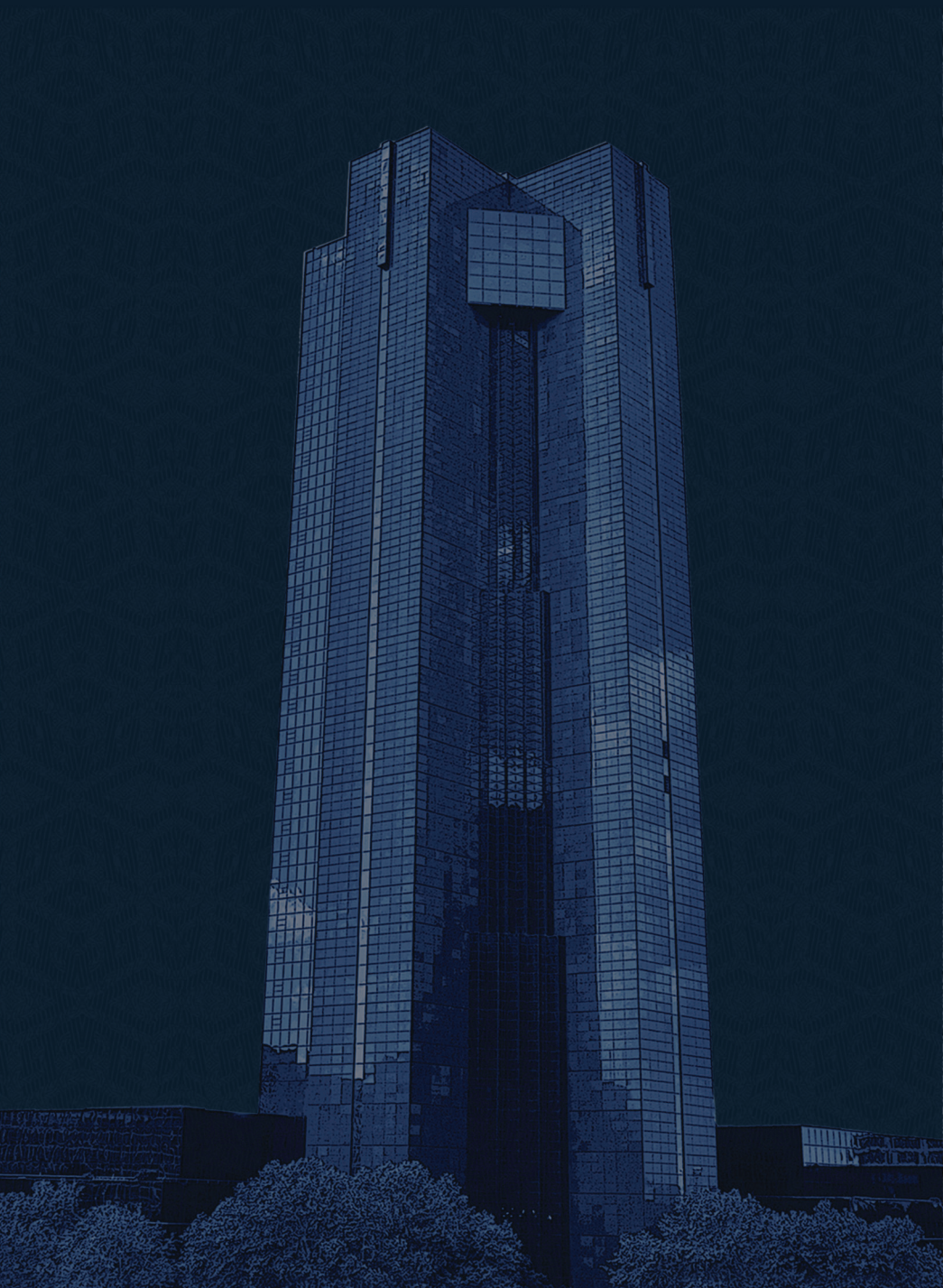
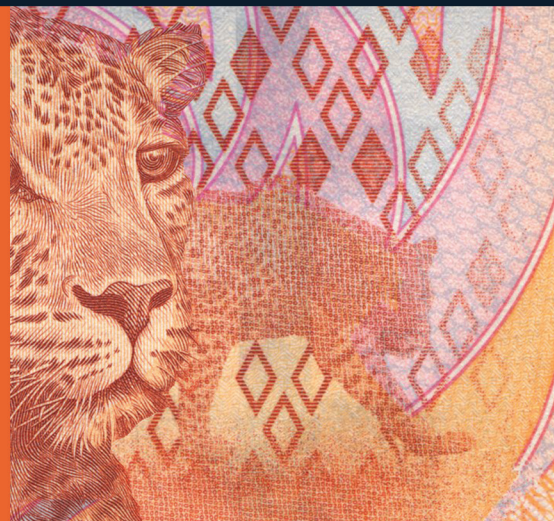


Monetary Policy Review

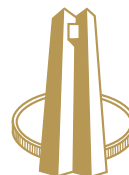
June 2014



South African Reserve Bank

Monetary Policy Review

June 2014



South African Reserve Bank

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Preface

The primary mandate of the South African Reserve Bank (the Bank) is to achieve and maintain price stability in the interest of balanced and sustainable economic growth. Low inflation helps to maintain and improve competitiveness, protects the purchasing power and living standards of all South Africans, and provides a favourable environment for balanced growth, investment and employment creation. In addition, the Bank has a complementary mandate to oversee and maintain financial stability. The Bank's Monetary Policy Committee (MPC) is responsible for monetary policy decisions, and comprises the Governor as Chairperson, the deputy governors and senior officials of the Bank.

Price stability is quantified by the setting of an inflation target range by government after consultation with the Bank. The Bank has instrument independence, with the commitment to pursue a continuous target of 3 to 6 per cent for headline consumer price index inflation. The MPC conducts monetary policy within a flexible inflation-targeting framework that allows inflation to be temporarily outside the target range under certain circumstances.

The MPC takes into account a viable medium-term time horizon for inflation and considers the time lags between policy adjustments and economic effects. This provides for interest rate smoothing over the cycle, and contributes towards more stable economic growth. The repurchase (repo) rate decision reflects the MPC's assessment of the appropriate monetary policy stance.

The decision of the MPC, together with a comprehensive statement, is announced at a media conference at the end of each bimonthly meeting. This announcement outlines the MPC's assessment of prevailing domestic and global economic conditions, as well as recent outcomes and forecasts for inflation and real economic activity.

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 affected inflation and that impact on the monetary policy stance. It also provides an assessment of the factors determining inflation and the Bank's forecast of the future path of inflation and economic growth. The *MPR* is presented by the Governor and senior officials of the Bank at Monetary Policy Forums in various centres across South Africa in an effort to develop a better understanding of monetary policy through direct interaction with stakeholders.

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Executive summary

Higher interest rates and persistent uncertainty

Global growth is improving, but progress is incremental and the outlook is suffused with uncertainty. Monetary policy normalisation in advanced economies, which presages a return to economic health after what has been an unusually protracted recovery, is both an unavoidable and essentially positive development. Nonetheless, this process will exert considerable pressure on emerging economy currencies and policy settings. It will also create volatility; over the past year, sentiment has moved sharply against emerging markets before reversing, as markets were persuaded that subdued inflation and modest growth in advanced economies meant interest rates would be lower for longer.

In this context, South Africa's macroeconomic settings remain generally expansionary. Interest rates are very low, with the real repurchase rate slightly negative. Fiscal deficits are substantial, although they are programmed to decline over the medium term. South Africa is absorbing considerable quantities of foreign savings to supplement its own meagre savings rate, and the corresponding current-account deficit has been large and persistent at more than 5 per cent of gross domestic product.

In January, the Bank's policy rate was raised from 5 per cent to 5,5 per cent, the first upward adjustment in over half a decade, marking the beginning of an interest rate tightening cycle. The policy change was predicated on a deteriorated inflation forecast, which showed an extended breach of the target starting sometime in the second quarter of 2014. In line with this projection, inflation breached the target in April, reaching 6,1 per cent. It is expected to remain outside the target range until the second quarter of 2015.

The primary cause of the deteriorating outlook has been rand depreciation, a trend dating back to 2011, and which accelerated in late 2013 and early 2014. Over much of this period, the pass-through from exchange rate weakness to consumer prices seems to have been low, aided by falling international food and stable crude oil prices. Petrol prices, which are administered, respond promptly to changes in the exchange rate, but there is now also a more generalised rise in prices, as evidenced by a gradual increase in core inflation. Furthermore, inflation expectations are clustered around the top end of the target, reducing policymakers' leeway to accommodate shocks.

In recent months, a relatively stronger rand has provided some moderation in depreciation-driven inflation, but this has stemmed mainly from increased global risk appetite instead of a specific re-assessment of South Africa's fundamentals. As a result, the rand remains sensitive to both global and domestic factors.

The short-term difficulty for monetary policy is that South Africa's exposure to international developments, and uncomfortable levels of inflation, are matched by a deteriorating domestic growth outlook. The economy has been buffeted by repeated negative supply shocks, the latest of which have produced the first quarter of negative growth (-0,6 per cent) since 2009. Domestic demand has been feeble, as seen in anaemic credit indicators and weak retail sales. In addition, South Africa's export income is moderating as the terms of trade edge lower, and government spending growth has slowed in line with tighter budget consolidation targets. These developments have partially mitigated cost-push pressures on inflation.

In the coming years, a more robust global economy should provide much-needed buoyancy to the South African economy. A depreciating currency should help narrow the current-account deficit by discouraging imports and boosting exports, and there is some tentative evidence for this in the trade data (although it is too soon to identify a new trend).

However, the deficit would certainly not benefit from a weaker currency if consumer price inflation were allowed to cancel out any competitiveness gains. Furthermore, the ability of firms and households to take advantage of improved foreign demand will depend greatly on how much of the current income they can spend on investment.

Overall, inflation in South Africa is projected to be above target for an extended period of time, with risks tilted towards higher inflation. Over the longer term, this necessitates higher interest rates, and therefore a tightening cycle. However, with domestic economic growth weak, and world inflation and interest rates remaining low, monetary policy tightening is likely to be moderate. This will provide continued support to the economic recovery. It is important not to mistake the direction of policy changes for the sum of the policy position: the change is towards higher rates, but actual rates are still not high. In the long run, rates will inevitably be higher, and also influenced by the pace of normalisation in the United States. But the road back to normality is unmapped and unlikely to be direct, with each leg of the journey depending on data and signals from a range of indicators.

The Monetary Policy Review

This *Monetary Policy Review* includes a technical appendix to aid the interpretation of the Bank's forecasts, as well as a comprehensive glossary. In addition, some topical issues are discussed in boxes. These include economic performance relative to forecasts (Box 1), rand volatility (Box 2) and inflation expectations (Box 3).

Monetary policy stance

The policy stance has been adjusted to counter rising inflation, which is projected to breach the target for four quarters, starting in the second quarter of 2014. While fuel and food prices have been the main contributors to rising inflation, overall inflationary pressure is much broader-based, as evidenced by rising core inflation. Domestic demand pressures, however, remain modest and have softened in recent months. With economic performance disappointing this creates difficult policy choices.

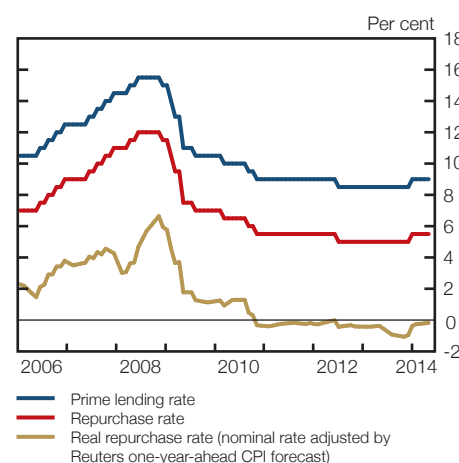
Overview of South Africa's policy settings and the global environment

Since the depths of the crisis in 2008 and 2009, South Africa's macro-economic policy settings have been set to support economic recovery. Fiscal policy has emphasised ongoing infrastructure development and sustained government spending, while monetary policy with negative real interest rates has been encouraging demand for credit and investment. The repurchase (repo) rate was lowered from 12,0 per cent at the time of the crisis to 5,5 per cent in late 2010, and then shifted further to 5,0 per cent in mid-2012 where it remained for 18 months.

Over the past six months, developments at home and abroad have prompted adjustments to both these settings. Global interest rates, proxied by the United States (US) five-year government bond yield, doubled between January 2013 and January 2014, rising from 0,79 per cent to 1,64 per cent. For South Africa, a greater sensitivity by the market to changing yield differentials has made it harder to sustain borrowing from the rest of the world. Foreign borrowing is represented by the current-account deficit, which has become a significant macroeconomic risk. The rand, which has depreciated steadily since 2011, weakened abruptly after May 2013 and again in January 2014, before recovering some of its value. The inflation outlook has deteriorated, with inflation now forecast to be outside the target for an extended period of time, owing to persistent cost-push pressures and the depreciating currency.

The fiscal response has been stronger budget consolidation, which complements the monetary policy decision to enter a tightening cycle. Both these policy changes are designed to minimise inflationary pressures, reduce demands on capital markets, and lower external payments risks as the global environment normalises. The policy adjustments should be incremental, however, as the world normalisation process is likely to be protracted and the domestic economy is vulnerable to a number of threats. Growth has been low and volatile, with the economy suffering from repeated supply shocks and tepid demand. Monetary policy remains accommodative, with the real repo rate (the current repo rate adjusted for expected inflation), still marginally negative.

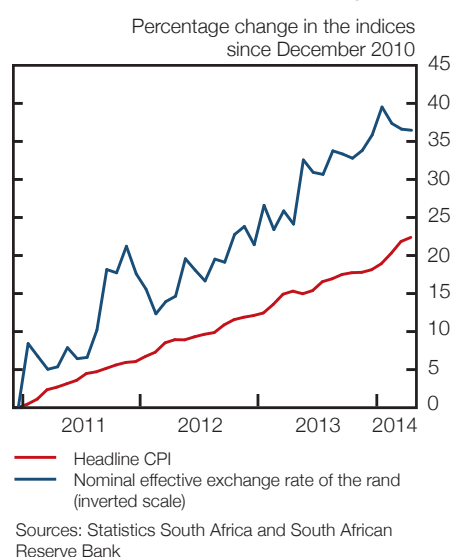
Figure 1 Monetary policy and the prime lending rate



Sources: Reuters and South African Reserve Bank

The view in January

Figure 2 Inflation and the exchange rate



At the time of the previous *Monetary Policy Review (MPR)* published in November 2013, inflation was projected to remain within the target band throughout 2014 and 2015 – but successive Monetary Policy Committee (MPC) statements emphasised the risks to this outlook. The period from November 2013 to January 2014 witnessed a shift in projected headline inflation as favourable food prices gave way to a sharp depreciation in the currency, exchange rate induced petrol price hikes, and an expected deterioration in food price inflation. As a result, the forecast for the January 2014 meeting showed a material and extended breach of the target.

Inflation expectations had been relatively well-anchored for some time, albeit at the upper end of the target range, where they risked becoming de-anchored by a more sustained depreciation. Other key drivers of domestic inflation such as unit labour costs remained elevated, although growth in these costs had decelerated to under 6 per cent in the fourth quarter of 2013 as the economy's output rebounded from the lows of the third quarter. The outlook for growth in the economy had also improved somewhat, as it became clearer that the economy had rebounded in the fourth quarter of 2013 from the poor results of the third quarter.

Together, the deteriorated inflation forecast, somewhat better growth outlook, risk of further currency weakness from policy normalisation, and the threat to inflation expectations from the new projections prompted an increase in the policy rate in January 2014 for the first time since 2008.

After January: A lull and a storm

Since January, the rand has strengthened but domestic economic performance has fallen well short of expectations as the economy suffered two severe shocks. In the platinum sector, the strike which began in January has persisted far longer than anticipated – a record 19 weeks thus far. Furthermore, electricity load shedding has impeded economic activity generally. In this context, credit growth to the household sector decelerated from 5,6 per cent in January to 4,6 per cent in April. General loans which are mainly made up of unsecured lending plummeted from 34,3 per cent in November 2012 to 3,5 per cent in March 2014, underscoring very modest household consumption growth and poor retail sales figures.

Meanwhile, the exchange rate's long depreciating trend was interrupted by renewed global appetite for risk. The rand joined the currencies of many other emerging markets in regaining some of the ground lost over previous months, and although it recovered by relatively less than many of its peers, it still appreciated by 7,5 per cent (against the US dollar). Domestic factors may explain some of this strengthening, with market sentiment bolstered by the responsiveness of monetary policy to the deteriorating outlook and some evidence of current-account narrowing. However, these are unsatisfying explanations for the exchange rate's improvement, both because it was replicated by several other countries and because domestic economic performance has been highly disappointing. Rather, the rand's appreciation stemmed from market assumptions that monetary policy in the US, euro area and the United Kingdom (UK) will not tighten as early as previously anticipated, given growth below expectations, economic slack and low inflation.

