

16 September 2011

Economic Commentary

Rand Prospects

The rand weakens in the face of dollar strength

- The slump in global confidence intensified over the past month.
- The Euroland crisis worsened, with concerns over sovereign debt and banks.
- A flood of capital into the safe havens of the US dollar, Swiss franc, Japanese yen and gold puts pressure on emerging market currencies.
- The rand's prospects have worsened but much now depends on the policy response in developed countries.

Comment

The rand continues to act as a barometer of global financial market confidence. Chart 1 shows the close relationship between equity market developments in the emerging world and the rand-dollar that has prevailed since the onset of the global financial crisis in 2008, with the rand weakening as markets come under pressure. The rand is a liquid currency backed by liquid domestic securities markets, and therefore typically is affected early by changes in general sentiment.

Since late July, financial markets have reflected growing unease over the health of the global economy as well as the state of developed world banks. The prevailing wisdom in the second quarter was that developed world growth was just taking a bit of a breather largely because of the effects of the Japanese natural and unnatural disasters and the effect on global supply chains. It was felt that once these issues were resolved growth would once again accelerate and a normal cycle would resume.

A number of events jolted this complacency. First, economic figures have generally been very poor, with downward revisions to gdp, and weak manufacturing and employment data. Forward-looking indicators such as Purchasing Managers' Indices also suggest that the weakness has extended into the third quarter, despite a resumption of Japanese output.

Second, the markets' focus turned to budget woes in the US because of the debate on the government's debt ceiling in early August. The wrangle itself hurt confidence, as it showed a depressing lack of appreciation of the gravity of the global crisis on the part of politicians. However, it also brought attention on the massive growing debt and the limited options over the medium term for containing its growth.

Third, the European debt crisis flared up once more. Weaker economic growth or even contraction implies that earlier assumptions of what will be needed to keep countries such as Greece meeting its commitments now look optimistic. Linked to this is growing resistance from German taxpayers to bailing out other countries as well as legal challenges. This makes a Greek default more likely, which in turn makes many European banks more vulnerable, given their large holdings of sovereign debt and particularly Greek sovereign debt. Chart 2 shows how much the credit default swap (CDS) spreads have deteriorated, suggesting that the market is now virtually certain that Greece will default in the near future.

Group Economic Unit

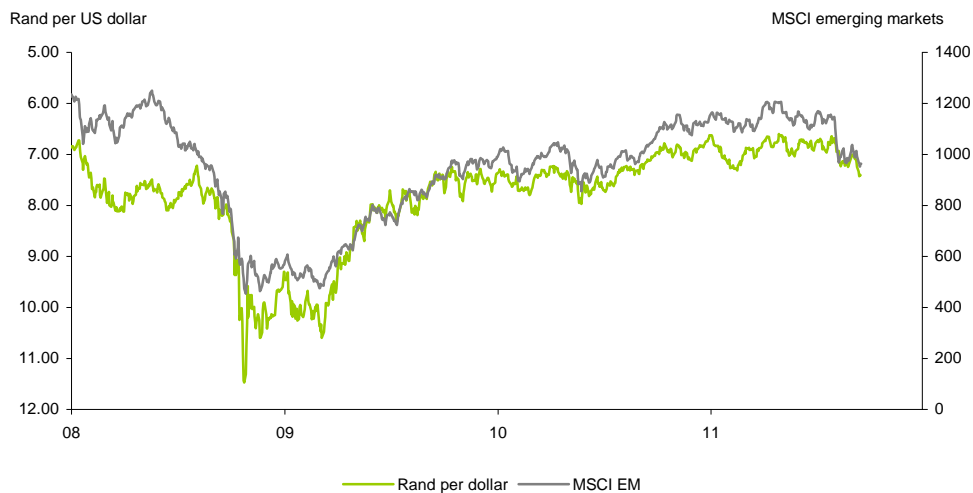
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Important disclosures can be found in the Disclosures Appendix.

