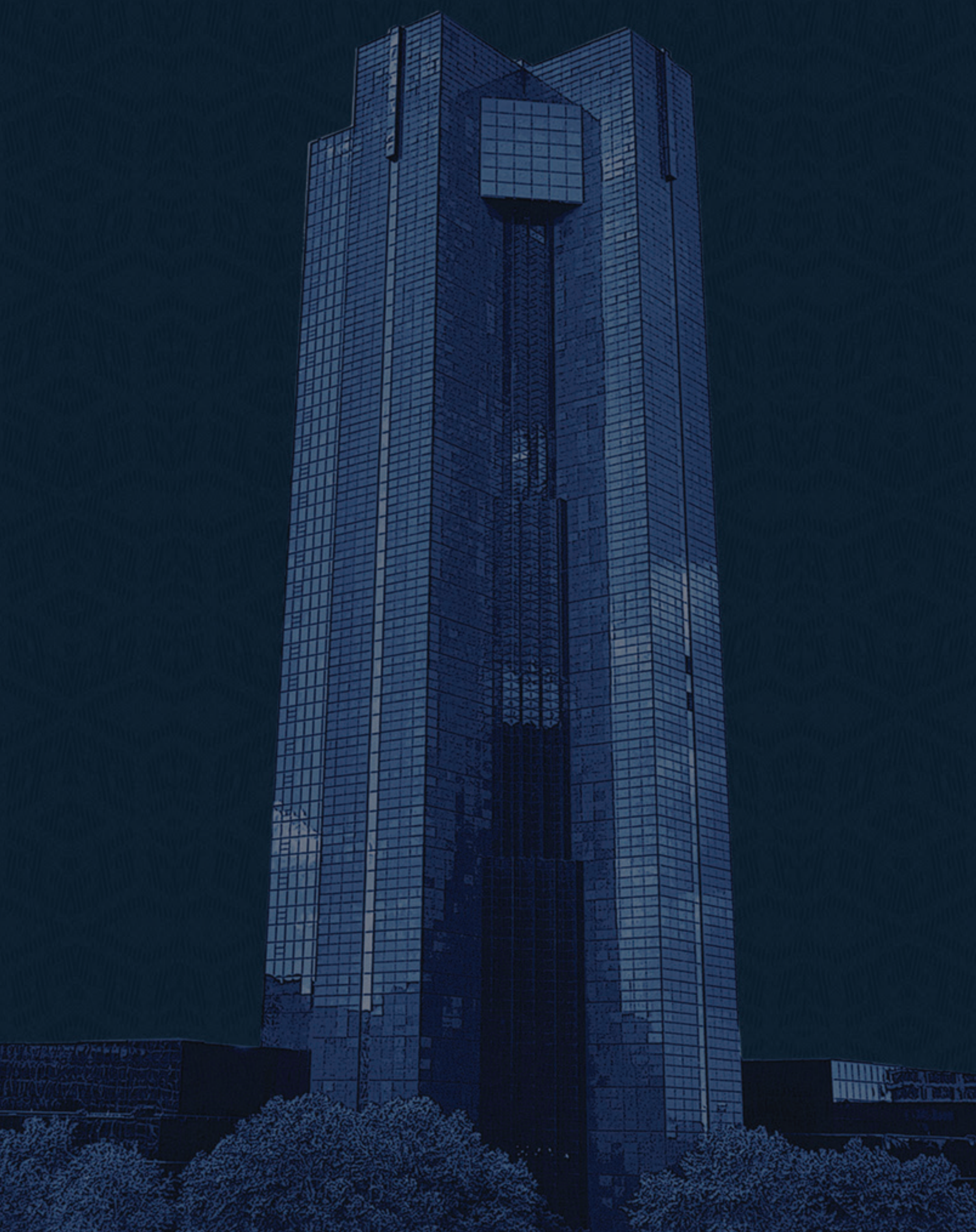
Monetary Policy Review

June 2013



South African Reserve Bank

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

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, and provides a favourable environment for growth and employment creation. In addition, the Bank 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 Bank's Monetary Policy Committee (MPC) takes into account a viable medium-term time horizon for inflation to return to within the target range, and considers the lags between policy adjustments and economic effects. This provides for interest rate smoothing over the cycle, and makes economic 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 October 2012 at a time of significant economic turmoil and heightened uncertainty about future economic developments. Given very low interest rates, the United States Federal Reserve (the Fed), the European Central Bank (ECB) and the Bank of Japan (BOJ) stepped up their use of unconventional monetary policy measures to address deteriorating conditions and financial market tensions. Growth in the fourth quarter of 2012 was widely expected to disappoint in most advanced economies and did, with the euro area remaining in recession and momentum falling in systemically important emerging-market economies. Consequences of this decelerating growth and recession have been a further moderation in price pressures and a subdued outlook for global inflation.

An interim fiscal cliff arrangement in the United States (US) and subsiding sovereign debt risks in Europe contributed to some improvement in global financial market sentiment as 2012 ended and 2013 began. A sluggish start in 2013 gradually gained momentum, with some key economies growing faster than expected and financial markets strengthening. A nascent recovery in the US solidified as private demand slowly strengthened, job creation picked up, and credit and housing markets healed. Yet events in the euro area (particularly Cyprus) and the unresolved fiscal gridlock in the US continue to sap confidence and undermine growth prospects.

The June 2013 *MPR* marks a point of considerable improvement in financial conditions and somewhat better economic outcomes in some countries, but in a global environment of sustained uncertainty and continued economic fragility. The better outcomes early in the year had only marginal effects on global growth forecasts for 2013. The sizeable mismatch between financial market and real economy outcomes has raised new concerns about the efficacy of support to global liquidity.

Some of the improvement in global conditions filtered through to South Africa early in the year but export demand and commodity prices remained weak. In subsequent months a range of prominent domestic factors have deteriorated, negatively impacting on the local economic landscape. Widespread labour market instability has undermined confidence, investment and output. Weak export demand, lower terms of trade and sustained domestic spending have further led to a widening current-account deficit on the balance of payments, and contributed to credit ratings downgrades. These domestic economic developments became the dominant drivers of the depreciating trend in the exchange value of the rand, in turn helping to support domestic inflation running against the global trend.

Despite a decent rebound in growth in the fourth quarter of 2012 from the poor outcome of the third quarter, growth in the first quarter of 2013 has turned out worse than expected. Investment had weakened by year-end and has slowed further in the new year. Constrained by slow growth in disposable income, rising inflation and subdued employment creation, household spending has remained modest.

Domestic short-term supply-side indicators suggest modest economic growth in 2013 remaining fragile and below potential. Real gross domestic product (GDP) growth amounted to 0,9 per cent in the first quarter of 2013. The Bank's growth forecast for 2013, which was revised marginally upwards at the March 2013 MPC meeting, was again lowered in May. The Bank's forecast for growth at the May meeting was 2,4 per cent with downside risks. With the latest data releases, this may need to be revised down at the next meeting of the MPC.

Despite stronger inflation momentum over the short term, inflation expectations remain anchored around the upper end of the inflation target range. Headline inflation levelled off at 5,9 per cent from February 2013 through to April, with core inflation also remaining below 6 per cent. The Bank's inflation outlook for 2013 has improved slightly since the March 2013 MPC meeting. The monetary policy stance remains accommodative, taking into account a sustained negative output gap and inflation driven primarily by global factors, especially exchange rate movements.

A stronger global economic recovery is immensely desirable, despite its potential to push up global prices. Stronger global growth would assist in reducing South Africa's external and domestic vulnerabilities – the current-account and fiscal deficits, and performance of export sectors. A sustainable global recovery, however, requires currency realignments and structural policy interventions in many economies, in addition to monetary accommodation in advanced economies that is more effective in generating stronger real growth and job creation. Contractionary fiscal policies will continue in debt-stressed economies, especially in peripheral Europe. Better fiscal outcomes and more aggressive currency rebalancing would provide much-needed signs of improved global prospects.

The *MPR* analyses the latest developments in and the factors affecting inflation. It reviews recent monetary policy developments, discusses the outlook for inflation, and presents the growth and inflation forecasts of the Bank. In addition, topical issues are discussed in boxes. The first box reviews the changes to the consumer price index and its expected impact, while the second box discusses the analytical value of various measures of inflation. The third box evaluates the accuracy of the Bank's economic growth forecasts, while the fourth box clarifies the role of the repurchase and the prime rates in the transmission of monetary policy.

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.

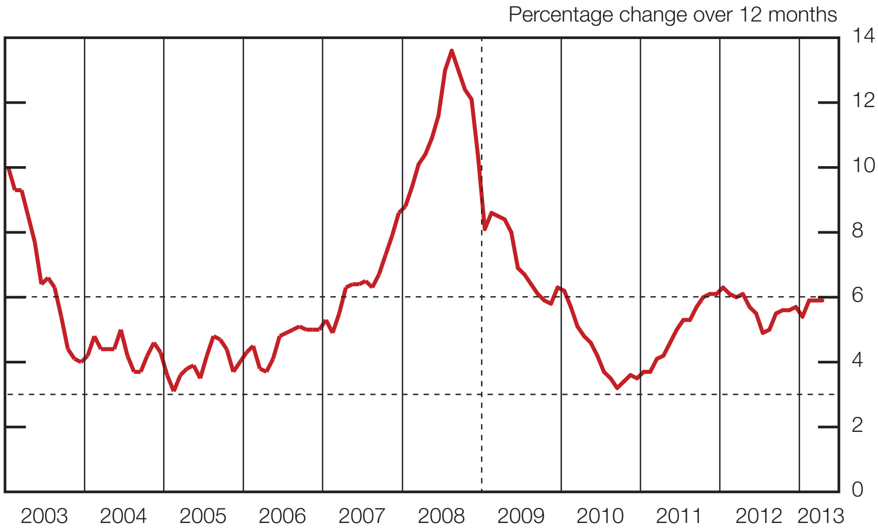
The evolution of inflation indicators

The upward trend in headline consumer price inflation – the targeted inflation rate – gained momentum from 5,4 per cent in January 2013 and then levelled off at 5,9 per cent from February through to April 2013. The moderation in food prices to March 2013 was more than offset by upward pressure on inflation emanating from, among other factors, the impact of higher petrol prices. Core inflation also trended upwards, though remaining contained below 6 per cent. Underlying inflationary pressures remained subdued in the absence of demand pressures and given a significant output gap, but the depreciation of the rand has already affected petrol prices and poses a risk in terms of second-round inflationary effects.

Targeted inflation

The headline consumer price index (CPI) – the measure targeted by the Bank – accelerated from a low of 4,9 per cent in July 2012 to 5,7 per cent in December. In January 2013 inflation surprised on the downside at 5,4 per cent with the release of a reweighted, rebased and revised basket of goods and services. (See Box 1 for a review of the changes to the consumer price index.) In subsequent months, and with ongoing rand weakness, the rate of inflation increased to 5,9 per cent in February and remained at this level through to April 2013 (Figure 1). April 2013 marked 12 months of CPI inflation remaining within the target band.

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

A decrease in goods price inflation was the main driver of the 0,3 percentage point decline in overall inflation from December 2012 to January 2013 (Table 1). Goods price inflation declined to 4,8 per cent in January 2013, driven by softer durable goods prices, a decrease in non-durable goods price inflation and the change in the weights of CPI components. Goods price inflation then accelerated to 5,1 per cent in April 2013, as non-durable goods price increases continued to exceed the upper band of the inflation target range. Services price inflation, which had remained stable and within the target range at, or just below, 6,0 per cent to January 2013, increased to 6,7 per cent in February 2013, with a significant increase in medical insurance costs. Services inflation remained stable at a high 6,6 per cent in April 2013, and upward pressure from services on overall inflation continues as it now commands a larger weight than goods inflation.

Table 1 Targeted inflation: Goods and services inflation

Percentage change over 12 months and percentage points*

	2012					2013				
	Weights*	Sep	Oct	Nov	Dec	Weights*	Jan	Feb	Mar	Apr
Targeted inflation	100,00	5,5	5,6	5,6	5,7	100,00	5,4	5,9	5,9	5,9
Goods inflation	54,20	5,2	5,3	5,3	5,2	49,86	4,8	5,0	5,2	5,1
Durable goods	14,79	-0,1	-0,2	-0,2	-0,2	8,02	-0,7	-0,8	-0,7	-0,5
Semi-durable goods	6,73	2,1	3,3	2,7	2,3	6,32	2,5	2,6	3,1	3,2
Non-durable goods	32,68	7,4	7,6	7,6	7,6	35,52	7,3	7,3	7,5	7,2
Services inflation	45,80	5,9	5,9	5,9	6,0	50,14	5,9	6,7	6,6	6,6

Source: Statistics South Africa

The dominant price categories contributing to targeted inflation are food and non-alcoholic beverages (NAB), housing and utilities, and transport (Table 2). The contribution of miscellaneous goods and services increased by 0,4 percentage points to become the second-largest contributor to overall inflation for February 2013. This was driven by increased inflation in the insurance category,[1] which increased by 3,3 percentage points from January 2013 to 8,3 per cent in February. Rising and then slightly lower petrol prices caused the contribution of the transport category to increase from 0,8 percentage points in January 2013 to 1,2 percentage points in March and the subsequent decline to 1,0 percentage points in April.

1. Medical insurance costs are surveyed in February of each year. These costs accelerated from a 12-month rate of 9,4 per cent in January 2013 to 10,5 per cent in February.

Table 2 Contributions to targeted inflation

Percentage change over 12 months* and percentage points

	2012					2013				
	Weights	Sep	Oct	Nov	Dec	Weights	Jan	Feb	Mar	Apr
Targeted inflation*...........................	100,00	5,5	5,6	5,6	5,7	100,00	5,4	5,9	5,9	5,9
Of which:										
Food and non-alcoholic beverages...	15,68	0,9	1,0	1,1	1,1	15,41	1,0	0,9	0,9	0,9
Food...	14,27	0,9	1,0	1,1	1,0	14,20	0,9	0,9	0,9	0,9
Housing and utilities	22,56	1,4	1,4	1,4	1,4	24,52	1,5	1,4	1,4	1,4
Transport..	18,80	1,1	1,1	0,9	1,0	16,43	0,8	0,9	1,2	1,0
Miscellaneous goods and services ...	13,56	0,7	0,7	0,8	0,8	14,72	0,7	1,1	1,1	1,1
Other..	29,40	1,4	1,4	1,4	1,4	28,92	1,4	1,6	1,3	1,5

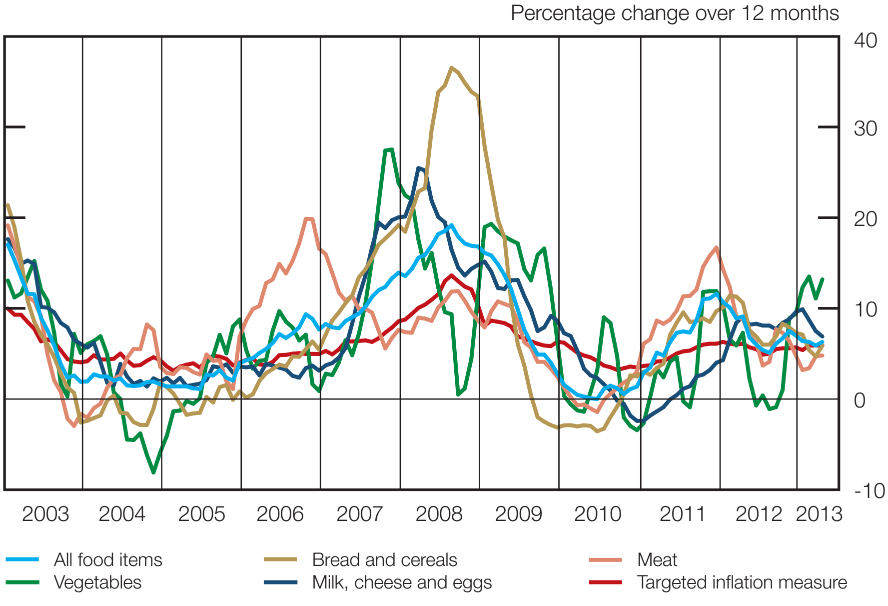
Sources: Statistics South Africa and own calculations

Food prices

As shown in Table 2, food price inflation has moderated in recent months, declining by 1,6 percentage points from a peak of 7,5 per cent in November 2012 to 5,9 per cent in March 2013. It then increased to 6,3 in April and remains a key contributor to the CPI. A significant slowdown in meat price inflation to February 2013, and a moderation in bread and cereals price inflation to March weighed against accelerations in vegetable price inflation and high milk, cheese and eggs price inflation (Figure 2). The negative year-on-year rates of international food price inflation until March 2013 have eased pressures on domestic food prices. The Food and Agriculture Organization (FAO) Food Price Index[2] of international food commodities remained at an elevated level, recording a year-on-year increase of 1,1 per cent in April 2013.

2. The FAO Food Price Index is a measure of the international prices of a basket of food commodities.

Figure 2 Targeted inflation* and food inflation

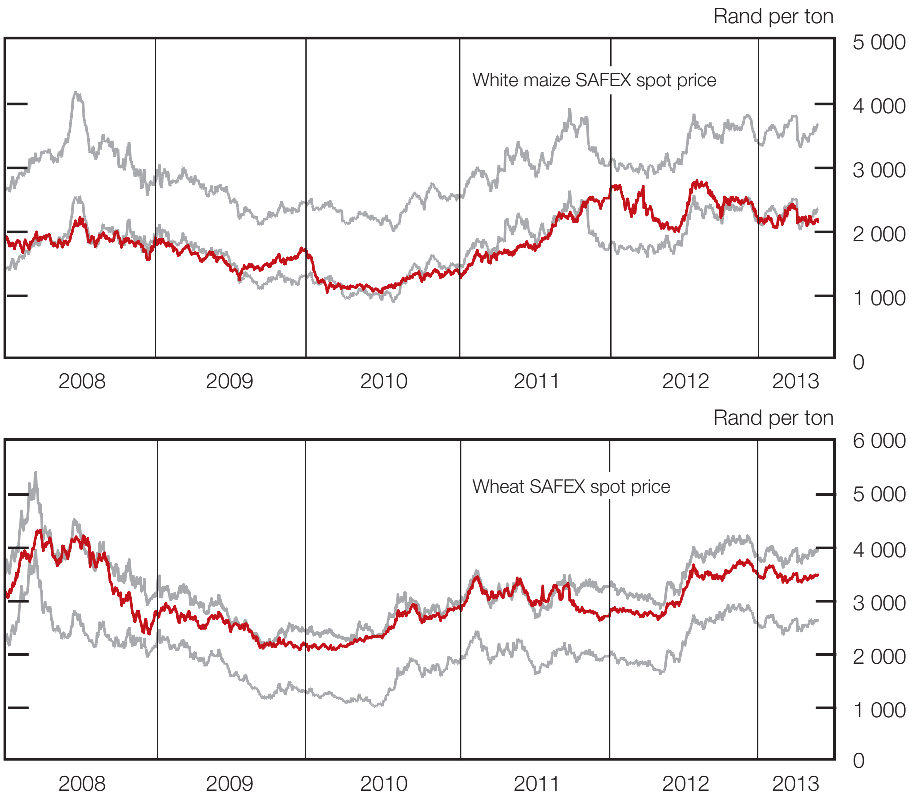


* CPIX for metropolitan and other urban areas until the end of 2008; CPI for all urban areas thereafter

Source: Statistics South Africa

Domestic prices of maize and wheat tracked global grain prices lower, though still at elevated levels as shown in Figure 3. The spot price of white maize followed US export parity prices lower as it declined by 18,9 per cent from a recent high of R2 509 in November 2012 to early February 2013. It then increased to R2 401 in March before again declining to R2 183 on 23 May. Wheat prices levelled off at a high level from July 2012, before declining by 6,4 per cent from 28 November 2012 to R3 515 per ton on 23 May 2013.[3] Going forward, the more favourable global food price developments could be offset in part by the depreciation of the currency.

Figure 3 Selected commodity prices



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

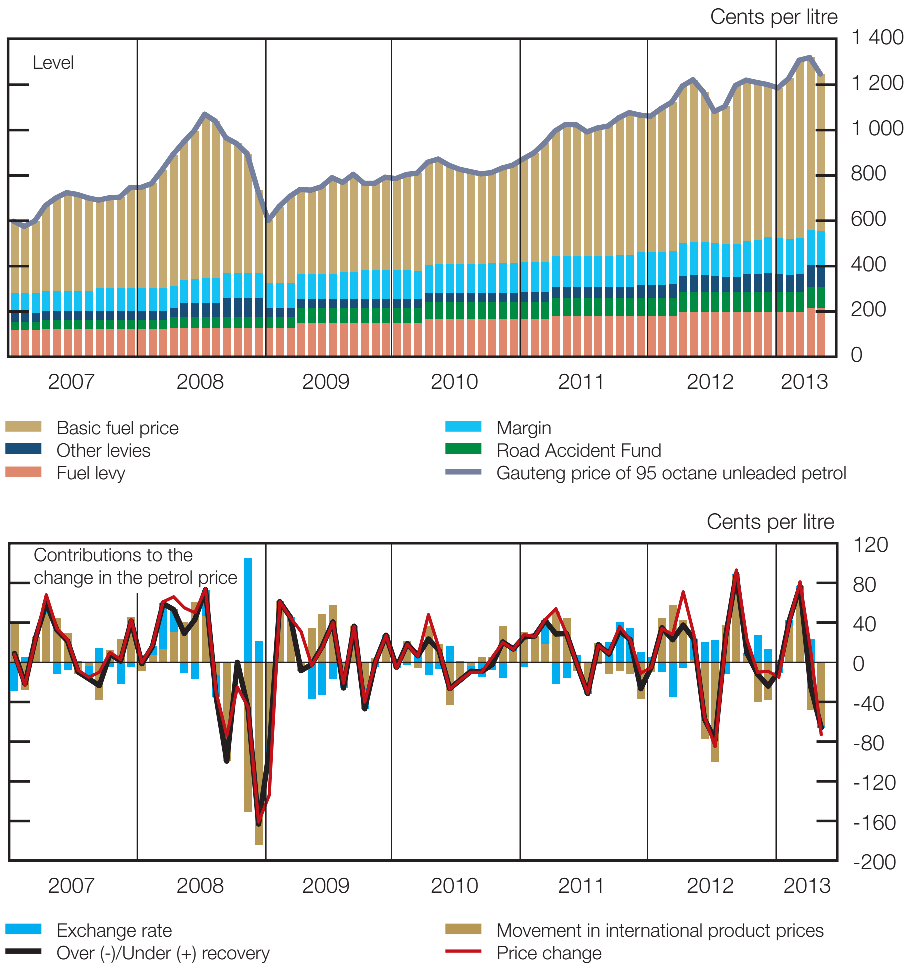
Source: Grain South Africa

Petrol prices

Petrol price inflation moderated from 17,6 per cent in September 2012 to a low of 11,6 per cent in January 2013. The subsequent increase to 16,4 per cent in March was followed by a moderation to 10,4 per cent in April. This volatility was largely driven by movements in international product prices through their effect on the basic fuel price as shown in Figure 4. The basic fuel price per litre has fluctuated between R6,65 and R7,85 since October 2012. The price of 95 octane unleaded petrol per litre in Gauteng Province decreased from R12,20 in October 2012 to R11,86 in January 2013 before increasing to R13,08 in March.

3. On 2 May 2013 the government approved an increase in the wheat tariff protection level to US$294 per ton free on board. This is effectively an increase in the price floor for wheat in South Africa, which guarantees local producers a minimum price of approximately R3 300 per ton compared to the long-term average of R2 951 per ton. Should the three-week moving average of the international reference price fall below this level, a duty would be imposed on imported wheat.

Figure 4 South African petrol price



Source: Department of Energy

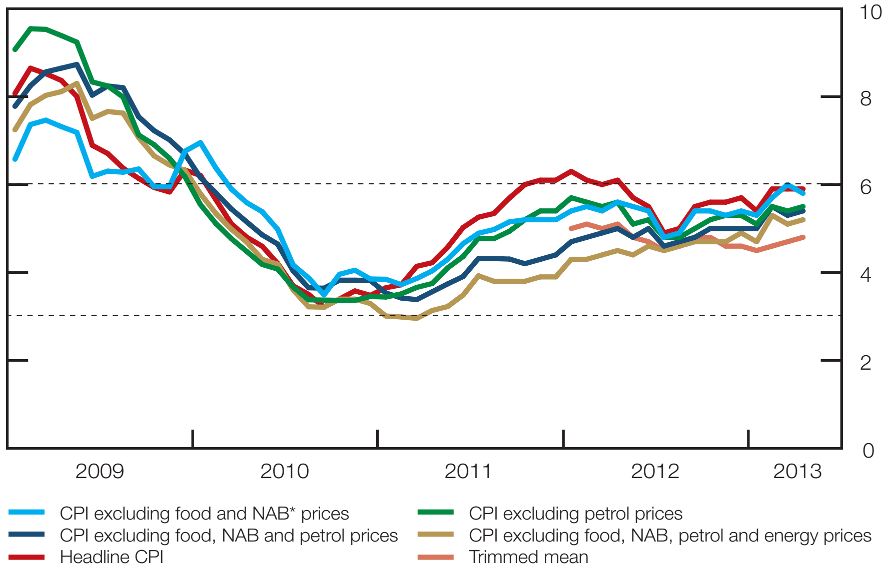
The lower, though still elevated, international oil price led to a decline in the basic fuel price in April 2013. However, this was more than offset by the impact of the rand depreciation, the 15 cents per litre increase in the fuel levy to 212,5 cents per litre, the 8 cents per litre increase in the Road Accident Fund levy to 96 cents per litre, and the 13,16 cents per litre increase in other levies, inclusive of the pipeline levy set by the National Energy Regulator of South Africa (NERSA). Consequently, in April 2013, the price of 95 octane unleaded petrol in Gauteng Province reached an all-time high of R13,20 per litre. This was followed by a 73 cent reduction in May, on account of the lower price of crude oil and a somewhat stronger exchange rate. At R12,47 per litre, the price of 95 octane unleaded petrol was 2 per cent higher than a year ago.

Core inflation

Underlying inflation as measured by CPI excluding food, NAB, petrol and energy prices accelerated gradually from 4,5 per cent in July 2012 to 5,3 per cent in February 2013 and 5,2 per cent in April (Figure 5).

Since the previous *MPR,* the tight dispersion between the exclusion-based measures widened somewhat before narrowing again. The upward effect of petrol prices is evident from the differences between the measure excluding food and NAB and measures excluding petrol. In addition, medical insurance costs contributed to the uptick in February 2013. Core inflation remained relatively well contained, reflecting moderate demand pressures. (See Box 2 for a discussion of various measures of inflation.)

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



* NAB: Non-alcoholic beverages

Sources: Statistics South Africa and own calculations

Administered prices

Administered prices (with an increased weight in the CPI of 18,48 percentage points), and regulated prices in particular (with a weight of 13,70 percentage points), are major drivers of the upward trend in core inflation measures. The administered price index (API) has remained high and above the upper limit of the inflation target range since the previous *MPR*. The 12-month change in API moderated from 9,8 per cent in September 2012 to 8,5 per cent in January 2013, before increasing to 8,9 per cent in April. The effect of the revised CPI weights can be seen in Table 3 as the contributions of both electricity and petrol increased by 0,4 percentage points from December 2012 to January 2013, despite a decline in the year-on-year rate of change in the petrol price and no change in the inflation rate of electricity over the period.

Table 3 Contributions to administered prices

Percentage change over 12 months* and percentage points

	Weights	2012				Weights	2013			
	CPI	Sep	Oct	Nov	Dec	CPI	Jan	Feb	Mar	Apr
CPI for administered prices*	14,66	9,8	9,5	8,7	8,8	18,48	8,5	8,9	10,6	8,9
Regulated component										
Water	1,10	1,0	1,0	1,0	1,0	1,55	1,0	1,0	1,0	0,9
Electricity................................	1,68	1,8	1,8	1,8	1,8	4,13	2,2	2,2	2,2	2,1
Petrol......................................	3,93	4,1	3,7	3,0	3,0	5,68	3,4	3,6	5,0	3,3
Other regulated administered prices	2,91	0,1	0,1	0,2	0,3	2,34	0,0	0,0	0,2	0,2
Unregulated component										
Assessment rates....................	2,07	1,0	1,0	1,0	1,0	1,30	0,5	0,5	0,5	0,5
Primary and secondary school fees	1,28	0,8	0,8	0,8	0,8	1,72	0,8	0,8	0,9	0,9
University fees	0,90	0,6	0,6	0,6	0,6	1,23	0,6	0,6	0,6	0,6
Other unregulated administered prices	0,79	0,6	0,6	0,6	0,6	0,53	0,2	0,2	0,2	0,1

Source: Statistics South Africa

Producer prices

Although differently constituted and not comparable to the previous data, the new producer price index (PPI) continues to measure the price changes of goods in South Africa at the factory gate. The first data, compiled in terms of Statistics South Africa's (Stats SA) newly introduced PPIs (at 2012 prices), were released in February 2013 for prices in the month of January 2013. In the new release designated headline PPI is now the PPI for final manufactured goods, whereas previously it was the PPI for domestic output.

The five new producer price indices and their year-on-year percentage changes are presented in Table 4. With the exception of agriculture, forestry and fishing, the price inflation of products produced in other sectors were either close to, or above, 6 per cent. However, headline PPI inflation (PPI for final manufactured goods) has remained contained since January 2013, accelerating from 5,4 per cent in February to 5,7 per cent in March. Food products, beverages and tobacco products price inflation of 5,9 per cent in March (with a weight of 33,47 per cent), and coke, petroleum, chemical, rubber and plastic products price inflation of 9,2 per cent (with a weight of 17,22 per cent) respectively contributed 2,0 and 1,6 percentage points to the annual percentage change in headline PPI inflation in March.

