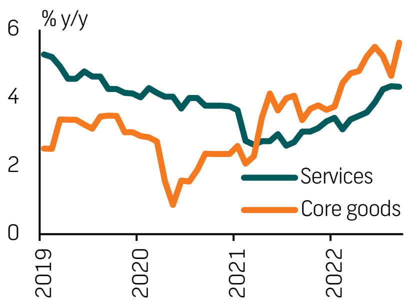
Economics weekly

21 October 2022

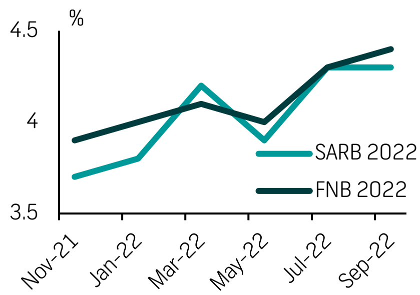
The rise of core inflation

Figure 1: Services vs core goods inflation



Source: Stats SA, FNB Economics

Figure 2: Evolution of core inflation forecasts (2022)



Source: SARB, FNB Economics

The risk of spill over from high fuel and food inflation to other goods and services in the consumer basket has been highlighted for some time. When the Monetary Policy Committee (MPC) started its current hiking cycle in November 2021, it emphasised the need to look through temporary price shocks and rather attend to second round effects. This indicated that the temporary shock to supply-driven prices could result in higher underlying or core inflation as producers pass those input cost pressures on to consumers. Furthermore, the higher cost of basic needs could result in higher inflation expectations and wage demands, also lifting core inflation. Since then, core inflation has risen from just above 3% to near 5%. We unpack the nuances here.

From the height of the pandemic, there was an expectation that consumer demand would naturally rotate from goods to services, as mobility and wages improved. While core goods inflation, including items such as vehicles and household contents, has been supported by changing household needs, supply chain disruptions and a related rise in input costs, services have taken longer to recover from pandemic lows. However, some service categories such as public transport and restaurants and hotels have shown a more immediate response to elevated input costs and currently sit at 22.1% and 7.9%, respectively. In addition, services that are related to tourism would have been severely affected by lockdown restrictions, resulting in some claw-back pricing behaviour. To the contrary, large weight services, housing and insurance, have been normalising gradually. Housing inflation should be supported by improved employment outcomes, a return to the office and rising interest rates shifting demand back to rentals. Meanwhile, improved mobility should result in higher utilisation of insurance cover, supporting that measure of inflation. As of September 2022, services inflation was 4.3%, slightly below the inflation target midpoint and core goods inflation was 5.6%, closer to the upper band of the target range.

We anticipate core inflation to average 4.4% in 2022, 0.5ppts higher than what we projected a year ago, post the September 2021 outcome. The SARB had projected 3.7% at their November 2021 meeting and currently expects 4.3%, 0.6ppts higher. This may not seem like much of a difference when compared to the shifts in fuel and food forecasts, but for a stable measure such as core inflation, it highlights how much quicker inflationary pressures have broadened and how risks have materialised. This becomes

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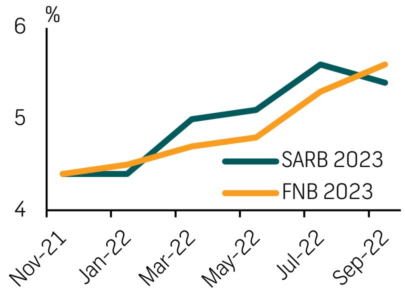
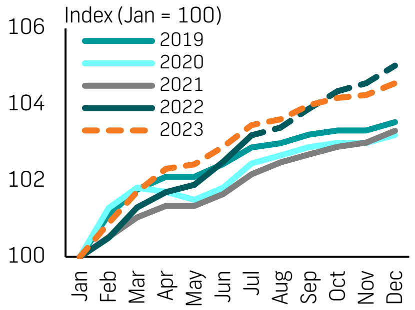
Figure 3: Evolution of core inflation forecasts (2023)



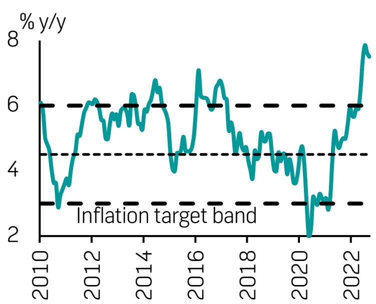
Source: SARB, FNB Economics

Figure 4: Core CPI trends



Source: Stats SA, FNB Economics

Figure 5: CPI



Source: Stats SA, FNB Economics

even clearer when looking at the shifts in 2023 forecasts. Last year, we and the SARB predicted core inflation of 4.4% on average in 2023, we now forecast 5.5% and 5.4%, respectively, each at least a full percentage point higher. In addition to the normalisation in services, a resilient consumer and higher inflation expectations should exert upward pressure to core inflation next year. Furthermore, potential growth that is constrained by electricity supply shortages means that current growth forecasts which average close to 2% over the medium-term result in the closing of the output gap, also adding to core pressures.

