

02 February 2011

# Economic Commentary

## Monthly insight

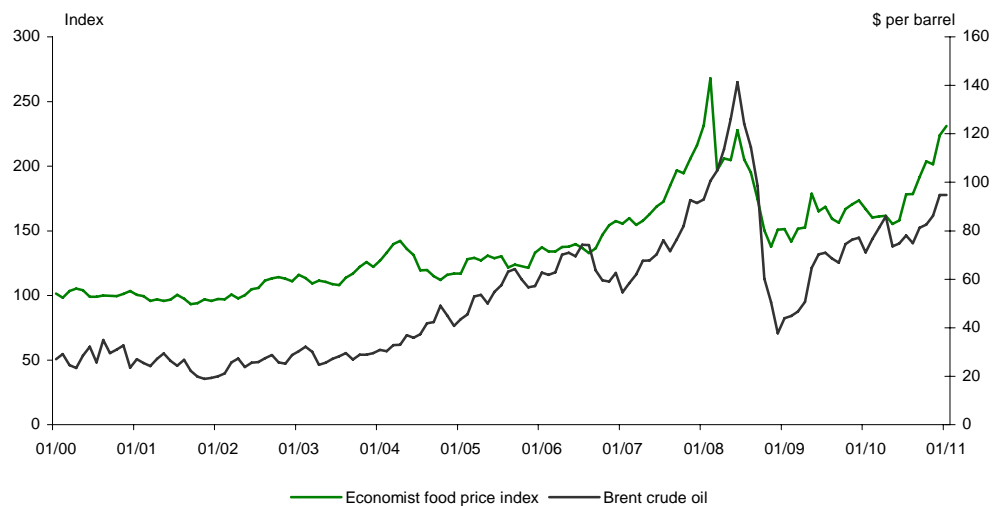
### Interests rates likely to remain on hold this year

- Higher food and fuel prices will be the key risks to the inflation outlook in 2011,
- Food inflation is forecast to end the year at 6%. However a spike in international agricultural prices and a weaker rand would cause domestic food inflation to pick up more quickly. Food inflation in excess of 10% would cause headline inflation to breach the 6% target
- 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 second quarter of 2012.

### Comment

January's monetary policy statement struck a slightly more hawkish tone compared with those delivered last year. Although inflation is expected to remain within the target band over the next two years, the forecast was revised upwards for the first time in over a year. The outlook for the domestic economy also improved, driven by consumer spending. Governor Marcus also highlighted that there "were more convincing signs that the recovery in the global economy will be sustained".

**Chart 1 : International food and fuel prices have risen sharply**



Source: StatsSA

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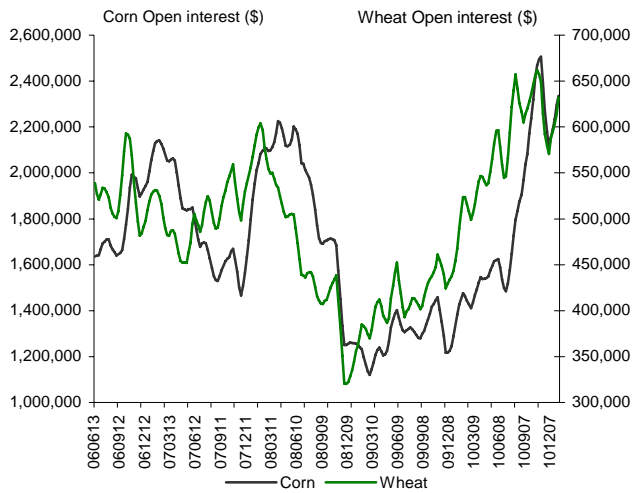
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Important disclosures can be found in the Disclosures Appendix.

The generally more upbeat tone of the address was interspersed with caveats, highlighting that domestic growth, although improving, would remain below potential and that significant risks to the outlook remained. The most significant of which emanates from Europe's troubled periphery, where markets remain unconvinced that debt levels are sustainable.

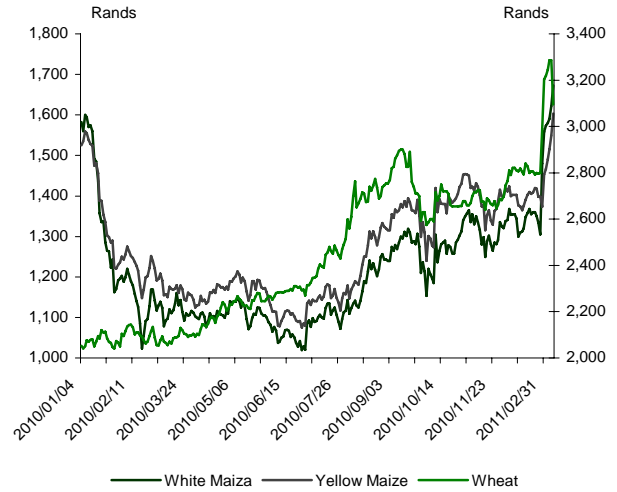
In the latest monetary policy statement, the Governor highlighted the risk posed by higher commodity prices, particularly food and fuel, to the benign inflation outlook. This month's Monthly Insight takes a closer look at the outlook for international food and fuel prices, and the implications for domestic inflation.

