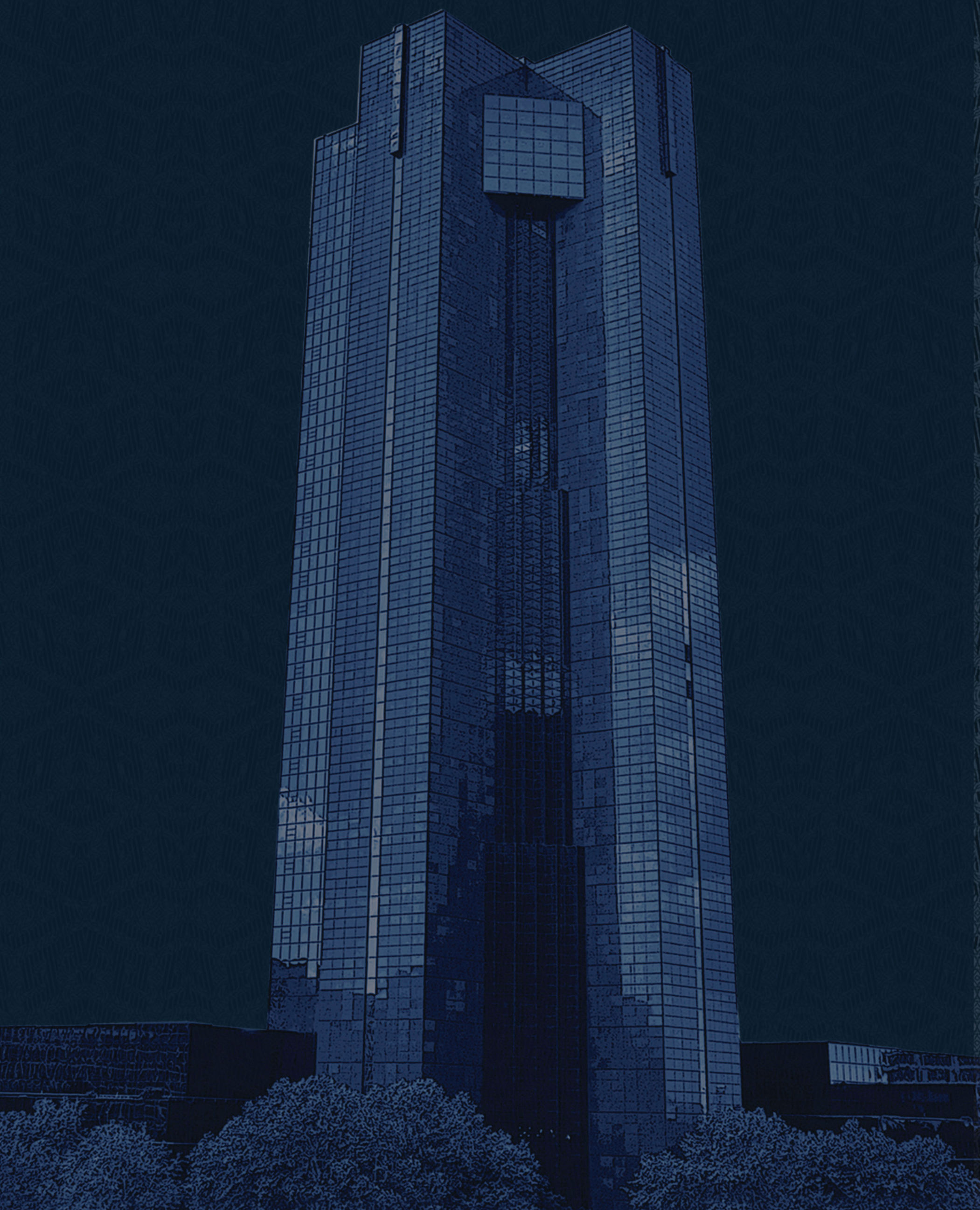
Monetary Policy Review

June 2015



South African Reserve Bank

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Preface

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

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

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

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

The *Monetary Policy Review* (MPR) is published twice a year and is aimed at broadening the understanding of the objectives and conduct of monetary policy. The MPR reviews domestic and international developments that have affected inflation and that impact on the monetary policy stance. It also provides an assessment of the factors determining inflation and the Bank's forecasts 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

Overview of the macroeconomic environment and policy stance

South African consumer price inflation has been near 6 per cent, at the top end of the target range, for the past three years. In recent months, this pattern has been interrupted by the sharp fall in oil prices, which slowed inflation to a low of 3,9 per cent in February 2015. However, prices are now accelerating again, and are expected to breach the target temporarily during the first half of 2016. Average inflation is forecast at 6,1 per cent for 2016, easing slightly to 5,7 per cent in 2017.

Petrol price inflation is forecast to spike early in 2016, reflecting the annual comparison with the low prices from the start of 2015. Food prices are also picking up in response to drought conditions in the maize triangle in South Africa. Meanwhile, underlying inflationary pressures are proving persistent, and risks to the forecast have increased. This raises the odds of a sustained breach of the inflation target and narrows the scope to look through price shocks, even if demand pressures in the economy remain weak. For these reasons, monetary policy in South Africa remains in a tightening cycle.

The evolution of the inflation outlook

From the vantage point of mid-2014, the plunge in oil prices has delivered sizeable inflation benefits. At that time, headline inflation was expected to average 5,9 per cent in 2015, barely within the target range. The forecast has since improved to 4,9 per cent, close to the target's midpoint. However, relative to the outlook from the start of the year, the windfall has been more disappointing. In January, the inflation forecast for 2015 averaged 3,8 per cent. It now appears that inflation will not be that low in even one month during 2015.

The oil benefit has been attenuated by several factors. Oil prices have recovered from under US$50 per barrel, averaging around US$65 in May, although they remain well below the levels seen in the middle of last year. Continued rand depreciation against the United States (US) dollar has pushed up domestic fuel costs, adding about 40 cents to pump prices since January. Higher fuel levies have also softened oil's disinflationary impact.

Cheaper oil is having only limited effects on the prices of other goods and services. Core inflation, which excludes food and energy prices, is projected to average 5,6 per cent in 2015, significantly above headline inflation. Inflation expectations as surveyed by the Bureau for Economic Research (BER) have shifted lower for 2015, but remain around the top of the target range for the next two years. Expectations have also converged in recent years, suggesting a greater degree of consensus that inflation will be close to 6 per cent. This is reflected in wage expectations and settlements, which have been slow to fall in line with lower headline inflation.

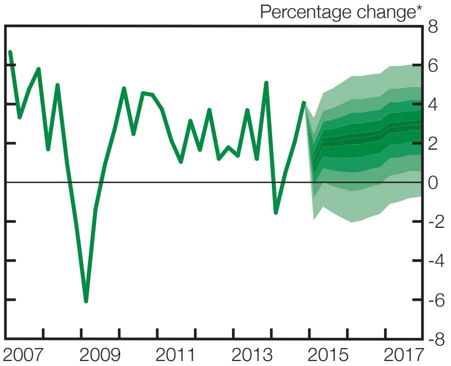
The risks to the inflation forecast have once again shifted to the upside, following a brief period of balanced risks. The rand remains vulnerable, in particular because the US Federal Reserve (the Fed) is expected to commence policy tightening some time this year. Higher rates in the US should attract capital away from emerging markets, especially those which have been absorbing large quantities of capital and are running correspondingly large current-account deficits. The Fed has taken pains to communicate the probability of rate hikes this year, as well as the likely gradual pace of tightening. This implies some of the exchange rate adjustment to higher US rates may be priced in. Additional policy easing by the European Central Bank (ECB) and the Bank of Japan may support capital flows to emerging markets, further moderating the risk of an abrupt decline in emerging-market (EM) currency prices. Nonetheless, recent history warns against relying on smooth market adjustments. Instead, currency markets have been characterised by intermittent, sharp sell-offs between periods of uneasy calm. So far this year, countries such as Brazil and Turkey have experienced large depreciations, with the Brazilian real falling by 13,2 per cent and the Turkish lira down 13 per cent against the US dollar. (By way of comparison, the South African rand has weakened by 3,7 per cent; in 2014 it depreciated 11 per cent. The real fell by 8,3 per cent and the lira by 12,9 per cent in 2014.)

A second important risk comes from electricity prices. These are currently scheduled to rise by more than headline inflation, directly adding approximately half a percentage point to the inflation forecast over each of the next three years. However, tariffs could be raised even further, and Eskom has approached the national regulator to re-open the multi-year tariff agreement. Higher electricity prices will promote more efficient usage of scarce electricity and ensure the sustainability of supply. Nonetheless, large additional increases are expected to place greater pressure on second-round inflation effects.

A further, familiar concern is real labour remuneration outpacing productivity gains. This sustains inflation at relatively high levels because wage settlements start at cost-of-living increases, which are often based on previous years' experiences. Furthermore, excessive wage deals also threaten to accelerate inflation as firms respond to growing costs by raising their prices. Some of this pressure is alleviated through reduced employment as firms substitute capital in place of labour. This tends to moderate wage-price spirals, but is an unwelcome shift in a high unemployment economy. Lower labour demand may also lag higher wages, and is therefore not necessarily inflation-neutral.

Growth prospects

Figure 1 Real GDP growth forecast



* At seasonally adjusted annualised rates

Source: South African Reserve Bank

The relatively unfavourable outlook for inflation is matched by mediocre growth prospects. For several years, growth has been forecast above 3 per cent, but it has repeatedly fallen below this level. A prominent cause of this underperformance has been strikes in the mining and manufacturing sectors. But low growth in South Africa is also the consequence of three broader, longer-term factors.

First, foreign demand is weak. Commodity prices have been sinking since 2011, weighing down South Africa's terms of trade. Cheaper oil has provided some stability recently, but this offers only partial and late compensation for comparably large declines in coal and iron ore prices. (Gold and platinum prices have also declined, but by smaller magnitudes.) Economic growth in trading-partner economies has been modest. In particular, the euro area has still to regain its pre-crisis levels of output. Growth in world trade has slowed markedly from pre-crisis averages. In this environment, and with sustained, robust growth in imports to South Africa, net exports have subtracted from gross domestic product (GDP) growth. It has also been more difficult to remedy the current-account deficit through higher exports, despite sustained currency depreciation.

Second, the financial cycle is not in a growth-accelerating phase: credit expansion has been low in real terms despite accommodative monetary policy settings. One aspect of this is that households have been paying off large debt burdens incurred during the pre-crisis boom. Another aspect is that businesses are reluctant to invest, given weak demand and other constraints reflected in low levels of business confidence. On top of these private-sector trends, the state's borrowing behaviour is changing. Since 2009, National Treasury has exploited the fiscal space won before the crisis to stimulate the economy with large budget deficits. This capacity is now largely exhausted. Persistent structural deficits have doubled the public debt level (as a share of GDP) and endanger the sustainability of non-interest spending. In response, government has correctly embarked on a programme of fiscal consolidation. The economy-wide appetite for greater leverage is currently quite limited, with both the public and private sectors expanding borrowing at a subdued pace.

Third, electricity shortages have returned as a major constraint on growth. Although South Africa's electricity supply problems have been widely known since 2008, they re-emerged with the resumption of load shedding towards the end of 2014, and it is now clear they will persist over the medium term. The electricity constraint will hamper growth both by interrupting production and by deterring future investment. The forecast shows growth picking up towards 3 per cent in 2017, but this will require a mix of efficiency gains and improved electricity supply.

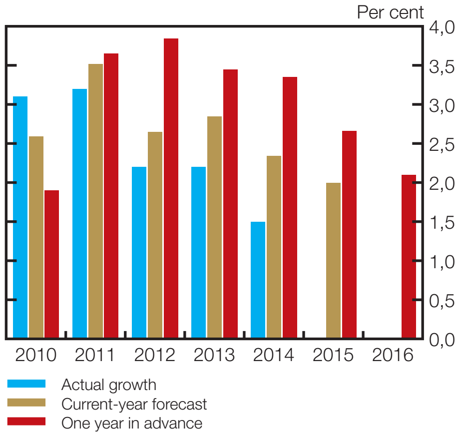
The policy stance

The macroeconomic policy response to the global financial crisis has been counter-cyclical. Large fiscal deficits and much lower interest rates provided significant support to growth. Growth rebounded in 2010, beating forecasts, and was slightly stronger in 2011. Inflation fell from pre-crisis levels well above 6 per cent to the bottom end of the target range, bottoming out at 3,2 per cent in September 2010. At this juncture, South Africa's economic recovery appeared broadly on track, with growth expected near 4 per cent in 2012 and inflation forecast to remain within the target range.

Economic conditions thereafter became more challenging. Growth in 2012 was closer to 2 per cent than 4 per cent, and disappointed again in both 2013 and 2014. With potential growth estimated at around 3 per cent, this meant the negative output gap kept widening. Weak demand implied minimal pressures on inflation. Nonetheless, adverse supply pressures yielded a series of inflation target breaches. Headline rose above 6 per cent for two months in 2011, three months in 2012, and two months in 2013. Given supportive factors, including relatively muted second-round effects and low pass-through from exchange rate depreciation, rates were not raised in response. Indeed, the repo rate was even cut one more time in July 2012, as growth slowed. Yet the combination of inflation settling in around the top of the target, and consistently underwhelming growth, presaged difficult choices for monetary policy.

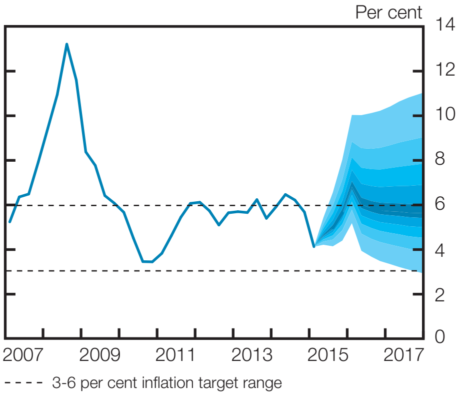
By the start of 2014, the inflation forecast indicated a sustained breach of the inflation target, due chiefly to exchange rate factors. Monetary policy entered a tightening cycle, with a repo rate hike of half a percentage point in January, followed by another quarter of a percentage point in July. Inflation breached the target in March and peaked at 6,6 per cent in May and June. It then declined sooner than expected, returning to target in September as oil prices began falling. By the first quarter of 2015, average inflation was below the midpoint of the target range. In this environment, the rate hiking cycle was paused.

Figure 2 Real GDP growth and forecasts diverged after 2011



Source: International Monetary Fund

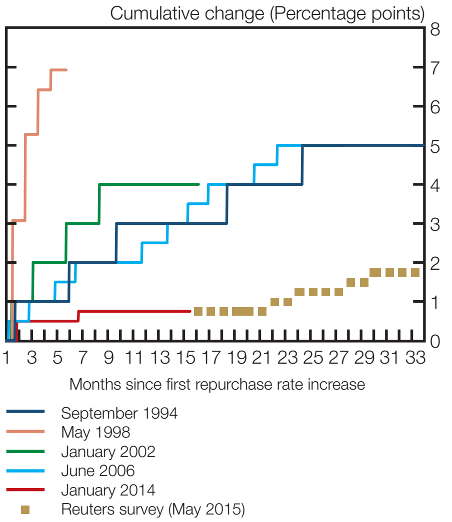
Figure 3 Targeted inflation* forecast



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

Source: South African Reserve Bank

Figure 4 Current and previous monetary policy tightening cycles



Sources: South African Reserve Bank and Reuters

However, the overall impact of cheaper oil has proven limited, with muted second-round effects. The inflation forecast deteriorated from the January 2015 to the March 2015 MPC meetings, as the outlook for domestic food prices worsened with drought in the maize triangle. The risks to the forecast also shifted. In January they were assessed to be more or less balanced, whereas in March the prospect of higher electricity prices tipped the balance towards higher inflation. The forecast for the May 2015 meeting showed inflation slightly higher than in March, with an average of 6,1 per cent projected for 2016, followed by 5,7 per cent in 2017. The risks remained skewed to the upside, with a strong chance of a sustained breach of the target. In this environment the case for rate cuts evaporated. Instead, the main question for monetary policy became how long to keep rates on hold.

Both electricity prices and the exchange rate could quickly shift forecasted inflation above the upper bound of the target. With underlying inflation and inflation expectations close to the top of the target range, continued flexibility in the face of supply shocks is likely to generate second-round effects inconsistent with the inflation target.

Demand pressures on inflation remain weak in the context of low growth. Part of the puzzle of consistently weak growth and missed forecasts has been resolved by evidence that potential growth has fallen. The output gap is accordingly smaller than indicated by earlier estimates. With actual growth in line with potential growth, the output gap remains largely static despite mediocre economic performance. Accordingly, most of the burden for achieving higher growth rates rests on structural reforms. The persistence of some slack in the economy, however, leaves space to maintain a relatively accommodative monetary policy stance.

Interest rates remain low in historical perspective, with the repo rate still negative in real, ex ante terms. Should the risks to the forecast materialise, with potentially significant second-round effects, interest rate normalisation will resume. Private-sector forecasts and market indicators are reflecting a more gradual pace of tightening than in previous hiking cycles. Moderate rate hikes are likely to achieve price stability, the Bank's primary mandate, without unduly sacrificing growth.

Box 1 Enhancing monetary policy transparency in South Africa

South Africa's flexible inflation-targeting framework allows policymakers discretion on how they make their decisions, for example, in distinguishing between first- and second-round effects from external shocks. But this discretion, coupled with the South African Reserve Bank's institutional independence, makes transparency an important operational principle to ensure public accountability.[1] In addition, transparency is central to the clear communication and explanation of monetary policy decisions.

The South African Reserve Bank (the Bank) has become progressively more transparent over the past two decades. In rankings of central bank transparency, it is above the global average, alongside peer emerging-market countries such as Brazil and Chile.[2] There are several options for advancing monetary policy transparency in South Africa. The Bank could release more information about the monetary policy decision making process or it could provide additional information on the inputs to policymaking.