Table 4 Measures of producer price inflation

Percentage change over 12 months

	2013		
	January	February	March
Final manufactured goods	**5,8**	**5,4**	**5,7**
Intermediate manufactured goods	5,8	6,0	7,7
Electricity and water	12,3	13,0	11,4
Mining	7,2	6,6	8,6
Agriculture, forestry and fishing	3,0	1,2	0,4

Source: Statistics South Africa

Intermediate manufactured goods price inflation accelerated to 7,7 per cent in March 2013. The already high annual electricity and water price inflation moderated to 11,4 per cent in March, mainly driven by electricity price inflation of 12,0 per cent. Annual mining price inflation decelerated from January to February 2013 before accelerating to 8,6 per cent in March. In agriculture, forestry and fishing the deceleration was largely on account of easing pressures on fruit and vegetable prices, and a notable decline in live animal prices.

Stats SA also introduced analytical PPI series, which are exclusion-based core measures. Two of these measures, PPI for final manufactured goods excluding petroleum products and the PPI for final manufactured goods excluding food, are shown in Table 5. The significant gap of 0,5 percentage points in March 2013 between headline PPI and that excluding petroleum products suggests that petroleum product prices are exerting upward pressure on producer prices. The narrow gap between headline PPI and that excluding food suggests little upward pressure from food prices.

Table 5 The effect of food and petroleum product prices on headline producer price inflation

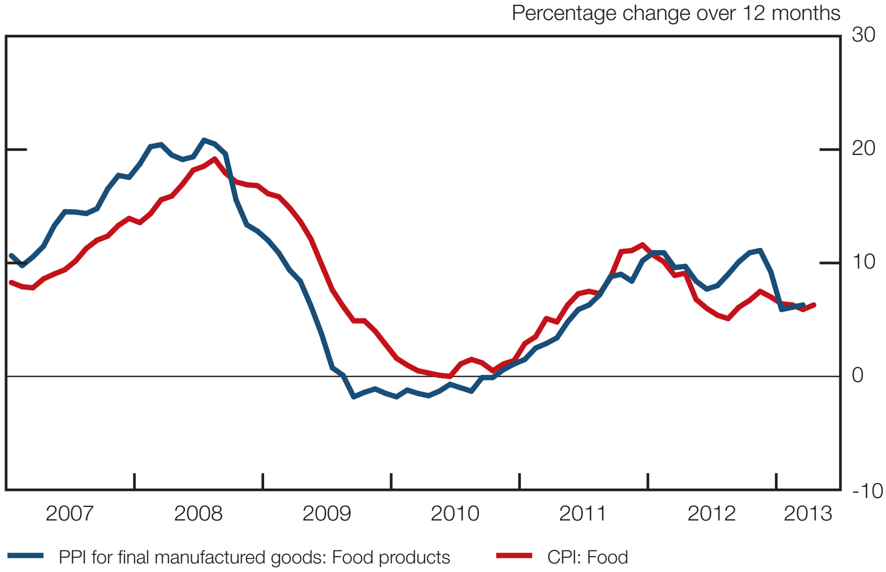
Percentage change over 12 months

	2013		
	January	February	March
Final manufactured goods	5,8	5,4	5,7
Excluding:			
Petroleum products	5,3	5,0	5,2
Food	5,8	5,3	5,7

Source: Statistics South Africa

Food price inflation in headline PPI moderated from a peak of 11,1 per cent in November 2012 to 6,3 per cent in March 2013 as shown in Figure 6. This was due to a deceleration in price increases in almost all the product categories surveyed. Annual price changes of food products as measured in headline PPI continued to move in tandem with that of food as measured in headline CPI.

Figure 6 Food prices in the PPI* and CPI



* PPI for final manufactured goods: Food products consist of the food at manufacturing component of the PPI for domestic output until December 2012 and the PPI for final manufactured goods, food products category, from January 2013.

Source: Statistics South Africa

Box 1 Changes to the consumer price index[1]

In line with international best practice,[2] Statistics South Africa (Stats SA) recently revised the weights and made minor changes to the constituent goods and services in the consumer price index (CPI) basket.[3] Stats SA then chain-linked the CPI indices at the new price and weight reference period, namely December 2012.[4]

The revisions are based on the survey of household expenditure, the Income and Expenditure Survey (IES) 2010/2011,[5] supplemented by additional data sources where necessary. The IES 2010/11 weights are price-updated to reflect 2012 prices. The CPI indices are rebased to December 2012 (December 2012 index values equal 100), with the old and new indices linked in December 2012 to ensure continuity and comparability of the new basket of items and weights.

Table B1.1 compares weights across expenditure categories, including certain within-category groups that have incurred significant changes. With the increase in consumer spending on services relative to goods, expenditure on services now commands a weight of 50,14 per cent. Medical insurance costs are a major driver in the miscellaneous goods and services category, contrasting with the lower weight of the health category which excludes health insurance and medical aid subscriptions.

Table B1.1 Comparison of change in CPI weights*

COICOP categories	2008	2012	Difference**	Change
	Per cent		Percentage points	Per cent
Goods	54,20	49,86	-4,34	-8,01
Services	45,80	50,14	4,34	9,48
Administered prices	14,66	18,48	3,82	26,06
Food and non-alcoholic beverages	15,68	15,41	-0,27	-1,72
Alcoholic beverages and tobacco	5,58	5,43	-0,15	-2,69
Clothing and footwear	4,11	4,07	-0,04	-0,97
Housing and utilities	22,56	24,52	1,96	8,69
Electricity	1,68	4,13	2,45	145,83
Household contents, equipment and maintenance	5,86	4,79	-1,07	-18,26
Health	1,47	1,46	-0,01	-0,68
Transport	18,80	16,43	-2,37	-12,61
Petrol	3,93	5,68	1,75	44,53
Communication	3,22	2,63	-0,59	-18,32
Recreation and culture	4,19	4,09	-0,10	-2,39
Education	2,19	2,95	0,76	34,70
Restaurants and hotels	2,78	3,50	0,72	25,90
Miscellaneous goods and services	13,56	14,72	1,16	8,56
Insurance	7,71	9,92	2,21	28,66
Medical insurance	3,68	7,90	4,22	114,67

* The weights of CPI represent the proportions of consumption expenditure by households in a specific period.
** Increased/Decreased compared to 2008

Source: Statistics South Africa

1 Statistics South Africa, "Consumer Price Index", *The South African CPI Sources and Methods Manual*, Release v.2 (Pretoria: Stats SA, 20 February 2013).

2 The International Labour Organisation (ILO) recommends that CPI reweighting occurs at least every five years. Stats SA last reweighted CPI in 2008.

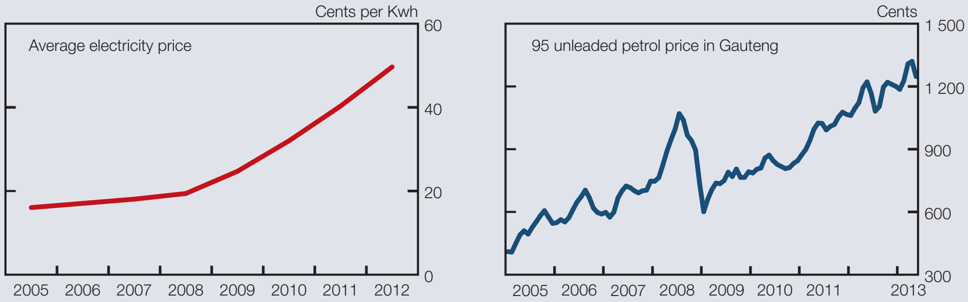
3 Stats SA classifies all measured items according to Classification of Individual Consumption by Purpose (COICOP) standards.

4 See also Box 1 in the March 2013 *Quarterly Bulletin* of the South African Reserve Bank for details on the reweighted and rebased consumer price index.

5 Statistics South Africa, "Income and Expenditure of Households 2010/2011", Statistical release P0100 (Pretoria: Stats SA, November 2012).

In total, the weight for administered prices has increased from 14,66 per cent to 18,48 per cent, driven by significant electricity and petrol price increases (see Figure B1.1). The new weights reflect the substantial increase in these prices, with that of electricity increasing by 146 per cent (or 2,45 percentage points) to 4,13 per cent, and that of petrol by 45 per cent (or 1,75 percentage points) to 5,68 per cent.

Figure B1.1 Electricity and petrol prices



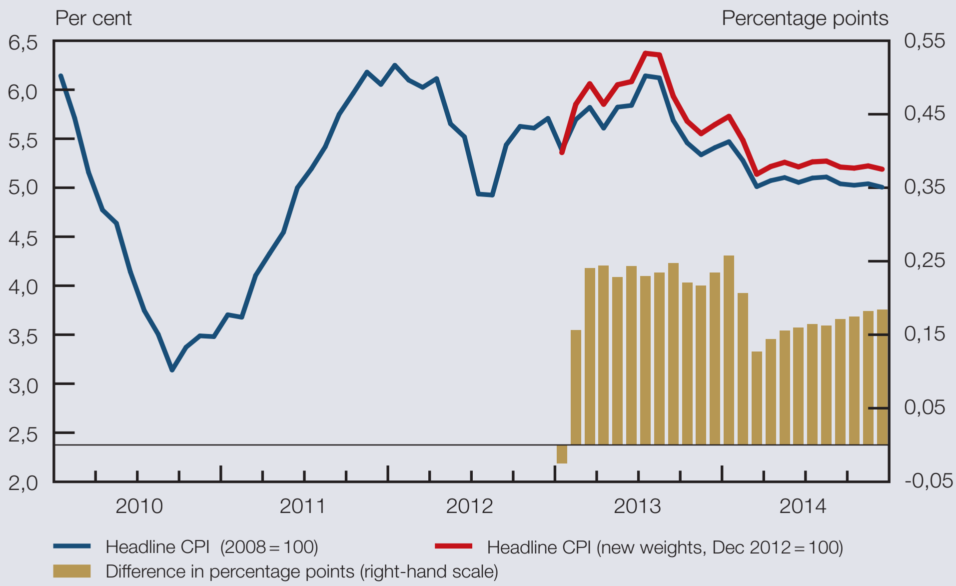
Sources: Eskom, South African Reserve Bank and Department of Energy

The 2012 reweighting entailed several changes to the composition of CPI, with multiple products added, including a newly designed seasonal fruit basket, and others excluded to reflect current consumer behaviour. Package holidays is a new group that has been added to the CPI, with a weight of 0,21 per cent.

On a broader level, the measurement of rural CPI has been revised to reflect prices experienced by consumers in rural areas themselves rather than merely reflecting secondary area prices. Prices will therefore be measured according to the place of purchase rather than the residential area. This change should increase the accuracy of data on rural areas and the understanding of the differential impact, if any, of inflation by geographical area.

Figure B1.2 illustrates the Bank's baseline inflation forecast and the estimated change to the forecast as a result of the new weights and base year through to 2014. These changes caused forecasted inflation to increase, on average, by approximately 0,2 percentage points over 2013. Nonetheless, it is clear that the overall inflation trajectory has not been altered by these changes. It should be noted that in Figure B1.2 both the baseline and the estimated change are forecasts, which may be modified due to revisions of assumptions.

Figure B1.2 Inflation forecast with changes to CPI



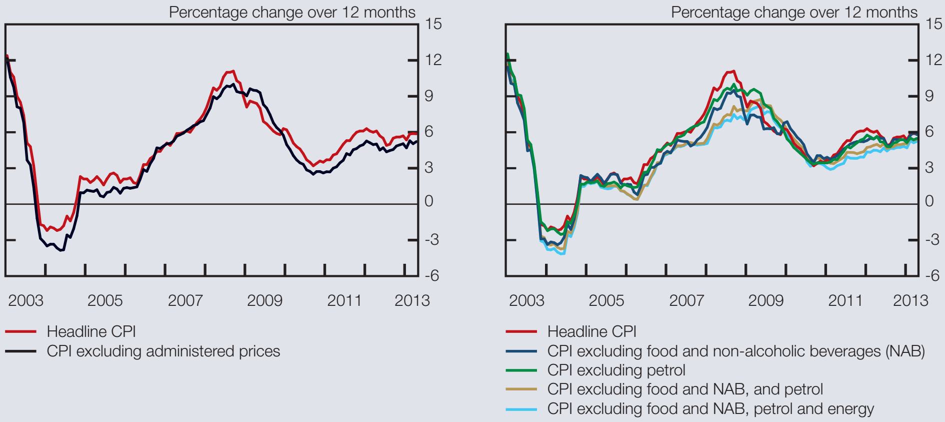
Sources: Statistics South Africa and South African Reserve Bank

Box 2 Monetary policy and various measures of inflation

In pursuing the Bank's primary objective, the Monetary Policy Committee (MPC) focuses on an inflation target over the medium term in the interest of balanced and sustainable growth. The interpretation of inflation outcomes is at times complicated by temporary or idiosyncratic shocks. In such conditions, policy-makers can look through temporary volatility by referencing various core measures of inflation that focus on underlying inflationary pressures.

Core measures can be derived by means of exclusion-based and statistical trimmed mean approaches, with the purpose of extracting the persistent component of inflation. Statistics South Africa (Stats SA) publishes various exclusion-based measures that remove certain items from the headline CPI. In terms of exclusions, the Bank in its analyses focuses mostly on CPI measures that exclude administered prices and CPI measures that exclude food, petrol and energy prices (see Figure B2.1).

Figure B2.1 Headline inflation and exclusion-based core measures

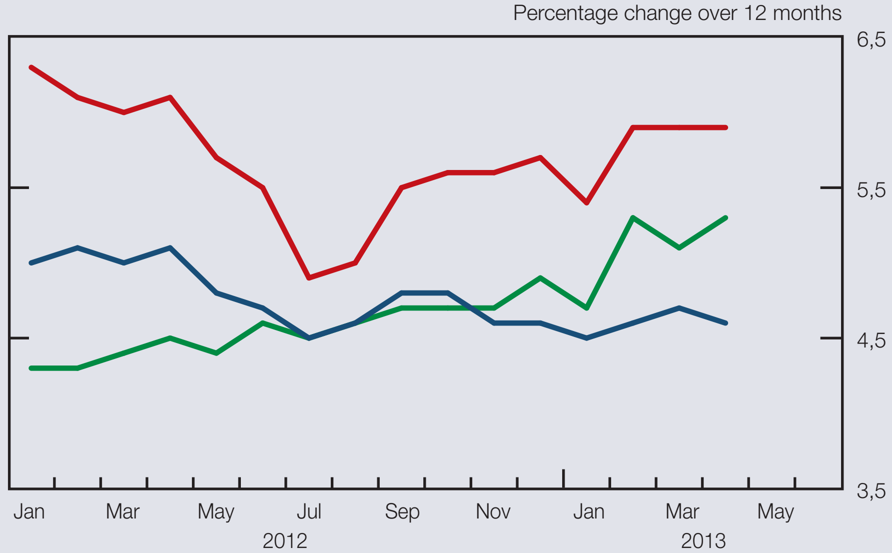


Source: Statistics South Africa

Another inflation measure is Stats SA's newly introduced trimmed mean inflation. Conceptually, this measure excludes items falling in the last 5 per cent of the tail (extremity) of the distribution of price-change observations for products and services, thus limiting the influence of these extreme changes on the calculation of the weighted average inflation number.[1] See Figure B2.2 for a comparison of the key measures of inflation.

1 Elementary indices are sorted by the size of their price change, with the cut at the 5 per cent and the 95 per cent cumulative weight points. Changes in the price of products and services surveyed less frequently (on a quarterly, semi-annual and annual basis) will be considered in terms of a rolling average between surveys.

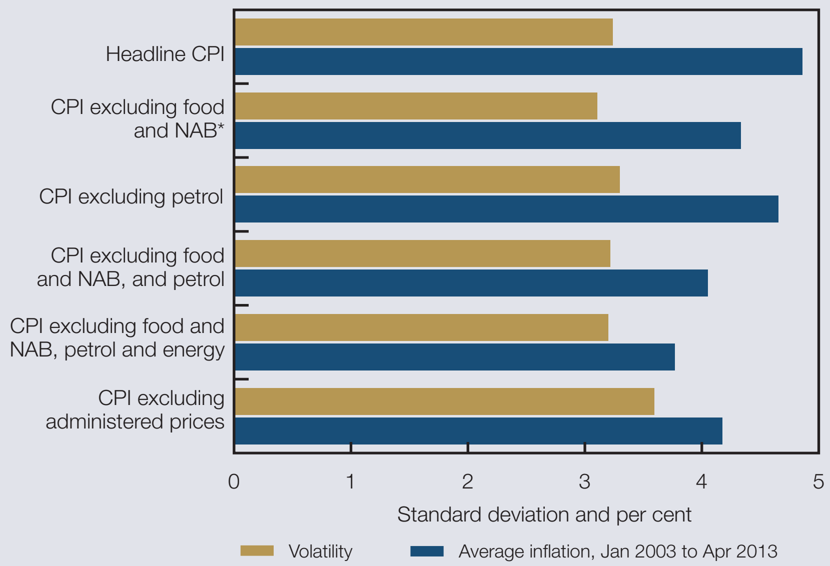
Figure B2.2 Comparison of main inflation measures



Sources: Statistics South Africa and own calculations

Figure B2.3 indicates that average long-run inflation measures of the various exclusion-based core measures are not significantly different from that of headline CPI over the period from January 2003 to April 2013. This is indicative of core measures capturing the underlying trend component of inflation, with the price shocks dissipating over a horizon of 18 to 24 months. Furthermore, the volatility of core measures over the review period, measured as the standard deviation[2] as shown in Figure B2.3, is close to or less than the volatility of headline CPI inflation. This indicates that the volatility of non-core items contributes most to volatility in headline CPI.

Figure B2.3 Comparison of long-run measures of inflation



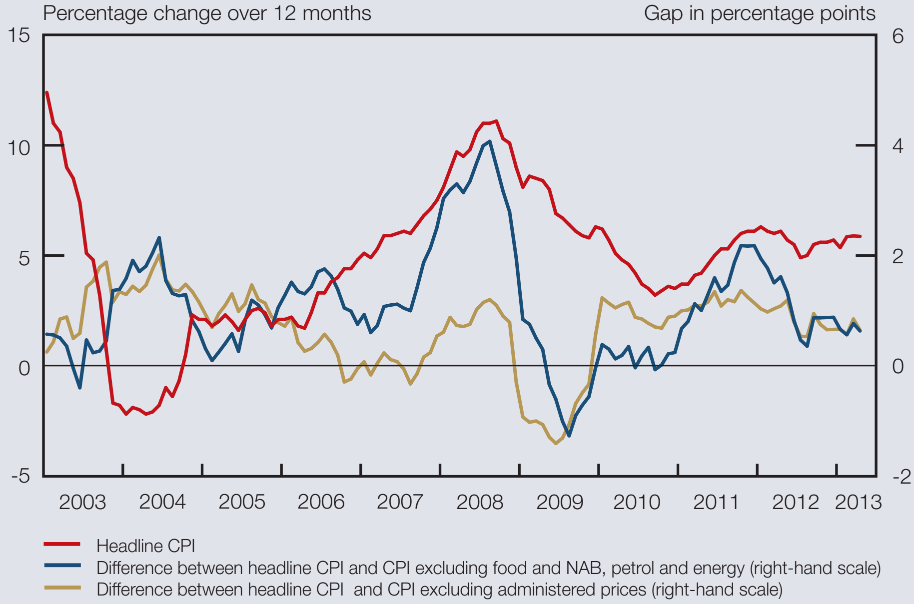
* NAB: Non-alcoholic beverages

Sources: Statistics South Africa and own calculations

2 The standard deviation is a measure of the dispersion of individual observations from the mean.

The gap analysis (Figure B2.4) shows that the gap between headline CPI and core measures has further analytical value as it distinguishes between transitory and more permanent changes affecting inflation. Large gaps are indicative of short-term (transitory) price shocks.

Figure B2.4 Gap analysis



Sources: Statistics South Africa and own calculations

International economic policy developments

Monetary policy decisions are made taking into account current and expected 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.

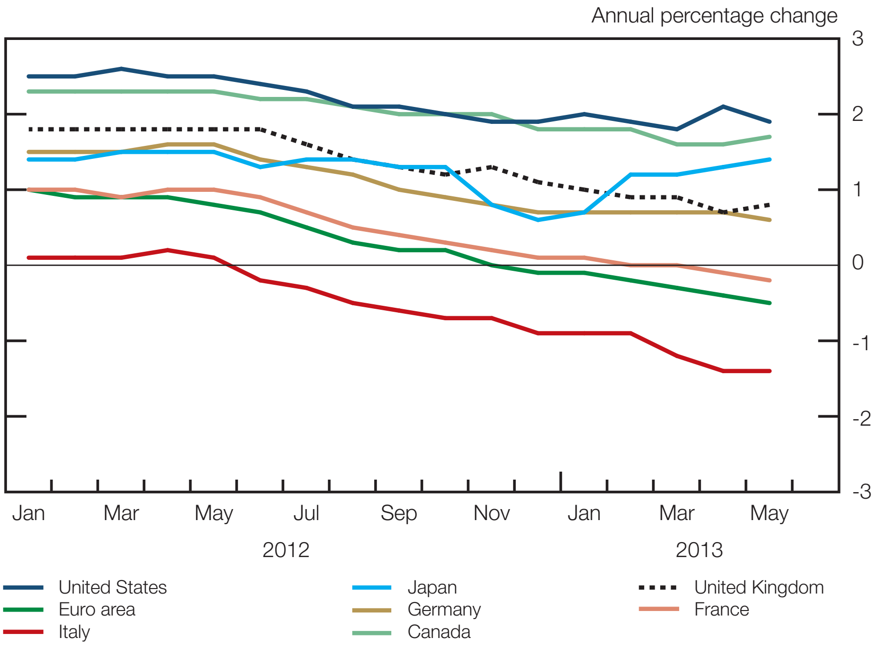
International economic developments

Although the trajectory for global economic growth in 2013 has not changed much since October 2012, economic outcomes in key areas have started to diverge, giving rise to the characterisation of a 'multispeed' recovery in global economic activity. More rapid growth in emerging-market and developing economies (developing Asia in particular) is set against continued, very weak outcomes in Europe and a stronger-than-expected recovery in the US. In the absence of demand pressures, and with an expected softening of food and oil prices, inflationary pressures are likely to remain subdued in most advanced and emerging-market economies.

Multispeed global growth

Despite very poor economic outcomes in the fourth quarter of 2012, a trough in global growth of 2,25 per cent was actually experienced in the second quarter of 2012. The global economy grew by 3,2 per cent in 2012. This global growth rate masked considerable diversity in national outcomes, underscoring the key role of a few major world economies in global outcomes and presaging the current 'multispeed' trajectory. As of April 2013, the International Monetary Fund (IMF) projects global real GDP to increase by 3,3 per cent in 2013; revised down from 3,5 per cent in January 2013 and 3,6 per cent in October 2012. Global economic growth is expected to be significantly higher in 2014 at 4,0 per cent.

Figure 7 Evolution of real GDP forecasts for 2013 for the G-7 and euro area



Source: Consensus Economics *Consensus Forecasts*

Growth in advanced economies

Economic conditions in major advanced economies deteriorated in the fourth quarter of 2012, with real GDP growth contracting by 2,3 per cent in the euro area and by 1,2 per cent in the United Kingdom (UK). During the same quarter, Japan's real GDP expanded marginally by 0,2 per cent as it recovered from a mild recession, and the US economy grew by a slow 0,4 per cent.

The variable economic growth performances of advanced economies in the latter part of 2012 have continued in 2013. The US leads the recovery, supported by positive trends in the labour and housing markets and household consumption expenditure – though somewhat countered by an expected drag on growth from fiscal consolidation. Real GDP growth in the US is expected to accelerate from 1,9 per cent in 2013 to 3,0 per cent in 2014.

The outlook for some of South Africa's other major advanced-economy trading partners is less positive. The IMF's forecast for the euro area has been revised in January 2013 to a contraction of 0,2 per cent and further to 0,3 per cent in April, with a gradual strengthening in the quarterly outcome to 1,0 per cent by the fourth quarter of 2013. ECB estimates for the euro area are similar, with growth of 1,4 per cent expected in 2014. The pace of the recovery is expected to be considerably slower in the periphery. In April 2013 the euro area manufacturing Purchasing Managers' Index (PMI) remained below 50 at 46,7, while the contraction in Europe's car market accelerated to a 10,2 per cent year-on-year decline in March 2013.

In 2012 the German economy slowed to 0,7 per cent, with its GDP contracting by 2,7 per cent in the fourth quarter. This was followed by weak positive growth in the first quarter of 2013, with the manufacturing PMI temporarily breaching 50 in February 2013. The ECB and the Bundesbank project 0,4 per cent growth in real GDP for Germany in 2013 and 1,8 to 1,9 per cent in 2014. The European Commission's GDP growth estimate for France is a small contraction of 0,1 per cent in 2013 before improving to growth of 1,1 per cent in 2014. The recovery in the UK is progressing slowly in the context of ongoing fiscal consolidation, with the IMF projecting the economy to expand by 0,7 per cent in 2013 and 1,5 per cent in 2014.

Table 6 IMF projections of world growth and inflation for 2013 and 2014*

Per cent

	Share of global GDP**	Real GDP growth						Consumer price inflation	
	2012	2013			2014			2013	2014
World	100,0	(3,6)	[3,5]	3,3	(4,1)	[4,1]	4,0	3,8	3,8
Advanced economies	50,1	(1,5)	[1,4]	1,2	(2,3)	[2,2]	2,2	1,7	2,0
United States	18,9	(2,1)	[2,0]	1,9	(2,9)	[3,0]	3,0	1,8	1,7
Japan	5,6	(1,2)	[1,2]	1,6	(1,1)	[0,7]	1,4	0,1	3,0
Euro area	13,7	(0,2)	[-0,2]	-0,3	(1,2)	[1,0]	1,1	1,7	1,5
United Kingdom	2,8	(1,1)	[1,0]	0,7	(2,2)	[1,9]	1,5	2,7	2,5
Canada	1,8	(2,0)	[1,8]	1,5	(2,4)	[2,3]	2,4	1,5	1,8
Other advanced economies	7,3	(3,0)	[2,7]	2,5	(3,5)	[3,3]	3,4	2,1	2,4
Emerging-market and developing countries	49,9	(5,6)	[5,5]	5,3	(5,9)	[5,9]	5,7	5,9	5,6
Sub-Saharan Africa	2,5	(5,7)	[5,8]	5,6	(5,5)	[5,7]	6,1	7,2	6,3
South Africa	0,7	(3,0)	[2,8]	2,8	(3,9)	[4,1]	3,3	5,8	5,5
Central and eastern Europe	3,4	(2,6)	[2,4]	2,2	(3,2)	[3,1]	2,8	4,4	3,6
Commonwealth of Independent States	4,3	(4,1)	[3,8]	3,4	(4,2)	[4,1]	4,0	6,8	6,6
Developing Asia	25,1	(7,2)	[7,1]	7,1	(7,5)	[7,5]	7,3	5,0	5,0
China	14,9	(8,2)	[8,2]	8,0	(8,5)	[8,5]	8,2	3,0	3,0
India	5,6	(6,0)	[5,9]	5,7	(6,4)	[6,4]	6,2	10,8	10,7
Middle East and North Africa	5,8	(3,6)	[3,4]	3,1	(3,8)	[3,8]	3,7	9,6	9,0
Latin America and the Caribbean	8,7	(3,9)	[3,6]	3,4	(4,1)	[3,9]	3,9	6,1	5,7

* IMF projections as at October 2012 ( ) and January 2013 [ ] in parenthesis
** GDP shares based on the IMF's purchasing power parity valuation of country GDPs for 2012

Source: IMF, *World Economic Outlook*, various issues

Table 7 Global manufacturing PMI: Overall

Index points

	2012				2013			
Country	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr
United States	51,6	51,7	*49,9*	50,2	53,1	54,2	51,3	50,7
Euro area	*46,1*	*45,4*	*46,2*	*46,1*	*47,9*	*47,9*	*46,8*	*46,7*
Germany	*47,4*	*46,0*	*46,8*	*46,0*	*49,8*	50,3	*49,0*	*48,1*
France	*42,7*	*43,7*	*44,5*	*44,6*	*42,9*	*43,9*	*44,0*	*44,4*
United Kingdom	*49,0*	*47,8*	*49,0*	51,0	50,8	*48,2*	*48,6*	*49,8*
Japan	*48,0*	*46,9*	*46,5*	*45,0*	*47,7*	*48,5*	50,4	51,1
China	*47,9*	*49,5*	50,5	51,5	52,3	50,4	51,6	50,4
India	52,8	52,9	53,7	54,7	53,2	54,2	52,0	51,0
Global	*48,8*	*48,8*	*49,6*	50,0	51,5	50,9	51,2	50,5

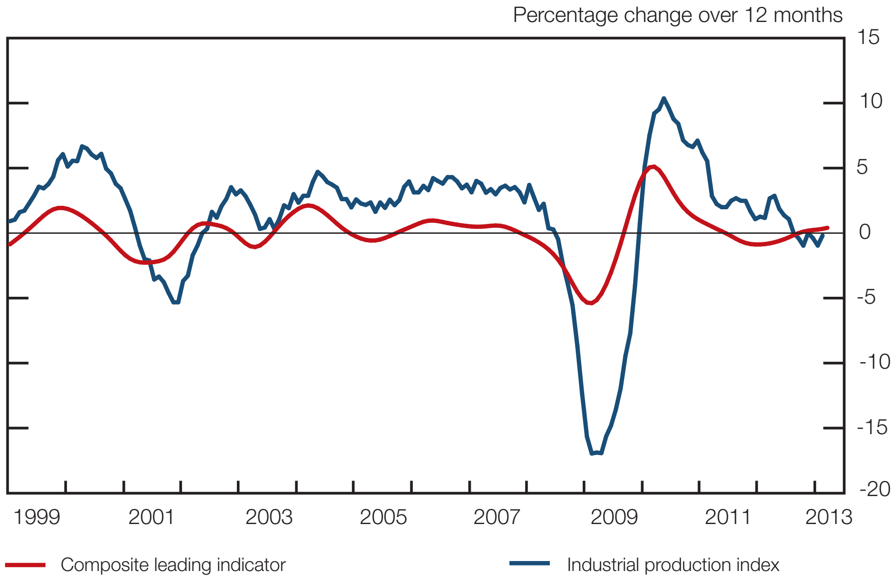
* Italics indicate outcomes below the 50 index points neutral level, non-italics outcomes above the 50 index points neutral level, green an increase in the level in the latest survey, red a decrease and black no change.

