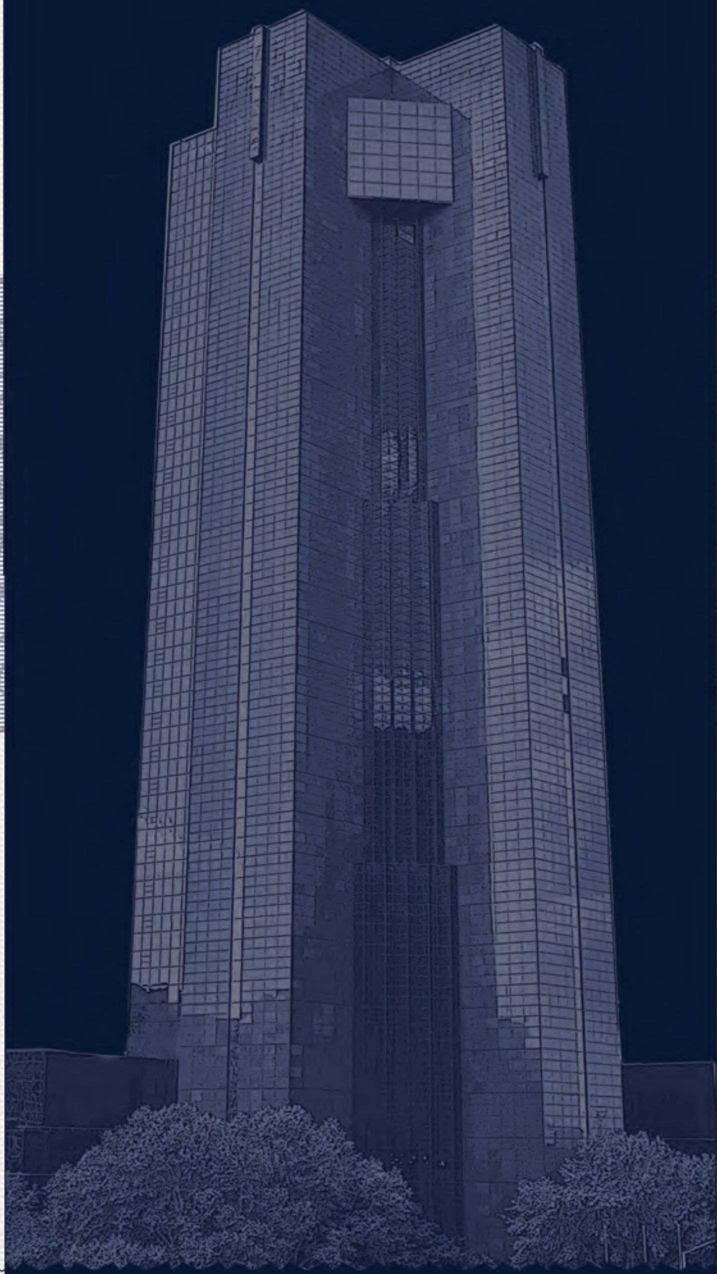

Monetary Policy Review

November 2011

South African Reserve Bank

90th Anniversary

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Monetary Policy Review

Introduction

Since the previous *Monetary Policy Review* (*MPR*) was published in May 2011, the prospects for global and domestic growth have deteriorated. Growth in a number of advanced economies has slowed, and confidence levels have been undermined by renewed financial market turbulence, generated in large part by the unresolved European sovereign debt crisis. Some advanced economies face prolonged periods of economic adjustment, and although emerging markets are expected to continue to outperform advanced economies, their growth will be affected by the challenging environment. Heightened perceptions of risk by global investors have resulted in increased volatility of capital flows worldwide. Recent shifts in capital flows have also impacted on the domestic capital and foreign-exchange markets.

South Africa's fragile and uneven domestic economic recovery is evident in recent economic data. After providing the main support to the domestic recovery for the past two years, growth in household consumption expenditure slowed markedly in the second quarter of 2011. Growth forecasts have been lowered following the deterioration in the global growth outlook, the weaker-than-expected domestic growth outcome in the second quarter, and the impact of industrial action on key sectors of the economy. Domestic inflation also picked up during the period under review, with oil, food and administered prices rising strongly. However, wage pressures have eased somewhat, and targeted inflation has remained within the inflation target range of 3 to 6 per cent.

This *MPR* analyses the latest developments in inflation and the factors that impact on it. It reviews recent monetary policy developments, discusses the outlook for inflation and presents the South African Reserve Bank's (the Bank) growth and inflation forecasts. In addition, topical issues are addressed in boxes. The first box reports on the high-frequency reaction of the rand per US dollar exchange rate to inflation surprises, and considers whether there is a negative correlation between inflation surprises and changes in the nominal exchange rate in the very short term. The second box provides an assessment of the accuracy of the forecasts of inflation provided by the Bank's suite of models.

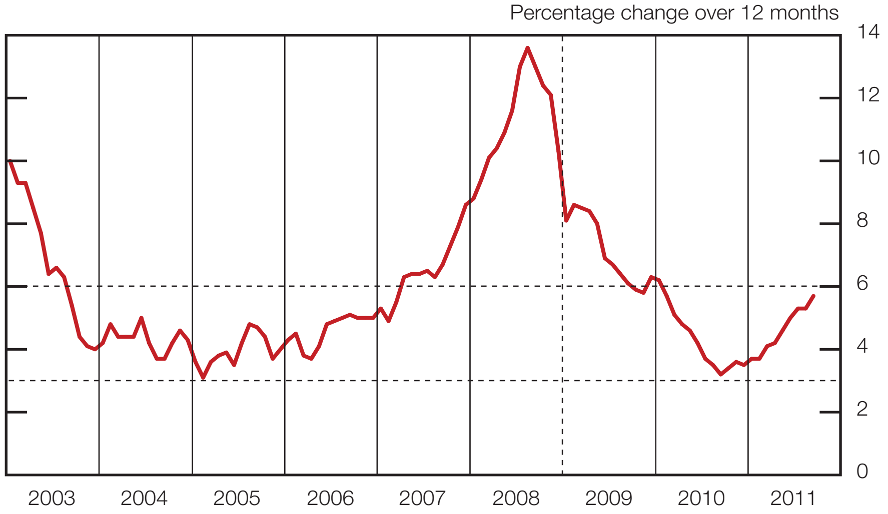
Recent developments in inflation

This section reviews recent trends in the main inflation indices and analyses developments in the main factors impacting on inflation in South Africa.

The evolution of inflation indicators

The year-on-year percentage change in the headline consumer price index for all urban areas (CPI), the measure of inflation targeted by the Bank, increased from 4,2 per cent in April 2011 to 5,7 per cent in September (Figure 1). Headline inflation has remained within the inflation target range of 3 to 6 per cent since February 2010.

Figure 1 Consumer price inflation: Targeted inflation*



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

Source: Statistics South Africa

The 1,5 percentage point increase in the inflation rate since April 2011 has been driven mainly by increases in the food and non-alcoholic beverages (NAB) and transport categories (Table 1). The contribution to the inflation rate from the food and NAB category has increased from 0,7 percentage points in April to 1,3 percentage points in September 2011. The transport category has also seen significant price increases, primarily due to petrol price increases, causing its contribution to increase from 0,6 percentage points in April to 1,1 percentage points in September 2011. The inflation rate has also been supported by a steady but high contribution from the housing and utilities category which has increased from 1,5 percentage points in April and May to 1,6 percentage points for the period from June to September 2011.

Table 1 Contributions to CPI inflation

Percentage change over 12 months* and percentage points

	2011					
	Apr	May	Jun	Jul	Aug	Sep
Total*	4,2	4,6	5,0	5,3	5,3	5,7
Of which:						
Food and non-alcoholic beverages	0,7	1,0	1,1	1,1	1,1	1,3
Alcoholic beverages and tobacco	0,3	0,3	0,4	0,4	0,4	0,4
Housing and utilities	1,5	1,5	1,6	1,6	1,6	1,6
Health	0,1	0,1	0,1	0,1	0,1	0,1
Transport	0,6	0,7	0,9	0,9	1,0	1,1
Education	0,2	0,2	0,2	0,2	0,2	0,2
Restaurants and hotels	0,2	0,2	0,0	0,2	0,2	0,2
Miscellaneous goods and services	0,5	0,5	0,6	0,6	0,6	0,7
Other	0,1	0,1	0,1	0,2	0,1	0,1

Source: Statistics South Africa

The year-on-year inflation rate for all food items increased from 4,8 per cent in April to 8,7 per cent in September 2011. This increase is largely the result of rising inflation in the breads and cereals, and the meat subcategories. The inflation rate for meat had risen by 3,8 percentage points since April to 12,1 per cent in September, resulting in the contribution of meat to headline inflation increasing from 0,4 percentage points in April to 0,6 percentage points in September (Table 2). Similarly, the inflation rate for breads and cereals had increased by 4,7 percentage points since April to 8,6 per cent in September, resulting in the contribution to headline inflation increasing from 0,1 percentage points in April to 0,3 percentage points in September.

Table 2 Contributions of food subcategories to headline CPI

Percentage change over 12 months* and percentage points

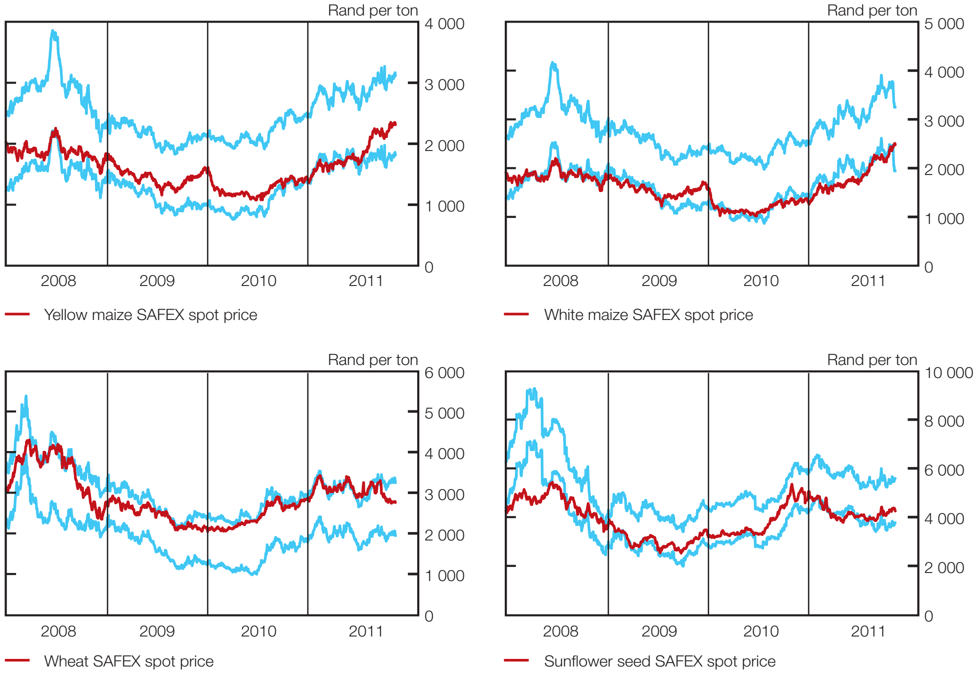
		2011					
	Weight	Apr	May	Jun	Jul	Aug	Sep
Headline CPI*	100,00	4,2	4,6	5,0	5,3	5,3	**5,7**
Of which:							
Food and non-alcoholic beverages	15,68	0,7	1,0	1,1	1,1	1,1	1,3
Food	14,27	0,7	0,9	1,0	1,1	1,0	1,2
Processed food	6,79	0,3	0,5	0,5	0,6	0,6	0,7
Unprocessed food	7,48	0,4	0,4	0,5	0,5	0,5	0,6
Bread and cereals	3,08	0,1	0,2	0,3	0,3	0,3	0,3
Meat	4,59	0,4	0,4	0,4	0,5	0,5	0,6
All other food	6,60	0,2	0,3	0,3	0,3	0,3	0,3

Please note that the contributions may not add up to the total due to rounding

Source: Statistics South Africa

Maize prices in South Africa continued to increase between April and November 2011, although the prices of wheat and sunflower seeds remained relatively unchanged (Figure 2). Maize and sunflower seeds traded at around export parity prices in 2011 due to good yields and increased international prices, resulting in increased export opportunities. Wheat prices have been at import parity as South Africa is a net importer of wheat. The export parity prices, which reflect the notional prices at which South African producers could export commodities, are calculated using international free-on-board (fob) prices, the exchange rate (rand per

Figure 2 Selected commodity prices



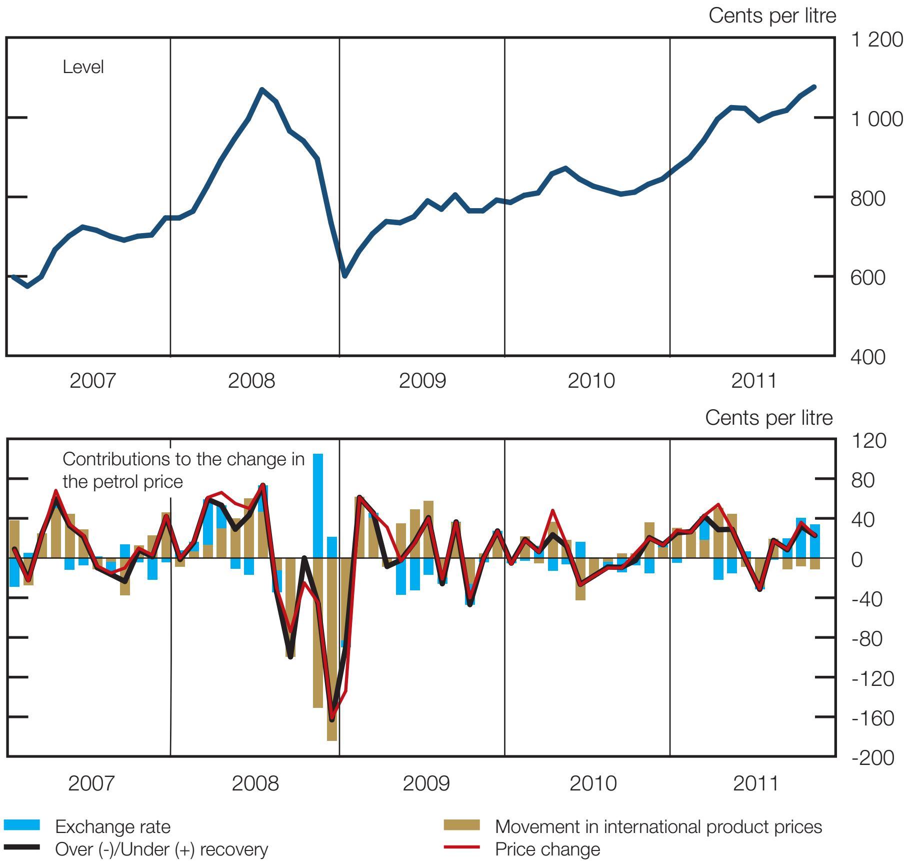
* Please note that the top blue line is the import parity price and the bottom blue line is the export parity price. These prices are the theoretical upper and lower bound prices for commodities

Source: Grain South Africa

US dollar), financing, loading and transport costs. Import parity prices, which provide the notional prices at which commodities could be imported, are calculated using international fob prices, the exchange rate (rand per US dollar), import tariffs and insurance, financing and transport costs.

Petrol prices have continued to increase, with the Gauteng price of 95 octane petrol rising to R10,77 per litre in November 2011, exceeding the previous peak price of R10,70 per litre recorded in July 2008. As Figure 3 shows, the increase in the past three months is mainly due to a depreciation in the value of the currency. The exchange rate used in the calculations of the petrol price depreciated from an average of R6,84 per US dollar in August to R8,00 per US dollar in the November petrol price calculation. Furthermore, during October 2011 the retail margin was increased by 4 cents per litre to cover the increased wages of service station industry staff.

Figure 3 South African petrol price



Source: Department of Energy

Goods and services price inflation have both trended upward since April 2011 (Table 3). Year-on-year goods price inflation increased from 3,7 per cent in April to 5,8 per cent in September 2011. The greatest pressure came from non-durable goods inflation which increased from 6,8 per cent in April to 9,7 per cent in September. Inflation in the durable goods and semi-durable goods categories remained below the lower level of the inflation target range over this period. The durable goods category has continued to experience deflation, with prices declining by 2 per cent in September. Services inflation increased from 4,7 per cent in April to 5,4 per cent in September 2011.

Table 3 CPI: Goods and services inflation

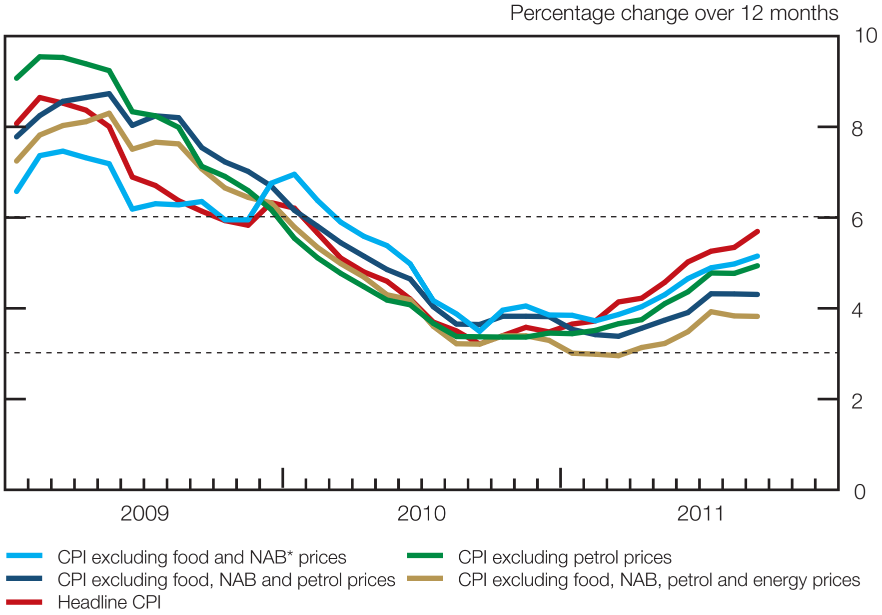
Percentage change over 12 months

	2011					
	Apr	May	Jun	Jul	Aug	Sep
Headline CPI	4,2	4,6	5,0	5,3	5,3	5,7
Goods inflation	3,7	4,5	4,9	5,1	5,4	5,8
Durable goods	-2,3	-2,3	-2,7	-2,1	-2,1	-2,0
Semi-durable goods	1,0	1,6	1,8	1,7	2,1	2,2
Non-durable goods	6,8	7,6	8,5	8,6	8,9	9,7
Services inflation	4,7	4,7	5,2	5,5	5,4	5,4

Source: Statistics South Africa

The measures of core inflation in Figure 4 (defined as year-on-year headline inflation excluding selected administered and volatile prices) show that food, petrol and energy prices continue to place upward pressure on headline inflation. Compared with overall headline CPI inflation of 5,7 per cent in September, core inflation was 4,9 per cent for CPI excluding petrol prices, 5,2 per cent for CPI excluding food and non-alcoholic beverage prices, and 3,8 per cent for CPI excluding food, non-alcoholic beverages, petrol and energy prices. However, these core inflation measures have all been trending upwards during 2011, reflecting general upward pressure on inflation.

Figure 4 The effect of food, petrol and energy prices on headline inflation



* NAB: Non-alcoholic beverages

Source: Statistics South Africa

Administered price inflation has remained significantly above the upper level of the inflation target range (Table 4). Movements in electricity and petrol prices have made the most significant contribution to the high and increasing administered price inflation rate, contributing over half of the increase each month since April 2011. Electricity prices contributed 3,0 percentage points to administered price inflation in September (electricity and other fuels prices, a category dominated by electricity prices, increased at a year-on-year rate of 17,3 per cent in September). Rising petrol prices over the period increased the contribution of this component to administered price inflation from 3,7 percentage points in April to 5,4 percentage points in September 2011. Assessment rates and water have also contributed significantly to overall administered price inflation over the period.

