

18 October 2010

Economic Commentary

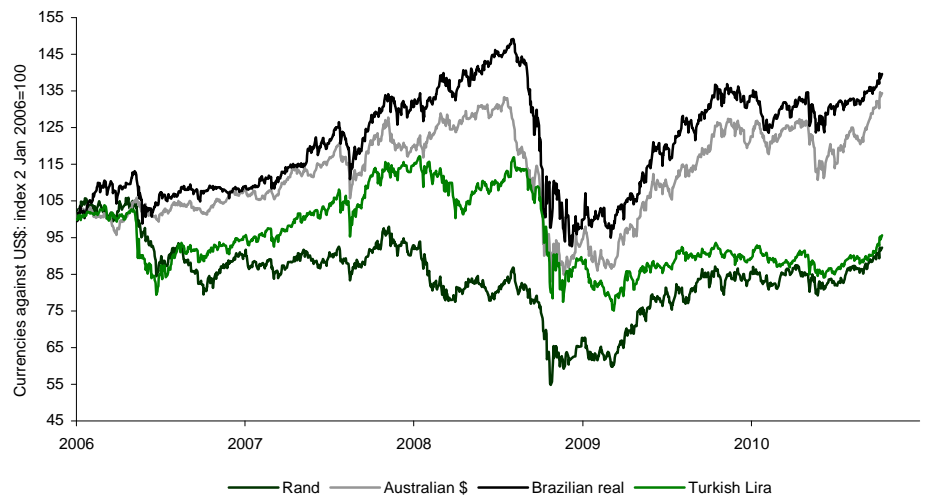
Rand Prospects

Rand forecast to remain strong

Comment

The strength of emerging market currencies, including the rand, continued unabated over the past month, supported by a steady influx of cheap money from advanced economies in search of high yields and growth opportunities. Speculation that the US Federal Reserve would initiate a second round of quantitative easing to bolster their economy, added to dollar weakness. The Hungarian forint, was among the best performing emerging market currencies, appreciating by 10% against the dollar last month, while the Australian dollar and the Turkish lira gained more than 5% over the same period. Since the middle of September the rand has fallen by 0,4% against the trade-weighted basket, with gains of 3,5% against the US dollar, 0,3% against the pound, but a decline of 3,7% against the euro.

Chart 1 : Emerging market currencies continued to appreciate against the dollar



Source: Inet

The strength of emerging market currencies, which many feel is eroding competitiveness and hurting growth, was on the agenda at the recent IMF annual meetings in Washington. While most acknowledge that there is a problem, there is no agreement on how to resolve it. In the last currency report we highlighted that the influx of foreign capital, particularly into bonds, was one of the main drivers of emerging market currencies, and the rand exchange rate, in particular. This month's currency insight will take one step backwards and look at what is behind the massive inflow of capital and how sustainable it is. It will also consider whether there is any truth behind the idea of a "currency war", by looking at some of the steps emerging market countries have taken to dampen exchange rate appreciation.

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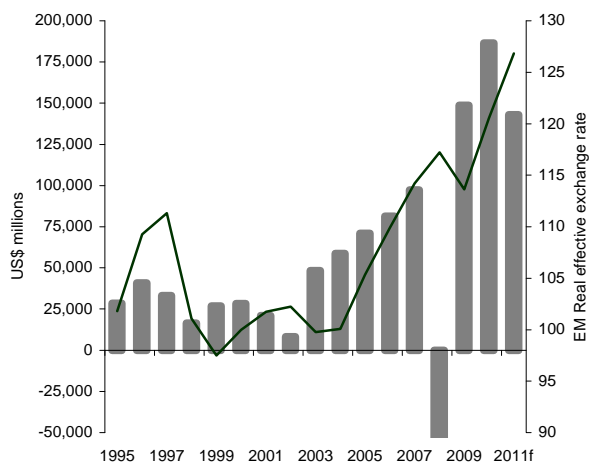
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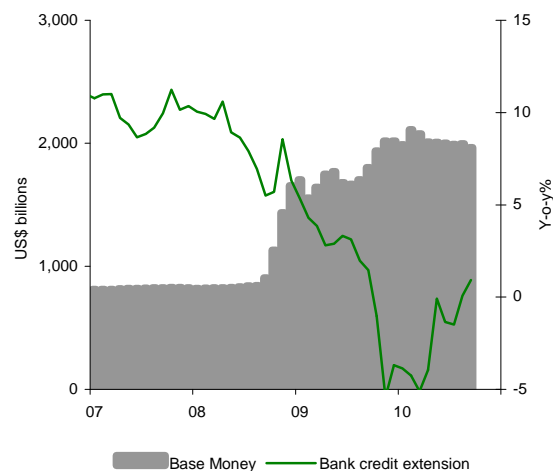
What's behind the flood of money?

