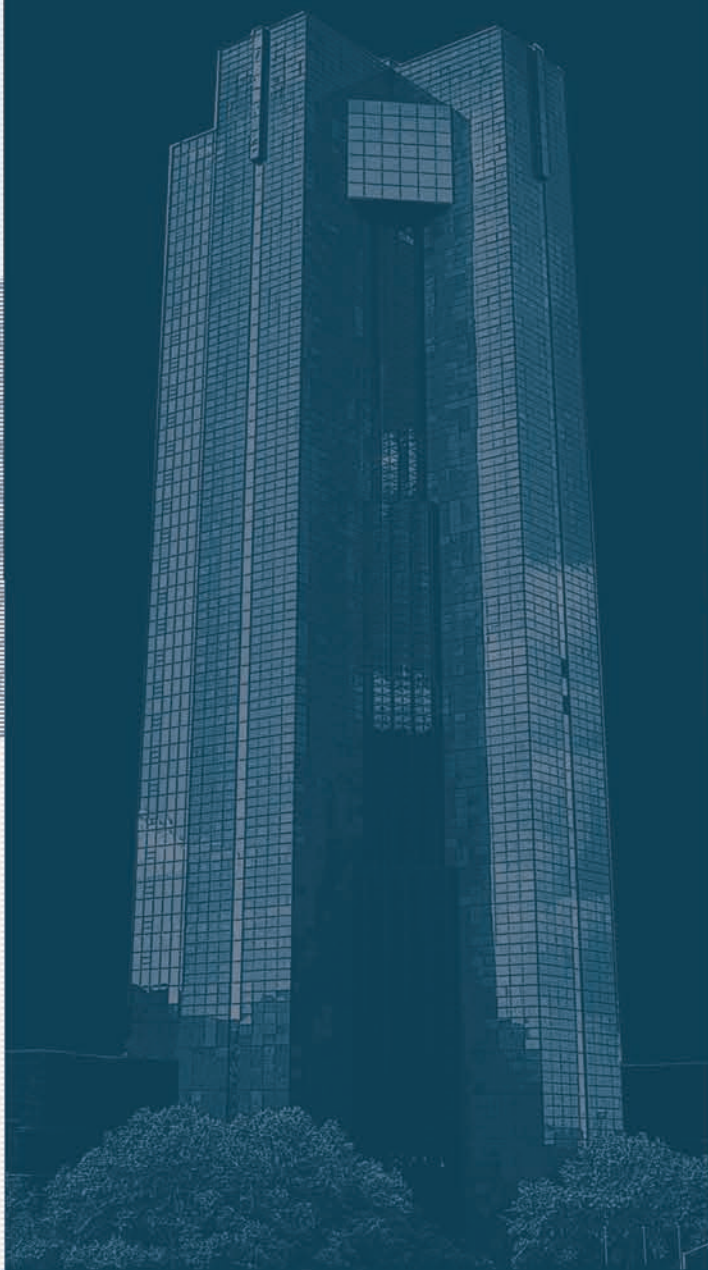

Monetary Policy Review

May 2011

South African Reserve Bank

90th Anniversary

Monetary Policy Review

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90th

Anniversary

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Introduction

The global recovery has remained on track in the period since the previous *Monetary Policy Review* was published in October 2010, but a number of vulnerabilities continue to characterise the global economy. The unresolved European sovereign debt crisis, rising international commodity prices and the tragic events in Japan may moderate the pace of recovery in the near term. Global inflation risks have also increased, particularly in emerging-market economies, a number of which have tightened their monetary policy stance in recent months. Pressures from developments in international commodity markets are likely to pose an increasing risk to both the global and domestic inflation outlook. The acceleration in international oil prices that was evident in the latter part of 2010 in response to strong global demand has been reinforced by the geo-political events in the Middle East and North Africa (MENA), which have raised concerns about the security of oil supplies. In a number of mature economies the process of withdrawing fiscal stimulus continued, and the first step in raising interest rates from exceptional lows was taken when the European Central Bank (ECB) increased its key policy rate in April 2011.

The domestic growth prognosis has improved, although growth remains below potential. The recovery in household consumption expenditure has been sustained and has been the main driver of growth, but growth in fixed capital formation has remained weak. At this stage there are no discernible inflationary pressures coming from the demand side of the economy, although the high, but moderating, level of real wage settlements and developments in food and commodity prices have been significant upside risks to the domestic inflation outlook. The main risks to the inflation outlook in this regard remain food and administered prices, and oil prices in particular. In addition, the potential exists for there to be adjustments in the exchange rate that would impact on the inflation outlook.

This *Monetary Policy Review* analyses the latest developments in inflation and the factors that impact on it. It reviews recent monetary policy developments, and presents the outlook for inflation and the South African Reserve Bank's (the Bank) inflation and growth forecasts. In addition, a number of topical issues are addressed in boxes. The first box considers what micro price data say about pricing conduct and how findings on pricing conduct from South Africa's consumer price microdata compare to international stylised facts. The second box reports on research undertaken on the rand as a carry trade target, and the third on sovereign debt developments in the peripheral euro area.

Recent developments in inflation

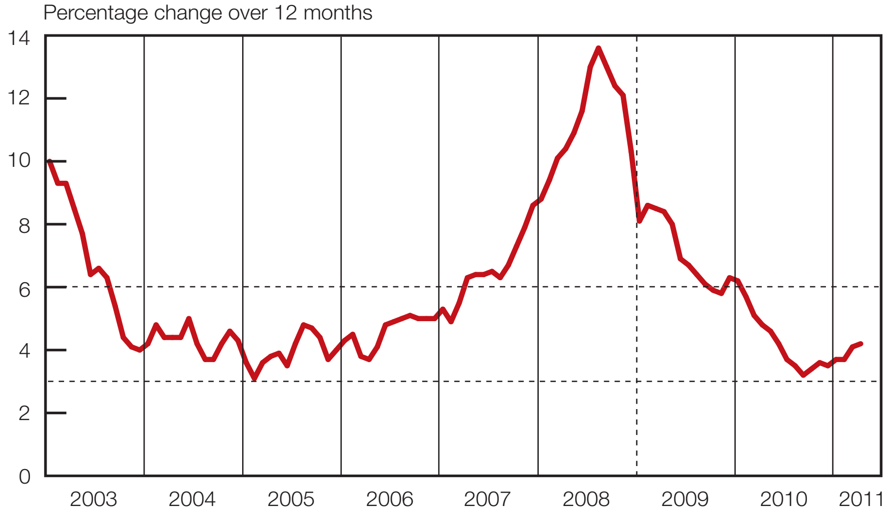
This section reviews recent trends in the main inflation indices and analyses developments in the main factors impacting on inflation in South Africa.

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, increased from a low of 3,2 per cent in September 2010 to 4,2 per cent in April 2011 (Figure 1). Headline inflation has remained within the inflation target range of 3 to 6 per cent for 15 months since moving back to within the range in February 2010.

Figure 1 Consumer price inflation: Targeted inflation*

Percentage change over 12 months



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

Source: Statistics South Africa

The main drivers of the trend in headline inflation since September 2010 were the food and non-alcoholic beverages, and transport categories (Table 1). The contribution from the food and non-alcoholic beverages category increased from 0,2 percentage points between September and December 2010 to 0,7 percentage points in April 2011.

Table 1 Contributions to CPI inflation

Percentage change over 12 months* and percentage points

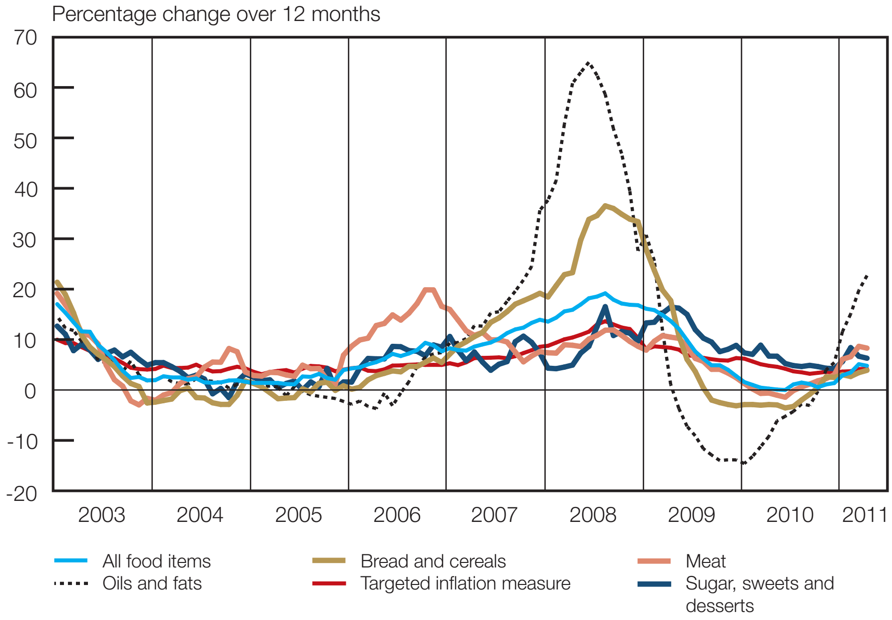
	2010					2011			
	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr
Total*..	3,5	3,2	3,4	3,6	3,5	3,7	3,7	4,1	4,2
Of which:									
Food and non-alcoholic beverages.........	0,3	0,2	0,2	0,2	0,2	0,5	0,6	0,8	0,7
Alcoholic beverages and tobacco...........	0,4	0,4	0,4	0,4	0,4	0,4	0,4	0,3	0,3
Housing and utilities	1,4	1,5	1,5	1,5	1,5	1,4	1,5	1,5	1,5
Health..	0,1	0,1	0,1	0,1	0,1	0,1	0,1	0,1	0,1
Transport...	0,2	0,0	0,3	0,4	0,3	0,4	0,4	0,6	0,6
Education	0,2	0,2	0,2	0,2	0,2	0,2	0,2	0,2	0,2
Miscellaneous goods and services	0,8	0,7	0,7	0,7	0,7	0,5	0,5	0,5	0,5
Other..	0,1	0,1	0,0	0,1	0,1	0,2	0,0	0,1	0,3

Source: Statistics South Africa

The contribution from the transport category increased from 0 percentage points in September 2010 to 0,6 percentage points in April 2011, largely as a result of higher petrol prices. The contributions from the housing and utilities, alcoholic beverages and tobacco, health and education categories remained broadly unchanged during the review period, although the housing and utilities category remained the single largest contributor to overall headline inflation. The contribution of the miscellaneous category declined from 0,7 percentage points during September–December 2010 to 0,5 percentage points in January–April 2011.

Inflationary pressure from food items has increased in the period under review (Figure 2). The year-on-year inflation rate for all food items rose from 1,2 per cent in September 2010 to 5,1 per cent in March 2011, before declining slightly to 4,8 per cent in April. Most categories included in the CPI food basket recorded positive year-on-year inflation rates in April, with the most notable increases in this month being for oils and fats (22,7 per cent), and meat (8,3 per cent).

Figure 2 Targeted inflation* and food inflation

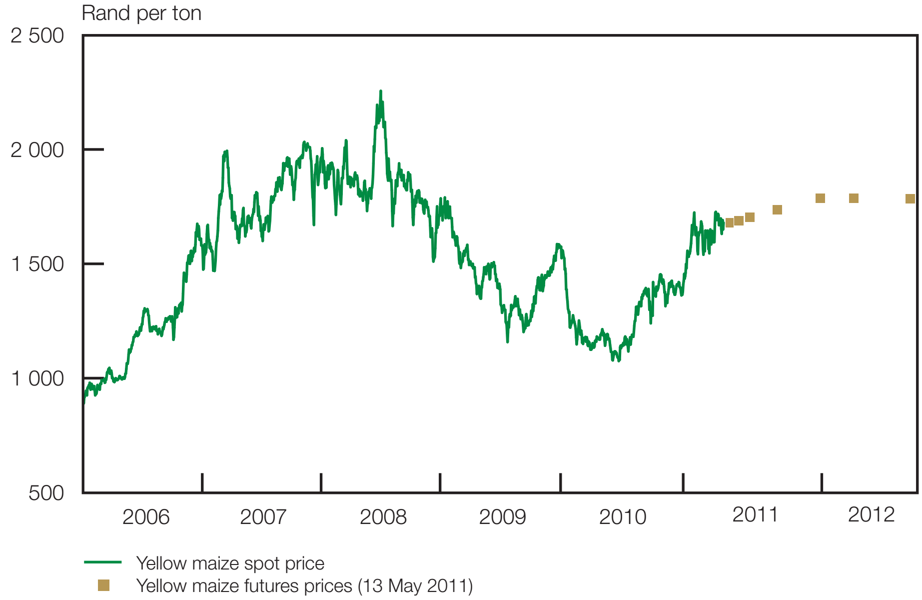


* CPIX for metropolitan and other urban areas until the end of 2008; CPI for all urban areas thereafter

Source: Statistics South Africa

Maize prices in South Africa have increased markedly since they bottomed out in June 2010 (Figure 3). Although domestic maize harvests have been good in recent years, international maize prices have risen due to increased demand globally for meat and dairy products, and more recently in line with increasing oil and commodity prices. The spot price of yellow maize averaged R1 361 per ton in October 2010 and had increased by approximately 23 per cent to average R1 676 so far in May 2011. Futures prices have also increased, with the futures price for July 2011 delivery rising from an average of R1 438 per ton in October 2010 to R1 702 in May 2011. Similarly, the July 2011 delivery price of wheat increased from an average of R2 791 per ton in November 2010 to an average of R3 129 per ton in May 2011.

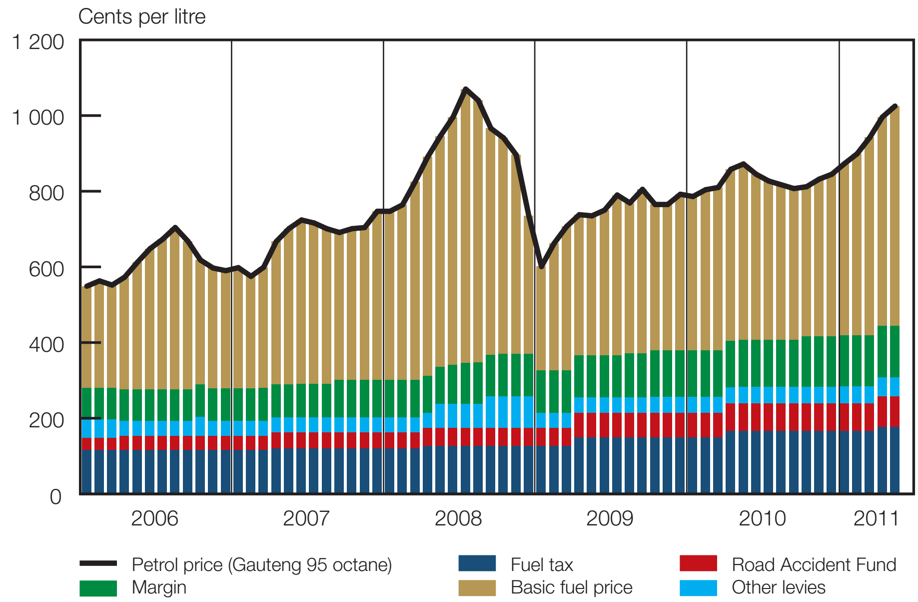
Figure 3 Yellow maize prices



Sources: Grain South Africa and SAFEX

Transport prices in the CPI have been impacted by rising petrol prices since the beginning of the fourth quarter of 2010. The price for 95 octane unleaded petrol in Gauteng Province increased from 807 cents per litre in September 2010 to 1 025 cents per litre in May 2011 (Figure 4). Increasing international oil prices have been the main driver of petrol price increases since September 2010. These increases more than offset the impact of appreciations in the rand exchange rate, which occurred for six of the eight months since September 2010. Regulatory changes also impacted adversely on domestic petrol prices. In October 2010 the retail margin included in the petrol price increased by 8,5 cents per litre. In April 2011 the fuel tax increased by 10 cents per litre and the Road Accident Fund levy increased by 8 cents per litre as announced in the National Budget speech on 23 February 2011.

Figure 4 South African petrol price



Source: Department of Energy

Table 2 shows the inflation rates for goods and services prices in the CPI. Goods inflation remained below the lower bound of the inflation target range for most of the period under review, before rising to 3,0 per cent in February 2011 and further to 3,7 per cent in April. Durable goods prices declined throughout the period, recording a year-on-year rate of change of -2,3 per cent in April 2011. Inflation rates for the non-durable goods and services categories have remained positive, with non-durable goods inflation increasing from 3,7 per cent in September 2010 to 6,8 per cent in April 2011 and services inflation declining from 5,2 per cent to 4,7 per cent over the same period.

Table 2 CPI: Goods and services inflation

Percentage change over 12 months

	2010					2011			
	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr
Headline CPI	3,5	3,2	3,4	3,6	3,5	3,7	3,7	4,1	4,2
Goods inflation	1,9	1,5	1,9	2,2	2,0	2,8	3,0	3,6	3,7
Durable goods	-3,1	-3,0	-2,0	-2,2	-2,3	-2,1	-2,6	-2,5	-2,3
Semi-durable goods	-0,3	-0,4	0,0	0,0	-0,2	-0,3	0,7	0,4	1,0
Non-durable goods	4,3	3,7	4,0	4,3	4,4	5,4	5,8	6,7	6,8
Services inflation	5,4	5,2	5,2	5,3	5,1	4,7	4,5	4,6	4,7

Source: Statistics South Africa

Table 3 considers developments in a number of measures of core inflation, calculated by excluding food, petrol and electricity prices from headline inflation. If petrol prices alone were excluded, inflation for the remaining items in the CPI changed moderately over the period, rising from 3,4 per cent in September 2010 to 3,8 per cent in April 2011. The inflation rate for the CPI excluding petrol prices has been less than, or equal to, that of the headline CPI since October 2010, indicating the upward pressure that petrol prices have exerted on inflation.

Table 3 The effect of food, petrol and energy prices on headline inflation

Percentage change over 12 months

	2010					2011			
	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr
Headline CPI	3,5	3,2	3,4	3,6	3,5	3,7	3,7	4,1	4,2
CPI excluding petrol prices	3,4	3,4	3,4	3,4	3,5	3,4	3,5	3,7	3,8
CPI excluding food and NAB*	3,9	3,5	4,0	4,1	3,9	3,8	3,7	3,9	4,0
CPI excluding food, NAB and petrol prices	3,7	3,6	3,8	3,8	3,8	3,5	3,4	3,4	3,6
CPI excluding food, NAB, petrol and energy prices	3,2	3,2	3,4	3,4	3,3	3,0	3,0	3,0	3,1

* NAB: Non-alcoholic beverages

Source: Statistics South Africa

Food prices continued to put downward pressure on CPI inflation for the first part of the period, resulting in the inflation rate for the CPI excluding food and non-alcoholic beverage prices being higher than the headline CPI rate until January 2011. This situation has reversed since March 2011. If both petrol prices, and food and non-alcoholic beverage prices are excluded, inflation for the remaining items in the CPI was higher than headline inflation until December 2010 and lower thereafter, reflecting the upward pressure that petrol and food prices have exerted on inflation in recent months. Finally, if the prices of petrol, food and non-alcoholic beverages, and energy (predominantly electricity) are excluded from headline CPI, the resulting inflation rate was lower throughout the period under review than the rate for CPI excluding petrol, and food and non-alcoholic beverage prices, reflecting the upward pressure energy prices placed on inflation.

The year-on-year inflation rate for the administered price index (API) has risen since September 2010, mainly due to the increased contribution from petrol prices, which rose from 0,1 percentage points in September 2010 to 3,7 percentage points in March and April 2011 (Table 4). The API inflation rate for April 2011 was 10,7 per cent, marking the seventeenth consecutive month that the inflation rate for administered prices has been above the upper level of the inflation target range. There has been little change in the contributions made by the items in the unregulated component of the API since September 2010, and the contributions of most items in the regulated component besides petrol have also remained constant. Over half of the API inflation rate in April 2011 is accounted for by contributions from electricity and petrol, although these items account for only a little over a third of the weight of the API.

Table 4 Contributions to administered prices

Percentage change over 12 months* and percentage points

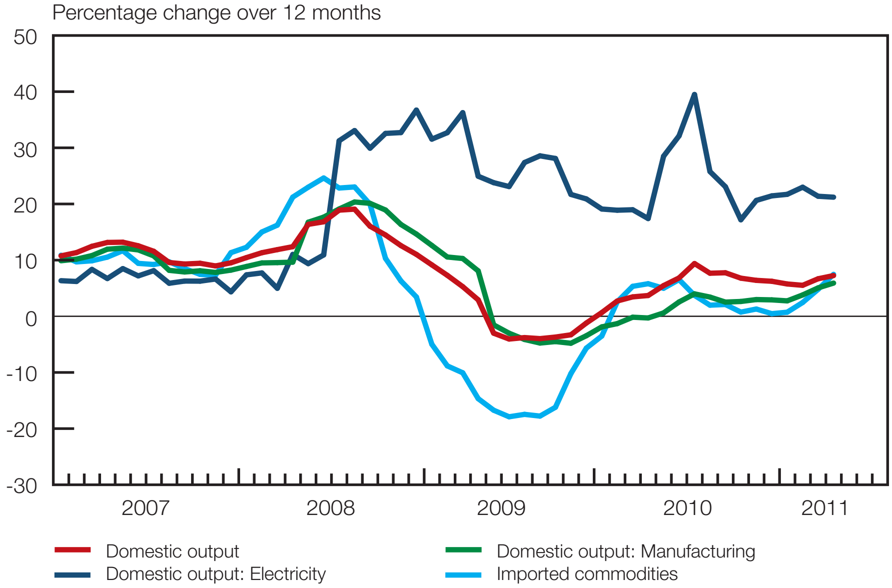
	Weights		2010					2011			
	CPI	API	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr
Regulated component											
Water	1,10	7,50	0,9	0,9	0,9	0,9	0,9	0,9	0,9	0,9	0,9
Electricity	1,68	11,46	3,0	3,0	3,0	3,0	3,0	3,0	3,0	3,0	2,9
Paraffin	0,16	1,09	0,0	0,0	0,0	0,0	0,0	0,1	0,1	0,1	0,1
Petrol	3,93	26,81	1,4	0,1	1,3	1,9	1,5	2,5	2,7	3,7	3,7
Telephone fees	1,26	8,59	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,1	0,1
Postage	0,02	0,14	0,0	0,0	0,0	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	-0,1	-0,1	-0,1
Unregulated component											
Assessment rates	2,07	14,12	1,2	1,2	1,2	1,2	1,2	1,2	1,2	1,1	1,1
Sewage collection	0,06	0,41	0,1	0,1	0,1	0,1	0,1	0,1	0,1	0,1	0,1
Refuse collection	0,09	0,61	0,1	0,1	0,1	0,1	0,1	0,1	0,1	0,1	0,1
Train fees	0,04	0,27	0,1	0,1	0,1	0,1	0,1	0,1	0,1	0,1	0,0
Motor vehicle licences	0,09	0,61	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0
Motor vehicle registration fees	0,10	0,68	0,1	0,1	0,1	0,1	0,1	0,1	0,1	0,1	0,1
Television licences	0,13	0,89	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0
Primary and secondary school fees	1,28	8,73	0,9	0,9	0,9	0,9	0,9	0,9	0,9	0,9	0,8
University fees	0,90	6,14	0,5	0,5	0,5	0,5	0,5	0,5	0,5	0,6	0,6
University boarding fees	0,28	1,91	0,2	0,2	0,2	0,2	0,2	0,2	0,2	0,2	0,2
CPI for administered prices*	14,66	100,00	8,3	7,1	8,4	8,9	8,5	9,6	9,9	10,9	10,7

Due to rounding, individual contributions may not add up to totals

Source: Statistics South Africa

The year-on-year inflation rate measured in terms of the producer price index (PPI) for domestic output has remained fairly stable since September 2010 (Figure 5). Over the year to March 2011 the PPI for domestic output increased by 7,3 per cent, with the highest rates recorded for products of petroleum and coal (17,1 per cent), mining and quarrying (8,1 per cent), basic metals (10,2 per cent), and electricity (21,2 per cent). The inflation rate for imported commodities increased from 0,7 per cent in September 2010 to 7,5 per cent in March 2011, boosted by the rising prices of crude oil.