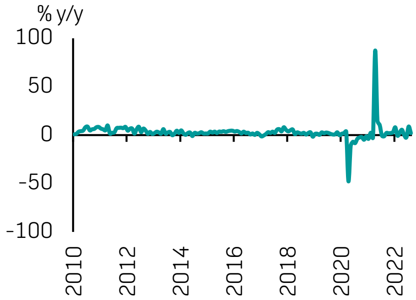
We see core inflation peaking at 6.0% in 1H23, which would undercut current core inflation outcomes in advanced markets such as the United States and United Kingdom, at 6.6% and 6.5%, respectively. While workers in SA have sought out higher wages to compensate for higher inflation, employment headcount is yet to recover from the pandemic impact, particularly full-time employment. This, along with weak economic outcomes, imposes limitations on labour and some sectors will experience real wage compression, restricting the acceleration in demand-driven inflation in SA, contrary to the experience of some advanced markets.

Risks to our outlook include the weaker rand-dollar exchange rate, which could exacerbate the ongoing passthrough of input costs to consumers. Furthermore, some medical aids are opting to hike their premiums later in the year, unlike previous years when they all implemented hikes in February. This presents some uncertainty to the peak in core inflation. Downside risks include the slowdown in the global economy, which could impede employment and income growth.

Week in review

Consumer inflation was 7.5% y/y in September, softening from 7.6% in August. Monthly pressure on headline inflation was 0.1%, with food contributing 0.1ppt, core adding another 0.4ppt, and fuel shaving off 0.4ppt. Core inflation increased to 4.7% y/y, from 4.4% previously, and had monthly pressure of 0.5% that was driven by the increase in housing costs, restaurants and hotels and alcoholic beverages and tobacco. Fuel inflation was -6.4% m/m and 34.1% higher than a year ago. Food and non-alcoholic beverages (NAB) posted 0.5% m/m and 11.9% y/y. Headline inflation should remain steady at 7.5% in October, averaging 6.9% in 2022. If there were to be no further monthly pressures in the remaining months, headline inflation would average 6.7% this year. However, key core surveys are forthcoming, including Discovery's medical aid premium hike in October and the December housing survey. In addition, the mid-month under-recovery in petrol prices of around 50c (R1.60 for diesel) indicates the likelihood of a fuel price hike in November. In addition, supply disruptions from the Transnet strike, the weak rand-dollar exchange rate, volatile international oil prices as well as lower global refinery capacity present risks. These could worsen input costs and exacerbate the passthrough to consumers, adding to the normalisation in core inflation. Nevertheless, our view remains that the peak in headline inflation for the current cycle was the 7.8% outcome in July.

Figure 6: Retail sales

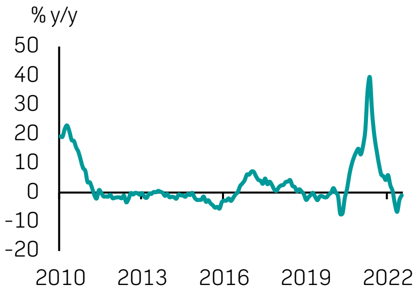


Source: Stats SA, FNB Economics

Retail trade sales volumes (not seasonally adjusted) grew by 2.0% y/y in August, reflecting a moderation from 8.9% y/y growth in July as last year's favourable base effects dissipated. Discouragingly, seasonally adjusted retail sales volumes contracted by 1.8% m/m after contracting by 0.1% m/m in July. The monthly decline in sales volumes has persisted for four successive months and, in our view, reflects the disproportionate impact of higher inflation, rising interest rates and an elevated unemployment rate on consumer spending power. The implied retail inflation was 6.2% y/y in August, increasing from a 3.2% trough in November last year. Further price increases will continue to weigh on purchasing power, putting pressure on retail sales growth performance. Overall, the 2.0% y/y growth in August was primarily underpinned by general dealers' sales volumes which grew by 6.4% y/y, contributing 2.8ppts while textiles, clothing, footwear, and leather goods grew by 4.8% y/y. The largest negative contribution emanated from hardware, paint, and glass, as well as food, beverages, and tobacco in specialised stores. YTD (January to August) retail sales volumes are up by 2.9% compared to 8.6% in the corresponding period last year. This is in line with our view that growth in household consumption expenditure should moderate to 2.9% this year from 5.4% last year as consumer headwinds persist.

