Economic commentary

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CONSUMER INFLATION

Research

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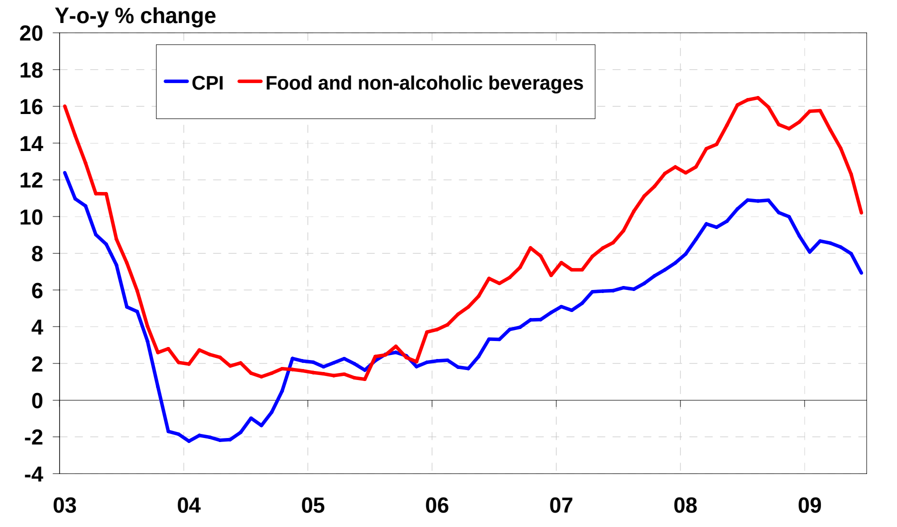
Inflation falls faster than market expectations

Latest (June 2009)

Overall: 6,9% y-o-y, 0,4 % m-o-m (8% y-o-y in May 2009)
Nedbank forecast: 7,1% y-o-y
Market forecast: 7,2% y-o-y

Graph 1: Consumer price inflation



Comment

Consumer inflation fell to 6,9%, below market expectations and to a rate last seen in November 2007. This supports our view that the inflation outlook will have improved sufficiently towards the end of the year to give the Reserve Bank some space to cut rates further.

Food prices fell by 0,4% m-o-m, taking the annual increase to 9,9% from 12,4% in the previous month. Fruit prices fell by 6,5% m-o-m, due to seasonal factors, while declines in bread and cereals, meat, fish and vegetable prices, were also contributors to the monthly decline.

Owner's equivalent and housing rentals rose strongly over the month, contributing over half the monthly increase in inflation. However, on an annual basis rental inflation continued to moderate, easing to 5,6% from 6,4% in the previous month and 9% a year ago.

Fuel prices rose by 2,2% over the month, but continued to fall over the year, declining by 25%.

Outlook

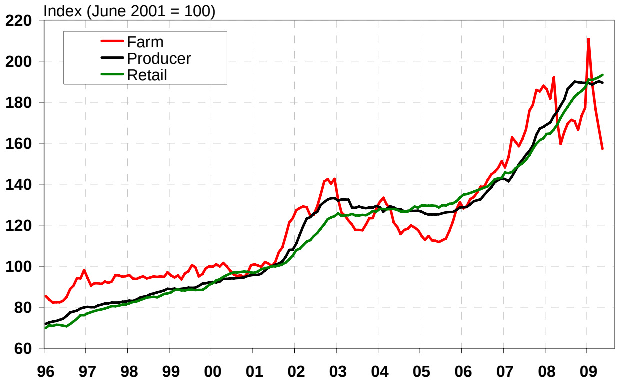
Our preliminary inflation forecast for July suggests a modest decline to 6,7%. Over the month, prices are expected to rise by 1,1%, mainly due to the 31% increase in the price of electricity, which will add roughly 0,6 percentage points to the monthly increase. Higher petrol prices will also contribute towards the monthly gain.

Inflation is expected to ease further over the coming months due to base effects. A slowdown in the rate of food price increases over the remainder of the year will ensure that food price inflation continues to moderate further (see box below). The rand's recent strength as well as weak demand conditions will also help to contain price increases. However, second-round effects appear to be well entrenched in the economy, making prices extremely sticky. Added to this, above-inflation wage demands, which have so far been insensitive to the severity of the recession, will add to inflationary pressures.