Source: JPMorgan

In Japan policy stimulus is expected to be significant, delivering a real GDP boost from fiscal policy alone of about 0,6 per cent in 2013. A weaker currency and external demand-driven rebound are expected to help the economy expand by 1,6 per cent in 2013, followed by softer growth of 1,4 per cent in 2014.

For the advanced economies, a slow start in 2013 is projected to be followed by a gradual acceleration in the second half of the year, with real GDP growing by around 2 per cent on average. For 2013 as a whole, growth in advanced economies will be broadly the same as in 2012 at about 1,2 per cent before increasing to 2,2 per cent in 2014. The Organisation for Economic Co-operation and Development (OECD) composite leading indicator projects a moderate expansion in member economies (Figure 8).

Figure 8 Selected OECD indicators of global economic activity



Source: OECD

Emerging and developing economies

Decelerating demand from advanced economies helped to slow real GDP growth in emerging-market and developing economies from 6,4 per cent in 2011 to 5,1 per cent in 2012. These economies have subsequently gathered momentum on the back of policy adjustments, resilient domestic consumption and investment, and improving global demand. Nonetheless, insufficient external demand and structural constraints will weigh against more robust outcomes in the medium term. The IMF projects that economic growth will increase to 5,3 per cent in 2013 and 5,7 per cent in 2014.

Growth in China and India slowed sharply in 2012, but these economies are expected to grow in 2013 by 8,0 per cent and 5,7 per cent respectively. Brazil's GDP growth rate is expected to strengthen from 0,9 per cent in 2012 to 3,0 per cent in 2013. Russia's real GDP is forecast to expand in 2013 by 3,4 per cent, as in 2012.

According to the IMF, seven of the world's ten fastest-growing economies between 2011 and 2015 will be located in sub-Saharan Africa (SSA), with economic growth in the region projected to accelerate from 4,8 per cent in 2012 to an average of about 5,9 per cent in 2013–14. Economic activity in both resource-rich and lower-income economies in SSA is expected to be increasingly broad-based.

Commodity prices and global inflation

Weak demand and downwardly revised projected emerging-market growth contributed to a general decrease in commodity prices from a recent high in September 2012. The near-term outlook for commodity prices reflects a slight softening of oil prices on the back of improved supply prospects.

Softer commodity prices and the absence of excess demand pressures in the major advanced economies suggest that global inflationary pressures are likely to remain subdued. Global inflation fell to about 3,6 per cent in February 2013 from 3,9 per cent in February 2012, and is expected to remain close to this level through to 2014. In the US and euro area inflation is expected to ease to below the 2 per cent level, while that of Japan is projected to become slightly positive in 2013 before increasing to 3,0 per cent in 2014.

Inflation is expected to remain contained in emerging-market and developing economies, with a slight deceleration in consumer price inflation from 5,9 per cent in 2013 to 5,6 per cent in 2014. However, inflationary pressures are high in some emerging-market and developing countries where output gaps are closing faster. In developing Asia inflation is expected to increase from 4,5 per cent in 2012 to 5,0 per cent in 2013 and 2014. China's inflation is expected to increase modestly to 3,0 per cent in 2013. In contrast, inflation in SSA is expected to decrease from 9,1 per cent in 2012 to 6,3 per cent in 2014.

Fiscal trends

With a relatively subdued economic recovery in many parts of the world, gradual fiscal consolidation has remained a challenge due to slower economic growth and the impact of lower spending on growth. The impact of fiscal consolidation on growth in advanced economies is expected to rise somewhat in 2013. In the advanced economies general government deficit ratios have declined but debt ratios continued to increase, although at a slower pace than in previous years. In emerging-market economies debt ratios fell, while deficit ratios increased modestly, but stronger economic growth is expected to improve these ratios going forward (Table 8).

Table 8 Fiscal balances and government debt

Per cent of GDP

				Projections	
	2010	2011	2012	2013	2014
Fiscal balances					
World	-6,0	-4,5	-4,3	-3,5	-3,0
Advanced economies	-7,8	-6,6	-5,9	-4,7	-3,8
Emerging markets	-3,1	-1,7	-2,1	-2,2	-2,2
South Africa	-5,1	-4,0	-4,8	-4,8	-4,2
General government gross debt					
World	79,5	79,7	81,1	79,3	78,6
Advanced economies	101,5	105,5	110,2	109,3	109,5
Emerging markets	40,3	36,7	35,2	34,3	33,6
South Africa	35,8	39,6	42,3	42,7	43,7

Source: IMF, *Fiscal Monitor*, April 2013

Oil price developments

Crude oil prices moderated from October to November 2012, before rising to a recent high in February 2013, primarily in response to improved confidence in the global economic recovery. The subsequent marked decline in crude oil prices reflected worse-than-expected short-term economic outcomes and the Organization of the Petroleum Exporting Countries' (OPEC's) expectations that oil supply would continue to exceed demand for oil by about 1 million barrels per day.

Between November 2012 and February 2013, the international price of crude oil has fluctuated between a low of US$105,82 per barrel and a high of US$119,34 per barrel. As economic growth rates stalled and expected growth rates were marked down, the price of Brent crude declined markedly to US$96,79 per barrel on 17 April 2013 – its lowest level since July 2012. Subsequently, the price of Brent crude increased slightly to US$102,21 per barrel on 23 May 2013 (Figure 9).

Figure 9 Price of Brent crude oil

Source: Bloomberg

Futures contracts dated 23 May 2013 for delivery in the third and fourth quarters of 2013 traded at around US$102,41 and US$101,57 per barrel respectively, as near-term futures prices for oil caught up with concerns about slowing global economic growth. The International Energy Agency (IEA) and OPEC have both lowered their short- and medium-term forecasts of global oil demand for 2013. Over the longer term, supply will be shaped by more rapid economic growth in the emerging and developing world, as well as US shale gas production, with the latter expected to expand significantly over the next five years.

The persistently high level of the price of Brent crude oil, combined with the weaker exchange rate of the rand, imparted both a negative income and a negative price shock to the domestic economy. In addition to increasing inflation, these shocks have diverted households' and firms' spending power, and pushed up the deficit on the trade account of the balance of payments. More recent weakness in oil prices, if maintained, could support an easing of domestic inflationary pressures in coming months.

International monetary policy developments

Since the previous *MPR*, the global trend of monetary easing has continued with greater use of quantitative easing (QE) and increased forward guidance. After a range of interest rate reductions in 2012, most economies maintained existing monetary policy settings in order for the full policy impact to become visible. Some emerging-market economies continued to ease policy gradually in 2013. On balance, policies have been set to support economic growth, which has consistently underperformed in most countries. Price outcomes remain a key concern for all central banks, with considerable variation in emphasis on deflation and inflation across advanced and emerging economies. Recent weakness in global growth has again, on balance and with variation across countries, moderated global inflation pressures.

Policy in advanced economies

4. The focus on specific, quantifiable thresholds for unemployment and inflation is referred to as the 'Evans Rule'.

Subdued inflationary pressures and poor growth facilitated a continuation of accommodative monetary policy in advanced economies. This led to improved global financial market conditions and risk appetite, along with signs of resilience in real economic activity in 2013. Policy in the US continues to set the tone across advanced economies. The Fed has maintained the federal funds rate at zero to 0,25 per cent since December 2008. This rate was recently linked explicitly to unemployment remaining above 6,5 per cent, and inflation (between one and two years ahead) no more than 0,5 percentage points above the 2 per cent longer-run goal, and with inflation expectations remaining well anchored.[4]

Unsterilised purchases of securities, or QE, have also continued, with the asset purchase programme accumulating US$40 billion of mortgage-backed securities per month. After the completion of the maturity extension programme at the end of 2012, the Fed commenced with the purchases of longer-term Treasury securities at an initial pace of US$45 billion per month. These measures supported the mortgage market, exerted downward pressure on longer-term interest rates and eased financial conditions. The Fed's balance sheet contracted by US$20 billion in 2012 to US$2,9 trillion but is projected to expand by US$1,0 trillion in 2013.

Table 9 Central bank total assets

US$ billions

	2011	2012	2013*
Bank of England	452,8	662,4	616,3
European Central Bank	3 605,8	3 957,5	3 324,9
The United States Federal Reserve	2 928,5	2 908,9	3 354,3
Bank of Japan	1 613,5	1 661,7	1 552,8

* Total assets to date: Bank of England (15 May 2013), European Central Bank (17 May 2013), the United States Federal Reserve (15 May 2013) and Bank of Japan (30 April 2013).

Sources: National central banks

Since the previous *MPR*, the BOJ proceeded with aggressive monetary easing by steadily increasing the outstanding amount of the Asset Purchase Program and also announcing the introduction of the Open-Ended Asset Purchases Method (i.e., without a set termination date) from January 2014 at ¥13 trillion per month. Its Loan Support Program was enhanced by establishing an unlimited Stimulating Bank Lending Facility to provide long-term funds. These measures are intended to make financial conditions more accommodative, encourage lower long-term interest rates and proactive credit demand, and to reduce risk premiums.

In January 2013 the BOJ changed from a medium-term inflation goal of 1 per cent to a long-term price stability target of 2 per cent. This policy adjustment was followed in early April with the introduction of further quantitative and qualitative monetary easing to achieve an inflation target of 2,0 per cent as soon as possible within two years. The BOJ changed the main operating target for money-market operations from the uncollateralised overnight call rate to the monetary base, and intends to almost double the monetary base over the next two years by injecting about ¥60–70 trillion per year into the Japanese economy. In addition, to bring about a further decline in interest rates across the yield curve, the BOJ will purchase Japanese Government Bonds (JGBs) of about ¥50 trillion per annum while extending their maturity from less than three years to about seven years. With the aim of lowering the risk premia of assets, the BOJ will purchase exchange-traded funds and real-estate investment trusts. Collectively, these measures are intended to overcome almost two decades of deflation, achieve sustainable economic growth and ensure financial stability in Japan.

In response to lower inflation and rising unemployment in 2013, the ECB lowered its rate on main refinancing operations in May to 0,50 per cent after keeping it at 0,75 per cent since July 2012. Monetary policy in the euro area has remained accommodative, supported by various refinancing operations, unconstrained liquidity for banks, and the Outright Monetary Transactions (OMTs) bond-buying program. These measures are intended to repair the transmission of monetary policy and to equalise sovereign borrowing costs across the euro area as reflected by significant narrowing of peripheral country bond spreads.

Table 10 Selected central bank interest rates

Per cent

Countries	25 Oct 2012	23 May 2013	Real interest rate*	Latest decision	Cumulative 2012	Cumulative 2013
South Africa	5,00	5,00	-0,20	23 May 2013	(-0,50)	(0,00)
United States	0,00–0,25	0,00–0,25	-1,80–-1,55	1 May 2013	(0,00)	(0,00)
Japan**	0,30	0,30	-2,85	22 May 2013	(0,00)	(0,00)
Euro area	0,75	0,50	-1,10	2 May 2013	(-0,25)	(-0,25)
United Kingdom	0,50	0,50	-1,96	9 May 2013	(0,00)	(0,00)
Canada	1,00	1,00	-0,78	17 Apr 2013	(0,00)	(0,00)
China	6,00	6,00	2,50	8 Apr 2013	(-0,56)	(0,00)
India	8,00	7,25	-0,55	3 May 2013	(-0,50)	(-0,75)
Russia	8,25	8,25	2,65	15 May 2013	(0,25)	(0,00)
Brazil	7,25	7,50	2,20	17 Apr 2013	(-3,75)	(0,25)
Australia	3,50	2,75	-0,25–0,75	7 May 2013	(-1,25)	(-0,25)
New Zealand	2,50	2,50	1,10	24 Apr 2013	(0,00)	(0,00)
Switzerland	0,00–0,25	0,00–0,25	-0,20–0,05	14 Mar 2013	(0,00)	(0,00)
Israel	2,25	1,50	-0,30	13 May 2013	(-0,75)	(-0,50)
South Korea	2,75	2,50	-0,30	9 May 2013	(-0,50)	(-0,25)
Chile	5,00	5,00	2,00	16 May 2013	(-0,25)	(0,00)
Poland	4,75	3,00	1,40	8 May 2013	(-0,25)	(-1,00)
Turkey	5,75	4,50	-0,40	16 May 2013	(-0,25)	(-1,00)
Nigeria	12,00	12,00	1,40	21 May 2013	(0,00)	(0,00)
Ghana	15,00	16,00	6,70	22 May 2013	(2,50)	(1,00)
Kenya	13,00	8,50	1,40	7 May 2013	(-7,00)	(-2,25)

* The real interest rate is calculated as the difference between the central bank's current nominal policy rate and one-year-ahead projected inflation.

** The Bank of Japan announced a change in its monetary target from the uncollateralised overnight call rate to the monetary base (to increase by ¥60–¥70 trillion annually) on 4 April 2013, thus the basic loan rate is now used in the table.

Sources: National central banks and Bloomberg

In the UK, the Bank of England (BoE) maintained the official bank rate paid on commercial bank reserves at 0,5 per cent. The stock of asset purchases financed by issuance of central bank reserves was also maintained at the £375 billion level set in July 2012 and has been rolled out at an average rate of £1,1 billion[5] per month since then. Together with the Funding for Lending Scheme,[6] which was extended until January 2015, these asset purchases are intended to ease credit conditions in the UK. Small and medium-sized enterprises benefited from this source of credit extension, and money-market interest rates declined to below the policy rate.

Following the UK government review of the monetary policy framework, the Chancellor of the Exchequer updated the remit of the BoE in March 2013. While a flexible inflation-targeting framework and a 2 per cent inflation target are retained, the new BoE remit requires clarification of policy trade-offs and recognises that inflation may temporarily deviate from the target to avoid undesirable output volatility.

After leaving its cash rate unchanged at 3,0 per cent at successive policy meetings since the last reduction in December 2012, the Reserve Bank of Australia (RBA) lowered the cash rate by

5. The monthly average is the outcome of both redemptions and inactivity over the period 5 July 2012 to 2 May 2013.

6. The Funding for Lending Scheme allows banks to borrow at a ratio of 10 to 1 for every pound lent out to small companies.

25 basis points to 2,75 per cent in May. The RBA noted that the inflation outlook afforded scope to ease the policy rate further to encourage sustainable growth in the economy, consistent with achieving the inflation target.

Policy in emerging-market economies

Emerging-market economies continued to deal with limited fiscal space, accelerating credit growth and divergent inflation outlooks. As shown in Table 10, real policy rates in most emerging markets remain positive, compared to the negative real rates in advanced economies. Within the Brazil, Russia, India, China and South Africa group of countries (BRICS), South Africa had the lowest nominal policy rate and the second-lowest real policy rate.

During its first quarterly meeting of 2013, the Monetary Policy Committee of the People's Bank of China (PBC) assessed China's real economy as having maintained its growth momentum and the financial sector as operating smoothly, with prices stable but with the future trend of inflation uncertain. Despite policy rate stability, the PBC has drained liquidity of 638 billion yuan (US$102,7 billion) for the year to date through repurchase transactions.

In order to support economic growth, the Reserve Bank of India (RBI) reduced its policy repo rate by 25 basis points to 7,75 per cent in January 2013, followed by equivalent reductions in March and May. The RBI indicated limited room for further monetary easing. Brazil's Monetary Policy Committee (COPOM) increased the Selic rate by 0,25 basis points in April 2013 in response to higher inflation and a deteriorating forecast for inflation. The move comes in the wake of reductions in 2012 that were intended to support the rapidly slowing economy. Since December 2012, the Central Bank of the Republic of Turkey (CBRT) reduced policy rates twice, by 50 basis points on each occasion. The Banco de México also lowered its policy rate by 50 basis points in March 2013 to 4,0 per cent, the first change in rates since July 2009.

Domestic economic developments and growth outlook

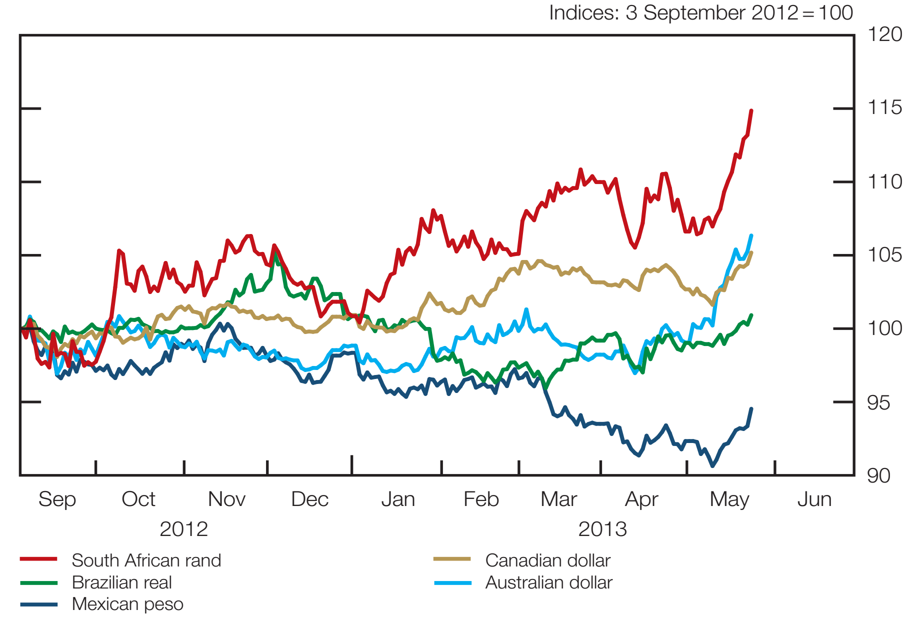
Monetary policy decisions are made on the basis of current and expected domestic developments in the wider economy. This section reviews medium-term developments, and assesses the near-term outlook in terms of prospects, risks and uncertainties for inflation.

Exchange rate developments

The rand continues to be influenced by external developments and is highly sensitive to changes in global risk perceptions as reflected by portfolio capital flows. Since the previous *MPR*, however, domestic economic and political developments have become considerably more important factors in rand movements. Currency volatility creates uncertainty and currency weakness poses an increased upside risk to the inflation outlook, among other effects. On a bilateral basis, the trend of the rand diverged from that of emerging markets, weakening in steps since October 2012 to its lowest post-crisis level of R9,66 to the US dollar in May 2013. On a nominal trade-weighted basis, the rand has depreciated by 7,4 per cent since the end of October 2012, with the real effective exchange rate (REER) at its weakest level since early 2009.

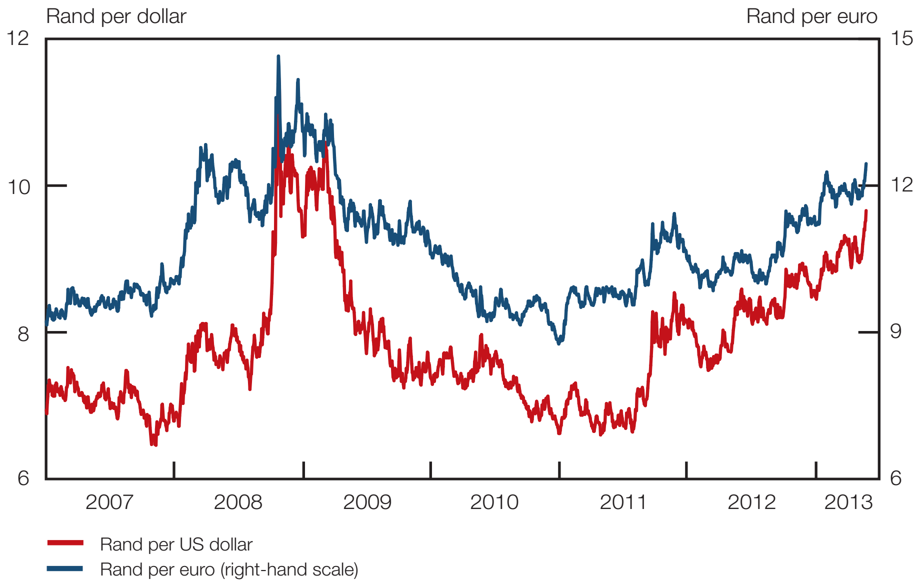
The rand has exhibited a general trend depreciation since about May 2012, with both global and domestic factors contributing to significant short-term volatility, as shown in Figures 10 and 11. Divergence from the trend in other emerging markets started in May 2012 and has escalated from October 2012. South Africa's expected inclusion in the Citigroup World Government Bond Index (WGBI) stabilised the rand somewhat in the period from June to September, before the inclusion actually started and before mining-sector events resulted in further weakness.

Figure 10 Exchange rate performance against the US dollar



Sources: Reuters and own calculations

Figure 11 Bilateral exchange rates of the rand

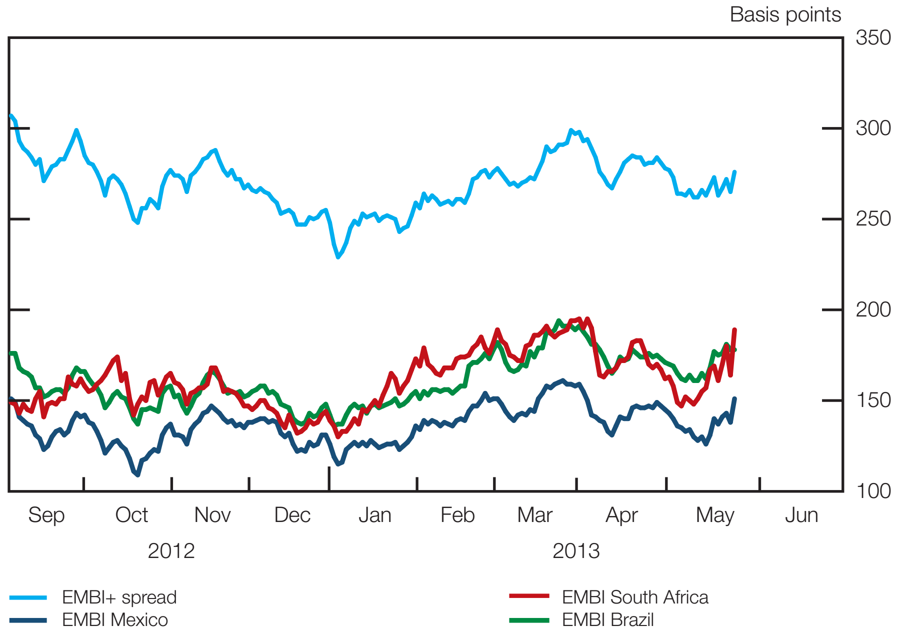


Source: Bloomberg

From November 2012 to early January 2013, the rand appreciated by 5,5 per cent against the US dollar. With the dollar strengthening due to better economic news in late December 2012 and early January 2013, the rand began to depreciate in a more sustained way. The crisis in Cyprus generated further impetus to the depreciation as investors sought out safe havens, thus the US dollar appreciated. This rise in risk aversion towards emerging markets can be seen in the JPMorgan Emerging Markets Bond Index Plus (EMBI+) spreads,[7] which, as shown in Figure 12, reveal significant deterioration in sovereign risk in 2013 towards the end of March. The retracing of the EMBI+ towards lower levels since March may have reflected expectations of sustained monetary accommodation and liquidity in global markets, rather than a prelude to currency appreciation. Subsequently, risk aversion again increased markedly during May.

7. The EMBI+ is a US dollar emerging-markets debt benchmark that tracks returns for actively traded external emerging-market debt.

Figure 12 Sovereign risk spreads

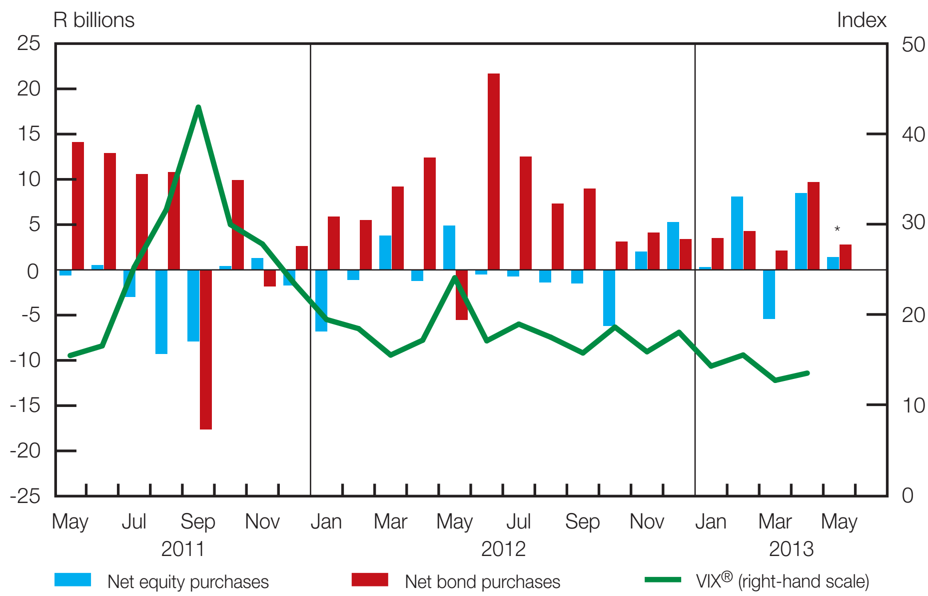


Source: JPMorgan

8. The Chicago Board Options Exchange Market Volatility Index (VIX®) measures the implied volatility of S&P 500 index options and serves as a popular indicator of investors' perception of risk.

Capital flows into rand-denominated assets shifted from bonds to equities, in particular from December 2012. This shift reflected a pause in non-resident purchases of bonds, and supported a moderation in share market volatility (VIX®).[8] As from March 2013 net purchases again favoured bonds. Cumulative net purchases of bonds amounted to R22,3 billion in 2013 up to 23 May compared with R88,6 billion in the whole of 2012. Non-resident interest in shares changed from net sales of R3,4 billion in 2012 to net purchases of R13,0 billion to 23 May 2013 (see Figure 13).

Figure 13 Non-resident net purchases of domestic securities and risk aversion



* Data up to 23 May 2013

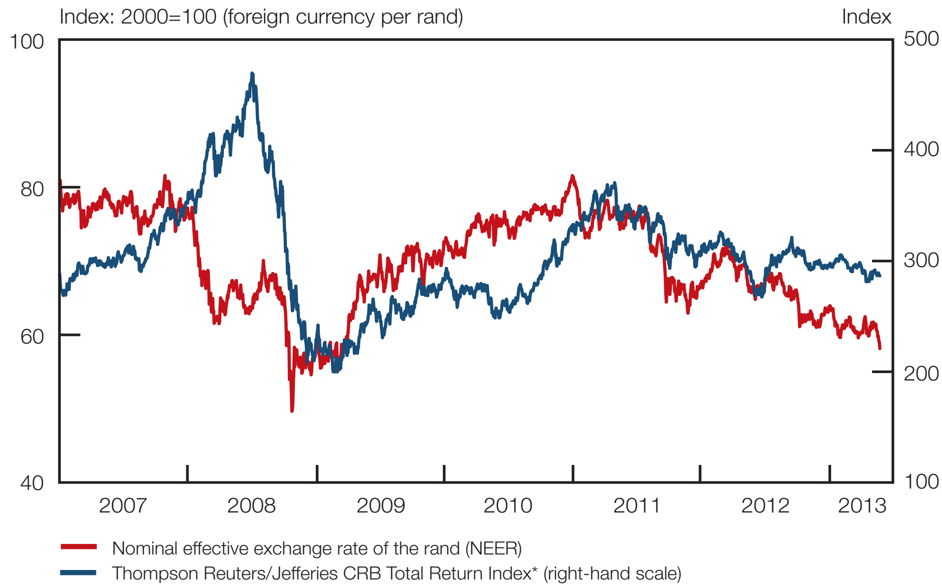
Sources: JSE Limited and I-Net Bridge

Prospects for capital inflows are less certain than they have been in recent years, as some of the underlying drivers of flows – the carry trade[9] and low returns in advanced economies – continue to evolve with global conditions. A reduction in the pace of capital inflows to South Africa – either as part of the trend affecting the emerging-market economies or as an idiosyncratic shock to South Africa – will affect the value of the currency and sustainability of the current-account deficit, with potentially serious policy implications.

In recent months domestic factors have played a critical role in driving down the currency. Resurgent labour market instability, the effect of work stoppages on exports, the trade deficit and a ratings downgrade by Fitch in January 2013 (following that of Moody's in September, and Standard & Poor's (S&P) in October 2012) contributed strongly towards a 14,3 per cent depreciation against the US dollar from 1 January to date. These factors and underlying macroeconomic risks in the form of twin deficits continue to differentiate South Africa from other emerging markets, many of which exhibit significantly better growth and macroeconomic fundamentals.

The nominal effective exchange rate (NEER) post-crisis peak occurred in December 2010. Since then the NEER has experienced persistent weakness, declining by 23,3 per cent as shown in Figure 14.[10] The weighted average NEER is based on trade in, and consumption of, manufactured goods between South Africa and its most important trading partners, and provides a nominal measure of competitiveness.

Figure 14 Exchange rate of the rand and commodity prices



* The TRJ/CRB Total Return Index tracks international commodity prices

Sources: Bloomberg and South African Reserve Bank

The monthly average NEER depreciated to 61 index points in March and April 2013 – its most depreciated level since early 2009. Some part of the currency weakness can be attributed to softer commodity prices, as suggested by an index that tracks returns to commodities which mirror the rand quite closely (Figure 14).[11]

The REERs[12] of developed commodity-exporting countries, such as Australia and Canada, have moved sideways since mid-2011 despite the decline in commodity prices. REERs provide an inflation-adjusted measure of competitiveness. South Africa's REER generally follows that of other commodity exporters, but the pattern has broken down as from mid-2011 (Figure 15). South Africa's REER depreciated by 10,7 per cent from March 2012 to April 2013 – its weakest level since early 2009, as with the NEER. This implies that South Africa's exports have become less expensive relative to its trading partners and competitors, and ought to support export volumes.

