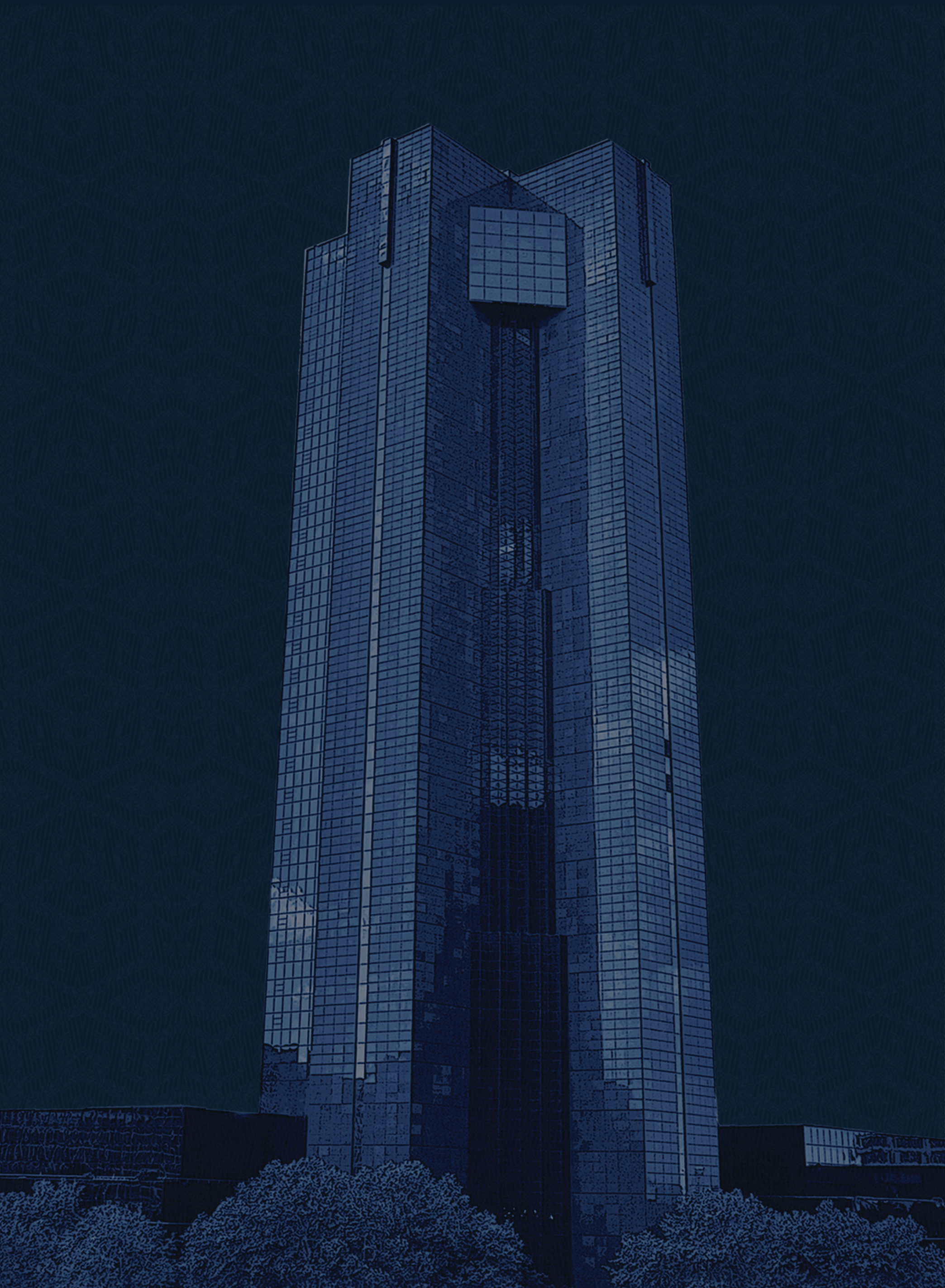
Monetary Policy Review

December 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 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.

Contents

Executive summary

The repurchase (repo) rate was raised by 75 basis points in 2014 as part of a gradual rate-hiking cycle. This is a response to a combination of a higher trajectory for headline inflation and elevated risks to the longer-term inflation outlook. Headline inflation has been outside the target for much of the year, peaking at 6,6 per cent in May and June, before falling to just within the target range in September and October. Significantly lower oil prices and moderating food price inflation have helped the near-term headline inflation outlook. Core inflation, however, is stubbornly high, propelled by rand weakness, inertia in price and wage setting and consistently high services inflation. Inflation expectations appear stable but are above the upper end of the target range.

South Africa's macroeconomic imbalances have grown more uncomfortable. The current-account deficit is large relative to historic norms and peer countries, and has been closing only slowly. Policy adjustment through a lower inflation rate and gradual fiscal consolidation will help over time to ease the current-account deficit to more sustainable levels, while contributing to lower long-term costs of borrowing.

Global financial conditions have become less hospitable for countries with large external financing requirements – a change emanating from a gradual normalisation of monetary policy in the United States (US). This process has already delivered a bumpy ride for South Africa, as it has for some other countries, with bouts of volatility (such as January 2014) interspersed with periods of uneasy calm (as in mid-2014). We cannot be sure how normalisation will proceed, or how much additional easing by the European Central Bank and the Bank of Japan will offset tightening by the US Federal Reserve (the Fed). The overall process should be protracted, with world interest rates moving higher at a slow and steady pace. Based on experience, however, it is unlikely that markets will adjust smoothly despite the best efforts of policymakers to communicate their intentions clearly. From this perspective, the rand exchange rate is likely to be intermittently volatile and could weaken further.

Domestic economic performance has been disappointing, with growth forecasts for the year reduced from 3 per cent (as of November 2013) to 1,4 per cent. This reflects a series of long- and short-term supply shocks, including rising intermediate input and labour costs, costlier and less reliable electricity, and severe strikes in the mining and manufacturing sectors. Estimates of potential growth show it has fallen, and it may have deteriorated further this year given the severity of these disruptions. Commodity prices have also declined, affecting South Africa's terms of trade. World economic growth has been subdued, owing in particular to protracted weakness in the euro area and a broad-based emerging-market slowdown. It is therefore unlikely that better export earnings will soon moderate South Africa's external financing requirements.

Growth is expected to pick up gradually over a two-year time horizon, approaching 3 per cent as the global environment improves and the economy recovers from domestic shocks. The monetary policy adjustment will ensure that inflation remains under control and expectations of future inflation are lowered. On its own this should reduce uncertainty about future economic prospects and support long-run investment. The current tightening cycle has been slower and more moderate than previous cycles, and rates remain close to historical lows, with the real repo rate still near zero – which supports growth in the economy over the near term. Fiscal policy strikes a similar balance, with spending growth slowing but still positive in real terms.

South Africa has the leeway to adjust quite gradually, protecting growth, thanks to two factors. First, global conditions are still generally supportive, with interest rates very low from a historical perspective and likely to stay that way for an extended period of time. Second, South Africa entered the crisis period with crucial policy buffers, including low debt levels and considerable policy credibility. These advantages have been exploited over the past half-decade, tiding the country over an unusually difficult period in modern economic history, and are not yet altogether exhausted. Provided that imbalances can be constrained now, before they develop into more serious vulnerabilities, South Africa will remain an attractive investment destination. We choose to adjust slowly so that we are not forced to adjust fast.

This *Monetary Policy Review* is divided into four sections. First is a short, chronological overview of the policy stance, followed by sections on inflation and the inflation outlook, the world economic environment and domestic growth. These combine to provide a full picture of monetary policy in South Africa, but may be read as stand-alone discussions on each subject.

Policy stance

Inflation has been above target for much of the year and expectations of future inflation stubbornly high. Economic growth, meanwhile, has been weak and volatile, confidence low, and demand slowing. Although some improvement in global growth is expected, the environment threatens ongoing currency depreciation for emerging markets with large macroeconomic imbalances, such as South Africa.

The monetary policy response to these challenges has been a gradual tightening cycle. This is echoed in the themes of fiscal policy, with spending growth still positive but slowing as budget deficits fall. Both these policy settings are calibrated to reduce South Africa's vulnerabilities, with a gradual adjustment supportive of demand in the short term while ensuring the environment remains conducive to longer-term growth.

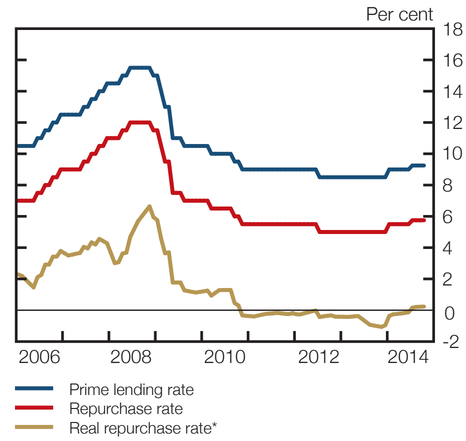
As of mid-2014, when the previous *Monetary Policy Review* (MPR) was published, the repo rate had been increased for the first time since 2008. Inflation was above target and the breach was expected to last until the second quarter of 2015. This forecast entailed a significant deterioration from the outlook at the end of 2013, which had shown inflation staying within the target range through 2014 and 2015, and growth rebounding to 3 per cent by 2014.

The first reductions in the Fed's asset purchase programme affected a number of emerging-market currencies, including the rand. The nominal effective exchange rate hit an all-time low in January 2014, with rand depreciation a major inflation threat. Oil and food prices were also exerting pressure; food costs in particular were rebounding from a brief decline towards the end of 2013. These factors risked second-round effects to wages and prices more generally, as well as to inflation expectations, which were already grouped at the high end of the target range.

The current MPR updates this narrative in a few important ways. Inflation appears to have peaked sooner than anticipated, at 6,5 per cent in the second quarter rather than 6,5 per cent in the last quarter of 2014, and has dipped by more than expected to just below the target in September and October. Electricity prices are set to increase sharply from the middle of next year, but other supply factors have been favourable. Food prices have ebbed again thanks to excellent harvests in many producer countries (including South Africa). Oil prices have shifted abruptly lower as global supply expands alongside weak demand forecasts. These positive supply shocks have brought down the most recent inflation forecasts, lowering the 2014 number from 6,2 to 6,1 per cent and the 2015 number from 5,7 to 5,3 per cent.

As with negative supply shocks, however, it is important to look through the first-round effects and focus on spillovers to underlying inflation and inflation expectations. Here there is less scope for relief. Core inflation is close to the top end of the target, having trended steadily upwards from 2011. It is forecast at 5,6 per cent in 2014, 5,7 per cent in 2015 and 5,3 per cent in 2016. Inflation expectations on average have remained relatively steady at just over 6 per cent, outside the target range. Analysts' expectations are within the target range, but expectations for business and union leaders are slightly higher. Wage increases have been correspondingly elevated.

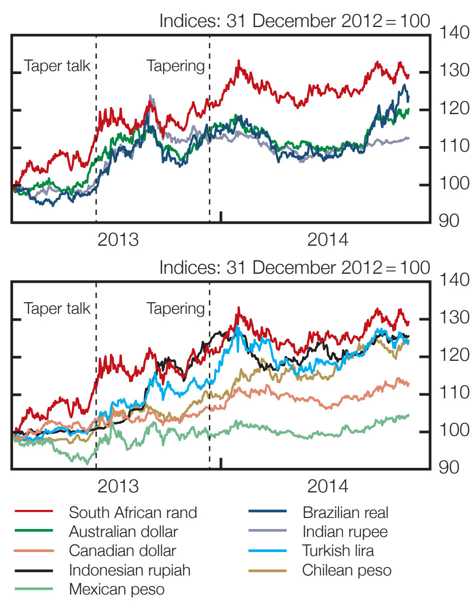
Figure 1 Monetary policy and the prime lending rate



* Nominal rate adjusted by Reuters one-year-ahead CPI forecast

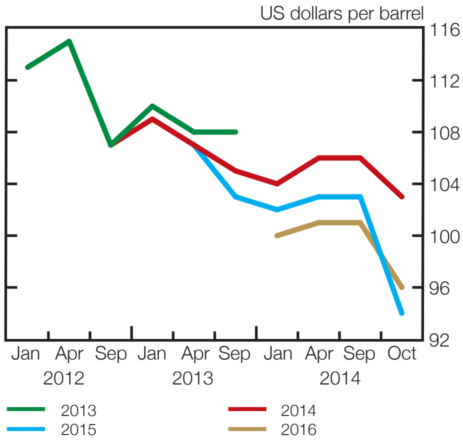
Sources: South African Reserve Bank and Reuters

Figure 2 Exchange-rate performance against the US dollar



Sources: Reuters and own calculations

Figure 3 Evolution of Brent crude oil price forecasts



Note: This graph denotes selected forecasts of average Brent crude oil prices since January 2012

Source: Reuters monthly oil poll of industry analysts

Since January 2014, the exchange rate has fluctuated sharply on foreign and domestic news but the overall trend has been quite flat, in contrast to the secular depreciation of the preceding three years. The path of the currency remains uncertain: it may be that markets have priced in appropriate assumptions for the world and local economy, but there is ample scope for miscalculation and surprises. The current-account deficit remains an important vulnerability, with an unexpectedly favourable figure in the first quarter supporting the rand while a worse-than-anticipated second-quarter figure helped weaken it again. For most of the period since the financial crisis, the global environment has actually been exceptionally supportive of South Africa's excess of expenditure over saving (reflecting the current-account deficit). But this climate is changing as a recovering US economy diverts capital flows. A stronger US economy is also bolstering the dollar, creating a divergence between the bilateral exchange rate and the broader nominal effective rate.

Global growth has disappointed expectations, even from earlier in 2014, with the International Monetary Fund (IMF) lowering its forecasts in October and warning of mounting downside risks, particularly from geopolitical instability. The euro area has fared worse than expected, with Italy in a prolonged recession, France stagnant and even Germany faltering in the second and third quarters. Emerging markets have in general slowed, partly for structural and partly for cyclical reasons, and appear unlikely to recover the growth levels seen before the crisis. The brightest spots in the global economy are the US and United Kingdom (UK), where unemployment levels have fallen sharply. Sub-Saharan Africa has also maintained high growth rates, although some countries are exposed to financial stress and a few West African countries are suffering a horrific outbreak of the Ebola virus, which has already caused over 5 000 deaths.

Domestic output was seriously damaged by strikes lasting into the third quarter of the year, forcing downward revisions of growth forecasts at each Monetary Policy Committee (MPC) meeting. However, growth in non-strike-affected sectors remained positive and leading indicators have picked up as strikes ended, pointing to better economic performance from the third quarter onwards. The forecast shows gross domestic product (GDP) growth reverting towards potential in 2015, with the output gap closing over the next few years as the economy recovers lost ground. With unit labour costs rising by close to the inflation rate, however, there seems to be little opportunity for stronger job creation. Strikes and electricity constraints may also have detracted further from South Africa's potential growth rate.

Box 1 Potential output: Towards a better real-time measure[1]

The output gap, defined as the difference between real GDP outcomes and the economy's non-inflationary production potential, serves as an indicator of inflationary pressures in the real economy. An economy's non-inflationary production potential cannot be observed directly and needs to be estimated. Real GDP is decomposed into two components: a trend and a cycle. The trend represents the economy's level of potential output and the de-trended cycle reflects a suitable measure of the output gap.

The Hodrick–Prescott (HP) filter provides a simple statistical methodology for this decomposition, but because the filtered trend series gravitates towards the observed data at the end of the sample, it often results in a biased estimate for the most recent quarter. The need to revise the HP estimates limits the usefulness of the HP filter for real-time policymaking.

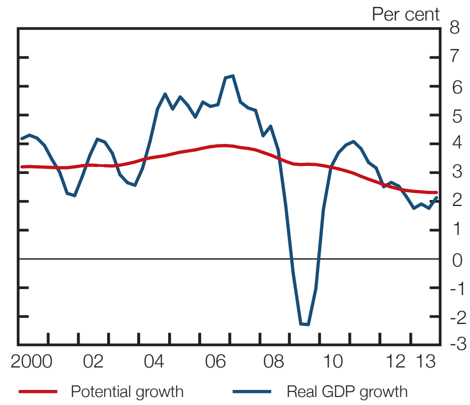
To overcome this weakness, the HP filter is enriched with additional real-economy information including growth in private-sector credit extension and the utilisation of production capacity in the manufacturing sector. The inclusion of additional information about the real economy improves the real-time output gap estimates, and reduces the extent of future revisions.

The global financial crisis and the ensuing mediocre recovery contributed to a global slowing in potential GDP growth. South Africa's potential growth also slowed, with an estimated decline from a pre-crisis peak of 3,9 per cent in 2006 to around 2,5 per cent in 2014 (see Figure B1.1). This is similar to the IMF's estimate for South Africa's potential growth, which is about 2,5 per cent for 2013–2014.[2] The slowdown in post-crisis potential growth implies an output gap of about -1 to -2 per cent in 2012 and 2013.

1 For further technical details, see V Anvari, N Ehlers and R Steinbach. 'A semi-structural approach to estimate South Africa's potential output', *South African Reserve Bank Working Paper WP/14/08*, November 2014.

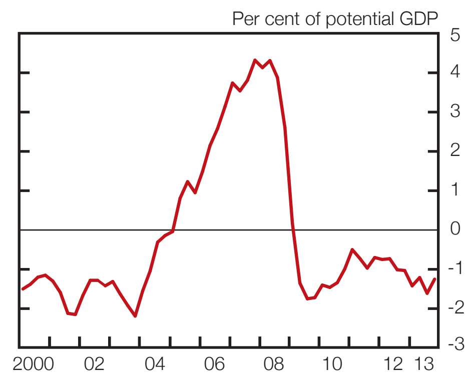
2 See Y Wu, 'IMF Selected Issues: Estimating South Africa's potential growth', internal IMF discussion paper, forthcoming.

Figure B1.1 South Africa's estimated potential output growth, 2000–2014



Source: *South African Reserve Bank Working Paper WP/14/08*, November 2014.

Figure B1.2 South Africa's estimated output gap, 2000–2014

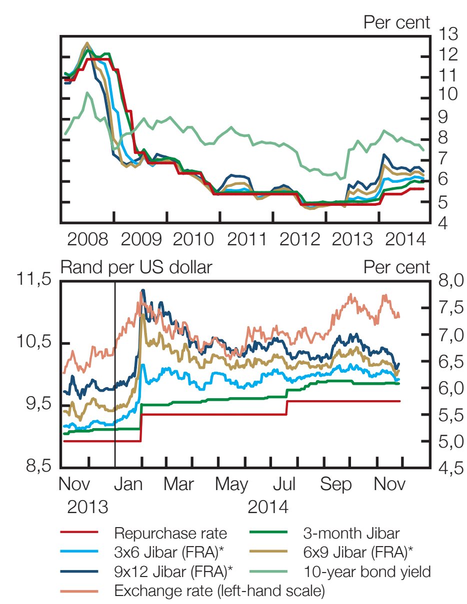


Source: *South African Reserve Bank Working Paper WP/14/08*, November 2014.

In responding to the mix of disappointingly low growth and high inflation, both worse than anticipated earlier in the year, the MPC raised the repo rate by 25 basis points in July 2014 but left policy unchanged in September and November. This marks gradual progress along the path to normalisation, but progress has been delayed by strikes and feeble domestic and global growth. The contrast with previous tightening cycles is striking: the repo rate has so far been raised by 75 basis points over 11 months, compared with 500 basis points in 25 months between 2006 and 2008, 400 basis points in nine months in 2002 and – in the pre-inflation targeting era – 695 basis points in just five months.

Financial markets appear to have understood that this cycle is different: forward rate agreements spiked upwards after the January rate increase but have since moderated in line with Bank communications. The short end of the yield curve has also been taking the brunt of the adjustment, at least in 2014. After increases in May 2013 and again in January 2014, 10-year government bond yields have declined over the year.

Figure 4 Money-market and forward rates, and 10-year bond yield



* FRA: Forward rate agreements

Sources: Bloomberg and Datastream

Fiscal policy complementarity

The October 2014 *Medium Term Budget Policy Statement* (MTBPS) heralds a 'turning point' for fiscal policy. Government spending will continue to grow in real terms, by 1,8 per cent a year, but this rate of increase is much lower than in previous years, and will be strictly limited to ensure it supports the economy instead of raising its vulnerability.