Chart 2 : Inflow of foreign capital into emerging markets



Source: IIF

Chart 3 : Ultra loose US monetary policy



Source: DataStream

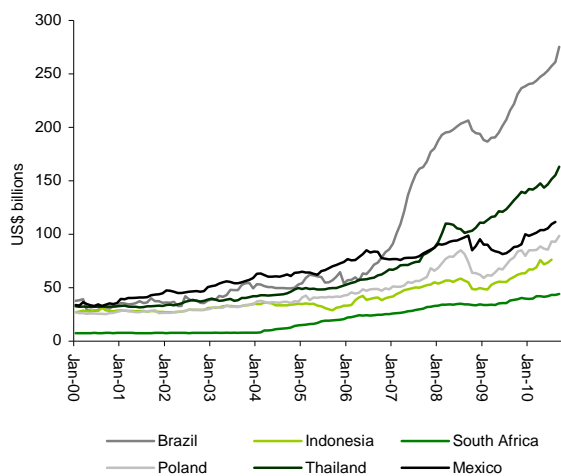
The Institute of International Finance (IIF) recently forecast a record inflow of portfolio investment into emerging markets for 2010 totalling \$168 billion, nearly double the inflows recorded during 2006 and 2007 - the boom years prior to the crisis. EPFR Global, a Massachusetts-Based research firm which tracks inflows into emerging markets, suggests a similar picture, finding that investors have ploughed around \$39,5 billion into bond funds in the first nine months of the year, with a further \$1 billion begin added during the first week of October. At the same time, investors took out \$3,2 billion from US stock funds, indicating that fund managers continue to search for higher-yielding assets. Broadly, there are three reasons behind the flood of capital into emerging markets. The first, ultra loose monetary policy in the US and elsewhere has driven down bond yields to all-time lows, causing investors to go in search of returns elsewhere (see September's Currency Insight). The second is a large growth differential between advanced and emerging countries, which makes emerging market equities look more attractive. The IMF, in its October World Economic Outlook, forecasts that emerging markets will grow by around five percentage points more than developed countries over the next two years. Lastly, risk averse US banks, which have cash-heavy balance sheets due to the Federal Reserve's quantitative easing programme, have been reluctant to lend to domestic consumers, due to persistent problems in the labour and housing markets (see graph 2). As a result, banks have also sought higher returns elsewhere.

What are the options?

Brazil's Finance Minister, Guido Mantega, recently sparked debate by saying that an international "currency war" had broken out, but efforts so far have hardly been retaliatory, with recent measures largely ineffective at stemming the inflows.

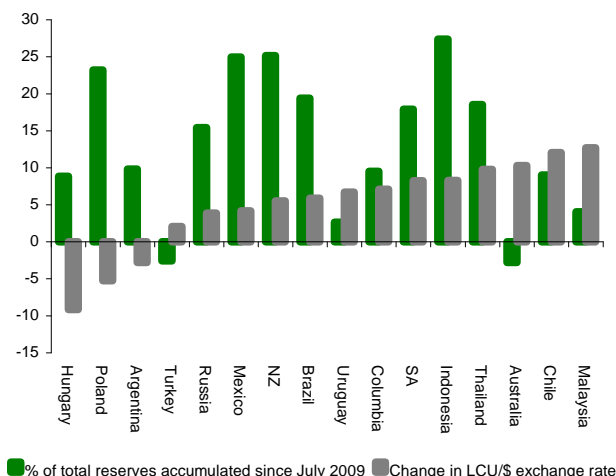
Accumulating foreign exchange reserves has been one of the first policy tools adopted by many emerging market policymakers to curb exchange rate appreciation. Graph 1 shows that reserve accumulation has picked up sharply since January 2009, with Russia, Brazil, Poland, Thailand, Mexico and South Africa, accumulating \$90 billion, \$70 billion, \$30 billion, \$40 billion, \$20 billion and \$10 billion respectively since January 2009. However, graph 3 suggests that the rapid accumulation of reserves has had only a limited effect on curbing exchange rate appreciation. A recent paper written by the Bank of International Settlements confirms that accumulating reserves has only a very limited impact on containing exchange rate appreciation particularly in the medium term.