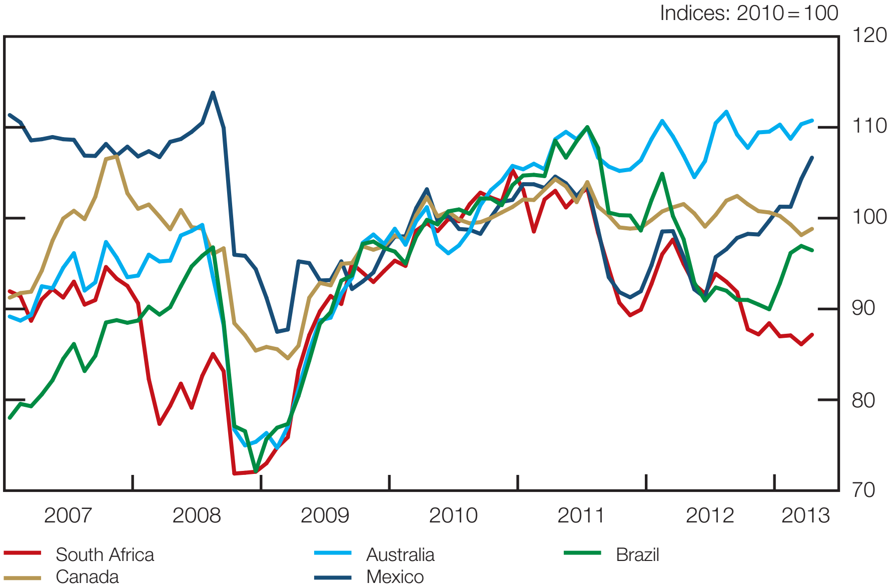
9. For further details on the carry trade and the rand as a carry trade target, see Box 2 in the May 2011 South African Reserve Bank *Monetary Policy Review* (Pretoria: South African Reserve Bank, May 2011) http://www.resbank.co.za/Publications/Pages/Publications-Home.aspx).

10. The methodology applied is described in an article in the South African Reserve Bank *Quarterly Bulletin* (Pretoria: South African Reserve Bank, December 2008) http://www.resbank.co.za/Publications/Pages/Publications-Home.aspx. 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.

11. The TRJ/CRB Total Return Index reflects a long-only, broadly diversified investment in commodities.

12. The Bank for International Settlements (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.

Figure 15 Real effective exchange rates



Source: Bank for International Settlements

Labour markets

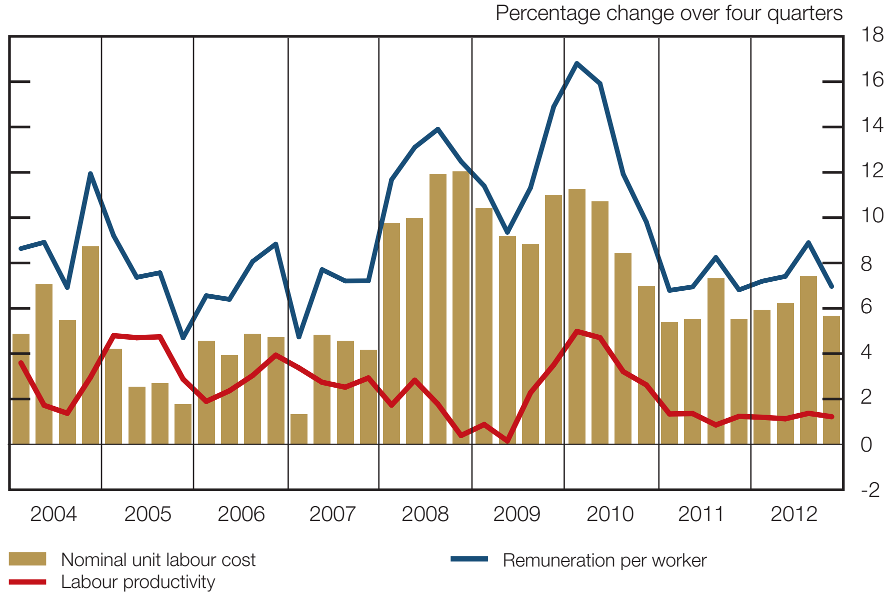
Labour markets in South Africa remained constrained by subdued economic growth and increased instability as unrest and wage demands spread from mining to agriculture and beyond. These developments pose substantial risks to the outlook for economic growth, employment and inflation. Unit labour cost growth – a primary driver of the inflation outlook – accelerated in 2012 to an average rate slightly higher than the upper band of the inflation target range, as increases in remuneration outpaced the marginal increases in productivity. Employment creation remained subdued, with the recovery in formal non-agricultural employment continuing to lag real economic activity since the economic recovery commenced.

The cost of labour per unit of output in the economy, known as 'unit labour costs',[13] grew by about 10 per cent per year between 2008 and 2010, before slowing to growth of 5,9 per cent in 2011 and 6,3 per cent in 2012. Over the course of 2012, unit labour costs accelerated from quarter to quarter (Figure 16), rising from 5,5 per cent in the final quarter of 2011 to 7,4 per cent in the third quarter of 2012, before decelerating to 5,7 per cent.

Average wage settlements in the collective bargaining system moderated slightly in 2012 from 2011, growing by 7,6 per cent, according to the *Andrew Levy Wage Settlement Survey* of 2012 (Figure 17). With inflation rising in 2012 compared to 2010 and 2011, the significant real wage gains of those years have moderated somewhat but remain positive. Outcomes in 2013 have increased, suggesting considerable real wage rigidity in the economy despite sluggish economic growth and weak job creation.

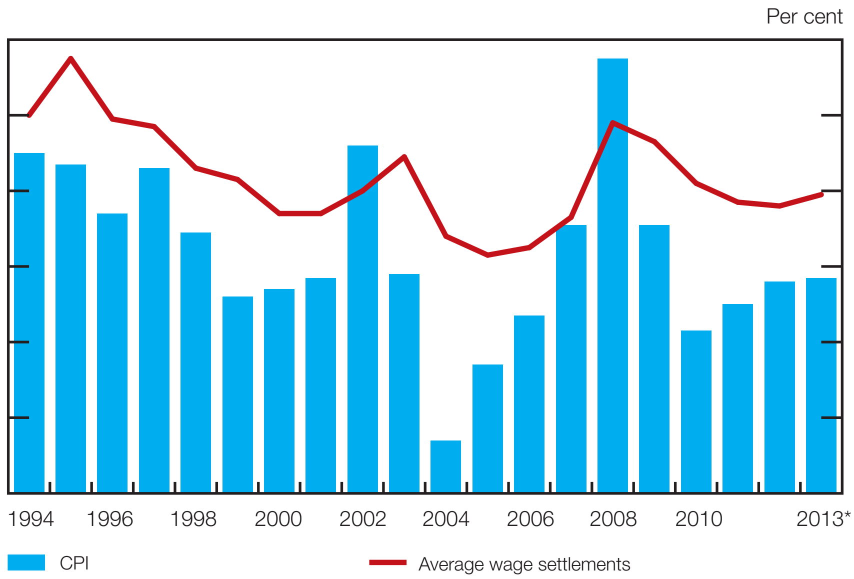
13. Unit labour costs represent a link between productivity and the cost of labour in producing output. The Bank calculates quarterly unit labour costs as the ratio of total salaries and wages to gross value added in the formal non-agricultural sector.

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

Figure 17 Average annual inflation and wage settlements



* Data for 2013 are for the first three months of the year

Sources: Andrew Levy Employment Publications and Statistics South Africa

Table 11 shows the average wage settlements in the major sectors in 2012 reported by Andrew Levy Employment Publications. In 2012 the highest and lowest average wage settlements were, as in 2011, respectively in the mining- and in the municipal and utility sectors. The rate of increase in settlements reached in the first quarter of 2013 ranged from 6,0 per cent in the retail and catering sector to 10,0 per cent in the transport and freight sector.

Table 11 Average percentages of wage settlement by major sector in 2012

Sector	Per cent
Building and construction	7,8
Chemical	7,8
Clothing and textile	7,5
Communication	7,5
Finance	7,0
Food and agriculture	7,1
Food and manufacturing	7,3
Health and education	7,5
Metal and engineering	8,0
Mining	8,6
Municipal and utility	6,8
Paper and printing	7,4
Retail and catering	7,7
Transport and freight	8,0

Source: Andrew Levy Employment Publications

Total employment creation in the formal non-agricultural sector as reported by Stats SA's *Quarterly Employment Statistics* (*QES*) survey has remained positive but subdued since June 2010. Total employment increased marginally from 8,379 million in the fourth quarter of 2011 to 8,461 million in the final quarter of 2012 – remaining below the peak of 8,512 million recorded in the corresponding quarter of 2008 (Table 12).

Table 12 Employment in formal non-agricultural industries

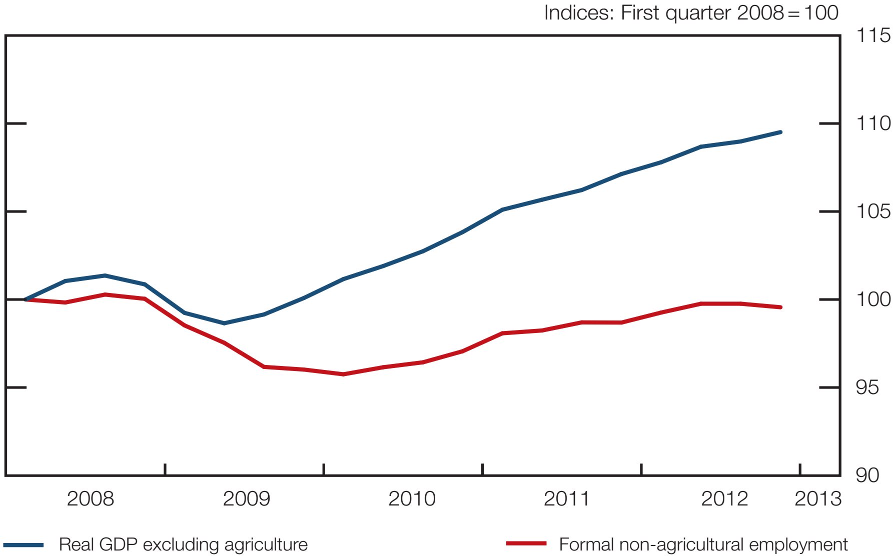
Thousands

Industry	Total employment				
	2008	2010	2011	2012	
	4th qr	1st qr	4th qr	3rd qr	4th qr
Mining and quarrying	518	491	518	518	519
Manufacturing	1 275	1 187	1 158	1 150	1 154
Electricity, gas and water supply	59	56	59	62	62
Construction	474	418	426	434	429
Wholesale trade and retail trade	1 747	1 630	1 700	1 690	1 709
Transport, storage and communication	366	359	369	372	383
Financial intermediation, insurance, real-estate and business services	1 914	1 742	1 831	1 835	1 841
Community, social and personal services	2 159	2 203	2 318	2 378	2 364
Total	8 512	8 086	8 379	8 439	8 461

Source: Statistics South Africa *Quarterly Employment Statistics*

The more recent outcomes of the *Quarterly Labour Force Survey* (*QLFS*) show a deterioration in total employment in the first quarter of 2013, including a rise in the unemployment rate to 25,2 per cent from 24,9 per cent in the fourth quarter of 2012, caused by a rise in labour force participation. The recovery in formal non-agricultural employment has continued to lag that of real economic activity since the economic recovery commenced (Figure 18).

Figure 18 Non-agricultural economic activity and employment*



* Data is seasonally adjusted

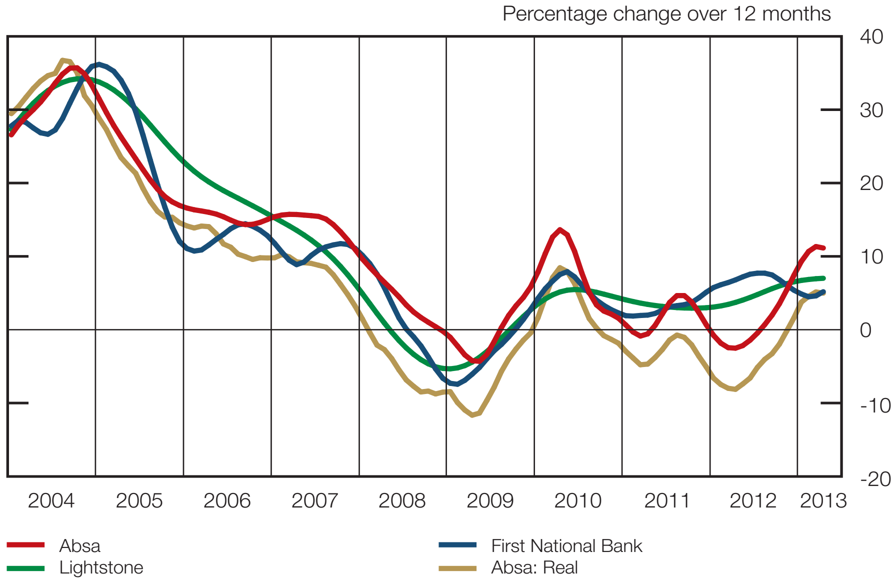
Sources: Statistics South Africa and South African Reserve Bank

Real-estate and equity prices

The real-estate market shows signs of a slight improvement in demand, along with a positive increase in real house prices. Domestic share prices scaled new highs in line with improved international financial market conditions, but in some contrast to softer commodity prices and labour unrest in the resources sector.

The real-estate market continues to be constrained by the fragile domestic economic recovery, high household debt levels and limited supply of mortgage finance. These factors are mirrored in nominal house price growth which, since October 2009, has grown at a subdued 4,5 per cent per year as recorded by First National Bank (FNB) and Lightstone. Absa's House Price Index, though more volatile, recorded a positive rate of change from August 2012, and increased strongly from February 2013, the highest growth rates in any of the indices since June 2010 (see Figure 19). Adjusted for inflation, real house prices increased by 5,0 per cent in April 2013.

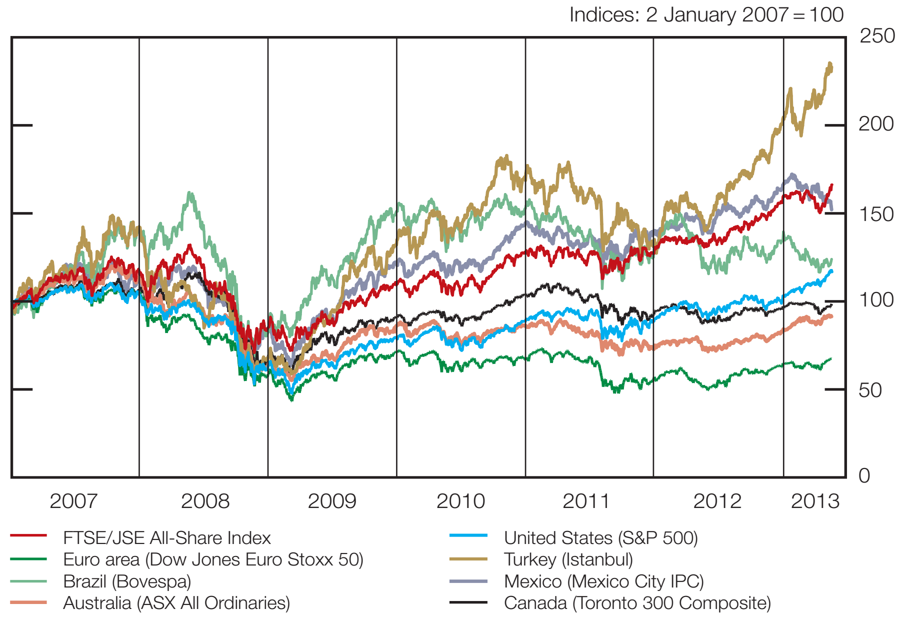
Figure 19 House prices



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

International financial market conditions continued to improve as accommodative monetary policies (in the form of low interest rates and increased global liquidity) encouraged greater risk-taking by investors. The FTSE/JSE All-Share Price Index (Alsi) moved higher in line with international markets and following the trend in emerging markets. A stronger recovery in the US economy appears to be supporting a rise in share prices there, beyond the levels reached prior to the Lehman crisis in October 2007. Figure 20 indicates the disparity between equity markets as the euro area remains weighed down by the still-unresolved sovereign debt crisis.

Figure 20 International share price indices*

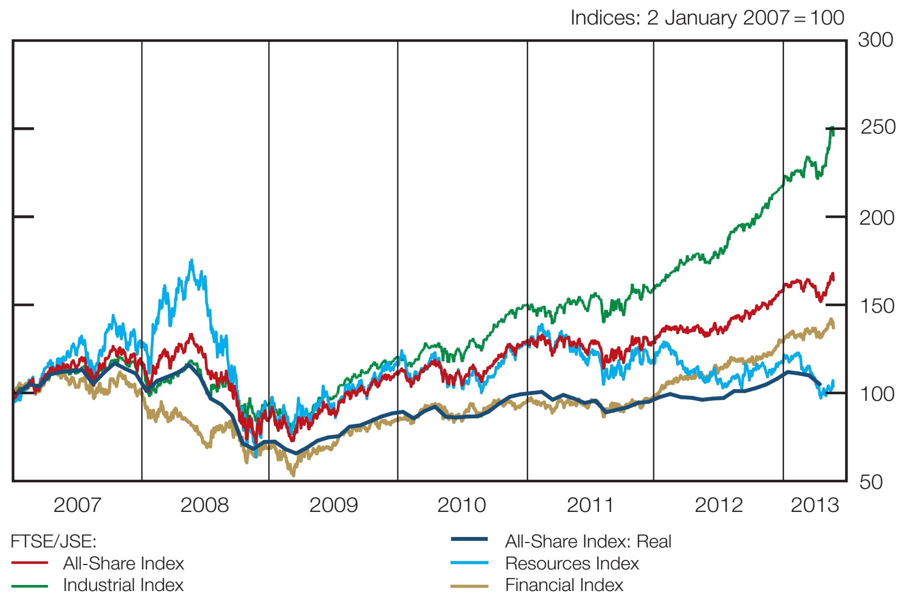


* Based on local currency share prices

Sources: JSE Limited and I-Net Bridge

The strong performance of domestic shares continued as the Alsi surpassed its previous record high of 22 May 2008 on 17 January 2012, and then scaled successive highs, breaching the 40 000 index level in early 2013 to a new all-time high of 41 836 index points on 22 May 2013.

Figure 21 Domestic share price indices



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

These gains were supported by trends in global equities through dual-listed share prices and the impact of the depreciation of the rand. Year to date the Alsi decreased in US dollar terms by 7,6 per cent, while increasing by 4,1 per cent in rand terms. Since October 2012, the Alsi was supported by the performance of the Industrial and Financial Indices, with sideways movement in the Resources Index reflecting softer commodity prices and domestic labour unrest. In real terms, the Alsi increased by 3,7 per cent from September 2012 to April 2013 but still yielded an overall loss compared to May 2008 (Figure 21).

Fiscal policy

In the context of subdued global and domestic economic growth, the 2013 Budget maintained its countercyclical approach. The weaker growth outcome for 2012 and into 2013 resulted in an increase in the budget deficit as revenue underperformed. Though fiscal consolidation has been delayed, the focus of the budget remains on fiscal sustainability and national development through investment and structural reforms.

The February 2013 *Budget Review* projected a small countercyclical rise in the consolidated deficit for the fiscal year 2012/13 from 4,8 per cent of GDP in the 2012 *Medium Term Budget Policy Statement* (*MTBPS*) to 5,2 per cent of GDP. With GDP growth slowing and revenue coming in weaker than expected, spending plans have been kept stable. Consolidated government revenue for the fiscal year 2012/13 as shown in Table 13 amounted to R887,8 billion, which was lower than the estimated R900,6 billion in 2012.

For 2013/14, the projected GDP outcome is expected to help reduce the consolidated government deficit to 4,6 per cent, somewhat lower than the 4,8 per cent projected for 2012/13 in the October 2012 *MTBPS*. The projected consolidated budget deficit for 2015/16 is 3,1 per cent of GDP.

Table 13 Public finance data

	2011/12	2012/13		2013/14	2014/15	2015/16
	Outcome	*MTBPS* estimates	Budget estimates	Medium-term estimates		
Consolidated government* (R billions)						
Revenue	836,9	900,6	887,8	985,7	1 091,1	1 199,8
Expenditure	954,2	1 057,1	1 055,9	1 149,4	1 244,3	1 334,1
Budget balance	-117,3	-156,5	-168,0	-163,7	-153,2	-134,4
Total net loan debt**	989,7	1 166,0	1 165,1	1 357,3	1 544,5	1 719,8
As a percentage of GDP						
Budget balance	-3,9	-4,8	-5,2	-4,6	-3,9	-3,1
Total net loan debt**	33,3	35,7	36,3	38,6	39,8	40,3
Public-sector borrowing requirement	5,5	7,1	7,4	6,4	5,2	4,4

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

Sources: National Treasury *Medium Term Budget Policy Statement* (*MTBPS*), October 2012 and *Budget Review 2013*

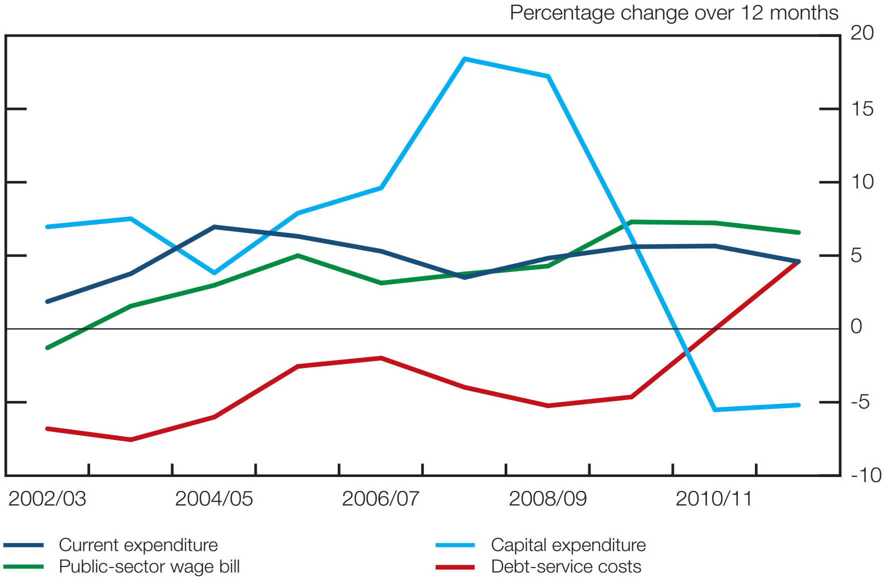
Government took steps to manage the expected widening of the budget deficit by spelling out additional measures to control spending. Real expenditure growth is reduced to an average of 2,3 per cent per annum over the Medium Term Expenditure Framework (MTEF) period compared to 2,9 per cent in the 2012 *MTBPS*.

Largely as a result of the wider budget deficit, the 2013 *Budget Review* projects the public-sector borrowing requirement (PSBR) to increase from 7,1 per cent indicated in the 2012 Budget Review to 7,4 per cent of GDP in 2012/13, before declining to 4,4 per cent in 2015/16. The growth in the PSBR has also reflected the borrowing required by non-financial public-sector enterprises and corporations for capital expenditure, which has averaged 2,0 per cent of GDP since 2007/08. Planned spending on public-sector infrastructure over the next three years of the MTEF period amounts to R827 billion, and the value of major public-sector projects in progress or under consideration until 2023 amounts to R3,6 trillion.

Substantial budget deficits and the slow economic recovery have worsened South Africa's debt position in recent years. With the projected decline in the budget deficit over the MTEF period, total net loan debt is expected to stabilise in 2015/16 at R1,7 trillion and as a ratio to GDP at 40,3 per cent compared with a ratio of 39,2 per cent indicated in the 2012 *MTBPS*.

The real growth of the wage bill has moderated slightly since 2009/10 (Figure 22), but the consolidated general government wage bill remains historically high at a ratio of 36,2 per cent of total expenditure in fiscal year 2011/12. Although real growth in capital expenditure has decreased significantly since 2008/09, the 2013 budget projects that real capital expenditure will grow at an annual rate of 3,4 per cent over the MTEF period. Despite extending the outstanding maturity of government debt, growth in national government's debt-service costs has recently increased in real terms from -4,6 per cent in 2009/10 to 4,6 per cent in 2011/12. However, debt-service costs as a ratio to GDP is expected to remain at 2,8 per cent over the medium term.

Figure 22 Real growth rates of selected aggregates*



* 3-year moving average

Sources: National Treasury, South African Reserve Bank and own calculations

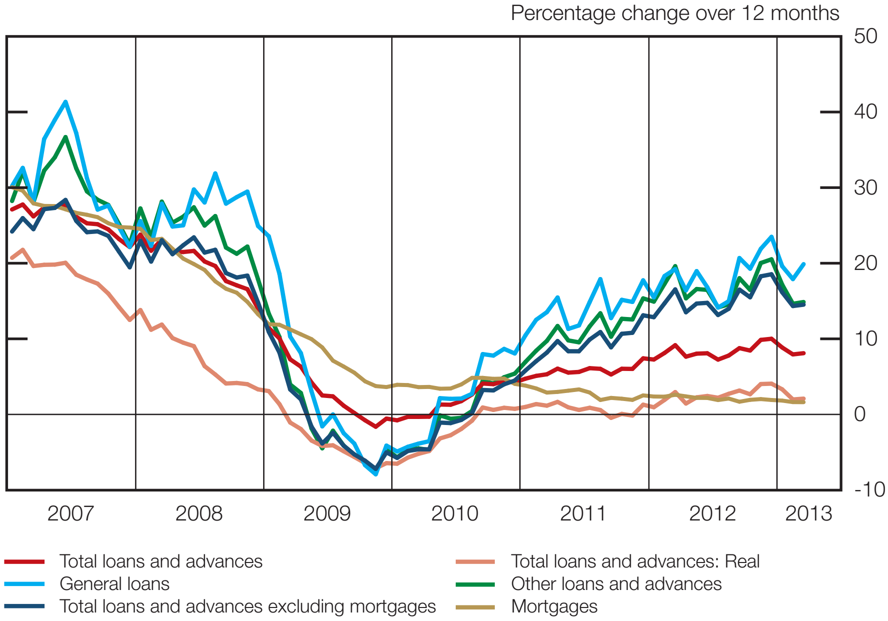
The 2013 *Budget Review* announced that tax policies would be reviewed to ensure that public spending is supported by an appropriate revenue base in a fair and equitable tax system.

Monetary conditions

Overall credit and money-supply growth remained inflation-neutral and broadly in line with nominal GDP growth. Modest single-digit growth in money supply peaked at 8,5 per cent in March 2013 in contrast to double-digit growth rates in total loans and advances excluding mortgage loans, which topped out at 18,6 per cent in December 2012. Other loans and advances, in particular general loans, remained the main driver of the uneven recovery of credit extension.

The low interest rate environment and vehicle sales supported credit extension, which was otherwise constrained by the size of outstanding household debt. Banks' total loans and advances to the private sector firmed to a post-recession high of 10,0 per cent in December 2012, before moderating somewhat to 8,1 per cent in March 2013 (Figure 23). In real terms, growth in total loans and advances increased modestly to 4,1 per cent in December 2012 – its fastest pace since October 2008. As of December 2012, growth in mortgage lending fell below its 2,1 per cent per year average growth rate in 2012 to a record low 1,6 per cent in March 2013.

Figure 23 Banks' loans and advances to the private sector by type



As growth in household income slowed, private-sector credit growth (excluding mortgage loans) peaked at 18,6 per cent in December – its strongest rate of growth since September 2008. It moderated to 14,5 per cent in March 2013, continuing its above 10 per cent growth rate for 18 consecutive months. The increased momentum in credit extension was supported by growth in other loans and advances (consisting of general loans, credit card advances and overdrafts). Growth in general loans, boosted by unsecured lending to households, peaked at 23,5 per cent in December 2012 before moderating somewhat.

Demand, output and expected growth

Economic activity regained some lost momentum in the final quarter of 2012. This was followed by weaker-than-expected growth in the first quarter of 2013. On the supply side, declining output levels in the mining sector contrasted with reasonable growth rates in the secondary and tertiary sectors in the fourth quarter of 2012. On the demand side, expenditure growth contracted in the final quarter of 2012. South Africa's terms of trade deteriorated as commodity prices weakened. Consistent with the Bank's composite leading indicator, South Africa's economic growth outlook has remained fragile and below potential thus far in 2013.

The economy regained some lost momentum in the final quarter of 2012 as it rebounded from the sharply lower growth of 1,2 per cent of the third quarter (Table 14). Excluding mining and agriculture, the economy grew by 2,7 per cent in the fourth quarter of 2012. The secondary sector rebounded from the earlier contraction to grow by 3,6 per cent, boosted by 5,0 per cent growth in manufacturing output. For the calendar year 2012 as a whole, real GDP increased by 2,5 per cent compared to 3,5 per cent in 2011. Real gross domestic expenditure increased by 4,1 per cent in 2012, slightly slower than the 4,6 per cent recorded in 2011.

Despite the depreciation of the rand, real exports of goods and services contracted in all but the third quarter of 2012 and increased by only 0,1 per cent in 2012 (compared to 5,9 per cent in 2011). This reflected subdued global growth, weak international demand, and the disruptive effect of domestic labour unrest on production and distribution. These effects were cushioned somewhat by the depreciated exchange rate and higher international commodity prices. Real imports, in step with the moderation in domestic demand, contracted by 12,4 per cent in the fourth quarter of 2012, largely because of a decline in the volume of imported vehicles and transport equipment. Overall growth in import volumes, however, still amounted to 6,3 per cent in 2012 compared to 9,7 per cent in 2011. With import prices increasing faster than export prices, South Africa's terms of trade deteriorated in the fourth quarter of 2012 and also on an annual basis (to -3,0 per cent) compared to 2011.

