11 May 2011

Economic Commentary

Monthly Insight

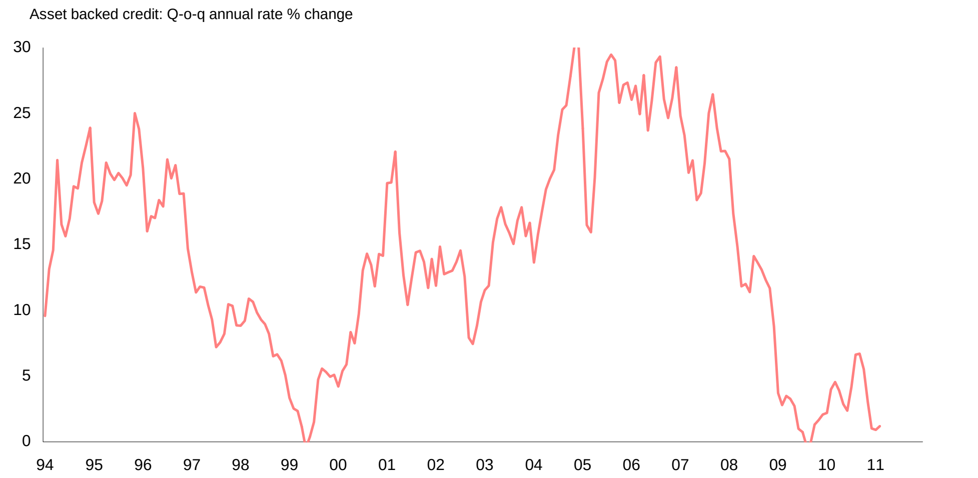
Inflation scenarios

- Cost-push factors could prompt the Reserve Bank's Monetary Policy Committee (MPC) to tighten monetary policy earlier than is needed to counter early cyclical demand pressures.
- Our baseline scenario is that inflation will remain in the 3% to 6% target range and that the central bank will raise rates from early 2012 only. This is based on the assumption of moderate economic growth, an oil price that is currently close to its peak and that will ease in the second half as geopolitical tensions fade, a rand that will be firm in the first half and that will decline moderately in the second half, and food price inflation that ends the year at around 6,5%
- However, the risks to this outlook are to the upside, with considerable uncertainty around the oil price and the rand's movements. We consider several scenarios that would result in inflation rising above the upper limit, increases the chances of a premature tightening in policy.

Comment

In last month's Monthly Insight we argued that cost-push pressures rather than strong demand would be behind rising inflation and growth would remain below potential. Hiking interest rates would do little to curb inflation but would curtail economic growth. We remain of the view that demand-side pressures are still benign. Chart 1 below shows that credit growth momentum remains very modest, partly because indebtedness at the start of the cycle was already high, making households reluctant to incur further debt, and partly because bank behaviour changed given the new regulatory environment and the experiences gleaned during the downturn. In contrast, cost-push pressures largely beyond the MPC's control have worsened, mainly due to higher oil prices.

Chart 1 : Asset-backed credit growth momentum slows



Source:

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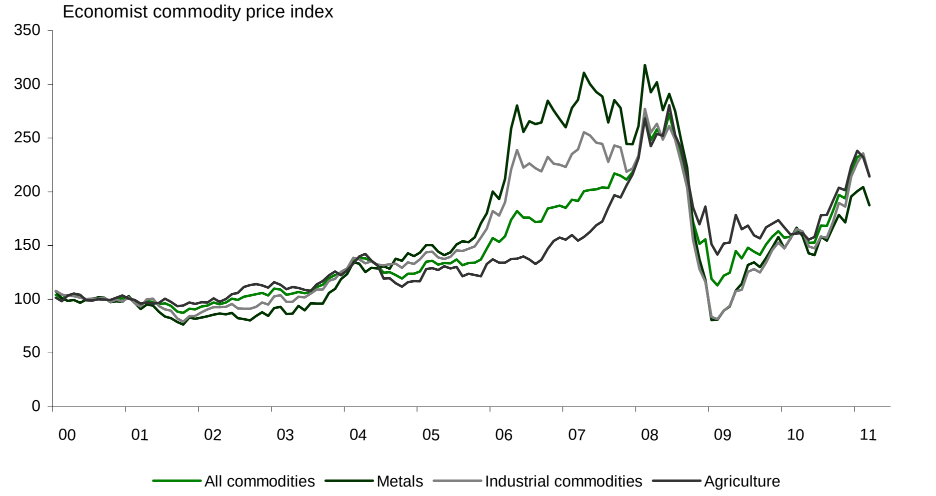
The MPC is clearly worried that these pressures will force a rethink of the current stance in the months ahead. March's Monetary Policy statement stated that "the risks to the outlook for domestic inflation have increased on the upside, mainly as a result of cost push pressures. The domestic growth prognosis has improved…although not at rates sufficient to make appreciable inroads into the unemployment situation in South Africa". The Governor ended off the statement by indicating that the MPC will "closely monitor any indicators of second-round effects on inflation emanating from cost pressures".