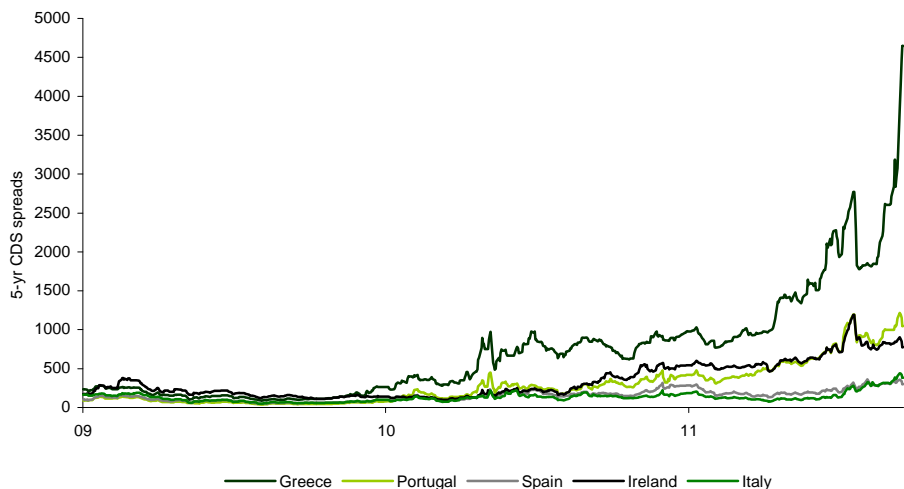
Chart 1 : The rand continues to track equity market performance



Source: DataStream

The implications of these developments are serious. Governments have very little room to manoeuvre, either in support of listing economies or if a further bailout of banks – this time because of sovereign defaults – becomes necessary. This places the ball back in the central banks’ court, where again options have been reduced by earlier expansionary policies. At the minimum, a clear, credible plan to deal with the Eurozone debt crisis is needed, while central banks have to ensure that banks have sufficient liquidity to continue in their day-to-day operations. The second is relatively easy and there have been renewed signals from central banks that they are very aware of the dangers. Unfortunately, the first is more difficult given unpalatable political dynamics. There needs to be an acceptance in the stronger Eurozone countries that fiscal transfers are inevitable and the longer the delays the more expensive the ultimate bill. Equally, longer-term reforms have to be agreed on to avoid a recurrence of the fiscal indiscipline that has led to debt exploding in certain countries. This must include severe, but plausible, penalties for those flouting the rules (say, expulsion rather than fines). Lastly, creditors have to accept that they are going to lose money.

Chart 2 : The market sends a clear message on Greek sovereign debt



Source: DataStream

What next for the rand?

The rand's fortunes will remain linked to global developments in the weeks ahead. Unfortunately, the currency is always going to be a geared play on investor sentiment and therefore will move more strongly than its peer group the more abnormal market conditions become. This was very much the case during the 2008 collapse and was also the reason why the rand outperformed from March 2009 onwards (see chart 1).

In last month's *Rand Prospects*, we outlined two possibilities for the rand. In the first, global prospects deteriorate further and the rand weakens disproportionately, and in the second, the global economy resumes its stop-start cycle, with the rand settling and perhaps even pulling back towards the R7 to the dollar level. There is as yet no clear path ahead, although the first scenario has been playing out more convincingly so far.

Much will now depend on the ability of the policymakers to restore some level of confidence. Even though the global financial system is malfunctioning and the global economy is weak, there are practical steps to restoring health. What the markets are looking for is a path back to health rather than health itself.

Conclusion

The downside risks for the rand remain dominant, with tensions in global markets continuing and economic weakness in the short term likely to continue. Much will depend on the ability of governments to come up with plausible plans and on central banks to counter any immediate liquidity problems. Next week's US Federal Reserve Open Market discussions and those at the IMF meetings will set the tone.

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 has pulled back after earlier weakness.	The dollar could firm once 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 been mixed but gold has been strong.	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 but rates elsewhere are also softening.	The carry trade will remain a supporting force as local rates move into the upcycle from late 2012 onwards.
Emerging market perceptions	Positive = good for rand.	Risk aversion has increased, with emerging market currencies easing.	Woes could spread more strongly 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 only 1,3% in the second quarter. Recent figures suggest weak growth continued in the third quarter.	Will still be positive, but could lose some momentum on a weaker global environment.
Current account	Large unsustainable deficit would be rand negative.	Deficit widened to 3,3% of gdp in the second quarter of 2011, up from 3,1% 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.	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 to be imposed.	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	Walmart deal eventually approved but future inflows likely to be limited in the current climate.	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.	Overvaluation has slipped to below 10% on purchasing power calculations given recent weakness.	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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