Monetary Policy Review

October 2012

South African Reserve Bank

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Enquiries relating to this *Review* should be addressed to:

Head: Research Department
Research Department
South African Reserve Bank
P O Box 427
Pretoria 0001
Tel. 27 12 313-3668

http://www.reservebank.co.za

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Preface

The primary 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. Low inflation helps to protect the purchasing power and living standards of all South Africans. Price stability or low inflation reduces uncertainty in the economy and provides a favourable environment for growth and employment creation. The Bank additionally has a complementary mandate to oversee and maintain financial stability.

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 May 2012 at a time of heightened uncertainty and deep concern about the risks posed to the global and domestic economy from developments unfolding in Europe and elsewhere. The global economic crisis has not eased appreciably since then and global economic growth momentum has moderated. A slowdown in major emerging-market economies (EMEs), in particular China and Brazil, has been prolonged by weaker-than-expected growth in the United States (US) and sustained recession in many euro area countries and the United Kingdom (UK).

This *MPR* marks a point where renewed efforts are being made by central banks in the US, the euro area and Japan to moderate or reverse the deterioration in global economic conditions and intensification of financial market tensions. These efforts are important steps forward, but as ongoing turmoil suggests, are merely part of a long series of ameliorative steps that still need to be taken. Improvements can be discerned in some key markets, such as in US housing, but these instances of positive outcomes remain overshadowed by a range of policy and co-ordination risks. As a result, market volatility remains high and negative spillovers to real economic activity and confidence are likely to continue in coming months.

While emerging markets continue to provide upward impetus to global growth rates, prospects have deteriorated in the face of weakening external demand. Global gross domestic product (GDP) growth estimates have been revised downwards.

Subdued economic growth, weak demand and lower commodity prices have softened inflationary pressures in many countries. The already relatively benign global inflation outlook is expected to moderate further in 2013. However, supply-side shocks from higher food prices and volatile international oil prices continue to pose a serious risk to the inflation outlook. A few countries have cited concerns about near-term inflationary pressures.

Many central banks have kept policy rates unchanged at low levels. A significant number of advanced and emerging economies have eased policy as growth fell off or implemented additional unconventional measures, while only a few have tightened policy.

Both global and domestic factors have shaped the outlook for the South African economy. Output in the primary sector in the first half of 2012 was volatile and growth in the secondary sector weakened. Household consumption has moderated. Gross fixed capital formation grew at a reasonable pace of 6,1 per cent, with greater impetus provided by government. Subdued credit extension picked up speed in September. Employment levels increased up to the middle of 2012, but industrial unrest in the mining sector suggests a worsening of prospects for the third and fourth quarters of this year. The impact will be exacerbated if confidence weakens significantly in other sectors of the economy.

Recent high-frequency data point to a moderation in domestic economic activity from the second to third quarter of 2012. The Bank's forecast for growth has been revised marginally downwards over the three-year forecast period to 2014. The South African economy is expected to grow by 2,6 per cent in 2012 and 3,4 per cent in 2013. The probability of future growth and financial shocks from global developments remains high and further risks are likely to be on the downside.

Headline consumer price inflation has been within the target range since May 2012. Better inflation outcomes, easing food and petrol prices, and somewhat weaker growth prospects shaped the decision by the MPC to adjust the repurchase rate down by 50 basis points at the July 2012 MPC meeting.

The Bank's inflation outlook, which had improved up to the July meeting of the MPC, suggests a moderate re-acceleration of inflation over the short to medium term. Headline CPI inflation is still expected to remain below the upper level of the target band, however, and should settle down into a flat trajectory over the 2013–14 forecast period. Upside pressure in coming months is expected to emanate from oil and food price increases, despite demand pressures remaining relatively benign.

Slowing world growth, sustained capital investment, and higher dividend payments to non-residents have contributed to a rapid but probably temporary widening in the current-account deficit. At the same time, concerns over developments in the mining sector appear to be a primary factor behind strong sales of South African equities by non-resident investors. Moody's Investors Service and Standard & Poor's lowered South Africa's credit rating in September 2012 and October respectively, citing rising political risk, slower economic growth and a weakening in government finances as factors motivating the downgrades.

Having, on balance, depreciated significantly over recent months by 14 per cent, partly driven by these factors, the exchange rate continues to pose risks to the inflation outlook. Domestic risks include future wage developments, food prices and, on the downside, weaker confidence and growth. The risks to the overall inflation forecast are assessed to be more or less balanced.

The *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 drivers of, and outlook for, food price inflation in South Africa. The second box reviews recent economic reforms in India. The third considers the importance of oil and South Africa's exposure to this commodity. The fourth box estimates the equilibrium value of the real effective exchange rate of the rand. The fifth measures the size of international spillovers to South Africa, the sixth quantifies the looming fiscal cliff in the US and the seventh box provides an updated evaluation of the accuracy of the Bank's inflation forecasts.

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

Headline consumer price inflation, the targeted inflation rate, has been within the target range since May 2012 as a result of subdued global price inflation and weak domestic price pressures. Headline inflation surprised on the downside as it decelerated to a short-term low point of 4,9 per cent in July before ticking up to 5,0 per cent in August and 5,5 per cent in September. International food prices, and domestic food and petrol prices rose and remain volatile due to widespread drought and geopolitical factors respectively. The rate of increase in electricity tariffs, however, moderated in 2012 as regulators agreed to a lower increase for the year compared to what had been expected. Core inflation is expected to remain well contained.

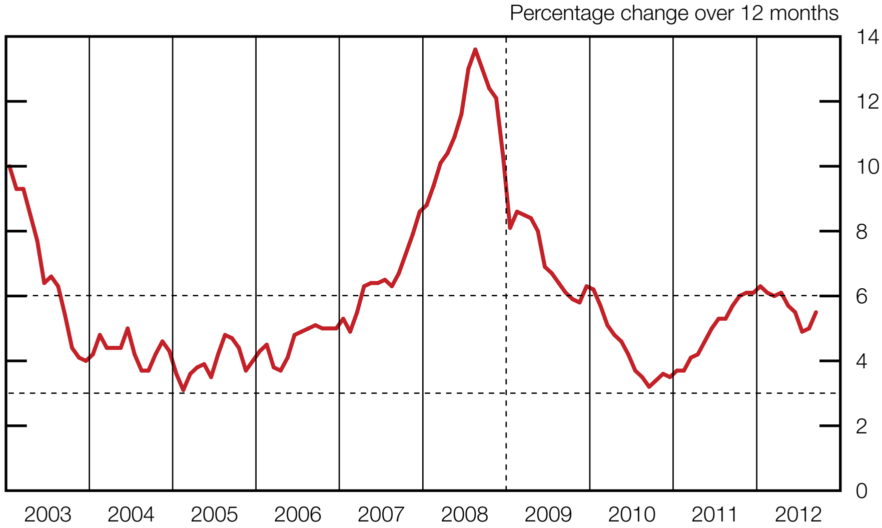
Targeted inflation

The year-on-year percentage change in the headline consumer price index (CPI) decelerated markedly from 6,1 per cent in April 2012 to 4,9 per cent in July before increasing to 5,5 per cent in September (Figure 1). Since May, headline CPI inflation has continuously been within the inflation target range.

Slowing increases in the prices of goods have pulled down the overall inflation rate as goods price inflation moderated from 6,3 per cent in April 2012 to 5,2 per cent in September. Within the goods category, however, prices of non-durable goods have raised the headline inflation rate. Prices of semi-durable goods rose by only 2,1 per cent over the twelve months to September, while durable goods prices continued to fall over this period. Prices of durable goods declined by 0,1 per cent in the year to September. Services inflation remained stable and within the target range at just below 6 per cent from April 2012 to September.

A further breakdown of the price categories shows that housing and utilities, transport, and food remain the three largest contributors to consumer price inflation as a result of relatively rapid price increases and their weight in the index (Table 1). After considerable moderation in these contributions from April to August 2012, there was a reversal in September.

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

Table 1 Contributions to targeted inflation

Percentage change over 12 months* and percentage points

		2012					
	Weights	Apr	May	Jun	Jul	Aug	Sep
Targeted inflation*..	100,00	6,1	5,7	5,5	4,9	5,0	5,5
Of which:							
Food and non-alcoholic beverages...................	15,68	1,4	1,0	0,9	0,8	0,8	0,9
Food..	14,27	1,3	1,0	0,9	0,8	0,7	0,9
Housing and utilities	22,56	1,6	1,5	1,5	1,4	1,4	1,4
Transport..	18,80	1,2	1,2	1,1	0,8	0,8	1,1
Other..	42,96	1,9	2,0	2,0	1,9	2,0	2,1

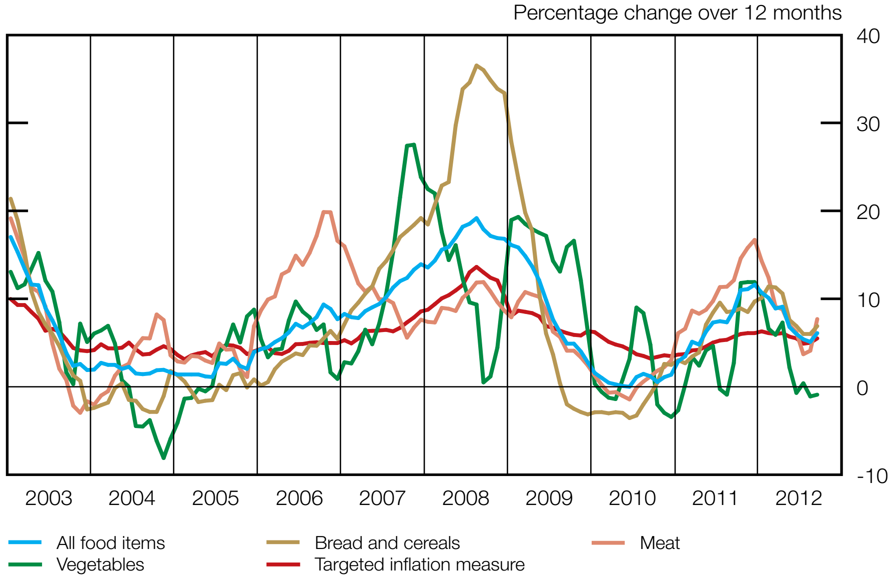
Sources: Statistics South Africa and own calculations

Food prices

As seen in Table 1, food prices have been a primary driver – both up and down – of South Africa's consumer prices over the past year. The pass-through of international food prices into domestic prices has been relatively strong for the 13 months leading up to June 2012, when it decelerated to 6,0 per cent from the 9,1 per cent reached in April. Food price inflation further moderated to 5,1 per cent in August, before increasing to 6,1 per cent in September (Figure 2). Bread and cereals, and meat prices in particular slowed sharply in July and August. This reversed in September when bread and cereals prices increased by 6,9 per cent and meat prices by 7,7 per cent.

The downward trend in food prices appears to have been stopped by the unexpectedly severe drought in the US that has had a significant impact on international food commodity prices. The US has experienced the worst drought since the 1950s and agricultural production, especially for maize and soya beans, has been severely affected. Dry conditions will also hurt spring wheat production in Russia and Kazakhstan. Agricultural prices have risen significantly and remain at elevated levels. These rose sharply during June and July before levelling off in August. The result of the step change in prices already became visible in September and could continue to be reflected in increased bread and cereals prices, and meat price rises in coming months. (*See Box 1 for drivers of, and outlook for, food price inflation in South Africa.*)

Figure 2 Targeted inflation* and food inflation

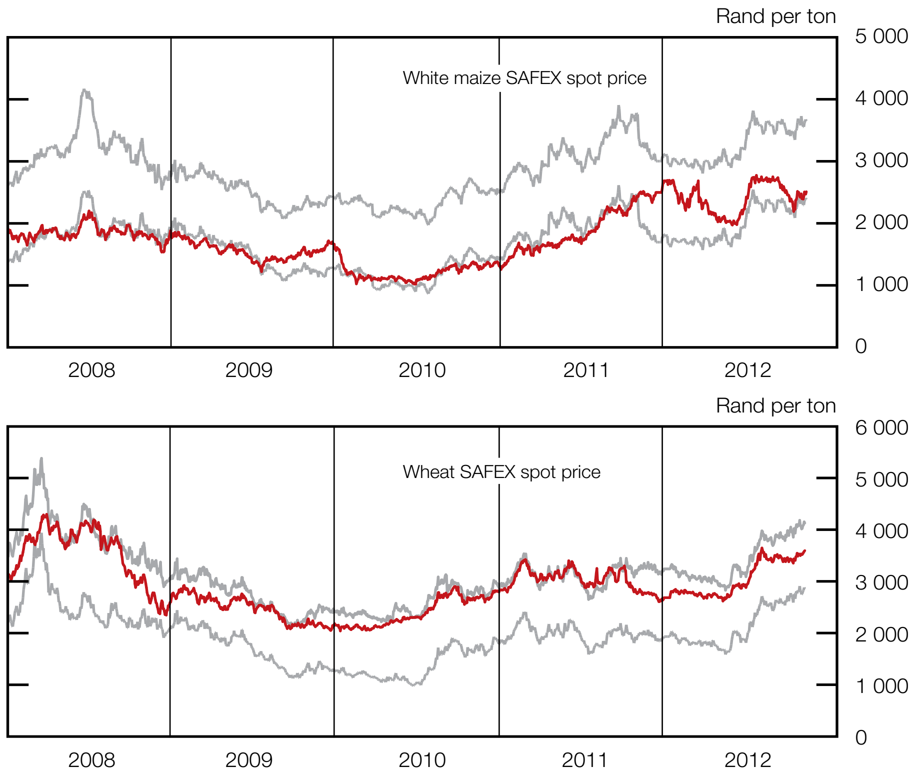


* CPIX for metropolitan and other urban areas until the end of 2008; CPI for all urban areas thereafter

Source: Statistics South Africa

The international price increases have led to higher prices for local agricultural commodities, with steep increases seen in June and July 2012. After falling by 27 per cent from late March to early June, the price of white maize more than fully reversed the decline by rising by almost 41 per cent from June to July. The price rose from R1 972 per ton in June to R2 774 at the end of July. It then stabilised at around R2 700 during August before moderating to a still-high R2 450 in October (Figure 3).

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

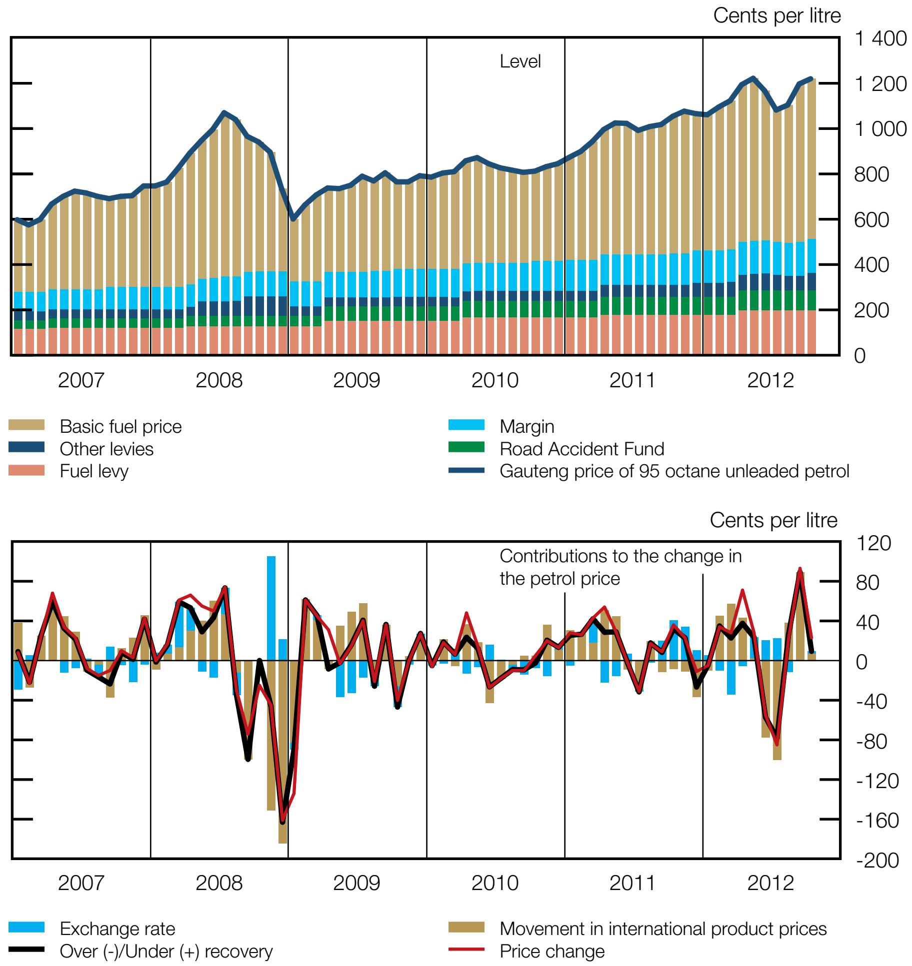
For now, the closeness of the domestic maize price to the export rather than the import parity price augers well for domestic food inflation, but the sustainability of this situation depends on the size of the local harvest.

Drought, low production levels, higher demand and quality concerns about wheat harvests in Europe and the US have also impacted on local wheat prices. The price of wheat, which remained close to import parity, rose by 27 per cent in June and July, from R2 865 per ton early in June to R3 646 per ton in late July. Wheat prices have since levelled off at a high level last experienced on occasion in the first half of 2011.

Petrol prices

Lower international oil prices led to a decrease in petrol prices during June and July 2012 (Figure 4). The price of 95 octane unleaded petrol in Gauteng fell by R1,40 per litre before almost fully reversing in the months to October by R1,38 per litre to R12,20 per litre as a result of increased oil prices and a slightly weaker exchange rate. Petrol price inflation slowed from 20 per cent in April 2012 to 8,9 per cent in July before accelerating to 17,6 per cent in September.

Figure 4 South African petrol price

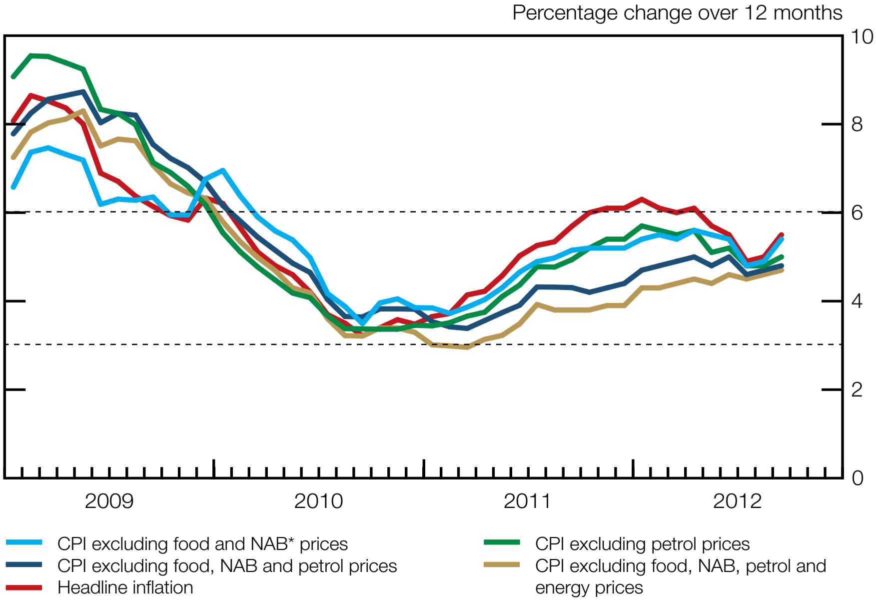


Source: Department of Energy

Core inflation

Core inflation remained well contained in 2012 (Figure 5) despite considerable food and petrol price changes. When broader demand pressures remain modest, volatility in such prices may have more muted effects on core measures than a sustained upward trend. Second-round effects of the exogenous drivers of the inflation process have therefore remained moderate. This can be seen in the various core measures, in particular the CPI excluding food, non-alcoholic beverages, petrol and energy prices, which was the most stable, averaging 4,6 per cent from April 2012 to September.

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



* NAB: Non-alcoholic beverages

Source: Statistics South Africa

Administered prices

In contrast to core measures, administered price inflation as measured by the administered price index (API) remained high and above the upper limit of the inflation target range between April and September 2012. Twelve-month API did moderate considerably, by 4,1 percentage points from 11,6 per cent in April to 7,5 per cent in July (Table 2) in line with a fall in the petrol price contribution from 4,8 percentage points in April to 2,0 percentage points in July.

Table 2 Contributions to administered prices

Percentage change over 12 months* and percentage points

	Weights		2012					
	CPI	API	Apr	May	Jun	Jul	Aug	Sep
CPI for administered prices*	14,66	100,00	11,6	11,4	10,1	7,5	8,0	9,8
Regulated component								
Water	1,10	7,50	0,9	0,9	0,9	1,0	1,0	1,0
Electricity	1,68	11,46	2,8	2,8	2,8	1,7	1,8	1,8
Petrol	3,93	26,81	4,8	4,8	3,5	2,0	2,2	4,1
Other regulated administered prices	2,91	19,83	0,0	0,0	0,1	0,0	0,1	0,1
Unregulated component								
Assessment rates	2,07	14,12	1,1	1,0	1,0	1,0	1,0	1,0
Primary and secondary school fees	1,28	8,73	0,8	0,8	0,8	0,8	0,8	0,8
University fees	0,90	6,14	0,6	0,6	0,6	0,6	0,6	0,6
Other unregulated administered prices	0,79	5,38	0,6	0,4	0,4	0,5	0,6	0,6

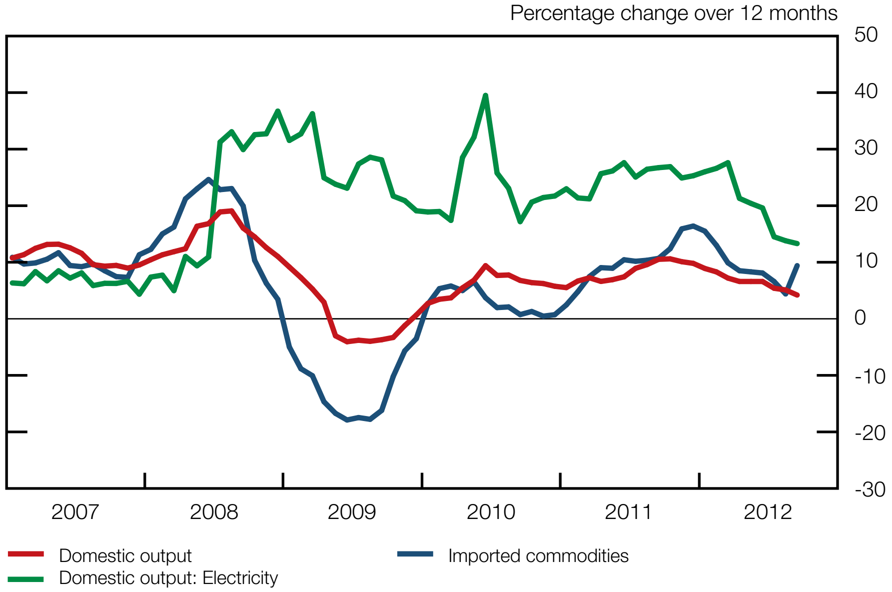
Source: Statistics South Africa

The contribution of electricity also declined by 1,1 percentage points from April to July. The revised tariff increase for electricity set out in March only appeared at the municipal consumer level by August. Following the municipal adjustment, the contribution of electricity to API increased to 1,8 percentage points in August and September. Thereafter, API rose to 9,8 per cent during September, boosted by the increase in petrol prices to a contribution of 4,1 percentage points.

