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# Economic research

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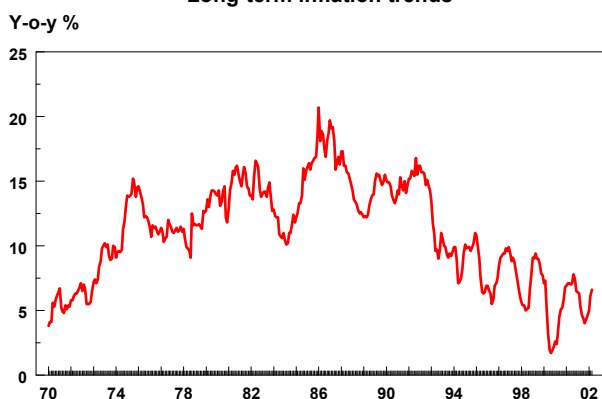
## PROSPECTS FOR INFLATION

The rand's dramatic plunge in late 2001 has been followed by a proliferation of press reports suggesting significant price hikes across a broad range of goods and services. Although the volatile rand has long hampered the monetary authorities' aim of price stability, its impact on inflation has generally been successfully contained in recent years. The latest crisis, however, threatens to be different in magnitude. It also struck just before the first year of inflation targeting. This article examines the extent of the inflationary buildup, the implications for monetary policy in the near future and inflation's likely long-term trend.

challenges and forced significant changes to the structure of South Africa's markets. The economic reforms adopted included substantial tariff reductions across a broad range of goods agreed to at the Uruguay round of the General Agreement on Trade and Tariff (GATT) concluded in 1991. Under GATT the average weighted import tariff for the manufacturing sector dropped from 16% in 1991 to 14% in 1994 and finally to 5% in 1999. In certain industries the reduction was dramatic. For example, the motor, clothing and textile industries saw average tariffs fall from 72%, 90% and 35% to current levels of 22%, 38% and 24%. The lowering of import tariffs exposed the previously protected and isolated domestic market to global competition in the form of increasingly cheaper imports.

The lowering of import tariffs also placed pressure on local producers to improve efficiency in order to compete with imports in terms of both quality and price. Local producers responded to the challenge by narrowing production ranges, upgrading and modernising plant and equipment, while at the same time embarking on aggressive labour rationalisation programmes. This process helped to improve the cost competitiveness of local producers, resulting in improved capital and labour productivity. Labour productivity rose at an annual average rate of 3,1% in the 1990s, compared with growth of only 0,2% in the 1980s and 0,3% in the 1970s. Productivity improvements were partly the result of significant labour rationalisation, as private sector employment declined by 2,1% per annum in the 1990s and by a further 2% in 2000.

Long-term inflation trends



## Historical trends

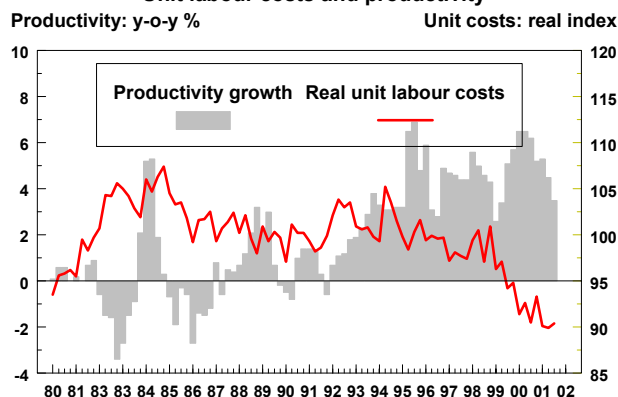
Significant progress has been made in recent years in bringing inflation under control. Inflation dropped below the psychologically important 10% level in 1993 after two decades in double-digit figures. A number of interrelated factors contributed to inflation's descent into single-digit territory in the 1990s.

## Factors supporting lower inflation

### Globalisation

First among these factors was the reintegration of South Africa into the global economy, complementing the transition to democracy in 1994. This brought new

Unit labour costs and productivity



Productivity growth far exceeded real wage and salary increases during this period and, as a result, real unit labour costs fell. In real terms, unit labour costs actually contracted by an annual average rate of 0,5% in the 1990s as a whole and by 1,3% annually between 1994 and 2000. In contrast, during the 1980s they rose by 0,9% in real terms.

