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Viewpoint

Scary potential for further fuel price jump in May

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Why does this matter to me?

Much of the focus on the implications of the Iran war has been on the increase in fuel prices last Wednesday, which could potentially push inflation up to 4.0%. Little has been mentioned about the fact that maintaining oil prices at elevated levels since the end of March implies a further substantial increase in fuel prices in early May. The figures are scary. Based on the average under-recovery through to yesterday in the month-to-date, petrol prices could rise by a further R4.70 per litre and diesel by a whopping R10.07 per litre in early May. This is even after incorporating the generous R3-per-litre fuel levy allocation to mitigate the April price increase and temper the damage to consumer spending, agriculture, and business.

This concession will now have to be extended at least through May, and even then, inflation is expected to rise to at least 4.5% in May. More concerning is the potential for inflation to shoot up further due to second-round price effects, especially in respect of food, as the war drags on. It means the Reserve Bank will have little option but to raise the repo rate at its May MPC meeting and might even have to do so by a full 0.5%. Much depends on whether the deadline offered to Iran tonight is met, in the absence of which there is likely to be a huge further escalation of hostilities that could see increased damage to oil and gas production facilities in the whole Gulf region.

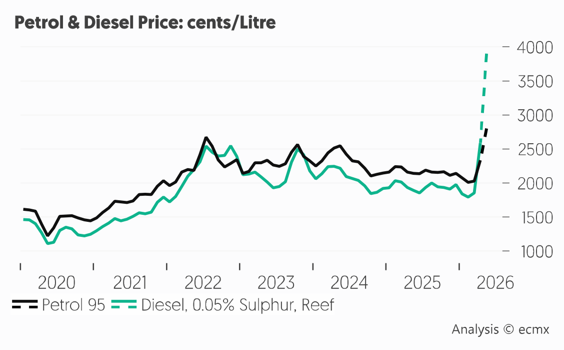
Dramatic further increase in under recovery on fuel

Much of the focus last week on the Iran war's implications for the South African economy was based on the extremely sharp increases in petrol to R3.06 per litre and diesel to R7.51 per litre, and on what these would do to inflation. The increases would have been R3 per litre higher still had the government not intervened, sacrificing R6bn in government revenue by reducing the fuel levy by that amount to alleviate the pain on consumers, agriculture, and business.

Unfortunately, one was shocked to peruse the latest fuel under-recovery figures for the new measurement month of May, from 27 March to 6 April. It clearly reflects the fact that oil prices, on average, have risen substantially further over this period than they did through March. The average under-recovery on 95 octane petrol amounts to no less than R4.70 per litre, whilst on diesel it is astronomically higher, at R13.12 per litre. Clearly, there is a significant shortfall in diesel production relative to petrol at overseas refineries due to the closure of the Straits of Hormuz.

The effects of a weakening Rand/Dollar exchange rate are relatively minor compared with the impact of higher oil prices, which have stubbornly hovered around $110 per barrel or more in recent days. The weakness in the currency accounts for just 37 cl of the R4.70 per litre shortfall on petrol and 63 cl on the R13.12 under-recovery on diesel. The rest is related to the surge in product prices.

One cannot be certain whether oil prices will remain at these levels through the course of May, but if they were to do so, it would mean that prices would have to increase on 6 May by equivalent amounts, taking the price of petrol up to over R28 per litre and diesel to R39 per litre. (If it's of any consolation to South Africans, these fuel prices are still significantly lower than those prevailing in Europe.)



This chart illustrates the potential rise in petrol and diesel prices in May.

Clear breach of inflation target

The impact on the headline CPI inflation rate, other things equal, of such increases in fuel prices would be to take the inflation rate for May up to 4.5% minimum. Why one emphasises the word "minimum" is that such a calculation is based purely on extrapolation of what fuel price increases would do directly to the headline inflation rate. It does not take into account the possibility of significant increases in the prices of a whole host of other product lines, most notably food prices. There has been a substantial increase of more than 50% in fertiliser prices. Furthermore, the cost of shipping and insurance has surged. So too has the cost of transporting food. Worse still, the real pain is reflected in diesel rather than oil. This affects the agricultural industry particularly hard.

Consequently, one suspects that there will be almost immediate elements of second-round price effects likely to emerge. The Reserve Bank will face a challenge maintaining credibility if it does not increase the repo rate in response to such a breach of the 3% +1% tolerance limit for inflation using the new target of 3%.

One is also rapidly recognising that even if there is a timely resolution to the Iran war and oil prices fall back sharply, much damage has already been inflicted on Middle Eastern production and refinery facilities to prevent refined petrol and diesel product prices from falling back commensurately to levels that prevailed prior to the Iran war. In other words, the scope for knock-on price effects is substantial. Indeed, there is an outside chance that the Reserve Bank might raise the repo rate by a full 0.5% at its May MPC meeting.

Much uncertainty surrounding resolution of the war

The implications for economic growth are increasingly ominous. Not only would higher interest rates imply an increase in debt servicing costs, but the erosion of disposable income from higher fuel prices could well erode the ability of consumers to spend.

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One is also very concerned about the agricultural sector, particularly how it can cope with such a shock in the face of increased production costs. Obviously, much depends on how quickly the war in Iran is resolved. However, there is significant uncertainty about the outcome and its effect on fuel prices.

One theory would be that the annihilation of Iran would expedite the reopening of the Straits of Hormuz and see oil prices tumbling. An alternative, however, is that Iran would retaliate in desperation and inflict greater damage on energy production facilities in the Gulf region, exacerbating the shortage of refined products from the region.

There is a further ominous implication in that these events are rapidly leading to an imperative on governments to increase their defence readiness at a huge cost to their fiscal situations. In a world where public debt in many leading countries has already surged to its highest levels in more than a century, one is confronted with the risk of an even greater escalation of such debt with potentially damaging implications for the financial health of the global economy. It could lead to a sharp rise in long-term interest rates over time, which would in turn raise the debt-servicing costs of governments carrying these high debts.

SA government to be forced to extend fuel levy cut

In respect of South Africa, the government will have little option but to extend the so-called temporary reduction in the fuel levy to cushion the economy from the full effects of the rise in fuel prices. Fortunately, it probably does have the wherewithal to maintain this relief for a good few months. As we have frequently suggested in our Viewpoints, South Africa is fortunate that the problems encountered globally are contributing to elevated precious metals prices. Indeed, the further upward pressure on public debt levels caused by the conflagration in the Middle East is likely to sustain such prices, as investors are increasingly likely to lose confidence in the currencies of highly indebted countries.

The potential windfall to the fiscus is substantial and could well be of the order of R50bn through the course of 2026. If that is so, then the government can afford to sustain a fuel subsidy for up to six months without allowing the fiscal deficit to balloon to levels not foreseen in the 2026 Budget. It is important to reiterate that this Budget provided for only a 5.1% increase in corporate tax revenue over the 2026/27 fiscal year. This is likely to be easily surpassed given the huge profits set to accrue to precious metals mining companies. Unfortunately, this is just partial consolation in the face of an increasingly scary global economic scenario.