Press release on Food Inflation Expectations for 2016 and beyond.

Bureau for Food and Agricultural Policy[1]

Recently there has been another wave of media reports on the impacts of the drought and the potential increases in food prices. In January BFAP projected[2] that year-on-year inflation of the staple food basket would reach 29%. These projections seem to be in line with the last increases that are reported by Statistics South Africa. The impacts are already apparent in retail products derived from maize, with super maize meal increasing 22% year on year in January 2016.

There are typically three levels or thresholds with a drought that determine the impact and length of the recovery period and consequently the impact on food prices. The three thresholds can be summarized as follows:

- Threshold 1 (October to January): Rainfall determines the summer crop plantings and yield potential. It is important for pasture growth but has limited direct impact on irrigated crops as long as the dams are full. Very high temperatures can also affect the yield of irrigated crops. The impacts on food prices are mainly short-term and significant recovery can take place within one production season, unless financial constraints of farmers force hectares out of production.
- Threshold 2 (February): Rainfall is critical to getting a decent yield for summer crops. This is also a critical month to determine the volume and quality of pasture. The first direct impact on irrigated crops can appear in cases where water availability becomes an issue or where very high temperatures affect pollination and crop or fruit filling. The impacts on food prices now tend to stretch into the medium term, especially if livestock herd numbers are reduced, which will take up to four years to rebuild.
- Threshold 3 (March- April): Rainfall has an impact on the yields of late plantings. Only a small window exists for some growth of pasture but it is becoming limited. At this stage the dam levels and boreholes can be severely affected, which will have an adverse impact on long-term high value crops. Irrigation potential for winter crops will also be limited. Significant structural changes take place in the production of food with potential long-term impacts on food prices.

With the record low rainfall that was received during the recent October to February period in the key summer crop production regions, one can conclude that the first and second thresholds have been crossed in most of South Africa. Consequently, maize prices have

[1] BFAP is a research programme based at the University of Pretoria and University of Stellenbosch and the Western Cape Department of Agriculture. BFAP wishes to acknowledge funding by the Maize Trust and the NRF/DST Centre of Excellence for Food Security that made research supporting the above analysis possible.

[2] For a comprehensive overview of the effect of the drought please consult the BFAP policy review on the effect of the drought. Available at: http://www.bfap.co.za/documents/research%20reports/BFAP_Drought%20Policy%20Brief_5%20February%202016.pdf

jumped from export parity to import parity due to much lower plantings. Furthermore, livestock farmers had to slaughter into herds as pastures and availability of hay in many of the key livestock regions will not be sufficient for the winter. The cost of feed has also increased drastically, which has caused intensive livestock and dairy units to reduce stocking rates and cut back on production.

However, with the good rains in March, it is likely that we will not cross the third threshold, so the impact on long–term high value crops and irrigation is in most cases expected to be limited. Preliminary reports indicate that a drop in production of around 8-10% can be expected in this season but the damage is still limited to the summer rainfall regions, while most of the high-value commodities are produced in the winter rainfall region which has not been affected by the summer drought.

Because raw commodity prices contribute a small share of the price of final food items, cost pressures in the entire value chain must also be monitored carefully. The sharp depreciation in the exchange rate has not only caused parity price levels to increase drastically, but also works its way throughout the value chain. Therefore, over the next six months, cost pressures in the value chain will become more apparent in final retail product prices due to increases in distribution and manufacturing costs.

South Africans spend almost 50% of their food expenditure on bread and cereals, and meat. Bread and cereals play a significant role as the staple food of most South African households and their prominence is driven by the quantity consumed. In contrast, meat is a high value product, so its importance is based on value. We turn now to the inflationary impacts and the structural changes that will drive the prices of these two product groups over the next 18 months.

Maize meal prices are still rising, as it takes three months for maize prices to work through the full supply chain. However, in a combined effort industry and government are working to combat further increases, and more importantly to ensure that sufficient white maize can be imported. The local maize price is currently trading at the import parity prices derived from Mexico, since Mexico is the only viable source of white maize. Yet, if changes or short-term concessions can be made to the regulations for GMO imports, white maize can be imported from the US. It is estimated that this would result in landed white maize prices approximately 10% lower than import parity levels derived from Mexico, leading to a 5% decrease in the retail prices of maize meal. Furthermore, this will ensure that the targeted requirements in excess of 1.2 million tons of white maize will be imported in order to balance South Africa's supply and demand. South Africa cannot afford to run out of white maize.

Over the next 18 months, if rainfall in the 2016/17 season is normal, and with an average R/USD exchange rate of R16.44 for 2017, it is projected that average white maize prices for 2017 will be 36% lower than in 2016 as South Africa regains its status as a surplus producer of white and yellow maize. This will result in average maize meal prices being roughly 19% lower than in the current year.

Average wheat prices are expected to remain relatively stable from 2016 to 2017. South Africa imports almost half of its domestic requirements and the size of the local crop has little impact on prices - in fact, the world price, exchange rate and the import duty explain close to 90% of domestic price movements. Therefore inflation in bread prices was far less than maize meal since the depreciation in the exchange rate was partly offset by the drop in world prices and freight rates, and the drought had no impact on the local price. Hence, production costs, at least for a significant part of the raw material used in bread production, are unlikely to increase substantially. However, political and social upheavals, which can result in a significant depreciation of the exchange rate, could further support cost pressures in the value chain.

On 8 April the National Treasury announced an increase in the wheat tariff from R911.20 per ton to R1223.31 per ton. This represents a tariff increase of roughly 34%, which will result in an increase of some 6% in wheat prices and ultimately 2.5% in bread prices. Government and industry are in discussion to review the wheat import tariff mechanism. To this end, we propose that the current tariff is shifted from a dollar-based system to a Rand-based system. This will ensure that duties are not introduced when the exchange rate is already fuelling food price inflation.

Over the past few months the price of beef has been increasing, despite an increased level of slaughtering as a result of the drought. This is in part the result of attractive export opportunities brought about by the weakened exchange rate. Over the short term it is expected that strong export demand will further support prices. In the medium term prices will increase further due to cost pressures associated with feed and grazing availability. Cost push and demand pull factors are therefore driving red meat prices higher over the next 18 months. Overall we anticipate a major structural change in the beef industry. On top of the 10% increase in carcass prices over the past year, average beef auction prices are expected to increase by 14% between 2016 and 2017. Price increases associated with poultry products are expected to more moderate (around 7% year on year average). Price increases are curbed, to some extent, by cheap(er) imports from the Northern Hemisphere. Exchange rate pressures are however contributing to the restrained inflation (compared to other meat products) that is expected over the medium term.

There is no denying the fact that the current drought has brought South Africa's vulnerability with respect to the climate and the availability of water to the forefront. In times of crisis it is important that differences between stakeholders be set aside in order to address the real issues at hand. Interventions should, however not only focus on the short-run but also take the long-run consequences into consideration in order to improve South Africa's resilience in times of a drought.

To conclude, under the assumption of favourable weather conditions in the next production season along with a positive supply response to current high prices, staple food inflation will decline. In this regard, NASA in the US has reported that historical patterns would indicate that the El Niño phenomenon of the current season has reached its peak and that temperatures in the Pacific Ocean could start to decrease. This would support the probability of having a normal or even above normal rainfall season in 2016/17.

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