Table 4 Contributions to administered prices

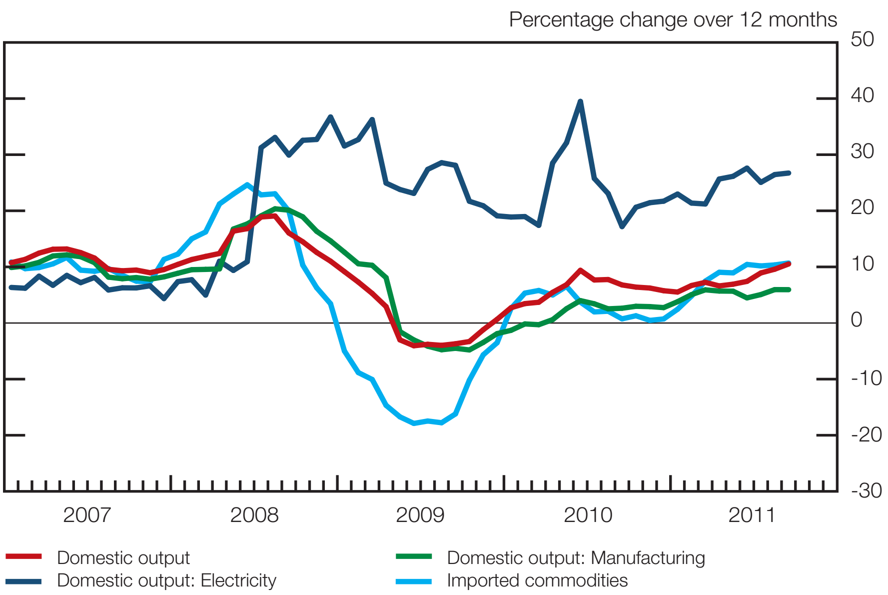
Percentage change over 12 months* and percentage points

	Weights		2011					
	CPI	API	Apr	May	Jun	Jul	Aug	Sep
Regulated component								
Water	1,10	7,50	0,9	0,9	0,9	1,0	1,0	1,0
Electricity	1,68	11,46	2,9	2,9	2,9	3,2	3,0	3,0
Paraffin	0,16	1,09	0,1	0,1	0,1	0,1	0,1	0,2
Petrol	3,93	26,81	3,7	4,1	4,8	4,2	4,9	5,4
Telephone fees	1,26	8,59	0,1	0,1	0,1	0,1	-0,1	-0,1
Postage	0,02	0,14	0,0	0,0	0,0	0,0	0,0	0,0
Cellular telephone calls	1,47	10,03	-0,1	-0,1	0,0	0,0	0,0	0,0
Unregulated component								
Assessment rates	2,07	14,12	1,1	1,1	1,1	1,1	1,1	1,1
Sewage collection	0,06	0,41	0,1	0,1	0,1	0,1	0,1	0,1
Refuse collection	0,09	0,61	0,1	0,1	0,1	0,0	0,0	0,0
Train fees	0,04	0,27	0,0	0,0	0,0	0,0	0,0	0,0
Motor vehicle licences	0,09	0,61	0,0	0,1	0,1	0,1	0,1	0,1
Motor vehicle registration fees	0,10	0,68	0,1	0,2	0,2	0,1	0,1	0,1
Television licences	0,13	0,89	0,0	0,0	0,0	0,0	0,0	0,0
Primary and secondary school fees	1,28	8,73	0,8	0,8	0,9	0,8	0,8	0,8
University fees	0,90	6,14	0,6	0,6	0,6	0,5	0,5	0,5
University boarding fees	0,28	1,91	0,2	0,2	0,2	0,2	0,2	0,2
CPI for administered prices*	14,66	100,00	10,7	11,3	12,0	11,7	11,9	12,5

Source: Statistics South Africa

The year-on-year inflation rate measured in terms of the producer price index (PPI) for domestic output was 10,5 per cent in September; a 3,9 percentage point increase from the rate of 6,6 per cent recorded for April 2011 (Figure 5). This is mainly due to high year-on-year increases

Figure 5 PPI for domestic output and imported commodities



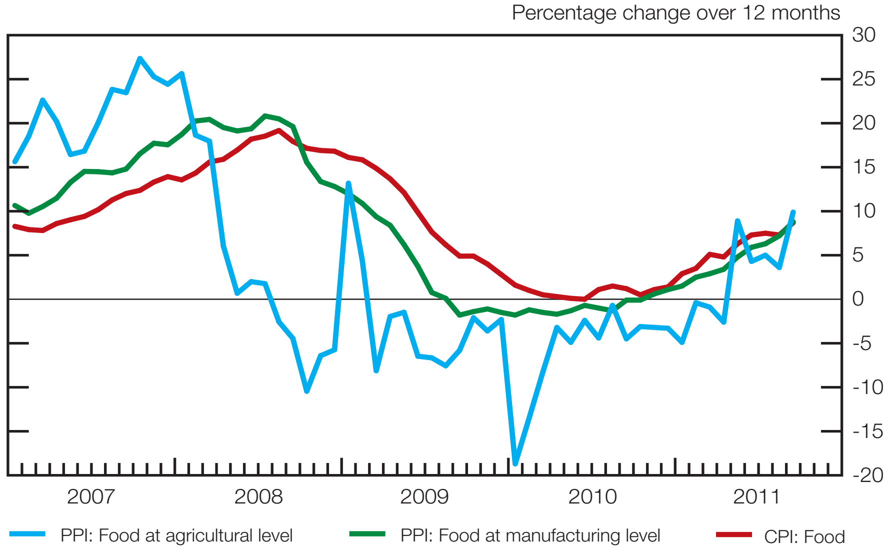
Details regarding changes to the PPI in this period are documented in statistical release P0142.1, February 2008, issued by Statistics South Africa

Source: Statistics South Africa

in the prices of electricity (26,7 per cent), mining and quarrying (17,7 per cent) and products of petroleum and coal (27,1 per cent) in September 2011. The year-on-year increase in the PPI for imported commodities rose to 10,7 per cent in September, mainly due to an increase of 36,3 per cent in the price of crude petroleum and natural gas.

After declining for an extended period, the price of food at the agricultural level in the PPI for domestic prices rose by 8,9 per cent on a year-on-year basis in May 2011 (Figure 6). This rate then moderated to 3,6 per cent in August 2011 before increasing sharply in September to 9,9 per cent as a result of increases in the inflation rates for the vegetables and the fruits and nuts subcategories. The year-on-year percentage change in the price of food at manufacturing level in the PPI for domestic prices has continued to increase since April 2011, rising to 8,8 per cent in September.

Figure 6 Food prices in the PPI and CPI



Source: Statistics South Africa

Box 1 The high-frequency response of the rand–US dollar rate to inflation surprises[1]

The median expectation in the financial markets for inflation in South Africa for the May 2002 to April 2003 period was 10,4 per cent in mid-May 2003.[2] When the data were released on 30 May 2003 at 11:30 Johannesburg time (GMT+2), they revealed an inflation rate of 8,5 per cent – an exceptionally large inflation surprise (and good news about inflation). The currency market's response to the official announcement of an inflation rate that was two percentage points lower than the earlier market expectation was a sharp and immediate depreciation of the currency (see Figure B1.1).[3]

Although inconsistent with the conventional wisdom that inflation is "bad" for the exchange rate, the direction of the currency's movement in response to this inflation surprise is not uncommon. Anecdotal evidence frequently indicates that at least some currencies consistently appreciate in response to unexpectedly high inflation and depreciate in response to unexpectedly low inflation. Recent research has shown the theoretical basis for this outcome.[4]

Farrell, Hassan and Viegi assess the high-frequency reaction of the rand–US dollar rate to inflation surprises to see if there is a negative correlation between inflation surprises and changes in the nominal exchange rate in the very short term (five minutes before, and five minutes after the inflation announcement) and whether it has changed with the adoption of inflation targeting.

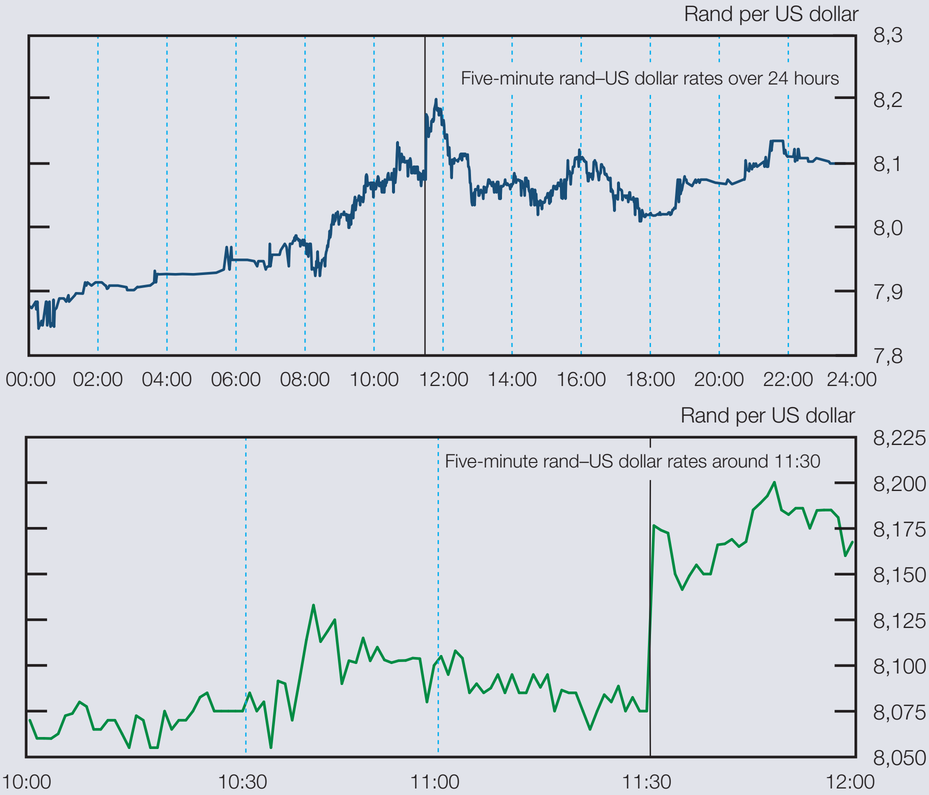
1 Greg Farrell, Shakill Hassan and Nicola Viegi, "The High-Frequency Response of the Rand–US Dollar Rate to Inflation Surprises", South African Reserve Bank Discussion Paper (2011a, forthcoming).

2 Bloomberg conducted a market survey of expected inflation in mid-May (the last survey before the official release). The rates refer to annual South African consumer price index excluding mortgage interest cost for metropolitan and other urban areas (CPIX) inflation.

3 Note that press reports in the weeks before the announcement (and an admission of an error in the computation of CPIX by the Minister of Finance shortly before the announcement) suggest that at least some market participants expected some degree of revision (and hence a "surprise"), but not its magnitude, nor with certainty.

4 See Richard Clarida and Daniel Waldman, "Is Bad News About Inflation Good News for the Exchange Rate? And, If So, Can That Tell Us Anything About the Conduct of Monetary Policy?" in *Asset Prices and Monetary Policy*, ed. John Campbell, ch. 9, (Chicago and London: University of Chicago Press, 2008) 371–392; and Greg Farrell, Shakill Hassan and Nicola Viegi, "Minimal Conditions for Bad News About Inflation to Cause Currency Appreciation on Impact", South African Reserve Bank Discussion Paper (2011b, forthcoming. Paper originally presented at the Biennial Conference of the Economic Society of South Africa, Stellenbosch University, Stellenbosch, South Africa, 5–7 September 2011).

Figure B1.1 Exchange rate behaviour on 30 May 2003

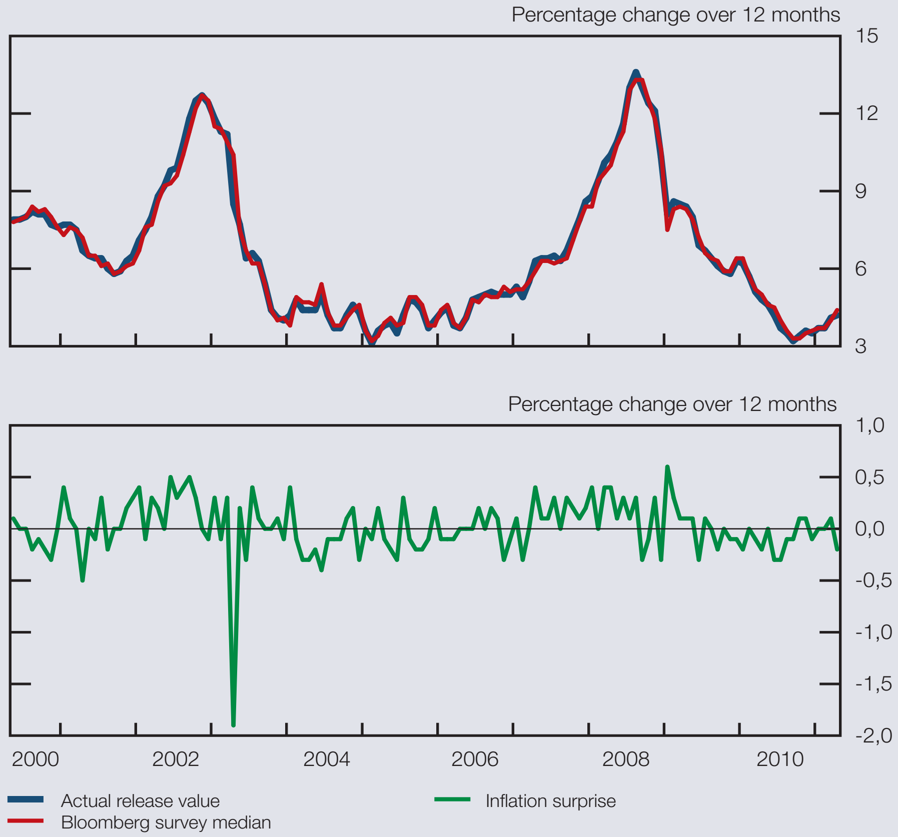


The high-frequency response of the South African rand to inflation surprises is to appreciate (respectively depreciate) on impact when inflation is higher (respectively lower) than expected, but only under inflation targeting. For the period before the adoption of inflation targeting, bad news about inflation is bad news for the currency. The exchange rate response is also larger when inflation is outside the central bank's target range. (Figure B1.2 and B1.3).

Figure B1.2 High-frequency rand–US dollar returns around inflation announcements

Sources: Olsen and Associates, and own calculations

Figure B1.3 Inflation surprises



Sources: Bloomberg, Statistics South Africa and own calculations

This implies that the market expects the bank to raise interest rates in response, with short-term movements in the currency still perceived as largely unpredictable. This is consistent with a credible inflation-targeting policy in South Africa.

Factors affecting inflation

Monetary policy decisions are made on the basis of current and expected developments in the wider macroeconomy. Recent developments in some of the main variables influencing inflation in South Africa are reviewed in this section, while the outlooks for these variables and their likely impact on inflation are discussed in a later section.

International economic developments

Recent data suggest that growth in some of the advanced economies has weakened against the backdrop of financial market turbulence, generated in large part by the unresolved European sovereign debt crisis. Financial market concerns about government debt have spread beyond the smaller economies in the euro area, despite the progress made in cutting budget deficits, and heightened risk aversion has resulted in increased volatility of capital flows globally and a flight from what are perceived to be more risky emerging-market assets. These developments have impacted on international capital and foreign-exchange markets.

In its September 2011 *World Economic Outlook (WEO)* the International Monetary Fund (IMF) estimates growth in the United States (US) at 1,5 per cent in 2011, compared with 3,0 per cent in 2010 (Table 5). Economic growth in the euro area is estimated at 1,6 per cent for the year 2011 compared with 1,8 per cent in 2010. In the United Kingdom (UK), growth of just 1,1 per cent is projected for 2011, compared with 1,4 per cent in 2010. For Japan, the IMF estimates negative growth of 0,5 per cent for 2011 compared with a positive 4 per cent in 2010. Economic growth in emerging and developing economies has continued to outperform that of the advanced economies. For developing Asia, IMF data show real output growth of 9,5 per cent in 2010 and 8,2 per cent in 2011. Headline inflation in emerging and developing economies increased from 6,1 per cent in 2010 to 7,5 per cent in 2011.

Table 5 Annual percentage change in real GDP and consumer prices

	Real GDP		Consumer prices	
	2010	2011 (estimate)	2010	2011 (estimate)
World	**5,1**	**4,0**	**3,7**	**5,0**
Advanced economies	**3,1**	**1,6**	**1,6**	**2,6**
United States	3,0	1,5	1,6	3,0
Japan	4,0	-0,5	-0,7	-0,4
Euro area	1,8	1,6	1,6	2,5
United Kingdom	1,4	1,1	3,3	4,5
Canada	3,2	2,1	1,8	2,9
Other advanced economies	5,8	3,6	2,3	3,3
Emerging-market and developing economies	**7,3**	**6,4**	**6,1**	**7,5**
Sub-Saharan Africa	5,4	5,2	7,5	8,4
Central and eastern Europe	4,5	4,3	5,3	5,2
Commonwealth of Independent States	4,6	4,6	7,2	10,3
Developing Asia	9,5	8,2	5,7	7,0
China	10,3	9,5	3,3	5,5
India	10,1	7,8	12,0	10,6
Middle East and North Africa	4,4	4,0	6,8	9,9
Latin America and the Caribbean	6,1	4,5	6,0	6,7

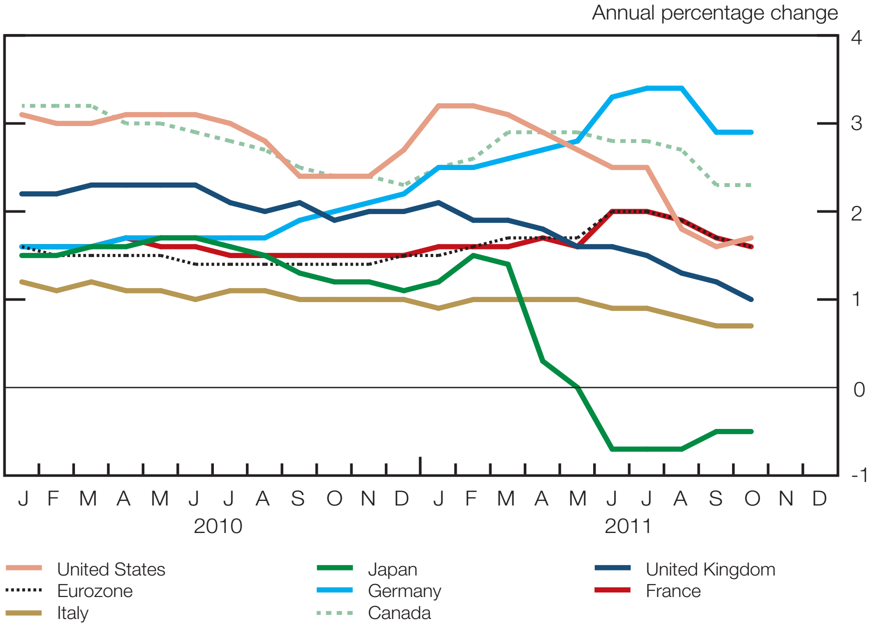
Source: IMF *World Economic Outlook*, September 2011

The IMF cautions that projections for some smaller advanced economies, as well as for emerging and developing economies, do not yet fully reflect the downward revisions to growth in the major advanced economies. These downward revisions are evident in the evolution of real gross domestic product (GDP) forecasts for 2011 for the Group of Seven (G7) and euro area countries published by Consensus Forecasts (Figure 7). The consensus forecast for the US was revised down by 1 percentage point between May and October 2011. Significant downward revisions to other G7 countries over this period include Canada (0,6 percentage points), the UK (0,6 percentage points), Japan (0,5 percentage points), and Italy (0,3 percentage points). The consensus forecast for Germany was raised by 0,1 percentage points between May and October 2011 while that of France remained unchanged. The forecast for the eurozone was revised down by 0,1 percentage points.

Economic growth projections have been negatively affected by a significant deterioration in overall global creditworthiness. According to Institutional Investor's most recent semiannual Country Credit Survey, the debt and budget crises in Western Europe and the US, and political upheavals across the Middle East and North Africa (MENA) led to countries in these regions posting sizable declines in creditworthiness. Most of the rest of the world showed only modest adjustments. The picture is mixed in Africa, with most of the creditworthiness gains reflecting commodities-based economic strength. The gainers include South Africa (up 3,5 points) and Angola (up 2,6 points). Conversely, Swaziland declined by 5,2 points, and Namibia dropped 3,1 points.[1]

1 Harvey D Shapiro, "Brazil Grows, But the Global Credit Picture is Otherwise Murky", Institutional Investor, 13 September 2011, http://www.institutionalinvestor.com/Popups/PrintArticle.aspx?ArticleID=2898625.

Figure 7 Evolution of real GDP forecasts for 2011 for the G7 and eurozone (surveys conducted during 2010 and 2011)

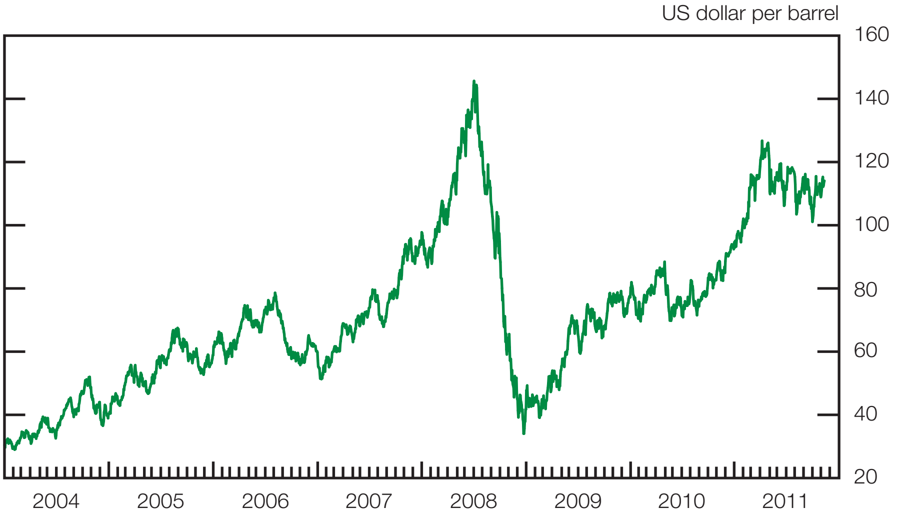


Source: Consensus Forecasts

Oil prices

The price per barrel of Brent crude oil rose to a high of US$126 per barrel at the end of April 2011 as supplies from the Middle East tightened and investors anticipated a more robust economic recovery (Figure 8). The subsequent decline in the oil price was initially aided by increased supply from the Organization of the Petroleum Exporting Countries (OPEC) and the release of crude oil and petroleum stocks from strategic emergency reserves by International Energy Agency (IEA) members. An increase in US crude oil inventories and escalating risks to the global growth outlook in recent months resulted in a continued decline in the oil price from US$114 per barrel early in September to around US$101 per barrel early in October. Although the oil price subsequently rose temporarily to US$115 per barrel in mid-October (mainly due to renewed US dollar weakness), the downward trend resumed thereafter and declined to US$108 per barrel in early November. The oil price has returned to levels that prevailed before the unrest in the MENA region as signs of slowing growth in the US, China and Germany heightened concerns that fuel demand will suffer.

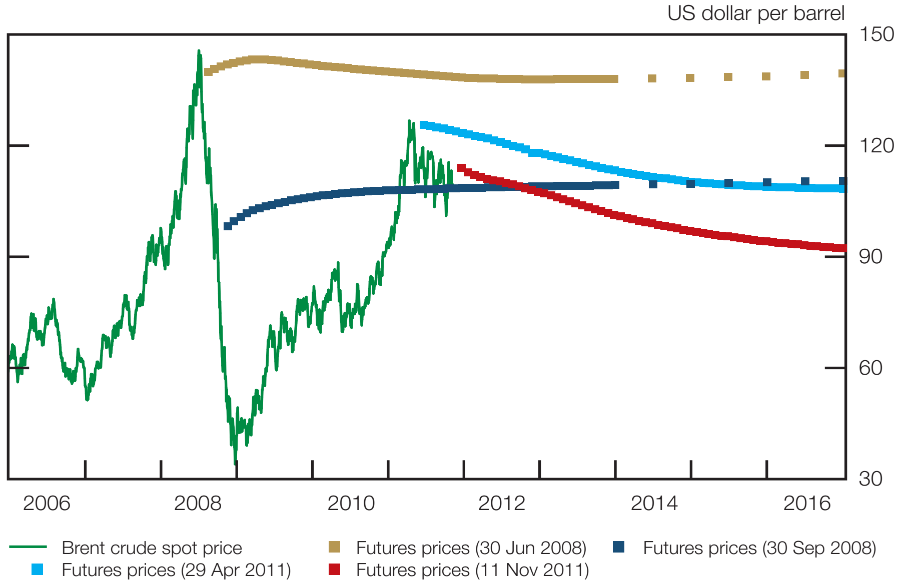
Figure 8 Price of Brent crude oil



Source: Bloomberg

However, in contrast to the market that prevailed in 2008, the futures market signals tighter near-term market conditions than are expected for contracts maturing further out (Figure 9). Futures contracts for delivery in the first and second quarters of 2012 are currently trading at around US$102 per barrel.