Figure 5 PPI for domestic output and imported commodities

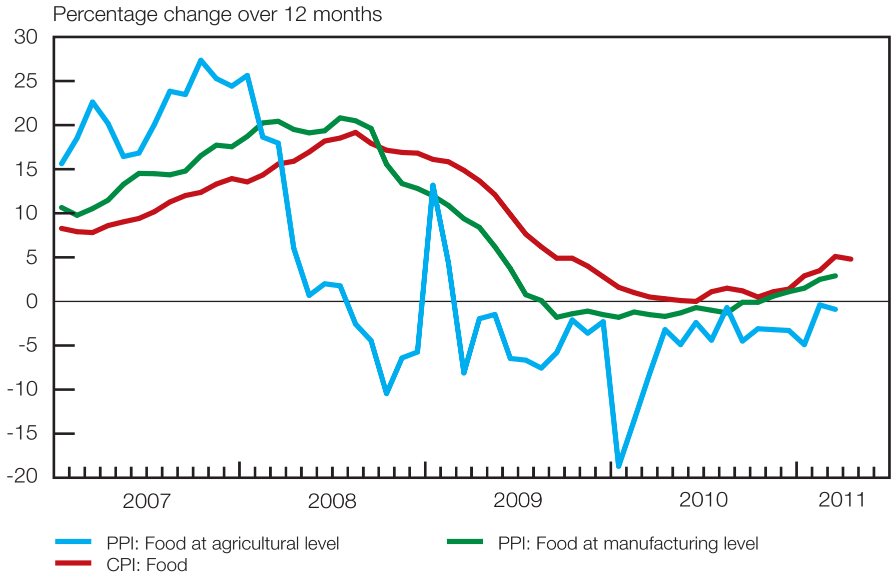


Details regarding changes to the PPI in this period are documented in statistical release P0142.1, February 2008, issued by Statistics South Africa

Source: Statistics South Africa

Figure 6 plots the year-on-year percentage changes in food prices in the domestic output PPI and the CPI. Food price pressures in the PPI for domestic output remain contained with the 12-month change in the downstream prices of food at the agricultural level at -0,9 per cent in March 2011. This is the twenty-fifth consecutive month that this change has been negative. The price of food at the manufacturing level has been accelerating since November 2010, but remained low at 2,9 per cent in March 2011.

Figure 6 Food prices in the PPI and CPI



Box 1 What price-level data can tell us about pricing conduct

The study of pricing microdata is emerging in the literature as an important method for understanding actual pricing conduct, and refining the modelling of pricing behaviour in macroeconomic models. Studies of the large price datasets used to compile consumer price index (CPI) and producer price index (PPI) measures have been undertaken in a number of countries. Klenow and Malin (2009, 2011) provide a recent synopsis of a wide range of international results on micro price data research in which they reviewed ten stylised facts on price-setting conduct. This box discusses how findings on pricing conduct from South Africa's pricing microdata, summarised in Creamer et al. (2011),[1] compare to Klenow and Malin's stylised facts.

Klenow and Malin (2009) suggest the following "ten facts modellers may want to know about pricing":[2]

1. Prices change at least once a year (p. 45)
2. [There is] substantial heterogeneity in the frequency of price changes across goods (p. 49)
3. On average, price changes are big (p. 50)
4. Many small price changes occur (p. 51)
5. Price changes are typically not synchronised over the business cycle (p. 52)
6. Neither frequency nor size is increasing in the age of the price (p. 53)
7. Sales and product turnover are often important for micro price flexibility (p. 46)
8. Reference prices are [often] stickier and more persistent than regular prices (p. 48)
9. More cyclical goods change prices more frequently (p. 50)
10. Relative price changes are transitory (p. 51).

Creamer et al. (2011, 6) report that individual South African prices change, on average, more frequently than once per annum (Fact 1). For the CPI microdata, the average price duration is 5,0 months (median 3,7 months).[3] The CPI data set offers evidence of a varying frequency of price changes and related price durations, over time, with a weighted average monthly price change frequency of 17,1 per cent over the period. The CPI data also offer evidence of asymmetry in pricing as price increases (11,1 per cent) occur more frequently than price decreases (6 per cent).

A summary of selected comparative findings for CPI data is presented in Table B1.1.[4] With regard to the frequency of price changes at the aggregate level, the finding for South Africa (17,1 per cent) using CPI-weighted data would appear to be broadly similar to findings for Spain (15 per cent), the euro area (15,1 per cent) and France (18,9 per cent). The United States (US) economy would appear to have a significantly greater frequency of price changes (24,8 per cent), including higher frequencies both of price increases and price decreases.[5] Similarly, Brazil has experienced a significantly higher frequency of price changes (37 per cent) than South Africa, and a higher frequency of both price increases and price decreases.

There is evidence for South Africa of substantial heterogeneity in pricing conduct across types of goods and industries (Fact 2). Services prices in the CPI data change less frequently (14,9 per cent of the time) than goods prices (17,0 per cent). Services prices increase more frequently than goods prices, but decrease less frequently than goods prices. The findings on the frequency of price changes by product category show that there is also considerable heterogeneity in pricing conduct for different product categories.

South Africa's pricing microdata reveal relatively large price changes (Fact 3). For the CPI, the weighted average magnitude of price increases is 10,7 per cent, compared to an average monthly CPI inflation rate of 5,4 per cent over the period. Table B1.1 shows that the average magnitude of price increases in South Africa is larger than for the euro area (8,2 per cent) and Spain (8,2 per cent), but smaller than

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1 For the South African CPI microdata set used in Creamer et al. (2011), a total of around 5 million individual price records were available over the period from December 2001 to December 2007. Based on the criteria that only data collected at a monthly frequency and only data with an acceptable capture status were to be included in the study, the dataset ultimately used comprised 3 930 977 price records. Each individual price record corresponds to a precisely defined item sold in a particular outlet at a given point in time.

2 The list of ten facts has been drawn from Klenow and Malin (2009), but the order in which the ten facts are presented has been altered to facilitate their comparison to the findings on the South African pricing microdata. More recently, in their chapter 6 in the *Handbook of Monetary Economics*, Klenow and Malin (2011) adjust their ten stylised facts by combining facts 3 and 4 into a single statement that "price changes are big on average, but many small changes occur". This enables the authors to introduce a new tenth stylised fact, which is that "price changes are linked to wage changes".

3 Such price durations are based on the direct measurement of the duration of uncensored spells during which prices are unchanged.

4 Sources for the country studies are provided in Creamer et al. (2011). Owing to the adoption of differing methodologies in the various studies, not all results are strictly equivalent, yet the results allow for general comparisons of pricing conduct in a number of economies.

5 An important technical reason for higher price change frequencies in the US data, as compared to the euro area and South Africa, is that the US data include a relatively large proportion of temporary sales prices, compared to other jurisdictions. In the period under study, in South Africa, the statistical authorities initially gave no indication in the data as to whether or not prices were related to temporary sales, but from March 2006 it is recorded for the CPI data whether or not a particular price record constitutes a sales price.

those of Brazil (16 per cent), the US (12,7 per cent) and France (12,5 per cent). The average size of price decreases in South Africa (-12,3 per cent) is similar to the average size of price decreases in Brazil (-12,6 per cent), is larger than for the euro area (-10 per cent), France (-10 per cent) and Spain (-10,3 per cent), but smaller than for the US (-14,1 per cent).

Table B1.1: Comparison of findings of CPI microdata analyses
Per cent

	Frequency of price changes	Frequency of price increases	Frequency of price decreases	Average size of price increases	Average size of price decreases
South Africa (2001–2007)...........	17,1	11,1	6,0	10,7	-12,3
Euro area (1996–2001)...............	15,1	8,3	5,9	8,2	-10,0
United States (1998–2003).........	24,8	16,1	13,2	12,7	-14,1
Spain (1993–2001).....................	15,0	9,0	6,0	8,2	-10,3
France (1994–2003)...................	18,9	9,7	6,5	12,5	-10,0
Brazil (1996–2006)......................	37,0	22,2	19,0	16,0	-12,6
Sierra Leone (1998–2003)...........	51,0	20,1	21,4		

Source: Creamer, et al. (2011)

Creamer et al. (2011, 13) report evidence in the South African data of many small price changes (Fact 4). They find that 10,56 per cent of all price changes in the CPI microdata can be described as inflation-indexed price changes, which they define as having a magnitude of less than, or equal to, 25 per cent of the prevailing CPI inflation rate.

The stylised facts that price changes are not synchronised over the business cycle and that neither frequency nor size is increasing in the age of the price (Facts 5 and 6) may be contradicted by evidence from the South African price microdata. Regression analysis in Creamer (2010) reveals some evidence that the frequency of price increases rises with the prevailing rate of inflation. The finding for the South African microdata is that at the level of specific products in specific stores, hazard functions tend to be upward sloping, indicating an increasing likelihood of price changes as time passes. With regard to the relationship between the magnitude of price changes and the age of the price, the South African microdata reveal that the magnitude of CPI price changes is increasing in the age of the price. This suggests time-dependence in pricing conduct in the South African context, as opposed to state-dependent pricing, where price duration is endogenous to the accumulation of shocks, rather than dependent on the passing of time.

In summary, there is clear confirmation that pricing conduct in South Africa is consistent with the first four stylised facts (1–4) of Klenow and Malin (2009), but there is some evidence from the South African data that appears to contradict stylised facts 5 and 6. The questions raised by stylised facts 7 to 10 have not as yet been addressed in the South African literature. Answers to these questions would undoubtedly contribute further to the understanding of pricing conduct in the South African economy and, armed with such knowledge, further refinements could be made in the areas of macroeconomic modelling and policy implementation.

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Factors affecting inflation

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

International economic developments

The global growth outcome for 2010 reflected the strong recovery in emerging and developing countries, and a less impressive but improved growth performance by the advanced countries. The possibility of a double-dip recession has not materialised, but the global recovery remains unbalanced. Advanced economies are still recovering too slowly, with output below potential and employment remaining weak. Housing markets continue to be depressed and banks are still struggling with non-performing loans. Emerging-market and developing countries have experienced better underlying growth and sounder fiscal positions, but rapid growth and strong capital inflows pose inflation and overheating risks to a number of these countries.

In the advanced economies the recovery has become more self-sustained but growth has remained too low to close output gaps and reduce unemployment much. The International Monetary Fund (IMF) in its April 2011 *World Economic Outlook* (*WEO*) estimates real gross domestic product (GDP) growth in the United States (US) of 2,8 per cent in 2010, compared with a contraction of 2,6 per cent in 2009 (Table 5). The recovery was supported by an easing in financial conditions, strengthening in private demand and an increased contribution from net exports. In Japan, although the recovery lost momentum in the second half of the year, positive economic growth of 3,9 per cent was recorded in 2010 compared to a contraction of 6,3 per cent in 2009. In the euro area economic growth strengthened to 1,7 per cent in 2010 and became increasingly driven by private demand and net exports. Growth in key economies such as Germany was robust compared to the stagnation experienced in the periphery. In the United Kingdom (UK) economic growth of 1,3 per cent was recorded in 2010, compared with a contraction of 4,9 per cent in 2009. Front-loaded fiscal consolidation in the UK has dampened domestic demand and muted the recovery.

Table 5 Annual percentage change in real GDP and consumer prices

	Share of global GDP*	Real GDP		Consumer prices	
	2010	2009	2010	2009	2010
World	**100,00**	**-0,5**	**5,0**	**2,5**	**3,7**
Advanced economies	**52,3**	**-3,4**	**3,0**	**0,1**	**1,6**
United States	19,7	-2,6	2,8	-0,3	1,6
Japan	5,8	-6,3	3,9	-1,4	-0,7
Euro area	14,6	-4,1	1,7	0,3	1,6
United Kingdom	2,9	-4,9	1,3	2,1	3,3
Canada	1,8	-2,5	3,1	0,3	1,8
Other advanced economies	7,5	-1,2	5,7	1,5	2,3
Emerging-market and developing economies	**47,7**	**2,7**	**7,3**	**5,2**	**6,2**
Sub-Saharan Africa	2,4	2,8	5,0	10,5	7,5
Central and eastern Europe	3,4	-3,6	4,2	4,7	5,3
Commonwealth of Independent States	4,2	-6,4	4,6	11,2	7,2
Developing Asia	24,0	7,2	9,5	3,1	6,0
China	13,6	9,2	10,3	-0,7	3,3
India	5,4	6,8	10,4	10,9	13,2
Middle East and North Africa	5,0	1,8	3,8	6,5	6,9
Latin America and the Carribean	8,6	-1,7	6,1	6,0	6,0

* GDP shares based on the IMF's purchasing power parity valuation of country GDPs for 2010

Source: IMF *World Economic Outlook*, April 2011

Average growth in emerging and developing economies rose sharply from 2,7 per cent in 2009 to 7,3 per cent in 2010 as a result of stronger external demand, higher commodity prices and the relatively limited damage suffered from the financial crisis. This broad-based recovery has continued in emerging Asian economies, with the IMF reporting growth of 9,5 per cent in 2010.

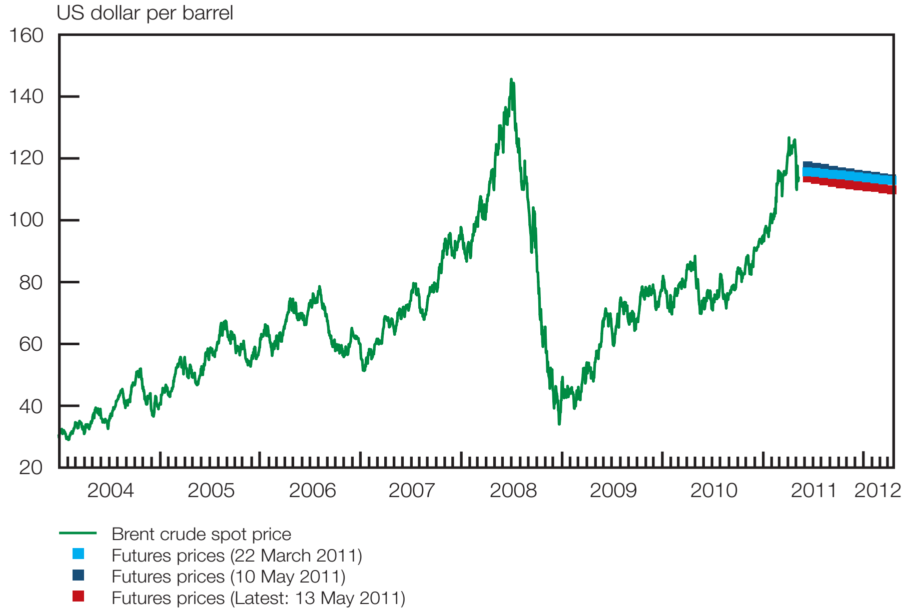
Many emerging and developing economies have also had to cope with the policy challenge of managing high commodity prices. Headline inflation in emerging and developing economies rose from 5,2 per cent in 2009 to 6,2 per cent in 2010, and in a number of the larger economies is close to or above central bank targets. Core inflation also rose significantly over the period, suggesting the inflation pressures are broad and indicative of tightening capacity constraints.

Economies in sub-Saharan Africa resumed faster growth in 2010, recording real growth of 5 per cent compared with 2,8 per cent in 2009. The region's inflation rate slowed notably from 10,5 per cent in 2009 to 7,5 per cent in 2010.

Oil prices

International oil prices have displayed considerable volatility in the period under review (Figure 7). The price of Brent crude oil remained relatively stable within a band of between US$80 and US$89 per barrel in October and November 2010, but rose to US$94 per barrel by the end of December and to US$100 per barrel by the end of January 2011 in response to higher-than-expected demand arising from relatively severe northern hemisphere weather conditions. Oil prices then levelled off slightly in the early part of February after reports that crude oil supplies in the US and production in the Organization of the Petroleum Exporting Countries (OPEC) had increased significantly. OPEC crude oil production in January had averaged 29,6 million barrels per day; the highest level in two years. According to data released by the International Energy Agency (IEA), oil stocks in the advanced countries had also increased sufficiently to cover about 61 days of demand, which was near the highest level in ten years and well above the less than 52 days' cover in early 2008. Oil traders nevertheless started becoming concerned about potential oil supply disruptions because of rising tensions in Egypt and other Middle East countries towards the end of January and the first weeks of February.

Figure 7 Price of Brent crude oil



Source: Bloomberg

After six weeks of region-wide protests ignited by the ouster of Tunisia's president in January and the fall of Egypt's president in February, the turmoil in the Middle East then spread to Libya, a major oil producer, causing the price of Brent crude oil to reach US$112 per barrel in late February 2011; a level not seen since August 2008. Demonstrations and violent protests later also spread to other parts of the MENA region. There was also growing concern that continued unrest in Egypt could halt crude oil shipments through the Suez Canal waterway. Major oil producers, including Saudi Arabia, increased production to make up for lost Libyan oil production. Spare production capacity, which was thought to be around 5 million barrels per day earlier in 2011, has since dropped to about 3 million barrels per day. The Brent crude oil price rose further to above US$126 per barrel at the end of April (its highest level since the onset of the financial crisis), before experiencing a sharp correction in the first week of May, when it dropped by almost US$17 per barrel, as profit-taking triggered a technical sell-off. Since then, prices have rebounded, with the price per barrel standing at US$113,80 on 13 May.

International monetary policy developments

Monetary policies have remained accommodative in most of the advanced economies since the previous *Monetary Policy Review* was published in October 2010 (Table 6). Official interest rates were left unchanged in the US and the UK. The Bank of England (BoE) has held off raising borrowing costs even after inflation had risen to more than twice its target, maintaining that price increases would moderate as government budget cuts restrained the recovery. The BoE's Monetary Policy Committee voted in April and May to maintain the official Bank Rate paid on commercial bank reserves at 0,5 per cent. The committee also voted to maintain the stock of asset purchases financed by the issuance of central bank reserves at £200 billion. Minutes of the BoE's Monetary Policy Committee's May 2011 meeting showed the majority of the committee members favoured keeping the policy rate and asset purchase programme stable due to concerns about protracted weakness in consumer demand and how tightening at this point could negatively affect consumer confidence. The committee was mindful of the potential effect of high inflation on inflation expectations, but felt that this effect was not materialising in the economy as shown by the low growth in wages.

Table 6 Selected central bank interest rates

Per cent

Countries	6 Oct 2010	17 May 2011	Latest decision (Change in percentage points)	
United States	0,00–0,25	0,00–0,25	27 Apr 2011	(0,00)
Japan	0,00–0,10	0,00–0,10	28 Apr 2011	(0,00)
Euro area	1,00	1,25	5 May 2011	(0,00)
United Kingdom	0,50	0,50	5 May 2011	(0,00)
Canada	1,00	1,00	12 Apr 2011	(0,00)
Denmark	1,05	1,30	7 Apr 2011	(0,25)
Sweden	0,75	1,75	20 Apr 2011	(0,25)
Norway	2,00	2,25	12 May 2011	(0,25)
Switzerland	0,00–0,75	0,00–0,75	17 Mar 2011	(0,00)
Australia	4,50	4,75	3 May 2011	(0,00)
New Zealand	3,00	2,50	28 Apr 2011	(0,00)
Israel	2,00	3,00	24 Apr 2011	(0,00)
China	5,31	6,31	5 Apr 2011	(0,25)
Indonesia	6,50	6,75	12 May 2011	(0,00)
Malaysia	2,75	3,00	5 May 2011	(0,25)
South Korea	2,25	3,00	13 May 2011	(0,00)
Taiwan	1,50	1,75	31 Mar 2011	(0,125)
Thailand	1,75	2,75	20 Apr 2011	(0,25)
India	6,00	7,25	3 May 2011	(0,50)
Brazil	10,75	12,00	20 Apr 2011	(0,25)
Chile	2,50	5,00	12 May 2011	(0,50)
Mexico	4,50	4,50	15 Apr 2011	(0,00)
Czech Republic	0,75	0,75	5 May 2011	(0,00)
Hungary	5,25	6,00	16 May 2011	(0,00)
Poland	3,50	4,25	11 May 2011	(0,25)
Russia	7,75	8,25	3 May 2011	(0,25)
Turkey	7,00	6,25	21 Apr 2011	(0,00)
Iceland	6,25	4,25	20 Apr 2011	(0,00)

Source: National central banks

The United States Federal Reserve System (the Fed) announced a renewed commitment to quantitative easing in November 2010 and has continued to state that it expected interest rates to remain low over an extended period. During December the Fed announced that it had authorised an extension of dollar liquidity swap agreements with the central banks of Canada, England, the euro area, Japan and Switzerland to 1 August 2011. This facility was previously scheduled to end in January 2011. At the end of April 2011 the Chairman of the Fed, Ben Bernanke, held the first of four press conferences to be held after selected Federal Open Market Committee (FOMC) meetings in 2011. It was announced during this conference that the FOMC aimed to complete the purchase of longer-term assets by the end of the second quarter of 2011, as announced in November 2010. The FOMC does not expect to conduct a third round of quantitative easing, given the current economic conditions in the US.

