points to 6,3 per cent and 6,5 per cent respectively, but have remained unchanged at 6,8 per cent in 2012. Financial analysts are the only category of survey respondents that expect the inflation target to be achieved during the forecast period.

Expectations derived from the markets are similar to those of the financial analysts. The break-even inflation rates, as measured by the yield differential between conventional government bonds and inflation-linked bonds, have declined since the previous meeting of the MPC, and reflect an expectation of the continued attainment of the inflation target over the medium term, although close to the upper end of the range.

The global economic growth outlook remains uncertain. In its July update of the *World Economic Outlook*, the International Monetary Fund raised the forecast for global growth from 4,2 per cent to 4,6 per cent, mainly on the basis of the higher-than-expected performance in the first quarter of the year. However, some moderation is expected in the second half of this year with a high degree of downside risk.

The sovereign debt crisis in Europe appears to have had a short-term respite, but significant longer-term risks and uncertainties persist. The planned fiscal consolidation and austerity programmes in a number of countries are expected to lead to persistently low growth for some time. The economic growth prospects in the United States (US) appear weaker than anticipated, with particular concerns about the continued weakness in the housing market, and an outlook described by US Federal Reserve Chairman Ben Bernanke as “unusually uncertain”. At the same time the Chinese authorities have taken steps to moderate the pace of economic growth. The expectation is that we are likely to see an extended period of below-potential growth in a number of regions.

Under these circumstances, global inflationary pressures are expected to remain subdued and are not seen to pose a risk to the domestic inflation environment. The weaker demand conditions are also likely to constrain global commodity price developments, including international oil prices. The price of Brent crude oil has been relatively stable for some time and has averaged around US$74 per barrel since the previous meeting of the MPC, down from the US$82 per barrel average that prevailed during the period between the March and May MPC meetings.

The continued low interest rate environment prevailing in the US and eurozone has resulted in a consistent search for yield, with a number of emerging markets being the recipients of significant capital inflows. South Africa has been no exception. Since the beginning of the year, non-residents have been net purchasers of bonds and equities to the value of around R72 billion, of which about R51 billion were bond purchases.

The rand exchange rate has been relatively volatile in the period since the previous meeting of the MPC, with the rand/dollar exchange rate fluctuating between around R8,10 and R7,43. However, since the beginning of June, the rand has been relatively stable and averaged around R7,60 per US dollar. Much of the underlying volatility can be ascribed to changes in global risk aversion related to events in Europe in particular, which saw a high degree of volatility in the US dollar/euro exchange rate. As a consequence, the rand has fluctuated against other currencies as well. Since the beginning of the year the rand has appreciated against the euro and pound sterling by 9,1 per cent and 2,9 per cent respectively, while it has depreciated by 2,9 per cent against the dollar over the same period. On a trade-weighted basis, the rand has appreciated by about 1,6 per cent since the beginning of the year.

The Bank is very aware of the impact of both the level and volatility of the rand on the economy, particularly the manufacturing, export and import-competing sectors. We are ready to continue to play our part in a considered manner, and discussions with the National Treasury about the various options available to address these issues, as well as the availability of resources to do so are ongoing.

While a range of levels has been proposed by various interest groups or analysts as desired or equilibrium levels – anything from R10,50 to R8,50 against the US dollar – we reiterate that we do not have a target level for the rand. It is very difficult to define with precision the degree of over- or undervaluation of an exchange rate. The approach when assessing this should be guided by a sense of when the value is clearly not consistent with equilibrium, which itself changes from time to time. Moreover, it is important not to underestimate how difficult it is to achieve a particular range of a weaker currency, or how costly this can be. Any actions would also have to be consistent with the inflation target, as there is no point in having a weaker currency if the benefits are simply eroded by inflation.

