MONETARY POLICY AND WORKERS

By: Public Servants Association (PSA)

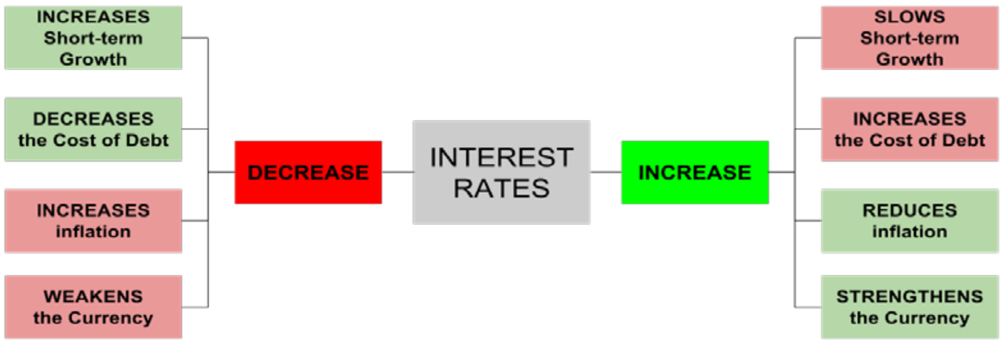
Introduction

The function of designing monetary policy lies with the Reserve Bank. On January 28, 2016, the South African Reserve Bank announced a 0,5% increase in the country's main interest rate, the repo rate. It followed on the heels of two increases in 2015: 0,25% in July and November. This signaled a significant break from a period of stable, low rates over the last five years. The decision was by no means an easy one, coming as it did in a climate of economic apprehension. At the latest rate's decision, the six-person Monetary Policy Committee, which decides on interest rates changes, was split three-to-three, with two of the remainder voting for a 0.25% increase and one voting for no change. The change is very significant on a number of levels. This article explores the impact of interest rates, and how changes in that regard affect workers.

How do workers feel it?

Increasing or decreasing interest rates creates costs and benefits. Setting interest rates too high or too low can be equally dangerous. For workers, every change brings opportunities and concerns. An overview of the impact of interest rates can be seen in Figure 1 below, depicting the effect a decrease in interest rates (left bar) or increase (right bar) has on the macro-economic environment.

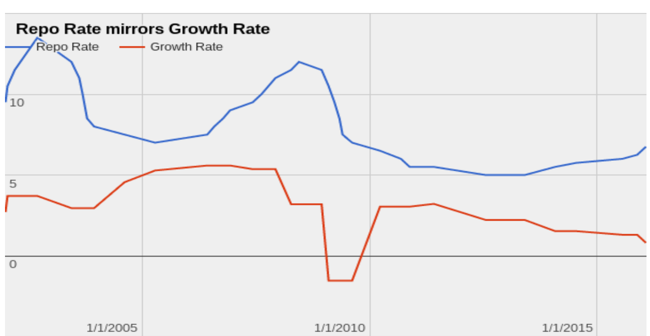
Figure 1: interpreting interest rate changes



Growth

Regarding growth, increases in interest rates tend to slow economic growth, at least in the short term. Interest rates achieve this by making debt more expensive, and discouraging the type of borrowing that is used to build new factories or expand the workforce. This may seem strange, since any policy that reduces growth would seem to make little sense, but in the long-term this slowing effect can be good for growth overall. Economies that boom (grow exceptionally fast) can overheat and spiral towards an economic crash. The slower growth promoted by lower interest rates can often be more stable over the long-run, and help the economy fend off the threats of crashes or other serious economic problems. Central banks often only focus on growth during periods of crisis. After the global economic crash of 2008, central banks around the world slashed interest rates, often to zero or into negative rates, in an effort to boost short-term growth and fend off the impact of the crash.

Figure 2: repo rate and growth



Inflation

The primary focus of most central banks, and the counterweight against which the growth effect is considered, is on managing inflation. Higher interest rates tend to decrease inflation. Inflation is damaging for a number of reasons: it makes everything more expensive for everyday people, it discourages savings by eroding the real benefits on offer, and it might encourage risk-taking amongst firms. South Africa employs a policy of inflation targeting, which aims to keep inflation between 3% and 6%, a range that interest rates have remained close to since 2009.

