

Weaker currencies add to need for tighter monetary policy

- *Sell-off in African currencies will put upward pressure on inflation...*
- *... with the largest impact in South Africa, Kenya and Ghana.*
- *This month's key events: rate hikes on the cards in Ghana.*

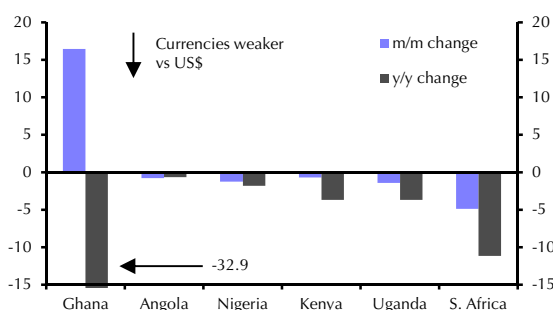
African currencies have not been immune to the recent sell-off in EM financial markets, raising concern in some countries about rising inflation. In this *Watch*, we examine which economies are likely to be hit hardest by this currency weakness, and how policymakers are likely to respond.

The broad-based sell-off in SSA currencies...

The currencies of SSA economies have generally weakened over the past month. The South African rand has fallen the furthest. (See Chart 1.) This is in part due to the country's large current account deficit, but also the fact that the rand is the only currency that is allowed to freely float.

The one currency to buck the recent trend has been the Ghanaian cedi, which has strengthened significantly after the authorities announced they had approached the IMF for support. **But the cedi is still down by more than 30% compared to this time last year, and it is annual changes in the exchange rate which affect inflation rates.**

CHART 1: EXCHANGE RATE VS US DOLLAR (%)

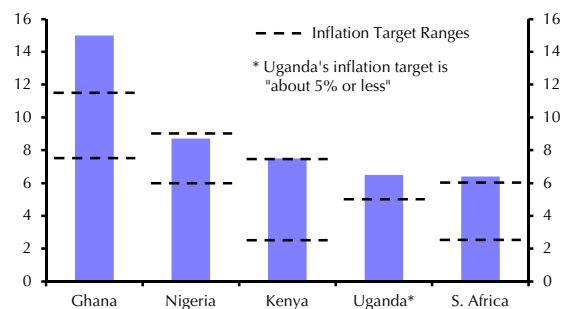


Sources – Thomson Datastream, Capital Economics

... will put upward pressure on import prices

This currency weakness presents a challenge to central banks in SSA economies, many of which are already facing high levels of inflation. (See Chart 2.)

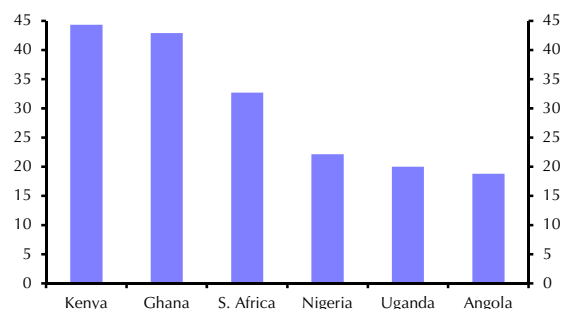
CHART 2: CE 2014 INFLATION FORECASTS (%)



Source – Capital Economics

But the impact of currency weakness will not just depend on how far exchange rates have fallen over the past year. If a country imports a lot, its inflation rate will tend be more vulnerable to exchange rate movements. Few SSA countries publish the weight of imported goods and services in their consumer price indices. **But Kenya, Ghana and South Africa have the highest ratio of imports to GDP, so are most likely to see inflation rise as a result of depreciating currencies.** (See Chart 3.)