Although the ECB continued with its Security Market Programme, it raised its main policy rate by 0,25 percentage points on 7 April 2011 due to concerns about broad-based inflationary pressures. However, the stance of monetary policy in the euro area remains accommodative at 1,25 per cent per annum. On 5 May 2011 the ECB kept interest rates stable at 1,25 per cent and mentioned that the HICP inflation rate was expected to stay above 2 per cent for an extended period due to commodity and energy prices.

Sweden's central bank raised its benchmark repurchase (repo) rate in April 2011 for the sixth time since July 2010. The Riksbank increased its benchmark interest rate in order to stabilise inflation close to the target of 2 per cent as economic activity strengthens and has indicated that it expects the repo rate to increase more rapidly than had been assessed at the end of 2010.

The Bank of Japan (BoJ) doubled its asset-purchase programme to ¥10 000 billion on 14 March 2011 and widened the range of collateral that is accepted to ensure that there was sufficient liquidity in the financial system in the aftermath of the March earthquake and tsunami. On 28 April the BoJ announced that it would offer temporary loans to financial institutions and central organisations of financial co-operatives with branches in the disaster areas totalling no more than ¥1 000 billion to encourage lending to companies with cash-flow shortages in the wake of the earthquake.

Australia's central bank left its benchmark interest rate unchanged, albeit at the highest level among the advanced economies, as floods disrupted coal mining in the nation's northeast and an appreciating currency tempered inflation. The Reserve Bank of Australia held the overnight cash rate target at 4,75 per cent for a fifth consecutive meeting, after having raised rates seven times between October 2009 and November 2010. The Reserve Bank of New Zealand reduced the official cash rate by half a percentage point to 2,5 per cent in March after the earthquake that struck Christchurch on 22 February had killed at least 172 people and impacted negatively on growth.

The Bank of Israel raised its policy interest rate by 50 basis points to 3 per cent in March 2011 as part of a move towards returning the policy rate to more normal levels. Effective 27 January, Bank of Israel Governor, Stanley Fischer, ordered Israeli banks to meet a 10 per cent reserve requirement for foreign-exchange derivative transactions by non-residents. Residents and non-residents are required to report foreign-exchange swaps and forwards of more than US$10 million a day. Non-residents trading beyond certain daily amounts in so-called Makam bills and other short-term government bonds are also required to report their transactions.

In Asia policy rates were raised in March–May 2011 by India, China, Vietnam, Taiwan, the Philippines, South Korea and Thailand. The Reserve Bank of India increased its key repo rate in May 2011 for the ninth time since March 2010, boosting the measure by a half of a percentage point to 7,25 per cent to rein in inflation. The People's Bank of China raised benchmark lending and deposit rates by one-quarter of a percentage point with effect from 6 April and on 12 May announced a 50 basis point increase in the reserve requirements ratio for banks for the fifth time in 2011, in its latest tightening move to limit inflationary pressures. China has implemented a variety of policies to curb inflation, including successive increases in banks' reserve requirement ratios and multiple increases in interest rates since October. The central bank boosted its benchmark one-year lending rate by a quarter point to 6,31 per cent from 6,06 per cent, while the one-year deposit rate will rise to 3,25 per cent from 3 per cent. This was the fourth interest rate increase in less than six months, signalling the government's determination to defuse overheating risks.

The Philippine central bank raised its benchmark interest rate in March 2011, for the first time since August 2008, and again in May, signalling that it was ready to raise policy rates further if required. Thailand's central bank increased interest rates by 25 basis points in March and April 2011, following the Thai MPC's assessment that the economic recovery, both locally and globally, was improving and that there was a need to return to more normal levels of the policy rate, in part to help anchor inflation expectations.

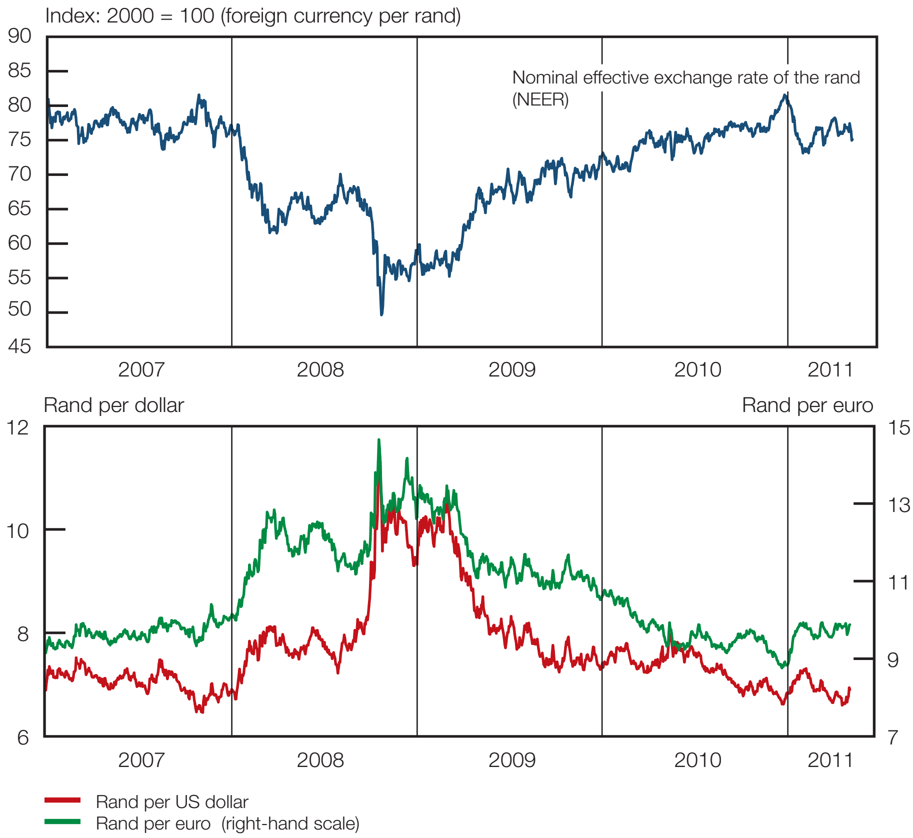
Although Turkey's economy grew by 8,9 per cent in 2010, with year-on-year credit growth surging to 35 per cent, the central bank has kept interest rates at historic lows in an attempt to curb capital inflows. It has in the meantime also almost trebled banks' required reserves ratios to 16 per cent since November 2010 in an effort to slow loan growth and stop the economy from overheating. Turkey's MPC again increased reserve requirements in April 2011 for macroprudential purposes.

The Monetary Policy Committee (Copom) in Brazil has continued to tighten interest rates, most recently raising the target for the Selic rate by 25 basis points in April 2011 to 12,00 per cent due to inflationary pressures and uncertainty stemming from commodity prices. Similar concerns about inflationary pressures have led the Central Bank of Chile to increase rates from 2,5 per cent in October 2010 to 5,0 per cent in May 2011.

Exchange rate developments

The nominal effective exchange rate (NEER) of the South African rand, which measures the value of the rand against a basket of 15 currencies, appreciated to above 81 index points at the end of 2010 despite portfolio capital outflows in the final quarter of the year, before declining to 73 index points in early February 2011 (Figure 8). More recently, it has averaged around 76 index points since March 2011. Measured on a bilateral basis, the rand has fluctuated between R8,76 and R9,93 against the euro since October 2010, and between R6,60 and R7,31 against the US dollar.

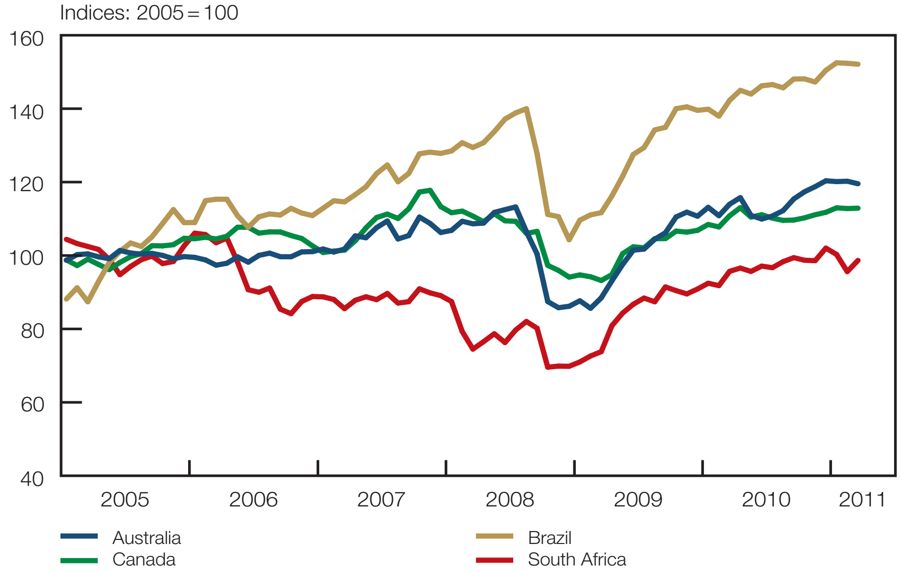
Figure 8 Exchange rates of the rand



During the period October 2010—May 2011 foreign investors disposed of their South African bond holdings as a high degree of uncertainty prevailed in the global financial markets. Cumulative non-resident net sales in the bond market amounted to R11,1 billion by the week ending 13 May 2011, compared with the total 2010 net purchases of R52,0 billion. Concerns of global investors included, among other factors, the potential impact of rising oil and other commodity prices on the inflation outcomes of emerging markets and the likelihood of subsequent monetary tightening by central banks. However, foreign investor net sales of domestically issued bonds were countered by net purchases in the share market. Between October 2010 and May 2011 cumulative non-resident share purchases amounted to R21,5 billion, compared with 2010 net purchases totalling R36,4 billion.

South Africa's real effective exchange rate, measured by the Bank for International Settlements (BIS), appreciated from October 2010, increasing from around 98,7 index points to 102 index points in December 2010, before declining to 98,7 index points in March (Figure 9). Compared on a consistent basis from the beginning of 2009, there has been generalised appreciation among commodity-exporting countries such as Australia, Canada, Brazil and South Africa.

Figure 9 Real effective exchange rates



Source: Bank for International Settlements

Box 2 The rand as a carry trade target

The 'carry trade' refers to currency speculation strategies designed to profit from a favourable interest rate differential, when the high-interest currency does not depreciate substantially relative to the low-interest currency – and the evidence is that in the short term and on average it does not. The simplest way to implement the trade unhedged is to borrow in the low-interest currency (the 'funding currency'), buy the high-interest currency (the 'target currency') in the spot market, deposit the proceeds or buy fixed-income securities denominated in the target currency and, finally, convert the terminal payoff back into the funding currency, facing the exchange rate risk. Alternatively, the speculator can use the low-interest currency to buy the target currency forward when the latter is trading at a discount in the forward market, that is, the forward value of the target currency is lower than its value in the spot market and, conversely, to sell the target currency forward when it is trading at a forward premium. Other variations can be designed and implemented through the derivatives markets.

Currency speculators targeting the rand through the carry trade were exposed to periodic, very large losses between 2007 and 2008. The appeal of the rand as a carry target, as well as that of other emerging-market currencies, was firmly restored from 2009.[6] Current research at the South African Reserve Bank (Hassan and Smith, 2011) shows that the rand is historically and on average an

6 The annualised average return from targeting the rand through Japanese yen-funded speculation, using the forward currency market and trading at the weekly frequency, between January and December 2010, was approximately 32 per cent, with a ratio of mean return to volatility of 1,89. This large return-to-volatility figure is close to the historic average performance of the rand as a (yen-funded) carry trade target over the past decade; and it is evidenced in the data despite the Bank decreasing its policy rate to a 30-year low, as speculators gained from appreciation in the rand, and a relative reduction in short-term volatility.

attractive carry target, despite its high volatility, producing a return-to-volatility ratio substantially above the Australian and New Zealand dollars, which are the two most common carry trade targets. Table B2.1 compares the historic average weekly return and volatility of the three widely traded commodity currencies, used as yen-funded carry trade targets, where the trade is implemented with forward contracts.

Table B2.1 Returns to the carry trade (weekly trading)

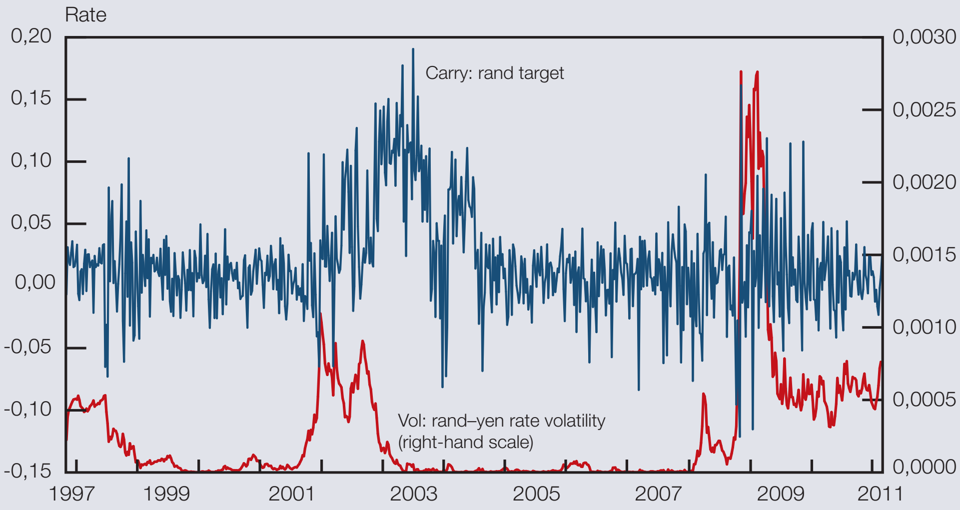
	Before transaction costs			After transaction costs		
Target	Mean (per cent)	SD* (per cent)	SR**	Mean (per cent)	SD* (per cent)	SR**
Australia	0,43	2,45	0,177	0,40	2,44	0,164
New Zealand	0,48	2,51	0,190	0,41	2,51	0,164
South Africa	1,77	4,04	0,437	1,18	3,72	0,316

* SD is the standard deviation of weekly returns
** SR is the return-to-volatility ratio
Sample period: 3 November 1997 – 21 February 2011

Source: Hassan and Smith (2011)

Hassan and Smith (2011) indicate that the most profitable periods to carry trade speculators are accompanied by a gradually appreciating rand and low exchange rate volatility. Conversely, rand-targeting carry traders typically incur the largest losses in periods of very high volatility in the currency market. Lower rand volatility reduces the size of exchange rate losses in unhedged carry positions, and reduces the cost of using options to hedge against the same losses. Figure B2.1 plots the weekly returns from a yen-funded rand-targeting strategy (Carry) against a measure of the conditional volatility of the rand–yen exchange rate (Vol).

Figure B2.1 Rand carry returns and exchange rate volatility



Source: Hassan and Smith (2011)

The carry trade affects foreign exchange market turnover and portfolio debt capital flows. It leads to portfolio flows when funded conventionally through borrowing, and/or when the speculator's counterparty hedges its exposure through the spot market. But the trade can also be implemented through the derivatives market, with no speculator-initiated flows at inception. The relationship between capital flows and rand-targeting carry positions is therefore only partial.

The sudden reversal of rand carry positions, usually built up gradually, can cause abrupt and potentially destabilisingly large depreciations. The rand's allure as a carry target depends on a host of factors, including changes in global risk appetite and volatility; monetary conditions in the eurozone, United States, Switzerland and Japan (the issuers of the main carry funding currencies); the growth and inflation outlooks, domestically and abroad; rand volatility; and the interest differential offered by South Africa.

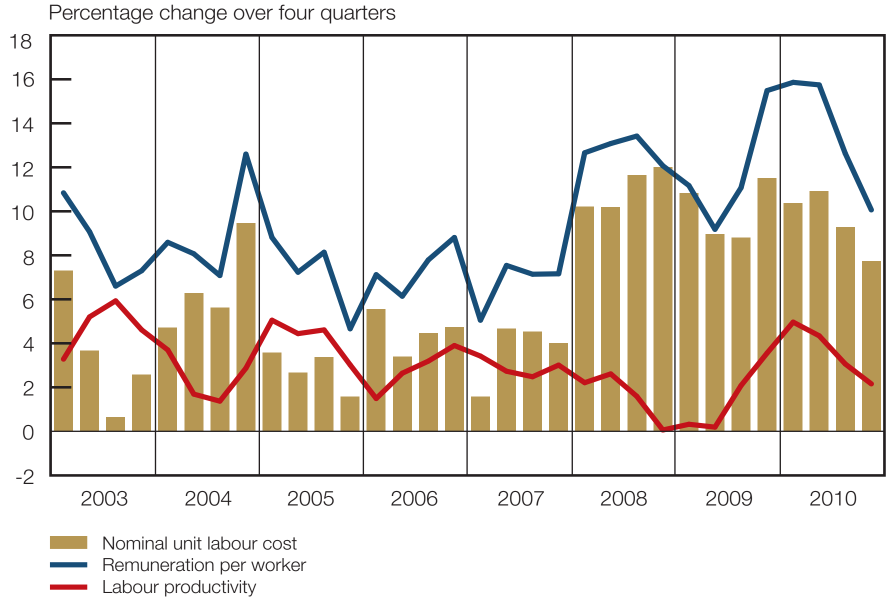
Reference

Hassan, S and S Smith. 2011. "The Rand as a Carry Trade Target". Discussion Paper DP/11/03, April. Pretoria: South African Reserve Bank.

Labour markets

Figure 10 shows that the year-on-year change in nominal unit labour cost declined from 11,5 per cent in the fourth quarter of 2009 to 7,7 per cent in the fourth quarter of 2010. Higher employment levels in successive quarters of 2010 were accompanied by a decline in the rate of increase in measured labour productivity from 5 per cent in the first quarter to 2,2 per cent in the fourth quarter. This was more than offset by the change in remuneration per worker, which declined from 15,9 per cent in the first quarter to 10,1 per cent in the fourth quarter of 2010.

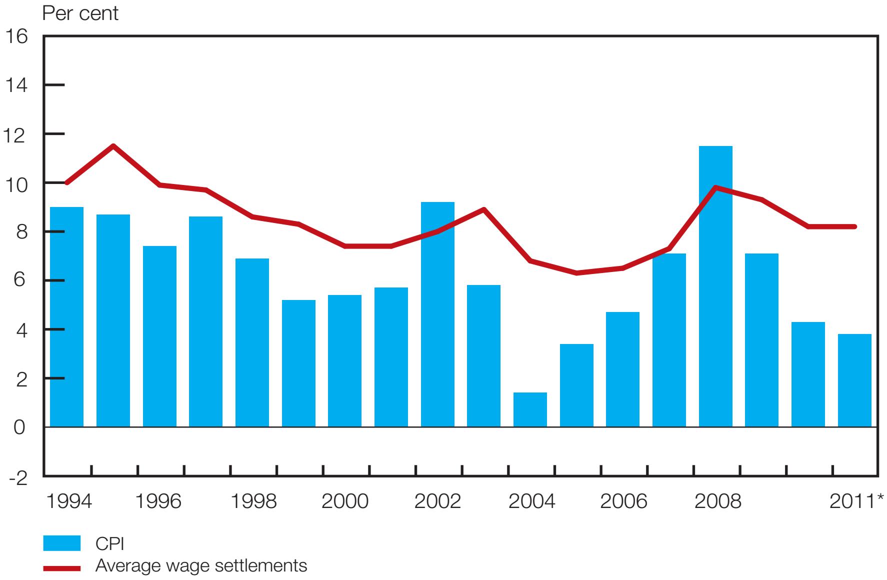
Figure 10 Remuneration per worker, labour productivity and unit labour cost in the formal non-agricultural sector



Sources: Statistics South Africa and South African Reserve Bank calculations

According to the outcome of the *Andrew Levy Wage Settlement Survey*, the average level of wage settlements declined to 8,2 per cent in 2010 from 9,3 per cent in 2009, influenced in part by the decline in the CPI inflation rate in 2010 (Figure 11). The average level of wage settlements in the first quarter of 2011 remained at 8,2 per cent.

Figure 11 Average annual inflation and wage settlements



* Data for 2011 are for the first three months of the year

Sources: Andrew Levy Employment Publications and Statistics South Africa

Table 7 shows the average wage settlements in major sectors in 2010 reported by Andrew Levy Employment Publications. The highest average settlement was 9,3 per cent, reached in the transport and freight sector, and the lowest was 7,3 per cent in the communication sector. Settlements reached at the centralised level tend to act as benchmarks for the sectoral settlements, and these moderated in 2010. In 2010 the settlement for the public sector was 7,5 per cent, below the double-digit increases received by parastatals in the latter part of 2009.

Table 7 Average percentages of wage settlement by major sector in 2010

Sector	Per cent
Transport/Freight	9,3
Finance	9,1
Retail/Catering	9,0
Building/Construction	9,0
Municipal/Utility	8,8
Health/Education	8,4
Metal/Engineering	8,3
Mining	8,3
Food/Manufacturing	7,9
Food/Agriculture	7,8
Chemical	7,7
Paper/Printing	7,7
Communication	7,3

Source: Andrew Levy Employment Publications

Total employment in the formal non-agricultural sector increased marginally from 8,2 million in the fourth quarter of 2009 to 8,3 million in the final quarter of 2010 but was still below the 8,5 million recorded in the corresponding quarter of 2008 (Table 8). In 2010 employment levels increased in mining and quarrying; wholesale and retail trade; electricity, gas and water supply; and finance, insurance, real-estate and business services. Only in the community, social and personal services sector was employment created over both periods. By contrast, sectors such as the manufacturing; construction; transport, storage and communication sectors all shed jobs in each of the periods.

Table 8 Employment in formal non-agricultural industries

Thousands

	Total employment		
	2008	2009	2010
	4th qr	4th qr	4th qr
Mining and quarrying	518	488	503
Manufacturing	1 275	1 185	1 166
Electricity, gas and water supply	59	56	58
Construction	474	415	400
Wholesale trade and retail trade	1 747	1 665	1 683
Transport, storage and communication	366	359	357
Financial intermediation, insurance, real-estate and business services	1 914	1 796	1 822
Community, social and personal services	2 159	2 199	2 267
Total	8 512	8 163	8 256

Source: Statistics South Africa *Quarterly Employment Survey*

Demand and output

Real GDP increased by 4,4 per cent on a quarter-on-quarter annualised basis in the final quarter of 2010, following increases of 2,8 per cent in the second quarter and 2,7 per cent in the third quarter of the year (Table 9). The improved performance in the fourth quarter mainly reflected stronger growth in the real value added by the secondary and tertiary sectors, which was partly offset by slower growth in the real value added by the primary sector. The real value added by the manufacturing sector recovered in the fourth quarter of 2010, with manufacturing output increasing at an annualised rate of 4,1 per cent following a decline of 4,9 per cent in the third quarter of the year. For 2010 as a whole, real GDP grew by 2,8 per cent, following a contraction of 1,7 per cent in 2009.