South Africa's trade balance deteriorated steadily from a surplus of R16,4 billion in 2011 to a deficit of R75,5 billion in 2012. The deficit on the services, income and current transfer account to GDP shrank slightly by 0,1 per cent from 2011 to 2012. Relative to GDP, the deficit on the current account of the balance of payments increased to 6,3 per cent in 2012 from 3,4 per cent in 2011. During 2012 the current-account deficit peaked at 6,8 per cent in the third quarter, before narrowing slightly to 6,5 per cent in the fourth quarter.

Table 14 Growth in real GDP and expenditure components

Per cent*

	2011	2012				
	Year	1st qr	2nd qr	3rd qr	4th qr	Year
Final consumption expenditure						
Households	4,8	4,0	3,2	2,7	2,4	3,5
General government	4,6	1,9	3,7	8,3	-0,7	4,2
Gross fixed capital formation	4,5	4,6	5,4	5,6	4,3	5,7
Changes in inventories (R billions)**	5,1	5,9	6,3	5,1	-4,1	3,3
Gross domestic expenditure	**4,6**	**4,4**	**4,4**	**4,1**	**-0,9**	**4,1**
Exports of goods and services	5,9	-3,0	-6,1	1,6	-4,3	0,1
Imports of goods and services	9,7	4,8	-0,5	12,0	-12,4	6,3
Gross domestic product	**3,5**	**2,5**	**3,4**	**1,2**	**2,1**	**2,5**

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

** Constant 2005 prices

Household consumption expenditure grew by 3,5 per cent in 2012 compared to 4,8 per cent in 2011. Spending remained constrained by rising inflation and moderate growth of 3,8 per cent in real household disposable income, compared to 5,2 per cent in 2011. Despite an increase in credit extension, the ratio of household debt to nominal disposable income receded slightly to 75,8 per cent in the fourth quarter of 2012.

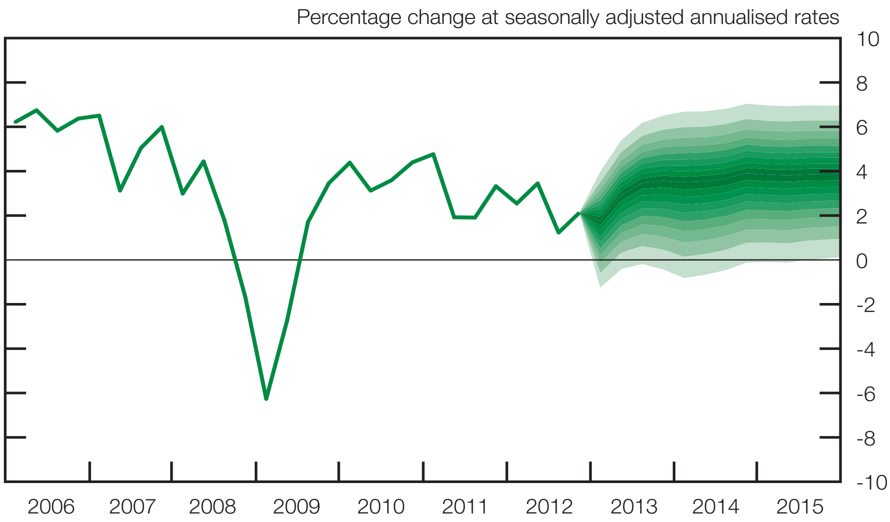
Consumption expenditure by general government in 2012 remained strong at 4,2 per cent. Excluding expenditure on armaments, the fourth-quarter growth rate was 3,6 per cent.

Growth in real gross fixed capital formation slowed to 4,3 per cent in the final quarter of 2012, reflecting the net effect of a moderation in capital outlays by public corporations and general government, and continued momentum of private business enterprises. For 2012 as a whole, real gross fixed capital formation increased by a fairly good 5,7 per cent compared to 4,5 per cent in 2011.

Real inventory investment turned negative in the fourth quarter of 2012 as the mining and manufacturing sectors depleted inventories to offset the effect of labour market instability on production.

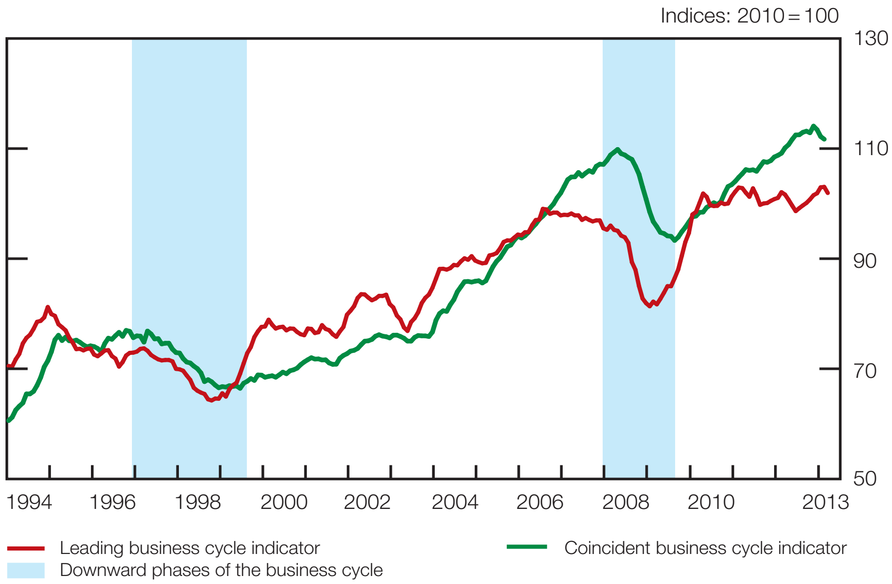
Global economic conditions remain subdued and adversely affect South Africa's economic outlook. South Africa's growth prospects therefore remain fragile at a below-potential pace. Growth in real GDP of 0,9 per cent was recorded in the first quarter of 2013. Projected growth has been lowered since the October 2012 *MPR*, reflecting the weaker global outlook and the negative impact of some domestic developments. The negative output gap of 2,0 per cent is expected to widen over the short term and reflects the continued subdued state of the economy. The May 2013 MPC meeting projected annual average growth in real output of 2,4 per cent in 2013, somewhat slower than the March 2013 forecast of 2,7 per cent, and 3,5 per cent in 2014 compared to 3,7 per cent in the previous forecast (Figure 24). This may have to be revised down at the next MPC meeting. (See Box 3 for an evaluation of the accuracy of the Bank's economic growth forecasts.)

Figure 24 Real GDP growth forecast



Looking forward, the relatively flat trajectory (with a slightly increasing trend since June 2012) of the Bank's composite leading business cycle indicator is consistent with the growth forecast (Figure 25). The Bank's coincident business cycle indicator has continued to trend upwards. Short-term indicators show relatively positive sentiment on the supply side of the economy, but still low consumer confidence on the demand side.

Figure 25 Composite business cycle indicators



The *Rand Merchant Bank (RMB)/Bureau for Economic Research* (*BER*) *Business Confidence Index* (*BCI*) increased by 6 index points from 46 index points in the fourth quarter of 2012 to 52 index points in the first quarter of 2013 – to a level close to the post-recession peak of 55 in the first quarter of 2011. Sentiment improved in four of the five sectors, with confidence declining only in the retail sector. According to the first-quarter 2013 *BER Manufacturing Survey*, manufacturing business confidence improved further by 4 index points to a still-low 42 index points.

The *Ernst & Young/BER Retail Confidence Index* fell by 4 index points to 50 index points in the first quarter of 2013, having been below the neutral level in the second and third quarters of 2012.

The *FNB Building Confidence Index* increased for the second consecutive quarter to 37 index points in the first quarter of 2013 – its highest reading since 2010. The improvement was mainly driven by retailers of building materials who saw significant growth in sales during the first quarter of 2013. Only subcontractors recorded a decline in confidence.

Table 15 Domestic economic sentiment indicators

	Historic range		Most recent		As at MPR:*	
	Low	High	Low	High	Oct 2012	Jun 2013
RMB/BER Business Confidence Index	10	91	23	55	47	52
BER Manufacturing Confidence Index	11	93	11	51	33	42
Ernst & Young/BER Retail Confidence Index	0	94	35	63	46	50
FNB Building Confidence Index	11	89	23	38	26	37
Kagiso Purchasing Managers' Index........................	34,6	63,4	47,1	55,4	48,3	50,5
FNB/BER Consumer Confidence Index	-33	23	-6	15	-1	-7

* Improved/Worsened since previous MPR

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

The *Kagiso Purchasing Managers' Index* (*PMI*) has improved unevenly from a recent low of 47,1 index points in October 2012, to above 50 index points in February 2013, before falling to 49,3 index points in March. This decline reflects weak economic conditions in the euro area – the largest market for exports of South African factory goods. In contrast to the trend in South Africa's major trading partners, the PMI then moved back to just above the neutral level at 50,5 index points in April 2013, signalling a slight improvement. Two of the five sub-indices were below the 50 mark, and the changes have been greatly influenced by volatile movements in the major contributors to the PMI, namely business activity at 52,2 index points and new sales orders at 53,7 index points.

The forward-looking indicators of the PMI suggest a marginal improvement in manufacturing conditions. In April 2013 expected business conditions increased to 51,3 index points from 47,0 in March – still significantly lower than the recent high of 58,2 index points in January 2013. The increase in the ratio of new sales orders to inventories to 1,1 in April 2013 suggests relatively low inventory levels to demand.

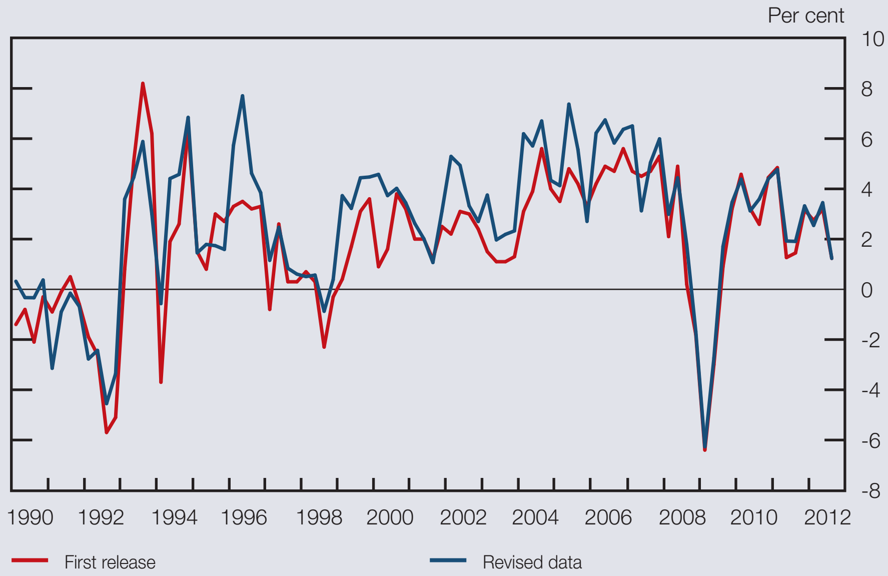
The *FNB/BER Consumer Confidence Index* (*CCI*) recorded its fourth successive negative reading as it declined further to a nine-year low of -7 index points in the first quarter of 2013 – even lower than at the height of the financial crisis in 2008. This was reflected by a significant deterioration in sentiment regarding the South African economic outlook, the financial situation of households and willingness to buy durable goods.

Box 3 An accuracy analysis of real gross domestic product growth forecasts

The accuracy of seasonally adjusted real gross domestic product (GDP) growth forecasts is assessed using real-time data, which is economic data known to the forecaster at the point of preparing the forecast.[1] Real-time data is that set of data that formed the basis of the forecaster's view of the future.

In South Africa average revisions to the actual quarterly GDP growth figures have been 1,1 percentage points between the first quarter of 1990 and the third quarter of 2012, with a maximum revision change of 4,2 percentage points recorded in the second quarter of 1996 (Figure B3.1). Most revisions during this period are upwards.

Figure B3.1 Data revisions to gross domestic product



Forecast errors are calculated as the forecast values minus the actual values. Therefore, a *negative* mean forecast error indicates that the model tends to under-predict the actual (first release) GDP outcomes. Overall forecast performance is assessed using a number of descriptive statistics. The most frequently used measures are the average forecast error (measuring projection bias in terms of systematic over- or under-estimation) and the root mean square error (indicating the absolute size of the error and how it relates to the variability of the series).

When the average forecast errors of the Bank's core model and those of the Reuters Consensus Forecast for the period March 2001 to December 2012 are compared (Figure B3.2), it is clear that all the average forecast errors are positive and therefore biased. Both the Bank and the Reuters participants, on average, overestimated the actual outcome of GDP over all forecast horizons, that is, one-quarter-ahead to seven-quarters-ahead forecasts.[2] Note that both the respective sets of forecasts have errors increasing initially along the early part of the forecast horizon but then declining along the remainder of the forecast horizon.[3]

1 Forecasted GDP growth rates are quarter-on-quarter annualised numbers.

2 Reuters only publishes forecasts that extend seven quarters into the future.

3 The root mean square error increases over the first several quarters as short-term indicators become progressively less useful. As the forecast horizon increases, accuracy gradually improves because of mean reversion in GDP growth rates. Forecast error bias is positive at all horizons in part because initial data releases over a large portion of the sample were subsequently revised upwards.

Figure B3.2 Average forecast error of gross domestic product

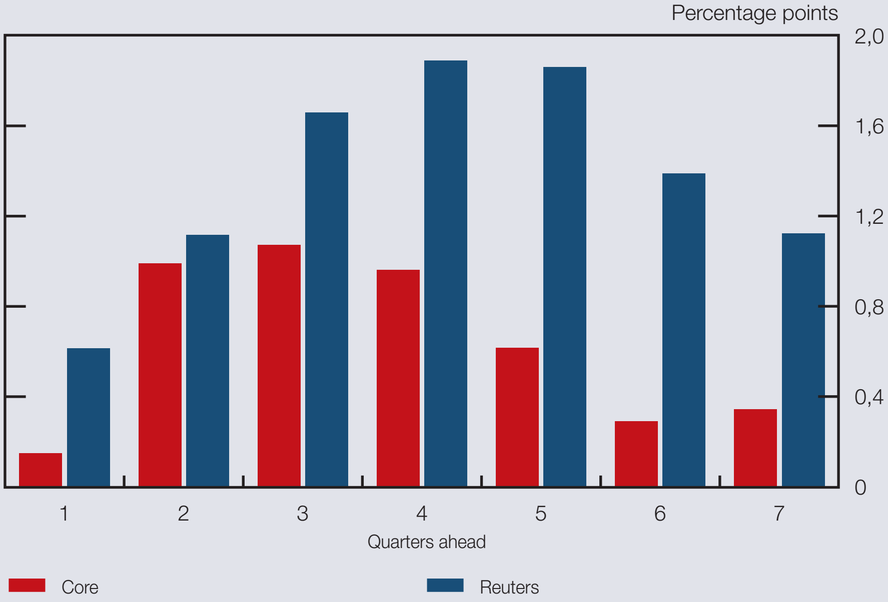
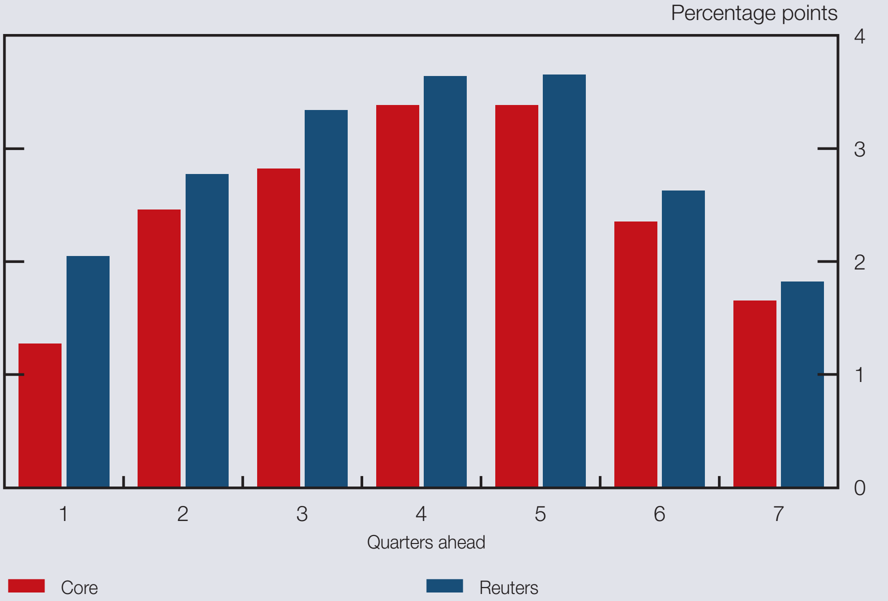


Figure B3.3 shows that the Bank's forecasts outperform those of the Reuters Consensus Forecast over all seven forecast horizons when comparing the respective root mean square errors.[4]

Figure B3.3 Root mean square error of gross domestic product

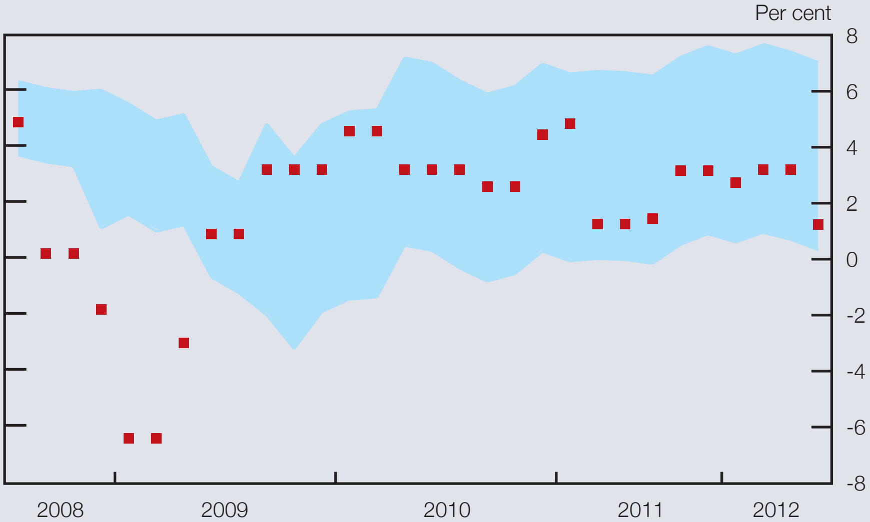


The Bank communicates forecasts of GDP growth to the general public through the use of probability distributions in the form of fan charts to indicate the balance of uncertainties surrounding possible future outcomes. When comparing the first release GDP growth rates

4 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 measure as the original data.

with the probability distribution around the individual one-year-ahead forecasts (see Figure B3.4), the values fall within the 90 per cent probability range in all periods except from the third quarter of 2008 to the second quarter of 2009.[5] This reflects the extraordinary shocks and impact of the global financial crisis on the real economy, resulting in forecast errors at levels significantly outside the historical probability ranges.

Figure B3.4 Probabilities for gross domestic product forecasts*



* For successive revised quarters, the change in confidence intervals reflects new information

Note: The shaded area depicts a 90 per cent confidence interval

The Bank's forecasting performance is also compared to the 16 individual forecasters or institutions and the average of the four best that participate in the Reuters survey. In Table B3.1 the root mean square errors of the various forecasts are compared over the one- to four-quarters-ahead horizons.

Table B3.1 Forecasting error comparison

Root mean square error

	Quarters ahead			
	1	2	3	4
Core model	1,2899	2,3905	2,7934	3,3376
Average of top four forecasts from Reuters	1,9664	2,4333	3,1673	3,3952
Average of total Reuters consensus forecasts...	2,1341	2,7728	3,2612	3,5466

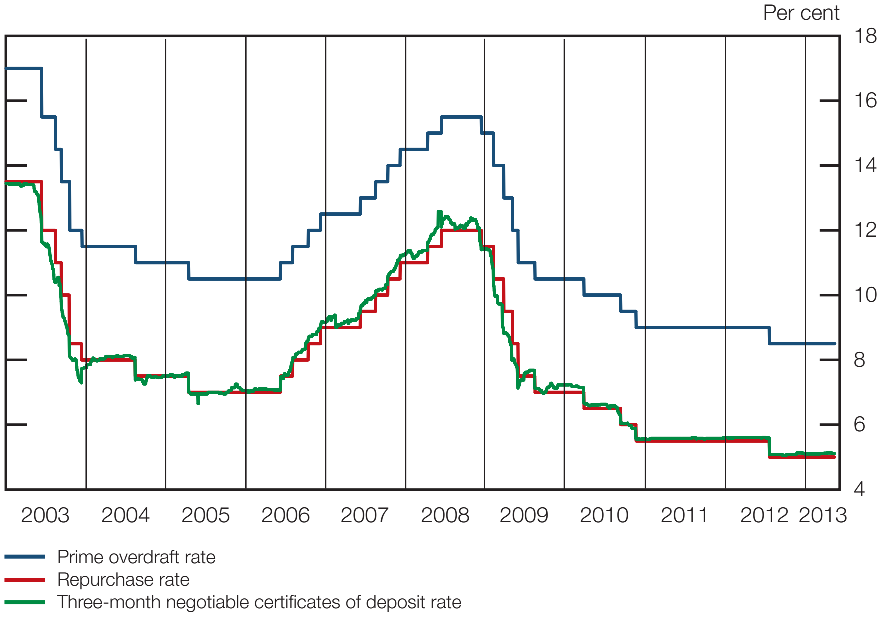
Sources: Reuters and own calculations

5 The forecast probability distribution of GDP, namely the width of the forecast fan, is based on the historical shocks that have impacted on the real economy.

Monetary policy

Since the publication of the previous *MPR* in October 2012, below-trend growth and subdued global inflation continue to characterise global conditions, notwithstanding improvements in some economies. Monetary policy in advanced economies remains highly accommodative. Global developments continued to affect South Africa's economic growth and inflation outcomes, but a range of domestic factors have become relatively more prominent. The domestic economic landscape worsened as a result of widespread labour market instability, with a general rise in uncertainty and a decline in confidence. As a result, the outlook for domestic economic growth has deteriorated with the balance of risks to the downside. The negative output gap persists and remains significant. Weaker domestic and global output has further contributed to a widening current-account deficit, ratings downgrades and a depreciated currency. These factors have sustained upside risks to the inflation outlook, contributing to successive decisions to keep the policy rate unchanged at 5,0 per cent per annum over the period (Figure 26). The outlook for inflation remains persistently skewed to the upside.

Figure 26 The repurchase rate and other short-term interest rates

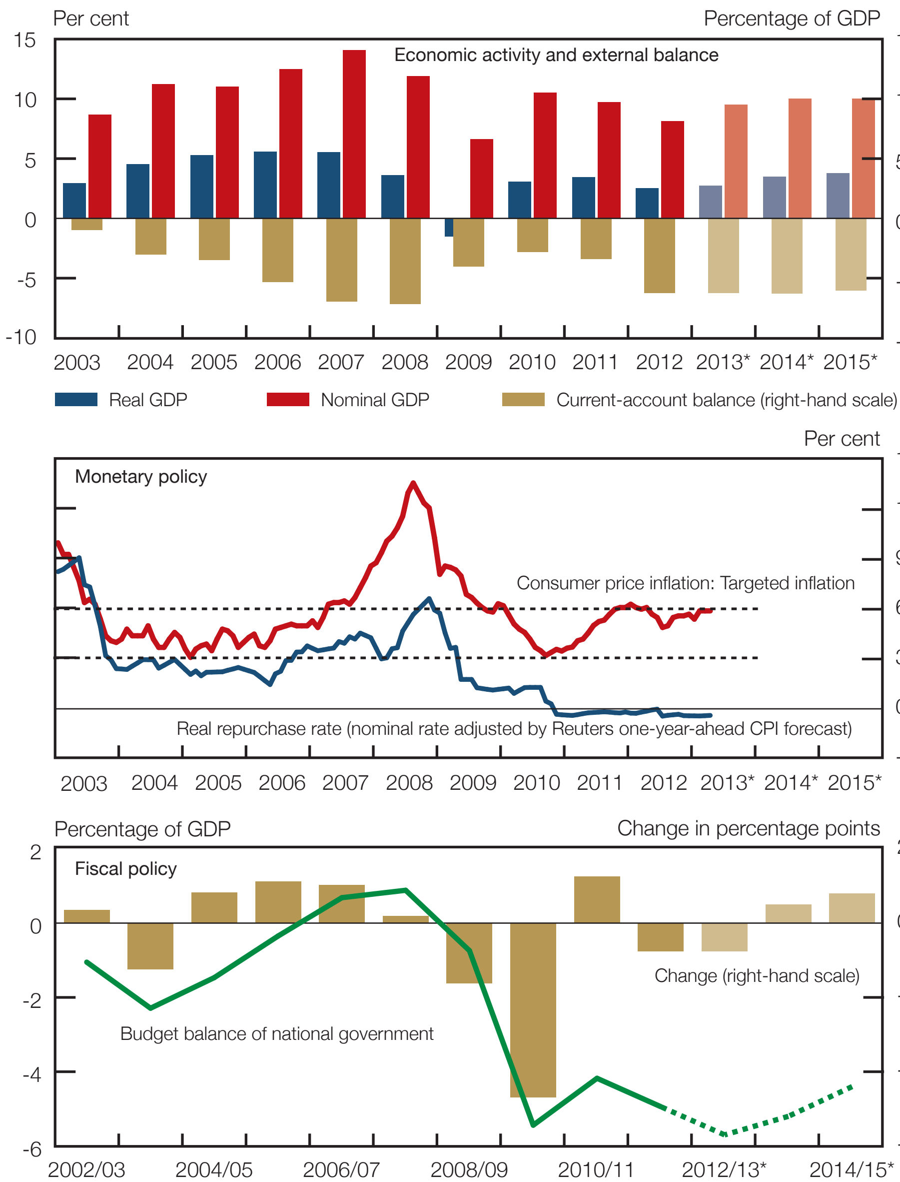


The period since the previous *MPR* has seen both a general deterioration in global economic conditions and some sign of improvement. Neither development has been unalloyed, however. Considerable strengthening in the US economy in 2013 is not evident in many others. Financial market conditions have also improved quite robustly in various markets, but can be seen to be increasingly disjointed from real economic outcomes in many of these markets. Secular developments appear to explain these variations and have given rise to the notion of a 'multispeed' recovery. One common feature of 2013 has been a moderation in inflation pressures in nearly all economies, barring a few. South Africa, India and Brazil fall outside the main group by exhibiting stronger inflation pressures.

The building up of inflation remains a policy challenge. For South Africa, inflation pressures do not derive from economic growth straining at available skills and resources. The output gap remains substantial and negative, suggesting considerable unused resources of capital and labour. Demand in the economy has been, and remains, well supported by fiscal and monetary policy settings, with a sustained and large fiscal deficit and real interest rates that have been negative since November 2010.

While the relative weights of the various factors propelling inflation have changed over the past year, rand depreciation, oil prices and food prices have all increasingly played a key role in South Africa's inflation outcomes.

Figure 27 Policy analysis



* Note: Data for 2013 to 2015 and fiscal years 2012/13 to 2014/15 are estimates from the *Budget Review 2013*

Sources: South African Reserve Bank, Statistics South Africa, *Budget Review 2013*, National Treasury and own calculations

Global factors

Global factors have continued to be critical to the considerations of monetary policy. In October and November 2012 the global environment was marked by the euro area returning to recession and heightened concern about whether and how the US 'fiscal cliff' would be resolved and about its impact on the US economy.

In early 2013, however, improvements in global financial market sentiment were evident, with progress made in respect of the US ‘fiscal cliff’ and more muted concerns about sovereign debt in the euro area. Global economic growth prospects, however, remained constrained by downside risks due to persistent structural problems and the unresolved euro area crisis. Monetary policy in most countries was expected to remain accommodative and increasingly expansionary, in particular in Japan.

Events in Cyprus in February unsettled global markets and reinvigorated pessimism about the euro area’s prospects at the same time as real economic indicators suggested weaker momentum. In successive months it became increasingly clear that global growth exhibited three distinct trends: stronger growth in some advanced economies, sustained weakness in others, and generally more rapid but also more variable growth in emerging markets.

In the US, the recovery continued to strengthen, with a rising consumer confidence index, stronger job creation and wealth effects from both a booming equity market and the recovering housing market. However, the euro area remained in recession, contracting by 0,9 per cent in the first quarter of 2013, as deleveraging by households, banks and governments continued, and financial markets fragmented and restructured. Peripheral Europe has and will continue to experience negative or, at best, very low growth for some time. In Japan economic growth accelerated sharply in the first quarter of 2013, although structural factors may constrain the efficacy of the fiscal, monetary and structural policy stimulus packages that were announced recently.

Emerging markets remain the main global source of growth, but there are signs of moderation in some of the systemically important countries, particularly China and India. The Brazilian economy should recover modestly this year. The rebalancing of the Chinese economy away from fixed capital formation and production towards internal consumption has resulted in some slowdown, and has contributed to the declining trend of global commodity prices.

Global inflation has moderated, reflecting persistently slow global growth and weaker commodity prices. This has prompted further monetary easing by the ECB and the BOJ. Alongside the Fed’s QE programme, these accommodative policy stances continue to increase global liquidity and, under current conditions, can be expected to be maintained over the medium term.

Domestic factors

Global factors have contributed to weaker-than-expected South African growth, exogenous price pressures and a depreciating exchange rate. However, domestic factors have become more important in assessing the future trajectory of growth and inflation. While the rand has trended lower in line with some of the other emerging markets, the depreciation has been considerably more pronounced as a result of South African-specific developments. Some of these factors carry major risks to inflation in addition to economic growth.

