Moses Kotane Institute

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COMMENTARY

Interest Rates Review

Elton Chinyanga, 31 May 2020

MKI Economics Commentary is a brief note intended to provide MKI's interpretation of key economic events such as the Budget, MTBPS, Monetary Policy (Interest Rates), Employment, data releases and other topical economic events.

SARB CUTS INTEREST RATE BY 50 BASIS POINTS

The Moses Kotane Institute notes the 50-basis points reduction in the repo rate to 3.75% effective Friday 22 May 2020 by the South African Reserve Bank (SARB)'s Monetary Policy Committee (MPC). This takes the prime commercial lending rate to 7,25%. Three members of the MPC voted for a 50-basis points cut while two preferred a 25-basis points cut. The reduction is by and large necessitated by the worsening economic contraction from the COVID-19 pandemic and comes hard-on-the-heels of a 100 basis points cut in April 2020.

HIGHLIGHTS FROM THE SARB MONETARY POLICY STATEMENT ON 21 MAY 2020

- The statement notes the generally observed robust policy responses by countries to the global Covid-19 crisis with magnitudes dependent on the degree of policy space.
- SARB currently expects GDP in 2020 to contract by a massive 7% compared to the April 2020 estimate of 6,1%, even as the lockdown is relaxed in coming months. Investments, exports and imports are expected to decline sharply.
- The Bank's headline consumer price inflation forecast averages 3,4% in 2020 and 4,4% in 2021 and 2022. Forecast for core inflation is lower at 3,5% in 2020, 3,8% in 2021 and 4,1% in 2022.
- Overall, risks to inflation outlook appear to be on the downside, with global producer price and food inflation appearing to have bottomed-out. Oil prices remain low but have recovered somewhat.
- Barring some noted risks (such as heighted fiscal risks) inflation is anticipated to be contained to within the mid-point range (of the SARB's inflation range of 3-6%) for 2021 and 2022.
- The SARB's Quarterly Projection Model expects two further repo cuts of 25 basis points in the next two quarters of 2020

EFFECT ON HOUSEHOLDS AND BUSINESSES

The Repo rate is the benchmark rate that the SARB lends money to commercial banks. By lowering the repo rate, the SARB makes borrowing cheaper and more accessible. When consumers and businesses can access credit, aggregate demand increases, lifting the economy in the process. The recent cut will give the economy a boost amidst the Covid-19 pandemic.

An interest rate cut means borrowers will pay lower interest on the money they owe to the banks. Those looking to make big purchases can be optimistic as they stand a better chance of receiving higher financing due to the repo rate cut. Consumers also realise significant monthly savings on other loans with banks such as personal loans, credit cards and car finance.

With the interest rate cut, businesses can borrow more readily. Low interest loans can fund business growth thus increasing profitability as businesses earn enough off new ventures enabling them to pay their loan interest and still retain some profit. On the other side of the coin, the overall banking system should see a boost in profitability from the increased lending business. As bank loans become affordable, consumers can borrow and spend more while spending less in borrowing.

RAND LEAPS AGAINST THE POUND AND OTHER MAJORS

The Rand leaped 1.5 % against the Pound on the news of the SARB's decision to cut the interest rate by 50-basis points. The decisive cut rallied the Rand as investors saw the decision as being supportive of a South African economy battered by coronavirus induced lockdowns. The reaction suggests the cut was deeper than what markets had expected. The Pound-to-Rand rate recorded a 1.52 % fall to reach 21.60 while the U.S Dollar-to-Rand dropped to 17.64. The Euro-to-Rand exchange fell to 19.36, a 1.6% fall.

FURTHER RATE CUTS LIKELY

The SARB's Quarterly Projection Model expects two further repo cuts of 25 basis points in the next two quarters of 2020. Together with bond-buying, the SARB has shown willingness to act in a data dependent manner. It should be noted that the SARB's Quarterly Projection Model remains a broad policy guide, which changes from meeting to meeting in response to new data and risks.

COMMENT ON THE ECONOMIC IMPLICATIONS OF CENTRAL BANK INTEREST RATE MEASURES

The SARB should be lauded for the latest rate cut which will provide relief to consumers and businesses strained by the health, social and economic effects of Covid-19, through lower cost of borrowing and access to funds. Monetary policy can ease financial conditions of households and businesses considering the economic implications of Covid-19. However, it should be reiterated that monetary policy's core mandate should be to ensure price stability while taking account of economic developments. Monetary policy can only create conditions favourable for economic growth temporarily. In the long-term, expansionary measures via monetary policy cannot achieve a lasting stimulation of aggregate demand. Such a policy will have an inflationary impact and can potentially destabilize the economy.

CONCLUDING REMARKS

It is our considered view that caution should be exercised in the interest rate cuts by considering the implications on the rand exchange rate and possible capital flight. The rate cuts should, in the current circumstances, be supported by the stepped-up government bond purchases in the secondary market as recently announced by the SARB. Fiscal measures should be additionally supportive, notwithstanding the constrained fiscal space that the country is faced with. Rate cuts may help but they may not be sufficient to counter the negative pressures on investment, exports and imports vested upon us by the Covid-19 pandemic. More needs to be done.