National Treasury's growth projections are similar to the Bank's, with the outlook for 2014 cut from 2,7 per cent (in the February 2014 Budget) to 1,4 per cent. Lower growth reduces tax revenues, threatening greater debt accumulation through larger deficits. South Africa's government debt-to-GDP ratio has increased by significantly more than its peer emerging markets'. Fiscal deficits of about 5 per cent (for the main budget) have become entrenched as growth repeatedly disappoints.[1] US monetary policy normalisation and credit ratings downgrades make additional debt more expensive. Financing requirements will also rise in 2017, when debt issued in the aftermath of the financial crisis matures.

Table 1 Public finance data

Consolidated government* (R billions)	2013/14	2014/15		2015/16	2016/17	2017/18
	Outcome	Budget	MTBPS estimates	Medium-term estimates		
Revenue	1 012,7	1 099,2	1 093,9	1 199,5	1 323,0	1 434,6
Expenditure	1 147,4	1 252,3	1 247,1	1 344,0	1 437,1	1 553,4
Budget balance	-134,7	-153,1	-153,2	-144,5	-114,1	-118,7
Total net loan debt**	1 379,5	1 589,0	1 588,7	1 799,0	1 989,7	2 191,9
As a percentage of GDP						
Budget balance	-3,9	-4,0	-4,1	-3,6	-2,6	-2,5
Total net loan debt**	40,0	41,9	42,8	44,6	45,4	45,9

* 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, *Budget Review 2014* and *Medium Term Budget Policy Statement* (MTBPS), October 2014

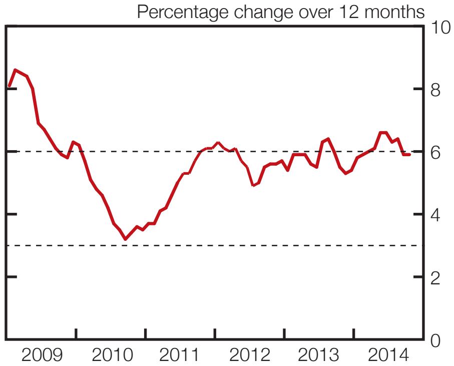
The MTBPS sets out a strategy to narrow the fiscal deficit and stabilise debt, aiming for it to peak at 45,9 per cent of GDP in 2017/18. One element of this is higher revenue collection, but the major decisions on this subject have been deferred to the 2015 Budget. The major, specific contribution from the MTBPS, by contrast, is to set out a variety of spending limits.

State-owned enterprises have sporadically required large bailouts over the past few years, putting unexpected pressure on the fiscus. To control these costs, National Treasury will henceforth only enact bailouts if and when needed through the use of deficit-neutral funding. The extra revenue will be raised through the sale of non-core state assets.

1 National Treasury, *Medium Term Budget Policy Statement*, http://www.treasury.gov.za/documents/mtbps/2014/mtbps/MTBPS%202014%20Full%20Document.pdf, p 20.

Expenditure will also be limited through the use of nominal spending ceilings, which are binding on all non-interest main budget expenditure. They were first adopted in 2012 and have been repeatedly lowered since, including in the 2014 MTBPS. To ensure spending comes in under the ceiling, the MTBPS withdrew funding for positions that have been vacant for an extended period. It also aims to lower transfers to public entities and limits expenditure growth on non-essential expenses such as consultants, advertising and travel. Crucially, should these measures prove insufficient to contain costs, the ceilings automatically require reductions elsewhere. One important risk is the government's wage bill, which is budgeted to rise in line with inflation but is exposed to demands for much higher increases. Another more general risk is higher inflation. National Treasury currently expects headline inflation to average 6,2 per cent for the 2014/15 fiscal year, falling to 5,3 per cent by 2017/18. Because the ceilings are nominal, additional inflation that pushes expenditure to the limit will require reductions in budget allocations. Monetary policy will make an important contribution by controlling inflation and thereby help the state achieve its spending priorities.

Figure 5 Consumer price inflation: Targeted inflation*

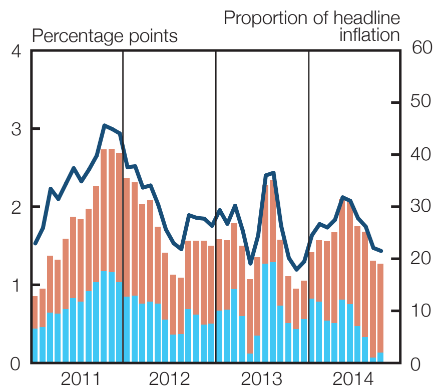


---- 3–6 per cent inflation target range

* CPI for all urban areas

Source: Statistics South Africa

Figure 6 Contribution of petrol and food prices to headline inflation*

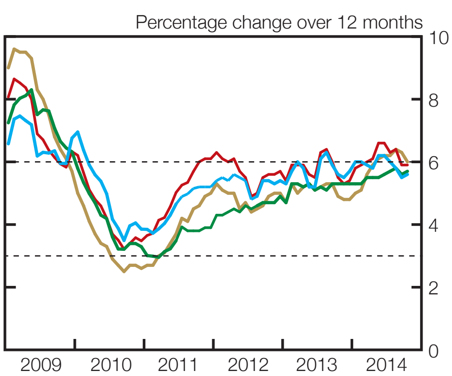


Petrol: Estimated contribution
Food: Estimated contribution
Combined contribution (right-hand scale)

* Petrol and food prices have a combined weight of almost 20 per cent in the basket and therefore have a significant effect on headline inflation

Sources: Statistics South Africa, Department of Energy and own calculations

Figure 7 Core measures of inflation



Headline CPI
CPI excluding food and NAB* prices
CPI excluding food, NAB*, petrol and energy prices
CPI excluding administered prices
---- 3–6 per cent inflation target range

* NAB: Non-alcoholic beverages

Source: Statistics South Africa

Inflation

Headline consumer price index (CPI) inflation cleared the top of the target in April 2014, rising to a high of 6,6 per cent in May and June before receding to 5,9 per cent in September and October. Food and petrol – mediated by the exchange rate – have been instrumental in determining which side of 6 per cent prices land: food prices have added over a full percentage point to headline inflation in each of the past six months, while petrol prices contributed nearly 1 percentage point to headline inflation in May and June. More recently the effect has reversed, pulling CPI inflation narrowly under 6 per cent earlier than anticipated.

Table 2 Contributions to targeted inflation

Percentage change over 12 months* and percentage points

		2013	2014						
	Weights	4th qr	1st qr	May	Jun	Jul	Aug	Sep	Oct
Goods inflation*	49,86	4,8	6,0	7,5	7,4	6,8	6,8	5,8	5,6
Services inflation*	50,14	5,9	5,9	5,9	6,0	6,0	6,0	6,1	6,0
Targeted inflation*	100,00	5,4	5,9	6,6	6,6	6,3	6,4	5,9	5,9
Food and non-alcoholic beverages	15,41	0,6	0,9	1,3	1,3	1,3	1,4	1,3	1,2
Food	14,20	0,5	0,8	1,3	1,3	1,3	1,4	1,2	1,1
Housing and utilities	24,52	1,3	1,3	1,4	1,4	1,4	1,4	1,4	1,4
Transport	16,43	1,0	1,3	1,5	1,4	1,1	1,0	0,7	0,8
Petrol	5,68	0,5	0,7	0,8	0,8	0,5	0,3	0,1	0,1
Miscellaneous	14,72	1,1	1,0	1,0	1,0	1,1	1,1	1,0	1,0
Other	28,92	1,5	1,4	1,4	1,5	1,4	1,5	1,5	1,5
Of which:									
CPI for administered prices*	18,48	7,6	8,6	8,9	8,6	7,0	6,2	4,7	5,1
Core inflation*, **	74,78	5,3	5,4	5,5	5,6	5,7	5,8	5,6	5,7

** CPI excluding food, non-alcoholic beverages, petrol and energy

Sources: Statistics South Africa and own calculations

Underlying the fluctuations from volatile components of the CPI are more broad-based and persistent elements of inflation, described by various core measures. All these indices have shown a slow upward trend since 2011, from near the bottom of the target to the top. This rise in core inflation has coincided with deteriorating growth and a negative output gap, with little evidence of excessive demand. There are instead more plausible causes: exchange-rate depreciation as well as food and energy price increases, which generated indirect first- and second-round effects, and above-inflation wage and salary adjustments.

Food prices

Earlier in the year the outlook for food prices was gloomy. Geopolitical tension between Ukraine and Russia threatened production in one of the world's major grain belts, while meteorologists warned of a severe El Niño event during the year, a phenomenon which typically reduces rainfall in South Africa. These fears, however, proved unfounded: 2014 is instead yielding bumper crops, both at home and abroad, suppressing food prices as a result. The Food and Agriculture Organization Food Price Index has declined to its lowest level since 2010, and the national Crop Estimates Committee has revised its final production estimates for white and yellow maize to 14,3 million tonnes for 2014 – which would be the second-largest maize harvest in South African history. The outlook is also helped by falling oil prices, given that oil is an important input to food production and also a substitute for biofuels, making it perhaps the single most important long-term driver of food prices over the past ten years.[2]

Petrol prices

Petrol price inflation has fallen since May 2014, helped by both declining world oil prices and a fairly stable exchange-rate trend. International crude oil prices fell below US$100 in September, despite geopolitical instability affecting important energy producers including Iraq and Russia. Prices fell even further to November, with Brent crude at four-year lows of below US$80 a barrel. Rand prices are correspondingly down but not as far down, given exchange-rate depreciation since 2011, with the rand price of Brent crude at a 17-month low in October 2014.

The decline in oil prices stems from three crucial factors: first, production from the Organization of the Petroleum Exporting Countries has risen, with Libyan output in particular rebounding sharply from instability-induced lows. Second, the US shale revolution is reshaping world energy markets, transforming the US into the world's largest oil producer, ahead of Saudi Arabia. (As a result, Nigeria has sold almost no oil to the US since July, despite having previously been one of the US's top five suppliers.) Third, global demand forecasts have also fallen steadily alongside deteriorating growth prospects for the world economy.

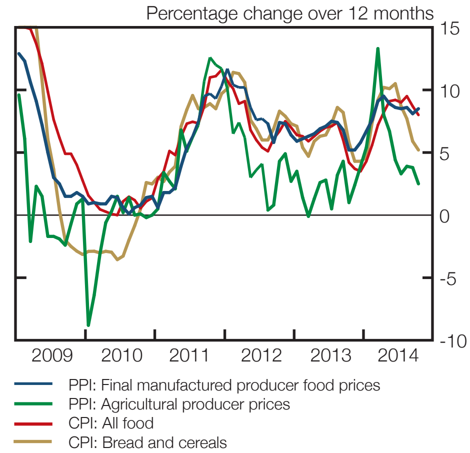
Core inflation and its drivers

The acceleration of food and petrol prices opened up a wedge between headline and core inflation. This wedge has recently narrowed as headline inflation comes down but core inflation continues its slow rise, and the forecast shows core inflation overtaking headline in 2015. There are several complementary explanations for core inflation's protracted rise. One is that price setters are catching up with the higher inflation they have experienced; a demonstration of indirect effects from earlier supply pressures. This applies particularly to services, a category which is strongly represented in most core measures, filling more than half of these baskets. Because services are generally non-tradeables, service price inflation is not simply a response to higher costs from a depreciated exchange rate. These prices also tend to be adjusted more infrequently than goods so they often lag headline developments – which implies core inflation will 'overshoot' headline inflation as food and oil prices fall.

A similar process affects wage deals, which reflect previous inflation outcomes but also factor into firms' costs, prompting corresponding increases in the prices they charge. This effect is accelerated by a separate mechanism, in which employees win above-inflation increases, resulting in further pressure on production costs. Wages in South Africa tend to be downwardly rigid in real terms and well-insulated from employment and growth conditions, boosting inflation even in a lacklustre economy (see Box 2).

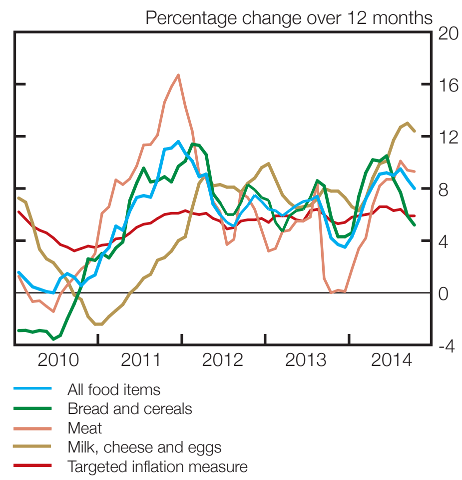
2 J Baffes and A Dennis, 'Long-term drivers of food prices', *World Bank Policy Research Working Paper 6455*, May 2013.

Figure 8 Consumer and producer food prices



Source: Statistics South Africa

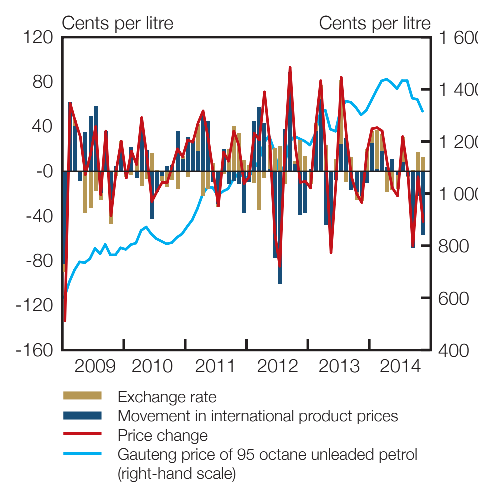
Figure 9 Targeted* inflation and food inflation



* CPI for all urban areas

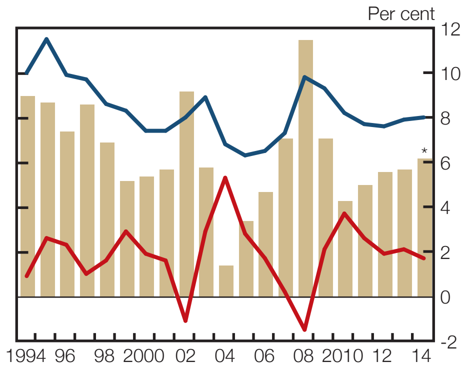
Source: Statistics South Africa

Figure 10 South African petrol price and contributions to changes in the basic fuel price



Source: Department of Energy

Figure 11 Average annual inflation and wage settlements

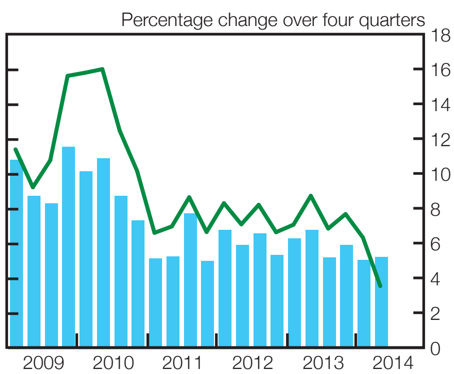


Average wage settlements
CPI
Average real wage settlements

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

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

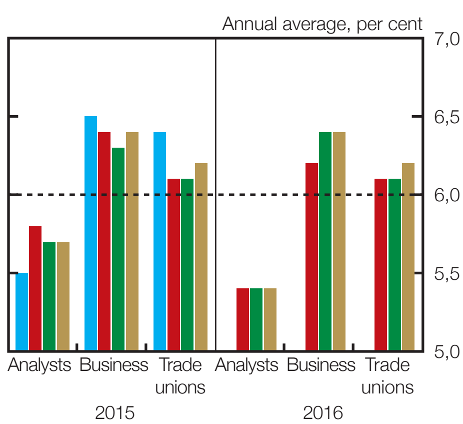
Figure 12 Remuneration per worker and unit labour cost in the formal non-agricultural sector



Nominal unit labour cost
Renumeration per worker

Sources: Statistics South Africa and South African Reserve Bank

Figure 13 Medium-term inflation expectations



4th qr 2013
1st qr 2014
2nd qr 2014
3rd qr 2014
6 per cent upper limit of the inflation target range

Source: Bureau for Economic Research, Stellenbosch University

Evidence for the 'inflation plus' approach is visible in quarterly releases of the *Andrew Levy Wage Settlement Survey*, which show consistent real growth in wage settlements since the crisis. This measure is limited by its coverage, representing a relatively small fraction of the workforce, but it points to consistent above-inflation wage increases, with average nominal wage settlements of about 8 per cent.

Remuneration per worker, a more general measure, shows a slightly lower growth rate, averaging 7,4 per cent between 2011 and the end of 2013. The first half of the year saw a sudden decline in remuneration growth, influenced by two factors. Strike action in the platinum-mining sector meant workers were employed but not paid, forfeiting wages of approximately R10,7 billion. Furthermore, a large number of temporary jobs were created around the election, which lifted public employment but had a much smaller effect on public-sector wages. The recent decline in remuneration per worker therefore probably does not presage moderating wage pressures; the longer-term average is more revealing.

Inflation expectations have been sticky around the upper end of the target range for most of the post-crisis period. The survey conducted by the Bureau for Economic Research (BER) provides expectations for three groups – financial analysts, business people and trade union leaders – with financial analysts typically anticipating less inflation than the other two categories of respondents. Whereas analysts see inflation within the target for both 2015 and 2016, businesses and unions have consistently predicted inflation narrowly above 6 per cent; the most recent predictions for 2015 are 6,4 per cent and 6,2 per cent respectively. This is significant because businesses and unions are price setters, and their actions will feed into core inflation even as headline inflation declines.

Box 2 Wage rigidities, employment conditions and inflation in South Africa

Like most economies, South Africa's economic output was negatively affected by the global financial crisis, but the recession was short-lived and relatively mild compared to most of the other economies. By contrast, our employment response was among the worst, with a loss of around one million private-sector jobs, or 7 per cent of the employed labour force, in less than one year. South Africa's inflation rate increased comparatively sharply just before the crisis, leading unit labour costs (ULCs) to ratchet higher as wage settlements matched the inflation rate. To test the reaction of ULCs to changes in GDP and changes in inflation, Viegi (2014) estimates a Philips Curve equation using South African data over various time frames.[1]

$$\pi^W_t = a + \gamma \bar{\pi}^p_{t-1} + \varphi_0 \hat{u}_t + \varphi_1 \hat{u}_{t-1} + \vartheta_t$$

Where π^W_t is the measure of wage inflation (proxied by private-sector, non-agricultural wage inflation or manufacturing unit labour costs inflation), $\bar{\pi}^p_{t-1}$ is the measure of inflation expectations (proxied by the previous period's inflation outcome or by using BER inflation expectations survey data) and $\hat{u}_t$ is the deviation of employment or unemployment from a long-term trend. A variety of estimations are done over the periods 1970–2014, 1994–2014 and 2000–2014, according to data availability.

Table B2.1 Estimated wage inflation: Private-sector wages

	(1)	(2)	(3)	(4)	(5)	(6)
	1970–2014	1994–2014	1970–2014	1994–2014	1970–2014	1994–2014
n_t	0,19***	0,07	0,13**	0,06	0,18**	0,11*
	(0,05)	(0,04)	(0,04)	(0,04)	(0,05)	(0,05)
n_{t-1}					-0,07	-0,06
					(0,05)	(0,05)
π_{t-1}			0,55***	0,25*	0,56***	0,27**
			(0,05)	(0,12)	(0,05)	(0,12)

*** denotes significance at the 1 per cent level, ** at the 5 per cent level and * at the 10 per cent level, standard errors in parenthesis

Note: n_t identifies the deviation of manufacturing-sector employment from its trend

Source: Viegi (2014)

The estimations show that the relationship between wage inflation and employment has become weaker over time, and especially in the period since 1994. This suggests that as the economy is buffeted by adverse economic shocks, wage and salary increases are largely insensitive to employment conditions. By contrast, inflation expectations feed into wage and salary inflation. This is corroborated when using trade unions' inflation expectations for the current year, the next year and two years ahead, as published by the BER.

Table B2.2 Estimated wage inflation: Trade union inflation expectations

	(1)	(2)	(3)
	$E\pi_t$	$E\pi_{t+1}$	$E\pi_{t+2}$
u_t	-0,37**	-0,35**	-0,37**
	(0,18)	(0,19)	(0,18)
$E\pi_t$	0,73***	0,72***	0,82***
	(0,23)	(0,26)	(0,29)
	2000 Q3–2013 Q4		

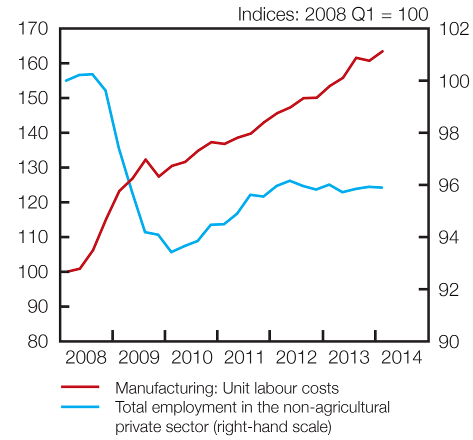
*** denotes significance at the 1 per cent level and ** at the 5 per cent level, standard errors in parenthesis

Source: Viegi (2014)

Further analysis using a dynamic stochastic general equilibrium model confirms that the domestic labour market exhibits pervasive wage rigidities, inducing rates of job destruction greater than job creation.