Producer prices

The producer price index (PPI) measures the price changes of goods produced in South Africa at the factory gate. Although the classification standard for the PPI and CPI differs, some PPI categories such as food give an indication of forthcoming consumer price pressures. The prices for domestic output moderated from 7,2 per cent in March 2012 to 4,2 per cent through to September – their lowest rate of increase since March 2010 (Figure 6). This outcome was in line with declining international commodity prices and was accounted for by significant declines in mining and quarrying inflation from 6,6 per cent in March to -0,1 per cent in September, and inflation in prices of products of petroleum and coal from 19,1 per cent to 10,4 per cent over the same period but with a low of 5,6 per cent in July. Electricity price inflation moderated from 27,6 per cent to 13,3 per cent over this period.

Figure 6 PPI for domestic output and imported commodities



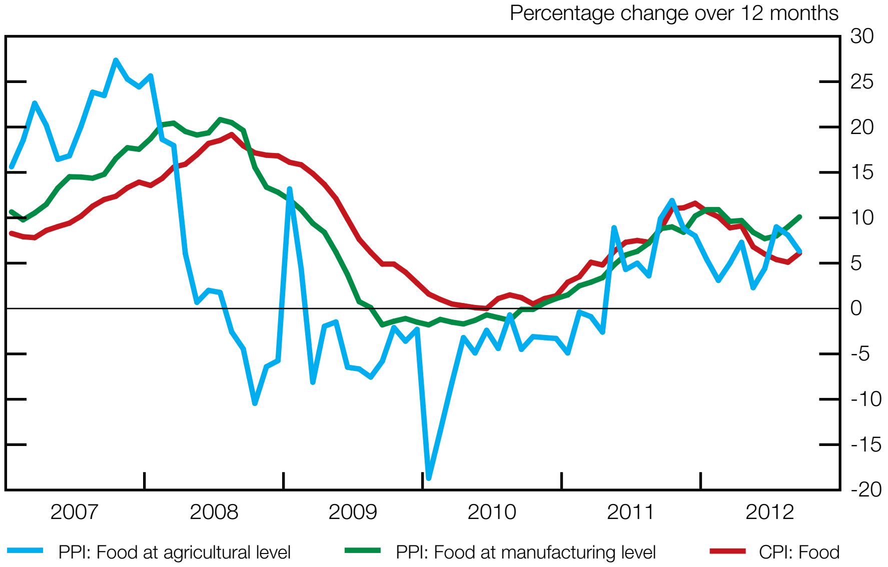
Details regarding changes to the PPI in this period are documented in statistical release P0142.1, February 2008, issued by Statistics South Africa

Source: Statistics South Africa

Inflation of imported commodities fell slightly more, from 9,9 per cent in March 2012 to 4,4 per cent in August, as crude petroleum, natural gas, and mining and quarrying inflation decreased. It then increased sharply to 9,4 per cent as mining and quarrying more than doubled to 25,1 per cent.

Food price inflation at the agricultural level continues to be volatile, with a low of 2,3 per cent in May followed by a rise of 6,3 per cent in September (Figure 7). Food price inflation at the manufacturing level fell to 7,7 per cent in June 2012 from 9,6 per cent in March before rising to 10,1 per cent in September. These movements were driven mainly by changes in meat and meat products, and grain mill and bakery products.

Figure 7 Food prices in the PPI and CPI

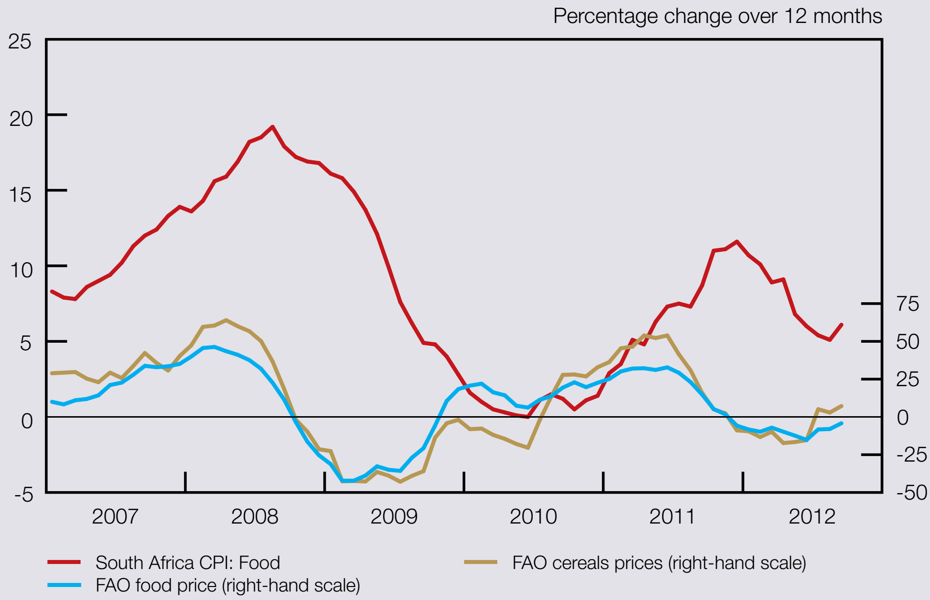


Source: Statistics South Africa

Box 1: The drivers of, and outlook for, food price inflation in South Africa

South Africa's food price inflation has tended to rise and fall with a significant lag to movements in international grain and food prices (Figure B1.1). This asynchronous adjustment to global prices may reflect South Africa's domestic food production conditions and lags in the transmission of imported food prices into the wholesale and retail food industry. Food price inflation, with a weight in CPI of 14,27 per cent, contributed 0,9 percentage points or 6,1 per cent, on average, to targeted inflation in the twelve months to September 2012.

Figure B1.1 Food price inflation

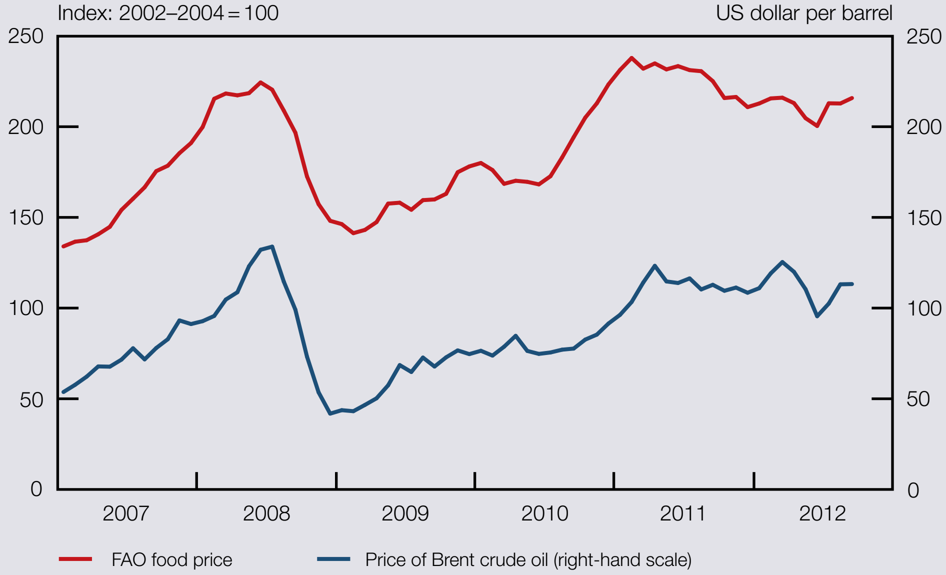


Sources: Statistics South Africa and FAOSTAT

Globally, food prices increased sharply to high levels in the first half of 2008 and again from the latter part of 2010 (Figure B1.2). The food price index of the Food and Agricultural Organization (FAO) of the United Nations (a measure of change in the international price of a basket of food commodities) was still high in September 2012 although 22 index points below the peak of February 2011 and 9 index points lower than in September 2011.

The price increases in 2012 have been driven by a range of factors, including supply pressures caused by drought and rising international oil prices. Higher prices for maize, high ethanol inventory levels and declining subsidies for ethanol appear to have taken some steam out of demand for maize for energy production. In contrast, weather conditions are impacting heavily on the US maize crop and wheat produced in Russia, leading to sharp increases in international prices in recent months.

Figure B1.2 Food and oil prices



Sources: Food and Agricultural Organization and Bloomberg

Globally, agricultural commodities are mostly priced in US dollars and, together with movements in the exchange rate of the rand and domestic production conditions, these factors largely determine domestic prices. Currency weakness in recent months is likely to put upward pressure on domestic food prices.

Local food production costs are also strongly influenced by oil prices. The FAO food price index and the monthly price of Brent crude oil exhibit a strong correlation of more than 90 per cent (Figure B1.2). The volatile and elevated price of crude oil affects food prices through transportation costs; diesel for field crops and crude oil in fertilisers; and the reallocation of land use for biofuels. In South Africa production costs have become more sensitive to changes in the crude oil price, with the share of costs accounted for by fertilisers in the production of maize roughly almost doubling from 1999/2000 to 2009/10. Other domestic cost–push pressures arise from high electricity, and thus refrigeration costs and wage increases.

As a price taker in the global commodities markets, South Africa's food prices are affected by import and export parity prices. Exposure increases when buffer stocks are depleted due to bad harvests or exports. When domestic agricultural production is supplemented through imports (as in the case of wheat), prices gravitate higher towards import parity. However, most of the products such as soya beans, sunflower seeds, sorghum and maize tend to trade closer to export parity. At this point in time, South Africa's final crop estimate for maize in 2011/12 looks fairly robust.

International economic and policy developments

Monetary policy decisions are made on the basis of current and expected international developments in the global economy. This section reviews medium-term developments, and assesses the near-term outlook in terms of prospects, risks and uncertainties for inflation.

International economic developments

The modest pace of the global recovery seen in early 2012 has slowed significantly. Economic growth in all major economic centres, advanced and emerging markets has been lower than expected. Fiscal austerity has dampened growth in Europe and negative spillovers from one economy to another have been significant, resulting in a sharp slowdown in world trade and reduced cross-border lending. Previously fast-growing emerging markets have also slowed and policy levers have been eased to support growth. Recent monetary policy measures by major central banks may help to put a floor under the current deceleration in global growth.

With uncertainty weighing on confidence and sentiment, the global economy continues to expand at a very modest pace. Global real GDP is projected by the International Monetary Fund (IMF) to slow from 3,8 per cent in 2011 to 3,3 per cent in 2012, revised down from 3,5 per cent earlier in 2012. World growth in 2013 is expected to be marginally higher at 3,6 per cent. Table 3 shows the downward revisions over the year to forecasts for growth.

Table 3 IMF projections of world growth and inflation for 2012 and 2013*

Per cent

	Real GDP						Consumer prices	
	2012			2013			2012	2013
World	(3,5)	[3,5]	**3,3**	(4,1)	[3,9]	**3,6**	**4,0**	**3,7**
Advanced economies	(1,4)	[1,4]	**1,3**	(2,0)	[1,9]	**1,5**	**1,9**	**1,6**
United States	(2,1)	[2,0]	2,2	(2,4)	[2,3]	2,1	2,0	1,8
Japan	(2,0)	[2,4]	2,2	(1,7)	[1,5]	1,2	0,0	-0,2
Euro area	(-0,3)	[-0,3]	-0,4	(0,9)	[0,7]	0,2	2,3	1,6
United Kingdom	(0,8)	[0,2]	-0,4	(2,0)	[1,4]	1,1	2,7	1,9
Canada	(2,1)	[2,1]	1,9	(2,2)	[2,2]	2,0	1,8	2,0
Other advanced economies	(2,6)	[2,4]	2,1	(3,5)	[3,4]	3,0	2,2	2,4
Emerging-market and developing economies	(5,7)	[5,6]	**5,3**	(6,0)	[5,9]	**5,6**	**6,1**	**5,8**
Sub-Saharan Africa	(5,4)	[5,4]	5,0	(5,3)	[5,3]	5,7	9,1	7,1
South Africa	(2,7)	[2,6]	2,6	(3,4)	[3,3]	3,0	5,6	5,2
Central and eastern Europe	(1,9)	[1,9]	2,0	(2,9)	[2,8]	2,6	5,6	4,4
Commonwealth of Independent States	(4,2)	[4,1]	4,0	(4,1)	[4,1]	4,1	6,8	7,7
Developing Asia	(7,3)	[7,1]	6,7	(7,9)	[7,5]	7,2	5,0	4,9
China	(8,2)	[8,0]	7,8	(8,8)	[8,5]	8,2	3,0	3,0
India	(6,9)	[6,1]	4,9	(7,3)	[6,5]	6,0	10,3	9,6
Middle East and North Africa	(4,2)	[5,5]	5,3	(3,7)	[3,7]	3,6	10,4	9,1
Latin America and the Caribbean	(3,7)	[3,4]	3,2	(4,1)	[4,2]	3,9	6,0	5,9

* IMF projections for 2012 as at April ( ) and July [ ] 2012 in parenthesis

Source: IMF *World Economic Outlook*, October 2012

Second-quarter outcomes for growth have been especially weak, particularly in Europe. The German economy slowed sharply in the second quarter, while the French economy shrank by 0,1 per cent and that of the UK by 1,5 per cent. Export growth has been soft and unemployment higher – in France reaching 3 million people. The UK recorded positive growth in the third quarter boosted by the summer Olympics.

Greece, Spain, Italy, Cyprus and Portugal are all in recession. Greece's GDP shrank by 6,3 per cent year on year during the second quarter. Of the peripheral economies, Ireland has achieved a more consistent recovery (Table 4).

Table 4 Real GDP growth in peripheral euro area countries*

Per cent

	Share of global GDP**	2007	2008	2009	2010	2011	2012	2013
Euro area	14,2	3,0	0,4	-4,4	2,0	1,4	-0,4	0,2
Italy	2,3	1,7	-1,2	-5,5	1,8	0,4	-2,3	-0,7
Spain	1,8	3,5	0,9	-3,7	-0,3	0,4	-1,5	-1,3
Greece	0,4	3,0	-0,2	-3,3	-3,5	-6,9	-6,0	-4,0
Portugal	0,3	2,4	0,0	-2,9	1,4	-1,7	-3,0	-1,0
Ireland	0,2	5,4	-2,1	-5,5	-0,8	1,4	0,4	1,4

* Forecasts for 2012 and 2013
** GDP shares based on the IMF's purchasing power parity valuation of country's GDP for 2011

Source: IMF *World Economic Outlook*, October 2012

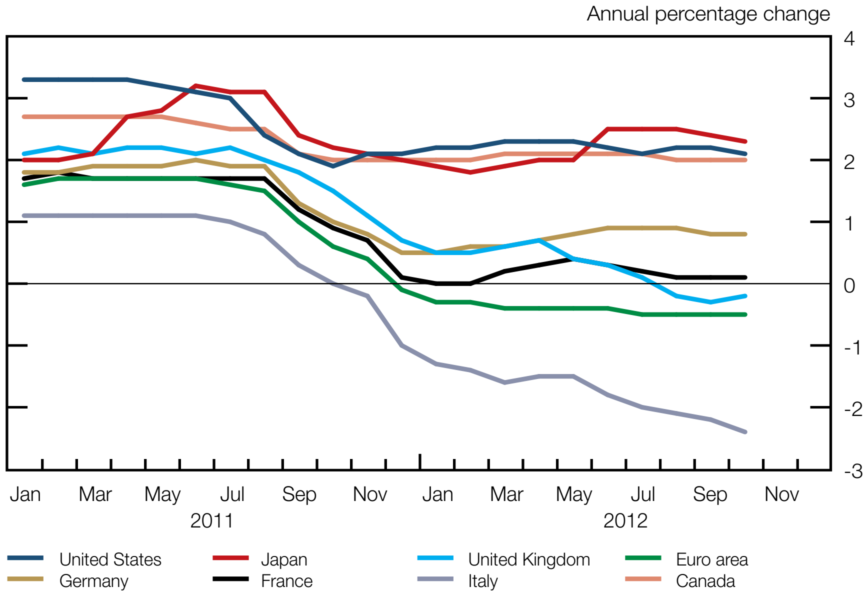
Emerging and developing economies will remain the driving force in the global economy as China continues to expand, but their growth will likely moderate to 5,3 per cent in 2012 before strengthening somewhat in 2013 to about 5,6 per cent. Developing Asia is still projected to grow by about 7,0 per cent on average during 2012–13 despite scaled-back expectations.

China's economy is expected to achieve a soft landing, in part because of a shift to a more aggressive pro-growth stance early in 2012. India's economy was hit by a massive electricity outage at the end of July and exports have been weaker than expected. Forecasts for India have been lowered, while recently announced economic reform initiatives will take time to bear fruit. (*See Box 2 for a reflection on recent economic reforms in India.*)

Growth estimates for advanced and emerging-market economies for 2012 and 2013 have been lowered by magnitudes of between 0,1 and 0,5 percentage points. Growth in sub-Saharan Africa remains buoyant, at 5,0 per cent in 2012 compared to 5,1 per cent in 2011.

The growth estimate for the US economy for 2012 was revised slightly upwards in October. The euro area economy should contract by about 0,4 per cent in 2012 compared to growth of 1,4 per cent in 2011, and achieve a lethargic 0,2 per cent in 2013. The major shift in the projections concern Germany, where the growth rate has declined from 3,1 per cent in 2011 to an expected 0,9 per cent in 2012 and 2013. The UK is expected to contract by 0,4 per cent in 2012, down from a meagre expansion of 0,8 per cent recorded in 2011, and then to rebound to 1,1 per cent growth in 2013.

Figure 8 Evolution of real GDP forecasts for 2012 for the G-7 and euro area



Source: Consensus Forecasts

Leading indicators still offer little encouragement for better global growth prospects. The composite leading indicator compiled by the Organisation for Economic Co-operation and Development (OECD) projects a further contraction in the OECD economies. The JPMorgan global manufacturing purchasing managers' index (PMI) declined from 51,4 in April 2012 to 48,9 in September – below the 50 mark that separates expansion from contraction.

The global inflation outlook continues to be relatively benign as the moderation of global economic activity has been a persistent headwind to upward price movements. Industrial commodity prices are likely to remain subdued until the recovery regains momentum. These muted demand pressures contrast, however, with supply factors affecting food and oil prices. The IMF projects that consumer price inflation in emerging and developing countries will decelerate marginally from 6,1 per cent in 2012 to 5,8 per cent in 2013.

Box 2: India's September 2012 announcements on economic reform

India responded to stagflation[1] and the current-account and fiscal deficits with the following reforms to facilitate fiscal consolidation, and to attract capital inflows to encourage private-sector investment:

– Reduced subsidies with the increase in the retail price of diesel by Indian rupees (INR) 5,00 per litre, or 13,5 per cent, and limiting cooking gas to six cylinders per customer per year.

– Introduced foreign direct investment (FDI) into the multi-brand retail sector with a cap of 51 per cent sanctioned by individual states and facilitating direct sales to Indian consumers.

– Relaxed conditions on 100 per cent FDI in single-brand retail by making the 30 per cent of the value of products sold, sourced from local, small-scale manufacturers optional.

– Liberalised FDI regulations by raising the maximum limit for foreign ownership in the broadcast sector from 49 per cent to 74 per cent and permitting foreign carriers to buy up to a 49 per cent stake in domestic airlines.

– Government equity disinvestments of around 10 per cent in five public corporations with a fiscal 2012–13 target of INR300 billion.

A second wave of reforms to open up the insurance and pension sectors to higher levels of foreign investment (from 26 to 49 per cent), the Companies Bill, and amendments to laws governing competition requires parliamentary approval.

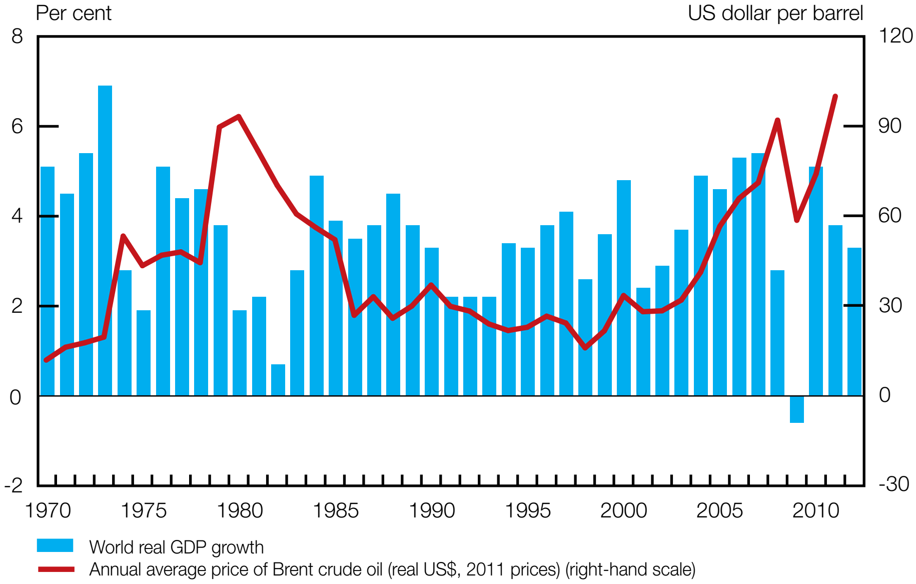
1. Slow economic growth and stubborn inflationary pressures.

