Monetary Policy Review

May 2012

South African Reserve Bank

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http://www.reservebank.co.za ISSN: 1609-3194

Preface

The mandate of the South African Reserve Bank (the Bank) is to achieve and maintain price stability in the interest of balanced and sustainable economic growth. The Bank plays a central role in overseeing and maintaining financial stability. Low inflation helps to protect the purchasing power and living standards of all South Africans. Price stability reduces uncertainty in the economy and provides a favourable environment for growth and employment creation.

Price stability is quantified by the setting of an inflation target range by government after consultation with the Bank. The commitment is to pursue a continuous target of 3 to 6 per cent for headline CPI inflation. The Bank conducts monetary policy within a flexible inflation-targeting framework that allows for inflation to be temporarily outside the target range as a result of supply shocks. The Monetary Policy Committee (MPC) takes into account a viable medium-term time horizon for inflation to return to within the target range, considering the lags between policy adjustments and economic effects. This provides for interest rate smoothing over the cycle and makes growth more sustained and consistent.

The *Monetary Policy Review* (*MPR*) is published twice a year, and is aimed at broadening the understanding of the objectives and conduct of monetary policy. The *MPR* reviews domestic and international developments that have impacted on inflation, and that motivate the monetary policy stance. The *MPR* also provides an assessment of the outlook for and the factors determining inflation and the Bank's forecast of the future path of inflation and economic growth. The *MPR* is presented by senior officials of the Bank at Monetary Policy Forums (MPFs) in various centres across South Africa to develop a better understanding of monetary policy through interaction with stakeholders.

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Introduction

The previous *MPR* was published in November 2011 at a time of deep concern about the global economy and its near-term trajectory. This *MPR* also marks a point of heightened uncertainty and concern over a range of critical economic developments, primarily in Europe. A key characteristic of the global financial and economic crisis and its aftermath has been a slow and turbulent recovery, marked by sharp swings in economic outcomes and sentiment. Political change has become an increasingly common occurrence as the global economy seesaws and unemployment remains stubbornly high.

The difficulties of the global economy were starkly evident in the second half of 2011, as forecasts for growth were marked down and inflation projections marked up nearly everywhere. A sharp rise in international oil prices contributed to an increase in headline inflation in almost all countries and regions in 2011. Growth in emerging-market and developing economies had remained quite strong but, as the end of the year approached, export and import dependencies and financial contagion effects, among other linkages, resulted in a more generalised slowdown. Robustly growing economies such as China, India and Brazil slowed abruptly.

A moderation in global consumer price inflation began late in 2011 and continued into 2012, providing some relief to the heightened concerns about inflation evident earlier in 2011. This trend has enabled major advanced and emerging economies to retain accommodative monetary policies to support real economic activity. Somewhat better-than-expected economic growth rates in a few larger economies in recent months have also contributed to marginal upward revisions to global growth forecasts for 2012 and 2013.

Yet, confidence in the recovery remains extraordinarily fragile due to the still-unresolved European sovereign debt crisis and the halting and inconsistent real economy outcomes. The financial situation of Europe's banks and sovereigns remains the single biggest risk to the global recovery. The combination of financial and real economy factors has resulted in sharp and unpredictable changes in risk aversion and, hence, volatility in international capital flows and exchange rates. In keeping with the ups and downs of the global situation, inflation concerns have ticked up again very recently in some advanced and emerging-market economies.

These international developments shaped domestic growth and inflation outcomes in South Africa, and set out the potential risks to the medium- to longer-term outlook. South Africa's uneven and fragile economic recovery gained momentum in the fourth quarter of 2011 as negative supply shocks dissipated. Growth in fixed capital formation firmed in the course of the year and into 2012. Household consumption expenditure continued to provide the main support to the domestic recovery as job creation picked up, alongside stronger growth in credit extension. Recent data, however, have been disappointing. The economic outlook for South Africa remains modest with a gradual recovery in domestic demand and supply expected, barring further international turbulence. The probability of future growth and financial shocks emanating from global developments remains high.

Domestic inflation breached the inflation target range in November 2011 but returned to the upper 6 per cent level in March 2012 before again breaching the target in April. The largest contributions came from food and administered prices. Wage pressures have moderated somewhat. Exogenous price pressures remain elevated, although again there are some indications of moderation. While core inflation remains moderate and contained, its upward trend has been a source of concern. Oil prices continue to pose a major risk to both growth and inflation outcomes in 2012 and beyond.

The inflation outlook has improved in terms of both the projected level of the peak and the profile of returning to the target. On balance, there is upside risk to the inflation outlook. The main risks to the inflation outlook remain the oil price, administered prices and the impact of global risk adjustments on the exchange rate.

This *MPR* analyses the latest developments in inflation and the factors that affect inflation. It reviews recent monetary policy developments, discusses the outlook for inflation and presents the growth and inflation forecast of the Bank. In addition, topical issues are addressed in boxes. The first box reviews the regulatory setting of tariffs in the energy sector. The second box considers how global investor sentiment, as reflected by risk aversion, impacted on asset prices in emerging-market countries, including exchange rates and how it, in turn, affects inflation in the case of South Africa. The third reports on recent changes to the Bank's monetary policy operational procedures to enhance domestic liquidity management as part of monetary policy implementation.

Recent developments in inflation

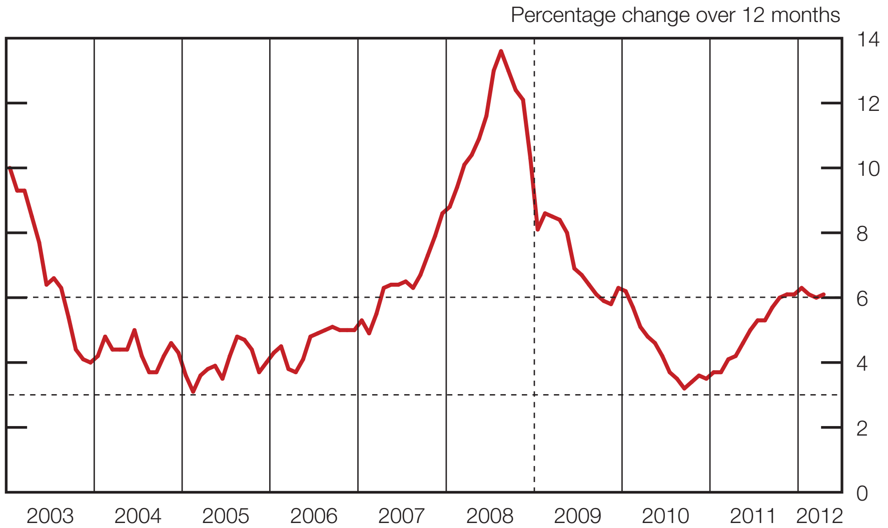
This section reviews recent trends in the main inflation indices and looks at the main factors impacting on inflation in South Africa.

The evolution of inflation indicators

Targeted inflation increased consistently in the course of 2011. It breached the upper band of the target range in November 2011, reaching 6,3 per cent in January 2012, before returning to within the target, recording 6,0 per cent in March 2012. Headline CPI increased again to 6,1 per cent in April. The largest contributions to overall inflation came from housing and utilities, followed by food, and transport. Food price inflation has moderated after 18 months of sustained increases, as meat and vegetable price inflation has eased markedly. Core inflation trended upwards within the target range, suggesting more generalised inflation pressures although still remaining well contained. Administered prices continued to increase at rates well above the upper band of the target range, driven by electricity, petrol and assessment rates.

The year-on-year percentage change in the headline consumer price index (CPI), the measure of inflation targeted by the Bank, increased from 5,7 per cent in September 2011 to 6,3 per cent in January 2012; breaching the upper band of the 3 to 6 per cent inflation target range in November 2011. In March 2012 inflation fell back into the target range at 6,0 per cent (Figure 1) before again increasing to 6,1 per cent in April.

Figure 1 Consumer price inflation: Targeted inflation*



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

Source: Statistics South Africa

The food and non-alcoholic beverages (NAB) category (weight in the CPI of 15,68 per cent) has continued to make a significant contribution to the increases in targeted inflation (Table 1). The contribution increased from 1,3 percentage points in September 2011 to a high 1,7 percentage points in November and December, receding somewhat to 1,4 percentage points in April 2012. Rising petrol prices have caused the contribution from the transport category to increase from 1,1 percentage points in September 2011 to 1,2 percentage points over the period October 2011 to February 2012, receding to 1,1 percentage points in March 2012 and edging up to 1,2 percentage points in April. The housing and utilities category has continued to make a stable but significant contribution to overall inflation.

Table 1 Contributions to targeted inflation

Percentage change over 12 months* and percentage points

	2011				2012			
	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr
Targeted inflation*..	5,7	6,0	6,1	6,1	6,3	6,1	6,0	6,1
Of which:								
Food and non-alcoholic beverages...................	1,3	1,6	1,7	1,7	1,6	1,5	1,4	1,4
Food..	1,2	1,6	1,6	1,7	1,5	1,4	1,3	1,3
Alcoholic beverages and tobacco.....................	0,4	0,4	0,4	0,4	0,4	0,4	0,5	0,5
Housing and utilities	1,6	1,6	1,6	1,5	1,6	1,5	1,5	1,6
Health..	0,1	0,1	0,1	0,1	0,1	0,1	0,1	0,1
Transport...	1,1	1,2	1,2	1,2	1,2	1,2	1,1	1,2
Education...	0,2	0,2	0,2	0,2	0,2	0,2	0,2	0,2
Restaurants and hotels.....................................	0,2	0,2	0,2	0,2	0,2	0,2	0,2	0,2
Miscellaneous goods and services	0,7	0,7	0,7	0,7	0,8	0,8	0,8	0,8
Other..	0,1	0,0	0,0	0,1	0,2	0,2	0,2	0,1

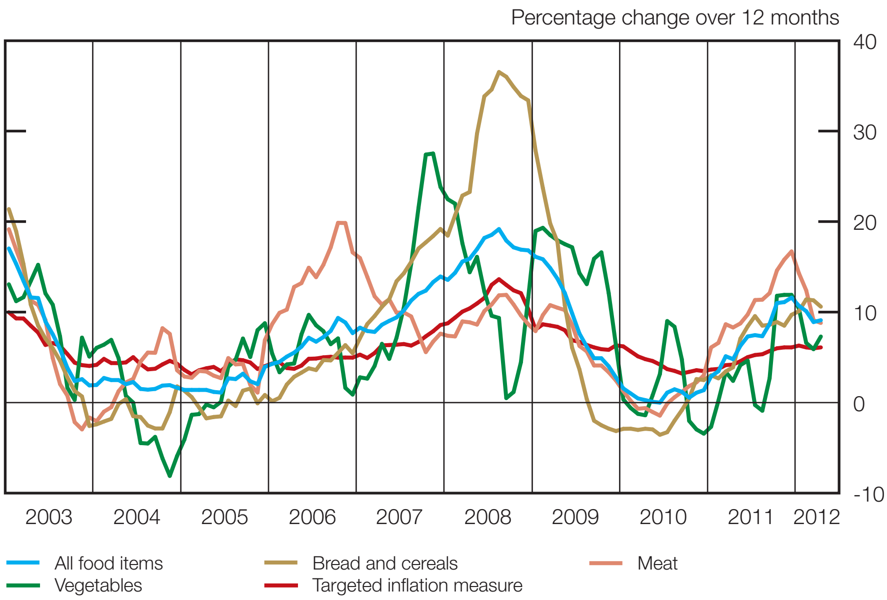
Sources: Statistics South Africa and own calculations

Food prices

Food price inflation continues to drive the overall outcome in the food and non-alcoholic beverages category. Food price inflation (weight in the CPI of 14,27 per cent) increased from 8,7 per cent in September 2011 to 11,6 per cent in December before falling to 9,1 per cent in April 2012 (Figure 2). This slight moderation can be attributed to meat price inflation (weight in the CPI of 4,59 per cent) which has eased significantly, falling from 16,7 per cent in December 2011 to a still-high 8,8 per cent in April 2012. Vegetable price inflation (weight in the CPI of 1,63 per cent) also peaked at 11,9 per cent in November and December 2011 before easing significantly to 5,9 per cent in March and then rising to 7,3 per cent in April 2012. There was continued pressure on food price inflation from the bread and cereals category (weight in the CPI of 3,08 per cent).

From late November 2011 to January 2012, white maize prices increased by about 10 per cent to R2 696 per ton, and then fell by about 18 per cent in February, only to recover to January levels in March (Figure 3). White maize prices then fell by 22 per cent to R2 088 per ton in May. The price level of white maize moved within the upper half of the range between import parity prices and export parity prices due to uncertainty about the availability of maize locally (in part because of large commitments to export maize) and concerns about the harvest, which is expected to be relatively subdued. This has recently been counteracted somewhat by early harvesting locally and news that the United States (US) has started early with planting maize for the next season and has intentions to plant the greatest area recorded since 1937.

Figure 2 Targeted inflation* and food inflation

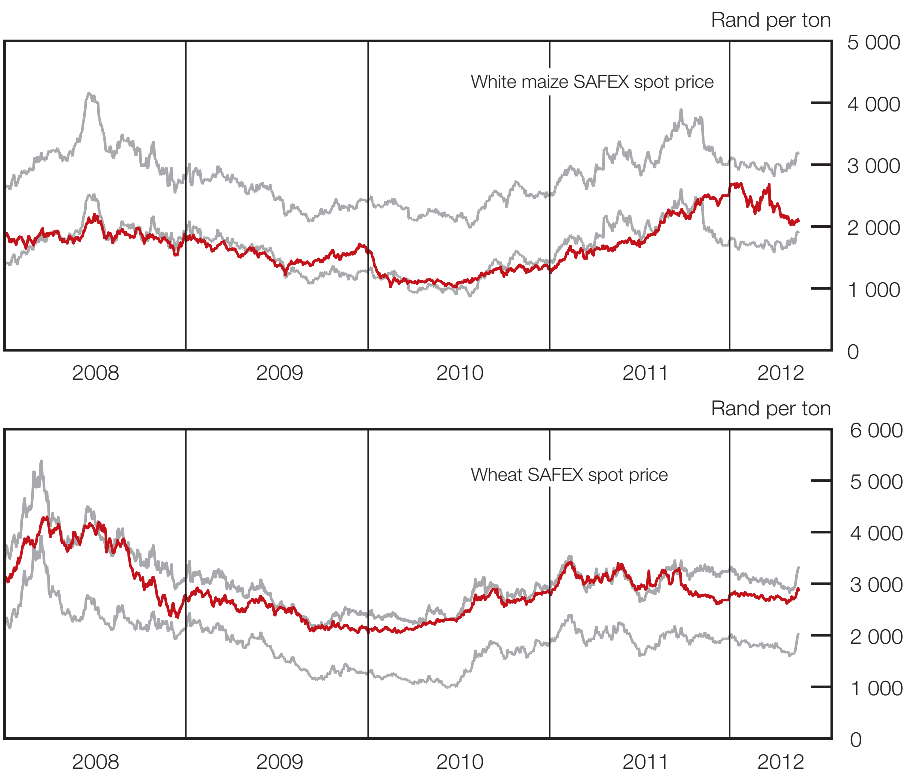


* CPIX for metropolitan and other urban areas until the end of 2008; CPI for all urban areas thereafter

Source: Statistics South Africa

Wheat price increases have been relatively moderate and trade close to import parity. A significantly improved recent crop estimate for the 2011 production season may sustain a larger gap between the SAFEX spot price of wheat and import parity.

Figure 3 Selected commodity prices



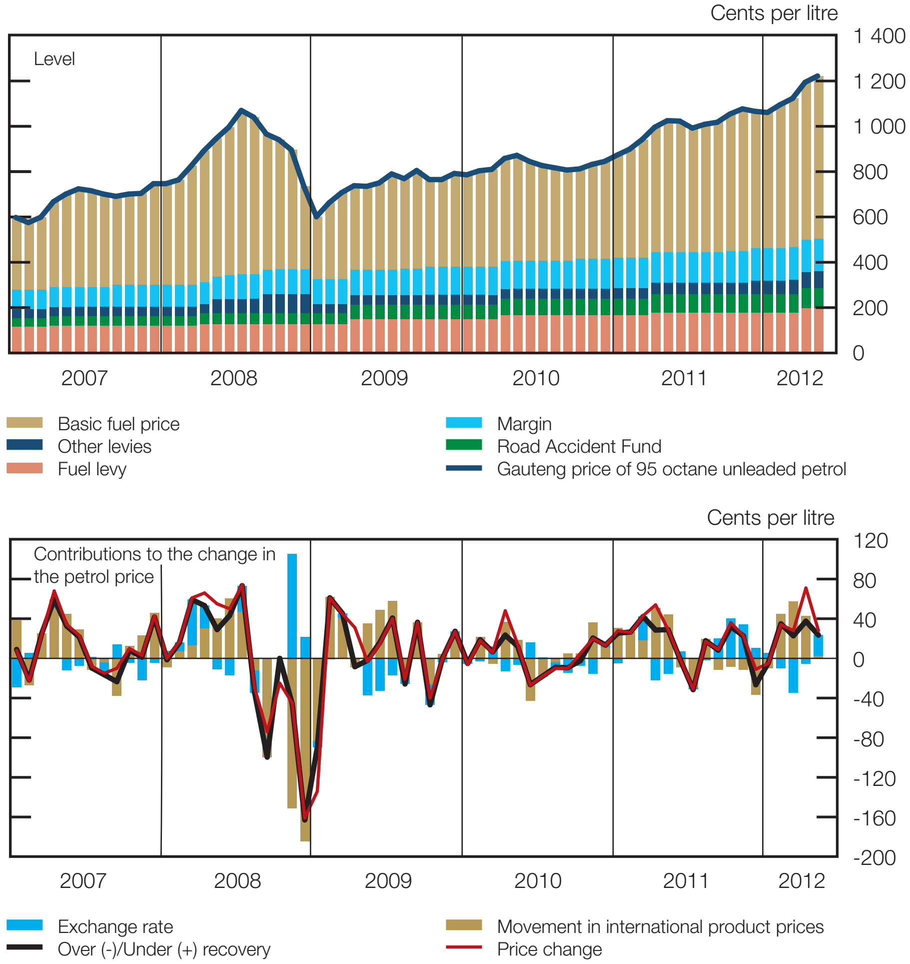
Note: The top grey line is the import parity price and the bottom grey line is the export parity price. These prices are the theoretical upper and lower bound prices for commodities.

Source: Grain South Africa

Petrol prices

The price of 95 octane unleaded petrol in Gauteng reached R10,70 cents per litre in July 2008. This was surpassed in November 2011 when it scaled R10,77 cents per litre. After a brief dip in petrol and underlying international oil prices in December 2011 and January 2012, (Figure 4) petrol prices increased again in February and March. A somewhat stronger exchange rate helped to offset the full increase coming from the international oil price. Prices rose again in April 2012, to R11,94 cents per litre, in large part due to the 20,0 cent increase in the fuel levy, an 8,0 cent increase in the Road Accident Fund contribution and a 3,9 cent increase in the zone differential levy. In May the petrol price rose by a further 28 cents per litre to R12,22 primarily as a result of weakness in the exchange rate. The year-on-year percentage change in the petrol price in CPI peaked at 30,0 per cent in October 2011 and has since fallen to 20,0 per cent in April 2012.

Figure 4 South African petrol price



Source: Department of Energy

Goods and services price inflation in the CPI has increased since September 2011 as shown in Table 2. The rate of increase in goods prices exceeded the upper band of the inflation target range between October 2011 and February 2012, briefly receding to 6,0 per cent in March 2012 before rising to 6,3 per cent in April. Non-durable goods prices have been the primary driver of overall goods price inflation, peaking at 11,1 per cent in November 2011, before subsiding to 9,6 per cent in April 2012. Inflation in semi-durable and durable goods has been very moderate and even negative.

Table 2 Targeted inflation: Goods and services inflation

Percentage change over 12 months

	2011				2012			
	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr
Targeted inflation	5,7	6,0	6,1	6,1	6,3	6,1	6,0	6,1
Goods inflation	5,8	6,5	6,6	6,7	6,5	6,5	6,0	6,3
Durable goods	-2,0	-2,7	-2,4	-2,1	-1,2	-0,8	-0,9	-0,8
Semi-durable goods	2,2	1,4	1,7	1,9	2,0	2,0	1,5	1,8
Non-durable goods	9,7	11,0	11,1	10,9	10,2	10,0	9,5	9,6
Services inflation	5,4	5,5	5,5	5,6	5,9	5,8	5,9	5,9

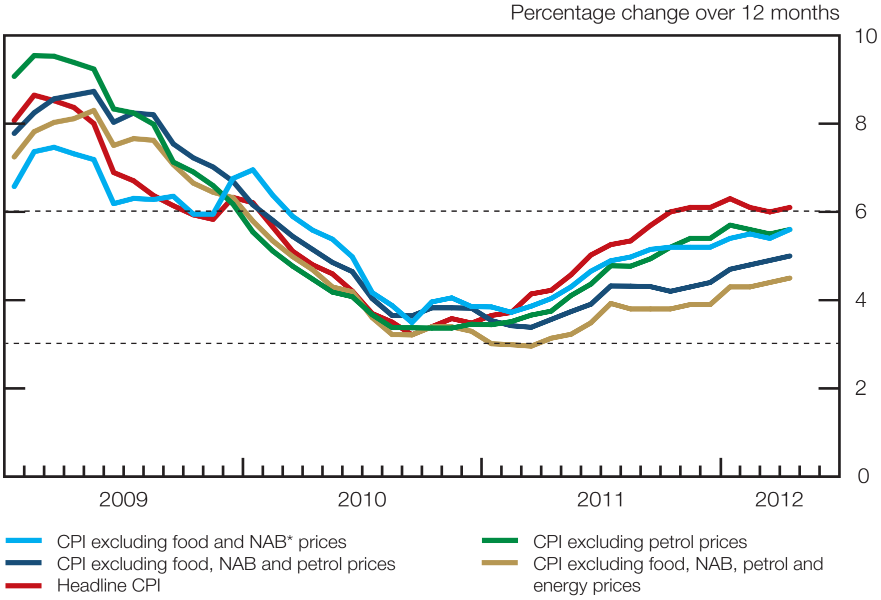
Source: Statistics South Africa

Although rising through the period, services price inflation has remained within the target range. Services inflation increased over the period under review by 0,5 percentage points from September 2011 to around 5,9 per cent between January and April 2012.

Core inflation measures have continued to trend upwards since the previous review, although remaining within the inflation target range (Figure 5). Core inflation has been driven by, among other things, inflation in alcoholic beverages, vehicles, public transport, insurance, and financial services. CPI excluding petrol prices rose to 5,7 per cent in January 2012 and has remained high since. Similarly, CPI excluding food and NAB rose to 5,6 per cent in April 2012 as did CPI excluding petrol, food and NAB which rose to 5,0 per cent. CPI excluding food, NAB, petrol and energy prices rose from 3,8 per cent in September 2011 to 4,5 per cent in April 2012.

The core inflation measures suggest that a strong impetus to headline inflation continues to come from administered prices, and in particular electricity and petrol prices. About three quarters of the rise in administered prices over the period came from electricity, petrol and assessment rates.

Figure 5 The effect of food, petrol and energy prices on headline inflation



* NAB: Non-alcoholic beverages

Source: Statistics South Africa

The range of administered prices, their weights in the CPI and their contribution to inflation are shown in Table 3.