Table 1.1 Evolution of transparency in the South African Reserve Bank

October 1999.........	First MPC meeting, accompanied by published statements with interest rate decision
February 2000........	Adoption of inflation-targeting framework (2002 as first target year)
March 2001............	First MPR, including inflation fan chart
June 2007..............	Core model published, WP/07/02
May 2010...............	Real GDP growth fan chart first published in MPR
November 2013	Core inflation forecast first published in MPR
November 2014	Interest rate decision preferences disclosed in the statement Potential growth model published, WP/14/08
July 2015	Forecast assumptions published with the MPC statement

Source: South African Reserve Bank

A risk arising from increased transparency is that the public may over interpret the data. Assumptions and forecasts inform policymakers' decisions but do not determine them: judgement plays a crucial role in navigating policy through the enormous complexity of the macroeconomy. Specific forecasts depend on many different assumptions – for instance, even a relatively simple forecast input such as the petrol price is affected by world oil prices, the exchange rate and fuel levies. Change one assumption and many others must also shift. There is also a risk of increasing financial market volatility. For instance, the Bank does not have a superior method of forecasting the exchange rate, and does not target it. Nonetheless, as the monetary authority, its exchange rate assumptions could move markets.

In light of these advantages and risks, the Bank will improve transparency about its forecasts and assumptions in a targeted way. From July 2015, the assumptions underlying the forecast will be published with the MPC statement. This MPR details the inflation and growth forecasts, and presents an alternative inflation scenario given additional hikes to electricity tariffs (Box 4). The central design principle is not just to give as many numbers as possible, but to provide useful information and to contextualise it.

1 J C Williams, 'Monetary policy and the independence dilemma', *Federal Reserve Bank of San Francisco Economic Letter 2015-15*. See http://www.frbsf.org/economic-research/publications/economic-letter/2015/may/fed-independence-goal-mandate-accountability-transparency/?utm_source=mailchimp&utm_medium=email&utm_campaign=economic-letter-2015-05-11.

2 N N Dincer and B Eichengreen, 'Central bank transparency and independence: updates and new measures', *International Journal of Central Banking* 10(1), 2014. The authors rank 120 central banks from 1998 to 2010; South Africa's score moved from 5 to 8,5 over the period, while the average score moved from 3,2 to 5,5. Sweden had the highest score of 14,5 (although this is below the potential maximum of 15).

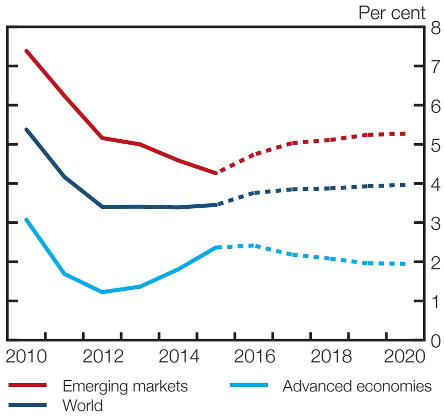
Global economic assessment

Growth in the world economy slipped below 3,5 per cent in 2012 and has remained at these rates since, betraying hopes of a prompt and robust recovery from the crisis. The composition of world growth shifted unexpectedly as emerging markets slowed, disturbing a pattern of rapid EM growth relative to advanced economies. The latter group, however, has improved its performance over the past two years, owing chiefly to a sustained recovery in the United States.

Over the next few years, these trends are likely to reverse. The United States should return to growth rates closer to 2 per cent, which are appropriate for a mature economy at the technological frontier. Many other wealthy countries will lag the US, given constraints including ageing populations and more restrictive labour and product market institutions. The euro area is expected to grow at about 1,5 per cent over the medium term; Japan's economy will likely expand by just 0,5 per cent annually. The advanced economy category will therefore slow.

Global growth should nonetheless accelerate. Emerging markets are expected to pick up from a trough this year. Furthermore, these economies will continue expanding their share of world production. Whereas in the 1980s rich countries accounted for 79 per cent of world output, at market exchange rates, by 2010 this was down to 66 per cent. By 2020 this proportion should fall to 57 per cent, or 39 per cent at purchasing power parity. As emerging-market productivity growth outpaces that of advanced economies, their larger share translates into faster overall expansion. Consequently, world growth should revert to approximately 4 per cent annually – a high rate in historical perspective.

Figure 5 World growth and components



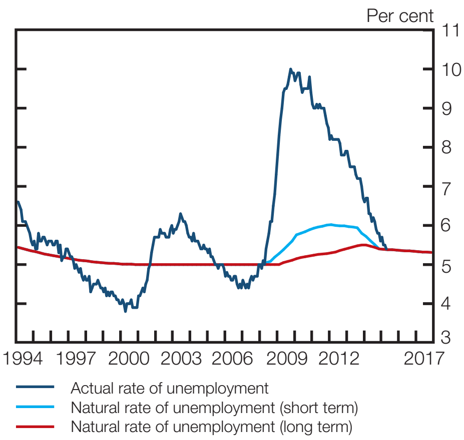
Source: International Monetary Fund

Trends in advanced-economy growth

The December 2014 MPR noted a divergence amongst advanced economies. The US and United Kingdom (UK) were recovering strongly, inclining monetary policymakers to contemplate normalisation. In the euro area and Japan, by contrast, growth was stagnant. Accordingly, monetary policies were premised on increasingly aggressive easing strategies.

These trends have persisted, although the collapse in oil prices has suppressed inflation everywhere, extending the lifespan of super-loose monetary policies. In the UK in particular, rate increases – once mooted for late 2014 – have been deferred in the face of inflation at 50-year lows. In the US, inflation is also very low, with consumer prices in deflationary territory during early 2015. First-quarter performance was also muted. Nonetheless, the economic recoveries in these countries remain healthy.

Figure 6 US unemployment and NAIRU*



* NAIRU: non-accelerating inflation rate of unemployment

Sources: Congressional Budget Office and US Bureau of Labor Statistics

The US recovery and monetary policy normalisation

In 2014 the US economy added over 3 million jobs, on a net basis – its strongest employment gains since 1999. In keeping with these developments, unemployment fell quite steadily, reaching 5,6 per cent at the end of the year. (By April 2015, unemployment was down to 5,4 per cent.) The Congressional Budget Office estimates the natural rate of unemployment to be between 5,5 and 5,7 per cent, and although these estimates are subject to some uncertainty, the US labour market is certainly close to full employment. The puzzle for US policymakers has, therefore, been the failure of low unemployment to spark inflation, both in wages and more broadly.

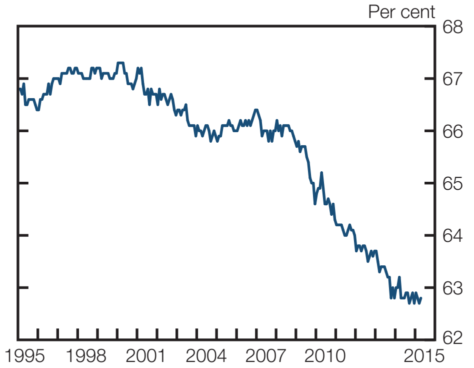
Prices should rise as tighter labour markets intensify competition between firms for workers, producing higher wages and also higher costs for firms. But wages have shown persistently small real gains. There are several possible explanations for this phenomenon. Perhaps the best is that the number of people working part time, despite preferring full-time work, remains elevated. This suggests that firms already have the employees they want. As the economy improves, they will increase hours rather than wages. A related explanation is that the labour force participation rate remains unusually low. Although this partly reflects demographic trends, as baby boomers retire, it also demonstrates the presence of discouraged people who might return to labour markets as conditions improve.[1] As such, the unemployment rate understates the true labour supply. A further explanation is that wages failed to fall sufficiently during the crisis, owing to their downward nominal rigidity – essentially, employers were very reluctant to cut wages, although this was warranted by economic conditions.[2] If this is true, wages are unlikely to grow until the excess accumulated during the crisis is exhausted. Finally, it remains possible that the disconnection between unemployment and inflation will be temporary, and the puzzle will evaporate over the coming months.

The overwhelming majority of Federal Open Market Committee members have taken the view that the economic recovery justifies raising interest rates this year. Unfortunately, much analysis of this consensus has focused on the exact timing of 'lift off' – the first adjustment of the federal funds rate above the zero lower bound. This question is less important than the pace of tightening. The Fed's economic projections indicate that over the longer run the policy rate should be about 3,5 per cent. Markets expect a much lower rate, in the range of 1,7 per cent. The gap has mostly to do with differing evaluations of the natural real rate, instead of expectations for unemployment or inflation. This divergence creates scope for another 'taper tantrum' event, as in May 2013, should markets suddenly shift towards the Fed's expressed views. However, the arrival of the longer run is probably not imminent. The inflation outlook remains benign, supported by both low energy prices and the stronger dollar. Headline personal consumption expenditure (PCE) inflation has fallen sharply to 0,3 per cent, whilst core PCE inflation has remained stable at around 1,3 per cent. (The Fed has a 2 per cent goal for PCE inflation.) When monetary tightening in the US occurs, it is therefore likely to take the form of a gradual hiking cycle.

Improving conditions in the euro area

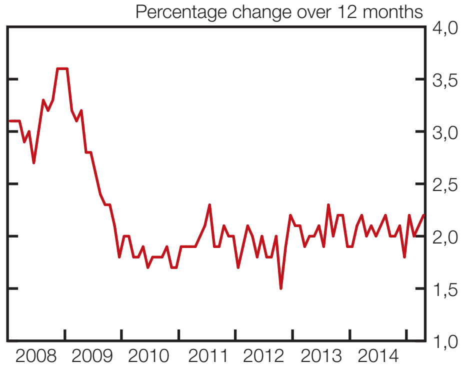
In the euro area, there are some tentative signs of recovery after a sustained period of stagnation. Output contracted in 2013, by half a per cent, but recovered this ground in 2014. The European Commission forecasts growth of around 1,5 per cent in 2015, roughly half the rates expected for the US or UK. Germany is expected to continue growing by slightly more than the eurozone average. It also enjoys the lowest unemployment rates in the currency bloc, below 5 per cent. By contrast, France and Italy – the next two largest economies in the euro area – are likely to lag, with persistent double-digit unemployment.

Figure 7 US labour force participation rate



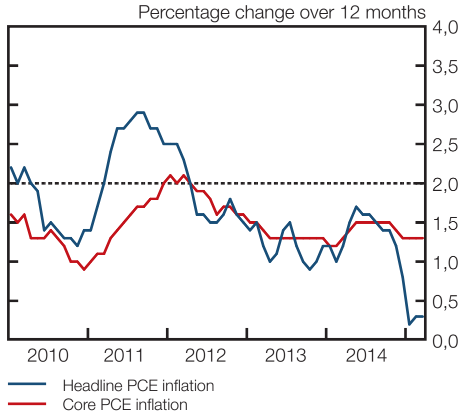
Source: US Bureau of Labor Statistics

Figure 8 US average hourly earnings: all private sector



Source: US Bureau of Labor Statistics

Figure 9 US personal consumption expenditure inflation

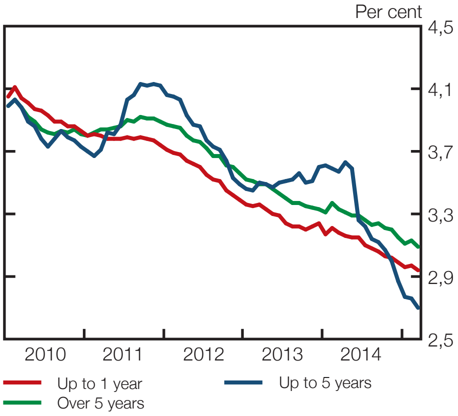


Source: Federal Reserve Economic Data (St Louis Fed)

1 J Yellen, 'Labor market dynamics and monetary policy', 22 August 2014. See http://www.federalreserve.gov/newsevents/speech/yellen20140822a.htm.

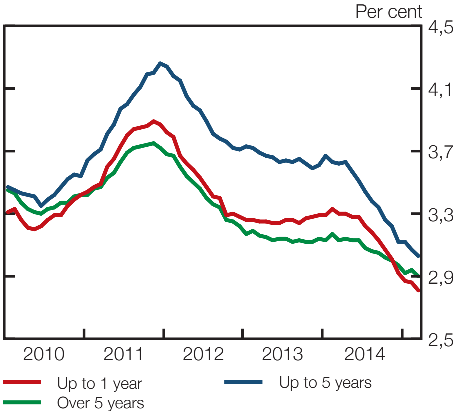
2 J C Williams, 'The view from here: the economic outlook and its implications for monetary policy', 23 March 2015. See http://www.frbsf.org/our-district/press/presidents-speeches/williams-speeches/2015/march/monetary-policy-federal-funds-rate-normalization-sf/.

Figure 10 Interest rates on new loans for house purchase



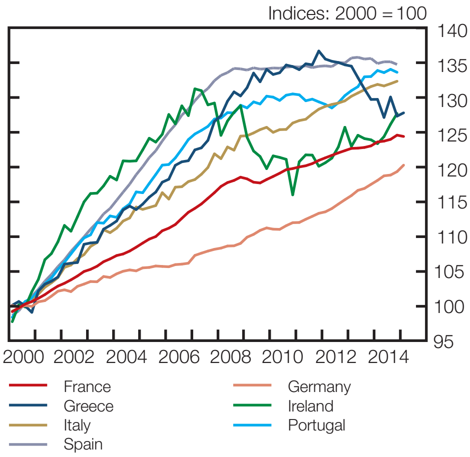
Source: European Central Bank

Figure 11 Interest rates on new business



Source: European Central Bank

Figure 12 Euro area deflators*



* Higher index values for the GDP deflators imply lower competitiveness within the common currency area

Source: World Bank

The European Central Bank has started quantitative easing, purchasing assets worth around €60 billion per month. It will continue this programme until September 2016, swelling its balance sheet by about €1 trillion. Bank lending surveys suggest that financial conditions are improving. Interest rates on new loans have fallen and lending standards have loosened. Inflation remains very low, with deflation recorded throughout the first quarter of 2015. However, retail sales data suggest consumers have not started deferring purchases in anticipation of lower prices. Demand is also likely to benefit from consumer confidence, which reached a seven-year high in March 2015.

The longer-run economic health of the euro area remains at risk from high debt burdens and uncompetitive price levels in some peripheral economies. Government debt levels in the euro area are over 90 per cent of GDP, more than one and a half times the permitted maximum under the Maastricht Treaty. However, with interest rates at historical lows, interest payments are claiming around 2,5 per cent of GDP, which is a manageable level. (By contrast, in South Africa interest payments are over 3 per cent of GDP, despite debt levels close to half the euro area average.)

The euro has depreciated significantly, losing 18,1 per cent against the US dollar since January 2014. This has helped sustain a substantial current-account surplus for the euro area as a whole. Peripheral countries remain largely uncompetitive, however, with their balance of payments improvements stemming more from import contractions than stronger exports. Their price disadvantages stem from years of relatively high internal inflation during the euro's first decade, which has been only partially reversed. This lack of competitiveness remains a fundamental constraint on these countries' growth prospects.

China's rebalancing

The Chinese economy continues to slow. This is more or less in line with the process of rebalancing towards domestic consumption, and away from export- and investment-led development. However, the extent of the slowdown is somewhat unsettling. Growth in 2014, at 7,4 per cent, was close to target but lower than in previous years. The first quarter of 2015 registered less rapid growth still, at 7,0 per cent year on year – the lowest quarterly number since the global financial crisis. Meanwhile, inflation has fallen markedly. Producer prices have been in deflationary territory for over three years, with falling commodity prices suppressing costs at factory gates. Excess capacity is also exerting strong disinflationary pressure. Consumer prices rose just 2 per cent in 2014, versus a target of 3,5 per cent. Inflation is likely to remain below target in 2015, despite the target being lowered to 3 per cent.

Chinese monetary policy is undergoing a paradigm shift as the exchange rate becomes less of a policy priority. The Chinese renminbi, which is connected to the US dollar by a crawling peg, has appreciated strongly against other major currencies. Foreign-exchange reserve accumulation has stopped, with China's holdings apparently peaking at almost US$4 trillion. This has liberated policymakers from the obligation to sterilise the renminbi created for reserve purchases. Accordingly, the authorities have been able to ease policy in response to weak growth and below-target inflation. Policy rates have been lowered three times in six months after two and a half years of stability. Required reserve ratios, previously the main sterilisation tool, have also been reduced. Both these policy settings nonetheless remain tight by world standards; the ex ante real policy rate, for instance, is one of the highest amongst major economies.

The dilemma for policymakers is that China has already experienced extremely rapid credit growth since the crisis, whilst output growth has slowed. Total debt now exceeds 200 per cent of GDP for the public and private sectors combined, an unusually high level amongst emerging markets. Additional policy easing risks even more debt accumulation. Yet below-target inflation and slowing growth makes debt servicing more difficult. Further easing measures are therefore to be expected, and will likely be targeted in an effort to limit credit growth in the most leveraged sectors.

Commodity prices and their consequences

China's slowdown is being felt across the world economy, particularly in commodity-exporting countries. Metals prices have been falling since 2011, the year China's growth peaked with the help of a massive stimulus package. Energy prices remained elevated until the second half of 2014, but then collapsed, catching up with metals. (Food inflation has behaved differently, with prices trending down gently over the past few years, although they remain elevated in historical perspective.)

The immediate causes of falling energy and metals prices differ. The oil price collapse is usually traced to large increases in North American production, which also weakened the Organization of the Petroleum Exporting Countries' monopoly power. Of course, this adjustment does not equally apply to copper, coal or iron ore prices. Nonetheless, energy and metals prices performed similar downward level shifts between 2011 and 2014. The common factor is a legacy of strong demand and high prices, starting in the mid-2000s, which elicited a vigorous supply response. This capacity is now serving to keep prices relatively low in a world of weaker global demand growth.