1 This box is based on a paper titled 'Labour Market and Monetary Policy in South Africa' presented by Nicola Viegi at the South African Reserve Bank Conference held in Pretoria on 30 and 31 October 2014.

Figure B2.1 Unit labour costs and employment in South Africa



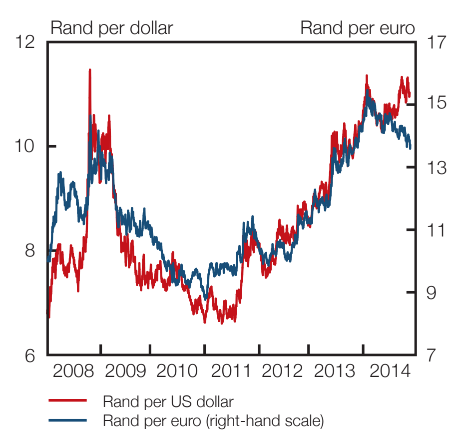
Source: South African Reserve Bank

Exchange rate

Rand depreciation has contributed to the sustained rise in headline and core inflation and remains a major risk to the inflation outlook. The threat to inflation takes two forms: the rand could depreciate further, or the pass-through from depreciation could rise.

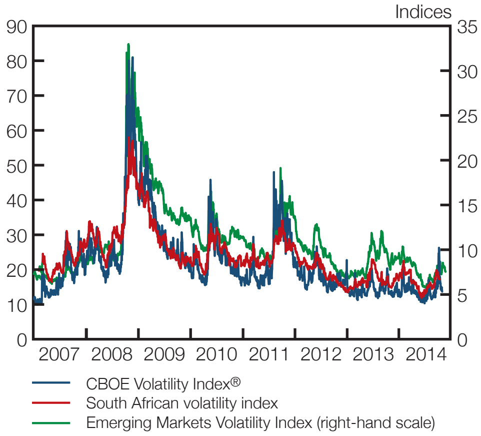
Over the course of the year, the exchange rate has been affected by distinct external and internal factors. Internationally, a crucial development has been US dollar strength. Robust growth in the US and the corresponding shift

Figure 14 Bilateral exchange rates of the rand



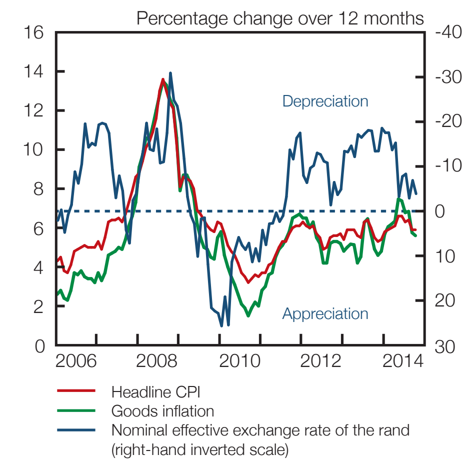
Sources: Bloomberg

Figure 15 Measures of developed- and emerging-market risk aversion



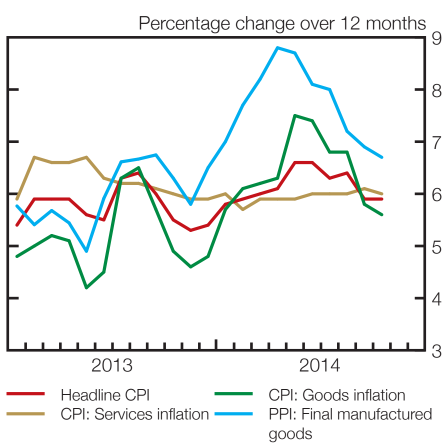
Sources: Bloomberg, JPMorgan, Chicago Board Options Exchange (CBOE) and JSE Limited

Figure 16 Inflation and the exchange rate



Sources: Statistics South Africa and South African Reserve Bank

Figure 17 Consumer and producer price inflation



Source: Statistics South Africa

to the normalisation of monetary policy by the Fed has boosted the dollar. At the same time, weak growth and ever-looser monetary policy by the next two largest central banks, the European Central Bank (ECB) and the Bank of Japan (BOJ), has cheapened the euro and yen. Furthermore, rising geopolitical risks and deteriorating world growth prospects have attracted investors to dollar-denominated safe haven assets. As a consequence, the dollar reached four-year highs at the end of November. The rand has accordingly weakened against the dollar but not to other major currencies.

Domestic factors have also intruded on the exchange rate, especially the large current-account deficit. The rand appeared to strengthen on a relatively good number for the first-quarter deficit but weakened alongside a more disappointing second-quarter number. Much of the difference between the first and second quarter figures came from large dividend inflows, which was a temporary effect. Strikes also depressed exports from the second quarter, with a recovery setting in towards the end of the third quarter. More fundamentally, South Africa's terms of trade have been weakening since 2011 as commodity prices decline, although they remain elevated from a historical perspective. Domestic import penetration has also been rising.

The dynamics of exchange-rate pass-through are more obscure. Some pass-through is complete and nearly immediate, which is the case with the petrol price, but for many other goods and services the link is less predictable. Firms might choose to absorb additional costs imposed by the exchange-rate change if they expect them to be temporary or believe raising prices would reduce demand excessively. By contrast, they might shift costs to consumers more readily if they judge depreciation will be permanent or find their profit margins are being unacceptably squeezed. Since the crisis pass-through appears to have been relatively low, perhaps because firms have moderated mark-ups in response to subdued domestic demand. This pattern may persist. However, there is a risk of pass-through reverting to its previous rate.

Table 3 Measures of producer price inflation in 2014

Percentage change over 12 months

	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct
Final manufactured goods	8,2	8,8	8,7	8,1	8,0	7,2	6,9	6,7
Excluding:								
Petroleum products....................	8,2	8,5	8,5	8,0	7,9	7,3	7,1	7,2
Food..	7,9	8,4	8,6	7,9	7,8	6,6	6,4	6,1
Intermediate manufactured goods...	10,1	10,2	9,8	9,0	8,5	6,7	7,0	6,2
Electricity and water	14,6	10,4	9,7	8,2	7,8	8,6	7,4	8,0
Mining	3,7	6,6	4,9	5,8	7,8	3,6	5,1	2,5
Agriculture, forestry and fishing........	11,7	7,6	6,7	4,5	3,9	4,2	4,4	3,0
Import unit value index*	20,7	20,8	21,8	21,5	19,2	15,3	12,5	

* 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

There is evidence of pressure on firms' costs in producer price indices (PPIs), which measure input price changes (at various stages of production) as experienced by South African goods producers. Although the PPIs cannot be interpreted as direct inputs into the CPI, there is close co-movement between headline PPI – the PPI for final manufactured goods – and the CPI for goods inflation. During the first four months of 2014, the PPIs for both intermediate and final manufactured goods increased robustly, owing to exchange-rate pressures (proxied by the import unit value index) as well as high PPI food prices. However, by May this trend had reversed, foreshadowing the moderation in headline CPI. PPI inflation nonetheless remains high and well above CPI.

Domestic expenditure

The main expenditure drivers of the private-sector economy are household final consumption expenditure and private-sector gross fixed capital formation. Both these forces have been trending gradually weaker since mid-2013, resulting in a negative output gap and therefore little inflationary pressure from the demand side. New estimates of the output gap, described in Box 1, suggest it may be smaller than previously estimated. The implications of this adjustment for inflation are mostly in the future: with a smaller output gap, the economy will reach full capacity sooner, at which point demand pressures will start to generate inflation.

Table 4 Growth in expenditure on GDP

Per cent*

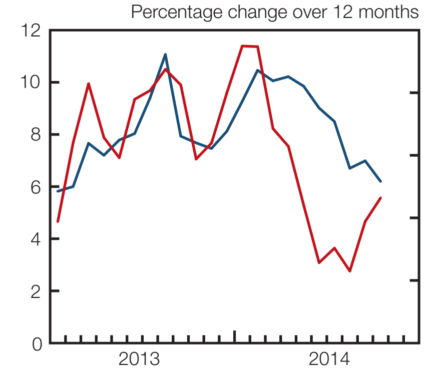
	2012	2013					2014	
	Year	1st qr	2nd qr	3rd qr	4th qr	Year	1st qr	2nd qr
Final consumption expenditure								
Households	3,5	2,4	2,5	2,1	2,0	2,6	1,8	1,5
Disposable income	*3,9*	*2,3*	*2,4*	*2,1*	*2,0*	*2,5*	*1,7*	*1,3*
General government	4,0	2,8	1,7	1,5	2,0	2,4	1,4	1,6
Gross fixed capital formation	4,4	3,8	5,6	7,0	3,1	4,7	2,6	0,5
Gross domestic expenditure	4,0	5,3	3,2	-0,8	-3,6	2,2	2,7	1,8
Exports of goods and services	0,4	5,9	9,0	16,7	3,9	4,2	5,4	-11,4
Imports of goods and services	6,0	21,5	7,3	7,0	-18,9	4,7	16,3	-5,2

* Quarterly data refer to quarter-on-quarter growth at seasonally adjusted annualised rates at 2005 prices

Source: South African Reserve Bank

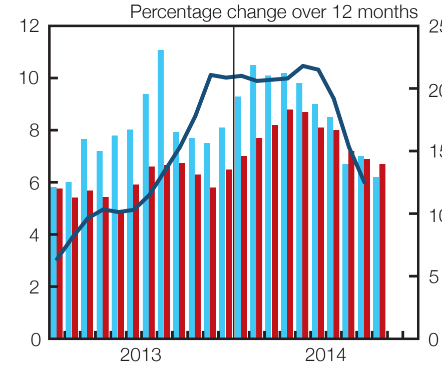
Final consumption expenditure by households is the single biggest component of demand, accounting for more than 60 per cent of gross domestic expenditure. Growth in this category has been weak for several reasons. Real disposable income has increased only moderately and job creation has been limited. Credit extension has been weak. Households are highly indebted and are therefore deleveraging, which is necessary but constrains final demand. House price growth has been muted. In this context, consumer confidence is predictably low.

Figure 18 Producer prices and the exchange rate



Sources: Statistics South Africa and South African Reserve Bank

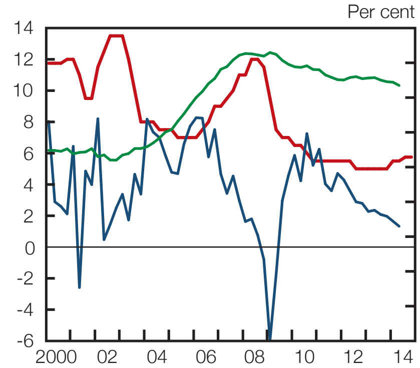
Figure 19 Producer price pressures



* Import unit value indices measure inflation in imported commodities using customs-level data from the South African Revenue Service

Source: Statistics South Africa

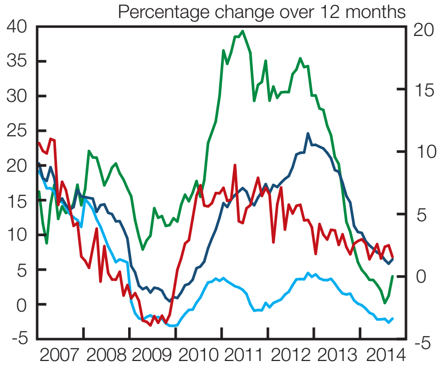
Figure 20 Household income and debt levels



* Percentage change over previous quarter at a seasonally adjusted and annualised rate

Source: South African Reserve Bank

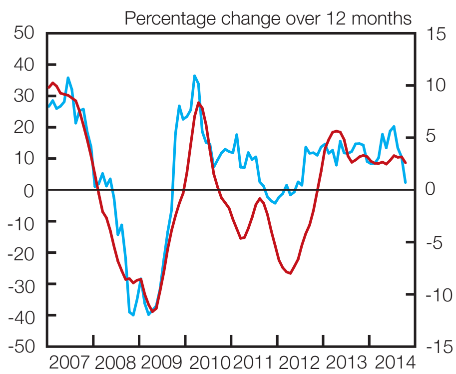
Figure 21 Bank credit to households and retail sales



* Smoothed average

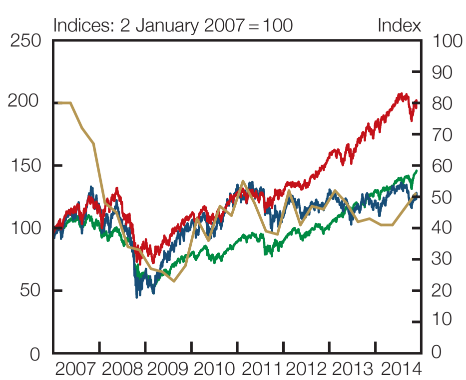
Sources: Statistics South Africa, South African Reserve Bank and own calculations

Figure 22 Real house and share prices



Sources: JSE Limited, Absa, Statistics South Africa and own calculations

Figure 23 Share prices



Sources: JSE Limited; Bloomberg; Bureau for Economic Research; Stellenbosch University; and own calculations

Credit extension to households has followed a 22-month downward trend. This pattern combines two factors: mortgage credit, which constitutes most of the stock of household credit and which was a key growth driver in the pre-crisis boom years, has contracted in real terms since the crisis. Meanwhile, smaller volume, higher interest-rate categories of credit have slumped after a period of strong growth. Instalment credit, which is mostly used for vehicle purchases, has been expanding more slowly since May 2013. Unsecured lending, which is included in general loans, contributed to improved household expenditure after 2009 but has fallen steeply since the beginning of 2013. The aftermath of the African Bank Investments Limited intervention may also be contributing to hesitance in unsecured credit extension.

Rising asset-price developments have been somewhat more favourable for households, supporting confidence and spending, but the gains have been mostly in the equity market. Over the past two years, house prices have staged a recovery after an extended period of weak, and, at times, negative real growth. Real house prices have yet to regain their pre-crisis peak, however, and the recovery is likely to remain subdued as interest-rate increases raise the cost of debt.

The performance of the FTSE/JSE All-Share Price Index (Alsi) has been more impressive, recovering from the crisis to record highs. In June 2014 the Alsi breached the 50 000 level for the first time, aided by non-resident net purchases amounting to a cumulative R111 billion since the beginning of 2009. It retreated sharply from the end of September to below 47 000 points, in line with global equity movements, but has since staged a partial recovery. These broad developments have provided quite limited support to household spending, however, as evidenced by indicators such as consumer confidence. One explanation for this is that overall wealth gains from investing in the equity market since 2007 remain muted when adjusted for currency depreciation and inflation. A second explanation is that equity ownership is quite concentrated in South Africa, such that wealth gains in this sector have a limited impact on overall household demand.

Households are therefore not contributing significantly to inflationary pressure, at least not through the demand channel. It is, however, quite likely that households are feeding inflation indirectly through two channels. First, stronger credit growth over the past few years has been seen in categories with significant import intensities, especially for consumer durables such as cars and household appliances. These have contributed to the current-account deficit and thereby weakened the exchange rate. The implication is that the recent slowdown in these credit categories will benefit inflation by moderating the current-account deficit. Second, debt accumulation has evidently become a major burden on households, driven by strong post-crisis debt growth in credit categories with higher interest rates, notably unsecured lending. Squeezed households are more likely to push for larger wage increases to help rectify their balance sheets, which may help explain high wage demands, protracted strikes and above-inflation wage settlements.

The other crucial driver of domestic spending, private-sector investment, has been even more muted than household demand. Private gross fixed capital formation contracted in the second quarter of 2014, for the first time since 2009, echoing weak business confidence. The Rand Merchant Bank/Bureau for Economic Research (RMB/BER) Business Confidence Index had been below the 50-point neutral level for six consecutive quarters up to the third quarter of 2014. Manufacturing capacity utilisation has also been low, suggesting little scope for additional investment.

By contrast, credit extension to corporates has picked up recently, both in terms of mortgage lending and general loans. This has supported overall growth in total credit extension to the private sector from a low in December 2013 to 8,8 per cent in September 2014. Nonetheless, this is fairly unremarkable when compared to the 10-year average growth rate of 12,9 per cent.

The Bank's inflation forecasts

After January 2014, inflation forecasts for this year have remained close to but above the 6 per cent upper end of the target range. By contrast, headline inflation forecasts for 2015 and 2016 have remained within the target band, fluctuating between 5,3 per cent and 5,9 per cent over successive MPC meetings. Positive developments in global food and oil prices caused an improvement in the November outlook, especially for 2015 and 2016. However, core inflation looks set to continue its upward trend until early 2015.

The 2015 headline inflation forecast has declined over time, assisted by higher interest rates and more recently by the expectation of lower global inflation. It increased briefly in July 2014, owing to a less favourable food price forecast, but recovered in September as petrol prices weakened and it became clear that excellent grain harvests were to be expected both domestically and internationally. At the same time, the outlook for electricity prices deteriorated when the National Energy Regulator of South Africa announced that it would allow Eskom to recover revenue losses of R7,8 billion by increasing its 2015 and 2016 prices by more than previously announced. This news was incorporated into forecasts as an 11,6 per cent increase in electricity costs in July of both these years, resulting in an upward adjustment to the inflation forecast of approximately 0,1 per cent for 2015 and 0,2 per cent for 2016.

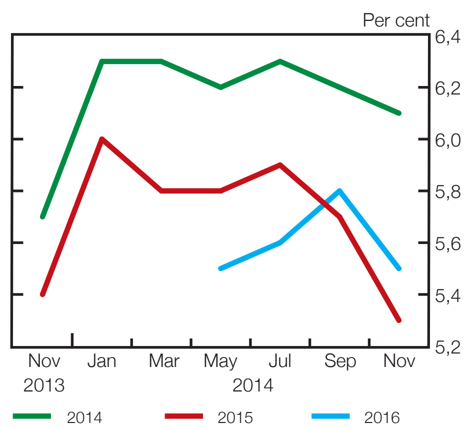
The Bank's most recent inflation outlook as at November 2014 has improved again following further petrol price cuts prompted by lower international crude oil prices – which are also likely to further reduce food prices as the two are highly correlated. As a result, headline inflation is now expected to return to within the target at 5,9 per cent by the fourth quarter of 2014. Inflation in 2015 is projected to average 5,3 per cent, which if realised would be a four-year low.