Table 9 Growth in real GDP and expenditure components

Per cent*

	2009	2010				
	Year	1st qr	2nd qr	3rd qr	4th qr	Year
Final consumption expenditure:						
Households	-2,0	5,5	4,4	5,7	5,1	4,4
General government	4,8	7,1	7,1	-0,6	3,9	4,6
Gross fixed capital formation	-2,2	-2,8	1,2	1,0	1,5	-3,7
Changes in inventories (R billions)**	-34,5	-7,9	-7,6	-0,9	1,1	-3,8
Gross domestic expenditure	**-1,7**	**11,5**	**2,9**	**6,2**	**1,2**	**4,2**
Exports of goods and services	-19,5	-17,0	18,1	14,0	8,2	4,7
Imports of goods and services	-17,4	9,7	15,3	26,3	-4,1	9,6
Gross domestic product	**-1,7**	**4,8**	**2,8**	**2,7**	**4,4**	**2,8**

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

Aggregate real gross domestic expenditure decelerated from 6,2 per cent in the third quarter of 2010 to 1,2 per cent in the fourth quarter, although growth of 4,2 per cent for the 2010 calendar year outstripped the contraction of 1,7 per cent recorded in 2009.

Growth in real final consumption expenditure by households slowed to 5,1 per cent in the fourth quarter of 2010 from 5,7 per cent in the third quarter, following slower increases in expenditure on durable and non-durable goods. By contrast, growth in real final consumption expenditure by general government was 3,9 per cent in the fourth quarter of 2010, following a contraction of 0,6 per cent in the third quarter. This was largely the result of increased spending on compensation of employees, the biggest subcomponent of general government expenditure.

Real gross fixed capital formation grew by 1,0 per cent in the third quarter of 2010 and 1,5 per cent in the fourth quarter. Real capital spending by public corporations increased further over the period, but there were lower capital outlays by private business enterprises and a continuation of the contraction in investment by general government. After having declined for ten consecutive quarters, the aggregate level of real inventory holdings increased by R1,1 billion in the fourth quarter of 2010, mainly from an accumulation of inventories in the mining and construction sectors. As a percentage of annualised non-agricultural GDP, industrial and commercial inventories declined to 11,3 per cent in the fourth quarter of 2010; its lowest quarterly level ever registered.

Real exports of goods and services grew by 14,0 per cent in the third quarter of 2010 and by 8,2 per cent in the fourth quarter, despite a strengthening in the exchange rate of the rand. It was aided by firm international commodity prices and an improvement in the country's terms of trade. By contrast, the volume of imports of goods and services declined by 4,1 per cent in the fourth quarter. The deficit on the current account of the balance of payments narrowed to 0,6 per cent of GDP in the fourth quarter of 2010; the smallest ratio since the third quarter of 2003.

South Africa's gross international reserve position strengthened from US$44,1 billion at the end of September 2010 to US$50,6 billion at the end of April 2011. Over the same period the international liquidity position improved from US$40,1 billion to US$46,0 billion, and the overbought forward position expanded from US$1,1billion to US$3,9 billion.

Real-estate and equity prices

Prices of shares on the JSE Limited (JSE) continued the upward trend established early in 2009. After recording a low for 2010 of 25 793 index points on 5 February, the FTSE/JSE All-Share Index (Alsi) improved to 31 951 index points on 16 May 2011. The Alsi has increased less than the Kuala Lumpur Composite, Bovespa, and Bombay Sensitive indices, but performed better than the Dow Jones Euro Stoxx 50, Standard & Poor's (S&P) 500, Nikkei 225 and Shanghai A share indices (Figure 12).

Figure 12 Share price indices

Sources: JSE Limited and I-Net Bridge

House price inflation has generally trended downwards since the middle of 2010 (Figure 13), reflecting the base effects of the turning point in house price inflation in mid-2009, higher household debt ratios and the absence of further stimulus from interest rate cuts. The year-on-year percentage change in the Standard Bank median house price index slowed from 8,3 per cent in September 2010 to 3,4 per cent in April 2011, while that of the First National Bank (FNB) national average house price index declined from a peak of 10,9 per cent in May 2010 to 2,2 per cent in April 2011. The rate of change in the Absa House Price Index declined from 13,4 per cent in April 2010 to a negative 1,5 per cent in April 2011, and that of the extended repeat sales house price index of Lightstone slowed from a peak of 6,8 per cent in June 2010 to 1,0 per cent in April 2011.[7] According to the FNB home-buying estate agent survey, the time taken for a house to be sold rose to 19 weeks and one day in the first quarter of 2011, up from 15 weeks and 6 days in the previous quarter. Moreover, 85 per cent of sellers dropped their asking price in the first quarter of 2011 compared to 80 per cent in the previous quarter and asking prices declined by 12 per cent compared with 11 per cent in the previous quarter.

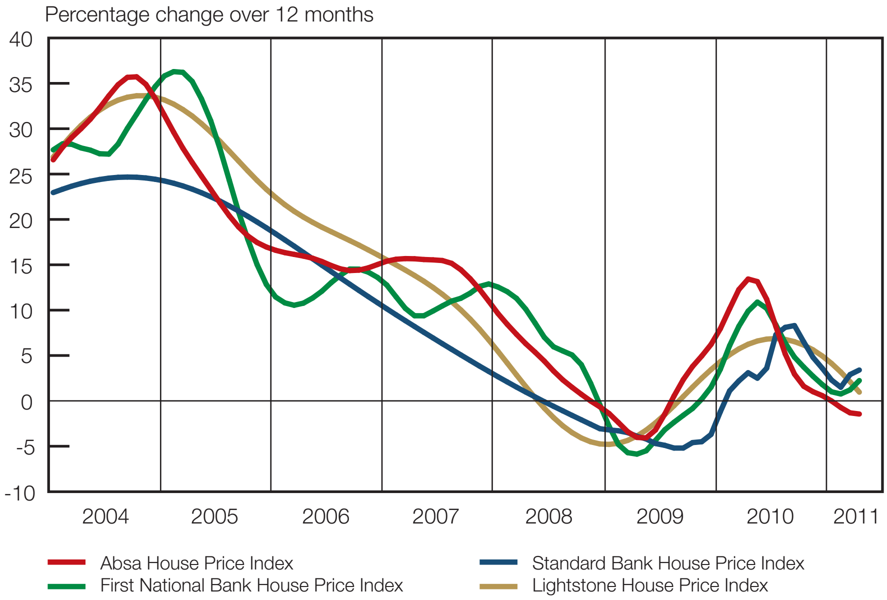
7 The First National Bank (FNB) House Price Index is constructed using the average value of housing transactions financed by FNB. In order to eliminate outliers from the data sample, transaction values must be above 70 per cent of the FNB Valuations Division's valuation of the property but below 130 per cent, while the purchase prices recorded as above R10 million are excluded. A statistical smoothing function is then applied to the data.

The Absa House Price indices are based on the total purchase price of houses in the 80 m^2–400 m^2 size category, priced at R3,5 million or less in 2011 (including improvements) in respect of which the mortgage loan applications were approved by Absa. Prices are smoothed in an attempt to exclude the distorting effect of seasonal factors and outliers in the data.

Standard Bank's House Price Index is based on the median house price of the full spectrum of houses where mortgage finance was provided by Standard Bank.

The Lightstone Repeat Sales House Price Index provides a measure of the actual price inflation of houses that have been transacted twice within a particular period of time, in order to reduce the influence of the mix of properties transacting during the period. Data are obtained from the Deeds Office, the Surveyor General and other sources.

Figure 13 House prices



Sources: Absa, Standard Bank, First National Bank and Lightstone

Table 10 shows the real value of building plans passed and buildings completed in larger municipalities as published by Statistics South Africa. So far in 2011, the total real values of buildings completed and the residential and non-residential subcomponents of buildings completed have contracted at a slower pace than in the preceding year. The real value of the non-residential component of building plans passed has improved in 2011 when compared with the corresponding period in 2010.

Table 10 Real value of building plans passed and buildings completed in larger municipalities

Annual percentage change

	2008	2009	2010	2011*
Building plans passed				
Total	-17,2	-23,2	-8,1	1,5
Residential	-26,1	-37,8	1,2	3,1
Non-residential	0,6	-11,0	-36,0	5,8
Additions and alterations	-12,0	-8,2	5,2	-3,3
Buildings completed				
Total	-0,4	-13,0	-23,7	-4,0
Residential	-9,5	-26,2	-22,1	-3,7
Non-residential	13,6	3,4	-34,1	-22,6
Additions and alterations	14,9	3,5	-13,2	14,8

* Data for 2011 are for the first three months of 2011 compared with the same period of the previous year

Source: Statistics South Africa

Fiscal policy

The 2011 National Budget was tabled before Parliament by the Minister of Finance on 23 February. Government indicated that job creation would be a key focus area over the medium term and allocated funds required for the implementation of the New Growth Path Strategy for economic development. The fiscal stance remains countercyclical while being mindful of the need to pursue fiscal consolidation and debt sustainability within a long-term framework. Government spending is projected to rise over the forecast period at a slightly lower rate than in recent years and as economic growth strengthens and tax revenue recovers, the deficit is expected to narrow to a level of 3,8 per cent of estimated GDP by the fiscal year 2013/14 (Table 11). This represents a slightly slower pace of deficit narrowing and a somewhat higher government debt trajectory than earlier official projections. However, the Budget also indicates that the economy is recovering at a faster-than-expected pace. Personal income tax collections climbed 11 per cent to R228 billion in the 2010/11 fiscal year while value-added taxes surged 24 per cent to R184 billion and customs duties rose 36 per cent to R27 billion. Company tax collections have been much slower to recover following the 2009 recession, and dropped 0,5 per cent to R152 billion. Government expects revenue growth to pick up as economic growth accelerates and forecasts that the South African economy will expand by 3,4 per cent in 2011.

Table 11 Public finance data

	2009/10	2010/11		2011/12	2012/13	2013/14
	Outcome	Budget	Revised estimates	Medium-term estimates		
Consolidated government* (R billions)						
Revenue	664,8	738,4	755,0	824,5	908,7	1 017,2
Expenditure	825,9	907,0	897,4	979,3	1 061,6	1 151,8
Budget balance	-161,1	-168,6	-142,4	-154,8	-152,9	-134,6
As a percentage of GDP						
Budget balance	-6,6	-6,2	-5,3	-5,3	-4,8	-3,8
Total net loan debt	27,6	33,2	30,8	34,3	37,5	39,3
PSBR**	8,9	11,1	10,5	9,5	8,1	6,3

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

Source: National Treasury *Budget Review 2011*

The revised consolidated budget balance for 2010/11 is a deficit of R142,4 billion. Government collected more tax revenue than expected in the 2010/11 fiscal year, while consolidated government capital expenditure continued to underperform budgeted amounts, resulting in an expected budget deficit of 5,3 per cent of GDP. Consolidated government revenue was expected to amount to R755,0 billion in 2010/11, significantly higher than the estimate of R738,4 billion made in February 2010. Consolidated government expenditure in 2010/11 was slightly lower than was projected in February 2010, falling marginally from R907,0 billion to R897,4 billion.

Government plans to narrow the deficit more slowly than originally planned over the next three years because of subdued growth in revenue and as it intends maintaining significant spending on roads, schools and hospitals. The deficit is projected to be 5,3 per cent of GDP in the fiscal year through March 2012, 4,8 per cent in fiscal 2012/13 and 3,8 per cent in the year thereafter.

The estimated public-sector borrowing requirement (PSBR), reflecting the higher financing requirements of government and the non-financial public enterprises, is expected to have widened to 10,5 per cent of GDP in 2010/11 but is projected to decline to 9,5 per cent of GDP in 2011/12, to 8,1 per cent of GDP in 2012/13 and to 6,3 per cent of GDP in 2013/14. Net loan debt as a share of GDP in 2010/11 has been revised to 30,8 per cent and is projected to increase to 39,3 per cent of GDP by 2013/14.

Monetary conditions

On a year-on-year basis the narrow M1 monetary aggregate grew at a faster pace from early 2009, while the wider M2 and M3 aggregates took longer to recover due to a strong preference among investors to hold their deposits at the short end of the maturity spectrum (Figure 14). Growth in broad money (M3) declined from 6,9 per cent in December 2010 to 6,5 per cent in

March 2011. The growth rate of M2 has been uneven and amounted to 4,6 per cent in March 2011. The growth rate of M1 has continued to rise since December 2010, increasing modestly from 6,9 per cent in December 2010 to 8,3 per cent in March 2011.

Figure 14 Growth in monetary aggregates

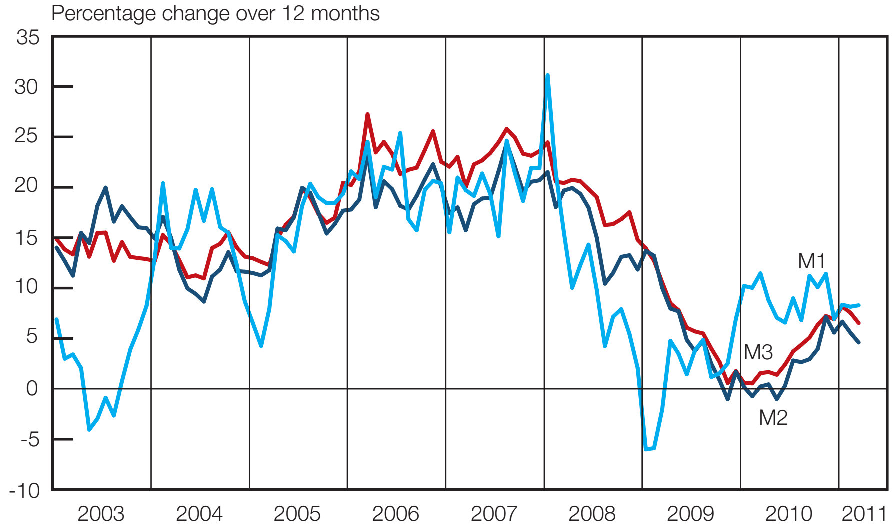
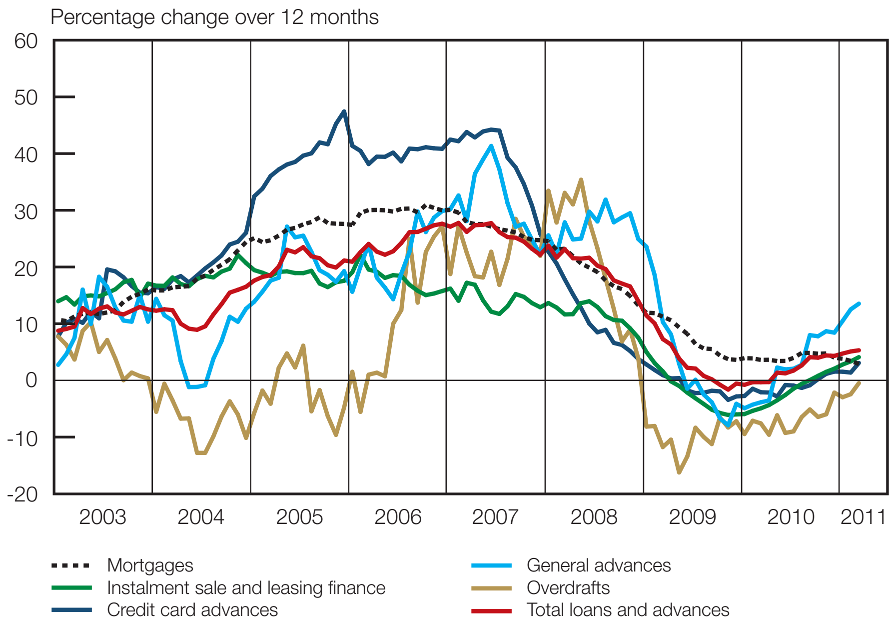


Figure 15 shows that as 2010 progressed total loans and advances to the private sector recovered from negative growth rates, driven by the rebound in the growth rates in instalment sale and leasing finance, and other loans and advances (in particular, general advances and credit card advances). Overdrafts have rebounded from the low levels recorded in 2009, although growth remains in negative territory. Growth in mortgage advances has fluctuated around 4 per cent. On a sectoral basis, the rebound in total loans and advances was underpinned by the household sector.

Figure 15 Banks' loans and advances by type

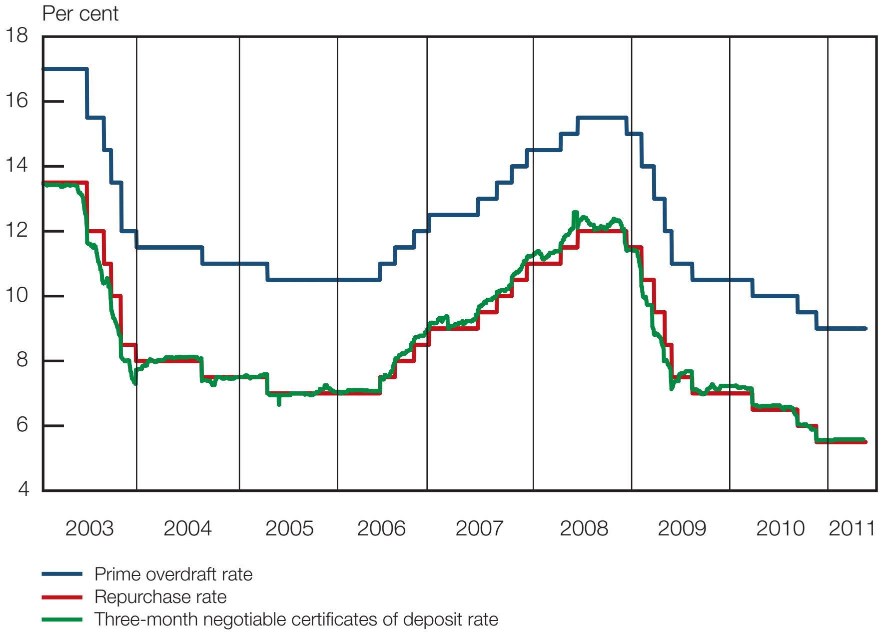


Monetary policy

The monetary policy environment has changed somewhat since the publication of the previous *Monetary Policy Review* in October 2010. At that stage, inflation was still on its downward trajectory and the domestic economic recovery appeared to be fragile. The exchange rate of the rand was also appreciating despite portfolio capital outflows in the final quarter of 2010.

Given this scenario, the MPC reduced the repo rate by a further 50 basis points to 5,5 per cent in November (Figure 16). This kept nominal and real policy rates at their lowest levels in over 30 years, and should be seen in the context of the weak economic conditions and low real interest rates in advanced economies. However, in the following months, the inflation outlook deteriorated significantly and although the monetary policy stance was left unchanged, the risks to the outlook moved to the upside.

Figure 16 The repurchase rate and other short-term interest rates



At the time of the MPC's November meeting, the latest CPI inflation reading (for September) had declined to 3,2 per cent, which turned out to be the low point of the current inflation cycle. At that stage, the Bank's forecast was adjusted down further, and the expectation was that inflation would average 4,3 per cent in 2011 and 4,8 per cent in 2012. Inflation expectations had also declined further, although they were, on average, still outside the target range. The global recovery was regarded as fragile and the further quantitative easing in the US was expected to sustain or increase capital flows to emerging markets, including South Africa. These developments were expected to underpin the strength of the rand exchange rate with a favourable impact on the inflation outcomes.

At the same time, the domestic economic outlook remained subdued: growth in gross fixed capital formation was minimal and the weak performance of the manufacturing sector was a source of concern. Overall business confidence remained low, although it had improved somewhat. Consumer confidence, however, was relatively high, and there were indications that consumption expenditure was recovering, and would be supported by positive wealth effects from higher asset prices and lower interest rates, but constrained by high unemployment and high household debt levels. Credit extension remained relatively subdued, but there were tentative signs of recovery.

At that time, the main risks to the inflation outlook were from cost–push factors, mainly administered prices and wage trends, which were, however, showing some tentative signs of moderation. Food and petrol prices were not viewed as immediate problems, but were identified as potential longer-term risks. Although international oil prices had risen to above US$80 per barrel, there was an expectation that the fragile state of the global economy would constrain further price increases. The domestic bumper maize crop and the strong exchange rate were expected to moderate pressures on domestic food prices.

Against this backdrop, the MPC expected the risks to the outlook to remain fairly evenly balanced. Given the fragile nature of the domestic recovery, the MPC decided that there was room for further stimulus, which would be consistent with the continued attainment of the inflation target.

The MPC noted, however, that the scope for further downward movement was limited, given the signs of recovery in household consumption expenditure and credit extension. The MPC also emphasised the limited nature of the impact of such actions on output: while monetary policy could impact on cyclical deviations of output from potential output, it could not determine the long-run growth path of the economy.

At the following three MPC meetings (in January, March and May 2011) a progressive deterioration in the inflation outlook was evident, mainly as a result of continued price pressures coming from international oil and food prices. By the time of the January meeting, inflation was already on an upward path, when the most recent measure (for December 2010) was 3,5 per cent. By the May meeting it had increased to 4,1 per cent (for March). Of greater significance was the sustained deterioration of the inflation forecast. In January the inflation forecast for 2011 was 4,6 per cent and for 2012, 5,3 per cent. By March the forecast was revised upwards to 4,7 per cent for 2011 and 5,7 per cent for 2012, still within the target range for the entire forecast period.

In May there was a further upward revision of the forecast, which was now expected to reach the upper end of the target in the fourth quarter of 2011 and to breach the upper end of the target range in the first quarter of 2012, when it was expected to average 6,3 per cent. Inflation was then expected to return to within the target range and to remain close to the upper end until the end of 2012. Inflation was expected to average 5,1 per cent in 2011 and 6,0 per cent in 2012. At both the March and the May meetings the risks to the outlook were also assessed to be on the upside.

The forecasts of private-sector analysts were also revised upwards over this period, and the consensus forecasts of analysts in the Reuters survey were similar to those of the Bank. The results of the survey conducted by the Bureau for Economic Research (BER) at Stellenbosch University continued to reflect a moderation in inflation expectations, particularly among business and trade union respondents. In the first quarter of 2011 the expectations of all categories of respondents for 2011 and 2012 had declined to within the target range.