At the March and May meetings, inflation projections were relatively unchanged when compared to the January forecast, although they still showed an extended breach of the inflation target. The Bank's gross domestic product (GDP) forecasts for 2014, however, fell to 2,6 per cent in March and 2,1 per cent in May, well below January's 2,8 per cent, with downside risks still prevalent. These developments supported the decisions of the MPC to leave the monetary policy stance unchanged at both these meetings, while indicating that the overall policy setting remains in a tightening cycle.

Evolution of the inflation outlook

Over the course of 2013, the Bank's inflation outlook was shaped by exchange rate concerns, low pass-through and declining commodity prices, with risks tilted to the upside. Between November 2013 and January 2014, the forecast for headline inflation deteriorated significantly, mainly as a result of changes to the exchange rate and expected upward pressure from lagged exchange rate pass-through. Increases in food and petrol prices were anticipated and priced-in to the forecast. Consequently, the January 2014 inflation projections for both 2014 and 2015 were higher by 0,6 percentage points, at 6,3 per cent and 6,0 per cent respectively.

The Bank's most recent central projection is similar to the March projection, although food prices are higher and unit labour costs slightly elevated. Inflation breached the upper bound of the target range in the second quarter of 2014 and is expected to peak at 6,5 per cent in the final quarter of 2014, before returning to within the target range by the second quarter of 2015. It is then expected to remain close to the upper level of the target range.

The central projection, found within the darkest band of the fan chart, is the best estimate of future inflation outcomes. Towards the end of the forecast horizon, uncertainty increases and so the bands become wider. In Figure 3 the larger shaded area above the central projection shows risks to the upside, indicating a higher probability of inflation outcomes above the central projection than below it.¹

Table 1 Evolution of the Bank's targeted inflation forecasts

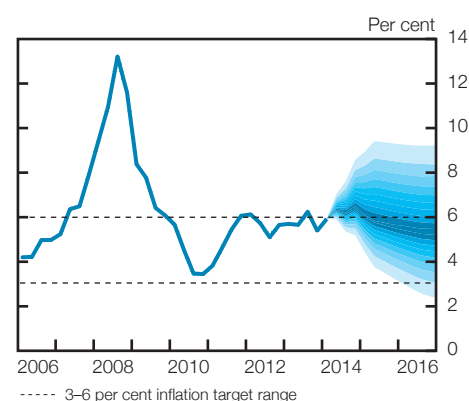
Per cent

MPC meetings	2014	2015	2016
November 2013.....	5,7	5,4	
January 2014.....	6,3	6,0	
March 2014.....	6,3	5,8	
May 2014.....	6,2	5,8	5,5

Source: South African Reserve Bank

The outlook for core inflation shows similar risks. The forecast moderated after the January increase in the repo rate, but underlying inflation is nonetheless expected to rise until 2015.

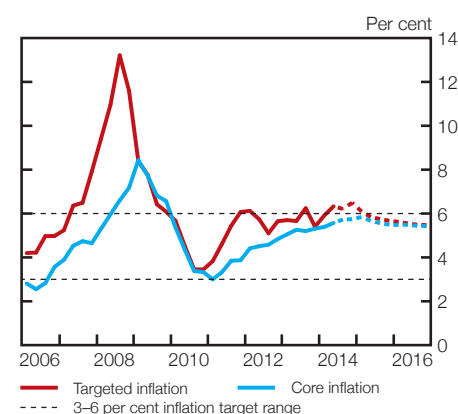
Figure 3 Targeted inflation* forecast



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

Source: South African Reserve Bank

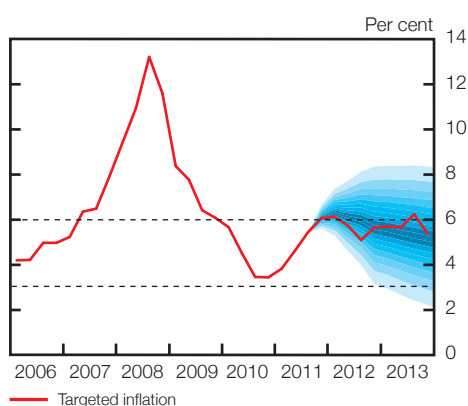
Figure 4 Targeted and core inflation forecasts



Source: South African Reserve Bank

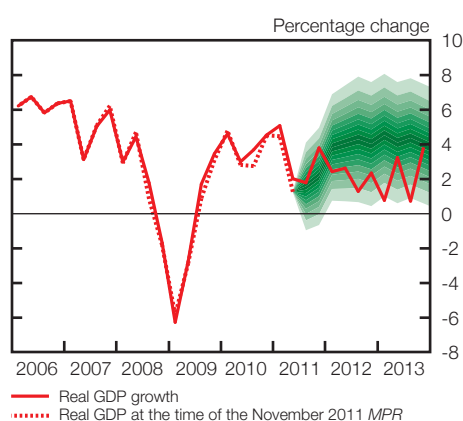
¹ See Appendix 1 on how the MPC uses the fan chart to assess the risks inherent in the forecast and communicates the uncertainties that lie ahead.

Figure B1.1 Targeted inflation outcomes and projection* from the November 2011 MPR



* CPI inflation trajectory nine quarters ahead
Sources: Statistics South Africa and South African Reserve Bank

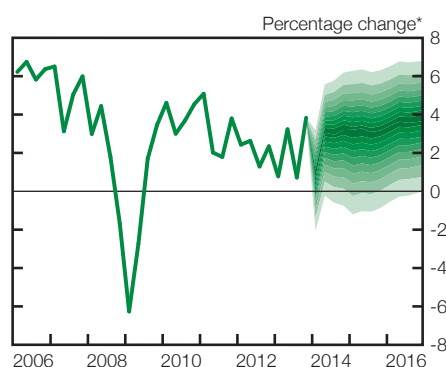
Figure B1.2 Real GDP growth outcomes* and projection** from the November 2011 MPR



* Real GDP growth outcomes differ from real GDP at the time the forecasts were made as the data have subsequently been revised
** Real GDP growth trajectory ten quarters ahead

Sources: Statistics South Africa and South African Reserve Bank

Figure 5 Real GDP growth forecast



* At seasonally adjusted annualised rates
Source: South African Reserve Bank

Table 2 Evolution of the Bank's core inflation forecasts

Per cent

MPC meetings	2014	2015	2016
November 2013.....	5,6	5,3	
January 2014.....	5,8	5,9	
March 2014.....	5,6	5,6	
May 2014.....	5,6	5,7	5,5

Source: South African Reserve Bank

Box 1 How the economy performed relative to the MPC's November 2011 forecasts

The MPC uses forecasts¹ of targeted inflation and real GDP growth when setting monetary policy. The first published forecasts for the entirety of 2012 and 2013 appeared in the November 2011 MPR, two and a half years ago. We now have actual data for this period, which allows us to contrast our forecasts with the outcomes. The comparison shows that inflation has behaved much as expected but growth has come in well below our central projection.

There were only two CPI surprises – in late 2012 and late 2013. Inflation was less than anticipated in the third quarter of 2012 owing to food and electricity prices, which grew but not as dramatically as had been forecast. The unexpected breach of the upper level of the inflation target in 2013 was primarily the result of higher petrol prices, which rose by a cumulative 111 cents (for 95-octane petrol) over the third quarter of 2013.

Domestic real GDP growth was correctly anticipated to remain weak during the second half of 2011 as South African exporters grappled with anaemic global demand and an appreciated currency. Growth was then expected to recover fairly quickly, reaching an above-trend average of around 4 per cent at an annualised rate towards the end of 2013. This failed to materialise, mostly because the euro area crisis proved more severe than expected and also because of unforeseen domestic developments, including protracted labour unrest and electricity-supply constraints.

1 The use of fan charts in the above analysis outlines how uncertain the outcomes may be when reacting to foreign and domestic shocks.

Evolution of the growth outlook

The South African economy is forecast to grow slightly faster in 2014 than in 2013, but the Bank's growth forecasts have been revised down markedly since the November 2013 MPR. The pace of anticipated growth is disappointing. There are also risks of growth falling short of even these lowered expectations, with protracted labour disruptions, commodity prices, and electricity shortages all clear dangers. However, the outlook gets some support from improving growth in advanced economies, as well as a depreciated real exchange rate, which could boost net exports. A one percentage point rise in GDP growth in South Africa's main trading partners typically increases domestic GDP with a lag and by slightly less than 1 per cent, as estimated over the past 14 years.

Domestic growth

South Africa's economy expanded just 1,9 per cent in 2013, its worst performance since the 2009 contraction. Growth was also particularly uneven, with the first and third quarters very weak and the second and fourth much stronger, owing to strike episodes. This pattern has persisted into 2014, with first-quarter growth dragged down by both the mining and manufacturing sectors. By contrast, the tertiary sector – which is the largest component of GDP – has seen muted but consistent growth.

Table 3 Real domestic sectoral growth rates

Per cent*

Sector	2012	2013					2014
	Year	1st qr	2nd qr	3rd qr	4th qr	Year	1st qr
Mining	-3,6	13,4	-5,4	11,4	15,7	3,1	-24,7
Gross value added at basic prices excluding the primary sector	2,8	0,0	4,0	-0,1	3,3	1,8	0,7
Manufacturing	2,1	-7,9	11,7	-6,6	12,3	0,8	-4,4
Wholesale and retail trade, catering and accommodation	3,8	2,1	3,1	1,3	2,3	2,2	2,1
Gross domestic product	2,5	0,8	3,2	0,7	3,8	1,9	-0,6

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

Sources: Statistics South Africa and own calculations

The Bank's most recent central projection for GDP growth incorporates the effect of the January 2014 rate hike and otherwise assumes an unchanged repo rate.² Economic growth for 2014 has been revised down by a cumulative 0,9 percentage points since November 2013, owing mainly to domestic factors, including lower government and household consumption expenditure. Global growth has made relatively small contributions to the changes in the forecasts. The positive outlook for advanced economies is counteracted by weakness in emerging markets and softening world commodity prices. The downward growth revision for 2014 suggests weaker demand for limited resources, alleviating some inflationary pressure. Despite the revision, growth is still expected to improve over the forecast horizon.

Table 4 Evolution of the Bank's real GDP growth forecasts

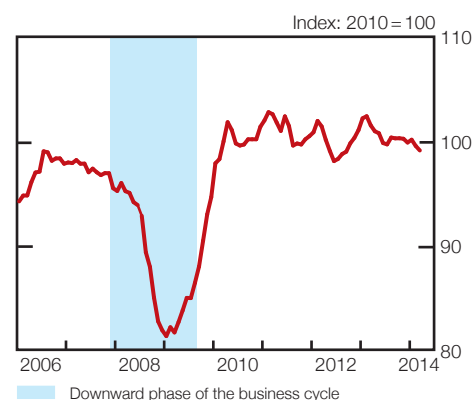
Per cent

MPC meetings	2014	2015	2016
November 2013.....	3,0	3,4	
January 2014	2,8	3,3	
March 2014.....	2,6	3,1	
May 2014.....	2,1	3,1	3,4

Source: South African Reserve Bank

Short-term economic indicators, which aim to assess economic performance in the near future, corroborate the Bank's subdued growth outlook for 2014. Business confidence is generally tepid although it varies from sector to sector, improving among builders but declining in the motor, civil construction and

Figure 6 Composite leading business cycle indicator



Note: The direction of movements of this indicator show the expected movements in aggregate economic activity over the next 6 to 12 months

Source: South African Reserve Bank

² This fan chart represents the information available to the MPC at the time of the May 2014 meeting.

wholesale trades. The pace of recovery in manufacturing capacity utilisation has been slow and there is still spare capacity, particularly with respect to durable goods production.

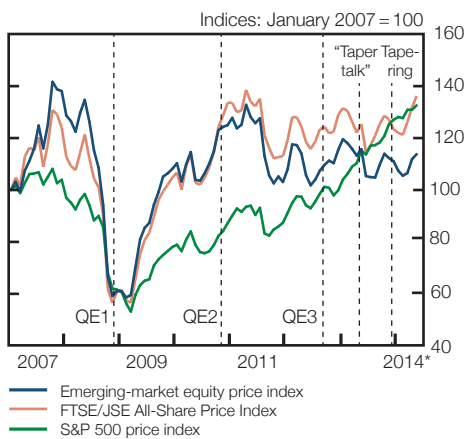
Table 5 Domestic economic sentiment indicators

	Historic range		Most recent		As at MPR*	
	Low	High	Low	High	Nov 2013	Jun 2014
RMB/BER Business Confidence Index	10	91	23	55	43	41
Kagiso/BER Purchasing Managers' Index	34,1	63,7	46,6	55,6	50,7	47,4
FNB/BER Consumer Confidence Index	-33	23	-8	15	-7	-6

* Improved/worsened since previous MPR

Sources: Rand Merchant Bank; Bureau for Economic Research, Stellenbosch University; Kagiso Securities; and First National Bank

Figure 7 Equity-market performance in US dollar terms



Note: Black vertical lines represent the US Federal Reserve's implementation of its quantitative easing programme (QE1) and subsequent renewals of the programme (QE2 and QE3) followed by the first announcement of the possibility of tapering and the month in which tapering was announced

* Data to 29 May 2014

Sources: Bloomberg and Reuters

Household consumption and wealth effects

Household expenditure slowed by almost one percentage point in 2013 and there are limited prospects for improvement in 2014, owing to rising inflation, weak employment growth and muted wealth effects. Household expenditure will also be constrained by continued moderate credit growth, knock-on effects from the mining strike and rate hikes, which raise debt service costs and disincentivise further borrowing. The household sector has, however, made progress in improving its balance sheet, with the debt-to-disposable income ratio declining from a record high of 83,0 per cent in the first quarter of 2009 to 74,3 per cent in the fourth quarter of 2013.³ However, even this reduced level of debt remains relatively high and will likely constrain credit demand for some time. Although nominal equity and property prices continue to increase, the real gains from such investment have been quite modest since the onset of the financial crisis, limiting wealth effects and consumption demand.

Table 6 Growth in expenditure on GDP

Per cent*

	2012	2013				
	Year	1st qr	2nd qr	3rd qr	4th qr	Year
Final consumption expenditure						
Households	3,5	2,4	2,5	2,1	2,0	2,6
General government	4,0	2,8	1,7	1,5	2,0	2,4
Gross fixed capital formation	4,4	3,8	5,6	7,0	3,1	4,7
Gross domestic expenditure	4,0	5,3	3,2	-0,8	-3,6	2,2
Exports of goods and services	0,4	5,9	9,0	16,7	3,9	4,2
Imports of goods and services	6,0	21,5	7,3	7,0	-18,9	4,7
Gross domestic product	2,5	0,8	3,2	0,7	3,8	1,9

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

Note: Data for 2012 and 2013 as published in the March 2014 *Quarterly Bulletin*

Source: South African Reserve Bank

3 The long-term average (1999–2013) for household debt-to-disposable income is 67,9 per cent.

Credit conditions

On aggregate, credit growth over the past six months remained nearly flat, averaging 7,7 per cent in nominal terms, but this conceals variation between different categories of credit. Mortgages, the largest component of credit, have grown at a rate of below 3 per cent since late 2011. Instalment sales and ‘other’ credit⁴ continue to grow strongly. Since mid-2012 these categories have grown at slightly more than 10 per cent, with general loans to businesses (for the recent phase of renewable energy contracts) driving the ‘other’ category in recent months. However, unsecured lending to households, which also fits into the ‘other’ category, has slowed markedly since November 2012 after a period of exceptionally rapid growth. Looking forward, a recovery in mortgage lending would be helpful in bolstering demand. Credit categories such as instalments have contributed to financing consumer durables which tend to be imported, such as cars, so reduced lending may well be the necessary concomitant of current-account rebalancing.

Government expenditure

The 2014 *Budget Review* reiterated government’s theme of gradual fiscal consolidation to ensure sustainable debt levels without jeopardising economic recovery. The budget deficit is expected to narrow to 4,0 per cent in 2013/14, down from 4,3 per cent in the 2012/13 budget, a level of deficit spending that remains expansionary.