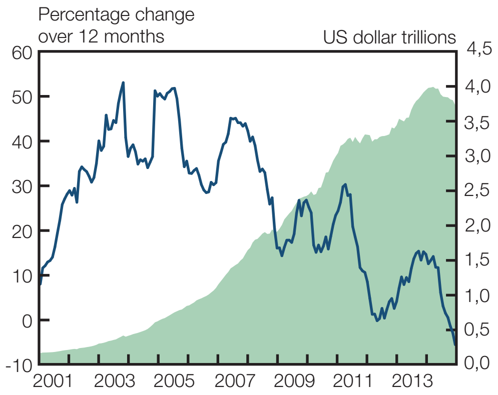
This environment poses acute challenges for commodity-exporting countries. In particular, it has been difficult to improve export performances. Brazil's current-account deficit has deteriorated to nearly 4 per cent of GDP, from 2 per cent in 2011. Over the same time frame, Colombia's has moved from 3 per cent to 5 per cent of GDP, Peru's from nearly 2 per cent to 4 per cent, and Indonesia's from a slight surplus to a deficit of 3 per cent of GDP. South Africa is similarly placed, with a current-account deficit of 5,4 per cent of GDP in 2014, from 2,2 per cent in 2011. These widening deficits have occurred despite significant currency depreciation in all these countries. The resulting predicament – unbalanced economies with limited export demand – is an important aspect of the worldwide emerging-market slowdown.

Faster growing emerging markets

Sub-Saharan Africa shares in this difficulty, to some extent. Energy producers have been hit by collapsing prices: the International Monetary Fund (IMF) estimates growth will be about 2,5 percentage points lower across oil exporters for 2015, relative to earlier forecasts. Other economies with large commodity sectors, such as Zambia, have also slowed. But all these economies are growing off low bases, and the returns from better policy frameworks and new technologies will in most cases permit growth to be sustained at quite rapid levels, despite sinking commodity prices and tighter world financing conditions. As a result, the region can look forward to output expanding by about 5 per cent a year over the medium term.

India is even better placed. It is the second largest of the BRICS (Brazil, Russia, India, China and South Africa) countries, but also the poorest in per

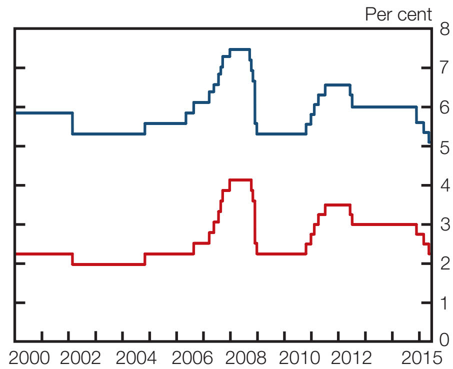
Figure 13 Growth in Chinese foreign reserves



Growth of reserves
Reserves (right-hand scale)

Sources: People's Bank of China and own calculations

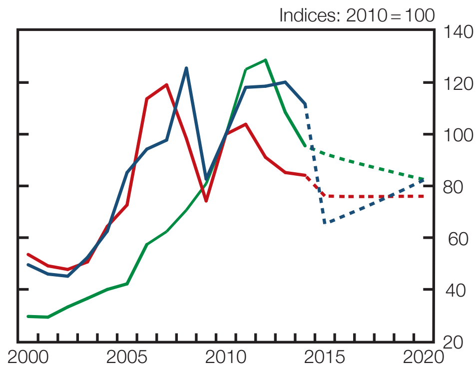
Figure 14 Chinese policy rates



1 Year Benchmark Lending Rate
1 Year Benchmark Deposit Rate

Source: People's Bank of China

Figure 15 Real commodity prices



Coal, crude oil and natural gas
Base metals
Precious metals

Source: World Bank

capita terms. Its growth is expected to overtake China's this year: the IMF forecasts 6,8 per cent growth in China versus 7,5 per cent in India. India has benefited from declines in both energy and metals prices – unlike many other emerging markets for which at least one of these categories is an important export industry. Its current-account deficit, a source of vulnerability during the 2013 'taper tantrum', has narrowed markedly, from about 4,8 per cent of GDP in 2012 to 1,4 per cent in 2014 (aided by restrictions on gold imports.) Reflecting these improvements, the rupee has been roughly constant against the US dollar this year, despite that currency's general strength. In addition, India has made progress on fundamental economic reforms. For instance, in the monetary sphere, this has included the adoption of an inflation target of 4 per cent, plus or minus 2 per cent, to be achieved from 2016/17.

Inflation developments and outlook

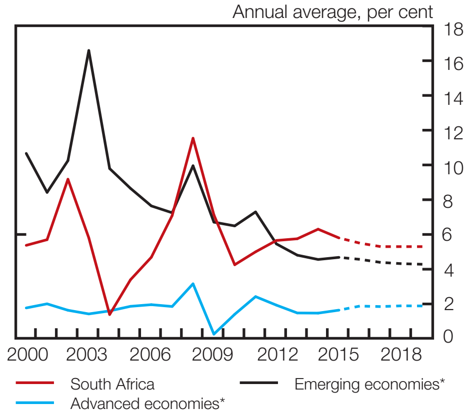
South Africa's inflation dynamics contrast starkly with prevailing global conditions. Many advanced economies, and even some emerging markets, are grappling with ultra-low inflation and sometimes deflation. South African inflation, however, has not fallen below the target range. Similarly, a number of central banks have reached the zero lower bound with their policy rates, forcing them to adopt unconventional measures, including negative rates and quantitative easing. By contrast, the repurchase rate in South Africa remains 575 basis points above zero. Furthermore, whilst central banks facing undesirably low inflation have welcomed currency depreciation as a stimulus to prices, in South Africa it is a primary threat to the inflation outlook.

The common factor explaining low world inflation has been weak demand pressures. Yet South African inflation has been close to the top of the target range despite subdued demand. The origins of this divergence lie in a series of cost shocks affecting food and administered prices (including petrol) that produced repeated target breaches. With headline inflation close to 6 per cent over several years, inflation expectations converged at the top end of the target range.

This pattern contrasts with the dispersion of expectations which occurred between 2007 and 2010. In these years, inflation moved in a wide range from 3 to 13 per cent, driven by turbulent commodity prices in the context of a global boom and bust. As inflation volatility receded in 2011, expectations began to converge. Since the start of that year, realised headline inflation has been locked in a range between 3 and 7 per cent; for 41 months out of 50 it has been between 5 and 7 per cent. By 2014, expectations were as concentrated as they have been at any stage since the introduction of the BER survey.

In keeping with these patterns, core inflation has shifted steadily upwards, towards the top of the target. Services inflation, a major component of core that tends to adjust quite slowly, has also settled close to 6 per cent. Break-even inflation rates, as measured by the yield differentials between ordinary and inflation linked bonds, are back above 6 per cent for all maturities, reversing a fall to within the target range in the second half of 2014. The result of these shifts is reduced monetary policy flexibility. With underlying inflation and expectations already at the high end of the target, additional shocks are more likely to produce sustained breaches of the target and detach expectations from the target range.

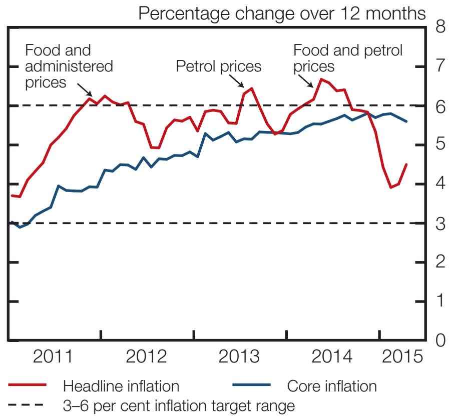
Figure 16 Inflation in South Africa and in trading-partner economies



* Trade-weighted averages

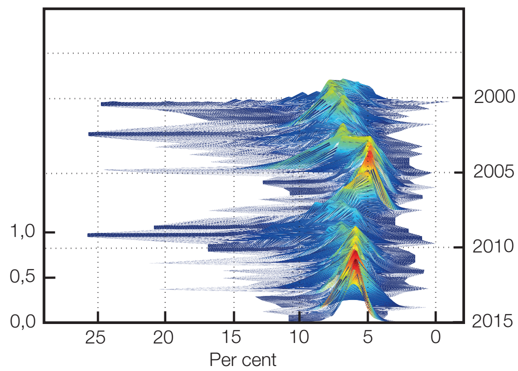
Sources: International Monetary Fund, South African Revenue Service and South African Reserve Bank

Figure 17 Shocks to headline inflation



Source: Statistics South Africa

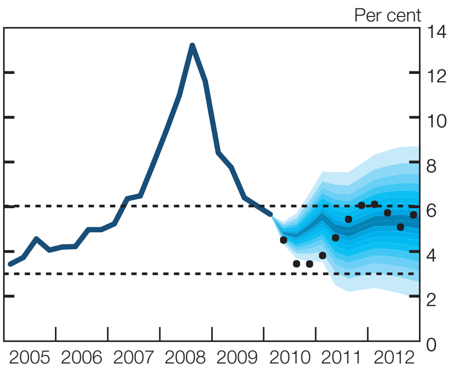
Figure 18 Inflation expectations in 3D*



* This graph illustrates the distribution of inflation expectations over time. 'Higher' peaks (i.e. red colouring) imply that expectations are converging

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

Figure 2.1 Targeted inflation outcomes and projection* from the May 2010 MPR

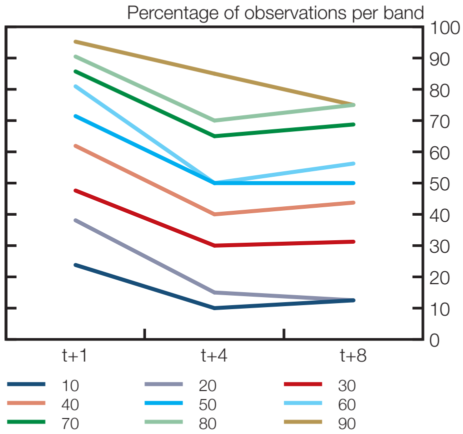


• Targeted inflation outcome
---- 3–6 per cent inflation target range

* CPI inflation trajectory 11 quarters ahead

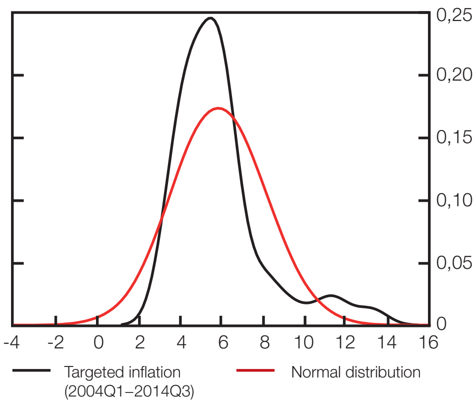
Sources: Statistics South Africa and South African Reserve Bank

Figure 2.2 Outcomes per band over time



Source: South African Reserve Bank

Figure 2.3 Normal distribution* and targeted inflation



* Normal distribution is a randomly generated normal distribution of 10 000 draws with mean and standard deviation of targeted inflation

Source: South African Reserve Bank

Box 2 Accuracy of the inflation fan charts

The MPR displays inflation forecasts using fan charts. These help convey the essentially probabilistic nature of forecasting, as well as the uncertainty involved in the process. By skewing the fans, it is also possible to show asymmetric risks to the forecasts.

Figure 2.1 shows an illustrative fan chart, from 2010, together with its observed inflation outcome. Over the past decade, more than 20 such charts have been published in the Bank's MPR. This box discusses the accuracy of those fans. Three aspects are explored: the confidence intervals, the shape and width of the fans, and the possibility of bias.

The Bank's fans have been divided into 10 per cent confidence intervals. This establishes a prediction: inflation should be within the 20 per cent confidence band 20 per cent of the time, within the 50 per cent interval half the time, and so forth. In fact, not all the bands have been reliable guides. In the near term, the forecasts are generally better than the confidence bands imply. Over the medium term, which is more relevant for monetary policy, a number of the bands have been less accurate. (See Figure 2.2) This shows that 10 per cent intervals pretend to a greater level of forecast precision than has proved achievable. Accordingly, the inflation fan charts will henceforth use fewer bands. The middle 10 per cent band, which has been reliable, will be surrounded by 20 per cent intervals out to 90 per cent. This is the same design used by the Central Bank of Chile. The majority of inflation-targeting central banks utilise even fewer bands, although a few use more (see Table 2.1).

Table 2.1 Fan charts of established inflation-targeting central banks

Countries	Confidence bands
Brazil, Mexico, South Africa, South Korea	10, 20–90
Chile	10, 30, 50, 70, 90
Czech Republic,* Norway,*....................................	30, 50, 70, 90
Thailand..	20, 50, 70, 90
Sweden*...	50, 75, 90
United Kingdom	30, 60, 90
Australia*	70, 90
Canada*	50, 90
New Zealand*...	None

* Central bank also publishes mode of fan chart

Sources: Policy documents of central banks

The width of the fans is broadly determined by the standard deviation of past forecast errors. At times, larger shocks have been discounted so as to avoid very wide fans. The distribution is assumed to be normal. However, when the risks to the forecast are skewed, a two-piece normal distribution is used instead.[1] The fans are drawn to cover 90 per cent of cases, with the remaining 10 per cent excluded in recognition of the uncertainty inherent in forecasting.

This analysis finds that the fans have actually missed 18 per cent of outcomes, showing the 'tail risks' to the forecasts have been larger than expected. However, statistical tests do not prove that observed inflation has followed a different distribution to that used for the fan charts. The misses mostly stem from 2007 and 2008, when inflation exceeded forecasts thanks to skyrocketing food and fuel prices and accelerating domestic demand pressures.

The final aspect is bias. Of the 154 inflation forecasts studied, 75 of the outcomes were below the midpoint of the fan and 79 above – an insignificant difference. Comparing different time horizons, it appears the forecasts have somewhat exaggerated inflation in the near term, meaning outcomes were lower than expected. By contrast, over the medium term, inflation has tended to come in above the central projection. However, this pattern is partially explained by the large inflation surprises of 2007 and 2008, and the sample size is too small to claim that the bias is meaningful.

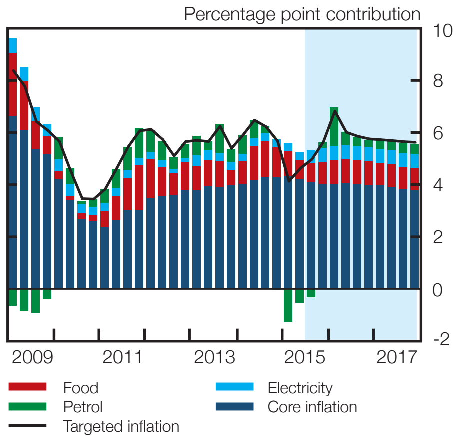
1 A two-piece normal distribution is made up of the halves of two normal distributions with a shared mode.

The Bank's inflation forecasts

Inflation is presently expected to average 4,9 per cent for 2015. This is a major improvement on last year's forecasts, which showed inflation much closer to the top of the target range than the midpoint. The latest forecasts, however, indicate that the disinflationary impact of petrol prices was not as great as projected in January, when it appeared headline inflation would be 3,8 per cent in 2015, below the midpoint of the target.

By the start of next year, base effects from petrol prices will cause headline inflation to spike, with the year-on-year figures high relative to the very low petrol price numbers experienced at the beginning of 2015. The result will be a temporary breach of the upper bound of the target range, with headline averaging 6,8 per cent in the first quarter of 2016. As the oil effect recedes, it will be replaced by food and electricity prices as the key determinants of price movements. These will keep headline inflation around the upper end of the target range. Average inflation for 2016 is forecast at 6,1 per cent, falling to 5,7 per cent in 2017.

Figure 19 Decomposition of targeted inflation



Sources: Statistics South Africa and South African Reserve Bank

Box 3 How will higher fuel levies affect inflation?

The collapse of oil prices created an opportunity for government to raise additional revenue. This is needed as part of South Africa's fiscal consolidation and to finance the Road Accident Fund (RAF). South Africa's fuel levies are comparatively low by international standards.[1] As a consequence, government announced an 80,5 cents per litre increase in fuel levies comprising a 30,5 cents per litre increase in the general fuel levy and a 50 cents per litre increase in the RAF contribution.

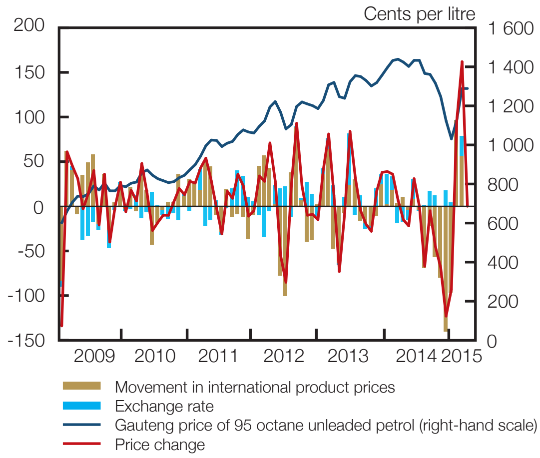
These increases are significant by historical standards. The RAF contribution increased by only 8 cents per litre each year over the past five years, while the general fuel levy increased by an average 14 cents per litre over the past eight years.

There are two channels through which increasing fuel levies will impact overall consumer price inflation. First, these levies will directly increase consumer inflation by the weight of petrol in the consumer price index (CPI) basket (5,68 per cent). Second, the petrol price increase should feed through to firms' production costs, raising the cost of other goods and services, as well as to inflation expectations, possibly increasing nominal wages. These effects are in comparison to price levels as they would have been without the higher levies – actual fuel prices will still be substantially lower than they were before world prices plunged.

Figure 3.1 highlights the likely impact of increased fuel levies, which are included in the baseline projection. Overall these levies add 0,3 percentage points to consumer price inflation, bringing it to 4,9 per cent in 2015. Most of that increment reflects the direct impact of petrol in the CPI basket. The petrol price is expected to decline by 8,4 per cent in 2015, compared to what would have been a 12,7 per cent drop without the higher levies. Over time the indirect impacts appear, pushing up the prices of other goods and services and raising inflation expectations. Targeted inflation in 2016 is expected to be 0,2 percentage points higher, mainly as a result of these indirect effects. One important contributing factor is food prices, which are expected to rise by 0,5 percentage points in 2016 to 5,9 per cent due to the importance of fuel in the food supply chain.

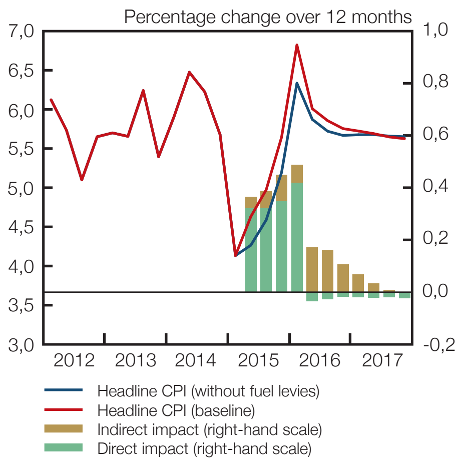
1 National Treasury, *Budget Review 2015*, 25 February 2015, p 4.