In each instance, the upward revision of the Bank's expected inflation path was mainly as a result of changes in the assumptions regarding administered prices, particularly oil prices. As discussed earlier in this review, the international oil price has been impacted by shocks on both the supply and demand side, and has been relatively volatile on an upward trend. Over this period, there was a progressive upward revision of the oil price assumption which, in turn, raised the inflation forecast. In formulating its assumptions about international oil prices, the MPC relies on internal Bank analysis of the oil market, but also looks at other indicators such as oil futures prices, and the forecasts of a number of international agencies and analysts. Nevertheless, the volatile nature of this market meant that during the past few months, most forecasts have generally underestimated the actual outcomes.

The MPC consistently viewed the risks to the inflation outlook to have emanated mainly from cost–push factors. Apart from the oil price, these factors included food prices and wage costs. Food prices had been increasing significantly in international markets for some time, but it took a while for these developments to start impacting on domestic prices. In May the MPC noted that there were signs that food prices may have peaked in international markets. Nevertheless, there was an expectation that domestic food prices were likely to increase further in the short to medium term.

Wage cost developments have been identified as a persistent risk to the inflation outlook. For some time, nominal wage increases have been significantly above inflation and productivity increases. However, in March the MPC noted that there was evidence that the risk to inflation from wage increases was moderating. This was a result of the observed decline in nominal wage and unit labour cost growth. The MPC also expressed its concern that high nominal wage increases would also constrain employment growth in the economy.

While there were definite and rising pressures on inflation coming from the cost–push side, the MPC assessed the pressures coming from the demand side as being benign. Growth in GDP was regarded as still being below potential, with a persistent negative output gap. The MPC viewed the growth recovery to be sustained but fragile, and insufficient to make a significant impact on the unemployment rate, which decreased marginally to 25,0 per cent between the first quarter of 2010 and the first quarter of 2011. In January the Bank's forecast of GDP growth was 3,4 per cent for 2011 and 3,6 per cent for 2012. This forecast was revised marginally upwards in subsequent meetings, and in May the respective forecasts were 3,6 per cent and 3,9 per cent.

The fragile nature of the recovery was, in part, a result of the low growth in gross fixed capital formation, having increased by 1,0 per cent in the third quarter of 2010 and by 1,5 per cent in the subsequent quarter. The manufacturing sector showed some improvement over the period, but the sector continued to be characterised by underutilised capacity and output levels well below those achieved prior to the financial crisis. The MPC also expressed concern about the continued weak state of the construction sector. However, the composite leading business cycle indicator of the Bank suggested that the recovery was expected to be sustained, and business confidence surveys suggested that sentiment was improving.

The main impetus to growth in 2010 came from consumption expenditure. The MPC highlighted the recovery in household consumption expenditure in particular, which grew at an annualised rate of 5,1 per cent in the final quarter of 2010, and by 4,4 per cent for the year as a whole. At the May 2011 meeting, however, the MPC noted that growth in retail sales and in new vehicle sales was showing signs of moderation. During the review period, the committee's view was that while the growth in household consumption expenditure was likely to be sustained, it was unlikely to accelerate to excessive levels. The MPC pointed to a number of factors that were likely to constrain consumption growth going forward despite relatively high real wage settlements and low levels of interest rates. These constraining factors included continued high levels of unemployment and high levels of consumer debt.

The ratio of household debt to disposable income declined only marginally to 77,6 per cent in the fourth quarter of 2010, and there had been a persistent increase in the number of consumers with impaired credit records since the implementation of the National Credit Act. In May the committee also expressed concern about the fact that commercial banks' ratio of impaired advances to gross loans and advances had remained more or less unchanged at around 5,8 per cent for some time. This high level of impairments was mainly attributable to retail loans.

These developments were reflected in banks' credit extension to the private sector, which continued to grow at very subdued rates. While this slow growth was seen to reflect both supply and demand weakness, in the May 2011 statement the committee suggested that there were some tentative signs that banks may have relaxed their lending criteria somewhat. Over the period there was a moderation in the growth in mortgage advances from a recent high of 4,8 per cent in November 2010 to 2,9 per cent in March 2011, consistent with the weak state of the housing market. The resulting negative wealth effects from the real-estate market were viewed as a further constraint on consumption expenditure growth.

The hesitant nature of the domestic recovery was also regarded as being a function of continued uncertainties in the global economy. During the period under review, the MPC noted the uneven global recovery, but in the most recent statement it observed that the recovery had become more hesitant in recent weeks in the wake of renewed concerns about peripheral Europe, the aftermath of the disaster in Japan and higher commodity prices. Global developments are not only important because of their impact on commodity prices, but also because of their possible impact on domestic growth and the exchange rate through demands for South African exports and the impact on capital flows. Although the rand was volatile during the period, having fluctuated against the US dollar in a range of R6,55 and R7,33, the MPC's view throughout this period was that the rand was unlikely to pose a significant upside risk to the inflation outlook. Interest rates in advanced economies, particularly the US, the euro area and Japan, are expected to remain low for an extended period. In the absence of significant global financial market risk aversion the rand exchange rate was, therefore, expected to remain relatively strong, despite the Bank's continued purchases of foreign exchange.

Against the backdrop of rising inflation, the repo rate has remained unchanged since November 2010. However, as outlined above, the MPC's view was that the observed pressures and risks to the inflation outlook emanated from supply-side shocks rather than from excess demand pressures. The MPC accepts that there is little it can do to prevent these price increases from impacting on headline inflation. The challenge facing policy-makers is that it is difficult to determine whether these shocks are of a temporary or permanent nature. The appropriate response under such circumstances is to remain vigilant to the emergence of possible generalised price increases, or so-called second-round effects. The MPC cannot ignore these upside risks and pressures because they have the potential to impact negatively on inflationary expectations and, in so doing, affect general wage and price-setting behaviour. At the end of its most recent meeting, the MPC warned that it would not hesitate to respond to signs that threatened to move inflation out of the target on a sustained basis.

The outlook for inflation

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

International outlook

The global economic recovery has been gaining strength since the previous *Monetary Policy Review* was published in October 2010. Although broader prospects for the global growth outlook in 2011 and 2012 have continued to improve, the outlook for global growth is clouded by a number of developments that have occurred during this period. In Japan, a severe earthquake (Japan's strongest on record) and tsunami have devastated parts of northeastern Japan and crippled one of the country's major nuclear power plants, thereby threatening many global manufacturers' supply chains. Queensland in Australia suffered an enormous flood and an earlier powerful earthquake had crippled large parts of Christchurch in New Zealand. Political turmoil in the MENA region has resulted in higher world oil prices that, together with a broader upturn in most commodity prices, have contributed to surging inflationary pressures that present new policy challenges.

These developments will undoubtedly slow the pace of the global economic recovery somewhat during the first half of 2011 and have also increased somewhat the downside risks to growth in the medium term. In its April 2011 *WEO*, the IMF's forecasts are therefore slightly lower than earlier forecasts for certain developed countries but, on balance, it projects that global output will expand by a robust 4,4 per cent in 2011 and 4,5 per cent in 2012 (Table 12). The IMF deems risks to its growth projections to be mainly to the downside given disruptions brought about by the natural disasters in some of the advanced countries and continued concerns about sovereign debt in the euro area (Box 3 discusses sovereign debt developments in the peripheral euro area).

Table 12 IMF projections of world growth and inflation for 2011 and 2012*

Per cent

	Real GDP			Consumer prices		
	2011		2012	2011		2012
World	(4,2)	4,4	4,5	(3,1)	4,5	3,4
Advanced economies	(2,2)	2,4	2,6	(1,3)	2,2	1,7
United States	(2,3)	2,8	2,9	(1,0)	2,2	1,6
Japan	(1,5)	1,4	2,1	(-0,3)	0,2	0,2
Euro area	(1,5)	1,6	1,8	(1,5)	2,3	1,7
United Kingdom	(2,0)	1,7	2,3	(2,5)	4,2	2,0
Canada	(2,7)	2,8	2,6	(2,0)	2,2	1,9
Other advanced economies	(3,7)	3,9	3,8	(2,5)	3,1	2,6
Emerging-market and developing economies	**(6,4)**	**6,5**	**6,5**	**(5,2)**	**6,9**	**5,3**
Sub-Saharan Africa	(5,5)	5,5	5,9	(7,0)	7,8	7,3
Central and eastern Europe	(3,1)	3,7	4,0	(4,1)	5,1	4,2
Commonwealth of Independent States	(4,6)	5,0	4,7	(7,9)	9,6	8,1
Developing Asia	(8,4)	8,4	8,4	(4,2)	6,0	4,2
China	(9,6)	9,6	9,5	(2,7)	5,0	2,5
India	(8,4)	8,2	7,8	(6,7)	7,5	6,9
Middle East and North Africa	(5,1)	4,1	4,2	(6,2)	10,0	7,3
Latin America and the Carribean	(4,0)	4,7	4,2	(5,8)	6,7	6,0

* IMF projections for 2011 as at October 2010 in parenthesis

Source: IMF *World Economic Outlook*, April 2011

Real GDP in advanced economies is projected to expand by 2,4 per cent in 2011 and 2,6 per cent in 2012, and although financial conditions continue to improve, they remain fragile. The recovery in the US economy began gaining momentum in the fourth quarter of 2010 and high-frequency economic indicators show more consistent improvement in the early months of 2011. The IMF projects GDP growth in the US to increase slightly from 2,8 per cent in 2011 to 2,9 per cent in 2012 but with risks to the outlook remaining elevated. In April 2011 S&P announced that it was altering its outlook on the long-term rating for the US from stable to negative. This was due to the large budget deficits and increasing government debt in the US, relative to other AAA-rated countries. S&P also emphasised that it was its view that the lack of a clear US government plan for addressing these two issues, and the risk that such a plan may not be formulated and implemented by 2013, would put the US in a weaker fiscal position than other AAA-rated countries.

The recovery in Japan has been hampered by the recent tragic earthquake and it is very difficult to determine the full economic impact at this stage. The devastating earthquake on 11 March 2011 has tilted the balance of risks to growth in the country firmly to the downside in the short run and there are concerns about spillovers through Japan's role in the global supply chain. The Organisation for Economic Co-operation and Development (OECD) estimated in April that Japan's GDP growth may be reduced by as much as 0,6 percentage points in the first quarter of 2011 and up to 1,4 percentage points in the second in the aftermath of the quake. The IMF estimates damage from the earthquake and tsunami to amount to between 3 per cent and 5 per cent of the country's GDP but that the global macroeconomic impact would be limited. Data reflecting the state of the economy since the earthquake point to a significant impact on production as manufacturing shrank at the fastest pace in nine years, according to the purchasing managers' index. The IMF projects GDP growth in Japan to increase from 1,4 per cent in 2011 to 2,1 per cent in 2012.

In the euro area the underlying momentum of economic activity continues to be positive but uncertainty regarding the growth outlook remains elevated. Following the 1,2 per cent increase in euro area real GDP in the fourth quarter of 2010, recent statistical releases and high-frequency indicators point towards a continued positive underlying momentum of economic activity in early 2011. Euro area exports are expected to be supported by the ongoing recovery in the world economy and, given an accommodative monetary policy stance and the relatively high level of business confidence, private-sector domestic demand is projected to contribute increasingly to economic growth. However, balance-sheet adjustment in various sectors is expected to dampen the recovery somewhat and downside risks to the growth outlook therefore continue to prevail. More specifically, threats to financial stability and growth are derived from continued strains in the most vulnerable euro area sovereigns and banks. The IMF projects that the euro area's GDP will grow by 1,6 per cent in 2011 and by 1,8 per cent in 2012. Risks to the medium-term outlook for price developments also remain elevated and on the upside, and relate to possible higher-than-assumed increases in energy prices. Risks also relate to the possibility of stronger-than-expected domestic price pressures in the context of a stronger-than-expected recovery in activity.

UK output growth was weaker than expected in the final quarter of 2010 but rebalancing of the economy is underway and demand has begun to shift from consumption to exports. Domestic consumption is being restrained by the effects of both fiscal consolidation and slow real income growth, while exports are beginning to show the effects of a more competitive exchange rate and improved growth in world demand. Following the 2,3 per cent decrease in UK real GDP in the fourth quarter of 2010, recent statistical releases and high-frequency indicators provide evidence of a significant margin of spare capacity in the economy but point towards a sustained improvement in the underlying momentum of economic activity. The IMF projects that GDP growth in the UK would increase to 1,7 per cent in 2011 and to 2,3 per cent in 2012. The Office for Budget Responsibility, formed by the UK government in May 2010 to make an independent assessment of public finances and the economy, in March cut its forecast for 2011 economic growth to 1,7 per cent from 2,1 per cent.

Growth in emerging-market and developing countries is projected to amount to 6,5 per cent in both 2011 and 2012. The IMF revised its 2011 and 2012 economic growth forecasts slightly for some emerging and developing countries, and now expects developing Asia to grow by 8,4 per cent in both 2011 and 2012. Rising food and oil prices, and Japan's earthquake disaster present a risk to sustained growth but the impact of the latter on the broader Asian region is expected to be temporary and limited.

Growth in Brazil, Russia, India, China and South Africa (the BRICS countries) is projected to outpace growth in the developed world. The IMF expects China's economy to expand by 9,6 per cent in 2011 and by 9,5 per cent in 2012, but the People's Bank of China has been increasing interest rates and raising bank capital requirements to keep inflation in check, which may serve to slow down China's economy somewhat. India's projected growth was lowered slightly to 8,2 per cent in 2011 and 7,8 per cent in 2012. Russia's growth forecast was boosted to 4,8 per cent in 2011 and 4,5 per cent in 2012, while Brazil's projected growth remained unchanged at 4,5 per cent in 2011 and 4,1 per cent in 2012. The IMF revised its MENA region growth forecasts for 2011 and 2012 downwards by almost 1 percentage point due to widespread political tensions in the region. A noticeable impact on GDP in the MENA region is likely to be felt over the next several months, and the IMF now expects the region's economy to expand by 4,1 per cent in 2011 and by 4,2 per cent in 2012. Faster and more sustainable growth has resumed in sub-Saharan Africa and the IMF projects growth of 5,5 per cent in 2011 and 5,9 per cent in 2012.

Commodity prices have increased more than had been expected following a number of supply shocks and strong economic growth in emerging markets, although currency appreciation in emerging and developing countries has helped fend off inflation pressures by keeping the local currency price of these goods down. The IMF projects that consumer-price growth in emerging and developing countries will increase to 6,9 per cent in 2011, before slowing somewhat to 5,3 per cent in 2012. The IMF cautions that boom-like conditions in some emerging and developing countries could develop into overheating as inflation pressure could build up significantly once production begins to face capacity constraints, and large food and energy price increases unleash demands for higher wages. Macroeconomic prospects for commodity prices are expected to remain supportive as growth projections suggest that emerging-market economies will continue leading the expansion.

Box 3 Sovereign debt in the peripheral euro area

Introduction

Various political groupings in the euro area have been calling for an end to the sovereign bailouts provided to peripheral euro area countries and for more rapid debt restructuring to be pursued. The main concern is that Greece, Ireland and Portugal in particular are facing crises of solvency rather than liquidity, and that the only way these countries can solve their current cash-flow problems is by writing off some of their debt. The groups suggest that the sooner these countries' fiscal positions are put on a sustainable footing, the sooner households and companies can start spending and investing again, thereby enabling sustainable economic growth. There is also concern that the longer this decision is delayed, the more the peripheral country debt burden is shifted onto wider eurozone taxpayers, either directly via bailout packages or indirectly via liquidity programmes.

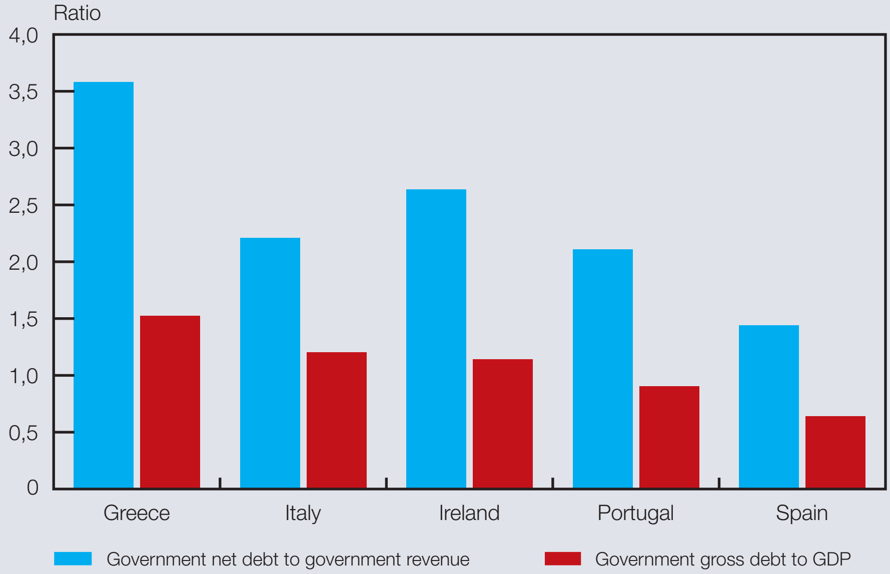
In recent months policy-makers in the euro area have taken further steps to strengthen crisis management, policies and governance. The effective lending capacity of the European Financial Stability Facility (EFSF) has been increased to €440 billion and the European Stability Mechanism (ESM) to €500 billion. This has been accomplished through a range of funding mechanisms that include IMF pricing principles for ESM loans. Despite these developments and an improved euro area economic outlook, sovereign credit rating downgrades have been issued for Greece, Ireland and Portugal in recent weeks and market concerns have continued focusing on political developments that could get in the way of a smooth resolution of the euro area's sovereign debt difficulties. Bank lending conditions in the periphery economies have at the same time remained tight amid tighter supervision and regulation and capital rebuilding. Many banks that hold periphery sovereign debt are still rebuilding their balance sheets and are facing significant challenges in implementing new capital requirements.

Key fiscal ratios in the peripheral euro area

The euro periphery sovereign crisis countries' incurred budget deficits of between 8 and 12 per cent of gross domestic product (GDP) in 2010 compared with the euro area average of about 6,5 per cent. Their gross public debt to GDP is projected to reach between 64 and 152 per cent of GDP in 2011 and only Spain and Portugal will be below 100 per cent. One of the most relevant measures to determine the sustainability of state leverage is the net sovereign debt to government revenue ratio. For some of the countries of peripheral Europe this specific measure has been raising concerns in markets. The ratio for these countries (Figure B3.1) implies that taxes will have to rise significantly and therefore that the higher taxes could constrain the economic growth that is being assumed will raise tax revenue sufficiently in the years ahead to service sovereign debt.

The process of normalising fiscal policy in the post-financial crisis period has been difficult for most euro peripheral countries as they have crossed the 90 per cent debt-to-income threshold which, according to Reinhart and Rogoff 2010, historically begins to be associated with lower growth on average (see Box 1: "Risks for the global growth outlook on the road to fiscal consolidation in advanced countries" in the October 2010 *Monetary Policy Review*). Substantial interest expenditure makes public finances more vulnerable to rising interest rates and in effect ensures further borrowing or fiscal tightening. Although a record-low interest rate environment has kept the carrying cost of debt relatively modest thus far, markets have expressed concern that a higher interest rate environment for an extended period would place an overly severe strain on national budgets of the euro peripheral countries.

Figure B3.1 Gross government debt to GDP and net government debt to government revenues, 2011



Source: IMF *World Economic Outlook*, April 2011 database

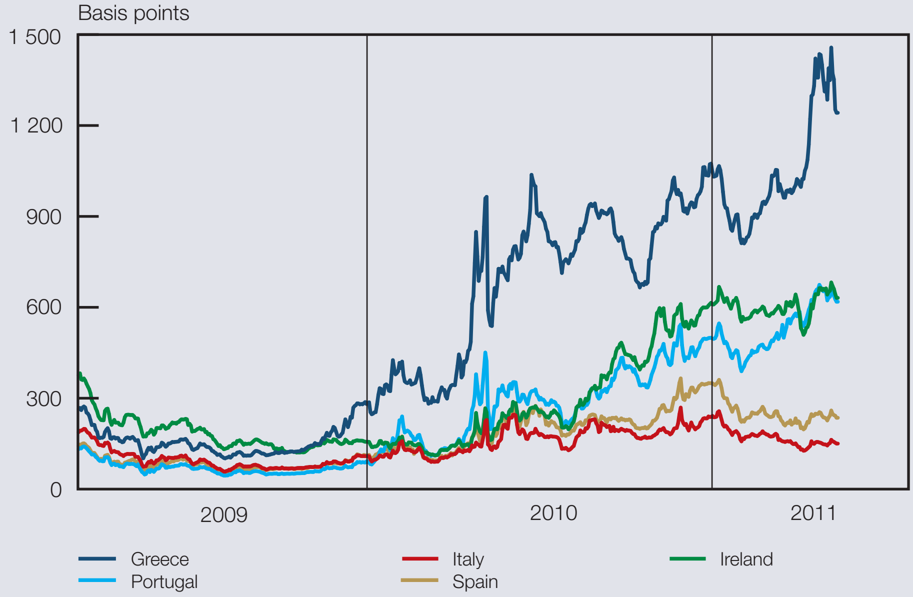
Figure B3.2 shows that sovereign peripheral and bank credit-default swap (CDS) spreads remained wide in early 2011 and in some cases widened further in recent weeks, thereby signalling a 64,5 per cent chance of default in the case of Greece within five years. Market expectations regarding debt restructuring in the euro periphery drove yield spreads of Greek government bonds over German Bunds to record highs. The cost of protecting against a default for five years on Greek government debt also increased sharply after media speculation on 14 April of plans by the Greek government to introduce new and deeper austerity measures as it enacts budget cuts demanded as a condition for the €110 billion lifeline from the European Union (EU) and the IMF. Over the past weeks, spreads have not only widened for Greece (spread over Germany up to 1 656 basis points) but also for Portugal (spread over Germany up to 759 basis points); and, significantly, for Spain (spread over Germany up to 166 basis points). By contrast, Irish spreads are slightly lower, albeit still very high (spread over Germany down 27 basis points, to 700 basis points).

The international financial institutions, the European Central Bank (ECB) and other sovereign peripheral country policy-makers' concerns about debt restructuring revolve around the following:

1. Restructuring any eurozone member's debts while the country is still running a primary deficit, excluding debt interest, would effectively defeat the purpose of the restructuring.
2. Given their substantial holdings of peripheral euro area sovereign debt, some European banks are not yet strong enough to absorb the losses from a haircut on government bonds, and the turmoil in bond markets associated with haircuts could lead to another financial crisis.
3. The outstanding stock of debt would not be reduced significantly with a voluntary restructuring via extending maturities or cutting interest payments and premature debt restructuring would ease the pressure on peripheral countries to push ahead with required structural reforms.

Any country that defaults would be shut out of debt markets and the government concerned would still require continued support to meet its commitments (the country would either need to restructure its debt with bondholders or ask European counterparts for further financial assistance either directly or through the EFSF).