Domestic economic growth has remained fragile and below potential, with a low probability for the closure of the negative output gap in the medium term. Forecasts for growth hovered around 2,6 per cent for 2013 throughout the period since October 2012. In the new year domestic growth prospects remained subdued despite better-than-expected fourth-quarter GDP growth and positive developments in the mining and manufacturing sectors in January. The mining sector was expected to remain under pressure, given the unsettled labour relations environment, while the outlook for manufacturing improved tentatively.

This relatively benign environment deteriorated in subsequent months as consumer confidence weakened and disruptions in the mining sector worsened. Electricity supply constraints became more evident and global growth prospects failed to improve. The growth forecast of the Bank has been revised down from 2,7 per cent to 2,4 per cent for 2013 and from 3,7 per cent to

3,5 per cent in 2014. Growth is expected to accelerate to 3,8 per cent in 2015. The risks to economic growth lie to the downside as a result of the potential for further job and output losses, particularly in the mining sector.

Government and household consumption is expected to be constrained by a range of factors, including relative price adjustments and high debt levels. Investment by public-sector corporations should continue to provide some growth momentum, but private-sector investment remains sensitive to confidence and uncertainty. Slower expenditure growth is reflected in a moderation in growth in credit extended, especially from December 2012 through to March 2013.

Widespread labour market instability and work stoppages reduced output and export volumes in the mining sector. These factors also raised the possibility of protracted wage negotiations, above-inflation wage settlements and a sustained widening of the deficit on the current account of the balance of payments. These developments, along with fiscal considerations, contributed to the ratings downgrades by rating agencies.

A key risk to the inflation and growth outlook has been and continues to be the prospect of sharply rising unit labour costs arising out of combinations of overly-high wage settlements and/or falling output and productivity. Protracted and disruptive strike action risks lowering output and exports. Excessively high wage settlements will come at the expense of retention of employees, employment creation and could result in higher inflation. A wage-price spiral would negate the benefits of wage increases to workers and undermine the competitive gains of the currency depreciation. Wage, salary and price restraint at all levels, including executive pay, could underpin confidence and provide stability to prices, including that of the currency, in ways that boost economic growth.

Inflation forecasts

The inflation forecast deteriorated significantly between November 2012 and January 2013, with the average of 5,5 per cent for 2013 shifting to 5,8 per cent. Inflation was expected to peak at 6,1 per cent in the third quarter of 2013 and then to moderate gradually to 5,1 per cent in the final two quarters of 2014.

This near-term deterioration was mainly due to an expected increase in food price inflation and rand depreciation. The pattern of upside risk to the inflation forecast and downside risk to growth continued in the assessment, informed by sustained pressure of food prices, uncertainty about exchange rate movements, the overall impact of the new CPI and the possible impact of higher wage increases relative to benign demand pressures. Inflation expectations remained anchored at around the upper end of the inflation target range.

Table 16 The Bank's real GDP growth and targeted inflation forecasts

Per cent

MPC meetings	Real GDP	Targeted inflation		
	2013	2013	Expected peak	Expected to stabilise
September 2012	3,4	5,2	4th quarter 2012 at 5,4 per cent	at 5,0 per cent level to the end of 2014
November 2012	2,9	5,5	1st quarter 2013 at 5,7 per cent	at 5,0 per cent level in 2014
January 2013	2,6	5,8	3rd quarter 2013 at 6,1 per cent	at 5,1 per cent level in the second half of 2014
March 2013.................	2,7	5,9	3rd quarter 2013 at 6,3 per cent	at 5,2 per cent level in the final quarter of 2014
May 2013....................	2,4	5,8	3rd quarter 2013 at 6,1 per cent	at 4,9 per cent level in the final quarter of 2015

While the risks to the forecast from food prices moderated somewhat over the medium term, the exchange rate, wage settlements and petrol prices remained important upside risk factors. Administered prices, on average, also remained well in excess of the upper end of the target range. The growth rate for electricity price inflation was adjusted from 16,0 per cent to 7,5 per cent with effect from July 2013.

Inflation increased to 5,9 per cent in February 2013, contributing alongside rising petrol prices and depreciation, to a slight deterioration to the March inflation forecast. The March inflation forecast was adjusted up to an average of 5,9 per cent in 2013 and 5,3 per cent in 2014. The temporary breach in the upper end of the target range shifted out to the third quarter of 2013, at an average 6,3 per cent for the quarter, before moderating gradually to 5,2 per cent in the final quarter of 2014.

The most recent inflation outcomes, for March and April, also came out at 5,9 per cent, but with variation in the underlying drivers of the overall rate. Food price inflation measured 6,3 per cent in April, reversing the downward trend that had prevailed since November 2012. Core inflation, which excludes food, petrol and electricity, measured 5,2 per cent, marginally up from 5,1 per cent in March.

The May inflation forecasts for 2013 and 2014 have declined slightly, to 5,8 and 5,2 per cent respectively due to changed assumptions about international commodity prices, including oil, and lower global inflation. A temporary breach of the upper end of the target range is still expected in the third quarter of 2013, but at a lower average level of 6,1 per cent (6,3 per cent previously), followed by a gradual moderation of inflation to 4,9 per cent in the final quarter of 2015.

Core inflation has risen and is expected to be significantly higher, averaging 5,3 per cent for 2013 compared to the previous forecast of 4,8 per cent. This follows the sharp increase in medical insurance costs in the February CPI. Core inflation is also expected to be adversely affected over the coming months by increases in a number of administered prices, particularly water and municipal rates and taxes. This measure is expected to peak at 5,4 per cent in both the third and fourth quarter of 2013, and to average 5,0 per cent and 4,6 per cent in the coming two years. Despite the higher near-term trend, this indicator is still assessed to reflect an absence of significant demand pressures.

Inflation expectations remain stable and anchored, as confirmed by both the Reuters survey of analysts and the survey conducted by the BER. For the latter, respondents expect inflation to average 6,0 per cent in both 2013 and 2014, and 6,1 per cent in 2015.

Risks to the outlook

With strong and negative global headwinds, the South African economy has become especially vulnerable to declining domestic and foreign investor confidence. This has been reflected in the depreciating and volatile exchange rate, which was already under pressure from the widening deficit on the current account of the balance of payments.

A backdrop of weakening commodity prices increases the risk that concerns over the financing of a large current-account deficit create further volatility and negative sentiment. Non-residents have remained net buyers of bonds and equities in 2013, totalling about R35,3 billion, and it will be important for these flows to be maintained. These developments have the potential to affect, directly and indirectly, South Africa's credit ratings, and increase the cost of much-needed finance. Although inflation is forecast to remain relatively contained, these factors have raised the upside risks to the outlook at a time of worsening real growth prospects.

The impact of the weaker rand on inflation is dependent on the extent, speed and duration of the depreciation, and on the phase of the business cycle. The current level of the exchange rate, if sustained, poses a significant upside risk to the inflation outlook. While some of the recent decline reflects changes in the underlying fundamentals, the rand remains highly vulnerable to changes in sentiment and overshooting.

International oil prices are expected to remain constrained by the subdued global growth environment, but vulnerable to political developments in the Middle East in particular. Having reached a recent high of around US$119,34 per barrel in mid-February 2013, Brent crude oil prices have remained in a range of between US$96 and US$111 per barrel since the beginning of April. Recent exchange rate movements have raised the probability of further petrol price increases in the near term and may reverse the recent moderation in food prices. The exchange rate poses an upside risk to food inflation as prices of agricultural commodities such as wheat and maize are based on international prices.

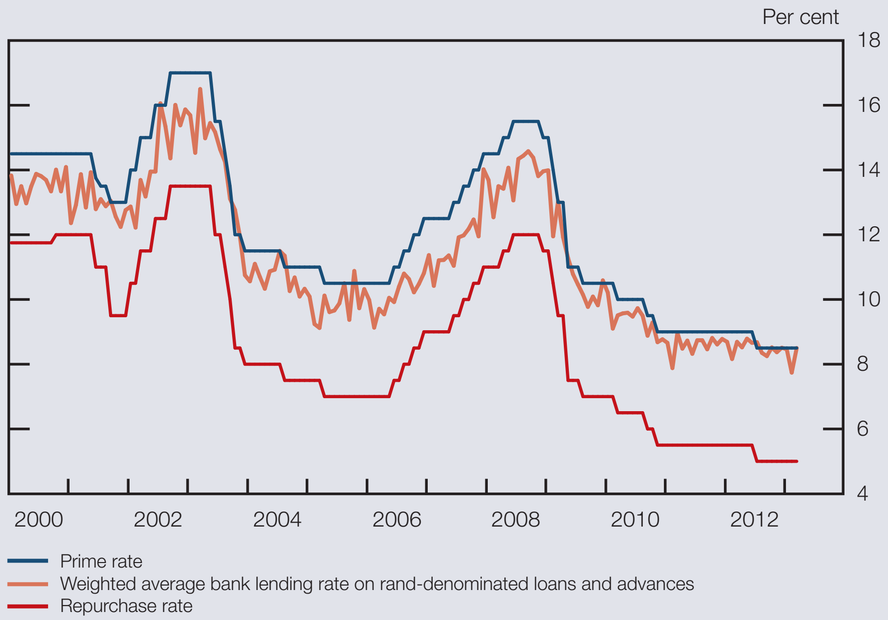
The deteriorating outlook for the South African economy remains a major concern for monetary policy, even though many of the drivers of the outlook lie outside the ambit of the Bank. These drivers include the financing of the deficit on the current account of the balance of payments; the fractious labour relations environment and the associated risks of protracted work stoppages and excessive wage increases; electricity supply constraints; upside risks to inflation; downside risks to growth and employment creation in a context of high unemployment; and declining domestic and foreign investor confidence which could impact directly on capital flows. These interrelated developments are reflected in the volatility and weakness in the exchange rate.

Global factors may have lessened somewhat in the balance of risks, but these nonetheless remain critically important and significant. Sentiment towards the South African economy is also a function of developments originating in foreign capitals and their markets. In particular, risks to financial markets and global capital flows from excessive global liquidity pushing up asset prices have grown in recent months. An early reversal of the US monetary policy stance looks less proximate, and likely to be extremely cautious, but its timing is complicated by excessive asset price increases and exuberance in financial markets.

Box 4 The role of the repurchase rate and the prime rate in the transmission of monetary policy

This box describes the role of the repurchase (repo) rate and the prime overdraft rate in monetary policy, and the difference between these two rates. The Bank, in the conduct of monetary policy, sets the level of the fixed repo rate at which short-term loans are provided to banks. This rate affects banks' funding costs and lending rates via the money-market yield curve and liquidity conditions. The level of banks' lending rates is determined by three main factors: operations, funding and capital costs; borrowers' credit risk profiles; and lenders' appetite for risk. Variations in these factors cause fluctuations in lending rates relative to the repo rate and the prime rate (Figure B4.1). This, in turn, influences other interest rates, the exchange rate of the rand, asset prices, the real economy and, ultimately, inflation.

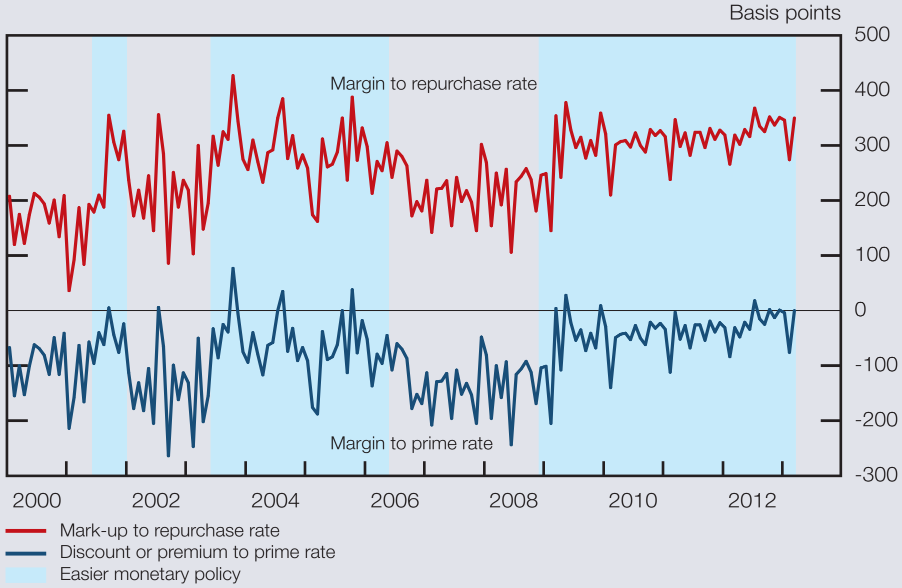
Figure B4.1 Lending rates in the banking sector



Sources: Banks' BA returns (DI returns prior to January 2008) and own calculations

This is known as the 'monetary policy transmission mechanism'. Owing to changes in market conventions, the role of the prime 'overdraft' rate in the domestic banking system changed in the 1980s from a 'minimum overdraft rate' (or 'best' lending rate) to a single reference (or benchmark) rate for different types of loans. These loans have since been priced relative or linked to the prime rate, with this link facilitating the transmission of broadly equivalent changes in the repo rate to existing floating rate loans. However, new loans are priced relative to the current repo and prime rates, and prevailing market conditions. As a result, banks can charge higher risk premia on new loans if they perceive lending conditions as riskier even during periods when the repo rate is lowered and vice versa.[1] This is illustrated by the shaded areas in Figure B4.2.

Figure B4.2 Relative margins to banks' weighted average lending rate



Source: Own calculations

In 2001 the spread between the repo rate and the prime rate widened to an appropriate, stable and constant 350 basis points, with the understanding that market interest rates would respond to changes in the repo rate.

Figure B4.3 shows how the weighted average bank lending rate[2] on rand-denominated loans and advances responds to and closely follows the monetary policy response. From a lending rate adjustment perspective, prime-linked assets tend to re-price faster in a downward interest rate cycle. This, together with banks' procyclical increase of risk premia on new loans, explains the narrower margin to prime and wider margin to repo in a downward interest rate cycle (Figure B4.2).

Figure B4.3 clearly shows that the prime rate is only a reference rate, with lending priced according to risk – on aggregate, at a discount to the prime rate. This refutes the general misconceptions that loans are priced off prime and that the size of the spread affects lending rates. Lending rates are not influenced by the 350 basis point spread between the repo rate and the prime rate. However, changes in the repo rate translate into changes in the prime rate and because floating rate loans are linked to the prime rate, the repo rate indirectly affects floating rates. Thus, the role of the spread is to facilitate the transmission of monetary policy to existing floating rate loans that are linked to the prime rate.

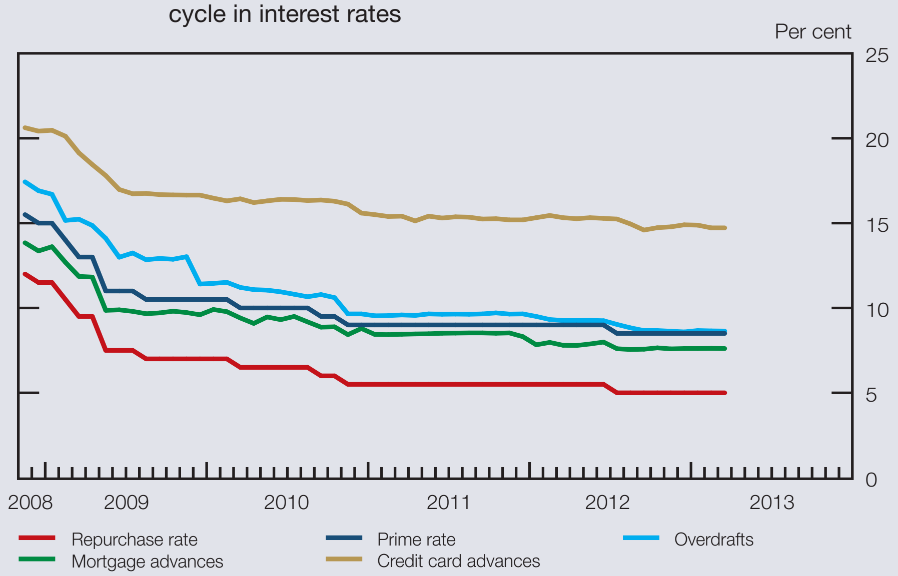
Akin to differentiating interest rates based on clients' risk profiles, banks also differentiate between products based on risk, as shown in terms of the respective weighted average interest rate levels of the credit products.[3] (Figure B4.4).

1 The tendency of banks to include a higher (lower) risk premium in the price of credit when the repo rate is low (high) is referred to as 'procyclical behaviour'.

2 The annualised weighted lending rate of banks is calculated as the total rand-denominated interest income flow divided by the stock of loans and advances.

3 The Bank calculates a weighted average rate per credit product by weighing the 5 major banks' reported weighted average rates based on outstanding balances.

Figure B4.3 The level of weighted lending rates in the latest downward cycle in interest rates

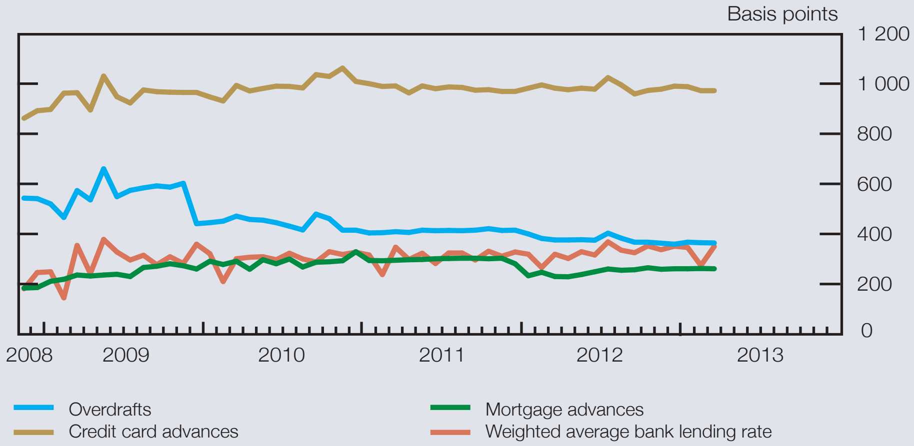


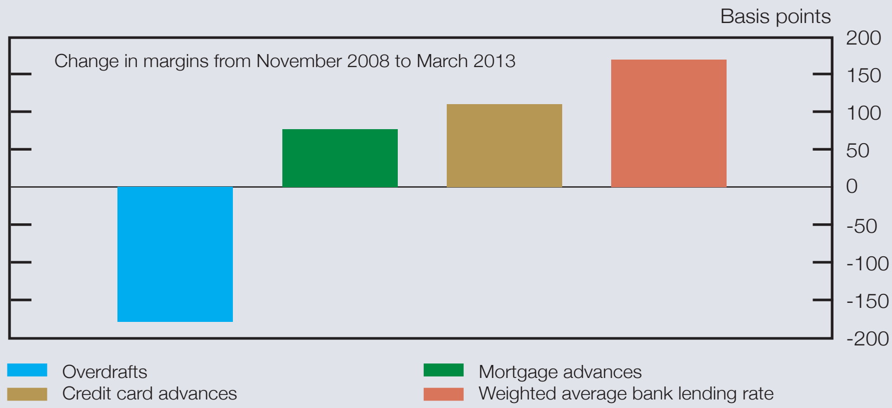
Sources: Banks' BA returns and own calculations

It is evident that credit card advances are deemed more risky than overdrafts, whereas collateralised mortgage advances are deemed less risky.

Figure B4.3 shows how lending rates have declined, as expected, across all bank product categories during the latest monetary policy easing cycle that started in December 2008. However, with the exception of overdrafts, margins on all credit product categories increased over this period, thus reaffirming the procyclical behaviour of banks (Figure B4.4).

Figure B4.4 Margins of weighted bank lending rates relative to the repurchase rate





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Expectations and the Bank's inflation forecast

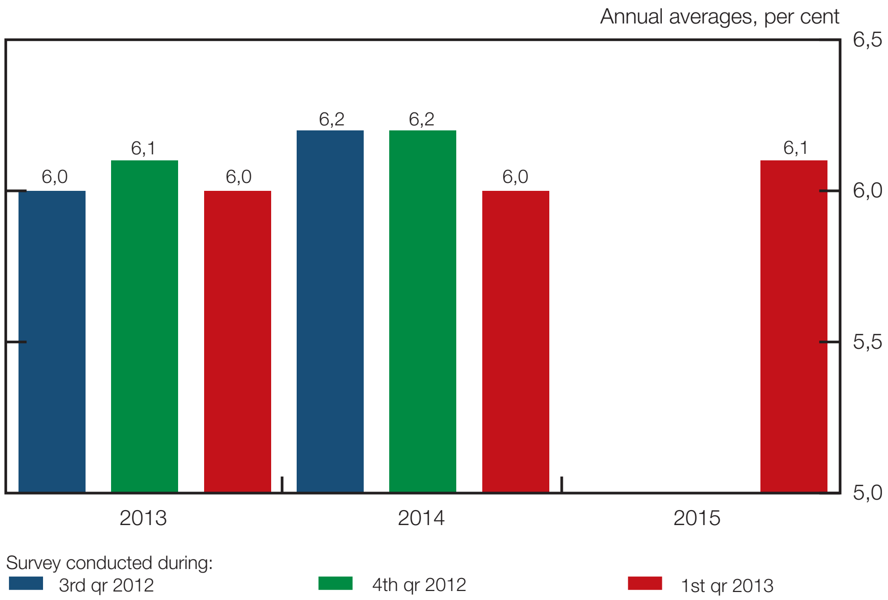
Given prospects, risks and uncertainties, the outlook for inflation is presented in this section.

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 remained well anchored with the Reuters survey showing average inflation well within the target range, the BER inflation expectations survey indicating inflation at, or just above, the upper band of the target range and break-even inflation rates suggesting inflation slightly above 6 per cent.

Measured headline CPI inflation fluctuated in a narrow range of between 5,4 and 5,7 per cent from September 2012 to January 2013 and then increased by 0,5 percentage points to 5,9 per cent from February through to April. The first-quarter 2013 BER survey of inflation expectations shows average inflation expectations for 2013 slightly lower at 6,0 per cent compared to the 6,1 per cent surveyed in the fourth quarter of 2012 (Figure 28). Inflation is expected to remain stable at 6,0 per cent in 2014 and then to increase moderately to 6,1 per cent in 2015. Lower expected inflation in 2013 resulted from a decline in the expectations of business people and trade union officials, with those of business above the inflation target and increasing from 2013 to 2014.

Figure 28 BER surveys of headline CPI inflation expectations



Source: Bureau for Economic Research, Stellenbosch University

Inflation expectations, as surveyed by Reuters (Table 17), continued to suggest that the average year-on-year percentage change in CPI would be less than 6 per cent. The median forecast for 2013 has increased slightly from 5,4 per cent in September 2012 to 5,8 per cent in April 2013 and has remained around 5,4 per cent for 2014.

The quarterly average year-on-year percentage change in CPI, according to the April 2013 survey, is expected to peak in the third quarter of 2013, while remaining within the inflation target range until the fourth quarter of 2014 (the final quarter of the survey). Forecasts of some respondents indicate a breach of the target to as high as 7,0 per cent in the third quarter of 2013.

Table 17 Reuters survey of CPI inflation forecasts: April 2013*

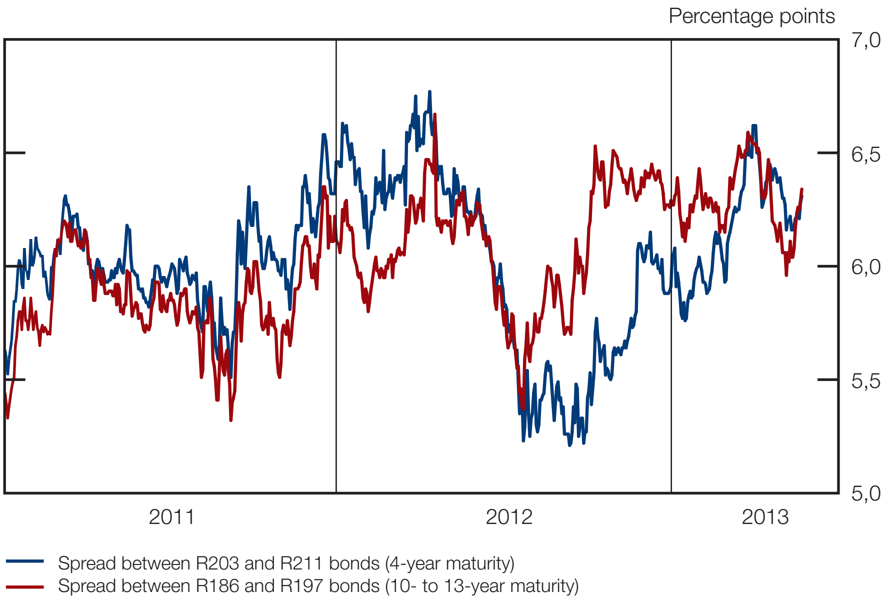
	2013			2014			2015	
Mean	[5,3]	(5,8)	5,8	[5,4]	(5,5)	5,4	(5,5)	5,6
Median	[5,4]	(5,8)	5,8	[5,4]	(5,4)	5,4	(5,5)	5,5
Highest	[6,2]	(6,2)	6,5	[6,0]	(6,4)	6,1	(6,0)	6,2
Lowest	[4,6]	(5,0)	5,3	[4,8]	(5,0)	5,0	(4,8)	4,8
Number of forecasters	[20]	(19)	19	[16]	(19)	19	(13)	16

* September 2012 [ ] and March 2013 ( ) survey results in parenthesis

Source: Reuters

Figure 29 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. The changes in the trend and level of break-even inflation rates since the October 2012 *MPR* reflected, among other things, changes in the exchange value of the rand and, more recently, net bond purchases by non-residents. Short-term break-even inflation rates have caught up with longer-term break-even inflation rates. The longer-term break-even inflation rates have consistently breached 6 per cent from late September 2012, followed by the shorter-term rates for brief periods from November 2012 and continually from late February 2013. This reflected less favourable near- and long-term inflation, with the short-term break-even inflation rates affected by increasingly negative real yields on inflation-linked bonds since November 2012.

Figure 29 Break-even inflation rates



Sources: JSE Limited and own calculations

The South African Reserve Bank inflation forecast

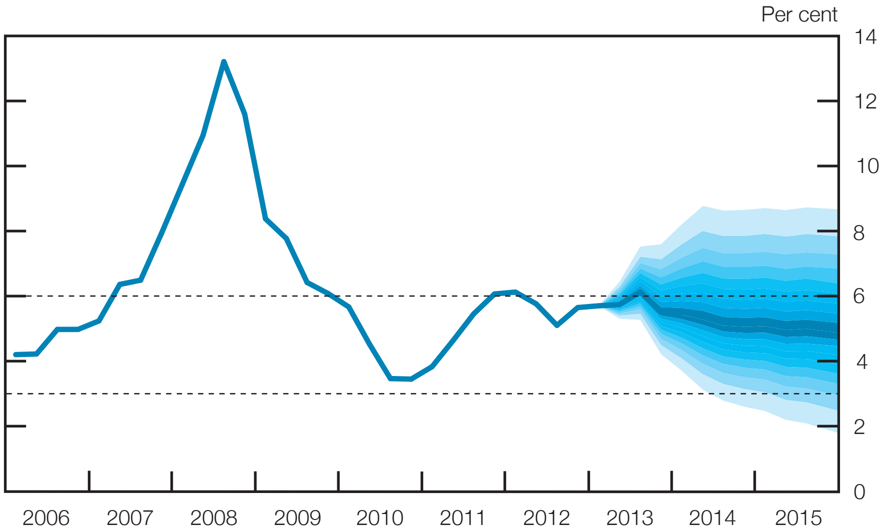
Since the October 2012 *MPR*, the Bank's forecast for annual 2013 targeted headline CPI inflation reflected a deterioration from 5,2 per cent at the September 2012 meeting of the MPC to 5,9 per cent in March 2013. Subsequently, the inflation outlook improved slightly. Although the projected peak receded slightly by 0,2 percentage points, the upper end of the target range will still be breached marginally at 6,1 per cent in the third quarter of 2013. Headline CPI is expected to gradually move back to within the target range to 4,9 per cent in the final quarter of 2015.

The most recent projections of the Bank's core quarterly forecasting model, presented to the MPC meeting on 21–23 May 2013, are reproduced in the form of a fan chart in Figure 30. The CPI inflation forecast of the Bank has been revised marginally downwards since the MPC's previous meeting in March 2013, primarily as a result of lower global inflation and commodity prices.

According to the central projection, which is conditional on an unchanged repurchase rate, headline CPI inflation is now expected to average 5,8 per cent in 2013 and 5,2 per cent in 2014, compared with the averages of 5,9 per cent and 5,3 per cent respectively projected at the time of the March 2013 meeting. At this meeting, the Bank's assumption for electricity tariff increases in the CPI basket had already been lowered to 7,5 per cent from July 2013. The average quarterly CPI inflation rate was expected at the May 2013 meeting to breach the upper end of the target range and peak at 6,1 per cent in the third quarter of 2013 before returning to within the target range, while moderating gradually to an average rate of 4,9 per cent in the final quarter of 2015.

When the unchanged repo rate assumption is replaced with the Reuters average expected path for the repo rate, headline CPI inflation is expected to average 5,7 per cent in 2013 and 5,1 per cent in 2014, with the average quarterly CPI inflation rate temporarily breaching the 6 per cent level in the third quarter of 2013.

Figure 30 Targeted inflation* forecast



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

Note: The MPC uses the fan chart to assess the risks inherent in the forecast and also to communicate the uncertainties that lie ahead. If future economic developments are deemed to be particularly volatile, the bands will be wider. If a fairly stable future is foreseen, the bands will, in turn, be narrower. The fan chart allows policy-makers to focus their discussion on the risks lying ahead and their effects on inflation. 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 the 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.

