

CURRENCIES HIT BY US INFLATION FEARS

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After a lengthy absence, inflation has started grabbing international financial headlines again, especially due to the higher inflation forecast by the US Federal Reserve's Open Market Committee.

In April, this Committee was of the opinion that US inflation would end the year at a level of 2.4%. Two months on, and the same Committee now expects the US consumer price index (CPI) to be a full 100 basis points higher.

Higher consumer inflation in the US and in several other countries has been attributed mainly to the swift economic recovery from the Covid-19 pandemic, which has led to a surge in pent-up demand as key economic sectors return to normality.

This phenomenon has resulted in global supply chain disruptions, which has been exacerbated by the uneven geographical pattern of recovery. According to some US economists, shortages of labour and intermediate inputs have caused the current spike in the consumer price index, but it is likely to dissipate as suppliers continue to ramp up production to pre-Covid levels.

% Decline against the US dollar between the first & third weeks of June - selected currencies			
	%		%
South African rand	-5.9	British pound	-2.7
Polish zloty	-4.7	South Korean won	-2.5
Mexican peso	-4.6	Chinese yuan	-1.7
Turkish lira	-4.3	Russian rouble	-1.7
Chilean peso	-4.2	Malaysian ringgit	-1.3
Euro	-2.9	Argentine peso	-0.8

Sources: Oanda; own calculations

The past two weeks has once again demonstrated how important developments in the US economy are to the performance of global capital markets. It was particularly visible in the sudden and pronounced depreciation of virtually the full spectrum of international currencies, with the South African rand taking a knock of almost 6% in the space of less than two weeks.

Fortunately, there was no reason for the country's economic policy makers to be overly concerned, as the rand was in pretty good company. From Europe to South America and throughout Asia, currencies felt the brunt of what is likely to be a short-term switch to a risk-off sentiment amongst global fund managers.

The short-term power of perception

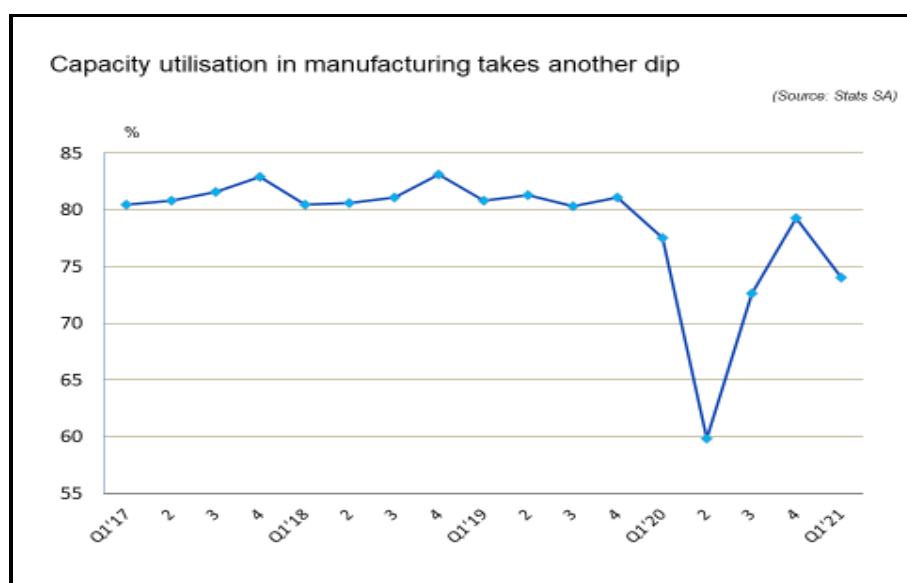
Global equity markets also took a beating, as investors started to favour US bonds again. Initially, it seemed like a monumental overreaction to the so-called new "hawkish stance" by the Fed, as the prospect of a marginal increase in the official bank rate (the federal funds rate) in two years' time, from a current level of only 0.25%, was no reason to spook the markets.

The real concern was about the magnitude and timing of the Biden administration's extravagant new stimulus programme at a time when the economic recovery in the US had started to gain traction, aided by massive pent-up demand and progress with achieving herd immunity via a highly efficient vaccination campaign.

Prices of all categories of goods, from cars to food, have risen sharply in recent weeks and the authoritative economist Lawrence Summers (a former Treasury secretary under Bill Clinton) is amongst those that fears a serious escalation of inflationary pressures.

Back home, South Africa has also witnessed a marked increase in the CPI. After recording an average rate of inflation of 3.2% in 2020, it rose to above 5% in May, leading to concerns that the SA Reserve Bank may start increasing the repo rate again soon.

Hopefully, the monetary authorities will take three important aspects into consideration when next they meet to decide on the fate of millions of indebted households that will suffer from any increase in debt servicing costs at a time when the economic recovery in several sectors remains fragile.



Firstly, demand has not remotely recovered to a level where fundamental price stability is being threatened. This is quite clear from the data on capacity utilisation in manufacturing, which has not yet recovered to above a level of 80%, and declined again in the first quarter of 2021. Insufficient demand represents the single most important reason for the high level of under-utilised manufacturing capacity and raising interest rates will undoubtedly exacerbate this problem.

Secondly, new investment in productive assets was woefully inadequate even before the pandemic and remains on a downward trajectory. Raising the cost of capital formation via a hike in the repo rate will act as a further disincentive for this much needed component of demand.

Thirdly, it is fairly obvious that the public sector, which is primarily responsible for administered prices, is the guilty party in the latest upward trend for the CPI. In the absence of administered prices, South Africa's latest CPI reading would have been 3.6%, a full 160 basis points lower than the May headline CPI of 5.2%.

Until such time as the inefficiencies in the public sector are addressed and government finds the courage to curb the power of public sector trade unions, inflationary pressures will not dissipate.