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Economic Commentary

Rand Prospects

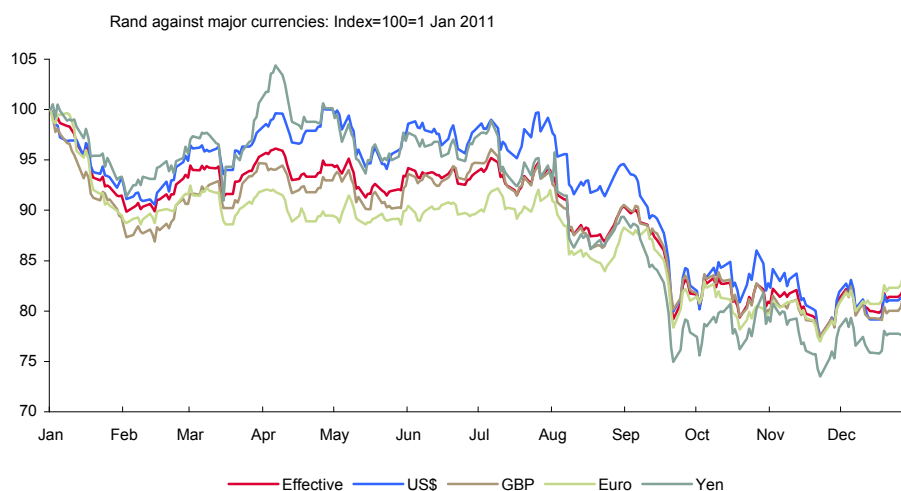
Volatility likely to continue in 2012

- The rand was hurt by increased risk aversion in 2011.
- The Eurozone crisis and disappointing global growth were mainly to blame for the rand's 18% depreciation in 2011.
- Global fiscal, financial and growth issues remain unresolved, pointing to continued volatility and vulnerability in the short term.
- Second half 2012 performance will largely depend on the ability of policymakers both here and elsewhere to produce credible fiscal and economic growth plans.

Comment

In *Rand Prospects* at the beginning of last year we speculated that “*The chance of a reversal [in the rand] has also increased this year, as the currency is well into overvalued territory.... Increased risk aversion, particularly from Europe, could accelerate this trend*”. In the event the rand did have a turbulent year in 2011, losing ground against most currencies. The main reason for the weakness was renewed risk aversion due to a worsening in the Eurozone crisis and disappointment over global economic prospects.

Chart 1 : The rand had mixed fortunes for much of 2011, but ended the year much weaker



Source: Reuters

After a shaky start to the year, the rand settled into a relatively narrow trading range until a renewal of global jitters in July and August pushed it significantly weaker. Markets began to realise that the Eurozone crisis was far from over and that there was a significant danger that it could spread to the “too big to fail and too big to support” category of countries in Europe, such as Italy and perhaps even France. Spreads on Italian 5-year credit default swaps (CDS) went from 133 points in early July to nearly 500 points in late September as participants scrambled to cover against the unthinkable. During this period the currency lost 16% against the trade-weighted basket, accounting for most of the cumulative 17,6% depreciation for the year.

The second concern to markets was the general loss of momentum in the global economy. As usual, the year had started with optimism over the outlook and a feeling that trend growth would at last start to resume. The combined natural and nuclear disaster in Japan in March 1

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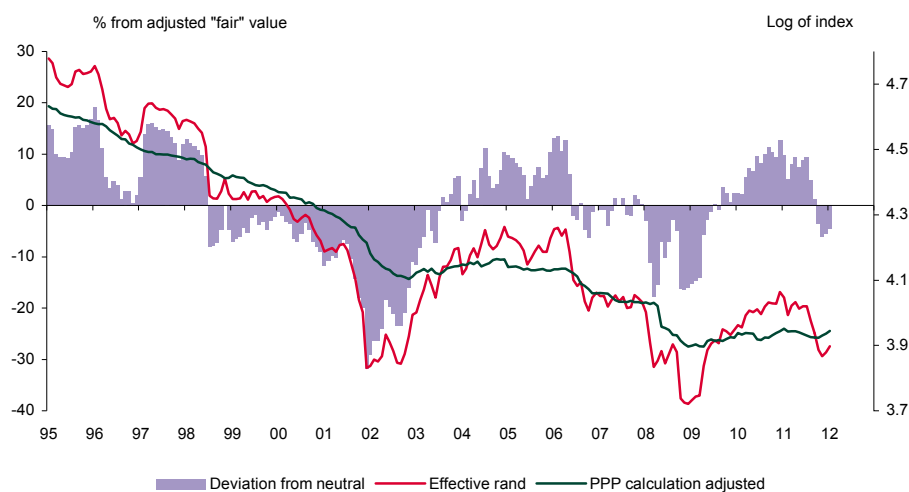
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led to a sudden contraction in Japanese economic production as well as supply chain disruptions across the globe. However, it was felt that the Japanese economy would bounce back quickly and that the global economy would strengthen in the second half of the year. Japan did stage a remarkable comeback but this was insufficient to offset a more general slowdown elsewhere. This included the United States, which was also embroiled in a fiscal battle (to raise the debt ceiling and come up with a bipartisan plan to cut the deficit over the next few years) and still had structural issues in the housing, labour and credit markets to contend with. China too started showing signs of slowing down and stress in certain areas such as the property market.