Oil price developments

Crude oil prices remain volatile and threaten already-fragile global economic conditions. A moderation in prices in the second quarter of 2012 has been followed by increases in recent months, primarily in response to geopolitical tensions in the Middle East but also to monetary policy easing in major economies. Global oil supply at 90,8 million barrels per day in the second quarter of 2012 outstripped demand of 89,0 million barrels per day.

At current levels, oil prices remain high in nominal and real terms (Figure 9). In 2008 the annual average real oil price almost reached the record level set in the early 1980s before declining due to sharply lower demand for oil in 2009. However, as the global recovery resumed in 2010, the annual average real oil price at first rose abruptly to a level close to that recorded in the early 1980s and thereafter ascended further to a new record level. (*See Box 3 for the importance of oil and an analysis of South Africa's exposure to oil.*)

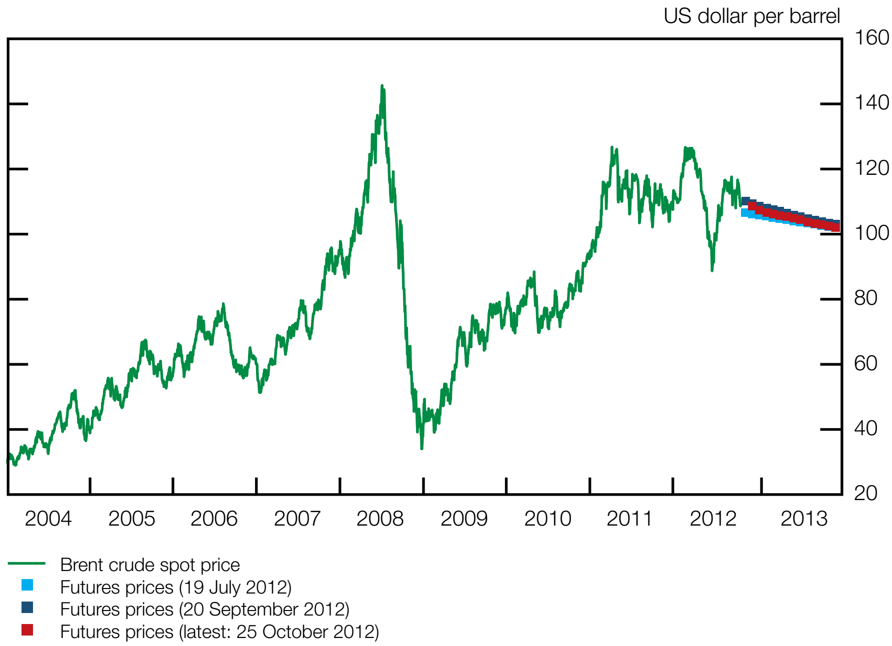
Figure 9 World real GDP* and the real price of oil



* Estimates for 2012
Sources: IMF *World Economic Outlook*, October 2012; Bloomberg; own calculations; and US Department of Labor, Bureau of Labor Statistics

The international oil price gradually trended lower (Figure 10) throughout most of the second quarter of 2012, declining by almost 30 per cent from a high in March to an 18-month low of US$88 per barrel towards the end of June. The price of Brent crude oil then rebounded from an average of US$96 per barrel in June, fluctuating between US$97 and US$118 as it gradually increased to an average of US$113 in October. Towards the end of October the dollar oil price was only about 14 per cent below the high in March 2012 but almost 25 per cent below the peak in 2008 at the onset of the financial crisis.

Figure 10 Price of Brent crude oil



Source: Bloomberg

The rebound and volatility in the crude oil price reflect the net effect of various developments. The Organization of the Petroleum Exporting Countries (OPEC) forecasts stable oil demand growth in 2012 while the International Energy Agency (IEA) lowered its demand projections due to weaker economic growth. Prices have been supported, alternatively, by policy stimulus by advanced countries and China. Decreases in US crude oil stockpiles, maintenance on North Sea oil rigs, revived geopolitical tensions and sanctions on Iranian output have supported prices from the supply side of the market.

Box 3: Does the oil price still matter? South Africa's exposure

Oil price trends and volatility affect medium-run growth and inflation outcomes worldwide. Over the longer term, oil price shocks can generate offsetting economic adjustments that, in turn, determine economic outcomes from future shocks. In particular, economic adjustment can result in lower energy intensity[1] or a lower oil burden[2] in oil-importing countries, reducing the economic impact of fluctuating oil prices. Insufficient economic adjustment can occur if oil price shocks are muted by excessive smoothing of prices or the high cost of technological change, sustaining negative effects from price movements.

South Africa was among the ten countries in 2011 with the highest energy intensity, at 0,299 koe/US$05p. This is slightly worse than China at 0,266 and much worse than the UK, which ranked second best at 0,093 among the ten lowest-intensity-ranked countries.[3]

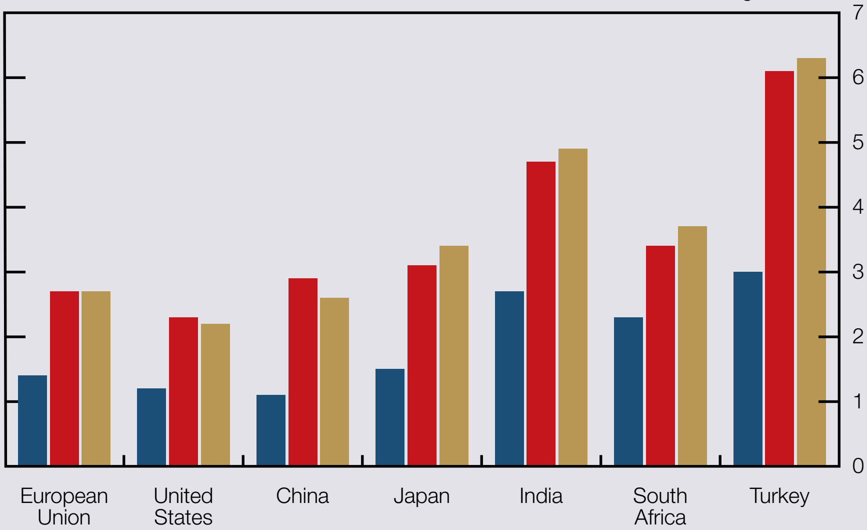
The oil burden measures the spending of an economy on oil compared to the value of all economic activity. When the nominal value of oil imports rises faster than nominal GDP, the economy becomes more vulnerable to oil price shocks. The oil burden for most economies rose sharply prior to 2008, before falling as the recession and financial crisis set in. As of February 2012, the oil burden neared its 2008 levels.[4] The International Energy Agency (IEA) estimates the oil burden to reach a record level of 2,3 per cent of GDP in the Organisation for Economic Co-operation and Development (OECD) countries in 2012, increasing by 0,2 percentage points for each US$10 per barrel increase in the oil price.[5]

The oil burden of selected advanced, emerging and developing economies and regions (Figure B3.1) shows an increase from the average for the period 1990–2010 to 2011 and a further slight increase for most countries in 2012. South Africa's oil burden (i.e., crude oil and refined imports net of exports) has increased more than two-fold from 1,4 per cent in 1998 to 3,4 per cent in 2011 (Figure B3.2). The oil burden has increased by about 0,28 percentage points of GDP for each US$10 per barrel increase in the oil price.

South Africa's oil burden is slightly higher than that of most of the advanced countries and significantly lower than that of some of its oil-importing BRICS peers. Compared to OECD economies, South Africa's adjustment potential to lower energy intensity appears to be large, with both adjustment costs and a lower oil burden attainable.

1. Energy intensity is measured as units of primary energy consumption per unit of GDP at constant US dollar purchasing power parities.
2. Oil burden is an oil price vulnerability indicator, calculated as the ratio of nominal oil expenditure (volume multiplied by average price) to nominal GDP.
3. Enerdata, "Energy Intensity of GDP at Constant Purchasing Power Parities", Global Energy Statistical Yearbook 2012 (London: Enerdata, 2011, http://yearbook.enerdata.net/#/energy-intensity-GDP-by-region.html). The following, koe/US$05p, is defined as a kilogram of oil equivalent at constant 2005 US$ purchasing power parity prices.
4. J Blas, "Soaring Crude Price Threatens Recovery", *Financial Times* (24 February 2012).
5. F Birol, "The Impact of High Oil Prices on the Economy", *World Energy Outlook* (Paris: International Energy Agency, April 2012, O: http://www.iea.org/newsroomandevents/news/2012/april/name,25467,en.html, accessed 5 June 2012).

Figure B3.1 The oil burden in selected countries and regions

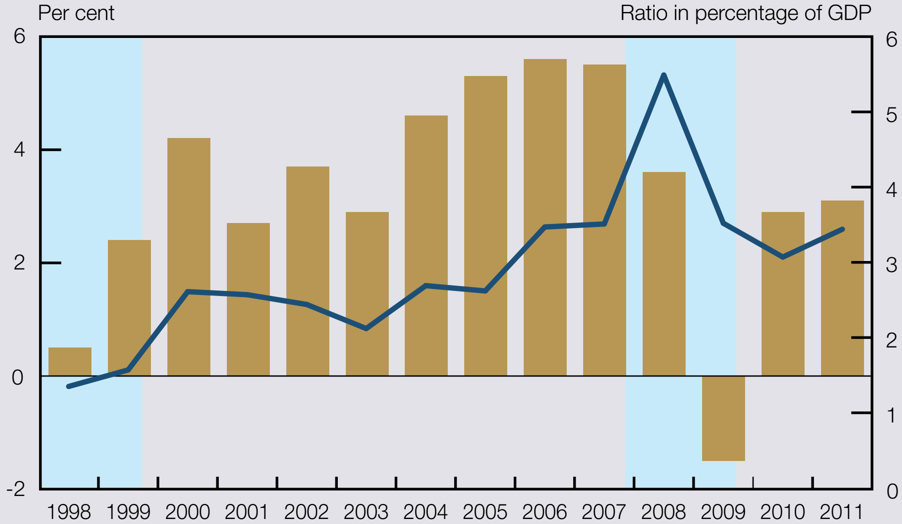


1990–2010 (average) 2011 2012

Advanced economies: European Union, United States, Japan
BRICS: India, China, South Africa
Emerging-market and developing economies: China, India, South Africa, Turkey

Sources: International Energy Agency (IEA) for European Union and all others World Economic Outlook database, October 2012

Figure B3.2 The oil burden and economic growth in South Africa



Real GDP growth
South Africa's oil burden (Net imports minus exports) (right-hand scale)
Downward phases of the business cycle

Sources: South African Reserve Bank and World Economic Outlook database, April 2012

International monetary policy developments

In 2011 many central banks tightened monetary policy as economic growth resumed and inflation pressures surfaced. Major world economies eased policy in 2012 in response to the slowing recovery and moderating inflation. Some economies have been undermined by a combination of domestic demand weaknesses and external vulnerabilities, such as financial instability and falling exports. Others have been primarily exposed to external shocks and negative spillovers, particularly declining demand, lower commodity prices and a retraction of cross-border lending. Authorities in some of the advanced economies have tended to pursue more aggressive easing policies and unconventional measures. All central banks have expressed concern about the threat posed by a further slowdown in global economic growth.

In the US the Federal Open Market Committee (FOMC) of the Federal Reserve (the Fed) kept the target range for the federal funds rate unchanged at zero to 0,25 per cent but indicated that US economic conditions would continue to warrant exceptionally low policy rates, at least through to mid-2015. In June 2012, the Fed extended the maturity extension programme (so-called Operation Twist) to the end of the year. The FOMC further decided to continue purchases of additional mortgage-backed securities at a pace of US$40 billion per month. These actions are intended to put downward pressure on longer-term interest rates, support the mortgage market and help to make broader financial conditions more accommodative.

Table 5 Selected central bank interest rates

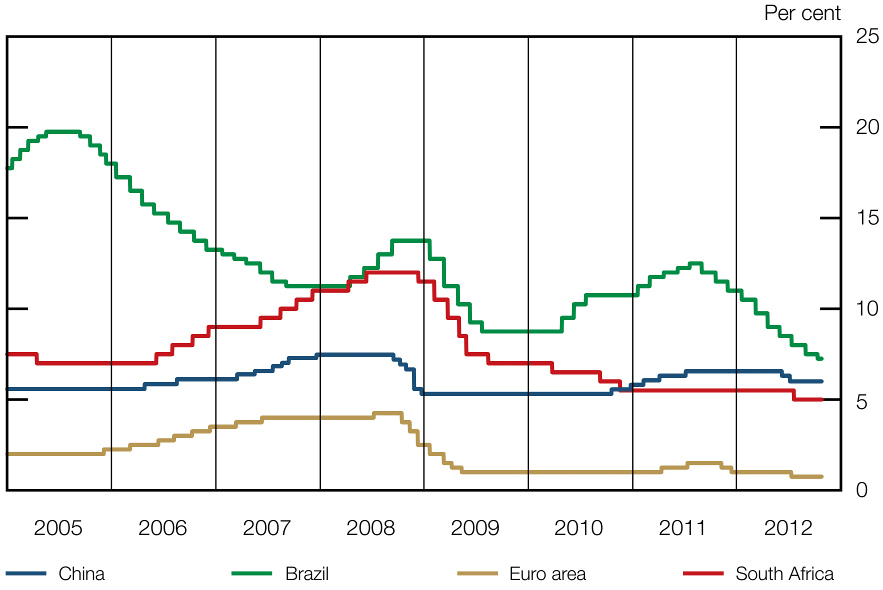
Per cent

Countries	24 May 2012	25 Oct 2012	Real interest rate	Latest decision		Cumulative for 2012
				Interest rate change in percentage points		
United States..........	0,00 – 0,25	0,00 – 0,25	-1,75 – -2,0	24 Oct 2012	(0,00)	(0,00)
Japan	0,00 – 0,10	0,00 – 0,10	0,4 – 0,5	5 Oct 2012	(0,00)	(0,00)
Euro area................	1,00	0,75	-2,15	4 Oct 2012	(0,00)	(-0,25)
United Kingdom	0,50	0,50	-2,30	4 Oct 2012	(0,00)	(0,00)
Canada	1,00	1,00	-0,20	23 Oct 2012	(0,00)	(0,00)
Denmark	0,75	0,00	-2,50	5 Jul 2012	(-0,25)	(-0,75)
Sweden..................	1,50	1,25	0,85	25 Oct 2012	(0,00)	(-0,50)
Norway...................	1,50	1,50	1,00	29 Aug 2012	(0,00)	(-0,25)
Switzerland.............	0,00 – 0,25	0,00 – 0,25	0,40 – 0,65	13 Sep 2012	(0,00)	(0,00)
Australia	3,75	3,25	1,25	2 Oct 2012	(-0,25)	(-1,00)
New Zealand	2,50	2,50	1,70	25 Oct 2012	(0,00)	(0,00)
Israel	2,50	2,25	0,15	24 Sep 2012	(0,00)	(-0,50)
China	6,56	6,00	4,00	6 Jul 2012	(-0,31)	(-0,56)
India	8,00	8,00	-1,90	17 Sep 2012	(0,00)	(-0,50)
Indonesia................	5,75	5,75	1,44	11 Oct 2012	(0,00)	(-0,25)
Malaysia	3,00	3,00	1,60	6 Sep 2012	(0,00)	(0,00)
Philippines	4,00	3,50	0,15	25 Oct 2012	(-0,25)	(-1,00)
South Korea	3,25	2,75	0,75	25 Oct 2012	(-0,25)	(-0,50)
Taiwan	1,875	1,875	-1,115	20 Sep 2012	(0,00)	(0,00)
Thailand..................	3,00	2,75	-1,37	17 Oct 2012	(-0,25)	(-0,50)
Brazil	9,00	7,25	1,95	10 Oct 2012	(-0,25)	(-3,75)
Chile.......................	5,00	5,00	2,20	18 Oct 2012	(0,00)	(-0,25)
Mexico	4,50	4,50	-0,30	7 Sep 2012	(0,00)	(0,00)
Czech Republic	0,75	0,25	-3,15	27 Sep 2012	(-0,25)	(-0,50)
Hungary	7,00	6,50	-0,10	25 Sep 2012	(-0,25)	(-0,50)
Poland....................	4,75	4,75	0,95	3 Oct 2012	(0,00)	(0,25)
Russia	8,00	8,25	1,65	5 Oct 2012	(0,00)	(0,25)
Turkey	5,75	5,75	-4,56	18 Oct 2012	(0,00)	(0,00)
Iceland	5,50	5,75	1,55	3 Oct 2012	(0,00)	(1,00)
Nigeria....................	12,00	12,00	0,70	18 Sep 2012	(0,00)	(0,00)

Sources: National central banks and own calculations

Quantitative easing was also continued by other central banks. On 4 October 2012 the MPC of the Bank of England (BoE) maintained the already-record-low official bank rate at 0,5 per cent and increased the asset purchases programme by £50 billion to £375 billion on 5 July 2012. Asset purchases could be increased further subject to the impact of the governments' credit-boosting programme, the £80 billion Funding for Lending Scheme (FLS) and other purchases of high-quality private-sector securities.

Figure 11 Selected policy rates



Sources: National central banks

The Governing Council of the European Central Bank (ECB) reduced rates by 25 basis points in July 2012 and announced in September that it would undertake outright open-market operations and further non-standard monetary policy measures to repair monetary policy transmission and to equalise sovereign borrowing costs across the euro area. The outright monetary transactions (OMTs) bond-buying programme, set up in place of the Securities Market Programme (SMP), provides for unlimited purchases of euro area countries' bonds with maturities of one to three years in the secondary market and for purchases of sovereign debt in the primary market of countries that have obtained EFSF/ESM support, once they have regained bond market access. The ECB further widened eligible collateral and lowered rating thresholds to ease collateral standards.

Policy efforts were supported in Europe by the June 2012 Euro Area Summit, which proposed to establish a single supervisory mechanism for banks in the euro area, backed by the ECB. In September the German Federal Constitutional Court ruled that Germany could legally participate in European Union (EU) rescue funds and budget agreements but that the German Federal Parliament, the Bundestag, must approve liabilities exceeding €190 billion. In the interim, assistance was provided to Spanish banks from the European Financial Stability Facility (EFSF), which was replaced with the European Stability Mechanism (ESM) on 8 October 2012.

In September 2012 the Bank of Japan (BOJ) increased its asset purchase programme and lending facility, currently its key monetary easing tool, by ¥10 trillion (US$127 billion) to ¥80 trillion. The BOJ announced that it would expand the asset-purchase fund to ¥55 trillion (US$695 billion) from ¥45 trillion but kept its lending facility at ¥25 trillion.

Inflation in China has declined significantly since January 2012 and, despite constraints imposed by the housing market, has allowed the People's Bank of China to reduce lending rates by about 56 basis points. In addition, the use of 7- and 14-day reverse repurchase (repo) contracts temporarily injected 826 billion yuan (US$130 billion) into the financial system. The reserve requirement ratio for banks, which was lowered sharply earlier in 2012, has remained at 20 per cent since mid-May.

In October 2012 Brazil's Monetary Policy Committee (COPOM) reduced the Selic rate for a tenth consecutive time by 0,25 percentage points to a record-low 7,25 per cent, bringing the total reduction since August 2011 to 475 basis points. Inflation is expected to reach 5,2 per cent in 2012, while growth has slowed to about 1,5 per cent, the largest drop in growth of any major emerging-market economy.

Russia's central bank raised all its key interest rates by 25 basis points in September in response to risks of exceeding its medium-term inflation target.

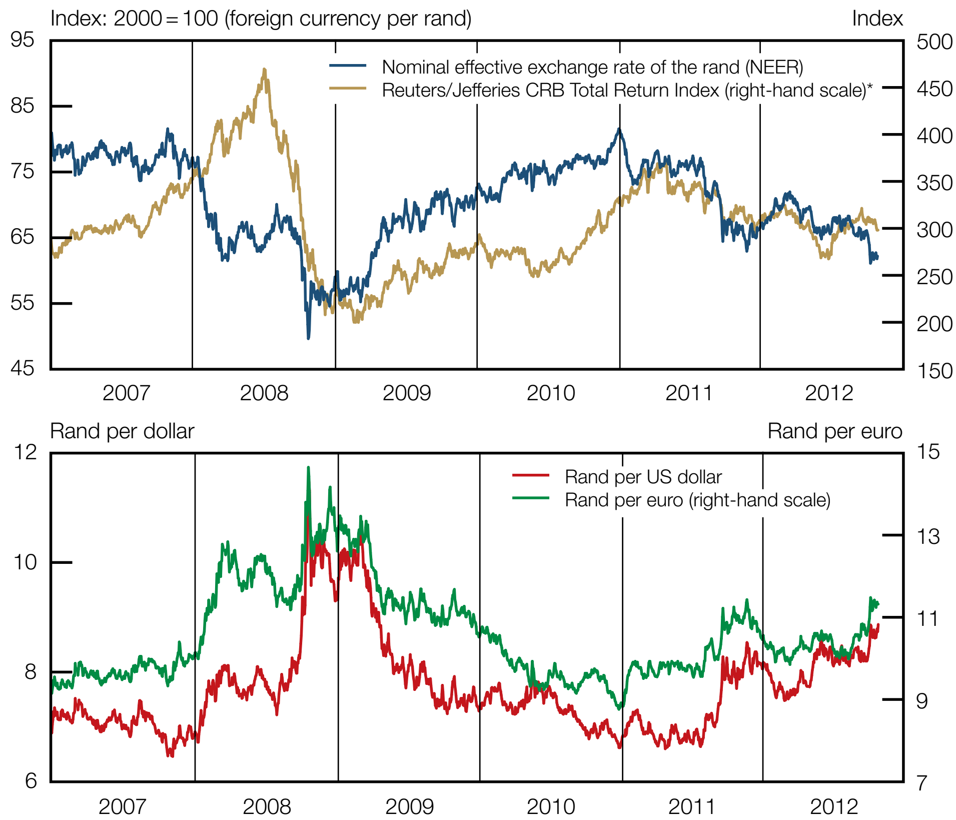
Domestic economic developments and growth outlook

Monetary policy decisions are made on the basis of current and expected domestic developments in the wider economy. This section reviews medium-term developments, and assesses the near-term outlook in terms of prospects, risks and uncertainties for inflation.