Figure 9 Brent crude futures prices



Source: Bloomberg

International monetary policy developments

A cooling global economy and the threat from Europe's debt crisis have refocused attention away from inflation risks to avoiding a slide back into recession. Policy rate increases have been limited primarily to developing nations with robust growth and upward inflationary pressures (Table 6), while policy rates have been kept stable or decreased in a number of developed countries and some developing countries who are concerned about the effect of increased global economic uncertainty on the pace of economic recovery. The European Central Bank (ECB) decreased interest rates in November; the US – still at the zero-lower-bound – has instead chosen to "twist" the maturities of its Treasury holdings in an effort to keep market interest rates low; and the UK has embarked on an additional round of quantitative easing. China and India have continued to tighten monetary policy due to concerns about inflationary pressures, but smaller open economies have chosen to keep interest rates stable or decrease them.

In August the United States Federal Reserve System (the Fed) announced its commitment to maintaining the current, exceptionally low level of the federal funds rate at least up to 2013. Following its meeting in September, the Fed also announced that it would rebalance its Treasury holdings to cut longer-term borrowing costs and that it was taking these new steps to try to boost the economy by making credit cheaper. The Fed said it would "twist" US$400 billion of its US$1,66 trillion in Treasury holdings into longer-dated debt. About 30 per cent of the purchases would be in the 20- to 30-year range. The Fed intends buying US$400 billion of Treasury securities with maturities between 6 and 30 years by June 2012, and selling an identical amount of shorter-term Treasuries (maturities from three months to three years).

The ECB reduced interest rates by a quarter of a percentage point to 1,25 per cent in November at the first policy meeting chaired by its new President Mario Draghi, after having raised interest rates further in July 2011 due to continuing concerns about inflationary pressures. In August and October measures were introduced to help relieve increasing strains in some European financial markets, including the introduction of additional long-term refinancing operations and the launch of a second covered bond purchase programme (called CBPP2) to the value of €40 billion.

Table 6 Selected central bank interest rates

Per cent

Countries	17 May 2011	14 Nov 2011	Latest decision (Change in percentage points)	
United States	0,00–0,25	0,00–0,25	2 Nov 2011	(0,00)
Japan	0,00–0,10	0,00–0,10	27 Oct 2011	(0,00)
Euro area	1,25	1,25	3 Nov 2011	(-0,25)
United Kingdom	0,50	0,50	10 Nov 2011	(0,00)
Canada	1,00	1,00	25 Oct 2011	(0,00)
Denmark	1,30	1,20	3 Nov 2011	(-0,35)
Sweden	1,75	2,00	27 Oct 2011	(0,00)
Norway	2,25	2,25	19 Oct 2011	(0,00)
Switzerland	0,00–0,75	0,00–0,25	15 Sep 2011	(0,00)
Australia	4,75	4,50	1 Nov 2011	(-0,25)
New Zealand	2,50	2,50	27 Oct 2011	(0,00)
Israel	3,00	3,00	24 Oct 2011	(0,00)
China	6,31	6,56	30 Sep 2011	(0,00)
India	7,25	8,50	25 Oct 2011	(0,25)
Indonesia	6,75	6,00	10 Nov 2011	(-0,50)
Malaysia	3,00	3,00	11 Nov 2011	(0,00)
Philippines	4,50	4,50	20 Oct 2011	(0,00)
South Korea	3,00	3,25	11 Nov 2011	(0,00)
Taiwan	1,75	1,875	29 Sep 2011	(0,00)
Thailand	2,75	3,50	19 Oct 2011	(0,00)
Brazil	12,00	11,50	19 Oct 2011	(-0,50)
Chile	5,00	5,25	13 Oct 2011	(0,00)
Mexico	4,50	4,50	14 Oct 2011	(0,00)
Czech Republic	0,75	0,75	3 Nov 2011	(0,00)
Hungary	6,00	6,00	25 Oct 2011	(0,00)
Poland	4,25	4,50	9 Nov 2011	(0,00)
Russia	8,25	8,25	28 Oct 2011	(0,00)
Turkey	6,25	5,75	20 Oct 2011	(0,00)
Iceland	4,25	4,75	2 Nov 2011	(0,25)
Nigeria	7,50	12,00	10 Oct 2011	(2,75)

Source: National central banks

The ECB also boosted liquidity to the European banking sector through, among other things, a dollar lending facility launched in September 2011.

The Bank of England's Monetary Policy Committee (MPC) continued to maintain the bank rate at 0,5 per cent at its most recent meeting in November. Concerns about the effect of the euro zone sovereign debt crisis on the economy, along with already weak domestic demand and low levels of credit extension, led the committee to increase the size of the asset purchase programme by £75 billion in October.

In early August 2011 the Swiss National Bank narrowed the target for the three-month London Interbank Offered Rate (LIBOR) to closer to zero. In September it set a minimum exchange rate at CHF 1,20 per euro. Sweden's Riksbank indicated in September that slowing growth and low underlying inflationary pressures had resulted in the decision to hold the interest rate at 2,0 per cent and temporarily to halt further interest rate increases, effectively lowering the Riksbank's expected interest rate path. Interest rates in emerging markets in Europe have mostly been kept stable given the economic climate, although Poland raised interest rates in June and Turkey cut interest rates in August.

The Bank of Japan (BoJ) has kept interest rates at as close to zero as possible over the period under review. In August and October 2011 the bank announced that it would increase the total size of the Asset Purchase Programme by a combined total of ¥15 000 billion, and in October the BoJ announced that it would extend the deadline for applications for loans supplied to financial institutions and central organisations of financial co-operatives in the disaster areas by six months to 30 April 2012.

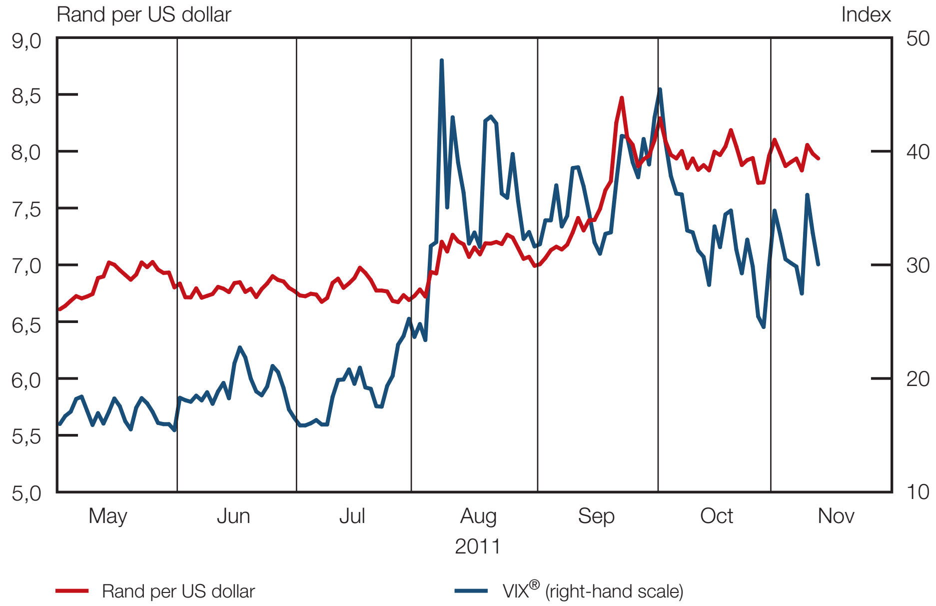
Interest rates have been raised by India, China, Taiwan and Thailand in the period since the previous *MPR* was published in May 2011. Monetary policy in China has remained tight, with key interest rates increasing in July and banks' reserve requirements increasing in June. In India interest rates increased on four occasions from 7,25 per cent in May to 8,50 per cent in October due to concerns over high inflation and high inflation expectations. In August the Bank of Thailand raised its key rate for the seventh time in as many meetings to 3,5 per cent, as part of a process of returning the policy interest rate to more normal levels.

In August and October Brazil's Copcom voted to decrease the selic rate by 50 basis points, effectively reversing the increases announced in 2011. This move was to help mitigate the effect of the continued uncertainty about the pace of the global economic recovery on the Brazilian economy, at a time when the Copcom felt that price pressures were easing. In June 2011 the central bank of Chile raised interest rates for the fifth time this year to 5,25 per cent, due to inflationary pressures in the economy. However, the monetary tightening has been halted during the meetings held since, due to concern about weaknesses in the global economy. The Bank of Mexico has continued to keep interest rates stable.

Exchange rate developments

The foreign-exchange rate of the rand has been highly volatile in recent months as risk aversion took hold of global foreign-exchange markets once more. Figure 10 shows that the Volatility Index (VIX®) published by the Chicago Board Options Exchange (CBOE) – which measures the options-implied volatility of the US Standard and Poor's (S&P) 500 index and serves as a popular indicator of global investors' perception of risk – rose sharply in July and August 2011, and has since remained at elevated levels. This volatility has been reflected in the exchange rates of a number of emerging-market and/or commodity currencies.

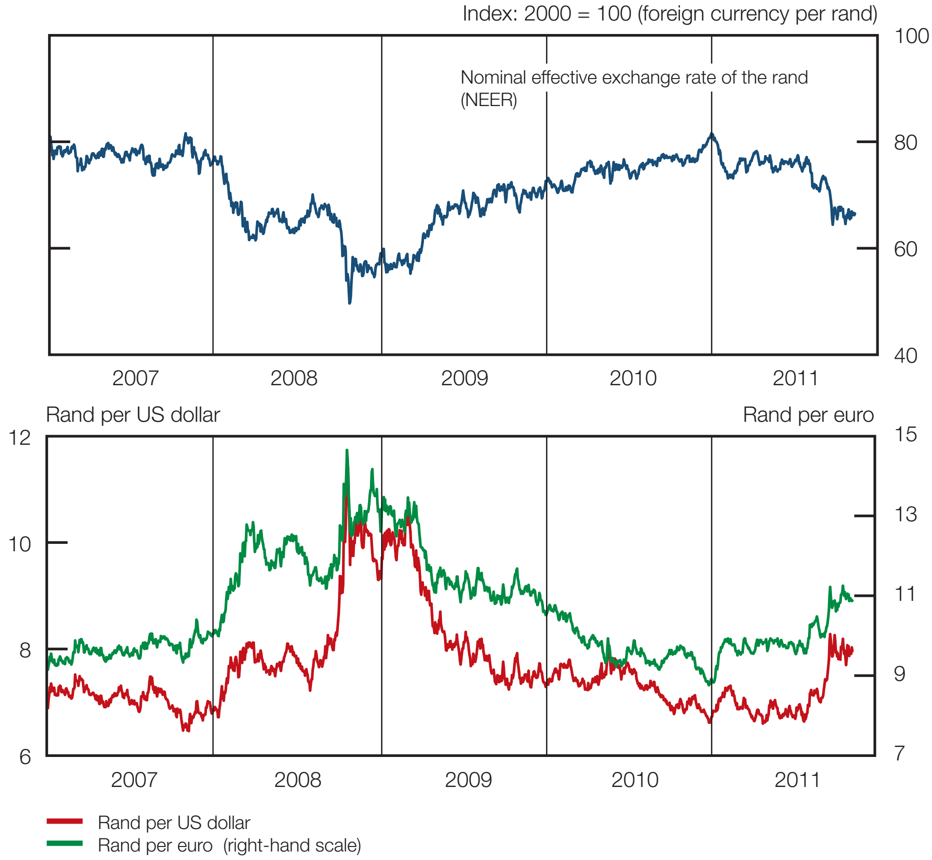
Figure 10 The VIX® and the rand–US dollar exchange rate



Source: Bloomberg

The nominal effective exchange rate of the South African rand (NEER), measured against a basket of 15 currencies,[2] averaged just below 76 index points between May and July 2011, and then depreciated to a low of 64,4 index points on 23 September before recovering slightly to its current value of 66,5 index points on 11 November 2011 (Figure 11). The real effective exchange rate measured against the same basket of currencies depreciated by 2,4 per cent from 113,4 index points in May 2011 to 110,7 index points in August.

Figure 11 Exchange rates of the rand

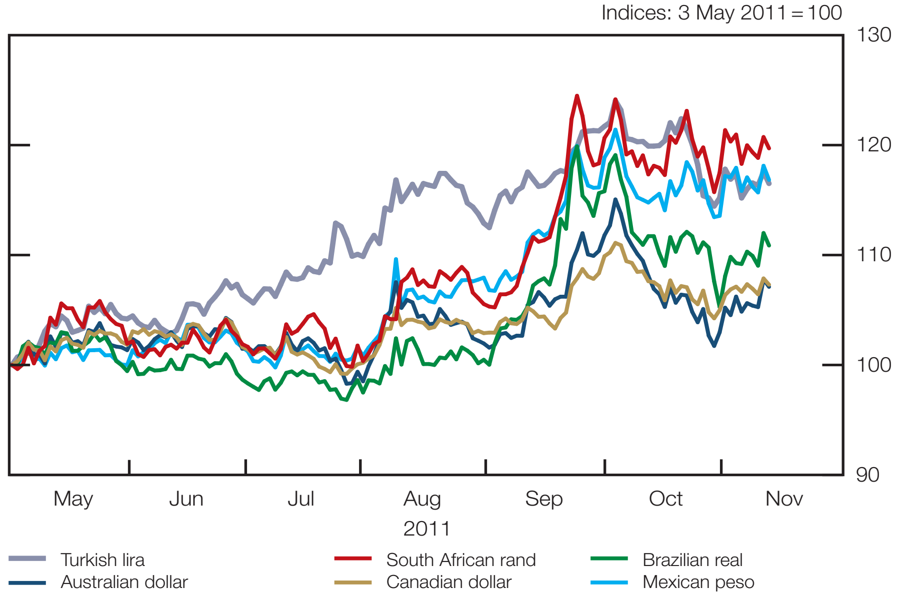


Measured on a bilateral basis against the US dollar, the rand fluctuated between R6,63 at the beginning of May 2011 and R8,28 on 23 September, subsequently recovering to R7,96 on 11 November. Measured against the euro, the rand depreciated from R9,54 on 11 July 2011 to R11,22 on 23 September, before recovering to R10,88 on 11 November.

The recent volatility in the rand exchange rate has mirrored that in a number of other emerging-market and/or commodity currencies. Compared to a base of 100 index points on 3 May 2011, all currencies in Figure 12 depreciated against the US dollar, particularly in August and September. On 11 November 2011 the rand stood at 120 index points, the Mexican peso at 117 index points, the Turkish lira at 117 index points, the Brazilian real at 111 index points and the Australian dollar at 107 index points.

2 The weighted average exchange rate of the rand is based on trade in, and consumption of, manufactured goods between South Africa and its most important trading partners. The methodology applied is described in an article in the December 2008 *Quarterly Bulletin*. The weighted average exchange rate of the rand is calculated against 15 currencies. The weights of the five major currencies are in brackets: Euro (34,82), US dollar (14,88), Chinese yuan (12,49), British pound (10,71), Japanese yen (10,12). Index: 2000 = 100.

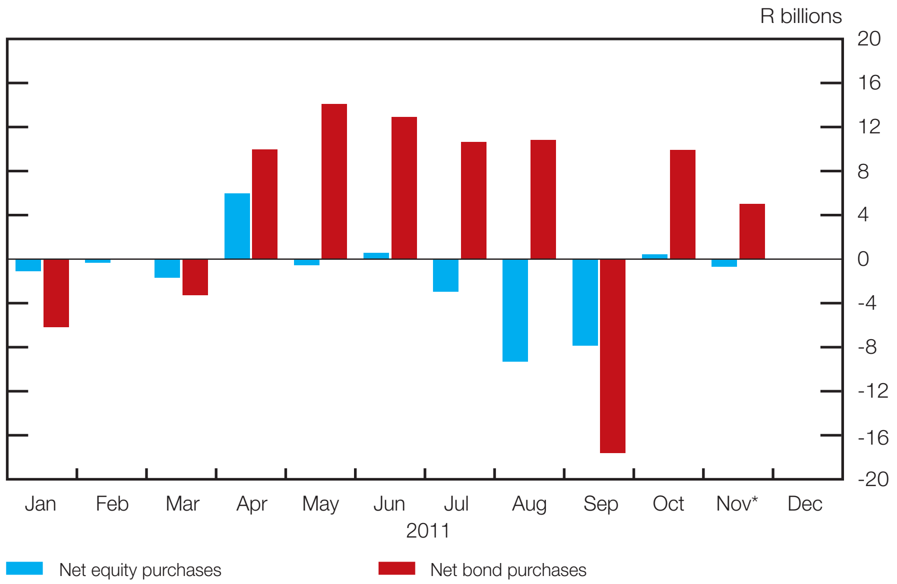
Figure 12 Exchange rate performance against the US dollar



Sources: Reuters and own calculations

Portfolio flows to the domestic equity and bond markets have also been volatile, in line with the experiences of emerging-market economies around the world. Non-resident purchases of South African bonds slowed in 2011, when compared with 2010, and investment in domestic equities has declined (Figure 13). Cumulative non-resident net purchases in the bond market were R51,2 billion by the week ending 11 November 2011 compared with net purchases of R70,9 billion in the comparable period in 2010. In the share market non-residents were net sellers in 2011, with cumulative net sales of R17,5 billion by 11 November 2011 (compared to cumulative non-resident share purchases of R26,4 billion at the same stage in 2010).

Figure 13 Non-resident net purchases of domestic bonds and equities



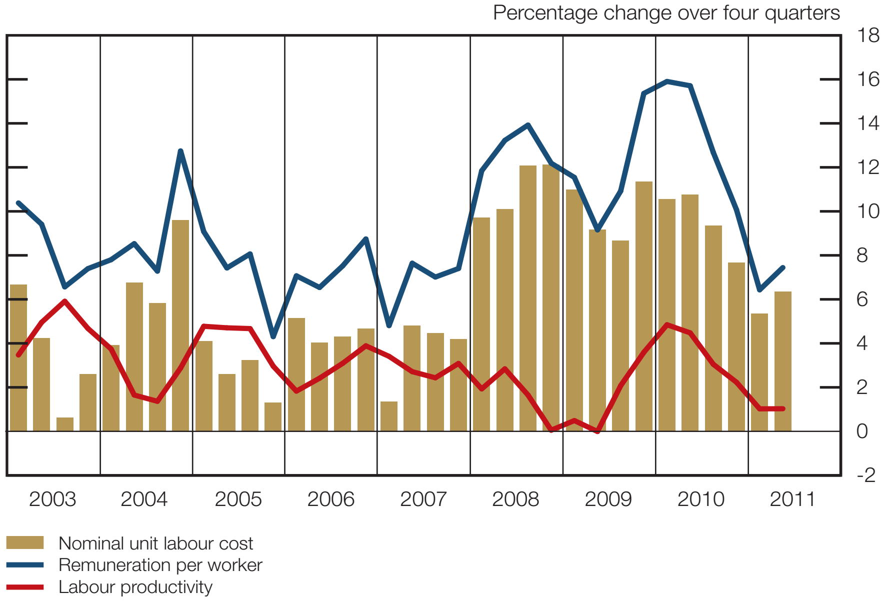
* Net purchases of bonds and equities for the month of November cumulative to 11 November 2011

Source: JSE Limited

Labour markets

Unit labour costs, calculated as the ratio of remuneration per worker to labour productivity, accelerated in the second quarter of 2011. Figure 14 shows that the year-on-year percentage change in nominal unit labour cost increased from 5,4 per cent in the first quarter of 2011 to 6,4 per cent in the second quarter. This was due to growth in labour productivity remaining unchanged in the first two quarters of the year, as employment levels remained stable, while the rate of increase in remuneration per worker rose from 6,4 per cent to 7,4 per cent.

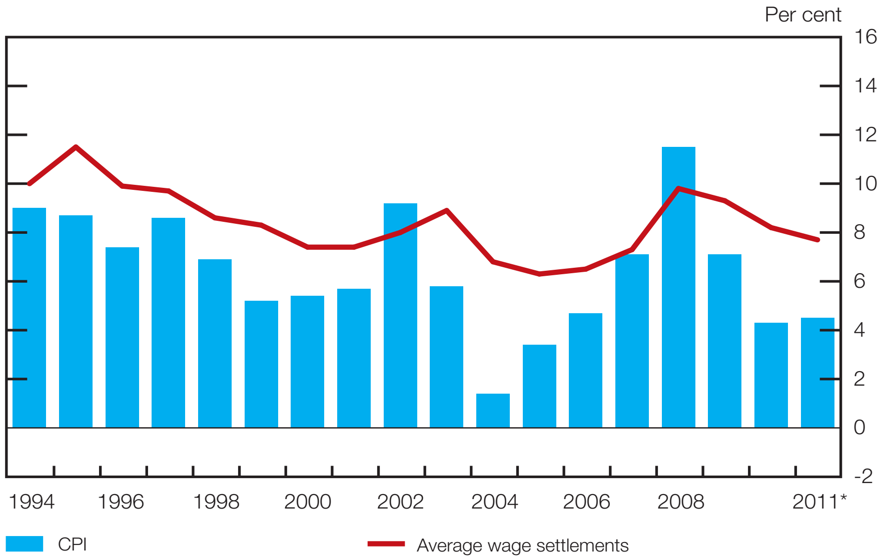
Figure 14 Remuneration per worker, labour productivity and unit labour cost in the formal non-agricultural sector



Sources: Statistics South Africa and South African Reserve Bank calculations

The *Andrew Levy Wage Settlements Survey* for the third quarter of 2011 reported that the average level of wage settlements fell from 8,2 per cent in March 2011 to 7,7 per cent in September 2011 (Figure 15), influenced by uncertainties about economic growth and relatively stable inflation.