Chart 4 : Accumulation of international reserves



Source: DataStream

Chart 5 : Reserve accumulation dampening exchange rates



Source: DataStream

With reserve accumulation proving both expensive and only marginally effective, some emerging markets have turned to capital controls. Mild forms of capital controls have been endorsed by the IMF as a legitimate short-term tool for reducing the impact of volatile capital flows. However, like reserve accumulation, evidence in favour of the effectiveness of such measures is limited. A number of countries have introduced capital controls or taxes on inflows over the past few months.

In Mid-October, Thailand introduced a 15% withhold tax on capital gains and interest payments on government and state-owned company bonds, there are also rumours that India and Philippines may follow suit shortly. Brazil increased its International Financial transaction tax (IOF) on bond investments from 2% to 4% in early October. In July, Indonesia introduced measures to damp speculative inflows including a one-month minimum holding period for central bank money market securities, limits on sales of central bank paper by investors, as well as lower interest rates on funds deposited at the central bank. South Korea introduced limits on financial firms' positions in currency derivatives and foreign currency loans, while Taiwan imposed restrictions of foreigners' access to some kinds of bank deposits.

Conclusion

Capital controls and reserve accumulation may help to stem the tide of capital flowing into emerging markets, but unless capital controls arbitrage away the yield and growth differential, international investors will continue to favour emerging market assets, putting upward pressure on currencies.

With another round of quantitative easing in the US likely following the mid-term elections in November, emerging market currencies and the rand should rise further on the back of dollar weakness during the remainder of the year.

The continued strength of the rand will put the Minister of Finance under pressure to introduce some measures to contain the currency, either in the upcoming medium-term budget policy statement or in next year's main budget. If the measures introduced are broadly in line with steps taken by other emerging market countries, it is unlikely to cause investors to exit the market,

For further information on capital controls and reserve accumulation, see the following two papers:

IMF (2010) Capital inflows: The role of controls (February 2010)

- <http://www.imf.org/external/pubs/ft/spn/2010/spn1004.pdf>

Bank of International Settlements (2006) Foreign exchange reserve accumulation in emerging market economies: what are the domestic implications?

- <http://www.bis.org/repofficepubl/arpresearch200609.01.htm>

Table 1 : 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 weakened further against major currencies on expectations of another round of quantitative easing.	The dollar is expected to weaken over the medium term, partly due to quantitative easing.
Commodity prices	Strong commodity prices are rand supportive.	Mixed, but mostly off peaks seen early in 2010.	In the long term Chinese demand will again be a dominating force. However, medium-term weakness is possible, given the possibility of economic setbacks.
Interest rate gap	Higher = positive, but depends on circumstances.	Further rate cut is still possible, if growth substantially weaker.	Although gap could close slightly in the short term, the carry trade will remain a strong supporting force.
Emerging market perceptions	Positive = good for rand.	Risk aversion eased slightly, markets are still more focused on Europe than emerging markets.	Woes could spread to emerging markets if the global economy disappoints over the next few months.
Predominantly domestic			
Growth perceptions	Rand strength if perceptions of relative growth are positive	Gdp rose by 2,8% in the second quarter, lower than market expectations. Recent figures have disappointed	Will still be positive, but a global double-dip recession would spell trouble for domestic prospects as well.
Current account	Large unsustainable deficit would be rand negative.	Deficit widened to 2,4% of gdp in the second quarter of 2010, down from 4,6% of gdp in the first quarter	Will widen as domestic economy improves; sustainability depends on consumer/ investment mix, commodity price cycle, policy and external perceptions.
Policy and policy perceptions	Rand positive, if promotes financial stability and economic growth.	Government is considering a tax on short-term capital inflows.	Less supportive in the medium term, with dangers of policy relapses occurring if weak global and local conditions persist.
Exchange controls	Relaxing potentially negative for rand in short term, positive in long term as foreign investment picks up.	Minor changes in February 2010 budget following major relaxation in October 2009.	Exchange control relaxation is being used as a tool to take upward pressure off rand. Further moves are possible.
Abnormal flows	Inflows/ outflows related to FDI transactions	Has been relatively limited.	Uncertain. Inflows should pick up once political and policy environment becomes clearer and the global climate settles.
Rand under- or overvalued?	If overvalued then will depreciate in long term and vice versa.	Over 10% overvalued at current levels.	Should revert to long-run fair value based on adjusted PPP implying some above-inflation differential depreciation at some point.

Source: Nedbank Economic Unit

Regular economic analysis is available on the Nedbank Group's internet site, <http://www.nedbankgroup.co.za>

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