Figure 20 South African petrol price and contributions to changes in the basic fuel price



Source: Department of Energy

Figure 3.1 Impact of fuel levy and RAF contribution on headline CPI

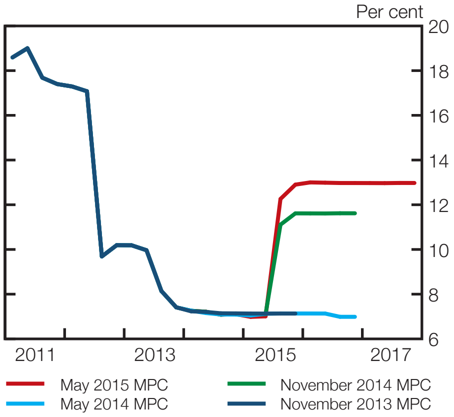


Source: South African Reserve Bank

Domestic food price inflation is forecast to average 5,2 per cent in 2015, down from a four-year high of 7,6 per cent in 2014. The decline in food prices will not be as large as previously thought as domestic drought conditions and exchange rate depreciation push a wedge between domestic and international prices. Drought conditions in the maize triangle are expected to accelerate domestic food prices in the second half of the year.

Meanwhile, international food prices have been favourable, with the Food and Agriculture Organization's Food Price Index presently at a four-year low. These prices are expected to contract by 11 per cent in 2015 before rebounding in 2016. As a result, domestic food prices should rise 5,9 per cent in 2016 and 5,5 per cent in 2017.

Figure 21 Evolution of the power subcomponent



Source: South African Reserve Bank

Electricity prices are assumed to increase by about 10 per cent in 2015 and by about 13 per cent annually in the next two years. Although electricity prices make up only 4,13 per cent of the inflation basket, these increases will add as much as 0,5 percentage points to targeted inflation in 2016 and 2017, before second-round effects. (The contribution is somewhat smaller in 2015 as the increase arrives late in the year.) It is possible that electricity prices will add even more to inflation if the scheduled tariff increases are revised. This scenario is explored in Box 4.

Core inflation should remain at the upper end of the target. Core most likely reached its peak in February 2015, at 5,8 per cent, and is expected to average 5,6 per cent in 2015. The decline in targeted inflation should lower inflation expectations in 2015 and feed into unit labour costs (ULCs). After an extended period above 6 per cent, ULCs are expected to moderate to 5,5 per cent in 2015 and 5,4 per cent in 2017. This development is premised on output picking up over the forecast horizon, as well as some moderation of wage and salary increases.

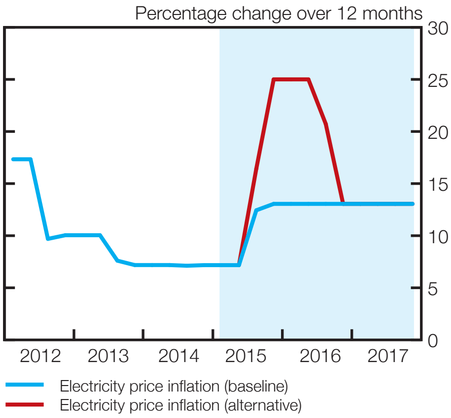
Risks to the forecast

This forecast faces a number of risks, all of which are skewed towards higher inflation than currently expected. Three are particularly prominent: electricity prices, wage settlements and the exchange rate.

Electricity prices

Electricity prices are already slated to rise faster than headline inflation. Nonetheless, Eskom has requested a 25,3 per cent tariff increase in 2015/16, considerably more than the confirmed 12,7 per cent increase. A large additional increase would have significant consequences for inflation. The inflation effects of a 25 per cent hike scenario are detailed in Box 4.

Figure 4.1 Impact of proposed electricity tariffs



Source: South African Reserve Bank

Box 4 Scenario on electricity tariffs

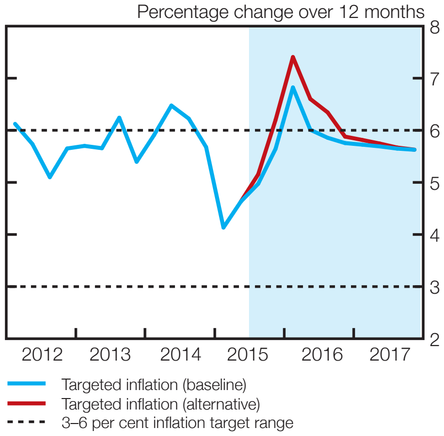
Eskom has recently applied to the National Energy Regulator of South Africa (NERSA) for higher electricity prices. The application proposes an increase of 25,3 per cent for 2015/16. This roughly doubles the 12,69 per cent increase already approved. It includes an additional 10,1 percentage points to cover higher generation costs, mainly from diesel powered open cycle gas turbines (OCGTs). It also covers a 2,51 per cent environmental levy, as announced in the *Budget Review 2015*.

If Eskom's application is successful, it is unlikely that the additional 10,1 per cent increase would be implemented in July, as has happened historically. Municipalities have already prepared budgets. They would also require their own approval from NERSA to amend the electricity prices they charge to their clients. Therefore, the scenario shown here assumes that prices will increase in September 2015, not July. Electricity price hikes are assumed to return to 13,1 per cent for 2016/17 and 2017/18.

In this scenario, headline inflation is 0,1 and 0,4 percentage points higher at 5,0 and 6,5 per cent in 2015 and 2016 respectively. Inflation breaches the target ceiling for four quarters, peaking at 7,4 per cent in the first quarter of 2016 compared to 6,8 per cent in the baseline. Most of the impact on targeted inflation is through the direct effects of electricity prices, which have a weight of 4,13 per cent in the CPI basket. The forecast also reflects some indirect effects, which are adding about 0,1 percentage points in 2016. Inflation remains unchanged in 2017 at 5,7 per cent.

The aim of Eskom's application is to frontload revenue collection. Given base effects from higher electricity tariffs in 2015/16, increases in 2016/17 and 2017/18 may be lower than those currently scheduled in the third Multi Year Price Determination (MYPD3). This could provide some inflation relief in 2017.

Figure 4.2 Impact of proposed electricity tariffs



Source: South African Reserve Bank

Wage settlements and inflation

In several major economies, including the United States and Japan, wage data are studied for the slightest indications of higher pay. These would suggest accommodative monetary policies are working to improve living standards and return inflation to targets. In South Africa, there is abundant evidence of real pay increases. But these increases are much less welcome, posing risks to both employment and inflation.

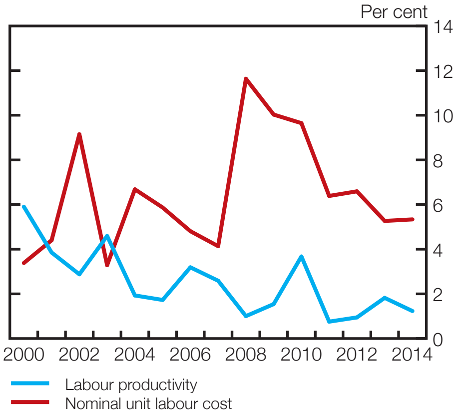
Excessive wage settlements affect inflation in two ways. The obvious problem is that inflation accelerates. The more subtle consequence is that inflation does not fall but is sticky at relatively high levels, pointing to wage indexation. It is possible that even high wage settlements could be consistent with low inflation, if firms respond to higher labour costs by reducing their demand for workers. But not all inflationary pressure is likely to be relieved in this way. In some instances, it may not be possible to substitute capital for labour. The connection between remuneration and job losses is also likely to operate with a lag, as firms start reducing labour demand only after conceding high wage settlements.

Wage settlements as measured by the Andrew Levy survey[3] have remained high and sticky, averaging 7,9 per cent from 2010 to 2014. (The average level for the first quarter of 2015 was also 7,9 per cent.) Wage and salary expectations are also above inflation, according to the BER's survey. In the first quarter of 2015, respondents reported 6,8 per cent for this year and 7,0 per cent for 2016 (although these figures are noticeably lower than expectations of 7,8 per cent captured in the previous quarter).[4]

Growth in average formal (non-agricultural) salaries and wages has averaged 8,4 per cent over the past five years. Labour productivity in the formal, non-agricultural sector has risen 1,7 per cent annually.[5] The gap between these numbers is reflected in higher unit labour costs (ULCs), which grew on average by just under 7 per cent over the same period (well above inflation, which averaged 5,4 per cent). ULCs spiked in 2008 and have since subsided slowly. In the years 2008 to 2012, ULCs grew by less than 6 per cent for only four quarters out of 20. More recently, growth in ULCs has been more moderate, at around 5 per cent, although it was back over 6 per cent towards the end of 2014.

This decline in ULCs suggests productivity gains and job shedding have together reduced the inflationary consequences of rising labour costs. However, the fact that ULCs continue to grow by close to 6 per cent shows these pressures continue to feed inflation.

Figure 22 Unit labour cost and productivity



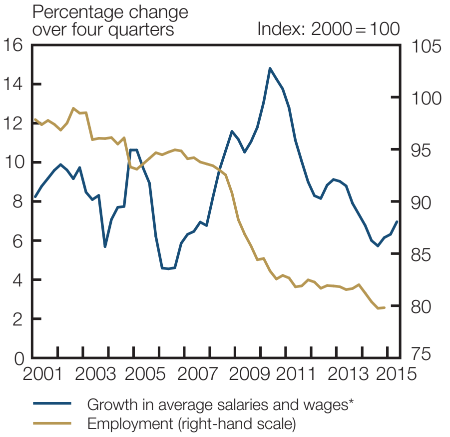
Source: South African Reserve Bank

3 This survey, however, covers a very small proportion of the labour force.

4 This question is also asked in the BER's inflation expectations survey.

5 These numbers must be interpreted with caution because of various measurement problems with labour data. However, the key point is the trend of total wage growth above growth in labour productivity or in general prices.

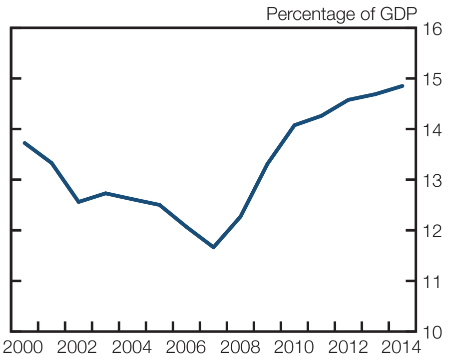
Figure 23 Employment and average wage growth in manufacturing



* Four-quarter moving average

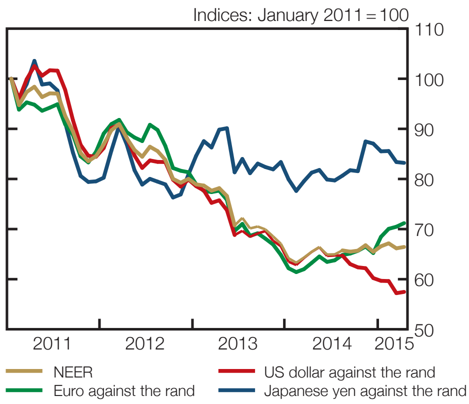
Sources: Statistics South Africa and South African Reserve Bank

Figure 24 Public-sector wages



Sources: Statistics South Africa and South African Reserve Bank

Figure 25 Various exchange rate measures



Sources: Bloomberg and South African Reserve Bank

Unemployment in South Africa has been fairly constant at around 25 per cent since 2010, and net job creation has been positive over that period, demonstrating that the economy as a whole has not been shedding jobs. However, there is some sectoral evidence of high wages driving job losses. The pattern is clearest in the manufacturing sector, which has seen a structural shift away from labour since about 2006. There is also evidence of job shedding in the mining sector, with the Chamber of Mines reporting about 35 000 job losses since 2012, close to 7 per cent of total mining employment.

The main engine of job creation since the crisis has been the public sector. By contrast, private-sector employment is still below pre-crisis levels. Over the past seven years, the public-sector workforce has expanded by over 400 000 people, on a net basis, and now accounts for almost 25 per cent of overall employment. (The private sector has shed close to 300 000 jobs, net, over the same time frame.) The state's wage bill has climbed from around 13 per cent of GDP during the 2000s, to 15 per cent of GDP, with individual wages rising 15 per cent between 2007 and 2015 in real terms. This wage growth is not easily evaluated because of the difficulty in measuring public-sector labour productivity. It is clearer, however, that although real public-sector wage costs will keep rising over the next three years, public-sector employment is likely to stop growing as the state implements a personnel head count freeze. Without the state driving employment gains, we may now begin to see net job losses not just in specific sectors but also across the economy as a whole. The alternative would be wage and salary moderation alongside rising productivity. This would provide a more sustainable basis for continued employment gains, and should over time stimulate private-sector employment.

Currency depreciation

The rand has been depreciating against the US dollar for over four years – the longest such trend since 1994. However, the rand's recent performance against other currencies has varied. In particular, although the domestic currency is presently close to a 13-year low against the US dollar, it has gained against the euro. In keeping with this divergence, the trade-weighted exchange rate has been little changed since early 2014.

What scope exists for additional currency depreciation? South Africa remains vulnerable to further rand weakness given a relatively large and persistent current-account deficit. This is likely to become more difficult to finance as the Fed normalises monetary policy, because higher interest rates in the United States should redirect capital away from emerging markets, including South Africa. The consequences of US normalisation could, however, be mitigated by several factors.

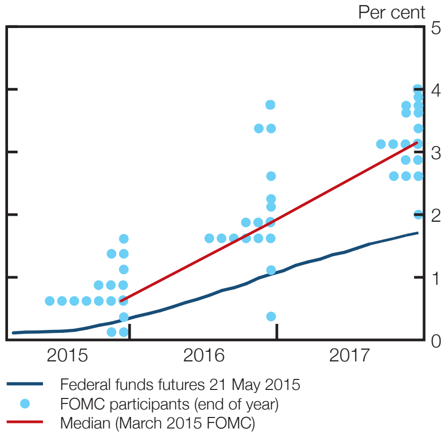
Long US rates will not necessarily move in tandem with short rates, a pattern last seen in the mid-2000s, when it was termed the 'Greenspan conundrum'. A comparable 'Yellen conundrum' would mean longer-term investors would not suddenly find more lucrative opportunities in the US relative to emerging markets, so capital flows would not reverse sharply.

Second, the policies of major central banks are diverging, with the ECB and the Bank of Japan still easing policy. This is keeping world monetary conditions loose and making investors' search for yield correspondingly difficult. (Indeed, this is a likely cause of the mooted 'Yellen conundrum').

Third, it is uncertain to what extent Fed normalisation has already been priced in to markets, including exchange rate markets. The process of normalisation has been extensively communicated. US policymakers are endeavouring to avoid repeating the 'taper tantrum' of May 2013, when market actors abruptly revised their views of the Fed's normalisation timetable following comments by the incumbent chairman, Ben Bernanke. But there is still scope for surprises over the exact pace and timing of Fed normalisation. For instance, market expectations of the federal funds rate remain well below the median expectations of policymakers, as expressed in the Fed's 'dot plots'. Domestic factors will also interact with US developments and may prompt sharp sell-offs, like those recently witnessed in several other emerging markets.

Compounding the difficulty of forecasting exchange rate developments is the problem of pass-through, an abiding concern for monetary policy in South Africa. The amount of depreciation that feeds through into consumer price inflation appears to have fallen during the current depreciating trend, relative to previous periods of rand weakening. Estimates vary, but pass-through may be closer to half its average longer-run level of around 20 per cent. This phenomenon is likely related to weak domestic demand, which makes it more difficult for importers to pass higher costs on to their customers. Other possibilities are that importers have been able to absorb higher costs through hedging strategies, or have deferred price hikes on the expectation that the currency will rebound. Should pass-through revert to its longer-run average, this would release pent-up inflationary pressure into the economy.

Figure 26 US Federal Reserve 'dot plot' and federal funds futures



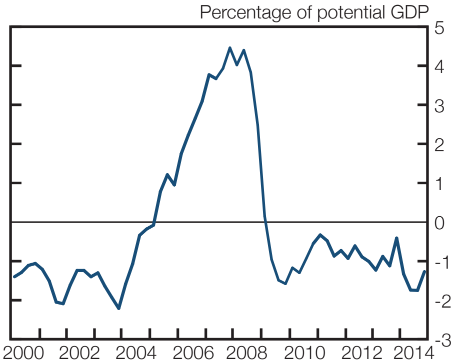
Sources: US Federal Reserve and Bloomberg

Domestic growth outcomes

South Africa recorded meagre growth in 2014. Output expanded just 1,5 per cent, even lower than the mediocre 2,2 per cent achieved in the preceding two years, and the lowest growth rate since the crisis. This under performance appears to have re-opened the output gap, which had been approaching zero at the end of 2013. The main driver of this was strikes, particularly the record-length platinum-sector strike in 2014. As these disputes were resolved in the second half of the year, growth rebounded, reaching an annualised rate of 4,1 per cent in the fourth quarter.

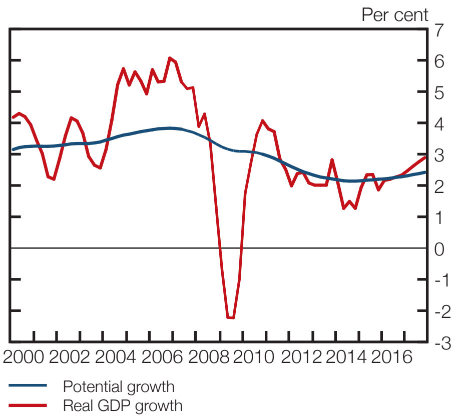
Yet that high number does not signal an upward shift in South Africa's growth trajectory. Instead, growth is likely to remain slightly over 2 per cent. This is similar to the average of the past three years, and significantly below pre-crisis levels. It is also close to estimates of the economy's potential growth rate. A major reason for this downward shift is electricity shortages. In addition, the credit cycle is not yet in a leveraging, growth-supporting phase. Furthermore, the external sector remains relatively unfavourable, with weak world trade growth and lower commodity prices.