Exchange rate developments

Globally, the downward shift in growth prospects and abrupt changes in risk perceptions in the financial markets led to volatility in both portfolio flows and currencies. For much of 2012, South Africa experienced a deterioration in investor sentiment, a wider current-account deficit and an overall declining trend in commodity prices which have resulted in rand weakness. This was, however, countered to some extent by strong bond inflows, boosted by global monetary easing and South Africa's inclusion in the Citi World Government Bond Index (WGBI). In September and October, however, rating agencies lowered South Africa's credit rating and maintained an investment grade with a negative outlook. The nominal effective exchange rate (NEER) of the South African rand has, on balance, depreciated since December 2010 by about 24 per cent.

Figure 12 Exchange rates of the rand



* The CRB Total Return Index tracks international commodity prices

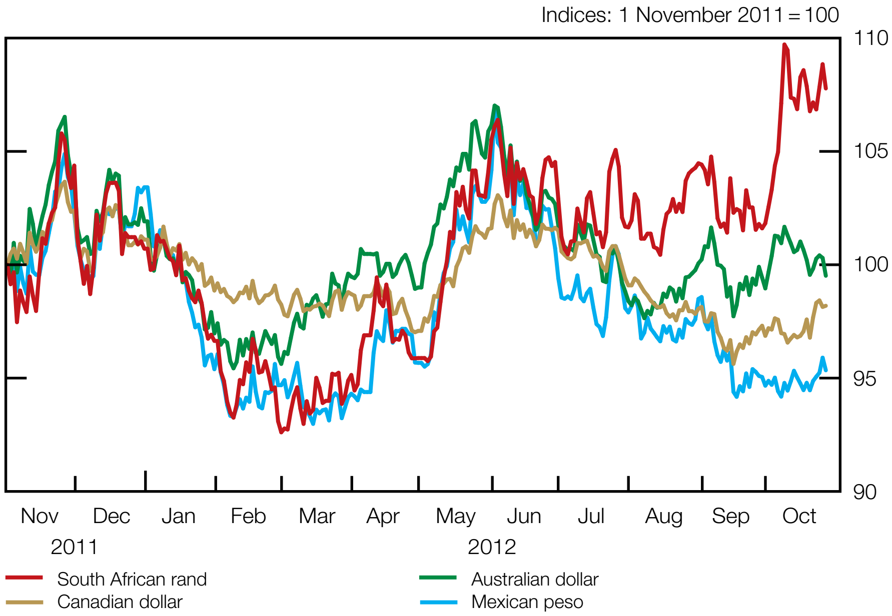
Sources: Bloomberg and South African Reserve Bank

The exchange rate of the rand has fluctuated within a wide range against major currencies in recent years, with differences in its movements against the euro and US dollar reflecting changes in the euro/dollar exchange rate, which were, in turn, driven by shifting sentiment and conditions in those major economies. Measured on a bilateral basis, the rand depreciated by 15 per cent against the euro from R9,85 per euro in mid-March 2012 to R11,32 on 25 October. Similarly, the rand depreciated by 16 per cent against the US dollar from R7,48 per dollar at the end of February 2012 to R8,70 on 25 October, reaching its lowest level since April 2009 (Figure 12). Against either currency, the rand weakened to levels around those achieved a year ago in November 2011, when the respective exchange rates were R11,43 and R8,54.

Since the end of December 2010, the NEER of the South African rand has oscillated around a depreciating trend.[1] From November 2011 to mid-March of 2012, the NEER appreciated by 9 points to an index level of 72, before depreciating again under the weight of deteriorating global and domestic economic sentiment, with the NEER reaching 61 index points in October 2012. Since June 2012, widespread industrial action has contributed to sales of equities by non-resident investors and further depreciation against the US dollar, in contrast to the appreciations experienced by some of the other emerging-market and commodity currencies (Figure 13).

1. 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 South African Reserve Bank *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), and Japanese yen (10,12). Index: 2000 = 100.

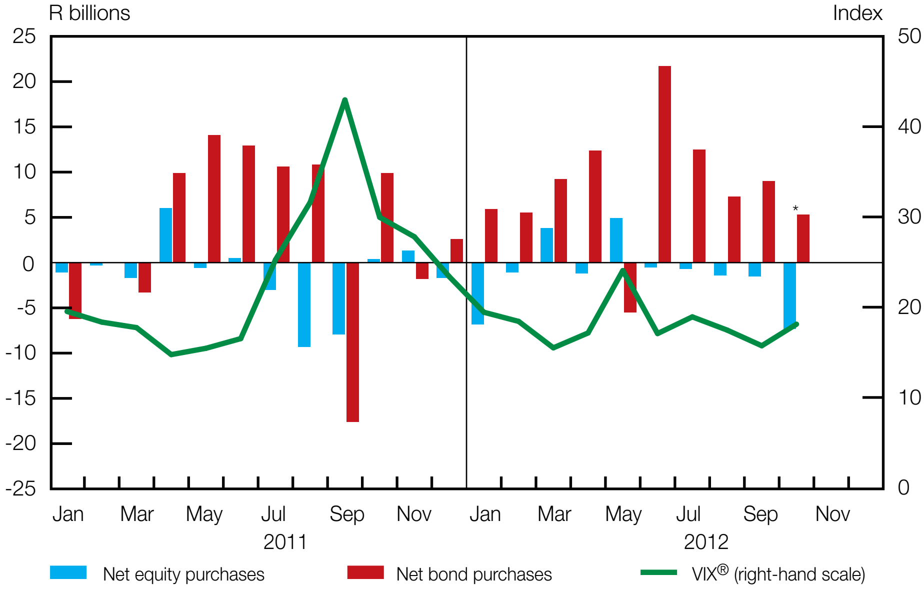
Figure 13 Exchange rate performance against the US dollar



Sources: Reuters and own calculations

From January 2012 to 25 October foreign investors' cumulative net purchases of bonds amounted to R83 billion compared to R42 billion in 2011 as a whole (Figure 14). In contrast, non-residents remained net sellers of shares in the year to October, as in 2011. A cumulative R11,7 billion has been sold by non-residents in the year to 25 October 2012, compared to net sales of R17,2 billion in the whole of 2011. The net sales of shares have been prompted primarily by concerns about industrial unrest and the recovery in domestic economic activity, given possible spillovers from the euro area crisis and weaker commodity prices.

Figure 14 Non-resident net purchases of domestic securities and risk aversion



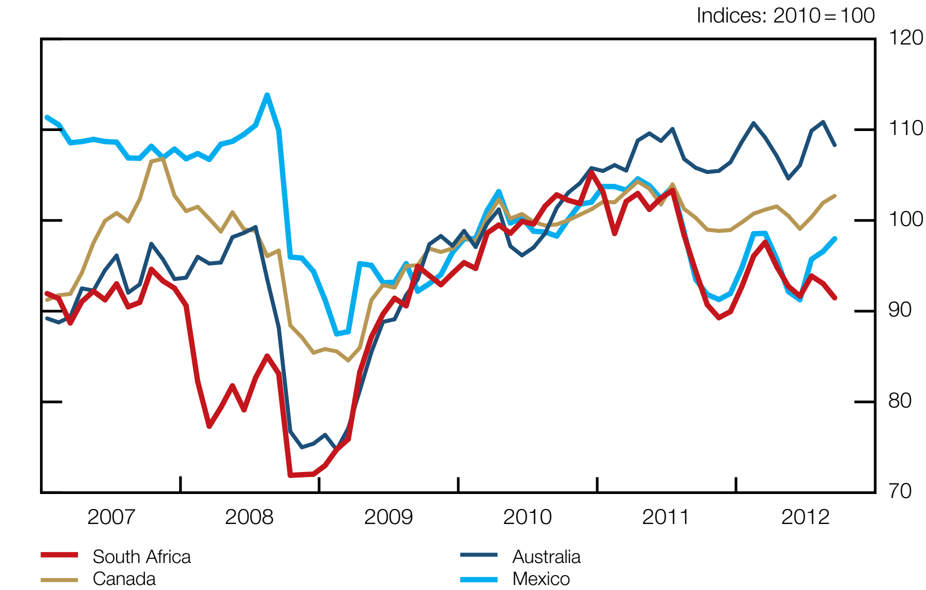
* Data up to 25 October 2012
Sources: JSE Limited and Bloomberg

2. The Reuters/Jefferies CRB Total Return Index reflects a long-only, broadly diversified investment in commodities.

3. The BIS REER indices include a total of 61 entities, including individual euro area countries and 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.

Some part of the currency weakness can be attributed to declining commodity prices, as suggested by the alignment of the Reuters/Jefferies CRB Total Return Index with movements in the rand as shown in Figure 12.[2] The trend and volatility in the rand/US dollar exchange rate since November 2011 have generally mirrored that of other emerging-market and commodity currencies (Figure 13). For instance, all emerging and commodity currencies reversed the appreciations experienced in the period November 2011 to April 2012 in the following period to June. Subsequently, the initial appreciation of the South African rand against the US dollar was not as strong as that of the other countries in the sample before deviating further. South Africa's real effective exchange rate (REER), as measured by the Bank for International Settlements (BIS), followed the same trend (Figure 15), depreciating by about 11 per cent since the middle of 2011.[3] *(See Box 4 for an estimate of the equilibrium value of the real effective exchange rate of the rand.)*

Figure 15 Real effective exchange rates



Source: Bank for International Settlements

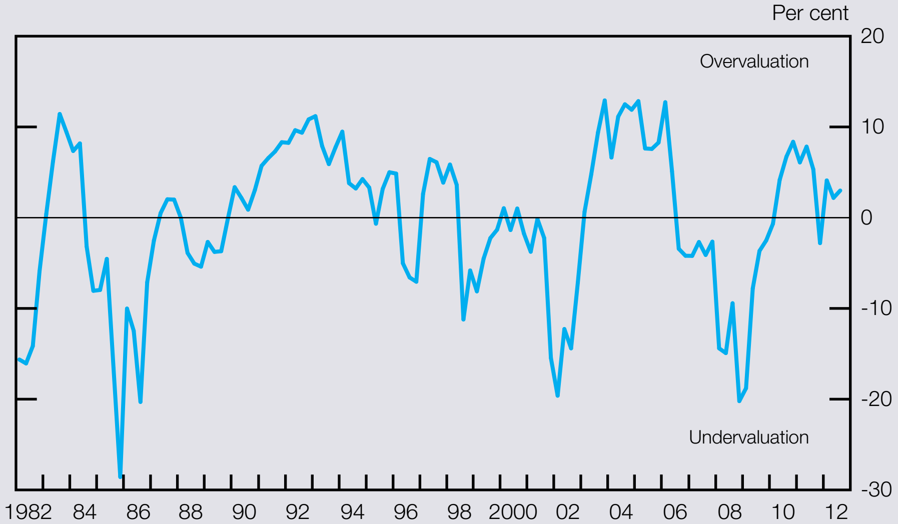
Box 4 Estimating the equilibrium value of the real effective exchange rate of the rand

The short-term value of a currency changes day to day as importers, exporters, and other users and investors buy and sell currencies as part of their transactions. A longer-term equilibrium value for an exchange rate can be measured that relates key economic fundamentals. Since this real equilibrium exchange rate cannot be observed directly, various methods are used to measure and calculate it.

De Jager estimates the trend of the real equilibrium exchange rate using a vector error correction model and a series of variables commonly found in the literature – a real interest rate differential, a productivity measure, commodity prices, the fiscal balance and capital flows.[1] The long-run trend level enables a perspective on shorter-run movements and the implied gap or extent of the over- or undervaluation.

The actual level of the REER continues to remain volatile, with the degree of misalignment between the current real value of the currency and its equilibrium level illustrated in (Figure B4.1). The graph suggests that, generally, in the absence of major exchange rate shocks, the gap of the actual to its equilibrium value seldom exceeds 10 per cent on either side of the equilibrium.

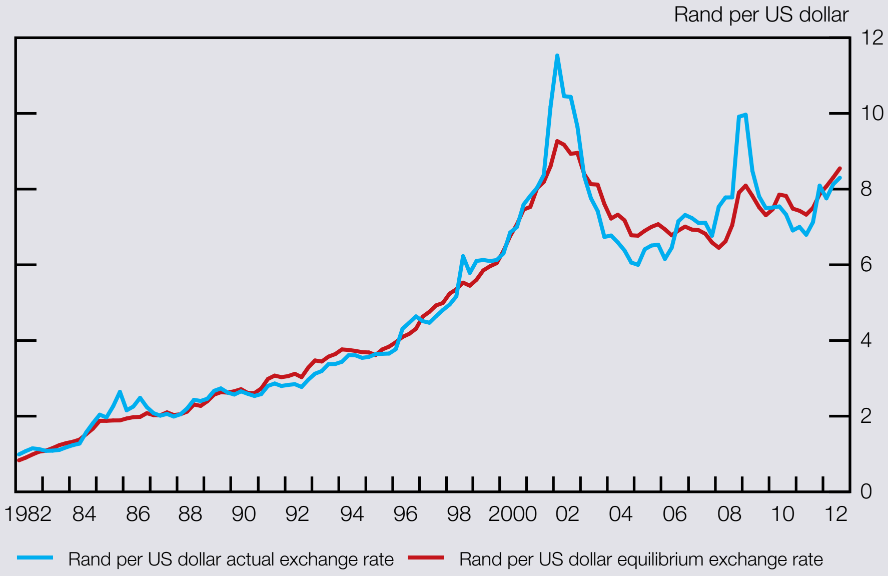
Figure B4.1 The extent of over-/undervaluation of the real value of the currency



The real equilibrium exchange rate was estimated to be nearly 20 per cent undervalued relative to its fundamentals, towards the end of 2008 at the height of the global financial crises. However, the exchange rate recovered quite strongly in relation to changes in fundamentals in the subsequent years and registered an overvaluation of almost 10 per cent towards the fourth quarter of 2010. The real equilibrium exchange rate then depreciated to show a more than 3 per cent undervaluation in the last quarter of 2011 and, based on assumptions for the current period, model estimates suggest the real equilibrium exchange rate was fairly close to its equilibrium value at an overvaluation of between 2 and 3 per cent in the second and third quarters of 2012 respectively. The decline in dollar-denominated commodity prices and the deterioration in the productivity differential from the middle of 2011 were identified as the two key factors contributing to the more depreciated equilibrium over the last few quarters.

1. "S de Jager, "Modelling South Africa's Equilibrium Real Effective Exchange Rate: A VECM Approach", South African Reserve Bank Working Paper series (WP/12/02) (Pretoria: South African Reserve Bank, April 2012). The VECM estimation technique basically consists of two components, the long-run relationship in level terms and the short-run VAR component in first differences.

Figure B4.2 The actual and equilibrium rand per US dollar exchange rates

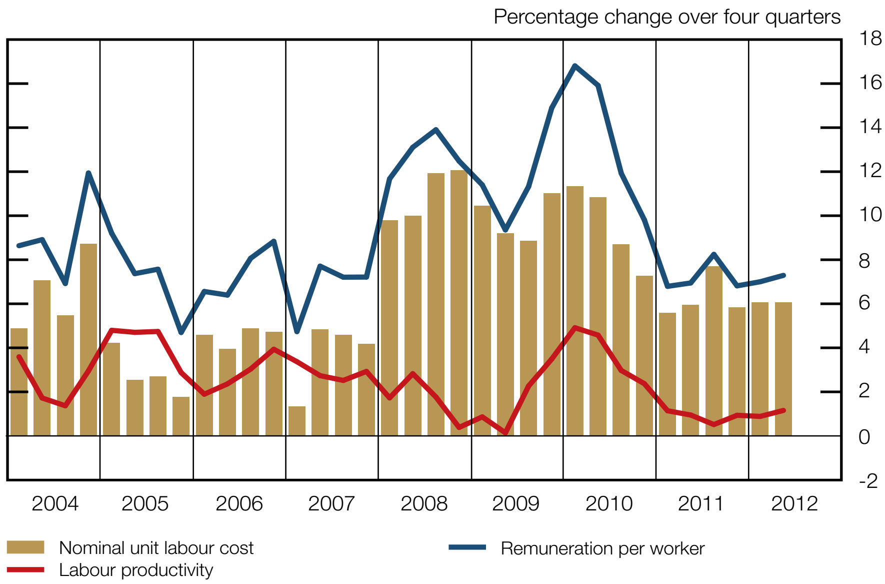


Labour markets

Employment levels increased at a slower pace in 2012 compared to 2011, with job creation remaining consistent with the moderate pace of recovery in real economic activity. The moderation in nominal unit labour costs in 2011 preceded a sideways movement in 2012 while average wage settlement rates moderated further. These developments may have mitigated inflationary pressures but have done little to encourage direct job creation. The outlook for wage growth in the wake of the events in the mining industry remains uncertain.

From the beginning of 2008 to the middle of 2010, nominal unit labour costs, a key measure of cost–push pressures, increased rapidly, averaging 10,5 per cent on a quarterly basis. Between March 2010 and June 2012, growth in nominal unit labour costs moderated significantly, reaching 6,1 per cent in the second quarter of 2012 (Figure 16). Somewhat higher productivity growth and moderating wage settlements appear to have contributed to this lower outcome.

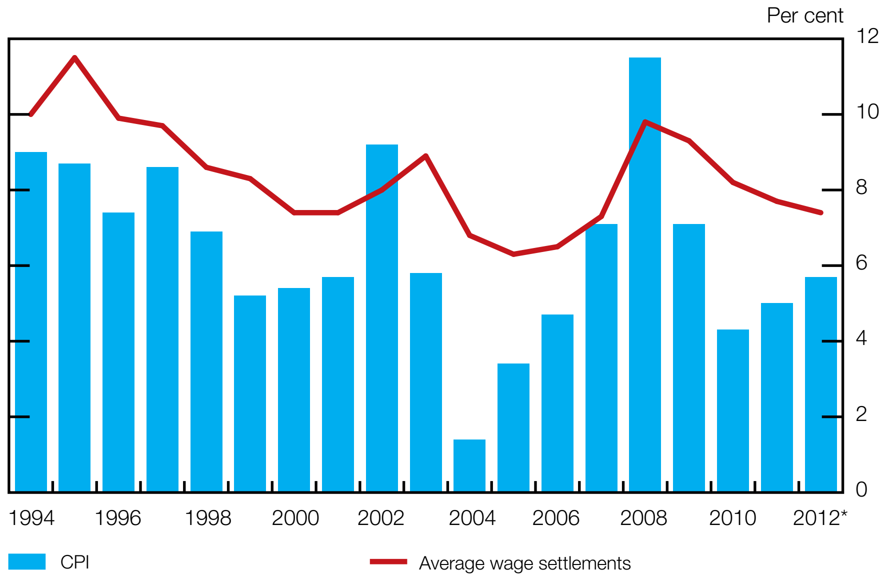
Figure 16 Remuneration per worker, labour productivity and unit labour cost in the formal non-agricultural sector



Sources: Statistics South Africa and South African Reserve Bank calculations

The third-quarter *Andrew Levy Wage Settlement Survey* of 2012 reported that the average level of wage settlements had moderated from 8,2 per cent in 2010 to 7,7 per cent in 2011 and slightly further to 7,4 per cent in the first nine months of 2012 (Figure 17). Lower measured and expected inflation and greater economic uncertainty may have contributed to moderation, while the 7 per cent public-sector wage settlement for the current year and developments in food, transport and electricity prices lent themselves to higher outcomes. Recent high wage settlements in the mining sector could set a precedent for wage settlements more generally.

Figure 17 Average annual inflation and wage settlements



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

Sources: Andrew Levy Employment Publications and Statistics South Africa

Job creation in the formal sector has remained incremental. Total employment in the formal non-agricultural sector as reported by Statistics South Africa's *Quarterly Employment Statistics (QES)* survey improved somewhat, with consistent quarter-on-quarter increases over nine quarters to the second quarter of 2012 (Table 6). In the four quarters to the second quarter of 2012, about 125 000 jobs were created. Total employment in the second quarter of 2012 was 339 000 more than the recent low in the first quarter of 2010, but still lower than the level reached in the fourth quarter of 2008.

Table 6 Employment in formal non-agricultural industries

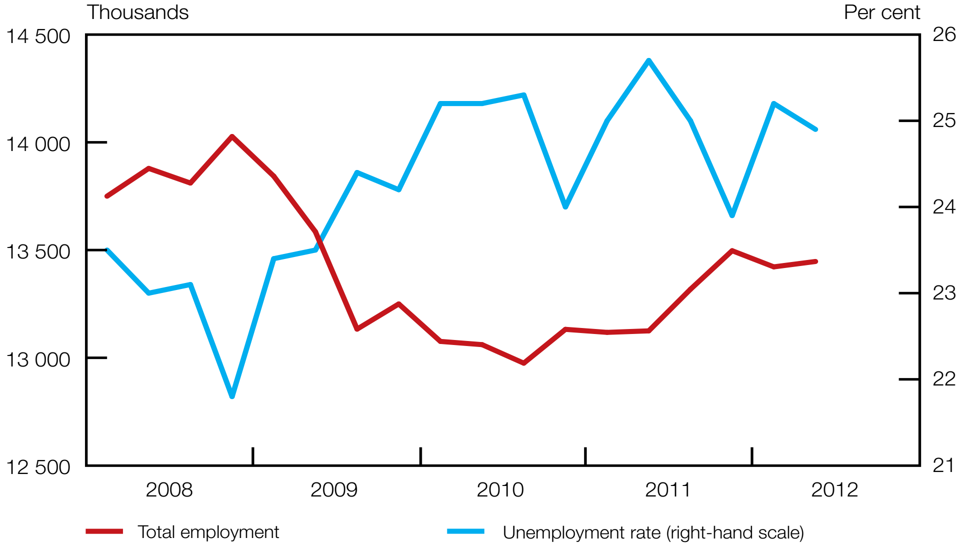
Thousands

Industry	Total employment				
	2009	2010	2011	2012	
	4th qr	1st qr	4th qr	1st qr	2nd qr
Mining and quarrying	518	491	518	523	533
Manufacturing	1 275	1 187	1 158	1 155	1 146
Electricity, gas and water supply	59	56	59	61	62
Construction	474	418	426	431	433
Wholesale trade and retail trade	1 747	1 630	1 700	1 678	1 685
Transport, storage and communication	366	359	369	369	375
Financial intermediation, insurance, real-estate and business services	1 914	1 742	1 831	1 832	1 833
Community, social and personal services	2 159	2 203	2 318	2 334	2 358
Total	8 512	8 086	8 379	8 383	8 425

Source: Statistics South Africa *Quarterly Employment Survey*

Relatively consistent with the former survey, Statistics South Africa's *Quarterly Labour Force Survey* (*QLFS*) shows a moderate improvement in total employment and a decline in the unemployment rate to 24,9 per cent in the second quarter of 2012 – slightly lower than the 25,7 per cent recorded in the second quarter of 2011 (Figure 18).