Table 3 Contributions to administered prices

Percentage change over 12 months* and percentage points

	Weights		2011				2012			
	CPI	API	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr
CPI for administered prices*	14,66	100,00	12,5	13,3	13,4	12,7	11,6	11,7	11,2	11,6
Regulated component										
Water	1,10	7,50	1,0	1,0	1,0	1,0	0,9	0,9	0,9	0,9
Electricity	1,68	11,46	3,0	3,0	3,0	3,0	3,0	2,9	2,9	2,8
Paraffin	0,16	1,09	0,2	0,2	0,2	0,2	0,2	0,2	0,1	0,1
Petrol	3,93	26,81	5,4	6,3	6,3	5,7	4,8	4,9	4,4	4,8
Telephone fees	1,26	8,59	-0,1	-0,1	-0,1	-0,1	-0,1	-0,1	-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
Cellular telephone calls	1,47	10,03	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0
Unregulated component										
Assessment rates	2,07	14,12	1,1	1,1	1,1	1,1	1,1	1,1	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
Refuse collection	0,09	0,61	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0
Train fees	0,04	0,27	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,1
Motor vehicle licences	0,09	0,61	0,1	0,1	0,1	0,1	0,1	0,1	0,1	0,1
Motor vehicle registration fees	0,10	0,68	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
Primary and secondary school fees	1,28	8,73	0,8	0,8	0,8	0,8	0,8	0,8	0,8	0,8
University fees	0,90	6,14	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

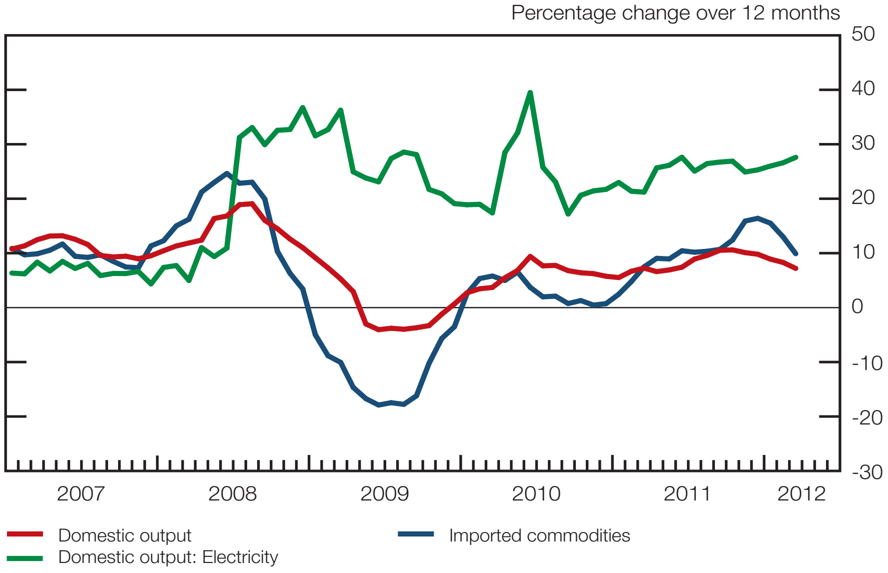
Source: Statistics South Africa

Administered price inflation rose from 12,5 per cent in September to a high of 13,4 per cent in November 2011 but has since fallen somewhat to 11,6 per cent in April 2012.[1] In March 2012 the National Energy Regulator of South Africa (NERSA) announced revised electricity tariffs for the period April 2012 to March 2013. The average price increase was revised downwards from 25,9 per cent to 16,0 per cent, with the guideline for the municipal tariff increase given at 11,03 per cent. NERSA has estimated that this downward revision in the tariffs would result in a decrease in the contribution of electricity prices to the CPI of 0,3 per cent over the 2012/13 financial year. *See Box 1 for a review of the setting of tariffs in the energy sector.*

1. Administered price inflation from September 2011 to April 2012 reflected a contribution to inflation of over 1,6 percentage points, calculated as the weight of the administered prices index in the headline index (14,66 per cent) multiplied by the year-on-year percentage change in the administered prices index.

The producer price index (PPI) measures the price changes of goods produced in South Africa as measured at the factory gate. Although the classification standard for the PPI and CPI differs, the prices of some PPI categories such as food give an indication of forthcoming consumer price pressures. Producer price inflation for domestic output rose to 10,6 per cent in October 2011 and has since fallen to 7,2 per cent in March 2012 (Figure 6). A decrease in the rate of inflation for mining and quarrying from 17,0 per cent in October 2011 to 6,6 per cent in March 2012 helped pull the PPI lower. The year-on-year increases in electricity prices of 27,6 per cent, and the prices of products of petroleum and coal of 19,1 per cent remained high in March 2012. Imported commodities prices rose to 16,4 per cent in December 2011 driven by continued high year-on-year rates of change in the mining and quarrying category of 50,7 per cent. This eased to 26,9 per cent in March 2012, leading to the easing of the year-on-year rate for imported commodities to 9,9 per cent. Mining and quarrying was largely influenced by crude petroleum and natural gas price changes.

Figure 6 PPI for domestic output and imported commodities

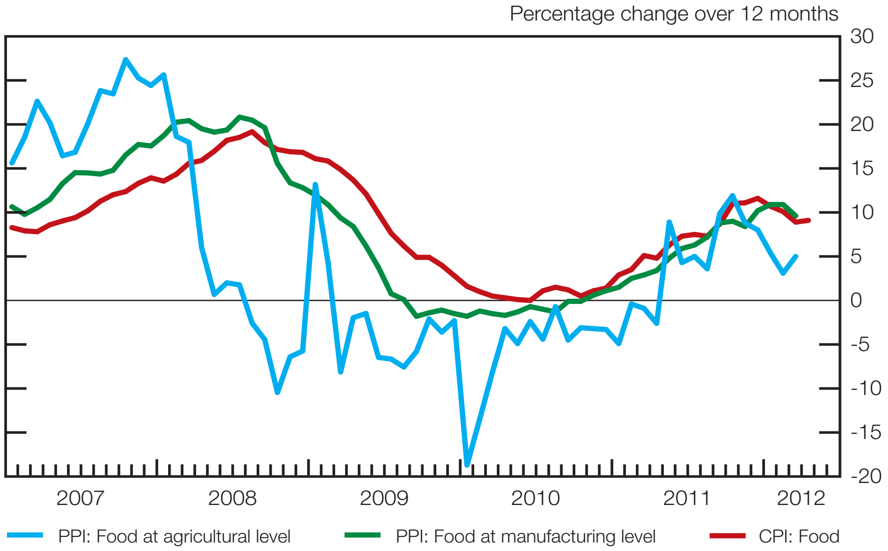


Details regarding changes to the PPI in this period are documented in statistical release P0142.1, February 2008, issued by Statistics South Africa

Source: Statistics South Africa

Food price inflation at the agricultural level as reported in the PPI remains volatile, and rose to 11,9 per cent in October 2011 before slowing significantly to 5,0 per cent in March 2012 (Figure 7). Food prices at the manufacturing level have increased since the November 2011 *MPR* to a high of 10,9 per cent in January and February 2012, and then fell to 9,6 per cent in March. As with food prices in the CPI, the trends were driven by meat and meat products, vegetables, grain mill products, and bakery products on account of developments in the grain market.

Figure 7 Food prices in the PPI and CPI



Source: Statistics South Africa

Box 1 Regulated energy tariffs as a driver of inflation and source of finance for infrastructure and economic growth

Regulation and setting of tariffs

The electricity, petroleum pipelines and piped-gas industries are regulated by various pieces of legislation, in terms of which the National Energy Regulator of South Africa (NERSA) sets and approves the tariffs of these industries in South Africa.

The basic tariff principle set out is that of 'cost reflectiveness'. A tariff should provide for the recovery of the full cost of supply (i.e., cost of rendering the service inclusive of capital, operations, maintenance, depreciation expenses, administration, working capital, interest charges and replacement cost of assets), and a fair and equitable risk-adjusted margin or return that ensures financial sustainability.

The rate of return is determined as the weighted-average cost of debt and equity capital. The cost of equity capital is, in turn, determined by the capital asset pricing model.[1] An efficient tariff structure should provide for the continued technical improvement of the service, promote overall demand and supply efficiencies, and enable the business to obtain reasonably priced funding to grow infrastructure.

Municipal base tariffs are also used to enable municipalities to recover the actual cost associated with rendering municipal electricity services, inclusive of bulk purchasing, overhead, operation maintenance, capital costs, a reasonable rate of return and other municipal surcharges.

Petroleum pipeline tariffs as a driver of inflation

On 15 March 2012 NERSA approved a tariff increase of 31,6 per cent for the period 4 April 2012 to 2 April 2013.

The pipeline tariff is used as a proxy for the cost of transporting fuel from Durban to Johannesburg. This resulted in a 4 cents per litre, or a 0,37 per cent, increase in the retail price of petrol in Gauteng over the period. Transnet proposed that future tariff applications could apply for a period of more than one year, thereby giving longer-term price signals.

Electricity tariffs as a driver of inflation

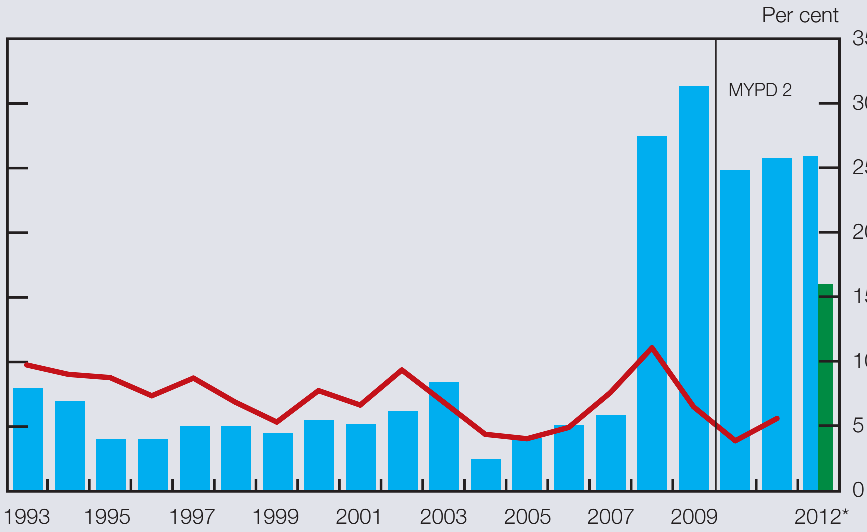
Eskom's average annual tariff adjustments over the 19 years up to the 2007/08 financial year have been below those of the corresponding annual CPI inflation rates in most years. As from Eskom's 2008/09 financial year, electricity price increases have exceeded the corresponding annual inflation rates by a significant margin, as shown in (Figure B1.1).

On 2 March 2012, Eskom applied to NERSA for a review of its tariffs for the period 1 April 2012 to 31 March 2013. Eskom proposed that the 25,9 per cent average price increase as approved by NERSA for the 2012/13 financial year be reduced by 9,9 percentage points to 16,0 per cent. The tariff reduction has been facilitated by government (as shareholder in Eskom) by re-phasing equity returns; an over-recovery held in the Regulatory Clearing Account at the end of the Multi-Year Price Determination 2 (MYPD 2) period; reduced sales volumes and lower demand projections; and Eskom's improved financial position. The current NERSA price determination ends in mid-2013 and subsequent tariff increases are still to be determined. Eskom has proposed a longer period than the standard three years for MYPD 3.

The higher tariffs led to a marked increase in the real price of electricity from the 2008/09 financial year, as shown in Figure B1.2, reversing a long period of falling real prices. The significant increases in the price of electricity were reflected in the administered price index and in headline CPI inflation.

1. The capital asset pricing model is a tool for pricing risky securities by modelling the relationship between risk and expected return to compensate investors for both the time value of money and risk.

Figure B1.1 Electricity tariff increases and the inflation rate

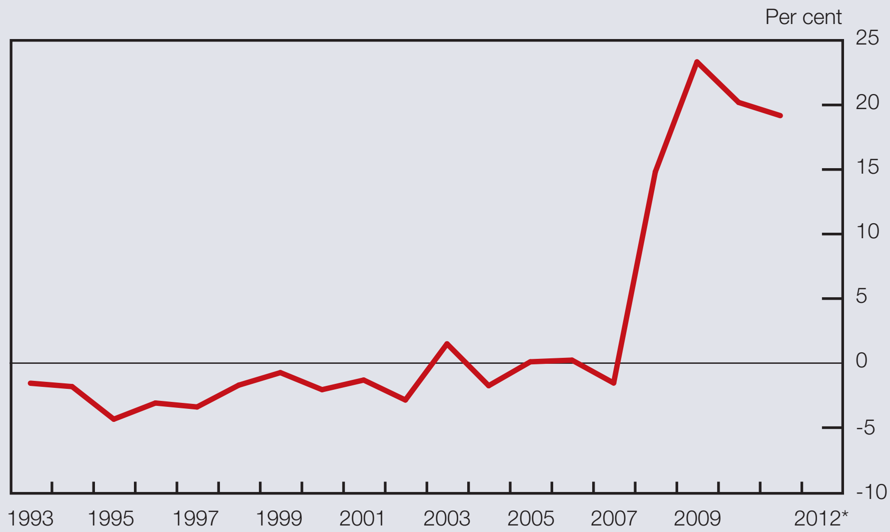


* Electricity tariff changes were effected on 1 January for 1993 through to 2005 and thereafter have been effected as of 1 April

Note: Eskom's 1 April 2008/09 tariff increase entailed two increases (an average 14,2 per cent on 1 April 2008 and 34,2 per cent on 1 July 2008). Linked inflation data comprise CPI total (metropolitan areas) from January 1993 to December 1999, CPIX total (metropolitan and other urban areas) from January 2000 to December 2008, and headline CPI for all urban areas as from January 2009 to date.

Sources: NERSA, Eskom and Statistics South Africa

Figure B1.2 Real average electricity tariff adjustments



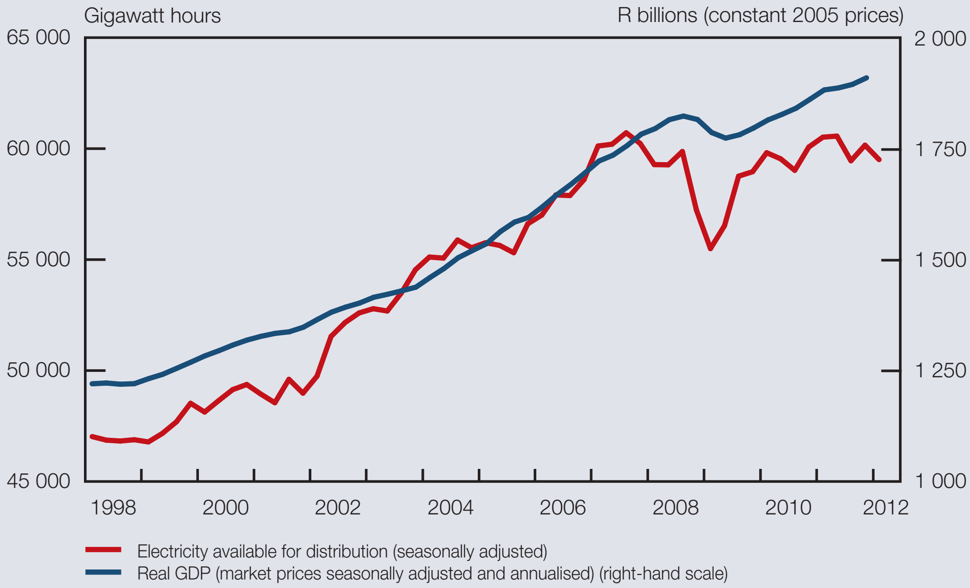
* Electricity tariff changes were effected on 1 January for 1993 through to 2005 and thereafter have been effected as of 1 April

Sources: NERSA, Eskom, Statistics South Africa and own calculations

Electricity infrastructure and the economy

A significant expansion of electricity-generation capacity is required to sustain higher levels of real economic growth in future (Figure B1.3). Longer-term certainty of the electricity price plays a critical role. From a producer's perspective, price certainty drives revenue certainty which is required for the funding and servicing of debt related to the much-needed supply infrastructure expansion. From an electricity user's perspective, clarity regarding the electricity price trajectory and an uninterrupted supply of electricity are important in making the investment decisions driving economic growth.

Figure B1.3 Electricity supply and real economic activity



Sources: Statistics South Africa and South African Reserve Bank

Factors affecting inflation

Monetary policy decisions are made on the basis of current and expected developments in the wider economy. This section takes a look back over medium-term developments and variables influencing inflation in South Africa in 2011 and the first quarter of 2012, while the near-term outlook for these variables and their likely impact on inflation are discussed in a later section.

International economic developments

Global economic activity rebounded to 5,3 per cent in 2010 but this robust growth proved short-lived and slowed to 3,9 per cent in 2011; only slightly above the long-term average. On balance, an increase was recorded in the global rate of inflation in 2011 compared with 2010. Although economic growth in 2011 was positive, for the advanced economies the current recovery has been hampered by high sovereign debt levels, and housing and financial market problems, sapping the strength of the recovery. Emerging-market economies grew more strongly due to their improved macroeconomic frameworks and lower cost structures. Economic growth nevertheless slowed significantly over the period under review because of extensive trade and investment linkages between emerging and advanced economies.

Economic growth in the advanced economies was disappointingly weak in the second half of 2011, reaching 1,6 per cent compared to the 3,2 per cent recorded the previous year. The US economy expanded by 1,7 per cent in 2011, compared with 3,0 per cent in 2010 (Table 4). Japan's economy contracted by 0,7 per cent in 2011, primarily as a result of the earthquake and tsunami, far below the 4,4 per cent achieved in 2010.

In the euro area economic growth weakened slightly to a revised 1,5 per cent in 2011 from the 1,9 per cent recorded in 2010. Growth in key economies such as Germany was still relatively robust at 3,0 per cent in 2011 compared to the stagnation experienced in the periphery. However, growth in central and eastern Europe was strong at 4,5 per cent in 2010 and increased to 5,3 per cent in 2011. In the United Kingdom (UK) economic growth slowed to 0,7 per cent in 2011, from 2,1 per cent in 2010.

Table 4 Annual percentage change in real GDP and consumer prices

	Share of global GDP*	Real GDP		Consumer prices	
	2011	2010	2011	2010	2011
World	**100,0**	**5,3**	**3,9**	**3,7**	**4,8**
Advanced economies	**51,1**	**3,2**	**1,6**	**1,5**	**2,7**
United States	19,1	3,0	1,7	1,6	3,1
Japan	5,6	4,4	-0,7	-0,7	-0,3
Euro area	14,3	1,9	1,4	1,6	2,7
United Kingdom	2,9	2,1	0,7	3,3	4,5
Canada	1,8	3,2	2,5	1,8	2,9
Other advanced economies	7,4	5,8	3,2	2,3	3,0
Emerging-market and developing economies	**48,9**	**7,5**	**6,2**	**6,1**	**7,1**
Sub-Saharan Africa	2,5	5,3	5,1	7,4	8,2
South Africa	0,7	2,9	3,1	4,3	5,0
Central and eastern Europe	3,5	4,5	5,3	5,3	5,3
Commonwealth of Independent States	4,3	4,8	4,9	7,2	10,1
Developing Asia	25,1	9,7	7,8	5,7	6,5
China	14,3	10,4	9,2	3,3	5,4
India	5,7	10,6	7,2	12,0	8,6
Middle East and North Africa	4,9	4,9	3,5	6,9	9,6
Latin America and the Carribean	8,7	6,2	4,5	6,0	6,6

* GDP shares based on the IMF's purchasing power parity valuation of country GDP's for 2011

Source: IMF *World Economic Outlook*, April 2012

Emerging and developing economies remain the driving force in global growth but their momentum has slowed more than previously forecast. Greater-than-expected policy tightening and progressively weaker outcomes in advanced economies have dragged growth lower, with average growth in emerging and developing economies falling from 7,5 per cent in 2010 to 6,2 per cent in 2011. China decelerated from 10,4 per cent in 2010 to 9,2 per cent in 2011 affecting the rest of Asia. Economies in sub-Saharan Africa continued to be supported by firm prices of export commodities, growing by a robust 5,3 per cent in 2010 and 5,1 per cent in 2011. The region's inflation rate accelerated notably to 8,2 per cent in 2011 from 7,4 per cent in 2010, driven mainly by escalating food prices.

Headline inflation in most economies reaccelerated between 2009 and 2011 as the oil price recovered from its 2008 collapse and food prices strengthened. With the exception of India, inflation in all major countries and regions increased in 2011 compared with 2010 (Table 4). However, core inflation in most advanced countries remained moderate or benign due to below-trend growth.

A timeline of some major events and policy responses related to the sovereign debt crisis in Europe since October 2011 is depicted in Figure 8.

Figure 8 Timeline of key events and policy responses in Europe since October 2011

Events	Date	Policy actions
	October 2011	ECB unveils emergency loan measures
	October 2011	G-20 pledges to preserve financial stability
	October 2011	Germany and France agree on measures to resolve debt crisis
Some private banks holding Greek debt accept 50 per cent loss	October 2011	Enlargement of the EFSF approved by all euro area members
Euro area bond yields soar	November 2011	ECB lowers key interest rates
Change in government in Greece, Italy and Spain	November 2011	G-20 commits to co-ordinate actions on growth and financial stability
Standard and Poor's places 15 of the 17 euro members on negative credit watch	December 2011	ECB lowers key interest rates
	December 2011	Attempts by the EU to agree to a new fiscal treaty fail
	December 2011	First three-year LTRO tranche of €489 billion allocated to banks by ECB
Talks between Greece and private creditors stall	January 2012	ECB buys Italian and Spanish sovereign debt
Standard and Poor's downgrades EFSF, France and 8 other EU countries	January 2012	Fiscal compact agreed with guidelines for fiscal discipline
European Commission casts doubt on Greek data	February 2012	Greek parliament passes austerity bill
Moody's cuts debt ratings of 6 European countries and affirms its top rating of the EFSF	February 2012	Agreement on new Greek debt deal
	February 2012	ECB temporarily suspends eligibility of Greek bonds as collateral
	February 2012	Second three-year LTRO tranche of €529 billion allocated to banks by ECB
	February 2012	European Commission requires enhanced fiscal austerity
Greece closes a restructuring deal with its creditors	March 2012	European leaders sign fiscal compact
	March 2012	Euro group and IMF back a second Greek bailout of €130 billion
	March 2012	Spain agrees to make bigger budget cuts than originally intended
Greece states that it may need a third bailout	March 2012	ECB reactivates eligibility of Greek bonds as collateral
	March 2012	Eurozone agrees to additional funding for EFSF and ESM
Spanish Prime Minister warns about the seriousness of the Spanish crisis	April 2012	ECB stresses its commitment to preserve price stability
Broad political and popular backlash calls for a "growth pact" to complement fiscal pact	April 2012	The G-20 and emerging countries commit US$430 billion to enable the IMF to further support the eurozone crisis
Standard and Poor's again downgrades Spain's sovereign credit rating	April 2012	
Yields on Spain's sovereign bonds rise	May 2012	Eurozone governments agree to release €4,2 billion to Greece from the EFSF, with an additonal €1 billion available to be paid out in June should the need arise
Change in government in France and political stalemate in Greece after elections raise concerns about an exit from the eurozone	May 2012	Spain nationalises Bankia
Greek bonds speads widen to historic highs	May 2012	Greece is authorised to use €3,3 billion to pay money owed to the ECB
Portugal drops four public holidays for 5 years in austerity move	May 2012	European Commission appeals for more pro-growth policies
Spain dismisses suggestions of European assistance while Bankia requests €23,8 billion in financial support	May 2012	Spain's government appoints independent auditing firms to evaluate banks' balance sheets

EFSF: European Financial Stability Facility ESM: European Stability Mechanism LTRO: Longer-Term Refinancing Operations

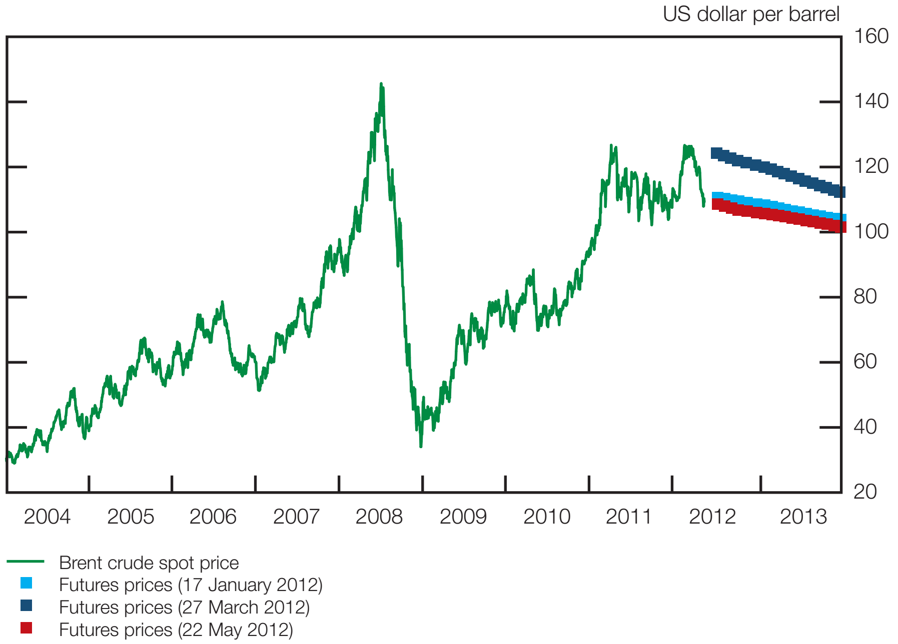
Sources: European Central Bank, Bank of England, British Broadcasting Corporation and Britannica Online Encyclopedia

Oil prices

A significant increase in the crude oil price has occurred despite the weak global growth environment. Political instability led to supply disruptions and geopolitical tensions added a risk premium. Global demand for oil has increased from an average of 86,9 million barrels per day in 2007/08 to 89,1 million barrels per day in 2011 and is expected to rise to 89,9 million barrels per day in 2012. The rising oil price has pushed up global inflation, reduced profit margins significantly in many sectors, and has contributed to the slowdown in world growth.

