

**GROWTH RISKS FOR 2009 ARE STACKING UP ...**

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Introduction

The April inflation numbers again exceeded expectations – the Reuters consensus for CPIX inflation was 10% (BER: 10.3%) compared to the actual rate of 10.4%; PPI came in at 12.4% compared to the consensus of 11.7% (BER: 11.6%). In fact, it is likely that within the next few months CPIX inflation will exceed the October/ November 2002 peak (11.3%, which was registered after the rand exchange rate's dramatic blow-out at the end of 2001). This time around it is food and energy prices doing the damage, with only a bit of exchange rate depreciation.

Juxtaposing the shocking inflation picture is finally more convincing evidence of the real economy buckling under the pressure from higher inflation and interest rates, electricity outages and a weaker global economy. However, this slowdown was foreseen – the BER's estimate for 08Q1 growth was 2.2% (saar) compared to the actual number of 2.1%. Excluding the 20% drop in mining real value-added (related to the mining shutdown at the end of January and the subsequent power rationing to the industry), real GDP growth came in at 3.4% in 08Q1, i.e. a better gauge of the current underlying growth momentum. In y/y terms, growth has decelerated from a peak of 5.8% (06Q4) to 4.2% (08Q1) and in the BER's view is heading for closer to 2% during the final quarter of 2008, with risks firmly on the downside. Such a deceleration in growth would be consistent with the 38 index point decline in business confidence since the 06Q1 peak of 86 index points and given the 3-4 quarter leading property of the RMB/BER BCI; should business confidence decline further in the current and coming quarters the growth deceleration will intensify going into next year.

While the current growth trajectory has been in line with our expectations, the latest inflation numbers have exceeded expectations by a substantial margin, mainly due to international oil prices scaling new and unforeseen highs above \$130/b. The rapidly deteriorating inflation outlook (also discounting stiff electricity price increases) has prompted aggressive monetary policy statements. The domestic capital markets are currently pricing in a full percentage point hike in the repo rate at the 11/12 June MPC meeting.

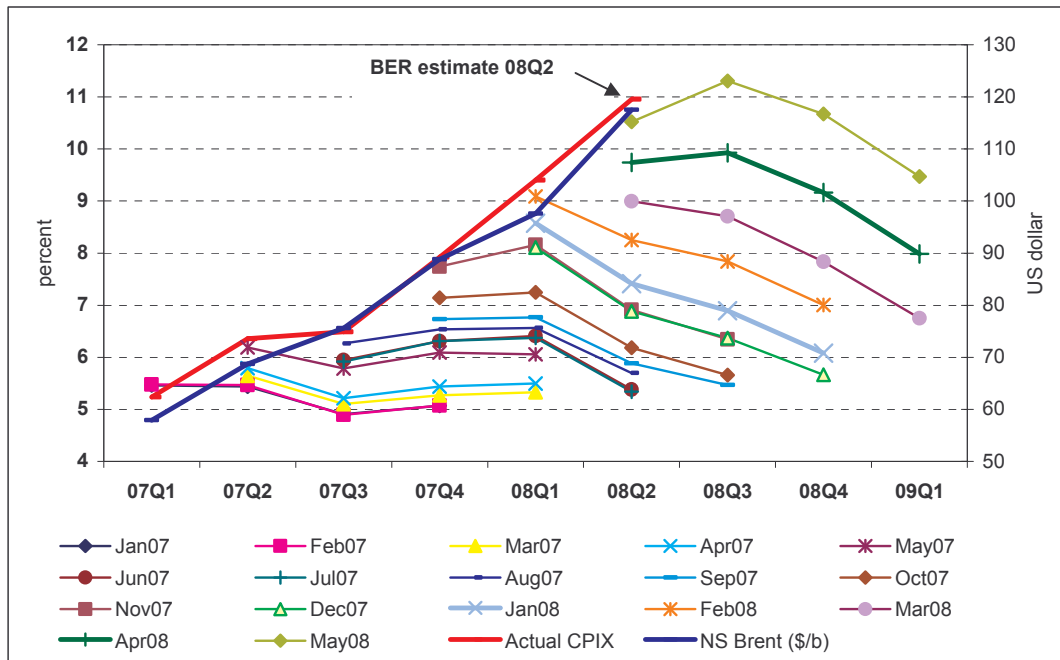
The aim of the present note is to provide some analysis in this regard and to highlight the implications and our (provisionally) revised forecast.