In the absence of significant demand pressures, the Bank's forecast of core inflation (i.e., headline CPI excluding food, petrol and electricity prices) shows a rising trend within the inflation target range, mainly due to expected increases in administered prices. This measure of core inflation is now expected to average 5,3 per cent in 2013 compared to 4,8 per cent previously, and with a higher peak of 5,4 per cent in the third and fourth quarter of 2013.

Given that the central projection for targeted inflation is the most likely outcome, the balance of risks to the inflation forecast in Figure 30 is viewed as being on the upside. These upside risks are mainly driven by the exchange rate and wage pressures but are mitigated somewhat by the downward revision of the commodity price assumption. Headline CPI inflation is expected to average 5,8 per cent in 2013 and 5,2 per cent in 2014.

Assessment and conclusion

In 2012 global economic activity remained weak, although stabilising somewhat in the latter part of the year when financial market tensions moderated. Subsequently, a weak start in 2013 gradually gained growth momentum. Financial market tensions eased, and the deterioration in global economic conditions moderated and reversed due to persistent and significant monetary policy easing. Global inflation remained benign.

Global inflation is expected to remain broadly unchanged, while global real economic activity is expected to progress gradually, with the US leading the way among advanced economies. Although short-term risks have eased, global prospects remain uncertain, with global economic activity likely to suffer periodic setbacks.

Domestic activity rebounded somewhat with the lessening of mining-sector tensions, and with some signs of improved global prospects and better financial conditions. This improvement proved short-lived, however, as ongoing prominent negative domestic factors undermined confidence and demand slowed. Since May 2012, the rand has depreciated by almost 25 per cent against the US dollar, reflecting primarily domestic uncertainty but also global developments. These factors have shaped, and will continue to shape, inflation outcomes over the medium term and at present create serious upside risk to the inflation forecast.

Since July 2012, the Bank's economic growth outlook has oscillated around 2,9 per cent. In May it was again revised slightly lower to 2,4 per cent and downside risks were identified. The output gap is expected to widen in 2013 before stabilising in 2014 and narrowing in 2015. The inflation forecast for the medium term has improved very slightly since the March 2013 MPC meeting but the risks to the inflation outlook are to the upside.

A more moderate inflation trajectory over the medium term would be brought about by greater stability of the exchange rate and commodity prices, more modest wage increases, and reduced administered price pressures.

Monetary policy has continued to provide stability through a period of both global and domestic uncertainty. The monetary policy stance has taken account of the expected temporary breach of the inflation target and the relatively weak economic recovery as reflected by a persistent negative output gap. The unchanged repo rate at 5,0 per cent per annum, and the modest negative real repo rate are expected to foster price stability and support the economic recovery.

Statement of the Monetary Policy Committee

22 November 2012

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

Since the previous meeting of the Monetary Policy Committee (MPC) the domestic growth outlook has deteriorated, while the upside risks to inflation have increased. Widespread labour market instability and work stoppages have reduced output and export volumes, with the potential for employment losses. Risks to the inflation outlook have been increased by a further depreciation of the rand exchange rate, partly in response to these developments, as well as by a possible higher trend in wage settlements and the impact of the reweighting and rebasing of the CPI basket by Statistics South Africa (Stats SA).

At the same time the global environment remains challenging with slowing growth in a number of regions, declining global industrial output, the worsening Japanese outlook, continued uncertainty regarding United States (US) fiscal policy and a resurfacing of concerns relating to the resolution of the crisis in the eurozone, which is now in recession.

The year-on-year inflation rate as measured by the consumer price index (CPI) for all urban areas at 5,6 per cent in October 2012, and up from 5,5 per cent in September, was 0,2 percentage points above the market consensus. The categories of food and non-alcoholic beverages, housing and utilities, and transport together accounted for 3,5 percentage points of the inflation outcome. The upside surprise was mainly attributable to food prices which increased by 2,8 per cent month on month, and 6,7 per cent on a year-on-year basis. Core inflation, as measured by the exclusion of food, petrol and electricity from CPI, measured 4,7 per cent, unchanged from September. Administered prices excluding petrol increased at a year-on-year rate of 7,5 per cent.

Year-on-year producer price inflation moderated further to 4,2 per cent in September, having measured 5,1 per cent in August. This favourable trend was driven mainly by lower rates of increase in the prices of mining products. A marked acceleration was seen in the food-related categories, with agricultural prices increasing at a year-on-year rate of 5,2 per cent in September, compared with 4,3 per cent in August and a recent low of 1,7 per cent in May. Manufactured food prices increased by 9,0 per cent and 10,1 per cent in August and September respectively.

The inflation forecast of the Bank reflects a deterioration in the inflation outlook for 2013 compared with the previous forecast. Inflation is now expected to average 5,6 per cent in the final quarter of 2012, and 5,6 per cent for the year. It is expected to average 5,5 per cent in 2013 and 5,0 per cent in 2014, with a peak of 5,7 per cent expected in the first quarter of 2013. This near-term deterioration is mainly due to higher expected food price inflation and the recent depreciation of the rand. Core inflation remains contained, indicating the absence of significant demand pressures. This measure is expected to peak at 5,0 per cent in the first quarter of 2013, and to average 4,8 per cent and 4,5 per cent in 2013 and 2014 respectively.

These forecasts do not incorporate the new CPI weights and rebasing recently announced by Stats SA as the finer details of these revisions, including the introduction of new products, and the method of linking the old and new baskets, have not yet been finalised. Preliminary evidence suggests that a slight upward bias to the Bank's central projection for headline CPI inflation could occur in 2013. On the assumption that the rate of increase in price changes for most goods and services, apart from food and electricity, is more or less unchanged, the combined average upward bias would be relatively small, in the order of around 0,2 percentage points. The new weights and the rebased index will be incorporated formally into the Bank's forecast in 2013 after the revisions have been finalised by Stats SA.

Inflation forecasts of financial analysts surveyed by Reuters have also been revised upwards. Financial analysts now expect inflation to average 5,5 per cent in 2013, compared with 5,3 per cent in the previous survey. The expectation for 2014 remains unchanged at 5,4 per cent. It is unclear if these forecasts already take account of the changes to the CPI weights.

The break-even inflation rates have also exhibited a moderate upward trend since the previous MPC meeting.

The global economic outlook has deteriorated somewhat with a return to recession in the eurozone. The prospects for the region remain bleak amid procyclical fiscal austerity, continued household- and banking-sector deleveraging in a tighter regulatory environment, and renewed concerns relating to the unresolved sovereign debt crisis. The deepening recession has served to heighten the solvency risk of the peripheral countries. The recently announced Outright Monetary Transactions (OMT) programme by the European Central Bank remains yet to be activated. The Japanese economy contracted in the third quarter and leading indicators point to a possible recession. Although the United Kingdom economy experienced positive growth in the third quarter, the outlook is negative as the favourable impact from the Olympic Games dissipates.

The prognosis for the US economy remains highly dependent on progress in resolving the so-called fiscal cliff. The related uncertainty has already adversely affected investment decisions, and while some last-minute political compromise is likely, the ultimate extent of the fiscal contraction and its impact on growth are still unclear. Failure to resolve this issue could result in a recession and derail the nascent recovery in the housing market.

Prospects for emerging markets, while still positive, have also deteriorated somewhat during the past months, contributing to the downside risk to the global recovery. Trend growth rates in Asia are declining, and both China and India are expected to experience weaker growth rates, with possible implications for commodity prices.

For some time the exchange rate of the rand has been determined primarily by external developments, particularly changing global risk perceptions. More recently, domestic factors appear to have become dominant determinants of the exchange rate. These include the increased risk posed to the economic outlook by labour market developments in the mining and agricultural sectors in particular; the widening deficit on the current account of the balance of payments, which is likely to have been exacerbated by the stoppages; and the ratings downgrades by two rating agencies while also retaining a negative outlook. Since the previous meeting of the MPC, the rand has depreciated by about 6,7 per cent against the US dollar, by 5,8 per cent against the euro, and by 5,8 per cent on a trade-weighted basis.

Inflows into the domestic bond market associated with South Africa's inclusion in the World Government Bond Index of Citibank probably helped to moderate the degree of depreciation over this period. Since the beginning of the year, net purchases of South African bonds by non-residents have totalled R85,2 billion. By contrast, non-residents have been net sellers of South African equities since the beginning of the year to the value of R6,8 billion.

The rand is expected to remain sensitive to both unfolding domestic economic and political developments, in addition to global risk perceptions. The extent to which the weaker rand feeds into inflation will be dependent on the trading range of the rand going forward and the duration of these moves. Most analysts do not expect further weakening of the rand from current levels, and a number of them expect some recovery. However, the rand is expected to remain volatile and subject to overshooting, and its depreciation poses an increased upside risk to the inflation outlook.

The domestic economic growth outlook has deteriorated recently, largely as a result of the continued global slowdown and aggravated by domestic events. Mining output has declined significantly as a result of work stoppages and there are likely to be longer-term implications for output, exports and employment as the mines adjust to higher labour costs. Labour unrest in parts of the agricultural sector is also expected to affect output and prices adversely.

Recent high-frequency data indicate that third-quarter growth was well below the 3,2 per cent recorded in the second quarter. Mining output contracted at a quarter-to-quarter rate of 3,2 per cent in the third quarter and further contractions are expected in the fourth quarter. The physical volume of manufacturing production was adversely affected by the road freight transport sector strike in September when a contraction of 2,3 per cent was recorded on a month-to-month basis. For the quarter as a whole manufacturing output increased by 0,3 per cent. The outlook for the sector remains negative, with the Kagiso Purchasing Managers Index declining to a level of 47,1 in October, reflecting an expectation of contraction in the coming months.

The Bank's forecast of gross domestic product (GDP) growth has been revised downward from 2,6 per cent to 2,5 per cent in 2012. Growth in 2013 is now expected to average 2,9 per cent, compared with 3,4 per cent previously, while the growth forecast for 2014 has been revised down from 3,8 per cent to 3,6 per cent. Moreover, the risks to this forecast remain on the downside. The RMB/BER Business Confidence Index declined marginally in the fourth quarter and remains below the 50 index level.

Consumption expenditure by households appears to have lost some momentum recently following the 2,9 per cent annualised growth rate in the second quarter. Consumer confidence in the third quarter, as measured by the FNB/BER Consumer Confidence Index improved marginally, but was still at low levels that were not consistent with robust consumer spending. Nevertheless, growth in retail trade sales, which account for about half of household consumption expenditure, has been relatively resilient having grown at a quarter-to-quarter rate of 1,9 per cent in the third quarter. However, passenger vehicle sales and expenditure on services were subdued.

There is, however, still little evidence of demand pressures on inflation. The resilience of consumer demand has been attributed to a number of factors, including low interest rates, relatively low inflation, real income growth, high growth rates in unsecured lending, and until recently a relatively strong exchange rate. Some of these factors may be a constraint on expenditure going forward, especially when combined with higher administered price increases which constrain discretionary spending.

The MPC is concerned about the recent trend in wage settlements and the potential negative impact on the economy, particularly on growth and investment. These developments could also result in lower growth in employment creation or an absolute decline in employment. Although the reported headline increases granted in some of the settlements are higher than the actual average increases, there is no doubt that the increases granted are well above inflation. This has the potential to increase aggregate demand and prices with a risk of a possible wage-price spiral, which could negate the real benefits of these wage increases to workers. However, the impact will be moderated to some extent by the inevitable job losses that are likely to accompany such increases in the context of a slowing economy. The cost-push effect of these wage increases will therefore depend on the actual increase in the total wage bill and unit labour cost developments.

The most recent wage data, which do not yet incorporate these latest trends, show that in the second quarter of 2012 growth in unit labour costs was 6,1 per cent, while Andrew Levy Employment Publications reported average wage settlement rates in collective bargaining agreements of 7,4 per cent for the first nine months of 2012. Wage settlements at these levels were not assessed to pose a major risk to inflation and these trends will be closely monitored as the collective bargaining landscape has become more fractious.

It is also too early to assess the impact of recent developments on employment. According to the Quarterly Labour Force survey, total employment increased by about 200 000 in the third quarter of 2012, but the increased number of unemployed workers resulted in the unemployment rate increasing to 25,5 per cent in September. It is expected, however, that the positive employment trend in the non-gold mining sector observed during the past year is likely to have reversed or slowed down, while the negative employment trends in manufacturing and gold mining are likely to persist. The net effect of higher wages and lower employment on aggregate expenditure is therefore still unclear at this stage.

Credit extension to the private sector moderated on a quarter-to-quarter basis in the third quarter of 2012, when an annualised increase of 5,4 per cent was recorded. Twelve-month growth in total loans and advances to the private sector was 8,8 per cent in September. However, mortgage loan growth remained subdued. When this category is excluded, loans increased at a significant twelve-month rate of 16,6 per cent. The main impetus has come from the persistently strong growth in unsecured lending to households, and this has been related to real income growth particularly in the public sector. Growth in unsecured lending to households remains in excess of 30 per cent but there are some tentative signs that this growth may be moderating. Although to date this has not represented a systemic risk, as it is still a small part of total loans and advances, this is being carefully monitored by the Bank. Unsecured lending has probably helped to underpin household consumption expenditure.

The fiscal policy stance, as reflected in the *Medium Term Budget Policy Statement* (*MTBPS*) remains supportive of the economy through its contra-cyclical stance. Although the goal of fiscal consolidation is being maintained, the timing has been pushed out further, as lower expected growth is likely to result in lower revenues. Growth in expenditure is projected to remain the same as that set out in the February budget, and no large boost to aggregate demand is expected that could impact on the inflation outlook.

Food prices remain a significant risk to the inflation outlook. Global food prices, while still high, have declined from recent peaks. The impact of this shock is still to fully filter through to domestic prices. Although there is usually a lag between the impact of global food price developments on domestic prices, the impact appears to have been felt more quickly than is generally the case. The recent depreciation is also expected to exacerbate the upside risk to food prices. Futures prices, however, indicate that maize prices may be moderating following a better-than-expected domestic harvest.

International oil prices have remained relatively unchanged since the previous meeting of the MPC, although in the past few days have increased following ongoing hostilities in the Middle East. Domestic petrol prices declined in November despite the depreciation of the rand and, should the exchange rate and international product prices remain at current levels, a further moderate decline can be expected in December. However, international prices remain highly dependent on the global growth outlook and political developments in the Middle East.

Since the previous MPC meeting the domestic landscape has seen a marked change. While the global crisis remains unresolved, South Africa has seen significant developments that have impacted on the economic outlook and confidence. These domestic developments, if not addressed in a comprehensive and constructive manner, have the potential to derail the progress made to date whereby South Africa has been able to withstand the worst contagion effects of the ongoing global crisis.

While recognising that there are real issues that underlie the recent wave of wildcat strikes, the Bank is concerned about the conduct of some of the parties involved in the recent labour market instability and, in particular, the unacceptable levels of violence that have accompanied the strikes. It is critical that both employers and employees take constructive steps to address the fraught relations that appear to be prevalent in a number of areas. Employers need to better appreciate the contribution to stability that an informed, experienced, skilled and organised workforce can make, and also need to be better informed about, and sensitive to, the conditions and circumstances of their employees. An important element of this is to take measures that enable employees to be better informed about the financial situation, strategy and future plans of the companies and sectors that they work in.

At the same time employees need to ensure an end to the use of violence in labour relations. In their quest for fair and decent employment conditions, employees need to recognise the potential negative effects of unsustainable cost structures on employment levels and competitiveness in the absence of improved productivity. In the prevailing conditions there is the danger of a wage-price spiral and, inevitably, it will be the workers who bear the brunt of the fallout.

The costs are not only the direct costs in terms of lost production, but also the possible increased costs of finance. In the context of a very weak global economy, where South Africa should strive to be a destination of choice and thereby grow the economy and achieve the pursued developmental and employment goals, the ability to attract investment and improve the country's ratings must be a clear objective.

While many of the strikes appear to have been resolved, long-term resolution of the underlying causes requires ongoing, concerted action on the part of all the parties involved. We need cohesion and certainty of policy, as well as unity of purpose to build an inclusive, longer-term vision. The National Development Plan is a broad unifying framework that has been adopted by both Cabinet and Parliament, and could form the base to take the country forward, enabling South Africa to play an effective role in the continent as a favoured trading and investment partner.

The MPC assesses the balance of risks to the inflation outlook to be on the upside, given the continued pressure of food prices, uncertainty of the exchange rate movements and the reweighting and rebasing of the CPI. Furthermore, the possible impact of higher wage increases could exert further upward pressure on inflation notwithstanding the concerns that recent developments in the labour market could impact negatively on employment. The MPC considers that the demand pressures on inflation at this stage remain relatively benign, as evidenced in the contained trend of underlying inflation. There are also signs of moderation of consumption expenditure against the backdrop of a weak supply side of the economy. The negative output gap is expected to persist for some time, and the balance of risks to the growth outlook remains on the downside.

In the light of these factors, the MPC is of the view that the current accommodative stance remains appropriate and has therefore decided to keep the repurchase rate unchanged at 5,0 per cent per annum. As always, the MPC will monitor developments closely and will not hesitate to act in a manner consistent with its mandate.

Statement of the Monetary Policy Committee

24 January 2013

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 has been some improvement in global financial market sentiment, but economic growth prospects in a number of the major advanced economies or regions remain constrained. Downside risks to the outlook persist as the structural problems in many countries, and in the eurozone, in particular, are still unresolved. Monetary policy in most countries is likely to remain accommodative in the absence of clear evidence of a sustained recovery, particularly against the backdrop of a relatively benign global inflation environment.

Despite a generally positive reaction to the ANC elective conference, ongoing labour conflict, the proposed scaling down of mining operations and ratings agency downgrades are symptomatic of the challenging domestic outlook. In the absence of coherent and consistent structural policy initiatives domestic economic growth is expected to continue to be well below both what is possible and required to make significant inroads into unemployment. In contrast to the situation in most advanced economies, the risks to the inflation outlook remain on the upside, due, in large part, to continued exchange rate and wage cost pressures.

The year-on-year inflation rate as measured by the consumer price index (CPI) for all urban areas was 5,7 per cent in December 2012, up from 5,6 per cent in November. The categories of food and non-alcoholic beverages, housing and utilities, and transport together accounted for 3,5 percentage points of the inflation outcome. Food price inflation moderated from 7,5 per cent in November to 7,0 per cent, mainly as a result of lower meat and grain price increases. Core inflation, as measured by the exclusion of food, petrol and electricity from CPI, which had been unchanged at 4,7 per cent since September, increased to 4,9 per cent in December, mainly as a result of increases in services price inflation and in line with the Bank's forecast. Administered prices increased by 8,8 per cent, and by 7,6 per cent excluding petrol.

Having reached a recent low of 4,2 per cent in September 2012, year-on-year producer price inflation increased to 5,2 per cent in both October and November. This reversal of the previous downward trend was mainly due to price increases in mining and quarrying, agricultural products and manufactured food. Agricultural prices increased at year-on-year rates of 6,3 per cent and 5,9 per cent in October and November respectively, while manufactured food prices increased at rates of 10,9 per cent and 11,1 per cent in these months respectively.

The inflation forecast of the Bank reflects a further deterioration in the inflation outlook for 2013 compared with the previous forecast. The forecasts do not yet incorporate the new CPI weights and rebasing recently announced by Statistics South Africa, but these changes will be incorporated formally into the Bank's next forecast. The impact on the inflation trajectory is likely to be marginal. Having averaged 5,6 per cent in 2012, inflation is now expected to average 5,8 per cent in 2013 and 5,2 per cent in 2014, compared with the previous forecasts of 5,5 per cent and 5,0 per cent for the respective years. Inflation is expected to peak at 6,1 per cent in the third quarter of 2013 and then to moderate gradually to 5,1 per cent in the final two quarters of 2014. This deterioration is largely due to higher expected food price inflation, the lagged effects of the depreciation of the rand and higher expected unit labour costs.

The forecast of core inflation is more or less unchanged, indicating the continued absence of significant demand pressures. This measure is expected to peak at 5,0 per cent in the first two quarters of 2013, and to average 4,9 per cent and 4,5 per cent in 2013 and 2014 respectively.

Inflation expectations remain anchored at around the upper end of the inflation target range. According to the Survey of Inflation Expectations conducted by the Bureau for Economic Research (BER) in the fourth quarter of 2012, inflation is expected to average 6,1 per cent in 2013 and 6,2 per cent in 2014. This represents a marginal increase of 0,1 percentage point for 2013 compared with the previous survey, while the forecast for 2014 is unchanged. Business executives are the most pessimistic about inflation, having raised expected inflation rates to 6,6 per cent and 6,7 per cent in 2013 and 2014, while trade union respondents reduced their forecasts to 6,1 per cent and 6,6 per cent respectively for these years. The forecasts of financial analysts increased marginally, but remain within the target range for the forecast period. For the past four quarters expectations for the next five years have remained unchanged at 6,2 per cent.

The global growth outlook remains challenging, notwithstanding improved sentiment in global financial markets following the interim deal related to the fiscal cliff in the US. The fiscal issues have not been fully resolved, with decisions on expenditure cuts and the debt ceiling delayed till later this year. While the worst-case fiscal scenario has been avoided, the uncertain fiscal outlook is likely to contribute to continued sub-trend US growth. On the positive side, there are continued signs of a recovery in the US housing market and improved corporate profitability.

Although sovereign debt risks in the eurozone have subsided for now and bond spreads on peripheral European debt have narrowed significantly, the region is likely to remain in recession for much of the year, as fiscal tightening and balance-sheet repair by banks and households continue. The unemployment rate has now reached 11,8 per cent, with youth unemployment at 24 per cent. The outlook for Germany, the main growth driver in the region, has also deteriorated. Growth prospects in the UK remain relatively weak, while the outlook for Japan is uncertain despite the announcement of substantial fiscal and monetary policy stimuli.

The outlook for emerging markets, particularly those in Asia, is more positive. The Chinese economy appears to have stabilised following concerns about a possible hard landing, and consensus forecasts suggest some growth acceleration in 2013 in both China and India. Growth in Africa is expected to be sustained at rates in excess of 5 per cent, while Latin American growth is expected to be more restrained, but an improvement on 2012.

The rand exchange rate continues to pose an upside risk to the inflation outlook. The exchange rate has been impacted by the widening deficit on the current account of the balance of payments during 2012 and changing global and domestic risk perceptions, particularly relating to the adverse developments in the South African labour market, and the downgrades by the various ratings agencies. Since the previous meeting of the MPC, the rand has been fairly volatile, having appreciated initially from R8,94 to the US dollar, to R8,45 at the end of the year, but subsequently depreciated to current levels of around R9,00. Since the beginning of the year, the rand has depreciated by 6,1 per cent on a trade-weighted basis and by about 6,6 per cent against the US dollar.

While the rand is expected to remain sensitive to domestic and global developments and continued volatility can be expected, most analysts do not expect significant further sustained depreciation in the coming months. The depreciation of the rand is expected to help moderate the current-account imbalance, although platinum export growth may be undermined to some extent by possible shaft closures. However, financing of the deficit may be more challenging despite relatively high domestic nominal bond yields, as sentiment towards South Africa has deteriorated, and non-residents already hold over one-third of the stock of outstanding government bonds.

Non-resident net purchases of domestic bonds totalled R88,6 billion during 2012, due in part to South Africa's inclusion in the Citibank World Government Bond Index. However, the pace of inflows declined substantially in the final quarter of the year, when net purchases amounted to R10,6 billion. Since the beginning of 2013, net purchases by non-residents have amounted to R4,3 billion. While non-residents were net sellers of equities during 2012 to the value of R3,4 billion, they were net buyers to the value of R7,3 billion in November and December. Year to date, however, the negative trend regarding equities has continued with net sales of R2,3 billion as growth prospects remain weak.

Domestic economic growth remains fragile and below potential following an annualised growth rate of 1,2 per cent in the third quarter of 2012, and an estimated growth rate of around 2,5 per cent for the year. A similar outcome is expected in 2013 with growth of 2,6 per cent forecast, revised down from 2,9 per cent in the previous forecast. A more favourable outcome of 3,8 per cent is forecast for 2014, compared with 3,6 per cent previously, driven in part by a more favourable global outlook. However, the risks to these forecasts are assessed to be on the downside, given uncertainties and instability in parts of the mining and agricultural sectors in particular. Constraints to growth are both external and internal. To achieve a higher internally-generated growth rate would require a serious commitment to implementing a range of structural reforms and making the necessary trade-offs as outlined in the National Development Plan.

The outlook for parts of the mining sector is bleak, following continued labour disputes and announcements of possible closures of shafts and mines, a consequence of increased cost pressures, weak global demand and prices. Although mining output increased on a month-to-month basis in November, on a three-month-to-three-month basis a contraction of 10,4 per cent was recorded.

There are mixed signals pertaining to the outlook for the manufacturing sector. The real volume of manufacturing production increased by 2,3 per cent in November, its highest month-on-month rate in 4 years, due in part to a rebound from widespread strike activity in previous months, and growth in the fourth quarter is estimated to have been relatively robust. Capacity utilisation has also increased. However, the Kagiso PMI declined to below the 50 index point level to 47,4 in December, indicating an expectation of some contraction in the sector.

The negative business sentiment evident in the confidence indicators is also reflected in the continued weakness in private-sector gross fixed capital formation. Recent developments in the mining sector are likely to reinforce this weakness as plans are scaled back. Investment expenditure is likely to remain underpinned by the government and state-owned enterprises. In the third quarter of 2012, gross fixed capital formation grew at an annualised rate of 7,2 per cent, but private-sector capital formation, which accounts for just under two thirds of the total, only grew at a rate of 2,8 per cent.

Growth in consumption expenditure by households moderated as expected in the third quarter of 2012 when it increased by 2,6 per cent. The main driver of the moderation was the decline in expenditure growth on services and non-durable goods. However, there are also signs of moderation in the growth of expenditure on durable and semi-durable goods, and the depreciated exchange rate is likely to sustain this trend. Growth in motor vehicle sales has slowed in recent months, and there was a marked decline in the confidence of new vehicle traders reported by the BER. Despite the higher-than-expected increase in retail trade sales in November, the quarterly rates suggest further moderation in growth. The FNB/BER Consumer Confidence Index declined by 2 index points to -3 index points in the final quarter of 2012.

On balance, the MPC does not assess growth in household consumption expenditure to be excessive or to pose significant inflationary risks, and further moderation is possible. Factors that affect the outlook for consumption expenditure, both positively and negatively, include concerns regarding employment, wage settlements, credit extension particularly unsecured lending, and administered price increases which impact on discretionary spending.

The upward momentum of banks' total loans and advances to the private sector has continued, with twelve-month growth of 9,9 per cent recorded in November, the highest growth rate since February 2009. Excluding mortgage advances, which remain subdued, the increase in November was 18,3 per cent. Bank credit extension to the household sector increased by 10,4 per cent. General loans to households, which is mainly unsecured lending, while still exhibiting rates of growth in excess of 30 per cent, shows some signs of moderation amid reports that banks are becoming more cautious in extending new loans in this category. Access to new loans may also be constrained by the increased size of outstanding debt. However, despite rising debt levels, household debt to disposable income appears to have stabilised at around 76 per cent.

The MPC remains concerned about the potential impact of the higher level of wage settlements on employment and inflation. There are indications that wage increases are trending higher, with growth in nominal remuneration per worker increasing from 7,2 per cent in the second quarter of 2012 to 8,1 per cent in the third quarter. Once productivity increases are accounted for, this translates into unit labour cost increases of 6,1 per cent and 6,7 per cent in these respective quarters. According to Andrew Levy Employment Publications, the overall average wage settlement rate in collective bargaining agreements amounted to 7,4 per cent in the first nine months of 2012.

The MPC is mindful of the danger of a possible wage-price spiral and further employment losses should unaffordable real wage demands be granted while economic growth remains constrained. The risks to inflation should this scenario play itself out are significant in the absence of productivity gains.

The subdued pace of employment creation in the private sector has been further undermined by the fractious nature of recent wage negotiations and the announcement of further possible restructuring in the mining sector, which would involve the closure or mothballing of mines or shafts. According to the Quarterly Employment Statistics survey of Statistics South Africa, non-agricultural formal sector employment grew by 1,0 per cent or 82 000 employees in the year to September 2012. Almost two-thirds of this increase was accounted for by the public sector, while net job losses over this period were experienced in the manufacturing and construction sectors, with employment in the mining sector unchanged. However, in the third quarter of 2012, 15 000 jobs were shed in the mining sector and there are fears that this trend could continue. Employment in the agricultural sector, which is not covered by the survey, is also at risk.

Food prices continue to pose a significant near-term risk to the inflation outlook, although there are signs that these price pressures may moderate during the year as a result of favourable base effects, as well as the recent moderation in global and domestic wheat and maize prices. The price of these commodities will also be influenced by developments in the exchange rate of the rand and unpredictable weather patterns.

Administered prices remain on average well in excess of the upper end of the target range, and there is as yet no clarity about the new Eskom tariffs to be implemented later this year. At this stage a 16 per cent tariff increase is assumed in the forecast. International oil prices have remained relatively stable for the past few months and are more or less unchanged from the previous meeting of the MPC. Futures prices reflect an expectation of some moderation in coming months, but some volatility can be expected. The domestic price of petrol, which is also impacted by the exchange rate, declined by a cumulative 34 cents per litre since early November, but much of this decline is likely to be reversed in February.

The MPC continues to assess the balance of risks to the inflation outlook to be on the upside. While the risks to the forecast emanating from food prices may have diminished somewhat, particularly over the medium term, the exchange rate and wage settlements remain the key upside risk factors. While the reweighting and rebasing of the CPI is still to be finalised, the impact is likely to be marginal, but on the upside. Core inflation trends indicate that demand pressures are relatively contained, and household consumption expenditure has continued to moderate.

Risks to economic growth are assessed to be on the downside, particularly given the uncertain outlook for the mining industry and ongoing unsettled labour relations. The negative output gap is therefore expected to persist. The MPC remains concerned about the possibility of a wage-price spiral and its potential to exacerbate the high level of unemployment in the economy. As we noted in the previous MPC statement, concerted action is needed on the part of all the parties involved. We need cohesion of policy and decision-making to provide the necessary certainty for sustainable economic growth and development.

