

WHY MORE INTEREST RATE INCREASES IN SOUTH AFRICA DO NOT HELP

To understand why more interest rate increases in South Africa (SA) may not effectively combat inflation, one must first understand the broader economic factors that contribute to higher inflation rates in emerging countries when compared with developed nations. According to research conducted by various institutions, including the International Monetary Fund (2018), the World Bank (2021), Alhassan and Biekpe (2020), and our own studies, weak economic fundamentals, political instability, commodity dependence, exchange rate volatility, and the United States (US) dollar surcharge, are major contributors to relatively higher levels of inflation in these countries.

Despite the South African Reserve Bank's (SARB's) status as an independent and healthy institution, the country's poorly-managed state and lack of fiscal discipline negate many of the benefits that a strong central bank may provide. Political instability further exacerbates the issue. Also, as a commodity-dependent country, SA is susceptible to inflationary pressures when global demand for scarce resources increases. Furthermore, with a volatile currency and a reliance on imports, SA is vulnerable to import inflation.

Typically, exchange rate disparities are driven by inflation differentials between countries and a 'sentiment' factor, which represents consumers', businesses', and investors' perceptions of a country. In SA, inflation differentials have accounted for nearly 73% of the difference in the USD/ZAR exchange rate since 1980, with sentiment contributing to the remaining 27%. However, sentiment can be volatile in the short term, resulting in exchange rate fluctuations. For example, negative long-term sentiment towards emerging markets, particularly SA, most likely caused the rand to depreciate by 7.75% and 16.42% in 2021 and 2022, respectively, despite having lower inflation rates than the US.

Developed and competitive countries, such as the US, Japan, Germany, and Switzerland, typically have strong exchange rates owing to lower inflation rates and supportive sentiment, which attract short-term capital for investment in their financial markets. In contrast, countries that are competitive but not developed, such as China, India, Malaysia, and Mexico, may have strong exchange rates in the short term owing to supportive sentiment but weaker rates in the long term owing to higher inflation rates. These countries often attract long-term capital in periods of positive sentiment where the return on investment can more than make up for an underperforming currency in the long term. The SARB's attempt to attract either short- or long-term capital and support the exchange rate, and thereby inflation, is, therefore, rather futile. Higher real interest rates in SA have been largely ineffective in supporting the rand. Since 2008, while the SARB persistently kept real interest rates higher than those in the US, the rand depreciated more than 125% from R8/\$1 to more than R18/\$1 in 2023. It even depreciated more than the 96% average depreciation of counterparts such as Brazil, Russia, India, China, Indonesia, and Malaysia, among others. The only ones who have benefitted from higher positive rates in SA are the handful of households with more assets than liabilities.

Finally, there is the US dollar surcharge, whereby the US uses their reserve currency status and their ability to generate excessive demand for globally-traded goods and commodities by using tools such as record-low interest rates, quantitative easing, and large stimulus checks to drive up prices. When inflation eventually occurs in the US, the Federal Reserve will increase interest rates, causing the dollar to appreciate significantly, thus exerting inflationary pressure on emerging countries owing to their declining buying power.

For these reasons, we have consistently cautioned against the rate and the size of the SARB's interest rate increases. In the past, this blunt tool might have been sufficient to address inflation. But today, where broader economic factors contribute to relatively higher inflation, it is more likely to be ineffective and places an unnecessary burden on a country that is already under severe strain. We agree that price stability is important for a healthy, growing economy, but we believe that the SARB has lost touch with the citizens they serve. Slightly higher inflation with lower interest rates would be easier for most families to stomach.