Shocking inflation numbers become a constant refrain

Figure 1 shows how inflation forecasts have consistently failed to predict the doubling in the y/y CPIX inflation rate over the past 18 months – the 12-month forecast of CPIX inflation averaged 5.2% in January 2007; actual CPIX inflation turned out at 6.5% on average in calendar 2007. More importantly, the 07Q4 actual average of close to 8% exceeded the consensus forecast at the start of the year by close to 3 percentage points. The problem is that the underestimation of inflation intensified in 2008. This is reflected in the fact that the 08Q2 actual inflation rate (current BER estimate, 11% with May/June outstanding) could be double the Reuters consensus forecast of June 2007 and no less than 4 percentage points higher compared to the December 2007 forecast! An interesting anecdote in this underestimation of the inflation trajectory is the fact that the international crude oil price more than doubled from \$58/b (07Q1) to the current levels above \$130/b; the spike in food prices has been another driver of the inflation overshoot.

The supply shocks to inflation are most intense, best reflected in the fact that food & transport account for more than 60% of the April 2008 y/y CPIX inflation rate of 10.4% - *see Table 1*. Including the June petrol price hikes, the coastal petrol price has risen by a cumulative R3/l over the past 9 months (from R6.67/l to R9.72/l), i.e. by close to 50%. The CPIX food price index is up 16% y/y in April. More worrying is the fact that 2nd round impacts are creeping into the statistics, best reflected in the fact that CPIX excluding food and transport

Figure 1: Reuters Consensus forecast of CPIX inflation – 4 quarters ahead (Jan07 – Apr08)



Source: StatsSA/ Reuters / BER

came in above target at 6.2 y/y in April; inflation expectations regarding 2009 have increased sharply to 7.8% in 08Q1. Services inflation accelerated to 6½% in April from 5½% on average in 2007. While the inflation rate on other consumer items remains well within target, this has accelerated to 4.2% in April 2008 from 1% in 2007. It is, however, difficult to assess how much of this acceleration is directly linked to the food & energy cost escalation and how much is pure inflation pass-through (i.e. retailers hiking prices simply as general inflation increases and/or sales volumes contract). The BER's business survey evidence at both the manufacturing and retail levels suggests little room exists to pass on cost increases, with profitability coming under severe pressure. The economic slowdown underway should go a long way in containing the dreaded 2nd round inflation effects, as well as inflation expectations (and wage/ price setting in the wider economy).

Table 1: Composition of CPIX inflation

	% weight	% yoy		% contribution	
		2007	Apr08	2007	Apr08
Goods	64.3	7.0	12.7	69.2	78.5
Food	25.7	10.3	15.9	40.7	39.2
Bev & tob	4.3	7.1	8.1	4.7	3.4
Transport	15.3	5.6	14.6	13.2	21.5
Consumer items	19.0	1.0	4.2	2.9	7.7
Services	35.7	5.6	6.5	30.8	22.3
Housing	11.6	5.8	6.7	10.3	7.5
Medical care	7.7	5.6	5.6	6.6	4.1
Fuel & power	4.3	7.8	10.0	5.1	4.1
Hhold operation	5.2	7.6	12.5	6.1	6.3
Education	3.8	7.7	8.3	4.5	3.0
Communication	3.2	1.0	2.1	0.5	0.6
Actual CPIX	100	6.5	10.4	100	100

Source: StatsSA

On the other hand, the recent 10½% salary & wage adjustment announced in the public sector does not bode well for inflation going forward – not only does it fully compensate for the food & energy driven price shock to general inflation, it also has a potent demonstration effect to labour demands in the private sector. *Should wage inflation move in this direction, the danger of an inflation-wage spiral is real.* This will require tighter monetary policy and probably result in sharp employment cutbacks in the private sector responding not

only to the slowdown in the real economy, but also to the resulting pressures on unit labour costs (fuelled by a combination of poorer production capacity utilisation and above productivity real wage inflation)¹.

Furthermore, local electricity prices are expected to increase by 20-30% from the middle of the year and there appears to be no end in sight for the relentless upward march in oil and – to a lesser extent – food prices. It is no wonder that the SARB is currently in such a fiercely hawkish mode. *The question is, how far may interest rates go and what will the implications for the economic outlook be?*

The real economy buckles, but this was expected

The 08Q1 GDP release by StatsSA finally confirmed that the economy is rapidly slowing from the 5% growth momentum achieved in recent years. The electricity blackouts in January/ February 2008 dealt a severe blow to the mining, electricity and – to a lesser extent – the manufacturing sectors (contracting by 22%, 6% and 1% respectively in Q1), which drove the growth momentum to 2%. However, as noted, excluding the 20% contraction in mining the underlying growth momentum during the first quarter is closer to 3½%. The bulk of the slowdown in the manufacturing and other sectors (e.g. financial services to 5%, internal trade to 3½% and transport & communication to 3½%) is of a cyclical nature (*see Economic Prospects, 2nd Quarter 2008*).