The monetary policy stance remains accommodative and appropriate, with the real policy rate remaining slightly negative, notwithstanding the expected temporary breach of the inflation target. However, further accommodation at this stage is constrained by the upside risks to the inflation outlook. The MPC has therefore decided to keep the repurchase rate unchanged at 5,0 per cent per annum. As always, the MPC will monitor developments closely and will not hesitate to act in a manner consistent with its mandate.

Statement of the Monetary Policy Committee

20 March 2013

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

There are a number of key developments that this meeting of the Monetary Policy Committee (MPC) had to consider, not least among them on the domestic front the challenge of moderate growth, rising inflation, a depreciated currency, a wider current-account deficit and difficult labour relations and unemployment that remains stubbornly high.

Since the previous meeting of the MPC the domestic inflation outlook has deteriorated slightly. Risks posed by the depreciation of the rand exchange rate have overshadowed the more favourable developments, including lower electricity price increases and some moderation in food price inflation. Nevertheless, inflation is expected to remain contained within the target range apart from a temporary breach in the third quarter of 2013. The domestic economic growth prospects remain fragile amid continued tensions in the labour market, particularly in the mining sector.

The global economy is still characterised by a multispeed recovery. However, recent events in Europe, particularly as they affect Cyprus, have increased risk and uncertainty in the region, and have the potential to reignite the banking and sovereign debt crisis and undermine growth prospects further. The global outlook is also clouded by the fiscal gridlock in the United States (US) that remains unresolved.

The year-on-year inflation rate as measured by the consumer price index (CPI) for all urban areas was 5,9 per cent in February 2013, up from 5,4 per cent in January. The upside surprise in February was mainly due to the increase in medical insurance costs, which resulted in the contribution to CPI from miscellaneous goods and services increasing from 0,7 percentage points to 1,1 percentage points. This category also impacted on core inflation, which increased markedly from 4,7 per cent in January to 5,3 per cent in February. Petrol prices also contributed to the upward trend, having increased by 11,9 per cent. Food price inflation measured 6,3 per cent, down from a recent high of 7,5 per cent in November 2012, and its contribution to overall inflation declined from 1,0 percentage points to 0,9 percentage points. Administered prices increased by 8,9 per cent, and by 7,5 per cent, excluding petrol, year-on-year. The producer price inflation for final manufactured goods measured 5,8 per cent in January.[1]

1. Statistics South Africa has adopted a "stages-of-production" concept for the producer price index (PPI) and no longer produces one aggregated series. The five producer price series are (i) PPI for final manufactured goods; (ii) intermediate manufactured goods; (iii) electricity and water; (iv) mining; and (v) agriculture, forestry and fishing. The PPI for final manufactured goods is regarded as best representing the effects of price changes through the five stages of production.

The inflation forecast of the Bank reflects a slight deterioration in the inflation outlook for 2013 compared with the previous forecast. The forecasts incorporate the new CPI weights and rebasing announced by Statistics South Africa (Stats SA), as well as the lower electricity price increase of 8 per cent granted to Eskom by NERSA. Inflation is now expected to average 5,9 per cent in 2013 and 5,3 per cent in 2014, compared with the previous forecasts of 5,8 per cent and 5,2 per cent for these respective years. Inflation is expected to breach temporarily the upper end of the target range in the third quarter of 2013, when it is expected to average 6,3 per cent, and then to moderate gradually to 5,2 per cent in the final quarter of 2014. This deterioration is largely due to the depreciation of the rand and higher petrol prices, which more than offset the impact of the lower electricity price increases and a lower starting point.

The forecast of core inflation is more or less unchanged for 2013 but higher for 2014, yet still indicates the continued absence of significant demand pressures. This measure is expected to peak at 5,1 per cent in the second quarter of 2014, and to average 4,8 per cent and 4,9 per cent in 2013 and 2014 respectively. This forecast is likely to be adjusted upwards in the light of the increase in medical insurance costs announced earlier today.

Inflation expectations as reflected in the Reuters survey of analysts conducted in February 2013 have remained more or less unchanged since December. Expectations remained anchored within the target range. but close to the upper end, and, as with the Bank's forecast, the peak is expected in the third quarter of 2013.

The global economic outlook presents a mixed picture following a disappointing fourth quarter in most of the advanced economies. Recent data from the US indicate positive trends in the labour market and household consumption expenditure due in part to positive wealth effects from the housing and equity markets. However, uncertainty about the possible negative impulse from fiscal tightening continues amid political differences over fiscal policy. Economic growth is still expected to remain below trend in 2013.

The outlook for some of South Africa's other main advanced-economy trading partners is less positive. The eurozone remains in recession, and is not expected to recover before mid-2013 at the earliest. The tail risks from a sovereign debt crisis appeared to have subsided, but the uncertainty created by the inconclusive Italian general election and the crisis in Cyprus have renewed concerns about the stability of the region. The outlook for the United Kingdom economy remains subdued against the backdrop of continued fiscal austerity.

Growth prospects in the Asian economies are more positive. The Japanese economy is expected to be bolstered by positive consumer sentiment in response to fiscal and monetary stimuli, but the response on the capital expenditure side is still cautious. Nevertheless, an improved growth performance is expected, particularly given the 18 per cent depreciation of the yen against the US dollar since October 2012. Growth in China is expected to be sustained at relatively robust levels as fixed investment expenditure remains strong despite a moderation in consumption expenditure growth. Growth in other emerging markets remains positive.

These trends suggest that monetary policy in the advanced economies will remain accommodative for some time despite recent fears in the financial markets of an early reversal of quantitative easing in the US. The relatively weak growth outlook in the advanced economies has contributed to the subdued global inflation environment.

The exchange rate of the rand continues to pose the main upside risk to the inflation outlook. Since the beginning of the year, the rand has depreciated by 8,4 per cent against the US dollar and fluctuated within a range of R8,45 and R9,26. However, given the significant realignment of global currencies, and particularly the depreciation of the Japanese yen and the pound sterling against the US dollar, the trade-weighted depreciation since the beginning of the year was more moderate at 5,6 per cent.

Domestic factors contributing to the recent rand depreciation include continued work stoppages in parts of the mining sector, which also have the potential to disrupt electricity supplies, and the further widening of the deficit on the current account of the balance of payments, which measured 6,3 per cent in 2012. Some narrowing of the deficit is expected in the course of the year in response to the depreciation, although the degree of response will be constrained by weak demand from advanced economies as well as strong infrastructure-related import demands. Mining export growth will also be dependent on the resolution of labour market issues with a resumption of full production and on the extent of possible shaft closures.

Equity and bond flows to emerging economies have generally moderated in the past few months, making for a more challenging global environment for financing the deficit. Inflows into South African bond and equity markets have, however, been sustained, and year-to-date non-resident net purchases of equities and government bonds have totalled R6,1 billion and R11,3 billion respectively. These flows have, however, been volatile, and the growing proportion of bonds owned by non-residents, currently around 37 per cent of the total outstanding stock of debt, could constrain the pace of inflows.

The rand is likely to remain sensitive to both domestic and global developments. The exchange rate is expected to remain volatile and subject to overshooting, and further sustained depreciation would increase the upside risk to the inflation outlook. The Reuters Econometer survey conducted in February shows that most analysts still expect the rand to appreciate from current levels during the year, although the degree of dispersion is indicative of the uncertainty around these forecasts. According to this survey, the consensus forecast for the rand/US$ exchange rate at the end of 2013 is R8,61, with a range of forecasts between R9,19 and R7,80.

Domestic growth prospects remain relatively subdued, notwithstanding a better-than-expected fourth quarter GDP growth outcome, and positive developments in the mining and manufacturing sectors in January. The economy grew by 2,5 per cent in 2012, having recorded annualised growth of 2,1 per cent in the fourth quarter, despite a 9,3 per cent contraction in the mining sector. The moderate pace of recovery is expected to continue in 2013. The Bank's forecast is for growth of 2,7 per cent this year, marginally up from the previous forecast of 2,6 per cent, and 3,7 per cent in 2014, compared with a previous forecast of 3,8 per cent. The risks to these forecasts are assessed to be on the downside.

The flat trajectory of the Bank's leading indicator of economic activity is consistent with this forecast. Growth this year is therefore expected to remain below potential output growth of 3,5 per cent, and this is expected to result in a slight widening of the Bank's revised estimate of the output gap which, at 2,0 per cent, reflects the continued subdued state of the economy.

The mining sector recorded year-on-year growth of 7,3 per cent in January, with three-month-on-three-month growth of 5,4 per cent following four consecutive months of contraction. Nevertheless, the sector is expected to remain under pressure, given the unsettled labour relations environment. The outlook for manufacturing appears to have improved, but this recovery is still very tentative. The sector grew at a year-on-year rate of 3,9 per cent in January, and by 1,8 per cent on a three-month-on-three-month basis. This was consistent with improvements in the Kagiso Purchasing Managers Index, which increased from 49,1 in January to 53,6 in February.

Growth in gross fixed capital formation, which measured 5,7 per cent in 2012, has been on a moderate upward trend since 2009, driven mainly by investment growth of around 9 per cent by public corporations and general government. Private-sector investment growth moderated from 4,6 per cent in 2011 to 3,9 per cent in 2012 due in part to excess capacity in manufacturing and electricity supply constraints.

While household consumption expenditure has been the main driver of growth since 2010, its contribution to growth has been diminishing. The general absence of demand pressures in the economy is reflected in the continued moderation in the growth in real consumption expenditure by households, which grew by 3,5 per cent in 2012 compared with 4,8 per cent in 2011. Nevertheless, growth in the consumption of durable goods remained robust at 11 per cent, compared with demand for services, which grew at only 1,8 per cent in 2012. Sales of new motor vehicles declined on both a month-on-month and on a three-month-on-three-month basis in February.

Retail trade sales in January appear to reflect this weakening trend, with a three-month-on-three-month decline of 0,7 per cent, and a lower-than-expected year-on-year increase of 1,9 per cent. There are indications that consumption growth may moderate further in 2013 amid slower real income growth, higher inflation, elevated household debt levels, and a possible slow-down in credit extension to consumers.

Twelve-month growth in banks' total loans and advances to the private sector measured 8,9 per cent in January, following growth of 10,0 per cent in December. Loans and advances to the corporate sector grew by 7,5 per cent in January, and to the household sector by 9,9 per cent. Growth in general loans to households – mainly unsecured lending – moderated to 30,1 per cent, following a recent peak growth of 39,3 per cent in June. General loans to households amounted to 8,3 per cent of total loans and advances, and 14,6 per cent of loans and advances to household. Growth in this category of lending is likely to be constrained by lower income growth and high household debt levels. Household debt to disposable income measured 75,8 per cent in the final quarter of 2012. Non-mortgage debt as a percentage of total household debt increased from 37 per cent in the third quarter of 2009 to 46 per cent in the final quarter of 2012.

The trend in wage settlements remains an upside risk to the inflation outlook, although recent data is somewhat contradictory. The minimum wage in the agricultural sector has been increased by 52,2 per cent, and indications from the Andrew Levy Employment Publications are that wage settlements in collective bargaining agreements picked up significantly from 6,8 per cent in the third quarter of 2012 to 8,2 per cent in the fourth quarter. According to Stats SA, average salaries and wages per worker in the non-agricultural sector increased over four quarters by 7,0 per cent in the final quarter of 2012, down from 8,9 per cent in the previous quarter, while unit labour cost increases declined from 7,4 per cent to 5,7 per cent in the same period.

The MPC remains concerned about the possible impact of excessively high wage increases on employment growth. Employment in the formal non-agricultural sector increased by 1,0 per cent during 2012, compared with annual employment growth of 1,6 per cent in 2011. This included employment growth of 0,2 per cent in the mining and quarrying industry, and a 0,3 per cent contraction in the manufacturing sector. In the fourth quarter of 2012 mining-sector employment increased by 1 000 employees, following a decline of 16 000 in the third quarter.

Of concern is the seasonally adjusted annualised decline of 0,7 per cent in total non-agricultural employment during the fourth quarter of 2012.

The recent national government budget tabled before parliament reflects a difficult balance between a commitment to medium-term fiscal consolidation and the need for counter-cyclical policy. The projected deficit of 5,7 per cent for the past fiscal year was wider than initially budgeted for – a result of lower revenue due to weaker economic growth. The fiscal deficit as a percentage of GDP is budgeted to be 5,1 per cent in the 2013/14 fiscal year, and to decline to 3,6 per cent by 2015/16. The government net debt-to-GDP ratio is expected to stabilise at around 40 per cent in 2015/16, well below the international benchmark for debt sustainability of around 60 per cent.

There are indications that the pressures on inflation emanating from food prices may be moderating. Food price inflation at the consumer price level declined from a recent high of 7,5 per cent in November 2012 to 6,4 per cent in January and 6,3 per cent in February. A similar trend is evident at the producer price level where manufactured food inflation declined to 5,9 per cent in January, compared with a recent peak of 11,1 per cent in November 2012. Similarly, producer price inflation in agricultural products moderated from a recent high of 6,3 per cent in October 2012 to 3,5 per cent in January. Global agricultural commodity prices have declined, on average, by almost 20 per cent since their recent peak in August 2012, and expectations are for further moderation in the absence of adverse weather shocks.

Administered prices continue to put upside pressure on inflation, although lower electricity price increases from the third quarter will dampen some of these pressures. The petrol price, which has increased by a cumulative R1,24 per litre since January 2013, remains an upside risk. Although global oil prices have declined over the past few weeks, resulting in an over-recovery of the petrol price so far this month, it is unlikely to be sufficient to offset the adverse exchange rate impacts and the fuel levy increases – and a further increase in the petrol price is likely in April.

The MPC continues to assess the balance of risks to the inflation outlook to be on the upside, mainly due to the exchange rate and wage pressures. These upside risks are mitigated in part by lower risk from food price inflation. Underlying inflation appears to be relatively contained, consistent with the moderating trend in consumption expenditure by households.

The economic growth outlook is more or less unchanged from the previous meeting of the MPC, and risks to the outlook remain on the downside. The unresolved labour disputes in the mining sector pose a significant risk to the exchange rate and to economic growth through their negative impact on export revenues, employment growth and investor perceptions of South Africa.

However, the depreciated exchange rate provides an opportunity for the manufacturing sector in particular to become more competitive despite the challenging export environment. Ensuring that this increase in competitiveness is sustained will require improved productivity, and the containment of wage and other cost pressures, which underline the need to keep inflation under control.

The MPC continues to assess the monetary policy stance to be appropriately accommodative, given the persistence of the negative output gap. At the same time, further accommodation remains constrained by the upside risks to the inflation outlook. The MPC has therefore decided to keep the repurchase rate unchanged at 5,0 per cent per annum. The committee will continue to apply monetary policy consistent with its mandate of price stability within a flexible inflation-targeting framework.

Statement of the Monetary Policy Committee

23 May 2013

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

The South African economy is facing a number of domestic challenges, while headwinds from the fragile and uneven global recovery remain a constraint to growth. The uncertain, and increasingly difficult, labour relations environment continues to dominate the economic landscape, contributing to declining domestic and foreign investor confidence. The growing vulnerability of the economy to changes in sentiment has been reflected in the depreciating and volatile exchange rate, which was already under pressure from the widening deficit on the current account of the balance of payments. Although inflation is forecast to remain relatively contained, these factors have raised the upside risks to the outlook at a time of worsening real growth prospects.

The year-on-year inflation rate as measured by the consumer price index (CPI) for all urban areas was 5,9 per cent in April 2013, unchanged from the previous two months. However, the drivers of the overall rate changed somewhat. Food price inflation measured 6,3 per cent in April, reversing the downward trend that had prevailed since November 2012. The contribution of food to overall inflation remained unchanged at 0,9 percentage points, while housing and utilities contributed 1,4 percentage points. Administered prices increased by 8,9 per cent, and by 7,8 per cent excluding petrol. Core inflation, which excludes food, petrol and electricity, measured 5,2 per cent – marginally up from 5,1 per cent in March. The headline producer price inflation for final manufactured goods measured 5,7 per cent in March – up from 5,4 per cent in February.

The inflation forecast of the Bank has remained relatively unchanged since the previous meeting of the MPC. Inflation is now expected to average 0,1 percentage points lower in 2013 and 2014 at 5,8 per cent and 5,2 per cent respectively, and to average 5,0 per cent in 2015. A temporary breach of the upper end of the target range is still expected in the third quarter of 2013, but at a lower average level of 6,1 per cent (6,3 per cent previously), followed by a gradual moderation of inflation to 4,9 per cent in the final quarter of 2015. The slight improvement is due to changed assumptions about international commodity prices, including oil, and lower global inflation.

The forecast for core inflation for 2013, at an average of 5,3 per cent, is significantly higher than the forecast of 4,8 per cent previously. This follows the sharp increase in medical insurance costs in the February CPI. Core inflation is also expected to be adversely affected over the coming months by increases in a number of other administered prices, particularly water and municipal rates and taxes. This measure is expected to peak at 5,4 per cent in both the third and fourth quarter of 2013, and to average 5,0 per cent and 4,6 per cent in the coming two years. Despite the higher near-term trend, this indicator is still assessed to reflect an absence of significant demand pressures.

Inflation expectations, as reflected in the Reuters survey of analysts conducted in April, has remained relatively stable for some months. The forecast is the same as the Bank's for 2013, although higher for the next two years but still within the target range. The relatively anchored inflation expectations at the upper end of the target range are also evident in the survey conducted by the Bureau for Economic Research (BER) at Stellenbosch University in the first quarter of 2013. Overall, respondents expect inflation to average 6,0 per cent in both 2013 and 2014, and 6,1 per cent in 2015.

The global economic environment remains challenging, with different regions growing at varying rates. Within the advanced economies, the United States (US) appears to be showing a number of positive signs of recovery: the University of Michigan's consumer confidence index is at its highest in almost six years; labour market developments have been more favourable; and there are strong wealth effects from the booming equity market as well as from the recovering housing market. However, headwinds can be expected from the fiscal contraction resulting from the fiscal cliff compromise and the spending cuts that were part of the recent sequester. The impact of this contraction is expected to be as high as 2 percentage points of GDP.

The eurozone remains in recession, having contracted at an annualised rate of 0,9 per cent in the first quarter of 2013, compared with a contraction of 2,7 per cent in the previous quarter. The French economy has recorded two consecutive quarters of negative growth, while Germany managed to avoid recession by recording annualised growth of 0,3 per cent in the first quarter of this year. The eurozone is constrained by continued deleveraging by households, banks and governments, and the region is also characterised by increasing financial fragmentation. Although a slower pace of fiscal consolidation in the periphery has been agreed to in terms of the bail-out agreements, negative or, at best, very low growth is expected to persist in the region for some time.

The Japanese economy rebounded from its 2012 recession in the first quarter of 2013, but it is still too soon to assess the impact of the fiscal, monetary and structural policy stimulus packages that were announced recently. The yen exchange rate, which has depreciated by around 30 per cent against the US dollar since October 2012, is likely to contribute positively to growth.

Emerging markets remain the main global source of growth, but there are signs of moderation in some of the systemically important countries, particularly China, India and Brazil. The rebalancing of the Chinese economy away from fixed capital formation and production towards internal consumption has resulted in some slowdown, which has contributed to the declining trend of global commodity prices.

The persistence of slow global growth and weaker commodity prices have resulted in a moderation in global inflation. This is particularly the case with respect to energy prices in the advanced economies. This combination of lower inflation and slow growth prompted further monetary easing by the European Central Bank, and with Japan yet to begin with its quantitative monetary easing, these accommodative policy stances are likely to persist for some time. While there are concerns about the possible risks posed to financial markets and global capital flows by an early reversal of the US monetary policy stance, any such action is likely to be extremely cautious, and is only expected to begin once a sustained recovery is well entrenched. There are, however, growing concerns that the buoyant conditions in the financial markets in many countries are indicative of bubbles caused by excessive global liquidity, rather than reflecting underlying positive growth prospects.

Movements in the exchange rate of the rand continue to be impacted by external developments, but since mid-2012 they have been compounded by domestic factors, which have undermined investor sentiment. The increasingly fraught labour relations environment, and high wage demands in the mining sector in particular, are likely to continue to impact adversely on the volume of mining exports against a backdrop of falling international commodity prices and concerns about the widening of the current-account deficit of the balance of payments. These developments also have the potential to affect, directly and indirectly, South Africa’s credit ratings, and increase the cost of much-needed finance. The rand has also been influenced in recent weeks by the hedging related to renewable energy projects and by a strengthening dollar. Since the previous meeting of the MPC, the rand has depreciated by around 4,6 per cent against the US dollar and by 3,7 per cent on a trade-weighted basis.

Despite the current negative sentiment towards the rand, non-residents have remained net buyers of bonds and equities this year. Since January, non-residents have been net buyers of equities to the value of R12,7 billion, and bonds to the value of R22,5 billion. However, these positive inflows can reverse very quickly in response to changing risk perceptions. Furthermore, any hedging of these exposures, as is sometimes the case during periods of rand weakness, puts pressure on the rand even though the underlying assets are still held by non-residents.

As we have noted previously, the impact of the weaker rand on inflation is dependent on the extent, speed and duration of the depreciation, as well as the phase of the business cycle. While some of the recent decline reflects changes in the underlying fundamentals, the rand remains highly vulnerable to changes in sentiment. The rand has a tendency to overshoot in either direction and, at times, for extended but uncertain periods, which makes the impact on inflation difficult to forecast. The current level of the exchange rate, if sustained, poses a significant upside risk to the inflation outlook.

Domestic growth prospects remain fragile amid low consumer confidence, continued output disruptions in the mining sector, electricity supply constraints and a weak global environment. The growth forecast of the Bank has been revised down from 2,7 per cent to 2,4 per cent for 2013 and from 3,7 per cent to 3,5 per cent in 2014. Growth is expected to accelerate to 3,8 per cent in 2015. At these growth rates, the negative output gap will widen further before stabilising next year, and begin to close during 2015. This outlook is consistent with the flat trajectory of the Bank's leading indicator of economic activity. Notwithstanding the increase in the Rand Merchant Bank/BER Business Confidence Index in the first quarter of 2013, given the difficult labour relations environment in the country and the risks to global growth, the downside risk to growth remains as does the possibility of increased job losses.

Although the physical volume of mining production recorded a quarter-to-quarter increase of 6,1 per cent in the first quarter of 2013 following the disruptions in the previous quarter, output contracted on a month-to-month basis in both February and March. The outlook for the sector remains bleak, with threats of shaft closures and retrenchments, falling commodity prices, high wage demands, and a risk of protracted periods of industrial action and further supply disruptions.

Manufacturing production declined in the first quarter of 2013 compared with the previous quarter, although the extent of the decline is complicated by the seasonal adjustment for the Easter weekend, which fell over March and April. The Kagiso Purchasing Managers Index, which increased marginally above the neutral 50 level in April, reflects the uncertain outlook for the sector. The depreciated value of the rand should improve the competitiveness of the sector, provided that gains are not eroded by rising wages and prices. The weaker rand is expected to result in some narrowing of the trade deficit. However, the subdued global demand, together with robust import volume growth, driven to a large extent by infrastructure projects, suggests that the net export position will remain negative over the forecast period and continue to be a constraint on growth. Nevertheless, the BER Manufacturing Confidence Index, while still low, improved somewhat in the first quarter.

The outlook for household consumption expenditure – in recent years the main driver of growth – appears to have weakened with the FNB/BER Consumer Confidence Index declining to a nine-year low in the first quarter of 2013. Retail sales grew at a modest quarter-to-quarter rate of 0,6 per cent in the first quarter of this year, while sales contracted on a month-to-month basis in March. This was consistent with the decline in the BER Retail Confidence Index in the first quarter. New vehicle sales growth, while increasing significantly on a year-on-year basis, moderated to 0,1 per cent on a three-month-to-three-month basis in April 2013.

Consumption expenditure by households is expected to be constrained in part by lower real income growth, significant increases in the price of electricity and petrol, and high debt levels. The slowdown in expenditure growth has also been related to the moderation in some categories of credit extension by banks. Year-on-year growth in total loans and advances to the private sector moderated steadily from a recent peak of 10 per cent in December, to 8,1 percent in March 2013. Excluding the weak growth in mortgage advances, year-on-year growth in loans and advances declined from 18,5 per cent in December 2012 to 14,5 per cent in March. Although growth in unsecured lending to households remains at high levels, it has declined continuously since September 2012, to measure 27,9 per cent in March. This moderating trend is expected to continue, due in part to the increasing number of impaired advances in this category of lending at some of the banks. However, the ratio of total impaired advances to total loans and advances in the banking sector continues to decline and stands at just below 4 per cent.

A number of sectors in the economy are entering into wage-bargaining rounds. The MPC is increasingly concerned about the prospect of settlements well above inflation and productivity growth, and the risk of protracted and disruptive strike action, with negative implications for growth and exports. Furthermore, excessively high settlements will come at the expense of retention of employees, employment creation and could result in higher inflation. The risk of a wage-price spiral remains high. This would negate the benefits of wage increases to workers, and undermine the competitive gains of the currency depreciation. According to Andrew Levy Employment Publications, the overall wage settlement rate in collective bargaining agreements increased from 7,6 per cent in 2012 to 7,9 per cent in the first quarter of 2013. Should this upward momentum continue, it is likely to impart an upside risk to inflation. At a time of high and rising unemployment, and slowing growth, the imperative of an economy-wide commitment to wage and salary restraint at all levels, including executive pay, cannot be over-emphasised.

International oil prices are expected to remain constrained by the subdued global growth environment, but vulnerable to political developments in the Middle East in particular. Having reached a recent high of around US$118 per barrel in mid-February of this year, Brent crude oil prices have remained in a range of between US$97 and US$105 per barrel since April. The domestic price of petrol increased by 12 cents in April, but declined by 73 cents in May, mainly as a result of lower international oil prices. Although there is currently a small average over-recovery on the petrol price, recent exchange rate movements have raised the probability of further petrol price increases in the near term.

The higher CPI food price increases in April may have reversed the favourable food price developments observed in recent months. Since the end of November 2012 to date, domestic maize prices have declined by about 17 per cent and wheat prices by around 9 per cent. This is reflected in the producer price index for agriculture which increased at a year-on-year rate of 1,4 per cent in February and declined by 0,2 per cent in March. Manufactured food prices, by contrast, increased by 6,1 per cent and 6,3 per cent in the same months respectively, in line with CPI food price increases. The exchange rate poses an upside risk to food inflation as the prices of agricultural commodities such as wheat and maize are based on international prices.

The MPC is increasingly concerned about the deteriorating outlook for the South African economy. There are a number of critical domestic issues that are contributing to the vulnerability of the economy that need to be addressed. urgently These include the financing of the deficit on the current account of the balance of payments; the fractious labour relations environment and the associated risks of protracted work stoppages and excessive wage increases; electricity supply constraints; upside risks to inflation; downside risks to growth and employment creation in a context of high unemployment; and declining domestic and foreign investor confidence which could impact directly on capital flows. These interrelated developments are reflected in the volatility and weakness in the exchange rate. There is an urgent imperative for all parties – government, business, labour and civil society – to interact and address these issues and vulnerabilities at a national level. While the Bank is prepared to play its part, many of these challenges are beyond the role, scope and effectiveness of monetary policy.

While a depreciated exchange rate is part of the balance-of-payments adjustment mechanism, the competitive advantages thereof need to be realised through price and wage restraint. In the absence of such restraint, the outcome is simply higher inflation, with the risk of an exchange rate–inflation spiral. Given the current unsettled environment in the economy, the MPC assesses the risks to inflation to be on the up side, while many of the above factors contribute to a downside risk to growth.

The MPC assesses the current stance of monetary policy to be accommodative. Given the risks outlined above, the scope for further monetary easing is limited at this stage. The MPC has therefore decided to leave the repurchase rate unchanged at 5 per cent per annum. The MPC is ready to act appropriately in either direction in the event of material changes in the outlook.

Abbreviations

Alsi	All-Share Price Index
API	administered price index
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
CBRT	Central Bank of the Republic of Turkey
CCI	Consumer Confidence Index
COICOP	Classification of Individual Consumption by Purpose
COPOM	Brazil's Monetary Policy Committee
CPI	consumer price index
CPIX	consumer price index excluding mortgage interest cost for metropolitan and other urban areas
CRB	Commodity Research Bureau
ECB	European Central Bank
EMBI+	[JPMorgan] Emerging Markets Bond Index Plus
FAO	Food and Agriculture Organization
FNB	First National Bank
GDP	gross domestic product
IEA	International Energy Agency
IES	Income and Expenditure Survey
ILO	International Labour Organization
IMF	International Monetary Fund
JGB	Japanese Government Bond
MPC	Monetary Policy Committee
MPF	Monetary Policy Forum
MPR	*Monetary Policy Review*
MTBPS	*Medium Term Budget Policy Statement*
MTEF	Medium Term Expenditure Framework
NAB	non-alcoholic beverages
NEER	nominal effective exchange rate
NERSA	National Energy Regulator of South Africa
OECD	Organisation for Economic Co-operation and Development
OMT	Outright Monetary Transactions
OPEC	Organization of the Petroleum Exporting Countries
PBC	People's Bank of China
PMI	Purchasing Managers' Index
PPI	producer price index
PSBR	public-sector borrowing requirement
QE	quantitative easing
QES	*Quarterly Employment Statistics*
QLFS	*Quarterly Labour Force Survey*
RBA	Reserve Bank of Australia
RBI	Reserve Bank of India
REER	real effective exchange rate
RMB	Rand Merchant Bank
S&P	Standard and Poor's
SSA	sub-Saharan Africa
TRJ	Thompson Reuters Jefferies
UK	United Kingdom
US	United States
VIX®	Chicago Board Options Exchange Market Volatility Index
WGBI	World Government Bond Index [Citi]

Glossary

repo	repurchase [rate]
Stats SA	Statistics South Africa
the Bank	South African Reserve Bank
the Fed	United States Federal Reserve