### **Restrictive fiscal and monetary policies**

The impact of increased import competition was further reinforced by the adoption of stricter fiscal and monetary policies aimed at restoring macroeconomic stability, including price stability. Fiscal policies focused on establishing a culture of fiscal discipline, aimed at containing real government consumption expenditure and eliminating government dissaving. The more conservative fiscal stance complemented the very restrictive monetary policy adopted from the late 1980s.

This policy entailed the maintenance of positive real interest rates. While interest rates were pushed dramatically higher by the emerging market crisis in 1998, nominal interest rates have nonetheless averaged a punishing 16,9% since 1994, even excluding this abnormal period, while real interest rates averaged 9,1% over the same period. High interest rates helped to reduce inflation partly by containing domestic demand and credit growth, but also by reducing inflationary expectations.

### **Low global inflation**

Low global inflation throughout the 1990s also contributed to the downward trend in local inflation. Inflation in both developed and most major developing countries declined significantly during the past decade. This was partly due to relatively low commodity prices, particularly that of oil. The Economist all-commodities dollar index contracted by an annualised 5,2% over the period 1994 to 1999. Apart from a short-lived spike in oil prices in 1990 due to the Gulf War, the Brent crude oil price rose by an average rate of only 2,9% per annum over the period 1994 to 1999, representing a fall in real terms. However, lower international inflation was also due to the conservative and credible monetary policies that prevailed in most developed countries over the decade.

### **Factors undermining lower inflation**

#### ***Imperfect competition in certain sectors***

Some sectors, particularly those dominated by state-owned enterprises, remained untouched by the significant structural adjustments that occurred within the overall economy since 1994. Certain areas of sectors such as energy, telecommunications and transport have remained largely isolated from effective competition mainly due to the slow progress with privatisation and deregulation in these markets. The lack of competition has resulted in both continued inefficiencies and significant pricing power to pass costs increases on to consumers.

Government's need to extend services to the

underprivileged has also placed upward pressure on prices in certain sectors. Examples include electricity, telecommunications, medical costs and education. The latter two areas have seen annualised price increases of 11,1% and 11,5% respectively since 1994, compared with overall inflation of 7,1%.

### **The rand**

The weak rand has placed upward pressure on inflation. There has been three periods of strong depreciation since the elections in 1994. (Refer to the 31 January 2002 edition of the Guide to the Economy feature article, *The rand collapse*, for a more detailed discussion.)

Each crisis has differed in its impact on prices. In 1996 the currency fell by 21,5% on a trade-weighted basis. This quickly flowed through to prices as domestic demand was relatively healthy at the time. Producer inflation started to edge higher in May 1996, some three months after the beginning of the rand's initial plunge in February 1996. Ultimately it rose from a low of 5,2% in April 1996 to a peak of 9,6% in March 1997. Retailers also responded and this, coupled with higher mortgage interest rates, pushed consumer inflation from a low of 5,5% in April 1996 to a peak of 9,9% in April 1997. It therefore took around 12 months to be reflected fully in the official figures. The rise in inflation in this episode was temporary, largely because the rand first stabilised and then strengthened within only four months of the initial drop.

In 1998 the rand depreciated by 19,2% on a trade-weighted basis. The impact of the rand's depreciation on inflation was more muted than in 1996. Producer inflation gradually rose off a very low base, of 2,3% in May 1998 to a peak of 6,4% in June 1999. Headline consumer inflation initially surged from 5,1% in May 1998 to a peak of 9,4% in November 1998, but this sharp upward movement in the space of seven months was mainly due to the dramatic hikes in interest rates from 18,3% in March 1998 to a peak of 25,5% in September 1998. CPIX, which excludes the impact of mortgage costs, rose at a substantially slower pace, edging higher from 7% in May 1998 to a surprisingly moderate peak of 7,6% in October 1998, before gradually easing off to lower levels.