Figure B3.2 Sovereign 5-year CDS spreads



Source: Bloomberg

Risks for the global growth outlook

Although financial conditions eased in most parts of the euro area during late 2010 and into early 2011, the progress in financial system repair has lagged behind the economic recovery and total leverage (public plus private) has continued to rise in euro area periphery countries. Banks in Europe hold a large percentage of euro peripheral sovereign debt (according to the Bank for International Settlements, French and German banks accounted for almost two-thirds of lending to both public and private debtors in Greece as at end September 2010 with French banks accounting for US$59,4 billion and German banks US$40,3 billion, followed by UK and Portuguese lenders to Greece). If sovereign entities were to default on their loans or come close, this could have disruptive implications for the euro area given that balance-sheet repair is still a work in progress for many banks. A credit crunch could ensue if banks have to take a haircut, suffer reserves depletion and are unable to raise new capital.

The euro crisis revolves around how best to deal with deleveraging that will have to take place in the years ahead. Sovereign and bank risks in the euro area are intertwined, and this has heightened concern regarding the systemic consequences of any debt restructurings and the inevitable impact this would have on the euro area growth performance. Contagion risks are therefore significant in the euro area and the current crisis of peripheral Europe could quickly evolve into a problem of systemic proportions. However, media concerns about a Greek sovereign debt default in the very near term still appear somewhat premature, given that Greece is currently adequately funded by the EU and the IMF, and that there is little incentive to restructure while still working through an adjustment programme.

Risks to the euro area growth outlook are elevated as countries such as Germany have very strong prospects but peripheral Europe is clearly quite weak. Default by a euro area member would also, at best, only provide a temporary solution before problems re-emerged relating to productivity and even-weaker growth outcomes. Periphery countries need more time than certain political groups appear willing to allow for them to turn around their fiscal positions and politics may yet force policy-makers' hands, particularly if economically stronger countries refuse to keep supporting bailouts. However, there appears to be no better alternative than the measured approach that policy-makers in Europe have thus far been pursuing in the concerted hope of paving the way for orderly economic recovery.

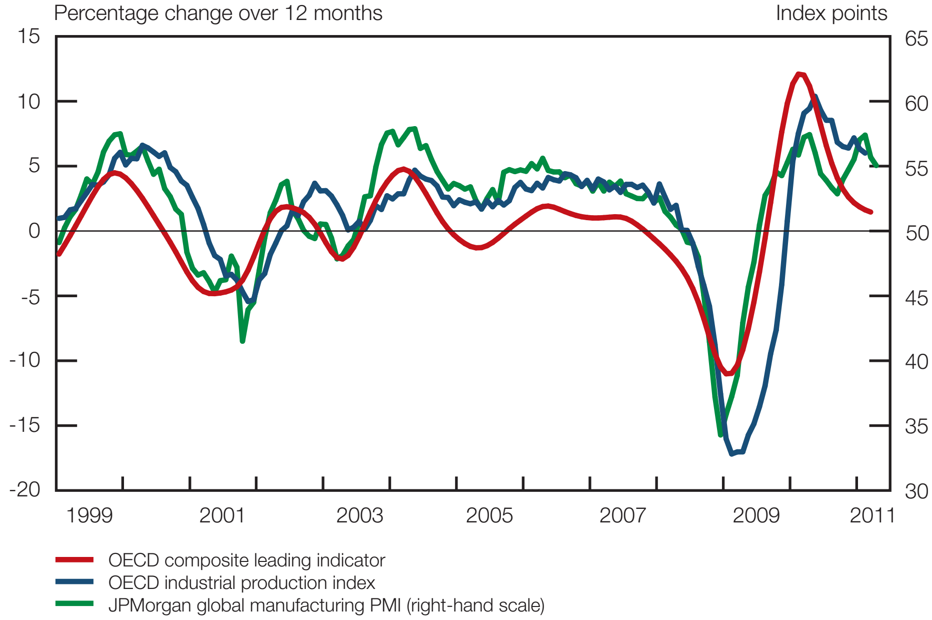
References:

Reinhart, C M and K S Rogoff. 2010. "Growth in a Time of Debt". NBER Working Paper No. 15639, January.

Bank for International Settlements. 2011. "What the BIS Banking Statistics Say (and what they do not) about Banking Systems' Exposures to Particular Countries and Sectors". *BIS Quarterly Review*, pp. 15–17, March. Basel: Bank for International Settlements.

The composite leading indicator compiled by the OECD projects continued economic expansion in OECD economies. It increased by 1,5 per cent in March 2011, compared with the corresponding month of the previous year (Figure 17). The JPMorgan global manufacturing PMI has remained comfortably above the neutral level of 50 for more than a year, and increased to a level of 57,4 in February 2011 before declining to 55,0 in April. The year-on-year rate of change in the OECD industrial production index slowed down slightly from 7,2 per cent in December 2010 to 6,0 per cent in February 2011.

Figure 17 Selected indicators of global economic activity

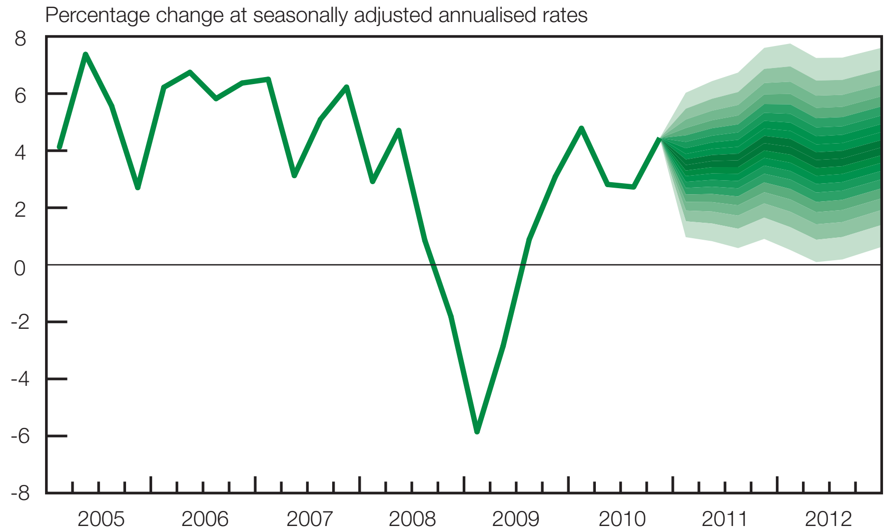


Sources: OECD and JPMorgan

Outlook for domestic demand and supply

According to the Bank's latest quarterly projection, annual average growth in real output is expected to be 3,6 in 2011 and 3,9 per cent in 2012 (Figure 18). Annualised real GDP growth is expected to exceed 3,5 per cent in all four quarters of 2011.

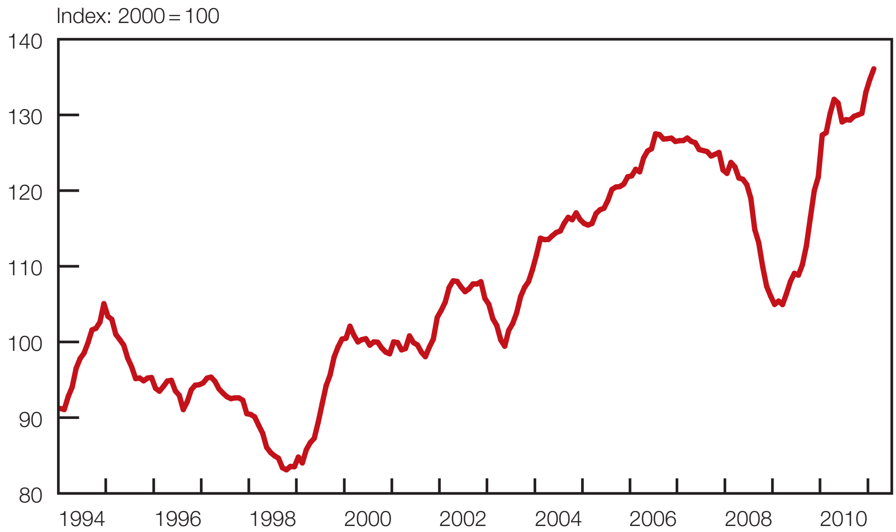
Figure 18 Real GDP growth forecast



National Treasury's February 2011 *Budget Review* projects growth in year-on-year real GDP of 3,4 per cent in 2011, followed by 4,1 per cent in 2012 and 4,4 per cent in 2013. By comparison, the April 2011 Reuters survey of long-term forecasts for the South African economy reveals that analysts expect year-on-year GDP growth to register 3,6 per cent in 2011, followed by 3,9 per cent in 2012 and 4,1 per cent in 2013. On the demand side, the main influences on growth during this forecast period are expected to be net exports and gross fixed capital formation, the latter projected to rise by 3,9 per cent in 2011, 5,5 per cent in 2012 and 6,8 per cent in 2013. On the supply side, the secondary and tertiary sectors are expected to be the main contributors to domestic growth.

The Bank's composite leading business cycle indicator increased by 1,0 per cent in February 2011 compared with the preceding month (Figure 19). Nine of the eleven component time series that were assessed for February 2011 increased, while two decreased. The largest positive contribution to the leading indicator came from the BER Business Confidence Index, followed by the BER average hours worked per factory worker in manufacturing. The two negative contributors in February were the number of building plans passed for flats, townhouses and houses larger than 80 m^2, as well as the six-month smoothed growth rate in the real M1 money supply.

Figure 19 Composite leading business cycle indicator



The seasonally adjusted Kagiso PMI stabilised at a level of 56,4 index points in April 2011, after having increased from 51,6 index points in February to 59,7 index points in March. While the business activity and new sales indices showed small declines, the forward-looking index measuring expected business conditions in six months' time remained unchanged at a level of 58,1 index points.

For the first time in three years, the Rand Merchant Bank (RMB)/Bureau for Economic Research at Stellenbosch University (BER) Business Confidence Index (BCI) broke the neutral level of 50 index points by rising from 44 points in the fourth quarter of 2010 to 55 in the first quarter of 2011. This indicates that there are more firms that are optimistic than pessimistic about prevailing business conditions. With the exception of the building sector, there has been a generalised improvement in business confidence in most sectors surveyed. The motor trade sector rose sharply to 84 index points in the first quarter of 2011; the highest level in five years. Wholesale sector confidence rose to 65 index points in the first quarter.

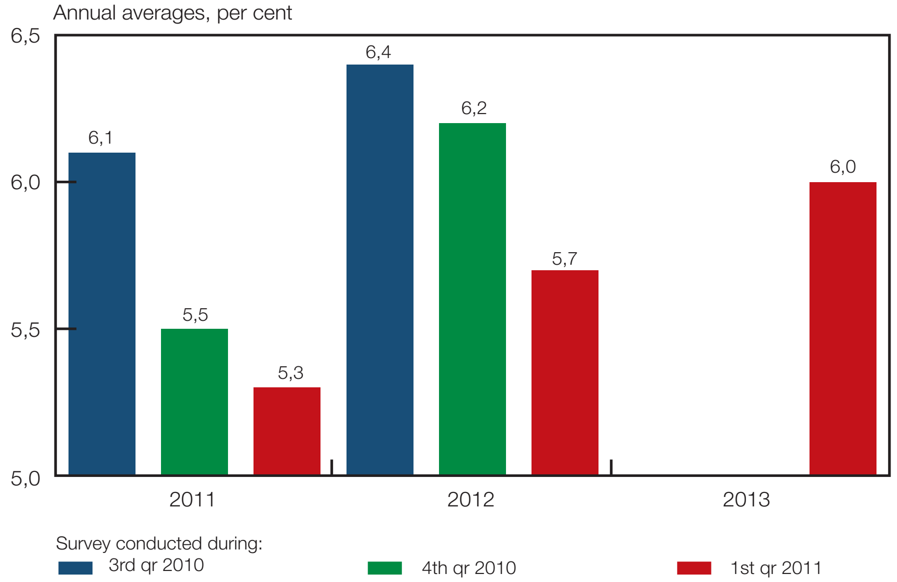
According to the first quarter 2011 BER Manufacturing Survey, manufacturing business confidence has improved by 10 points to reach 51 index points in the first quarter of 2011. Owing to improving business conditions, rising domestic sales volumes and capacity utilisation, manufacturers are planning to increase fixed investment in the second quarter of 2011. The outlook for fixed investment has improved as the net majority expecting total fixed investment to rise in 12 months' time increased from 11 to 19 per cent.

According to the BER's Retail Survey, a net majority of retailers and wholesalers reported an improvement in business conditions in the first quarter of 2011. Retailers in non-durable goods reported that their first quarter 2011 sales growth exceeded their earlier expectations. New vehicle dealers and retailers in durable goods reported that sales growth strengthened in the first quarter of 2011. Wholesalers in both consumer goods and non-consumer goods also reported a substantial improvement in sales volumes, suggesting that the trade sector recovery is on track. In general, both the retailers and wholesalers are optimistic about their sales prospects during the second quarter of 2011.

Indicators of inflation expectations

Inflation expectations surveyed by the BER in the first quarter of 2011 continued to trend downwards (Figure 20). Average expectations for 2011 declined from 5,5 per cent in the survey undertaken in the fourth quarter of 2010 to 5,3 per cent in the first quarter of 2011 survey. Inflation is expected to be 5,7 per cent in 2012 and 6,0 per cent in 2013.

Figure 20 BER surveys of headline CPI inflation expectations



Source: Bureau for Economic Research, Stellenbosch University

Financial analysts surveyed by the BER expect inflation to reach 4,7 per cent in 2011, 5,5 per cent in 2012, and 5,6 per cent in 2013. For 2011, business people revised their fourth quarter 2010 expectations from 6,0 to 5,6 per cent in the first quarter of 2011. For 2011 and 2012 trade unions have revised their inflation expectations to 5,6 and 5,8 per cent respectively. Trade unions and business expect inflation to breach the target band in 2013.

The latest estimates of inflation expectations for the period from 2011 to 2013 obtained from the Reuters survey conducted in April 2011 show that average annual CPI inflation is expected to remain below the upper level of 6 per cent of the CPI inflation target range, although estimates have been revised upwards since March. As depicted in Table 13, average CPI inflation expectations for 2011 are 5,0 per cent, followed by 5,8 per cent for 2012 and 5,7 per cent for 2013.

Table 13 Reuters survey of CPI inflation forecasts: April 2011*

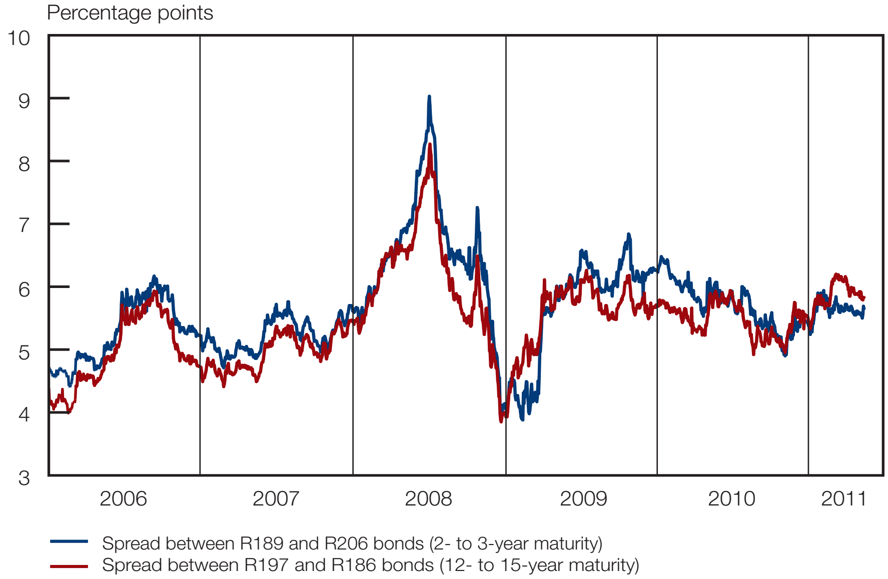
	2011		2012		2013	
1. Mean	(4,8)	5,0	(5,7)	5,8	(5,7)	5,7
2. Median	(4,8)	5,0	(5,6)	5,7	(5,8)	5,8
3. Highest	(7,3)	5,5	(7,9)	7,0	(6,5)	6,5
4. Lowest	(4,1)	4,6	(5,3)	5,4	(5,0)	5,0
Number of forecasters	(19)	19	(19)	19	(13)	16

* March 2011 survey results in parentheses

Source: Reuters

Inflation expectations derived from break-even inflation rates, measured as the difference between the the yields on conventional South African nominal government bonds and CPI inflation-linked government bonds of similar maturity, have been trending higher from October 2010 (Figure 21). In May 2011 the 12- to 15-year maturity break-even rates were higher than the 2- to 3-year maturity break-even rates, suggesting that investors expect long-term inflation to be higher, although both long- and short-maturity break-even rates were within the inflation target range. On 13 May 2011 break-even inflation in the 2- to 3-year maturity range stood at 5,6 per cent, while that over 12 to 15 years was at 5,8 per cent.

Figure 21 Break-even inflation rates



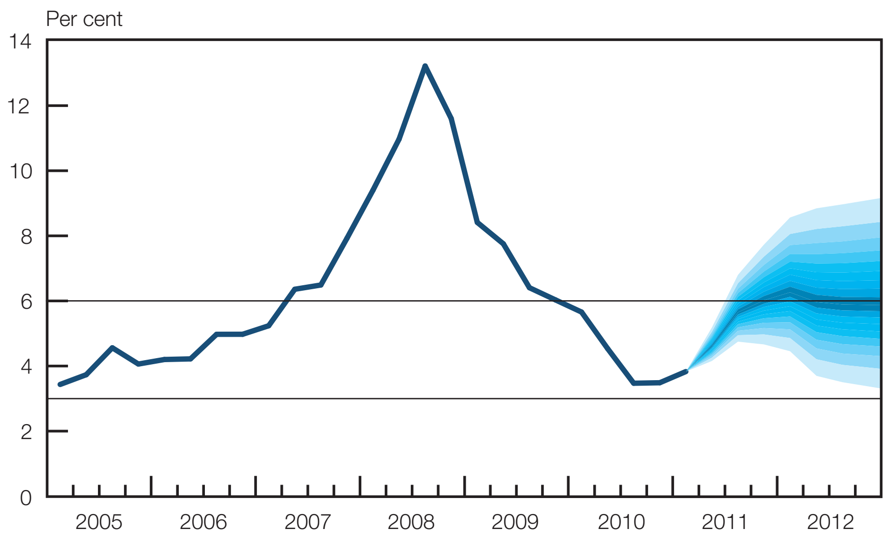
The South African Reserve Bank inflation forecast

The most recent projections of the Bank's quarterly inflation forecasting model, presented to the MPC meeting on 10–12 May 2011, are reproduced in the form of a fan chart in Figure 22. These projections show that there has been a further upward revision to the CPI inflation forecast of the Bank since the previous meeting of the MPC in March 2011, mainly as a result of revised assumptions regarding administered price increases over the forecast period.

The central projection, conditional on an unchanged repurchase rate, is for the average quarterly CPI inflation rate to reach the upper limit of the inflation target range at 6,0 per cent during the final quarter of 2011, and to peak at 6,3 per cent in the first quarter of 2012. Inflation is then projected to return to within the target range by the second quarter of 2012 and remain close to the upper limit of the range for the rest of the year. Inflation is expected to average 5,1 per cent in 2011 and 6,0 per cent in 2012, compared with the averages of 4,7 per cent and 5,7 per cent that were forecast at the time of the previous meeting.

The main risks to the inflation outlook continue to emanate from cost–push pressures, including administered prices. The acceleration in food prices is expected to persist for some time, despite indications that global food price inflation may have peaked, and international oil prices have displayed considerable volatility recently. Underlying demand conditions in the economy remain relatively restrained and are not seen to pose a significant risk to the inflation outlook at this stage, although a depreciation of the exchange rate of the rand would generate a more pessimistic outcome for targeted inflation. On balance, there is deemed to be a slight upside risk to the forecast of targeted inflation displayed in the fan chart in Figure 22.

Figure 22 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 economic recovery has continued to be uneven, characterised by generally high growth in emerging economies and low growth in many of the advanced economies. While there is a general view that the recovery is sustainable, there are a number of risks to the growth outlook. These include the impact of rising commodity prices, the sovereign debt crisis in peripheral Europe and the implications of the disaster in Japan. There are also still some concerns about the relatively weak private-sector expenditure in some of the advanced economies, and their ability to weather any withdrawal of government fiscal and monetary policy stimuli. As debt sustainability and the need for fiscal consolidation are receiving more focused attention in many countries, the burden of supporting growth has fallen increasingly on monetary policy. This implies that interest rates in a number of the advanced economies, particularly the US and Japan, are likely to remain low for a protracted period. This would seem to imply continued capital flows to emerging-market economies with implications for their exchange rates.

Emerging markets in general have been experiencing strong growth, and there has been a general trend of monetary policy tightening in response to emerging inflationary pressures. More recently, attempts made by some emerging-market economies, particularly China, to moderate the growth in their economies have also had an impact on the pattern of capital flows and commodity prices.

South Africa remains an outlier compared with its emerging-market peers. Domestic growth remains below potential, and although growth is expected to be sustained, it is expected to be below that of emerging-market economies in general. This is due, in part, to the persistently low growth in fixed capital formation, the uncertain growth prospects in some of South Africa's traditional trading partners and to possible constraints on consumption expenditure growth.

Since the publication of the October 2010 *Monetary Policy Review*, the global and domestic inflation environment has deteriorated markedly, mainly as a result of oil and food price increases. The challenge facing monetary policy-makers is to determine whether these developments are of a temporary or permanent nature. This is not always easy. The appropriate monetary policy response will differ, depending on the nature and persistence of the shock and the extent to which inflation expectations are well entrenched. If expectations are not well anchored, even temporary shocks could cause the first-round effects to translate into more generalised inflation. For this reason, it is important that monetary policy is seen to be focused on its inflation objective over the appropriate time horizon. This then becomes a fine balancing act for the MPC, as a flexible inflation-targeting framework requires that monetary policy actions be mindful of the impact on the real economy as well. This is particularly the case when the domestic economy is relatively fragile and there is underutilised capacity.

At its most recent meeting (May 2011), the MPC noted the adverse inflation outlook and the fact that inflation was expected to exceed the upper limit of the target range temporarily during the first quarter of 2012. At the same time, the MPC noted that the factors behind this deterioration were mainly of a cost–push nature, and not a result of excess demand conditions, given the continued existence of a negative output gap. This does not mean that these inflation developments can be ignored. While it is clear that the first-round effects cannot be avoided, the MPC will remain vigilant with respect to indications of second-round effects or generalised inflation, and will not hesitate to take timeous appropriate action, particularly if inflation is expected to move out of the target range on a sustained basis. The Bank will continue to give primacy to its objective of price stability, and implement monetary policy within a flexible inflation-targeting framework.