The base scenario

In our base scenario, inflation moves gradually higher over the next four months on rising global food and fuel prices, but a firm rand and price-sensitive domestic consumers contain the increase to around 4% up to April. Thereafter inflation moves up off a lower base and a softer rand, ending 2011 around 5,7%, close to the 6% upper limit of the Reserve Bank's target band. In this scenario the oil price eases in the second half of the year as tensions in Northern Africa and the Middle East ease and the US Federal Reserve begins phasing out its programme of quantitative easing.

Chart 2 : Commodity prices



Source: StatsSA

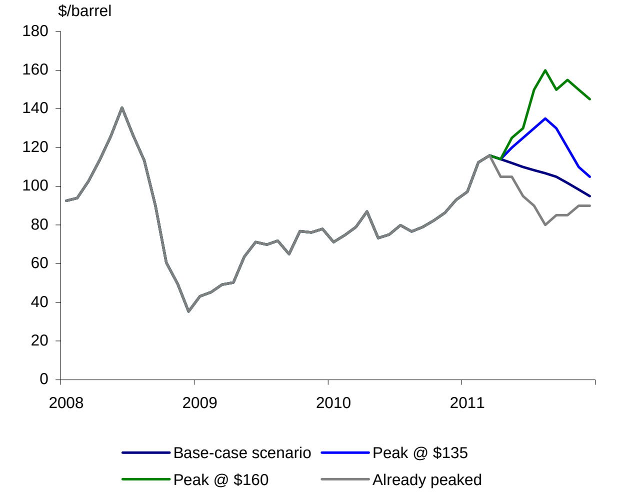
Clearly the dangers to the outlook are higher than expected commodity prices, with oil and food prices overshooting their expected ranges either due to stronger global economic growth or continued provision of excess liquidity by key central banks.

Inflation's sensitivity to the oil price

Energy makes up around 4% of the CPI basket directly and obviously has knock-on effects on a broader range of goods and services. The price of Brent crude oil rose by 20% last year to $95 per barrel, supported by robust growth in Asia, particularly China, OPEC quotas and strong investor demand. The civil unrest in Libya as well as more broad-based political upheaval in North Africa have seen the oil price increase to $120 a barrel.

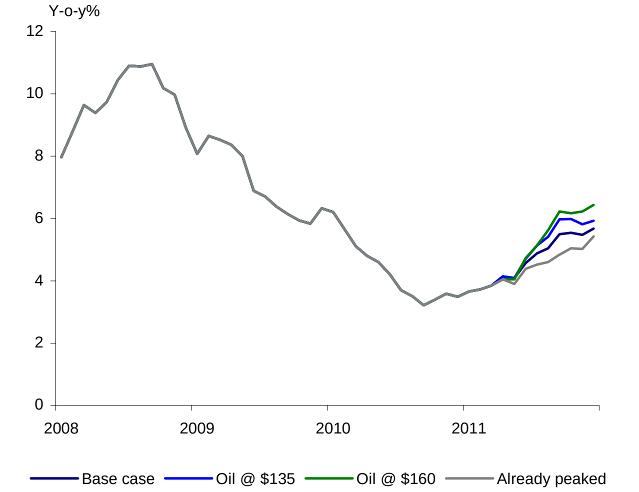
The fundamental case for higher oil prices over the short term remains weak, due to still high oil stock piles and ample spare capacity in OPEC states, which should allow the industry to meet firmer global demand. However, significant risks remain, including possible disruptions to oil production in key oil producing states in the troubled Northern African region and Nigeria, should there be renewed violence in the Niger Delta. Charts 3 and 4 show two scenarios where the price of oil exceeds that in our base case scenario. All other variables are kept constant. In the first, the oil price rises to $135 dollars a barrel by the middle of the year resulting in inflation exceeding the target band by October. In the second, oil prices rises to $160 per barrel, inflation up close to 7% by the end of the year.