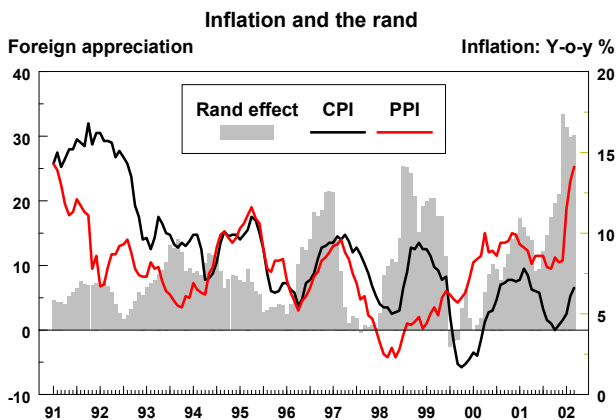
The modest impact on inflation during this period was largely due to further significant tariff cuts, deflationary global conditions and weak domestic demand partly brought about by higher interest rates. This forced both producers and retailers to absorb some of the cost pressures by reducing profit margins. While there is no direct measure of economy-wide margins, the contribution of the gross national operating surplus to factor income can be used as an imperfect proxy. Unfortunately, it is distorted by the changes in the business cycle, productivity gains as well as the positive impact on export margins due to the rand's depreciation itself. Even so, nominal growth in operating surpluses fell to 7,1% in 1998 from 10,6% in 1997, while contracting by 2,9% in real terms following real growth of 2,5% in 1997. As a percentage of gross factor income, the operating surplus dropped to 42,4% in 1998 from 43,7% in 1997.

## Recent developments

The recent collapse of the currency threatens to have a more damaging effect on inflation because of its extent and duration as well as the limited ability of businesses to absorb cost increases.

The rand's decline started in February 2000 and intensified in late 2001, breaking new lows against all major currencies throughout November and into December. On a trade-weighted basis the rand fell by 15% and 33,5% in 2000 and 2001 respectively.

Inflation was already edging higher when the rand started to fall in February 2000. The rand's renewed depreciation aggravated the impact of a dramatic hike in international oil prices, which had been the main culprit behind the rise in domestic inflation from October 1999. However, despite continued rand weakness, all measures of inflation moderated significantly once international oil prices started to ease in 2001. While producer inflation remained relatively high, it dropped from a peak of around 10% in 2000 to a low of 7,8% in September 2001. Headline inflation rose to a peak of only 7,8% in February 2001, but the index eased back quickly to a low of 4% once the lower oil prices translated into falling fuel prices locally. CPIX peaked much earlier, reaching a high of 8,2% in October 2000, before falling to a low of 5,8% in September last year, below the upper range of the Reserve Bank's inflation target of between 3% and 6%.



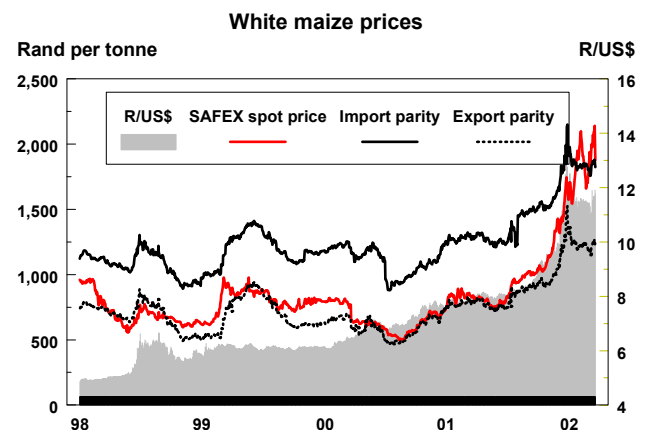
The initial impact of the rand's decline on both producer and consumer inflation was therefore surprisingly small, suggesting that at least a portion of rand-induced cost increases was absorbed along the supply chain. However, the final plunge in the currency in late 2001 reduced both the will and the ability to absorb price increases across a broad range of goods. An examination of the detailed breakdown of the CPI shows that, while the cost of imported goods and particularly luxury goods has increased as might have been expected, surprisingly most of the upward pressure on inflation has come from food prices.

The prices of a wide range of food products, including grain products, meat, fish, fruit and vegetables, started to accelerate from around September last year. Although some of these were seasonal, rises in

most categories were unusually strong and picked up after the rand's final fall in December. Grain and meat prices pose the most significant threat to inflation as they carry weightings of 3,81% and 5,66% respectively in the overall consumer price index (CPI), and 4,84% and 6,95% respectively in the CPIX measure.