Figure 27 South Africa's estimated output gap



Source: South African Reserve Bank

Figure 28 South Africa's estimated and forecast potential output growth 2000–2017



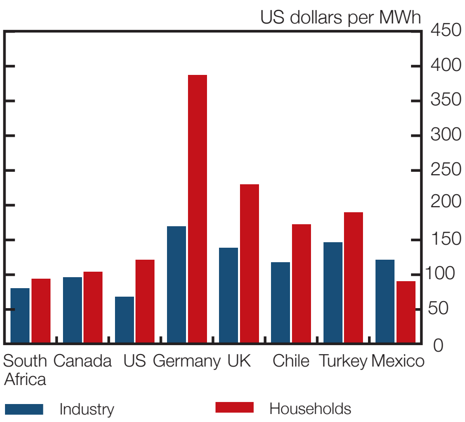
Source: South African Reserve Bank

Electricity

In November 2014, an accident at the Majuba power station prompted the return of load shedding in South Africa. Although originally considered a temporary disturbance, load shedding has continued through the first half of 2015. Shortages of electricity are now expected to persist over the medium term – a crucial constraint on growth. The problem has several dimensions. Eskom has seen underinvestment in generating capacity over the past 20 years. New investments have been hampered by prolonged and repeated construction delays. South Africa's usage of electricity is also comparatively inefficient.

Following supply shortages during the 1970s, Eskom invested heavily in new generating capacity. Weak growth in the 1980s led to excess supply, a situation which persisted through the 1990s. Thereafter, a resurgent economy began reducing the slack, but new capacity was not approved until 2004. This delay stretched supply and created a maintenance backlog. Over the past five years, Eskom's energy availability factor – the proportion of theoretical capacity actually available to generate power – has declined to around 75 per cent, compared to a target of 80 per cent. More than half of the recent load shedding has been caused by breakdowns or emergency maintenance. The electricity problem is unlikely to be alleviated by the completion of the main new power stations, Medupi and Kusile, which have anyway experienced repeated delays and will be years overdue. The maintenance backlog means these plants will merely substitute for others which will need to be taken off line for repairs. Furthermore, parts of Eskom's fleet are old and due for decommissioning.

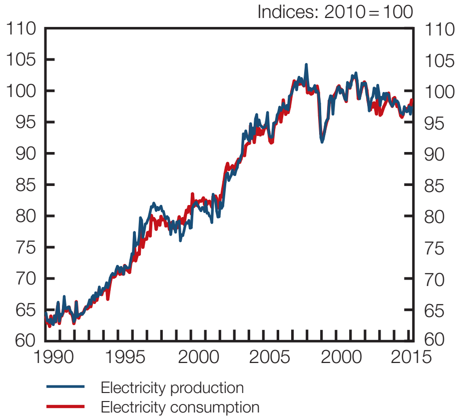
Figure 29 2013 electricity prices in global comparison



Sources: International Energy Agency, Eskom, i-Net and own calculations

Compounding the problem, South Africa's economy is relatively energy-intensive. Historically low electricity prices have encouraged inefficient use of electricity by firms and households. The World Economic Forum's Energy Architecture Performance Index shows that South Africa produces less output per unit of energy than commodity-producing peers such as Australia, Brazil and Canada. The Organisation for Economic Co-operation and Development (OECD) has also demonstrated that South African electricity is relatively cheap, despite recent price increases.[6] In other countries, higher prices have induced users to moderate their electricity requirements. Pushing electricity costs closer to world norms should serve the same purpose here, although it will stoke inflation. Price increases are also likely to achieve a more efficient allocation of scarce electricity by reducing demand at the margins, instead of rationing electricity more indiscriminately through load shedding.

Figure 30 Electricity production and consumption



Source: Statistics South Africa

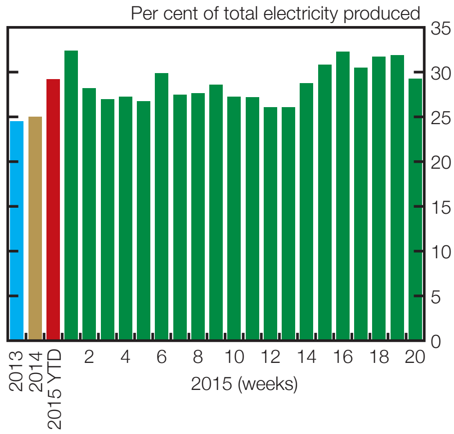
Electricity supply constraints affect economic growth by interrupting production in the short term, and deterring investment, which is a longer-term problem. Production suffers immediately because firms cannot quickly ensure alternative energy sources for production. Over the longer run, uncertainty over the availability and pricing of electricity may cause firms to postpone expansion plans, despite extremely favourable financing conditions. They are also likely to divert some investment expenditure to mitigate electricity shortages. For example, they may purchase generators or make alternative energy supply arrangements with independent power producers.

Table 1 South Africa's international ranking for electricity provision and quality

	WB: Ease of Doing Business	WEF: Global Competitiveness Index	WEF: Energy Architecture Provision Index
	Getting electricity	*Quality of electricity supply*	*Overall*
Latest ranking	158/189 (2015)	99/144 (2014/15)	66/125 (2015)
Previous ranking	156/189 (2014)	94/144 (2012/13)	59/105 (2013)

Sources: World Bank (WB) and World Economic Forum (WEF)

Figure 31 Planned and unplanned electricity outage factor

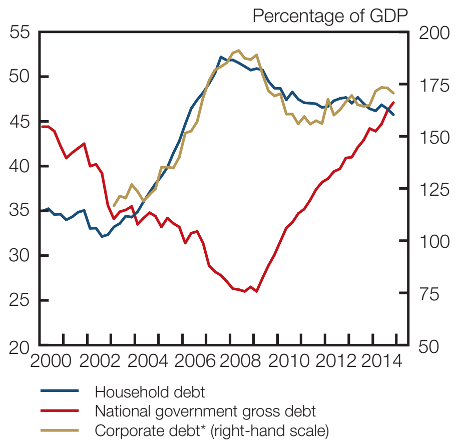


Source: Eskom

The credit cycle

During the boom of the mid-2000s, the South African private sector leveraged up fast – an important ingredient in South Africa's growth surge. The public sector, meanwhile, acted in a counter-cyclical manner, with the state reducing its (gross) debt burden to around 26 per cent of GDP by 2008. When the crash came, this left significant fiscal space for expansionary policy. Meanwhile, an overextended private sector lost its appetite for additional debt, despite very low interest rates. This combination of public leveraging and private deleveraging has prevailed since the crisis. As a result, sustained fiscal deficits have pushed the state's debt burden to relatively high levels. National government net debt is expected to reach 40,8 per cent of GDP in 2014/15. Total public sector debt, including local government and public enterprises, is closer to 60 per cent of GDP. Slowing potential growth has raised the structural component of the deficit, meaning debt will not automatically stabilise over the cycle. National Treasury has therefore begun a fiscal consolidation process to gradually reduce the speed of debt accumulation.

Figure 32 Public and private debt-to-GDP ratios



* Includes loans and bonds

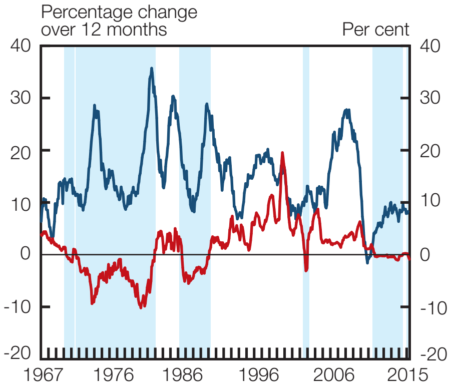
Sources: National Treasury and South African Reserve Bank

South Africa's debt dynamics contrast with the patterns seen in other major emerging markets, where private-sector borrowing typically ramped up only after the crisis and public-sector debt growth has been more modest. Nonetheless, South Africa's overall debt levels are close to the emerging-market average. South Africa is also following what appears to be a widespread turn in EM credit cycles, away from debt accumulation and towards net deleveraging – an important contributing factor to the generalised emerging-market growth slowdown.

6 Organisation for Economic Co-operation and Development, *OECD Economic Surveys: South Africa 2013*, OECD Publishing, 2013. See http://dx.doi.org/10.1787/eco_surveys-zaf-2013-en.

Private-sector credit growth has been slow despite extremely accommodative monetary policy settings. The reasons for this lie in a mix of supply and demand factors. Credit demand is weak owing to high debt levels in households and firms' low confidence. Meanwhile, it appears that credit supply has been at least partly affected by continuous large-scale changes in financial regulation in reaction to the global financial crisis.

Figure 33 Credit growth and accommodative monetary policy



Total loans and advances
Real repurchase rate* (right-hand scale)
Shaded area: negative real repurchase rate

* Real repurchase rate is calculated as repurchase rate less one-year-ahead inflation up to 2002, and less Reuters consensus forecast for one-year-ahead inflation after 2002.

Sources: Statistics South Africa, Reuters and South African Reserve Bank

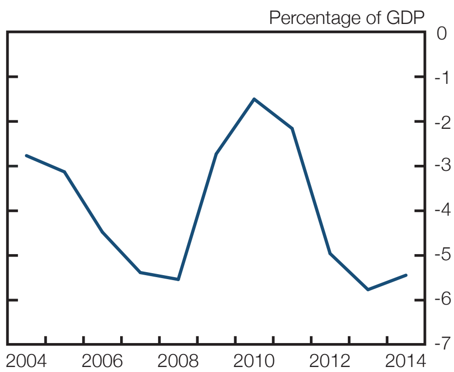
The average household debt to disposable income ratio is now 77,6 per cent, compared to a 2008 peak of 88,8 per cent. This indicates that households have made gradual progress in improving their balance sheets since the crisis. The main driver of the change has been meagre growth in mortgage lending, a category that dominates household debt stocks, such that even large increases in categories such as unsecured lending do not change the overall deleveraging trend. (Mortgage lending accounts for nearly 60 per cent of household credit extension, down from 70 per cent in 2010. General loans, a category which includes unsecured lending, is about 15 per cent of the total.) For corporates, pressure to deleverage has been low in an environment of plentiful, cheap funding via low-yield bond markets or high-priced equities. Lending to corporates has seen some growth over the past year, to fund working capital requirements, renewable energy projects and expansion abroad (especially on the African continent), amongst other activities. This has offset household deleveraging and maintained credit growth to the private sector, in real terms, at around 2,3 per cent in 2014, in line with the two preceding years.

On the supply side, financial institutions in South Africa – as in highly developed financial markets internationally – are in the midst of transformative regulatory changes. These include the implementation of the stepwise Basel III requirements as well as domestic measures such as the Regulations for Affordability Assessment as part of revisions to the National Credit Regulations. The process of reform entails some uncertainty, which in itself may be hampering lending. These changes may also raise risk premiums on new credit for financial institutions, reducing the willingness to make loans.

An unfavourable external environment

The third contributing factor in South Africa's growth slowdown is a relatively unfavourable external environment. World trade has slowed markedly since the crisis, and commodity prices have declined. In this environment, the current-account deficit has been large and persistent. The domestic economy has continued shifting resources from the tradeable to the non-tradeable sector – a pattern which pre-dates the crisis. This helps explain the economy's relatively soft response to substantial rand depreciation.

Figure 34 The current-account deficit



Source: South African Reserve Bank

Prices for South Africa's commodity exports peaked in 2011. They remain elevated in historical perspective, and the collapse in oil prices has improved South Africa's terms of trade. Nonetheless, these are still 8 per cent down on 2011 levels, with more favourable oil prices only now compensating for the comparable collapses seen in some of our main export commodities. Coal, which accounts for 6 per cent of exports, has seen its price fall by 37,8 per cent from 2011 to 2014. For iron ore, which provides close to 7 per cent of exports, prices have moved even more dramatically, falling 65 per cent from 2011 to the first quarter of 2015 (before staging a partial recovery more recently). Precious metals prices, especially for gold and platinum, have moved less sharply, falling 19 per cent each.

Growth in world trade has shifted to a new, lower level in the wake of the crisis. This pattern holds for the world as well as advanced and emerging economies separately. World growth in imports, for instance, which averaged 6,8 per cent annually from 2000 to 2007, has fallen to just 3,6 per cent for the period 2011 to 2014. This has narrowed one of the more successful routes used by emerging markets to move up development rankings. It has also made it more difficult for countries with undesirably large external imbalances to remedy them through higher exports.

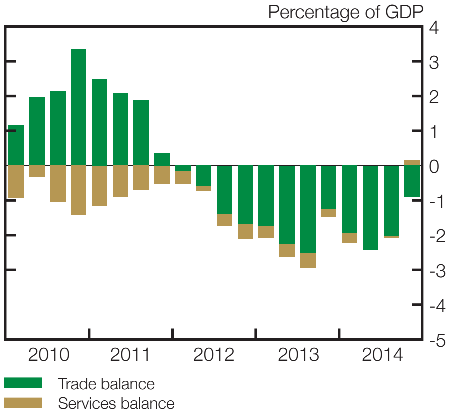
South Africa's current-account deficit has averaged 5,4 per cent of GDP since 2012 – an uncomfortably high number, particularly in the context of diminished domestic growth. Part of this stems from net income payments and transfers, categories that are permanently in deficit (by about 3,5 per cent of GDP on average for the past three years). More important for understanding the change in the current account has been South Africa's trade performance, both in goods and services. Services exports have grown steadily, with particular help from travel receipts – net services exports achieved a surplus in the fourth quarter of 2014 for the first time since the end of 2004. However, the share of services exports in total real exports is quite small, at 16,5 per cent in 2014 (up from 11 per cent in 2000). Goods exports, meanwhile, remain below their 2008 peak. And the proportion of exports in GDP, which fluctuated between 31 per cent and 33 per cent of GDP before the crisis, has since fallen to around 29 per cent. This weak growth in total exports, coupled with rising import penetration, is reflected in a negative contribution of net exports to GDP growth, averaging -0,1 percentage points over the past three years.

One aspect of this weak trade performance is that the part of the economy producing tradeables has declined relative to the non-tradeable sector. The tradeables sector covers businesses that compete with foreign producers, either in the domestic market or abroad. Since about 2000, this sector – which contains mining, manufacturing and agriculture – has grown more slowly than the non-tradeables sector, which comprises everything else in the economy, including the public sector. More precisely, the non-tradeable sector has expanded faster than the tradeable sector in 41 of the last 58 quarters. As a result of this growth divergence, the ratio of the non-tradeable sector to the tradeable sector has risen from 2:1 in the mid-1990s to 3:1 currently. This shift helps explain the persistence of a large current-account deficit despite sustained currency depreciation: the share of the economy that benefits from a weaker real exchange rate has shrunk.

Domestic growth outlook

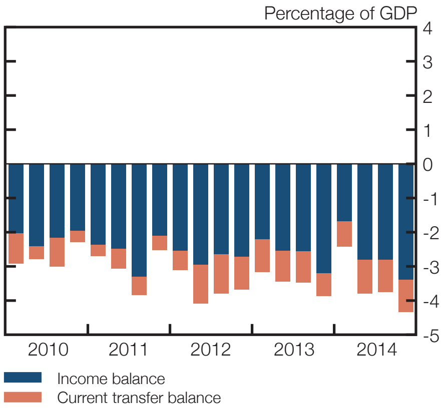
In line with the forces discussed above, the domestic growth outlook has deteriorated. Forecasts of growth over 3 per cent in 2015 and 2016, which were maintained until the middle of 2014, have now given way to growth expectations of just over 2 per cent. In particular, the outlook has been changed by the electricity constraint. Reflecting this, the Bank's GDP growth forecast was revised down significantly at the January 2015 MPC meeting, by 0,3 and 0,5 percentage points for 2015 and 2016 respectively. The forecast also reflects goverment's shift to fiscal consolidation. The February 2015 *Budget Review* announced higher personal income taxes and spending reductions of R25 billion, as well as significant increases in the general fuel levy and contributions to the Road Accident Fund. These measures will moderate the short-term growth boost from government leveraging.

Figure 35 Net exports of goods and services



Source: South African Reserve Bank

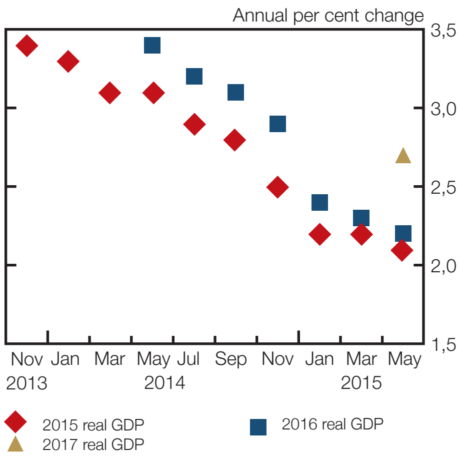
Figure 36 Income and current transfer components of the SIT* account



* SIT: services, income and current transfer account

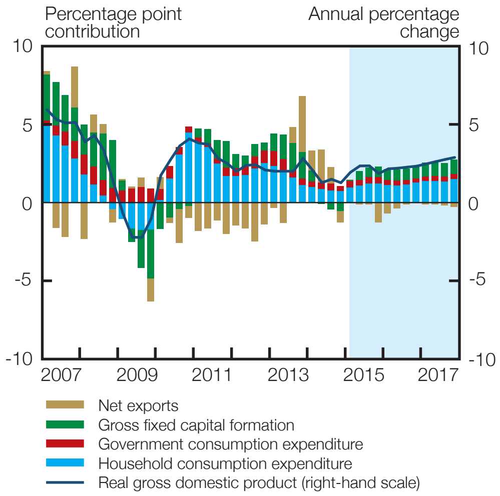
Source: South African Reserve Bank

Figure 37 Evolution of the real GDP growth forecast



Source: South African Reserve Bank

Figure 38 Select components of growth



Source: South African Reserve Bank

They will also reduce the growth benefit from cheaper oil, although this is still providing support to economic activity through stronger world growth as well as higher household incomes.

The growth forecast improves in 2017, with a rebound to 2,7 per cent. This assumes that electricity shortages will be relieved by new production coming online, as well as reduced demand from rising electricity prices.