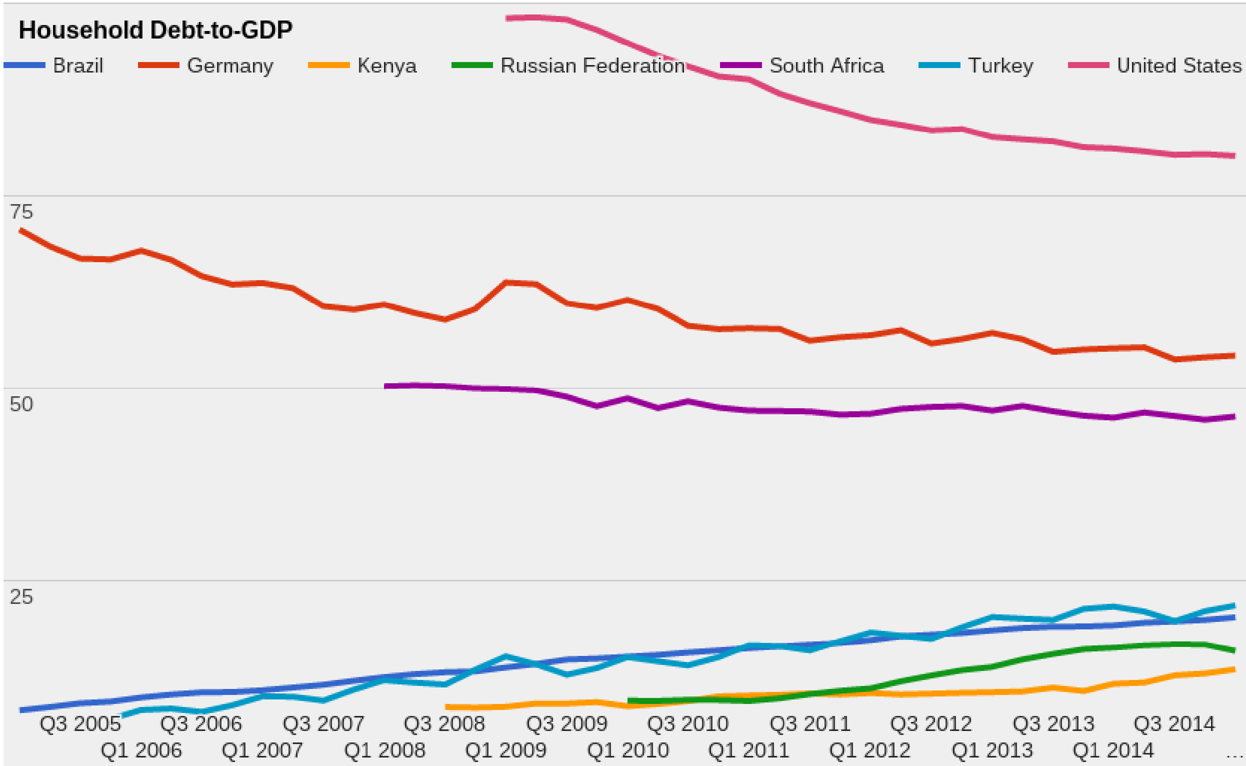
Figure 3: inflation trends

Inflation has a number of extremely important consequences for workers. The CPI usually acts as the baseline measure for salary negotiations, and strong inflation rates can often encourage larger wage settlements. Higher inflation, however, is often used as a de facto measure to decrease real salaries. Since workers will rarely accept salary cuts, salary increases that are below inflation are used as a mean to decrease real wages.

Cost of debt

The most direct impact of an interest rate change for the average person is the effect on the cost of debt. South African households tend to have a wide variety of debt products, including: home loans, vehicle finance, credit cards, overdraft facilities, and retail credit from stores. Most of these tend to be linked to the headline interest rate. These instruments become more expensive to repay as the rate increases. In other words, interest rates represent the cost of debt. On the flip side, savings and investments generate more money, but the average South African is much more likely to have debt than significant savings - especially amongst the poor.