The recovery in domestic economic growth has continued. Real gross domestic product (GDP) grew at an annualised rate of 4,6 per cent in the first quarter of 2010, driven mainly by the recovery in the manufacturing and mining sectors. However, indications are that second quarter growth was likely to have been less favourable, and the negative output gap is expected to persist for some time. The Bank forecasts economic growth to average around 2,9 per cent during 2010, with the uncertainties emanating from the global economy posing the main downside risks.

The relatively unfavourable outlook can be ascribed in part to an expected slowdown in the manufacturing sector. Growth in this sector in the three months to May 2010 compared with the previous three months measured 1,2 per cent. The Kagiso/BER Purchasing Managers' Index has been moderating consistently since its peak in February 2010, and in July the index reflected an expectation of a contraction in the sector. The construction sector also remains under pressure, as evidenced in the 29,9 per cent year-on-year decline in total building plans passed in May. Civil construction is also showing declining activity and, according to the First National Bank (FNB) civil construction survey, the industry is experiencing unsatisfactory business conditions. The Rand Merchant Bank (RMB)/BER Business Confidence Index also declined during the second quarter of 2010. Private sector gross fixed capital formation continued to decline in the first quarter of 2010, albeit at a slower rate of contraction.

There are signs of recovery in domestic household consumption expenditure. In the first quarter of 2010 consumption expenditure grew at a higher-than-expected annualised rate of 5,7 per cent. The recovery was fairly broad-based except for expenditure on services, which remained relatively subdued. The positive trend is expected to have been maintained in the second quarter. Retail trade sales increased at a year-on-year rate of 4,6 per cent in May. However when comparing the three months to May with the preceding three months, an increase of 0,3 per cent was recorded. Consumption expenditure is expected to have received a boost from the 2010 FIFA World Cup™. New vehicle sales increased by 20,7 per cent on a year-on-year basis in June, although they declined by 9,7 per cent relative to the previous month.

The BER retail survey suggests that the outlook for the sector remains fragile. After two consecutive positive quarters, retail business confidence declined in the second quarter of 2010, and overall business conditions, sales volumes and profitability performed worse than expected.

The outlook for household consumption expenditure is being affected by contradictory forces. Positive factors include lower interest rates, lower inflation, positive wealth effects arising from favourable house price and equity market developments, and high levels of real wage increases for those in employment. In the first quarter of 2010 unit labour costs increased by 9,6 per cent compared with the same quarter a year ago. According to Andrew Levy Publications, the average wage settlement rate amounted to 8,2 per cent in the first half of 2010, compared with 9,3 per cent for 2009 as a whole. Wage expectations also remain elevated, according to the BER inflation expectations survey.

Factors constraining consumption expenditure include continued job losses and high levels of household debt and low levels of credit extension to the private sector. According to the *Quarterly Employment Statistics* survey of Statistics South Africa, employment levels declined further in the first quarter of 2010, as private-sector employment contracted for the seventh consecutive quarter. Youth unemployment is particularly evident.

Growth in bank credit extension to the private sector turned positive in May when growth over twelve months in total loans and advances measured 1,4 per cent, mainly as a result of an increase in credit extension to the corporate sector. Twelve-month growth in mortgage advances has remained stable at levels around 3 per cent since November 2009. There are some indications, as evidenced in the most recent Ernst & Young/BER financial services survey, that in the second quarter of 2010 retail banks loosened their credit criteria somewhat. However, bank lending to consumers may be constrained by the persistently relatively high levels of impaired advances, particularly in relation to retail loans. Demand for loans may also have been negatively affected by the continued high levels of household debt, which measured 78,4 per cent of disposable income in the first quarter of 2010.

The main upside risks to the inflation outlook continue to emanate from cost–push pressures, particularly recent wage settlements and high levels of administered price increases.

Monetary policy stance

The MPC assesses the risks to the inflation outlook as being evenly balanced and views the current monetary policy stance as appropriate. Therefore, the MPC decided to keep the repurchase rate unchanged at 6,5 per cent per annum. The committee is aware of the fragilities and vulnerabilities to the domestic economy, driven in part by global uncertainties. The committee will continue to assess economic and financial developments, and should circumstances warrant it, the appropriate response will be taken, consistent with the Bank's inflation-targeting mandate.