A volatile international oil price trended lower throughout most of 2011 before moving sideways between October (when it reached a low point of US$102 per barrel) and December. Since mid-December 2011, the price of Brent crude oil has surged by 21,7 per cent to US$126 per barrel in mid-March 2012 – surpassing the high of April 2011 and reaching a new peak since the onset of the financial crisis – before declining somewhat to a still-high US$109 per barrel on 22 May (Figure 9).

Figure 9 Price of Brent crude oil



Source: Bloomberg

The significant increase in the crude oil price has occurred despite the weak global growth environment. On the demand side, an unusually cold winter in Europe caused an increase in demand for heating oil. Demand in Asia has also increased with China's demand expected to increase by 3,8 per cent in 2012. Japan is currently consuming more than double the amount of oil from a year ago as an alternative to nuclear power in the aftermath of last year's nuclear disaster. The International Energy Agency (IEA) estimates that global oil consumption will grow by 830 000 barrels per day in 2012, more than the 740 000 barrels per day growth in 2011.

Supply was disrupted by developments in the Middle East and North Africa (MENA) as political instability spiked, and lost production in Libya has been slow to recover. This, together with the oil embargo on Iran, tightened the physical market.

Geopolitical tensions over Iran's nuclear ambitions have added a risk premium to the oil price, which has also amplified price volatility. Higher production by particular producers, including Saudi Arabia, have boosted output. Futures contracts dated 22 May 2012 for delivery in the third and fourth quarters of 2012 respectively traded at around US$108 and US$106 per barrel.

International monetary policy developments

Monetary policies in the major advanced economies remained accommodative to support growth against a backdrop of easing demand and a likely slowdown in global consumer price inflation in the medium term.

Since the November 2011 *MPR*, monetary policies have remained accommodative in most advanced economies (Table 5) or as in some emerging markets became more countercyclical. A co-ordinated central bank action plan was announced on 30 November 2011 to provide liquidity support to the global money markets which succeeded in easing strains in the financial markets at the time.

The United States Federal Reserve (the Fed) has continued with its policy approach of an extraordinarily low interest rate environment and balance-sheet expansion. After two rounds of large-scale asset purchases, known popularly as quantitative easing (QE 1 and 2), the size of the Fed's balance sheet has increased to around US$3 trillion. The Fed's maturity extension programme (Operation Twist) further exerts downward pressure on longer-term interest rates by exchanging shorter for longer maturity financial assets but without adding to the size of its balance sheet. It was implemented from September 2011 to June 2012. The asset purchase operations have supplemented unusually long-term projections for policy rates. The Federal Open Market Committee (FOMC) projection of a near-zero policy rate through mid-2013 was later revised and extended to the latter part of 2014.

The Fed also indicated that new steps would be taken if the US economy were to deteriorate. The FOMC also took the important step of announcing a formal inflation target of 2 per cent as a means of anchoring inflation expectations. The FOMC's inflation target statement stressed a balanced approach to its dual mandate.[2]

2. The Fed's measure of inflation is the annual change in the price index for personal consumption expenditure.

The Bank of England (BoE) announced in February 2012 that it would purchase an additional £50 billion to bring total asset purchases to £325 billion. The bank kept its policy rate at a record low of 0,50 per cent for the 38th consecutive month in May.

The European Central Bank (ECB) lowered its key interest rate in early December 2011 by 25 basis points, followed by additional liquidity injections. The ECB's Longer-Term Refinancing Operation (LTRO) in February 2012 attracted even more demand than the first held in December 2011. Eight hundred banks requested €529 billion in three-year loans compared to five hundred and twenty-three banks requesting €489 billion in loans earlier in December. Stripping out the refinancing of existing ECB facilities, the amount of net new money provided to the European financial system amounted to €310,7 billion, up from €200 billion in December.

The ECB's balance sheet has increased by more than €1 trillion since July 2011 to €3 trillion and is now, in US dollar terms, about a third larger than that of the Fed. The ECB has become the most active central bank in the world in its efforts to ease financial conditions and provide support to the real economy of the euro area.

In February this year the Bank of Japan (BoJ) kept the overnight lending rate between zero and 0,1 per cent but announced a sizeable ¥10 trillion (US$83 billion) expansion in its asset purchase programme, taking the programme to ¥65 trillion (US$538 billion). The central bank also clarified its policy stance by, for the first time, setting a specific inflation target of 1 per cent to help overcome nearly 20 years of deflationary pressure. On 27 April 2012 the BoJ added monetary stimulus by expanding its asset purchase fund to ¥70 trillion (US$585 billion or 14,7 per cent of Japan's GDP) from ¥65 trillion and extending the maturity of bonds it buys to three years.

The central banks of Sweden and Israel lowered interest rates partly due to concerns about the sovereign debt crisis in Europe. Norges Bank also cut its overnight deposit rate by a quarter of a percentage point to 1,5 per cent in March due to the downturn in Europe and the continued krone appreciation that has kept inflation low. It kept its policy rate unchanged at the subsequent meeting in May.

In December 2011 the Reserve Bank of Australia (RBA) lowered its overnight cash rate by 25 basis points and kept it at 4,25 per cent during the next four months. This was followed in May by a further 50 basis points reduction to 3,75 per cent (effective 2 May 2012) after economic conditions weakened and inflation had moderated. New Zealand's central bank held interest rates unchanged.

Table 5 Selected central bank interest rates

Per cent

Countries	14 Nov 2011	24 May 2012	Latest decision (Change in percentage points)	
United States	0,00–0,25	0,00–0,25	25 Apr 2012	(0,00)
Japan	0,00–0,10	0,00–0,10	23 May 2012	(0,00)
Euro area	1,25	1,00	3 May 2012	(0,00)
United Kingdom	0,50	0,50	10 May 2012	(0,00)
Canada	1,00	1,00	17 Apr 2012	(0,00)
Denmark	1,20	0,75	24 May 2012	(0,00)
Sweden	2,00	1,50	18 Apr 2012	(0,00)
Norway	2,25	1,50	10 May 2012	(0,00)
Switzerland	0,00–0,25	0,00–0,25	15 Mar 2012	(0,00)
Australia	4,50	3,75	1 May 2012	(-0,50)
New Zealand	2,50	2,50	26 Apr 2012	(0,00)
Israel	3,00	2,50	23 Apr 2012	(0,00)
China	6,56	6,56	31 Mar 2012	(0,00)
India	8,50	8,00	17 Apr 2012	(-0,50)
Indonesia	6,00	5,75	10 May 2012	(0,00)
Malaysia	3,00	3,00	11 May 2012	(0,00)
Philippines	4,50	4,00	19 Apr 2012	(-0,25)
South Korea	3,25	3,25	10 May 2012	(0,00)
Taiwan	1,875	1,875	22 Mar 2012	(0,00)
Thailand	3,50	3,00	2 May 2012	(0,00)
Brazil	11,50	9,00	18 Apr 2012	(-0,75)
Chile	5,25	5,00	17 May 2012	(0,00)
Mexico	4,50	4,50	27 Apr 2012	(0,00)
Czech Republic	0,75	0,75	3 May 2012	(0,00)
Hungary	6,00	7,00	24 Apr 2012	(0,00)
Poland	4,50	4,75	9 May 2012	(0,25)
Russia	8,25	8,00	10 May 2012	(0,00)
Turkey	5,75	5,75	18 Apr 2012	(0,00)
Iceland	4,75	5,50	16 May 2012	(0,50)
Nigeria	12,00	12,00	22 May 2012	(0,00)

Source: National central banks

Over the review period, Asian central banks largely kept policy rates unchanged. The Bank of Korea kept the benchmark seven-day repurchase (repo) rate at 3,25 per cent for the eleventh consecutive month in May. The monetary policy statement focused on the stabilisation of consumer price inflation which, despite slowing in April, faces risks from higher inflation expectations. Malaysia's central bank had previously cut its policy rate in February 2009 before raising it on four occasions, most recently in May 2011, to its current level.

Other central banks in emerging economies such as Brazil, Chile, Indonesia, Thailand and the Philippines have lowered policy rates in recent months, primarily due to concerns about slowing growth. However, the central bank of Hungary raised its base rate in November 2011 to protect the forint after the country's credit rating downgrade. In May Poland's central bank increased its policy rate by a quarter-point to 4,75 per cent in response to inflation exceeding the 2,5 per cent inflation target and taking into account the slowdown in the euro region. Several central banks in Africa have also raised their policy rates in recent months in the face of inflationary pressures.

Over the past two years, the Reserve Bank of India (RBI) has increased interest rates 13 times to dampen food and demand-led inflationary pressures, resulting in a moderation in wholesale price inflation to below 7 per cent in March 2012. This has enabled the RBI to reduce its main policy rate by 50 basis points in April in response to weaker-than-expected growth.

Like other emerging economies, China is contending with slower growth while trying to maintain a low inflation rate at risk from secular price pressures. The reserve requirement ratio of banks was reduced by 50 basis points in November 2011, another 50 basis points on 24 February 2012, and a further 50 basis points on 18 May to 20,0 per cent to boost liquidity and support economic growth. In March 2012 the Chinese government announced that it was maintaining the 2011 target for inflation of 4 per cent. At the same time, reforms appear to be moving in the direction of gradual currency appreciation. The yuan's soft trading band has been increased to 1 per cent from 0,5 per cent against the dollar for the first time since 2007. Earlier in April China's regulators raised investment quotas for foreigners buying onshore equities and bonds to US$80 billion from US$30 billion, and increased the amount of yuan held offshore that could be invested locally.

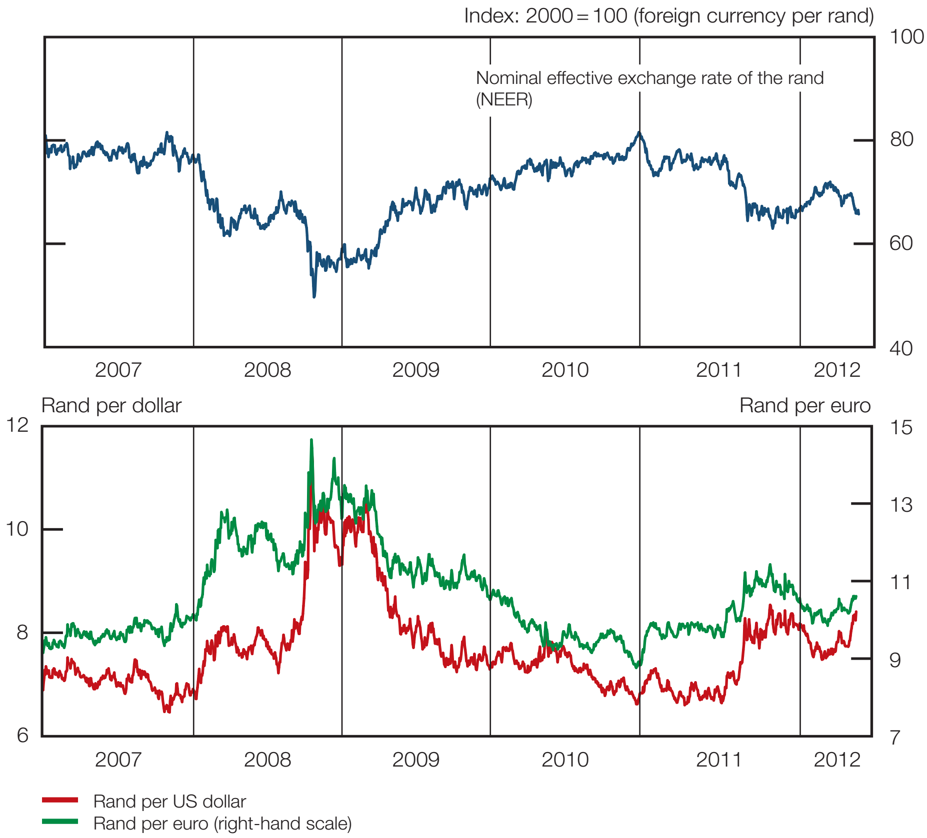
Exchange rate developments

Changes in investor sentiment and global risk aversion have led to volatility in both portfolio capital flows and the rand exchange rate. As in the case of other emerging markets, South Africa experienced a slowdown in bond inflows and net equity outflows in 2011. The equity trend continued into 2012 but bond inflows have accelerated recently. Although the trend since January 2011 has been for rand depreciation, from November there has been some appreciation – before depreciating again in recent weeks as risk aversion spiked. The exchange rate trend and short-term movements have mirrored those of other commodity and emerging-market currencies.

From January 2011, the nominal effective exchange rate (NEER) of the South African rand depreciated gradually from an index level of 78 (and an average of 75 in 2010) to about 65 in November.[3] The NEER then appreciated to almost 72 index points in mid-March 2012 before depreciating again to 66 index points in May as global market sentiment deteriorated (Figure 10).

3. The weighted average exchange rate of the rand is based on trade in, and consumption of, manufactured goods between South Africa and its most important trading partners. The methodology applied is described in an article in the December 2008 *Quarterly Bulletin*. The weighted average exchange rate of the rand is calculated against 15 currencies. The weights of the five major currencies are in brackets: euro (34,82), US dollar (14,88), Chinese yuan (12,49), British pound (10,71), Japanese yen (10,12). Index: 2000 = 100.

Figure 10 Exchange rates of the rand

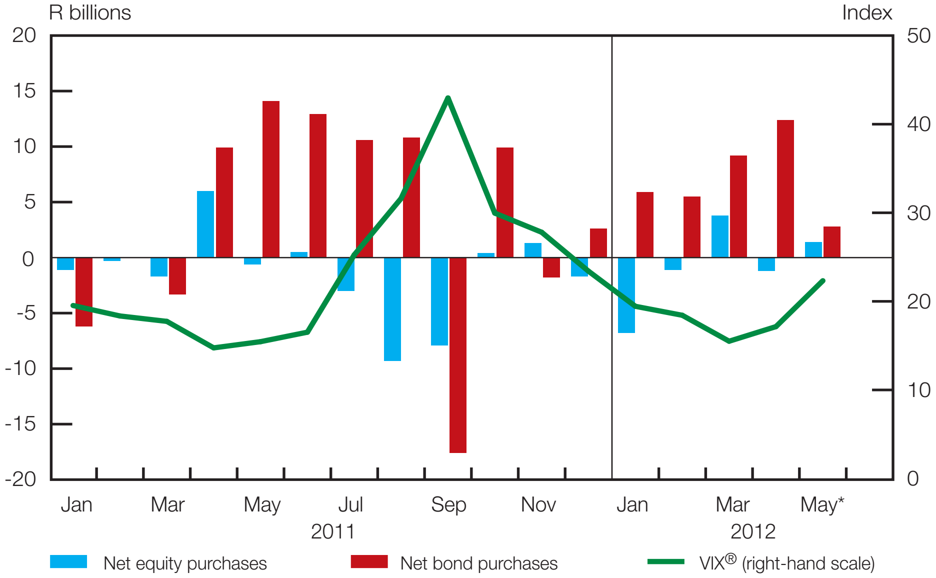


Measured on a bilateral basis, the rand appreciated against the euro from R11,43 in November 2011 to R9,85 in mid-March 2012 but then depreciated to R10,61 in May. Similarly, the rand appreciated against the US dollar from R8,54 in November 2011 to R7,48 at the end of February 2012 before depreciating to R8,41 in May. From November 2011 to May 2012, the overall appreciation against the euro was much more pronounced than against the US dollar at 7,2 per cent and 1,5 per cent respectively. This reflects the relative changes in the euro/dollar exchange rate in response to economic conditions in advanced countries.

4. The VIX® measures the options implied volatility of the S&P 500 index and serves as a popular indicator of investors' perception of risk.

Investor sentiment, as reflected by volatility in portfolio flows, continued to be mainly influenced by the sovereign debt crisis in the euro area, the low interest rate environment and additional liquidity impacts of the unconventional monetary policy responses internationally. *See Box 2 for the impact of global investor sentiment on asset prices and inflation*. From October to December 2011, foreign investors bought R10,7 billion worth of South African bonds as risk aversion fell relative to September (Figure 11).[4]

Figure 11 Non-resident net purchases of domestic securities and risk aversion



* Data for May cumulative to 23 May 2012

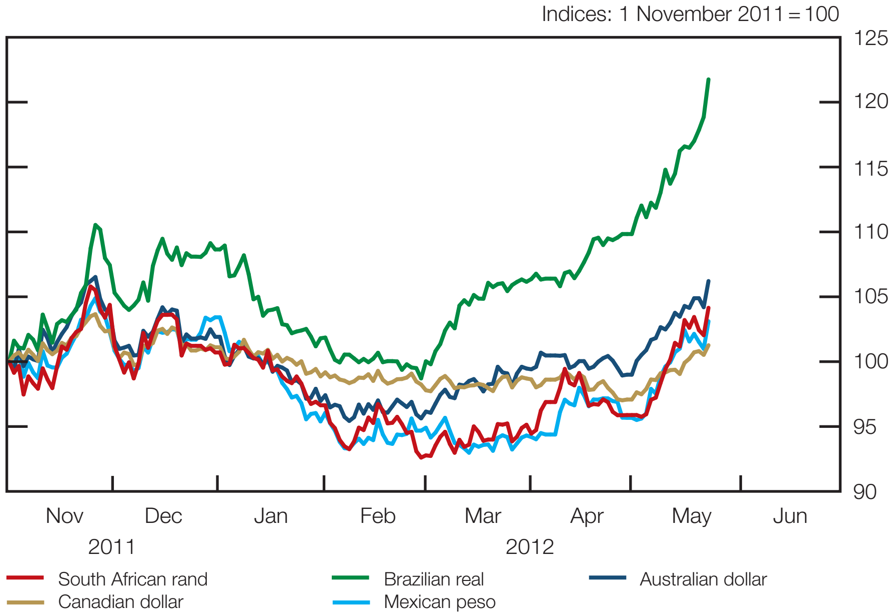
Sources: JSE Limited and Bloomberg

Cumulative non-resident net purchases of bonds amounted to R35,8 billion in 2012 up to 23 May compared with R42,0 billion in 2011 as a whole. Non-resident purchases of bonds have been stronger due to the announcement of the pending inclusion of South Africa in the Citibank World Government Bond Index (WGBI) and expected capital appreciation. In contrast, net sales of shares amounted to R3,8 billion and R17,2 billion respectively, over the comparable periods.

The trend and volatility in the rand exchange rate have mirrored those in a number of other emerging-market and/or commodity currencies. Country-specific policy settings and macroeconomic conditions have resulted in idiosyncratic pressure on exchange rates in a number of emerging-market countries.

As shown in Figure 12, all currencies considered appreciated against the US dollar from the latter part of November 2011 to the end of February 2012 or mid-March. Subsequently, all these currencies have depreciated against the US dollar with the Mexican peso, Canadian dollar and the rand initially lagging somewhat. However, the depreciation of the rand gathered momentum as from April. Over the whole period under review the rand correlated the most with the Mexican peso followed by the Australian dollar.

Figure 12 Exchange rate performance against the US dollar

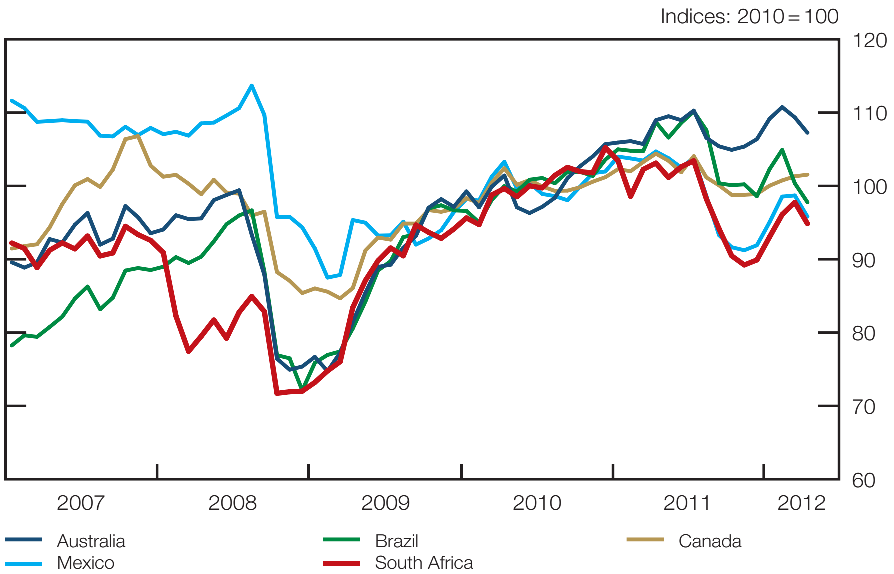


Sources: Reuters and own calculations

Commodity exporters' real exchange rates appreciated during 2009 and 2010 in line with the sustained improvement in commodity prices, before declining significantly in the second half of 2011. As a commodity-exporting emerging-market country, South Africa's real effective exchange rate (REER), as measured by the Bank for International Settlements (BIS), generally followed that of other commodity-exporting countries such as Australia, Canada and Brazil (Figure 13).[5] Swings in risk aversion since November 2011 have resulted in reversals in nominal and real exchange rates.

5. The BIS REER indices include a total of 61 entities including individual euro area countries and also the euro area as a separate entity. The base year for the indices is 2010 and the REERs are geometric-weighted averages of bilateral exchange rates adjusted by relative consumer prices.

Figure 13 Real effective exchange rates



Source: Bank for International Settlements

Box 2 Risk aversion as a driver of the rand exchange rate and inflation

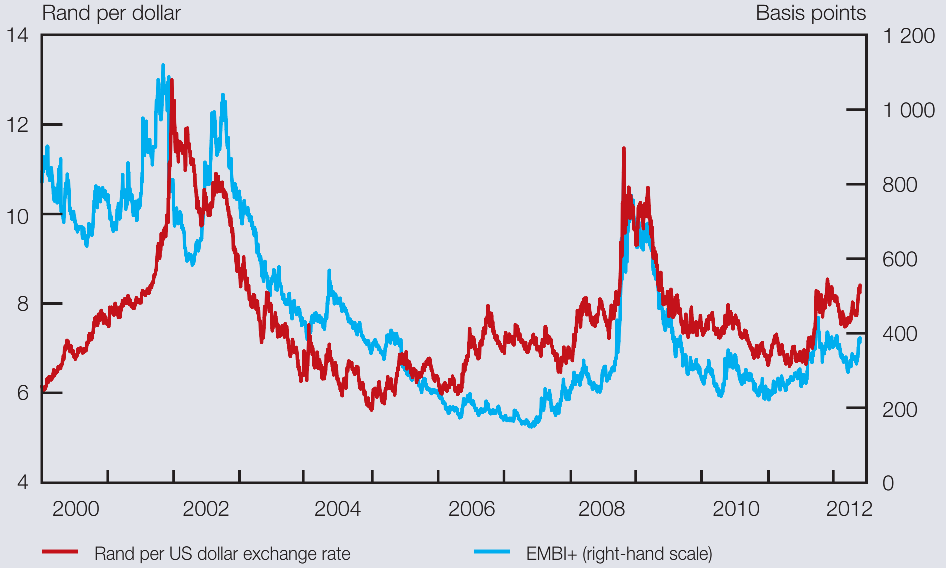
The investment community's perceptions of policy actions in response to the global financial crisis and the euro area sovereign debt crisis are a major driver of changes in market sentiment and risk aversion in all asset markets. As financial markets have become increasingly linked, changes in global risk aversion have impacted broadly similarly on the level and volatility of equity, bond and currency markets in developed and emerging-market economies.