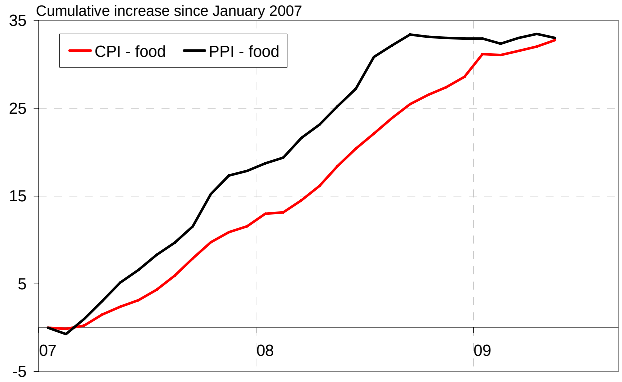
BOX: Food prices

Inflation has fallen more slowly than had been expected earlier in the year despite weak domestic demand conditions, the recovery in the rand and low commodity prices. One of the concerns has been that food prices at the retail level have not fallen in line with prices at the agricultural level or even stabilised in line with manufactured food prices. One explanation is that retail prices did not fully reflect earlier price rises at the manufacturing level, but graph 3 shows that this gap has now disappeared.

Graph 2: Food prices

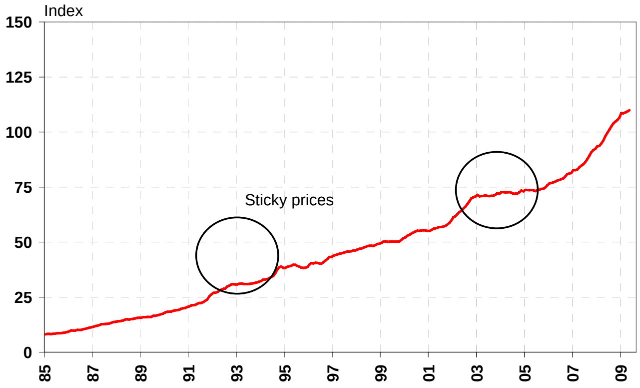


Graph 3: Cumulative food price increase

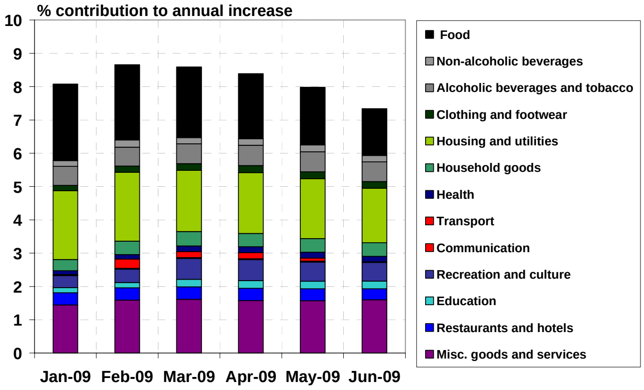


The past two decades suggest that aggregate food price increase in the CPI do not fall meaningfully in response to declines at the agricultural and production levels (graph 4). Part of the explanation for this could lie with the emphasis retailers place on keeping gross profit margins relatively constant. In addition, rising non-food input costs may add some upward pressure to food prices. Expenses such as wages, electricity and insurance etc, make up around 16% of food retailer's expenses. The stickiness of service inflation, combined with rising administered prices as well as above-inflation wage demands, make this component more likely to rise more aggressively over the next few months.

Graph 4: Sticky food prices



Graph 5: Contribution to Inflation



Although agricultural prices remain volatile, they have recently been rising again. This reflects a combination of improved optimism about the global economy, dollar weakness, generally low stock levels as well as concerns about *el Nino*. In the very short term this trend will probably continue. Local agricultural futures suggest that prices may trade slightly higher over the coming months. Towards the end of the year, a reversal in confidence about growth prospects could see agricultural prices following other commodity prices lower, bringing some relief at the retail level. Added to this, public scrutiny and the pressure that is being brought to bear on retailers by the Competition Commission could also moderate further increases or even result in reductions in certain product's prices. Food inflation's overall contribution to overall inflation should decline as the year progresses.

Implication

The period of aggressive easing is over. However, towards the end of the year the current optimism around the 'green shoots' of recovery may have turned more realistic, with the short-term boost provided by fiscal stimulus packages and the turn in the inventory cycle beginning to dissipate. Policymaker's attention will turn to the prognosis for economic growth for 2010, which is likely to remain weak and well below potential. The rate of easing in inflation will probably pick up some pace by then. This should tip the scales in favour of further modest rate cuts before the end of the year, bringing prime down to 10% at the bottom of the cycle.

