EFFICIENT GROUP

ECONOMIC COMMENTARY

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YOUR WEEKLY ECONOMIC UPDATE

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INTEREST RATES IN SOUTH AFRICA

Little over a week ago, the South African Reserve Bank (SARB) decided to increase interest rates by 0.25%, as we expected they would. With a slight 3-2 majority, the Monetary Policy Committee voted in favour of an increase rather than to keep the rates unchanged. Markets seemed unhappy with the news and the rand faltered. But we believe that this was caused by dollar strength and by a lack of clarity around why the rates were increased, more so than because of the SARB's dovish tone.

The SARB's mandate is to keep inflation in its target range of 3% to 6%. They do this by using the repurchase (repo) rate, commonly referred to as the "interest rate" or "short-term interest rate". This rate is the rate that they charge banks who borrow money from them to keep their reserve ratios in line with legislation. South African banks are required to keep 2.5% of the money we deposit in cash reserves, the rest they can loan out. If, however, after a day of money flowing in and out, they realise that they have less than 2.5%, they must borrow from the SARB, at the repo rate. So, if the SARB increases the repo rate, the banks usually follow suit, otherwise they make less money from loaning money to me and you. It should be noted that this process is about to change, but, in theory, the new system should have the same impact.

In South Africa (SA), unlike elsewhere in the world, our banks formed a coalition to charge a fixed 3.5% on top of the repo rate as a starting, or base, interest rate. This rate is known as the "prime interest rate". It means that the banks in SA are already making 3.5% on whatever they loan to us. If they thus charge you a prime plus rate, they earn even more. Using repurchase rates in this manner is the most basic of monetary policy tools. Central banks in rich countries have a couple of additional levers that they can pull, such as quantitative easing, where they simply print more money and buy assets from banks. In this way, they force more liquidity into the economic system, and try to get banks to loan out more, to boost the credit cycle, which can, in turn, grow the economy. In practice, however, things did not play out like that: Even though banks were reluctant to loan out more money, which ended up having no real effect on economic performance, markets still priced in better growth, which led to asset price appreciation, most notably among equities.

This brings us back to the SARB: Inflation is not an issue, so why increase the interest rate? In fact, inflation in SA is lower than in most developed countries, and will remain well within the SARB's target range and well below our ten-year inflation average. We believe that, in this case, the increase had more to do with protecting and preparing consumers for what lies ahead, the unsustainable nature of negative real interest rates, as well as international capital competitiveness.

Waiting too long to increase interest rates can make it a lot more difficult to retain inflation, which ends up meaning that interest rates must be adjusted by a greater percentage and a lot faster. Multiple, incremental increases are, therefore, more palatable. Increasing interest rates by 0.25% means that every R1 million of debt you have becomes R208 more expensive each month, which most households will be able to carry. But being forced to increase interest rates by 3% means that each R1 million of debt becomes R2 500 more expensive each month. That being said, the real reason probably has more to do with the unsustainable nature of having negative real interest rates. If inflation is expected to be 4.5% in 2021, but the repo rate is only 3.75%, it means that real (inflation-adjusted) rates are negative. This means that consumers (with credit) are benefitting at the expense of savers, who must borrow to those consumers at negative rates – it does not really make sense because everyone knows that you earn positive interest if you loan money to someone. In the short-term, central banks use negative rates to boost consumption and support economic recovery. But, in the long-term, this reduces the demand for investment, which stifles growth, especially in a developing country like SA, which still needs a lot of capital investment. So, to be more attractive to investors, the SARB increased interest rates, but not too quickly as to ruffle the feathers of struggling consumers. Expect more increases in the upcoming months; the SARB will most likely increase interest rates by 0.75% to 1.50% in 2022.

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