Annual growth in real consumption expenditure by households is forecast to remain below 2 per cent over 2015 and 2016, despite the gains from lower international crude oil prices. Additional fuel taxes by government will redirect some of this windfall away from households. Household incomes will also be affected by the announced increase in the marginal personal income tax rate. Employment growth is likely to be weak, in the context of lower economic growth and the public-sector personnel head count freeze.

Total fixed investment has been revised down in line with lower growth, weak demand and fragile business confidence. Private-sector fixed investment growth fell to a five-year low in 2014, with six sectors contracting during the year, including manufacturing and finance. Furthermore, a spike in green energy investment in 2013 went unrepeated in 2014, pulling down the year-on-year comparison. Private investment should improve somewhat over the forecast period, reaching 4,7 per cent in 2017. This follows from a mild recovery in business confidence, opportunities for further independent power producers, and the need to maintain and upgrade existing equipment. In the public sector, investment by general government is forecast to slow in 2015 from double-digit growth rates over the past couple of years. Investment by public corporations will be lower than previously expected due to revised investment plans by Eskom and Transnet.

Net exports are expected to remain a drag on growth over the forecast period, although their impact is likely to be smaller than in previous years. Export volumes are forecast to rebound in 2015 as mining exports normalise from 2014's multi-month platinum-sector strike. These will be more than offset, however, by the simultaneous rebound in import volumes, with a projected increase in import penetration. Demand for intermediate goods is expected to remain robust as firms substitute away from domestic suppliers, particularly those affected by rising costs and unreliable electricity. Diesel import volumes are likely to be elevated, with Eskom relying heavily on OCGT power stations to meet electricity demand.

Risks to the forecast

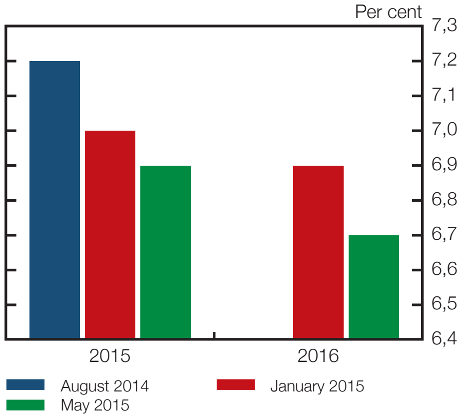
Risks to growth remain mainly on the downside. The electricity constraint is a primary concern. The baseline forecast suggests it will relax over the medium term, owing to more efficient electricity usage and improved supply. However, these expectations may be misplaced. In particular, additional delays to new capacity or further breakdowns in existing infrastructure could lower growth across the forecast horizon.

Protracted labour disruptions represent an ongoing risk to growth. In 2014, close to 12 million workdays were lost to strikes, mainly in the mining and metal or manufacturing sectors. (By comparison, 3,5 million days were lost in 2012 and 5,2 million in 2013.) This year, new wage deals are due in the coal and gold sectors. In 2016, wage agreements need to be reached in the automobile production, fuel, and retail motor industries. Encouragingly, the new public-sector pay deal was achieved without work stoppages. But there is a risk this could be the exception and not the rule.

The world economy poses significant additional risks. China is expected to slow gradually and the euro area to accelerate slightly. In both cases, however, there is a non-trivial risk of significantly worse outcomes. China has so far managed to avoid a hard landing, but still faces the challenge of bringing debt to sustainable levels whilst maintaining adequate growth. An abrupt slowdown in China could affect South Africa directly through lower commodity prices and indirectly through weaker world growth. In the euro area, the main risk to South Africa is a spillover from the Greek crisis to the rest of the euro area. By itself, the Greek economy is a relatively small fraction of the eurozone's. There are presently few signs of spillovers to other euro area economies, including Italy and Spain, the third and fourth biggest economies on the continent. But the outlook is subject to considerable uncertainty.

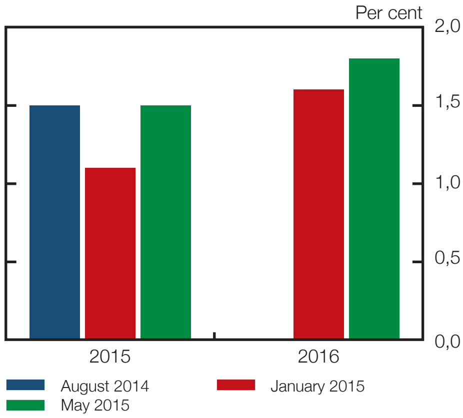
A final, important risk to growth comes from the adjustment to monetary normalisation in the United States. As this process unwinds, emerging markets, including South Africa, should see interest rates rise across the yield curve to maintain inflows, with exchange rates acting as shock absorbers to ease the transition. The baseline expectation is that policy changes in the US will be gradual and clearly communicated, helping markets to adjust smoothly. If markets abruptly revise their expectations of US policy, however, these adjustments could be sharp, which would raise borrowing costs and might damage confidence. That said, the macroeconomic framework is designed to insulate the real economy from such shocks, in particular through low levels of foreign-currency debt and a floating exchange rate. There are many historical examples of emerging markets suffering crises when US monetary policy tightened, but these countries tended to have more brittle policy frameworks.

Figure 39 Evolution of 2015 and 2016 growth forecasts for China



Source: Consensus Economics

Figure 40 Evolution of 2015 and 2016 growth forecasts for the euro area



Source: Consensus Economics

Conclusion

The main storylines of this MPR are as follows.

Collapsing oil prices have lowered inflation in 2015, keeping it close to the midpoint of the target range. The respite is proving to be quite brief. A temporary breach of the target is expected early next year as petrol prices rebound. Food prices and electricity costs are also exerting pressure. Average headline inflation in 2016 should be 6,1 per cent, falling to 5,7 per cent in 2017.

Underlying inflationary pressures are resilient and expectations have converged at the top of the target range. This makes a sustained breach of the inflation target more likely. Furthermore, risks to the forecast are skewed towards higher inflation. Three stand out. The exchange rate may depreciate further, with US monetary policy expected to enter a rate hiking cycle this year. Electricity prices could rise even faster than currently scheduled, should NERSA amend the existing tariff increase in line with Eskom's request. Remuneration of employees may rise by more than productivity, in real terms, and put pressure on prices. Given all these factors, monetary policy remains in a tightening cycle.

South Africa's economic growth rates are converging with estimated potential growth. Unfortunately, this process has entailed falling potential rather than rising growth. The output gap nonetheless remains negative. This tends to alleviate demand-side inflation pressures in the economy. As a result, the rate hiking cycle is expected to be gradual.

Potential growth appears to be around 2 to 2,5 per cent. Actual growth could come in even lower, as in 2014, if shocks such as protracted strikes intervene. But there are deeper reasons that explain why even normal growth is quite low. The external environment is fairly unfavourable. In particular, commodity prices have declined. Furthermore, the euro area – a major trading partner – has still not recovered its pre-crisis level of output. The financial cycle is not accelerating growth. Private-sector credit extension has been subdued since the crisis; more recently, the public sector has begun a process of consolidation to guarantee debt sustainability. Finally, the electricity supply has emerged as a major constraint on growth. It is expected to relax only slowly, with help from improved supply and more efficient demand. By the end of the forecast period, growth may therefore approach 3 per cent.

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. These fan charts assume that the repurchase rate will remain fixed at its pre-meeting rate throughout the forecast horizon.

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 20 per cent to the probability, until the whole shaded area depicts a 90 per cent confidence interval.[7] 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.

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

Statement of the Monetary Policy Committee

29 January 2015

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 inflation outlook has been dominated by the further decline in international oil prices, from around US$75 per barrel in late November to current levels of around US$46 per barrel. Domestic petrol prices declined by almost R2 per litre over the period (and over R3 per litre since August), and a further sizeable decrease is expected in February. This decline in domestic prices occurred despite some offsetting effects from a further depreciation of the rand against the US dollar.

The near-term inflation outlook has therefore changed significantly, but the favourable impact of these developments on both inflation and growth in the longer term will depend on the persistence of the oil price decline. Even a moderate increase in oil prices going forward will reverse the favourable inflation trajectory, and the inflation and growth benefits, while welcome, are expected to be temporary. At the same time, the impact of load shedding and a deterioration of the global growth outlook are likely to offset some of the positive impacts of the lower petrol price on domestic growth.

The year-on-year inflation rate as measured by the consumer price index (CPI) for all urban areas maintained its recent downward trend and measured 5,8 per cent and 5,3 per cent in November and December respectively, down from its recent peak of 6,6 per cent in May and June 2014. This trend reflected continued moderation in food and petrol prices. Food price inflation measured 7,4 per cent in December, down from 7,7 per cent in November, while petrol prices declined by 5,5 per cent. By contrast, core inflation, which excludes food, petrol and electricity, remained near the upper end of the inflation target range, but moderated to 5,7 per cent in December from 5,8 per cent previously.

Headline producer price inflation for final manufactured goods was also favourably impacted by declining oil and agricultural crop prices, and measured 6,5 per cent and 5,8 per cent in November and December respectively compared with 6,9 per cent and 6,7 per cent in the preceding two months.

The decline in international oil prices has prompted a downward revision of the oil price assumption in the Bank's forecasting model, with a significant impact on the near-term inflation forecast. The longer term impact will be dependent on the persistence of these lower prices, which have been a reaction to global supply and demand factors as well as a change in the behavior of key oil producers. With supply still plentiful and global growth prospects remaining relatively subdued, lower oil prices are expected to persist for some time. However, our forecast makes provision for a moderate increase over the next two years.

Having averaged 6,1 per cent in 2014, inflation is now expected to average 3,8 per cent in 2015, compared with the previous forecast of 5,3 per cent, and to reach a low of 3,5 per cent in the second quarter of this year compared with 5,1 per cent previously. The steep decline in 2015, however, produces a strong base effect in 2016, and, when combined with a slightly higher oil price assumption and a depreciated nominal effective exchange rate of the rand, results in an average inflation forecast of 5,4 per cent for the year (5,5 per cent previously), and 5,3 per cent in the final quarter.

The impact on core inflation is far less pronounced. Core inflation is expected to average 5,5 per cent and 5,1 per cent in 2015 and 2016 respectively, from 5,7 per cent and 5,3 per cent previously. The peak is expected at 5,8 per cent in the first quarter of 2015.

Inflation expectations as reflected in the survey conducted by the Bureau for Economic Research at Stellenbosch University moderated from 6,1 per cent in the third quarter of 2014 to 5,8 per cent in the final quarter. Analysts and trade unionists revised their forecasts for 2015 downwards by 0,3 percentage points to 5,4 per cent and 5,9 per cent respectively, while the forecasts of business people were 0,2 percentage points lower at 6,2 per cent. Forecasts for 2016 are unchanged for the latter category, but both analysts and trade unionists expect a 0,1 percentage point increase in 2016 relative to 2015. While this downward revision is a welcome development, it is too early to assess whether or not this represents the start of a sustained downward trend. At these levels, expectations still remain uncomfortably close to the upper end of the target range.

According to the Reuters poll of economic analysts conducted in January 2015, the median inflation expectation is 5,0 per cent in 2015, rising to 5,5 per cent in 2016. The low point of the inflation trend is expected in the second quarter, with the median at 4,6 per cent, but with expectations ranging from 3,4 per cent to 5,9 per cent. Inflation expectations as reflected in inflation-linked bonds have been volatile, having increased in response to the weaker exchange rate in November 2014, but since mid-December have exhibited a steep decline. Both the 5-year and 10-year break-even rates have declined to levels below 5,5 per cent.

The global economic growth outlook remains mixed, despite a strong performance by the United States (US) economy, lower international oil prices and the quantitative easing announced by the European Central Bank (ECB). The US economy grew at an annualised rate of 5,0 per cent in the third quarter of 2014, the fastest quarterly growth since 2003. The unemployment rate continued to decline as job creation accelerated, and lower oil prices have provided a boost to consumption expenditure. Growth in the United Kingdom (UK) also remains robust, despite slower fourth-quarter growth. By contrast, growth prospects in a number of other advanced economies have deteriorated, with Japan in a technical recession and the eurozone remaining weak amid fears of deflation.

Lower oil and other commodity prices have had divergent implications for growth forecasts of different emerging-market economies. Deteriorating prospects in some emerging markets contributed to the lowering of the International Monetary Fund's (IMF) 2015 global growth forecast by 0,3 percentage points to 3,5 per cent, with notable downward revisions to Brazil, China, Mexico, Nigeria and Russia. Growth in China is now expected to moderate to 6,8 per cent from 7,4 per cent in 2014 as the economy continues to rebalance towards domestic consumption and reduce vulnerabilities in its banking system. Although Africa remains one of the high-growth regions, weaker commodity prices pose a risk to the outlook.

The impact of lower oil prices on global inflation is expected to influence monetary policy responses. Although the US Federal Reserve (the Fed) has indicated that policy rates are still likely to rise from around the middle of the year, recent market expectations are pricing in a later start, as inflation remains low. Furthermore, Fed guidance suggests that normalisation, when it does begin, is likely to be at a gradual pace. Whereas the UK had been expected to be the first of the advanced economies to begin raising policy rates in the first half of this year, the lower expected inflation trajectory has changed expectations to later in 2015 or early 2016.

While the UK and US contemplate monetary tightening, the ECB has embarked on open-ended quantitative easing, amid risks of deflation, and the slowdown in Japan is also expected to result in a resumption of asset purchases. Since the previous meeting of the MPC, monetary policy rates have been lowered in Canada, China, Denmark, Egypt, India, Norway, Switzerland and Turkey, while policy has been tightened in Brazil, Nigeria and Russia.

Global foreign-exchange market volatility increased in recent weeks in anticipation of quantitative easing by the ECB; possible risks to the euro from the Greek elections; the ending of the Swiss franc floor against the euro; and changing expectations regarding the timing and pace of US policy normalisation. Since the previous MPC meeting, the euro has depreciated by about 10 per cent against the US dollar. Over the same period, the rand depreciated by 5 per cent against the US dollar and by 1,5 per cent against the pound sterling, but appreciated by about 6 per cent against the euro. Given the relatively high weight of the euro in the trade-weighted index, the nominal effective exchange rate of the rand depreciated by 0,6 per cent.

Market perceptions of a possible delay in US normalisation, coupled with the ECB action, has changed global market risk sentiment and improved the near-term prospects for capital flows to emerging markets. This follows a generalised sell-off in December. These flows are likely to be highly volatile and expected to be more discriminating than in the past. The spill-over effects of the ECB quantitative easing on the rand are therefore not expected to be as pronounced as was the case with the US quantitative easing.

Capital flows to South Africa have been in line with these global developments. During December 2014, non-resident net sales of bonds and equities amounted to R17,9 billion and R8,2 billion respectively. This trend reversed in late December, as portfolio flows to emerging markets resumed, and in the first three weeks of January 2015, non-residents were net purchasers of bonds to the value of R5,8 billion, while net equity sales amounted to R1,5 billion.

The rand has also been affected by domestic factors, including the disappointing domestic growth and current-account deficit outcomes, as well as a resumption of load shedding by Eskom. The rand is expected to remain sensitive to developments on the current account of the balance of payments, which measured 6,0 per cent of gross domestic product (GDP) in the third quarter of 2014. Non-oil commodity prices have been on a declining trend since around 2011, so the recent decline in the oil price represents a positive terms of trade shock that could have a favourable impact on the current account. However, this effect is expected to be limited, in part due to the possible constraining effects of load shedding on exports.

The domestic economic growth outlook remains subdued. Despite an expected growth acceleration in the fourth quarter of 2014 following an annualised growth rate of 1,4 per cent in the previous quarter, growth for 2014 is expected to average 1,4 per cent, with at least 1 percentage point lost to work stoppages. The Bank's forecast for growth in 2015 has been revised down from 2,5 per cent to 2,2 per cent, and that for 2016 from 2,9 per cent to 2,4 per cent. This forecast attempts to take account of electricity-supply disruptions which more than offset the positive growth impact of lower oil prices. The Bank's composite business cycle indicator has followed a moderate downward trend in the past months, confirming the subdued outlook. More positively, the Rand Merchant Bank/Bureau for Economic Research (RMB/BER) Business Confidence Index returned to net positive levels for the first time since the first quarter of 2013, when it increased by 5 points to 51 index points in the fourth quarter of 2014.

The mining sector, which expanded output by 6,2 per cent on a three-month-to-three-month basis in November, is expected to contribute positively to fourth-quarter growth, despite the 1,2 per cent month-to-month contraction in that month. Nevertheless, platinum output still remains below pre-strike levels, and the sector is likely to face headwinds in 2015 from lower commodity prices and electricity-supply uncertainty. The outlook for the manufacturing sector, which contracted for three consecutive quarters, is looking more positive following the resolution of the strikes in the sector, with a three-month-to-three-month increase in November of 4,1 per cent. However, output declined by 2,1 per cent on a month-to-month basis due to electricity-supply disruptions. The Kagiso Purchasing Managers' Index (PMI) declined to 50,2 index points in December from 53,3 points in November, indicating an expectation of positive but subdued growth in the sector.

Although gross fixed capital formation was the largest contributor to GDP growth in the third quarter of 2014, the trend remains weak. Growth in gross fixed capital formation measured 2,1 per cent in the third quarter of 2014 following two consecutive quarters of contraction. While the private sector investment reversed its negative trend in the previous two quarters, at 0,7 per cent it remains extremely low.

The weak growth and investment trends are reflected in the slow rate of formal sector employment creation. According to the Quarterly Employment Survey of Statistics South Africa, employment levels decreased by 5,9 per cent on a seasonally adjusted basis in the third quarter of 2014, mainly due to the termination of temporary employment contracts related to the general elections in the second quarter. This contributed to the annualised 20,8 per cent decline in public-sector employment, while private-sector employment over the quarter increased by 0,1 per cent or 2 000 jobs. Compared with a year ago, employment increased by 1,0 per cent, predominantly in the public sector.