South Africa's deep financial markets attract foreign portfolio investment flows into, and out of, the domestic bond market. Risk aversion, measured by the EMBI+, shows a close correlation with changes in the exchange value of the rand against the United States (US) dollar.[1] (Figure B2.1)

This exchange rate impact, in turn, affects inflation. While estimates can vary somewhat, (see *Monetary Policy Review,* April 2002) around 78 per cent of an exchange rate change passes through to import prices, and half of this adjustment occurs in less than one year.[2] Pass-through is, however, not complete even in the long run. A number of factors explain this phenomenon. At a disaggregated level, the pass-through coefficient is influenced by the homogeneity and substitutability of the goods concerned, the degree of market concentration and competition, and the currency in which imports are denominated.

A more recent paper by Aron et al. (2010) found long-run equilibrium pass-through to import prices of about 75 per cent when feedback effects are ignored.[3] The authors further concluded that pass-through is probably less under an inflation-targeting monetary policy regime; in the very short run exchange rate volatility reduces pass-through; and pass-through is higher for small appreciations.[4]

Figure B2.1 Emerging-market bond risk driving the rand



Sources: Bloomberg, JPMorgan and South African Reserve Bank

1 The JPMorgan Emerging Market Bond Index Plus (EMBI+) is a US-dollar emerging-markets debt benchmark that tracks returns for actively traded external emerging-market debt.

2 Exchange rate pass-through refers to the relationship between changes in the rand exchange rate and changes in the domestic currency prices of imports.

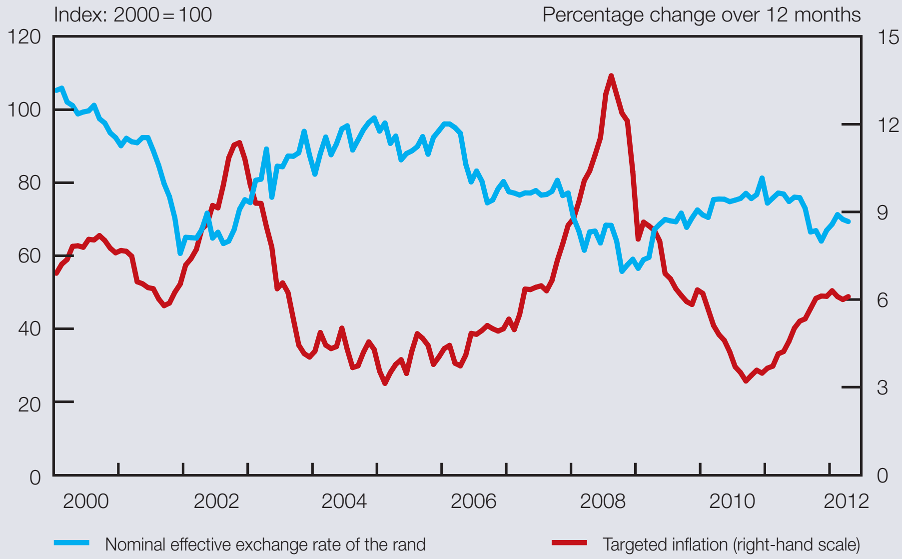
3 J Aron, G Farrell, J Muellbauer and P Sinclair, "Exchange Rate Pass-Through and Monetary Policy in South Africa" (Centre for Economic Policy Research Discussion Paper Series, No. 8153, December 2010), http://www.cepr.org/pubs/new-dps/dplist.asp?dpno=8153, PDF file.

4 Exchange rate pass-through results for other countries vary widely from 0 per cent to over 100 per cent. This is dependent on the level of disaggregation and the estimation approach used.

Exchange rate pass-through ultimately affects domestic consumer price inflation. Figure B2.2 shows how in the case of South Africa, exchange rate pass-through in a small open economy impacts on targeted inflation.

Currency depreciations normally lead to an increase in the measured year-on-year inflation rate whereas currency appreciations normally lead to a slowdown in the year-on-year inflation rate. As exchange rate pass-through to imported goods is not complete, it is unlikely for it to be complete in the case of the consumer price index which includes the cost of services (not included in import price indices) and locally manufactured goods. An estimate for exchange rate pass-through to CPI inflation in South Africa is about 0,2.[5]

Figure B2.2 Inflation and the exchange rate



Sources: Statistics South Africa and South African Reserve Bank

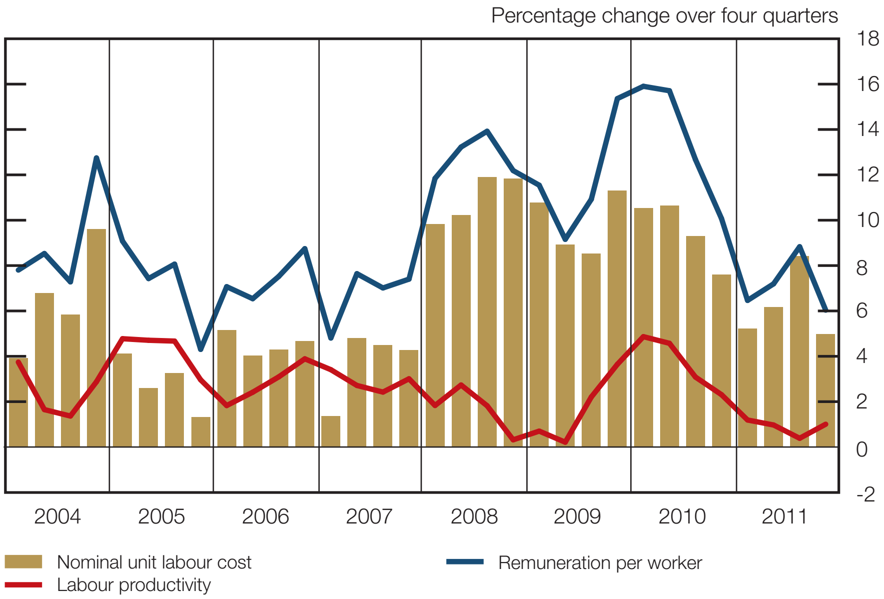
5 G Marcus, "Challenges to South African Monetary Policy in a World of Volatile Capital Flows", (address by the Governor of the South African Reserve Bank to the Swiss Chamber Southern Africa, 7 May 2012, accessed 15 May 2012), http://www.resbank.co.za/Publications/Speeches/Detail-Item-View/Pages/default.aspx?sarbweb=3b6aa07d-92ab-441f-b7bf-bb7dfb1bedb4&sarblist=a01d874c-c3f6-4b93-a9dc-c984cf8652cf&sarbitem=341, PDF file.

Labour markets

The unemployment rate increased marginally from 25,0 per cent in the first quarter of 2011 to 25,2 per cent in the first quarter of 2012. Employment losses suffered during the recession have still not been recovered and future prospects remain uncertain, given the positive but fragile economic outlook. Average wage settlement rates moderated in 2011 and levelled off. In the fourth quarter of 2011 the rate of increase in remuneration per worker slowed and, together with a slight acceleration in productivity resulted in a slower increase in nominal unit labour cost. These developments have been favourable for inflation outcomes.

After growing rapidly from 2008 to 2010, unit labour cost decelerated in the final quarter of 2011. Figure 14 shows that the year-on-year percentage change in nominal unit labour cost decreased from 8,4 per cent in the third quarter of 2011 to 5,0 per cent in the fourth quarter. With output growth exceeding employment growth, labour productivity increased from 0,4 per cent in the third quarter of 2011 to 1,0 per cent in the fourth quarter. The rate of increase in nominal remuneration per worker decelerated from 8,8 per cent in the third quarter to 6,0 per cent in the fourth quarter.

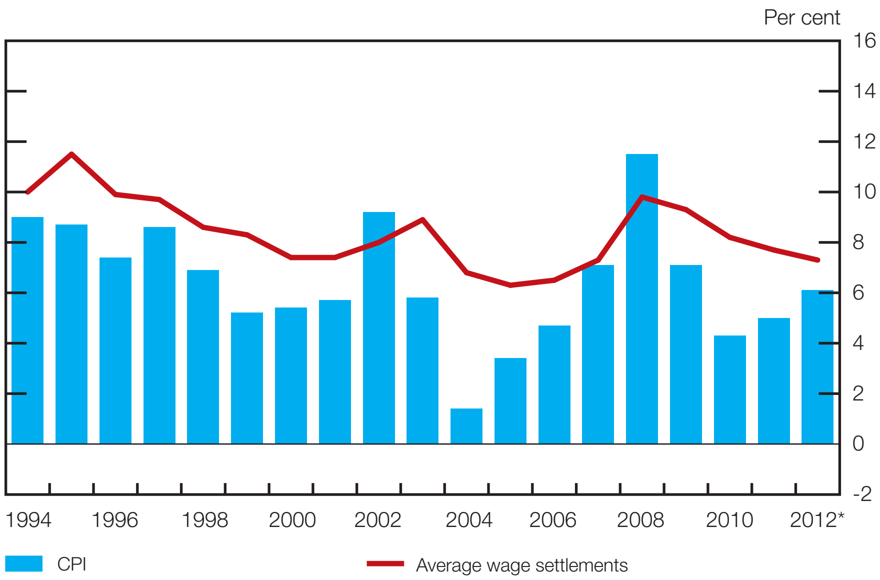
Figure 14 Remuneration per worker, labour productivity and unit labour cost in the formal non-agricultural sector



Sources: Statistics South Africa and South African Reserve Bank calculations

The fourth quarter *Andrew Levy Wage Settlement Survey* of 2011 reported that the average level of wage settlements declined to 7,7 per cent in 2011 from 8,2 per cent in 2010 (Figure 15). The average level of wage settlements in the first quarter of 2012 amounted to 7,3 per cent.

Figure 15 Average annual inflation and wage settlements



* Data for 2012 are for the first three months of the year

Sources: Andrew Levy Employment Publications and Statistics South Africa

Table 6 shows the average wage settlements in major sectors in 2011 reported by Andrew Levy Employment Publications. The highest average settlement was 8,7 per cent in the mining sector, and the lowest was 6,5 per cent in the municipal and utility sector. The levels of settlements reached in the first quarter of 2012 ranged from 5,9 per cent in the health and education sector to 8,0 per cent in the building and construction sector. The survey reported that wage settlements are expected to stabilise in 2012 in a range of between 7,5 per cent and 8,5 per cent. The 2012 National Budget provided for a 5,0 per cent cost of living adjustment for civil servants.

Table 6 Average percentages of wage settlement by major sector in 2011

Sector	Per cent
Transport and freight	8,0
Finance	6,7
Retail and catering	8,3
Building and construction	7,0
Municipal and utility	6,5
Health and education	7,4
Metal and engineering	8,5
Mining	8,7
Food and manufacturing	7,3
Food and agriculture	7,5
Chemical	8,3
Paper and printing	7,0
Communication	7,3

Source: Andrew Levy Employment Publications

Total employment in the formal non-agricultural sector as reported by Statistics South Africa's *Quarterly Employment Survey (QES)* increased marginally from 8 251 thousand in the fourth quarter of 2010 to 8 381 thousand in the final quarter of 2011 but was still below the 8 512 thousand recorded in the corresponding quarter of 2008 (Table 7). In 2011 employment levels increased in all the sectors except for manufacturing, which shed jobs. Two sectors, namely (i) community, social and personal services and (ii) construction accounted for about 60 per cent of employment creation in 2011. On a quarterly basis, strong employment growth of 58 000 jobs in the third quarter of 2011 was followed by 23 000 jobs in the fourth quarter.

Table 7 Employment in formal non-agricultural industries

Thousands

Industry	Total employment			
	2008	2009	2010	2011
	4th qr	4th qr	4th qr	4th qr
Mining and quarrying	518	488	504	518
Manufacturing	1 275	1 185	1 164	1 158
Electricity, gas and water supply	59	56	58	60
Construction	474	415	399	425
Wholesale trade and retail trade	1 747	1 665	1 687	1 703
Transport, storage and communication	366	359	361	369
Financial intermediation, insurance, real-estate and business services	1 914	1 796	1 812	1 830
Community, social and personal services	2 159	2 199	2 266	2 318
Total	**8 512**	**8 163**	**8 251**	**8 381**

Source: Statistics South Africa *Quarterly Employment Survey*

Demand and output

South Africa's economy gained further momentum in the fourth quarter of 2011 as activity in the mining and manufacturing sectors recovered. Growth in real gross domestic expenditure also accelerated mainly due to increased consumption by households and government, and sustained and stronger growth in investment. Imports increased more strongly than exports and the trade balance switched to a deficit while the deficit on the current account of the balance of payments narrowed. The terms of trade weakened somewhat as the rand price of exports grew slower than that of imports.

The economy gained momentum in the final quarter of 2011, with growth in real gross domestic product (GDP) accelerating to an annualised rate of 3,2 per cent, following sluggish growth of 1,0 per cent in the second quarter and 1,7 per cent in the third quarter of the year (Table 8). The firm increase in economic activity in the fourth quarter can be ascribed to a normalisation of production in mining and manufacturing after extensive industrial action and other constraints. The tertiary sector continued to post strong growth throughout 2011, though moderating somewhat in the final quarter. In comparison to the third quarter of 2011, real output of the primary sector contracted at a markedly slower pace in the fourth quarter – along with an increase in mining production and a continued, though moderating, contraction in agriculture. For the year 2011 as a whole, real GDP increased by 3,1 per cent compared to 2,9 per cent in 2010.

Growth in real gross domestic expenditure accelerated further from 4,8 per cent in the third quarter of 2011 to 5,1 per cent in the fourth quarter. For the calendar year 2011 as a whole, real gross domestic expenditure increased by 4,3 per cent; marginally faster than the 4,2 per cent recorded in 2010.

Table 8 Growth in real GDP and expenditure components

Per cent*

	2010	2011				
	Year	1st qr	2nd qr	3rd qr	4th qr	Year
Final consumption expenditure						
Households	3,7	6,2	3,4	3,8	4,6	5,0
General government	4,9	9,4	-0,4	4,8	7,3	4,5
Gross fixed capital formation	-1,6	4,4	5,0	5,9	7,2	4,4
Changes in inventories (R billions)**	-1,8	7,1	3,1	4,0	4,9	4,8
Gross domestic expenditure	**4,2**	**4,6**	**1,4**	**4,8**	**5,1**	**4,3**
Exports of goods and services	4,5	7,3	6,1	8,0	4,4	5,9
Imports of goods and services	9,6	7,0	6,7	18,5	11,0	9,7
Gross domestic product	**2,9**	**4,6**	**1,0**	**1,7**	**3,2**	**3,1**

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

** Constant 2005 prices

Consumption expenditure by households continued to provide the main support to domestic expenditure, growing by 4,6 per cent in the fourth quarter of 2011 from already relatively healthy rates of 3,4 per cent and 3,8 per cent in the second and third quarters of the year respectively. Stronger growth in real disposable income, less negative wealth effects, and the reversal in the trend in job losses and employment creation have all supported spending. Low interest rates have further contributed to a gradual decline in household indebtedness. Constraining factors for credit extension have been relatively tight lending standards by banks, higher inflation rates and stagnant house prices.

Consumption by general government accelerated strongly from 4,8 per cent in the third quarter of 2011 to 7,3 per cent in the fourth quarter. Growth in real gross fixed capital formation rose from 5,9 per cent in the third quarter of 2011 to 7,2 per cent in the fourth quarter, driven by stronger momentum in the private and public sectors. Capital investment grew by 4,4 per cent in 2011 compared to a contraction of 1,6 per cent in 2010, and accelerated in the course of the year.

Real exports of goods and services increased by 4,4 per cent in the fourth quarter of 2011, as improved growth in the American and Asian regions more than offset weaker demand from Europe.

Commodity prices in US dollar terms declined somewhat as a result of subdued international demand and an uncertain global economic outlook. The slower pace of increase in the rand price of exports relative to the rand price of imports resulted in South Africa's terms of trade also weakening in the fourth quarter of 2011.

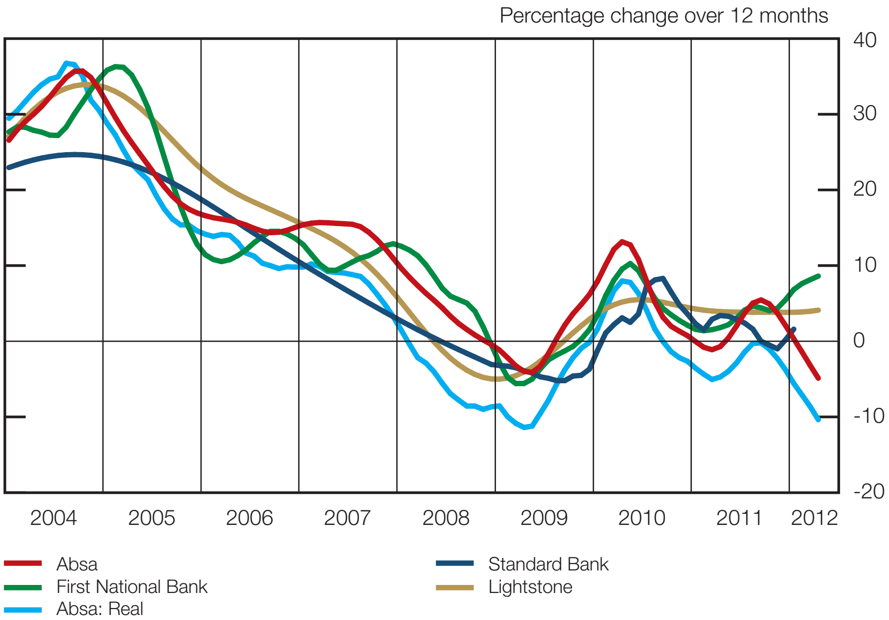
The increase in gross domestic expenditure in the fourth quarter of 2011 led to a significant increase in the volume of non-oil imports of goods. With imports increasing faster than exports during 2011, the trade balance switched to a deficit in the fourth quarter. The balance on the services, income and current transfer account with the rest of the world improved noticeably in the fourth quarter of 2011, offsetting the deterioration in the trade balance. The deficit on the current account of the balance of payments accordingly narrowed over the period to 3,6 per cent of GDP in the final quarter of 2011.

Real-estate and equity prices

Weak and declining nominal house prices reflect underlying economic conditions, and a continued imbalance between demand and supply in the real-estate market. After accounting for inflation, house prices continued to decrease in 2011 and into 2012. Domestic share prices increased to a new record high in line with global equity markets and the strengthening of domestic economic growth, before receding somewhat more recently.

Downward pressure on nominal house prices has been reflected in falling or moderating house price indices published by Absa and Lightstone from September 2011. House prices published by First National Bank (FNB) and Standard Bank recorded increases (Figure 16). Adjusted for inflation, changes in Absa house prices have been negative from September 2010. Real price changes stabilised around August 2011, before deteriorating again to a negative 10,4 per cent in April 2012.

Figure 16 House prices

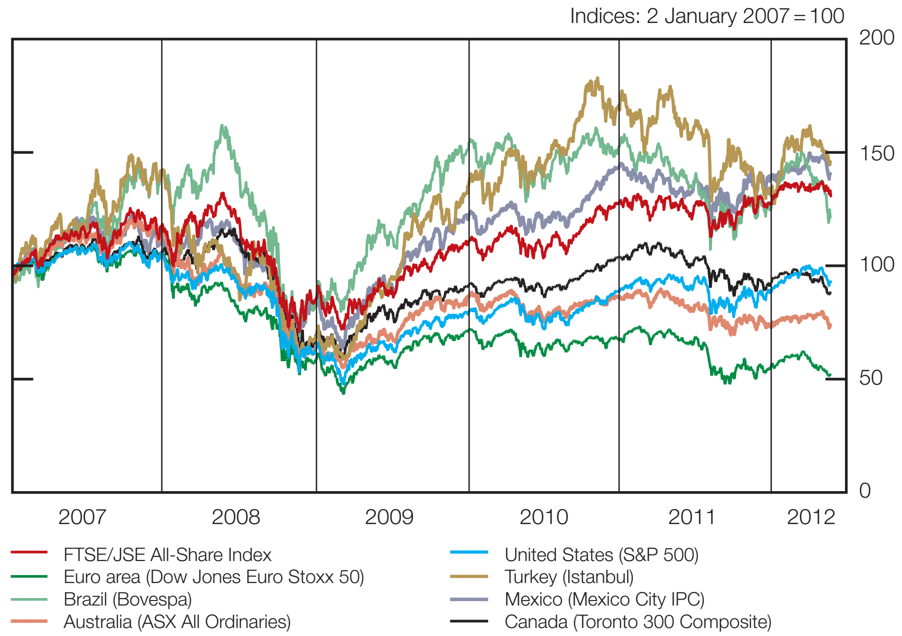


Sources: Absa, Standard Bank, First National Bank, Lightstone and own calculations

The lack of recovery in nominal house prices could be attributed to the still-high level of household indebtedness, the relatively strict credit environment and the dearth in mortgage lending, the uneven and relatively moderate recovery in economic activity, and uncertainty about future economic conditions. According to the first quarter 2012 *FNB Home-Buying Estate Agent Survey*, the imbalance between demand and supply improved somewhat as the average time that a house remains on the market before being sold decreased (after three consecutive quarterly increases) to 15 weeks and 6 days in the first quarter of 2012 from 17 weeks and 6 days in the final quarter of 2011 – closer to, but still far above the 8-week level deemed as representing a balance between demand and supply.

The FTSE/JSE All-Share Price Index (Alsi) continued to be affected by global developments such as the unresolved European sovereign debt crisis, concomitant sovereign debt rating downgrades and accommodative monetary policy. Dual-listed share prices reflected these trends. Alongside these global developments, the increase in share prices on the JSE Limited (JSE) further reflected the strengthening of domestic economic growth and positive investor sentiment. The index increased from a low of 28 391 index points on 8 August 2011 to an all-time high of 34 482 index points on 2 May 2012 – surpassing the previous high recorded on 22 May 2008 – before receding somewhat to 32 887 index points on 23 May 2012 (Figure 17). The improvement in share prices since 2009 represents only a modest rise in real terms when the extended period of the crisis is taken into account.

Figure 17 Share price indices*



* Based on local currency share prices

Sources: JSE Limited and I-Net Bridge

Fiscal policy

The fiscal policy stance sets a fine balance between support for economic growth and the gradual consolidation of the fiscal position. Stronger growth in public spending on capital investment relative to consumption is expected to boost long-run growth.

The Minister of Finance tabled the 2012 National Budget on 22 February. The fiscal framework is aimed at supporting the economy through capital investment and improved public service performance while narrowing the gap between spending and revenue. The budget set out markers for moderating growth in government consumption that would benefit future economic growth. Fiscal consolidation is to be phased in as the economy strengthens to prevent economic and social dislocations.

The revised budget projections are more favourable than those set out in the October 2011 *Medium Term Budget Policy Statement* (*MTBPS*). The budget deficit for fiscal 2011/12 and those projected over the medium term are consequently all lower, despite the downward revisions to National Treasury's real GDP growth estimates.