Figure 15 Average annual inflation and wage settlements



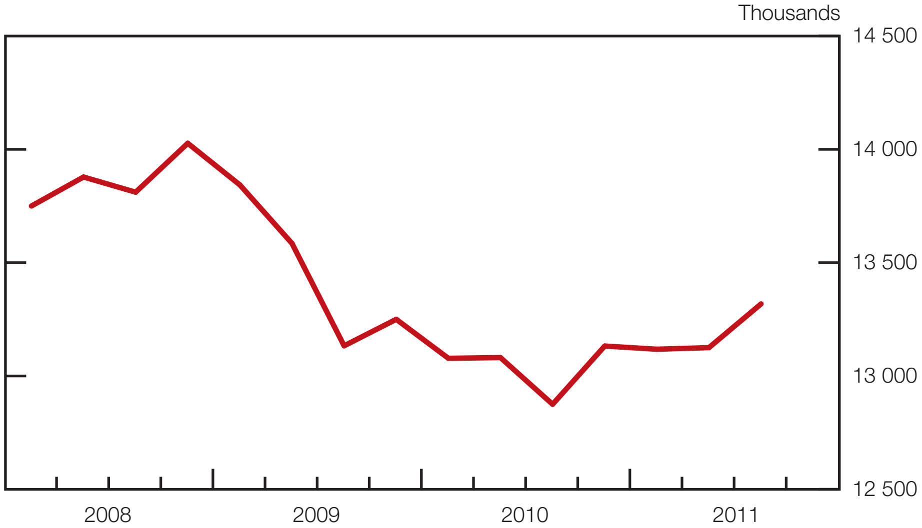
* Data for 2011 are for the first nine months of the year

Sources: Andrew Levy Employment Publications and Statistics South Africa

The levels of settlements reached in the third quarter of 2011 ranged from 3 per cent in the food/manufacturing sector to 10 per cent in the retail, transport and food/agricultural sectors. The survey reported that 78 per cent of wage settlements were for one year, 16,9 per cent for two years and 5,1 per cent for three years.

Figure 16 shows total employment in the formal and informal non-agricultural, agriculture and private household sectors between the first quarter of 2008 and the third quarter of 2011 as reported by Statistics South Africa's *Quarterly Labour Force Survey*. Total employment declined from 13,844 million in the fourth quarter of 2008 to 12,975 million in the third quarter of 2010, a loss of 869 000 jobs, before increasing to 13,319 million in the third quarter of 2011. The unemployment rate fell from 25,3 per cent in third quarter of 2010 to 25,0 per cent in the third quarter of 2011.

Figure 16 Total employment



Source: Statistics South Africa *Quarterly Labour Force Survey*

The total employment increased by 343 000 between the third quarter of 2011 and the corresponding quarter of 2010. The sectoral contributions indicate that employment in the community and social services industry increased the most, rising by 158 000 jobs. By contrast, employment in the utilities sector declined by 26 000 jobs; the highest loss recorded over the period.

Demand and output

Real GDP increased by 1,3 per cent on an annualised basis in the second quarter of 2011, following growth of 4,5 per cent in both the fourth quarter of 2010 and the first quarter of 2011 (Table 7). Widespread industrial action, which continued into the third quarter of 2011, contributed to this subdued outcome. Real value added by both the primary and secondary sectors contracted in the second quarter. The largest negative contribution came from the manufacturing sector, where real value added declined by 10,2 per cent.

Real gross domestic expenditure also slowed down significantly from an annualised growth rate of 7,9 per cent in the first quarter of 2011 to 1,3 per cent in the second quarter.

Consumption expenditure by households has, to date, been the main driver of growth. However, in the second quarter of 2011, growth in consumption expenditure moderated to an annualised rate of 3,8 per cent, compared with an increase of 5,2 per cent in the first quarter. Consumption expenditure is expected to remain constrained, to some extent, by low rates of credit extension and continued debt deleveraging by households. The ratio of household debt to disposable income declined further to 75,9 per cent in the second quarter of 2011 from a peak of 82,0 per cent in the first two quarters of 2008.

Table 7 Growth in real GDP and expenditure components

Per cent*

	2010					2011	
	1st qr	2nd qr	3rd qr	4th qr	Year	1st qr	2nd qr
Final consumption expenditure							
Households	5,5	4,4	5,7	4,8	4,4	5,2	3,8
General government	7,1	7,1	-0,8	3,9	4,6	9,5	-0,1
Gross fixed capital formation	-2,8	1,2	1,0	1,5	-3,7	3,1	4,1
Changes in inventories (R billions)**	-7,9	-7,6	-0,9	1,1	-3,8	9,3	5,6
Gross domestic expenditure	**10,9**	**3,2**	**6,6**	**2,4**	**4,2**	**7,9**	**1,3**
Exports of goods and services	-16,4	18,2	12,5	5,7	4,5	-11,9	13,9
Imports of goods and services	7,8	17,0	26,5	-2,0	9,6	2,7	11,4
Gross domestic product	**4,8**	**2,8**	**2,7**	**4,5**	**2,8**	**4,5**	**1,3**

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

Real final consumption expenditure by general government contracted at an annual rate of 0,1 per cent in the second quarter of 2011, after having increased by 9,5 per cent in the first quarter. This deceleration is mainly attributable to the fact that in the second quarter no armaments were acquired by government in terms of the defence procurement programme, in contrast to significant purchases in the first quarter.

A positive development was the further acceleration in the growth of real gross fixed-capital formation, albeit off a low base, from an annualised rate of 3,1 per cent in the first quarter to 4,1 per cent in the second quarter. Nevertheless, the ratio of gross fixed capital formation to GDP, at 18,9 per cent, is still well below the peak of 24,6 per cent measured in the fourth quarter of 2008. The level of real inventory accumulation slowed from the first to the second quarter of 2011 – real inventory investment (annualised, at 2005 prices) amounted to R5,6 billion in the second quarter of 2011 compared with R9,3 billion in the first quarter. The slower accumulation of inventories was evident in most of the sectors, with the exception of the mining and manufacturing sectors.

In the first half of 2011 imports rose more strongly than exports, resulting in smaller trade surpluses in both the first and second quarters. Successive supply shocks weakened demand from trading-partner countries early in 2011 and these developments, together with a moderate increase in the shortfall on the services, income and current transfer account of the balance of payments, gave rise to a widening of the current-account deficit. The ratio of the deficit on the current account of the balance of payments to GDP increased from 1 per cent in the fourth quarter of 2010 to 3,1 per cent in the first quarter of 2011 and to 3,3 per cent in the second quarter.

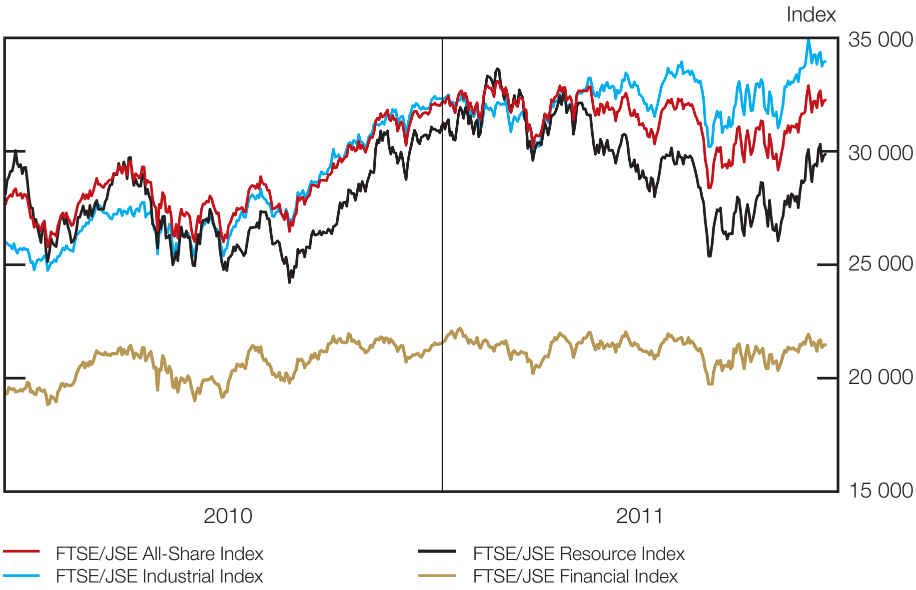
South Africa's gross international reserve position declined from US$50,0 billion at the end of June 2011 to US$49,7 billion at the end of September, before increasing to US$50,3 billion at the end of October. The international liquidity position rose from US$47,2 billion at the end of June to US$47,9 billion at the end of September and US$49,2 billion at the end of October.

Real-estate and equity prices

Global developments have impacted significantly on the FTSE/JSE All-Share Index (Alsi) in the period since May 2011. From a level of 32 384 index points on 27 May 2011, the index declined to a low 28 391 index points on 8 August. This was in line with international experiences, as contagion effects from the European sovereign debt crisis, concerns over France's AAA rating, and S&P downgrading of the US credit rating from AAA to AA+ impacted on markets. Stock market volatility continued into September and October due to uncertainty over downgrades for French banks and concerns that a number of European banks were highly exposed to indebted nations such as Greece. Greece's call at the beginning of November 2011 for a referendum on the Euro deal agreed to on 27 October 2011 to reduce its debt burden added to volatility in the global equity markets.

Trends in four major South African stock price indices that comprise the Alsi are shown in Figure 17. Since August 2011, the volatilities of these four indices have tended to move in line with developments in global stock markets.

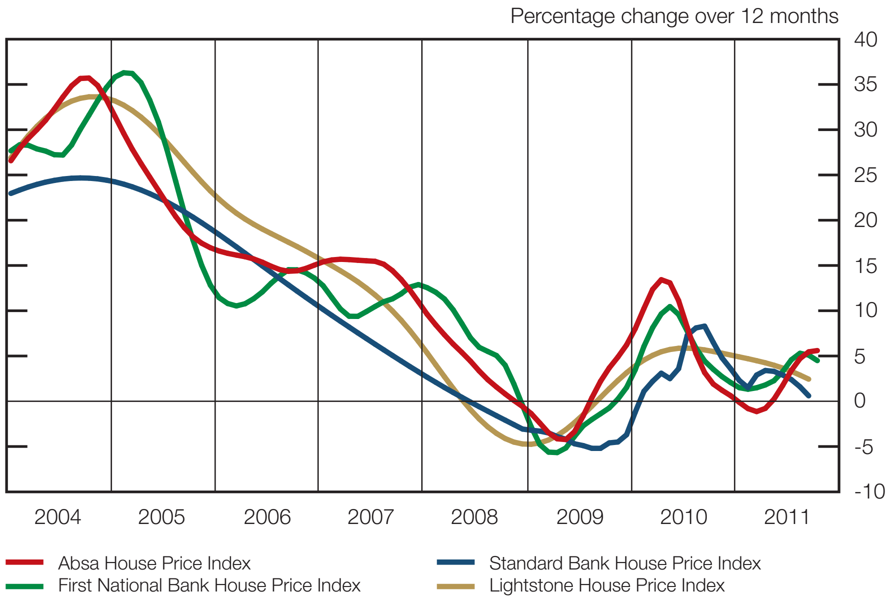
Figure 17 Domestic share price indices



Sources: JSE Limited and I-Net Bridge

The year-on-year percentage changes in nominal house prices published by Absa, Standard Bank, First National Bank (FNB) and Lightstone all currently show modest increases despite having diverged since mid-2011 (Figure 18). The year-on-year percentage change in the Standard Bank median house price index slowed from 3,4 per cent in April 2011 to 0,6 per cent in September, while the extended repeat sales house price index of Lightstone continued to decelerate from a peak of 5,9 per cent in July 2010 to 2,4 per cent in September.

Figure 18 House prices



Sources: Absa, Standard Bank, First National Bank and Lightstone

By contrast, the rate of change in the Absa House Price Index shows a recovery, increasing from negative 1,1 per cent in March 2011 to 5,6 per cent in October. Similarly, the rate of increase in the FNB national average house price index continued to improve from 1,3 per cent in February 2011 to 4,5 per cent in October 2011.

The FNB estate agent survey indicates that the estimated average time taken to sell a house in the third quarter of 2011 was approximately 17 weeks, considerably higher than the nearly 6 weeks taken in 2005/6. The proportion of properties sold at less than the asking price was 91 per cent in the third quarter of 2011 compared with 30 per cent in 2004. Sellers' initial asking prices for houses sold decreased by 13 per cent on average in the third quarter of 2011.

Table 8 shows that the annual percentage changes in the total values of both buildings completed and plans passed have been negative for four years. All subcomponents of the real value of buildings completed contracted at a slower rate in 2011 than in 2010, and both the residential and non-residential components of the total value of building plans passed increased in 2011 compared to 2010.

Table 8 Real value of building plans passed and buildings completed in larger municipalities

Annual percentage change

	2008	2009	2010	2011*
Building plans passed				
Total	**-17,2**	**-23,2**	**-7,9**	**-0,7**
Residential	-26,1	-37,8	0,7	3,9
Non-residential	0,6	-11,0	-34,3	3,2
Additions and alterations	-12,0	-8,2	5,2	-8,8
Buildings completed				
Total	**-0,4**	**-13,0**	**-23,7**	**-9,2**
Residential	-9,5	-26,2	-22,1	-8,0
Non-residential	13,6	3,4	-34,0	-15,3
Additions and alterations	14,9	3,5	-13,2	-5,4

* Data for 2011 are for the first eight months of 2011 compared with the same period of the previous year

Source: Statistics South Africa

Fiscal policy

The Minister of Finance presented the *Medium Term Budget Policy Statement (MTBPS)* on 25 October 2011. In contrast to the more restrictive fiscal policies that have had to be adopted in several countries because of high initial debt levels, South Africa's fiscal stance remains countercyclical. Government debt is set to rise to about 40 per cent of GDP by 2015, after which it is expected to stabilise and decline. Government aims to achieve fiscal consolidation by shifting the composition of public expenditure towards investment and economic development in order to ensure sustainable long-term economic growth. The Minister announced that measures to promote industrial development and expand trade opportunities would be strengthened. Financial support for housing and urban infrastructure investment would also be extended while funding for employment programmes and training would be increased.

The *MTBPS* calls for greater accountability, transparency and moderation in remuneration across public and corporate sectors. Substantial improvements in public-service remuneration and increases in employment have raised the wage bill to about 42 per cent of government revenue over the past four years. The *MTBPS* provides for a 5 per cent cost-of-living adjustment for public-sector employees, implemented with effect from April each year, while similar adjustments to social grants are assumed in the expenditure estimates.

The revised budget balance for 2011/12 is a deficit of R164,6 billion, which represents 5,5 per cent of GDP (Table 9). This revised budget balance is larger than the deficit of 5,3 per cent of GDP projected in the Budget Review 2011. Consolidated government revenue reflects the impact of lower earnings and reduced consumption and imports on tax revenues, and is now expected to be R814,2 billion in 2011/12, significantly lower than the estimate of R824,5 billion made in February. Consolidated government expenditure in 2011/12 is expected to be slightly lower than projected in February, declining from R979,3 billion to R978,8 billion. In the medium term, projected deficits as a percentage of GDP are 5,2 per cent for 2012/13, declining to 4,5 per cent for 2013/14, and to 3,3 per cent for 2014/15.

Table 9 Public finance data

	2010/11	2011/12		2012/13	2013/14	2014/15
	Outcome	Budget	Revised estimates	Medium-term estimates		
Consolidated government* (R billions)						
Revenue	758,4	824,5	814,2	890,0	994,5	1 113,0
Expenditure	885,8	979,3	978,8	1 062,3	1 157,4	1 247,0
Budget balance	-127,4	-154,8	-164,6	-172,3	-162,9	-134,1
As a percentage of GDP						
Budget balance	-4,6	-5,3	-5,5	-5,2	-4,5	-3,3
Total net loan debt	29,7	34,3	33,8	36,7	38,9	39,7
PSBR**	6,5	9,5	8,1	7,8	6,8	5,1

* Includes national government, provinces, social security funds and selected public entities
** PSBR: Public-sector borrowing requirement

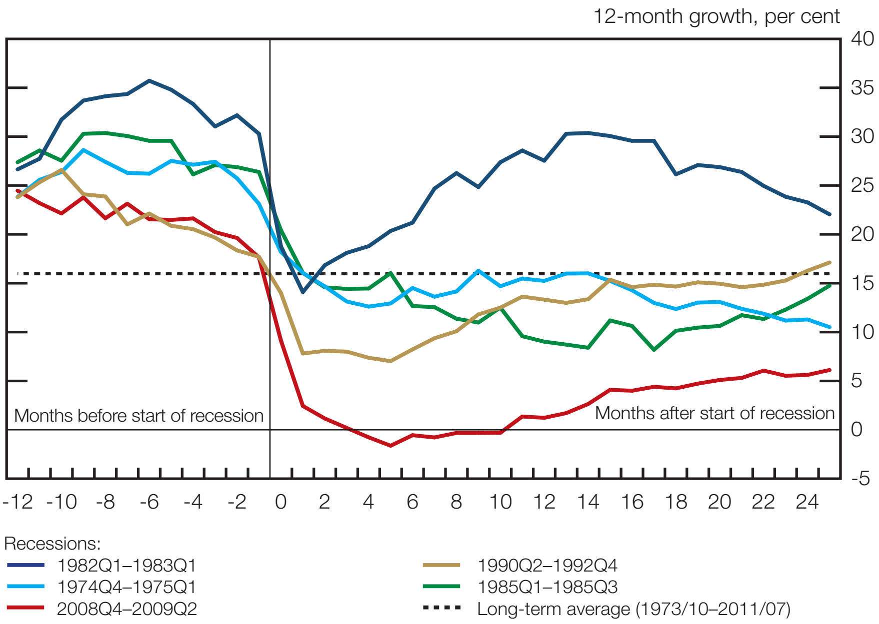
Source: National Treasury *Medium Term Budget Policy Statement 2011*

The estimated public-sector borrowing requirement (PSBR), reflecting the higher financing requirements of government and the non-financial public enterprises, increased from R177,5 billion in 2010/11 (6,5 per cent of GDP) to a revised R241,5 billion for 2011/12 (8,1 per cent of GDP). With the higher main budget deficit set out in the *MTBPS,* the PSBR is projected to remain relatively high over the medium term before declining to 7,8 per cent of GDP in 2012/13 and to 5,1 per cent of GDP in 2014/15. Net loan debt is projected to increase to 39,7 per cent of GDP by 2014/15.

Monetary conditions

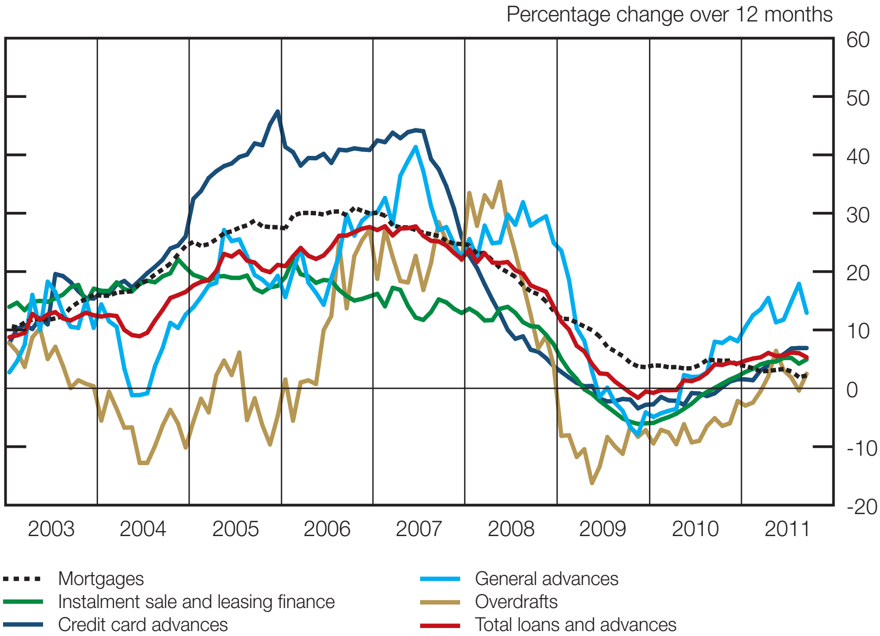
Growth in private-sector credit extension has remained subdued at around 6 per cent per annum over the period under review, despite interest rates being at 30-year lows. The recovery in the growth in total loans and advances following the 2008/09 recession has been slow when considered in historical context (Figure 19). Following the recessions of 1974/75, 1982/83, 1985, and 1990/92, the growth in total loans and advances had returned at least once to the long-term average rate of above 15 per cent within the current 27-month period.

Figure 19 Historical trends in total loans and advances at times of recession



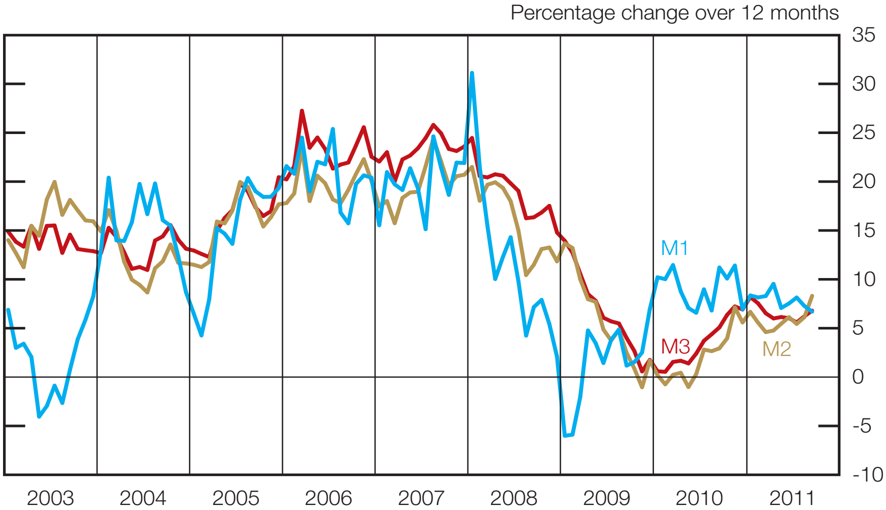
The year-on-year growth in banks' total loans and advances was 5,5 per cent in May 2011 and rose to 6,1 per cent in July before declining to 5,3 per cent in September (Figure 20). Credit extension has been underpinned by the performance of the general advances component, which recorded year-on-year growth of 17,9 per cent in August and 12,9 per cent in September. Mortgage advances, which constitute just over half of the outstanding balance for total loans, grew by just 2,2 per cent in September, consistent with the weak levels of activity in the residential and commercial property sectors.