Table 7 Public finance medium-term estimates

Percentage of GDP

Consolidated government*	2013/14		2014/15		2015/16		2016/17	
	MTBPS	Budget	MTBPS	Budget	MTBPS	Budget	MTBPS	Budget
Revenue	28,7	29,2	28,6	29,0	28,5	28,9	28,7	29,1
Expenditure	32,8	33,2	32,7	33,0	32,3	32,6	31,7	31,9
Budget balance	-4,2	-4,0	-4,1	-4,0	-3,8	-3,6	-3,0	-2,8
Total net loan debt**	39,3	39,7	41,4	41,9	43,1	43,5	43,9	44,3
Public-sector borrowing requirement		6,6		6,1		5,9		4,3

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

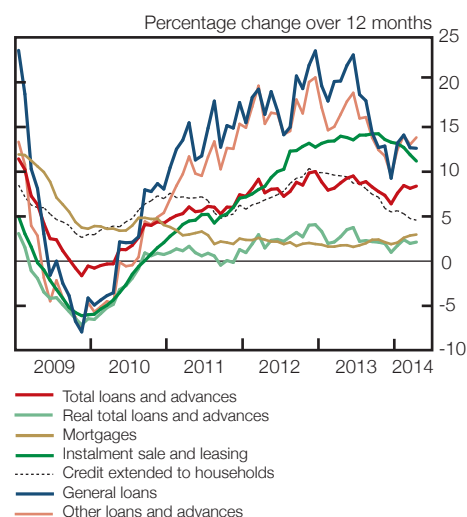
** National government

Note: Owing to a change in presentation of budget statistics, the budget balance now includes extraordinary receipts and payments

Sources: National Treasury, *Medium Term Budget Policy Statement (MTBPS)*, October 2013 and *Budget Review 2014*

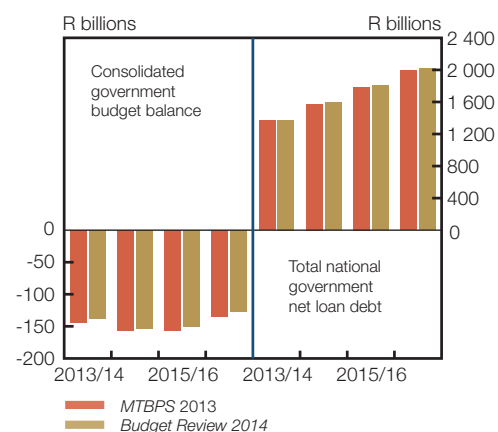
As the economy begins to grow more rapidly, the budget deficit is projected to narrow over the medium term expenditure framework to 2,8 per cent by 2016/17, at which time projected net debt is expected to stabilise at around R2 trillion or 44,3 per cent of expected GDP. Crucial to achieving these outcomes is the non-interest spending ceiling, which limits real expenditure growth to 1,9 per cent per annum.⁵

Figure 8 Banks’ loans and advances to the private sector



Source: South African Reserve Bank

Figure 9 Fiscal stance



Sources: National Treasury, *Medium Term Budget Policy Statement (MTBPS)*, October 2013 and *Budget Review 2014*

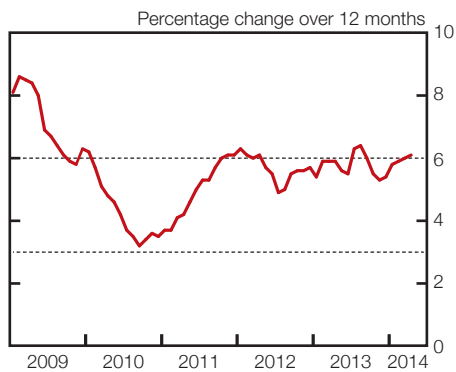
⁴ ‘Other’ credit consists of general loans, overdrafts and credit card advances.

⁵ Non-interest spending refers to expenditure by government on policy-related items such as wages and infrastructure. Interest spending is related to the amount of debt that government has outstanding, as well as prevailing interest rates.

Inflation outcomes

Consumer price inflation

Figure 10 Consumer price inflation:
Targeted inflation*



* CPI for all urban areas

Source: Statistics South Africa

Headline consumer price index (CPI) inflation⁶ – the measure targeted by the Bank – has been on a moderate upward trend since mid-2012. Inflation temporarily breached the target in July 2013, reaching 6,4 per cent in August, followed by an equally brief dip to 5,3 per cent in November caused by short-lived reductions in food and petrol prices. CPI inflation then breached the upper bound of the target range in April 2014, in line with the Bank's forecasts, reaching 6,1 per cent.

Table 8 shows contributions to targeted inflation. Services inflation remains high and sticky, with health insurance, water supply and education inflation far in excess of 6 per cent. Goods inflation has increased strongly in 2014, with significant contributions from food and petrol prices driving the changes in headline inflation. Inflation in administered prices, which includes petrol prices, remains above the target, but has moderated in recent months.

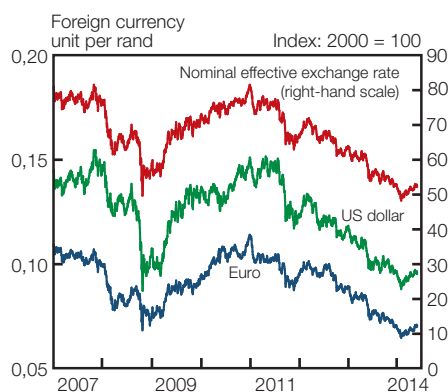
Table 8 Contributions to targeted inflation

Percentage change over 12 months* and percentage points

	Weights	2013			2014			
		Oct	Nov	Dec	Jan	Feb	Mar	Apr
Goods inflation*	49,86	4,9	4,6	4,8	5,7	6,1	6,2	6,3
Services inflation*	50,14	6,0	5,9	5,9	6,0	5,7	5,9	5,9
Targeted inflation*	100,00	5,5	5,3	5,4	5,8	5,9	6,0	6,1
Food and non-alcoholic beverages	15,41	0,6	0,6	0,5	0,7	0,8	1,1	1,2
Food	14,20	0,6	0,5	0,5	0,6	0,8	1,0	1,2
Housing and utilities	24,52	1,3	1,3	1,3	1,3	1,3	1,4	1,4
Transport	16,43	1,0	1,0	1,0	1,3	1,3	1,2	1,1
Petrol	5,68	0,5	0,4	0,6	0,8	0,8	0,5	0,5
Miscellaneous	14,72	1,1	1,1	1,0	1,0	1,0	1,0	1,0
Other	28,92	1,5	1,3	1,6	1,5	1,5	1,3	1,4
<i>Of which:</i>								
CPI for administered prices*	18,48	7,8	7,3	7,8	9,3	9,1	7,6	7,4

Sources: Statistics South Africa and own calculations

Figure 11 Exchange rates of the rand



Note: A depreciation is represented by a downward movement in the above graph

Sources: Bloomberg and South African Reserve Bank

The exchange rate

One of the most important causes of rising inflation has been pass-through of rand depreciation. The currency has been on a steady downward trajectory since 2011, which accelerated in 2013 and early 2014. Against the US dollar, the rand depreciated by 19 per cent in 2013 and slipped a further 6 per cent from the beginning of 2014 to the January meeting. The nominal effective exchange rate (NEER), a broader trade-weighted measure, followed a similar trend. The January repo rate increase was followed by a steady appreciation of the currency back to end 2013 levels, in line with the experience of other emerging markets that suffered large depreciations and raised policy rates. However, the causes of rand depreciation, especially softening commodity prices and a large current-account deficit, are unlikely to abate, and the

⁶ This refers to the 12-month percentage change in the headline CPI.

currency is expected to remain vulnerable to changing global expectations for US monetary policy and appetite for risk.

The rate of pass-through varies depending on economic conditions but also the kind of price. For certain administered prices, such as petrol, pass-through is fast and complete. In other categories, pass-through has been low over much of the recent depreciation period, in part because firms have delayed price increases in the face of subdued demand conditions. The rise in inflation in 2014, however, suggests that firms are pricing-in a larger share of rand depreciation, passing it on to consumers and producing a broad-based rise in inflation.

Box 2 Exchange rate volatility under inflation targeting: Is the rand excessively volatile?

The adoption of inflation targeting in South Africa occurred in parallel with (and largely required) less central bank activity in the foreign exchange market. The scale of capital movements and shifts in direction that accompanied the long period of international financial contagion in the late 1990s and into the 2000s made currency intervention as a policy tool ineffective and unsustainable. In this new environment, it might be expected that the shift to a floating exchange rate policy regime would result in a major increase in exchange rate volatility. However, international evidence on whether flexible inflation targeting per se leads to this increase is mixed. Figure B2.1 compares long-term currency volatility before and after the adoption of inflation targeting for six significantly traded emerging-market currencies. It shows, on average, an overall decline in long-term¹ volatility after the adoption of inflation targeting for all but two countries.²

Despite this decline, volatility could still prove excessive. Amod and Hassan establish a benchmark for 'normal' volatility calculated using a standard monetary model, comparing exchange rate volatility against that justified by volatility in the macroeconomic fundamentals of monetary conditions, real output, and price levels. If a currency's volatility exceeds scaled³ changes in these fundamentals, then it is considered excessively volatile. By this measure the rand is not excessively volatile, although volatility relative to macroeconomic fundamentals has increased in the inflation targeting period.

How should we interpret this result? Evidence on the effects of volatility on growth is mixed. Moderate volatility may in fact be beneficial, if it means that the currency is reacting nimbly to economic news and thereby avoiding large exchange rate misalignments in real terms. In South Africa, real misalignment has decreased by about 10 per cent in the inflation targeting period. This outcome is positive given the clear evidence that substantial, persistent real exchange rate misalignment is damaging to growth.

1 Long-term volatility is measured using quarterly data. Because countries adopted inflation targeting at different times, the pre- and post-inflation targeting periods vary, but the shortest period for any country in our sample is 15 quarters. This analysis is not applicable to short-term currency volatility.

2 Shaista Amod and Shakill Hassan, "Are Emerging Market Currencies Excessively Volatile Under Inflation Targeting?", *South African Reserve Bank Working Paper Series* (forthcoming).

3 The monetary model relates discounted (expected future) macroeconomic fundamentals to the exchange rate. The scaling term is based on the discount factor.

Figure 12 Exchange rate performance against the US dollar

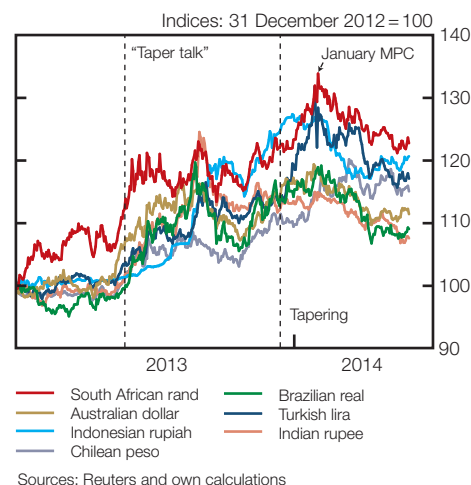
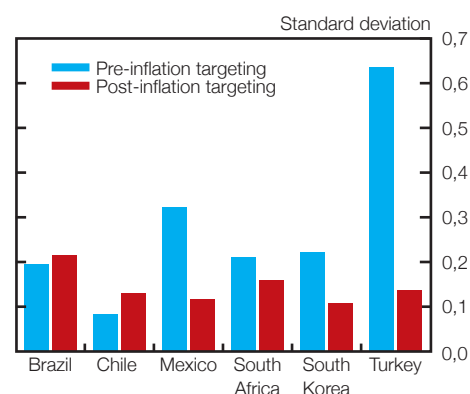


Figure B2.1 Exchange rate volatility against the US dollar before and after adoption of inflation targeting



Source: Amod and Hassan

Input costs

Producer price indices (PPIs) suggest strong ongoing cost pressure on firms from currency depreciation and other sources. Headline PPI inflation, the PPI for final manufactured goods, spiked twice in the past 12 months, after May 2013 and January 2014, both periods of marked currency depreciation. It also displayed an upward trend over this period, driven by almost all the subcategories of the index, including vehicles and machinery, which tend to

Figure 13 Price pressures

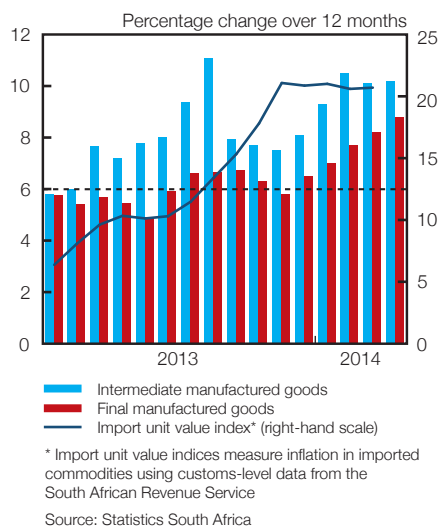


Figure 14 Spot and futures prices of Brent crude oil, and the petrol price

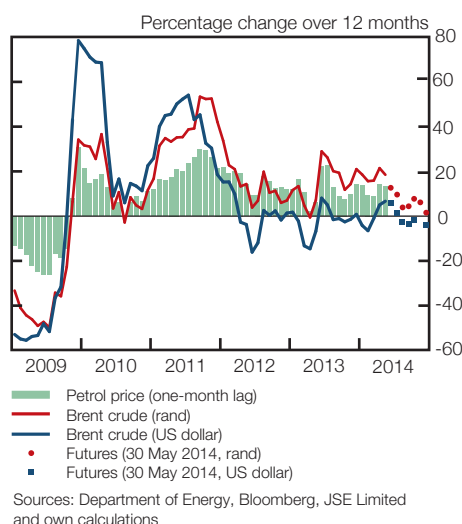
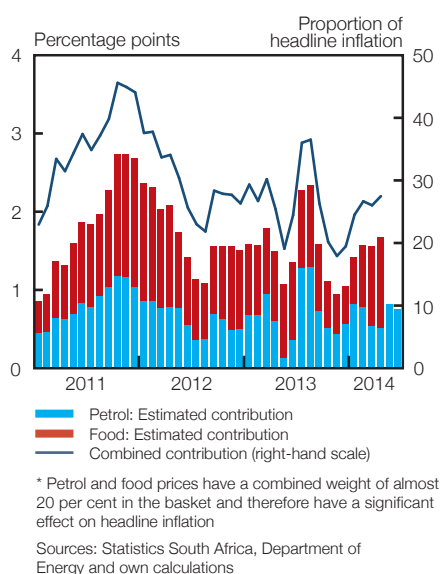


Figure 15 Contribution of petrol and food prices to headline inflation*



be imported, as well as food. Another measure of input costs, the PPI for intermediate manufactured goods, shows a rapid rate of growth, especially since the start of 2013. Importantly, both headline PPI and intermediate goods PPI have generally remained above headline CPI, indicating that some producers and retailers have been absorbing rising production and import costs.

Table 9 Measures of producer price inflation

Percentage change over 12 months

	2013			2014			
	Oct	Nov	Dec	Jan	Feb	Mar	Apr
Final manufactured goods	6,3	5,8	6,5	7,0	7,7	8,2	8,8
Excluding:							
Petroleum products.....	6,3	5,9	6,4	6,8	7,7	8,2	8,5
Food.....	6,6	6,0	6,8	7,1	7,8	7,9	8,4
Intermediate manufactured goods ...	7,7	7,5	8,1	9,3	10,5	10,1	10,2
Electricity and water	14,6	15,8	14,3	14,5	14,5	14,6	10,4
Mining	-0,2	1,4	2,4	4,8	5,3	3,7	6,6
Agriculture, forestry and fishing.....	1,8	2,8	4,1	5,6	8,0	11,7	7,6
Import unit value index*	17,8	21,1	20,9	21,0	20,6	20,7	

* Unit value indices use customs-level data to measure inflation in imported and exported commodities. They are not comparable to the old PPI series for imported commodities.

Source: Statistics South Africa

Petrol and food prices

International crude oil prices have been high but fairly stable in recent years, with a moderate downward trend since April 2011. Brent crude oil has traded between US\$100 and US\$120 per barrel for most of the past three years, and its price has been in the bottom half of that range in 2014, at around US\$108 per barrel. Although geopolitical instability in a number of major producing regions has hampered production, this effect has been offset by strong US shale oil growth, so international markets have been relatively well supplied. But domestic prices have been volatile and rising, owing to currency movements which pass through to the basic fuel price⁷ quickly and completely. The basic fuel price has increased by a cumulative 71 cents in 2014, and by June 2014 unleaded petrol in Gauteng cost R14,02 per litre, up from R13,02 in November 2013. In recent months, currency appreciation has provided some relief, with the price of 95-octane petrol declining by 37 cents per litre over May and June.

Food prices are more complex than the petrol price, comprising many different items and having a large domestic supply component, which buffers the exchange rate impact. Since the previous *MPR*, food prices moved sharply down and then sharply up again. The trough came in December 2013, with food inflation of just 3,5 per cent, the lowest rate since February 2011, following the drought-related culling of herds which increased the meat supply and reduced demand for animal feed. In 2014 prices reversed, with vegetable and meat prices in particular rebounding strongly.

⁷ This reflects the price of refined oil, excluding levies and surcharges imposed by government.

International food prices have maintained a declining trend over the past three years although they have ticked up in recent months. In particular, cereals prices responded to weather uncertainty in the US and geopolitical tensions in Ukraine (an important supplier of wheat to South Africa).

Food prices remain a risk to the inflation outlook, although the short-term risks have moderated somewhat after the recent sharp reversal in domestic maize prices, which followed an upward revision of the domestic maize crop forecast. If sustained, this development could help mitigate the pressures evident in the PPI since the beginning of the year.

Core inflation

Food and petrol prices are volatile, causing at times significant but not necessarily persistent movements in headline inflation. To gauge underlying inflationary pressures, which move less but also have more momentum, the Bank considers several measures of core inflation. The broadest measure – which excludes food, non-alcoholic beverages (NAB), petrol and energy prices – started increasing again after a period of stability, reaching 5,5 per cent in March and April 2014. The core measure including energy, but excluding food and NAB, shows a stronger uptick in recent months, as does the core measure excluding administered prices. These pressures are assessed to be a reflection of exchange rate pass-through, rather than strong underlying demand pressures.