Over the Medium-term Expenditure Framework (MTEF) period, government intends moderating growth in remuneration, while shifting the emphasis from consumption to capital formation. As revenue recovers, public debt as a percentage of GDP should stabilise.

Budgeted and approved public-sector infrastructure projects over the MTEF period amount to R844,5 billion and the full list of projects under longer-term consideration by government comprise investments worth an estimated R3,2 trillion.

The revised budget balance for 2011/12 is a deficit of R142,3 billion (Table 9). Government collected significantly more tax revenue than expected in the 2011/12 fiscal year, while under-spending on capital assets further narrowed the budget deficit. Consolidated government revenue amounted to R830,2 billion in 2011/12, significantly higher than the estimate of R814,2 billion made in October 2011. Consolidated government expenditure in 2011/12 was slightly lower than was projected in October 2011, falling marginally from R978,8 billion to R972,5 billion. The estimated budget deficit, at 4,8 per cent of GDP for 2011/12, is consequently significantly lower than previously projected.

Table 9 Public finance data

	2010/11	2011/12		2012/13	2013/14	2014/15
	Outcome	*MTBPS* estimates	Budget estimates	Medium-term estimates		
Consolidated government* (R billions)						
Revenue	757,5	814,2	830,2	904,8	1 005,9	1 118,2
Expenditure	874,2	978,8	972,5	1 058,3	1 149,1	1 239,7
Budget balance	-116,7	-164,6	-142,3	-153,5	-143,3	-121,5
Total net loan debt**	818,8	1 006,1	997,5	1 189,4	1 370,7	1 537,7
As a percentage of GDP						
Budget balance	-4,2	-5,5	-4,8	-4,6	-4,0	-3,0
Total net loan debt**	29,7	33,8	33,3	36,0	37,8	38,5
PSBR***	6,5	8,1	7,1	7,1	6,2	5,0

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

Source: *National Treasury Budget Review 2012* and for the budget estimates for 2011/12 the *MTBPS* October 2011

Government has continued to finance its borrowing requirement mainly in the domestic capital market. The estimated public-sector borrowing requirement (PSBR) in 2011/12 is projected to be 1 percentage point of GDP (R30 billion) lower than that published in the October 2011 *MTBPS*. As a percentage of GDP, the public-sector borrowing requirement falls to 7,1 per cent and is also projected to be 7,1 per cent of GDP in 2012/13, falling thereafter to 6,2 per cent and 5,0 per cent of GDP respectively in the outer years 2013/14 and 2014/15. Net loan debt as a share of GDP in 2011/12 has been revised to 33,3 per cent and is projected to increase to 38,5 per cent of GDP by 2014/15 stabilising at an estimated R1,5 trillion.

Monetary conditions

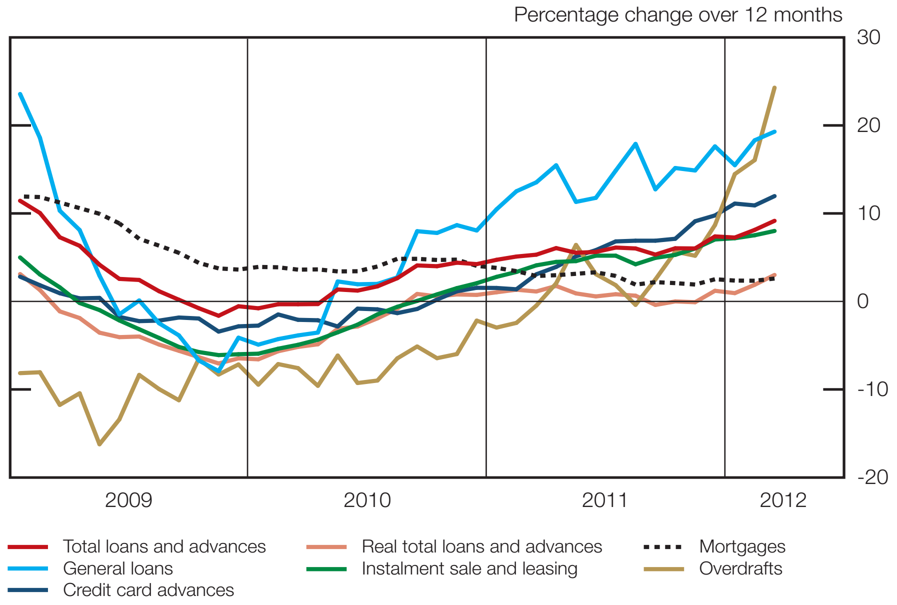
Credit growth has returned but remains subdued. With the exception of mortgages, the other categories of credit extension, in particular general loans, have showed signs of stronger growth over the period under review. Credit extension remains constrained by relatively high levels of household indebtedness and cautious bank lending practices.

Banks' total loans and advances remained subdued at 5,3 per cent in September 2011, before increasing to 7,4 per cent in December and, as 2012 progressed, to 9,2 per cent in March. In real terms, growth in total loans and advances fluctuated around zero during the second half of 2011, and has again turned positive as from December 2011 (Figure 18).

The main drivers of growth in credit extension have been general loans, overdrafts, credit card advances, and instalment sale credit and leasing finance. Instalment sale and leasing finance increased from growth of 4,3 per cent in August 2011 to 8,0 per cent in March 2012 in conjunction with the improvement in vehicle sales. Credit card advances accelerated from 6,9 per cent in September 2011 to 12,0 per cent in March 2012 and overdrafts from 2,5 per cent to 24,3 per cent over the same period.

General loans (inclusive of unsecured lending) accelerated from year-on-year growth of 12,7 per cent in September 2011 to 17,6 per cent in December and 19,3 per cent in March 2012. Mortgage advances grew at an average of just above 2 per cent per annum over the period under review, consistent with continued weakness in the housing market.

Figure 18 Banks' loans and advances to the private sector by type



Monetary policy

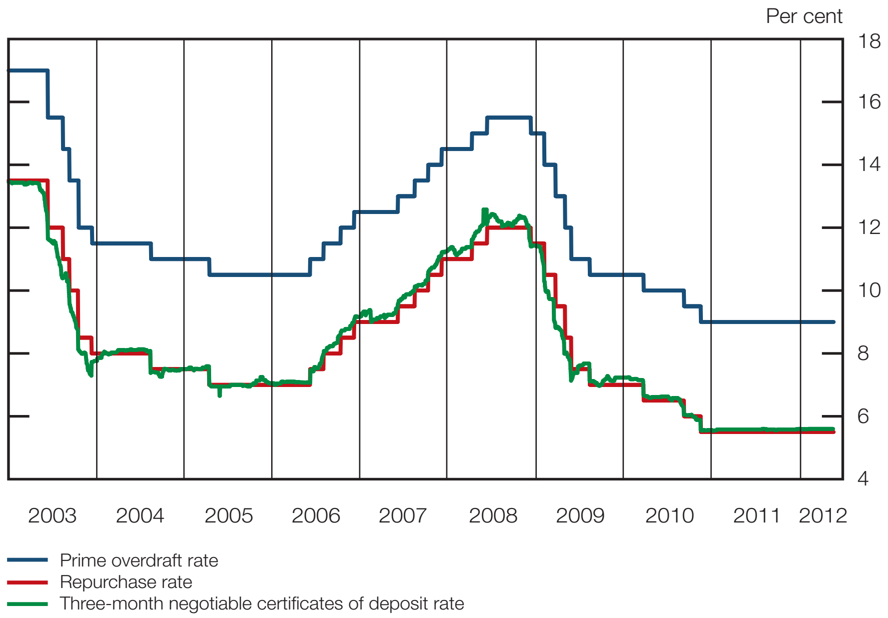
At the time of the publication of the previous *MPR* in November 2011, conditions pointed to lower expected domestic economic growth and higher expected inflation (Table 10). The unresolved sovereign debt crisis and concerns about the banking sector in Europe, together with the inability of advanced economies to generate sustained growth, weighed heavily on the global economic outlook. The economic environment has continued to change. At the time of the January 2012 MPC meeting, the outlook for domestic economic growth and inflation had deteriorated, but this assessment changed by the March 2012 meeting to a slight improvement in both the domestic economic growth and the inflation outlook. At the time of the May 2012 MPC meeting, the outlook for domestic economic growth remained unchanged, whereas the inflation outlook improved. The policy rate (Figure 19) has been kept stable at 5,5 per cent per annum over the period given the exogenous nature of most price pressures, the uncertain global environment and the fragile domestic recovery. See Box 3 for recent changes to the Bank's monetary policy operational procedures.

Economic confidence around the world remains fragile due to the still unresolved sovereign debt crisis in Europe and the vagaries of the global economic recovery. This global economic environment continues to weigh heavily on monetary policy considerations as it impacts economic growth, inflation and (through shifts in risk aversion) capital flows and exchange rates.

By the January 2012 meeting, the MPC noted that the domestic growth outlook had worsened. This was primarily due to the risk of contagion from the ongoing crisis in Europe, which showed no sign of a timely resolution. Notwithstanding an expectation that economic growth in the fourth quarter was likely to have exceeded that in the previous two quarters, the Bank's forecast for growth in 2012 was revised downwards due to global considerations. Growth in 2012 was expected to average 2,8 per cent compared with 3,2 per cent in the previous forecast, while the forecast for growth in 2013 was revised down from 4,2 per cent to 3,8 per cent.

Global inflation moderated on account of weaker demand which, in turn, had contributed to lower food and commodity prices. Oil prices, however, had been influenced by risks to supply due to geopolitical factors. The MPC noted a deterioration in the outlook for domestic inflation, with inflation expected to remain above the upper end of the target range for a more extended period. However, there was still no evidence of significant demand pressures in the economy.

Figure 19 The repurchase rate and other short-term interest rates



Inflation was expected to remain outside the upper end of the target range for the whole of 2012, and to peak in the second quarter of 2012 at around 6,6 per cent, before declining gradually and returning to within the target range in the first quarter of 2013. Inflation was expected to measure 5,5 per cent in the final quarter of 2013. The Bank's forecast of core inflation, excluding food, petrol and electricity, exhibited a moderately rising trend, peaking at about 5,5 per cent in the first two quarters of 2013. The upward revision of the forecast was mainly due to a change in the exchange rate view, which was partly offset by the downward adjustment to global growth.

The MPC considered the various risks to the inflation outlook to be fairly evenly balanced. The exchange rate, however, remained a major source of uncertainty while global economic developments posed a downside risk. Inflation pressures were largely of a cost–push nature. A concern at the time was that a persistent upward trend in inflation, accompanied by a prolonged breach of the inflation target, could adversely affect inflation expectations. This could, in turn, reinforce upward inflation dynamics.

Monetary policy was kept on hold, given the slowdown in the domestic economy and the absence of demand pressures. The monetary policy stance was already accommodative and supportive of the real economy with the nominal policy rate at a long-term low and the real policy rate slightly negative. The MPC maintained a preference for a stable interest rate environment, given the conflicting pressures on monetary policy at that stage.

By the March 2012 meeting of the MPC, it appeared that the intensity of the financial crisis in the eurozone had subsided somewhat, even though the crisis had not been resolved. Despite a number of positive indications, the global outlook remained fragile amid concerns about the strength and sustainability of the US recovery, a recession in Europe, the extent of a slowdown in China and higher international oil prices.

It was noted that domestic economic growth remained constrained. However, the better performance of the domestic economy in the fourth quarter of 2011, together with some positive global economic developments, resulted in a slightly improved outlook. An annual real growth rate of 3,1 per cent was recorded in 2011 following a fourth quarter growth rate of 3,2 per cent. The latter was mostly driven by positive contributions from the manufacturing and mining sectors. This reflected some normalisation following the impact of industrial action and other disruptions earlier in the year.

As a result of these factors, the Bank's GDP growth forecast was revised marginally upwards to 3,0 per cent for 2012, compared with 2,8 per cent in the previous forecast. The growth forecast for 2013 was increased from 3,8 per cent to 3,9 per cent. Nevertheless, the expected growth rates remained disappointing and implied a persistent negative output gap.

Global inflation appeared to be broadly contained as food prices declined and economic growth slowed. High unemployment rates in many economies suggested significant levels of slack in global labour utilisation. However, international oil price developments, driven mainly by geopolitical factors, posed a risk not only to inflation, but also to the growth outlook.

The then most recent inflation outcome in February surprised on the downside, while inflation expectations continued to be anchored around the upper band of the inflation target range. Inflation appeared to be somewhat more broad-based but in line with the previous forecasts. Risks to the outlook remained evenly balanced.

The Bank's inflation forecast was marginally lower than at the time of the previous meeting of the MPC. Inflation was still expected to peak in the second quarter of 2012 but at a slightly lower rate of 6,5 per cent and to average 6,1 per cent in the final quarter of 2012 and 5,6 per cent in the subsequent quarter. Inflation was expected to measure 5,2 per cent by the end of 2013.

The inflation trajectory improved somewhat mainly due to a less-depreciated exchange rate assumption. Following NERSA's change in electricity tariffs, the electricity price assumption was lowered from 17,3 per cent to 12,0 per cent. However, given the low weight of electricity in the CPI basket, the revised assumption had a marginal impact on the forecast. The forecast for core inflation, as measured by headline inflation excluding food, electricity and petrol, continued to exhibit an upward trend. This measure was expected to peak at an average of 5,4 per cent in the final quarter of 2012, which was marginally lower than in the previous forecast.

The relatively subdued pace of the recovery was not expected to increase demand pressures significantly. The main sources of upside risk to inflation were seen to come from international oil prices, and food price inflation was expected to moderate in the medium term. The exchange rate was, as usual, highly uncertain, but the risk posed to inflation had subsided somewhat in recent months, given the decline in volatility in a still uncertain, global environment.

Given this scenario and the projected medium-term inflation trajectory and in the light of expectations that domestic economic growth would remain below potential, the MPC was of the view that at that stage the then current stance of monetary policy was appropriate to support the real economy while at the same time maintaining the commitment to achieving the inflation target over the medium term. The repo rate remained unchanged at 5,5 per cent per annum.

By the **May 2012** meeting of the MPC, the crisis in Europe had deepened. Increased speculation about a possible Greek exit from the eurozone had shaken financial markets, and posed increasing downside risk to the global and domestic economy. These developments had the potential to undermine the fragile recovery in advanced economies and to reinforce the slowdown in some major emerging-market economies.

Table 10 The Bank's real GDP growth and targeted inflation forecasts

Per cent

MPC meetings	Real GDP	Targeted inflation		
	2012	2012	Expected peak	Expected return to target
September 2011	3,6	5,9	1st quarter 2012 at 6,2 per cent	2nd quarter 2012
November 2011	3,2	6,1	1st quarter 2012 at 6,3 per cent	4th quarter 2012
January 2012	2,8	6,4	2nd quarter 2012 at 6,6 per cent	1st quarter 2013
March 2012................	3,0	6,3	2nd quarter 2012 at 6,5 per cent	1st quarter 2013
May 2012...................	2,9	6,0	1st quarter 2012 at 6,1 per cent	2nd quarter 2012

The domestic economic growth outlook remained relatively subdued as global uncertainties imparted downside risk. Some recent developments underscored the continued fragile and uneven nature of the recovery. Mining output contracted in the first quarter of 2012 due to strike action, safety-related stoppages and temporary closures for maintenance. The manufacturing sector's performance in the first quarter of 2012 was more positive with an increase in the physical volume of manufacturing production. This contributed to expectations that the manufacturing sector could make a strong contribution to first quarter GDP growth. Household consumption expenditure, the main driver of growth in 2011, showed signs of moderation but was still expected to contribute positively to real gross domestic expenditure in the first quarter, albeit at a slower pace.

These factors informed the Bank's growth forecast, which remained more or less unchanged at 2,9 per cent for 2012, and 3,9 per cent for 2013. The output gap was expected only to begin contracting in the course of 2013. However, contagion from a further slowdown in Europe was expected to impact domestic growth through the trade channel and to impart downside risk to this forecast.

Global inflation remained relatively well contained. While the level of international oil prices remains high, there has been a moderation in recent weeks as the global growth outlook deteriorated and Saudi Arabian production increased significantly.

Turbulence in global financial markets caused the rand to depreciate, but the associated risk to the inflation outlook was offset to some extent by the lower international oil prices. Domestic inflation increased from 6,0 per cent in March 2012 to 6,1 per cent in April. The increase was mainly due to the 71 cent per litre increase in the petrol price. As expected, the downward trend in food price inflation was reversed in April with expectations of a resumption in the downward trend in May.

Despite the recent depreciation of the rand, inflation was nevertheless expected to remain within the target range over the medium term. The Bank's inflation forecast was lower over the near term than at the time of the previous meeting of the MPC. Inflation was expected to have peaked in the first quarter of 2012 at 6,1 per cent compared with the previous forecast of 6,5 per cent in the second quarter. Inflation was expected to average 6,0 per cent in the second quarter of 2012 and then to follow a gradually declining trend within the target range. The forecast period was extended to the end of 2014, and inflation was expected to average 6,0 per cent in 2012, 5,5 per cent in 2013, and 5,0 per cent in 2014.

In terms of risks to the inflation outlook, the exchange rate had re-emerged as an upside risk together with developments in global food prices. Increases in administered prices, on average, remained in excess of the upper end of the target range and were the main factor exerting upside pressure on inflation.

Increased uncertainty regarding Europe and associated global financial market turbulence has impacted on the perceived risks to the outlook for both domestic inflation and growth. These developments pose a downside risk to the hesitant domestic growth prospects.

The balance of risks to the inflation outlook is less clear. While the inflation forecast appears to be more favourable, there are renewed upside risks from a possible further weakening of the exchange rate. However, weaker demand and lower commodity prices, particularly that of oil, could act as countervailing pressures. On balance, the MPC judged these risks to the inflation outlook to be somewhat on the upside.

In this highly volatile and uncertain environment the MPC was of the view that it was appropriate to maintain the then prevailing accommodative monetary policy stance, given the continued absence of clear signs of excess demand pressures. The MPC therefore decided to keep the repurchase rate unchanged at 5,5 per cent per annum.

Box 3 Changes to the South African Reserve Bank's monetary policy operational procedures

The South African Reserve Bank (the Bank) conducts monetary policy within a flexible inflation-targeting framework, with a target range for the headline CPI inflation rate at 3 to 6 per cent. The Bank's repurchase (repo) rate is transmitted to the South African economy through the Bank's monetary policy implementation framework which entails a range of money-market operations to manage liquidity. A number of refinements have been made to the Bank's monetary policy operations since the introduction of the repurchase system in 1998.

In 2005 the Bank improved the effectiveness of the refinancing system by abolishing the regular supplementary refinancing facility, the marginal lending facility and the final clearing facility, and by reducing the spread between the repo rate and the standing facilities promoted a more active money market. In 2007 the Bank addressed the then limited availability of liquid assets by introducing Category 2 assets for use in the Bank's refinancing operations to free up liquid assets for prudential requirements. In 2010 and 2011 the Bank dealt with challenges encountered with open-market operations that had resulted in a decline in the money-market shortage to levels that reduced the effectiveness of the monetary policy operational framework.

These changes increased participation in the Bank's debenture auctions and ensured a more adequate level of the money-market shortage. The following three further enhancements to the monetary policy operational procedures were made on 1 March 2012:

i. In instances where the weekly main repo auction is over-subscribed, the amounts tendered by banks are now allocated on a pro rata basis, up to the announced average daily liquidity requirement for the week. This change addressed the unintended consequences of the money market remaining in a surplus position and with banks being penalised for depositing such surpluses at the Bank.
ii. During the week of the announcement of the Monetary Policy Committee's (MPC) interest rate decision, 2- and 5-day main repo transactions are now conducted to synchronise the Bank's main repo auctions with the interest rate announcements. This removes the misalignment of interest rates that could lead to a dislocation of interest rates in the interbank market.
iii. To enhance participation in the Bank's open-market operations, SARB debentures and reverse repo transactions of 7- and 14-day maturities are now issued in addition to the existing 28- and 56-day maturities. Through its open-market operations, the Bank is active at the short-end of the money-market yield curve and the shorter maturities should enhance the implementation of monetary policy.

These changes also enhance the effectiveness of earlier changes. For more detailed information regarding the changes to the Bank's monetary policy operational procedures please consult the Bank's website at http://www.reservebank.co.za.[1]

1 South African Reserve Bank, "An Implementation Paper on the Changes to the Monetary Policy Operational Procedures of the South African Reserve Bank" (paper issued by the Financial Markets Department, 27 January 2012, accessed 16 March 2012), http://www.resbank.co.za/MonetaryPolicy/MonetaryPolicyOperations/MarketOperations/DomesticMarket/ComMarketParticipants/Pages/Modifications-to-the-Money-Market-Operations.aspx, PDF file. South African Reserve Bank, "Changes to the South African Reserve Bank's Monetary Policy Operational Procedures" (media release, Pretoria, Wednesday, 22 February 2012, accessed 16 March 2012), http://www.resbank.co.za/publications/detail-item-view/pages/publications.aspx?sarbweb=3b6aa07d-92ab-441f-b7bf-bb7dfb1bedb4&sarblist=21b5222e-7125-4e55-bb65-56fd3333371e&sarbitem=4968. South African Reserve Bank, "Operational Notice: Money Market Operations" (media release, 22 February 2012, accessed 16 March 2012), http://www.resbank.co.za/MonetaryPolicy/MonetaryPolicyOperations/MarketOperations/DomesticMarket/Pages/Operational-Notice.aspx, PDF file. This note includes the terms of issuance of SARB debentures. South African Reserve Bank, "An Implementation Paper on the Modifications to the Money Market Operations of the South African Reserve Bank" (paper issued by the Financial Markets Department, 10 May 20005, accessed 10 April 2012), http://www.resbank.co.za/publications/detail-item-view/pages/publications.aspx?sarbweb=3b6aa07d-92ab-441f-b7bf-bb7dfb1bedb4&sarblist=21b5222e-7125-4e55-bb65-56fd3333371e&sarbitem=4179, PDF file.

The outlook for inflation

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

International outlook

The global economic outlook deteriorated towards the end of 2011 but has since improved somewhat. Fears of a global recession have moderated due to better outcomes in the US economy and the ECB's liquidity injections, although economic activity in Europe continued to decelerate. Significant downside risks are evident and the global growth picture remains mixed. Day-to-day news continues to lead to sharp spikes and reversals in risk aversion. Less-robust growth is projected for emerging and developing economies than expected in September 2011, and growth in China has slowed. On balance, therefore, the risks to global growth appear skewed to the downside, reflecting the lack of momentum in advanced economies, higher oil price effects and risk aversion. Major political and policy challenges remain in advanced economies. Global consumer price inflation is projected to ease in 2013 as the global economy slows, but oil and food prices pose significant risks to the inflation outlook.

Since the publication of the previous *MPR* in November 2011, the global growth outlook has been subjected to intensified sovereign debt concerns in Europe, which dampened confidence and economic activity. Towards the end of the year, financial and economic conditions deteriorated as reflected in the increase in sovereign yields and under the impact of both bank deleveraging and fiscal consolidation. This led to expectations of a recession in the euro area in 2012, and slower growth in emerging and developing economies (Table 11). With the deterioration in the near-term outlook, the International Monetary Fund (IMF) in its January 2012 *World Economic Outlook* (*WEO*) revised its global growth forecast for 2012 down to 3,3 per cent from 4,0 per cent in September.