CHART 3: IMPORTS (% OF GDP, 2013)



Source – Thomson Datastream

Other factors will offset this slightly

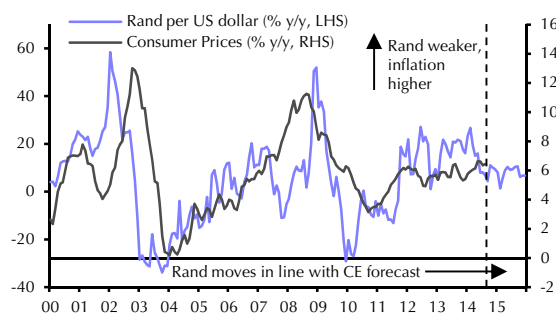
Part of the impact of weaker currencies will be offset if import prices fall in foreign currency terms. For example, the price of Brent crude is about 15% lower than a year ago. What's more, if an economy is operating below its potential, a weaker currency could prompt importers to switch their consumption to cheaper domestic items.

But weaker currencies will at least prevent all of the impact of lower commodity prices feeding through to domestic prices. And it is not obvious that SSA economies are operating much below their potential, particularly South Africa's.

Inflation most concerning in SA and Kenya

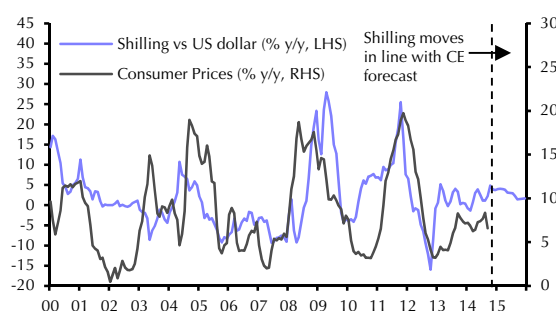
Because there are many factors that affect inflation other than the exchange rate, the relationship between the exchange rate and inflation is not perfect. **But based on past form and our currency forecasts, we think that exchange rate movements are most likely to keep inflation high, and close to the upper limits of their target ranges, in South Africa and Kenya.** (See Charts 4 & 5.)

CHART 4: RAND EXCHANGE RATE & SA'S INFLATION



Sources – Thomson Datastream, Capital Economics

CHART 5: SHILLING EXCHANGE RATE & KENYA'S INFLATION

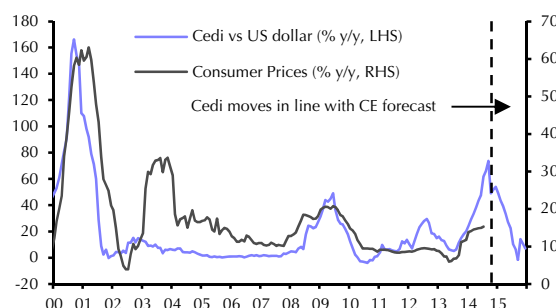


Sources – Thomson Datastream, Capital Economics

Meanwhile, the effect of exchange rate movements on the outlook for inflation in Ghana is less clear.

It is possible that the lagged effects of the cedi's decline over the past year have not yet fully fed through to domestic prices, suggesting inflation could rise further. But the currency has appreciated recently and, in any case, our forecast implies that the annual change in the exchange rate will decline next year. (See Chart 6.) Our best guess is that inflation in Ghana will average around 15% y/y in 2014 and 13% y/y in 2015.

CHART 6: CEDI EXCHANGE RATE & GHANA'S INFLATION



Sources – Thomson Datastream, Capital Economics

In Nigeria, where imports are equivalent to a smaller share of GDP, the relationship between the exchange rate and inflation has been weaker over the past fifteen years. But over the past few years at least, a weaker currency has generally been associated with higher rates of inflation. **So the naira's small depreciation over the past twelve months is another reason to think inflation will stay high in Nigeria, even if it does not shoot up.**

Conclusion

As a result, we forecast continued monetary tightening in South Africa and Ghana this year and next, with Kenya likely to begin raising interest rates early next year. But rate increases are likely to be fairly gradual, particularly in South Africa where economic growth looks fragile.

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Data Preview – South Africa Manufacturing Production

Thu. 9th Oct.