Figure 24 Private-sector investment and business confidence

* Percentage change over previous quarter at a seasonally adjusted and annualised rate

Sources: Bureau for Economic Research; Stellenbosch University; Rand Merchant Bank; and South African Reserve Bank

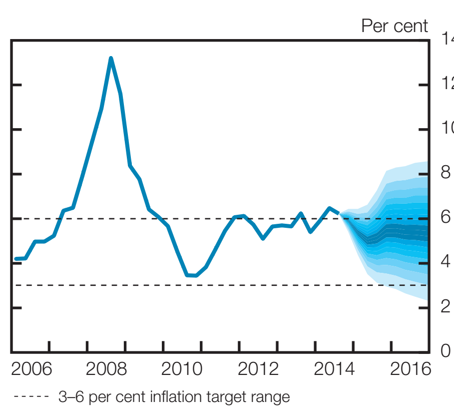
Figure 25 Evolution of the Bank's targeted inflation forecasts



Note: This graph denotes forecasts of average annual targeted inflation as at each of the MPC meetings held since November 2013

Source: South African Reserve Bank

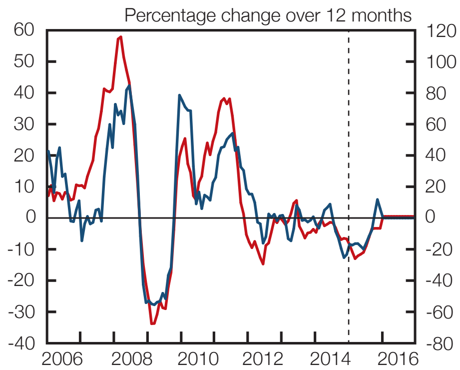
Figure 26 Targeted inflation* forecast



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

Source: South African Reserve Bank

Figure 27 International food and crude oil prices*

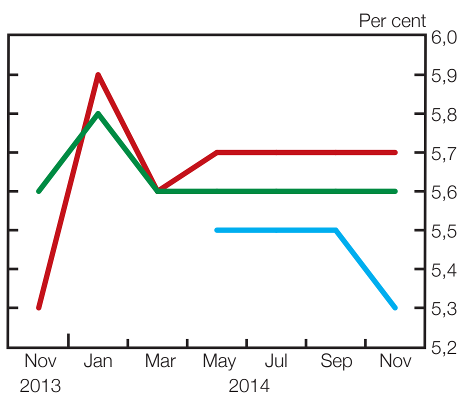


FAO Food Price Index
Brent crude oil price (right-hand scale)

* Prices are in US dollars

Sources: International Monetary Fund, Food and Agriculture Organization (FAO), Reuters and own calculations

Figure 28 Evolution of the Bank's core inflation forecasts

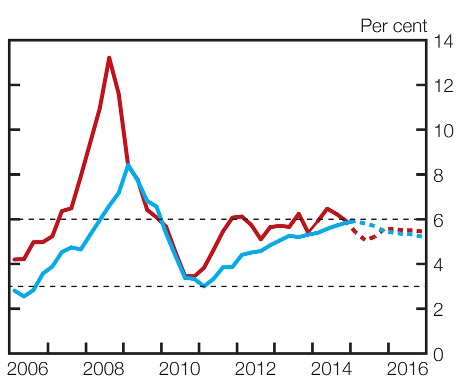


2014 2015 2016

Note: This graph denotes forecasts of average annual core inflation as at each of the MPC meetings held since November 2013

Source: South African Reserve Bank

Figure 29 Targeted and core inflation forecasts



Targeted inflation Core inflation
3–6 per cent inflation target range

Source: South African Reserve Bank

The outlook for core inflation[3] has developed less favourably. Core inflation is forecast to overtake headline inflation in 2015, averaging 5,7 per cent for the year, with a peak in the first quarter of 2015 at 5,9 per cent. This should mark the high point of a long upward trend in core inflation dating back to 2011 – evidence of sustained, broad-based inflationary pressure which has been a significant concern for the MPC. The outlook for 2016 is more favourable, however, with this year's interest-rate hikes and lower oil prices contributing to more moderate underlying inflation of about 5,3 per cent.

The risks to headline inflation have evolved such that there is now an equal probability of outcomes above or below the central projection, that is, the risks are balanced. The key upside risk factors remain the exchange rate and the interaction between high wage settlements and prices. However, headline inflation could surprise on the low side if food and petrol prices decline further. In particular, the oil price assumption is above the lows reached in November. It is very difficult to forecast both oil and food prices and the exchange rate, as the review of previous forecasts in Box 3 attests, creating significant uncertainty in the inflation outlook.

3 The measure of core discussed here is CPI excluding food, non-alcoholic beverages, energy and petrol prices.

Box 3 Inflation forecast accuracy

In a forward-looking inflation-targeting framework, monetary policy decisions require forecasts of key economic variables, including inflation. To evaluate the accuracy of these inflation forecasts, they are contrasted to actual outcomes using specific error statistics. The accuracy of the forecasts obtained from the chosen error measures are then compared to outside forecasters' accuracy. For the purposes of this analysis, accuracy is evaluated over two periods. The first period (P1) is up to and including the worst of the financial crisis – the sample begins in the first quarter of 2003 and ends in the third quarter of 2009. The second period (P2) is after the crisis nadir and stretches from the fourth quarter of 2009 until the second quarter of 2014.

Two common error statistics are used, namely the average forecast error and the root mean square error (RMSE).[1] The error statistics are calculated for both the Bank and Reuters consensus forecasts, after subtracting the inflation outcomes from their projections. The average forecast error measures projection bias in terms of systematic over- or underestimation. Meanwhile, the RMSE gives an indication of both the size and the variability of the errors.

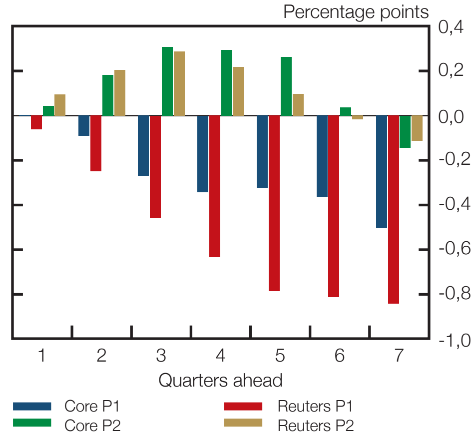
Both the Bank and Reuters' average errors are negative for most of the forecast quarters during period P1 and thus biased downwards. This suggests that these projections have underestimated the actual outcome of headline CPI inflation, on average, before and during the crisis. However, the opposite is true for period P2 where the pattern of the average forecast error is largely reversed. Here, the bias is to the upside, which indicates that both the Bank and the average of Reuters' forecasts overestimated the outcomes of inflation, on average, for most of the quarters over the post-crisis period.

The RMSE (Figure B3.2) gives an approximation of the magnitude of the errors. This measure shows that the Bank's forecast is marginally more accurate than the Reuters consensus forecast for all seven forecast quarters over the period up to and including the crisis, and for the first four quarters in the post-crisis period. In period P1, the RMSE for the four-quarters-ahead inflation forecast of the Bank is 2,0 percentage points, while that of the Reuters average is 2,4 percentage points. For the period P2, the RMSEs of the Bank and Reuters decline by 1,2 and 1,4 percentage points to 0,8 and 1,0 percentage points, respectively. This post-crisis improvement in forecasting accuracy largely relates to the relative stability of inflation over this period, as opposed to the high variation of inflation rates that were seen in the pre-crisis period.

Sizeable inflation forecast errors result from South Africa being a small and open economy, subjected to a number of large external shocks. This was particularly evident during the period up to and including the financial crisis. These shocks mostly emanate from significant movements in international oil and food prices which transmit quickly to inflation. The free-floating rand exchange rate also moves rapidly at times and has a marked effect on the price of imports. These large price movements pose significant challenges to forecasting inflation. As the forecast horizon extends into the future, the uncertainty surrounding future shocks increases and, as a result, the forecast accuracy tends to worsen.

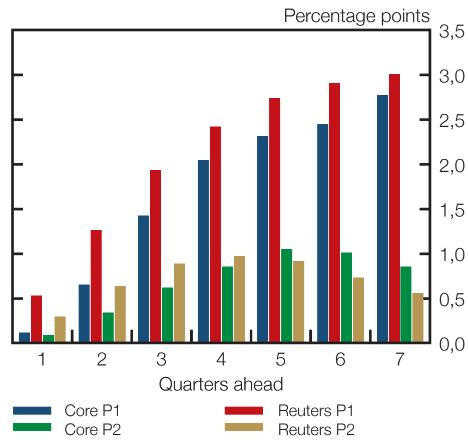
1 The root mean square error is the square root of the average of squared forecast errors.

Figure B3.1 Average forecast error



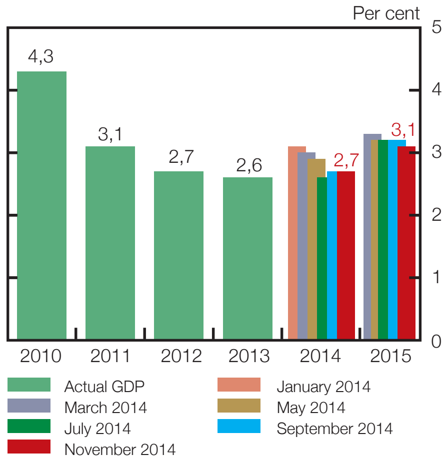
Sources: Reuters consensus and own calculations

Figure B3.2 Root mean square error



Sources: Reuters consensus and own calculations

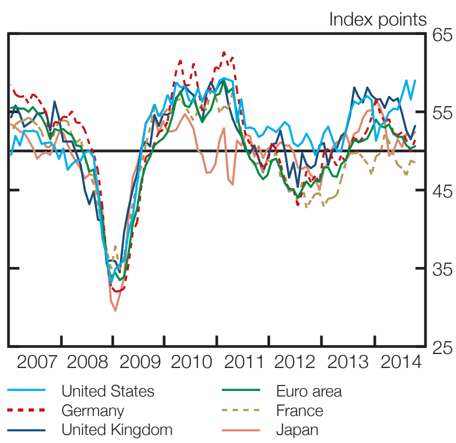
Figure 30 Evolution of global real GDP forecasts*



* Data weighted by market exchange rates

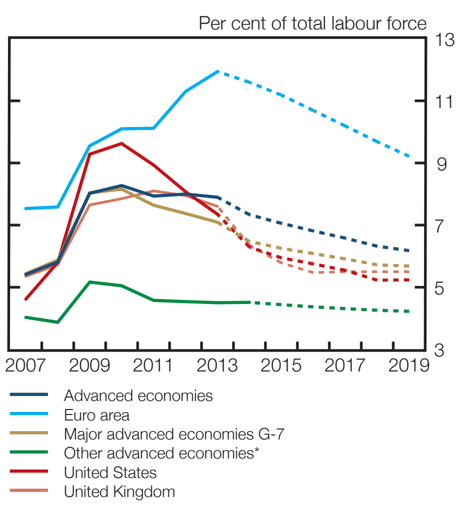
Source: Consensus Economics

Figure 31 Selected advanced-economy Purchasing Managers' Indices



Source: JPMorgan

Figure 32 Unemployment



* Advanced economies excluding the G-7 and euro area

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

Global economic assessment

Forecasts for world economic growth have fallen in 2014, as indeed they have every year since 2011. The outlook for 2015 is for improved growth, albeit just over 3 per cent, which is a lower level than in previous forecasts for the coming year and also much closer to the average growth rates of the past three years. Put more simply, forecasts have now caught up with the disappointing realities of the recent past.

Advanced economies

In the advanced-economy universe, there is a marked divergence between the US and UK, which are now growing strongly, and the euro area and Japan, which have once again stalled.

At the end of 2013, most commentators were optimistic that the US economy was about to experience a robust recovery after several false starts. The first quarter instead delivered a large growth contraction, owing mostly to unusually bad weather, and this predictably yielded a strong rebound in the second quarter, for an overall inconclusive growth performance for the first half of the year. The third quarter provided more encouraging news with a better-than-expected 3,9 per cent growth rate (according to the advance estimate), and leading indicators promise a strong finish to the year, with the manufacturing Purchasing Managers' Index (PMI) at a 44-month high.

Unemployment outcomes have been encouraging all year, with unemployment slipping below 6 per cent in September and job creation averaging nearly 230 000 monthly in 2014. Wage growth has been more limited, however, and this, along with muted inflation and the low labour force participation rate, suggests persistent labour market slack. The Fed has judged this progress adequate to conclude its programme of quantitative easing in October, as expected, but is only anticipated to move the policy rate off the zero lower bound sometime in mid-2015, with rates increasing gradually thereafter.

The UK has claimed the mantle of fastest-growing economy in the G-7 for 2014, a title only partly earned by the earlier weakness of its recovery. Revisions to GDP data have altered the narrative of the crisis, with output now seen to have fallen less and recovered sooner than originally thought. In particular, the latest data indicates that the UK regained its pre-crisis peak in the third quarter of 2013 instead of the second quarter of 2014. Unemployment peaked at 8,5 per cent during the second half of 2011, but has since declined much faster than expected, reaching 6 per cent at the end of the third quarter of 2014 alongside an employment rate close to its record high. Inflation, meanwhile, has fallen below the 2 per cent target and might well drop below 1 per cent – which will likely postpone the first rate increases since the crisis. An additional delaying factor is the British recovery's exposure to risks from the broader world economy, particularly stagnation in the euro area and fraught relations with Russia.

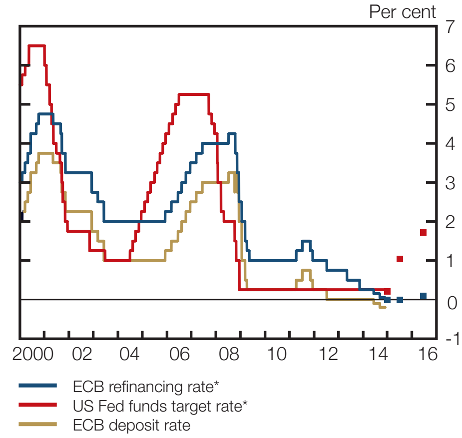
In contrast to the US and the UK, the euro area's prospects have deteriorated over the year, with two developments of particular concern. The first is the relocation of slow or negative growth from the periphery to the centre. Of the two largest euro area economies, France and Germany, France has been stagnant since mid-2012, with government spending sustaining demand through large fiscal deficits alongside feeble private consumption and investment. Germany, meanwhile, contracted in the second quarter of the year. This dip could, in part, be blamed on weather effects, but deeper risks to growth seem to underpin recent disappointing manufacturing data – especially the slowdown in China and the effects of Russian sanctions and counter-sanctions. Reflecting these weaknesses, the European Commission slashed its November forecasts for 2015 growth in both these countries, taking France from 1,5 per cent to 0,7 per cent and Germany from 2 per cent to 1,1 per cent. These contrast unfavourably with the forecast for the euro area as a whole, revised down from 1,7 per cent to 1,1 per cent – a demonstration of the weakness of the centre.

The second problem is extremely low inflation. The Harmonised Index of Consumer Prices grew a mere 0,4 per cent in October 2014, far below the ECB's 2 per cent target. Inflation expectations have also fallen, including even expectations for five years ahead, threatening a deflationary experience similar to Japan's. The ECB has responded with a slew of initiatives including negative rates, the creation of special loan facilities to banks to encourage lending, and asset purchases. These policies are aimed at adding about €1 trillion to the ECB's balance sheet, restoring it to 2012 levels of about a third of euro area GDP. The consequences for inflation have so far been limited, although the new programmes remain in their infancy. The most tangible gain so far has been a weaker euro, down 11 per cent against the US dollar since May 2014, which may help raise inflation and support expectations. This effect, however, is likely to be neutralised by falling oil and food prices.

In Japan, growth in the first half of the year was volatile as consumers brought spending forward to avoid a value-added tax (VAT) increase, producing a large boost in the first quarter and an offsetting bust in the second. Overall output dropped slightly from the beginning of the year to its mid-point, and then fell further in the third quarter, indicating significant economic fallout from the tax hike. Fiscal policy, originally one of the three arrows of Abenomics, has thereby instead become a threat to short-term growth. Monetary policy, however, has become even more aggressive, which is an extraordinary shift given that the BOJ was already enacting the most radical balance-sheet expansion of the big advanced-economy central banks, having accumulated assets worth more than half of GDP – compared to approximately a quarter for the Fed and the Bank of England. Under the new policy, the BOJ will acquire even more government debt, shifting annual purchases from ¥50 trillion to ¥80 trillion a year and also buying longer maturities, extending its lead as the largest holder of Japanese government bonds (with about 20 per cent of the total). It will also purchase stocks and property funds. The goal of these policies is to achieve a 2 per cent inflation target, and although inflation has turned positive and is in fact just over 3 per cent, much of this effect comes from the VAT increase and will therefore drop out of the data in early 2015. What remains is inflation consolidated around 1 per cent, which is a victory over deflation but not yet the target.

The broader problem for Japan is that higher inflation without corresponding growth and wage increases will simply lower living standards. In this way, a 'one arrow' strategy, lacking fiscal and structural reform components, could be self-defeating. The result – protracted stagnation – would also be a serious concern for the global recovery. In the pre-crisis period, world output could flourish despite Japan's weakness thanks to fast growth (sometimes

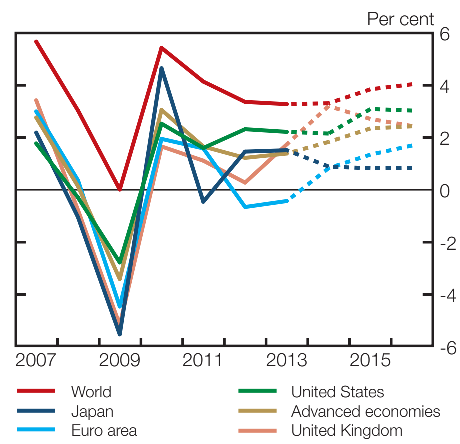
Figure 33 European Central Bank and United States Federal Reserve interest rates



* Both forecasts are proxied by Consensus Economics projections of three-month rates – the Treasury bill rate for the Fed and Euribor rate for the ECB

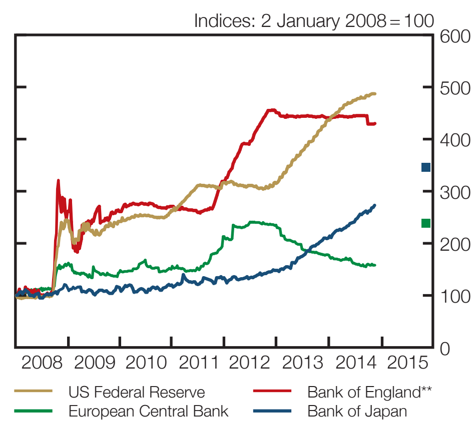
Sources: Datastream, Consensus Economics and own calculations

Figure 34 Growth rates in advanced economies



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

Figure 35 Central bank balance sheets*

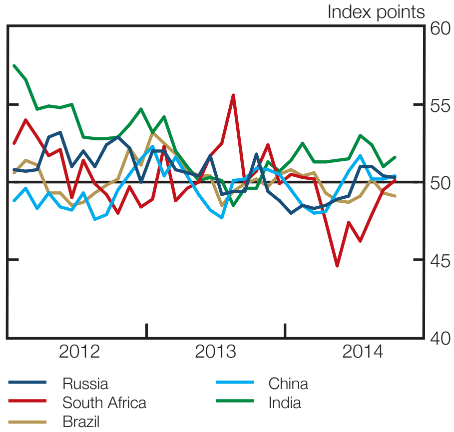


* The calculations above are based on local currency values of the selected countries' balance sheets

** There is a break in the balance sheet disclosure by the Bank of England from October 2014 in which bilateral operations are excluded. As a result, from October 2014 the weekly reported assets have been used

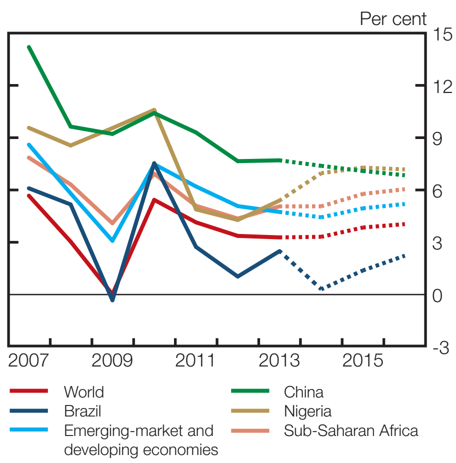
Sources: US Federal Reserve, Bank of England, European Central Bank, Bank of Japan and own calculations

Figure 36 Selected emerging-market economy Purchasing Managers' Indices



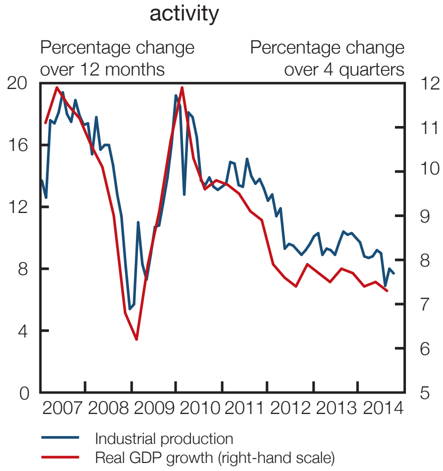
Source: JPMorgan, Bureau of Economic Research; Stellenbosch University; and Kagiso

Figure 37 Growth rates in emerging-market economies



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

Figure 38 Growth in China's industrial production and economic activity



Source: Bloomberg

excessively fast) in the US and euro area, as well as in China and many other emerging markets. But now much of this growth has abated and the Japanese contribution is more visible for its absence.

Emerging markets

In the immediate aftermath of the crisis the world seemed to be experiencing a two-speed recovery, with advanced economies stumbling and emerging markets speeding ahead; as late as April 2013 the IMF could insist that, "Emerging market and developing economies are still going strong…".[4] This position has now yielded to something close to its opposite, with hopes for the world recovery centring on the US and other smaller advanced economies, and emerging markets generally slowing.