Inflation expectations

Inflation expectations shape prices and wage demands and therefore inflation outcomes. When expectations are well-anchored, they remain stable well within the inflation target. This is a significant policy advantage because it frees policymakers to ‘look through’ temporary departures from the inflation target, chiefly those generated by supply shocks. However, inflation expectations have become a steadily greater concern as they have clustered around the top end of the target.

The Bureau for Economic Research (BER) surveys three groups – financial analysts, firms and trade unions – to establish their expectations for inflation. The average of these opinions indicates above-target inflation in both 2014 and 2015, an outlook held since the second quarter of 2013. More problematically, firms and unions, which have greater influence on actual price outcomes, have systematically higher expectations than financial analysts, rendering the average expectation somewhat misleading. The latest survey, conducted after the January 2014 repo rate increase, suggests a healthy impact from the policy adjustment on expectations for 2016, which return to within the target range – although the expectations of businesses and unions remain above the target.

A similar pattern emerges from Reuters surveys of private-sector economists, aimed at establishing their inflation expectations over a three-year horizon.

Figure 16 Maize and cereals prices

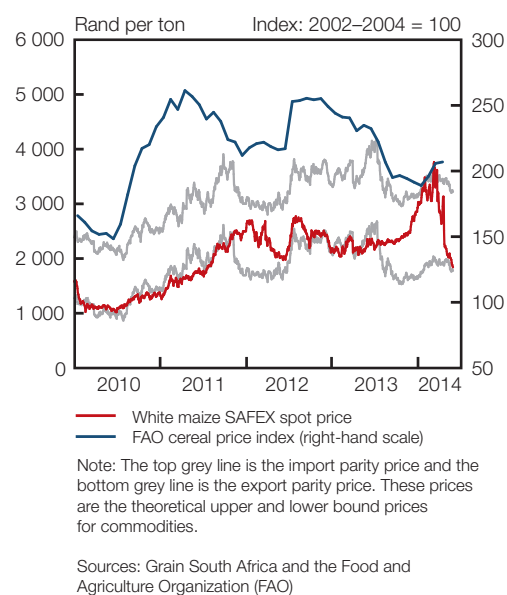


Figure 17 Targeted inflation* and food inflation

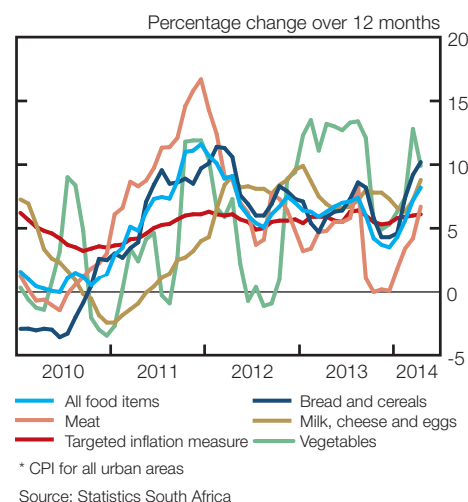


Figure 18 Core measures of inflation

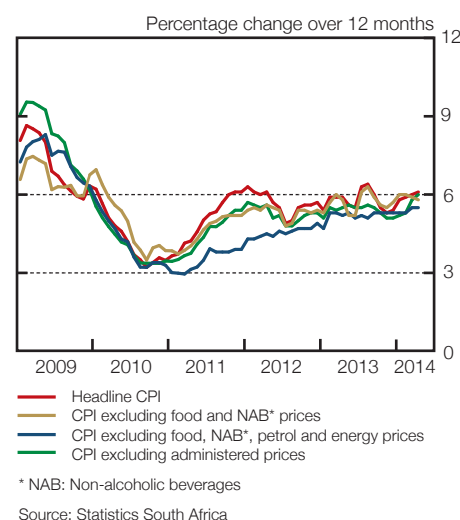
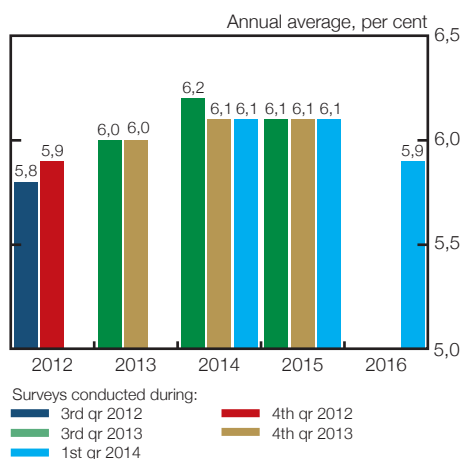


Figure 19 BER surveys of headline CPI inflation expectations



Source: Bureau for Economic Research, Stellenbosch University

The median forecasts, between December 2013 and January 2014, revealed deteriorating inflation expectations for both 2014 and 2015. However, more recent surveys indicate declining inflation over the period to 2016.

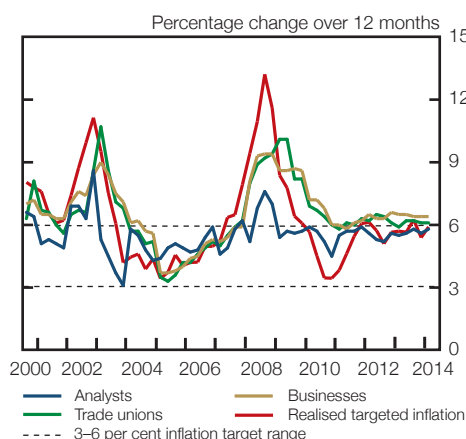
Table 10 Reuters survey of CPI forecasts: May 2014*

Per cent	2014		2015		2016	
Median	(5,9)	6,2	(5,7)	5,7	(5,5)	5,5
Mean	(5,9)	6,2	(5,6)	5,6	(5,4)	5,4
High	(6,2)	6,6	(6,0)	6,1	(6,0)	5,8
Low	(5,3)	5,5	(4,6)	5,0	(4,8)	4,8
Number of forecasters.....	(19)	32	(19)	31	(14)	19

* January 2014 forecasts in parenthesis

Source: Reuters

Figure B3.1 One-year-ahead inflation expectations and realised inflation



Sources: Bureau for Economic Research, Stellenbosch University; and Statistics South Africa

Box 3 Are inflation expectations in South Africa homogeneous?¹

Inflation outcomes are partially determined by the public's expectations about future inflation. In South Africa, the Bureau for Economic Research (BER) surveys inflation expectations of analysts, businesses and trade unions, and provides an average for these three groups. This average underpins most discussion on the subject. In a recent paper, however, Kabundi, Schaling and Some show that the three groups have systematically different expectations. The authors demonstrate this with implicit inflation targets, meaning the long-run average inflation expectation for each group. Analysts have an implicit inflation target of 5,4 per cent, which contrasts sharply with businesses (6,8 per cent) and trade unions (6,6 per cent).

While analysts' expectations are generally well-anchored within the Bank's 3 to 6 per cent target range, the expectations of businesses and trade unions seem to track realised inflation with a significant lag. Businesses and trade unions reacted with prolonged spikes in expectations following the negative supply shocks of 2002 and 2008 (which drove inflation above the target band), whereas the reactions of analysts were transient and restrained.

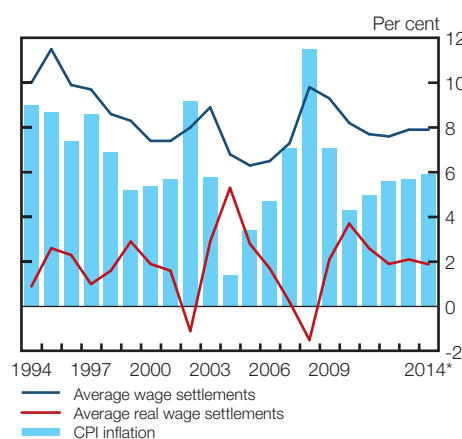
1 This work is based on a recent paper by Alain Kabundi, Eric Schaling and Modeste Some (2014) published as South African Reserve Bank Working Paper 1401.

Labour costs

The past ten years provide ample evidence that feedback effects from inflation outcomes to and from wage and price determination are strong and operate in both directions. Rising wages, when they are not matched by productivity gains, push up firms' costs and may cause them to raise their prices, lifting inflation. In turn, spikes in the CPI are likely to provoke high wage demands for several years, as seen after the 2002 and 2008 highs.

Growth in nominal remuneration per worker, a broad measure encompassing non-agricultural employees in the economy, declined from 16,8 per cent in the first quarter of 2010 to less than half of that over the succeeding three years as the impact of the 2008 CPI acceleration gradually dissipated. Similarly, growth in unit labour costs declined from 11,2 per cent in the first quarter of 2010 to an average of 6,0 per cent in 2013. This reflected lower nominal wage growth relative to CPI but also the economic recovery, which pushed up productivity per worker and thereby moderated growth in unit labour costs.

Figure 20 Average annual inflation and wage settlements



* Data for 2014 are for the first three months of the year

Sources: Andrew Levy Employment Publications, Statistics South Africa and own calculations



However, labour-market outcomes are unlikely to contribute to lower inflation in the medium term. Wage settlements increased by an average of 7,9 per cent in 2013 and have maintained that growth rate in the first quarter of 2014. Furthermore, moderate growth rates in unit labour costs may not be sustained without stronger economic activity.

Global growth and policy developments

Since 2009, the global economy has twice started to recover but then stumbled, first in 2011 and then again in 2013, when world growth hit a four-year low. The end of 2013 brought some improvement, but it is too soon to tell if this is the beginning of the oft-predicted sustained recovery or merely another false start. In contrast to the pattern of the past four years, prospects for stronger growth now depend on advanced economies, which are starting to accelerate even while emerging markets slow down. The US and the UK in particular are expected to perform strongly, while the euro area is no longer contracting. Meanwhile, the biggest emerging markets have exhausted their old growth strategies.

Table 11 Global growth rates

Per cent

	Long-run average*	Outcomes					Estimates		
		2010	2011	2012	2013	2014	2015	2016	
World	3,4	5,2	3,9	3,2	3,0	3,6	3,9	4,0	
Advanced economies.....	2,9	3,0	1,7	1,4	1,3	2,2	2,3	2,4	
Emerging-market and developing countries	4,3	7,5	6,3	5,1	4,7	4,9	5,3	5,4	
Sub-Saharan Africa	3,2	5,6	5,5	4,9	4,9	5,4	5,5	5,8	

* Long-run average: Average growth rates from 1980 until 2006

Source: International Monetary Fund, *World Economic Outlook*, April 2014

Advanced economies: Sunnier with a chance of storms

Viewed purely from the growth numbers, the US recovery is not so obviously impressive: the second half of 2013 was certainly better than the first, but the economy contracted in the first quarter of 2014. Much of this disappointment seems attributable to bad weather, but lingering weakness in the housing market, and disappointing retail sales in April, suggest additional obstacles to a robust recovery. The labour market is more encouraging, however, with the unemployment rate falling to a low of 6,3 per cent in April 2014. This is still some way from the 5,5 per cent natural rate of unemployment (as estimated by the Congressional Budget Office), but much better than the 10,0 per cent level reached in October 2009. Furthermore, other measures of labour market health now tend to corroborate the good news from this indicator, with the participation rate bottoming out, more people leaving their jobs voluntarily, long term unemployment declining and wage growth rising. Inflation, which has long been below the US Federal Reserve's (the Fed) 2 per cent goal, has also edged higher. Consumer prices rose 2 per cent in April and private consumption expenditure inflation, the Fed's preferred measure, is forecast to rise to similar levels in the second quarter of 2014.

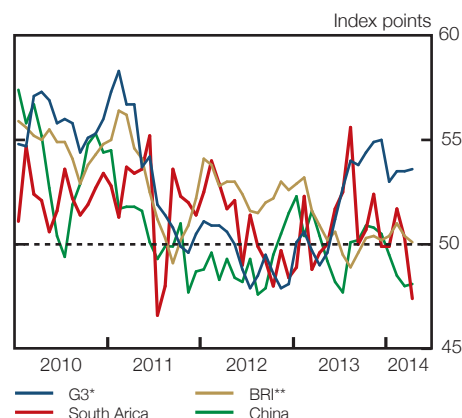
In this context, the members of the Federal Open Market Committee have been willing to continue tapering their programme of monetary stimulus through asset purchases, in regular decrements of US\$10 billion per meeting, and foresee raising the policy rate from the zero lower bound

Figure 21 Remuneration per worker and unit labour cost in the formal non-agricultural sector



Sources: Statistics South Africa and own calculations

Figure 22 Purchasing Managers' Indices

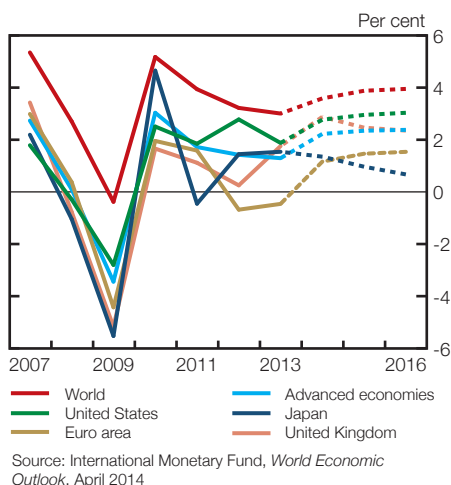


* G3: Purchasing power parity (PPP)-weighted index of PMIs of the United States, Japan and the euro area

** BRI: PPP-weighted index of PMIs of Brazil, Russia and India

Sources: JPMorgan; International Monetary Fund, *World Economic Outlook*, April 2014; and own calculations

Figure 23 Growth rates in advanced economies



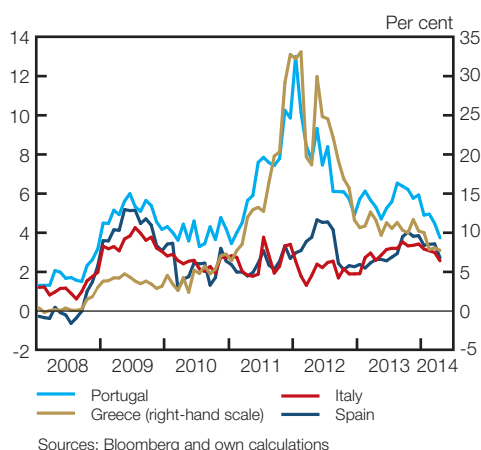
sometime in 2015. Meanwhile, fiscal policy has become more supportive of growth, with the approval of a budget in January 2014 and the suspension of the debt ceiling for a year.

The recovery in the UK has been strong at 3,2 per cent in the first quarter of 2014, with growth of 2,9 per cent expected for 2014, and stronger growth now overdue. Unemployment has fallen much more quickly than anticipated. The Bank of England has kept policy rates and asset holdings unchanged, and has emphasised that it is waiting for significant improvement in a broad range of economic indicators before it starts normalising policy rates – although the threat to financial stability from buoyant house prices may force its hand.

In Japan, authorities face a difficult choice between reviving what has long been a moribund economy and managing the fiscal challenge of the world's highest debt level. Abenomics has so far had some success in boosting asset prices and bolstering growth, which reached 1,5 per cent in 2013. It also appears to have ended deflation, with prices rising by 3,4 per cent in April 2014. However, the value-added tax increase of 1 April 2014, implemented to ensure fiscal sustainability, may arrest the economy's momentum.

The euro area returned to positive growth from the second quarter of 2013, although growth for the whole year remained negative at -0,4 per cent. The forecast for 2014 indicates a 1,2 per cent expansion, with Germany expected to grow somewhat faster, at 1,7 per cent. The peripheral economies at the heart of the crisis have all experienced huge and painful adjustments, with current accounts shifting from large deficits to small surpluses, growth finally returning and ratings agencies now awarding more upgrades than downgrades to both sovereigns and companies. Bond yields for the peripheral countries have come down sharply, in most cases reaching pre-crisis lows, signaling confidence in these economies.

Figure 24 Ten-year real bond yields in the euro area periphery



The biggest threat to the euro area recovery has become low and falling rates of inflation. By April 2014, Greece, Cyprus, Portugal and Slovakia had experienced at least three consecutive months of deflation. Furthermore, all but three euro area countries had inflation at less than 1 per cent, significantly below the European Central Bank's 2 per cent guideline. Deflation is a significant risk to euro area growth as it could cause consumers to defer purchases and raises the real cost of debt. Indeed, the decline in sovereign yields for peripheral countries is less marked if one calculates real yields using current inflation rates, and by this measure these yields are quite distant from pre-crisis norms.

Emerging-market imbalances

The emerging-market slowdown has a variety of drivers, the greatest of which is China, which grew at 7,7 per cent in 2013 and is expected to slow down to between 7,0 and 7,5 per cent in 2014, its slowest pace of expansion since 1990. Some of China's deceleration is the natural consequence of rebalancing towards more sustainable sources of growth, with consumption displacing exports and investment.

The most important vulnerability in China, and the most plausible trigger for a growth collapse, is its financial system. Credit expansion has been extremely strong since the crisis, with credit to the non-bank private sector

now at about 180 per cent of GDP. Money supply growth has finally begun to slow, returning to levels last seen more than a decade ago, and the authorities have also begun introducing greater market discipline into credit allocation, eliminating tacit debt guarantees and planning for liberalised interest rates. Significantly lower growth will likely prompt small stimulus packages from time to time.