Figure 18 Labour market indicators



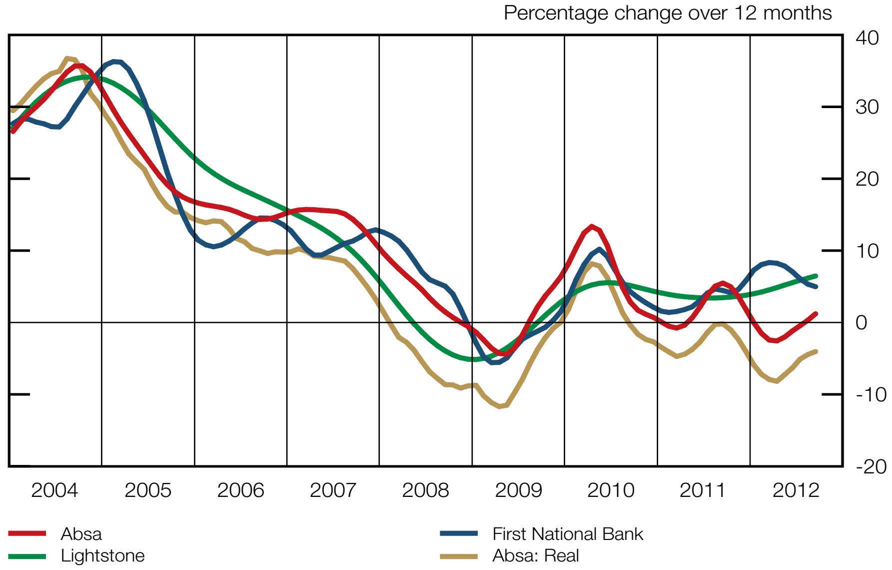
Source: Statistics South Africa *Quarterly Labour Force Survey*

Real-estate and equity prices

Reflecting underlying economic conditions, the real-estate market remained subdued, with a moderately positive rate of increase in nominal house prices and a slight decrease in the average time that properties remain on the market. Domestic share prices scaled new highs on the back of low interest rates, international monetary easing and stronger equity markets in key economies, despite growth concerns and softer international commodity prices.

Underlying domestic economic conditions continue to weigh on the real-estate market. First National Bank (FNB) house price growth has moderated as from April 2012 and in August Absa's House Price Index recorded its first positive rate of change since December 2011 (Figure 19).

Figure 19 House prices

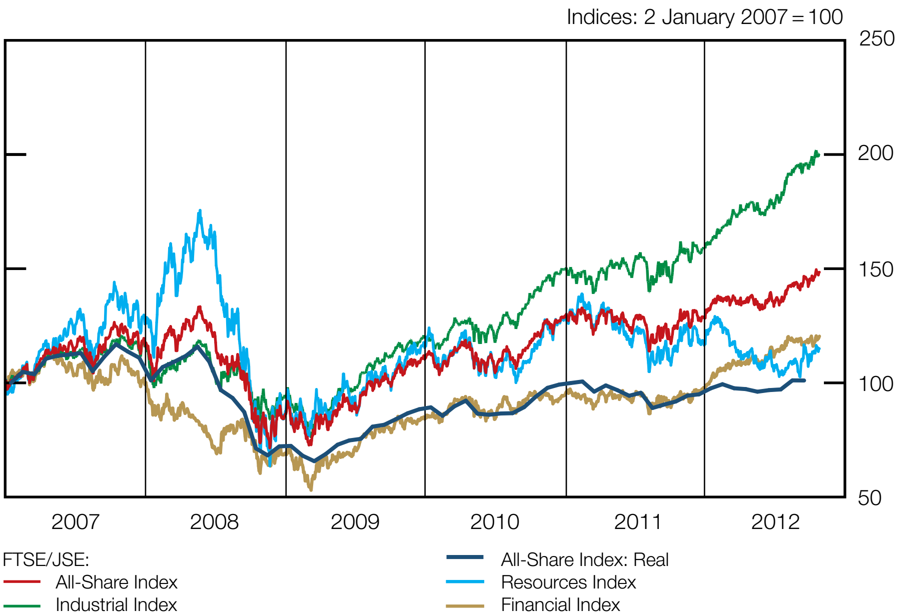


Sources: Absa, First National Bank, Lightstone and own calculations

Adjusted for inflation, real price changes have become slightly less negative as from May 2012 to a negative 4 per cent in September 2012. The third-quarter 2012 *FNB Home Buying Estate Agent Survey* showed a small improvement in the average time that properties remain on the market from 17 weeks and 4 days in the second quarter of 2012 to 15 weeks and 6 days in the third quarter – still above the 8-week level deemed as representing a balance between demand and supply.

The FTSE/JSE All-Share Price Index (Alsi) increased from a low 28 391 index points on 8 August 2011 to a high of 34 482 index points on 2 May 2012 – surpassing the previous record high of 22 May 2008 – and then scaled a number of successive record highs in subsequent months to an all-time high 37 275 index points on 17 October. Over this period, the Alsi was supported by the performance of the Industrial and Financial Indices but was held back by the Resources Index which responded to lower international commodity prices (Figure 20). Compared to the high point in May 2008, the 12 per cent nominal gain in the Alsi still yields an overall loss in real terms.

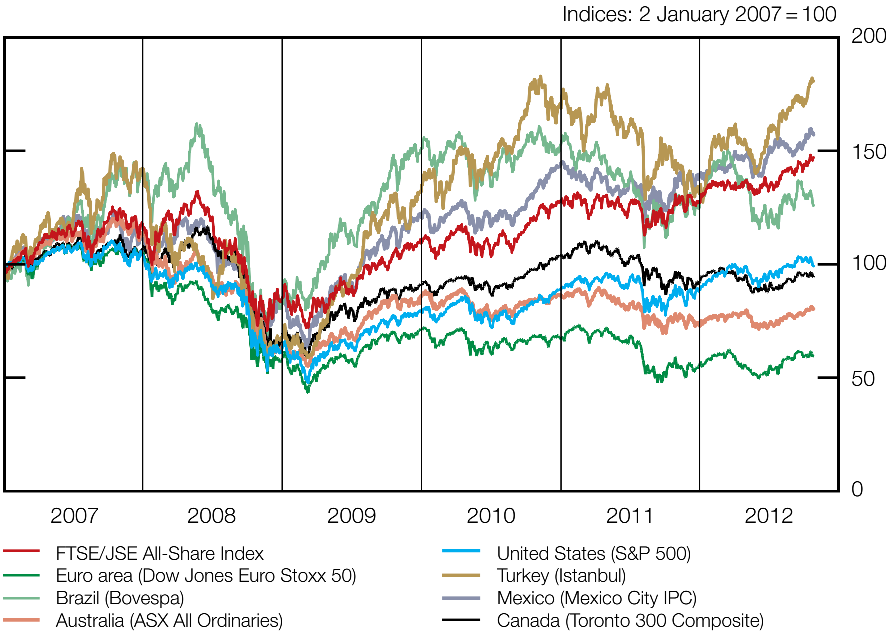
Figure 20 Domestic share price indices



Sources: JSE Limited, I-Net Bridge and own calculations

The Alsi also followed the trend in global share prices and especially that of emerging-market and developing countries (Figure 21), with global sentiment being influenced positively by renewed monetary policy easing in response to global growth concerns amid the continuing sovereign debt crisis in the euro area.

Figure 21 International share price indices*



* Based on local currency share prices

Sources: JSE Limited and I-Net Bridge

Fiscal policy

Over the course of the global financial and economic crisis, fiscal authorities have implemented a countercyclical policy that has been supportive of economic growth, and mindful of the need to avoid unsustainable debt and tax burdens on future generations of South Africans. The fiscal stance is projected to adjust to a slower growth environment to rebuild fiscal space over the medium term.

The budget balance is expected to reach -4,8 per cent of GDP in the current fiscal year 2012/13 before declining to -4,5 per cent in 2013/14 and -3,7 per cent in 2014/15. Non-interest expenditure over the three years of the Medium Term Expenditure Framework (MTEF) is expected to remain in line with the projections set out in the February 2012 budget.

Table 7 Public finance data

	2011/12	2012/13		2013/14	2014/15	2015/16
	Outcome	Budget	*MTBPS* estimates	Medium-term estimates		
Consolidated government* (R billions)						
Revenue	837,0	904,8	900,6	986,1	1092,1	1205,0
Expenditure	964,4	1 058,3	1 057,1	1 147,4	1 238,1	1 339,0
Budget balance	-127,4	-153,5	-156,5	-161,3	-146,0	-134,0
Total net loan debt**	989,7	1 189,4	1166,0	1 352,8	1 535,6	1 709,9
As a percentage of GDP						
Budget balance	-4,2	-4,6	-4,8	-4,5	-3,7	-3,1
Total net loan debt**	32,8	36,0	35,7	37,7	38,8	39,2

* Includes national government, provinces, social security funds and selected public entities
** National government

Source: National Treasury *Medium Term Budget Policy Statement (MTBPS), October 2012* and *Budget Review 2012*

With spending on social programmes and infrastructure development maintained, real growth in public expenditure is expected to amount to about 3,1 per cent a year over the MTEF. The fiscal stance remains in line with the trajectory of the domestic recovery, providing support to close the output gap without creating upward pressure on domestic prices.

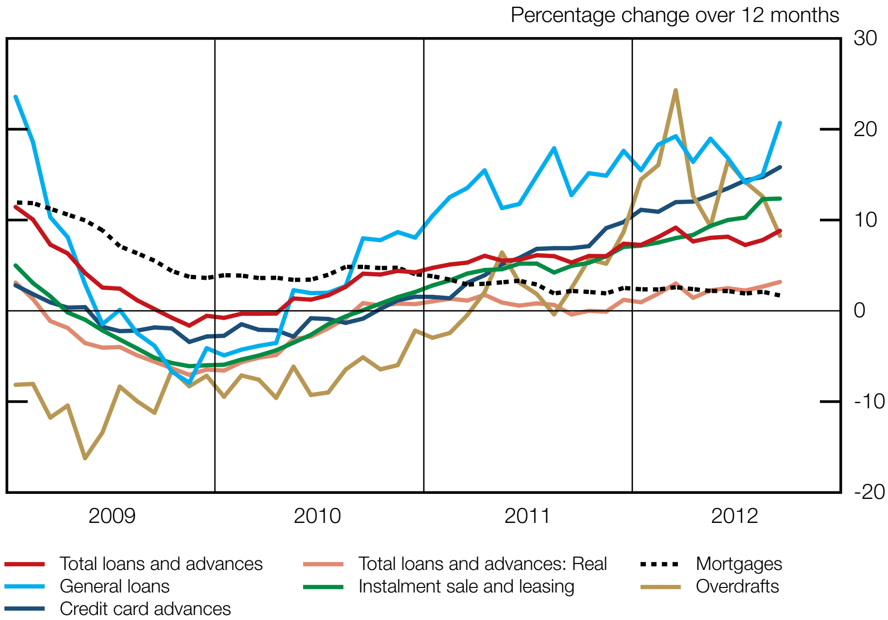
Monetary conditions

Modest, single-digit growth in money supply and credit extension is consistent with the recently observed moderate pace of domestic economic activity. In the first nine months of 2012 money-supply growth increased slightly, while growth in credit extension to the private sector remained fairly subdued before picking up speed in September. With the exception of mortgages, the other categories of credit extension, especially general loans and overdrafts, continued to record strong growth over the period under review, with the ratio of household debt to disposable income increasing somewhat in the first half of 2012.

Total loans and advances to the private sector firmed to 9,2 per cent in the year to March 2012, the highest level since early 2009, before moderating to 7,3 per cent in July followed by a slight acceleration to 8,8 per cent in September 2012 (Figure 22). In real terms, growth in total loans and advances have turned positive as from December 2011, increasing modestly to 3,2 per cent in September 2012 – its fastest pace since January 2009.

Other loans and advances (i.e., general loans, credit card advances and overdrafts) accounted for 70 per cent of the increase in total loans and advances in 2011, and continued to be the main driver of growth in credit extension. General loans (inclusive of personal loans) have softened somewhat from 19,2 per cent in March 2012 before recording a strong growth rate of 20,7 per cent in September, while growth in overdrafts fell back sharply towards its longer-term trend.

Figure 22 Banks' loans and advances to the private sector by type



Growth in instalment sale and leasing finance, benefiting from strong vehicle sales and low interest rates, continued to accelerate, and from April 2012 has exceeded that of total loans and advances for the first time since early 2005. Growth in mortgage lending declined from around the 2 per cent level in the first eight months of 2012 to 1,7 per cent in September, being constrained on the demand side by continued weakness in the real-estate market and on the supply side by weak profitability due to tight interest margins and non-performing loans.

Demand, output and expected growth

Economic activity in South Africa expanded at a firmer pace in the second quarter of 2012 due to a brisk, but probably temporary, recovery in the primary sector. However, the rest of the economy lost some momentum as the secondary sector contracted and the tertiary sector slowed. Spending by general government and capital expenditure remained healthy, while household consumption moderated somewhat. Domestic economic activity is expected to moderate from the second to the third quarter of 2012. Growth forecasts have been revised lower in line with the Bank's subdued composite leading business cycle indicator.

Growth in real GDP gained momentum in the second quarter of 2012, accelerating to an annualised rate of 3,2 per cent from 2,7 per cent in the first quarter (Table 8). This increase in economic activity was mostly driven by the more volatile primary sector, with a moderate acceleration in agricultural output and a substantial recovery in mining output. Excluding the primary sector, however, growth in the rest of the economy slowed from 3,8 per cent in the first quarter of 2012 to 1,6 per cent in the second quarter. Within the secondary sector, a revival in the construction sector was more than offset by a contraction in the electricity, gas and water, and manufacturing sectors. The tertiary sector lost momentum as real growth in the finance and business services and trade sectors decelerated.

Table 8 Growth in real GDP and expenditure components

Per cent*

	2011					2012	
	1st qr	2nd qr	3rd qr	4th qr	Year	1st qr	2nd qr
Final consumption expenditure							
Households	6,2	3,4	3,8	4,6	5,0	3,1	2,9
General government	9,4	-0,4	4,8	7,3	4,5	2,2	4,1
Gross fixed capital formation	4,4	5,0	5,9	7,2	4,4	5,3	5,7
Changes in inventories (R billions)**	7,1	3,1	4,0	4,9	4,8	5,9	7,0
Gross domestic expenditure	4,6	1,4	4,8	5,1	4,3	4,3	4,7
Exports of goods and services	7,3	6,1	8,0	4,4	5,9	-1,4	-6,2
Imports of goods and services	7,0	6,7	18,5	11,0	9,7	4,8	0,9
Gross domestic product	4,6	1,0	1,7	3,2	3,1	2,7	3,2

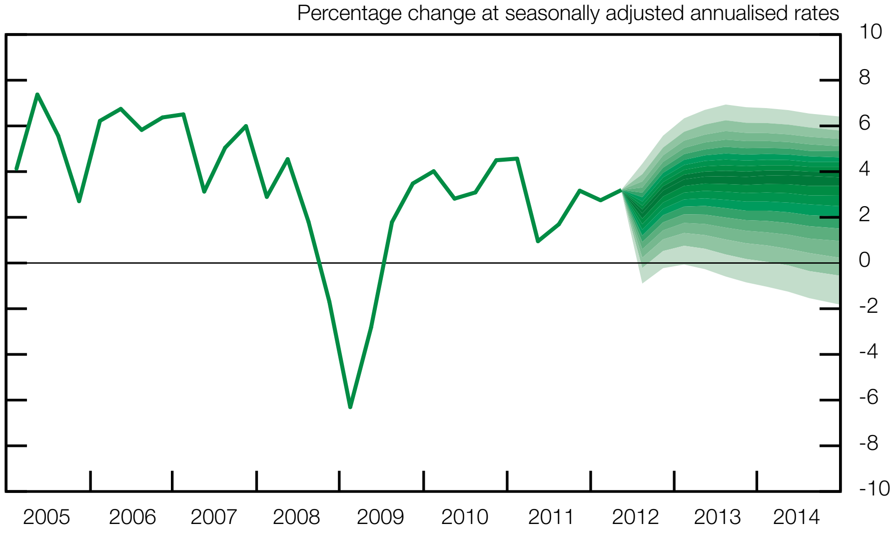
* Quarterly data refer to quarter-on-quarter growth at annual rates of seasonally adjusted data
** Constant 2005 prices

A stronger outcome in government consumption and real gross fixed capital formation by private businesses and government in the second quarter was only partly offset by a moderation in household spending, resulting in a rise in real gross domestic expenditure growth from 4,3 per cent in the first quarter of 2012 to 4,7 per cent in the second quarter.

Despite the depreciation in the exchange value of the rand, real exports of goods and services contracted by 6,2 per cent in the second quarter of 2012, reflecting slowing global growth. Import volumes, however, increased in the second quarter of 2012 on the back of buoyant domestic expenditure, while South Africa's terms of trade deteriorated somewhat further. (*See Box 5 for a measure of the size of international spillovers to South Africa.*)

The intensified global financial crisis and slower global growth have reduced commodity prices and domestic exports, in turn negatively affecting South Africa's growth outlook. Since May 2012, quarterly projections of annual average growth in real output have decreased marginally at each of the consecutive MPC meetings. The September 2012 MPC meeting projected growth of 2,6 per cent in 2012, 3,4 per cent in 2013 and 3,8 per cent in 2014 (Figure 23).

Figure 23 Real GDP growth forecast

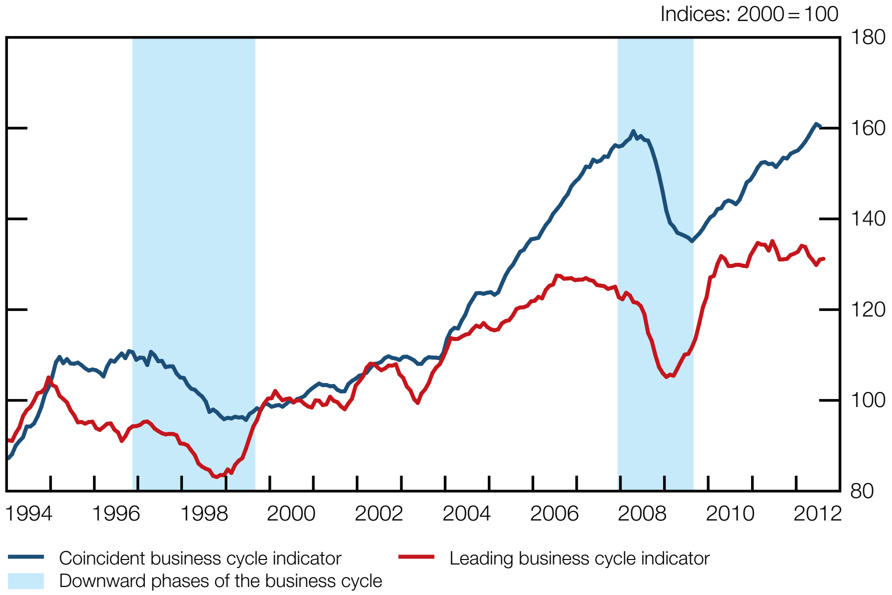


Short-term indicators show that growth in the third quarter of 2012 is likely to be lower than in the second quarter and point to a somewhat more pessimistic near-term growth outlook. This implies that the current sizeable negative output gap will endure over the forecast period.

The main drivers of expenditure growth on the demand side are expected to be gross fixed capital formation and real household consumption expenditure. On the supply side, the mining sector is expected to be weaker due to the labour unrest in the third quarter and high base effects of the second quarter of 2012. In the non-primary sector, manufacturing is expected to remain weak along with anticipated firm growth in the tertiary sector during the third quarter.

The Bank's composite coincident business cycle indicator reflected the upward trend in the economy for the year (Figure 24). Looking forward, the Bank's composite leading business cycle indicator declined for four consecutive months through to June 2012 to its lowest level since late 2010. In July and August 2012 the leading indicator edged up slightly, but still recorded a 2,2 per cent decrease since February – and remained subdued relative to recent highs.

Figure 24 Composite business cycle indicators



Survey results support the assessment that economic growth (excluding mining) will soften in the third quarter. The *Rand Merchant Bank (RMB)/Bureau for Economic Research (BER) Business Confidence Index* (BCI) again fell below the neutral level of 50 as from the second quarter of 2012, with sentiment improving somewhat in the third quarter. The increase of 6 index points to 47 in the third quarter of 2012 only partially neutralised the 11 index point decline in the second quarter (Table 9).

Table 9 Domestic economic sentiment indicators

	Historic range		Most recent		As at MPR:*	
	Low	High	Low	High	May 2012	Oct 2012
RMB/BER Business Confidence Index	10	91	23	55	52	47
BER Manufacturing Confidence Index	11	93	11	51	47	33
Ernst & Young/BER Retail Confidence Index	0	94	35	63	61	46
FNB Building Confidence Index	11	89	23	38	34	26
Kagiso/BER Purchasing Managers Index	35,3	63,4	48,2	57,9	53,7	46,2
FNB/BER Consumer Confidence Index	-33	23	-6	15	5	-1

* Improved/Worsened since previous MPR

Sources: Kagiso Securities, Rand Merchant Bank, First National Bank, Ernst & Young and the Bureau for Economic Research, Stellenbosch University

Although business confidence improved in all five sectors surveyed, the level indicates a slight majority of respondents being negative about prevailing business conditions. Only the wholesale sector recorded consistent quarterly improvements in sentiment in 2012. The third-quarter survey shows an improvement in manufacturing, retail and building contractor confidence but remains below the neutral level of 50.

