EFFICIENT GROUP

ECONOMIC COMMENTARY

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YOUR WEEKLY ECONOMIC UPDATE

27 September 2023

THE ANSWER TO SOUTH AFRICA'S PREDICAMENT IS COMPLETE STATE REFORM

In his address to the public last week, Lesetja Kganyago, the Governor of the South African Reserve Bank (SARB), announced that the Monetary Policy Committee will keep the repurchase rate unchanged at 8.25%. This came shortly after Statistics South Africa showed that consumer prices were contained well within the SARB's target range of 3% to 6%. After a decrease to 4.7% in July, prices only marginally increased to 4.8% in August, driven mostly by higher food, household, and utility prices. Interestingly, the cost of transport, which includes fuel prices, was lower compared with a year ago.

Looking forward, the recent fuel price increase can add some inflationary pressure in the short term but a persistently weak economy will continue to be a drag on higher prices. The Organisation of the Petroleum Exporting Countries (OPEC), the world's largest oil cartel together with Russia, wants to increase fuel prices to $100 a barrel, up from current levels around $94. However, we believe that the shale gas producers in the United States (US) will help to contain prices over the next year or so. Also, compared with many other emerging market currencies, the rand has been hit the hardest over the last year. Should markets start to expect that the election in South Africa (SA) will not be an absolute worst-case scenario, we should see some rand strength or, at least, no further deterioration. This means that inflation in SA should be a thing of the past. This, in turn, means that there should be room to start reducing interest rates, unless the rest of the world is stuck in a high inflationary environment.

It is noteworthy that, compared with other emerging markets, our prime interest rate is not too high. The prime interest rate in Brazil is 12.75%, in Russia it is 13.00%, in India it is 10.10%, in Turkey the rate is 31.50%, and in Indonesia it is 8.52%. But, even though households in these countries face higher interest rates, their overall economies are faring much better, barring some exceptions. Interestingly, the real (inflation-adjusted) rates in SA, especially those of our 10-year government bonds, are of the highest in the world. Yet, we are still unable to attract sufficient short-term capital to support the rand. One of the main reasons for this is international sentiment: Investors are simply too risk-averse to take a chance on emerging markets, and simply too well incentivised to keep investing in countries like the US. For this reason, the SARB can increase interest rates to the moon but it will probably do very little to attract sufficient capital to SA in the short term. Another reason, of course, is the dire state of our economy.

Two macro-economic deficits help us to understand our particular predicament. First, the budget deficit: Our government not only spends too much but we also spend on the wrong things. Persistently spending more than you earn will bankrupt you and this is exactly the direction our government is spending us into. Our government also spends too much on social upliftment, like spending on grants and wages, and too little on economic upliftment, like spending on capital (infrastructure, machinery, software, etc.). Overall, this deteriorates not only our state finances but also the economy, which means long-term interest rates must increase to accommodate for the higher risk of investing in SA. This, in turn, means that our government must spend more on interest and have less to spend on critical items. Second, the current account deficit (CAD): Running a CAD means that we import more than we export, which means we demand foreign currencies relatively more than our local currency (which must be balanced by our financial account), which means that our rand will remain relatively weak. These systemic shortcomings can only be addressed by a complete state reform: Better politics (accountable leaders who take ownership), which can lead to better policies (economic and not social upliftment), which can create the environment needed to attract short-term capital (money invested in our markets) and long-term capital (foreign direct investments, and local businesses who are willing to take a chance and create wealth and jobs).

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