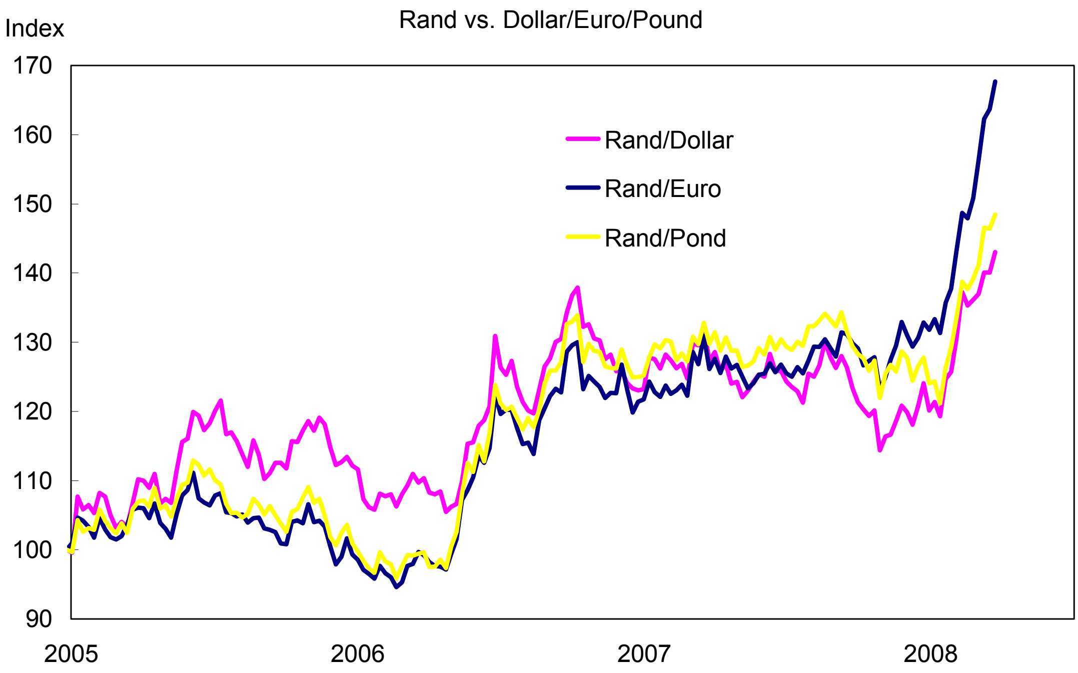
Economic commentary

Jac Laubscher
Group Economist
19 March 2008

Currency confusion

At the time of writing this commentary, the rand is trading at R8.15/$, R12.85/€ and R16.40/£. It has weakened by respectively 21%, 32%, and 18% against these currencies since 1 November 2007. The graph below shows that the recent behaviour of the rand has been very similar to that during the previous bout of emerging-market jitters in mid-2006.



At the same time gold is trading at $1 024 per ounce and platinum at $2 000 per ounce. If these levels are maintained, South Africa's terms of trade will improve tremendously, and the current account deficit will shrink to less than 6% of GDP in 2008, in spite of the negative impact of power shortages on mining production. Normally these developments would have led to a strengthening in the exchange rate of the rand.

Furthermore, in recent months the rand has been remarkably weaker than the currencies of other countries with large current account deficits, such as Hungary, Turkey, Australia and New Zealand. To confuse matters even more, the marked depreciation of the rand contrasts sharply with the appreciation in the currencies of other commodity-producing countries such as Brazil and Chile.

What are we to make of all this?

Clearly the rand is being buffeted by the ebb and flow of international capital movements, and one should therefore focus on the causes of changes in the direction and magnitude of these flows.

Firstly, the rand's fortunes are inextricably bound to the fluctuations in global risk aversion. The prevailing high level of uncertainty is reflected in constantly shifting assessments of the severity of the crisis in the banking system, and of the probability of a US recession. Negative shifts in sentiment cause the dollar to weaken and commodity prices to rise, but the implied deterioration in risk appetite still causes the rand to depreciate. Positive shifts have the opposite effect, of course.

Secondly, it appears as if additional factors peculiar to SA are driving the exchange rate of the rand. It is striking that the depreciation in the rand has accelerated sharply from mid-January. Two factors that have probably been at play are the increase in political uncertainty after the change in the leadership of the ANC and the negative impact of the electricity crisis on economic activity.

As far as the political uncertainty is concerned, we have to accept that it will not be fully resolved until after the general election in 2009 and the subsequent inauguration of SA's new president. The composition of the new cabinet will be closely watched for any signs of a possible shift in policy.

Economic growth forecasts for 2008 have already been revised downwards, as have projections of company profits, with resultant net sales of SA equities by foreign investors. However, of more importance is whether this is a mere blip or whether SA's medium-term growth outlook has been damaged. Foreign portfolio investors started reducing their historical underweight position in SA shares only once they accepted that SA has succeeded in closing the growth gap between itself and its peers in the emerging-markets universe. Should they decide that the gap is set to open up yet again, their retreat from SA's equity market will gain momentum.

In conclusion, the weaker bias to the rand is likely to persist for some time yet. A stronger dollar could paradoxically be accompanied by a stronger rand as it would signal a return to normality in financial markets.