According to the third-quarter 2012 *BER Manufacturing Survey*, manufacturing business confidence fell sharply in the second quarter by 18 index points and has since recovered somewhat to 33 index points. Expected business conditions in 12 months' time deteriorated markedly, with a net majority of 19 per cent expecting conditions to deteriorate and 7 per cent an improvement.

Retail business confidence fell by 22 index points to 39 in the second quarter of 2012, before rising by 7 index points to 46 in the third quarter according to the *Ernst & Young/BER Retail Survey*. Confidence was supported by low interest rates and unsecured credit growth, and weighed down by moderating real income growth and slow employment creation.

Confidence in the building industry remains weak despite a pick-up in construction-sector activity and rising confidence among architects.

Since the previous *MPR*, the seasonally adjusted *Kagiso/BER PMI* has fallen below the neutral level of 50 to 48,2 in June 2012 and 46,2 index points in September 2012, influenced by business activity and new sales orders (the components of the PMI with the largest weights). The PMI indicates weaker manufacturing activity in the third quarter.

Forward-looking PMI indicators have remained subdued since the previous *MPR*. Expected business conditions in six months' time fell from 59 index points in May 2012 to 52,9 index points in August, before increasing to 55,5 index points in September. The ratio of new sales orders to inventories remained below 1 for the sixth consecutive month in September, indicating that inventories exceed demand for manufactured goods.

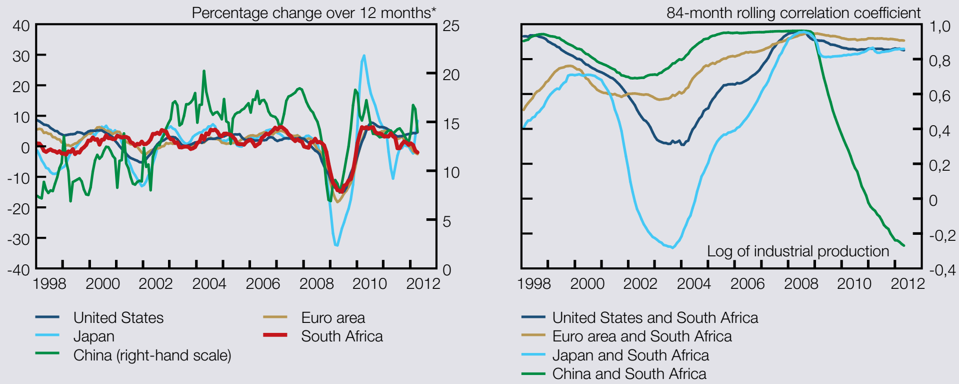
The *FNB/BER Consumer Confidence Index* (CCI) declined by 8 index points to -3 index points in the second quarter of 2012 – its lowest level since the fourth quarter of 2008 as the global financial crisis intensified – before improving slightly to -1 index points in the third quarter of 2012.

Box 5: International spillovers: Some implications for South Africa

More extensive and intensive trade and financial linkages between economies in recent decades have been the primary factors driving globalisation. These same connections between economies, however, also allow negative economic growth shocks to propagate between economies and across regions. Measuring the size of spillovers and whether they have increased in magnitude have become important to estimating the impact of contemporaneous and future shocks.

South Africa's economic cycles are very much in line with developments in advanced countries. Figure B5.1 shows that South Africa's economic activity is strongly correlated with that of the US, euro area, Japan and China. The relationship intensified during the pre-crisis period and has remained high. There has been a significant decline in the correlation coefficient with China, as Chinese economic activity remained robust while that of South Africa slowed markedly in the post-2009 period.

Figure B5.1 Trends in industrial production for South Africa, the United States, the euro area, Japan and China

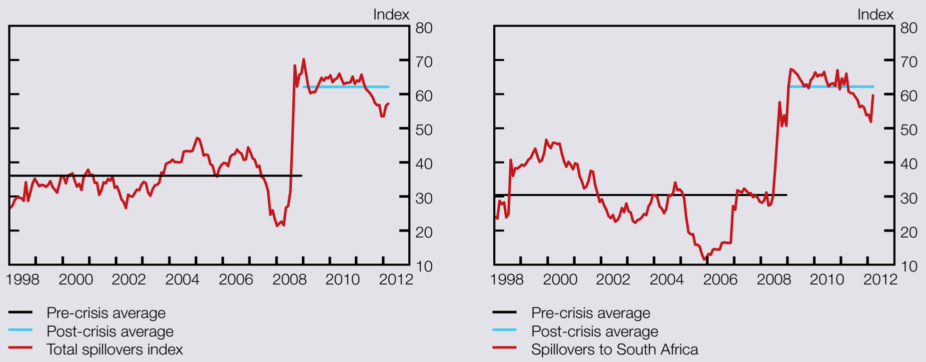


* Three-month moving average

Sources: OECD and F Ruch, "The Impact of International Spillovers on the South African Economy", South African Reserve Bank Discussion Paper 12/06 (Pretoria: South African Reserve Bank, 21 August 2012).

An estimated business cycle spillover index shows the total share of the variation in domestic industrial production that is explained by international spillovers.[1] Figure B5.2 (left-hand panel) reflects the total spillover index with the pre- and post-crisis averages for the period 1998m1 to 2012m3. The estimates show a significant rise in the magnitude of international spillovers after the start of the crisis. Over the pre-crisis period (1998 to 2008) around 36 per cent of variation in industrial production for the sample as a whole, very close to the estimate for South Africa, was due to spillover effects – increasing to around 62 per cent after the crisis.

Figure B5.2 Business cycle spillover indices



Source: F Ruch, "The Impact of International Spillovers on the South African Economy", South African Reserve Bank Discussion Paper 12/06 (Pretoria: South African Reserve Bank, 21 August 2012).

1. The index considers both the contemporaneous correlation of shocks and lagged transmission of shocks to other countries. A generalised vector autoregressive (VAR) framework in which forecast-error variance decompositions are invariant to the variable ordering is used for the estimations. (For a detailed description of the methodology, see F X Diebold and K Yilmaz, "Measuring Financial Asset Return and Volatility Spillovers, with Applications to Global Equity Markets", *The Economic Journal*, 119 (534): 158–171). The VAR is estimated using a seven-year rolling window (i.e., 84 months) to provide a time-varying analysis of spillovers.

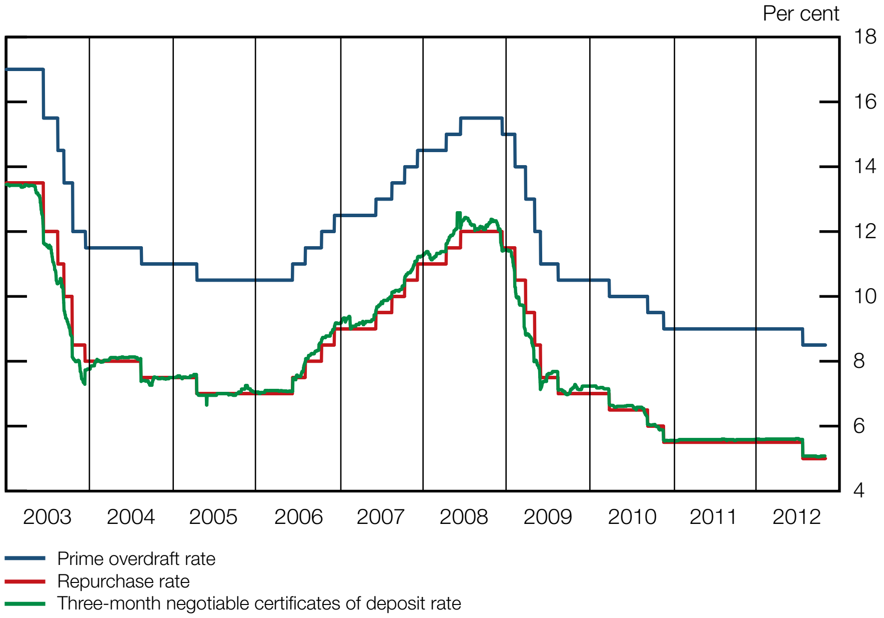
A range of factors may account for the magnitude of spillovers, including a heightened focus by economic agents on international economic linkages and global risks, financial interdependence, the role of global pricing of commodities, and greater openness as shown in the weight of cross-border trade and finance in economic activity. More integrated financial and currency markets are also likely to play an important role in increasing the size of spillovers.

Monetary policy

At the time of the publication of the previous *MPR* in May 2012, the domestic inflation outlook had improved (Table 10). Since then, global financial conditions and the outlook for global growth have deteriorated. Global inflation, however, has been kept in check. Under these conditions, monetary policy was eased in a range of countries, while others held policy steady, given already-low interest rates and mostly favourable inflation expectations. The MPC of the Bank has kept policy rates low since November 2010 and opted to lower the rate by 50 basis points in July 2012 in response to significantly better inflation projections and deteriorating growth (Figure 25). The policy stance in coming months will continue to be shaped by uncertainty derived from global developments, food and oil price shocks, exchange rate movements, and domestic considerations. Oil prices have ticked up again recently and food prices are likely to rise in coming months. Industrial unrest may result in further deterioration in economic growth and adverse wage developments.

By the **July 2012** meeting of the MPC, the outlook for the global economy had worsened, with signs of a widespread slowdown and deteriorating global financial conditions. This negative growth outlook in an environment of declining commodity prices, subdued global inflation, and harmful spillover effects between economies and regions contributed to renewed monetary policy easing in a number of both advanced and emerging-market countries.

Figure 25 The repurchase rate and other short-term interest rates



Despite some optimism early in 2012 and a reasonable growth rate of 2,7 per cent in the first quarter of the year, by mid-year it was clear that the global environment and domestic factors were weighing on domestic growth. Sectoral outcomes showed diverse trends, with mining and manufacturing output choppy. Both investment and household spending growth moderated from the final quarter of 2011 to the first quarter of 2012. Consumer and business confidence weakened, consistent with a decline in the Bank's composite leading business cycle indicator.

These factors informed the downward revision of the Bank's growth forecast from 2,9 per cent to 2,7 per cent for 2012 and to 3,8 per cent in 2013, with the projection for 2014 remaining unchanged at 4,1 per cent. The possibility of a more widespread global downturn introduced downside risks through trade links and commodity prices.

Global inflation remained benign, given the environment of weaker global growth prospects and lower commodity prices. Higher grain prices, however, driven up by the drought in the US, posed a risk to international food prices. For South Africa, the timing of the pass-through of global prices into domestic food prices remained uncertain. Domestic inflation continued its downward trend, with the year-on-year inflation rate as measured by CPI for all urban areas decelerating to 5,5 per cent in June 2012. Core inflation (excluding food, petrol and electricity from the headline CPI measure) increased in line with expectations from 4,4 per cent in May 2012 to 4,6 per cent in June.

These lower-than-expected inflation outcomes contributed to an improved forecast. Headline CPI was seen peaking at 6,1 per cent in the first quarter of 2012, followed by moderation to a low of 4,9 per cent in the second quarter of 2013 and to remain fairly stable around the 5 per cent level to the end of 2014. Inflation was expected to average 5,6 per cent in 2012, and 5,1 per cent in both 2013 and 2014.

The forecast for core inflation improved, even though the upward trend was expected to persist in the short term. Core inflation was expected to amount to 5,4 per cent in the final quarter of 2012, before declining to an average of 4,8 per cent in 2014.

Downside risks increased as the negative global growth outlook spread beyond Europe, in particular to the US, China, India and other emerging-market economies. The likely intensification of negative spillover effects to South Africa was a source of concern, given the fragility of the domestic economy. The MPC therefore regarded the balance of risks to the growth forecast to be skewed to the downside.

Inflation was expected to remain within the target range over the forecast period and the risks to the inflation forecast were seen to be relatively balanced. Lower global commodity prices would partially offset upside pressures, while demand pressures were expected to remain muted. Given these developments and prevailing conditions, the MPC was of the view that further monetary accommodation was appropriate and would not undermine the inflation outlook. The MPC therefore decided to reduce the repo rate by 50 basis points to 5,0 per cent from Friday, 20 July 2012.

Table 10 The Bank's real GDP growth and targeted inflation forecasts during 2012

Per cent

MPC meetings	Real GDP	Targeted inflation		
	2012	2012	Expected peak	Expected return to target
March..........................	3,0	6,3	2012 Q2 at 6,5 per cent	2013 Q1
May............................	2,9	6,0	2012 Q1 at 6,1 per cent	2012 Q2
			Expected low	Expected to stabilise
July	2,7	5,6	2013 Q2 at 4,9 per cent	at 5 per cent level to the end of 2014
September	2,6	5,6	2014 Q3 at 5,0 per cent*	at 5 per cent level to the end of 2014

* For the short-term, inflation is expected to peak at 5,3 per cent in the 4th quarter 2012

By the **September 2012** meeting, the domestic growth outlook had deteriorated somewhat in response to both domestic and global developments. Global growth had softened further and the outlook remained weak, with significant risks still remaining, notwithstanding significant policy initiatives. Local developments, particularly in the mining sector, suggest lower output in the near term while high-frequency data pointed to lacklustre third-quarter growth, despite the accommodative macroeconomic policy environment. The Bank's forecast for growth in 2012 was revised down to

2,6 per cent, compared with 2,7 per cent in the previous forecast, while the forecast for growth in 2013 was revised down from 3,8 per cent to 3,4 per cent with further downside risks.

Global inflation remained relatively benign, with supply shocks being the major risks. Domestically, inflation surprised on the downside, reaching a short-term low point in July before ticking up by 0,1 percentage point in August. Inflation expectations appeared to remain well contained, albeit around the upper end of the target range. Inflation was expected to remain contained within the target range over the forecast period, although the inflation outlook for 2013 was slightly worse than the previous forecast. The trajectory remained relatively flat over the entire forecast period. The Bank expected inflation to average 5,3 per cent in the final quarter of 2012, 5,2 per cent in 2013, and 5,0 per cent in 2014. Core inflation appeared well contained and was projected to peak at 4,9 per cent in the final quarter of 2012, compared with the previous forecasted peak of 5,4 per cent.

Box 6: The looming "fiscal cliff" in the United States

In the US, the current state of fiscal affairs is a federal budget deficit of 7,3 per cent of GDP at US$1,1 trillion for fiscal year 2012 (ending 30 September). Federal debt reached 73 per cent of GDP at the end of fiscal 2012 – its highest level since 1950 and nearly double the level in 2007.

A "fiscal cliff" looms in January 2013 when tax cuts are revoked and spending cuts are implemented in terms of the Budget Control Act of 2011. Table B6.1 shows the Congressional Budget Office's analysis of scenarios where current law is applied as is and where an alternative is created from the outcome of negotiations between the relevant parties in the US Congress. Intense political debate is expected before January to attempt to phase in the fiscal measures and reduce the negative effects on the economy, and the actual outcomes are contingent on these discussions.

Table B6.1 US Congressional Budget Office projections

	2012	2013	
	Current	Baseline[3]	Alternative[4]
Budget projections (US$ billions)			
Revenue	2 435	2 913	2 583
Expenditure	3 563	3 554	3 621
Deficit/Surplus (-/+)	-1 128	-641	-1 037
Outstanding debt	11 318	12 064	12 460
Ratios (percentage of GDP)			
Deficit/Surplus	-7,3	-4,0	-6,5
Outstanding debt	72,8	76,1	78,6
Economic projections (per cent)	2012	2013	
Real GDP	2,1	-0,5[1]	1,7
Unemployment rate	8,2	9,1[2]	8,0

Source: Congress of the United States, Congressional Budget Office (CBO), "An Update to the Budget and Economic Outlook: Fiscal Years 2012 to 2022", August 2012, http://www.cbo.gov/publication/43539, accessed 1 October 2012.

1. Fourth quarter to fourth quarter percentage change.
2. Fourth quarter level in per cent.
3. Baseline projection of changes contained in current legislation.
4. All expiring tax provisions are extended indefinitely except the payroll tax reduction in effect in calendar years 2011 and 2012; alternative minimum tax (AMT) is indexed for inflation after 2011; Medicare payment rates are held constant; automatic spending reductions are not implemented but the capped discretionary appropriations remain in place.

Demand pressures were expected to remain benign, with cost–push pressures from food and petrol considered to be the main upside risks to the inflation outlook. These price increases were expected to filter through to domestic consumer prices in coming months. The exchange rate continued to pose a potential risk to the inflation outlook, particularly in the event of an unsustainable widening of the deficit on the current account of the balance of payments. Against this backdrop, the MPC assessed the risks to the inflation forecast to be more or less balanced.

Although global and domestic growth conditions remained challenging in a fairly benign inflation environment, the MPC was of the view that a further reduction in the repo rate was not appropriate and left the rate unchanged at 5,0 per cent per annum.

Expectations and the Bank's inflation forecast

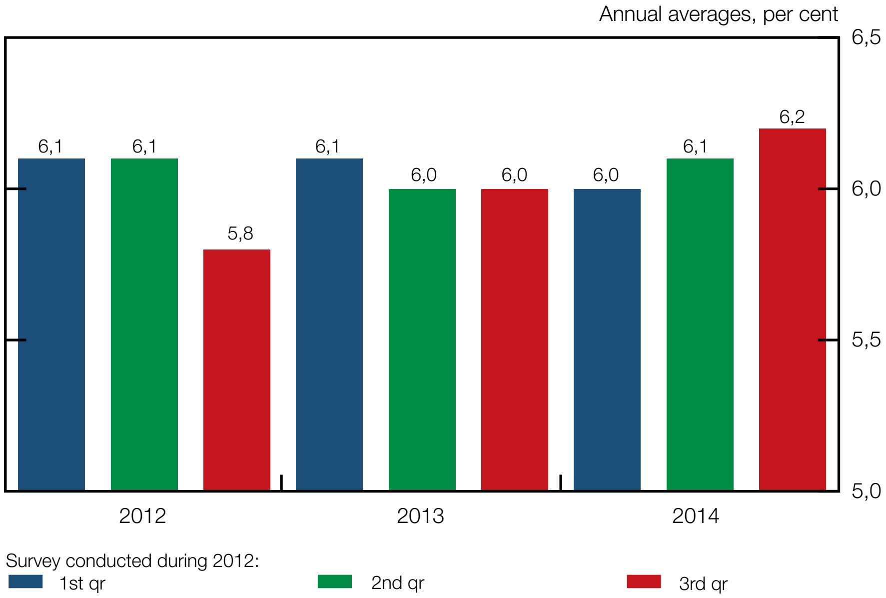
Given prospects, risks and uncertainties, the outlook for inflation is presented in this section.

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 remain well anchored even though they continue to straddle the upper limit of the target range.

Measured headline CPI inflation decelerated by 1,2 percentage points from April 2012 to 4,9 per cent in July and then increased by 0,6 percentage points to 5,5 per cent in September. Expected inflation continues to straddle the upper limit of the target range. The BER survey of inflation expectations undertaken during the third quarter of 2012 shows combined average expected inflation for 2012 of 5,8 per cent (Figure 26). This compares favourably with the 6,1 per cent surveyed in both the first and second quarters. Expected inflation remained unchanged at 6,0 per cent in 2013, followed by a slight increase to 6,2 per cent in 2014 – indicating "sticky" longer-term inflation expectations.

Figure 26 BER surveys of headline CPI inflation expectations



Source: Bureau for Economic Research, Stellenbosch University

Lower expected inflation in 2012 involved a decline of expectations to within the target by all subgroups. Trade union officials revised their inflation expectations for 2014 higher to 6,9 per cent.

Inflation expectations, as surveyed by Reuters (Table 11), suggest that the average year-on-year percentage change in CPI declined to August and levelled out in September 2012. The quarterly average of the year-on-year percentage change in CPI is expected to remain within the target through to the second quarter of 2014.

Table 11 Reuters survey of CPI inflation forecasts: September 2012*

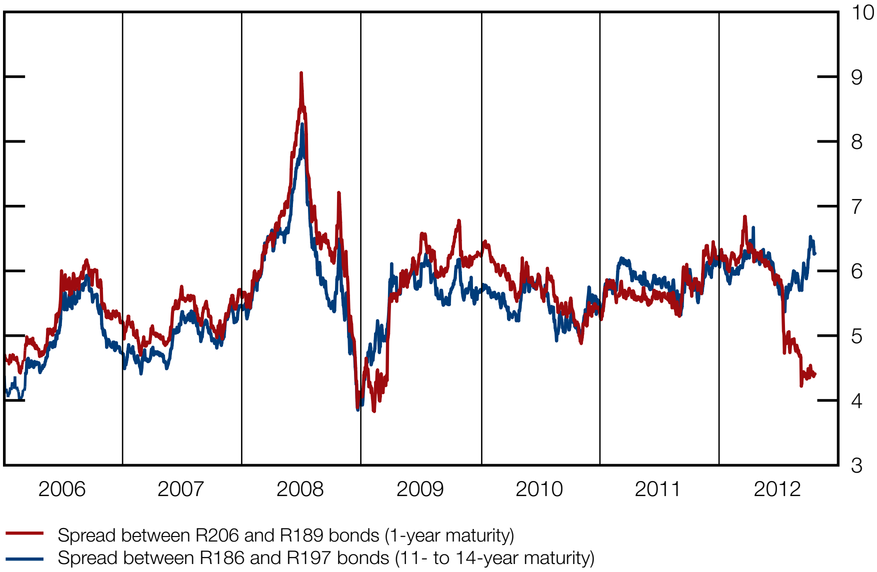
	2012			2013			2014		
Mean	[6,0]	(5,5)	5,5	[5,5]	(5,3)	5,3	[5,5]	(5,4)	5,4
Median	[6,0]	(5,5)	5,5	[5,6]	(5,4)	5,4	[5,7]	(5,4)	5,4
Highest	[6,3]	(6,5)	6,5	[6,6]	(6,2)	6,2	[7,1]	(6,0)	6,0
Lowest	[5,0]	(5,4)	5,0	[4,7]	(4,5)	4,6	[4,9]	(4,4)	4,8
Number of forecasters	[19]	(17)	20	[19]	(17)	20	[13]	(13)	16

* April [ ] and August ( ) 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. Short-term break-even inflation rates have declined since the May 2012 *MPR*, reflecting more favourable near-term inflation expectations. However, longer-term break-even inflation rates returned to May 2012 levels reflecting, among other factors, expectations of higher future inflation.

