

15 June 2011

# Economic Commentary

## Rand Prospects

### Rand likely to remain volatile

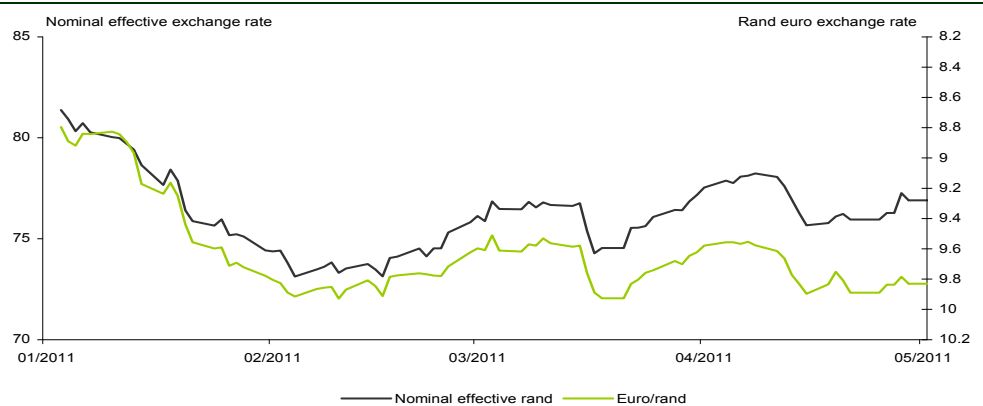
- The rand has strengthened over the past month, supported by a sharp increase in inflows into the domestic bond market.
- Although the rand has remained strong against the dollar this year, on a trade-weighted basis the currency has weakened 6%.
- Despite this correction, the rand remains overvalued on a purchasing power parity basis.
- The rand is likely to be supported by strong global liquidity in the short term. However, some easing is expected in the second half of the year as policy starts to tighten in key economies.

### Comment

Investors are still favouring emerging markets, rattled by weak economic data out of the US as well as the growing likelihood of a Greek default. Over the past month the rand has continued to benefit from an influx of foreign capital – around R13 billion has flowed into the domestic bond market. As a result, the rand has appreciated by 3,6%, 1,7 % and 2,6% against the US dollar, the euro and the British pound.

The strength of the rand against the dollar has continued to grab headlines over the past couple of months. However, on a trade weighted basis the currency looks less impressive, depreciating by 6,3% since the start of the year. The rand has fallen by nearly 10% against the euro, which makes up 34% of the basket and by 7% and 1%, against the British pound and Chinese yuan, which add 11% and 13% to the basket respectively.

**Chart 1 : The rand has weakened on a trade-weighted basis since January 2011**



Source: Thomson Reuters

### Group Economic Unit

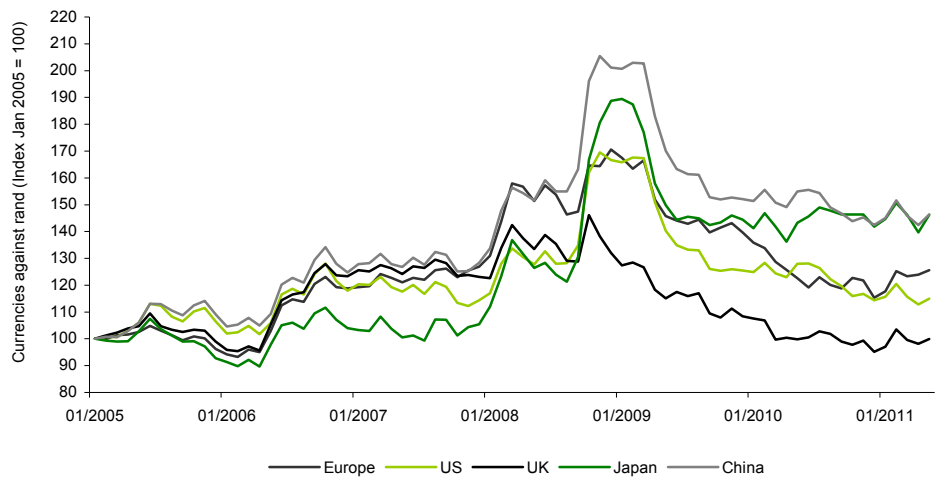
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Important disclosures can be found in the Disclosures Appendix.