Several other major emerging markets join China in experiencing growth challenges and debt vulnerability, but these cases differ in that they have lower savings rates and therefore borrow abroad. This borrowing gives rise to large current-account deficits and thereby greater exposure to global risk sentiment, which in 2013 and 2014 has intermittently moved against emerging markets. Consequently, these countries have suffered currency depreciation and rising inflation, requiring tighter monetary policy, for example in Brazil, India, Indonesia and Turkey. The exception is Chile, which has eased monetary policy in the face of slower growth and declining terms of trade – a response made possible by low inflation and anchored inflation expectations.

Although the most adverse symptoms of the Fed's tapering have appeared in emerging markets with high current-account deficits and not in emerging markets generally, it is misleading to characterise these imbalances as a purely domestic problem. Emerging-market deficit countries have aided the world's recovery by generating demand which has otherwise been scarce in a world of excess savings and ultra-low interest rates. The eight largest emerging-market current-account deficits totalled around US\$277 billion in 2013, almost three-quarters of the US figure. The implication is that pressure to narrow deficits will cause already anaemic global demand to decline. The best case would be for surplus countries to generate more demand and for deficit countries to find safer ways to fund their deficits.

Global inflation and commodity prices

In line with weak world demand, global inflationary pressures remain subdued. The International Monetary Fund projects consumer price inflation in advanced economies to increase by 0,1 percentage points to 1,5 per cent in 2014, and to fall by 0,3 percentage points to 5,5 per cent over the same period for emerging-market and developing economies. In addition to subdued demand, these inflation outcomes are influenced by relatively stable food and energy price trends.

Viewed over the longer term, metal commodity prices remain elevated, but they have trended downwards over the past two to three years, owing mainly to weaker growth in resource-intensive countries such as China. The outlook for commodities is varied, with base and precious metals likely to do worse as China rebalances, but food prices much less affected. Although moderating commodity prices are generally helpful for inflation, falling metals prices are a concern for producer countries such as Australia, Chile, South Africa and Zambia. The danger is especially acute where trade performance is already inadequate, as falling commodity prices would damage export performance and push up trade deficits.

Figure 25 Growth rates in emerging-market and developing economies

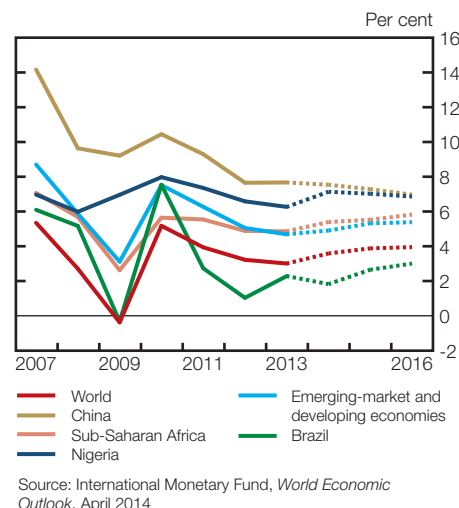


Figure 26 Monetary policy interest rates of selected countries

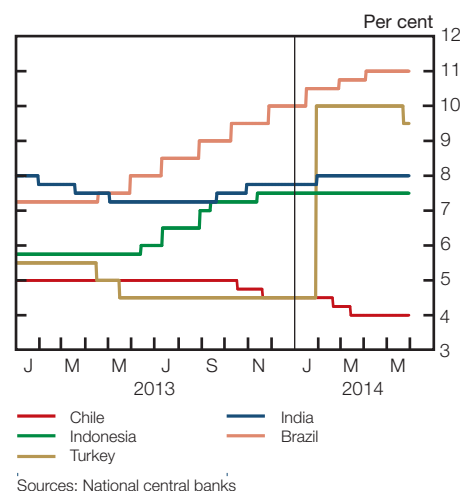
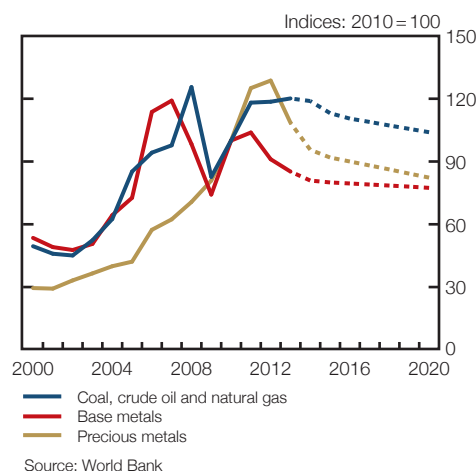


Figure 27 Real commodity prices



Risks to the outlook

The Bank bases its projections on a set of assumptions about the future behaviour of key economic variables. These assumptions inform the baseline scenario. However, due to risks associated with these assumptions, the MPC also considers alternative scenarios.

The main international risks to the Bank's forecast are unforeseen changes to the pace of monetary policy normalisation by advanced economies and the economic slowdown in China (described earlier in this *MPR*). Domestically, the economy remains vulnerable to supply shocks, notably labour disruptions and electricity shortages, and the possibility of credit rating downgrades. These risks, together with high structural unemployment, amplify South Africa's vulnerability to global risks.

Global risks

Monetary policy normalisation

Advanced-economy central banks responded to the global financial crisis with extraordinary stimulus, including zero interest rates, large-scale asset purchases and unprecedented policy co-ordination. Monetary policy normalisation entails unwinding stimulus policies, with central banks raising interest rates, tapering asset purchases and consolidating balance sheets. For emerging markets, the basic policy implications of this process are reasonably clear: policy rates will ultimately rise and fiscal policy should adjust in the direction of reduced debt. Nonetheless, there is considerable scope for surprises around the implementation of exit strategies, as evidenced by the shock waves unleashed by Fed tapering. Financial markets seem to have priced in continued steady quantitative easing tapering in the US, reducing volatility and uncertainty.

South Africa's capital flows and borrowing

Since October 2013, South Africa has continued to record a net inflow of foreign capital in the balance of payments despite fairly consistent net sales by non-residents of both domestic government bonds and shares. Non-resident net inflows declined from R85,2 billion in 2012 to only R1,3 billion in 2013. Strong net outflows of R71,0 billion were recorded from November 2013 to January 2014. Non-resident net transactions then reverted to inflows of R33,9 billion from February to May 2014, following the January rate hike, thereby providing support to the currency. South Africa's current-account deficit is not funded exclusively by non-resident inflows. In fact, more than half of the 2013 deficit was paid for by the category of 'unrecorded transactions', which also covered the majority of the deficit in the crisis year of 2008. The Bank continues to devote resources to providing a more adequate accounting of these transactions, and further details will be forthcoming in future *Quarterly Bulletin* publications.

Figure 28 Flow of capital to and from South Africa

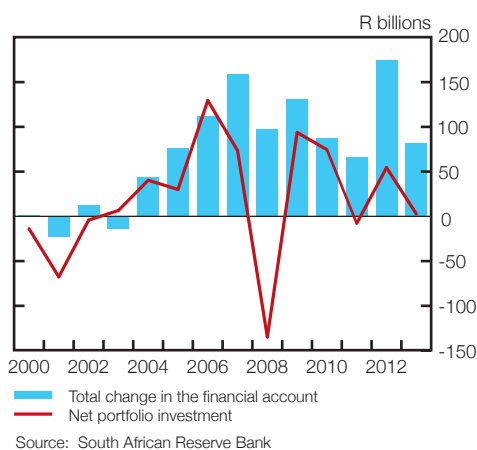
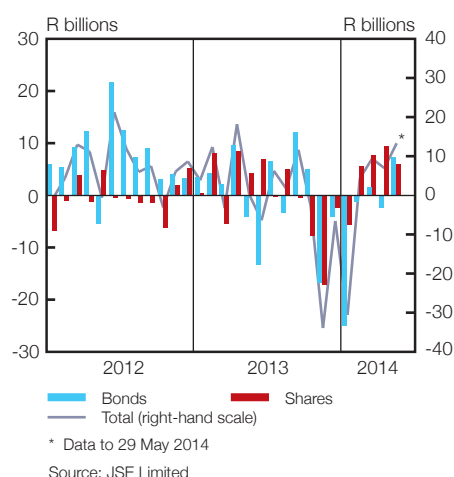


Figure 29 Monthly non-resident net purchases of domestic securities



Trade flows and the current account

As global capital flows have grown scarcer and more erratic, South Africa's large current-account deficit has become a serious macroeconomic vulnerability. The expansion of the deficit over the past half-decade stems from disappointing export performance, linked to falling terms of trade and production disruptions, and rising imports. Of the latter, three main categories of imports stand out: capital goods for investment, durable consumption goods (such as motor vehicles) and intermediate goods (fuel). Policy changes will help to moderate demand for some of these items, while the depreciating currency should make South African goods more attractive to foreign buyers and discourage imports.

By January 2014, the real effective exchange rate had reached a six-year low, and trade surpluses were recorded during some months in late 2013 and early 2014. However, it is too early to say whether these mark a new trend, especially because these surpluses have been mixed with very large deficits. South Africa will still need to attract significant capital inflows. An important risk here is that declining terms of trade, likely linked to China's slowdown, could place further pressure on the current-account deficit. There is also a danger that elevated inflation outcomes will cancel out the effects of the exchange rate depreciation, depriving South Africa of sorely needed competitiveness.

Domestic risks

Electricity

As in the previous upward phase of the business cycle, output growth is significantly outpacing electricity-supply growth, necessitating load shedding in early 2014. An unreliable electricity supply is especially detrimental for the embattled mining and manufacturing sectors, which are large contributors to growth and employment. Chronic electricity shortages hinder private fixed capital formation and economic growth. Although new electricity-generating capacity is now scheduled to come on line during 2014, construction of the requisite power stations has faced repeated delays.

Employment and labour relations

Employment creation remains the most significant challenge to long-term economic stability and growth. In the first quarter of 2014, unemployment increased to a high 25,2 per cent in a declining growth environment. Figure 32 shows that since the onset of the global financial crisis, employment growth in South Africa has been concentrated in the public sector. The slow recovery in private-sector employment is a concern, particularly in the context of fiscal consolidation.

The other great concern in the labour market is antagonistic labour relations and persistent strikes. In particular, changes in the structure of mining unionisation over the past few years have caused multiple, often violent disruptions to production, with the most recent example being the record-length and ongoing platinum-sector strike. These events have been

Figure 30 Trade and current accounts*

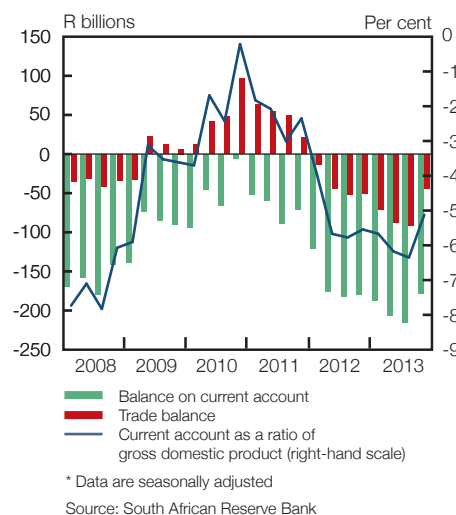


Figure 31 Growth in electricity supply and real GDP in the upward phase of the business cycle

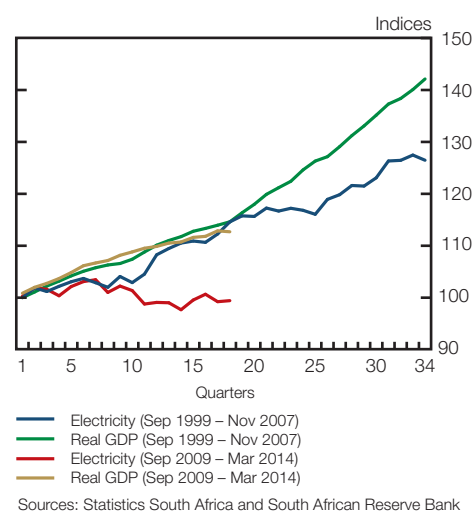
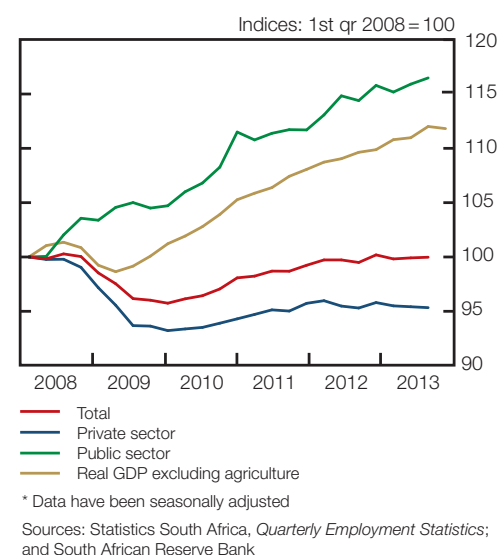


Figure 32 Formal non-agricultural-sector employment and GDP*



costly in several ways, depriving households of wage income and retailers of customers, damaging exports, and ultimately compromising investment and employment. The Chamber of Mines estimates the cumulative loss of wages from the mining strike to be R9 billion.

Conclusion

The MPC faces difficulty in determining policy options in the rising inflation–slow growth environment that persists. The inflation outlook has deteriorated and inflation is expected to remain outside the target for an extended period of time. The exchange rate remains a significant source of upside risk to the forecast, and although these pressures have abated somewhat compared to the start of the year, there are stronger indications of pass-through.

The policy rate has been adjusted upwards, but it is rising from very low levels, so the monetary policy stance remains supportive of South Africa's recovery. Domestic demand pressures have weakened in recent months. The domestic economy has also suffered a number of adverse supply shocks, particularly from strike action and electricity shortages, culminating in negative first quarter growth in 2014 – the economy's worst performance since the 2009 recession. Although the second quarter is expected to show some improvement, the risks to the 2014 forecast are to the downside.

The world economy is back in the start phase of what has been a stop-start recovery, as the Fed has started tapering its extraordinary stimulus measures. As a consequence, international capital flows have become more erratic, creating new pressures on emerging markets. Monetary policy is in a rising interest rate cycle and will align to the speed of global policy normalisation. It will do so, however, within a flexible inflation-targeting framework that allows MPC decisions to remain sensitive to changing data and the fragility of the domestic recovery.

Appendix 1: The Bank's fan charts

This appendix is intended to assist in interpreting the growth and inflation fan charts. The MPC uses fan charts to focus the discussion of risks lying ahead and their impact on the inflation and growth forecasts.

Fan chart projections are based on assumptions and are subject to uncertainty. These graphical representations reflect the MPC's collective judgement (a single view of the probability) of the most likely path of inflation and growth outcomes in the future. However, there is no mechanical link between either the central projection or the distribution at the forecast horizon and the setting of monetary policy.

Fan charts reflect the MPC's view of uncertainty associated with the projections at different horizons through a range of confidence intervals. The mode – darkest band at the centre of the fan chart – represents the most likely 10 per cent of the probable outcomes, including the central projection. Moving away from the central projection, the area covered by 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.⁸ The width of the coloured confidence bands is an indication of the estimated uncertainty.

The fan becomes progressively wider and flatter as the projection extends into the future, reflecting increased uncertainty. The MPC also takes a view on the balance of risks. The probability distribution will be symmetrical if risks are viewed as evenly spread. If risks are viewed as not evenly spread then the probability distribution will be asymmetrical and skewed. A skewed probability distribution reflects a higher likelihood of outcomes in one direction (above or below the central projection). An upward bias is reflected by a slightly larger shaded area covered by the upper bands and a downward bias by a slightly larger shaded area covered by the lower bands.

⁸ Actual inflation and growth outcomes are therefore expected to be somewhere within the fan on 90 out of 100 occasions. For the remaining 10 out of 100 occasions inflation and growth can be anywhere in the area outside the shaded range.

Statement of the Monetary Policy Committee

29 January 2014

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

Since the previous meeting of the Monetary Policy Committee (MPC), the expected cutback in quantitative easing by the United States (US) Federal Reserve (the Fed) has begun. Although the initial response in global financial markets was generally fairly muted, emerging markets have subsequently experienced a high degree of turbulence, particularly in the wake of renewed fears of a slowdown in China. While the Fed action signals a recovery in the US, and the United Kingdom (UK) economic outlook is also improving, it does not mean that the global financial crisis is over. Rather, we are now entering a phase of the crisis that is creating new challenges for emerging-market economies.

In the longer run a sustained recovery in the US should be positive for the global economy in general, but the adjustment to the withdrawal of quantitative easing is likely to create significant short- to medium-term challenges. How to respond to a combination of sharply depreciating currencies, capital outflows, slowing growth, rising inflation, significant current account and/or fiscal deficits and deteriorating confidence is posing policy challenges and very difficult trade-offs for many emerging markets.

The rand exchange rate has been one of the currencies affected by these developments, and the recent depreciation of the rand, if sustained, will raise significantly the risk to the inflation outlook. Our inflation forecast shows a marked deterioration, despite the absence of clear evidence of domestic demand pressures.