Table 11 IMF projections of world growth and inflation for 2012 and 2013*

Per cent

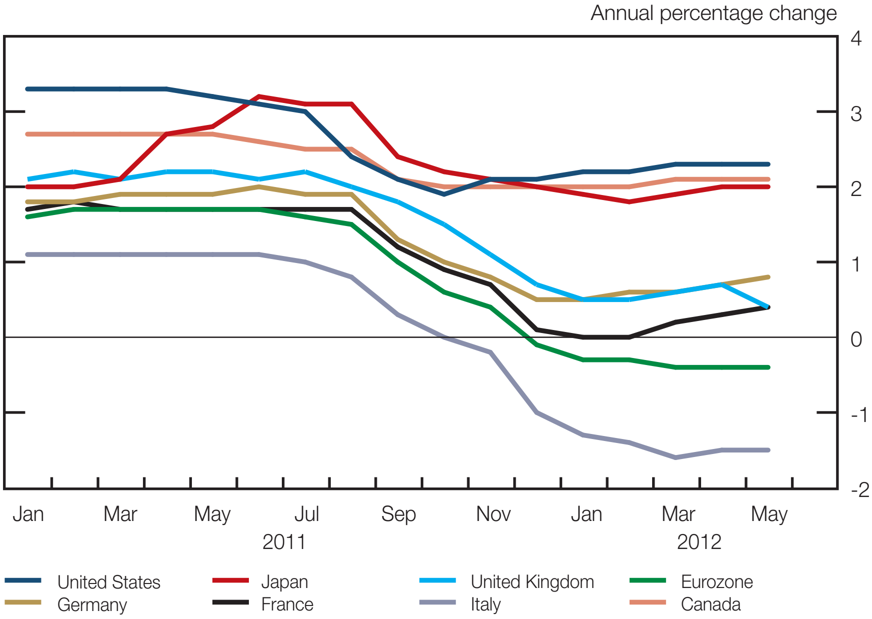
	Real GDP			Consumer prices		
	2012		2013	2012		2013
World	**(4,0)**	**3,5**	**4,1**	**(3,7)**	**4,0**	**3,7**
Advanced economies	**(1,9)**	**1,4**	**2,0**	**(1,4)**	**1,9**	**1,7**
United States	(1,8)	2,1	2,4	(1,2)	2,1	1,9
Japan	(2,3)	2,0	1,7	(-0,5)	0,0	0,0
Euro area	(1,1)	-0,3	0,9	(1,5)	2,0	1,6
United Kingdom	(1,6)	0,8	2,0	(2,4)	2,4	2,0
Canada	(1,9)	2,1	2,2	(2,1)	2,2	2,0
Other advanced economies	(3,7)	2,6	3,5	(2,8)	2,5	2,5
Emerging-market and developing countries	**(6,1)**	**5,7**	**6,0**	**(5,9)**	**6,2**	**5,6**
Sub-Saharan Africa	(5,8)	5,4	5,3	(8,3)	9,6	7,5
South Africa	(3,6)	2,7	3,4	(5,0)	5,7	5,3
Central and eastern Europe	(2,7)	1,9	2,9	(4,5)	6,2	4,5
Commonwealth of Independent States	(4,4)	4,2	4,1	(8,7)	7,1	7,7
Developing Asia	(8,0)	7,3	7,9	(5,1)	5,0	4,6
China	(9,0)	8,2	8,8	(3,3)	3,3	3,0
India	(7,5)	6,9	7,3	(8,6)	8,2	7,3
Middle East and North Africa	(3,6)	4,2	3,7	(7,6)	9,5	8,7
Latin America and the Carribean	(4,0)	3,7	4,1	(6,0)	6,4	5,9

* IMF projections for 2012 as at September 2011 in parenthesis

Source: IMF *World Economic Outlook*, April 2012

Global economic activity has continued to decelerate but fears of a global recession have subsided (Figure 20), despite a high degree of instability. Prospects for global growth are better than they were a few months ago. Most advanced economies are expected to avoid recession, while emerging and developing economies grow at a less robust pace. The IMF's April forecast showed global output rising by 3,5 per cent in 2012, slightly up from the January forecast of 3,3 per cent. The 2013 projection was revised up to 4,1 per cent from the previous forecast of 3,9 per cent.

Figure 20 Evolution of real GDP forecasts for 2012 for the G-7 and eurozone



Source: Consensus Forecasts

Real GDP in advanced economies is now projected by the IMF to expand by just 1,4 per cent in 2012 and 2,0 per cent in 2013.

While US data have been surprisingly encouraging, America's growth momentum could moderate in the near term. Labour market data have generally improved and the unemployment rate has declined to 8,1 per cent in April from 9,1 per cent in August. The generally strong dollar, together with the global and eurozone slowdown, may weaken US exports, while still-elevated oil prices push up the energy import bill, further impeding growth. Growth in the first quarter of 2012 tracked a little lower than in the previous quarter.

April growth projections for most other advanced economies have also been lowered. This is mainly due to adverse spillovers from the euro area via trade and financial channels, and limited policy room to counter these effects. However, Japan's GDP contracted by 0,7 per cent on an annualised basis in the fourth quarter of 2011 – less than the government had initially projected – after a jump in companies' capital spending. The IMF projects GDP growth in Japan of 2,0 per cent in 2012 and 1,7 per cent in 2013.

The Fund has projected a mild recession for the euro area for some months, with expected growth of -0,3 and 0,9 per cent for 2012 and 2013 respectively. As a result of widespread economic weakness, Europe's economy contracted at an annualised rate of 1,3 per cent in the fourth quarter of 2011. Growth in Germany and France was somewhat better than expected in both quarter four of 2011 and the first quarter of 2012 (Table 12).

The UK has fallen into a double-dip recession. Preliminary figures released in April showed that GDP had shrunk by 0,8 per cent in the first quarter of 2012 and by 1,2 per cent in the fourth quarter of 2011. GDP growth in the UK is expected to be weak in 2012.

Table 12 Real GDP growth rates

Percentage change

		2011	2012	
		4th qr*	1st qr*	Year**
Germany	Expected	-0,3	0,1	0,6
	Actual	0,2	0,5	-
France	Expected	-0,2	0,0	0,5
	Actual	0,1	0,0	-
United Kingdom	Expected	-0,2	0,1	0,8
	Actual	-0,3	-0,2	-

* Quarter-on-quarter percentage change of seasonally adjusted data
** Annual percentage change

Sources: Bloomberg and International Monetary Fund

Growth in emerging-market and developing countries is projected to average 5¾ per cent in 2012 and 6,0 per cent 2013; ½ a percentage point lower than projected in the September 2011 *WEO*. The deterioration in the external environment and a slowdown in some leading emerging economies are the key reasons for the downward revision.

China's economy has slowed for two consecutive quarters. It grew by 7,2 per cent in the first quarter of 2012; the slowest pace since the fourth quarter of 2008. Export growth and domestic consumption have both decelerated. China's trade deficit has expanded, and residential investment and commercial real-estate activity have slowed significantly. Infrastructure investment has also decelerated. The IMF, like many private forecasters, projects China's economic growth to moderate somewhat to 8,2 per cent in 2012 – annual growth below 9 per cent for the first time since 2001 – before rising again to 8,8 per cent in 2013. The Chinese government indicated that it intended to focus growth policy on internal consumption and services.

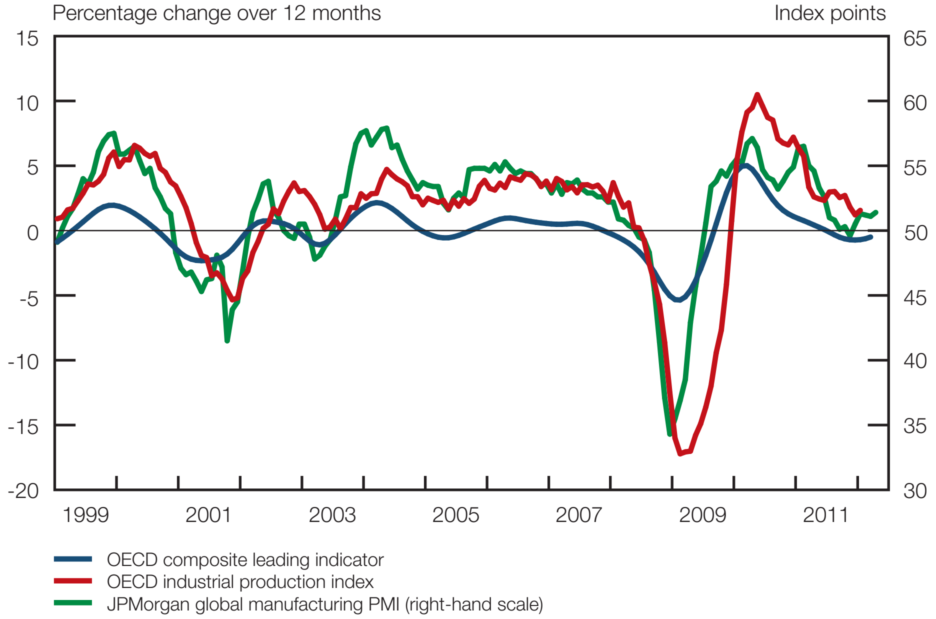
The Indian government's forecast for growth in 2012 is 6,9 per cent, similar to the growth rate obtained in the year to March. Despite a downward revision of about ¾ percentage point, developing Asia is still projected to outperform with a 7½ per cent growth rate on average during 2012–13. Elsewhere in Asia, Singapore's economy contracted for the second time in three quarters in quarter four of 2011 and Taiwan contracted for a second consecutive quarter. South Korea's economy grew at a mere 1,3 per cent in the same period; the slowest pace in two years. Growth in the newly industrialised Asian economies improved significantly in the first quarter of 2012, with quarterly rates averaging 3,3 per cent.

Economic growth is expected to be somewhat stronger in 2012 in the MENA region, with growth around 4,2 per cent. Sub-Saharan Africa should maintain robust growth of about 5,3 per cent on average in 2012 and 2013.

The composite leading indicator compiled by the Organisation for Economic Co-operation and Development (OECD) projects a contraction in member economies. It declined by 0,5 per cent in March 2012, compared with the corresponding month of the previous year (Figure 21). The JPMorgan global manufacturing Purchasing Managers' Index (PMI) has remained above the neutral level of 50 since December 2011, and rose to a level of 51,4 in April 2012. The year-on-year rate of change in the OECD industrial production index rose from 1,2 per cent in December 2011 to 1,6 per cent in January 2012.

The global inflation outlook remains subject to conflicting pressures. Stronger exchange rates and declining food prices moderated inflation pressures in emerging-market and developing countries early this year, despite higher oil prices. Data released by the OECD in early May showed consumer prices in its 34 member countries had risen by 2,7 per cent in the 12 months to March 2012. Long-term inflation expectations in the US have edged up.

Figure 21 Selected indicators of global economic activity



Sources: OECD and JPMorgan

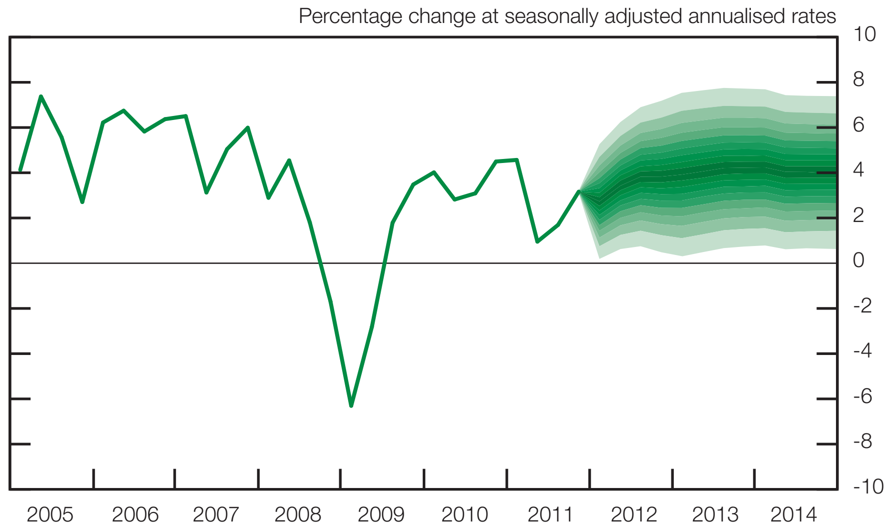
The IMF projects that consumer price inflation in emerging and developing countries will decelerate to 6,2 per cent in 2012 before slowing to 5,6 per cent in 2013 as the oil price stabilises.

Outlook for domestic demand and supply

Economic activity is expected to moderate in the first quarter of 2012 as recent short-term indicators disappointed. Growth forecasts and forward-looking indicators show a generally unchanged outlook for a moderate and sustained recovery in domestic demand and supply. The Bank's composite leading indicator showed some moderation in its otherwise positive trend.

The Bank's latest quarterly projection shows annual average growth in real output to be more or less unchanged compared to previous expectations, at 2,9 per cent in 2012 and 3,9 per cent in 2013 (Figure 22).

Figure 22 Real GDP growth forecast



The March 2012 MPC forecast projected 3,0 per cent for 2012 and 3,9 per cent for 2013 (Table 13). Short-term indicators show that growth in the first quarter of 2012 would probably be slightly lower than initially anticipated. Annualised real GDP growth is expected to exceed 3 per cent in the last three quarters of 2012. Although the output gap remains negative, the projection implies a narrowing of the gap during 2013 and 2014.

Table 13 Comparison of real GDP growth forecasts

Per cent

Source	2012	2013	2014
South African Reserve Bank (as at MPC meetings)			
November 2011	3,2	4,2	-
January 2012	2,8	3,8	-
March 2012	3,0	3,9	-
May 2012	2,9	3,9	4,1
IMF (*World Economic Outlook*)			
September 2011	3,6	4,0	3,8
January 2012	2,5	3,4	-
April 2012	2,7	3,4	4,0
National Treasury			
MTBPS 2011	3,4	4,1	4,3
Budget Review 2012	2,7	3,6	4,2
Reuters surveys			
October 2011	3,3	4,0	-
January 2012	2,8	3,5	3,9
April 2012	2,8	3,6	4,0

Sources: IMF *World Economic Outlook*, various issues; National Treasury and Reuters

The IMF revised South Africa's growth forecast for 2012 down from 3,6 per cent in September 2011 to 2,5 per cent in January 2012, but followed in April 2012 with a slight upward revision to 2,7 per cent.

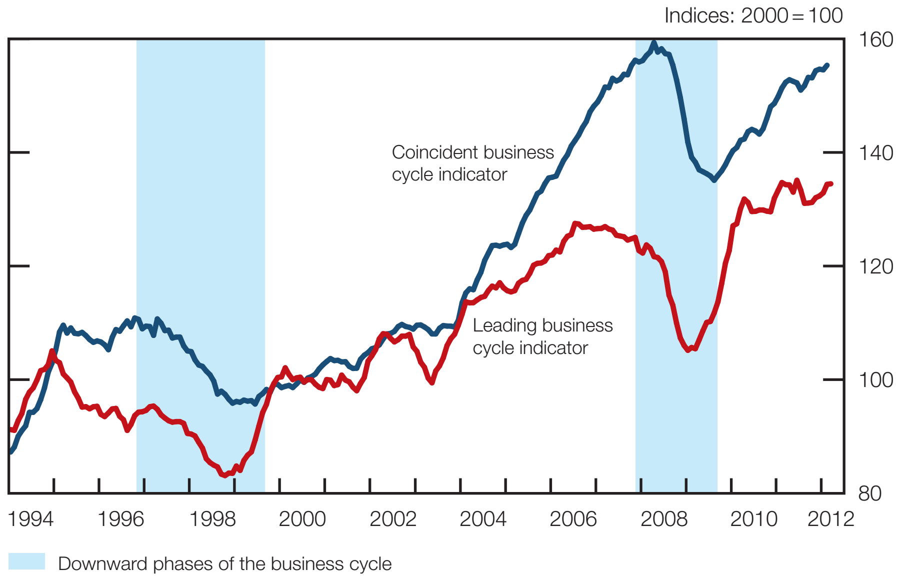
The National Treasury's February 2012 *Budget Review* projects growth in year-on-year real GDP at 2,7 per cent in 2012, followed by 3,6 per cent in 2013 and 4,2 per cent in 2014, somewhat lower than forecast in the October 2011 *MTBPS*.

On average, analysts surveyed by Reuters in April 2012 expect annual GDP growth to increase by 2,8 per cent in 2012, followed by 3,6 per cent in 2013 and 4,0 per cent in 2014.

The main drivers of expenditure growth are expected to be household consumption and gross fixed-capital formation, which are projected by the Bank respectively to register 3,8 per cent and 4,4 per cent in 2012, 4,2 per cent and 5,4 per cent in 2013 and 4,1 per cent and 6,7 per cent in 2014. On the supply side, stronger manufacturing and mining are expected alongside the continued healthy outcomes in each subsector of the tertiary sector.

The composite coincident business cycle indicator, with its upward trend and middle-of-the-year hesitation, has predicted well the growth performance of the South African economy in 2011 (Figure 23). The Bank's composite leading business cycle indicator followed a broadly sideways trajectory in 2011–12 and, on balance, increased by 1,8 per cent from November 2011 to March 2012. Five of the ten component time series that were available for March 2012 increased, while five decreased.

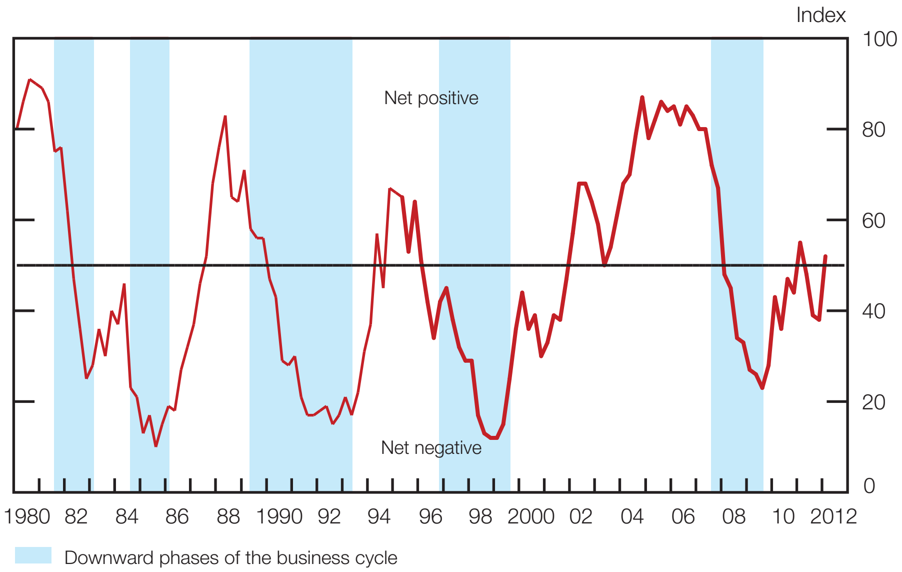
Figure 23 Composite business cycle indicators



The largest positive contribution to the leading indicator in March came from the 12-month change in job advertisement space and leading indicators of South Africa's major trading-partner countries. Negative contributions came from the decrease in the export commodity price index and the decline in the average hours worked in manufacturing. Preliminary April data suggest a continuation of the recovery at a moderate pace.

The *Rand Merchant Bank (RMB)/Bureau for Economic Research (BER) Business Confidence Index* (BCI) increased sharply by 14 index points from 38 index points in the fourth quarter of 2011 to 52 index points in the first quarter of 2012; breaking the neutral level of 50 for the first time since a year earlier (Figure 24). The level indicates a slight majority of respondents comfortable with prevailing business conditions. However, some underlying trends suggest that GDP growth in the first quarter of 2012 will not improve on the rate attained in the fourth quarter of 2011.

Figure 24 RMB/BER Business Confidence Index



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

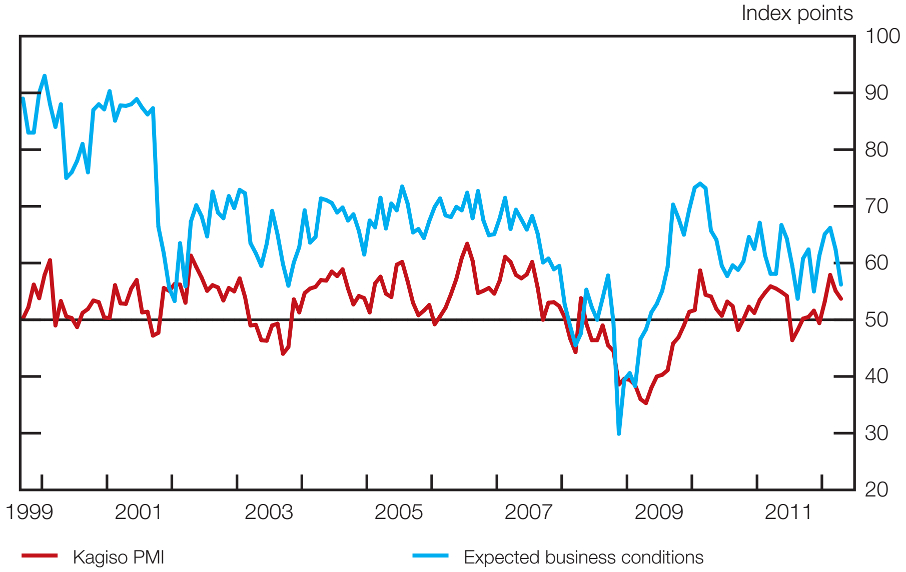
For the first time since the third quarter of 2010, sentiment improved in all five sectors surveyed, as higher confidence followed from better expectations of improved future economic conditions. Confidence was sharply higher in the first quarter of 2012 (+29 index points to a level of 73) in new motor trade as sales rose. Both new vehicle trade and retail exceeded the neutral level of 50. Building contractors' confidence increased to a three-year high.

According to the first quarter 2012 *BER Manufacturing Survey*, manufacturing business confidence improved by 12 index points to 47 index points. Confidence has been boosted by an increase in pricing power and higher-than-expected domestic sales, and moderated by somewhat-lower sales reported by exporters. Output has remained below capacity and the rate of increase in per unit total cost stabilised. More manufacturers reported increased fixed investment levels and higher-than-expected investment in 12 months' time.

Retail business confidence increased by 5 index points to a level of 61 in the first quarter 2012 according to the *Ernst & Young/BER Retail Survey*. The rise in confidence of residential and non-residential building contractors has been a very encouraging development, with the biggest increase recorded by the latter. The *FNB/BER Building Confidence Index* increased from 29 to 34 in the first quarter of 2012.

The seasonally adjusted *Kagiso/BER PMI* increased notably from 49,4 index points in December 2011 (below the neutral level of 50) to 53,7 in April 2012 (Figure 25). Although the index moved firmly to expansionary territory, the second consecutive monthly decline in April signals an easing of momentum after a strong first quarter.

Figure 25 Kagiso PMI



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

The increase in the PMI to April 2012 was primarily driven by business activity and new sales orders; the two sub-indices with the highest weighting. The seasonally adjusted business activity index increased sharply from 49,7 index points in December 2011 to 57,7 index points in April 2012. The new sales orders index rose from 48,3 index points to 55,4 index points over the same period, suggesting strong demand for South African factory goods and significantly stronger domestic manufacturing-sector activity than would have been expected, given the depressed economic activity levels of some parts of Europe.

The forward-looking indicators of the PMI suggest a somewhat less-optimistic outlook. Expected business conditions in six months' time weakened to 56,2 index points in April 2012, while new sales orders to inventories declined below 1 (to 0,96). The ratio indicates that the current level of inventories in the manufacturing sector is high relative to the demand for factory goods and that the rate of demand growth appears to have moderated in recent months.

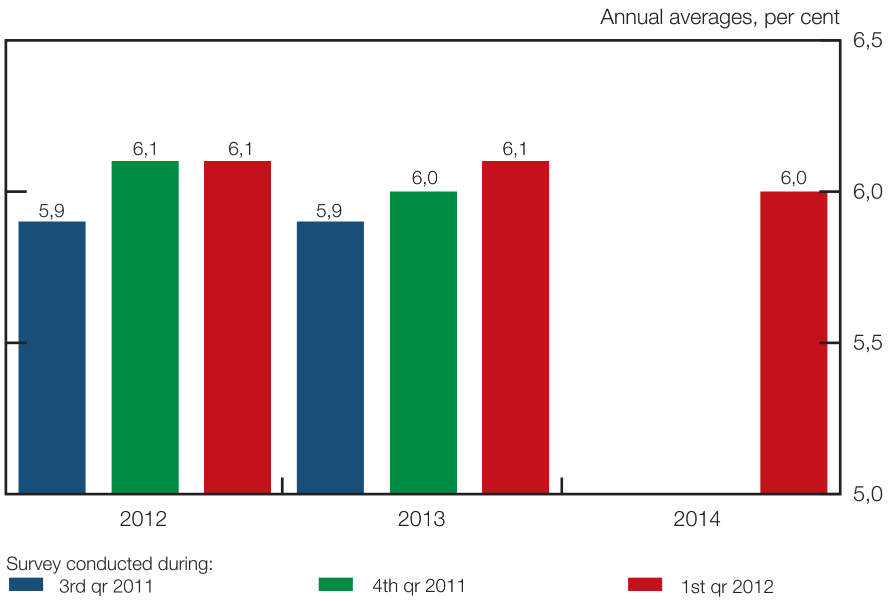
After edging up to +5 index points in the fourth quarter of 2011 the *FNB/BER Consumer Confidence Index* (CCI) remained unchanged in the first quarter of 2012. At +5 the CCI suggests a fairly neutral level compared to an average reading for the CCI since 1994 of +6 index points.

