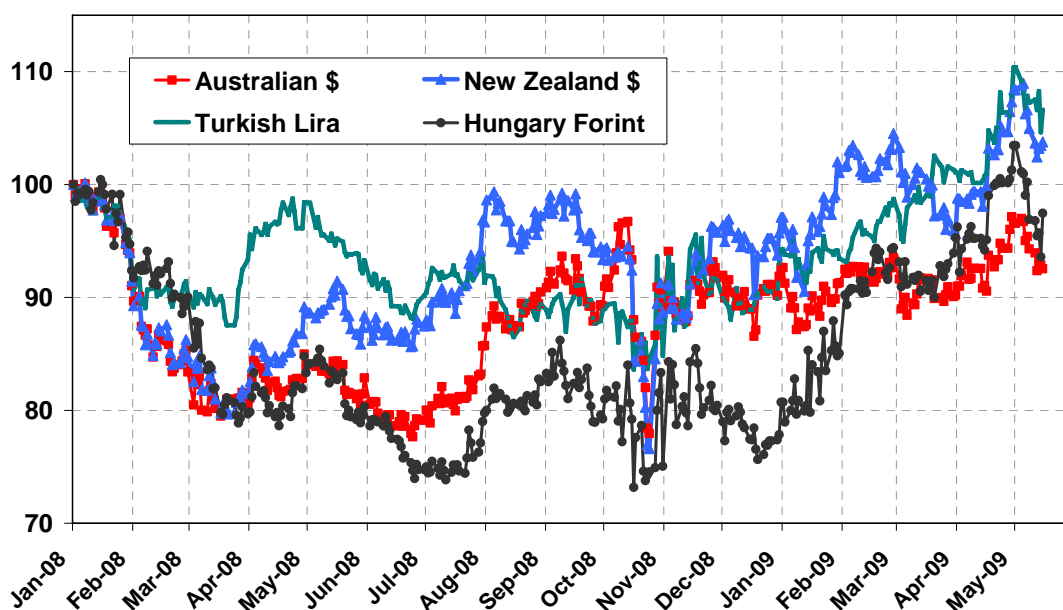


## Rand prospects: can rand strength continue?

The rand gained further against major currencies over the past month, rising by 4,9% against the trade-weighted basket, 7,2% against the dollar, 4,3% against the euro, 5,0% against sterling and 3,3% against the yen. The local unit has strengthened since early March on the back of lower global risk aversion and – linked to that - the weaker US dollar. However, the rand has eased off its early May highs, perhaps suggesting that its period of outperformance against peer currencies is coming to an end.

Figure 1: The rand has performed well against peer currencies

### Currencies against the rand: Index 2 Jan 2008=100

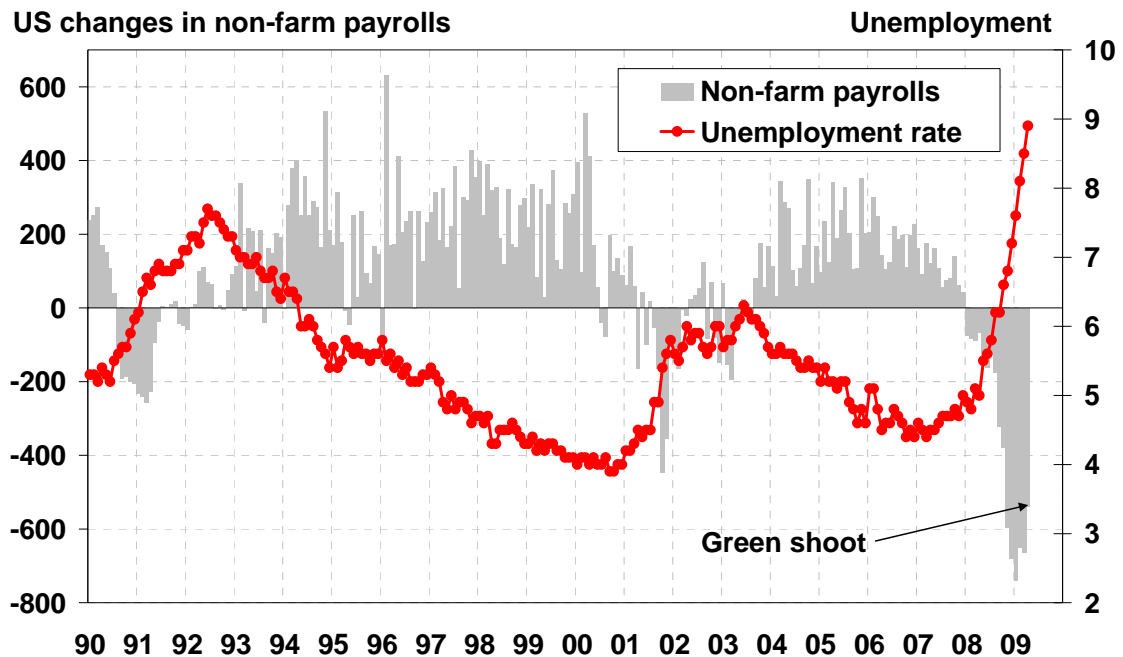


Over the past few months global factors have largely determined the rand's performance. As a highly liquid currency, it was initially severely punished with the escalation of the financial crisis in October last year (see figure 1). Investors are always able to exit deep South African capital markets easily even after the onset of a crisis and the rand therefore tends to magnify movements in other emerging market currencies. However, the currency subsequently did well as South Africa proved to be relatively well placed to weather the initial storm – domestic banks were not directly affected by subprime and the government and the Reserve Bank had policy flexibility to respond to the slowdown.