That change in fortune has varying origins, with the Chinese experience quite distinct from that of other large emerging markets. In China, the surprise is not so much the slowdown as the fact that it took so long to happen; as Larry Summers and Lant Pritchett have recently observed, no other economy in history has grown so fast for so long.[5] Slower growth is appropriate as the Chinese economy matures, switching its growth drivers from investment and exports to consumption. This will also be helpful for the world economy as it will reduce current-account and savings imbalances and bolster demand. In the short term, however, China's transformation poses a number of risks. It has become such a large economy that it cannot reduce speed without also bringing down the world growth rate. Its appetite for commodities has delivered windfall gains for commodity exporters, but these countries are now also feeling their vulnerability to lower commodity prices as Chinese demand wanes. It is also uncertain whether China can manage to slow just the right amount; many observers have warned of the possibility of a hard landing, a cliché that nonetheless describes a serious risk. The property sector in particular has seen bubble-like conditions, with excessive construction leading to large unsold inventories.

Through much of the fast-growth period, China has solved its economic problems with more investment. This pattern has persisted through 2014, with stimulus packages following promptly on fears of below-target growth. Over time, this model has delivered stellar GDP results but also unprecedented levels of debt (217 per cent of GDP in 2013, excluding financial sector borrowing, of which 168 per cent is private, according to the *Geneva Report*) as well as investment (at around 50 per cent of GDP).[6] Perhaps the overriding challenge for Chinese rebalancing is maintaining growth *without* resorting to even more saving and investment – a recourse that has almost certainly become unsustainable.

Other big emerging markets look quite different to China. Where China runs a current-account surplus, and would like to reduce investment, the average large emerging market reports a deficit and aims to raise savings and investment. Chinese inflation has been very low and stable, but for the average emerging market peer inflation has been rising, and many central banks have responded with rate hikes (including Brazil, Indonesia, Turkey, Russia and South Africa). China joins other emerging markets in

4 International Monetary Fund, *World Economic Outlook*, April 2013, page xiii.

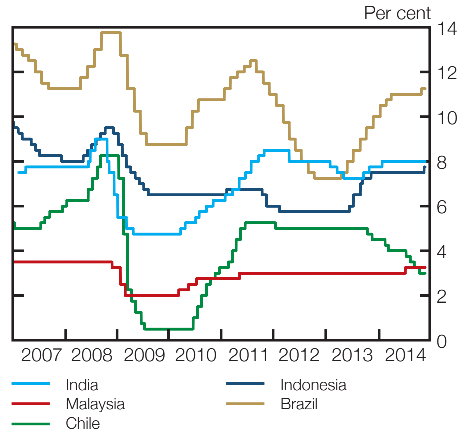
5 L Pritchett and L H Summers, 'Asiaphoria meets regression to the mean', *NBER Working Paper 20573*, October 2014.

6 L Buttiglione, P R Lane, L Reichlin and V Reinhart, 'Deleveraging? What deleveraging?' *Geneva Reports on the World Economy*, No. 16, September 2014, p 12.

having experienced falling growth, but Chinese growth remains well above levels seen elsewhere and Chinese policymakers are deliberately targeting a reduced pace of expansion.

The current emerging-market slowdown has been surprisingly widespread and protracted. Previous episodes aligned with crisis episodes (as in 1994, 1997–1998 and 2008–2009) and ended comparatively quickly.[7] In this instance, the culprit is elusive: different factors apply to different cases. For commodity exporters, particularly in Latin America, declining terms of trade damaged growth and pushed current accounts into deficit. Loose monetary policies, aided by capital inflows from advanced economies, powered credit booms that left balance sheets overstretched – typically in the private sector – necessitating a period of consolidation. Easy credit may have lulled policymakers into deferring structural reforms, lowering potential growth. A weak world economy has also undermined export-led growth, long a staple strategy of the most successful emerging markets. In some instances, especially in the Middle East, North Africa, Russia and Ukraine, geopolitical instability has profoundly affected economies.

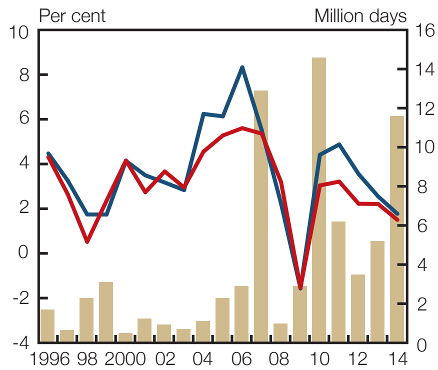
Figure 39 Policy rates



Source: Bloomberg

7 G Fayad and R Perrelli, 'Growth surprises and synchronized slowdowns in emerging markets – an empirical investigation', *IMF Working Paper WP/14/173*, Washington: IMF, September 2014. See https://www.imf.org/external/pubs/ft/wp/2014/wp14173.pdf.

Figure 40 Real economic activity and strike action



Final consumption expenditure by households*
GDP***
Work days lost to strike action (right-hand scale)**

* Data for 2014 are for the first two quarters of the year
** Data for 2014 are for the first three quarters of the year
*** Growth in unadjusted GDP for the first three quarter of 2014 compared with the same period in 2013

Sources: Statistics South Africa, South African Reserve Bank and Andrew Levy Employment Publications

Domestic growth outcomes

South Africa's economic performance has been seriously damaged by strikes in 2014. The economy contracted by 1,6 per cent during the first quarter of 2014 – the first contraction since 2009. This was followed by a weak recovery of 0,5 per cent in the second quarter, rising to 1,4 per cent in the third quarter.

Table 5 Real domestic growth rates

Per cent*

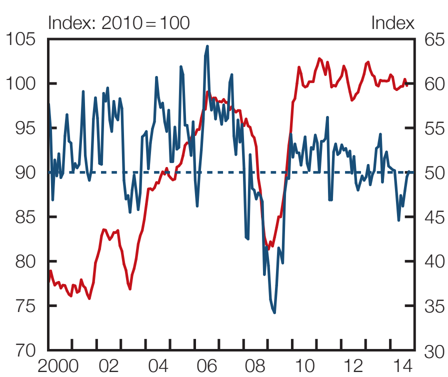
Sector	2012	2013					2014		
	Year	1st qr	2nd qr	3rd qr	4th qr	Year	1st qr	2nd qr	3rd qr
Primary sector	-2,1	10,1	-3,7	10,2	14,8	3,4	-17,7	-1,2	3,1
Agriculture	0,6	-2,9	-1,1	3,6	6,8	1,5	3,3	5,3	8,2
Mining	-2,9	14,3	-4,5	12,3	17,2	4,0	-23,0	-3,1	1,6
Secondary sector	1,6	-6,1	9,3	-4,3	8,2	0,9	-3,8	-2,5	-2,0
Manufacturing	1,9	-7,8	11,7	-6,6	12,3	0,7	-6,4	-4,0	-3,4
Tertiary sector	3,1	2,4	3,2	2,1	2,7	2,5	1,7	1,9	2,4
Wholesale and retail trade	3,6	0,9	2,2	0,3	1,8	1,9	1,5	-0,2	3,4
Finance, real-estate and business services	3,0	4,8	5,0	2,8	2,6	3,0	1,4	1,2	2,4
Non-mining sector	*2,7*	*0,3*	*4,4*	*0,7*	*4,0*	*2,1*	*0,5*	*1,0*	*1,6*
Total	2,2	1,4	3,7	1,2	5,1	2,2	-1,6	0,5	1,4

* Quarterly data refer to quarter-on-quarter growth at seasonally adjusted annualised rates at 2010 prices

Sources: Statistics South Africa and own calculations

Given the timing of and the sectors affected by strikes, it is no surprise that losses have been concentrated in mining and manufacturing, and particularly in the first half of the year. The economy began to recover in the third quarter, and some platinum producers returned to full capacity by October, earlier than expected, suggesting that the primary sector will support fourth-quarter growth.

Figure 41 Forward-looking growth indicators *



Composite leading business cycle indicator
PMI neutral level (right-hand scale)
Purchasing Managers' Index (right-hand scale)

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

* Data are seasonally adjusted

Sources: Bureau for Economic Research; Stellenbosch University; Kagiso; and South African Reserve Bank

Other sectors of the economy have fared better. Agriculture and services have been positive throughout the year. An ample maize harvest (noted in the inflation section) has bolstered growth in the primary sector, and the tertiary sector has continued to expand, with financial and business services the outstanding contributor. The wholesale and retail trade sector, however, experienced a contraction in the second quarter of 2014.

Leading indicators suggest an economy picking up from strike disruptions. The PMI has been rising since July and cleared the 50-point level (denoting expansion) in October, promising better growth in the fourth quarter. Consumer confidence has risen from extremely low levels in late 2013 and early 2014 (worse even than during the 2008–2009 crisis), although it remains significantly below its long-term average. The composite leading business cycle indicator has been edging up from lows in the first half of the year, but is still under 2013 levels. These data are consistent with forecasts of higher, but not high growth.

Given the distorting impact of strikes, 2014 is quite an unhelpful year for understanding the economy's trajectory since the crisis. Taking a longer view, the economy has expanded, in real rand terms, by about 2,5 per cent per year since 2009 and the second quarter of 2014. Growth in 2010 and 2011, which includes the inevitable post-crisis bounce, averaged 3,4 per cent. Since then, average growth has slowed to just 2 per cent. Throughout, the strongest contributor has been household consumption, which constitutes the largest share of GDP. But the sustainability of this growth is threatened by its reliance on debt and imports, exposing it to constraints from household balance sheets and the current-account deficit.

Private-sector investment has been one of the great disappointments of the post-crisis period. Although its growth has been positive since 2010, it has been low at roughly half the rates achieved before the crisis – despite very favourable monetary policy settings. The result has been not only lower short-term growth, but also weaker foundations for long-term growth, contributing to falling estimates for potential output. Lower potential growth in turn means inflation picks up even at low growth rates, placing a serious constraint on policy. A number of factors influence private-sector investment decisions. Business confidence, one strongly correlated indicator, has been volatile but usually below neutral over the period, with longer-term components such as building and manufacturing indices particularly low. This pattern has persisted through 2014 even as other indicators such as the PMI and consumer confidence have picked up.

Table 6 Domestic economic sentiment indicators

	Historic range		Most recent		As at MPR*	
	Low	High	Low	High	Jun 2014	Dec 2014
RMB/BER Business Confidence Index	10	91	23	55	41	51
Kagiso Purchasing Managers' Index................	34,1	63,7	44,3	55,6	47,4	50,1
FNB/BER Consumer Confidence Index	-33	23	-8	15	-8	-1

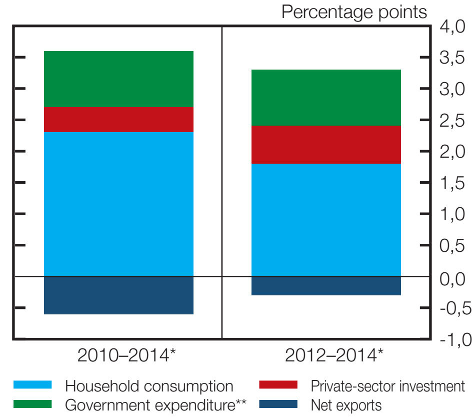
* Improved/worsened since previous MPR

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

Government's role as a source of counter-cyclical demand is visible in its relatively large contributions to overall growth – almost a quarter of the total expansion since 2009. As with household consumption, this has provided welcome support to the economy but also created vulnerabilities, particularly through an expanding debt burden. The public sector has also accounted for all net job creation in South Africa since the crisis, whereas private-sector employment has yet to regain 2008 levels.

Finally, the contribution from net exports has been negative since the crisis (although positive in some quarters, such as at the start of 2014). Net exports represent South Africa's borrowing from abroad to fund imports of consumer and investment goods above what exports can pay for. Because this imbalance has become a significant vulnerability for the economy, it merits a more extensive discussion.

Figure 42 Contributions to real gross domestic product

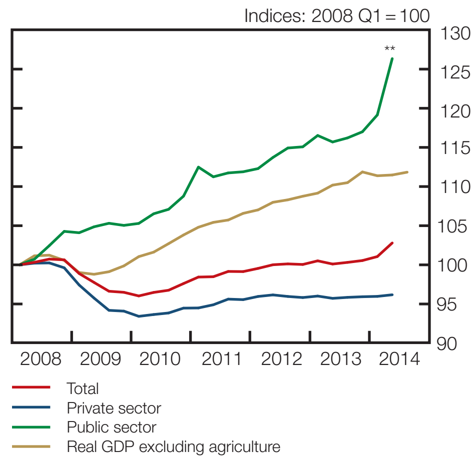


* 2014 data are up to the second quarter at 2005 prices

** Government expenditure includes consumption and investment expenditure of government

Source: South African Reserve Bank

Figure 43 Formal non-agricultural employment and GDP*

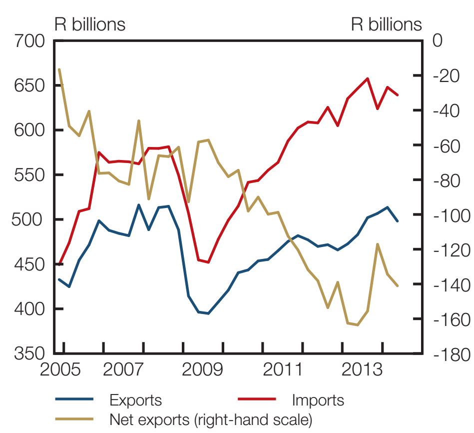


* Data are seasonally adjusted

** Public-sector employment increased temporarily in the second quarter of 2014 due to elections

Sources: Statistics South Africa; *Quarterly Employment Statistics*; and South African Reserve Bank

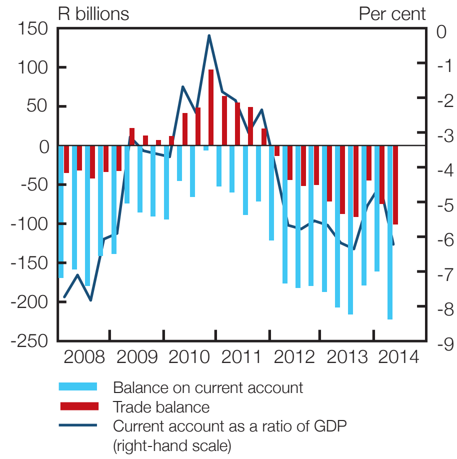
Figure 44 Real exports and imports of goods and services*



* Data are seasonally adjusted at an annualised rate

Source: South African Reserve Bank

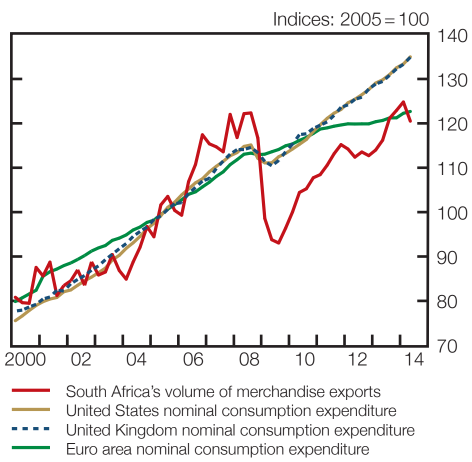
Figure 45 Trade and current accounts*



* Data are seasonally adjusted

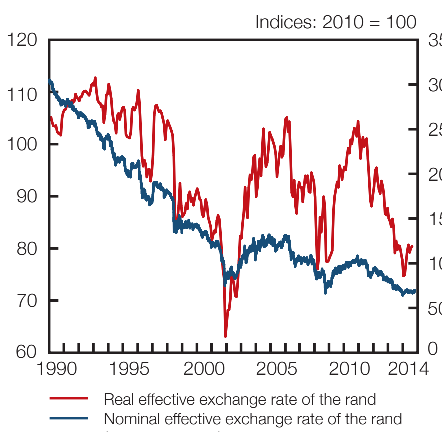
Source: South African Reserve Bank

Figure 46 South Africa's exports and consumption expenditure of selected export partners



Sources: South African Reserve Bank; Bureau of Economic Analysis; 'Personal income and outlays', Eurostat; and the Office for National Statistics

Figure 47 Nominal and real effective exchange rates of the rand



Source: South African Reserve Bank

The current account and slow growth

South Africa runs large current-account deficits during periods of growth, as an expanding economy sucks in imports. Symmetrically, the current-account deficit typically closes during periods of weak growth and crisis, as investment flows abate and confidence fails, as in 2009. The change is driven by the trade account, which swings between surplus and deficit. The services, income and current transfer account, by contrast, is more stable and always in deficit, reflecting our borrowing from foreign savers.

South Africa's tendency to run a trade deficit whenever growth is healthy is unsurprising. We are a small, open economy with a low savings rate, and we benefit from importing advanced technology and scarce resources from countries with better endowments of those goods. Historically, an increase in the growth rate has been associated with more net imports, with 1 per cent extra growth detracting about 1,4 per cent from the trade balance. Since the crisis, however, significantly slower growth has not also produced a much smaller trade deficit.

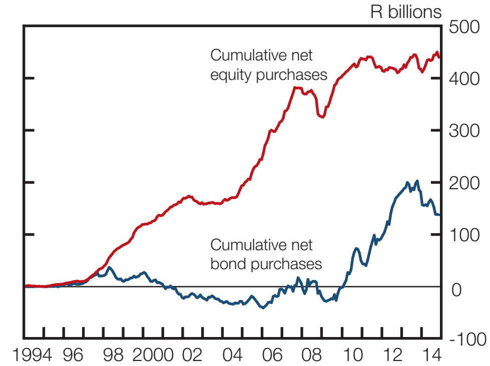
One explanation for the shift is that growth is also weak abroad, reducing demand for our exports. In part, this has to do with a slowing, rebalancing China consuming fewer commodities, as reflected in a falling terms of trade. Another aspect is the protracted euro area crisis, which has flattened consumption in a region that remains the single largest destination for South African exports. Other advanced economies have also been weak, although the US and UK are now rebounding.

Our export performance has also been hampered by competitiveness problems. A sustained depreciation in our exchange rate should have made our exports much more attractive in global markets (and supported import-competing industries locally), helping to shift the trade account back towards surplus through a J-curve. The actual adjustment, however, is proceeding very slowly. Part of the problem is that the exchange-rate advantage has been tempered by rising domestic prices, with inflation rates markedly above our peers'. Electricity shortages and labour disruptions have also dragged on the tradeables sector, which may explain why it has declined relative to the non-tradeables sector (which is dominated by wholesale, retail, finance and government). It is the tradeables sector that benefits from exchange-rate depreciation; the smaller and weaker it is, the slighter the depreciation benefit to growth and net exports.

South Africa's import appetite, by contrast, remains robust. There are several explanations for this pattern. One is that low pass-through softens incentives to avoid imports, moderating inflation but also flattening the J-curve. Another is that capital goods imports are necessary for longstanding investment plans which cannot be easily deferred. Similarly, South Africa imports inputs into other goods and services for which there may not be readily available domestic substitutes. The structure of South African imports is approximately 20 per cent consumer goods, 20 per cent capital goods and the remainder intermediate inputs, of which roughly a third is oil. Some relief from falling oil prices may be anticipated, but this could be qualified by lower export prices for goods such as coal, platinum and iron, which also respond to lower world growth prospects. Some import compression may also be expected as credit extension slows.

In contrast to the fluctuating trade account, the services, income and current transfer account is always in deficit. This is the natural consequence of sustained current-account deficits: foreigners will own increasing stocks of assets on which they will enjoy returns. As South Africa becomes increasingly integrated with the rest of the world, following its period of forced isolation, these holdings will rise towards the levels seen in other countries which are financially open and invest more than they save. However, investment and therefore ultimately income payments are not strictly one-way as evidence by unexpectedly high inflows in the first quarter of 2014. In recent years, South African companies have been expanding abroad, including into the rest of Africa (see Box 4). Over time, these asset holdings will offset some of the income outflows to foreign investors and so help reduce pressure on the current-account deficit.