Statement of the Monetary Policy Committee

9 September 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 July meeting of the MPC, domestic inflation has moderated to lower-than-expected levels, and it is anticipated that it will remain within the target range for the rest of the forecast period. Contributing to this development were the further appreciation of the rand exchange rate and the relatively weak domestic demand conditions. The output gap has remained negative and economic growth in the second quarter of 2010 was lower than market expectations. Growth is expected to remain below potential for some time, against the backdrop of a fragile global economy.

Recent developments in inflation

The year-on-year inflation rate as measured by the consumer price index (CPI) for all urban areas declined to 3,7 per cent in July 2010, compared with 4,6 per cent in May. Goods price inflation measured 2,1 per cent in July, while services inflation, which had been relatively sticky, declined to below the upper level of the target range and measured 5,4 per cent.

The categories of housing and utilities (mainly electricity) and miscellaneous goods and services (predominantly insurance costs) together contributed 2,2 percentage points of the 3,7 per cent inflation outcome. However, electricity price increases were lower than expected. There was also a quick reversal of the influence of the 2010 FIFA World Cup™ on some categories. This was particularly noticeable in the category of hotels which experienced a month-on-month price decline of 11,2 per cent. CPI excluding administered prices measured 2,9 per cent, that is, below the lower limit of the inflation target band.

The recent upward trend in producer price inflation was reversed in July when it measured 7,7 per cent, having peaked at 9,4 per cent in June. Food price inflation remained benign, with agricultural prices increasing by 0,2 per cent on a year-on-year basis, while manufactured food prices declined by 1,0 per cent over the same period. This suggests that food prices at the consumer level are likely to remain contained for some time, notwithstanding higher global food prices.

The outlook for inflation

Partly as a result of the recent lower-than-expected inflation outcomes, the inflation forecast of the Bank was revised downwards, particularly in the short to medium term. Targeted CPI inflation is expected to reach a low point of 3,7 per cent on average in the third quarter of 2010. Inflation is expected to average 4,8 per cent in 2011 and to measure 5,1 per cent in the final quarter of 2012.

The lower inflation trend has had a favourable impact on inflation expectations in the financial markets. Break-even inflation rates, as measured by the yield differential between conventional government bonds and inflation-linked bonds, have declined across all maturities since the previous meeting of the MPC and remain below the 6 per cent level. The Reuters survey of analysts published in September also shows an

improvement of expectations, and inflation is expected to average 4,6 per cent and 5,2 per cent in 2010 and 2011 respectively.

The global economic outlook continues to be characterised by heightened uncertainty. Although fears of a reversion to recession in the advanced economies have diminished somewhat, the downside risks remain high. In the course of the year forecasts of global growth have generally been downgraded in the wake of the European sovereign debt crisis, high rates of unemployment in the United States (US) and the euro area, and weak demand in many of the advanced economies. The US economy is expected to experience below-trend growth for some time and doubts remain about the sustainability of the fiscal austerity programmes in some of the southern European economies. A number of Latin American and Asian economies, apart from Japan, have maintained their strong growth performances, but China has experienced a moderate policy-induced slowdown.

While the low-growth global outlook poses a downside risk to prospects for domestic economic growth, inflationary pressures emanating from the advanced economies are likely to remain benign. The hesitant global recovery has also helped to maintain international oil prices in a relatively stable range of between US$70 and US$80 for some time.

These international developments also imply that policy rates are likely to remain abnormally low for an extended period of time in a number of the advanced economies. The resultant search for yield by foreign fund managers has had implications for the rand exchange rate, which remains the main downside risk to the inflation outlook. Since the previous meeting of the MPC, the rand has appreciated by about 4,6 per cent against the US dollar and by 5,6 per cent against the euro. On a trade-weighted basis, the rand has appreciated by 4,0 per cent since the July meeting and by 5,7 per cent since January 2010.