Indicators of inflation expectations

Inflation expectations are an important factor in product price setting and in wage negotiations, and hence in determining future inflation outcomes. Inflation expectations have remained relatively well anchored despite the upward trend in measured inflation and the breach of the upper band of the inflation target range.

The BER survey of inflation expectations undertaken during the first quarter of 2012 shows average inflation expectations for 2012 unchanged, just outside the inflation target range since the fourth quarter of 2011 at a level of 6,1 per cent compared to the 5,9 per cent surveyed in the third quarter of 2011 (Figure 26). Inflation is expected to remain stable at 6,1 per cent in 2013 and then to moderate slightly to 6,0 per cent in 2014.

Figure 26 BER surveys of headline CPI inflation expectations



Source: Bureau for Economic Research, Stellenbosch University

According to the BER survey results, only analysts revised up their 2012 inflation forecast. Business people kept their forecast unchanged and trade union officials revised their forecast downwards. For 2013, analysts have kept their forecast unchanged and the other two groups revised their expectations upwards. Labour reported the lowest inflation expectations for 2012, and analysts the lowest in 2013 and 2014.

Inflation expectations, as surveyed by Reuters in April 2012 (Table 14), suggest that the average year-on-year percentage change in the CPI will be slightly greater than the 6 per cent upper band of the inflation target range for 2012, before falling to within the target range in 2013 and 2014. These expectations are slightly lower compared to the survey results of March 2012. The quarterly average of the year-on-year percentage change of CPI shows that inflation is expected to fall within the target range sometime by the last quarter of 2012.

Table 14 Reuters survey of CPI inflation forecasts: April 2012*

	2012		2013		2014	
Mean	(6,1)	6,0	(5,6)	5,5	(5,7)	5,5
Median	(6,1)	6,0	(5,7)	5,6	(5,9)	5,7
Highest	(6,5)	6,3	(6,8)	6,6	(7,2)	7,1
Lowest	(5,4)	5,0	(4,8)	4,7	(4,9)	4,9
Number of forecasters	(18)	19	(18)	19	(12)	13

* March 2012 survey results in parenthesis

Source: Reuters

Figure 27 shows inflation expectations associated with break-even inflation rates. The break-even inflation rate proxy for expected inflation is measured as the difference between the nominal yields on conventional South African government bonds and the real yields on CPI inflation-linked government bonds of similar maturity. Since the November 2011 *MPR,* bond yields have been influenced by changes in the exchange value of the rand, firm non-resident investor demand for bonds and the trend in inflation. Both near-term and long-term break-even inflation rates have increased, mostly due to lower real yields on inflation-linked bonds. The real yield on the R189 (inflation-linked bond maturing in March 2013) turned negative during November 2011 and remained negative into 2012. The trend in real yields on inflation-linked bonds indicates that the breach in the inflation target is perceived to be temporary.

Figure 27 Break-even inflation rates

Sources: JSE Limited and own calculations

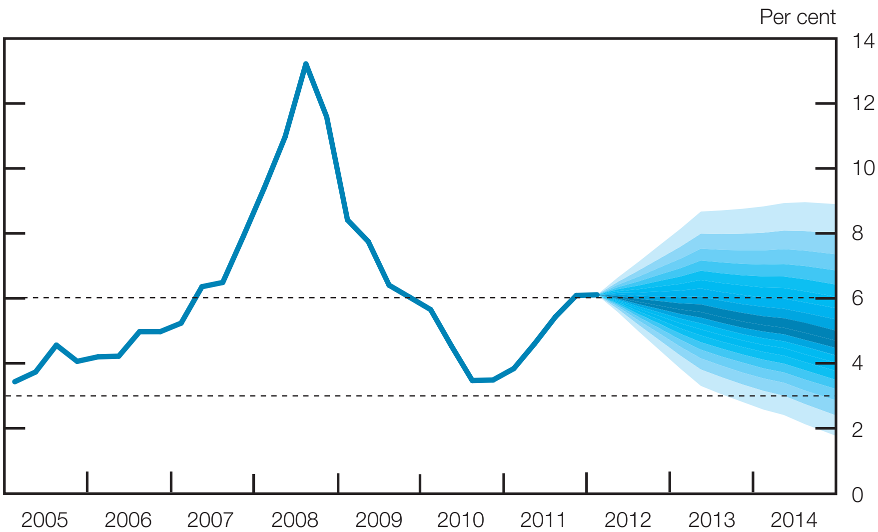
The South African Reserve Bank inflation forecast

The Bank's outlook for targeted inflation improved in recent months in terms of both the projected peak rate and the time profile for returning to the target. Following a further downward revision, CPI inflation is expected to have peaked in the first quarter of 2012 before returning to within the target range during the second quarter of 2012 and thereafter to follow a gradually declining trend within the target range.

The most recent projections of the Bank's core quarterly forecasting model, presented to the MPC meeting on 22–24 May 2012, are reproduced in the form of a fan chart in Figure 28. The CPI inflation forecast of the Bank has been revised down since the MPC's previous meeting in March 2012, mainly as a result of a lower-than-expected inflation outcome in the first quarter of 2012.

The central projection, conditional on an unchanged repurchase rate, is for the average quarterly CPI inflation rate to have peaked at an average rate of 6,1 per cent in the first quarter of 2012, before returning to within the target range at an average rate of 6,0 per cent in the second quarter of 2012. Inflation is expected to average 6,0 per cent in 2012 and 5,5 per cent in 2013, compared with the averages of 6,3 per cent and 5,4 per cent forecasted at the time of the March 2012 meeting. The Bank's forecast of core inflation still shows a moderately rising trend, but with a lower peak of around 5,5 per cent expected in the second quarter of 2013.

Figure 28 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*).

Given the central projection for targeted inflation as the most likely outcome, the risks to the forecast in Figure 28 are viewed as being to the upside. Core inflation has trended gradually higher and remains contained. Future developments in cost–push pressures emanating from international oil prices, administered prices and the exchange rate pose upside risks to the outlook.

Assessment and conclusion

In 2011 the global rate of inflation increased and global economic activity slowed. A higher international oil price contributed to the increase in global inflation. Economic activity in advanced economies turned out disappointingly weak, whereas the initially strong growth in emerging-market and developing economies moderated due to a slowdown in China and the rest of Asia.

Somewhat better economic outcomes in the first quarter of 2012, in particular a softening of inflationary pressures, have been accompanied by regular spikes in uncertainty and risk aversion arising out of Europe's financial and debt travails. Economic growth is constrained by fiscal tightening and deleveraging. Oil price levels remain high and risks to prices remain to the upside for the medium term. Both remain highly sensitive to global growth developments and, as a result oil prices and risk perceptions, will likely exhibit considerable volatility in the coming weeks and months.

South Africa was challenged by lower-than-expected domestic economic growth and rising inflation for much of 2011. The uneven economic recovery gained some momentum in the fourth quarter of 2011, supported by firm growth in fixed capital formation and a sustained improvement in household consumption expenditure. The growth outlook for 2012 is broadly unchanged. Although headline CPI remains high and just outside the target band, the inflation outlook has improved in terms of both the projected peak and profile of returning sustainably to the target.

The major drivers of inflation are housing and utilities, followed by food prices, which have moderated recently, and transport, as a result of increases in the petrol price. Although nearly all administered price increases remained in excess of the upper end of the inflation target range, the pace of growth in electricity prices will be lower than previously expected. Given the high degree of uncertainty surrounding many of the developments in global and domestic environments in recent months, management of inflation expectations has proved challenging. Inflation expectations appear to have remained anchored around the upper end of the inflation target range. Core inflation has trended higher but remains relatively moderate, with the potential for more generalised price pressures contained.

Despite the slightly stronger economy, the level of output remains low and growth itself below estimates of potential growth. Demand pressures are muted. Average wage settlement rates moderated in 2011 and growth in unit labour cost slowed in the final quarter, making labour market prices more consistent with demand trends. Employment losses suffered during the recession have still not been recovered and future prospects for job creation remain uncertain.

Policy-setting has taken into account the moderate economic recovery and the continued prevalence of under-utilisation of production capacity.

Cost–push pressures emanating from international oil prices and the impact of changes in global risk perceptions on the exchange rate remain the central unknowns for policy going forward, as they have been for the period under review.

Central to the Bank's approach is the objective of price stability implemented within a flexible inflation-targeting framework focused over the appropriate time horizon with well-anchored inflation expectations to minimise the effect of temporary shocks on inflation and economic activity.

Statement of the Monetary Policy Committee

19 January 2012

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 and economic growth has deteriorated, posing a serious challenge for monetary policy going forward. Inflation is now expected to remain above the upper end of the target range for a more extended period, but there is still no evidence of significant demand pressures in the economy. While economic growth in the fourth quarter was likely to have exceeded that in the previous two quarters, the forecast for growth in 2012 has been revised downwards. The primary reason for the worsening domestic growth outlook is the risk of contagion from the persistent crisis in Europe, which shows no sign of a speedy resolution.

The year-on-year inflation rate as measured by the consumer price index (CPI) for all urban areas was 6,1 per cent in December 2011, unchanged from November. The categories of food, housing and utilities, and transport together accounted for 4,4 percentage points of the December outcome. Food price inflation accelerated further to 11,6 per cent, from 11,1 per cent in November, while petrol prices increased by 26,4 per cent. Administered price inflation excluding petrol was unchanged at 8,7 per cent. CPI inflation excluding food, petrol and electricity remained unchanged at 3,9 per cent, indicating relatively benign core inflation outcomes.

Producer price inflation moderated from a year-on-year rate of 10,6 per cent in October 2011 to 10,1 per cent in November. The impact of the depreciated rand exchange rate is evident in the 15,9 per cent increase in the price of imported commodities. Food price inflation remained elevated, with agricultural prices increasing at a year-on-year rate of 12,1 per cent in November, and manufactured food prices increasing by 8,4 per cent.

The inflation forecast of the Bank has been subject to a further upward revision. Inflation is now expected to remain outside the upper end of the target range for the whole of 2012, and to peak in the second quarter of 2012 at around 6,6 per cent before declining gradually and returning to within the target range in the first quarter of 2013. Inflation is expected to measure 5,5 per cent in the final quarter of 2013. The Bank's forecast of core inflation, which excludes food, petrol and electricity, shows a moderately rising trend, with the peak of around 5,5 per cent expected in the first two quarters of 2013. The main factor contributing to the upward revision of the forecast is the changed assumption relating to the exchange rate of the rand, which was partly offset by the downward adjustment to the global growth assumption.

Inflation expectations, as reflected in the survey conducted by the Bureau for Economic Research (BER) at Stellenbosch University in the fourth quarter of 2011, have increased moderately but have remained relatively anchored around the upper end of the inflation target range. Inflation is expected to average 6,1 per cent in 2012, compared with 5,9 per cent expected in the previous survey. Expectations for 2013 increased from 5,9 per cent to 6,0 per cent. All categories of respondents revised their forecasts moderately upwards for both years, except for business executives whose expectations for inflation in 2013 remained unchanged at 6,3 per cent.

The global outlook remains clouded by the worsening situation in the eurozone, and growth forecasts for the region have generally been revised down amid widespread sovereign ratings downgrades. It is now generally accepted that the eurozone is likely to experience a recession in 2012, but the extent and duration is still uncertain. The increasingly fragile sentiment is exacerbated by the lack of resolution of the sovereign debt crisis and the consequent increase in sovereign debt yields; further fiscal austerity measures in the region; and the impact on the real economy of higher capital requirements for banks and consequent bank deleveraging.

Tightened lending standards have also had cross-border implications for a number of emerging-market economies, particularly in Eastern Europe and Latin America.

Although the Organisation for Economic Co-operation and Development (OECD) leading indicators and global Purchasing Managers' Indices (PMIs) are trending downwards, the economic growth outcomes in Japan and the United States (US) have been more favourable than was the case in mid-2011. The unemployment rate in the US has declined, and both consumption and investment expenditure have shown some signs of recovery, although downside risks from fiscal consolidation and the continued weakness in the housing market remain.

Growth in emerging-market and developing countries, while still relatively favourable, is also expected to moderate somewhat, in part due to contagion effects from the European crisis as well as policies that have been aimed at curbing domestic demand pressures. Economic growth in China is also expected to slow, but a hard landing is not anticipated. Sub-Saharan Africa, which has become an increasingly important destination for South African exports, is expected to continue to grow at a rate in excess of 5 per cent.

Global inflation appears to be moderating, as weaker demand has contributed to declines in food and commodity prices. Oil prices, however, have been underpinned by risks to supply due to geopolitical factors.

The rand exchange rate has continued to display a relatively high degree of volatility in response to erratic changes in global risk aversion. Since the previous meeting of the MPC the rand has traded in a range of between R7,93 and R8,60 to the US dollar, but for the past month the range has generally been between R8,00 and R8,20 . Since the previous meeting, the rand has remained more or less unchanged against the dollar, and appreciated by about 6 per cent per cent against the euro, reflecting the influence of the euro/dollar exchange rate on the domestic currency. On a trade-weighted basis, the rand appreciated by almost 3 per cent over the same period.

South Africa's experience with portfolio capital flows during 2011 was similar to the general emerging-market experience of slowing bond inflows and net equity outflows. For the year as a whole non-resident purchases of bonds amounted to R42 billion, while net sales of equities to the value of R17 billion were recorded.

The outlook for the rand exchange rate remains highly dependent on global risk appetite. While the rand remains vulnerable to global developments, it has been relatively stable in the past few weeks, and consensus forecasts reflect an expectation that the current levels will be sustained for a protracted period. But this is significantly dependent on global sentiment and developments.

The outlook for domestic economic growth remains subdued. According to the Bank's forecast, the annual real growth rate in 2011 is estimated to have been in the region of 3,1 per cent, but the outlook for 2012 and 2013 has deteriorated relative to the previous forecast, mainly due to a downward revision to the global growth assumption. Growth in 2012 is expected to average 2,8 per cent compared with 3,2 per cent in the previous forecast, while the forecast for growth in 2013 has been revised down from 4,2 per cent to 3,8 per cent. This implies a further expected widening of the output gap during this period.

Despite the less-favourable outlook, some improvement is expected in the mining and manufacturing sectors, which both contracted in the second and third quarters of 2011. Although mining output contracted further in October, it rebounded on a month-on-month basis in November, but the change in the three months to November compared to the previous three months showed a contraction of 0,7 per cent. The manufacturing sector experienced positive growth in October and November, with the physical volume of manufacturing output increasing at a three-month-on-three-month rate of 2,6 per cent. Nevertheless, the sector is expected to remain under pressure. Following four consecutive months of increases, the Kagiso PMI declined to below the neutral 50 level to 49,4 in December.

The construction sector also remains subdued, notwithstanding an increase in the real value of building plans passed in November, and a slight increase in the First National Bank (FNB) Building Confidence Index in the fourth quarter. On the positive side, the sector could benefit from the continued but slow improvement in the growth of gross fixed capital formation which increased at an annualised rate of 5,6 per cent in the third quarter of 2011. According to the Rand Merchant Bank (RMB)/BER Business Confidence Index, business confidence remains relatively low, having declined marginally in the fourth quarter of 2011.

Despite the weak economic performance in the third quarter, employment growth surprised on the upside. According to the *Quarterly Employment Survey* of Statistics South Africa (Stats SA), formal non-agricultural employment increased by 47 300 in the quarter and by 207 000 year on year, with the bulk of the increases in the second and third quarters coming from the private sector. This trend is consistent with that observed in the *Quarterly Labour Force Survey*. However, the employment losses suffered during the recession have still not been recovered and future employment prospects remain uncertain given the fragile economic outlook.

Growth in consumption expenditure by households continues to be the main driver of growth in the economy but growth rates remain moderate and are not expected to pose a risk to inflation. Real final consumption expenditure by households increased at an annualised rate of 3,7 per cent in the third quarter of 2011, up from 3,3 per cent in the previous quarter, but lower than the levels recorded in previous quarters. Real retail sales grew at a year-on-year rate of 6,8 per cent in November, while on a three-month-to-three-month basis growth of 3,1 per cent was recorded. According to the FNB/BER Consumer Confidence Index, consumer confidence increased marginally in the fourth quarter of 2011.

Consumption expenditure continues to be constrained by relatively tight lending standards by banks, high levels of household debt and consistently above-average increases in a range of administered prices which reduce the amount available for household discretionary expenditure.

The gradual deleveraging by households has continued, with the ratio of household debt to disposable income declining further from 75,8 per cent in the second quarter of 2011 to 75,0 per cent in the third quarter, compared with a peak of 82,3 per cent in 2009. The decline in the ratio, however, reflects the fact that disposable income is increasing at a faster rate than debt accumulation.

Trends in credit extension have remained subdued and more or less unchanged since the previous meeting of the MPC, with year-on-year growth in banks' loans and advances to the private sector measuring 6,0 per cent in both October and November. Mortgage advances remained relatively depressed in line with the weak state of the housing market, and increased by 1,9 per cent in November. The main drivers of credit extension in November were the 6,0 per cent increase in instalment sales credit and leasing finance, reflecting improved motor vehicle sales, and other loans and advances which increased at a year-on-year rate of 12,6 per cent in both October and November. This category was driven mainly by general loans which include unsecured lending.

The main pressures on inflation continue to emanate primarily from cost-push pressures. Administered prices remain a concern in the inflation outlook. The price of electricity has been an important driver of inflation, and increases of 17,3 per cent are assumed for both 2012 and 2013. However, the current National Energy Regulator of South Africa (NERSA) determination ends in mid-2013 and subsequent price increases are yet to be determined. The case for further significant above-inflation increases is questionable. The determination of administered prices should not act as an inhibitor to growth and investment.

International oil prices have been subject to conflicting pressures. Downside pressures have emanated from the weaker global growth environment, while upside pressures emanate from geo-political factors which have raised fears of possible supply disruptions. Nevertheless, the price of Brent crude oil has been surprisingly stable and, despite some volatility, is at similar levels to those prevailing at the time of the previous MPC meeting. Domestic petrol prices have decreased by a cumulative 16 cents per litre since early November, but the current under-recovery suggests that a further increase can be expected in February.

According to Andrew Levy Employment Publications, the overall average wage settlement rate in collective bargaining agreements amounted to 7,7 per cent in the first nine months of 2011, compared with 8,2 per cent in 2010. However there are indications that the downward trend in nominal remuneration may have reversed. According to Stats SA, growth in average remuneration per worker increased by 8,6 per cent in the third quarter of 2011 compared with the same quarter in 2010, up from 6,4 per cent and 7,4 per cent in the previous two quarters respectively. Adjusting for declining labour productivity trends, this has resulted in growth in nominal unit labour costs increasing from 5,2 per cent in the first quarter to 8,3 per cent in the third quarter of 2011. These developments could pose further upside risk to the inflation outlook.

Food prices remain a major driver of inflation, influenced by both local and global factors. Domestic food prices have been negatively affected by the recent depreciation of the rand, and a smaller-than-expected maize crop which contributed to the doubling of the domestic maize price over the past year. Futures prices of maize suggest that some relief may be expected during the first half of 2012. Furthermore, global food prices have been declining, with the Food and Agriculture Organization (FAO) Food Price Index falling by 11,3 per cent in December 2011, compared to its most recent peak in February of that year. Nevertheless, domestic food price inflation at the consumer level is expected to remain relatively high for some time.

The MPC has reflected on the various risks to the inflation outlook and considers these risks to be fairly evenly balanced, notwithstanding the reality that the exchange rate remains a significant source of uncertainty. The main downside risk continues to emanate from global economic developments.

The MPC remains of the view that inflation pressures are primarily of a cost-push nature, but is concerned that a persistent upward trend in inflation and prolonged breach of the inflation target could have an adverse effect on inflation expectations which could reinforce the upward inflation dynamics. However, the MPC is also cognisant of the slowing domestic economy and feels that given the lack of demand pressures, monetary tightening at this stage would not be appropriate. At the same time, the nominal policy rate is at a long-term low and the real policy rate is slightly negative, indicating a monetary policy stance that is accommodative and supportive of the real economy.

The MPC maintains a preference for a stable interest rate environment, given the conflicting pressures on monetary policy at this stage. However, the committee will continue to monitor domestic and global economic and financial developments and the risks to the outlook, and remains ready to act appropriately to ensure the attainment of the inflation target over the medium term while being supportive of the domestic economy. The MPC has therefore decided to keep the repurchase rate unchanged at 5,5 per cent per annum.

Statement of the Monetary Policy Committee

29 March 2012

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 Monetary Policy Committee (MPC) the intensity of the financial crisis in the eurozone appears to have subsided somewhat, but the very mixed signals indicate that the crisis is not necessarily resolved. Despite the positive indications, the global outlook remains fragile amid doubts about the strength of the United States (US) recovery, a recession in Europe, the extent of a slowdown in China and higher international oil prices.

Domestic economic growth remains constrained, but the improved performance of the South African economy in the fourth quarter of 2011 and some positive developments in the global economy indicate a slightly better outlook than previously expected. The most recent inflation outcome surprised on the downside and there has been a slight downward revision to the inflation forecast while inflation expectations continue to be anchored around the upper end of the inflation target band. Inflation appears to be somewhat more broad-based but in line with our previous forecasts, and the risks to the outlook remain evenly balanced.

The year-on-year inflation rate as measured by the consumer price index (CPI) for all urban areas was 6,1 per cent in February, down from 6,3 per cent in January. This favourable outcome was primarily the result of a moderation in food price inflation, from 10,7 per cent to 10,1 per cent. The categories of food, housing and utilities, and transport together accounted for 4,2 percentage points of the inflation outcome. CPI inflation excluding food, petrol and electricity increased from 3,9 per cent in December to 4,3 per cent in January, and was unchanged in February.

Year-on-year producer price inflation has continued its moderating trend, measuring 8,9 per cent and 8,3 per cent in January and February 2012 respectively. Agricultural price inflation declined from 7,9 per cent in January to 4,6 per cent in February, while manufactured food price inflation remained unchanged at 10,9 per cent.

The inflation forecast of the Bank is marginally lower than at the time of the previous meeting of the MPC. Inflation is still expected to peak in the second quarter of 2012 but at a slightly lower rate of 6,5 per cent and to average 6,1 per cent in the final quarter of 2012 and 5,6 per cent in the subsequent quarter. Inflation is expected to measure 5,2 per cent by the end of the forecast period at the end of 2013. The slightly improved inflation trajectory is mainly a result of a less depreciated exchange rate assumption. Following the change in the electricity tariffs by the National Energy Regulator of South Africa (NERSA), the electricity price assumption has been reduced from 17,3 per cent to 12,0 per cent. Given the low weight of electricity in the CPI basket, the impact on the forecast was marginal.

The forecast for core inflation, as measured by headline inflation excluding food, electricity and petrol, continues to show an upward trend, reflecting possibly more broad-based inflation pressures and base effects. This measure is expected to peak at an average of 5,4 per cent in the final quarter of 2012, which is marginally lower than in the previous forecast.