Figure 27 Break-even inflation rates



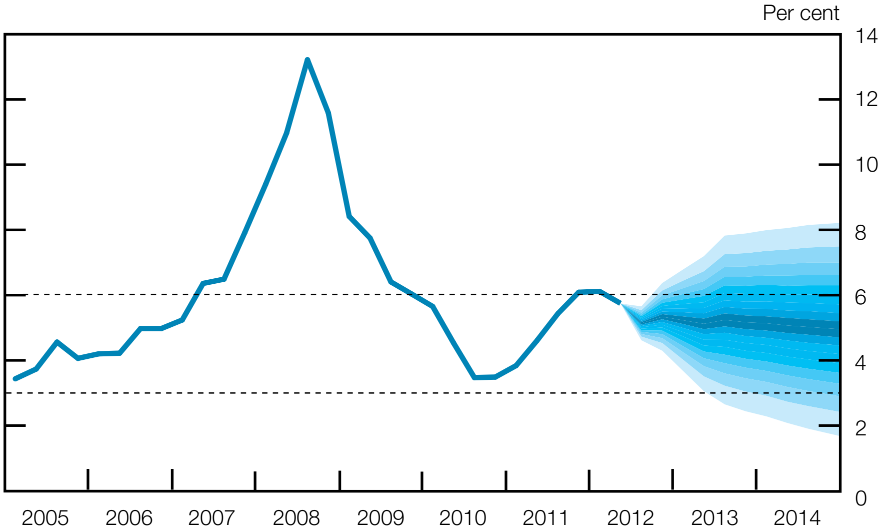
Sources: JSE Limited and own calculations

The South African Reserve Bank inflation forecast

At the time of the May 2012 *MPR* the Bank's inflation outlook had improved at both the March and May meetings of the MPC. The outlook improved even further at the July meeting in terms of both the projected peak and the time profile for returning back to within the target band. However, at the September 2012 meeting of the MPC, the Bank's outlook for targeted inflation reflected a moderate deterioration over the short to medium term, with a relatively flat trajectory for the remainder of the forecast period. CPI inflation is expected to have troughed in the third quarter of 2012 at 5,1 per cent, before rising marginally in the fourth quarter of this year. Headline CPI is then expected to gradually converge to 5,0 per cent over the remainder of the forecast period to 2014.

The most recent projections of the Bank's core quarterly forecasting model, presented to the MPC meeting on 18–20 September 2012, are reproduced in the form of a fan chart in Figure 28. The CPI inflation forecast of the Bank has been revised marginally upwards since the MPC's previous meeting in July 2012, with aggravated upside pressures expected from the significant increase in the petrol price and the anticipated acceleration in domestic food prices.

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*).

Conditional on an unchanged repurchase rate, headline CPI inflation is consequently expected to average 5,6 per cent in 2012, and 5,2 per cent and 5,0 per cent in 2013 and 2014 respectively. The Bank's forecast of core inflation (excluding food, petrol and electricity prices) has improved slightly. While an upward trend is still expected to prevail in the short term, core inflation appears to be well contained with a peak of 4,9 per cent expected in the final quarter of 2012, compared to the previous forecast peak of 5,4 per cent. This measure is now expected to average 4,6 per cent in both 2013 and 2014. (*See Box 7 for an updated evaluation of the accuracy of the Bank's inflation forecasts.*)

Given the central projection for targeted inflation as the most likely outcome, the risks to the forecast in Figure 28 are viewed as being more or less balanced. A number of supply-side risks exist from higher petrol prices and an anticipated increase in food prices, but these are offset by benign demand pressure and excess capacity. Lastly, expectations of a widening current-account deficit could contribute to a depreciation of the rand which, in turn, has the potential to aggravate inflationary pressures over the forecast period to 2014.

Box 7: An accuracy analysis of inflation forecasts

Monetary policy decisions require forward projections of key economic variables as one input to the decision-making process. These forecasts are created by statistically estimating future values based on past measured values of key variables and put together into economic models that are imperfect facsimiles of the real world. Forecast outcomes are uncertain because errors arise from a variety of sources, including incomplete or misspecified economic relationships, data revisions, unforeseen shocks to the economy, and incorrect or partial assumptions.

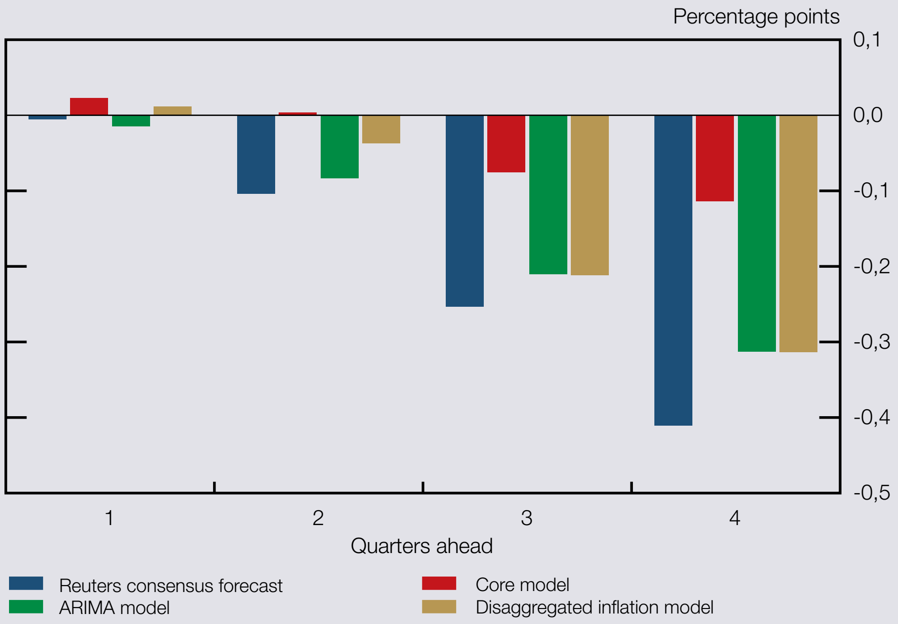
This inflation forecast accuracy analysis compares the South African Reserve Bank's (the Bank) forecasts of headline consumer price inflation produced by its core model, the autoregressive integrated moving average (ARIMA) model and the disaggregated inflation model to the Reuters consensus forecast and both relative to actual measured inflation outcomes. Since the size of the errors obtained from forecasts (percentage points in Figure B7.1 of this analysis) is relative to the original (inflation) data, the prediction errors from a particular model can only be assessed by either comparing them to those of a naïve forecast or to those of other models or institutions. It is, furthermore, reasonable to expect that the model-based forecasts of inflation produced by the Bank should, on average, be better than other forecasts, both naïve and those produced by other institutions.

The core model is a simultaneous-equation macroeconometric model consisting of 27 stochastic equations and several identities. The ARIMA model is based on the historical properties of the series, providing relative accuracy over the very short term. The disaggregated inflation model forecasts the main components of the headline consumer price index (CPI) individually and then aggregates them with the appropriate weights to calculate the forecast of the headline CPI. The Reuters survey is published monthly and contains forecasts of several macroeconomic variables over a relatively long time span. The forecasters consist of economists from major investment banks, corporations, consulting firms and academic institutions, using different methods and models to produce their forecasts. On average, the survey contains 22 forecasts each month, and most of the forecasters have participated in the survey for several years.

A number of descriptive statistics are used in the assessment of the accuracy of the inflation forecast. The most frequently used error measures are the *average forecast error* (measuring projection bias in terms of systematic over- or underestimation) and the *root mean square error* (relating errors to the variability of the series).

The average forecast errors for the period May 2003 to August 2012, relative to actual inflation outcomes, are negative and biased downwards (Figure B7.1).

Figure B7.1 Average forecast error



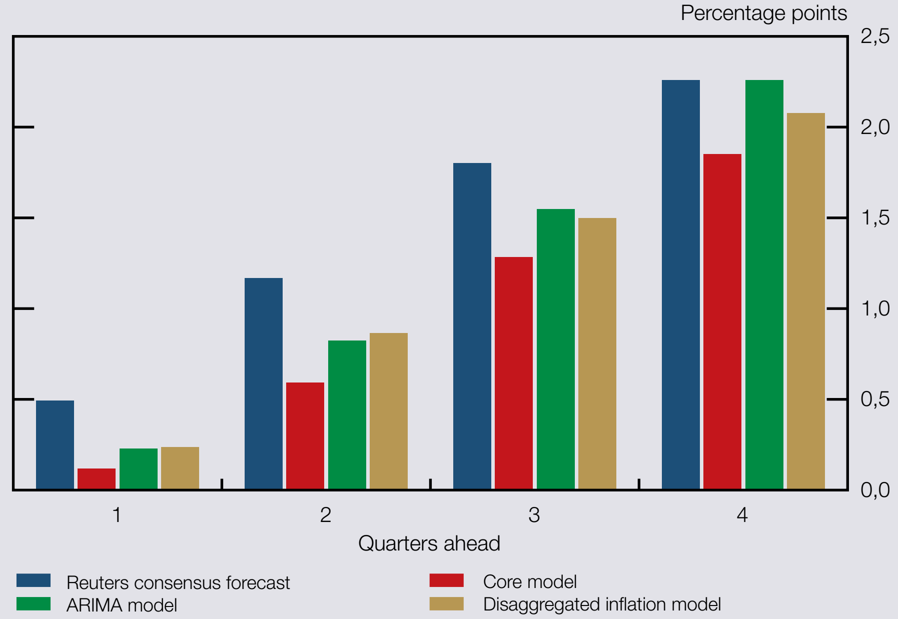
Sources: Reuters and own calculations

This bias indicates that both the Bank and the Reuters participants, on average, underestimated the actual outcome of headline consumer price inflation over the medium-term forecast horizon, that is, two to four quarters ahead. These errors were primarily caused by supply-side shocks in 2007 and 2008, including commodity (oil and food) prices that sharply accelerated quarterly rates of year-on-year headline inflation (exceeding 13 per cent in the third quarter of 2008). The persistence of these shocks resulted in a series of large consecutive negative forecast errors that dominated and drove up the average forecast error. Once the supply-side shocks dissipated and more stable inflation rates were achieved, the forecast errors became smaller and less biased – more evenly distributed around zero.

A fundamental difference between the forecasts of Reuters and those produced by the Bank is that the core model employs a constant interest rate assumption, rather than a "most-likely outcome-based" interest rate forecast.[1] The reason for this constant interest rate assumption is to enable the MPC to assess the impact of all other assumptions and other changes on the inflation rate between meetings. The constant interest rate assumption can lead to biases in forecasts in both directions, and should generate a slightly better performance by the Bank's forecasts due to information asymmetries.

A second summary statistic used in error analysis is the root mean square error, which gives a good indication of the magnitude of the error.[2] The root mean square error, as shown in Figure B7.2 indicates that the Bank's models are generally considerably more accurate than the Reuters consensus forecast. However, as the forecast horizon extends and uncertainty increases, the difference in the forecast accuracy narrows. When looking at the size of the four-quarters-ahead root mean square error, it can therefore be expected that the forecast of inflation one year ahead, using the core model, will be incorrect by a margin of slightly more than 1,8 percentage points, while the forecast-error of Reuters[3] will be approximately 2,3 percentage points.

Figure B7.2 Root mean square error



Sources: Reuters and own calculations

1. Implying that the interest rate does not change over the forecast period.
2. The root mean square error is calculated in three steps. Firstly, the forecast errors are calculated and then squared. Secondly, the average of these numbers is calculated and, finally, the square root is taken to bring the answer back to the same unit of measure as the original data.
3. The Bank's forecast performance is also compared to the 16 individual forecasters or institutions that regularly participate in the Reuters survey. However, the Reuters consensus forecast is treated in this instance as a forecasting entity in its own right. It is therefore not the average of the forecast errors of the selected participants in the Reuters survey.

The size of this error reflects South Africa's relatively small and open economy, subject to regular and substantial external shocks. These shocks are mostly commodity price- and exchange rate-related, and pose significant challenges to forecasting inflation rates over most horizons.

The Bank's forecasting performance is also compared with the 16 individual forecasters or institutions that participate in the Reuters survey. In Table B7.1 the root mean square errors of the various forecasts are compared over the one- to four-quarters-ahead forecast horizons.

Table B7.1 Forecasting error comparison

Root mean square error

	Quarters ahead			
	1	2	3	4
ARIMA model	0,2275	0,8223	1,5482	2,2575
Disaggregated inflation model..........................	0,2363	0,8637	1,4973	2,0773
Average of top 4 forecasts from Reuters	0,4675	1,1416	1,7466	2,1839
Average of total Reuters consensus forecasts...	0,4922	1,1686	1,8006	2,2597

Sources: Reuters and own calculations

Assessment and conclusion

The global crisis has created major challenges for all countries, and their fiscal and monetary authorities. One critical challenge – that of global deflation – appears to have been averted by the combination of fiscal support and monetary accommodation. Yet, faltering and weak economic growth outcomes in most of the world suggest that some distance needs to be travelled before economic growth returns to higher sustainable rates. A combination of deleveraging, higher productivity and job creation, relative price adjustments and reforms supportive of private-sector growth will be needed to allow fiscal deficits and monetary accommodation to be unwound in coming years. At a national level, macroeconomic policies should support those outcomes by creating stability and greater certainty wherever possible. At an international level, co-ordination of much-needed exchange rate adjustments would help to provide confidence that deficit economies will be able to grow in future and would increase standards of living globally.

Better economic growth and greater macroeconomic policy co-ordination could set the broad framework for building confidence as other challenges are addressed. Financial regulations and the restructuring of financial systems will take time to complete. Re-creating social consensus in many countries is needed to reconnect governments and citizens, and this too will take time in a volatile environment. Less amenable to government or central bank action, periodic shocks to the supply of agricultural products, food and oil will remain a source of turbulence.

It should perhaps also not be too surprising that in an environment of weak growth, social dislocation and uncertainty that competing visions of how to resolve challenges are asserted. This has lent, and will continue to lend, itself to policy uncertainty in many places and, in some instances, generate considerable economic and market volatility.

Over the course of 2012, the global economy has slowed amid negative shocks and spillovers and heightened concern over policy direction. This has also softened inflationary pressures generally, despite spikes in food and oil prices, with only a few countries citing concerns about near-term inflationary pressures.

With that context in mind, monetary policy in South Africa has remained accommodative, but consistent with keeping inflation under control and inflation expectations well anchored. The repurchase rate was lowered to 5,5 per cent in November 2010 and then again at the July 2012 meeting of the MPC. This stability in rates stands in some contrast to more frequent policy rate movements in other countries. In 2011, many central banks tightened policy as inflationary pressures surfaced. Then in 2012, major central banks of advanced countries pursued aggressive easing and unconventional measures to arrest the deceleration in growth, while others held rates steady at already low levels or reduced policy rates even further.

The MPC decision of July 2012 was shaped by inflation surprising on the downside to well within the target range, weakening confidence and high-frequency data pointing to a slowdown in domestic growth. Since then the Bank's growth outlook has been revised marginally lower, while the short- to medium-term inflation outlook deteriorated somewhat – though remaining within the target range.

Including both domestic and international factors, growth risks remain skewed to the downside while inflation risks appear fairly evenly balanced. Recent volatility in the mining sector and a weaker secondary sector suggest lower output growth for the economy as a whole in the third and likely fourth quarters of 2012. Greater stability in the wage and industrial relations environment would boost confidence and prove supportive of growth across the economy in coming months.

Exogenous price pressures coming from higher oil and food prices are expected to continue to feed through to inflation outcomes in the near future. The exchange rate has responded to the widening current-account deficit, volatile capital flows and changes to sovereign ratings, and continues to pose a potential risk to inflation.

Monetary policy decisions over the past year have sought to provide stability through a period of extraordinary uncertainty, inconsistent inflation pressures and a faltering global economic recovery. These decisions are made within an inflation-targeting policy framework that enables the MPC to address negative and positive shocks to the economy flexibly, helps to smooth the growth of output, and focuses public expectations about the future trajectory of price inflation.

Statement of the Monetary Policy Committee

19 July 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), there have been further indications of a generalised slowdown in the global economy, amid the continuing risks posed by the banking and sovereign debt crisis in the eurozone. This negative outlook has contributed to renewed monetary policy easing in a number of countries, including in emerging-market economies, in an environment of declining commodity prices and subdued global inflation.

Domestic inflation has continued its downward trend, and is expected to remain within the target range over the forecast period. However, despite some moderate employment creation over the past year, the economic growth outlook appears to be threatened by global developments and deteriorating domestic business and consumer confidence.

The year-on-year inflation rate as measured by the consumer price index (CPI) for all urban areas was 5,5 per cent in June 2012, down from 5,7 per cent in May. The categories of food, housing and utilities, and transport together accounted for 3,5 percentage points of the inflation outcome. Food prices increased by 6,0 per cent, petrol by 14,2 per cent and electricity by 17,1 per cent on a year-on-year basis. Core inflation, as measured by the exclusion of food, petrol and electricity from CPI, increased in line with expectations from 4,4 per cent in May to 4,6 per cent in June. Administered prices, excluding petrol, increased at a year-on-year rate of 8,7 per cent in both May and June.

Year-on-year producer price inflation moderated further, measuring 6,6 per cent in both April and May 2012, its lowest rate of increase since April 2011. More than half of this outcome was accounted for by mining and quarrying and electricity price increases. Food price inflation continued its downward trend with agricultural prices increasing at a year-on-year rate of 1,7 per cent in May, while manufactured food prices increased by 8,4 per cent.

The inflation forecast of the Bank has been revised downwards since the previous meeting of the MPC, apart from the final quarter of 2014 when a slightly higher outcome is forecast. With inflation expected to have peaked at an average of 6,1 per cent in the first quarter of 2012, it is now expected to continue to moderate over the next few quarters, reaching a low of 4,9 per cent in the second quarter of 2013. Inflation is then expected to remain fairly stable around the 5 per cent level to the end of 2014. Inflation is expected to average 5,6 per cent in 2012, and 5,1 per cent in both 2013 and 2014. The improved forecast is mainly due to lower-than-expected recent inflation outcomes.

The forecast for core inflation is also more favourable, although the upward trend is expected to continue in the short term. Core inflation is expected to measure 5,4 per cent in the final quarter of 2012 and the first quarter of 2013, before declining and averaging 4,8 per cent in 2014.

Inflation expectations as reflected in the survey conducted by the Bureau for Economic Research at Stellenbosch University in the second quarter of 2012 were almost unchanged since the previous quarter and remain anchored at around the upper end of the target range. On average, respondents expect inflation to average 6,1 per cent in 2012 and 6,0 per cent and 6,1 per cent in the next two years respectively. The break-even inflation rates declined across all maturities since the previous meeting of the MPC to within the target range.

The outlook for the global economy has worsened somewhat since the previous meeting of the MPC, with mounting evidence of a broad-based global slowdown. Negative indicators include a fall in the global manufacturing Purchasing Managers Index (PMI) to its lowest level in three years. The lack of meaningful progress towards a resolution of the eurozone crisis continues to be a source of global instability and risk, despite initiatives to stabilise the banking sector. The growth outlook for the region remains negative, as fiscal austerity measures and bank deleveraging continue to impact adversely on growth and on unemployment rates that have reached new euro-era highs. In the first quarter of 2012, most of the eurozone members recorded negative or marginally positive growth, particularly those in the periphery. The United Kingdom (UK) economy is currently also experiencing a recession.

The United States (US) economy slowed in the second quarter and the outlook has deteriorated. Concerns relating to the so-called fiscal cliff (the possible sharp contraction of fiscal policy in 2013) are beginning to weigh on consumption and investment decisions, and these pressures are expected to intensify during the second half of this year. Any resolution of this issue seems unlikely before the end of 2012.

Spill-over effects have also been felt in emerging markets. China recorded a growth rate of 7,6 per cent in the second quarter of 2012, the slowest since early 2009, amid a property-market downturn and weak exports. It is still unclear if the policy responses of the Chinese authorities will be sufficient to contain this trend. Materially slower growth has also been recorded in India and Brazil.

In response to these developments, monetary policy has been eased in a number of both advanced and emerging-market countries. In the UK, the Bank of England increased the size of its asset purchase programme, and although the Federal Open Market Committee has not resumed its programme of quantitative easing, the maturity extension programme has been extended and monetary policy is expected to remain highly accommodative for a prolonged period.

Global inflation continues to be benign, given the slowing growth prospects and lower commodity prices. One area of risk to the inflation outlook emanates from the higher grain prices in response to the continuing drought in the US.

The increasingly unfavourable and volatile global backdrop continues to impact on the rand exchange rate, primarily through changing risk perceptions in global financial markets. Since the previous meeting of the MPC, exchange rate volatility has increased and the rand has fluctuated in a range of between R8,06 and R8,70 against the US dollar, partly in response to fluctuations of the euro against the US dollar. The rand has, however, appreciated since the previous meeting by around 3,4 per cent against the US dollar, by 5,5 per cent against the euro and by 3,7 per cent on a trade-weighted basis.

During this period the rand was also impacted by strong inflows into the domestic bond market, following the confirmation that South Africa will be included in the Citibank World Government Bond Index (WGBI) from late September. Since the beginning of the year, non-residents have been net purchasers of South African government bonds to the value of R60,1 billion. In June alone net purchases of bonds by non-residents amounted to R21,7 billion, the second-highest monthly inflow ever into the bond market. Much of this is estimated to have been real money inflows, which possibly contributed to the generally appreciating exchange rate trend in that month and declining yields in the domestic government bond market. These inflows are expected to persist for some time after the actual inclusion in the index, and will not only help fund the fiscal deficit but also the widening current-account deficit of the balance of payments.

The rand is expected to remain vulnerable to erratic shifts in global risk perceptions. While a deterioration of global risk sentiment could cause further rand weakness, this could be offset to some extent by continued inflows into the bond market or the possible resumption of quantitative easing in the US.

The domestic economy appears to be slowing further, following the 2,7 per cent annualised growth rate recorded in the first quarter of 2012. The Bank's forecast of gross domestic product (GDP) growth for 2012 has been revised down from 2,9 per cent to 2,7 per cent, and to 3,8 per cent in 2013. The forecast for 2014 remains unchanged at 4,1 per cent. However, given the possibility of a more widespread global downturn, the risks to this forecast are seen to be on the downside, with the external impact coming through trade links and commodity prices. The Bank's estimate of the output gap is unchanged at around 3,5 per cent. The composite leading business cycle indicator of the Bank declined for the second consecutive month in April, indicative of the uncertain and subdued outlook.

