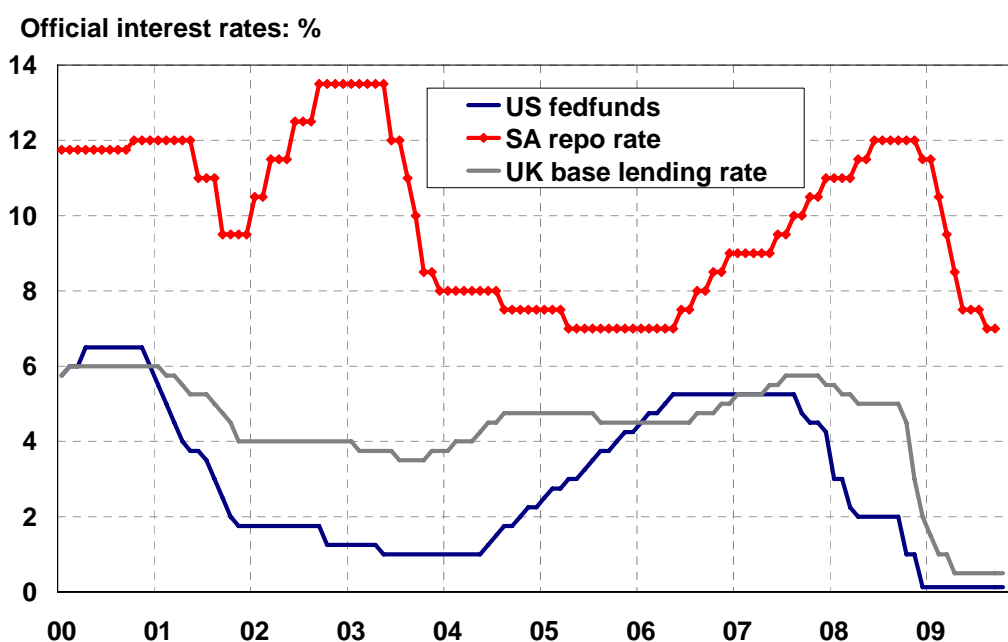


Rand prospects: still benefiting from a more conducive global environment

The rand firmed again over the past month, rising by just under 1% against the trade-weighted basket. It improved against most major currencies, rising by 1,3% against sterling, 1% against the Japanese yen and by 0,3% against the US dollar. However, it eased by 1,2% against the euro. The local unit continues to gain on global themes rather than on local developments and this trend now looks fairly entrenched. The Reserve Bank of Australia's decision to raise its cash rate from 3% to 3,25% helped bolster the rand given its recent close relationship with the Australian dollar, while it took the collapse of the MTN/Bharti deal in its stride.

Figure 1: South African interest rates are still high

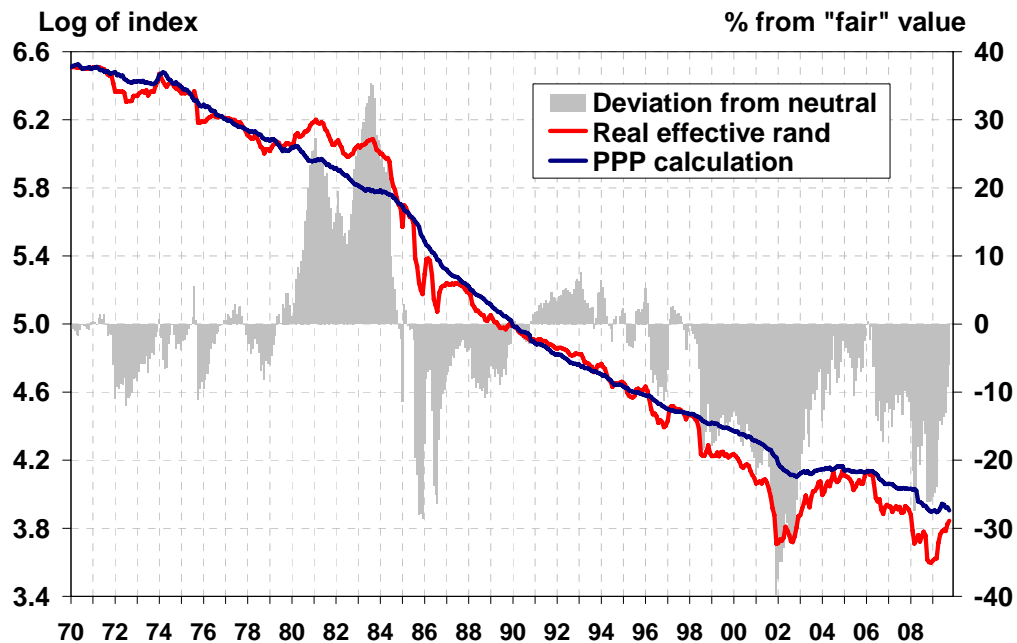


The prevailing view that has emerged over the past few months is that developed economies are going to underperform developing ones for some time into the future, with important consequences for emerging market currencies and commodity prices. The US and UK, in particular, are expected to experience subpar economic activity over several years as banking and securitized markets recover only slowly from the structural damage caused by the financial crisis. There is a strong view that interest rates will be held at low levels for an extended time in support of the fiscal stimulus currently underway, with the implication that governments are quite happy to allow currency depreciation as part of the package. In contrast, China's remarkably strong recovery this year and the relatively good performance in a number of emerging market economies in Asia, South America and even Europe has raised hopes that growth in developing economies will remain strong despite woes elsewhere. Because these economies are at an earlier stage of development and because their populations are massive, global growth over the medium term would be very commodity-intensive as a result if this proved to be the case.