The recent inflation data reflect positive outcomes that belie the incipient risks, largely from the depreciation of the currency, that our forecasts highlight. The year-on-year inflation rate as measured by the consumer price index (CPI) for all urban areas measured 5,3 per cent in November 2013 and 5,4 per cent in December, resulting in an average annual inflation rate of 5,7 per cent for 2013. Food and non-alcoholic beverage price inflation continued to moderate from a recent peak of 7,1 per cent in August, to 3,8 per cent in November and 3,5 per cent in December. The contribution of this category to the average CPI increase was 0,5 percentage points in December compared with 0,6 percentage points in the previous month. The petrol price, which was the main contributor to the higher overall inflation in December, increased at a year-on-year rate of 10,0 per cent, up from 7,7 per cent in November. Core inflation, which excludes food, petrol and electricity, has been unchanged at 5,3 per cent for the four months to December, while administered price inflation excluding petrol measured 6,8 per cent. The headline producer price inflation for final manufactured goods measured 5,8 per cent in November, compared with 6,3 per cent in October.

The headline inflation forecast of the Bank has deteriorated since the previous meeting of the MPC, mainly as a result of revisions to the assumptions regarding the rand exchange rate. The forecast average inflation rate for 2014 is 0,6 percentage points higher at 6,3 per cent, and 0,6 percentage points higher at 6,0 per cent in 2015, with inflation expected to average 5,9 per cent in the final quarter of that year. Inflation is expected to breach the upper end of the target range in the second quarter of 2014, and to reach a peak of 6,6 per cent in the final quarter of the year, before declining to 6,0 per cent in the second quarter of 2015.

Core inflation, which averaged 5,2 per cent in 2013, is expected to average 5,8 per cent in 2014, compared with 5,6 per cent in the previous forecast, while the forecast for 2015 has increased from 5,3 per cent to 5,9 per cent. The deterioration in this measure of underlying inflation continues to be driven primarily by the lagged effects of the depreciation of the rand exchange rate.

Inflation expectations appear to have remained relatively anchored at the upper end of the target range. According to the survey conducted in the fourth quarter of 2013 by the Bureau for Economic Research at Stellenbosch University, average inflation expectations of respondents measured 6,1 per cent for both 2014 and 2015, and have remained more or less unchanged since 2011. There is, however, some divergence between the average expectations of respondents, which range between 5,6 per cent and 6,4 per cent in 2014, and 5,5 per cent and 6,5 per cent in 2015. Financial analysts have the lowest forecasts, which are also reflected in the latest Reuters survey that indicates expectations of 5,6 per cent and 5,5 per cent in 2014 and 2015 respectively.

While the economic growth outlook for a number of emerging-market economies has deteriorated somewhat in recent months, the prospects in the advanced economies have improved, particularly in the US and the UK. However, the recovery remains uneven and not without risks. In the US, growth is being driven by a recovery in the housing market, robust private-sector demand, and a dissipation of the negative impulse from fiscal consolidation. In its latest *World Economic Outlook (WEO)* update, the International Monetary Fund (IMF) forecasts growth of 2,8 per cent in 2014 for the US, compared with 1,9 per cent in 2013. The outlook for the eurozone remains fragile and uneven, particularly in the southern periphery where the risk of deflation, strong fiscal consolidation and weak banking sectors are constraining the recovery. Eurozone growth in 2014 is expected to remain subdued at around 1,0 per cent.

The Japanese economy has maintained its positive growth, but there are still doubts about its sustainability in the absence of continued fiscal stimulus. The outlook for the Chinese economy is increasingly uncertain, given the challenge of containing the excessive increase in credit extension without adversely impacting on growth. Although a growth rate of around 7,5 per cent is still generally expected, the latest Purchasing Managers' Index (PMI), which suggests a contraction of industrial production, indicates some downside risk to this outlook. This uncertainty has contributed to increased risk aversion and volatility in financial markets of emerging economies in recent weeks, and is also likely to impact negatively on commodity prices.

Significant currency depreciation and weaker growth prospects are also evident in a number of other large emerging economies, particularly Brazil, Russia and Turkey, while the outlook for the Indian economy appears to have improved somewhat.

Global inflation remains benign despite abundant liquidity. However, spillover effects from increasingly divergent monetary policies are creating a difficult and volatile environment for emerging markets. There is still some uncertainty regarding the pace of tapering by the Fed in the coming months, and although market expectations are that the US policy rate is unlikely to increase before at least mid-2015, long-term bond yields have increased to around 2,8 per cent from around 1,6 per cent in May 2013. A further sustained improvement in UK growth and employment trends has brought forward the prospect of monetary tightening by the Bank of England. However, monetary policy is expected to remain highly accommodative in Japan and the eurozone where the risk of deflation persists.

The expectation of tapering by the Fed since May 2013 resulted in significant outflows from emerging economies' domestic bond and equity markets, putting pressure on exchange rates and long-term bond yields, particularly in those countries with sizeable current-account deficits. Some countries, including Brazil, Turkey, Indonesia and India, responded by tightening monetary policy, either in reaction to inflationary pressures or in an attempt to stem the depreciation. Since May 2013, cumulative interest rate increases have amounted to 300 basis points in Brazil and 75 basis points in India. The most recent instance has been Turkey which raised its overnight interest rate (MFR) by 425 basis points to 12 per cent.

The impact of these developments on the rand exchange rate has resulted in a marked increase in the upside risk to the inflation forecast, despite the relatively muted pass-through to date. Since the previous MPC meeting, the rand has depreciated by about 7,4 per cent against the US dollar, by 9,0 per cent against the euro and by 8,0 per cent on a trade-weighted basis. Year to date the rand/dollar depreciation has been about 3,5 per cent.

In the final two months of 2013, total net sales by non-residents of South African domestic government bonds and equities amounted to R21,0 billion and R19,4 billion respectively. These flows effectively reversed the inflows that occurred during the earlier part of the year, with net purchases of bond and equities for 2013 by non-residents amounting to R1,3 billion, compared with R85,2 billion for 2012. Year-to-date net sales of equities and bonds have totalled R19,3 billion, of which R15,6 billion were bonds.

While the recent rand weakness is part of a general emerging-market phenomenon, it has been reinforced by idiosyncratic factors including declining terms of trade, ongoing labour disputes, and the higher-than-expected current-account deficit in the third quarter.

Although to date the current account has been slow to react to the depreciation of the rand, the trade surplus of R0,8 billion recorded in November may signify a possible narrowing of the current-account deficit in the fourth quarter of 2013. However, given the volatility of the monthly trade data, it is too early to assess whether or not this is the beginning of a sustainable trend. The extent to which the strikes in the mining sector and resulting decline in exports are likely to impede the current-account adjustment further will depend on the duration of the strikes and the extent to which lost output can be compensated for by running down inventories.

The economic growth outlook remains subdued amid continued low business confidence. Growth in the fourth quarter of 2013 is estimated to have recovered somewhat from the low base of 0,7 per cent in the third quarter, and annual growth in 2013 is estimated to have been around 1,9 per cent. Although an improved outcome is forecast for 2014, growth is still expected to remain below estimated potential output of between 3,0 and 3,5 per cent. The Bank's forecasts for growth in 2014 and 2015 have been revised to 2,8 per cent and 3,3 per cent respectively, down from 3,0 per cent and 3,4 per cent in the previous forecast round. The Bank's composite leading business cycle indicator continues to trend sideways, and was marginally negative in November.

The mining sector is expected to remain under pressure in the face of work stoppages in the major platinum mines, with the risk of these disruptions spreading to the gold mines. Mining output recovered somewhat in the fourth quarter of 2013 from the September lows, and the sector is expected to have made a positive contribution to fourth-quarter growth. The manufacturing sector is also expected to have exhibited stronger growth in the final quarter, following the strike-induced contraction in the third quarter. However, the sector has yet to exhibit a meaningful response to the weaker exchange rate, and the Kagiso PMI declined to just below 50 index points in December, for the first time since April 2013.

The construction sector presents a mixed picture. The FNB/BER building confidence index remained unchanged at 48 index points in the fourth quarter of 2013, the highest level in 5 years. However, the upward trend in the real value of building plans passed observed in the earlier part of 2013 has levelled off, and there was a notable decline in November by 12,5 per cent on a month-to-month basis, and a 14,5 per cent decline on a year-on-year basis. The outlook for civil construction, by contrast, appears to be more favourable.

These restrained developments in the real sector have contributed to the slow pace of employment creation in the economy, and continued job losses in the private sector remain a concern. According to the Quarterly Employment Statistics (QES) survey of Statistics

South Africa, formal-sector employment increased by 13 400 in the year to the third quarter of 2013, or by 0,2 per cent. In the third quarter of 2013, employment losses were most pronounced in mining and construction.

Growth in consumption expenditure by households moderated from 2,8 per cent in the second quarter to 2,3 per cent in the third quarter, and is expected to remain relatively constrained by disappointing employment growth and a modest rise in credit extension. Slow growth was particularly evident in the consumption of non-durable goods and services. Real expenditure on durable goods remained strong, with growth of 9,3 per cent. Nevertheless, domestic new vehicles sales appear to be under pressure, having contracted by 3,3 per cent on a quarter-to-quarter basis in the final quarter of 2013. Although retail trade sales increased by 1,2 per cent on a month-to-month basis in November 2013, they increased only marginally, by 0,1 per cent, when the three months to November are compared to the previous three months. Consumer confidence, as reflected in the FNB/BER consumer confidence index, remained at a low level of -7, a marginal improvement from the previous quarter.

Growth in credit extension by the banking system to the private sector continued to lose momentum. Twelve-month growth in total loans and advances to the private sector moderated to 7,4 per cent in November, with credit extension to households measuring 5,9 per cent, compared with 10,4 per cent at the same time in 2012. Twelve-month growth in general loans to households, mainly unsecured lending, measured 8,1 per cent in November, the lowest rate of growth since April 2009, while annualised growth over three months showed a contraction of 0,8 per cent. Although there has been an increase in commercial mortgage credit extension, growth in outstanding residential mortgages remains subdued at 1,3 per cent. Instalment sale credit and leasing finance has continued to be relatively brisk, but could moderate if motor vehicle demand continues to decline. Household debt as a percentage of household disposable income declined slightly from 75,8 per cent in the second quarter to 75,5 per cent in the third quarter of 2013.

Wage settlement rates, as measured by Andrew Levy Employment Publications, measured 7,9 per cent during 2013. However, according to QES data, growth in nominal remuneration per worker declined from 8,8 per cent in the year to the second quarter of 2013, to 6,6 per cent in the year to the third quarter. For the economy as a whole, despite a small decline in labour productivity growth, unit labour cost growth declined over the year from 6,9 per cent in the second quarter to 4,9 per cent in the third quarter. However there are important sectoral differences. For instance, unit labour cost growth in the manufacturing sector accelerated from 5,6 per cent to 6,9 per cent during the same period, while nominal remuneration per worker in the mining sector increased by 9,0 per cent.

Food prices have been the main contributor to the downside surprises in inflation in the past two months, with prices increasing by 3,5 per cent in December. Global food prices generally declined during the year amid improved wheat and maize harvests. The rand exchange rate, coupled with disappointing domestic harvests due to drought in some areas, has impacted adversely on the domestic maize and wheat prices in recent weeks, with the spot prices of maize increasing by about 12 per cent during January, following increases of around 20 per cent between August and December 2013. These pressures have not as yet been observed in the producer price index where cereal and other crop prices declined by one per cent over the year in November. Persistent drought conditions in a number of regions have resulted in the culling of cattle, leading to extremely low meat price inflation since September (0,1 per cent in December). However, these favourable food price outcomes are not expected to persist as higher spot grain prices work through to consumer prices.

Although the exchange rate pass-through has generally been relatively muted to date, the impact on the petrol price has been almost immediate. International oil prices have been

fairly stable, with Brent crude oil trading in a range of between US\$106 and US\$109 during January. In December and January the domestic petrol price was increased by a cumulative 55 cents per litre, and a further significant increase, in excess of 30 cents per litre, can be expected in February, primarily as a result of the weaker exchange rate. Sustained upside pressure from petrol prices on inflation can therefore be anticipated should the rand continue to depreciate.

The MPC carefully considered the economic challenges facing South Africa and the appropriate policy response. On the one hand, inflation forecasts indicate the possibility of being out of the target range for an extended period, largely due to the impact of the depreciating currency. The risks to the inflation forecast are seen to be significantly on the upside. Large adjustments to the exchange rate will inevitably impact on inflation, even in conditions of relatively low pass-through such as we have been experiencing.

On the other hand, the growth outlook remains of concern. Credit extension is low and declining, few jobs on a net basis are being created, and gross fixed capital formation, particularly from the private sector, is significantly below what is required.

Capital outflows and a current-account deficit exacerbate the difficulties that lie ahead. Exchange rate pressures are expected to intensify as markets adjust to the new pattern of global capital flows. Although monetary policy in the advanced economies remains accommodative, the process of normalisation has begun, and the spillovers have implications for our own monetary policy.

The primary responsibility of the Bank is to keep inflation under control and ensure that inflation expectations remain well anchored. The depreciation experienced so far could improve our international competitiveness, provided that it is not eroded through higher wage and other input prices.

In the light of these circumstances and taking account of policy trade-offs, the MPC has decided to increase the repurchase rate by 50 basis points to 5,5 per cent per annum as of 30 January 2014. The MPC is of the view that, notwithstanding this increase in the repo rate, monetary policy remains accommodative. Further moves in the repo rate will be highly data-dependent. We will continue to monitor developments closely and will not hesitate to act as required in keeping with our mandate.



Statement of the Monetary Policy Committee

27 March 2014

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

Since the previous meeting of the Monetary Policy Committee (MPC), the global economic environment has remained challenging, notwithstanding some improvement in sentiment. Key factors affecting the environment include the possibility of an earlier-than-expected increase in the United States (US) policy rate in 2015, further evidence of a slowdown in China, and geo-political tensions arising from the situation in Ukraine.

The domestic economic outlook remains subdued amid continued strikes in the platinum sector and uncertainty regarding a stable and sufficient electricity supply in the coming months. While the most recent inflation forecasts suggest marginal improvements in the medium term, upside risks to the inflation outlook persist despite the recent appreciation of the rand, which remains vulnerable to shifts in global risk sentiment and adverse domestic developments. Together with downside risks to growth, this continues to pose a dilemma for monetary policy.

The year-on-year inflation rate as measured by the consumer price index (CPI) for all urban areas measured 5,8 per cent and 5,9 per cent in January and February 2014 respectively, up from 5,4 per cent in December 2013. This marked upward trend was in line with the forecasts of the South African Reserve Bank (the Bank). Food and non-alcoholic beverage price inflation reversed its previous downward trend, measuring 4,3 per cent and 5,4 per cent in the past two months, compared with the recent low of 3,5 per cent in December. The contribution of this category to the overall CPI inflation increase was 0,8 percentage points in February 2014, compared with 0,5 in December 2013. The petrol price, which was the other main contributor to the higher CPI inflation in February, increased at a year-on-year rate of 14,0 per cent. Core inflation, which excludes food, petrol and electricity, was unchanged at 5,3 per cent, the sixth consecutive month at this level. This was despite upward pressures from exchange rate sensitive categories such as clothing and footwear, and motor vehicle inflation, which were offset to some extent by a lower rate of increase in medical insurance costs. Administered price inflation excluding petrol measured 6,9 per cent. The headline producer price inflation for final manufactured goods measured 7,7 per cent in February, compared with 7,0 per cent in January.

The Bank's forecast of headline inflation is unchanged for 2014 and is expected to average 6,3 per cent, with the peak of 6,6 per cent still expected in the fourth quarter. The forecast average inflation for 2015 declined from 6,0 per cent previously to 5,8 per cent, with inflation expected to average 5,6 per cent in the final quarter of that year, compared with 5,9 per cent previously. This improvement is mainly the result of the lagged effect of the repurchase (repo) rate increase. Inflation is still expected to breach the upper end of the target range in the second quarter of 2014, and to return to within the target range in the second quarter of 2015, when it is expected to measure 5,9 per cent.

The outlook for core inflation has improved and is expected to average 5,6 per cent in both 2014 and 2015, compared with the previous forecast of 5,8 per cent and 5,9 per cent for these two years respectively. Notwithstanding this improvement, the upward pressures continue to be seen to be coming from the lagged effects of the exchange rate depreciation. The MPC still assesses the risks to the inflation outlook to be skewed to the upside, as extended periods of overshooting of the exchange rate remain a possibility in the current uncertain global environment. There is also a risk that the current low level of pass-through may not persist.

Inflation expectations as measured by the survey conducted by the Bureau for Economic Research (BER) in the first quarter of 2014, remained unchanged at an average of 6,1 per cent for both 2014 and 2015, with inflation of 5,9 per cent expected in 2016. Although the 2014 expectations of analysts increased to 6,1 per cent from 5,6 per cent in the previous survey, the expectations of business people declined to 6,2 per cent from 6,4 per cent, with trade union expectations unchanged at 6,1 per cent. Analysts expect inflation to moderate during the next two years to within the target range, while business and labour respondents expect inflation to remain steady at just over 6 per cent, indicating that expectations continue to be relatively well anchored, albeit at the upper end of the target band.