	Time (BST)	Previous	Median	Capital Economics
Manufacturing Production (%y/y)	12.00	-7.9%	-3.9%	-2.0%

Manufacturers bouncing back, but growth still sluggish at best

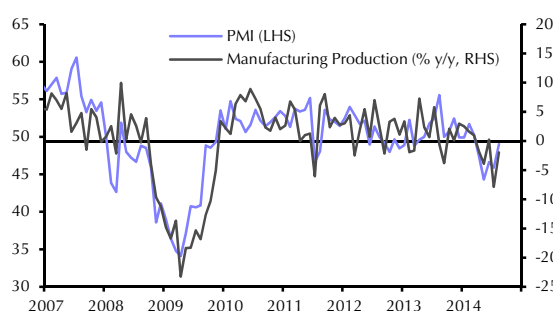
The contraction in South Africa's manufacturing production appears to have eased in August, after widespread strikes in the sector ended. But the sector is still unlikely to grow at a healthy pace for some time to come.

The fact that staff in the steel and engineering sectors returned to work in August suggests that output probably rose in month-on-month terms. And the PMI has increased further since then. In September it rose above 50 – which in theory separates expansion from contraction – for the first time since March.

But the PMI still pointed to a contraction in output in August in annual terms. (See Chart 7.) And looking further ahead, prospects for demand are fairly poor

at home and abroad. The domestic economy is growing slowly and the euro-zone, which is a major source of demand for South Africa's manufacturers, appears to be losing steam.

CHART 7: SOUTH AFRICA MANUFACTURING PRODUCTION & PMI



Source – Thomson Datastream

Data Preview – South Africa Medium-term Budget

Wed. 22nd Oct.

	Time (BST)	Previous	Median	Capital Economics
Medium-term Budget	-	-	-	-

Weak growth to hit public finances

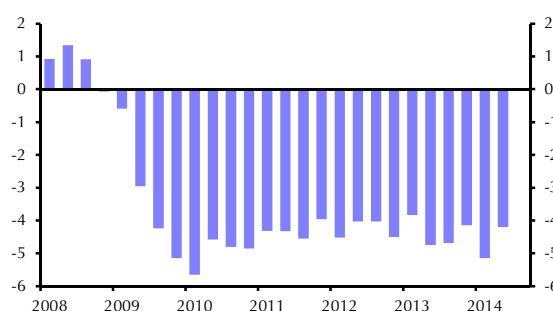
South Africa's Finance Minister, Nhlanhla Nene, will announce the medium-term budget later this month, which is likely to include a number of downward revisions to growth and revenue projections.

At the time of February's budget statement, GDP growth was forecast to be 2.7% in 2014 and 3.2% in 2015. The weak economic performance since then suggests these will be revised down substantially. Our own forecasts are 1.5% and 2.0%, respectively, and the risks probably lie to the downside.

The underperformance of the economy in the first half of the year does not appear to have dramatically hurt the public finances, though. In fact, the budget deficit fell in Q2. (See Chart 8.) But slower growth

over the next few years than forecast in February suggests that additional measures might be needed in order to achieve the government's aim of fiscal consolidation.

CHART 8: SOUTH AFRICA BUDGET BALANCE (% OF GDP)



Sources – Thomson Datastream, Capital Economics

Data Preview – Ghana Interest Rate

3rd – 10th Nov.

	Time (GMT)	Previous	Median	Capital Economics
Ghana Interest Rate (%)	-	19.00%	-	20.00%

High inflation to prompt rate hikes

We think that rising inflation and pressure from the IMF will prompt the Bank of Ghana to hike its policy rate by 100bp to 20.00% next month.

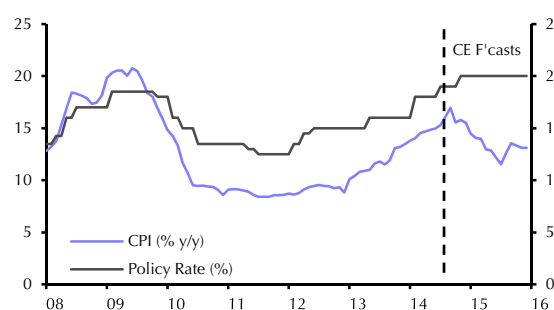
The government's turn to the IMF and subsequent rally in the cedi allowed the central bank to keep interest rates on hold last month.