Chart 3 : Oil price assumptions



Source: StatsSA and Reuters

Chart 4 : Inflation implications

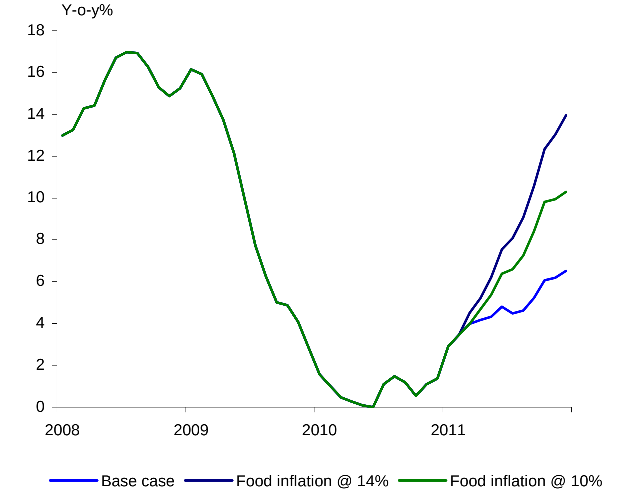


Source: StatsSA

Food prices

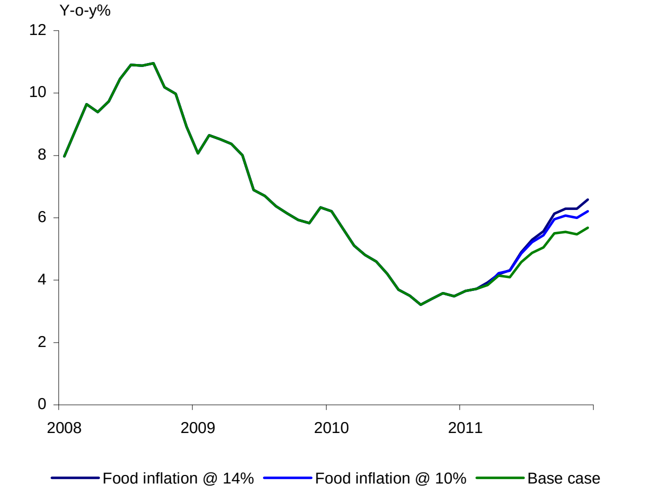
Food makes up some 14,3% of the basket and has been a key reason why inflation was so low in 2010. However, international food prices rose sharply in the final months of 2010 on the back of strong demand for commodities as an asset class. Severe droughts in Russia, rains in Canada and Pakistan and more recently flooding in Australia, have also put upward pressure on some agricultural prices. Despite the correction in agricultural food prices in mid March, off a very high base, supply constraints will persist, which should support prices.

Chart 4 : Food inflation scenarios



Source: StatsSA and Reuters

Chart 5 : Inflation implications

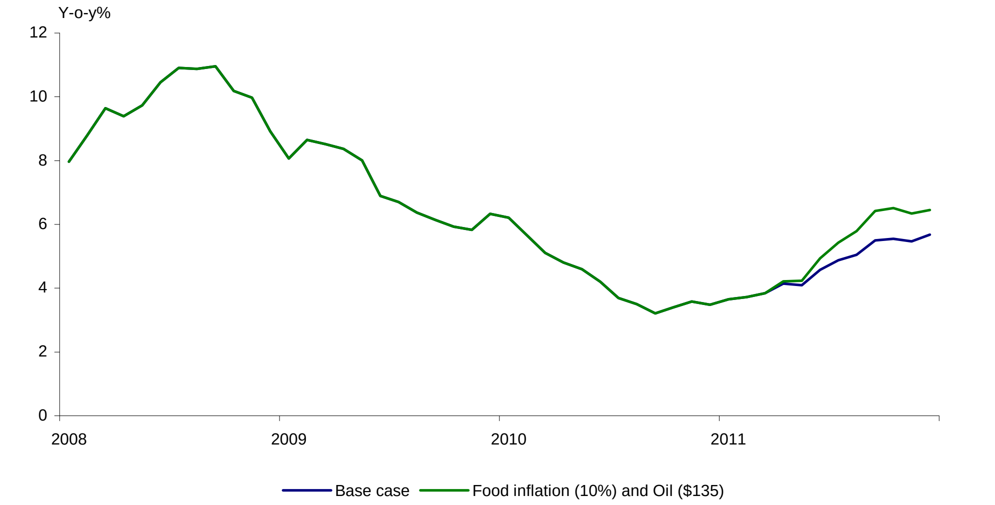


Source: StatsSA

Agricultural commodity prices are forecast to increase further in 2011, on continued investor interest, supply constraints and low stockpiles of some commodities. The Economist Intelligence Unit recently revised its forecast for agricultural prices upwards, forecasting a 29% increase in 2011, following growth of 11% last year.