The Reuters survey of economic analysts conducted in March 2014 shows that inflation expectations of economists are more or less unchanged since the previous survey and also remain, on average, anchored at the upper end of the band. The expectation is that inflation will breach the upper end of the target range in the third and fourth quarters of 2014 at an average rate of 6,1 per cent before returning to within the target range.

The global economic recovery continues to be uneven, with a first quarter slowdown in growth in the advanced economies compared with the fourth quarter of 2013, due in part to severe weather conditions, particularly in the US. Nevertheless, the underlying US growth prospects remain relatively favourable despite a slower pace of employment growth, amid positive investment and consumption indicators. The United Kingdom economy continues to show signs of sustained improvement, with declining inflation and unemployment rates as well as a buoyant housing market. The eurozone's growth prospects remain weak, although there are signs of a modest recovery, and the unemployment rate appears to have peaked. Japanese economic growth in the fourth quarter of 2013 was lower than expected, and there are indications that the recovery could be losing momentum.

The global outlook is, however, overshadowed by unfolding developments in the Ukraine and Russia regarding Crimea, although to date contagion effects have been limited to those countries with direct trade and financial links with the region. The other downside risk factor relates to a deteriorating outlook in a number of the larger emerging market economies, including Brazil, Russia and China. Recent short-term data from China indicate that economic growth could decline below the government's target of 7,5 per cent, at a time of increased risks in the banking sector.

The slowdown in China is expected to maintain downward pressure on global commodity prices, particularly industrial commodities, while there are upside risks to some commodities, particularly oil and grains, from the tensions in Crimea.

Global inflation pressures remain benign, particularly in the advanced economies. Since the previous meeting of the MPC, the US has continued its steady path of tapering, although the financial markets now believe that the first interest rate increases may occur earlier in 2015 than previously expected. Over the same period, monetary policy has been tightened in New Zealand, Brazil and Russia, and loosened in Israel, Thailand, Chile and Hungary.

The exchange rate of the rand has been relatively volatile since the previous meeting of the MPC, having fluctuated in a wide range between R10,60 and R11,39 against the US dollar. There has been an appreciating trend over this period, in line with an improving risk sentiment towards emerging markets. Since the previous meeting of the MPC, the rand has appreciated by about 2,4 per cent against the US dollar, and by 2,2 per cent on a trade-weighted basis.

While the risk to the inflation outlook from the exchange rate may have moderated somewhat since the previous meeting, these risks are still assessed to be on the upside. The MPC is of the view that the exchange rate will continue to be highly sensitive to both domestic and global developments, remaining prone to further bouts of volatility and protracted periods of overshooting.

The current account of the balance of payments narrowed significantly, from 6,4 per cent of gross domestic product (GDP) in the third quarter of 2013 (revised down from 6,8 per cent previously) to 5,1 per cent of GDP in the following quarter, with a deficit for the year of 5,8 per cent. The contraction of the trade account was a result of both a 3,6 per cent decline in the value of merchandise imports and a 0,9 per cent increase in export earnings. Although we expect the current account to respond to the depreciated exchange rate, this adjustment is likely to be gradual and some widening of the trade deficit is expected in the first quarter of 2014. Constraining factors include the protracted nature of the strike in the platinum sector and the relatively inelastic import demand, particularly with respect to imported capital equipment. Promisingly, net exports made positive contributions to GDP growth in the final two quarters of 2013.

Tapering by the US Federal Reserve and the expectation of US interest rate normalisation continued to impact on the pattern of global capital flows and financial market volatility. The domestic yield curve flattened since the previous MPC meeting, as the short end increased in response to monetary tightening, while the long end of the curve shifted downwards. In contrast to emerging markets in general, South Africa experienced net inflows into the equity markets in February and March 2014 totalling R11,6 billion, following net sales of R25,1 billion between November 2013 and January 2014. Non-residents remained net sellers of bonds but at a slower pace: net sales of bonds amounted to R46,0 billion over the same three-month period, but moderated to R1,2 billion in February 2014, and net purchases of R2,1 billion in March to date.

The domestic economic growth outlook remains subdued. Despite a rebound in the fourth quarter of 2013, when an annualised growth rate of 3,8 per cent was recorded, economic growth is expected to remain below potential of between 3,0 per cent and 3,5 per cent in 2014, with a consequent widening output gap. The Bank's forecast for economic growth has declined marginally to 2,6 per cent in 2014, compared with 2,8 per cent previously, while the forecast for 2015 has been revised down from 3,3 per cent to 3,1 per cent. The risks to this forecast are seen to be on the downside, given the protracted strike in the platinum sector and electricity supply constraints. This deterioration comes amid continued low levels of business confidence, with the RMB/BER Business Confidence Index declining to 41 index points in the first quarter of 2014, the fourth consecutive month at a level below the neutral 50 index points. The sideways movement of the composite leading business cycle indicator of the Bank also points to a restrained outlook.

The growth outcome in the fourth quarter of 2013 was led by strong growth in the manufacturing sector in particular, following the strike-induced contraction in the previous quarter. In January 2014, a 2,5 per cent year-on-year rate of growth in manufacturing output was recorded. According to the BER manufacturing survey, business confidence in the sector remains low despite increasing to 41 index points in the first quarter of the year, from 36 previously. There are, however, some positive signs in the sector, with the Kagiso Purchasing Managers' Index (PMI) increasing to 51,7 index points in February, and the BER's indicators for manufacturing export sales and orders improving further in the first quarter of 2014, to their highest level in ten years.

Despite strong performance in the fourth quarter of 2013, the outlook for the mining sector remains bleak: mining output contracted at a month-on-month rate of 1,1 per cent in January of this year, and the ongoing strike in the platinum sector is likely to impact adversely on mining output and exports.

Growth in real gross fixed capital formation accelerated to 4,7 per cent in 2013, compared with 4,4 per cent in the previous year. During the past year, real capital outlays by the private sector increased by 5,5 per cent, while public corporations and general government investment increased by 3,1 per cent and 3,5 per cent respectively.

Consistent with moderate economic growth, employment growth has remained weak. According to the Quarterly Employment Statistics (QES) of Statistics South Africa, employment levels in the formal non-agricultural sector increased marginally at a seasonally adjusted rate of 0,2 per cent in the fourth quarter of 2013, or by 5 100 employment opportunities. In the year to the fourth quarter of 2013, the increase was 0,5 per cent or 40 900 jobs, with the public sector contributing 39 000 of these jobs. Overall, private-sector employment declined during the fourth quarter of 2013, with losses most pronounced in the gold mining, construction and electricity sectors.

The weakening trend in the growth in household consumption expenditure continued into the final quarter of 2013, with growth of 2,0 per cent recorded, and its contribution to GDP growth declining from 2,3 percentage points in 2012 to 1,7 percentage points in 2013. Growth for the year averaged 2,6 per cent, while consumption expenditure by general government averaged 2,4 per cent. Household spending on durable goods remained firm, but grew at a slower pace of 6,9 per cent, and is likely to moderate further as vehicle sales come under increasing pressure. Total domestic new vehicle sales declined in February 2014 by 2,6 per cent on a month-to-month basis and by 3,1 per cent year on year. Although real retail trade sales exceeded market expectations in January following a month-to-month increase of 0,8 per cent and a 6,8 per cent increase year on year, the outlook for consumption expenditure is expected to be constrained by slow employment growth, high debt levels of consumers, slow rates of growth in credit extension and the higher interest rate environment.

Growth in government consumption expenditure is expected to be contained. According to the recent budget, the expenditure cap has been maintained and a consolidated budget deficit of 4,0 per cent of GDP is estimated for 2014/15, in line with that of the past fiscal year. A faster pace of fiscal consolidation is indicated, with the deficit-to-GDP ratio expected to decline to 2,8 per cent in 2016/17.

Bank credit extension to the private sector has maintained its weak underlying trend, particularly with respect to credit extended to households, reinforcing expected pressures on household consumption expenditure. By contrast, credit extension to the corporate sector was relatively robust, with growth rates of around 10 per cent. Although twelve-month growth in total loans and advances to the private sector increased from 6,4 per cent in December 2013 to 7,6 per cent in January 2014, credit extension to households increased by 5,5 per cent and 5,6 per cent in these two months respectively. This probably reflects both supply- and demand-side considerations. Mortgage lending remained weak, with twelve-month growth of 2,1 per cent in January, amid moderate house price growth. Twelve-month growth in general loans to households (mainly unsecured lending) continued its downward trend, measuring 5,0 per cent in January, the lowest rate of growth since February 2005. Instalment sale credit and leasing finance has remained buoyant but is growing at a more moderate pace, in line with declining vehicle sales.

The trend in wage settlements has remained relatively unchanged. According to Andrew Levy Employment Publications, the overall average wage settlement rate in collective bargaining agreements measured 7,9 per cent in 2013, compared with 7,6 per cent in 2012. Data from Stats SA show that the growth in nominal remuneration per worker increased from 6,7 per cent in the year to the third quarter of 2013 to 7,0 per cent in the fourth quarter. Once the slight increase in productivity growth is accounted for, this translates into a unit labour cost increase of 5,2 per cent in the fourth quarter. While this appears to be relatively contained, there are wide variations across sectors, and the outcome of wage negotiations during the year in an unsettled labour relations environment will be an important determinant of inflation pressures.

As anticipated, the favourable trend of food prices in the CPI has reversed, and pressures are expected on headline inflation from this source despite the moderation of prices at the global level. Having reached a recent low of 3,5 per cent in December 2013, consumer food

price inflation increased to 4,3 per cent and 5,6 per cent in the subsequent two months. Final manufactured producer food price inflation accelerated to 7,6 per cent in February 2014, and further pressures are evident in the agricultural producer price inflation for cereals and other crops which accelerated from -8,2 per cent in August 2013 to 27,6 per cent in February 2014. This contributed to the 7,4 per cent increase in bread and cereals prices at the consumer price level in February. The wheat and maize prices reflect exchange rate pressures and domestic drought conditions. Although futures prices indicate some possible moderation in the coming months following the recent rains, near-term pressures remain.

International oil prices have been relatively unaffected by the Crimean crisis, and the price of Brent crude oil fluctuated between a relatively narrow range of US\$106 and US\$111 per barrel since the previous meeting. The exchange rate has been the main driver of the rand petrol price, which increased by a cumulative 75 cents per litre in February and March. The recent appreciation of the rand has resulted in the current over-recovery in the petrol price, and this is expected to offset in part the 20 cents per litre fuel levy increase due to be implemented in April.

The MPC is acutely aware of the policy dilemma of rising inflation pressures in a subdued economic growth environment. Despite a marginal improvement in the medium-term inflation forecast, the trajectory remains uncomfortably close to the upper end of the target range.

The main upside risk to the forecast continues to come from the exchange rate, which, despite the recent relative stability, remains vulnerable to global rebalancing. The expected normalisation of monetary policy in advanced economies is unlikely to be linear or smooth, and the timing and pace is uncertain.

The rand is also vulnerable to domestic idiosyncratic factors, including protracted work stoppages, electricity supply constraints, and the slow adjustment of the current-account deficit. Pass-through from the exchange rate to prices has been relatively muted to date but there is some evidence that it is accelerating. However, the forecast already incorporates a higher pass-through than has been experienced up to now.

At the same time, the domestic economic outlook remains fragile, with the risks assessed to be on the downside. Demand pressures remain benign as consumption expenditure continues to slow amid weakening credit extension to households and high levels of household indebtedness. The upward trend in the core inflation forecast is assessed to reflect exchange rate pressures rather than underlying demand pressures.

Given the lags with which monetary policy operates, the MPC will continue to focus on the medium-term inflation trajectory. The committee is aware that too slow a pace of tightening could undermine inflation expectations and may require more aggressive tightening in the future. Consistent with our mandate, a fine balance is required to ensure that inflation is contained while minimising the cost to output.

The real policy rate is currently below what can be considered normal in the long run and is likely to increase over the medium term. The pace of tightening will depend on a number of factors, including projected inflation, inflation expectations, the state of the economy and global developments. At this meeting, the MPC decided to keep the repo rate unchanged at 5,5 per cent per annum.

We wish to reiterate that even though we are in a tightening cycle, there will not necessarily be a change in the stance at every meeting, and that the increments may not always be of the same magnitude.

Statement of the Monetary Policy Committee

22 May 2014

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

Since the previous meeting of the Monetary Policy Committee (MPC), inflation has breached the upper end of the target band and is expected to remain outside the target for some time. This development was in line with the inflation forecast of the South African Reserve Bank (the Bank), which is more or less unchanged since the previous meeting of the MPC. The exchange rate has appreciated somewhat since its lows in January in response to a more benign global monetary policy environment, moderating some of the near-term upside risks to inflation. Nevertheless, risks to the inflation outlook remain skewed to the upside.

Despite a more favourable global growth environment, the domestic economic growth outlook has deteriorated markedly. There is still no end in sight to the protracted strike in the platinum sector, and the economic and social costs are escalating and are potentially devastating. Both the mining and manufacturing sectors appear to have contracted in the first quarter of the year, with electricity supply constraints adding to the weak outlook. Against this backdrop, monetary policy faces an increasingly challenging scenario.

The year-on-year inflation rate, as measured by the consumer price index (CPI) for all urban areas, came to 6,0 per cent and 6,1 per cent in March and April 2014 respectively, up from 5,9 per cent in February. Food and non-alcoholic beverage price inflation accelerated significantly, measuring 7,0 per cent and 7,8 per cent in the past two months, compared with a recent low of 3,5 per cent in December 2013. The contribution of this category to headline inflation was 1,2 percentage points in April, compared with 0,8 percentage points in February. The categories of food, housing utilities and transport together accounted for 3,7 percentage points of the inflation outcome in April. Core inflation, which excludes food, petrol and electricity, measured 5,5 per cent in both March and April after six consecutive months at 5,3 per cent. Administered price inflation excluding petrol continued its gradual decline, measuring 6,5 per cent in April from 6,7 per cent in March. The headline producer price inflation for final manufactured goods measured 8,2 per cent in March compared with 7,7 per cent in February, driven mainly by food prices, and is indicative of further upside pressures on CPI inflation in the near term.

The Bank's forecast of headline inflation changed marginally since the previous meeting. Inflation is expected to average 6,2 per cent in 2014 compared with 6,3 per cent previously, with the peak of 6,5 per cent (previously 6,6 per cent) expected in the fourth quarter. The forecast average inflation for 2015 remained unchanged at 5,8 per cent. The forecast horizon has been extended and inflation is expected to average 5,5 per cent in 2016 and 5,4 per cent in the final quarter of that year. Inflation is still expected to remain outside the target band from the second quarter of 2014 until the second quarter of 2015.

The outlook for core inflation is also largely unchanged. This measure is expected to average 5,6 per cent and 5,7 per cent in 2014 and 2015 respectively, compared with the previous forecast of 5,6 per cent for both years, moderating to 5,5 per cent in 2016. The upward pressure is assessed to be a response to the lagged effects of the exchange rate depreciation rather than evidence of strong domestic demand pressures. The MPC still sees the risks to the inflation forecast to be skewed to the upside, and remains concerned that the current low level of pass-through may not persist.

The Reuters survey of inflation expectations of economic analysts conducted in May is more or less unchanged since the previous survey. Inflation is expected to average 6,3 per cent in the second quarter and 6,2 per cent in the final two quarters of 2014 before returning to within the target at an average of 5,8 per cent in the first quarter of 2015. Annual inflation is

expected to average 6,2 per cent in 2014, and 5,6 per cent and 5,4 per cent in the subsequent two years respectively, somewhat lower than the Bank's forecast.

The global economic outlook remains mixed. Growth in the United States (US) stalled in the first quarter as a consequence of the severe weather conditions, while retail sales in April were below expectations. Despite the downside risk to growth from the housing market, the recovery is expected to remain on track, although at a lower rate than that forecast earlier in the year. While the US Federal Reserve (the Fed) expects growth of between 2,8 and 3,0 per cent for 2014, the market consensus is closer to 2,5 per cent. Economic recovery in the United Kingdom (UK) also appears to be resilient, despite some slack in the economy. By contrast, the eurozone continues to lag, following a lower-than-expected annualised growth rate of around 0,8 per cent in the first quarter.

The annualised growth rate of 5,9 per cent recorded by the Japanese economy in the first quarter of this year is not expected to be sustained as higher consumption taxes take effect, and consensus forecasts are for annual growth of around 1,5 per cent. The Chinese economy grew at an annualised rate of 5,8 per cent in the first quarter of 2014 amid weakening trends in industrial production and retail sales. Although an annual growth rate of between 7,0 per cent and 7,5 per cent is still generally expected, there are concerns that the loss of momentum in the property market and declining credit growth could pose downside risks to growth.

The shift in global growth dynamics towards the advanced economies has been reinforced, with a number of emerging markets facing a more challenging outlook. Low growth is expected in a number of the larger economies, including Brazil, Russia, Argentina, Turkey and Thailand, but some analysts have revised upwards their growth forecasts for India. More positively, growth in sub-Saharan Africa is expected to average 5,4 per cent, but this is vulnerable to weaker commodity prices in the event of slower growth in China.