Week ahead

Figure 7: SARB leading indicator

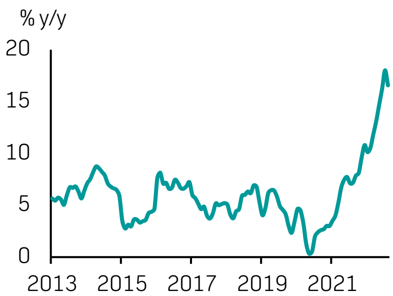


Source: SARB, FNB Economics

On Tuesday, the **leading business cycle indicator** for August will be published. The leading business cycle indicator recorded 126.2 points in July, reflecting a 1.0% decline from the previous month. The leading indicator was also down by 1.0% compared to the same month last year. The decline in the leading indicator was broad-based, with six constituent variables falling while four increased. Overall, the poor reading corroborates our view of a subdued recovery after GDP declined by 0.7% q/q in 2Q22. Furthermore, the ongoing global economic slowdown should dampen local economic prospects.

On Wednesday, the Minister of Finance will table the **Medium-Term Budget Policy Statement (MTBPS)**. This statement should outline how fiscal revenue has outperformed the projections in the Budget speech tabled in February, supported by export earnings. However, revenue growth is unlikely to remain as strong in the second half of the fiscal year, constrained by Transnet challenges and moderating global economic activity. Meanwhile, expenditure growth has been modest, but pressures should arise from higher debt service costs as global financial conditions have tightened and risk aversion has weighed on emerging markets. Furthermore, higher-than-budgeted public sector wages (without headcount reductions), the bailout of state-owned companies and extended social relief of distress grants pose additional pressure on government spending. In line with this, we should see a lift in public sector wage growth projections following labour disputes. The Minister should also provide details on how Eskom's debt will be handled. Our detailed preview is available here.

Figure 8: PPI



Source: Stats SA, FNB Economics

On Thursday, data on **producer inflation** for September will be published. Producer price inflation for August was 16.6% y/y, reflecting a moderation from what could be a peak of 18.0% y/y in July. For the first time since May 2020, producer prices declined by 0.5% m/m in August, underpinned by a relatively pronounced monthly decline in petrol and diesel, which registered -5.5% m/m and -3.6% m/m, respectively. In addition, there was a notable decline (1.3% m/m) in prices of non-metallic mineral products; while the prices of "metals, machinery, equipment and computing equipment" as well as "electrical machinery, communication and metering equipment" fell for the second successive month. On the upside, manufactured food product prices increase by 1.0% m/m. Although it is still too early to say with conviction whether producer inflation has peaked, there are signs that supply chain pressures are gradually easing. If sustained, this could cement a moderating producer inflation trend, although the volatility in oil and the exchange rate continues to pose key risks.

Tables

The key data in review

Date	Country	Release/Event	Period	Act	Prior
19 Oct	SA	CPI m/m	Sep	0.1%	0.2%
	SA	CPI y/y	Sep	7.5%	7.6%
	SA	CPI core m/m	Sep	0.5%	0.2%
	SA	CPI core y/y	Sep	4.7%	4.4%
	SA	Retail sales y/y	Aug	2.0%	8.9%
	SA	Retail sales m/m	Aug	-1.8%	-0.1%

Data to watch out for this week

Date	Country	Release/Event	Period	Survey	Prior
25 Oct	SA	Leading indicator	Aug	--	126.2
26 Oct	SA	Medium-Term Budget Policy Statement	Oct	--	--
27 Oct	SA	PPI y/y	Sep	--	16.6%
	SA	PPI m/m	Sep	--	-0.5%
28 Oct	SA	Monthly Budget Balance (Rands)	Sep	--	-42.7 bn

Financial market indicators

Indicator	Level	1 W	1 M	1 Y
All Share	65,794.28	2.2%	-1.2%	-1.6%
USD/ZAR	18.30	0.2%	3.4%	27.0%
EUR/ZAR	17.91	0.3%	1.5%	6.7%
GBP/ZAR	20.55	-0.7%	2.1%	3.2%
Platinum US$/oz	916.25	1.4%	-0.9%	-13.0%
Gold US$/oz	1,628.02	-2.3%	-2.2%	-8.6%
Brent US$/oz	92.38	-2.3%	1.9%	7.6%
SA 10 year bond yield	10.93	1.0%	4.0%	17.0%

FNB SA Economic Forecast

Economic Indicator	2020	2021	2022f	2023f	2024f
Real GDP %y/y	-6.3	4.9	1.9	1.8	1.8
Household consumption expenditure %y/y	-5.9	5.6	2.9	1.3	1.7
Gross fixed capital formation %y/y	-14.6	0.2	4.3	5.3	5.4
CPI (average) %y/y	3.3	4.5	6.9	5.7	4.7
CPI (year end) % y/y	3.1	5.9	7.3	4.7	4.6
Repo rate (year end) %p.a.	3.50	3.75	6.75	7.25	7.00
Prime (year end) %p.a.	7.00	7.25	10.25	10.75	10.50
USDZAR (average)	16.60	14.80	16.43	17.40	17.40

Source: FNB