In our base case scenario food inflation ends the year at around 6,5%. However, persistent high increases in global agricultural prices could see this rise to 10% and push inflation above the target range, with inflation reaching 6,5% at the end of the year.

Chart 6 : Combined scenario :



Source: StatsSA

In the last scenario we consider what would happen if both food and fuel prices were to rise only slightly more than anticipated, with food inflation increasing to 10% and oil to $135 dollars a barrel. In this scenario, inflation would accelerate more quickly over the coming months, breaching the upper limit of the target in September 2011, and reaching 6,5% by the end of 2011.

Conclusion

A spike in global food prices and fuel prices could place the Reserve Bank's inflation target in jeopardy. A weaker rand would only exacerbate the situation. However, given the Reserve Bank's reluctance to respond to external shocks, unless it results in second round inflation, the Bank is unlikely to hike rates too quickly.

Despite the risk, our base case scenario remains relatively favourable. Domestic food and fuel prices are expected to rise further this year, but inflation is still forecast to remain below the upper limit of the Reserve Bank's inflation target. We also expect credit growth to remain contained and as a result, we anticipate that interest rates will remain unchanged until the first quarter of 2012.

Table 1 : SARB checklist

Factor	SARB's most recent interpretation (MPC March)	Recent tendency
International economy		
Growth	'The domestic growth prognosis has improved, and the recovery is expected to be sustained, although not at rates sufficient to make appreciable inroads into the unemployment situation in South Africa"	Global growth prospects for 2011 have recently been revised upwards, but significant risk remains particularly from peripheral Eurozone countries.
Inflation and interest rates	' The global inflation outlook has also deteriorated somewhat in the face of higher oil and food prices	Rising on higher food and fuel inflation, breached targets in both the UK and EU.
Oil	'Brent crude oil prices have increased by almost US$20 per barrel. Domestic petrol prices have increased by just under R1 per litre since January 2011, and a further upward adjustment is expected in April in addition to the increased fuel levy.'	The price of Brent crude oil has risen above $115 per barrel
Food	'.Food price pressures remained relatively subdued in January despite marked increases in global food prices.'	Food inflation at consumer level remains low.
Domestic economy		
Balance of Payments	Current account deficit narrowed to 0,6% of gdp in the fourth quarter, from 2,5% of gdp in third quarter of 2010.	A trade deficit of R350 million was recorded in February, due to a sharp decline in imports.
Exchange rate (rand)	'The rand exchange rate is relatively unchanged since the previous meeting of the MPC, but has fluctuated between R6,80 and R7,33 per US dollar during this period. Part of the recent strength of the rand can be ascribed to US dollar weakness'	The rand has strengthened agasint the dollar and trades between $6:70 and $6,80
Labour markets (unit labour costs)	'In Q2 2010, unit labour costs have eased to 9,1% y-o-y. Wage expectations also remain elevated'	Wage demand have moderated slightly.
Administered prices	'The main risk to the inflation outlook remained administered prices, particularly electricity price increases.'	Eskom proposal watered down to 25% pa over three years from original 45% pa.
Domestic demand and supply	'GDP growth now expected to average 3,7 per cent and 3,9 per cent in 2011 and 2012 respectively. These growth rates, while an improvement, are still too low to have a significant impact on the unemployment rate which measured 24,0 per cent in the fourth quarter of 2010.'	Household spending is recovering but fixed investment remains weak. A favourable outlook for the global economy should support domestic manufacturing.
Monetary conditions	'Underlying credit extension remains weak but there has been some improvement in the past months.'	Credit demand is still weak, but continued to improve in July. Credit is being dragged down by weak corporate demand for credit.
Fiscal policy	'…the MPC does not foresee a possible conflict with	Budget deficit is very large, but not an immediate threat to

	monetary policy objectives.'	inflation unless public sector wages rise strongly again.
Indicators of inflationary expectations	'Average inflation expectations for both 2011 and 2012 have increased with inflation expected to average 4,7% in 2011 and 6% in 2012'	Rising headline inflation will push expectations up higher

Source: Nedbank

Regular economic analysis is available on the Nedbank Group's internet site, http://www.nedbankgroup.co.za