Figure 20 Banks' loans and advances by type



Monetary growth was below the growth in nominal GDP during the period under review. The year-on-year growth in the M3 monetary aggregate, which had slowed early in 2011, remained relatively stable for most of the period and then rose somewhat in September (Figure 21). Growth in M3 increased marginally from 6,1 per cent in May to 6,2 per cent in August 2011, before rising to 6,8 per cent in September. By comparison, M2 growth rose from 5,5 per cent in May to 6,1 per cent in August, and to 8,3 per cent in September.

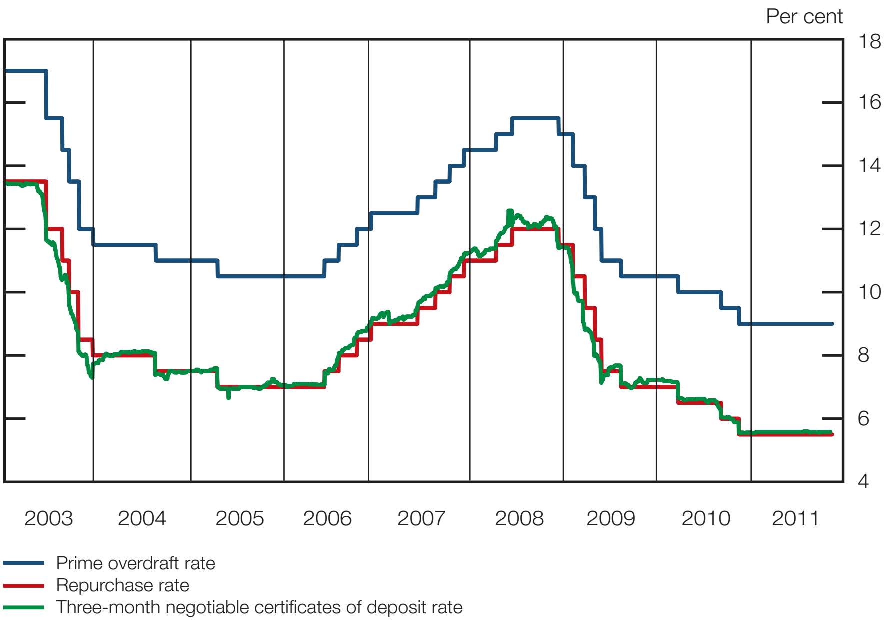
Figure 21 Growth in monetary aggregates



Monetary policy

A global economic recovery and slowly rising inflation pressures marked the first half of the year before giving way to significantly weaker economic prospects, diverging inflation trajectories and sharply higher uncertainty. With South Africa's headline CPI remaining within the inflation-targeting band of 3 to 6 per cent despite gradually rising food and petrol prices and the economic recovery weakening significantly, the monetary policy stance remained unchanged for the year (Figure 22). The potential for cost–push pressures to raise headline consumer prices, rising unit labour costs and administered prices presented the most serious upside risks to the inflation forecasts for 2011 and 2012. A deepening of the financial crisis in Europe, and potential for a downturn in the global and domestic economy were the primary downside risks considered by the MPC.

Figure 22 The repurchase rate and other short-term interest rates



In the months up to May, most economic indicators and growth projections for key economies remained favourable, suggesting a moderate and sustained economic recovery. The MPC noted the strong growth in manufacturing and the uneven character of the global recovery, with robust growth in emerging-market economies combined with modest but stronger growth in most advanced economies. The MPC felt there were convincing signs that the global economic recovery would be sustained.

These initially favourable economic growth trends deteriorated in mid-2011, resulting in markedly lower expectations for much of the world for the latter half of the year and extending into 2012. Many global growth projections had tended to downplay the role of rising commodity prices as a potential drag on global growth and looked past contemporaneous events that had negative real economy effects, such as the tsunami and its aftermath in Japan or the unfolding of the Arab Spring and the impact of higher oil prices. With hindsight, each of these factors may have played a stronger role in undermining growth momentum than had been previously estimated.

By July and August of this year concerns about the recovery were sharply exacerbated by rising tension associated with key fiscal and sovereign debt issues in the US and Europe. Weaker economic growth, policy indecision and financial tensions interacted with one another and contributed to a serious deterioration in the global economic outlook.

The MPC noted the risks reflected in increasing credit default swap (CDS) spreads for Europe's peripheral economies, the developing political turmoil in the Middle East and North Africa, and the potential for medium-term disruption to global supply chains from the crisis in Japan. Although the latter risk turned out to be less damaging to regional and global growth, the developing sovereign debt crisis in Europe and fiscal policy concerns in the US contributed much more strongly to global financial uncertainty. In Europe the crisis worsened in the run-up to the November meeting of the committee.

The sovereign debt concerns facing peripheral European countries evolved into a dual crisis of financial institutions weak balance sheets and ineffectual regional policy-making in the eurozone. These risks intensified between May and November, resulting in the focus of concern shifting to the larger economies of Italy and Spain, and to some extent France. The MPC expressed high levels of concern about the need to resolve the sovereign debt crisis fully to restore confidence and reduce volatility in financial markets. A disorderly write-down of debt was identified as a potential trigger for systemic financial difficulties. By November the committee observed little meaningful progress in resolving those issues, and recognised the need to be prepared and capable of responding to adverse effects on the South African economy.

The worsening financial and policy environment contributed to deteriorating economic outcomes across the world economy. Global economic growth prospects were clearly less benign by August 2011 and confirmed by the revisions to projections set out by the IMF in September. The larger downward revisions related to the advanced economies. The MPC felt, however, that there was insufficient clarity on whether the stalled state of advanced economies would translate into a recession.

For much of the year emerging-market economies exhibited robust economic growth. Some emerging markets show signs of overheating, with high and rising inflation and growth well above estimates of potential. A combination of country-specific dynamics and the spillover effects of deterioration in advanced economies, however, suggested that emerging markets would also begin to slow and be subjected to greater volatility in risk perceptions, capital flows and exchange rate movements.

The MPC took a stronger view over time on the importance of downside risks to the global economy, and in particular the role of the European crisis. Monetary accommodation in key advanced economies was expected to persist for the foreseeable future, particularly where fiscal policy was constrained.

For much of the first half of 2011 the global recovery was seen to be supporting South Africa's economic recovery, and stronger confidence in businesses and households. A sustained and moderate recovery and reasonably well-contained price pressures were expected. The

Rand Merchant Bank (RMB)/ Bureau for Economic Research at Stellenbosch University (BER) Business Confidence Index (BCI), Kagiso/BER Purchasing Managers Index, and the Bank's composite leading business cycle indicator showed stronger real economic conditions.

The healthy performance of the economy in the first quarter of 2011, however, was not sustained in the second. Following the 4,5 per cent annualised growth for the first quarter, the economy slowed to 1,3 per cent in the second quarter. The MPC noted with growing concern the increasing fragility of the economy and the hesitant nature of the recovery. The second quarter growth rate reflected a combination of weaker growth elsewhere and faltering output domestically, in part due to widespread industrial action. The RMB/BER BCI fell to below the neutral 50 level in the second quarter of 2011. The Kagiso/BER Purchasing Managers Index (PMI) weakened sharply in July in line with the decline in manufacturing output. The building sector in particular continued to lag growth in the rest of the economy, with continued weakness showing in house prices, mortgage advances, and indicators of future building plans. Having increased through much of the year, capacity utilisation declined from July.

Gross fixed capital formation in the first and second quarters of 2011 exhibited a modest recovery from the decline in 2010, growing by 3,1 per cent and 4,1 per cent respectively. Private- and public-sector corporation investment increased, while the sustained decline in general government investment appears to have ended. The Bank's forecast shows a significantly rising contribution to GDP growth in 2012 and 2013 compared with the modest contribution of 0,5 percentage points expected for 2011.

Household consumption had played a major role in sustaining growth in the economy in 2010 and into 2011. Moderate growth in household spending is expected to continue, although a range of factors should constrain household spending from returning to its pre-crisis pace. The MPC observed that although household net wealth had recovered partially since the recession, it remained below the peak achieved in 2007, due in part to weak nominal house price growth. Household debt as a percentage of disposable income has fallen from a high of 82 per cent in 2008 to about 75,9 per cent of disposable income in the second quarter of 2011. This is still a high level compared to the average level of 64,3 per cent in 2005. Growth in retail sales and new vehicle sales has been volatile, and consumer confidence moderate and declining in recent months.

Credit demand from households has been very weak and lending conditions constrained. The ratio of impaired advances to gross loans and advances, largely attributable to retail debt, had remained at around 5,5 to 5,8 per cent in the first half of the year. The MPC expressed concern over the lack of movement in this ratio despite growth in the economy. By the November meeting the ratio of impaired advances had started to fall, reaching 5,1 per cent.

The third quarter also revealed further strengthening in the money supply and credit extension. Credit advanced to corporates and for motor vehicle sales had shown greater signs of life than other credit categories. By the end of September, general advances had grown by about 13 per cent. Mortgage advances have weakened over the course of the year, reflecting a distinct faltering in the housing market recovery that was thought to be evident early in the year.

The considerably weaker trajectory of the domestic economy from the second quarter of the year and downward adjustments of global growth have resulted in a lower forecast for average growth in GDP. By September the forecast for 2011 GDP growth had declined to 3,2 per cent from 3,7 per cent at the July meeting. The forecast for 2012 was similarly marked down from 3,9 per cent to 3,6 per cent, while the 2013 projection remained unchanged at 4,4 per cent. The November forecast continued the downward trend in outlook for both the global economy and South Africa. GDP growth for South Africa's largest 15 trading partners (the measure used in the Bank's forecasting process) is expected to be 3 per cent for 2011, decelerating to 2,7 per cent in 2012. The South African economy is projected to grow by 3,0 per cent in 2011 and by 3,2 per cent in 2012.

The modest global economic recovery of the first half of 2011 was associated with rising inflation pressures driven primarily by global food and oil prices. Food and oil price pressures drove up the imported component of consumer prices in many economies, with the risk of pass-through into broader consumer prices or measures of core inflation higher in countries experiencing strong economic growth. In some economies, property market buoyancy and GDP growth running above potential output were indicative of a broadening in inflationary pressures. Some rapidly growing emerging-market economies began to shift to a tighter monetary policy stance early in the year. In advanced economies, core measures of inflation remained somewhat muted, reflecting weak underlying demand conditions.

Early in 2011, the MPC raised concerns about the extent of international food price pressures caused by changing weather patterns, rising demand for food in emerging markets and tight food supplies. Sharply rising wheat prices late in 2010 posed a potential challenge for South Africa, although the impact on consumer prices was moderated by increases in the exchange rate of the rand. The Bank's inflation forecast set out the potential for food prices to put sustained upward pressure on headline consumer price inflation through the year, despite the view that global food prices were seen to be peaking around the middle of 2011.

At the March MPC meeting the Bank's inflation forecast remained within the target range, despite the headline CPI projection increasing by about half-a-percentage point in 2012. By the May meeting the headline CPI forecast had increased to above the top end of the target band for the final quarter of 2011 and peaked at 6,3 per cent in the first quarter of 2012 before moderating somewhat. The July forecast saw headline inflation peaking at about the same time and level, and then remaining stuck at around 6 per cent for several quarters in 2012 and then declining. The primary driver of the increase in the headline CPI forecast was higher international oil prices. With the softening in global economic conditions in August and September, the Bank's inflation forecast showed the peak expected in the first quarter of 2012 at 6,2 per cent before declining to average 5,5 per cent in the final quarter of 2013.

The Bank's November forecast reflected a somewhat sharper rise in monthly food and petrol prices in 2011, offset somewhat by weaker demand-side pressures in 2012 and 2013. Headline CPI is forecast to average 5 per cent for 2011, 6 per cent for 2012 and 5,5 per cent for 2013. The peak is expected in the first quarter of 2012 at 6,3 per cent before returning to within the target in the fourth quarter. A core measure of inflation excluding food, petrol and energy remained well contained.

Oil prices had moderated significantly before sharply increasing as the crisis in Libya unfolded in February and oil exports slowed dramatically from that country. Tighter supply was accompanied by large swings in oil prices as futures prices reacted to the release of oil stocks by the International Energy Agency in June. The MPC expressed its concern that the future trajectory of oil prices had become less clear. In September the committee noted that oil prices would be affected by the extent to which the Chinese economy slowed in coming months. The combination of strong global demand and falling supply were expected to keep international oil prices at elevated levels. Since December 2010 the petrol price increased by a cumulative 232 cents per litre or 27,5 per cent, with a large increase in October caused by the depreciation of the rand.

The prospect of sustained high wage settlements presented a further risk to the inflation outlook. Wage settlements started to moderate in 2011 with strong growth in 2010 of 8,2 per cent easing to 7,5 per cent in the first and second quarters of 2011. The MPC noted that continued moderation of unit labour cost growth could contribute meaningfully to low inflation and employment creation, although negative outcomes posed a significant upside risk to the outlook.

The firm exchange rate of the rand for much of 2010 and 2011 has had a moderating effect on domestic inflation, primarily by dampening the impact of rising prices for imported food and oil. The exchange rate has also enabled a sustained low repurchase rate. Yet the MPC also noted over the course of its meetings that bouts of global risk aversion – associated in 2011 mostly with the low interest rate environment and events in the US and Europe – have resulted in large swings in capital flows to South Africa and in volatility in the value of the currency. Volatility increased dramatically in August and September as events came to a head in these major economies, and the rand depreciated sharply. Between the September and November meetings of the MPC, the rand has traded in a range against the US dollar of between R7,70 and R8,50. Since January, the rand has depreciated by 19 per cent against the dollar, by 24 per cent against the euro and by 18 per cent on a trade-weighted basis.

The MPC noted that the extent and persistence of the depreciation trend will have a determining impact on the degree to which the currency's movements present an upside risk to the inflation forecast. In September the MPC deemed the risk to be relatively moderate but rising.

Expectations of future inflation play a key role in the monetary policy toolkit and are watched with care by the MPC. The January committee meeting noted that expectations held by business executives and trade unionists continued to decline in line with the moderating inflation trend at that time.

Financial analysts, however, had already begun shifting to a less sanguine view of future inflation. The second quarter of 2011 revealed a bottoming out of inflation expectations and over the next few months inflation expectations followed the general upward trend in the Bank's inflation forecast, driven largely by global food and oil price pressures. The September and November MPC discussions revealed inflation expectations hovering at the upper end of the target range. At the time of the September meeting, market analysts expected an upward policy rate change. By the November meeting, the expectation of policy rate normalisation had been pushed out significantly by the majority of analysts. Market-based expectations of long-run future inflation, as measured by breakeven inflation rates on longer-term debt, tended to rise above the short- and medium-term forecasts of inflation.

In the context of extraordinary global tensions and changes to growth and inflation trajectories, the MPC held the view that the inflation risks facing South Africa primarily lay in cost–push pressures emanating from international food and oil prices. The committee emphasised its concern that these prices could feed into headline CPI and generate expectations of rising inflation that would have serious negative economic effects. The committee also expressed its concern at the possibility that moderating unit labour cost outcomes, which will tend to support growth and employment creation, could be reversed. The MPC repeatedly cautioned that it would closely monitor indications of second-round effects arising from cost–push pressures.

Domestic economic developments, and since May the global growth trajectory, have weakened demand pressures in the economy and may have lessened the build-up of significant second-round inflation effects. Despite the expected peak in headline CPI in early 2012 at 6,3 per cent, the trajectory shows re-entry into the target band later in the year without a policy adjustment. The September MPC meeting felt that the downside risks to inflation from a disorderly debt workout in Europe and weak domestic growth prospects were delicately balanced against ongoing cost–push pressures. The November meeting suggested that while core inflation was expected to be contained, there was greater potential for marginally worse inflation expectations for 2012 and on balance upside risks to the headline inflation outlook.

The outlook for inflation

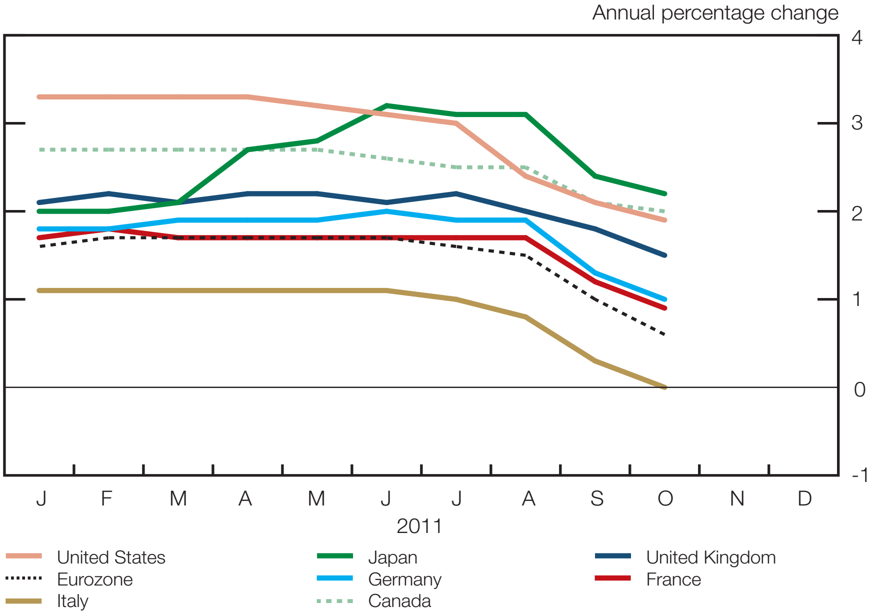
The prospects, risk and uncertainties relating to some of the factors that determine the outlook for inflation are presented in this section.

International outlook

The global economic outlook has deteriorated markedly since the previous *MPR* was published in May 2011, and growth forecasts for 2012 have generally been revised downwards in recent months (Figure 23). The tide had begun to turn in May as economic data, especially for manufacturing, softened worldwide and some investors became concerned about the end of the Fed's second round of quantitative easing that ended in June. Successive negative shocks – including the tsunami in Japan and the deepening euro area debt crisis – have contributed to an increasingly fragile economic recovery in recent months. Mixed signals on the US economic outlook, S&P's downgrading of the US' credit rating on 5 August, and a sovereign debt crisis that pushed government bond yields in Spain, Italy and Greece to euro-era records also impacted negatively on global investor, business and consumer sentiment.

In its September *WEO*, the IMF sharply downgraded its growth forecasts for the US, the euro area, and the UK, warning that strong action was needed to prevent a return to recession. Given escalating risks to the global recovery, it cautioned policy-makers in leading economies not to tighten fiscal policy too sharply but, nevertheless, expects the recent financial turmoil to delay rather than derail the economic recovery in advanced countries.

Figure 23 Evolution of real GDP forecasts for 2012 for the G7 and eurozone (surveys conducted during 2011)



Source: Consensus Forecasts

As Table 10 shows, global output is projected to expand by 4,0 per cent in 2012 and the growth forecast for advanced economies has been reduced to 1,9 per cent. On balance, the IMF expects continued, uneven expansion and deems risks to its growth projections to be mainly to the downside given continued concerns about sovereign debt in the euro area.

Table 10 IMF projections of world growth and inflation for 2011 and 2012

Per cent

	Real GDP		Consumer prices	
	2011	2012	2011	2012
World	**4,0**	**4,0**	**5,0**	**3,7**
Advanced economies	**1,6**	**1,9**	**2,6**	**1,4**
United States	1,5	1,8	3,0	1,2
Japan	-0,5	2,3	-0,4	-0,5
Euro area	1,6	1,1	2,5	1,5
United Kingdom	1,1	1,6	4,5	2,4
Canada	2,1	1,9	2,9	2,1
Other advanced economies	3,6	3,7	3,3	2,8
Emerging-market and developing economies	**6,4**	**6,1**	**7,5**	**5,9**
Sub-Saharan Africa	5,2	5,8	8,4	8,3
Central and eastern Europe	4,3	2,7	5,2	4,5
Commonwealth of Independent States	4,6	4,4	10,3	8,7
Developing Asia	8,2	8,0	7,0	5,1
China	9,5	9,0	5,5	3,3
India	7,8	7,5	10,6	8,6
Middle East and North Africa	4,0	3,6	9,9	7,6
Latin America and the Caribbean	4,5	4,0	6,7	6,0

Source: IMF *World Economic Outlook*, September 2011

In the US growth is expected to be higher in 2012 than in 2011, although the IMF has reduced its projection for 2012 by 0,9 percentage points to 1,8 per cent, with risks to the outlook remaining elevated. Euro area growth is expected to decline in 2012, with the IMF expecting real GDP to expand by about 1,1 per cent.

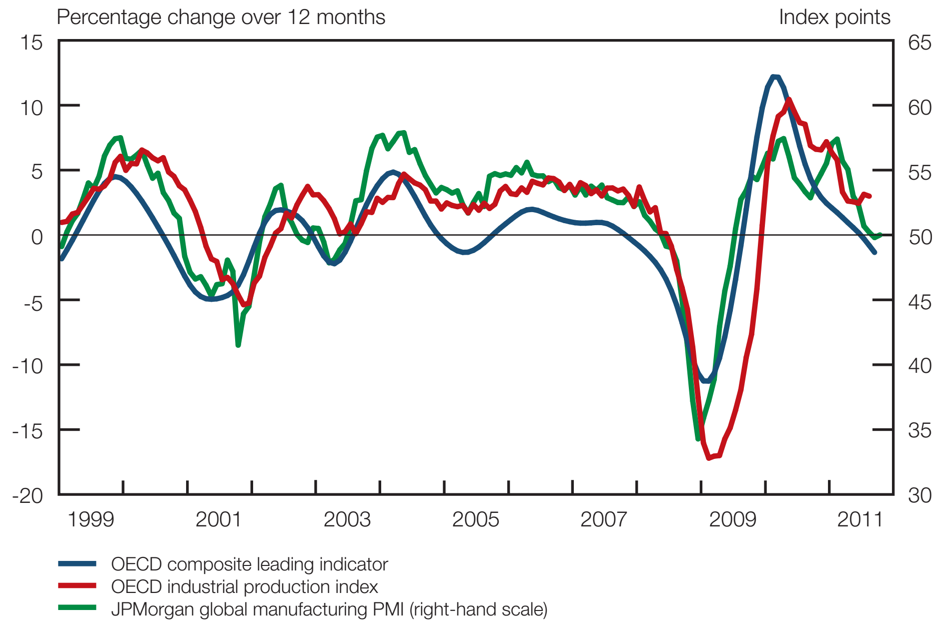
In November the European Commission more than halved its euro area GDP growth forecast for 2012 to 0,5 per cent, citing the risk of an ongoing fiscal crisis leading to recession in the region. In Japan the earthquake and tsunami on 11 March had a greater-than-anticipated effect on international supply chains and global growth, but industrial production rebounded in the second half of 2011. The IMF projects GDP growth in Japan to improve significantly from a negative 0,5 per cent in 2011 to 2,3 per cent in 2012. The growth forecast for the UK is projected to increase moderately to 1,6 per cent in 2012 from 1,1 per cent in 2011.