	CPI							
		June 2009					**May 2009**	
	Weights Base 2008	Month-on-month %	% contrib	Year-on-year %	Average m-o-m past 3 yrs	Average y-o-y past 3 yrs	Month %	Year %
CPI for all urban areas	100	0.4	0.38	6.9	0.8	7.77	0.4	8.0
Food and non-alcoholic beverages	**15.68**	**-0.3**	-0.04	**10.2**	**0.7**	**11.61**	**0.5**	**12.3**
Food	14.27	-0.4	-0.05	9.9	0.7		0.5	12.1
Bread and cereals	3.08	-0.1	0.00	6.0	2.0	16.88	-0.1	10.8
Meat	4.59	-0.2	-0.01	8.6	0.3	9.38	0.7	10.3
Fish	0.66	-0.1	0.00	11.4	1.1	10.18	0.3	14.1
Milk, eggs and cheese	1.79	0.3	0.00	13.1	1.2	14.18	1.4	13.1
Oils and fats	0.53	-0.9	0.00	-7.2	1.2	21.17	-1.8	-3.7
Fruit	0.47	-6.5	-0.03	10.1	-5.0	9.55	-1.9	14.8
Vegetables	1.63	-0.7	-0.01	17.2	0.6	11.64	0.3	17.6
Sugar, sweets and deserts	0.77	0.2	0.00	14.9	0.7	9.62	1.2	16.2
Other	0.75	0.1	0.00	15.7	0.7	12.32	2.1	17.9
Non-alcoholic beverages	1.41	0.0	0.00	13.6	0.4	9.36	1.0	14.9
Alcoholic beverages and tobacco	**5.58**	**0.0**	0.00	**10.5**	**0.5**	**8.98**	**0.0**	**10.8**
Alcoholic beverages	3.29	-0.1	0.00	8.6	0.1	7.41	0.3	9.1
Tobacco	2.29	0.1	0.00	13.3	1.1	11.14	0.2	13.3
Clothing and footwear	**4.11**	**0.3**	0.01	**4.9**	**0.1**	**2.65**	**0.1**	**5.0**
Clothing	2.9	0.2	0.01	5.1	0.0	2.81	0.2	5.5
Footwear	1.21	0.3	0.00	4.2	0.1	2.21	0.1	3.9
Housing and utilities	**22.56**	**1.0**	0.24	**7.3**	**1.5**	**10.22**	**0.0**	**8.0**
Actual rentals for housing	3.49	1.8	0.06	5.6	2.0	8.96	0.0	6.4
Owners equivalent rent	12.21	1.4	0.18	0.0	1.2	0.00	0.0	0.0
Maintenance and repairs	1.68	0.4	0.01	13.5	0.7	11.40	0.4	15.0
Water and other services	3.31	0.0	0.00	0.0	0.0	0.00	0.0	0.0
Electricity and other fuels	1.87	-0.2	0.00	28.6	0.2	14.64	-0.1	29.5
Household contents and equipment	**5.86**	**0.9**	0.06	**7.0**	**0.6**	**5.45**	**0.4**	**7.0**
Furnishings, floor coverings and textiles	2.17	-0.5	-0.01	0.2	-0.3	-1.18	0.2	0.9
Appliances, tableware and equipment	1.05	0.3	0.00	15.9	0.3	6.82	0.3	16.1
Supplies and services	2.64	2.2	0.06	9.0	1.4	8.99	0.6	8.6
Domestic workers wages	1.99	2.9	0.06	6.4	1.9	8.47	0.0	6.2
Health	**1.47**	**-0.1**	0.00	**11.4**	**0.1**	**8.49**	**0.3**	**11.7**
Transport	**18.8**	**0.5**	0.09	**-2.2**	**1.5**	**3.46**	**0.8**	**0.5**
Purchase of vehicles	11.25	0.1	0.01	3.9	0.3	0.28	1.4	4.8
Private transport operation	4.82	1.7	0.08	-18.5	2.9	7.90	-0.3	-16.2
Petrol	3.93	2.2	0.09	-25.0	3.6	7.93	-0.5	-22.7
Other running costs	0.89	0.2	0.00	13.2	0.6	10.31	0.4	13.8
Public Transport	2.73	0.8	0.02	4.7	3.8	6.15	0.4	14.7
Communication	**3.22**	**-0.3**	-0.01	**0.6**	**-0.1**	**0.02**	**0.0**	**0.9**
Recreation and culture	**4.19**	**-0.4**	-0.01	**13.4**	**-0.1**	**5.48**	**0.5**	**13.7**
Education	**2.19**	**0.0**	0.00	**10.5**	**0.0**	**8.02**	**0.0**	**10.5**
Restaurants and hotels	**2.78**	**0.5**	0.01	**12.0**			**0.5**	**13.0**
Miscellaneous goods and services	**13.56**	**0.2**	0.02	**11.8**	**0.2**	**8.01**	**0.1**	**11.6**
Personal Care	2.20	0.1	0.00	15.6	0.2	9.06	0.8	15.8
Insurance	7.71	0.1	0.01	7.7	0.0	7.01	0.0	7.5
Financial Services	1.27	0.4	0.00	20.0	0.8	11.32	0.0	19.6
Other Services	2.38	0.0	0.00	17.2	0.1	7.82	0.0	17.2

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