Selected consumer price increases – March 2002			
Category	Weight	Y-o-y %	Q-o-q annualised
<b>CPIX</b>		<b>8,0</b>	<b>15,5</b>
<b>CPI Breakdown:</b>			
Vegetables	2,00	23,6	14,6
Dairy	1,96	14,5	24,7
Meat	5,66	14,5	7,3
<b>Food Total</b>	<b>20,99</b>	<b>13,0</b>	<b>16,2</b>
Appliances	0,80	12,7	35,8
Grain	3,81	12,6	28,6
<b>Medical</b>	<b>7,15</b>	<b>11,5</b>	<b>43,9</b>
<b>Tobacco</b>	<b>1,14</b>	<b>10,5</b>	<b>18,6</b>
<b>Alcoholic drinks</b>	<b>1,40</b>	<b>10,3</b>	<b>33,9</b>
Vehicles	5,95	9,0	24,8
<b>Cold drinks</b>	<b>1,10</b>	<b>8,8</b>	<b>20,6</b>
<b>Fuel &amp; power</b>	<b>3,49</b>	<b>8,4</b>	<b>5,1</b>
<b>Education</b>	<b>3,48</b>	<b>7,5</b>	<b>33,8</b>
<b>CPI all items</b>	<b>100,0</b>	<b>6,6</b>	<b>17,9</b>
<b>Transport Total</b>	<b>14,84</b>	<b>6,3</b>	<b>17,5</b>
Petrol & diesel	7,05	5,7	17,8
<b>Furniture &amp; Appl</b>	<b>2,53</b>	<b>5,6</b>	<b>17,7</b>
<b>Communication</b>	<b>2,98</b>	<b>5,2</b>	<b>21,2</b>
Furniture	0,95	4,2	13,6
<b>Housing</b>	<b>22,14</b>	<b>4,0</b>	<b>25,1</b>
Fruit	1,09	-0,7	27,9
<b>Clothing &amp; Shoes</b>	<b>3,25</b>	<b>-4,5</b>	<b>-3,7</b>

Prices of white and yellow maize increased by a massive 127% and 104% respectively in 2001, while wheat prices have increased by over 60% over the same period. This resulted from a combination of the weak rand, initial expectations of disappointing crops in the 2001/02 season as well as exceptionally high regional demand, the latter being due to shortages in the Southern African region following the drier-than-normal conditions in many neighbouring countries and significant disruptions to commercial farming in Zimbabwe as a result of the controversial land reform programme of the past two years.



The rand's role in determining grain prices has increased following the deregulation of the agricultural sector. Prices are now mainly influenced by dollar-based export and import parities as well as other factors influencing crop outputs. The export parity price of maize is the rand price exporters receive for their crops, which is a function of the exchange rate of the rand to the US dollar, as well as financing, loading and transport costs. Import parity prices are determined by export parity prices including insurance and import tariffs. The spot price for maize has generally traded between export and import parity prices, tending to match export parity at times of domestic surpluses, while trading closer to import parity at times of domestic shortages. After the rand's dramatic drop in November and December both white and yellow maize prices shot up towards import parity prices, with a similar pattern visible in prices of wheat and sunflower seeds.

Although initial concerns over the size of grain crops are likely to be unfounded, prices are expected to remain high given strong demand from the rest of Africa. The second official production estimate by the National Crop Estimate Committee suggests a maize crop of around nine million tons, 19,6% more than last season's crop. The outlook for wheat production is equally sound, with a better chance of an easing in prices over the short term.