But inflation stood at 15.9% y/y in August, well above the central bank's target of 9.5% \pm 2 percentage points. And we suspect that it will remain high, with the lagged effects of past currency depreciation unlikely to have fully fed through.

A further reason to expect interest rates to rise next month is that the IMF is likely to recommend tighter

policy in order to rein in bank lending and weaken domestic demand, which would help to reduce Ghana's large current account deficit. (See Chart 9.)

CHART 9: GHANA CONSUMER PRICES & POLICY RATE



Sources – Thomson Datastream, Capital Economics

Data Preview – Kenya Interest Rate

3rd – 10th Nov.

	Time (GMT)	Previous	Median	Capital Economics
Kenya Interest Rate (%)	-	8.50%	-	8.50%

Tighter policy on the horizon

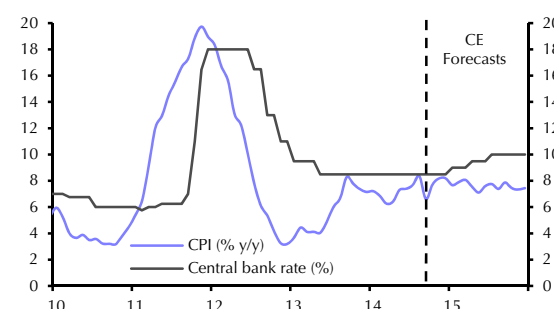
We suspect that the central bank will keep its key policy rate on hold at 8.50% at its meeting next month, but tighter policy will come in early 2015.

Inflation fell from 8.4% y/y in August to 6.6% y/y in September, taking it back within the central bank's target range of 2.5% - 7.5%. This is likely to stay the central bank's hand at its next meeting at least.

But the slowdown in inflation in September was down to favourable base effects, and we expect it to rebound in October. Recent exchange rate movements and growth in the money supply point to inflation of close to 10% over the coming year.

So tighter monetary policy is probably just around the corner. We have pencilled in 150bp of interest rate hikes between now and the end of next year, taking the policy rate to 10.00%. (See Chart 10.)

CHART 10: KENYA CONSUMER PRICES & POLICY RATE



Sources – Thomson Datastream, Capital Economics

Main Forecasts

TABLE 1: REAL GDP & CONSUMER PRICES (% Y/Y)

















	Share of World ⁽¹⁾	GDP				Inflation ⁽²⁾			
		2013	2014f	2015f	2016f	2013	2014f	2015f	2016f
Nigeria	0.90	5.5	6.5	6.5	7.0	8.5	8.7	9.5	9.0
South Africa	0.70	1.9	1.5	2.0	2.5	5.7	6.4	5.7	5.5
Angola	0.16	7.0	5.0	5.0	6.0	8.8	9.5	10.0	10.0
Kenya	0.10	4.7	5.0	5.0	5.5	5.7	7.5	7.0	6.5
Ghana	0.10	7.0	4.0	4.0	6.0	11.6	15.0	12.0	10.0
Tanzania	0.08	7.0	7.0	7.5	7.5	7.9	8.0	8.5	8.5
Uganda	0.06	5.0	5.0	6.0	6.0	5.5	6.5	8.0	8.0
Côte d'Ivoire	0.05	8.0	8.0	8.0	6.5	2.6	3.0	3.0	4.0
Botswana	0.04	5.4	5.5	5.5	5.0	5.9	6.0	7.0	7.0
Mozambique	0.03	7.0	8.0	8.0	7.0	4.3	6.0	6.0	6.0
Zambia	0.03	6.7	4.5	4.5	6.0	6.5	8.0	7.0	6.0
Mauritius	0.02	3.0	4.0	4.0	4.0	3.5	4.0	4.0	4.0
Namibia	0.02	4.3	5.0	5.0	5.0	5.6	6.0	6.0	6.0
Rwanda	0.02	4.3	5.0	7.0	7.0	6.0	6.0	6.0	7.0
Sub-Saharan Africa	2.70	5.5	5.0	5.0	5.5	7.5	8.0	8.0	7.0
US	18.7	1.9	1.7	3.0	3.0	1.5	2.0	2.2	2.5
Euro-zone	12.8	-0.4	1.0	1.5	1.5	1.4	0.5	0.5	1.0
Japan	5.3	1.5	0.9	0.5	0.8	0.4	2.7	1.6	2.6
UK	2.7	1.7	3.3	3.0	3.0	2.6	1.4	1.3	1.8