Statement of the Monetary Policy Committee

18 November 2010

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

Since the previous meeting of the MPC, the outlook for domestic inflation has improved further against the backdrop of a continued negative domestic output gap and sustained strength in the exchange rate of the rand. Persistently low growth in the United States (US) and renewed quantitative easing, combined with renewed concerns about the solvency of some euro area countries, are expected to prolong the current environment of low global interest rates and continued capital flows to emerging market economies. While a number of cost–push factors are beginning to pose some upside risk to domestic inflation, the overall risks to the inflation outlook are assessed to be fairly evenly balanced.

The year-on-year inflation rate as measured by the consumer price index (CPI) for all urban areas declined to 3,2 per cent in September 2010, compared with 3,5 per cent in August. Goods price inflation measured 1,5 per cent in September, while services inflation amounted to 5,2 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 3,2 per cent inflation outcome. CPI excluding administered prices measured 2,6 per cent, while administered prices excluding petrol measured 9 per cent.

Of the twelve broad CPI categories, only one category had an inflation rate that was within the target range of 3 to 6 per cent, while the inflation rates of six categories were below the lower end of the target range. Five categories, with a combined weighting of 34,6 per cent, had inflation rates above the 6 per cent level.

Having peaked at 9,4 per cent in June 2010, producer price inflation has since moderated somewhat and measured 6,8 per cent in September. Despite higher global food price trends, agricultural prices and manufactured food prices continued to decline on a year-on-year basis. This indicates subdued pressure on food prices in the coming months at the consumer level, where food prices increased at a year-on-year rate of 1,2 per cent.

The lower-than-expected inflation outcomes contributed to a further downward adjustment in the inflation forecast of the Bank throughout the forecast period to the end of 2012. Targeted CPI inflation averaged 3,5 per cent in the third quarter of 2010. A similar average outcome is expected during the fourth quarter, resulting in an expected average inflation rate of 4,3 per cent for 2010. Inflation is then expected to remain at an average of 4,3 per cent in 2011 and to increase to 4,8 per cent in 2012. In the final quarter of 2012 inflation is expected to average 4,8 per cent, compared with the previous forecast of 5,1 per cent.

The more favourable forecast is a result of an expected moderation in administered price inflation, a more appreciated nominal effective exchange rate of the rand, as well as lower-than-expected actual inflation outcomes, which lowered the starting point of the forecast.

Inflation expectations as reflected in the survey conducted by the Bureau for Economic Research (BER) at Stellenbosch University during the third quarter have been revised downwards for all categories of respondents. Expectations have been on a consistent downward trend since reaching a peak in the second quarter of 2009. Nevertheless, in contrast to expectations of the financial analysts, who expect inflation to remain within the target range over the forecast period, the expectations of trade unions and business executives remain outside the target range. According to this survey, inflation is expected to average 5,7 per cent in 2010, and 6,1 per cent and 6,4 per cent in 2011 and 2012 respectively.

The Reuters consensus survey of financial analysts, conducted in October, also shows a more favourable outlook with inflation expected to average 5,5 per cent in 2012. Break-even inflation rates as derived from the inflation-linked bonds have also declined significantly across all maturities, to levels of around 5 per cent.

The global economic recovery has continued in an uneven manner, with downside risks to the growth outlook in a number of the advanced economies including the US, Japan and the euro area. Further fiscal stimulus in the United States (US) appears unlikely, suggesting that the burden of supporting the flagging growth and persistent unemployment will fall disproportionately on monetary policy. The recent resumption of quantitative easing, against a backdrop of deflation fears, indicates that monetary policy in the US is likely to remain highly expansionary for some time. There is heightened uncertainty in the euro area with the focus, once again, shifting to the peripheral countries, as concerns relating to the solvency of the Irish banking system and the sustainability of Irish public-sector deficits have raised fears of possible contagion within Europe and possibly to the global financial sector. Spreads on sovereign debt have widened again in some of the Southern European countries after a relatively steady period, and in some instances have exceeded the levels reached in April 2010, when sovereign debt concerns reached their peak.

Apart from the risks to the fragile global recovery, there are also significant risks to financial stability emanating from these developments in the advanced economies. Should the problems in the euro area not be resolved in an orderly manner, there are risks of a sudden reversal of capital flows to emerging markets.

By contrast, growth in the emerging markets has remained buoyant and in some instances monetary policy has been tightened in response to increased demand pressures. Furthermore, the strong growth in Asia, and China in particular, has underpinned commodity prices, which have contributed to the stronger trend in inflation in these countries. It the extent to which growth in the emerging markets can be sustained independently of a recovery in the industrialised economies is still unclear. Despite the higher commodity prices, global inflationary pressures remain relatively benign.

The quantitative easing has continued to have spillover effects on emerging-market economies. The search for yield resulting from this increase in liquidity has implications for the exchange rates of the recipient countries. South Africa has been no exception in this respect and appreciation pressures are expected to persist for some time, in the absence of renewed bouts of global risk aversion. The exchange rate therefore remains a downside risk to the inflation outlook.

Since the previous meeting of the MPC, the rand has appreciated by over 3 per cent against the US dollar and is more or less unchanged on a trade-weighted basis. This has been despite lower domestic interest rates and the higher pace of reserve accumulation in the past two months. In October the Bank acquired the proceeds of the foreign purchase of Didata, which were in excess of US$2 billion. The recent observed volatility in the bilateral rand exchange rates has been mainly as a result of the volatility in the euro/dollar exchange rate. From a policy perspective, focus is maintained on the trade-weighted exchange rate.

The domestic growth outlook remains subdued and below-trend growth is expected to persist. The forecast of the Bank is relatively unchanged since the previous meeting of the MPC, with GDP growth remaining at 2,8 per cent for 2010 and expected to average 3,3 per cent and 3,6 per cent in 2011 and 2012 respectively. The composite leading business cycle indicator of the Bank has been trending sideways since April, suggesting a possible moderation in the pace of recovery in the months ahead. Private sector gross fixed capital formation is expected to have remained weak in the third quarter of 2010.

The manufacturing sector, in particular the motor vehicle and components sector, was hit particularly hard by industrial action, which contributed to the contraction of manufacturing output in the sector in the third quarter. Year-on-year growth in manufacturing sector output in September measured 1,4 per cent, much lower than market expectations, while output contracted by 1,5 per cent on a quarter-on-quarter basis in the third quarter. This was consistent with the declining manufacturing capacity utilisation in the third quarter, as well as the weakening Kagiso Purchasing Managers Index, which has returned to below the neutral level of 50. The construction and civil engineering sectors are also facing a challenging outlook. By contrast, output growth in the mining sector improved markedly in the third quarter and contributed positively to third-quarter GDP growth. The Rand Merchant Bank (RMB)/BER business confidence index has been increasing, but still reflects negative sentiment overall. As a result of these trends, unemployment in the economy has shown little sign of reversing.

There are indications of recovery in household consumption expenditure in the economy. Retail trade sales decreased by 1,4 per cent on a month-on-month basis in August, but increased by 0,4 per cent in September. On a year-on-year basis, the increase was 6,1 per cent. Although vehicle sales have grown significantly on a year-on-year basis, the short-term trends have moderated somewhat but were likely to have been impacted by the industrial action in this sector. Consumer confidence, as reflected in the FNB/BER consumer confidence index remains relatively high, but was largely unchanged during 2010. Household consumption expenditure is expected to be supported by positive wealth effects as is reflected in higher asset prices and lower interest rates, but constrained by high unemployment and significant household debt levels.

Growth in total loans and advances to the private sector by banks has continued to an increase at a moderate pace, having increased by 4,1 per cent in September. This figure was somewhat inflated by technical factors such as the acquisition of mortgage loan books and a general loan book by banks from non-banks in the past three months. Mortgage advances were again the main contributors to the positive trend, increasing by 4,8 per cent on a year-on-year basis in both August and September. Growth in instalment sale credit and leasing finance turned marginally positive after 17 consecutive months of contraction, while other loans and advances accelerated to a year-on-year growth of 4,5 per cent in September, from 0,4 per cent in August. Credit card advances and bank overdrafts, however, continued to contract.

In the banking sector, impaired advances to gross loans and advances declined marginally to 5,7 per cent in September 2010, having reached a peak of slightly over 6 per cent in November 2009. There is, however, some evidence that the banks are still charging higher spreads above the repurchase rate than was the case before the crisis, which indicates that the recent monetary policy easing has not been fully passed through to new borrowers.

The fiscal policy stance has tightened moderately with the narrowing of the expected deficit before borrowing from the original estimate of 6,5 per cent to a revised estimate of 5,3 per cent for the current fiscal year, representing an estimated structural deficit of 4,1 per cent. The deficits for the coming fiscal years have also been adjusted downwards, and a 3,2 per cent deficit is expected in 2013/14. Most of the adjustment has been due to higher-than-expected revenue collections.

The main risks to the inflation outlook continue to emanate from cost–push factors. These include wage trends and administered prices. Food and petrol prices are also identified as potential longer-term risks.

There are some tentative indications of moderation in wage growth. According to Andrew Levy Employment Publications, the average wage settlement rate amounted to 8,3 per cent in the first nine months of 2010, compared with 9,3 per cent in 2009 as a whole. However the Quarterly Employment Survey of Statistics South Africa indicates that in the second quarter of 2010 the year-on-year average nominal remuneration per worker increased by 15,8 per cent. The unit labour cost increase, which adjusts for productivity increases, amounted to 10,8 per cent, up from 10,3 per cent in the previous quarter.

Global food prices have been affected by adverse weather conditions in a number of regions, but the impact on domestic prices has been counteracted in part by the rand exchange rate trends and the bumper maize crop. The exchange rate has also moderated domestic petrol price increases. Having remained relatively stable in a narrow range for the past few months, the price of Brent crude oil has increased over the past weeks to above the US$80 per barrel level, resulting in a cumulative increase in domestic petrol prices of 25 cents per litre in October and November, and a further increase is likely in December. Global oil prices are, however, expected to be constrained somewhat by slow growth in the advanced economies.

In considering the prevailing conditions and data, it is important to emphasise that the focus, notwithstanding any immediate impact or influence, is on the situation that might exist 12 to 18 months hence. There are significant voices and varied opinions aired in the public domain, all expressing a view on what needs to be done. While it is important to listen and hear what is being said, it is the responsibility of the MPC to determine the path of interest rates without fear or favour. And this is what we will continue to do.

The MPC has taken cognisance of the improved longer-term inflation outlook and assesses the risks to this outlook to be fairly evenly balanced. The domestic economic recovery remains fragile and the adverse global developments make the growth outlook more uncertain. The MPC believes that while monetary policy cannot determine the long-term growth path of the economy, it can impact on cyclical deviations of output from potential output. The view of the MPC is that there is room for further stimulus, given the weakness in the supply side of the economy.

The MPC has accordingly decided to reduce the repurchase rate by 50 basis points to 5,5 per cent per annum with effect from 19 November 2010. This action is viewed to be consistent with the continued attainment of the inflation target. The scope for further downward movement, however, is seen to be limited, given the signs of recovery in household consumption expenditure and credit extension. This will be assessed on an ongoing basis.

Statement of the Monetary Policy Committee

20 January 2011

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

Since the previous meeting of the MPC, there have been more convincing signs that the recovery in the global economy will be sustained. However, growth in the advanced economies is expected to be slow and is subject to a number of downside risks, including the sovereign debt crisis that continues to beset the eurozone. The more promising global growth outlook, as well as the unfavourable weather conditions, has implications for commodity prices, particularly those of food and energy. These pressures are likely to pose an increasing risk to both the global and domestic inflation outlook. Nevertheless, domestic inflation is expected to remain within the target range for the forecast period.

Domestically, the output gap remains negative and gross domestic product (GDP) growth is expected to remain below potential over the next two years. However, there are indications that the outlook for output growth, while hesitant, is somewhat more positive. The recovery in household consumption expenditure appears to be sustained.

The year-on-year inflation rate as measured by the consumer price index (CPI) for all urban areas moderated to 3,5 per cent in December from 3,6 per cent in November 2010. The average inflation rate for 2010 was 4,3 per cent compared with 7,1 per cent in 2009. Food price inflation in December measured 1,4 per cent, unchanged on a month-on-month basis. The main contributor to the inflation outcome remained housing and utilities, primarily electricity, which contributed 1,5 percentage points to the 3,5 per cent outcome. Administered prices excluding petrol increased at a rate of 9,1 per cent in both November and December.

Year-on-year producer price inflation reached a recent peak of 9,4 per cent in June 2010, and has declined moderately since then. In November, the producer price index (PPI) increased by 6,2 per cent, compared with 6,4 per cent the previous month. The impact of the exchange rate on producer prices is still clearly evident, with the prices of imported commodities increasing at a year-on-year rate of 0,5 per cent. Manufactured food prices increased by 0,6 per cent, while agricultural prices declined by 0,3 per cent.

The CPI forecast of the Bank has been revised upwards since the MPC's previous meeting. Nevertheless, the domestic inflation trajectory is still expected to remain within the target range over the entire forecast period to the end of 2012. Inflation is now expected to average 4,6 per cent in 2011 and 5,3 per cent in 2012. The upward adjustment is mainly due to revised assumptions of the international oil price over the forecast period, and we will continue to monitor global inflation trends closely.

The Bank's forecast is similar to the Reuters consensus forecast. In the December survey, the mean forecast of CPI inflation was 4,5 per cent for 2011, 5,4 per cent for 2012 and 5,6 per cent for 2013. These forecasts were slightly higher than those in the November survey. The break-even inflation rates across all maturities also continue to reflect inflation expectations within the target range.

Inflation expectations as reflected in the survey conducted by the Bureau for Economic Research (BER) at Stellenbosch University in the fourth quarter of 2010 continued to trend downwards. For the first time, average expectations for 2011 are within the inflation target band at 5,5 per cent. The expectations of all categories of respondents declined, with both business executives and trade union officials expecting inflation to average 6,0 per cent, while those of the financial analysts declined to 4,5 per cent.

All categories of respondents expect inflation to increase again in 2012 when it is expected to average 6,2 per cent.

The global economic outlook remains uncertain but there appears to be increasing optimism that the recovery, albeit relatively weak, will be sustained. Most forecasts have been revised upwards in recent months but indicate that global growth is expected to be slower in 2011 than in 2010. However, the prospects remain uneven across countries and regions, and a number of risks remain.

Growth in the United States (US) continues to be supported by strong monetary and fiscal intervention, while growth in Japan remains subdued. In the euro area, the recovery is being driven by strong growth in Germany but this is expected to moderate in 2011. In the rest of the euro area, confidence has declined in the wake of the worsening sovereign debt crisis, which remains a major risk to the outlook. Recent co-ordinated measures appear to have stabilised the sovereign debt markets for now, but significant risks remain and a further escalation of the crisis could impact negatively on global growth prospects.

The emerging markets continue to outperform the advanced economies, with strong recoveries in consumption and investment in the major emerging-market economies.

Inflation developments and prospects also appear to reflect the divergent growth trends. Persistent large negative output gaps in the advanced economies have helped to contain inflation pressures, despite rising international oil and food prices. There is still some risk of deflation in the US, although this risk is declining. By contrast, inflation in emerging markets has been increasing, partly as a result of stronger demand pressures but also as a result of the higher weights of energy and food in the consumer price baskets. These trends have resulted in generally tighter monetary policies in emerging markets, but monetary accommodation is expected to persist in most of the major industrialised countries for some time.

The exchange rate of the rand has been relatively volatile since the previous meeting of the MPC, when it was around R7,00 against the US dollar. By early January the rand had appreciated to R6,55, but has since retraced to levels prevailing at the time of the previous meeting. During this period, non-residents became net sellers of rand-denominated bonds as expectations that there would be further interest rate reductions were reversed, but were net buyers of domestic equities.

Factors influencing the exchange rate during this period included developments in the euro/dollar exchange rate, further acceleration in commodity prices and persistent capital flows to emerging markets.

In the absence of general risk aversion, or a tightening of the monetary policy stances in the advanced economies, the rand exchange rate is expected to remain relatively strong. Since the previous meeting of the MPC, the nominal effective exchange rate of the rand depreciated by 0,4 per cent.

During 2010 total direct foreign-exchange reserve accumulation by the Bank and National Treasury amounted to US$7,4 billion, or a spend of just over R53 billion. Despite this, the rand continued to appreciate – 12 per cent against the US dollar during 2010 – and remained strong. Portfolio and foreign direct investment inflows continued, and the net purchases of bonds and equities by non-residents amounted to R89,5 billion in 2010. The Bank will continue to accumulate foreign-exchange reserves as and when possible.

Domestic GDP growth remains subdued, with growth of 2,6 per cent in the third quarter of 2010. Although there are mixed signals about the sustainability of the output recovery, high-frequency data indicate a stronger fourth quarter performance, and forecasts for 2011 have generally been subject to moderate upward revision. The Bank's forecast was also adjusted marginally and growth is now expected to average 3,4 per cent in 2011. The forecast for 2012 is unchanged at 3,6 per cent. The composite leading business cycle indicator of the Bank has been relatively flat in the past few months and declined moderately in October, reflecting the uneven growth prospects.

Gross domestic fixed capital formation is still subdued, having increased by 0,9 per cent in the third quarter of 2010. This rate of investment growth remains too low to impact meaningfully on output growth, and is currently primarily dependent on state-owned enterprises' pipeline commitment to infrastructure, while investment in the manufacturing sector is being constrained by low levels of capacity utilisation. The labour market appears to have stabilised in the third quarter when employment levels were more or less unchanged, although unemployment remains stubbornly high at 25,3 per cent.

The recovery in the manufacturing sector remains hesitant. Manufacturing output increased by 4,6 per cent on a year-on-year basis in November, compared with 2,3 per cent in October. Production of motor vehicles, parts and accessories, in particular, including vehicle exports which increased by 52,8 per cent quarter-on-quarter in the final quarter of 2010, have exhibited robust growth.

The Kagiso Purchasing Managers Index (PMI) confirms the uncertain outlook. Following a strong improvement in the index in November to a level in excess of the neutral level of 50, it declined again in December, although still indicating an expansion of the sector. The mining sector has also been improving and grew at a year-on-year rate of 9,6 per cent in November. The Rand Merchant Bank (RMB)/BER Business Confidence Indicator remained relatively unchanged throughout 2010, but with a negative outlook.

The recovery in domestic consumption expenditure appears to be sustained. Real final consumption expenditure by households increased at an annualised rate of 5,9 per cent in the third quarter of 2010. Strong expenditure growth was observed in all components of consumption. Real retail trade sales increased at a year-on-year rate of 7,8 per cent in November 2010. New vehicle sales also continued their strong performance, having increased by almost 30 per cent in December. Consumer confidence as reflected in the First National Bank (FNB)/BER Consumer Confidence Index has been at a relatively high level during the past year.

Credit extension maintained its moderate upward trend during 2010. Total loans and advances to the private sector increased by 4,4 per cent in November. Growth over 12 months in mortgage advances has fluctuated around 4,8 per cent since August 2010, reflecting a loss of momentum in the real-estate market. House prices increased somewhat in the first half of 2010, but since then the rate of increase has declined, with some house price indexes indicating that prices have been falling.

Growth in instalment sale and leasing finance, and other loans and advances maintained a positive trend. Within the latter category, growth in credit card advances was positive for the first time since the end of 2008. Bank overdrafts were the only major category that continued to contract, although at a slower rate. Household debt remains high at 78,5 per cent of disposable income.

However, lower interest rates have reduced the ratio of debt-service costs to disposable income to 7,8 per cent, compared with 12,6 per cent in the third quarter of 2008.

Expenditure has been positively affected by growth in real disposable income, lower interest rates and some favourable wealth effects. Share prices on the JSE Limited have reached levels in line with the peaks reached before the onset of the global financial crisis. In 2010 the all-share index increased by 16,1 per cent.

Risks to the inflation outlook emanating from global commodity price increases have become more evident. These risks relate mainly to oil and food price developments. Having fluctuated in the range of US$70–US$80 per barrel for much of 2010, the price of Brent crude oil began to increase in late November and is currently at around US$98 per barrel. The surge in oil prices is due in part to stronger global oil demand and the exceptionally cold weather in the northern hemisphere. These price trends were also affected by US dollar developments, particularly following the announcement of additional quantitative easing by the US Federal Reserve in November.

The domestic petrol price, which has been cushioned, to some extent, by exchange rate developments, has increased by 66 cents per litre since September 2010, and by 11 per cent over the past year.

Since September, the rand exchange rate has offset the petrol price increase by a cumulative 45 cents per litre.

Global food prices have also continued to increase, driven by tight food supplies, changing weather patterns and rising demand in emerging-market economies. To date South Africa has been shielded, to some degree, from these increases by the exchange rate and the bumper maize crop. Domestic maize prices have been increasing since the middle of 2010, but in January 2011 were still about 11 per cent lower than a year ago. By contrast, South Africa is a net importer of wheat, which has increased in price by almost 40 per cent over the past year. Although producer price developments suggest that domestic food price inflation will remain low in the short term, these global developments, unless reversed, will inevitably impact on consumer food price inflation.

Administered prices and wage settlements remain upside risks to the inflation outlook. Although wage increases have moderated slightly over the past months, they are still significantly in excess of the current and expected inflation outcomes. According to Statistics South Africa, the year-on-year rate of increase in average nominal remuneration per worker in the formal non-agricultural sector declined from 15,8 per cent in the second quarter of 2010 to 12,6 per cent in the third quarter. Once labour productivity developments are accounted for, unit labour cost increases amounted to 10,9 per cent and 9,3 per cent in these two quarters respectively. According to Andrew Levy Employment Publications, the average wage settlement in the first nine months of 2010 amounted to 8,3 per cent compared with 9,3 per cent in 2009.

The current level of the repurchase rate is at its lowest level in nominal terms in over 30 years, while the real interest rate is at a level below 1 per cent. This has helped with the recovery in consumption expenditure and should also stimulate domestic investment and growth by reducing the cost of borrowing. However, low interest rates on their own cannot ensure sustainably higher long-run trend growth and employment creation.

The MPC has taken note of the improving growth outlook for the economy, and is of the view that the recovery in domestic consumption expenditure will be sustained. While there are increasing risks to the inflation outlook, they emanate primarily from external cost–push factors, and inflation is expected to remain within the target range until the end of the forecast period.

The MPC has therefore decided to keep the repurchase rate unchanged at 5,5 per cent per annum. At this stage there are no signs of incipient excess demand in the economy, and unless there are significant unexpected changes in the global or domestic outlook, the monetary policy stance is expected to remain relatively stable for some time. The MPC will continue to monitor developments closely and stands ready to act should the need arise.