**Chart 2 : Investment demand for commodities risen sharply**



Source: Inet

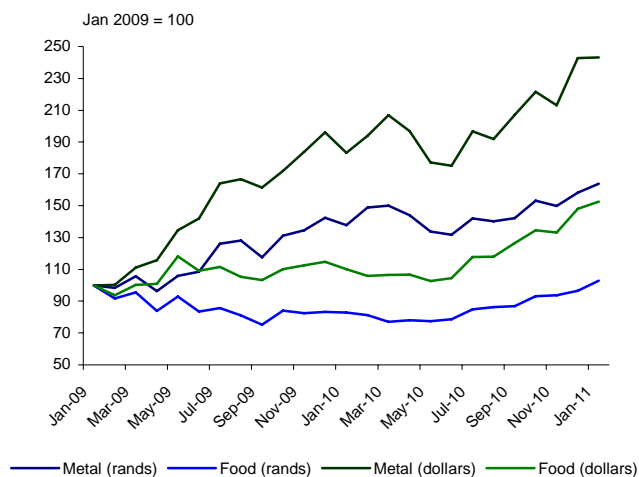
**Chart 3 : Forward contracts suggest further price increases**



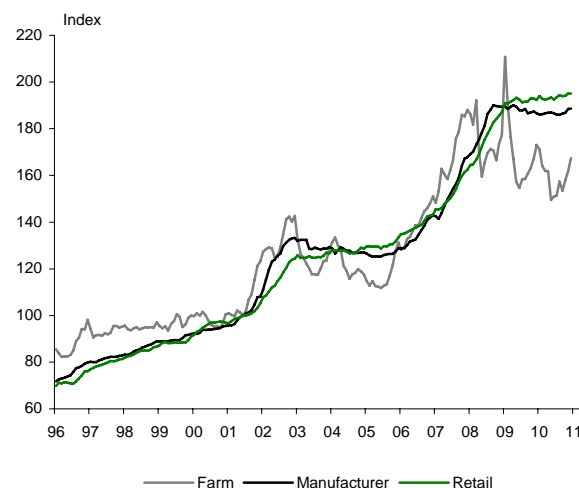
Source: SAFEX

International food prices rose sharply in the final months of 2010 on the back of strong demand for commodities as an asset class. Open futures and options positions, used as an indication of investment demand for commodities, in wheat and corn increased by 50% and 90% over the past year (chart 2). Severe droughts in Russia, rains in Canada and Pakistan and more recently flooding in Australia, have also put upward pressure on some agricultural prices. Upward revisions to global growth prospects in the final quarter of 2010 also supported prices. However, the impact domestically has been muted so far due to the strength of the rand (see chart 4).

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 20% increase, following growth of 11% last year. Agricultural forward contracts on the South African Futures Exchange (SAFEX) suggest that the market currently anticipates significant price increases. The price of white maize is expected to increase by 28%, while wheat prices are anticipated to rise by 10% over the year.

**Chart 4 : Strong rand has muted impact of higher prices**

Source: Inet

**Chart 5 : Domestic food inflation remains well contained**

Source: SAFEX

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 as well as strong investor demand. The story for 2011 is expected to remain largely unchanged, supporting oil prices at their current levels. However, neither the forward market nor most forecasters predict that the oil price will spike this year, due to still high oil stock piles and ample spare capacity in OPEC states, which should allow the industry to meet a stronger-than-expected recovery in global demand. However, significant risks do remain, including possible disruptions to oil production in Nigeria on renewed violence in the oil-producing Niger Delta. The persistent threat that broad-based political upheaval in North Africa spreads to some of the major oil producing Arab nations with similar domestic problems, is also a concern.

What are the implications for domestic inflation?

Although food inflation is expected to increase further this year, ending the year around 6%, it poses no immediate threat to our favourable inflation outlook. However, with international food and to a lesser extent fuel prices expected to rise further, albeit much less than the increases seen in 2008, the impact on domestic prices could be higher. A weaker rand would compound the impact. Using our current inflation model as a baseline, if food inflation was to increase to 10%, roughly half of what it was in 2008, inflation would rise above 6% by the end of the year. Although this is not our base case scenario, it does highlight the risks to the current inflation outlook.

## Conclusion

A spike in global food prices combined with a weaker rand could place the Reserve Bank's inflation target in jeopardy. However, given the Reserve Bank's reluctance to respond to external shocks, unless it results in second round inflation, the Bank is unlikely to respond by hiking 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 second quarter of 2012.

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