Since the beginning of the year, non-residents have been net buyers of equities and bonds to the value of R100 billion, of which R75 billion were bond purchases. This compares with net purchases of bonds totalling R15,5 billion in 2009 as a whole. Whereas in previous years bond flows appeared to be mainly speculative in nature, the recent developments suggest that there could have been a fundamental shift in these flows. There are indications that a significant proportion of these flows are more long term in nature as foreign pension funds and other fund managers take advantage of higher yields in emerging-market economies. The higher levels of bond market inflows are not unique to South Africa. It is estimated that emerging-market bond funds have recorded year-to-date inflows of US$32 billion, compared with the previous full-year high of US$9,7 billion in 2005.

The appreciating trend of the rand exchange rate has been sustained despite further accumulation of foreign-exchange reserves by the Bank. The Bank does not target a level for the exchange rate, but takes advantage of prevailing conditions to continue to build reserves. However, this is a costly exercise and in order to sterilise the impact on the money market, the Bank is now engaged in longer-term foreign-exchange swap transactions. This, in effect, results in an overbought foreign-exchange position, and adds to the international liquidity position, but not to the gross reserves. Gross reserves will only be affected if and when these swaps are not rolled over, and the Bank takes delivery of the dollars. Any profits or losses will be borne by the National Treasury in keeping with its stated commitment to supporting the Bank in its reserves accumulation efforts.

Domestic economic growth declined in the second quarter of 2010, to a quarter-on-quarter annualised rate of 3,2 per cent, following a growth rate of 4,6 per cent in the previous quarter. The slower growth was due mainly to the 20,8 per cent contraction in the mining sector in this quarter. Growth in the manufacturing sector moderated to 6,9 per cent from 8,4 per cent in the first quarter, while the tertiary sector grew at a rate of 4,0 per cent.

Growth in the second half of 2010 is expected to moderate further. The composite leading business cycle indicator of the Bank declined in May and June, suggesting a slowdown in the pace of recovery in the coming months. Although the Rand Merchant Bank (RMB)/Bureau for Economic Research (BER) Business Confidence Index rebounded markedly in the third quarter following the second quarter decline, the overall index remains below the 50 level, and confidence has remained particularly weak in the manufacturing and construction sectors.

The Kagiso/BER Purchasing Managers' Index increased slightly in August, but it nevertheless points to a deceleration of the growth momentum in the sector. At the same time, manufacturing capacity utilisation, which increased moderately in the second quarter, remains below the long-term average. The construction sector also continues to be under pressure, as evidenced in the low growth in building plans passed, while private-sector gross fixed capital formation is expected to remain subdued. The Bank's forecast of gross domestic product (GDP) growth has declined moderately since the previous meeting of the MPC, with growth now expected to average 2,8 per cent in 2010 and 3,2 per cent in 2011.

Household consumption expenditure has shown some signs of recovery following the contraction during 2009. Growth in real final consumption expenditure by households moderated to an annualised rate of 4,8 per cent in the second quarter of 2010 compared with growth of 5,7 per cent in the first quarter. The impact of the 2010 FIFA World Cup™ on expenditure is unclear at this stage, but some moderation can be expected in coming months. Motor vehicle sales have shown a particularly strong year-on-year recovery, although off a low base. Pre-emptive buying ahead of the introduction of the carbon emissions tax may have contributed to this outcome.

The outlook for household consumption expenditure continues to be affected by contradictory forces. The main negative factors include low levels of credit extension, high levels of household indebtedness, high levels of unemployment and continued job losses.

Underlying credit extension remains weak, but there has been some improvement in the past months. Growth over 12 months in banks' total loans and advances to the private sector measured 1,7 per cent in July; its highest level in over a year. Growth in mortgage advances, which measured 4,0 per cent, was the main driver of this growth. Instalment sale and leasing finance, as well as other loans and advances, continued to contract, but at a slower rate. Within the latter category, general loans exhibited positive year-on-year growth of 2,1 per cent. Growth in the retail portfolios of banks remained weak, and the ratio of impaired advances to gross loans and advances amounted to 5,9 per cent in June, relatively unchanged from the previous quarter. Although banks appear to have relaxed their credit criteria somewhat, they remain relatively cautious and their pricing for risk still appears to be higher than was the case before the crisis.