Growth in real final consumption expenditure by households remains weak, despite a slight acceleration in the third quarter of 2014 to 1,3 per cent from 1,1 per cent in the previous quarter. However, expenditure on durable goods increased at an annualised rate of 6,2 per cent, and reflected in stronger new vehicle sales. Retail trade sales improved in November with a month-to-month increase of 1,5 per cent, and year-on-year by 2,6 per cent. Consumption expenditure is expected to get some boost from lower petrol prices. Consumer confidence, while still relatively low, also showed a slight improvement in the fourth quarter of 2014, having increased to a level of zero from the previous level of -1.

Trends in bank credit extension to the private sector continue to reflect tight conditions for households while credit to the corporate sector remains buoyant. Growth over twelve months in total loans and advances to the private sector measured 8,7 per cent in November. However, growth in loans to households, which has been steadily declining over the year, reached a low of 3,6 per cent in November 2014, while that to the corporate sector recorded 15,2 per cent. Growth in general loans to the private sector, mainly unsecured lending, remains weak, despite an increase to 2,9 per cent in November, growth in instalment sale credit and leasing finance moderated further to 6,1 per cent, while mortgage advances continued to grow below 3 per cent in line with the subdued housing market. These trends are assessed to be a reflection of both continued tight credit conditions and weak demand, as household indebtedness remains high.

Wage settlements indicate a continuation of above-inflation wage and salary increases. According to Statistics South Africa data, nominal remuneration per worker in the formal non-agricultural sector increased at a year-on-year rate of 6,9 per cent in the third quarter of 2014. With labour productivity growth of 0,3 per cent, growth in nominal unit labour costs amounted to 6,7 per cent in the quarter. According to Andrew Levy Employment Publications, the average settlement rate in collective bargaining agreements amounted to 8,1 per cent in 2014, compared with 7,9 per cent in 2013. The outcome of the public-sector wage settlement, due to be implemented in April, is expected to have an important bearing on the general trend of wage settlements in the economy in 2015.

Food prices remain a major source of inflation pressure with increases still in excess of the headline inflation rates. However, the moderation observed in recent months is expected to continue, despite the reversal of the downward trend in manufactured food prices at the producer level since October. Agricultural food price inflation remains low, having measured 1,4 per cent in December, with a bumper maize crop expected this year. Global food prices have continued to decline, with the Food and Agriculture Organization's Food Price Index declining by 3,7 per cent in 2014.

The inflation landscape has changed significantly in recent weeks, but the outlook for international oil prices is highly uncertain. Unless a persistent oil price decline is assumed, the impact on the inflation trajectory will dissipate over time. The key issue for the MPC is the extent to which second round effects become evident and lead to a more generalised inflation moderation over the forecast period, and to a further and sustained decline in inflation expectations. The forecast of core inflation at this stage indicates a relatively muted decline in underlying inflation.

The rand exchange rate against the US dollar remains an upside risk to the inflation outlook and is vulnerable to the timing and pace of US policy normalisation, despite the partial offset from a weaker euro. Further depreciation of the rand against the US dollar could also erode the positive benefits of lower oil prices on inflation. The slow pace of contraction of the current account will continue to keep the rand sensitive to both domestic and external factors.

Along with the exchange rate, wage and salary increases in excess of inflation and productivity growth remain an upside risk to the inflation outlook. Unless nominal wage increases moderate in the lower inflation environment, the beneficial effects of the depreciated currency on competitiveness will be eroded. The MPC views the overall risks to the inflation outlook to be more or less balanced, with no evidence of excess demand pressures on inflation.

Notwithstanding a downward revision to the growth forecast, the risks are assessed to be moderately on the downside. This is due to the likely protracted nature of the electricity supply constraints, and their consequences for domestic output, as well as for business and consumer confidence. However, given the supply-side nature of this constraint, the impact of further monetary policy accommodation on growth is likely to be limited, in the absence of progress being made in the alleviation of electricity constraints. In addition, the implementation of structural reforms is necessary to raise potential growth.

For some time we have emphasised that we are in a process of interest rate normalisation. The lower inflation path gives us some room to pause in this process, particularly against the backdrop of continued weakness in the economy. The MPC has therefore unanimously decided to keep the repurchase rate unchanged at 5,75 per cent per annum.

The MPC is aware that the moderation in inflation could raise expectations of lower interest rates. The MPC is of the view that the bar for further accommodation remains high and would require a sustained decline in the inflation rate and inflation expectations.

Statement of the Monetary Policy Committee

26 March 2015

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 near-term inflation outlook has deteriorated with the partial reversal of the recent petrol price declines, emerging upside pressures on food, and possible further electricity tariff increases. The rand exchange rate has depreciated further, adding to upside inflation risks, against the backdrop of the expected, but uncertain, tightening of United States (US) monetary policy. The domestic economy, however, remains weak amid electricity supply constraints and relatively subdued domestic demand.

The year-on-year inflation rate as measured by the consumer price index (CPI) for all urban areas measured 4,4 per cent and 3,9 per cent in January and February respectively. The lower trend in inflation was mainly due to lower petrol prices, but recent oil price and exchange rate developments suggest that this is likely to be the low point for the medium-term inflation trajectory. The February outcome was marginally above market consensus and the Bank's forecast of 3,8 per cent, partly as a result of higher-than-expected health insurance price inflation of 9,6 per cent.

Petrol prices declined by 26,6 per cent in February, while food price inflation measured 6,5 per cent in February, down from 6,6 per cent in January. By contrast, core inflation, which excludes food, petrol and electricity, remained near the upper end of the inflation target range, having measured 5,8 per cent in both January and February.

The favourable impact of the lower oil price was also evident in the headline producer price inflation for final manufactured goods, which measured 3,5 per cent and 2,6 per cent in January and February respectively, compared with 6,5 per cent and 5,8 per cent in the preceding two months. The downward trend is also expected to reverse in the face of adverse fuel and food price developments.

According to the Bank's latest forecasts, inflation is now expected to average 4,8 per cent in 2015, compared with the previous forecast of 3,8 per cent. A first-quarter average of 4,2 per cent is now projected as the low point, compared with 3,5 per cent previously. The strong base effects in the first quarter of 2016 are expected to result in a temporary one-quarter breach of the inflation target during that quarter at 6,7 per cent, with the average for the year expected to measure 5,9 per cent, compared with 5,4 per cent previously. Inflation is expected to average 5,5 per cent in the final quarter of the year, compared with the previous forecast of 5,3 per cent.

The forecast for core inflation is more or less unchanged at 5,5 per cent and 5,2 per cent in 2015 and 2016 respectively, the latter up marginally from 5,1 per cent. The peak is still expected at 5,8 per cent in the first quarter of 2015. The deterioration in the headline forecast is due to an expected acceleration in food price inflation and the impact of the higher fuel and Road Accident Fund (RAF) levies on the petrol price, due to be implemented in April. This is in addition to the current under-recovery on the petrol price. The international oil price assumption remains unchanged from the previous meeting, with a moderate increase over the next two years. The electricity price assumption is also unchanged, with increases of 11,6 per cent assumed from July 2015 and July 2016. However, there is a high possibility of significant further electricity tariff increases.

Inflation expectations, as reflected in the Bureau for Economic Research (BER) survey conducted in the first quarter of 2015, improved for all respondents for 2015, but returned to levels around the upper end of the target range in the next two years. On average, expectations for 2015 declined from 5,8 per cent to 5,4 per cent, with a 1 percentage point decline in the expectations of analysts to 4,4 per cent, and a 0,2 percentage point decline in expectations of business people and trade union officials to 6,0 per cent and 5,7 per cent respectively. However, expectations for 2016 and 2017 are higher, with expectations of the categories of respondents ranging between 5,6 per cent and 6,2 per cent in 2016, and between 5,3 per cent and 6,3 per cent in 2017.

The global economic outlook remains uncertain, with a moderate slowdown in the US and China, and an improvement in the outlook and performance of the euro area and Japan. The US grew at a rate of 2,2 per cent in the fourth quarter of 2014, down from 5,0 per cent in the previous quarter, as the stronger dollar impacted negatively on export growth and investment. Nevertheless, the longer-term growth outlook remains positive. By contrast, the weaker euro and accommodative European Central Bank (ECB) monetary policy have contributed to improved growth prospects in the region, particularly in the core countries. In the fourth quarter of 2014, euro area growth surprised on the upside at 1,3 per cent and ECB forecasts for 2015 have been revised upwards by 0,5 percentage points to 1,5 per cent. The Japanese economy emerged from two quarters of negative growth, recording a growth rate of 1,5 per cent in the fourth quarter.

The larger emerging markets continued to be a drag on global growth. China's economic prospects remain relatively subdued with most domestic demand indicators weakening since the beginning of the year. Consensus forecasts are for both Russia and Brazil to record negative growth rates in 2015. The outlook for the Indian economy, by contrast, is more positive.

Global financial markets continue to be dominated by changing expectations of the timing and speed of the normalisation of US monetary policy. Favourable labour market data in the past weeks in the US resulted in a strong appreciation of the US dollar against most currencies, as expectations of the start of policy tightening were brought forward. However, these expectations were tempered following the March Federal Open Market Committee (FOMC) meeting where the growth and inflation forecasts were downgraded. Uncertainty persists regarding the timing of the first interest rate increase. The FOMC has not only re-emphasised the gradual nature of the expected path of interest rates, but the members' individual expectations of the interest rate path were also revised down significantly. In response to this guidance, the dollar weakened somewhat against most currencies.

While the US prepares to tighten monetary policy, the global trend has generally been towards policy easing or maintaining an accommodative bias. Both Japan and the euro area have continued with their quantitative easing, while a number of countries have eased their policy further, amid benign inflation pressures and concerns about deflation in some countries.

The volatile global trends were reflected in the high degree of volatility in the rand/US dollar exchange rate. Since the previous MPC meeting, the rand has depreciated by about 2 per cent against the US dollar, but traded in a wide band of around R11,27 and R12,52 against the US dollar, with a marked recovery after the recent FOMC meeting. Over the same period, the rand was more or less unchanged against the euro. On a trade-weighted basis, the rand depreciated by 0,7 per cent. Although the rand movement reflected US dollar strength to a large degree, the rand was also negatively impacted by domestic factors, including the weak January trade data and issues relating to Eskom and the domestic growth outlook.

The rand is expected to remain volatile while uncertainty regarding the outlook for US monetary policy persists. The commencement of US interest rate increases, when it happens, is expected to put the currency under pressure. The rand is also expected to remain sensitive to developments on the current account of the balance of payments. The marked narrowing of the trade account in the fourth quarter, reflective of higher export volumes and lower import volumes, contributed to the narrowing of the deficit to 5,1 per cent of gross domestic product (GDP) in that quarter, and to 5,4 per cent for the year. At this stage it is unclear whether or not this represents the beginning of a sustained compression of the current account after a long period of real exchange rate depreciation. While lower international oil prices are expected to continue to impact favourably on the import bill, as oil imports account for just under 20 per cent of merchandise imports, the wide trade deficit in January, should it persist, suggests that the adjustment may remain slow.

Although the current-account deficit to date has been relatively comfortably financed, the global capital flow environment is increasingly challenging, particularly against the backdrop of expected increases in US interest rates. During the fourth quarter of 2014, the deficit was financed primarily through flows into the banking sector. In the year to date, the net sales of bonds and equities by non-residents as reported by the exchanges suggest that net portfolio flows on the financial account of the balance of payments in the first quarter may be negative for the second consecutive quarter.

The outlook for the domestic economy remains overshadowed by the electricity supply constraint, which appears to have had an adverse effect on recent economic activity. This constraint is likely to persist for some time, and has resulted in a downward revision of short-term potential output to between 2,0 and 2,5 per cent. Nevertheless, some improvement on the 2014 growth rate of 1,5 per cent is expected in 2015, in the absence of protracted work stoppages. The Bank's growth forecast for 2015 is unchanged at 2,2 per cent, and marginally lower at 2,3 per cent for 2016. The Bank's leading indicator of economic activity, which had followed a moderately declining trend in 2014, also suggests a continuation of the sluggish growth outlook.

Underlying this outlook is the continued weakness in growth of gross fixed capital formation, which contracted by 0,4 per cent during 2014, with private-sector fixed investment contracting by 3,4 per cent, despite some recovery in the final quarter of the year. The main contribution to fixed capital formation came from general government, which accounts for a relatively small proportion of the total. With business confidence subdued, and amid binding electricity supply constraints, the prospects for a meaningful acceleration remain weak.

Initial high frequency data for 2015 are also a cause for concern, should the trends persist. Both real mining and manufacturing output contracted on a month-on-month basis in January; the Kagiso Purchasing Managers' Index (PMI) declined sharply to below the neutral 50 level in February; the Rand Merchant Bank/Bureau for Economic Research (RMB/BER) Business Confidence Index declined to below the neutral 50 level in the first quarter of 2015 to 49 points, with the decline most marked in the manufacturing sector; and the building sector also shows signs of slowing, with both buildings completed and new plans passed declining, along with lower confidence in the sector, particularly with respect to residential construction.

Against this backdrop, employment growth has stagnated and is likely to remain low: according to the Quarterly Employment Statistics of Statistics South Africa, formal-sector non-agricultural employment contracted by 0,2 per cent over four quarters in the final quarter of 2014, with growth in public-sector employment more than offset by job shedding in the private sector.

Growth in final consumption expenditure by households increased marginally to an annualised quarterly rate of 1,6 per cent in the fourth quarter of 2014, and measured 1,4 per cent over the year. Both retail trade and wholesale trade sales declined on a month-to-month basis in January, and the outlook remains uncertain, as the potential boost to consumption from lower petrol prices has been partially reversed. However, confidence of retailers, particularly of durable goods, remains relatively high. High debt levels, low employment growth and continued tight credit conditions are likely to constrain consumption expenditure growth in the absence of strong increases in real disposable incomes or strong positive wealth effects.

Fiscal policy is set to continue on its consolidation path. As outlined in the recent *Budget Review*, the projected deficit for both 2014/15 and 2015/16 is estimated at 3,9 per cent of GDP, despite lower GDP growth forecasts, and is expected to narrow to 2,5 per cent of GDP by 2017/18. This is envisaged to be achieved through a combination of lower expenditure compared with the 2014 budget estimate and higher tax revenues. This is expected to exert a moderate constraining effect on household consumption expenditure growth.

Trends in bank credit extension to the private sector have remained relatively unchanged, with highly divergent patterns in loans granted to the corporate and household sectors. While growth over twelve months in total loans and advances to the private sector measured 8,3 per cent in January, credit extended to corporates increased by 14,3 per cent, while that to households increased by 3,5 per cent. Growth across all the main categories of credit extension to households has remained subdued in recent months, despite a slight increase in unsecured lending off a low base. Both mortgage credit extension and instalment credit and leasing finance reflected slow growth in housing and motor vehicle sales. Commercial mortgages, by contrast, experienced buoyant growth.

The recent higher trend in wage settlements has the potential to put further upside pressure on inflation. Nominal remuneration per worker over four quarters increased by 7,7 per cent in the fourth quarter of 2014 and, after accounting for changes in labour productivity, resulted in a unit labour cost increase of 6,2 per cent, up from 5,7 per cent in the previous quarter. The Andrew Levy Employment Publications survey shows that during 2014, the average wage settlement rate in collective bargaining agreements amounted to 8,1 per cent, compared with 7,9 per cent in 2013. The public-sector wage settlement is still not agreed, and the outcome is expected to have an important bearing on the general trend of wage settlements in the economy in 2015.

The recent downward trend in consumer food price inflation is forecast to be reversed in the coming months, following the severe drought in some of the maize producing areas of the country. With drastically reduced maize crop estimates, South Africa is expected to become a net importer of maize during the year, and spot prices have moved closer to import parity. The spot price of white maize, for example, has increased by around 30 per cent since the beginning of the year, reinforced by a depreciating currency and despite moderating global prices. Meat prices have also remained elevated.

International oil prices have been relatively volatile but at vastly lower levels than those that prevailed for much of 2014. Having reached a low of around US$45 per barrel in January, Brent crude oil prices increased to around US$62 per barrel at the end of February, before declining to current levels of around US$57 per barrel. The partial recovery in the international oil price, in conjunction with the recent depreciation of the rand against the US dollar, and the impending fuel and RAF levies, will have reversed a large part of the favourable impact on domestic petrol prices, which had declined by about R4 per litre between August 2014 and February 2015.

The respite to the headline inflation outlook from lower international oil prices appears to have been short-lived. However, the expected breach of the target range in 2016 is likely to be temporary, and the main drivers of the deterioration of the inflation forecast are exogenous. While the MPC will look through these developments, the Committee remains concerned about the possible impact on inflation expectations, which remain at the upper end of the target range over the longer term.

The rand exchange rate continues to be the main upside risk to the inflation outlook, and remains highly vulnerable to the timing and pace of US monetary policy normalisation. The extent to which US rate increases are priced into the exchange rate remains uncertain. While the weaker euro has provided some offset, and therefore a more moderate depreciation of the trade-weighted exchange rate, this effect is partial. Furthermore, the rand will also remain sensitive to domestic developments, including the slow pace of contraction in the deficit on the current account of the balance of payments.

Wage and salary increases in excess of inflation and productivity growth also pose an upside risk to inflation. The MPC assesses the risk to the inflation outlook to be on the upside, with the possibility of further electricity tariff increases accentuating this risk.

At the same time, the growth outlook remains constrained by electricity supply concerns and low business confidence, and the risks to the growth forecast are assessed to be moderately on the downside. Demand pressures on inflation remain muted, reinforced by a moderately tighter fiscal policy stance.

In its previous statement the MPC noted that the more favourable inflation path allowed for some room to pause in the process of domestic monetary policy normalisation. The deterioration in the outlook suggests that this scope has narrowed. However, given the uncertainties related to US policy normalisation and the weak state of the domestic economy, the MPC has unanimously decided to keep the repurchase rate unchanged for now.

The timing of future interest rate increases will be dependent, as before, on a range of domestic and external factors. The MPC will remain vigilant and will not hesitate to act in order to maintain the integrity of the inflation-targeting framework.

Statement of the Monetary Policy Committee

21 May 2015

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

The challenges facing monetary policy have persisted and, as expected, the downward trend in inflation, which was mainly attributable to the impact of lower oil prices, has reversed. Headline inflation is expected to temporarily breach the upper end of the target range early next year, and thereafter to remain uncomfortably close to the upper end of the target band for most of the forecast period. The upside risks have increased, mainly due to further possible electricity price increases. The exchange rate also continues to impart an upside risk to inflation as uncertainty regarding impending United States (US) monetary policy continues. Domestic demand, however, remains subdued, while electricity constraints continue to weigh on output growth and general consumer and business confidence.