Figure 48 Non-resident purchases of equities and bonds*



* Data up to 25 November 2014

Source: JSE Limited

Box 4 Trends in international income flows

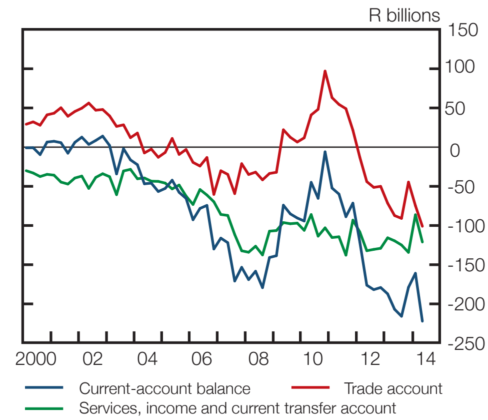
South Africa's openness has increased following a period of extreme isolation ending in the 1990s. This change is best represented by the current account; the magnitude of the trade account and the services, income and current transfer (SIT) account totals have increased dramatically, particularly in the past ten years, representing increased trade and investment between South Africa and the rest of the world. Although this openness is a source of volatility in our exchange rate and foreign capital flows, such volatility is rarely transmitted to the real economy. More importantly, our openness facilitates South Africa's access to international markets, which is an essential factor for long-run economic growth.

South Africa has repeatedly seen large net inflows of foreign capital, causing a structural deficit in the SIT account. Within this deficit, the income component dominates, comprising net dividend, interest and other[1] receipts. Interest payments related to foreign debt of the public and private sector increased substantially over the quantitative easing periods from 2009 to 2014, yet equity purchases by non-residents had been growing even before the crisis. Over the past ten years, net dividend payments accounted for 77 per cent of net income payments, spiking to 95 per cent in late 2007.

Integration has also enabled a steady rise in foreign assets and associated receipts, particularly through dividends paid to South African holders of foreign equities. Despite the post-crisis growth slowdown, the FTSE/JSE All-Share Price Index has reached new highs over the past three years. Hassan and Paul (2014)[2] analysed equity issued[3] on the JSE from 2012 to 2014.[4] The amount of capital raised through equity issuances has increased over each of the years, yet this was not related to increased domestic investment activity or in anticipation of higher aggregate demand. Instead, the authors found that by 2014 at least 46 per cent of these issuances had been raised for investment abroad.[5]

Hassan and Paul's findings indicate that South African firms are expanding abroad more aggressively, although it will take time for this expansion to result in significant dividend inflows to South Africa from new operations.[6] At least some of this expansion continues a trend of South African firms expanding into Africa, reinforcing the notion that Africa is a particularly (and increasingly) important trade and investment partner for the country.

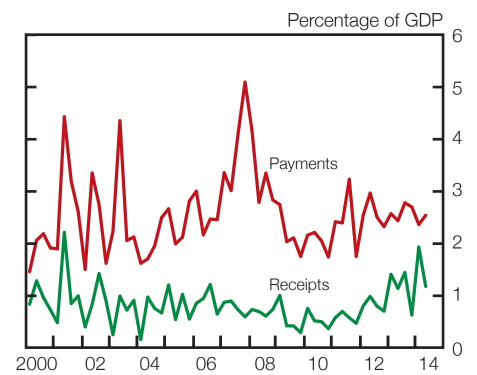
Figure 49 The disaggregated current-account balance*



* Data are seasonally adjusted at an annualised rate

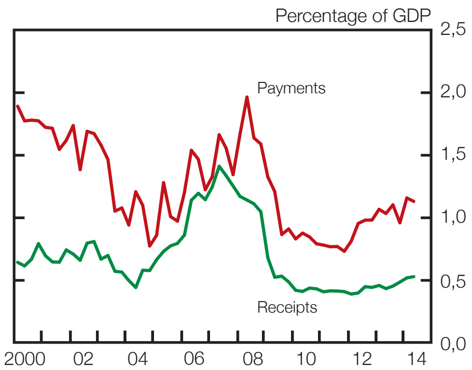
Sources: South African Reserve Bank and own calculations

Figure B4.1 Dividend payments and receipts



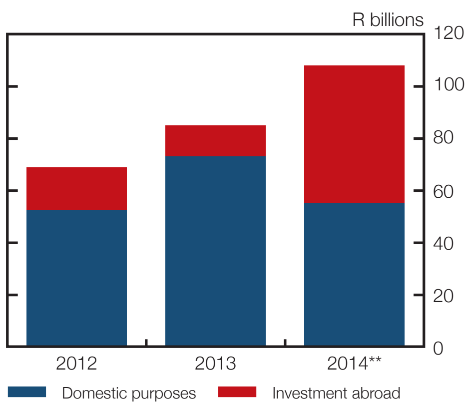
Source: South African Reserve Bank

Figure B4.2 Interest payments and receipts



Source: South African Reserve Bank

Figure B4.3 Equity capital raised by purpose*



* Excludes capital raised relating to share incentive schemes
** Data for 2014 are up to 4 August

Sources: Hassan and Paul (2014) and own calculations

Larger flows and a structural deficit on the SIT account are not necessarily problematic. This structural deficit cannot be considered in isolation; the macroeconomic context is crucial. Thus the SIT-account deficit will be problematic if it is continuously accompanied by a trade deficit (as large and persistent current-account deficits are undesirable) or if it represents an unsustainable debt burden. However, alongside higher economic growth, an offsetting trade surplus or real effective exchange-rate depreciation (encouraging a trade surplus), a SIT-account deficit may be a sign of healthy investor attention and domestic business activity.

1 Net other receipts were approximately 1 per cent of the total income component from 2004 to 2014, hence they are excluded from discussion.

2 S Hassan and M Paul, 'Recent capital raising by firms listed on the JSE: where is the money going?', *South African Reserve Bank Economic Note EN/14/17.*

3 Of the ten largest issuers, forming approximately 65 per cent of total equity issuances over the period.

4 Up to 4 August 2014.

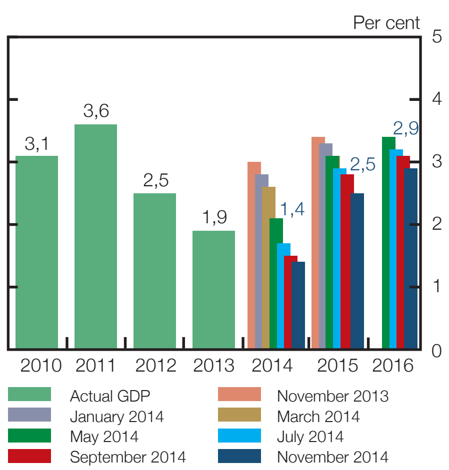
5 For dual-listed firms, capital could be raised either through the JSE or the other exchange on which they were listed, and not all firms specified the location of issuances.

6 Many large companies on the JSE are dual-listed, and the profit destination depends on the primary listing of the company. Dividends will nonetheless flow to shareholders wherever they are resident.

The corollary of weak growth in South Africa's trading partners has been very loose monetary policy in those economies, lowering borrowing costs and encouraging a search for yield. This has led to increased non-resident demand for bonds and equities, purchases of which have financed most of the current account deficit since 2010. Over the past five years, non-residents have purchased net equities to the value of R38,3 billion and net bonds worth R140,1 billion. However, South Africa's substantial external financing requirements create vulnerability to changing risk attitudes in financial markets. South Africa saw dramatic capital outflows during the May 2013 'taper tantrum', and since then, non-residents have sold over R62 billion of South African bonds (net).

The Bank's growth forecasts

Figure 50 Evolution of the Bank's real GDP forecasts



Sources: Statistics South Africa and South African Reserve Bank

Since November 2013 the forecast for real GDP growth for 2014 has shrunk to 1,4 per cent, lower even than 2013's disappointing 2,2 per cent. Growth is expected to pick up gradually in 2015 and 2016, but the pace of the recovery is slower than previously anticipated, with growth still fractionally below 3 per cent in the second year of the forecast.

The main drivers of improved growth are really just returns to normalcy. The world economy is expected to pick up from its current lows, led by the US, thus raising exports. Similarly, the 2014 strikes were exceptionally severe and are unlikely to be repeated. A more natural number of working days will raise earnings and support consumer spending. Once this rebound is effected, growth is expected to persist at levels above 2013 and 2014, but below the pre-crisis period. Households are already heavily indebted which will continue to suppress spending and confidence; household consumption is therefore forecast to grow more slowly than overall GDP over the next two years. Similarly, government's need to consolidate its finances will also depress demand growth. Investment from the public and private sector, is expected to do better, especially in the outer years of the forecast as spending plans by parastatals come to fruition and private-sector investment rebounds.

Although the US remains the world's largest economy, it will have little help from other economies and will struggle to pull the world out of stagnation by itself. Net exports for South Africa will therefore be constrained, both by stronger investment (and therefore capital goods imports) and a paucity of foreign demand.

Risks to growth

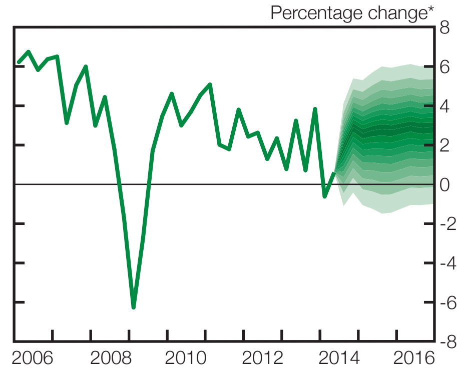
South Africa's growth has long been constrained by deep structural factors, with skills shortages and spatial legacies perhaps especially damaging. These factors have lately been exacerbated by additional problems in the form of dysfunctional labour relations and electricity shortages and these, along with a struggling world economy, now pose the most acute risks to resumed growth.

Strike action in 2014 has been unusually severe, carrying the threat of longer and more violent strikes. Should these become the norm, the case for investing in South Africa would be weakened and there would be stronger incentives for substituting capital for labour. Large salary and wage increases, in excess of productivity gains and inflation, are also a threat to South Africa's competitiveness. Such increases would potentially reverse real exchange-rate gains and prolong the current-account deficit, high inflation and weak growth.

Electricity-supply constraints have proven even tighter than originally anticipated, presenting another barrier to investment, especially in the manufacturing and mining sectors. Large new investments in capacity are under way, particularly the Kusile and Medupi power stations, but even once these come online existing capacity will be desperately in need of maintenance and therefore electricity constraints will not be satisfactorily lifted. November furnished an effective demonstration of the problem when an accident at the Majuba power station in Mpumalanga forced rolling blackouts, reminiscent of the electricity crisis of 2008.

Growth prospects are also at risk from external demand. A stronger US economy should grow at around 3 per cent over the next two years, before reverting to potential of about 2,1 per cent, but it has repeatedly failed to achieve 3 per cent annual growth since the crisis. It is also unlikely that the US can power a robust world recovery unaided. The euro area is expected to see a moderate uptick in growth, but this is endangered by geopolitical risks and weakness in the three largest economies, Germany, France and Italy. China has so far managed a relatively smooth growth deceleration but could still suffer a hard landing. Japan's unexpected contraction in the third quarter of 2014 suggests it will struggle to achieve a new era of growth, especially if it also proceeds with VAT increases to improve its fiscal position. Many emerging markets require difficult reforms to restore growth, and some, including fast-growing sub-Saharan African countries, are exposed to falling commodity prices and rising borrowing costs. In sum, global growth confronts a host of risks and could quite easily fall below forecasts.

Figure 51 Real GDP growth forecast



* At seasonally adjusted annualised rates

Source: South African Reserve Bank

Conclusion

Inflation has been high all year, either near the top end of the target or above it. Expectations are clustered just above 6 per cent and core inflation has persisted in its steady upward drift, from 3 per cent in early 2011 to 5,7 per cent in October 2014. However, positive oil and food price shocks have recently lowered the headline inflation forecasts. Expected inflation for 2015 has declined from 5,7 per cent to 5,3 per cent, and the risks to this forecast appear quite evenly balanced.

Domestic growth has been weak. The economy has suffered a series of short-term shocks, especially strikes. In addition, potential growth appears to have declined. The output gap remains negative, although smaller than previously estimated, and credit growth is slow, contributing to minimal inflationary pressures from the demand side.

Domestic imbalances, meanwhile, are a source of vulnerability. Substantial fiscal deficits since the crisis have expanded the state's debt burden, and growth is unlikely to rebound strongly enough that these deficits will fall significantly without separate policy adjustments. The current account deficit requires financing, exposing South Africa to changing risk assessments and appetites in financial markets. This danger is mitigated by the floating exchange rate, but further currency depreciation remains an inflation risk.

South Africa's major macroeconomic settings are being adjusted. The pace of fiscal consolidation has accelerated. Monetary policy has embarked on a moderate rate-hiking cycle. This has so far taken the form of two rate increases in six meetings, for a total of 75 basis points. The scale and timing of future increases will depend on various factors, including inflation expectations, wage developments and changes in the global financial environment.

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 – the 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

17 July 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 economic growth outlook has deteriorated against the backdrop of protracted strike action in the mining and manufacturing sectors. The economy contracted in the first quarter of 2014, and the growth outlook for the rest of the year remains subdued amid low business confidence. Compounding the MPC's policy dilemma, inflation has breached the upper end of the target range, driven primarily by the exchange-rate depreciation and rising food prices, while a possible wage-price spiral resulting from recent wage settlements and wage demands considerably in excess of inflation and productivity growth have added to the upside risk to the inflation outlook.

The year-on-year inflation rate as measured by the consumer price index (CPI) for all urban areas measured 6,6 per cent in May, up from 6,0 per cent and 6,1 2 per cent in March and April 2014 respectively. The main driver of this marked acceleration was food and non-alcoholic beverage price inflation which measured 8,8 per cent in May compared with 7,0 per cent and 7,8 per cent in the previous two months respectively. This category contributed 1,3 percentage points to the headline CPI outcome, compared with a recent low of 0,5 percentage points in December 2013. The categories of food, housing utilities and transport together accounted for 4,2 percentage points of the inflation outcome in May, compared with 3,7 percentage points in the previous month. The transport index increased at an annual rate of 8,9 per cent, from 6,8 per cent in April, despite a 15 cents per litre decline in the petrol price in May. Core inflation, which excludes food, petrol and electricity, remained unchanged at 5,5 per cent for the third consecutive month. Administered price inflation excluding petrol was unchanged from the previous month at 6,5 per cent. The headline producer price inflation for final manufactured goods moderated slightly from 8,8 per cent in April to 8,7 per cent in May, driven in part by lower agricultural product inflation.

The marginal improvement in the Bank's forecast of headline inflation at the previous meeting has been more or less reversed, as recent food price developments surprised on the upside. Inflation is now expected to average 6,3 per cent in 2014, compared with 6,2 per cent previously, with the quarterly peak of 6,6 per cent (previously 6,5 per cent) still expected in the fourth quarter, following a slight moderation in the third quarter. The forecast average inflation for 2015 increased to 5,9 per cent from 5,8 per cent, while the forecast for 2016 increased marginally to 5,6 per cent, and to 5,5 per cent in the final quarter of that year. Inflation is still expected to return to within the target band during the second quarter of 2015 provided that there are no further shocks to the system, particularly from possible higher tariff increases being granted to Eskom by the National Energy Regulator of South Africa (Nersa) from 2015.

The forecast for core inflation is unchanged. This measure is expected to average 5,6 per cent and 5,7 per cent in 2014 and 2015 respectively, moderating to 5,5 per cent in 2016, with the moderate upward pressure coming from the lagged effects of the exchange-rate depreciation rather than evidence of strong domestic demand pressures. As before, the MPC sees the risks to the headline inflation forecast to be skewed to the upside.

Inflation expectations as reflected in the survey conducted by the Bureau for Economic Research (BER) at Stellenbosch University have remained anchored at the upper end of the target band. The average inflation expectation of analysts, business people and trade union officials for this year and next year has remained unchanged for six consecutive quarters at 6,1 per cent for both years, declining to 5,9 per cent in 2016. Within these categories, the largest change was by business people for 2016, where expectations increased from 6,2 per cent in the previous survey to 6,4 per cent. However, their expectation for 2015 moderated slightly. Inflation expectations of households for 2014 declined from 6,7 per cent in the first quarter to 6,3 per cent in the second quarter.

The Reuters survey of inflation expectations of economic analysts conducted in May remained more or less unchanged since the previous survey, with a slight upward shift. The outcome of the survey shows a divergence of views among analysts as to whether inflation will peak in the second or fourth quarter of 2014. On average, the expectation is for inflation to peak in the second quarter, at an average of 6,4 per cent, and to return to within the target range in the first quarter of 2015. According to the survey, annual inflation is expected to average 6,2 per cent in 2014, and 5,7 per cent and 5,5 per cent in the subsequent two years respectively.

The global economy continues to exhibit mixed signals regarding the economic growth outlook. Since the previous meeting of the MPC, consensus forecasts for growth in 2014 have been revised downwards for the United States (US) and the eurozone, but those for Japan and the United Kingdom (UK) have been revised upwards. The earlier optimism that the US would grow at around 3 per cent in 2014 has been moderated following the 2,9 per cent annualised contraction in the first quarter, partly as a result of severe weather conditions and a decline in expenditure on health care. Most analysts now expect US growth to be closer to 2 per cent. This weaker growth is despite larger-than-expected improvements in the unemployment rate. The outlook for the eurozone has also deteriorated, following weak industrial output in Germany in May, and slowing growth in France and Italy. Real output in Japan is expected to contract in the second quarter following the surge in expenditure in the first quarter in advance of the increase of consumption taxes. The UK recovery, however, appears to be sustained with growth of around 3 per cent expected in 2014.

The outlook for emerging markets remains relatively subdued, but some emerging Asian economies have benefited from stronger US growth. The Chinese economy is expected to grow by just under 7,5 per cent in 2014, although concerns about the shadow banking system remain. Subdued growth is expected in a number of emerging markets, including Brazil, Russia, Thailand and Argentina.

Global financial-market developments remain dominated by expectations of changes in monetary policy in the advanced economies, amid concerns that the current low interest rate and low volatility environment may encourage excessive risk taking and asset price bubbles. By contrast to a number of emerging-market economies, inflation remains benign in the advanced economies, although the risk of deflation in the eurozone persists. The UK is expected to be the first advanced economy to raise interest rates, but at a moderate pace, while the US is generally not expected to begin the process of normalisation before the third quarter of 2015. However, the tapering of bond purchases by the US Federal Reserve (Fed) is expected to continue at a steady pace. This process is fully discounted in the markets, and is expected to be completed later this year.

By contrast, the European Central Bank (ECB) has recently announced a range of new monetary policy measures aimed at stimulating the economy through encouraging bank lending and preventing deflation, while Japanese monetary policy is expected to remain highly stimulatory for some time. Since the previous meeting of the MPC, a number of countries have reduced their policy rates, including the eurozone, Sweden, Mexico, Hungary and Turkey, while the tightening cycle continued in New Zealand.

The exchange rate of the rand continues to pose an upside risk to the inflation outlook. Having appreciated to a level of R10,29 against the US dollar soon after the previous MPC meeting, the rand exchange rate followed a depreciating trend, reaching a new trading range of between R10,60 and R10,80 since the beginning of June. Since the previous meeting, the rand has depreciated by 2,6 per cent on a trade-weighted basis. The appreciation of the rand in May was in response to more benign global factors as market participants absorbed the forward guidance provided by the central banks in the advanced economies. This contributed to lower risk aversion and renewed flows to emerging markets in general. Since the previous meeting, non-resident net purchases of bonds and equities have amounted to R7,2 billion, and R44,2 billion since the beginning of February.

Despite these inflows, since early June the rand has largely decoupled from its emerging-market peers, and depreciated relative to most currencies, as it reacted to deteriorating domestic fundamentals. These included the negative gross domestic product (GDP) growth rate, the adverse reports from the ratings agencies, and the protracted nature of the platinum and metal workers' strikes. The impact of the platinum-sector strikes on exports began to be felt in April and May, and it is estimated that during these two months the value of platinum group metals (PGM) exports was around R20 billion lower than during the first quarter. This is likely to put pressure on the current account of the balance of payments in the second quarter, following a narrowing of the deficit in the first quarter to 4,5 per cent of GDP.

South Africa's growth outlook has deteriorated since the previous meeting of the MPC, compounded by continued labour disruptions. Following a contraction of 0,6 per cent in the first quarter, the outlook for the second quarter is expected to be positive but subdued, particularly in the light of weak mining and manufacturing data in May. The Bank's latest forecast, which assumes a speedy resolution of the metal workers' strike, sees growth in 2014 at 1,7 per cent, compared with 2,1 per cent previously and 2,8 per cent at the beginning of the year. Growth forecasts for the coming two calendar years have been reduced to 2,9 per cent and 3,2 per cent, from 3,1 per cent and 3,4 per cent respectively. The Rand Merchant Bank (RMB)/BER Business Confidence Index remained low and unchanged at 41 index points in the second quarter of 2014, with a sharp decline particularly evident among manufacturers. The Bank's leading indicator of economic activity declined moderately, reflecting subdued growth expectations.

