



FLIGHTS STREAM

February 2009

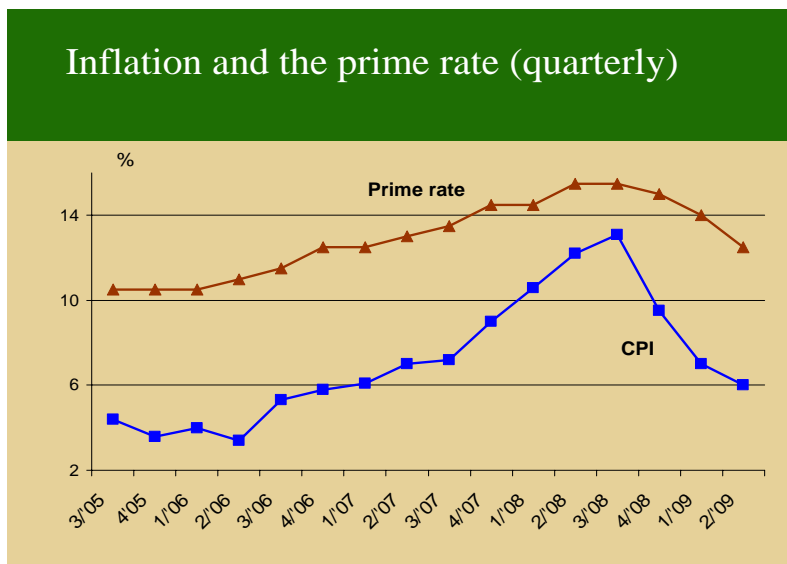
Welcome relief for consumers

Several months ago, this column predicted a sharp drop in South Africa's inflation rate, mainly as a result of a fairly dramatic reversal in commodity prices, weaker global demand patterns and a recovery of output levels for key staple foods.

At the time, most local economists remained pessimistic about the inflation outlook, with several predicting that double-digit inflation would last well into 2010. Fortunately, the pessimists have now seen the light and have recently made significant downward adjustments to their forecasts for inflation and, as an inference, also for interest rates.

At the event of the Annual general Meeting of CAASA, the author also accurately predicted the likelihood of an interest rate cut as early as December, when several leading economists were expecting the first rate cut to occur only in June 2009.

Since then, short-term interest rates have been lowered by 150 basis points, with Reserve Bank officials being on record for hinting at a further rate cut in March and probably also in April. The accompanying figure illustrates the downward trend for inflation and interest rates, including forecasts for the end of quarters one and two of 2009.



Two-pronged positive effect

All of this is, of course, good news for households, most of whom own some form of debt, particularly mortgage loans. The recent reversal of 30 months of tight monetary policy

has already resulted in a decline in the cost of credit (and capital) of 10%, a figure that should double to 20% within the next two to three months.

It is important to recognise the fact that the twin evils of higher inflation and higher interest rates have both resorted to reverse mode. Over the next six months, consumers are likely to benefit from significant price reductions, a trend which enhances real disposable income.

These reductions are already occurring and are directly related to the sharpest decline in commodity prices in the recorded history of the world (over a seven-month period), as vividly illustrated by the accompanying table.

Cynical attitudes towards so-called “downward stickiness” of prices are currently being refuted by the fact that the price of diesel at filling stations has declined by more than 30% over the past six months. The magnitude of the commodity price declines of the past seven months dictates that a significant element will be shifted forward to consumers.

Further proof of the downward trend in prices may be found in the recent announcement by a major retail group of price cuts for 245 different items in its stores. Another large retail group has also recently announced its intention to secure lower prices from many of its suppliers and to pass these on to consumers.

Commodity price trends June 2008 to January 2009	
Commodity	% decline
Energy	
Coal (Australia)	-50%
Crude oil (Brent)	-66%
Natural gas Index	-25%
Agriculture	
Coffee (robusta)	-26%
Tea (Kolkata auctions)	-20%
Coconut oil	-54%
Soybeans	-34%
Maize	-40%
Rice (Thailand, A1)	-46%
Wheat (US, hard red)	-31%
Meat (beef)	-29%
Raw Materials	
Sawn wood, (Cameroon)	-36%
Cotton A Index	-26%
Rubber (Singapore)	-54%
Fertilizers	
Phosphate rock	-28%
Urea	-58%
Metals and Minerals	
Aluminium	-52%
Gold	-3%
Steel products index	-12%
Source: World Bank	

Secondly, lower interest rates will lead to downward adjustments of monthly mortgage loan repayments. This effect is not unlike the predictable outcome of a tax cut for middle-income earners, which becomes almost immediately visible in higher levels of personal disposable income.

Fast response

Due to the fact that middle-income earners possess an extraordinarily high propensity to consume from modest increases in disposable income, it stands to reason that household consumption levels will now start reversing the sluggish trend of the past six months.

Unfortunately, several commentators continue to voice the opinion that this fortuitous scenario will only be translated into higher retail sales activity next year. Although certain durable consumption categories may take longer than others to respond to the two-pronged purchasing power boost of lower interest rates and a sharp drop in inflation, such opinions are void of economic substance.

During the third quarter of 2008, real consumption expenditure by households (which represents more than 60% of GDP) was 8.1% higher than in the same quarter two years ago. For services, which represents the largest category of household expenditure, the increase was 8.7% and for semi-durables, it was as high as 19.8%. Only the category for durable consumption (which is only 10% of the total) posted a decline over this period.

Overly negative views on the medium-term prospects for the economy are also refuted by the strong financial performance for the year ended December 2008 of one of the country's largest banks, announced on 9 February.

It speaks volumes for the resilience and underlying fundamental stability of the South African economy that a local bank with 10 million customers can record double-digit growth in attributable earnings and maintain a dividend cover of 2.5 in the midst of a global commodity crash, the demise of large international investment banks and declining GDP growth in the US and Western Europe.

The chances of a soft landing and swift recovery from the flat GDP growth trend of the second half of 2008 are excellent, particularly as a result of the inevitable resurgence of household consumption. The consumer price index should decline to within the Reserve Bank's target range of 3% to 6% by the second quarter, which will allow the prime overdraft rate to continue on a downward trend, possibly to below 12% by the third quarter.

Furthermore, domestic capital formation (which currently represents almost 24% of GDP) is bound to maintain a high degree of immunity vis-à-vis slower world growth, mainly due to government's commitment to capital expenditure of R600 billion over the next three years, combined with adequate fiscal affordability and the additional bonus of tax cuts for middle-income earners (announced by the Minister of Finance in February).

Economic growth in 2009 may therefore rebound faster than is generally anticipated and should return to above 5% in 2010.