The year-on-year inflation rate as measured by the consumer price index (CPI) for all urban areas measured 4,0 per cent and 4,5 per cent in March and April respectively. The petrol price increase of R1,56 per litre in April resulted in a decline in the rate of disinflation from the transport category, from -5,0 per cent in March to -1,1 per cent in April, while food price inflation moderated further. The main contributions to the April headline rate came from the categories of food and non-alcoholic beverages, housing and utilities, and miscellaneous goods and services, which together accounted for 3,2 percentage points of the outcome. Core inflation, which excludes food, petrol and electricity, moderated from 5,7 per cent in March to 5,6 per cent in April.

Producer price inflation for final manufactured goods appears to have reached a low point in February at 2,6 per cent, following the 3,1 per cent outcome in March, which was higher than market consensus. While food price inflation moderated, the main upside contribution came from coal and petroleum products where disinflation slowed. The recent increase in international oil prices and higher agricultural crop prices, along with further electricity price increases from mid-year are likely to sustain the upward momentum.

The inflation forecast of the Bank has changed since the previous meeting of the MPC. Inflation is now expected to average 4,9 per cent in 2015, with a first quarter low of 4,1 per cent. A temporary breach of the upper end of the inflation target band is still expected during the first quarter of 2016, to peak at 6,8 per cent, and to decline to 6,0 per cent by the second quarter of that year. An average inflation rate of 6,1 per cent is forecast for the year. The forecast period has now been extended to the end of 2017, with an average inflation rate of 5,7 per cent expected for the year, and 5,6 per cent in the final quarter.

The forecast for core inflation has also increased marginally, to 5,6 per cent in 2015, and to 5,4 per cent in 2016. Core inflation is expected to average 5,2 per cent in 2017, with a final quarter average of 5,1 per cent. Much of the persistence of core inflation at these levels is attributed to high levels of wage growth, currency depreciation and inflation expectations entrenched at the upper end of the target range.

The headline inflation forecast assumes electricity price increases of 13,0 per cent from July 2015 and July 2016 in line with the original multi-year price determination process of the National Energy Regulator of South Africa (NERSA). However, the application by Eskom for a further 12,6 per cent increase from 1 July 2015 will be decided at the end of June. Given the uncertainty regarding this decision, both in terms of quantum and timing of implementation, it has not been incorporated into the forecast, but poses a significant upside risk. Should NERSA fully accede to the Eskom request, a higher peak of headline inflation as well as a more extended breach of the target can be expected. The direct and indirect effects of such an increase could increase average inflation by around 0,5 percentage points over a year.

The Bureau for Economic Research (BER) inflation expectations survey for the second quarter of 2015 will only be released in June 2015. Median inflation expectations as reflected in the Reuters Econometer poll, at 4,9 per cent and 5,9 per cent for 2015 and 2016 respectively, are similar to the Bank's forecast, although there is a fairly wide dispersion between respondents. The break-even inflation rates, as reflected in the yield differential between conventional bonds and inflation-linked bonds, have been more volatile and are above the upper end of the target range over all maturities, having reversed their earlier declines this year.

The outlook for the global economy is broadly unchanged since the previous meeting of the Monetary Policy Committee (MPC). The US growth forecast for 2015 has been revised down by about half a percentage point following the broad-based first quarter estimate of 0,2 per cent, although this deterioration is generally believed to be temporary. Growth of around 3,0 per cent is now expected in 2015, still above estimated potential. Eurozone growth has surprised on the upside, and while still relatively subdued at an expected 1,5 per cent for 2015, there are indications that the region is responding to the European Central Bank (ECB) monetary stimulus. Any possible fall-out from the debt crisis in Greece remains uncertain. Japan is expected to growth by just below 1 per cent this year.

Growth in some of the larger emerging markets remains weak. Negative growth is being experienced in Brazil and Russia, and although the Chinese economy is still slowing, with first quarter growth of around 5,3 per cent, a hard landing is not expected amid further monetary policy easing. By contrast, the Indian economy has been performing strongly, partly in response to policy reforms. While growth in Africa has remained relatively robust, downside risks have emerged in some of the oil and commodity-producing countries.

Global inflation remains benign, but the partial recovery in the international oil price has ameliorated the deflationary risks in some of the advanced economies in particular. Higher, but still low, inflation expectations contributed to a sharp rise in bond yields in some of the advanced economies, with spillovers to other bond markets. However, most central banks remain in loosening mode, with further reductions in policy interest rates in a number of countries since the previous meeting of the MPC. A notable exception has been Brazil, where monetary policy was tightened for the third time this year.

Global financial markets remain focused on the timing of US monetary policy tightening. Low inflation and the weaker first quarter growth outcome have pushed out expectations regarding the starting date, but financial markets generally expect the first move to be during 2015, most likely in September, followed by a gradual data-dependent tightening cycle. Continued financial market volatility is likely to ensue with each relevant data release.

The uncertainty regarding US growth prospects contributed to a weakening of the US dollar against most currencies in recent weeks. Since the previous meeting of the MPC, the rand has traded in a relatively narrow band of between R11,80 and R12,20 against the US dollar, and is currently almost unchanged since then. However, in line with US dollar weakening, the rand has depreciated by 0,6 per cent against the euro and by 4,0 per cent against the pound sterling. On a trade-weighted basis, the rand has depreciated by 0,3 per cent.

The rand continues to be vulnerable to the ebbs and flows of global risk perceptions and associated capital flows, particularly in response to anticipated changes to US monetary policy. At the same time, there is a great deal of uncertainty regarding the extent to which US monetary policy normalisation has been priced into the rand. However, past patterns suggest that some further pressure is likely on the exchange rate and long bond yields as the start of the US tightening cycle becomes more certain. Reflecting this uncertainty, non-resident bond and equity flows have been quite volatile. According to JSE Limited data, non-residents have been net buyers of bonds and equities to the value of around R15 billion since the beginning of this year.

The rand therefore remains an upside risk to the inflation outlook, although the degree of upside risk is tempered somewhat by the continued relatively low level of pass-through to consumer price inflation. The Bank estimates that the actual pass-through could be about half of what is currently implied in the forecast model, but it is still uncertain as to whether this reflects a permanent change or a temporary phenomenon which can reverse rapidly.

The domestic growth outlook remains weak, amid continued electricity supply constraints and low and declining levels of business and consumer confidence. The Bank's forecast for gross domestic product (GDP) growth is marginally down from the previous forecast: growth is expected to average 2,1 per cent and 2,2 per cent in 2015 and 2016 respectively, and to increase to 2,7 per cent in 2017. Growth for the next two years therefore is expected to be more or less in line with the Bank's estimate of short-term potential output growth of between 2,0 and 2,5 per cent. It also suggests that the negative output gap, currently estimated at around 1,5 per cent, is likely to persist. This forecast makes an assumption regarding the persistence of electricity shortages, which are expected to be relieved somewhat only in 2017. However, the risks to growth are assessed to be on the downside. The moderate decline in the Bank's composite leading business cycle indicator also suggests a continuation of the sluggish growth outlook.

Despite a strong performance by the mining sector in March, first-quarter growth is expected to be subdued and much lower than the 4,1 per cent measured in the fourth quarter of 2014. According to Statistics South Africa, the physical volume of mining output increased at a quarter-to-quarter rate of 1,9 per cent in the first quarter. Platinum group metals output was particularly strong in March with a month- on-month increase of 26,6 per cent. By contrast, manufacturing output appears to have contracted by about 0,6 per cent in the quarter, consistent with the continued decline in the Kagiso Purchasing Managers' Index (PMI), down to 45,4 index points in April, and the slight decline in capacity utilisation in the manufacturing sector. The real value of building plans passed declined for a fourth successive month in February, in line with a weaker First National Bank/Bureau for Economic Research (FNB/BER) Building Confidence Index in the first quarter of the year.

Consumption expenditure by households is expected to remain relatively subdued, as higher personal tax rates take effect and the benefits of lower petrol prices dissipate. There are mixed signals from the retail trade sales, which rebounded strongly in February but then contracted in March on a month-on-month basis. A quarterly growth rate of 0,9 per cent was recorded in the first quarter of 2015. Growth in expenditure on durable goods in particular is expected to decline, as reflected in the sluggish new vehicle sales, which decreased further in April. The FNB/BER Consumer Confidence Index declined sharply in the first quarter of 2015, signalling modest growth in consumption expenditure going forward.

Subdued levels of household consumption expenditure are reflected in credit extension by banks to households, where the divergence between households and corporates continues. Growth in credit extension to the corporate sector was 13,9 per cent in March 2015, compared with 3,6 per cent to households. The latter is reflective of continued weak growth across all the main categories of credit, influenced by both supply and demand factors. These trends are likely to be reinforced further by the implementation of affordability assessment regulations as part of revisions to the National Credit Regulations in March. The impending changes in the Basel III regulatory requirements are also contributing to relatively tight credit conditions. At the same time, weak employment growth, high debt levels and continued household deleveraging, as well as expectations of higher interest rates may have impacted on the demand for credit.

Trends in remuneration growth remain a concern to the MPC. Average wage and salary growth has been in excess of inflation for some time, imparting some degree of automatic indexation to wage settlements, and therefore maintaining higher levels of inflation. In the fourth quarter of 2014, year-on-year growth in nominal remuneration per worker in the non-agricultural formal sector increased by 7,7 per cent. After accounting for labour productivity growth of 1,3 per cent, unit labour costs showed an increase of 6,3 per cent, from 5,7 per cent in the previous quarter. According to Andrew Levy Employment Publications, the average wage settlement rate in collective bargaining agreements measured 7,9 per cent in the first quarter of 2015. The public-sector wage settlement appears to have been settled at an increase of 7 per cent, but the full impact on the total government wage bill is still unclear. Upside risks to inflation from wage pressures are still expected, with the unresolved settlements in the coal and gold-mining sectors of particular concern.

While high wage settlements could underpin household consumption expenditure, this could be offset in part by inevitable reductions in employment.

Food price inflation is expected to contribute to upside inflation pressures. This is despite the continued moderation of global food prices and a recent declining trend of food price inflation at the CPI level and lower meat price inflation at the producer price level. Food price inflation measured 5,0 per cent in April following eight successive months of moderation. Similarly, final manufactured food producer price inflation moderated to 5,8 per cent in March. However, domestic drought conditions have resulted in a need to import yellow maize, contributing to maize prices rising close to import parity levels. These pressures, along with the weaker exchange rate, are expected to reverse the favourable trend in food price inflation by the second half of this year.

The international oil price appears to have stabilised in the US$60–US$70 per barrel range, as capital expenditure plans have been scaled back following the collapse of prices in the later part of last year. Since the previous meeting of the MPC, Brent crude oil prices have increased by about US$10 per barrel. Domestic petrol prices remained unchanged in May, but a further increase of around 50 cents per litre, should current trends persist, is likely in June, attributable mainly to higher international product prices.

Although the upward revision of the inflation forecast was relatively small, the persistence of medium-term inflation at elevated levels and the deteriorating risks to the outlook are an increasing concern to the MPC. While currently the breach is expected to be temporary, the longer-term trajectory is close to the upper end of the target range, and the upside risks make this trajectory vulnerable to any significant changes in inflation pressures.

The main risks to the outlook remain electricity tariff increases, the exchange rate and wage settlements. Significant additional electricity tariff increases are likely to cause inflation to diverge significantly from the target range for a more extended period than our baseline forecast suggests. The rand remains vulnerable to global market reaction to US policy normalisation, particularly in the context of South Africa's twin deficits. Any significant weakening of the exchange rate in reaction to US monetary policy tightening could cause inflation to diverge even further from target, and set in motion an exchange rate-inflation spiral. Furthermore, the possibility of a wage-price spiral, should settlements well in excess of inflation become an economy-wide norm, also poses a risk to the outlook.

The MPC recognises that domestic inflation is not driven by demand factors that are more easily dealt with through monetary policy responses. Household consumption expenditure remains relatively subdued. While monetary policy should generally look through supply side shocks, such as large electricity tariff increases and oil price changes, the MPC has to be mindful of the second-round effects of such shocks. In particular, we need to monitor closely the possible impact on inflation expectations which remain uncomfortably close to the upper end of the target range over the longer term.

Growth remains fragile, constrained by electricity shortages and low business confidence, and the risk to the outlook remain on the downside. But this cannot be solved by monetary policy alone. Monetary policy action will need to achieve a fine balance between achieving the Bank's primary mandate of price stability and not undermining growth unduly.

The MPC has decided to keep the repurchase rate unchanged at this meeting. Four members of the committee favoured an unchanged stance while two favoured a 25 basis point increase. The deteriorating inflation outlook suggests that this unchanged stance cannot be maintained indefinitely. The MPC will continue to closely monitor the evolution of inflation expectations and other factors that could undermine the longer-term inflation outlook and stands ready to act when appropriate.

From the next meeting in July, the Bank will take further steps to increase transparency by publishing the assumptions underlying the Bank's forecast with the MPC statement.

Abbreviations

BER	Bureau for Economic Research
BRICS	Brazil, Russia, India, China and South Africa
CPI	consumer price index
ECB	European Central Bank
EM	emerging market
FOMC	Federal Open Market Committee
GDP	gross domestic product
IMF	International Monetary Fund
MPC	Monetary Policy Committee
MPR	*Monetary Policy Review*
MYPD	Multi Year Price Determination
NAIRU	non-accelerating inflation rate of unemployment
NEER	nominal effective exchange rate
NERSA	National Energy Regulator of South Africa
OCGT	open cycle gas turbine
OECD	Organisation for Economic Co-operation and Development
OPEC	Organization of the Petroleum Exporting Countries
PCE	personal consumption expenditure
Repo [rate]	Repurchase [rate]
RAF	Road Accident Fund
SIT	services, income and current transfer [account]
the Bank	South African Reserve Bank
the Fed	United States Federal Reserve
UK	United Kingdom
ULC	unit labour cost
US	United States
WB	World Bank
WEF	World Economic Forum

Glossary

Administered prices: These prices are set according to government's policy rather than determined by market supply and demand forces.

Advanced economies: Advanced economies are countries with high levels of GDP per capita. These countries are sometimes described as industrialised. With further growth, however, they have tended to diversify, with particular emphasis on services sectors.

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.

Basel III: This refers to a set of global banking reforms in both the micro- and macroprudential spheres. It is aimed at improving banking regulation, supervision and risk management. Implementation began in early 2013 and is ongoing.

Baseline (forecast): The baseline forecast is the one that is considered most likely. Alternative scenarios use different assumptions.

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.

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 energy, agriculture, metals and minerals. 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: Core generally refers to underlying inflation, excluding volatile elements, e.g. food and energy prices. The Bank's forecasts and discussions refer to headline CPI excluding food, non-alcoholic beverages, petrol and electricity prices.

Crawling peg: An exchange rate regime that lies between the fixed and floating regimes. A crawling peg adjusts slowly based on the changes to an 'anchor' exchange rate against which it is linked.

Crude oil price: This is the price, in US dollars, per barrel of unrefined oil (Brent crude refers to 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.

Ex ante: This refers to an object's value before an event.

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-round effects: Price shocks entail direct and indirect first round effects. For example, should the petrol price rise sharply, this directly affects the cost of transport for the consumer. It also impacts on producers who will then increase the price of their goods to cover the transport, thus indirectly affecting consumer prices.

Fiscal consolidation: A process whereby the government reduces its budget deficits and the pace of its debt accumulation, in order to ensure a sustainable financial position.

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

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

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

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

Gross fixed capital formation (investment): 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 consumption: 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.

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).

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.

Leverage: This refers to a process of borrowing money to buy assets or fund consumption; highly leveraged entities are those with a large amount of outstanding debt.

Load shedding: Eskom has adopted a policy of load shedding to manage insufficient electricity supply. This entails pre-planned, rotating interruptions to electricity supply to alleviate pressure on the national grid, thus avoiding a national blackout.

Maastricht Treaty: The signing of this treaty brought the European Union (EU) into existence in 1992. It includes a number of rules governing limits to government debt and budget deficits. EU countries must abide by these rules in order to use the common currency (the euro).

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

Monetary policy normalisation: Refers to the unwinding of unusually accommodative monetary policies. It could also mean adjusting the economy's policy rate towards its real neutral policy rate.

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

Nominal effective exchange rate (NEER): A NEER is an index that expresses the value of a country's currency relative to a basket of other (trading partner) currencies. An increase (decrease) in the effective exchange rate indicates a strengthening (weakening) of the domestic currency with respect to the selected basket of currencies. The weighted average exchange rate of the rand is calculated against 15 currencies. The weights of the five major currencies are as follows: euro (34,82), US dollar (14,88), Chinese yuan (12,49), British pound (10,71) and Japanese yen (10,12). Index: 2000 = 100. The real effective exchange rate, by contrast, is the NEER adjusted by relative consumer prices in South Africa and its main trading partners.

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

Output gap/potential growth (GDP): 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, which accumulates over time. 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 are inflationary.

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.

Purchasing power parity: PPP is based on the law of one price, assuming that in the long run, exchange rates will adjust so that purchasing power across countries is approximately the same. It is often used to make crosscountry comparisons without the distortionary impact of volatile spot exchange rates.

Quantitative easing (QE): QE involves the central bank purchasing assets on the open market so as to inject liquidity into the economy.

Real effective exchange rate (REER): *See* 'Nominal effective exchange rate'.

Repurchase rate (repo rate): This is the policy rate that is set by the Monetary Policy Committee (MPC). It is the rate that commercial banks pay to borrow money from the South African Reserve Bank.

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

Second-round effects: If a price shock goes beyond first-round effects by shifting inflation expectations (and hence wage demands), then it is seen to have second-round effects. These are the effects that the MPC would seek to counter in the event of a price shock.

Sterilisation: In monetary policy terms, this refers to actions taken to offset undesired increases in the overall money supply, which are triggered by the purchase of foreign exchange.

Structural reforms: The reforms necessary to increase a country's potential growth rate, which differ from country to country. In South Africa, the National Development Plan is considered the most comprehensive guide to necessary structural reforms for the economy.

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.