Figure 4: comparative debt levels



South Africa's debt-to-GDP ratio for households is much higher than most developing countries, albeit lower than leading developed countries. On the plus side, South Africa's debt service and principal payments to income ratio - which measures how much of a given salary goes to paying back loans - is 9.64%, substantially lower than all the examined countries below, except Germany.

Currency

Exchange rates are set according to the demand for the Rand, which increases when foreigners want to either buy goods from or invest in South Africa. An increase in interest rates boosts the investment into the country, as foreign investors enter to take advantage of the higher returns on offer. As this happens, the currency tends to strengthen. This is particularly important in the case of South Africa, where the flow of finance has a bigger impact on the currency than even trade does.

Figure 5: exchange rate

The current change

The primary justification for the most recent increase in interest rates was, predictably, centred on inflation. The statement announcing the change noted that, "having averaged 4,6 per cent in 2015, inflation is now expected to average 6,8 per cent in 2016 and 7,0 per cent in 2017", while a "peak of 7,8 per cent is expected in the fourth quarter of 2016 and the first quarter of 2017."[i]

The South African Reserve Bank (SARB) identified two primary drivers of increasing inflation. First was the deteriorating exchange rate. South Africa imports many important goods, ranging from food that every household needs to capital goods that firms need for expansion. A weaker exchange rate means all of those goods are more expensive. The SARB hopes that higher interest rates will strengthen the currency and reduce these costs. Second is the impact of the drought, which is likely to drive up the cost of food. Importing maize, for example, could be very expensive in the context of a weaker exchange rate, further pushing up the price of food, and making life harder for sectors of the economy, such as agriculture, where maize is a feedstock for livestock. There is already substantial evidence that costs are mounting, with the cost of potatoes, for example, having more than doubled since November.[ii]

Likely impact

There is no doubt that the increase in the repo rate will increase the cost of debt for workers. Workers who have significant debts or who need to borrow in the near future will have to pay more, while workers without much debt won't be as seriously affected. But the change in the cost of debt cannot tell us whether the rate change will be good or bad, that will depend on its impact on growth, exchange rates and inflation.

Growth is unlikely to be seriously affected. While the increase might slow growth, this impact should be mild, since interest rates are still low by historical standards. In 2008, for example, the interest rate hit 12%, versus 6,75% now. While firms are quite heavily indebted, they do still have room to increase their debt service payments.
Probably firms will not want to invest much at the moment, since growth is weak, and therefore the amount of discouraged investment is quite low. The primary vehicle for an impact on growth

might be through consumer demand, as customers might be discouraged from buying with debt in the short-term. Overall, the impact on growth is likely to be mildly negative.

Exchange rates, however, are also unlikely to change much. The collapse of the exchange rate is not driven significantly by changes in South Africa as an investment destination; rather it is driven by the slowdown in emerging markets and in commodity prices. The Rand is highly traded on international financial markets, and its value tends to be determined more by what happens in the rest of the world than by what's happening in South Africa. The interest rate increase was probably necessary to slow down the devaluation of the rand, but it is unlikely to turn it around. That will only happen if global trends change. Overall, the impact on exchange rates is likely to be mildly positive.

This is a concern for workers, because improving exchange rates is one route to slowing inflation. Food prices are the other major route. But these are also unlikely to be affected by the interest rate. Interest rates have little ability to cope with external supply-side shocks: when you just can't produce enough, changing the interest rates won't change much. With the exchange rate and food prices barely changing, the impact on inflation is likely to be very mildly positive.

In conclusion, while the cost of borrowing goes up, the countervailing positive impacts will be very small. Workers are still likely to face more expensive groceries, while struggling with more expensive debt. Nevertheless, this change needs to be thought of as part of a broader process. While the current change isn't likely to slow inflation, progressive changes in the future might have more of an impact. The Reserve Bank can't increase interest rates too quickly without risking shocking the economy into recession, and so this may be the first step in a longer upward trend of increasing interest rates. That will come at a cost to workers, but it could save them money if it slows inflation. For now, however, unions will have to focus their attention on using wage negotiations to offset the coming inflation and debt burden.

End notes

[i] South African Reserve Bank, "Statement of the Monetary Policy Committee", 28 January 2016.
[ii] Peters F., "Food prices to soar as drought bites", *Business Day*, 15 February 2016.