

ECONOMIC COMMENTARY

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YOUR MONTHLY ECONOMIC UPDATE

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THE TALE OF INTEREST RATE INCREASES

During July, the main themes on the economic front were interest rates and the fight against inflation. Most central banks across the globe have now set their firing power against inflation. Past rumours around 'transitory' (read temporary) inflation have long since quietened down. In fact, many analysts are now pushing out their forecasts for when they believe inflation will be back in the different target ranges that the central banks have set.

In South Africa (SA), the South African Reserve Bank (SARB) increased interest rates by 0.75% after Statistics South Africa (Stats SA) reported that annual inflation reached 7.4% in June, slightly outside of the SARB's target range of 3% to 6%. In total, the SARB has now increased rates by 2% since they started this hiking cycle in November 2021, increasing the repurchase rate to 5.5%, and the prime rate to 9%. Consumers who have been worn out by higher fuel and food prices, as well as low wage increases and job creation opportunities, are in a lot of pain. But even on a global scale, consumer sentiment is approaching all-time lows as consumers are wary about their financial prospects over the medium term. Our view is that local interest rates will probably increase by another 0.50% this year, and then by 1% to 1.5% in 2023.

In the United States (US), the Federal Reserve (Fed) also increased interest rates by 0.75% for the second consecutive month. These recent increases are the most aggressive tightening by the Fed in more than a generation, and have taken the federal funds rate (that is, the repurchase rate) up to 2% to 2.25%. Market observers compare these rapid increases with the price-fighting action taken by Fed Chair Paul Volcker in the early 1980s, shortly after inflation peaked at around 14.5%. US inflation has not soared to these levels again but did recently peak at a new four-decade high of 9.1%. For this reason, US officials expect the federal funds rate to reach 3.4% in 2022, and 3.8% in 2023. They are hoping that these additional increases of 1.15% to 1.55% can bring inflation back to their 2% target in late 2024, without pushing the economy into a hard recession in the next 18 to 24 months. Technically, the US has now entered a recession, after their Department of Commerce reported that the economy shrank in both the first and second quarters of 2022, by -0.9% and -1.6% respectively.

However, the US has not entered a 'hard' recession yet. This would be characterised by a broad-based and sustained contraction where unemployment increases rapidly. In fact, unemployment remains at a near record low of 3.6% and shows no signs of weakening. Whilst the overall economy shrank in both the first and second quarters, consumption increased by 1.8% and 1% respectively. Demand also remains high because of a decade's worth of loose monetary policy and the more recent support from fiscal policy. Mostly, it was inventory volatility that caused the contraction, wiping 2% off the economic growth figure. Inventory management has been very difficult the last two years, partly because of supply-chain problems and partly because of hyped-up demand. Higher interest rates have further throttled residential and business investments, which might continue to weigh down economic performance, but we see no sign of the US entering a hard recession. For now, the news of a technical recession will, most likely, not prevent the Fed from increasing rates until they see demand ease off, and unemployment starts to rise.