Table 2: Sector real GDP growth (quarterly annualised): 2007/08Q1

Sector	07Q1	07Q2	07Q3	07Q4	08Q1F	08Q1
Agriculture	3.8	9.0	5.8	10.4	~~5.0~~	12.5
Mining	-8.8	-3.1	4.0	-1.7	~~-20.0~~	-22.1
Manufacturing	4.5	-0.1	-2.5	8.2	~~2.2~~	-1.0
Electricity & water	3.4	2.8	3.0	-1.8	~~-5.0~~	-6.2
Construction	29.1	11.8	14.7	14.2	~~13.0~~	14.9
Internal trade	5.1	4.7	4.5	2.1	~~3.0~~	3.6
Transport & comm..	6.0	6.1	4.4	3.6	~~3.4~~	3.5
Financial services	7.6	10.2	12.3	8.5	~~4.7~~	4.9
General government	4.1	1.2	3.3	4.4	~~3.4~~	4.6
Personal services	2.8	4.3	5.1	4.3	~~3.7~~	3.9
Total GDP	5.1	4.4	4.8	5.3	~~2.2~~	2.1
Excl. Fin services	4.5	2.9	3.0	4.5	~~1.6~~	1.4

Source: Statistics SA / BER forecast

In fact, a range of indicators confirm that the real economy has probably reached the so-called 'tipping point'. This is particularly evident in the consumer/ retail sector. Developments in the auto sector has been a leading indicator of the consumer sector slowdown and the sustained plunge in passenger car sales in May 2008 attests to the erosion of consumer buying power and confidence. While some support may still result from sustained employment creation, high salary & wage adjustments and social transfers, underpinning sales in the non-durable goods, services and semi-durable goods sectors, the BER's 08Q1 retail survey indicated that the food & energy price pressures are beginning to erode real income growth and spending in these sectors as well. A particular worrying factor is the slowing employment tendency in the wider economy – *see Figure 2*. Even the fast growing (and non-cyclical) tertiary sector (growing by close to 6% on average in real terms, 2006/7) is slowing down, from close to 7% in 07Q3 to 4.2% in 08Q1. The BER survey in this sector reveals a corresponding downturn in the positive employment tendency in the sector.

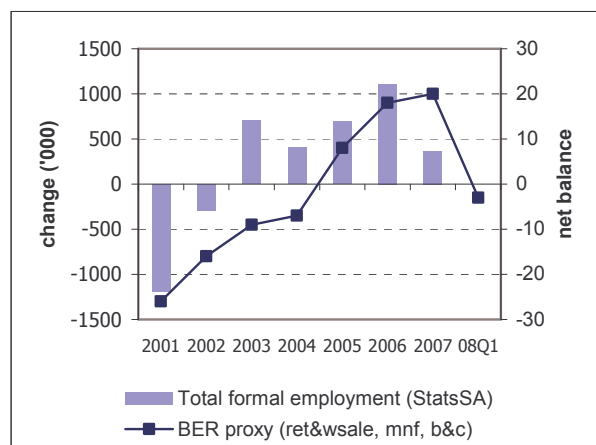
According to NAAMSA, passenger car sales are down 17% y/y during the first five months of the year; light commercial vehicle sales are down 7½% and medium commercial sales are flat; heavy commercial vehicle sales, in turn, grew by 15½% y/y over the corresponding period, reflecting the sustained buoyancy in the construction sector of the economy (*see Table 2*). Construction activity linked to public sector infrastructure fixed investment spending will remain a key support to growth over the short term. However, the cyclical deterioration in domestic demand conditions is bound to affect private sector fixed investment spending negatively.

The evidence point to the fact that the consumer sector of the economy has reached a 'tipping point' – it is now only a matter of how deep and protracted the downturn will be. A key risk relates to the housing

¹ The hard reality in terms of inflation fighting in the face of the (rolling) food & energy price shocks that SA (and the rest of the world) is currently experiencing, is that business and labour have to absorb these through increased production efficiencies and/or lower real profits & wages. While the short-term impact is painful and can be quite severe, the output cost pales into insignificance compared to that required to unwind a wage/ price spiral in the longer term (in terms of lower economic growth and employment creation). This more than anything else explains the SARB's current hawkish monetary policy stance. In the medium term inflation discriminates severely against the poor; in the short term other measures need to be looked at to contain the impact on poverty, e.g. VAT zero-rating of food; nutritional support programmes, etc. However, to inflate our way out of the pain is no solution; it will simply delay more severe pain down the line.

market where average house prices are beginning to fall. Households' debt service burdens are approaching critical levels, which can easily trigger a broader capitulation by the consumer.

Figure 2: Growth in formal employment is coming under pressure ...



Source: Statistics SA / BER

Growth risks for next year are piling up ...