The relevance for South Africa is that the country's terms of trade (the ratio of export to import prices) is likely to perform well, placing the country in a favourable position to do well under the new economic order. However, one consequence would be that the rand would also perform well, both relative to developed economy currencies as well as non-commodity emerging world currencies. Given that most economists already feel that the currency is overvalued (see figure 2, which shows that it is closest to its long-term purchasing power parity line than it has been since

2006), this would place further pressure on manufacturers, ultimately reducing diversity in the economy and – at some later point again – making it more vulnerable to external shocks or changes in perceptions. This presents a dilemma for policymakers. Cutting interest rates would not reduce upward pressure on the rand as they would still be higher than in many other countries that do not have a currency underpin. At the same time reducing them by too much and for too long could reignite the consumer boom and suck imports back into the economy, ultimately leading to currency weakness and a costly rise in interest rates later in the cycle. The second solution, intervention, has been very unsuccessful in the past and is also very costly as the Reserve Bank has to buy dollars and then sterilise the rise in money supply by issuing bonds in the local market, with the interest differential between the US and South Africa representing the loss to the Bank. However, other countries have gone this route, calculating that the cost of not doing so would be even more significant.

Figure 2: Rand is at its strongest levels since 2006 in real terms



Conclusion

The rand's short-term prospects appear stronger than they were a month ago. The currency has weathered the vagaries around the proposed MTN/Bharti deal and the global situation also seems relatively calm, with most expecting the fiscally-inspired bounce in the global economy to continue in the short term. Although the authorities are clearly unhappy with the current level of the currency, there is a reluctance to do anything about it. However, the rand will remain vulnerable to any setbacks internationally that challenge the prevailing view on commodity prices and emerging market economies.

19 October 2009

Influences on the rand			
Factors	Effect	Tendency	
		Recent	Expected longer-term
External or international			
US dollar	Weak dollar normally implies firmer trade-weighted rand.	Dollar has been falling against peer currencies as US continues to encourage a competitive devaluation and investors become more disillusioned.	Difficult to predict as EU also has structural weaknesses and the US current account deficit is likely to improve over time.
Commodity prices	Strong commodity prices are rand supportive.	Commodity prices have improved on the back of the weaker dollar and positive view of prospects in commodity-intensive economies such as China.	In the long term Chinese demand will again be a dominating force. However, medium-term weakness is likely, given the possibility of economic setbacks.
Interest rate gap	Higher = positive, but depends on circumstances.	SARB paused at the last MPC meeting.	MPC will probably ease again given economic weakness, but interest rates are now close to the trough.
Emerging market perceptions	Positive = good for rand.	Risk aversion has eased and investors are looking to emerging markets for economic growth.	Strong risks of a relapse in sentiment if global economy disappoints over the next few months.
Predominantly domestic			
Growth perceptions	Rand strength if perceptions of relative growth are positive	SA's second quarter gdp figure was better than expected, contracting by 3% after the 6.4% fall in the first. The economy is probably past the worst.	Depends on global growth cycle, but could become more favourable in relative terms in 2010.
Current account	Large unsustainable deficit would be rand negative.	Fell to 3,2% of gdp in the second quarter after rising to 7% of gdp in the first	Will remain wide in the global context; sustainability depends on consumer/ investment mix, commodity price cycle, policy and external perceptions. Lower dividend payments will help.
Policy and policy perceptions	Rand positive, if promotes financial stability and economic growth.	Policy debate has re-opened with potentially negative consequences for the rand. The mandates of the current economic portfolios need to be clarified. Despite this, Moody's has moved SA into the A3 category.	Less supportive in the medium term, with dangers of policy relapses occurring if weak global conditions persist.
Exchange controls	Relaxing potentially negative for rand in short term, positive in long term as foreign investment picks up.	No major changes expected in the short term.	Uncertain, but probably less impetus for relaxation.
Abnormal flows	Inflows/ outflows related to FDI transactions	MTN deal has fallen through, but with little fallout for the rand.	Uncertain. Inflows should pick up once political and policy environment becomes clearer and global climate settles.
Rand under- or overvalued?	If overvalued then will depreciate in long term and vice versa.	Probably slightly overvalued at current levels although undervalued on strict PPP.	Should revert to long-run fair value based on adjusted PPP.

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