Economic Overview for Business Owners

November 2018

The Reserve Bank, the Rand and Interest Rates

Following outright declines in real GDP growth in the first two quarters of 2018 it hardly seems the time for the Reserve Bank to consider hiking interest rates. However, at the conclusion of the Bank's September 2018 Monetary Policy Committee meeting only four of the seven committee members preferred to leave the repo rate unchanged. That was a 'close call' and is a warning that the Bank will act if needed. The key reason for this is the Bank's assessment that inflation risks are skewed to the upside.

I imagine a number of economists would argue it is not clear-cut that an interest rate hike is needed at this point. After all, inflation is not, given current information, expected to breach the upper limit of the inflation target range for a sustained period over the medium term forecast horizon of the Reserve Bank.

Further, domestic demand and credit extension data are subdued and do not suggest excessive demand will be a source of inflation pressure anytime soon. Rather, inflation risk is to be found in supply-side shocks and elevated regulated and administered prices (for example, petrol prices and electricity prices).

Encouragingly, GDP growth is expected to lift into 2019, supported by expectations of an improvement in investment spending. President Ramaphosa's recent Investment Summit was especially promising, because of its emphasis on co-operation between government and private sector companies. It is from this perspective that the R290 billion worth of investment projects announced for the next few years is significant.

Lift-off is, however, unlikely to be rapid, given the structural constraints confronting the economy. The investments announced in part reflect existing and ongoing investment in some of the sectors involved. Also, there will be significant import leakages associated with the announced projects. On balance, the impact is likely to be positive, but the anticipated acceleration in economic growth into 2019 is likely to be moderate only.

The Bank is keenly aware of the challenges faced by the economy. But there are a range of factors the Monetary Policy Committee (MPC) must weigh up in reaching interest rate decisions.

The most notable of these is the sharp upward shift this year in the expectations of market participants for the future path of the US policy rate. The US Federal Reserve Open Market Committee (FOMC) is mindful of the risk posed by the country's low unemployment rate and its fiscal expansion to inflation expectations and outcomes. Accordingly, the FOMC, which has already ended its quantitative easing programme, continues to signal further interest rate hikes.

This implies tightening of financial conditions for emerging market economies. The focus is on those countries running macroeconomic imbalances, including South Africa.

In turn, the accompanying slump in the Rand exchange rate is a risk to inflation. At least, the pass-through from changes in the currency to inflation has been muted relative to the longer-term history of South Africa. However, against the backdrop of closer scrutiny of policy stances South Africa's failure to implement successful fiscal consolidation is an additional source of upward pressure on real interest

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rates.. Minister Tito Mboweni's Medium Term Budget Policy Statement speech hit the right notes and suggests a turning point is at hand. But time is needed to steady the fiscal ship.

The Bank does not target a level for the Rand exchange rate, but should the currency weaken to the point where it threatens to fashion a sustained breach of the inflation target, the MPC can be expected to act in keeping with its mandate – even if the level of real economic activity is weak.

Given the current level of the Rand, we do not seem to have reached the point as yet. But the probability of an interest rate hike in late November or early next year is not nil. Much depends on the direction of the currency.

The key point, though, is that in times of extreme currency volatility the credibility of the central bank is of paramount importance. If the Bank can anchor inflation expectations at a suitably low level it should help anchor the Rand exchange rate. South Africa has a credible central bank and it is important that its independence is maintained.

Meanwhile, it should be noted that the SA Reserve Bank has signaled its intention to guide inflation expectations and outcomes towards the middle of the inflation target range (i.e.4.5%) *in the long run*. It is mindful of not damaging South Africa's fragile economic recovery in pursuit of this objective, but, even so, if the Bank succeeds in its objective, it is likely to extend the current trend in lower nominal GDP growth relative to history.

If so, one possible implication of this for South African companies is lower domestic company earnings momentum in current prices relative to history. In turn, this implies a keener focus on sales volumes.

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