EFFICIENT GROUP

Weekly Economic Newsletter

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ECONOMIC COMMENTARY

- By Francois Stofberg

Throwing Tantrums

At their last meeting, the US Federal Reserve (Fed) decided to keep interest rates unchanged – a decision that once again came as no surprise. One thing the Fed has done well in recent years was to lead markets sufficiently to avoid a blow-out, not only in their own market but also in international markets. Unlike interest rate decisions in South Africa (SA), where the impact is limited to SA, decisions made by the Fed can adversely affect many other countries.

Even before the taper tantrum in 2013, the Fed gave ample warning that quantitative easing (QE) would be halted and rates gradually increased to normal. However, even though markets were warned, countries who held US$-denominated debt felt the pinch when QE was slowed and interest rates increased. For one, higher interest rates meant that the debt these countries held would become more expensive. More importantly, many of the countries who held US$-debt were emerging economies who at the same time experienced a substantial decrease in the value of their local currencies. Depreciation like this amplifies the cost of debt repayments; if a country experiences currency depreciation they pay more of their local currency for each unit of debt. Higher interest rates have, however, not deterred emerging economies from borrowing even more US$-debt. Since 2009, US$-debt has increased by 83% to a level of $10.7 trillion – for the simple reason, that money is extremely cheap (compared to historic rates).

Like 2016, markets are once again convinced that the Fed will increase interest rates at their last meeting of 2017. Markets are also starting to price in more hikes in 2018, making certain emerging economies quite restless. Particularly countries like Chile, Mexico and Turkey, are dreading these increases. Not only have these countries experienced currency depreciations but they also hold large amounts of US$-debt. As a percentage of their total debt, Chile holds 35% US$-debt, Mexico holds 25%, and Turkey 23%. Luckily in SA, only about 10% of our total debt is US$-debt.

As the demand for US$-debt ballooned and the Fed started increasing interest rates, a strange symbiotic relationship emerged between the US and the rest of the world. Although the Fed talks tough, saying that their focus is limited to their own US economy and that they are not concerned with the rest of the world, things are a bit more complicated. Having countries default on the debt they owe the US will ultimately have an adverse impact on the US economy itself. Throwing a large enough tantrum might, therefore, halt the Fed's rapid rate increases expected in 2018.

In local news, producer prices increased by 4.2% in August, up from the 3.6% which was reported in July. The unexpected surge came as a result of large price increases in petrochemical products, as well as intermediary food products. The rate is still well within the South African Reserve Bank's (SARB) target range of 3% - 6%, and many analysts believe the rate should remain subdued for the remainder of 2017. Ultimately, lower producer prices imply that lower prices are passed on to consumers.