(1) % 2013, in PPP terms. (2) annual average







Table 2: Interest Rates (%)

	Interest Rate	End 13	Last Change	Latest	Forecasts		
					End 14	End 15	End 16
South Africa	Repo Rate	5.00	Up 25bp (Jul '14)	5.75	6.00	7.00	7.50
Nigeria	Policy Rate	12.00	Up 275bp (Oct '11)	12.00	12.00	12.00	12.00
Kenya	Central Bank Rate	8.50	Down 100bp (May '13)	8.50	8.50	10.00	10.00
Uganda	Central Bank Rate	11.50	Down 50bp (Jun '14)	11.00	10.00	12.00	12.00
Ghana	Policy Rate	16.00	Up 100bp (Jul '14)	19.00	20.00	20.00	20.00
Euro-zone	Refinancing Rate	0.25	Down 10bp (Sep '14)	0.05	0.05	0.05	0.25
US	Fed Funds Target	0-0.25	Down 75bp (Dec '08)	0-0.25	0-0.25	1.0-1.25	2.75-3.0
Japan	Overnight Rate	0-0.1	Down 20bp (Dec '08)	0-0.1	0-0.1	0-0.1	0-0.1

The Month Ahead

Date	Country	Release/indicator/event	Time (BST)	Previous*	Median*	CE Forecast*
October						
Wed 8 th	 Gha	GDP (Q2)	-	(+6.7%)	-	-
Thu 9 th	 SA	Mining Production (Aug)	10.30	(-7.7%)	(-5.6%)	-
	 SA	Manufacturing Production (Aug)	12.00	(-7.9%)	(-3.9%)	(-2.0%)
Mon 13 th	 Ken	GDP (Q2)	-	(+4.1%)	-	(+5.5%)
Tue 14 th	 Uga	Interest Rate Announcement	-	+11.00%	-	+10.50%
	 Nga	Trade Balance (Q2)	-	N2,424bn	-	-
Wed 15 th	 SA	Retail Sales (Aug)	12.00	(+2.4%)	-	-
	 Gha	CPI (Sep)	-	(+15.9%)	-	(+16.7%)
Thu 16 th	 Nga	CPI (Sep)	-	(+8.5%)	-	(+8.7%)
Wed 22 nd	 SA	Medium-Term Budget Statement	-	-	-	-
	 SA	CPI (Sep)	09.00	(+6.4%)	-	(+6.4%)
Mon 27 th	 Ang	Interest Rate Announcement	-	+8.75%	-	-
Fri 31 st	 SA	Trade Balance (Sep)	Rand	12.00	-16.3bn	-
	 Uga	CPI (Oct)	-	(+1.4%)	-	(+3.4%)
	 Ken	CPI (Oct)	-	(+6.6%)	-	(+7.7%)
November						
Mon 3 rd	 SA	Manufacturing PMI (Oct)	Kagiso	09.00	50.7	-

Expected during this period:

October						
6 th – 24 th	 Uga	GDP (Q2)	-	(+4.7%)	-	-
11 th – 16 th	 Ang	CPI (Sep)	-	(+7.1%)	-	-
24 th – 31 st	 Zam	CPI (Oct)	-	(+7.8%)	-	(+8.6%)
November						
3 rd – 10 th	 Ken	Interest Rate Announcement	-	+8.50%	-	+8.50%
3 rd – 10 th	 Gha	Interest Rate Announcement	-	+19.00%	-	+20.00%
3 rd – 14 th	 SA	Business Confidence (Oct)	SACCI	-	-	-

*m/m(y/y) unless otherwise stated; p= provisional estimate.