There has also been a pronounced slowdown of growth in emerging-market and developing economies. The IMF expects the major countries in this group to continue to grow faster than the advanced economies, but also expects them to remain vulnerable to contagion effects from a possible significant slowdown or recession in these economies. Growth in these countries is projected to be 6,1 per cent in 2012, with developing Asia projected to grow by 8,0 per cent. China is projected to continue to grow at rates of around 9,0 per cent in 2012, while India is projected to achieve growth well above 7,0 per cent per annum for the year.

The IMF projects that consumer-price growth in the global economy will decline to 3,7 per cent in 2012 from 5,0 per cent in 2011. Consumer price inflation is expected to slow in 2012 in both advanced economies (from 2,6 to 1,4 per cent) and emerging and developing countries (from 7,5 to 5,9 per cent).

Selected indicators of global economic activity are shown in Figure 24. The Organisation for Economic Co-operation and Development (OECD) index of composite leading indicators, designed to give a broad indication of economic activity six months ahead, suggests a slowdown in economic activity into early 2012. It declined by 1,3 per cent in September 2011, compared with the corresponding month of the previous year. The year-on-year rate of change in the OECD industrial production index likewise slowed significantly from 5,8 per cent in February to 3,0 per cent in August 2011. The JPMorgan global manufacturing Purchasing Managers' Index (PMI) has also declined from a level of 57,4 in February 2011 to 50,0 in October.

Figure 24 Selected indicators of global economic activity

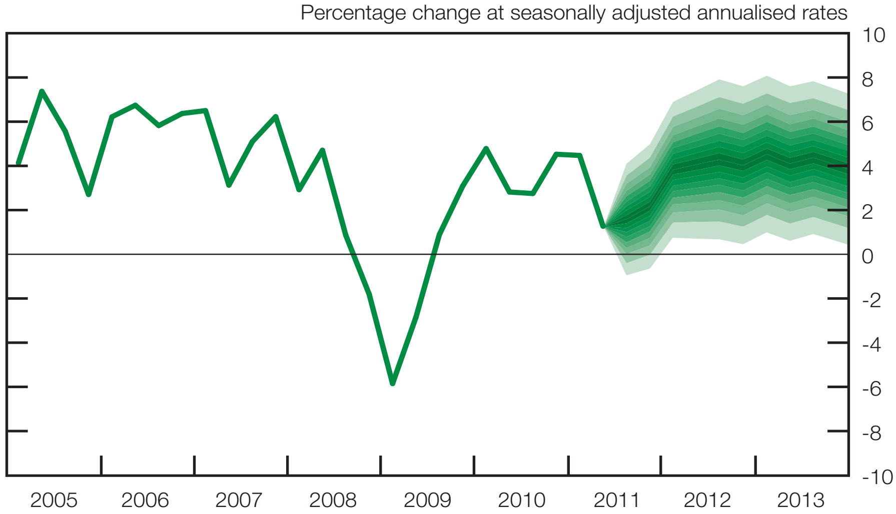


Sources: OECD and JPMorgan

Outlook for domestic demand and supply

According to the Bank's latest quarterly projection, annual average growth in real output is expected to be 3,0 per cent in 2011, followed by 3,2 per cent in 2012 and 4,2 per cent in 2013 (Figure 25). The lower forecast is mainly a result of the lower-than-expected economic growth outcome in the second quarter and downward revisions to global growth.

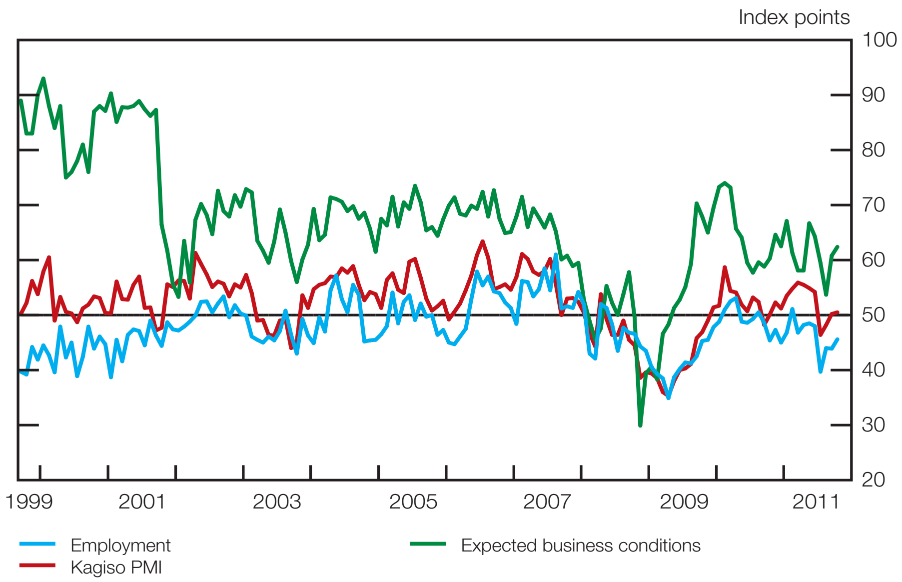
Figure 25 Real GDP growth forecast



The 2011 *MTBPS* forecasts slightly higher annual average economic growth of 3,1 per cent in 2011 and 3,4 per cent in 2012. For the years 2013 and 2014 GDP growth is forecast to reach 4,1 per cent and 4,3 per cent, respectively, as global uncertainties decrease and confidence strengthens. The Reuters October 2011 survey showed that financial analysts, on average, expect annual GDP to increase by 3,2 per cent in 2011, followed by 3,3 per cent in 2012 and 4,0 per cent in 2013.

The seasonally adjusted Kagiso/BER PMI had risen for the third time since July, when it registered 46,4 index points, to reach 50,5 in October 2011, moving back above the neutral level of 50 (Figure 26). The business activity index posted 50,9 index points, and new sales orders improved to 51,6 index points. Purchasing commitments registered 55,4 index points and expected business conditions rose to 62,4 index points in October, up from 60,8 points in September.

Figure 26 Kagiso PMI

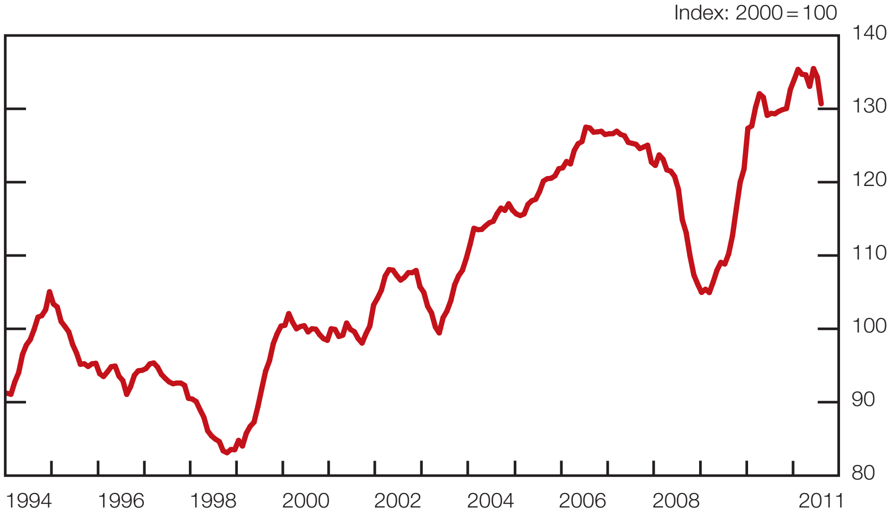


Sources: Kagiso Securities and Bureau for Economic Research, Stellenbosch University

According to the Ernst & Young/BER retail survey, the percentage of wholesalers rating business conditions as satisfactory declined from 47 in the second quarter of 2011 to 31 in the third quarter. The Ernst & Young/BER retail confidence index gained 1 index point to reach a level of 48 during the third quarter.

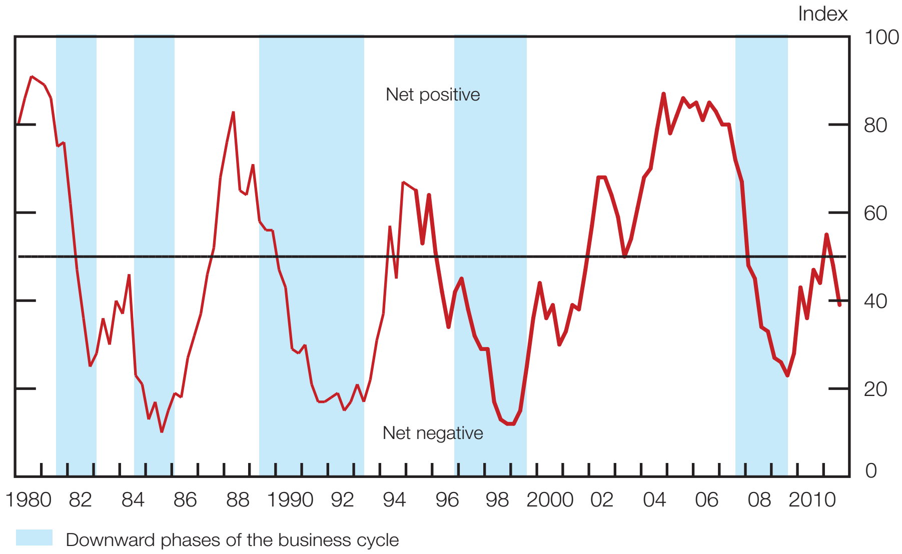
The Bank's composite leading business cycle indicator decreased in August 2011, having also decreased in July (Figure 27). Ten of the eleven component time series that were available for August decreased, while one increased. The major negative contributors to the movement in the leading indicator in August were the year-on-year percentage change in the composite leading business cycle indicator of South Africa's major trading-partner countries, followed by the prices of all classes of shares traded on the JSE. The only positive contribution came from the export commodity price index. Since February 2011, the leading indicator has been following a moderate downward trend, pointing to a possible slowdown in aggregate economic activity in the months ahead.

Figure 27 Composite leading business cycle indicator



The RMB/BER BCI fell sharply from 48 index points in the second quarter of 2011 to 39 index points in the third quarter. Business confidence declined in the new vehicle trade, manufacturing and wholesale trade sectors, but increased in the retail trade sector. Confidence in the building sector remained low and declined marginally from 21 index points in the second quarter to 20 index points in the third quarter.

Figure 28 RMB/BER business confidence



Sources: Rand Merchant Bank and Bureau for Economic Research, Stellenbosch University

According to the BER Manufacturing Survey, manufacturing business confidence declined from 51 index points in the second quarter of 2011 to 36 points in the third quarter, with the net majority reporting general business conditions as worse than a year ago rising from 8 per cent to 33 per cent. The net majority who reported a rise in domestic sales volumes fell from 26 per cent during the second quarter to 3 per cent in the third quarter, while the net majority reporting an increase in domestic orders fell from 14 per cent to 1 per cent. The percentage of total respondents rating the present level of output as below capacity rose from 67 per cent to 74 per cent.

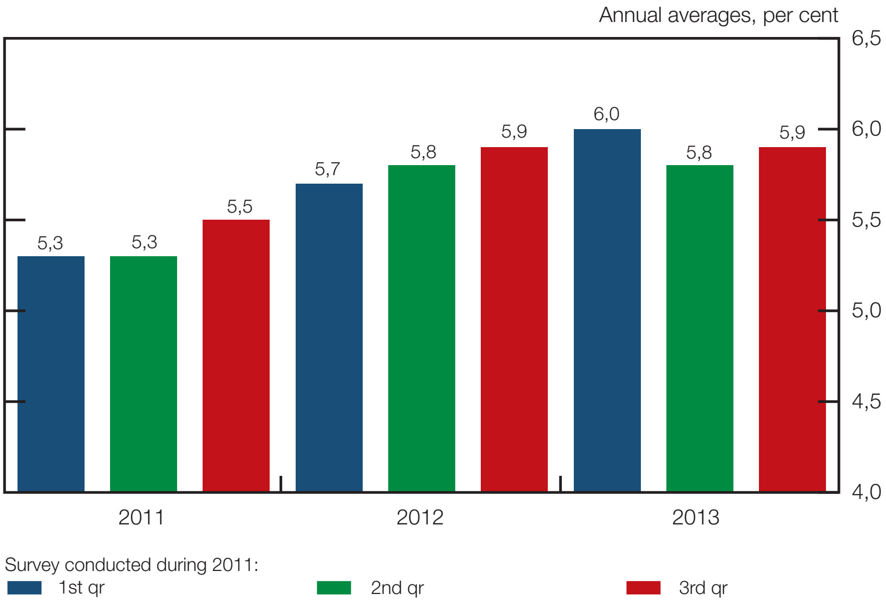
The FNB/BER Building Confidence Index declined marginally from 24 index points in the second quarter of 2011 to 23 index points in the third quarter. Three quarters of respondents in the surveyed sectors of the building industry rated the prevailing business conditions as unsatisfactory. The confidence of quantity surveyors, sub-contractors and building material merchants increased, while that of architects, main contractors and building material manufacturers declined relative to second quarter.

The FNB/BER Consumer Confidence Index (CCI) declined from +11 index points in the second quarter of 2011 to +4 index points in the third quarter. The fall in the third quarter can mostly be attributed to a large decline in the percentage of consumers expecting an improvement in the economy. The percentage of consumers expecting an improvement in their own finances also declined, while the percentage rating the present as an unsuitable time to buy durable goods remained almost unchanged relative to the second quarter.

Indicators of inflation expectations

Inflation expectations play an important role in price setting and wage negotiations, and are therefore an important factor in determining future inflation outcomes. The BER survey of inflation expectations undertaken in the third quarter of 2011 shows that average inflation expectations remain within the target range, rising from 5,5 per cent in 2011 to 5,9 per cent in 2013 (Figure 29). However, expectations have increased from the time the previous survey was undertaken in the second quarter of 2011. The average inflation expectation for 2011 has risen from 5,3 per cent in the second quarter of 2011 to 5,5 per cent in the third quarter. The average inflation expectation for 2012 and 2013 also increased in the third quarter by 0,1 percentage points to 5,9 per cent.

Figure 29 BER surveys of headline CPI inflation expectations



Source: Bureau for Economic Research, Stellenbosch University

According to the BER survey results, all respondent groups revised their 2011 inflation forecast upwards in September 2011. Financial analysts forecast that consumer headline inflation would remain below 6 per cent over the entire 2011–13 period, while business now expects inflation to breach the upper inflation target limit and reach 6,1 per cent in 2012, before accelerating to 6,3 per cent in 2013. Trade unions expect inflation to reach 6 per cent in 2012 before moderating to 5,9 per cent in 2013.

The Reuters survey of long-term forecasts for the South African economy shows the forecasts for CPI inflation rising in 2012. The mean CPI forecast is for inflation of 5,1 per cent in 2011, 5,8 per cent in 2012 and 5,6 per cent in 2013 (Table 11). The inflation forecasts were relatively unchanged between September and October 2011.

Table 11 Reuters survey of CPI inflation forecasts: October 2011*

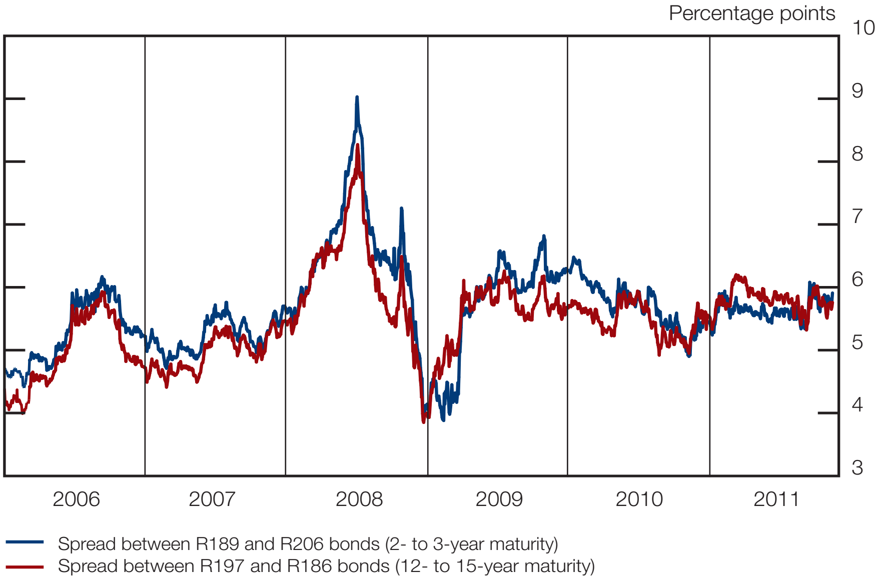
	2011		2012		2013	
1. Mean	(5,0)	5,1	(5,8)	5,8	(5,7)	5,6
2. Median	(5,0)	5,0	(5,8)	5,8	(5,7)	5,6
3. Highest	(5,1)	6,2	(7,0)	7,0	(6,0)	6,5
4. Lowest	(4,7)	4,9	(5,4)	5,1	(4,9)	4,9
Number of forecasters	(17)	19	(17)	19	(12)	15

* September 2011 survey results in parentheses

Source: Reuters

Figure 30 shows the inflation expectations associated with break-even inflation rates, measured as the yield differential between South African government CPI inflation-linked bonds and conventional nominal bonds of similar maturity, assuming constant inflation and liquidity risk premia over the period until the bond matures. In September break-even rates rose as a result of sharp increases in government bond yields and a weakening in the foreign-exchange rate of the rand. Increased risk aversion resulted in non-resident investors selling emerging-market economies' bonds (including South Africa's) due to eurozone sovereign debt issues, and there was an expectation of increased bond issuance to be announced in the *MTBPS*. Break-even rates then reversed as non-residents returned to the domestic bond market in October and National Treasury announced a less-than-expected long-term bond issuance on 25 October 2011.

Figure 30 Break-even inflation rates

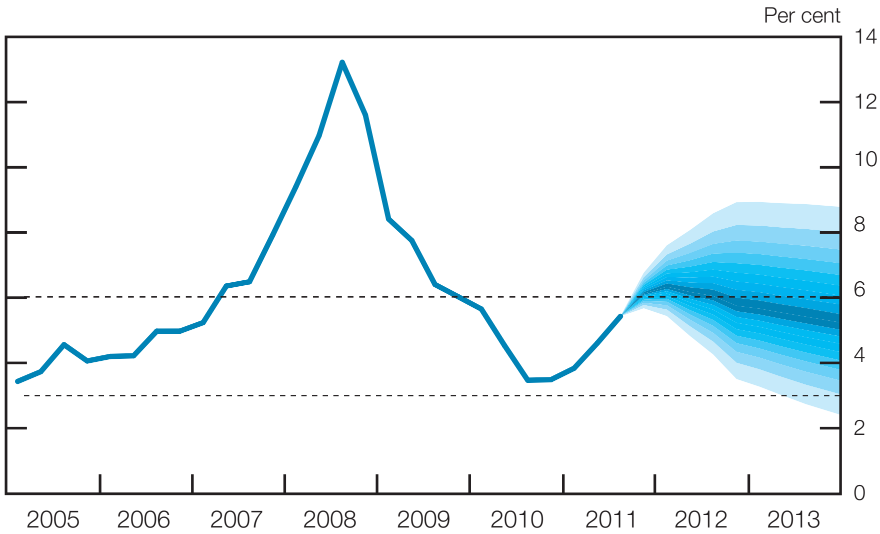


The South African Reserve Bank inflation forecast

The most recent projections of the Bank's core quarterly inflation forecasting model, presented to the MPC meeting on 8–10 November 2011, are reproduced in the form of a fan chart in Figure 31. According to these projections, the inflation forecast of the Bank has shown a modest increase since the previous meeting of the MPC. The targeted inflation rate is expected to continue to trend upwards, moving above the upper level of the inflation target range from the fourth quarter of 2011 to the third quarter of 2012, before returning to within the target range for the remainder of the forecast period.

The central projection, conditional on an unchanged repurchase rate, is for the average quarterly CPI inflation rate to peak at an average rate of 6,3 per cent in the first quarter of 2012, then decline gradually to average around 5,2 per cent in the final quarter of 2013. Movements in oil prices, electricity prices or the exchange rate of the rand that differ from those assumed for the forecast will impact on the central projection, with alternative scenarios for movements in these variables generating more optimistic or pessimistic outcomes for targeted inflation. The forecast makes provision for electricity price increases of 17,3 per cent per annum in the third quarters of 2012 and 2013.

Figure 31 Targeted inflation* forecast



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

Note: The fan chart uses confidence bands to depict varying degrees of certainty. The darkest band of the fan chart covers the most likely 10 per cent of probable outcomes foreseen for inflation, including the central projection. Each successive band, shaded slightly lighter and added on either side of the central band, adds a further 10 per cent to the probability, until the whole shaded area depicts a 90 per cent confidence interval (see Box 4 "Understanding the fan chart" on p. 27 of the March 2001 *Monetary Policy Review*).

Given the central projection for targeted inflation as the most likely outcome, the risks to the forecast in Figure 31 are viewed as being skewed slightly to the upside. Uncertainty regarding future developments in cost–push pressures and the exchange rate pose an upside risk to the outlook, which more than offsets the downside risks from possible contagion effects from the European crisis and associated slow growth.

Box 2 An accuracy analysis of inflation forecasts

Despite the high degree of uncertainty involved in economic forecasting, forward-looking projections of inflation and other variables play a critical role in any monetary policy decision-making process.

Forecast errors arise from a variety of sources, including misspecification of economic relationships, data revisions, unforeseen shocks to the economy and incorrect or partial assumptions for exogenous input into the models. Models are always imperfect as they are simplified facsimiles of the real world.

