

YOUR WEEKLY ECONOMIC UPDATE

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HIGHER INTEREST RATES IN SOUTH AFRICA

The South African Reserve Bank (SARB) has, again, increased interest rates by 0.25%. This is the third increase since December 2021, bringing the repurchase, or policy, rate that the SARB offers banks up to 4.25%. The SARB's quarterly projection model, a model used to guide the market but also to assist the SARB in making interest rate decisions, shows that interest rates should increase gradually in South Africa (SA) over the next few years. However, some analysts are expecting to see a more aggressive rate hiking cycle that will see interest rates go up to 5.75% by the end of 2022, another 1.5% increase from where we are now. The reasoning is that the SARB can use the slightly stronger economy, higher asset prices, and the healthy terms of trade to get ahead of higher inflation expectations. Even some of the Monetary Policy Committee members, the SARB's core team that makes the interest rate decisions, have started to vote in favour of higher interest rate increases. But another 1.5% will be a tough pill to swallow for already struggling consumers. It will imply that, over the course of a year, every R1-million debt that a household has would be R1 875 more expensive each month.

From our perspective, we still maintain that the current interest rate increases have less to do with inflation than they have to do with normalising interest rates and remaining competitive in global capital markets. Our conclusion is similar in that interest rates should increase by another 1% to 1.5% by the end of 2022. Except in a worst-case scenario, where oil prices reach and sustain levels around \$185 to \$200 a barrel, and the Ukraine is almost completely unable to produce key global agricultural commodities, there is no reason to believe that inflation will remain elevated in SA for too long. Our consumers simply do not have the confidence to pull inflation higher.

The case for normalising interest rates goes as follows: For too long, real interest rates, that is, nominal interest rates minus inflation, have been negative, benefitting consumers at the expense of savers. At its current nominal rate, the South African policy rate of 4.25% is still much lower than the current inflation rate reported by Statistics South Africa, which has remained unchanged at 5.75% in February 2022. Subtracting the two from one another shows that SA's short-term real interest rate is negative, -1.5% to be exact. In times of crises, it might be fair to support consumption, which, in many countries, constitutes the largest share of economic activity by offering negative real rates. But, once out of a crisis, it is important to offer sufficient returns for investors to attract both short- and long-term capital to boost both short- and long-term economic growth. Since 2008, SA has been a perfect case study to prove that it is a foolish idea to try and build an economy based on consumption through redistribution without the necessary productive investments. All we have to show for this misguided idea is record debt and unemployment figures, amongst others. It is, therefore, important for SA to retain positive real interest rates as soon as possible.

This brings us to the case for remaining competitive in global capital markets: Because the United States (US) increased interest rates, and should continue to do so throughout the year until their policy rate is somewhere close to 1.9%, it will be necessary for SA to follow suit. If we do not, the higher yielding, safer shores of the US will attract capital away from us as well as other countries. This will not be good news for any of our local markets, that is, the stock market, the bond market, or the currency market.

So, what does this mean for the rand? Usually, increasing interest rates is good for a currency because it attracts foreign capital. And although the US will, most likely, increase interest rates more aggressively than SA, we believe that the rand should remain strong against the US dollar. Since Nenegate in December 2016, the rand has been too weak and has only recently returned to what we consider normal levels. Add to that the shift in sentiment towards emerging countries and all the uncertainty about how the US economy will be able to cope with tighter monetary policy, and you have a strong case for a strong rand.