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Economics

The prospect of stagflation

This week, Statistics South Africa (Stats SA) released inflation data for October. Consumer inflation edged higher to 5.6% y/y during the month, driven mostly by stronger prices in food and non-alcoholic beverages, transport and miscellaneous goods and services. The 2.8% monthly increase in the food price index is the highest since August 1994 (4.1%).

Amid the worsening outlook for domestic inflation, the South African Reserve Bank kept rates on hold yesterday. This comes as no surprise to us if you consider the prospect of increasing inflation with factors such as the pressure on food prices, our depreciating currency, rising trend in wage settlements and the impact of the reweighting and rebasing of the CPI basket, all driving inflation to the upper end of the target range of between 3% and 6%.

Stats SA also released the results of the new Income and Expenditure Survey (IES) for 2010/11 recently, revealing some interesting changes in consumers' income and expenditure patterns. The results of the survey serve as an input into identifying the goods and services that should be included in the new Consumer Price Index (CPI) in January 2013.

Average annual household income expanded, in real terms (i.e. without the effect of inflation), by 16.7% since the previous survey in 2005/06. More granular detail reveals that, as a population group, the incomes of Black Africans outpaced other groups, expanding by 34.5% over five years. Incomes of Indian and Asian households expanded by 36.8%, and in Coloured and White households, incomes expanded by 27.7% and 0.4% respectively. Household consumption expenditure increased (in real terms) by 24.6%, considerably faster than income growth. The survey results indicated significant increases in spending on clothing and footwear (42.7%), housing, water, electricity and other fuels (47.9%), education (26.0%) and communication (41.4%). The drastic increase in housing costs could be explained by severe increases in electricity tariffs (111.4%, versus 37.3% for all items) during the surveyed periods. The previous IES survey and CPI restructuring was five years ago. The new inflation basket will be updated more frequently in order to reflect an accurate and current value of monthly CPI.
However, the transition between the old and new CPI baskets could perhaps not be as smooth as anticipated. Changes in products in the basket and reweighting could affect the level of inflation when it is implemented early next year. The table below illustrates the changes to the sub-categories.

Category	New weights %	Current weights %
Food and non-alcoholic beverages	17.5	18.3
Alcohol and tobacco	5.4	5.6
Clothing	4.5	4.4
Housing	22.8	21.0
Household contents	5.2	6.1
Health	1.4	1.5
Transport	15.4	17.8
Communication	2.9	3.1
Recreation	4.5	3.9
Education	2.7	2.2
Restaurants and hotels	3.4	2.8
Miscellaneous goods	14.4	13.3

We have calculated that these changes could result in marginally higher inflation (0.5%-1.0%) when implemented, but Stats SA warned that further adjustments to these weightings could occur to include the inflation data of the last few months of 2012. Bear in mind that inflation could still be pulled down by the effect of lower local demand resulting from the general slowdown in advanced economies. Higher inflation could have serious implications for interest rate decisions and financial markets next year. Another unknown factor is the inflationary effect of the immense monetary stimulus in the European Union and the United States (set to continue now that Obama has been re-elected).

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The bottom line:

South Africa has certainly done a lot to stimulate the economy during the latest economic downturn. We have lowered interest rates to the point of negative real interest rates, with visible results – the latest private sector credit extensions indicate growth of 9.1% in September. There has certainly been fiscal stimulus - government spending to GDP reached 22.1% in the second quarter of this year.

Yet some challenges remain; advanced economies continue to struggle economically, and this affects our trade account. The latest results from our manufacturing and mining industries show substantial contractions mainly due to the industrial action in August (manufacturing production was down 1.1% y/y and mining production down 8.3% y/y). Downgrades from international rating agencies and the possibility of stagflation in 2013 are added woes that we can ill-afford. We might reach a point soon (if we haven't already) where there is no more room for further monetary or fiscal stimulus.

Given all the challenges listed, it is imperative that we have excellent guidance and political leadership with a clear sense of economic policy direction in the next year.

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