**Chart 2 : The rand against major trading partners**



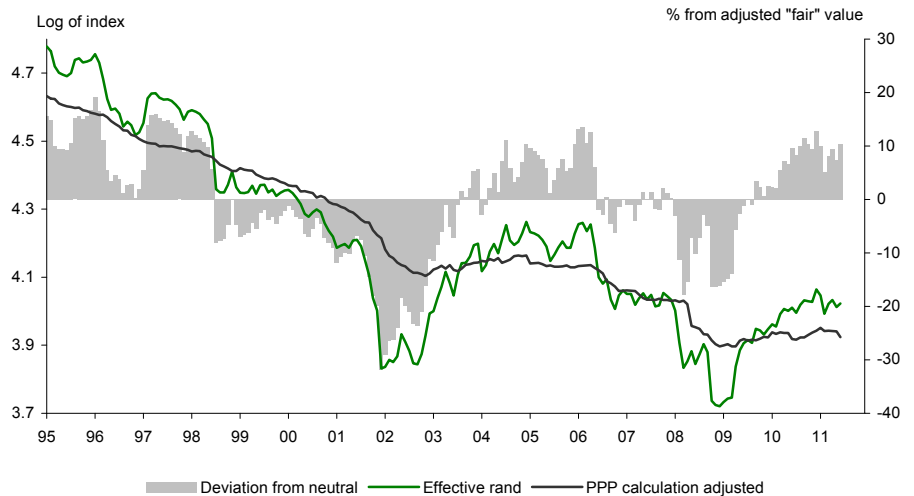
Source: Inet

**Is the currency still overvalued on a trade-weighted basis?**

Although it is difficult to determine what the fair or true value of a currency should be with any degree of accuracy, a useful measure to consider is purchasing power parity (PPP) – a theory to derive the long-term equilibrium value of the exchange rate. It assumes that without transaction costs, or barriers to trade, goods should be the same price in any country. Basically, any good should (in dollars) cost the same in South Africa as it does in Germany or China. The Economist magazine’s Big Mac index gives a light hearted view of this, although it is based on a non-traded good.

A theoretically more sound way of assessing a currency’s relative strength is to look at relative price movements between countries, or the difference in inflation rates. Relative PPP suggests that in the long-run, the percentage depreciation or appreciation of the exchange rate is the same as the difference in inflation between those two countries. In practice, this theory does not always hold true, as there are many factors that affect exchange rates from interest rates to growth prospects and investor sentiment. However, PPP still provides a useful guide as to whether a currency is over or undervalued over the long term.

**Chart 3 : The rand remains overvalued**



Source: Inet

Chart 3 shows the difference between the nominal effective exchange rate and the exchange rate based on purchasing power parity – where the exchange rate should be based purely on inflation differentials. It shows that the rand has been roughly 10% overvalued for much

of the past year, following the steep correction in 2009. The last time the rand experienced a similar period of overvaluation was in 2005/06, where many of the same factors – a weak dollar, inflows of foreign capital and strong commodity prices – which are currently supporting the currency, were in play.

What does this suggest going forward? While a currency can experience deviations from its implied-PPP value for an extended period of time, like the rand did between 2004 and 2006, it does increase the likelihood of a correction the longer a currency remains in overvalued territory.

In our view, the rand is likely to remain volatile but relatively firm in the short term. The dominant factors behind the carry trade, including excess liquidity and divergent interest rates, will remain in effect in the short term and should support the currency. However, these supporting factors are expected to start diminishing as the second half of the year progresses and policy in developed markets starts to tighten and growth begins to slow.

## **Conclusion**

While PPP provides little insight into the day-to-day movements of a currency, it can give a useful indication of what path a currency may take in the medium term. With the rand well into overvalued territory for quite some time now, it adds to our view that we are probably entering a period of relative rand weakness. The risk of a more dramatic correction remains, particularly if a Greek default sparks a more general increase in risk aversion or if growth in key economies starts to falter and commodity prices fail to correct.

**Table 1 : Influences on the rand**

Factors Effect		Tendency	
		Recent Expecte	d longer-term
<b>External or international</b>			
US dollar	Weak dollar normally implies firmer trade-weighted rand.	Dollar has pulled back after earlier weakness.	The dollar could firm in the second half as stimulatory policy is withdrawn and European woes persist. However, the long-term trend is probably still down.
Commodity prices	Strong commodity prices are rand supportive.	These have eased after earlier strong rises.	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.	Local rates are moving sideways and rates elsewhere are trending higher.	The carry trade will remain a strong supporting force as local rates move into the upcycle from 2012 onwards.
Emerging market perceptions	Positive = good for rand.	Risk aversion has 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.
<b>Predominantly domestic</b>			
Growth perceptions	Rand strength if perceptions of relative growth are positive	Gdp rose by 4,4% in the fourth quarter, higher than market expectations. Recent figures have been mixed but first quarter growth of over 4% is likely.	Will still be positive, but could lose some momentum on a weaker global environment.
Current account	Large unsustainable deficit would be rand negative.	Deficit narrowed to 0,6% of gdp in the fourth quarter of 2010, down from 3,1% of gdp in the third quarter. Recent trade statistics have been relatively favourable.	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.	Policy stance has become more interventionist and protectionist, but monetary and fiscal stance continues to allay investor fears.	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.	Further relaxation in the budget. Government is considering a tax on short-term capital inflows but this is unlikely.	Exchange control relaxation is being used as a tool to take upward pressure off rand. Further relaxation is possible.
Abnormal flows	Inflows/ outflows related to FDI transactions	Has been relatively limited and opposition to Walmart deal casts a cloud over foreign involvement.	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

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