Against this background, commodity prices were generally weak in 2011, particularly in the second half of the year as gloomier sentiment set in. Two exceptions were oil and gold, which both performed strongly until September when they corrected from elevated levels.

Chart 2 : The rand is now more fairly valued on purchasing power parity considerations



Source: South African Reserve Bank and Nedbank calculations

Prospects for 2012 are less clear than they were at the start of 2011. As chart 2 shows the currency is much closer to fair value than it was at the start of last year, suggesting that most of the expected correction has already taken place. However, all purchasing power parity estimates (which use inflation differentials to estimate competitiveness losses and gains) have their limitations and graph 2 also shows that the rand often deviates significantly from theoretical fair value over extended periods.

Opinions of the global economic and financial outlook also differ, with optimists looking for a better-based recovery in the US, market attention on Eurozone woes fading and easier policies in China leading to a soft landing. Our own views are less rosy. On the US there has been some encouraging news, with producer and consumer confidence improving and some – very early – signs of life in the problem areas of the labour and housing markets. It is also an election year suggesting that some stimulus may be found in the system. However, structural issues in the credit markets remain, the overall fiscal position is poor and a weak Europe and firmer dollar may hamper gains.

On Europe itself, the problems look set to continue. Last year's final EU deal addressed the issue of longer-term fiscal rules and the ECB's recent extensive provision of liquidity to European banks has taken off one of the key pressures that led to the deterioration in the third quarter of last year. However, there will be no relief for affected countries and no real plans to stimulate growth. Banks are also more likely to cut back on credit to meet new, stringent regulatory requirements. A recession in the short term looks inevitable, with the main questions being how long and how deep?

On China, the authorities have shown time and time again their ability to provide quick and effective stimulus to the economy when needed. It is therefore brave to question their ability to do so again in 2012. However, it does seem unlikely that the authorities would be able or even willing to carry the global economy to the extent that it did in 2009. Massive fiscal and

monetary stimulus carries not only economic and financial risks but also political and social ones too.

The last set of considerations is the domestic policy and political environment. Two ratings agencies – Moody's and Fitch – have already signalled their concerns through "negative outlook" warnings that the climate could deteriorate in the coming months. The key fiscal issue will be government's ability to contain the massive rise in social spending and the public sector wage bill. Although the budget in February will give some idea of intentions, it will be the public sector wage round towards the middle of the year that will test political will. This will be made even more difficult because of the ANC's elective conference in December, where the future leadership will be chosen. The ANC's policy conference in June could also potentially hurt market sentiment at a time when government's borrowing needs – and its reliance on foreign investors – are growing.

Conclusion

The early part of 2012 is likely to be a continuation of 2011. European difficulties are likely to continue and could even deepen and the international economy will remain fairly weak. We are forecasting global growth of around 3%, well below trend but avoiding a world recession. Locally, policy will hold much of the key. The authorities have to ensure that some of the doubts in investors' minds do not become realities. On balance the rand is expected to continue its weaker trend but at a more moderate pace.

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 on European woes.	The dollar will probably continue firming, but significant strength will be resisted.
Commodity prices	Strong commodity prices are rand supportive.	Generally weaker on global fears.	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 1,4% in the third quarter. Recent figures suggest some improvement in fourth 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 3,8% of gdp in the third quarter of 2011, up from 2,9% in the second 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.	Rand now slightly undervalued 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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