The mining sector is expected to achieve positive but modest growth in the second quarter of 2012 following the 16,8 per cent annualised contraction in the first quarter. In May the three-month-to-three-month growth was 1,3 per cent and 0,8 per cent on a year-on-year basis. Despite this improvement, the mining sector is expected to face a number of challenges, including declining commodity prices, and further domestic cost pressures which have already resulted in stresses for some platinum mines.

The manufacturing sector, which grew at an annualised rate of 7,7 per cent in the first quarter of 2012, is showing some signs of moderation in the second quarter. In May the sector grew at a year-on-year real rate of 4,2 per cent, but contracted by 0,9 per cent on a three-month-to-three-month basis. The Kagiso/BER Purchasing Managers Index fell to 48,2 index points in June, its lowest level since August 2011, as the sub-indices for business activity and new sales orders declined further. This is consistent with the weaker RMB/BER Business Confidence Index which declined by 11 index points to 41 in the second quarter.

Growth in real gross fixed capital formation lost momentum, having moderated from an annualised 7,2 per cent rate in the final quarter of 2011 to 5,3 per cent in the first quarter of 2012. Of concern is the substantial decline in the growth of private-sector fixed capital formation to 1,8 per cent, following successive quarters of steady increases in excess of 5 per cent during 2011. This development, if sustained, will contribute to the fragility of the growth outlook. By contrast, increases of 13,1 per cent and 9,3 per cent were recorded by public corporations and general government, reflecting capital spending on infrastructure. This was consistent with the improvement in the FNB/BER Civil Construction Confidence Index. However, the FNB Building Confidence Index declined further and remains at low levels, with the real value of building plans passed declining by 8,7 per cent on a three-month-to-three-month basis in April.

Final consumption expenditure by households, which grew by 5,0 per cent in 2011, also appears to be slowing somewhat, with growth having moderated to 3,1 per cent in the first quarter of 2012. While real retail sales increased by 6,4 per cent on a year-on-year basis, the momentum appears weaker, with sales declining by 0,8 per cent on a month-on-month basis in May, while in the three months to May compared with the previous three months, sales increased by 0,4 per cent. The FNB/BER Consumer Confidence Index deteriorated in the second quarter, with the index declining from 5 to -3, the lowest level of the index since 2008. According to the RMB/BER Business Confidence Index, confidence of retailers declined markedly during the same period to its lowest level in two years. Somewhat anomalously, new vehicle sales have remained relatively buoyant.

Growth in credit extension to the private sector remains relatively subdued, with twelve-month growth in total loans and advances to the private sector increasing by 8,0 per cent in May. Growth in credit extension to the corporate sector moderated during April and May, while credit extension to households continued to increase, with growth over twelve months of 7,5 per cent in May. This includes the growth in general loans (including personal loans) which has shown a softer trend but still at elevated levels of 30,4 per cent. Mortgage advances remained subdued, reflecting continued weakness in the housing market, while instalment sale credit and leasing finance increased steadily in line with positive vehicle sales. Despite the increase in personal loans, household debt to disposable income declined further to 74,7 per cent in the first quarter of 2012. Personal loans now account for 11,0 per cent of total household debt, but have not led to excessive consumption expenditure.

Formal-sector employment creation has remained slow. According to the Quarterly Employment Statistics (QES) of Statistics South Africa, in the four quarters to the first quarter of 2012, just over 100 000 jobs were created, representing an increase of 1,2 per cent.

The outlook for wage growth is uncertain. Growth in nominal remuneration per worker declined from 6,8 per cent in the year to the fourth quarter of 2011, to 6,6 per cent in the first quarter of 2012, while unit labour cost increases declined from 5,8 per cent to 5,7 per cent. This trend may have been reversed recently. According to Andrew Levy Employment publications, the average wage settlement rates amounted to 7,7 per cent in the first half of 2012. The outcome of the public-sector wage settlement will be important in this respect.

Administered price increases have remained relatively unchanged, but we still await Nersa's determination of tariff increases to be granted to Eskom for the coming years. Some of the other important cost-push factors may have reached a lower turning point recently. Domestic food price inflation is still expected to moderate further in the short term, but the medium-term outlook is clouded by the drought-induced increases in maize, wheat and soya bean prices in the US. This has already impacted on domestic prices of both maize and wheat, and poses some upside risk to the inflation outlook.

Brent crude oil prices also rebounded from their recent lows of around US$90 per barrel, partly due to geopolitical factors. Currently oil is trading at around US$105 per barrel, well below the levels of almost US$130 per barrel that prevailed earlier this year, and prices are expected to be constrained by weak global demand. The domestic petrol price has declined by a total of R1,40 per litre in the past two months, although a slight increase may be recorded next month.

The MPC is concerned about the increased downside risks posed to the domestic economy by global developments. The problems in the eurozone are likely to persist for a protracted period and since the previous meeting the negative growth outlook has spread beyond Europe, in particular to the US, China, India and other emerging-market economies. The negative spill-over effects to South Africa are likely to intensify. This unfavourable outlook is reinforced further by the fragile domestic private-sector investment and consumption trends which are confirmed by declining business and consumer confidence. The MPC therefore sees the risks to the growth forecast to be on the downside.

The MPC also considered the inflation environment to have improved somewhat, notwithstanding possible pressures coming from food and energy prices in the medium term. Upside pressure on inflation could be offset to some extent by lower global commodity prices, while demand pressures are expected to remain muted. Although the exchange rate is likely to remain vulnerable to global risk aversion, the rand has shown some resilience in recent weeks. The MPC expects inflation to remain within the target range over the forecast period and sees the risks to the inflation forecast to be relatively balanced.

In the light of these developments the MPC views the prevailing conditions to be appropriate for further monetary accommodation to the economy that will not undermine the inflation outlook. The MPC has therefore decided to reduce the repurchase rate by 50 basis points to 5,0 per cent from Friday, 20 July 2012. While it is recognised that such a move on its own will not overcome the challenges facing the economy, it is felt that it can help alleviate some of the pressures faced by some sectors. A sustained increase in the potential output of the economy will require a concerted and co-ordinated effort from both government and the private sector. The MPC will continue to monitor both domestic and global developments, and will act appropriately in line with its mandate.

Statement of the Monetary Policy Committee

20 September 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, the global growth outlook has weakened further. However, the near-term risks to global financial markets arising from the eurozone debt crisis seem to have subsided somewhat following the announcement of the bond purchase programme by the European Central Bank. While this appears to be a positive step, significant risks still remain. At the same time, the global environment has been impacted by further monetary easing in the United States (US) and Japan.

Domestically, inflation continued to surprise on the downside, although it appears that the short-term low point could have been reached. Despite a number of upside supply-side risks, inflation is expected to remain contained within the target range over the forecast period. The growth outlook, however, has deteriorated somewhat in response to both domestic and global developments.

The year-on-year inflation rate as measured by the consumer price index (CPI) for all urban areas was 5,0 per cent in August 2012; up from 4,9 per cent in July. The categories of food, housing and utilities, and transport together accounted for 3,0 percentage points of the inflation outcome. Food prices increased by 5,1 per cent, petrol by 9,3 per cent and electricity by 10,0 per cent. Core inflation, as measured by the exclusion of food, petrol and electricity from CPI, measured 4,6 per cent; up from 4,5 per cent in July. Administered prices excluding petrol increased at a year-on-year rate of 7,5 per cent.

Year-on-year producer price inflation moderated to 5,4 per cent in July 2012, having measured 6,6 per cent in each of the previous three months. A reversal in the downward trend in food price inflation was observed, although still at relatively low levels, with agricultural prices increasing at a year-on-year rate of 3,0 per cent in July, compared with a recent low of 1,7 per cent in May and 2,2 per cent in June. Manufactured food prices increased by 7,7 per cent and 8,0 per cent in June and July respectively.

The inflation forecast of the Bank reflects a moderate deterioration for 2013 compared with the previous forecast, and a relatively flat trajectory over the entire forecast period. Inflation is now expected to average 5,3 per cent in the final quarter of 2012, 5,2 per cent in 2013 and 5,0 per cent in 2014. The near-term deterioration is mainly due to higher expected petrol and food inflation. Core inflation appears to be well contained, with a peak of 4,9 per cent expected in the final quarter of 2012, compared with the previous forecast peak of 5,4 per cent. This measure is now expected to average 4,6 per cent in both 2013 and 2014.

Inflation expectations as reflected in the survey conducted by the Bureau for Economic Research (BER) at Stellenbosch University in the third quarter of 2012 were again virtually unchanged, particularly for 2013 and 2014, and remain anchored at around the upper end of the target range. Respondents expect inflation to average 5,8 per cent in 2012 and 6,0 per cent in 2012 and 6,2 per cent in 2014 respectively.

There is, however, a divergence of views between the respondents: while all categories of respondents expect average inflation to be within the target range in 2012, trade union officials and business executives expect it to exceed the upper end of the target range in both of the following two years. This is in contrast to financial analysts who expect inflation to average just over 5 per cent in both of these years.

The survey conducted by Reuters indicates that market analysts expect inflation to average 5,3 per cent in 2013 and 5,4 per cent in 2014. Market expectations as reflected in the break-even inflation rates initially increased after the previous meeting of the MPC, but have since declined somewhat. Expectations over the various maturities continue to reflect expectations of inflation within the target range.

The global growth outlook remains weak, notwithstanding significant policy initiatives announced by the United States Federal Reserve (the Fed), the ECB and Bank of Japan, and the initial positive reaction from global financial markets. The decision by the Fed to engage in a further round of quantitative easing was prompted by an assessment that the expected growth trajectory was not strong enough to generate a sustained improvement in the labour market. The US economy grew at an annualised rate of 1,7 per cent in the second quarter of 2012, and the outlook is clouded by the risk of a severe fiscal contraction early next year. The outcome of the US elections in November 2012 will be critical in determining the prospects for a favourable resolution of this "fiscal cliff". In the meantime the attendant risks have had an adverse impact on investment expenditure in the US and various indicators of industrial output point to a subdued growth outlook.

In the eurozone the immediate risks posed by the continuing debt crisis appear to have abated somewhat with the announcement by the ECB of its Outright Monetary Transaction (OMT) or bond purchase programme. In addition, two important event risks were also avoided following the decision of the Federal Constitutional Court in Germany to uphold the ratification of the treaty to establish the European Stability Mechanism, although under specific conditions, and the pro-euro outcome of the Dutch election. The precise workings of the OMT, particularly the issues relating to conditionality, are still uncertain, but the initiative has bought some time to implement more permanent solutions. Despite this potential progress, the risk of a Greek exit from the eurozone remains, and growth prospects in the region have deteriorated following the overall contraction in the second quarter of this year, continued bank deleveraging and a further decline in cross-border lending. The UK economy has contracted for three consecutive quarters, while Japanese economic growth also moderated markedly in the second quarter. The impact of the US actions on the Japanese yen prompted a surprise increase of ¥10 trillion by the Bank of Japan in the size of its asset purchase programme. Although the yen depreciated in response, the impact appears to have been short-lived.

Growth momentum is also somewhat weaker in some of the systemically important emerging-market economies, particularly in China, Brazil and India, in the face of weakening external demand. A number of countries have responded by easing monetary policy and, as in the case of Brazil, by introducing measures to stimulate domestic demand and competitiveness.

Global inflation remains relatively benign, given the weak demand, but supply-side shocks in the form of higher food prices, due to droughts in the US and some parts of eastern Europe, and resilient international crude oil prices pose a risk to the outlook. Both of these shocks are not only a risk to inflation, but could also represent an additional drag on near-term growth; a combination that poses enormous challenges to monetary policy.

The rand exchange rate has fluctuated generally within a range of R8,10 and R8,50 against the US dollar since May, and continues to be affected by changing risk perceptions in global financial markets. More recently, the rand appears to have decoupled from the euro and reacted to domestic issues, including the wider-than-expected current-account deficit and developments in parts of the mining sector, following the tragic events at Marikana.

The rand has, however, been underpinned, to some extent, by continued inflows into the domestic bond markets in the lead-up to South Africa's inclusion in the Citi World Government Bond Index (WGBI). Non-resident purchases of South African bonds have amounted to R12,1 billion since the previous meeting of the MPC, and R74,5 since the beginning of 2012. These inflows are expected to persist for some time as non-resident portfolios adjust to the WGBI inclusion. Although the rand, along with most other currencies, initially appreciated against the dollar following the announcement of further quantitative easing by the Fed, it depreciated against the euro following the positive response to the announcement of the OMT. Since the previous meeting of the MPC, the rand has depreciated by about 2,4 per cent against the dollar, by 7,5 per cent against the euro and by 5,0 per cent on a trade-weighted basis. Over this period the dollar depreciated by 5,5 per cent against the euro.

The current account of the balance of payments has emerged as a risk to the exchange rate outlook following the widening of the deficit to 6,4 per cent of GDP in the second quarter. The Bank's forecast for the current account in 2012 is for a deficit in the order of 5¼ per cent of gross domestic product (GDP). This widening deficit is a consequence of declining commodity exports, and increased imports and service payments. The current-account deficit has been financed mainly through portfolio inflows, but could pose a risk to the exchange rate unless it moderates over the coming months.

The domestic economic growth outlook remains constrained by the weak global outlook and by recent work stoppages in the mining sector. The economy recorded a growth rate of 3,2 per cent in the second quarter of 2012, but this reflects a distortion arising from the strong contribution from the mining sector, which recovered from a deep contraction in the first quarter. Non-mining real output growth measured 1,7 per cent, due in large part to negative growth in the manufacturing sector.

The Bank's leading indicator has declined for four consecutive months, and the Bank's growth forecasts have been revised down. Real GDP growth is now expected to average 2,6 per cent in 2012 and 3,4 per cent in 2013, compared with 2,7 per cent and 3,8 per cent in the previous forecasts. Notwithstanding these downward revisions, the Bank sees further risks to the downside.

Recent high-frequency data point to a lacklustre growth performance in the third quarter. Mining output contracted by 1,5 per cent in July compared with June and the impact of the recent strikes in the mining sector is yet to be reflected in the data. The physical volume of manufacturing production contracted by 1,1 per cent on a month-on-month basis in July, while the year-on-year increase of 5,8 per cent was exaggerated by weak base effects. The Kagiso PMI, which has been moderating consistently since February, declined further in August and remains marginally above the neutral level of 50.

The First National Bank (FNB)/BER Business Confidence Index improved in the third quarter following the sharp decline in the second quarter, but remained below the neutral level. The survey reflected very negative sentiment among manufacturers and building contractors, while the vehicle trade exhibited high and rising levels of confidence, as reflected in robust vehicle sales.

The real value of building plans passed declined in June and July 2012 after a tentative recovery in the previous two months. While positive growth was observed in the non-residential sector up to June, building activity in the residential sector remains subdued, indicative of the weak housing market. By contrast, confidence in the civil construction index has improved, in line with increased civil construction activity.

Growth in gross fixed-capital formation increased to 5,7 per cent, contributing 1,2 percentage points to overall GDP growth. Private-sector investment remains weak, with annualised growth rates of 1,8 per cent, and 2,4 per cent in the first and second quarters of 2012. By contrast, fixed-capital formation by public corporations grew at an annualised rate of 9,1 per cent in the second quarter.

Formal-sector employment growth has remained weak. According to the Quarterly Employment Statistics (QES) released by Statistics South Africa, employment growth over four quarters to the second quarter of 2012 measured 1,5 per cent. This represents an increase of 123 300 jobs, one third of which were in the public sector. Although the current level of formal-sector employment is still about 60 000 less than that attained before the onset of the crisis, the trend remains positive even if too slow.

Final consumption expenditure by households was again the main contributor to GDP growth, contributing 1,9 percentage points. Nevertheless, expenditure growth moderated to 2,9 per cent in the second quarter, mainly due to the contraction in real outlays on services. Expenditure on goods, particularly durable and semi-durable goods, remained robust. Retail sales also grew at a more moderate year-on-year rate of 4,2 per cent in July 2012. Despite the decline in total new vehicle sales in August, the positive momentum in this sector seems to have been sustained, although exports to Europe are expected to remain under pressure. The FNB/BER Consumer Confidence Index increased marginally in the third quarter following a large decline in the second quarter, but remains at a low level. At these levels, consumption expenditure is not seen to pose a risk to the inflation outlook.

Following a recent high in March 2012, growth in credit extension to the private sector has moderated. Twelve-month growth in banks' total loans and advances declined from 9,2 per cent in March, to 8,1 per cent, and 7,3 per cent in June and July respectively. Credit extension to the household sector increased at a rate of 8,1 per cent in July, while credit extended to the corporate sector eased somewhat. Mortgage loans remained subdued, while instalment sale credit and leasing finance reflected the robust vehicle sales.

Growth in general loans to households, which is mainly unsecured lending, accelerated to 32,8 per cent in July, but was still below the peak growth of 39,3 per cent experienced in June 2011. Growth in unsecured lending to companies moderated to 8,3 per cent in July, from a recent high of 16,1 per cent recorded in March. The continued high rates of unsecured lending have contributed to rising household debt, with the ratio of household debt to disposable income increasing from 75,6 per cent to 76,3 per cent between the first and second quarters of 2012. There is no evidence that unsecured lending has had an adverse impact on the asset quality of the banking sector, as impaired advances as a percentage of gross loans and advances measured 4,4 per cent in July compared with 5,5 per cent a year earlier.

The trends in wage growth have been relatively benign from an inflation perspective. Measured over four quarters, nominal unit labour cost growth was 6,1 per cent in both of the first two quarters of 2012. According to Andrew Levy Employment publications, the overall wage settlement rate in collective bargaining agreements amounted to 7,7 per cent in the first half of 2012, while the public sector settled on an increase of 7,0 per cent. However, there is a risk that the recent wage settlements in the mining sector could set a precedent for wage demands more generally.

Food and petrol prices are the main upside risks to the inflation outlook. Following a sharp spike in July 2012, global grain prices stabilised and then moderated, but remain at elevated levels. Futures prices indicate an expectation that these prices may have stabilised and may subside in the medium term. Domestic spot prices of maize and wheat followed global trends, having increased by about 40 per cent and 20 per cent respectively between the beginning of June and the end of July. These increases are expected to filter through to domestic consumer prices in the coming months.

The price of Brent crude oil continued its recent upward trend, reaching around US$117 per barrel on 14 September, or US$12 per barrel higher than at the time of the previous MPC meeting. However, the Saudi Arabian government commitment to increasing the supply of oil has elicited a price response, with oil prices declining to current levels of around US$108 per barrel. How sustainable this impact will be remains to be seen, given the geo-political factors prevailing in the Middle East. The domestic price of petrol has increased significantly as a result, largely offsetting the recent price decreases. Since August, the price of petrol has increased by a cumulative R1,15 per litre, and a further increase is expected in October.

The MPC remains concerned about the risks posed to the domestic economy from the global environment. The actions of the ECB appear to have reduced immediate liquidity concerns in the region and have had a positive impact on sentiment. The continued risk of a possible Greek exit and its contagion effects are likely to hang over the markets for some time. The fundamental problems of the eurozone remain, and low or negative growth is likely to persist going forward.

Despite renewed stimulus in the US, growth is expected to remain subdued, at least until the "fiscal cliff" issue is resolved. This negative global outlook, which is reinforced by a slowdown in Asia, poses a downside risk to domestic growth prospects, particularly in the form of a weaker export performance.

The domestic outlook is also likely to be constrained by local developments, particularly in the mining sector, which have the potential to undermine the already-fragile private-sector investment sentiment despite the accommodative macroeconomic policy environment. While the Bank's forecast for growth has been revised down, the MPC assesses that further risks are somewhat on the downside.

Recent inflation outcomes have been more or less in line with the Bank's expectations, but some upside pressure is still expected from food and petrol price increases. Demand pressures are, however, expected to remain benign. The exchange rate poses a potential risk to the inflation outlook, particularly in the event of an unsustainable widening of the deficit on the current account of the balance of payments. To date, the rand has remained relatively resilient. The committee assesses the risks to the inflation forecast to be more or less balanced.

At its previous meeting the MPC assessed that conditions justified a pre-emptive loosening of the monetary policy stance. Although global and domestic growth conditions remain challenging, the MPC is of the view that a further reduction in the repurchase rate is not appropriate at this stage. The MPC has therefore decided to keep the repurchase rate unchanged at 5,0 per cent per annum. This accommodative stance is assessed to be consistent with the Bank's price stability mandate, and conducive to encouraging growth and domestic investment. Further actions going forward will be highly dependent on global and domestic developments that may change the risks to the outlook.

Abbreviations

Alsi	All-Share Price Index
API	administered price index
ARIMA	autoregressive integrated moving average
BCI	business confidence index
BER	Bureau for Economic Research [Stellenbosch University]
BIS	Bank for International Settlements
BoE	Bank of England
BOJ	Bank of Japan
BRICS	Brazil, Russia, India, China and South Africa
CCI	consumer confidence index
COPOM	Brazil's Monetary Policy Committee
CPI	consumer price index
ECB	European Central Bank
EFSF	European Financial Stability Facility
EME	emerging-market economy
ESM	European Stability Mechanism
EU	European Union
FAO	Food and Agricultural Organization
FDI	foreign direct investment
FLS	Funding for Lending Scheme
FNB	First National Bank
FOMC	Federal Open Market Committee
GDP	gross domestic product
IEA	International Energy Agency
IMF	International Monetary Fund
INR	Indian rupee
MPC	Monetary Policy Committee
MPF	Monetary Policy Forum
MPR	*Monetary Policy Review*
MTBPS	*Medium Term Budget Policy Statement*
MTEF	Medium Term Expenditure Framework
NEER	nominal effective exchange rate
OECD	Organisation for Economic Co-operation and Development
OMT	outright monetary transaction
OPEC	Organization of the Petroleum Exporting Countries
PMI	Purchasing Managers' Index
PPI	producer price index
QES	*Quarterly Employment Statistics*
QLFS	*Quarterly Labour Force Survey*
REER	real effective exchange rate
RMB	Rand Merchant Bank
SMP	Securities Market Programme
UK	United Kingdom
US	United States
WGBI	World Government Bond Index [Citi]

Glossary

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