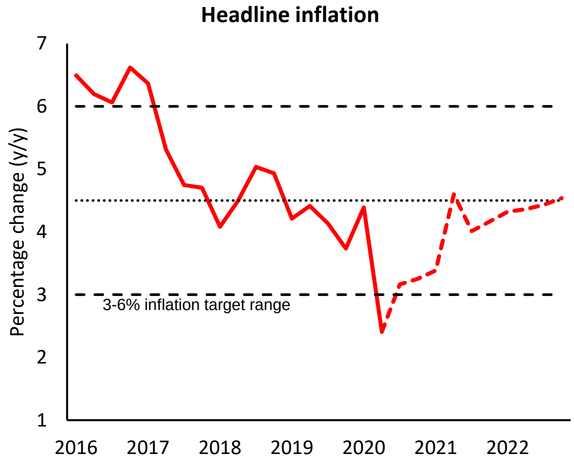
Monetary policy now: a five-minute summary

SOUTH AFRICAN RESERVE BANK

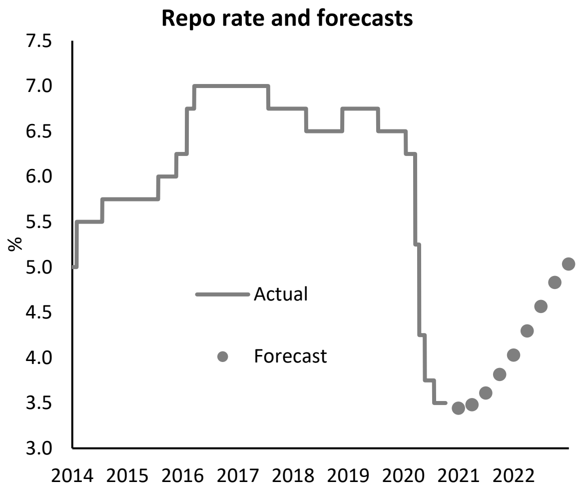
The SARB has just released its six-monthly *Monetary Policy Review*, a comprehensive updated on monetary policy. But maybe you don't have all morning to read that, so here's the short version.



Sources: Stats SA and SARB

Interest rates are very low at the moment. In fact, the last time prime was this low was in the 1960s. These low rates are a response to the huge COVID-19 shock, which has caused the biggest economic contraction in South African history (we expect the economy to contract by 8.2% this year). More than 2 million people lost their jobs between April and June 2020. Given lower oil prices and weak demand, inflation has fallen significantly: it was 4.5% in January and it's 3.1% now. We have had two months of inflation below the 3-6% target range. In this context, the SARB cut the repo rate from 6.25% (as of January) to 3.5% - one of the biggest rate reductions implemented in any country.

Lower interest rates take some time to affect the economy. In normal conditions the biggest effects arrive after 12-18 months. Knowing this, and realizing early on what COVID-19 would do to the economy, the SARB cut interest rates up front. The two biggest moves were in March and April. Later on, when inflation fell below the target, questions arose about why we weren't doing more large cuts. Our decisions were based on data outcomes which were close to our forecasts.



Sources: Bloomberg, Reuters and SARB

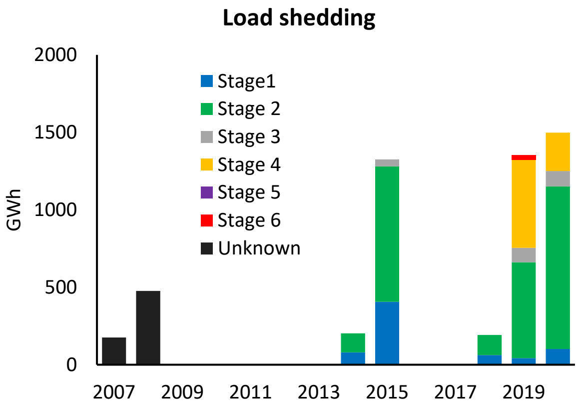
By the middle of the year monetary policy was mostly in wait-and-see mode, with some fine tuning but no big changes. This doesn't rule out further rate moves: if the facts changed, we would respond accordingly. From what we know now, a repo of 3.5% looks about right, but this judgement isn't set in stone.

Our best estimates now are that the economy will continue to recover and inflation to rise back to about 4.5%. As a result, interest rates are likely to gradually rise after 2021, but to remain on the low side, seen from a longer-term perspective. That outlook could change if the facts change, for instance if the recovery is stronger than expected, or if there is a big, new inflation shock.

What are low rates doing for the economy? In the early stages of lockdown, rate cuts mainly helped people with existing debts, by reducing interest costs. Now that restrictions on economic activity have been eased, low rates are also encouraging people to borrow for new purchases. The number of new mortgages granted, for instance, has climbed to a ten-year high. It is clear that some households are under intense pressure from lost jobs, and the outlook for the economy is uncertain. But we are still seeing demand for credit.

Low interest rates are also helping government borrow more cheaply. Despite losing investment grade status, government's average interest rate has declined this year. This is happening, in part, because National Treasury is issuing more short-term debt, which is closely tied to the low repo rate set by the SARB. (Cheap loans from the IMF and others have helped, too.) The SARB has also been intervening in the bond market to keep it functioning, further supporting government efforts.

Another headwind to recovery is electricity shortages. This year's load-shedding has been the worst yet, despite a huge slowdown in economic activity. The new power stations don't work properly, the old ones haven't received necessary maintenance, and progress on adding additional capacity has been slow. Electricity shortages will continue to hamper economic activity and deter people from making new investments.



Source: CSIR

Overall, South Africa has just completed its worst growth decade on record, and the 2020s are off to a bad start. It is a good thing that inflation is under control, because this protects people's spending power and allows low interest rates. Other economies don't have low inflation, and we shouldn't take this advantage for granted. As we have said on many occasions, however, economic prosperity is a team sport. The central bank is just one player, with a relatively narrowly defined role. Its main contributions are protecting financial stability and controlling inflation. These things are necessary for balanced and sustainable growth, but they aren't sufficient. Economic success will require contributions from everyone on the national team.