The weak business confidence is mirrored in the 2,6 per cent growth in gross fixed capital formation in the first quarter of 2014. Growth in fixed investment by the private sector, which accounts for about two thirds of gross fixed capital formation, weakened further, from 2,4 per cent in the fourth quarter of 2013 to 1,0 per cent in the first quarter of 2014.

The mining sector contracted by an annualised 24,7 per cent in the first quarter of 2014, and although mainly driven by the strike-induced decline in PGM output, the contraction was fairly broad-based across the sector. Despite a higher-than-expected performance in April, the data for May show that the outlook for the second quarter is also bleak. In May the physical volume of mining output declined by (a non-annualised) 3,1 per cent on a month-to-month basis, and by 5,6 per cent on a three-month-to-three-month basis, with PGM output declining by 34,1 per cent. While the strike is over and miners are returning to work, PGM production is not expected to normalise for some time, and possible shaft closures could reduce the longer-term potential of the sector.

The manufacturing-sector performance in the first two months of the second quarter has also been disappointing, following the 4,4 per cent contraction in the first quarter. In May manufacturing output declined by 3,7 per cent on a year-on-year basis, and by 2,0 per cent on a three-month-on-three-month basis. The sector was negatively impacted by electricity supply constraints and the platinum-sector strike, while the current strike by metal workers is likely to undermine the outlook for the third quarter. The Kagiso Purchasing Managers' Index (PMI) registered a slight improvement in June, measuring 46,6 index points, but has remained below the neutral 50 index point level for three consecutive months.

Trends in employment growth are indicative of the weak private-sector investment. Although formal non-agricultural employment increased for the third consecutive quarter in the first quarter of 2014, all the gains were in the public sector. While overall employment increased by 42 000 jobs in the year to the end of March, 49 000 jobs were created in the public sector while the private sector shed jobs, particularly in the mining sector where almost 29 000 jobs were lost.

Final consumption expenditure by households remains the main driver of GDP growth, but with a declining contribution of 1,2 percentage points in the first quarter of 2014. Growth in household consumption expenditure, which measured 2,6 per cent in 2013, declined to 1,8 per cent in the first quarter of 2014, with a marked moderation in the growth of expenditure on durable goods and a contraction in spending on non-durable goods. Real retail sales growth contracted by 0,8 per cent on a three-month-to-three-month basis in May, and increased at a month-to-month rate of 0,8 per cent. Domestic motor vehicle sales declined by 2,3 per cent on a year-on-year basis, but increased by 4,7 per cent on a month-to-month basis in June. Despite these weak trends, consumer confidence surprised on the upside in the second quarter, with the FNB/BER Consumer Confidence Index increasing from -6 to 4 index points, although respondents do not deem the present time as appropriate to buy durable goods.

Growth over twelve months in total loans and advances to the private sector measured 8,2 per cent in May 2014, but the divergent trends in bank credit extended to households and the corporate sector have continued. Growth in credit extended to the corporate sector has been steadily increasing since the beginning of the year, measuring 13,3 per cent in May, due in part to renewable energy contracts. By contrast, growth in credit extended to the private sector has continued to trend downwards, to measure 4,3 per cent in May. Twelve-month growth in general loans to households, mainly unsecured lending, declined to 2,8 per cent in May; its lowest growth since February 2005. Mortgage credit extension remained within the 2 to 3 per cent range observed since January 2013, and instalment sale credit and leasing finance also continued to moderate from growth rates of around 13 per cent in the second half of 2013 to 8,6 per cent in May. These credit extension trends to households reflect a combination of weakening household consumption expenditure and stricter bank lending criteria for unsecured loans in particular. Household debt to disposable income remains elevated, but declined marginally to 74,5 per cent in the first quarter of 2014.

The trend in wage settlements poses an upside risk to the inflation outlook, and these pressures are likely to intensify in the current difficult labour relations environment. According to Andrew Levy Employment Publications, the average wage settlement rate in collective bargaining agreements increased from 7,9 per cent in the first quarter of 2014 to 8,1 per cent in the second quarter. However, increases over four quarters in nominal unit labour costs in the formal non-agricultural sector declined from 5,9 per cent in the fourth quarter of 2013 to 4,8 per cent in the first quarter of 2014. The MPC is concerned that recent wage settlements in the mining sector and current demands in the metals sector could set a precedent for wage demands more generally. Unless accompanied by higher productivity, such settlements could generate a wage-price spiral, and are also likely to have a negative impact on employment trends. While the focus has generally been on wage demands, there is an imperative for attention to also be paid to excessive salaries and bonuses of management and executives.

Food prices have been one of the main drivers of inflation since the beginning of the year and have generally surprised on the upside in recent months. There are, however, some tentative indications that we may be near the peak: in May manufactured food producer price inflation moderated for the first time since October 2013 and measured 8,9 per cent, down from 9,5 per cent in April. Agricultural producer price inflation declined from a recent peak of 13,3 per cent in March to 6,7 per cent in May reflecting in part the sharp decline in maize prices to export parity price levels. Prices of cereals and other crops declined by 0,8 per cent in May, having reached a recent peak of 27,6 per cent in February. Global food price pressures are also benign, with the year-on-year inflation rates as reflected in the Food and Agriculture Organization (FAO) food price index being negative for twelve consecutive months. Apart from weather-related risks, the overall trend in food prices will remain highly sensitive to exchange-rate developments.

Despite recent geopolitical risks, particularly in Ukraine and Iraq, international oil prices have remained relatively stable. Apart from a brief spike to a level of around US$115 per barrel in June, the price of Brent crude oil has generally traded in a range of US$105 and US$110 per barrel, and is currently at around US$105 per barrel. Domestic petrol prices have therefore been driven primarily by exchange-rate changes. Following the appreciation of the rand in April, the petrol price was reduced by a total of 37 cents per litre in May and June, but this was largely reversed in July when the price increased by 31 cents per litre. If the current trends persist, a further small increase in the petrol price can be expected in August.

The MPC remains concerned about weak growth, the widening output gap and the negative employment outlook. The strike in the platinum sector contributed to the downward revision of the growth forecast, and the latest forecast has not factored in the possibility of a protracted work stoppage by the metal workers, which would potentially have much wider ramifications because of the direct linkages to other sectors of the economy. This weak growth outlook, however, is not something that monetary policy can ameliorate.

The MPC is also increasingly concerned about the inflation outlook and the further upside risks to the forecast. Although the exchange rate remains a key factor in this regard, the possibility of a wage-price spiral, should wage settlements well in excess of inflation and productivity growth become an economy-wide norm, has increased. Although the inflation trajectory has not deteriorated markedly since the previous meeting, upside risks have increased, and it is expected to remain uncomfortably close to the upper end of the target range when it does eventually return to within the target. The upside risk factors make this trajectory highly vulnerable to any significant changes in inflation pressures.

Although inflation expectations have remained relatively anchored, should inflation persist outside the target band, these expectations risk becoming dislodged.

The MPC is, however, cognisant of the fact that the inflation pressures do not reflect excess demand conditions in the economy. Household consumption expenditure remains weak and credit extension to households is contracting in real terms. However, we do have to be mindful of second-round effects of supply-side shocks.

The MPC faces an increasingly difficult dilemma of rising inflation and slowing growth. The core mandate of the Bank remains price stability but, at the same time in achieving this mandate, we have to be mindful of the impact of our actions on economic growth and tread a fine line between acting effectively to address the inflation objective while not undermining growth unduly.

The MPC has decided to continue on its gradual normalisation path and raise the repurchase rate by 25 basis points to 5,75 per cent per annum, effective from Friday, 18 July. Given the expected inflation trajectory, the real repurchase rate remains slightly negative and well below its longer-term neutral level. The monetary policy stance remains supportive of the domestic economy and, as before, any future moves will be gradual and highly data-dependent.

We would like to reiterate that monetary policy should not be seen as the growth engine of the economy. The sources of the below-par growth performance are largely outside the realms of monetary policy. In the short term, an improvement in the interaction and relationships between management and labour is essential to foster a climate of trust and confidence, and get South Africa back to work. Given that the key headwinds preventing a return to trend growth are structural, there is an urgent need to implement necessary structural reforms, as envisaged in the National Development Plan, in order to achieve higher and more inclusive growth.

Statement of the Monetary Policy Committee

18 September 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 domestic inflation forecast has improved slightly, but the inflation trajectory remains uncomfortably close to the upper end of the target range. At the same time, the domestic economic growth outlook has deteriorated further, with declining growth in both consumption expenditure and gross fixed capital formation, as confidence remains low. The combination of stubborn inflation and a sluggish growth outlook continues to pose a difficult dilemma for monetary policy.

The global environment has been characterised by increased financial market volatility following heightened speculation relating to the timing and extent of United States (US) monetary policy normalisation. This impacted on emerging-market currencies in general, and on the rand in particular. This was further illustrated after yesterday's Federal Open Market Committee (FOMC) meeting which reaffirmed the gradual pace of US monetary policy normalisation and its data-dependent nature. However, despite increased political instability and significant risks in a number of regions, the international oil price has declined along with continued weakness in global food prices, contributing to a more benign global backdrop for the domestic inflation outlook.

The year-on-year inflation rate as measured by the consumer price index (CPI) for all urban areas surprised on the upside at 6,4 per cent in August, having measured 6,6 per cent and 6,3 per cent in June and July 2014 respectively. The higher turnout was mainly due to higher-than-expected food prices, which had been anticipated to continue their recent downward trend. Downward pressure was exerted by petrol prices which increased by 5,8 per cent, down from 8,3 per cent in July. The categories of food, housing utilities and transport together accounted for 3,8 percentage points of the inflation outcome in August, unchanged from the previous month. Core inflation, which excludes food, petrol and electricity, increased to 5,8 per cent from 5,7 per cent in July, driven mainly by the impact of the weaker exchange rate on some goods categories.

Administered price inflation excluding petrol measured 6,5 per cent, up from the 6,4 per cent measured in July. The headline producer price inflation for final manufactured goods, which reached a recent high of 8,8 per cent in April, measured 8,1 per cent and 8,0 per cent in June and July respectively, driven in part by lower agricultural product inflation.

The Bank's forecast of headline inflation is slightly more favourable than that presented at the previous meeting, mainly a result of lower expected food and petrol price pressures. Whereas for some time inflation had been forecast to peak at an average of 6,6 per cent in the fourth quarter of this year, the peak now appears to have occurred in the second quarter, at an average of 6,5 per cent. Inflation is now expected to average 6,2 per cent in 2014, compared with 6,3 per cent previously, and 5,7 per cent in 2015 (5,9 per cent previously), and to return to within the target range in the first quarter of 2015 instead of the second quarter as previously forecast. The inflation forecast for 2016 increased to 5,8 per cent from 5,6 per cent, mainly as a result of the revised electricity price assumption following the review of Eskom tariffs by the National Energy Regulator of South Africa (Nersa). The revised assumption makes provision for electricity price increases of 11,6 per cent from July 2015 and again from July 2016.

The forecast for core inflation is unchanged at an average 5,6 per cent and 5,7 per cent in 2014 and 2015 respectively, reaching a peak of 5,8 per cent in the first quarter of 2015, and moderating to 5,5 per cent in 2016. As before, the MPC sees the risks to the headline inflation forecast to be skewed to the upside, with possible renewed pressure coming from the exchange rate.

Inflation expectations, as reflected in the survey conducted by the Bureau for Economic Research (BER) at Stellenbosch University in the third quarter of 2014, have again remained more or less unchanged, and anchored at around the upper end of the target range. Inflation is expected to average 6,2 per cent in 2014 and 6,1 per cent and 6,0 per cent in 2015 and 2016 respectively. As usual, there is a fairly wide dispersion of expectations between the different categories of respondents. While business people expect inflation to average 6,4 per cent in 2015 and 2016, analysts' expectations average 5,7 per cent and 5,4 per cent. Expectations of trade unionists are for 6,2 per cent in both years, and all categories of respondents expect inflation in the current year to average 6,2 per cent. Household inflation expectations for 2014 remained unchanged at 6,3 per cent.

The global growth recovery remains asynchronous amid sustained improvements in the US and United Kingdom (UK), and deteriorating prospects in the eurozone and Japan. Although growth in the US is not expected to exceed the 2,2 per cent achieved in 2013, this is mainly a result of the contraction during the first quarter of this year. Real output growth of 4,2 per cent was recorded in the second quarter of 2014, and consensus forecasts are for growth rates of around 3 per cent in the next two quarters. Similar growth rates are expected in 2015. At the same time, the unemployment rate has been declining at a faster pace than previously anticipated. While the growth outlook for the UK remains positive, possible downside risks could emerge should Scotland vote for independence from the UK.

Growth in the eurozone has remained weak, with the German economy also under pressure following a contraction in the second quarter. Sanctions on Russia are expected to be an additional constraint affecting the eurozone's growth outlook. Although the Japanese economy appears to be recovering from the value-added tax (VAT)-induced slump in the second quarter, the recovery looks fragile.

While emerging Asia appears to be benefiting most from the US recovery, emerging markets generally are facing increasing headwinds. Signals coming out of China continue to be mixed amid a sharp slowdown in industrial production in August. Latin American economies also face a challenging outlook, particularly in Argentina, Venezuela and Brazil, which are currently experiencing a technical recession. Growth in sub-Saharan Africa is expected to remain relatively strong, although commodity producers may be adversely affected by lower commodity prices and possible spillover effects from the Ebola outbreak.

There is a continued absence of significant upside global inflation risks despite pressures experienced in some emerging markets. The various indicators of US inflation remain well contained below the 2 per cent level, while the fear of deflation in the eurozone persists. Declining international oil and food prices, along with a number of other commodity prices, are expected to reinforce the current benign global inflation environment.

The divergent growth outlooks in the advanced economies are likely to be the main drivers of monetary policy developments. The UK is expected to tighten monetary policy early next year. The stronger performance of the US labour market has led to heightened speculation that normalisation may begin earlier than previously anticipated. These expectations resulted in an appreciation of the US dollar against most currencies, as well as rising long-term US Treasury yields ahead of yesterday's FOMC meeting. At yesterday's press conference, the FOMC Chair reaffirmed the view that policy normalisation will occur gradually, but is contingent on no surprises to employment growth or inflation in either direction.

The data-dependent nature of the forward guidance means that changes in the outlook for inflation, unemployment and growth are likely to lead to bouts of global financial market uncertainty in advance of FOMC meetings in the coming months.

At the same time, however, the European Central Bank (ECB) has loosened monetary policy and has indicated its willingness to embark on some form of quantitative easing should this be necessary. Monetary policy is also expected to remain accommodative for some time in Japan. Since the previous meeting of the MPC, policy rates have been reduced in the eurozone, Israel, South Korea, Chile and Hungary, and increased in Russia and New Zealand.

Following a few weeks of relative stability, the rand exchange rate weakened in the past few days in response to US dollar strength, as well as the widening deficit on the current account of the balance of payments to 6,2 per cent of gross domestic product (GDP). Since the previous meeting of the MPC, the rand initially traded in a range of R10,50 and R10,75 against the US dollar, but has weakened since early September, reaching a low of R11,07. On a trade-weighted basis, however, the rand depreciated by 0,4 per cent, having appreciated against the euro and the British pound. The rand is expected to remain sensitive to changes in sentiment regarding possible changes in US policy which will affect the appetite for emerging-market assets generally, as well as to possible impacts from geopolitical risks and domestic factors.

Since the previous MPC, non-residents have been net sellers of bonds to the value of R29,3 billion, but this has been offset in part by net purchases of equities to the value of R16,2 billion over the same period. In the year to date, there have been net outflows of bonds and equities to the value of R6,3 billion. These trends indicate that the financing of the current account through portfolio inflows is likely to become increasingly challenging.

The current-account deficit in the second quarter of 2014 was wider than generally expected by the markets, following the 4,5 per cent of GDP recorded in the first quarter. This widening was a result of increased dividend outflows, lower dividend inflows following a large one-off inflow during the first quarter, and weak export growth, impacted to some extent by the platinum strike. Export growth in the third quarter is expected to remain constrained by the slow return to full capacity production by the platinum mines and the strike in the steel and engineering sector in July, which had significant spillover effects on the manufacturing sector in general. The current account is anticipated to narrow gradually over time.

The domestic economic growth outlook remains weak following growth rates of -0,6 per cent and 0,6 per cent in the first and second quarters of the year respectively. These growth rates are well below potential output growth and indicative of a widening output gap. Partly as result of this outcome, as well as the expected impact of the metal workers strike in July, the Bank's forecast for GDP growth for 2014 has been revised down further to 1,5 per cent, from 1,7 per cent previously, with the risks still assessed to be on the downside. The forecasts for both 2015 and 2016 have been revised down by 0,1 percentage points to 2,8 per cent and 3,1 per cent respectively. The Bank's leading indicator of economic activity continues to trend sideways, consistent with a subdued growth outlook. Business confidence, as reflected in the Rand Merchant Bank/Bureau for Economic Research (RMB/BER) Business Confidence Index, remains negative despite a 5 index point increase to 46 in the third quarter. Adding to prevailing concerns are indications from Eskom that electricity supply constraints may be more severe and endure for longer than previously expected.

The near-term outlook for mining remains subdued, with platinum production not expected to return to full capacity before the end of the year. In July, mining production recorded a broad-based year-on-year decline of 7,7 per cent, but a 0,9 per cent increase on a month-to-month basis. Manufacturing output declined significantly in July, recording year-on-year and month-to-month contractions of 7,9 per cent and 5,4 per cent respectively, largely due to the impact of the four-week strike in the steel and engineering subsector. Capacity utilisation in the sector declined from 82,1 per cent in the first quarter of 2014 to 80,6 per cent in the second quarter. More positively, the Kagiso Purchasing Managers' Index (PMI) reflected some improvement in sentiment in August, with the index rising 3,1 index points to 49, marginally below the neutral level, while the construction sector has recorded growth rates of 5 per cent in the first two quarters of the year.

Growth prospects have been constrained by the weakening trend in gross fixed capital formation which grew at an annualised rate of 0,5 per cent in the second quarter. Real fixed capital expenditure by both the public corporations and the private sector contracted during the quarter. Of particular concern is the continued downward trend over the past three quarters in private-sector investment, despite higher capital outlays in the manufacturing sector. This has been reflected in the continued slow pace of employment creation in the private sector and the rise in the unemployment rate to 25,5 per cent in the second quarter of 2014.

Consumption expenditure by households also continued its moderating trend which began in the first quarter of 2012 amid declining real disposable income growth. Annualised growth of 1,5 per cent was recorded in the second quarter of 2014. The slowdown was particularly marked in the durable and semi-durable goods categories, probably impacted by the prolonged strikes in the mining and manufacturing sectors. Retail trade sales contracted by 0,9 per cent in June on a month-to-month basis, but increased by 1,2 per cent in July, higher than generally expected. Wholesale trade sales contracted by 5,2 per cent month-to-month in July, and by 4,6 per cent year-on-year. Domestic vehicle sales have also slowed. Given the above, somewhat surprisingly the First National Bank/Bureau for Economic Research (FNB/BER) Consumer Confidence Index increased from -6 to +4 in the second quarter.

Trends in credit extension to households are consistent with the weak growth in household consumption expenditure, showing a further divergence between credit extension to households and to the corporate sector. Growth in total loans and advances over the year measured 9,7 per cent in July, with lending to the corporate sector increasing by 17 per cent and to households by 4,1 per cent. The latter reflects continued sluggish growth in mortgage credit extension and tighter credit criteria for unsecured lending in particular. Twelve-month growth in general loans to households, which is mainly unsecured lending, reached a low of 0,2 per cent in July, while growth over three months exhibited an annualised contraction of 2,5 per cent. This decline is across all income groups, but more pronounced at the lower levels. A positive development is that household debt to disposable income moderated from 74,4 per cent in the first quarter to 73,5 per cent in the second quarter.

Growth in corporate-sector borrowing during the first half of the year was dominated by the agricultural sector, electricity supply (renewable energy projects) as well as the wholesale and retail trade sectors. The cost of bank funding appears to have increased recently as a result of changed regulatory requirements relating to the implementation of Basel III, the impact of the bail-in of certain African Bank Limited creditors and the consequent rating action by Moody's Investors Service, all of which could result in tighter funding conditions.

No new wage and unit labour cost data have been released since the previous meeting of the MPC, although settlements in the steel and engineering sector and the clothing sector have been well above current and expected inflation rates. The MPC remains concerned about the apparent delinking of wage demands and some wage settlements from underlying inflation and productivity growth trends, as well as the possible impact of forthcoming wage negotiations, including in the public sector. These concerns relate to settlements at all levels, including executive pay. Excessive wage settlements could have adverse impacts on employment, inflation, the general competitiveness of the economy, and the profitability and viability of small businesses in particular.