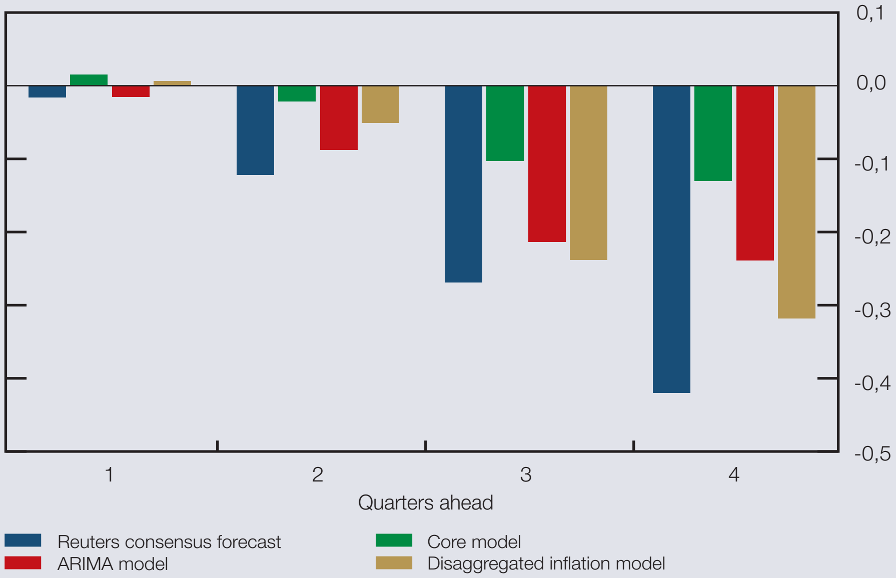
Monetary Policy Committee (MPC) decisions are based, in part, on the forecast and on the analysis and assessment of other information, coupled with the balance of risks affecting the baseline forecast.

The South African Reserve Bank (the Bank) compares the accuracy of its forecasts of headline consumer price inflation produced by its core model, [1] the Autoregressive Integrated Moving Average (ARIMA) model and the disaggregated inflation model against the Reuters Consensus Forecast.[2]

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

The average forecast errors of the Bank's models and that of the Reuters Survey (the average of the participants) for the period May 2003 to September 2011, presented in Figure B2.1, are negative and biased downwards. This bias indicates that both the Bank and the Reuters participants, on average, underestimated the actual outcome of headline consumer price inflation over the medium-term forecast horizons, that is, two-quarters-ahead to four-quarters-ahead forecasts.

Figure B2.1 Average forecast error



Source: Reuters and own calculations

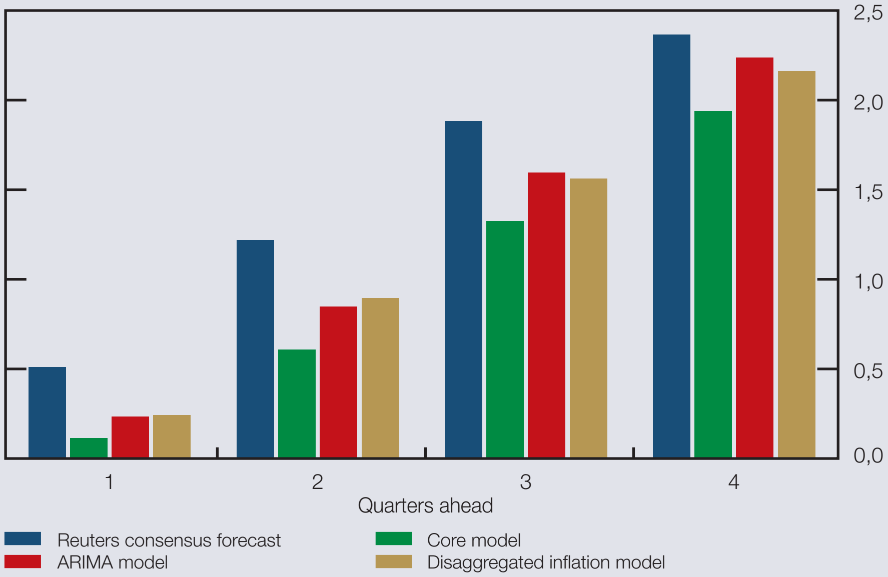
Supply-side shocks in 2007 and 2008 – largely unexpected changes in international commodity, oil and food prices – contributed to a sharp acceleration of quarterly rates of year-on-year headline inflation. This exceeded 13 per cent in the third quarter of 2008. These exceptional shocks resulted in large consecutive negative forecast errors dominating the outcome of the average forecast error.

1 The core model is a simultaneous-equation macroeconometric model consisting of 27 stochastic equations and several identities. It provides a well-defined conceptual framework for macroeconomic analysis. The ARIMA model is based on the historical properties of the series, which is intended for the very short term. In the disaggregated inflation model the main components of the headline consumer price index are forecast individually and then aggregated with the appropriate weights to calculate the forecast of headline consumer price index.

2 The Reuters Survey is published monthly and contains forecasts of several macroeconomic variables over a relatively long time span. The forecasters consist of economists from major investment banks, corporations, consulting firms and academic institutions, using different methods and models to produce their forecasts. On average, the survey contains 22 forecasts each month, and many of the forecasters have participated in the survey for several years.

In Figure B2.2 it is evident that the Bank's models are considerably more accurate than that of the Reuters Consensus Forecast over the one-quarter-ahead horizon when comparing the respective root mean square errors. However, as the forecast horizon extends and uncertainty rises, the gap in the forecast accuracy declines.

Figure B2.2 Root mean square error



Source: Reuters and own calculations

The Bank's forecasting performance is also compared with the 16 individual forecasters or institutions that participate consistently in the Reuters Survey.[3] The results show that the forecast produced by the Bank's core model is consistently the best over the one-, two and three-quarters-ahead forecast period, with only the ARIMA model slipping to the fourth position over the four-quarter-ahead forecasting period.

3 The Reuters Consensus Forecast is treated in this instance as a forecasting entity in its own right. It is therefore not the average of the forecast errors of all the participants in the Reuters Survey. All other participants are identified by a number only and the same number is attached to a particular participant throughout the analysis and forecast horizon.

Assessment and conclusion

The global economy remains extraordinarily turbulent. Efforts at global, regional and national levels to make policy decisions underscore the complexity of the world's current economic and financial difficulties. Since the previous meeting of the MPC, there has been little meaningful progress towards resolving the sovereign debt crisis that is engulfing the euro area. Coalition governments in some countries may help to unlock tough decisions. Advanced economies generally need to achieve more rapid economic growth rates but this goal remains hampered by policy uncertainty, slow deleveraging by households and financial institutions, and blocked credit channels.

Growth in emerging-market economies has up to now supported the overall growth rate of the world economy. Forecasts for emerging markets are being marked down because of their sensitivity to growth in advanced economies. Downward revisions are likely to remain limited, however, as China and India avoid hard landings and the US avoids a recession more comfortably than expected a few months ago. Emerging markets that are more dependent on growth in advanced economies, such as in Latin America and Central Europe, should experience more significant economic slowdowns.

For advanced economies, headline inflation should be expected to moderate in line with declining economic activity and the softer trend in commodity prices. Inflation remains quite high in many emerging-market economies, although in recent weeks some moderation has been seen. Economic growth concerns and financial fragility suggest that monetary policy in advanced economies is expected to remain accommodative for a considerable period. This policy stance may support a continuation of the somewhat higher rate of global price inflation experienced in 2011 despite weaker growth. The rise in prices has been caused primarily by supply pressures on resources and food that will only gradually ease over the longer term.

The heightened uncertainty of advanced economy developments and weaker growth has had implications for the pattern of global capital flows and exchange rates in emerging markets. Capital flows to emerging-market economies and commodity producers may remain strong over the medium and long term, even as short-term flows are volatile. This implies that inflation expectations need to remain well anchored around a sound inflation target to ensure that temporary shocks have minimal effects on inflation or the economy more generally. A clear price stability objective implemented within a flexible inflation-targeting framework is central to the Bank's approach.

The South African economy has been significantly affected by global developments and domestic constraints to the recovery. The domestic recovery remains hesitant and confidence low. Domestic demand pressures on inflation are restrained at this point in time but various supply-side factors have resulted in a deterioration of the inflation outlook. The subdued character of domestic demand is expected to keep core inflation contained. Food and petrol prices, and administered prices more broadly, are the drivers of the poorer outlook. Compared to the May assessment a more protracted, but relatively small, breach of the inflation target is expected in 2012.

Cost–push pressures and sustained exchange rate depreciation are the primary upside risks to the inflation outlook. Downside risks emanate from the potential contagion effects of the crisis in Europe and negative spillover effects on global economic growth. While the MPC viewed these risks overall to be skewed to the upside, the committee is aware of the dangers of a disorderly resolution of the crisis, and the systemic implications for the global and domestic economy, and remains ready to act appropriately should the need arise.

Statement of the Monetary Policy Committee

21 July 2011

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

Since the previous meeting of the Monetary Policy Committee (MPC), the global economic outlook has deteriorated. Events in the eurozone appear to have entered a new phase, with the focus moving from the peripheral countries to some of the larger economies in the region. The global systemic risks posed by any failure to overcome the sovereign debt crisis are enormous, and are exacerbated by the potential failure to resolve the debt ceiling crisis in the United States (US). These events are taking place against the backdrop of a slowdown in growth in many of the advanced economies.

The domestic economic recovery has continued, but in a hesitant manner. The strong performance of the economy in the first quarter of the year is unlikely to have been repeated in the second quarter, and growth prospects will also be dependent on global developments. Domestic inflation has been increasing in line with expectations, driven mainly by cost-push pressures, but more broad-based pricing pressures are beginning to emerge.

The year-on-year inflation rate as measured by the consumer price index (CPI) for all urban areas increased to 5,0 per cent in June 2011, from 4,6 per cent in May. As was the case in the previous few months, the main contributions to the inflation outcome came from food, housing and utilities, and transport categories which, together, accounted for 3,6 percentage points of the 5,0 per cent outcome in June. Food price inflation continued its marked upward trend, measuring 7,3 per cent in June, from 6,3 per cent in May. Petrol and electricity prices increased at rates of 21,4 per cent and 19,0 per cent respectively in June. Administered price inflation excluding petrol was unchanged in June at 9,3 per cent.

The underlying inflation trends have remained relatively moderate. In May and June CPI excluding food and petrol measured 3,7 per cent and 3,9 per cent respectively, while CPI excluding food, petrol and electricity measured 3,2 per cent and 3,5 per cent in these months.

Year-on-year producer price inflation has displayed some volatility in recent months, partly as a result of commodity price fluctuations. Producer prices increased by 6,6 per cent and 6,9 per cent in April and May respectively, compared with 7,3 per cent in March. Price increases in electricity and products of petroleum and coal were major contributors to the PPI outcome, but there were also significant increases in food prices, which had until recently remained subdued. Agricultural prices increased by 6,8 per cent in May, from 2,1 per cent in April, while manufactured food prices increased at rates of 3,4 per cent and 4,8 per cent in April and May respectively.

The inflation forecast of the Bank has shown a slight near-term deterioration since the previous meeting of the MPC. Inflation is now expected to breach marginally the upper end of the target range in the final quarter of 2011, and to average 6,3 per cent in the first quarter of 2012. Thereafter it is expected to remain at the upper end of the target range for the next two quarters, before declining somewhat in the final quarter of the year. The forecast period has been extended to the end of 2013 and inflation is expected to decline gradually during the year, to measure 5,6 per cent in the final quarter of 2013. The Bank's forecast of core inflation shows a moderately rising trend, peaking at around 5 per cent in the second quarter of 2012.

Inflation expectations for 2011 as reflected in the survey conducted by the Bureau for Economic Research (BER) at Stellenbosch University had been declining for six consecutive quarters, but remained unchanged in the second quarter of 2011. Expectations for 2012 increased marginally, but remained within the target range, and declined for 2013. The average inflation expectation for the three main categories of respondents was 5,3 per cent for 2011 and 5,8 per cent for the next two years.

Inflation expectations as measured by the Reuters survey of financial analysts showed very little change when compared to the forecasts at the time of the previous MPC meeting, with inflation expected to remain, on average, within the upper end of the target range until the end of 2013. Inflation expectations as reflected in the break-even inflation rates of the inflation-linked bonds have moderated slightly since the previous meeting.

The MPC assesses the risks to the global economic environment to be on the downside, and continued weakness in the economies of the US and United Kingdom has extended the likely duration of monetary accommodation, particularly in the face of declining fiscal stimuli.

Risks relating to debt sustainability in peripheral Europe have intensified, with further ratings downgrades to some countries. The focus has also moved beyond the periphery to larger countries such as Spain and Italy. As long as the sovereign debt crisis is unresolved, confidence will not be restored and periodic bouts of risk aversion can be expected to contribute to a high degree of volatility in financial markets. There are concerns that a disorderly write-down of this debt could have systemic implications because of the high exposure of European banks to the debt of these countries.

By contrast, there are encouraging trends in other parts of the world. The reconstruction of the Japanese economy in the wake of the natural disasters has begun to have some positive impact on that country's growth rate. Growth in emerging markets has generally remained strong, and fears of a marked slowdown in Chinese growth have been allayed somewhat by robust second quarter growth performance.

Global inflation has been driven primarily by food and oil price developments. There are, however, some indications that these price pressures may have peaked. Both the International Monetary Fund and Food and Agricultural Organization food price indices have shown a flattening out since the beginning of the year. International oil prices have contributed to, and in turn have also been constrained by, the slowdown in global growth.

The bouts of risk aversion relating to developments in the euro area have impacted on the volatility of the rand exchange rate. Since the previous MPC meeting, the rand has fluctuated within a range of R6,67 and R7,02 against the US dollar. The current level of the rand exchange rate against both the dollar and the euro has remained more or less unchanged since the previous MPC meeting. In recent months the rand has also been affected by a number of actual and expected direct investment transactions, and by net purchases of bonds and equities by non-residents totalling around R32,6 billion since the beginning of May. Net bond purchases by non-residents amounted to R34,1 billion, while net sales of equities amounted to R1,5 billion.

From a macroeconomic perspective, the rand has remained relatively strong despite heightened global risk aversion, and despite continued purchases of foreign exchange by the Bank with the support of National Treasury. Between September 2009 and August 2010, the rand dollar exchange rate fluctuated in the range of around R7,40 to R7,80. Since September of 2010, the rand has generally traded in the range of around R6,60 to R7,00, apart from a short period in early 2011 when it breached the R7,20 level.

The domestic economic recovery remains fragile. Annualised GDP growth in the first quarter of 2011 measured 4,8 per cent, driven primarily by a 14,5 per cent growth in the manufacturing sector. This performance is not expected to be sustained in the second quarter: the monthly data for manufacturing-sector output in April and May suggest that unless there is a major upside surprise in June, the positive contribution of the sector to second quarter growth is likely to be minimal. The Kagiso Purchasing Managers Index, while still indicating positive growth in the sector, has declined for three consecutive months. Some of the slowdown in manufacturing can be ascribed to temporary factors such as the impact of the earthquake in Japan on the global motor industry supply chain. The outlook for the sector will also be influenced by developments in Europe, which is a significant market for South African-manufactured exports. Growth in the physical volume of mining production was weak in April and May.

Growth in gross fixed capital formation improved in the first quarter of 2011 to register an annualised growth rate of 3,1 per cent. This was mainly due to the higher levels of investment by public corporations. Growth in private-sector fixed capital formation, while rising, was still subdued at 2,7 per cent.

Despite the expected growth slowdown in the second quarter, the forecast of the Bank for gross domestic product growth in 2011 and 2012 remains unchanged at 3,7 per cent and 3,9 per cent respectively, while growth in 2013 is expected to average 4,4 per cent. With a potential output growth rate of around 3,5 per cent, the estimates of the Bank show that the output gap, although closing, is still negative at around 2,5 per cent. This is consistent with the fact that the levels of output in both the manufacturing and mining sectors are still below pre-crisis levels, as is the level of capacity utilisation in the manufacturing sector. Business confidence, as reflected in the Rand Merchant Bank/Bureau for Economic Research Business Confidence Index, reversed its positive trend when it declined to below the neutral 50 level in the second quarter of 2011. Confidence in the construction sector remains at an extremely low level, and the real value of new building plans passed declined further in April.

Household consumption expenditure, which grew at an annualised rate of 5,2 per cent in the first quarter of 2011, has been the main driver of the domestic growth recovery. There are indications that this growth may have moderated in the second quarter. The robust growth in real retail sales in April was more than offset in May when a month-on-month decline of 4,7 per cent was measured, while the year-on-year growth rate was zero. New vehicle sales increased by 12,6 per cent year on year, but declined by 4 per cent in the second quarter compared with the previous quarter. The First National Bank/Bureau for Economic Research Consumer Confidence Index increased marginally in the second quarter of 2011, but remains below levels reached in 2010.

The MPC expects household consumption expenditure to be constrained by a number of factors, including subdued credit market conditions, high levels of household debt, negative wealth effects and persistently high rates of unemployment.

Growth in total loans and advances extended by banks to the private sector remain relatively subdued and grew at a year-on-year rate of 5,5 per cent in May, compared with 6,0 per cent in April. Growth in “other loans and advances” , particularly general loans, was the major driver, as growth in mortgage loans – the largest category of loans – was restrained at around 3 per cent, in line with the weak housing market. The subdued state of the credit markets reflects in part the high levels of consumer indebtedness, which measured 77 per cent of personal disposable income in the first quarter of 2011. The ratio of impaired advances to gross loans and advances has remained at elevated levels for some time but declined marginally to 5,73 per cent in May.

Wealth effects have been negatively affected by the subdued housing market. The various house price indices indicate that house prices are falling in real terms, although there appears to be some positive nominal growth. While the JSE is at relatively high levels, it is vulnerable to correction in the event of a significant global slowdown. Although household net wealth to disposable income has recovered somewhat since the recession, it is still below the peak reached in 2007.

Employment trends have been improving slowly. According to the Quarterly Employment Survey of Statistics South Africa, formal non-agricultural employment increased by 2,6 per cent in the first quarter of 2011, compared with the first quarter of 2010. This represented an increase of 212 000 jobs, just over half the number of formal-sector jobs lost during the crisis. The majority of jobs created have been in the public sector and the recovery in employment in the private sector remains slow.

Wage settlement rates have been declining, with Andrew Levy Employment Publications reporting an average overall wage settlement rate in collective bargaining agreements of 7,5 per cent in the first half of 2011, compared with 8,2 per cent in 2010 as a whole. Similarly, nominal unit labour costs, which account for productivity changes, moderated to 5,2 per cent in the first quarter of 2011, from 7,7 per cent in the fourth quarter of 2010. However, given that most of the wage negotiations take place in the second half of the year, and that some of the recent high-profile settlements appear to have reversed the moderating trend, this positive outcome could change. Should these higher trends set a precedent for other wage settlements, this could represent a significant upside risk to the inflation outlook. The high trends in executive remuneration increases are also cause for concern.

Food and oil price developments remain the major risks to the inflation outlook. As noted above, international food prices appear to have levelled out. Domestic food price inflation has lagged global trends, and further increases can be expected in the near term. However, these increases could be constrained should the favourable global developments persist.

The price of Brent crude oil, currently at around US$117 per barrel, is at levels similar to those prevailing at the time of the previous meeting of the MPC. The price has experienced some volatility in recent weeks, particularly following the release of oil stocks by the International Energy Agency in June, when the price declined to US$106 per barrel. Although supply conditions are expected to remain tight, further upside potential is likely to be constrained by the uncertain global growth outlook. These developments allowed for a 31 cent per litre reduction in domestic petrol prices in July, following a 2 cent per litre decline in June. However, an increase is expected in August.

The view of the MPC continues to be that the underlying inflation pressures are mainly of a cost-push nature, notwithstanding signs of a possible moderate increase in underlying inflation. Despite the upside risks posed by cost-push factors, the MPC sees a number of downside risks to the inflation outlook, with the risks being seen to be delicately balanced. These risks include the continued fragile nature of the domestic recovery and risks posed by the ramifications of a possible disorderly debt default in the eurozone.

It is, however, recognised that should there be unexpectedly high inflation outcomes, particularly with respect to underlying inflation trends, this could impact negatively on inflation expectations, which to date appear to be relatively well anchored. For this reason, the MPC is not complacent and will remain vigilant and continue to monitor closely any indications of second-round effects on inflation emanating from these cost pressures and from the changing risk profile of the inflation outlook.

In the light of the above, the MPC has decided to keep the repurchase rate unchanged at 5,5 per cent per annum, for the time being. The MPC will not hesitate to respond timeously to signs that threaten to move inflation out of the target range on a sustained basis.

Statement of the Monetary Policy Committee

22 September 2011

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

Since the previous meeting of the Monetary Policy Committee (MPC) the downside risks to the global and domestic growth prospects have increased. Growth in some of the advanced economies has weakened against the backdrop of financial market turbulence, generated in large part by the unresolved European sovereign debt crisis. Although economic growth in emerging markets is expected to continue to outperform that of the advanced economies, these economies are unlikely to emerge unscathed from the challenging environment. Heightened risk aversion has resulted in increased volatility of capital flows globally and a flight from what are perceived to be more risky emerging-market assets. These developments have impacted on the domestic capital and foreign-exchange markets.

Recent data have confirmed the fragile and uneven nature of the domestic economic recovery, and unfavourable forward-looking indicators are consistent with a downward revision of the Bank's economic growth forecast. At the same time, a number of exogenous factors have continued to put upward pressure on domestic inflation. This combination of declining growth and rising inflation poses a challenge to monetary policy going forward, and is a feature being experienced in a number of emerging markets.

The year-on-year inflation rate as measured by the consumer price index (CPI) for all urban areas was unchanged at 5,3 per cent in August 2011. The categories of food, housing and utilities, and transport together accounted for 3,7 percentage points of the August outcome. Although food price inflation moderated from 7,5 per cent in July to 7,3 per cent, further acceleration is expected in the coming months. Administered price inflation excluding petrol declined from 9,3 per cent in July to 8,8 per cent in August. Underlying inflation trends remained relatively well contained with CPI excluding food, petrol and electricity declining from 3,9 per cent in July to 3,8 per cent in August.

Year-on-year producer price inflation followed a strong upward trend, increasing by 7,4 per cent and 8,9 per cent in June and July respectively. Price increases in the categories of mining, electricity, and products of petroleum and coal remained the major contributors to the PPI outcome, but there were also significant contributions from chemical and other manufactures. Food prices continued to trend higher: agricultural prices increased by 5,1 per cent and 6,2 per cent in June and July respectively, while manufactured food prices increased at rates of 5,9 per cent and 6,3 per cent in these months.