Consumers are also constrained by high levels of debt, although the cost of servicing the debt has declined in line with lower interest rates. Household debt as a ratio to disposable income has moderated very slowly from its peak of over 80 per cent.

Household consumption expenditure is also expected to be constrained by the continued unemployment trends. According to the *Quarterly Labour Force Survey* of Statistics South Africa, the unemployment rate increased marginally in the second quarter of 2010 to 25,3 per cent. In the two years to the second quarter of 2010 one million jobs were lost, while the number of discouraged workers increased by 900 000. Consistent with the slowdown in manufacturing and construction, job shedding was most marked in these sectors.

Factors that could provide a positive impetus to household consumption expenditure include lower nominal interest rates, lower inflation, positive wealth effects arising from improving house prices and equity market developments, and high levels of real wage increases for those in employment.

Wealth effects over the past year have been positive, with house prices increasing at year-on-year rates of over 10 per cent. However, in July the rate of increase declined moderately according to both the Absa and First National Bank (FNB) house price indices. The bond market rally has continued, and equity prices have recovered significantly from their lows in the first quarter of 2009, although they remain below pre-crisis levels.

Wage settlements in excess of inflation, while providing a positive impetus to consumption, are also the main upside risk to the inflation outlook. Some wage demands and a number of settlements have been made without regard to the lower inflation outcomes and the improved inflation outlook. Unless accompanied by higher productivity, such settlements could put pressure on domestic prices and impact negatively on our international competitiveness. Such settlements are also likely to have a negative impact on employment trends.

Risks from cost–push pressures are relatively unchanged. Administered price increases, on average, remain at elevated levels and therefore place upside pressures on the inflation outlook. Potential risks emanate from food price increases at the global level, particularly related to wheat prices. However, the impact domestically is expected to be constrained by the relatively strong exchange rate and the recent domestic bumper maize crop.

Monetary policy stance

The assessment of the MPC is that the improved inflation outlook creates sufficient room for monetary policy to provide additional stimulus to the somewhat fragile recovery of the domestic economy, which remains vulnerable to the uncertain global environment.

The MPC has decided to reduce the repurchase rate by 50 basis points to 6,0 per cent per annum with effect from 10 September 2010. The MPC views this action to be consistent with the continued attainment of the inflation target, having given due regard to the risks to the outlook. The scope for further downward movement is seen to be limited, but this will be assessed on an ongoing basis. Our approach remains forward-looking, and is informed by close examination of the data and future developments.

Abbreviations

Alsi	All-Share Index
API	administered price index
BER	Bureau for Economic Research (Stellenbosch University)
CCI	Consumer Confidence Index
CPI	consumer price index for all urban areas
ECB	European Central Bank
EGARCH	exponential GARCH
EU	European Union
FNB	First National Bank
G-20	Group of Twenty
GARCH	generalised autoregressive conditional heteroskedasticity
GDP	gross domestic product
GIIPS	Greece, Italy, Ireland, Portugal and Spain
GIPS	Greece, Ireland, Portugal and Spain
IEA	International Energy Agency
IMF	International Monetary Fund
JSE	JSE Limited
MPC	Monetary Policy Committee
NAB	non-alcoholic beverage
OECD	Organisation for Economic Co-operation and Development
OPEC	Organization of the Petroleum Exporting Countries
PMI	Purchasing Managers' Index
PPI	producer price index
REER	real effective exchange rate
RMB	Rand Merchant Bank
SAMOS	South African Multiple Option Settlement
the Bank	South African Reserve Bank
the Fed	United States Federal Reserve
UK	United Kingdom
US	United States
VAT	value-added tax
WEO	*World Economic Outlook*