Global inflation remains benign amid relatively stable food and energy price trends. Financial markets appear to have priced in continued steady tapering of quantitative easing in the US, and recent guidance from the Fed appears to have reduced the degree of volatility and uncertainty in financial markets regarding the pace and timing of monetary policy normalisation. Policy rates look set to increase at a moderate pace in both the US and the UK during 2015, while the possibility exists of further easing in Japan and the eurozone where the risk of deflation persists. Since the previous meeting of the MPC, monetary policy has been tightened in New Zealand, Brazil and Russia in response to inflation pressures or exchange rate concerns, but was eased slightly in Hungary.

With global financial markets pricing in a slower pace of US policy normalisation, global risk appetite has improved. Apart from sizeable outflows from Russia in the wake of the crisis in the Ukraine, capital flows to emerging markets have resumed or outflows slowed, resulting in generally appreciating emerging-market currencies and declining long bond yields. This improved sentiment has also impacted on the rand exchange rate, which appreciated by 3,3 per cent against the dollar and by 3,1 per cent on a trade-weighted basis since the previous meeting of the MPC. During this period, the rand traded in a range of between around R10,29 and R10,70 against the US dollar.

Portfolio flows to South Africa have been in line with general global trends. Following cumulative net sales of South African government bonds and equities by non-residents of R71 billion from November 2013 to the end of January 2014, net purchases of bonds and equities since the beginning of February have totalled R8,3 billion and R29,9 billion respectively. Year-to-date net inflows into bonds and equities total R7,6 billion.

While recent exchange rate developments have afforded some near-term respite from further inflation risks from the exchange rate, the MPC is mindful of the sensitivity of the rand to both global and domestic factors.

The rand is expected to remain vulnerable to changing global perceptions of US monetary policy and associated capital flows. However, while the recent appreciation is more a reflection of changing global risk perceptions rather than a specific reassessment of South African fundamentals, domestic factors have also impacted on the rand. The exchange rate is likely to remain sensitive to domestic factors, including developments in the current account of the balance of payments and perceptions of its sustainability. In particular, the ongoing strike in the platinum sector is expected to begin to have a significant negative impact on exports now that inventories are reaching low levels, and a further extension of the strike could impede the required current-account adjustment process.

The domestic economic growth outlook has deteriorated markedly, with the reversal of a number of the tentative positive signs observed at the beginning of the year. The Bank's forecast for economic growth for 2014 has been revised down, from 2,6 per cent at the previous meeting to 2,1 per cent, implying a further widening of the negative output gap. The forecast for 2015 remains unchanged at 3,1 per cent, and growth in 2016 is expected to average 3,4 per cent. However, the risks to these forecasts are increasingly to the downside against the renewed possibility of electricity load-shedding, among other factors. The Bank's leading indicator of economic activity declined marginally in February, and the sustained sideways movement confirms the subdued outlook amid weak business confidence. The RMB/BER Business Confidence Index declined by 2 index points to 41 index points in the first quarter of 2014.

The first quarter growth outcome was negatively affected by contractions in both the mining and manufacturing sectors. In the first quarter of 2014, the physical volume of mining production declined by 6,8 per cent (not annualised) when compared with the previous quarter. This decline was not confined to the platinum group metals, with production declining in seven of the twelve mining subcomponents, and expectations are for this negative trend to continue.

The physical volume of manufacturing production declined by 1,6 per cent (not annualised) in the first quarter of the year. This contraction was also broad-based and the outlook for the sector remains subdued, as reflected by the marked decline in the Kagiso Purchasing Managers' Index (PMI) to 47,4 index points in April. This follows two consecutive months when the index was above 50 points. The new sales orders component of the PMI remained well below 50 points for the second consecutive month. There appears to be continued underutilisation of manufacturing production capacity, particularly with respect to durable goods production.

The favourable trend in the real value of building plans passed during the past two years has been maintained in keeping with the rising levels of building confidence. The real value of building plans passed increased by 13,6 per cent on the 3-month-to-3-month basis in March 2014 and by 5,9 per cent on a year-on-year basis.

The unemployment rate remained elevated at 25,2 per cent in the first quarter of 2014 in a declining growth environment. This follows a decline in employment in the first quarter of 2014 of 122 000 jobs, although on a seasonally adjusted basis the decrease was 32 000 jobs.

Consumption expenditure by households is expected to remain constrained in the face of continued weakness in credit extension, rising inflation, high consumer indebtedness, as well as the knock-on effects of the mining strike, where the cumulative loss of wages is estimated to have exceeded R8 billion. Real retail sales grew by 0,6 per cent on a quarter-to-quarter basis in the first quarter of this year, having declined in March by 1,4 per cent on a month-to-month basis. New vehicle sales declined by 0,7 per cent on a 3-month-to-3-month basis in April, and by over 10 per cent on a year-on-year basis, while the National Association

of Automobile Manufacturers of South Africa expects new vehicle sales to contract over the year. Although the FNB (First National Bank)/BER Consumer Confidence Index improved marginally in the first quarter of 2014, it remained at a low level of -6.

Growth in bank credit extension to households continued to moderate, while that to companies has remained relatively robust. The twelve-month growth in total loans and advances to the private sector measured 8,2 per cent in March 2014, driven by a 12,7 per cent increase in credit extension to companies related in part to the awarding of a new round of renewable energy contracts. By contrast, growth in credit extension to households moderated further to 4,8 per cent, as unsecured lending continued its downward trend. Growth over twelve months in general loans to households, mainly made up of unsecured lending, measured 3,5 per cent in March, the lowest rate of growth since 2005. Growth in mortgage advances to households remained below 3 per cent, in line with the relatively subdued volume growth in the housing market. While growth in instalment sale and leasing finance recorded annual growth of 10,1 per cent in March, it is on a declining trend, particularly with respect to households. These trends in credit extension are expected to remain a constraint to consumption expenditure growth.

The trend in wage settlements is more or less unchanged. According to Andrew Levy Employment Publications, the overall average wage settlement rate in collective bargaining agreements was unchanged from the previous year, at 7,9 per cent in the first quarter of 2014. However, the main wage negotiations are yet to be completed, in particular the re-negotiation of a new multi-year agreement in the Steel and Engineering Bargaining Council. The outcome of this, as well as the impasse in the platinum sector, could have an important bearing on the general trend of wage settlements.

Food prices remain a risk to the inflation outlook although the risk may have moderated somewhat following the sharp reversal in domestic maize prices in recent weeks. Having reached a peak of almost R3 800 per ton in March, maize prices declined in May to around R2 000 per ton and an 8 per cent decline over the year. This was in response to an upward revision of the domestic maize crop forecast, now expected to be 11 per cent higher than last year, which has resulted in a move from import to export parity prices. This development, if sustained, could help ameliorate the considerable pipeline pressures that have been evident in the producer price index since the beginning of the year. Final manufactured producer food price inflation accelerated to 9,1 per cent in March, and further pressures are evident in the agricultural producer price inflation for cereals which measured 26,5 per cent in March, although this is expected to moderate in response to lower spot prices.

The international oil price has remained within the range of US\$105 to US\$111 for some time. The domestic price of petrol has benefited from the stronger trend in the exchange rate over the past weeks. In May, the price of 95-octane petrol declined by 15 cents per litre, following a 7 cent per litre increase in April. Should current trends continue, a further reduction can be expected in June.

The MPC continues to face the difficult dilemma of dealing with upside risks to inflation and a deteriorating domestic economic growth outlook. Although the breach of the upper end of the inflation target band was in line with the Bank's forecast, the risks to the forecast remain on the upside. The policy dilemma is increased by the fact that inflation is seen to be driven primarily by supply-side factors, while demand conditions in the economy remain subdued.

Although the immediate pressures from the exchange rate are lower than was the case earlier in the year, the exchange rate remains a significant source of upside risk to the forecast. The respite from the stronger exchange rate could be temporary and respond quickly to changes

in both domestic and external conditions. Although the pass-through from the exchange rate to inflation is still relatively low, there are indications of some acceleration. In addition, food prices are expected to add further upside impetus to inflation in the near term, but this risk may have moderated to some extent given the sharp decline in maize prices and low global food inflation.

As indicated earlier, the Bank's economic growth forecast for 2014 has been revised down significantly to 2,1 per cent, and the first quarter growth outcome is anticipated to be the lowest quarterly growth rate since the recession in 2009. Although growth in the second quarter is expected to improve somewhat, the risks to the 2014 growth forecast are strongly on the downside, with developments in the mining sector an ongoing cause for concern. The demand side of the economy is also weakening: household consumption expenditure growth continues to moderate amid slower credit extension to households, high levels of consumer debt levels and moderate job growth. However, the weak state of the economy cannot be resolved through monetary policy actions alone.

The committee continues to hold the view that we are in a rising interest rate cycle, and interest rates will have to be normalised in due course. We embarked on this process with our first move in January 2014. At this stage, the pace and timing of normalisation in the advanced economies appears to have been pushed out further and may be more moderate than previously believed. We are also aware that this can change very quickly.

Accordingly, the MPC decided to keep the repurchase rate unchanged at 5,5 per cent per annum at this stage.

Future actions will be data-dependent and determined by developments in the inflation outlook and inflation expectations. Inflation is currently at uncomfortable levels, and a marked deterioration in the outlook may require action that we will not hesitate to take. The MPC reiterates that a rising interest rate cycle does not mean that rates will be raised at each meeting or by the same amount each time.

Abbreviations

CPI	consumer price index
CPIX	consumer price index excluding mortgage interest cost for metropolitan and other urban areas
GDP	gross domestic product
MPC	Monetary Policy Committee
<i>MPR</i>	<i>Monetary Policy Review</i>
NAB	non-alcoholic beverages
NEER	nominal effective exchange rate
PMI	Purchasing Managers' Index
PPI	producer price index
REER	real effective exchange rate
repo	repurchase [rate]
Stats SA	Statistics South Africa
the Bank	South African Reserve Bank
the Fed	United States Federal Reserve
UK	United Kingdom
US	United States

Glossary

Accommodative monetary policy: These are monetary policy-related actions intended to stimulate economic activity by lowering interest rates, increasing the quantity of money or by keeping already low interest rates stable in the economy.

Administered prices: These prices are set according to government's policy rather than determined by market supply and demand forces (usually because the product is related to social welfare). These prices may or may not have an economic regulator.

Advanced economies: Advanced economies are highly industrialised countries with high levels of GDP per capita.

Balance of payments: This is a record of transactions between the home country and the rest of the world over a specific period of time. It includes the current and financial accounts. *See also 'current account' below.*

Bond yield: This refers to the return on an interest-bearing instrument accruing to its owner. The yield-to-maturity takes into account the price of the bond, all coupon cash flows, and the remaining term to maturity.

Budget deficit: A budget deficit indicates the extent to which government expenditure exceeds government revenue (a budget surplus occurs when revenue exceeds expenditure).

Business and consumer confidence: These are economic indicators that measure the state of optimism about the economy and its prospects among business managers and consumers.

Capacity utilisation: The percentage utilisation of production capacity in the manufacturing industry is a measure of the use of manpower, plant and machinery in manufacturing. The degree of capacity constraint experienced in the manufacturing industry is determined by obtaining indications from large manufacturing enterprises regarding skills shortages and other reasons, such as downtime due to maintenance, changes in productivity and seasonal factors. The measure is used to assess the degree of capacity constraint experienced in the manufacturing industry.

Capital flow reversals: These indicate the movement of portfolio investment in bonds and equities from a recipient country back to the country of origin.

Central projection: This is the most likely outcome for the variable of interest over the period, according to South African Reserve Bank forecasts.

Commodity prices: Commodities can refer to food, oil or precious metals. Major South African-produced commodities include platinum and gold.

Consumer price index (CPI): The CPI provides an indication of aggregate price changes in the domestic economy. The index is calculated using a number of categories forming a representative set of goods and services bought by consumers.

Core inflation: This is inflation excluding food and energy (including petrol) prices, which is considered a better reflection of the trend underlying inflation.

Crude oil price: This is the price, in US dollars, per barrel of unrefined (North Sea) oil.

Current account: The current account of the balance of payments consists of net exports (exports less imports) in the trade account, as well as the services, income and current transfer account.

Demand pressures: Demand pressures refer to price pressures from increased consumption in the domestic or foreign economy.

Developing economies: Developing economies have not reached a significant level of industrialisation, have less-developed infrastructure, and have lower standards of living and literacy compared to developed nations.

Emerging-market economies: Emerging-market economies are those with low to middle income per capita. They are advancing rapidly and are integrating with global (product and capital) markets.

Exchange rate depreciation (appreciation): Exchange rate depreciation (appreciation) refers to a decrease (increase) in the value of a currency relative to another currency.

Exchange rate pass-through: This is the effect of exchange rate changes on domestic inflation (i.e., the percentage change in domestic CPI due to a 1 per cent change in the exchange rate). Changes in the exchange rate affect import prices, which in turn affect domestic consumer prices and inflation.

Fiscal consolidation: These are government policies aimed at reducing budget deficits through decreases in government spending, increases in taxation, or a combination of the two. Other terms used to refer to fiscal consolidation include ‘fiscal austerity’ and ‘fiscal reform’.

Flexible inflation targeting: This refers to inflation-targeting regimes that consider changes in inflation and other variables affecting the real economy in the short term. Under strict inflation targeting only inflation matters, but flexible inflation targeting takes into account other variables, such as output.

Forecast horizon: This is the future period over which the Bank generates its forecasts, typically between two and three years.

Gross domestic expenditure: This refers to the total value of expenditure on goods and services within the country plus expenditure on imports less exports.

Gross domestic product (GDP): GDP is the total market value of all goods and services produced in a country. It includes total consumption expenditure, capital formation, government consumption expenditure and the value of exports less the value of imports.

Gross fixed capital formation: Value of acquisitions of capital goods (e.g., machinery, equipment and buildings) by firms, adjusted for disposals, constitutes gross fixed capital formation.

Headline consumer price index (CPI): Headline CPI refers to CPI for all urban areas that is released monthly by Stats SA. Headline CPI is a measure of price levels in all urban areas. The 12-month percentage change in headline CPI is referred to as ‘headline CPI inflation’ and reflects changes in the cost of living. This is the official inflation measure for South Africa.

Household final consumption expenditure: This is the amount of money spent by households on consumer goods and services.

Household disposable income: Household disposable income is defined as primary income, net current transfers and social benefits, less taxes on income and wealth.

House price index: This is a measure of the prices at which residential dwellings are bought and sold over time.

Inflation (growth) outlook: This outlook refers to the evolution of future inflation (growth) over the forecast horizon.

Inflation targeting: This is a monetary policy framework used by central banks to steer actual inflation towards an inflation target level or range.

Interest rate smoothing: This is the gradual decrease (increase) of the policy rate over the business cycle. Policymakers target the medium term, thus they allow time for previous changes to have an effect before making further changes (if necessary). Gradual interest rate changes also permit economic stakeholders to adapt their expectations about future interest rate changes.

Median: This is a statistical term used to describe the observed number that separates ordered observations in half.

Mortgage: A mortgage is a form of secured loan extended for the purchase of real estate.

Nominal effective exchange rate (NEER): NEER is an index that expresses the value of a country's currency relative to a basket of other currencies. An increase (decrease) in the effective exchange rate indicates a strengthening (weakening) of the domestic currency with respect to the selected basket of currencies. 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.

Net exports: See 'current account'.

Nominal variables: Nominal variables are stated in current prices and represent the cost of an item.

Producer price index (PPI): This index measures changes in the prices of goods at the factory gate. Stats SA currently produces five different indices that measure price changes at different stages of production. Headline PPI is the index for final manufactured goods. PPI measures indicate potential pressure on consumer prices.

Productivity: Productivity indicates the amount of goods and services produced in relation to the resources utilised in the form of labour and capital. The most common measure is labour productivity.

Purchasing Managers' Index (PMI): This index shows the sentiment of purchasing managers in the manufacturing sector, indicating the broader economic health of the sector.

Quantitative easing: QE is an unconventional monetary policy tool implemented largely in the US, the UK, the euro area and Japan. QE involves the central bank purchasing bonds on the open market so as to inject liquidity into the economy. This also leads to a markedly higher level of money supply in the economy.

Real effective exchange rate (REER): The REER is the NEER adjusted by relative consumer prices in South Africa and its main trading partners.

Real variables: These variables are adjusted for inflation and hence are expressed in constant prices (of some base year) and represent the volume of an aggregate.

Real repo rate: This is the nominal repurchase (repo) rate, as set by the Monetary Policy Committee, adjusted for expected inflation.

Repurchase rate (repo rate): This is the rate that commercial banks pay to borrow money from the South African Reserve Bank.

Terms of trade: These refer to the ratio of the value (in price terms) of exports to the value (in price terms) of imports. If this ratio is below one, then the value of imports exceeds that of exports.

Unit labour costs: A unit labour cost is the labour cost to produce one 'unit' of output. This is calculated as the total wages and salaries in the non-agricultural sector divided by the real value added at basic prices in the non-agricultural sector of the economy.

Unsecured loans: Loans extended without any collateral (guarantees or underlying assets) as security to protect the value of the loan are called 'unsecured loans'.