The inflation forecast of the Bank has remained more or less unchanged since the previous meeting of the MPC. Inflation is still expected to breach marginally the upper end of the target range in the final quarter of 2011 and to peak in the first quarter of 2012 at around 6,2 per cent before returning to within the target range in the second quarter. Inflation is then expected to decline gradually and to measure 5,5 per cent in the final quarter of 2013. The Bank's forecast of core inflation, which excludes food, petrol and electricity, shows a moderately rising trend, peaking at around 5,1 per cent in the second and third quarters of 2013.

Inflation expectations, as reflected in the survey conducted in the third quarter of 2011 by the Bureau for Economic Research at Stellenbosch University, on average remain within the target range for the forecast period ending 2013. Inflation is expected to average 5,5 per cent in 2011 and 5,9 per cent in both 2012 and 2013. This represents slight upward adjustments for all three years. While financial analysts and trade union officials expect inflation to remain within the target range over the forecast period, business executives expect average inflation to exceed moderately the upper end of the target range in the coming two years.

Inflation expectations as measured by the Reuters survey of financial analysts also remain fairly stable at the upper end of the target range. According to the survey, inflation is expected to average 5,8 per cent and 5,6 per cent in 2012 and 2013 respectively.

The growth performance in the advanced economies has remained weak. There is a general expectation of even weaker outcomes in the near-term, although it is still unclear if the stalled state that many economies find themselves in will translate into a recession. The International Monetary Fund, in its latest World Economic Outlook, has reduced its forecast for growth in the United States (US) by 1,0 per cent in 2011 and by 0,9 per cent in 2012 to 1,5 per cent and 1,8 per cent respectively. euro area growth has been revised down to 1,6 per cent and 1,1 per cent in these two years. The risks are seen to be on the downside.

This slowdown comes against the backdrop of a deterioration in the sovereign debt crisis in the euro area and the inability of the member countries to reach agreement on a credible and workable solution. Concerns have also spread to the European banking sector, particularly to those banks with exposures to peripheral Europe, resulting in ratings downgrades of a number of French and Italian banks. Growth in the US is also being affected by continued weakness in the housing market and political disagreements on the pace and nature of fiscal consolidation.

Emerging markets are still expected to experience faster growth than the advanced economies, but remain vulnerable to contagion effects from a possible significant slowdown or recession in the advanced economies. In line with the current two-speed global economy, inflation trends are higher in the emerging economies, driven mainly by food and energy prices.

Over the past two years, the extraordinarily low interest rate environment in the advanced economies has resulted in significant capital flows to emerging markets, with consequences for their exchange rates and asset prices. However, the pattern of flows has not been smooth. During bouts of global risk aversion, there has been a tendency for these flows to reverse to so-called safe havens. Risk aversion associated with recent events in the US and Europe has resulted in a high degree of volatility of flows to emerging markets, including South Africa.

Since the beginning of the year, non-residents have been net sellers of equities to the value of R16,9 billion and net buyers of bonds to the value of R44,3 billion. However, since the beginning of September, non-residents were net sellers of both bonds and equities valued at R4,6 billion and R7,6 billion respectively.

These recent outflows, together with increased risk aversion, have contributed to the high degree of volatility observed in the JSE All-share Index, in domestic bond yields and in the exchange rate of the rand. Since the previous meeting of the MPC, the rand has traded in a range against the US dollar of between R6,68 and R8,33 per US dollar, and has depreciated by around 15,6 per cent against the dollar, by 11,0 per cent against the euro and by 12,7 per cent on a trade-weighted basis. Since the beginning of the year the rand has depreciated by 18,6 per cent against the US dollar.

The depreciation of the rand poses a potential upside risk to the inflation outlook. However, the degree of this risk will depend on the extent and persistence of the depreciation trend which, in turn, will be influenced by the duration and intensity of global risk aversion. The rand tends to be more sensitive to changes in global risk perceptions than most of its emerging-market peers. At this stage, the MPC still considers the upside risk to the inflation outlook from this source to be relatively moderate, but rising.

Domestic economic growth remains disappointing, with the negative output gap widening to around 3 per cent in the second quarter of 2011 and gross domestic product (GDP) growing by 1,3 per cent, following the 4,5 per cent increase recorded in the first quarter. Both the primary and secondary sectors contracted in the second quarter, while real value added by the tertiary sector increased only marginally. Widespread industrial action, which continued into the third quarter, contributed to this subdued outcome, and is expected to weigh negatively on third-quarter prospects as well.

Recent high-frequency indicators are also not very favourable. Mining production contracted at a year-on-year rate of 5,1 per cent in July, and by 4,3 per cent on a month-on-month basis. Manufacturing output declined at a month-on-month and year-on-year rate of 6,0 per cent in July, confirming the sharp decline to 44,2 index points observed in the Kagiso/BER Purchasing Managers' Index (PMI) in July. Despite a modest recovery in August to 46,7 index points, the

PMI remained below the neutral 50 level, pointing to a further possible contraction in the sector. The construction sector also remains subdued with both the first First National Bank (FNB) Building Confidence Index and the FNB Civil Construction Index remaining at very low levels, while there was a further decline in the number of building plans passed in the third quarter.

Overall business confidence, as reflected in the Rand Merchant Bank (RMB)/BER Business Confidence Index, has declined for two consecutive quarters, and at 39 index points is well below the neutral level of 50. The Bank has lowered its forecast for average growth in 2011 to 3,2 per cent, down from 3,7 per cent, while the forecast for 2012 has been reduced from 3,9 per cent to 3,6 per cent. The forecast for 2013 remains unchanged at 4,4 per cent. The lower forecast is a result of the lower-than-expected outcome in the second quarter, as well as a downward adjustment to the global growth assumption. The risks to this outlook are seen to be on the downside.

The lower growth trajectory does not bode well for employment creation, which has been relatively muted. According to Statistics South Africa, employment in the formal non-agricultural business sector increased by 0,1 per cent or 5,701 people in this second quarter of 2011. The outcome was, however, negatively affected by the decline in public-sector employment associated with the termination of contracts of temporary employees hired for the municipal elections.

Consistent with the moderation in domestic production, growth in real gross domestic expenditure also declined, from an annualised growth rate of 7,9 per cent in the first quarter of 2011, to 1,3 per cent in the second quarter. A positive development was the further acceleration in the growth of real gross fixed-capital formation, albeit off a low base, from an annualised rate of 2,7 per cent in the first quarter to 4,0 per cent in the second quarter. Nevertheless the ratio of gross fixed capital formation to GDP, at 18,9 per cent, is still well below the peak of 24,6 per cent measured in the fourth quarter of 2008.

Consumption expenditure by households has been the main driver of growth to date. However, in the second quarter of 2011, growth in consumption expenditure moderated to an annualised rate of 3,8 per cent, compared with an increase of 5,2 per cent in the first quarter. Real retail trade sales increased at a year-on-year rate of 2,8 per cent in July, but declined by 0,7 per cent in the three months to July compared with the previous three months. Growth in motor vehicle sales, while still positive, has also declined. Consumption patterns may have been distorted somewhat by the high base effects arising from the 2010 FIFA World Cup™ tournament and a clearer picture should emerge in August. The RMB/BER Consumer Confidence Index has declined for two consecutive quarters, underlying the fragility of the outlook.

Consumption expenditure is expected to remain constrained to some extent by low rates of credit extension and continued debt deleveraging by households. The ratio of household debt to disposable income declined further to 75,9 per cent in the second quarter of 2011 from a peak of 82,0 per cent in the first two quarters of 2008. Twelve-month growth in total loans and advances extended by banks to the private sector has fluctuated around 6 per cent in the three months to July. Mortgage advances, which is the largest category of credit, grew at a year-on-year rate of 2,9 per cent, consistent with the slow pace of recovery in the domestic property market. The main driver of growth in credit extension was the category of other loans and advances, in particular general loans which reflect primarily corporate-sector borrowing. This category grew by almost 15 per cent in the year to end of July.

Nominal wage settlements have continued to moderate somewhat and have been lower than many of the highly publicised initial demands. Nevertheless, wage increases have been well above the upper end of the inflation target range.

The main upside risks to the inflation forecast continue to emanate from administered prices and exogenous factors. Since the previous meeting of the MPC the price of Brent crude oil has fluctuated in a range of around US$104 and US$118 per barrel. The outlook for the oil price will be determined in part by global growth developments, and in particular by the extent to which China is affected by the slowdown. The recent depreciation of the South African rand against the US dollar is likely to contribute to a further increase in the domestic petrol price in October.

Food prices are also expected to maintain their upward momentum for some time. The major global food price indices have remained relatively stable but at elevated levels during the past few months. However, global wheat and maize prices have increased markedly, and have impacted on the domestic prices of these commodities. These increases have been compounded by the weaker exchange rate of the rand. The price of white maize, for example, has increased by over 70 per cent during the past year, but futures prices reflect some expected moderation in the medium term.

The MPC remains of the view that the underlying inflation pressures are mainly of a cost–push nature, and at this stage there is no evidence of significant second-round effects from these increases. Although the inflation trend remains on an upward trajectory, both headline and core inflation forecasts appear to be consistent with the continued attainment of the inflation target over time. Demand-side pressures remain subdued and are expected to be constrained in the short to medium term. Inflation expectations also appear to be relatively well anchored.

However, there have been some changes in the MPC's assessment of the risks to the inflation outlook. The recent volatility in the rand exchange rate has imparted a degree of upside risk to the inflation forecast. Although the rand may not return to the elevated levels reached in the earlier part of 2011, the MPC considers some of the recent volatility to be of a short-term nature, influenced by the vagaries of global risk aversion. Downside risks are seen to come from the heightened risks to global growth and its consequences for the domestic economy. The overall risks to the inflation outlook are assessed to be delicately balanced. The MPC will continue to assess the changing risk profile of the inflation outlook and monitor closely those factors that could push inflation outside the target on a sustained basis.

In the light of the above the MPC has decided to keep the repurchase rate unchanged at 5,5 per cent per annum, for the time being. The MPC is, however, concerned at the potential impact of the current global turmoil on domestic economic prospects and stands ready to act appropriately should the need arise.

Statement of the Monetary Policy Committee

10 November 2011

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

Since the previous meeting of the Monetary Policy Committee (MPC), there has been no meaningful progress to resolving the sovereign debt crisis that is engulfing the euro area, with the primary focus now on Italy and Greece. The interlinked nature of the debt crisis and concerns about the banking sector in Europe, coupled with the inability of the advanced economies to generate sustained growth, continues to weigh negatively on the global economic outlook. The heightened uncertainty has had implications for the pattern of global capital flows and exchange rates in emerging markets.

The domestic economic recovery remains hesitant. The relatively weak economy has ensured that demand pressures on inflation are restrained at this stage. Nevertheless exogenous supply-side factors have resulted in a deterioration of the inflation outlook, with a more protracted breach of the inflation target expected in 2012.

The year-on-year inflation rate as measured by the consumer price index (CPI) for all urban areas increased to 5,7 per cent in September 2011, up from 5,3 per cent in August. The categories of food, housing and utilities, and transport together accounted for 4,0 percentage points of the September outcome. Food price inflation accelerated from 7,3 per cent in August to 8,7 per cent. Petrol and electricity prices increased by 26,2 per cent and 17,3 per cent respectively. Administered price inflation, excluding petrol was unchanged at 8,8 per cent. CPI inflation excluding food, petrol and electricity remained unchanged at 3,8 per cent in September.

Year-on-year producer price inflation continued its strong upward trend, increasing by 10,5 per cent in September, from 9,6 per cent in August. These price developments were strongly influenced by global commodity price movements as well as by the depreciation of the rand exchange rate. Price increases in the categories of mining, electricity and products of petroleum and coal, as well as other manufacturers remained the major contributors to the producer price inflation outcome. Food prices also continued their higher trend, with agricultural prices increasing by 10,7 per cent and manufactured food prices by 8,8 per cent in September.

The inflation forecast of the Bank has shown a modest increase since the previous meeting of the MPC. Inflation is expected to breach the upper end of the target range in the final quarter of 2011 and to peak in the first quarter of 2012 at around 6,3 per cent, before declining gradually and returning to within the target range in the final quarter of 2012. Inflation is expected to measure 5,2 per cent in the final quarter of 2013. The Bank's forecast of core inflation, which excludes food, petrol and electricity, continues to show a moderately rising trend, with the peak of around 5,2 per cent expected in the first quarter of 2013.

Market expectations of inflation, as reflected in the Reuters survey of financial analysts, show expectations to be anchored around the upper level of the inflation target range over the medium term. In the October survey inflation was expected to peak at an average of 6,1 per cent in the first quarter of 2012, and to measure 5,4 per cent by the second quarter of 2013. Break-even inflation rates have moderated against most maturities since the previous meeting.

The global growth outlook continues to be characterised by heightened uncertainty, with weak growth and declining consumer confidence in a number of the major advanced economies. The protracted crisis in the euro area has now spread beyond the peripheral countries, despite recent attempts to devise a credible and workable approach to contain the problem. The risks created by these developments are likely to exacerbate the low or negative growth expected in the region, amid increased fiscal austerity, tightened bank lending standards and deleveraging, and tightening conditions in the European interbank markets. Weak growth is also forecast for the United Kingdom and Japan.

On the positive side, fears of a return to recession in the United States (US) have dissipated somewhat with a higher-than-expected growth outcome in the third quarter, driven mainly by a recovery in household consumption expenditure. Although employment increased in the past quarter, the unemployment rate is expected to remain at elevated levels for some time, along with persistent weakness in the housing market.

Growth in many of the emerging markets has moderated during the year. Growth forecasts have generally been revised down, and are sensitive to developments in the advanced economies. China has experienced a policy-induced slowdown, but fears of a possible hard landing have receded somewhat. Significant growth reductions have been experienced in a number of Latin American and emerging European countries.

Headline inflation appears to have peaked in many of the advanced economies, and is expected to moderate in line with declining economic activity and the softer trend in commodity prices. Inflationary pressures remain at elevated levels in many of the major emerging-market economies.

The exchange rate of the South African rand continues to be subject to changes in risk aversion in global financial markets. Since the previous meeting of the MPC, the rand has fluctuated between R7,70 and R8,50 to the US dollar, but has generally traded in a more narrow range of between R7,80 and R8,00. On a trade-weighted basis, the rand has depreciated by around 18,6 per cent since the beginning of the year. Since the last meeting of the MPC the rand has appreciated by 1,0 per cent on a trade-weighted basis and by 1,4 per cent against the US dollar. Although the rand tends to be more volatile than most of its emerging-market peers, the movements of the currency have been in line with other emerging-market and commodity-linked currencies.

The exchange rate has also been influenced to some extent by volatile capital flows. Non-residents have been persistent net sellers of South African equities for most of 2011, with cumulative net sales since the beginning of the year amounting to R16,6 billion. Between April and August, non-residents were net buyers of bonds to the value of R58,4 billion but as the European crisis intensified, net sales of R17,0 billion were recorded in September. In October this trend was reversed somewhat with non-resident net purchases of R9,8 billion. Year to date net purchases of bonds and equities amount to R29,4 billion.

The uncertainty related to the exchange rate imparts an upside risk to the inflation outlook. However, unless the rand continues on a depreciating trend, the impact is likely to be relatively limited and should dissipate in the short to medium term. While the rand is not expected to return to its previous elevated levels, consensus forecasts indicate an expectation of a moderate appreciation from the current levels in the course of 2012. This is largely dependent on global developments.

The slower domestic economic growth in the second quarter of 2011 appears to have continued in the third quarter and the forecast of the Bank has been subject to downward revision. Real GDP growth in 2011 is now expected to average 3,0 per cent, compared with 3,2 per cent in the previous forecast. The growth forecasts for 2012 and 2013 have been revised down to 3,2 per cent and 4,2 per cent from 3,6 per cent and 4,4 per cent respectively. The downward revision is a result of revised assumptions primarily of international commodity prices and global growth.

The composite leading business cycle indicators of the Bank continued the moderate downward trend that began in February. It decreased for the second consecutive month in August, corroborating the expected restrained economic conditions.

There has been some normalisation of manufacturing activity following widespread industrial action in July. The physical volume of manufacturing output increased at a year-on-year rate of 7,7 per cent in September, following the revised 5,9 per cent increase in August. On a quarter-on-quarter basis, a slight contraction of -0,1 per cent was measured in the third quarter. Despite the recent recovery, the Kagiso/BER PMI remained marginally above the neutral 50 level in September and October, in line with subdued global PMIs.

Mining output has continued its overall downward trend, with the physical volume of mining output declining by 5,1 per cent in September on a quarter-on-quarter basis and by 5,4 per cent on a year-on-year basis. The construction sector remains under stress with the FNB/BER civil construction index declining further in the third quarter.

Despite the disappointing growth outcomes, the *Quarterly Labour Force Survey* published by Statistics South Africa indicates that the number of people employed increased by 195 000 in the third quarter of 2011. The prospects for further employment creation are uncertain, given the slowing growth of the domestic economy and the fragile global economic environment.

Growth in consumption expenditure by households is expected to have remained relatively subdued following its moderation in the second quarter of 2011 to 3,8 per cent from 5,2 per cent in the previous quarter. When comparing the three months to August with the previous three months, real retail trade sales increased by 0,7 per cent. The BER Retail Survey for the third quarter of 2011 shows that business confidence among retailers, at a level of 48, remained below the neutral level of 50. These trends reflect, in part, concern about employment, slower wage and income growth, and declining levels of consumer confidence. Other factors expected to constrain consumption expenditure include high levels of household debt, constrained access to credit and consistently above-average increases in a range of administered prices which reduce the amount available for household discretionary expenditure.

Growth in credit extension to the private sector remains lacklustre, reflecting both supply-and-demand considerations. After reaching a recent high of 6,1 per cent in July, 12-month growth in banks' total loans and advances extended to the private sector moderated to 5,3 per cent in September. Twelve-month growth in mortgage advances declined to 1,9 per cent, consistent with the subdued state of the domestic housing market. The main driver of credit extension was the category of other loans and advances, in particular general loans, which grew at a rate over 12 months of 12,9 per cent, down from 17,9 per cent in August. General loans account for 11 per cent of total loans and advances to households. The ratio of impaired advances as a percentage of gross loans and advances of banks has declined to 5,1 per cent in September 2011, down from 5,9 per cent in September 2010, indicating some improvement in the balance sheets of the banks.

According to the *Medium Term Budget Policy Statement (MTBPS)*, fiscal policy is set to be more expansionary than indicated in the main budget in February. Nevertheless the commitment to medium-term deficit consolidation remains. For the current fiscal year, the deficit is expected to increase from 5,3 per cent of GDP to 5,5 per cent, compared with the 4,6 per cent deficit recorded in 2010/11, and is expected to decline to 3,3 per cent of GDP by 2014/15. The wider deficit for the current year is a result of a 0,7 per cent of GDP increase in expenditure, and lower tax revenues of 0,3 per cent of GDP which result from the slower economic growth. The primary deficit is expected to decline from 2,9 per cent of GDP in the current year, to 0,5 per cent in 2014/15. If maintained within the parameters as set out in the *MTBPS*, the fiscal consolidation and debt dynamics should be sustainable.

Food prices continue to pose an upside risk to the inflation outlook, and a further acceleration of food inflation is expected in the near term. This follows the marked food and agricultural price increases at the PPI level, and the depreciation of the exchange rate which has contributed to the increase in maize prices in recent weeks. Global food prices have remained relatively stable over the past months, albeit at high levels, and could signal some relief going forward.

International oil prices have remained relatively stable since the last meeting of the MPC and are expected to remain constrained by the weak growth outlook in the advanced economies. At current prices, Brent crude oil is about US$10 per barrel lower than the peak prevailing earlier in 2011. At present there is a small over-recovery on the domestic petrol price and, if maintained, could provide some relief to consumers following four consecutive months of price increases which has resulted in domestic petrol prices being at their highest levels ever. Other administered prices, particularly electricity, are expected to maintain upside pressure on the inflation rate.

The MPC remains of the view that the underlying inflation pressures are of a cost–push nature and that the subdued state of domestic demand and output will contribute to core inflation remaining contained, notwithstanding the continued pressures from some administered prices. However, the committee is concerned that the change in the profile of the inflation forecasts and the extended breach of the upper end of the inflation target range may impact adversely on inflation expectations. At this stage the breach of the upper limit is still expected to be relatively small and inflation is expected to return to within the target range by the end of 2012.

The committee assesses the risks to the inflation outlook to be on the upside mainly due to cost–push pressures. The exchange rate is also seen to pose some upside risk to the outlook, while downside risks are seen to come from possible contagion effects from the European crisis and associated slow growth. The committee is aware of the dangers of a disorderly resolution of the crisis and the systemic implications for the global and domestic economy, and remains ready to act appropriately should the need arise.

Under the prevailing circumstances the MPC has decided to keep the repurchase rate unchanged at 5,5 per cent per annum.

Abbreviations

Alsi	All-Share Index
API	administered price index
ARIMA	Autoregressive Integrated Moving Average
BCI	Business Confidence Index
BER	Bureau for Economic Research [of Stellenbosch University]
BoJ	Bank of Japan
CBOE	Chicago Board Options Exchange
CCI	Consumer Confidence Index
CDS	credit-default swap
CPI	consumer price index for all urban areas
ECB	European Central Bank
FNB	First National Bank
fob	free on board
G7	Group of Seven
GDP	gross domestic product
IEA	International Energy Agency
IMF	International Monetary Fund
JSE	JSE Limited
LIBOR	London Interbank Offered Rate
MENA	Middle East and North Africa
MPC	Monetary Policy Committee
MPR	*Monetary Policy Review* [of the South African Reserve Bank]
MTBPS	*Medium Term Budget Policy Statement*
NAB	non-alcoholic beverage
NEER	nominal effective exchange rate
OECD	Organisation for Economic Co-operation and Development
OPEC	Organization of the Petroleum Exporting Countries
PMI	Purchasing Managers' Index
PPI	producer price index
PSBR	public-sector borrowing requirement
RMB	Rand Merchant Bank
S&P	Standard and Poor's
UK	United Kingdom
US	United States
VIX®	Chicago Board Options Exchange Volatility Index
WEO	*World Economic Outlook*

Glossary

the Bank	South African Reserve Bank
the Fed	United States Federal Reserve