The SARB is clearly caught between a rock and a hard place. On the one hand, medium-term growth and inflation considerations demand tight monetary policy in order to get inflation back to within the target range. Given the recent sharp deterioration in the inflation outlook, it may be necessary to tighten rates further – this appears to be the Governor's firm commitment. On the other hand, the impotency of rate hikes to stem the supply shocks to inflation and the firm evidence of economic slowdown, which should take care of the 2nd round inflationary pressures going forward, provides good grounds to hang back with further hikes.

Our call is that the Bank will hike next week given recent developments and monetary policy statements; the question is: *will it be a full percentage point (as the markets are factoring in) or only 50 basis points?* In our view, chances are split close to 50/50. We simulated the impact of both scenarios (also assuming June will be the peak in the current interest rate cycle in both scenarios, followed by 150 bps and 200 bps easing of rates in 2009 respectively). We also revised our CPIX inflation forecast to 10.5% (2008) and 6.8% (2009). The outcome of these revised assumptions is that real consumer spending decelerate to 2.2% (2008, from 7% in 2007) and further to 1.7% in 2009 (assuming only a further 50 bps increase in prime overdraft rates). This compares to our April forecast of 2.4% and 3.1% respectively; in the 1% hike scenario, the outcome is worse at 2.1% and 1.6% respectively.

Including some downward revision to private fixed investment spending, our revised overall real GDP growth forecast for 2008/9 is 3.3% and 3.2% respectively (compared to 3.4% and 3.8% in April 2008); in the 1% hike scenario, growth will be closer to 3% next year. Needless to say, a further deterioration in the inflation/interest rate outlook will lead to even lower growth next year and the risk of a recession increases. On the basis of the current evidence, substantial further tightening of monetary policy risks becoming seriously pro-cyclical.

What about the external sector?

In our 2nd quarter *Economic Prospects* report, we argued that the exchange rate adjustment since mid-2006 combining with the cyclical adjustment in the domestic market will improve SA's net export performance and being the source of sustained resilience in the broader economy. On the commodity front, the baseline assumptions regarding global growth in general and that in emerging economies in particular continue to favour continued strength and as SA has strong trading links with Asia in terms of its commodity trade, export demand in this area should remain strong. On the other hand, much of SA's trade in manufactured goods are with industrial countries where demand conditions are under pressure, while it may take more time for SA's broader manufacturing exports to respond comprehensively to the more competitive level of the currency. It is also clear that extreme cost pressures and infrastructure and logistics bottlenecks are constraining manufacturing competitiveness. One would for instance have expected a more visible stimulus from import substitution benefiting local manufacturers given the weaker level of the rand exchange rate.

This suggests that we may have to be more patient in expecting an improvement in manufacturing; the improvement in manufacturing purchasing managers' 6-month expectations in the May 2008 PMI survey is heartening, but not entirely convincing at this stage. *There is an additional risk:* should the economic slowdown in the G3 countries be deeper (e.g. linked to higher than expected oil prices/ inflation and/or renewed financial turbulence linked to the sub-prime overhang) and the spillover to emerging markets be more serious (with these economies also harder hit by the cost/ inflation impact of higher oil and food prices), the expected correction in the commodity price cycle may be more severe over the short term. This is bound to have a negative impact on SA's commodity exports and capital inflows on the balance of payments next year, putting pressure on the currency, inflation and interest rates.

While the headwinds began hitting the economy since September/October last year, it seems as if all forces are conspiring to deal a blow to growth prospects next year. *The risks clearly remain on the downside.*

See Table 3 for our provisionally revised headline forecasts; final revisions will follow in our Economic Prospects, 3rd Quarter 2008 report to be released towards the middle of July 2008. Also visit our website: www.ber.ac.za for more detailed updated forecasts.

Table 3: BER forecast of key economic variables: 2008/9

SA economy: June 2008	2006	2007	2008F	2009F
Real GDP growth	5.4	5.1	3.3	3.2
Real HCE growth	8.2	7.0	2.2	1.7
Real GC growth	5.2	5.0	4.6	4.5
Real GDFI growth	13.8	14.8	7.4	4.1
Real GDE growth	9.2	6.0	3.2	2.9
Real export growth	5.6	8.3	3.7	6.6
Total employment growth	2.3	2.7	1.5	1.7
CPIX inflation	4.6	6.5	10.5	6.8
PPI inflation	7.6	10.0	13.9	10.5
Prime interest rate (eop)	12.50	14.50	15.50	14.00
R157 bond yield (eop)	7.74	8.44	9.45	8.25
R/\$ exchange rate (Q4)	7.32	6.77	8.35	8.60
R/€ exchange rate (Q4)	9.44	9.81	13.00	12.80

HCE: Household Consumption Expenditure; **GDFI:** Gross Domestic Fixed Investment; **GC:** Government Consumption

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