Notwithstanding the 9,5 per cent increase in July, food price inflation is expected to slow over the coming months. Pipeline pressures from agricultural prices continue to moderate following sharply lower maize prices since March, while manufactured food price inflation declined to 8,5 per cent in July, compared with 9,5 per cent in April. International food prices, as reflected in the Food and Agriculture Organization (FAO) international food price index, declined for the fifth consecutive month in August 2014 in response to positive maize and wheat supply conditions. These developments are expected to impact favourably on domestic consumer prices, although base effects are likely to interrupt the declining year-on-year trend in the final months of the year.

International oil prices declined in recent weeks, having traded in a range of between US$105–US$114 per barrel for the year to the end of July. Since August, the price has fallen below this range and is currently trading at around US$98 per barrel. This is despite rising tensions and instability in the Middle East and conflict in Ukraine, events that in the past would likely have resulted in an oil price spike. As a result of this lower price, the domestic petrol price was reduced by 67 cents per litre in September, having been unchanged in August. At this stage there is an average over-recovery on the petrol price due to the lower international price, but the favourable impact is being partially offset by continued rand weakness.

Despite the slight near-term improvement in the inflation outlook and the relatively stable inflation expectations, the MPC is concerned that the forecast remains uncomfortably close to the upper end of the target band. Given the upside risks to the forecast, the proximity to the upper end of the band makes the inflation outcomes highly vulnerable to changes in inflationary pressures.

A key upside risk is the exchange rate, which is vulnerable to the slow pace of adjustment to the current-account deficit, as well as to the uncertainty surrounding the future path of monetary policy in the advanced economies. At this stage it is difficult to assess the extent to which normalisation of US monetary policy is already priced in to the rate.

The MPC remains concerned about the risks of a wage-price spiral, should settlements well in excess of inflation and productivity growth become the economy-wide norm. Such developments could also undermine South Africa's international competitiveness and delay the current-account adjustment.

The deterioration in the longer-term inflation trajectory relative to the previous forecast is a result of the revised tariff increases granted to Eskom by Nersa. The view of the MPC is that such relative price adjustments should not be reacted to automatically. However, while the focus of monetary policy should be on the second-round effects of these increases, this is complicated given the multi-year nature of the adjustment.

While inflation is the primary focus of the Committee, the MPC is also mindful of the anaemic state of the domestic economy, rising unemployment and the downside risk to its growth forecast. Domestic expenditure has deteriorated further, particularly private-sector fixed capital formation and, together with continued moderation in household consumption expenditure, is indicative of the lack of demand pressures in the economy.

The MPC is still of the view that interest rates will have to normalise over time. However, given the slightly improved inflation outlook notwithstanding the upside risks, the stable inflation expectations and the downside risks to the weak growth outlook, the MPC has decided that the repurchase rate will remain unchanged at 5,75 per cent per annum.

Despite the 75 basis point increase so far this year, monetary policy remains accommodative, and will continue to be supportive of the domestic economy subject to achieving its primary inflation-targeting objective. Future decisions will, as always, be highly data-dependent.

Statement of the Monetary Policy Committee

20 November 2014

Issued by Lesetja Kganyago, 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 sharp decline in international oil prices has contributed to a more benign global inflation environment. This development may also ameliorate the deteriorating growth outlook in some regions by providing a boost to consumption expenditure. Lower oil prices have also had a favourable impact on domestic headline inflation, with the medium-term forecast improving relative to the previous forecast. However, the underlying inflation pressures, as reflected in core inflation, persist.

The domestic growth outlook remains challenging, but after two quarters dominated by the fall-out from extended strikes, some recovery is expected, but demand remains subdued. The coming quarters are expected to see an improved performance in the mining and manufacturing sectors, but the outlook is inhibited by domestic structural constraints, as well as by a weak global economy and the continued declining trend in non-oil commodity prices. Growth next year is expected to remain weak.

The year-on-year inflation rate as measured by the consumer price index (CPI) for all urban areas measured 5,9 per cent in both September and October, having measured 6,4 per cent in August. Downward pressure on inflation in October came from continued moderation in food and petrol prices. Food price inflation continued its downward trend, measuring 8,0 per cent in October, down from 8,7 per cent previously, while petrol prices increased by 2,4 per cent. Core inflation, which excludes food, petrol and electricity, moderated to 5,6 per cent in September from 5,8 per cent in August, but measured 5,7 in October, reflecting primarily continued exchange-rate pass-through to some goods categories.

Administered price inflation excluding petrol measured 6,4 per cent in October, down from 6,5 per cent in September. Headline producer price inflation for final manufactured goods, which reached a recent high of 8,8 per cent in April, measured 7,2 per cent and 6,9 per cent in August and September respectively, driven in part by lower food and fuel price inflation.

The Bank's forecast of headline inflation has improved since the previous meeting of the MPC, mainly due to the impact of declining international oil prices. Having reached a peak of 6,5 per cent in the second quarter of this year, inflation is now expected to average 5,9 per cent in the final quarter of 2014, and average 6,1 per cent for the year, compared with 6,2 per cent previously. The downward trend is expected to continue into next year, with inflation forecast to reach a low of 5,1 per cent in the second quarter, and to average 5,3 per cent for the year, compared with 5,7 per cent previously. The forecast for 2016 has been revised down from 5,8 per cent to 5,5 per cent, and is expected to measure 5,4 per cent in the final quarter of the year.

The forecast for core inflation, by contrast, is more or less unchanged at an average 5,6 per cent and 5,7 per cent in 2014 and 2015 respectively, reaching a peak of 5,9 per cent in the first quarter of 2015 (previously 5,8 per cent), and moderating to 5,3 per cent in 2016, down from 5,5 per cent previously. The MPC assesses the risk to the headline inflation forecast to be broadly balanced.

The results of the fourth quarter inflation expectations survey of the Bureau for Economic Research (BER) will only be released in December. Market-based surveys, as reflected in the Reuters Econometer survey, however, show that the median CPI inflation expectation of analysts has remained unchanged over the past two months at 5,7 per cent and 5,5 per cent for 2015 and 2016 respectively. Break-even inflation rates (the yield differential between conventional government bonds and inflation-linked bonds) declined since the previous meeting and reflect expectations within the target range for 5-year maturities, and marginally above the upper limit of the inflation target range at 10-year maturities.

The United States (US) and the United Kingdom (UK) remain the main drivers of global growth although more broadly, global growth may get some impetus from lower oil and food prices, which should provide some boost to consumers. US economic growth was better than expected in the third quarter with the first advanced estimate of 3,5 per cent, and the unemployment rate declining to 5,8 per cent – the lowest level since June 2008. The UK recorded growth of 2,8 per cent in the third quarter, while the unemployment rate was unchanged at 6,0 per cent. The Japanese economy contracted for a second consecutive quarter during the third quarter, and has prompted a reconsideration of a further value-added tax (VAT) increase next year. The response to the further additional monetary stimulus announced recently remains uncertain amid a tighter fiscal policy stance. The eurozone outlook also remains bleak, including in the core countries such as France and Germany, although lower food and oil prices, coupled with further monetary easing, may have a positive impact.

The outlook for emerging markets is mixed, with emerging Asian economies expected to benefit most from the positive spillovers from the US recovery. This is expected to offset in part the adverse impact of the slowdown in China, where growth is expected to be lower than in the past few years, as the economy rebalances away from investment towards consumption. This moderation is expected to continue to impact negatively on commodity prices. The Indian economy is showing signs of sustained recovery, while the other BRICS partners, Russia and Brazil, face significant growth headwinds. Oil exporters generally are expected to face challenges from international oil price weakness.

Global inflation is expected to moderate in the face of benign food price inflation and falling international oil and other commodity prices. While this is welcome in the higher inflation regions, particularly emerging markets, it does aggravate deflationary risks in some of the advanced economies, particularly in the eurozone and Japan. Monetary policy stances are expected to remain ultra-loose in these two regions, with a significant stimulus package announced recently in Japan, and the European Central Bank (ECB) is anticipated to conduct further asset purchases. The US Federal Reserve (the Fed) has ended its programme of quantitative easing, but at this stage it is not contracting its balance sheet and proceeds from maturing assets are being reinvested. Although the general expectation is that the Fed will begin raising interest rates in mid-2015, there are also some expectations that the more benign inflation outlook could delay this. Forward guidance from both the Bank of England and the Fed is that any adjustment is likely to be gradual, and policy rates may be lower than their estimated long-run normal rates for some time despite the improved growth outlooks. Since the previous meeting of the MPC, policy rates have increased in Brazil, Russia and Indonesia, but reduced in Sweden, South Korea, Chile and Poland.

The exchange rate of the rand has been relatively volatile since the previous meeting in response to external and domestic factors, including changing expectations of the timing of the first US interest-rate increase as well as the downgrade of South Africa's credit rating by Moody's Investors Service. Although the rand initially weakened sharply against the US dollar, at one stage reaching a level of R11,36 against the US dollar, this move has since largely been reversed. Since the previous meeting of the MPC, the rand has depreciated marginally against the US dollar, but appreciated by 2,1 per cent and 3,5 per cent against the euro and sterling respectively, and by 1,8 per cent on a trade- weighted basis.

The rand is expected to remain susceptible to sudden shifts in sentiment regarding changes in monetary policy stances in the advanced economies, and the continued uncertainty regarding the extent to which US normalisation is already priced in to the exchange rate. The asynchronous nature of advanced economy monetary policies is expected to complicate the outlook and outcomes. However, the rand is likely to remain more sensitive to changes in financial conditions in the US than in Japan and the eurozone. The persistently slow adjustment of the current-account deficit also makes the rand vulnerable to swings in sentiment that raise concerns about the financing of this deficit. Although the lower oil prices should reduce the oil import bill, its positive impact on the deficit may be limited by further declines in other commodity prices.

The volatility in portfolio capital flows is indicative of fickle global investor sentiment. Net bond sales by non-residents amounted to R12,6 billion in September and R2,1 billion in October and a further R1,5 billion to date in November. In the equities market, having been marginal net sellers in September, non-residents were net buyers to the value of R5,7 billion in October but net sellers of R6,3 billion to date.

The domestic growth outlook remains subdued. Although an improved growth outcome is expected in the third quarter, following the 0,6 per cent growth in the second quarter, this is off a low base following prolonged strikes in the mining and manufacturing sectors. The Bank's forecast for gross domestic product (GDP) growth in 2014 has declined marginally from 1,5 per cent to 1,4 per cent, and forecasts for 2015 and 2016 have been revised down from 2,8 per cent and 3,1 per cent to 2,5 per cent and 2,9 per cent respectively. This restrained outlook is consistent with the Bank's composite leading indicator of economic activity which continues to trend sideways, with a slight upward move recently. The Rand Merchant Bank/Bureau for Economic Research (RMB/BER) Business Confidence Index improved in the third quarter but, at 46 index points, remains below the neutral level of 50.

The mining sector appears to be recovering to some extent from the strike-affected first half of the year, and is expected to contribute positively to third-quarter growth, following two consecutive quarters of contraction. The physical volume of mining production increased by 0,7 per cent in the third quarter compared with the second quarter, and further increases can be expected in the final quarter, as platinum output is still below pre-strike levels. By contrast, although the physical volume of manufacturing production increased in September, the month-long strike in the steel and engineering industry in July contributed to a quarter-to-quarter contraction of 1,3 per cent in the third quarter. Sentiment indicators suggest that the outlook for the sector remains bleak, with the manufacturing confidence index still at very low levels and capacity utilisation rates back at 2011 levels. More positively, the Kagiso Purchasing Managers' Index (PMI) edged above 50 index points in October for the first time since March, driven mainly by the inventory and new sales orders subindices.

The outlook for the construction sector is more positive, with the real value of building plans passed increasing for the fourth successive month in August. On a three-month-to-three-month basis, an increase of 9,8 per cent was recorded. However, while the various building confidence indices have generally improved, they remain below the neutral level.

The weak pace of economic growth is mirrored in the unemployment rate which, according to the Quarterly Labour Force Survey published by Statistics South Africa measured 25,4 per cent in the third quarter, compared with 24,5 per cent a year earlier. Total employment increased at a year-on-year rate of 0,5 per cent in the quarter. At the same time, the number of discouraged workers increased sharply, by almost 100 000, and now total 2,5 million.

Consumption expenditure by households has remained relatively subdued, but there are signs of a moderate increase in the quarterly growth rate, as the negative effects of the protracted strikes on consumption dissipate. Consumption expenditure could be positively impacted by lower petrol prices. Although retail sales growth declined by 0,8 per cent (non-annualised) in September, quarter-to-quarter growth of 0,9 per cent was recorded in the third quarter, and 2,3 per cent year on year. Similarly, wholesale trade sales contracted in the third quarter, but increased by 5,9 per cent on a year-on-year basis. Motor vehicle sales have also shown some signs of recovery, although domestic sales are expected to be lower this year than in 2013. Retail-sector confidence improved, with the BER reporting retailer confidence above the neutral level for the first time in two and a half years. Consumer confidence, however, declined significantly in the third quarter following an unexpected increase in the second quarter.

Trends in bank credit extension to the private sector have remained characterised by declining growth in advances to households, while advances to corporates have been buoyant. Total loans and advances grew at a twelve-month rate of 8,8 per cent in September, but excluding mortgages the growth rate was 13,5 per cent, compared with a recent high of 18,6 per cent in December 2012. Credit extension to the household sector grew by 3,7 per cent in September, as unsecured lending remained weak despite a reversal of the negative growth trend in the month, but credit to the corporate sector grew by 15,3 per cent. Twelve-month growth in mortgage advances to households remained at levels below 3 per cent, while instalment sale credit and leasing finance continued its downward trend with growth of 6,9 per cent. These trends are likely to constrain consumer demand in the coming months.

According to the October *Medium Term Budget Policy Statement,* government remains committed to its policy of fiscal consolidation in order to prevent an increase in the debt ratio to unsustainable levels. The fiscal deficit is expected to decline from a projected 4,7 per cent of GDP in the current fiscal year to 3,0 per cent in 2017/18.

This is expected to be achieved through adherence to a nominal expenditure growth ceiling and increased tax revenues. The ability to achieve the nominal expenditure targets will be determined to an important degree by the public-sector wage settlement.

Wage trends have remained broadly unchanged since the previous meeting of the MPC. According to Andrew Levy Employment Publications, wage settlement rates averaged 8,0 per cent in the first nine months of the year. Nominal remuneration per worker as well as productivity trends in the formal non-agricultural sector were distorted by the significant increase in temporary employees by the Independent Electoral Commission, which contributed to the decline in the year-on-year increase in remuneration from 6,3 per cent to 3,5 per cent, while productivity declined by 1,6 per cent. The net result was a marginal increase in unit labour costs of 5,2 per cent in the second quarter from 5,1 per cent previously.

Food price inflation remains a major driver of inflation, but is expected to continue to moderate in the coming months. Food price inflation appears to have peaked at 9,5 per cent in August, and has since moderated to 8,0 per cent in October as lower producer prices of crops and cereals, which declined by 6,3 per cent in September, are beginning to have an impact at the consumer price level. Restocking of herds following the drought in 2013, however, has kept meat price inflation elevated. Food price pressures also remain benign at the global level, with the Food and Agriculture Organization international food price index declining for seven consecutive months to its lowest level since August 2010.

International oil prices have declined markedly since their recent peak in June 2014 of around US$115 per barrel to current levels of below US$80 per barrel. This decline reflects a combination of factors, including increased supply coming from the US and Libya, moderating demand from China in particular, and changes in the internal dynamics within the Organization of the Petroleum Exporting Countries (OPEC) cartel. The general expectation in the market is that these lower prices could persist for some time. Although some of the advantage of lower international oil prices has been offset to some extent by a weaker rand exchange rate, domestic petrol prices have declined by a cumulative R1,17 per litre since August and, should current trends continue, a further decline of around 70 cents per litre can be expected in December.

The marked decline in international oil prices has had a significant impact on the medium-term outlook for headline inflation in the global economy and in South Africa. At this stage it is unclear whether this is a temporary shock, or if it will be sustained or decline further. As with an oil price increase, we would look through the impact effect and focus on the possible second-round effects of this decline. The possibility that oil prices are sustained at current levels introduces a degree of downside risk to the inflation forecast.

The domestic growth outlook remains challenging, and the risks to the forecast are assessed to be moderately on the downside. The MPC does not see significant signs of excess demand pressures that are impacting on the inflation outlook and household consumption expenditure is expected to remain constrained.

At the same time, despite its recent relative stability, the exchange rate remains an upside risk to the inflation outlook, vulnerable to changing perceptions of the timing of global monetary policy adjustments, and the slow pace of contraction in the current-account deficit. The extent to which policy normalisation is already priced into the exchange rate is also unclear.

A further upside risk to the inflation forecast comes from a possible increase in wage settlement rates in excess of inflation and productivity growth in the coming year.

In light of this assessment, the MPC sees the overall risk to the headline inflation forecast to be more or less balanced. However, given the elevated level of core inflation and the fact that headline inflation is expected to increase later in the forecast period as the first-round effect of the oil price decline dissipates, the Committee remains vigilant and will continue to monitor developments closely.

The Committee remains of the view that interest rates will have to normalise over time. However, given the lower trajectory of headline inflation and the continued weak state of the economy, the MPC has unanimously decided to keep the repurchase rate unchanged at 5,75 per cent per annum at this stage.

The timing of future interest-rate increases will be dependent on a range of factors, including the evolution of inflation expectations, the speed of normalisation of monetary policy in the US and the state of the domestic economy.

Abbreviations

Alsi	FTSE/JSE All-Share Price Index
BER	Bureau for Economic Research
BOJ	Bank of Japan
CPI	consumer price index
CBOE	Chicago Board Options Exchange
ECB	European Central Bank
FRA	Forward rate agreements
GDP	gross domestic product
HP	Hodrick–Prescott [filter]
IMF	International Monetary Fund
JSE	JSE Limited
MPC	Monetary Policy Committee
MPR	*Monetary Policy Review*
MTBPS	*Medium Term Budget Policy Statement*
NEER	Nominal effective exchange rate
PMI	Purchasing Managers' Index
PPI	producer price index
REER	Real effective exchange rate
repo	repurchase [rate]
RMB	Rand Merchant Bank
RMSE	root mean square error
SIT	services, income and current transfer [account]
the Bank	South African Reserve Bank
the Fed	United States Federal Reserve
VAT	value-added tax
UK	United Kingdom
ULC	unit labour cost
US	United States

Glossary

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.

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.

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.

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.

First- and second-round effects: A price shock has direct as well as indirect first-round effects; for example, higher oil prices leading to increased petrol prices (direct) and then higher prices for goods and services for which petrol is an input (indirect). This shock may also have a second-round effect if it causes an additional change in inflation expectations, wage settlements or underlying inflation.

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.

Forward rate agreement (FRA): A contract that determines the rate of interest to be paid or received on an obligation beginning at a future start date.

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.

Import penetration: This ratio shows the degree to which domestic demand is satisfied by imports. It is calculated as imports divided by domestic demand (where domestic demand is gross domestic product minus exports plus imports).

Import unit value indices (UVI): This measures inflation in imported commodities. The average value changes are calculated by dividing the value of imported goods per category with the respective amount of the goods. The Statistics South Africa import UVI is calculated as a five-month moving average using customs data as a proxy for inflation in imported commodities.

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.

J–curve: The path followed by a country's trade balance in response to currency depreciation. A delayed reaction of more expensive imports and less valuable exports will initially worsen the trade balance before it improves, tracing a path that looks like a letter "J".

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): The 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 20 currencies. The weights of the five major currencies are in brackets: euro (29,26), Chinese yuan (20,54), US dollar (13,72), Japanese yen (6,03) and British pound (5,82). Index: 2010 = 100.

Non-tradeables: Goods and services produced and consumed domestically that are not close substitutes to goods and services that are imported or exported.

Output gap/potential growth: Potential growth is the rate of GDP growth that could theoretically be achieved if all productive assets in the economy are employed in a stable inflation environment. The output gap is the difference between actual growth and potential growth. If this is negative, then the economy is viewed to be underperforming and demand pressures on inflation low. If the output gap is positive, the economy is viewed to be overheating and demand pressures inflationary in nature.

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: This refers to the ratio of export prices to import prices.

Tradeables: Goods or services that are imported or exported.

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'.

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