Inflation expectations, as reflected in the Survey of Inflation Expectations conducted by the Bureau for Economic Research (BER) at Stellenbosch University during the first quarter of 2012, appear to have remained relatively anchored around the upper end of the inflation target range. Respondents expect inflation to average 6,1 per cent in both 2012 and 2013, and 6,0 per cent in 2014. Compared with the previous survey, the forecast for 2012 is unchanged, while that for 2013 is up by 0,1 percentage point. Business executives are the most pessimistic, with expectations of 6,5 per cent for both 2013 and 2014. The expectations of financial analysts are marginally higher than those reflected in the latest Reuters survey of market analysts, which shows expected inflation to average 6,2 per cent in 2012 and 5,7 per cent in the following two years.

The immediate threat to the global economy posed by the European sovereign debt crisis appears to have subsided somewhat, but significant risks remain. Market signals in respect of what progress is being made with the resolution of the crisis are mixed, but spreads on sovereign debt of the affected European economies have narrowed significantly, partly as a result of the Greek debt swap, and liquidity provision by the ECB, which has been directed in part to increased purchases of sovereign debt by banks. Despite these positive developments, the eurozone economy is still expected to experience a recession 2012 in the face of widespread fiscal austerity and tight bank lending conditions. Continued deleveraging by banks is a considerable risk, given potential spillover effects.

The US economy shows signs of improvement but the economy still has a negative output gap and there are some doubts about the sustainability of this growth performance. The Chinese economy has shown signs of slowing, but a hard landing is not generally expected. Emerging-market growth generally is also more subdued, and the policy tightening that had been a feature of many of these economies earlier in 2011 has either stopped or been reversed.

Global inflation appears to be broadly contained amid slowing growth and declining food price trends. However, international oil price developments, driven mainly by geopolitical factors, are posing an increasing risk not only to inflation, but also to the growth outlook.

Since the previous meeting of the MPC, the rand has appreciated in line with declining risk aversion in global financial markets. The volatility of the rand has also moderated, with the rand fluctuating in a range of between R7,45 and R7,78 to the US dollar since the beginning of February. Since the beginning of the year, the rand has appreciated by 5,0 per cent against the US dollar, by 2,3 per cent against the euro, and by 4,8 per cent on a trade-weighted basis. The Reuters poll in February reflects an expectation that the rand will continue to trade at around current levels for the rest of the year. However, the currency is expected to remain sensitive to changes in global investor sentiment.

The pattern of portfolio flows to South Africa has persisted, with non-residents being net buyers of bonds and net sellers of equities despite a resumption of net flows into emerging equity markets in general. Since the beginning of the year, non-residents' net purchases of bonds have totalled R17,5 billion, while net sales of equities have totalled R6,0 billion.

The domestic economic outlook appears slightly more favourable against the backdrop of a more positive global outlook. In 2011 an annual real growth rate of 3,1 per cent was recorded, following a fourth quarter growth rate of 3,2 per cent. The latter was driven mainly by positive contributions from the manufacturing and mining sectors, partly reflecting some normalisation following the impact on the third quarter growth performance of industrial action and other disruptions. The Bank's gross domestic product (GDP) growth forecast was revised marginally upwards to 3,0 per cent in 2012, compared with 2,8 per cent in the previous forecast, mainly as a result of a slightly more favourable global outlook, which remains uncertain. The growth forecast for 2013 has increased from 3,8 per cent to 3,9 per cent. This moderately improved outlook is consistent with the increase in the Rand Merchant Bank/BER Business Confidence Index in the first quarter of 2012 to above the neutral level of 50, as well as the positive trend observed in the Bank's composite leading indicator. Nevertheless, the expected growth rates remain disappointing and still imply a persistence of the negative output gap.

Notwithstanding the improved forecast, the outlook for the mining sector continues to disappoint with an annualised growth rate of 0,7 per cent in the final quarter of last year. In January 2012 mining output contracted at a month-on-month rate of 4,6 per cent, and output in February is expected to have been negatively impacted by industrial action, maintenance shut-downs and electricity supply constraints.

More positively, the recovery in the manufacturing sector is expected to continue. The physical volume of manufacturing output increased by 1,2 per cent on a month-on-month basis in January, while the Kagiso/BER Purchasing Managers Index increased significantly from 53,2 index points in January to 57,9 index points in February, its highest level since February 2010. Nevertheless, the sector is still characterised by excess capacity, which is likely to constrain investment in this sector.

Trends in gross fixed capital formation are also encouraging, with an annualised growth rate of 7,2 per cent in the fourth quarter of 2011, and 4,4 per cent for the year. Nevertheless, the ratio of gross fixed capital formation to GDP at 18,9 per cent, is still significantly below the peak of 24,6 per cent reached in the final quarter of 2008. The renewed focus by government on infrastructure expenditure and successful implementation should underpin fixed capital formation, and also give a boost to the domestic construction sector which remains under pressure. There are concerns, however, that continued underspending on infrastructure by provincial and local governments, as well as possible electricity supply constraints, could retard these developments.

Formal-sector employment growth was relatively low in the fourth quarter of 2011. According to the Quarterly Employment Statistics (QES) of Statistics South Africa, formal sector employment grew at a quarter-on-quarter rate of 0,3 per cent but, on a seasonally adjusted basis, the growth was in fact slightly negative, and by 1,6 per cent over four quarters, amounting to 130 000 employees. Formal-sector employment will have to grow by a further 131 000 to reach the levels achieved in 2008 before the crisis.

Household consumption expenditure remained robust in the final quarter of 2011 when it grew at an annualised rate of 4,6 per cent, compared with 3,8 per cent in the previous quarter, and by 5,0 per cent for the year. This category was the largest contributor to GDP growth in 2011. The increased pace of spending, particularly on durable goods, was consistent with a further increase in disposable income of households, positive wealth effects and a low interest rate environment.

At these growth rates, consumption is not expected to pose a significant risk to inflation, and there are some indications that consumption expenditure growth may have peaked following the 0,6 per cent contraction in retail sales growth in January and a moderation in new vehicle sales growth in February. The First National Bank/BER Consumer Confidence Index also remained unchanged at a relatively neutral level in the first quarter of 2012.

There has been a gradual increase in the growth of credit extension in recent months, reflecting in part the increase in consumption expenditure. Having fluctuated around 6 per cent for much of 2011, 12-month growth in total loans and advances to the private sector increased to 7,4 per cent in December 2011 and 7,3 per cent in January 2012. Growth in mortgage advances has remained subdued at 2,4 per cent in January, with the main driver coming from the category of “other loans and advances”. All the components of this category showed strong 12-month growth in January: credit card advances increased by 11,1 per cent (a three-and-a-half-year high); bank overdrafts by 14,5 per cent, having experienced negative growth between January 2009 and March 2011; and general loans which moderated slightly to 15,5 per cent in January from 17,6 per cent in December.

The last-mentioned category is mainly made up off unsecured lending, where loans to households continue to grow at rates of around 30 per cent. While this is still a relatively small proportion of total loans and advances, it appears to be an increasingly important source of funding of consumer credit. At this stage it is not translating into excessive consumption expenditure, but this trend towards unsecured lending is being carefully examined to ensure a better understanding of what constitutes this lending.

Despite the resulting higher household indebtedness, the ratio of household debt to disposable income declined further to 74,6 per cent in the final quarter of 2011, compared with the peak of 82,7 per cent in the first quarter of 2008. The household debt-service-costs-to-disposable income are at levels well below their long-term average.

The recent national government budget tabled before parliament indicates a moderately tighter fiscal policy stance compared with that in the October 2011 Medium Term Budget Policy Statement (MTBPS), and the commitment to medium-term fiscal consolidation remains. The fiscal deficit as a percentage of GDP is now budgeted to be 4,6 per cent in the 2012/13 fiscal year, compared with 5,2 per cent in the MTBPS, and to decline to 3,0 per cent by 2014/15. The government gross debt: GDP ratio is expected to peak at 42,4 per cent in 2014/15 (and the net debt: GDP ratio at 38,5 per cent), which is much lower than the international benchmark for debt sustainability of around 60 per cent.

Cost–push pressures remain the main drivers of inflation, but there have been some favourable developments with respect to administered prices. NERSA accepted Eskom's proposal for an average electricity tariff increase of 16 per cent for the 12 months beginning 1 April compared with the previous approved increase of 25,9 per cent. The guidelines for municipal tariff increases is 11,03 per cent compared with 16,6 per cent previously. Nevertheless, nearly all administered price increases remain in excess of the upper end of the target range, apart from communications and television licences.

Wage settlements on average remain in excess of inflation. According to Andrew Levy Employment Publications, the average wage settlement rate in collective bargaining agreements declined to 7,7 per cent in 2011. Growth in nominal remuneration per worker declined from 8,8 per cent in the year to the third quarter of 2011, to 6,0 per cent in the fourth quarter. Unit labour costs declined from 8,4 per cent to 5,0 per cent over this period.

Oil prices remain a risk to the outlook and have increased by around US$15 per barrel since the previous meeting, mainly as a result of increased geopolitical risk. While an escalation of these risks could cause further upward pressures, oil price increases are likely to be constrained by the fact that higher oil prices could derail the global recovery and therefore reduce demand. Domestic petrol prices have been impacted by these global developments. In the past two months, petrol prices have increased by 62 cents per litre, but would have been significantly higher were it not for the more appreciated exchange rate. A further sizeable increase is expected in April, which will include a 28 cent per litre increase in the fuel levy.

Food prices remain an important determinant of inflation, and as noted earlier, were the main contributors to the downward movement of CPI inflation in March. Some further moderation, partly a result of base effects, may be expected over the coming months. Global food price indices were declining consistently in 2011, but there has been some reversal of this trend in January and February. Nevertheless, global food prices remain well below the levels reached in the first few months of 2011. The impact of these developments on domestic prices will also depend on the rand exchange rate and local harvests. There has been some moderation in domestic grain price increases, following sharp increases in maize prices in the second half of 2011. We therefore could see a further moderation in food price inflation in the coming months, but the longer-term outlook is uncertain.

The MPC is of the view that while the main pressures on inflation are of a cost–push nature, there is some evidence that these pressures may be becoming more broad-based. However, these developments are in line with our previous forecasts and are expected to remain contained by the relatively subdued state of the domestic economy. Although at this stage the committee assesses the risks to the inflation outlook to be fairly evenly balanced, greater vigilance will be required going forward.

The main upside risk to inflation is seen to emanate from global oil prices, and while food price inflation is expected to moderate in the short run, the longer-term risks remain. The exchange rate is, as always, highly uncertain, but the risk posed to inflation in recent months has subsided somewhat, given the less-volatile, albeit uncertain, global environment.

Domestic economic growth is expected to remain below potential. In the light of this and the expected medium-term inflation trajectory, the committee is of the view that at this stage the current stance of monetary policy is appropriate to support the real economy while at the same time maintaining its commitment to achieve the inflation target over the medium term. The MPC has therefore decided to keep the repurchase rate unchanged at 5,5 per cent per annum.

Statement of the Monetary Policy Committee

24 May 2012

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 Monetary Policy Committee (MPC) the risks posed to the global and domestic economy from the crisis in Europe have intensified. The mounting speculation about a possible Greek exit from the eurozone has shaken financial markets, as the dangers of contagion effects translating into a global crisis escalate. These developments have the potential to undermine the fragile recovery in the advanced economies further, and reinforce the current slowdown seen in some of the major emerging-market economies.

The global uncertainties impart a downside risk to the domestic economic growth outlook which remains relatively subdued. The turbulence in the financial markets has caused the rand to depreciate, but the associated risk to the inflation outlook is offset to some extent by the lower international oil prices and depends on how sustained the depreciation will be. Inflation is, nevertheless, expected to remain within the target range over the medium term.

The year-on-year inflation rate as measured by the consumer price index (CPI) for all urban areas was 6,1 per cent in April, up from 6,0 per cent in March. The increase relative to March was mainly due to the 71 cent per litre increase in the petrol price in April, which includes the higher levies that were announced in the budget. The categories of food, housing and utilities, and transport together accounted for 4,2 percentage points of the inflation outcome. Core inflation, as measured by the exclusion of food, petrol and electricity from CPI, increased from 4,4 per cent in March to 4,5 per cent in April. Food price inflation reversed the downward trend observed since December 2011, and increased from 8,9 per cent in March to 9,1 per cent in April. This was in line with expectations, and a resumption in the downward trend is expected in May.

Year-on-year producer price inflation moderated further, measuring 8,3 per cent and 7,2 per cent in February and March 2012 respectively. Food inflation continued to decline, particularly at the agricultural level. Agricultural price inflation, which reached a recent peak of 12,9 per cent in October 2011, declined from 4,6 per cent in February 2012 to 4,1 per cent in March. Manufactured food price inflation declined from 10,9 per cent to 9,6 per cent over the same period.

The inflation forecast of the Bank is lower over the near term than at the time of the previous meeting of the MPC. Inflation is seen to have peaked in the first quarter of 2012 at 6,1 per cent compared with the previous forecast when a peak of 6,5 per cent in the second quarter was anticipated. Inflation is expected to average 6,0 per cent in the second quarter of 2012 and thereafter to follow a gradually declining trend within the target range. The forecast period has been extended to the end of 2014, and inflation is expected to average 6,0 per cent in 2012, 5,5 per cent in 2013, 5,0 per cent in 2014, and 4,7 per cent in the final quarter of that year. The improved near-term forecast is due to lower-than-expected recent inflation outcomes, which lowered the starting point of the new forecast.

The forecast for core inflation continues to show a moderate upward trend in the short to medium term. This measure is expected to peak at an average of 5,5 per cent in the second quarter of 2013, marginally higher than in the previous forecast, before moderating, and averaging, 4,5 per cent in the final quarter of 2014.

The survey of financial analysts conducted by Reuters in April also indicated an expectation of lower inflation compared with the March survey. Analysts expect inflation to return to within the CPI target range in the final quarter of 2012, and to average 5,5 per cent in the subsequent two years.

Global economic prospects continue to cloud the domestic outlook. The stabilising impact of earlier European Central Bank interventions, particularly the Long Term Refinancing Operations (LTRO), appears to be losing momentum, and their positive impact on spreads on some peripheral European country debt proved to be short-lived. These spreads have risen to levels similar to those prevailing before the first LTRO in November. Uncertainties posed by, and the ramifications of, a possible Greek exit from the eurozone have resulted in heightened risk aversion in financial markets. Volatility is likely to persist unless decisive political decisions are taken. However, the fluid political dynamics in the region have increased the unpredictability of policy responses. Growth in the eurozone remains weak, with a technical recession being avoided because of a stronger-than-expected outcome in Germany. However, almost half of the European Union countries are experiencing recessions against the backdrop of continued bank deleveraging, banking stress in some countries, fiscal consolidation, and high and rising unemployment.

The current turmoil in Europe poses a danger to global prospects generally, along with high oil prices. The United Kingdom economy is in recession and growth in the United States (US) and Japan has also moderated. Although growth in the US is expected to remain positive for the rest of this year, the risks to the outlook come mainly from a possible sharp fiscal adjustment at the beginning of next year.

Growth in emerging markets remains positive, but some loss of momentum has been observed. The Chinese Purchasing Managers' Index (PMI) declined further in May, and downside risks to growth are likely in emerging markets in the event of an unfavourable and disorderly eurozone outcome. Growth in sub-Saharan Africa continues to be robust, but could be negatively affected by weaker commodity prices. World inflation remains relatively contained despite high international oil prices.

Movements in the rand exchange rate continued to be dominated by changing investor sentiment in international financial markets. Since the previous MPC meeting, rand volatility increased and it appreciated to a level of R7,65 against the US dollar before resuming a depreciating trend. The exchange rate was given some impetus by the announcement in April of the possible inclusion of the rand in the Citibank World Global Bond Index. However, renewed concerns about the eurozone outlook caused the rand to depreciate further, in tandem with the weakening euro, reaching a level of around R8,40 against the US dollar. This was despite net purchases of bonds and equities by non-residents over that period. Since the previous meeting of the MPC, non-residents have been net purchasers of bonds and equities to the value of R16,4 billion. Over the same period, the rand has depreciated by 9 per cent against the US dollar, by 3 per cent against the euro and by 6,2 per cent on a trade-weighted basis.

The extent to which the rand depreciation feeds into the inflation outlook depends on the extent and duration of the moves. This, in turn, is likely to be highly dependent on the timing and nature of the developments in the eurozone, and therefore a protracted period of exchange rate volatility is possible. In the absence of a speedy resolution to the crisis, the rand is likely to remain at current levels or even weaken further in the event of a disorderly unravelling of the eurozone crisis. Under such circumstances, the unfavourable impact on inflation could be ameliorated to some extent by offsetting movements in international oil prices. However, the exchange rate has re-emerged as an upside risk to the inflation outlook.

The deteriorating global outlook poses a downside risk to domestic growth. The Bank's central forecast for gross domestic product (GDP) growth has more or less remained unchanged since the previous meeting of the MPC at 2,9 per cent for 2012, and 3,9 per cent for 2013. Growth is expected to average 4,1 per cent in 2014. The output gap (around 3,5 per cent) is only expected to begin to contract in the course of 2013. However, the possible contagion effects from a further slowdown in Europe will impact on domestic growth through the trade channel, imparting a downside risk to this forecast. The Bank's composite leading business cycle indicator has been increasing slowly, consistent with the uncertain economic environment.

Recent developments underscore the continued fragile and uneven nature of the recovery. Mining output contracted at a seasonally adjusted rate of 5,5 per cent in the first quarter of this year, a result of strike action, safety-related stoppages and temporary closures for maintenance. Commodity prices are expected to remain under pressure due to global uncertainties.

The performance of the manufacturing sector has been more positive, with the physical volume of manufacturing production having increased at a seasonally adjusted rate of 1,9 per cent in the first quarter of 2012, and is therefore expected to make a strong contribution to first-quarter GDP growth. However, manufacturing production contracted on both a year-on-year basis (-2,7 per cent) and a month-on-month basis (-4,3 per cent) in March. The Kagiso PMI reflects the slowing momentum in the sector: having increased markedly in February to 57,9, it declined in the subsequent two months, but at 53,7 in April still indicates positive growth in the sector. The utilisation of production capacity in manufacturing increased marginally to 80,5 per cent in the first quarter of 2012 from 80,1 per cent in the previous quarter.

The construction sector reflects the hesitant recovery in the economy. While the sectoral growth performance appears to have improved, particularly with respect to civil construction in the first quarter of 2012, the real value of building plans passed declined for the third successive month in March, reversing the recent positive trend. The three-month-on-three-month decline was 10,2 per cent, while the year-on-year decline was 24,2 per cent.

Consumption expenditure by households, which was the main driver of growth in 2011, has shown some signs of moderation. Real retail sales contracted at a quarter-to-quarter rate of 1,2 per cent in the first quarter of 2012, although the year-on-year increase was 6,8 per cent. Nevertheless, household consumption expenditure is still expected to contribute positively to GDP expenditure in the first quarter, albeit at a slower rate than the annualised 4,6 per cent measured in the final quarter of 2011. New vehicle sales growth remains positive, although the short-term momentum has slowed notably in recent months. Motor vehicle exports are also being adversely affected by the weakness in the eurozone economy.

The outlook for consumption expenditure will be determined in part by employment and wage settlement trends, and by credit extension. These developments are likely to underpin expenditure at sustainable levels. According to the Quarterly Labour Force Survey of Statistics South Africa, the number of people employed increased by 304 000 from the first quarter of 2011 to the first quarter of 2012, despite the unemployment rate increasing from 25,0 per cent to 25,2 per cent over the same period.

According to Andrew Levy Employment Publications, the overall average wage settlement rate in collective bargaining agreements was 7,3 per cent in the first quarter of 2012. The outlook for wage growth is likely to be impacted to a significant degree by the outcome of the public-sector wage negotiations.

Credit extension to the private sector has accelerated recently despite subdued mortgage lending. Twelve-month growth in total loans and advances by banks to the private sector measured 9,2 per cent in March 2012, the highest growth rate since February 2009. This was mainly underpinned by growth in the category of other loans and advances, which was driven initially by household sector demand. However, in the first three months of 2012 corporate-sector demand has been more significant, possibly reflecting improved business activity. Twelve-month growth in total loans and advances to households measured 6,8 per cent in March. This includes the growth in the largely unsecured general loans to households. Growth in this category moderated to a still-high 29,4 per cent, from a peak of 39,3 per cent in June 2011. However, notwithstanding the need to monitor carefully developments with respect to unsecured lending, there are no signs of stress in the banking sector. Impaired advances as a percentage of gross loans and advances have declined steadily from 5,8 per cent in March 2011 to 4,6 per cent in March 2012.

International crude oil prices have moderated in recent weeks in line with the deteriorating global outlook and a significant increase in Saudi Arabian production. Having traded at around US$125 per barrel since mid-February, the price of Brent crude oil declined in mid-April to below US$110 per barrel. The domestic petrol price increased by a cumulative 99 cents per litre in April and May. However, a sizeable reduction is expected in June, despite partially offsetting exchange rate movements.

Food prices have continued their moderating trend, which is expected to continue in the short term notwithstanding the reversal in April that was due to base effects. Domestic maize prices are substantially lower than those prevailing at the beginning of the year and have reverted to trading close to export parity levels. However, global food prices have increased in the first quarter of this year, and although they remain well below the levels reached in 2011, may indicate further food price pressures in the medium term.

Administered price increases, on average, remain in excess of the upper end of the target range and are the main factor keeping upside pressure on inflation. Administered price inflation measured 11,6 per cent in April, and 8,9 per cent when excluding petrol. The main drivers included the 17,3 per cent increase in electricity prices and the 9,0 per cent increase in education costs. Communication costs, by contrast, continued to decline.

The greater uncertainty in Europe and associated global financial market turbulence have impacted on the perceived risks to the outlook for both domestic inflation and growth. The MPC is of the view that these developments pose a downside risk to the hesitant domestic growth prospects.

The balance of risks to the inflation outlook is less clear. While the inflation forecast appears to be more favourable, there are renewed upside risks from a possible further weakening of the exchange rate. However, countervailing pressures could come from weaker demand and lower commodity prices, particularly those of oil. On balance, the committee judges these risks to the inflation outlook to be somewhat on the upside.

In this highly volatile and uncertain environment the MPC is of the view that it is appropriate to maintain the current accommodative monetary policy stance, given the continued absence of clear signs of excess demand pressures. The MPC has therefore decided to keep the repurchase rate unchanged at 5,5 per cent per annum. However the committee will continue to monitor events closely and assess the risks to the outlook on an ongoing basis, and stands ready to act in either direction should it be deemed appropriate.

Abbreviations

Alsi	All-Share 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
CCI	Consumer Confidence Index
CPI	consumer price index [for all urban areas]
ECB	European Central Bank
EMBI+	[JPMorgan] Emerging Markets Bond Index Plus
FAO	Food and Agriculture Organization
FNB	First National Bank
FOMC	Federal Open Market Committee
G-7	Group of Seven
G-20	Group of Twenty
GDP	gross domestic product
IEA	International Energy Agency
IMF	International Monetary Fund
JSE	JSE Limited
LTRO	Longer-Term Refinancing Operation
MENA	Middle East and North Africa
MPC	Monetary Policy Committee
MPF	Monetary Policy Forum
MPR	*Monetary Policy Review*
MTBPS	*Medium Term Budget Policy Statement*
MTEF	Medium-term Expenditure Framework
MYPD	Multi-Year Price Determination
NAB	non-alcoholic beverage
NEER	nominal effective exchange rate
NERSA	National Energy Regulator of South Africa
OECD	Organisation for Economic Co-operation and Development
PMI	Purchasing Managers' Index
PPI	producer price index
PSBR	public-sector borrowing requirement
QE	quantitative easing
QES	*Quarterly Employment Survey*
RBA	Reserve Bank of Australia
RBI	Reserve Bank of India
REER	real effective exchange rate
RMB	Rand Merchant Bank
S&P	Standard and Poor's
Stats SA	Statistics South Africa
UK	United Kingdom
US	United States
VIX®	Chicago Board Options Exchange Volatility Index
WEO	*World Economic Outlook*
WGBI	[Citibank] World Government Bond Index

Glossary

the Bank	South African Reserve Bank
the Fed	United States Federal Reserve
repo	repurchase [rate]