Statement of the Monetary Policy Committee

24 March 2011

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

The domestic growth prognosis has improved, and the recovery is expected to be sustained, although not at rates sufficient to make appreciable inroads into the unemployment situation in South Africa. Household consumption expenditure has been the main driver of growth, whereas growth in fixed capital formation has remained weak. At this stage, there are no discernible inflationary pressures coming from the demand side of the economy.

The global recovery appears to have remained on track, but the unresolved European sovereign debt crisis, rising international oil prices, partly a result of geo-political events, and the tragic events in Japan may moderate the pace of recovery in the near term. Global inflation risks have also increased, particularly in emerging-market economies, a number of which have tightened their monetary policy stances in recent months.

The year-on-year inflation rate as measured by the consumer price index (CPI) for all urban areas measured 3,7 per cent in January and February. Food price inflation, while still low, has been increasing. In February it measured 3,5 per cent and contributed 0,6 percentage points to the overall inflation outcome. On a month-on-month basis, food prices declined by 0,1 per cent. Housing and utilities, primarily electricity, contributed 1,5 percentage points to the outcome. Petrol prices increased at a year-on-year rate of 12,3 per cent, while administered prices excluding petrol increased by 9,1 per cent. CPI inflation excluding administered prices was unchanged at 2,7 per cent, while CPI inflation excluding food and petrol measured 3,4 per cent.

Year-on-year producer price inflation continued its recent downward trend in January when it measured 5,5 per cent, compared with 5,8 per cent in December 2010. Food price pressures remained relatively subdued in January despite marked increases in global food prices. Manufactured food and agricultural prices increased by 1,5 per cent and 0,5 per cent respectively. This suggests that food price increases at the consumer price level may be moderated in the near term.

The trajectory of the Bank's CPI forecast has changed somewhat since the MPC's previous meeting. Nevertheless, inflation is still expected to remain within the target range over the entire forecast period. Inflation is now expected to average 4,7 per cent in 2011 and 5,7 per cent in 2012. This represents an upward adjustment of approximately half a percentage point in 2012. Inflation is expected to peak at 5,8 per cent in the first quarter of 2012 before declining to 5,6 per cent in the fourth quarter. The upward adjustment is mainly due to revised assumptions regarding the international oil price over the forecast period.

The survey conducted by Reuters also reflects a moderate upward adjustment in the inflation forecasts. In the February survey the mean forecast of CPI inflation increased by 0,2 percentage points to 4,7 for 2011, and by 0,4 percentage points to 6,0 per cent for 2012. Inflation expectations for 2013 remained more or less unchanged at around 5,7 per cent. Break-even inflation rates have increased to above the 6 per cent level over the longer-term maturities.

Inflation expectations as reflected in the survey conducted by the Bureau for Economic Research (BER) at Stellenbosch University in the first quarter of 2011 also indicate a slight deterioration in financial analysts' expectations. However, there was some improvement in the expectations of business executives and trade unionists. Inflation is now expected to average 5,3 per cent in 2011 and 5,7 per cent in 2012, compared with 5,5 per cent and 6,2 per cent in the previous survey. Inflation is expected to average 6,0 per cent in 2013. While all categories of respondents expect inflation to remain within the target range in 2011 and 2012, business and trade union expectations average 6,2 per cent in 2013, compared with 5,6 per cent for financial analysts.

The global economic recovery, although uneven, is expected to continue, led by a strong performance in global manufacturing. However, significant downside risks remain, due to the confluence of shocks that have the potential to stall the nascent recovery. These shocks include higher international oil prices, driven in part by events in the Middle East and North Africa, and the recent disasters in Japan, which could have a negative impact on the global manufacturing supply chain. The sovereign debt crisis in the euro area remains a concern, with credit default swap (CDS) spreads signalling increased risks of sovereign debt defaults. The United States' (US) outlook appears favourable, but the weak housing market and the ability of the economy to sustain growth once the fiscal stimuli dissipate during the year are some of the risks that persist.

Growth in emerging markets remains robust, but Asian economies in particular may be negatively impacted by the recent developments in Japan. The global growth outlook may also be dependent on the extent to which the authorities in China manage to slow their economy down.

The global inflation outlook has also deteriorated somewhat in the face of higher oil and food prices, although in some of the advanced economies there is a marked divergence between core and headline inflation. This reflects the relatively weak underlying demand conditions, and the generally accommodative monetary policies in these countries. In the faster-growing emerging markets, inflation pressures are more pronounced and monetary policy tightening has become more widespread.

The strong capital inflows to emerging markets that were a feature of most of 2010 have slowed down and in some instances reversed. South Africa has also experienced net sales of bonds since November, and in the year to date, net sales of bonds and equities by non-residents have amounted to R19,2 billion. Despite these net sales and the continued purchase of foreign exchange by the Bank, the rand exchange rate has remained firm but volatile.

The rand exchange rate has remained relatively unchanged since the previous meeting of the MPC, but has fluctuated between R6,80 and R7,33 per US dollar during this period. Part of the recent strength of the rand can be ascribed to US dollar weakness. During this period, the US dollar depreciated by almost 5 per cent against the euro, despite rating downgrades in a number of euro area countries. Since the previous meeting, the rand has depreciated by over 3,0 per cent against the euro and by about 1,0 per cent on a trade-weighted basis.

Domestic growth prospects appear to have improved moderately. Real gross domestic product (GDP) grew by 2,8 per cent in 2010, and at an annualised rate of 4,4 per cent in the fourth quarter. The Bank's forecast has increased somewhat since the previous MPC meeting, with GDP growth now expected to average 3,7 per cent and 3,9 per cent in 2011 and 2012 respectively. These growth rates, while an improvement, are still too low to have a significant impact on the unemployment rate, which measured 24,0 per cent in the fourth quarter of 2010. According to Statistics South Africa, formal non-agricultural employment increased by approximately 65 000 jobs in that quarter. The more favourable growth performance was driven mainly by the mining and manufacturing sectors.

A number of high-frequency indicators suggest that the growth momentum will be sustained. The composite leading business cycle indicator has maintained its positive trend, and the Kagiso/BER Purchasing Managers Index has remained above the neutral level since November 2010, suggesting a favourable outlook for the manufacturing sector. The physical volume of manufacturing production increased at a moderate year-on-year rate of 1,3 per cent in January, but the three-month-on-three-month rate increased by 2,8 per cent. However, output levels are still below those achieved before the crisis and the sector remains characterised by underutilised capacity. The utilisation of production capacity increased from 79,2 per cent in the third quarter of 2010 to 80,7 per cent in the fourth quarter compared with a pre-crisis average of around 85 per cent.

Output in the mining sector has maintained its general upward trend, notwithstanding the 1,9 per cent month-on-month decline in January. Reflecting these developments, the Rand Merchant Bank/BER business confidence index increased significantly in the first quarter of 2011 to reach a level above neutral for the first time in three years. The building sector was the only sector in which negative sentiment was recorded. This is consistent with the quarter-on-quarter decline in the real value of new building plans passed in the fourth quarter of 2010, and the persistently low level of the First National Bank (FNB) civil construction index.

Domestic growth prospects will also be dependent on developments in gross fixed capital formation, which declined by 3,7 per cent in 2010 and made a negative contribution to GDP in that year. In the fourth quarter of 2010 an annualised increase of 1,5 per cent was recorded. Capital expenditure by public corporations increased by 3,3 per cent in the fourth quarter of 2010, while private-sector investment, which declined by 4,4 per cent over the year, grew at an annualised rate of 1,6 per cent in the same quarter.

The relatively weak capital expenditure growth contributed to the decline in imports which, along with improved commodity prices, allowed for a marked decline in the deficit on the current account of the balance of payments to 0,6 per cent of GDP in the fourth quarter of 2010. However, should capital expenditure pick up, as envisaged by the public corporations, the current-account deficit is likely to widen.

Real final consumption expenditure by households increased by 5,1 per cent in the final quarter of 2010, indicative of continued positive consumer sentiment and positive disposable income growth. This category of expenditure made the largest contribution – 2,8 percentage points – to growth in GDP during the year. There are indications that although consumption expenditure growth will remain relatively robust, it is unlikely to accelerate to excessive levels in the short term.

The FNB/BER consumer confidence index declined in the first quarter of 2011, but still remains at a relatively high level. This was consistent with the decline in confidence, albeit from high levels, evident among retailers in the business confidence index, and the retail trade sales growth in January, which was below market expectations. Expenditure on durable goods, in particular new motor vehicles, has been strong.

Consumption expenditure is expected to be constrained to some extent by the continued high levels of household indebtedness, which declined marginally to 77,6 per cent of disposable income in the fourth quarter, and the further increase in the number of consumers with impaired credit records since the implementation of the National Credit Act. Banks' ratio of impaired advances to gross loans and advances has remained relatively unchanged at around 5,8 per cent for some time.

Bank credit extension to the private sector has remained subdued. Total loans and advances by banks to the private sector have been growing at an annual rate of around 4 per cent since September 2010, driven largely by mortgage loans and general loans, mainly to the household sector. Growth in mortgage advances, however, declined from 4,8 per cent in November 2010, to 3,8 per cent in January 2011, reflecting the subdued state of the property market.

The various house price indices all indicate that house prices are either falling or increasing at very low nominal rates. This, combined with the recent decline in equity prices, may contribute to a moderation of the impact of wealth effects on consumption.

The recent national government budget tabled before parliament indicates a moderately looser fiscal policy stance through a slower pace of fiscal deficit reduction compared with that in the October 2010 Medium Term Budget Policy Statement (MTBPS). The fiscal deficit is now estimated to decline to 3,8 per cent of GDP by the 2013/14 fiscal year compared with 3,2 per cent in the MTBPS. The government debt-to-GDP ratio is expected to peak at 43,1 per cent in 2013/14, which is much lower than the internationally acceptable norm of around 60 per cent.

High real wage settlements have been a significant upside risk to the inflation outlook. However, there are indications that nominal wage settlement rates may be moderating. According to Andrew Levy Employment Publications, the overall average wage settlement rate in collective bargaining agreements amounted to 8,2 per cent in 2010, compared with a rate of 9,3 per cent in 2009. Similarly, the downward trend in year-on-year growth in unit labour costs continued into the fourth quarter of 2010 when it measured 7,7 per cent, compared with 9,3 per cent in the previous quarter. This positive trend, if continued, may contribute meaningfully to attaining an environment of low inflation and employment creation.

The biggest risks to the inflation outlook remain food and administered prices, in particular oil prices. International oil prices had already accelerated in the latter part of 2010 in response to strong global demand and this upward trend has been reinforced by the geopolitical events in the Middle East and North Africa, which have raised concerns about the security of oil supplies. Should these political issues be resolved soon, the underlying demand pressures are likely to still keep oil prices at relatively elevated levels. Since the previous MPC meeting, Brent crude oil prices have increased by almost US$20 per barrel. Domestic petrol prices have increased by just under R1 per litre since January 2011, and a further upward adjustment is expected in April, in addition to the increased fuel levy.

The MPC is of the view that the risks to the inflation outlook are on the upside. However, these risks and underlying pressures are mainly of a cost–push nature. In the light of the above, the MPC has decided to keep the repurchase rate unchanged at 5,5 per cent per annum for the time being. Given the significant upside risks to the inflation outlook, the MPC will closely monitor any indications of second-round effects on inflation emanating from these cost pressures.

Statement of the Monetary Policy Committee

12 May 2011

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

Since the previous meeting of the MPC, the inflation outlook has deteriorated further, mainly as a result of external cost–push factors. Underlying demand conditions remain relatively restrained, and are not seen to pose a significant risk to the inflation outlook at this stage. However, there are elevated risks that these external price shocks could ultimately feed through to more generalised inflation.

The domestic economic recovery has been sustained, although still at relatively moderate rates, and there are no signs of a significant increase in employment. Moreover, the international outlook remains uncertain, and the economic recovery has become more hesitant in the past weeks, in the wake of renewed concerns about peripheral Europe, the earthquake in Japan and higher commodity prices.

The year-on-year inflation rate as measured by the consumer price index (CPI) for all urban areas increased to a higher-than-expected level of 4,1 per cent in March 2011, from 3,7 per cent in February. The main contributions to the inflation outcome came from food, housing and utilities, and transport which, together, accounted for 2,9 percentage points. Food price inflation increased markedly to a year-on-year rate of 5,1 per cent from 3,5 per cent in February, while petrol and electricity prices increased at rates of 16,9 per cent and 19,3 per cent respectively. Administered price inflation excluding petrol remained unchanged at 9,1 per cent. Underlying inflation pressures remained relatively stable, and in February and March CPI inflation excluding food and petrol measured 3,4 per cent; the lowest rate since September 2006.

Year-on-year producer price inflation reversed its recent downward trend and measured 6,7 per cent and 7,3 per cent in February and March respectively. Electricity, mining and quarrying, and products of petroleum and coal were the main contributors to this upward trend. In contrast to developments at the CPI level, food price pressures remained relatively subdued in February and March. Agricultural and manufactured food prices increased by 2,7 per cent and 2,9 per cent respectively in March.

Since the previous meeting of the MPC, there has been a further upward revision to the Bank's CPI forecast. Inflation is now expected to reach the upper limit of the inflation target range during the final quarter of 2011 and to peak at 6,3 per cent in the first quarter of 2012, before returning to within the target range by the second quarter of 2012 and remaining close to the upper limit of the range for the rest of that year. Inflation is expected to average 5,1 per cent in 2011 and 6,0 per cent in 2012, compared with averages of 4,7 per cent and 5,7 per cent forecast at the time of the previous meeting. The upward adjustment is mainly due to revised assumptions regarding administered price increases over the forecast period.

The survey of market analysts conducted by Reuters also reflects a further upward adjustment in the inflation forecasts. In the April survey the mean forecast of CPI inflation measured 5,0 per cent for 2011, and 5,8 per cent for 2012; up from 4,8 per cent and 5,7 per cent respectively in the March survey. Expectations for 2013 were unchanged at 5,7 per cent. The break-even inflation rates, as reflected in the yield differential between conventional government bonds and inflation-linked bonds have also exhibited an upward trend.

The global economic environment continues to be characterised by uneven recoveries within and across regions. Growth prospects in a number of the advanced economies, including the United States (US), the United Kingdom and some European economies remain uncertain in the face of the need for fiscal consolidation and risks posed by higher commodity prices, which have the potential to destabilise inflation and growth. Unemployment has also remained persistently high in a number of industrialised countries, notably in the US and Spain. Spending in Europe, in particular, has been constrained in part by the undercapitalisation of a significant portion of the banking sector. There are heightened concerns about the ability of some of the peripheral European countries, particularly Greece, Ireland and Portugal, to meet their debt obligations and this poses a systemic risk to the region. Lower growth in Japan and the disruption to the global supply chain caused by the earthquake and its aftermath are also likely to impact negatively on near-term global growth prospects.

By contrast, growth in emerging markets has generally remained strong, with evidence of overheating in some countries, particularly in Asia and Latin America.

Global headline inflation has increased, driven primarily by higher food and other commodity prices, particularly oil. In advanced economies core inflation appears to be generally subdued against the backdrop of persistent output gaps. However, in a number of emerging market economies, supply-side pressures have been accompanied by strong aggregate demand pressures and above-trend growth, resulting in a generally tighter monetary policy environment.

Since the MPC's previous meeting, the exchange rate of the rand against the US dollar has been relatively volatile. During this period, the rand fluctuated in a range of R6,95 and R6,54 against the US dollar, and on a trade-weighted basis the rand depreciated by 0,9 per cent. These developments were affected to a significant extent by the depreciation of the US dollar against other currencies, driven in part by the expected continuation of the accommodative stance of monetary policy in the US. The relatively strong rand exchange rate persisted despite continued purchases of foreign exchange by the Bank.

Other factors underpinning rand strength during this period included strong commodity prices, the narrower current-account deficit and a resumption of portfolio flows to South Africa. Since the beginning of April, non-residents have purchased around R27,1 billion worth of domestic bonds and equities, and net purchases year to date stand at R14,5 billion. This marked a reversal of the negative trend in portfolio capital flows experienced by South Africa and some other emerging markets since the final quarter of 2010.

Domestic economic growth is lower than that of our emerging-market peers. The Bank's forecast for economic growth is 3,6 per cent (previously 3,7 per cent) and 3,9 per cent for 2011 and 2012 respectively. The composite leading business cycle indicator of the Bank is suggestive of the continued recovery in the economy. Manufacturing sector output growth has improved somewhat against the backdrop of positive business confidence. In March the year-on-year increase in the physical volume of manufacturing output measured 4,6 per cent, compared with 5,7 per cent in February. On a three-month on three-month basis, the increase was 4,0 per cent.

Consistent with this recovery, the Kagiso Purchasing Managers Index has remained above the neutral level since November 2010, although the positive trajectory seen in the past few months was reversed marginally in April. Despite these positive developments, the level of output remains below that attained before the global crisis and the sector remains characterised by underutilised capacity. The utilisation of production capacity measured 79,4 per cent in February 2011, compared with 81,6 per cent in November 2010 and 78,4 per cent in February 2010.

Mining output has been more subdued in the past months. Mining production declined by 1,4 per cent on a year-on-year basis in March, but when comparing the three months to March with the preceding three months, an increase of 0,4 per cent was recorded. The construction sector also remains under pressure, with the real value of building plans passed declining by 18,2 per cent on a month-to-month basis in February, and by 13,1 per cent on a year-on-year basis. The First National Bank (FNB) Civil Construction Index continued the downward trend that has been evident since 2008.

The positive momentum observed in the past few quarters in the growth in household consumption expenditure appears to have been sustained. However, these levels are not giving rise to any obvious inflationary pressures and there are tentative signs that this momentum may be levelling off. Year-on-year real retail sales growth moderated from 6,3 per cent in January to 5,6 per cent in February. On a month-on-month basis, real retail sales declined by 1,0 per cent in February, but increased by 2,2 per cent when comparing the three months to February 2011 with the previous three months. Year-on-year growth in new vehicle sales declined to 8,0 per cent in April, from

22,8 per cent in March. This slowdown has been ascribed to the high number of public holidays in that month and to the impact of the disaster in Japan on the sector.

Growth in credit extension to the private sector remains relatively subdued. The twelve-month growth rate of total loans and advances to the private sector measured 5,3 per cent in March, but annualised growth in the first quarter of 2011 declined to 4,5 per cent, from 5,4 per cent in the previous quarter. Growth was driven mainly by other loans and advances, particularly general loans, and by a recovery in instalment sale and leasing finance, reflecting strong motor vehicle sales. Twelve-month growth in mortgage advances declined from a recent high of 4,8 per cent in November 2010 to 2,9 per cent in March 2011, consistent with the continued weakness in the housing market.

Credit extended to the corporate sector increased at a year-on-year rate of 2,3 per in March 2011, compared with 1,3 per cent in January, amid tentative indications that banks may have relaxed their risk premiums somewhat. Demand for credit by the household sector remains constrained by high debt levels and the high number of consumers with impaired debt records. The ratio of impaired advances to gross loans and advances has remained at around 5,8 per cent since December 2010, mainly attributable to retail debt. The fact that this ratio has not declined further over the past six months is cause for concern.

According to the Quarterly Labour Force Survey published by Statistics South Africa, the unemployment rate in the first quarter of 2011 stood at 25,0 per cent, marginally lower than the 25,2 per cent measured in the first quarter of 2010. Despite the unfavourable employment environment, wage settlements and unit labour cost increases remain at levels in excess of inflation. According to Andrew Levy Employment Publications, the overall average wage settlement rate in collective bargaining agreements amounted to 8,2 per cent in the first quarter of 2011. Unit labour costs increased by 7,7 per cent in the fourth quarter of 2010, with labour productivity growth declining from 3,1 per cent in the third quarter to 2,2 per cent in the fourth quarter.

The main risks to the inflation outlook continue to emanate from cost–push pressures, including administered prices. The acceleration in food price inflation is expected to persist for some time, despite indications that global food price inflation may have peaked.

The international oil price has also displayed a marked degree of volatility in the past week, when prices fell by as much as US$13 in one day. Having risen sharply over recent weeks, the price of oil reached a peak of around US$126 per barrel. The price of Brent crude oil today, 12 May, has fallen and is about US$3 per barrel lower than that prevailing at the time of the previous MPC meeting. While international oil prices are not expected to decline further in the near term, it is unclear if prices will consolidate at current levels, or if they will continue on their upward path. In the past two months the domestic petrol price has increased by 8,8 per cent, and by 17,4 per cent since the beginning of the year.

The MPC continues to be of the view that the underlying inflation pressures are mainly of a cost–push nature. These developments are expected to result in a temporary breach of the upper limit of the target band during the first quarter of 2012. It is recognised that these pressures have the real potential to generate second-round effects, which can result in more generalised inflation.

In the light of the above, the MPC has decided to keep the repurchase rate unchanged at 5,5 per cent per annum, for the time being. Given the upside risks to the inflation outlook, the MPC will monitor closely any indications of second-round effects on inflation emanating from these cost pressures. The MPC will not hesitate to respond in a timely manner to signs that threaten to move inflation out of the target range on a sustained basis. In addition, the MPC will remain vigilant with respect to any inflation risks that could emanate from domestic demand developments.

Abbreviations

Alsi	All-Share Index
API	administered price index
BCI	Business Confidence Index
BER	Bureau for Economic Research [of Stellenbosch University]
BIS	Bank for International Settlements
BoE	Bank of England
BoJ	Bank of Japan
BRICS	Brazil, Russia, India, China and South Africa
CDS	credit-default swap
Copom	Monetary Policy Committee [Brazil]
CPI	consumer price index for all urban areas
ECB	European Central Bank
EFSF	European Financial Stability Facility
ESM	European Stability Mechanism
EU	European Union
FNB	First National Bank
FOMC	Federal Open Market Committee
GDP	gross domestic product
HICP	harmonised index of consumer prices
IEA	International Energy Agency
IMF	International Monetary Fund
JSE	JSE Limited
MENA	Middle East and North Africa
MPC	Monetary Policy Committee
NAB	non-alcoholic beverage
NEER	nominal effective exchange rate
OECD	Organisation for Economic Co-operation and Development
OPEC	Organization of the Petroleum Exporting Countries
PMI	Purchasing Managers' Index
PPI	producer price index
PSBR	public-sector borrowing requirement
REER	real effective exchange rate
RMB	Rand Merchant Bank
S&P	Standard & Poor's
UK	United Kingdom
US	United States
WEO	*World Economic Outlook*

Glossary

the Bank	South African Reserve Bank
the Fed	United States Federal Reserve
repo	repurchase