This outperformance lasted over the election period, something contrary to our expectations given the volatile political mood and uncertainty over the post-election policy environment. However, for the markets it all seemed to go quite well – political stability in that the ruling party was returned with a strong majority, but not with the two-thirds majority that would have ensured total dominance and the ability to change the constitution unilaterally. Strong hints that Trevor Manuel, the popular minister of finance, was going to be retained in the new planning commission and that Pravin Gordhan, the successful South African Revenue Services head would take over at treasury bolstered markets in the days following the election. This was subsequently confirmed, but the introduction of new ministries and confusion over the mandates of these and existing economics portfolios, where there seem to be clear overlaps and potentially strongly contrasting views on key issues, has since tempered some of the enthusiasm. For example, markets cooled noticeably in the wake of the revelation that there was to be a debate on inflation targeting, an old hobbyhorse

of the left. The bond market's immediate – and correct – interpretation of this was that there was a bigger chance of higher inflation in the medium term and that therefore short-term interest rates would ultimately go up more (or down less) than might otherwise have been probable (ironically, just the opposite to the left's goal). On the rand, the view on the left has tended to be that it should be kept weak to improve the country's competitiveness. It is not clear what level this might be, but, again, talk of intervention could unsettle markets over the weeks to come.

Figure 2: Global economy still under strain



For the moment global issues will probably continue to dominate. The 'green shoots' of recovery theory still seems to be favoured in the markets despite any material evidence. A good example was the market relief over the massive 539 000 job loss in April. At best, the latest statistics suggest that the rate of deterioration in major economies is starting to slow, a not surprising result given the plunge in output over the past six months at least. We still believe that there will be many false dawns, both for economies and in markets. In the short term there could be a moderate bounce in inventories in the US, which could produce one or two quarters of growth. However, the risk of a double-dip recession is material given the headwinds of employment losses, high debt levels and weak consumer confidence.

## Conclusion

The rand is likely to remain volatile over the next few months as global risk aversion fades and returns. There also appears to be an increased risk of controversial economic policy changes, something which could affect financial markets over the next few months. On balance, the rand should end the year a bit weaker on a trade-weighted basis.

15 May 2009

<b>Influences on the rand</b>			
<b>Factors</b>	<b>Effect</b>	<b>Tendency</b>	
		<b>Recent</b>	<b>Expected longer-term</b>
<b>External or international</b>			
US dollar	Weak dollar normally implies firmer trade-weighted rand.	Dollar has been mixed, at times hurt by lower risk aversion, but helped by European woes.	Becoming more ambiguous given EU weakness. Weaker long-term trend still likely, especially following the massive fiscal and monetary stimulation now taking place.
Commodity prices	Strong commodity prices are rand supportive.	Some improvement on industrial commodities as hopes of firmer Chinese demand increases. However, gold has faltered on lower risk aversion.	In the long term Chinese demand will again be a dominating force. However, medium-term weakness is likely, given the serious deterioration in the global economy.
Interest rate gap	Higher = positive, but depends on circumstances.	SARB has started to cut interest rates more aggressively, but this could be seen as positive given the global climate.	SA will continue to relax in 2009 in line with other countries.
Emerging market perceptions	Positive = good for rand.	Some easing in risk aversion but climate still potentially volatile.	Emerging markets could be more adversely affected if global downturn is protracted. In relative terms most are better placed than developed countries, however.
<b>Predominantly domestic</b>			
Growth perceptions	Rand strength if perceptions of relative growth are positive	SA's fourth quarter gdp figure was down an annualised 1.8% and early indications from the first quarter are not good.	Depends on global growth cycle, but could become more favourable in relative terms as 2010 approaches.
Current account	Large unsustainable deficit would be rand negative.	Narrowed to 5,8% of gdp in the 4 <sup>th</sup> quarter 2008 from 7,8% in third quarter and 7,3% in the second quarter. Recent trade figures have been poor and perceptions still unfavourable.	Will remain wide; 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.	Less supportive in the medium term, although uncertainty will be reduced after the elections.
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.	Should be relaxed further over time, but very gradually.
Abnormal flows	Inflows/ outflows related to FDI transactions	Nothing expected either way.	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.	More fairly valued at current levels although undervalued on strict PPP.	Should revert to long-run fair value based on adjusted PPP.

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