



ECONOMIC COMMENTARY - By Dr. Francois Stofberg

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INTEREST RATES AND INFLATION

Last week the South African Reserve Bank (SARB) cut South Africa's repurchase (repo) rate by another 0.50% to 3.75%. This marks the third cut over the last couple of months, a total reduction of 2.50%. Seeing as our expectation for inflation is around 2% for 2020 this still leaves some room for more cuts. In times of crisis, positive real interest rates (nominal rates minus inflation) are not as important as they are during expansion when positive rates help to fuel more investments, and with it, long-term economic growth. During crises, however, the disposable incomes of consumers are under pressure, something South Africans are experiencing first-hand, in which case having to spend less on debt can make a difference.

We saw something a bit counterintuitive after the rates were cut: the rand appreciated. Theory often predicts that when interest rates are cut, consumers spend more, driving up inflation. With that inflation differentials (differences in inflation between countries) are also higher and as a result a country's currency devalues. Lower interest rates are also less attractive to foreign capital. A reduction or slowdown in foreign capital, in turn also puts pressure on a currency to devalue. But as we have explained in the past, the "market" is nothing else but the collective of all of us, all our wants, needs and the eventual decisions we make because of them. Just like us, the market can therefore also be quite emotional, especially if the market is lied to. A good example is the asymmetric information that was in the market leading up to the global financial crisis in 2008. During this time markets believed a couple of things that turned out to be a lie. The two most prominent lies were probably that:

- + extremely low interest rates could be maintained in a healthy, growing economy and market;
- + the trillions of dollars in debt that was being issued in the United States was secured.

When markets realised that they had been lied to, they crashed. But markets can also be relieved. Relieved that what was expected to occur didn't, and most likely we saw the markets relieved when the rand appreciated. Markets were expecting an interest rate cut and most likely believed that it might increase spending more than inflation, in which case the real (after inflation) part of the economy grows faster than expected.

We will be discussing inflation in more detail as the months progress but for now it's important to note that we don't believe inflation will remain as low (both locally and abroad) as we've seen over the last 5-10 years. In the past, technology, trade (globalisation) and titans (industry) have been very deflationary. What we've seen since United States President Donald Trump announced the trade war, is that these deflationary drivers are most likely going to come to a standstill, and possibly turnaround. Globalisation, although wonderful on aggregate, has not been as good for specific income-cohorts in specific countries. Titans of industry have also reduced the negotiating power of labour (unfortunately not in South Africa) and both industry and technology have reduced the amount of labour in economies. The result has been low to no growth in the real wages of the masses and the result was the rise of Donald Trump and Brexit. It's also becoming ever more difficult to move production to cheaper countries because there just aren't as many of them left. Enter COVID-19, and the inflationary process that was initiated many years ago is accelerated. Except for the turnaround in the deflationary dynamics of technology, trade and titans, fiscal expansion is one of the greatest catalysts for inflation. As countries spend more to save lives and livelihoods, the increase in fiscal expenditure can easily become a high difficult to get off from.