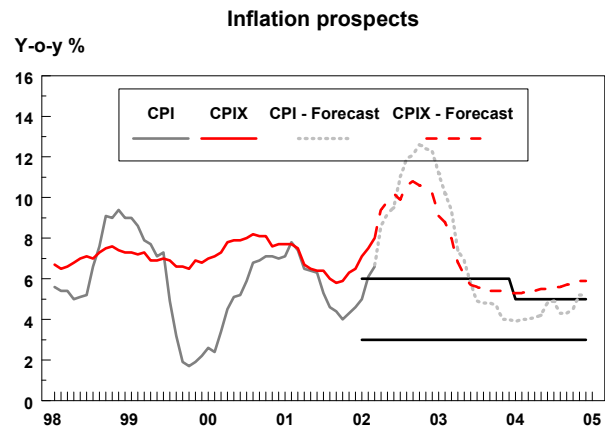
Maize prices unfortunately have significant knock-on effects. White maize is an input in many food products and 90% of yellow maize production is used as feedstock in the meat, poultry, dairy and egg industries. Partly as a result of this, meat prices have also soared. The weaker rand has also pushed the costs of tractors and other farming implements significantly higher during the past 12 months. However, supply shortages seem to be the main reason behind the sharp rise in meat prices. Strong demand from continental Europe and the UK following the devastating effects of foot-and-mouth disease in those regions has reduced supply to the local market, while some farmers have also opted to rebuild herds as grazing conditions have improved after the rains late last year.

The high maize and other grain prices are therefore expected to persist during the next few months. This will keep upward pressure on food prices at both producer and retail level, particularly during the first half of the year.

### Outlook and conclusion

Inflation will escalate over the **short term** as the aftershocks of the rand's depreciation flow through to consumer prices. Producers and retailers have already signalled their unwillingness to take further strain on margins. While the risk of this strategy for business remains a significant decline in sales volumes later this year, the generous tax relief extended to individuals in this year's budget should help to prevent major cutbacks in consumer outlays in the short term. Rising inflationary expectations may also make it seem easier to pass cost increases on to consumers for retailers looking for opportunities to boost margins.

High food, fuel and other administered prices will add further pressure in the short term. CPIX inflation is forecast to rise to a peak slightly above 10% in and around September, which is well above the Reserve Bank's inflation target of between 3% and 6% for 2002. The Reserve Bank seems to have accepted this, with the focus of monetary policy shifting to meeting the same inflation-targeting range in 2003.



The attainment of the 2003 inflation targets will depend on several factors. First, the rand itself – a pullback to the R10 level or below against the dollar will impact positively once import cover taken out at around Christmas 2001 works its way out of the system. Prospects are reasonable given the reduced net open forward position and the reversal of leads and lags in the forward market. However, the uncertain international environment continues to pose a threat, making the rand vulnerable to sudden changes in sentiment.

The second factor is the oil price. This has important knock-on effects on other prices. Here supply-side threats due to the Middle East crisis have helped to boost prices over the past few months. However, any calming of the situation should lead to some reversal, as global demand should not be all that robust over the next 18 months.

The third factor is inflationary expectations. A sudden rise in inflation over the next few months could lead to behaviour that almost institutionalises a higher inflation rate in the medium term. This is particularly true of wages where high settlements in the coming months could threaten targets not only in 2003 but also in 2004 when a lower target of 3% to 5% comes into effect. This is because settlements will not only become effective in 2003 but could affect longer-term multiyear agreements. There is a real danger that settlements could exceed productivity growth, reversing one of the key reasons behind inflation's decline in recent years. Other players might also start to factor in double-digit inflation in their pricing decisions, further threatening the medium-term outlook. Against this background the rise in interest rates since the beginning of the year is understandable, but regrettable. The Reserve Bank has had to send a strong message, but risks harming short-term growth prospects, which may even be to the detriment of the rand and hence to inflation. The key is probably a more flexible monetary policy

throughout the business cycle. Interest rates could and should have fallen to lower levels after the 1998 crisis. Subsequent interest rate rises would then have been less damaging as they would have been off lower levels and yet still sent the right message to counter inflationary expectations.

Prospects for inflation over the **longer term** are no less crucial. In the short term the rand's fall has unleashed significant price pressures, which need to be countered before they become entrenched. There is also a danger that much of the downward momentum provided to inflation by the restructuring of the economy is slowing. Further tariff declines will be more modest, although bilateral trade deals such as those with the EU will continue to encourage competitive forces in the local economy. Strong cost rationalisations are unlikely. Further productivity improvements will have to be made through expanded production arising from the economy's competitive position and good access to the EU and US markets. Although certain industries such as the motor industry have already shown strong growth on this basis, business in general needs to become more alert to opportunities and more aggressive in taking advantage of them.

A further major downward push of inflation in the longer term also requires an acceleration of the restructuring process in those key sectors still isolated from effective competition but that nonetheless provide essential inputs to business.

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