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Economic Overview for Business Owners

September 2015

A more painful adjustment than we would like?

Four years ago the Rand was trading at close to Rand/$7. At the time of writing it is trading at around R/$13. Popular explanations for the extent of the currency's plunge include electricity shortages, work stoppages and fears about a possible downgrade of South Africa's sovereign debt rating to junk status.

Some of these factors do not provide us with a plausible explanation for the *persistent* currency weakness of the past four years. Electricity outages commenced in December 2014. Work stoppages amounted to more than 12 million working days in 2007 and more than 14 million working days in 2010. At the time South African economists were debating whether or not South Africa should impose capital controls to stem the currency's persistent appreciation.

Certainly, persistent deterioration in government expenditure discipline from 2008 to 2011, as its consumption expenditure ballooned at the expense of infrastructure spending, was not helpful. The currency is known as an economy's share price and there is more than enough literature to illustrate the importance of sensible economic policy as a necessary condition for an economy's well-being. But although there are still risks associated with fiscal policy, the National Treasury's track record on sticking to its expenditure ceiling has been exemplary over the past three fiscal years.

Moreinteresting is that the start of the Rand's fall coincided with the beginning of the downturn in South Africa's commodity export prices in 2010 – when China's post-financial crisis bounce in industrial production peaked. China is the world's largest importer of commodities.

Over time we expect the Rand to change in line with the inflation differential between South Africa and its trading partners. That is we *assume* that purchasing power parity (PPP) holds over time. But we know the currency deviates from the path suggested by PPP for years on end. In our history, one of the most common causes of these deviations is commodity price shocks. For example, a falling gold or platinum price puts downward pressure on the Rand, pushing it weaker than its "fair value".

The problem is that swings in commodity prices are no easier to forecast than currencies. All we can, therefore, say is that the Rand is cheap relative to an estimated "fair" value. But it could remain cheap.

Whichever explanation we favour for the Rand's persistent weakness, at the very least, we should not ignore the message the currency carries regarding unfolding developments in the global economy. Following the 2008 financial crisis, credit extension growth has been strong in many developing countries, including China, against the backdrop of extraordinarily loose monetary policy stances in developed economies.

At the same time, macroeconomic imbalances (current account and budget deficits) have built up in numerous economies. Tighter global financial conditions have exposed the vulnerabilities of Emerging Markets (EM) economies. This has been reflected in the "capitulation" sharp depreciation of numerous currencies, including Brazil, Russia, Indonesia, Thailand, Nigeria, Angola, Ghana, Zambia,

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Hungary, Turkey and Australia (although the latter is not an EM economy). Liquidity has waned and funding costs have increased, while the required adjustment of these imbalances implies significant downside risk to expected growth, including in South Africa.

But what does the Reserve Bank make of all of this? In hiking its policy rate by 25bp in July 2015, the Reserve Bank's accompanying Monetary Policy Committee (MPC) statement suggested that the MPC is concerned that South Africa's real policy rate is too low, given likely increases in the US Federal Fund target rate in the year ahead. Specifically, the Bank is worried that sustained Rand weakness and sticky domestic inflation expectations could translate into persistently high inflation. Further interest rate hikes cannot, therefore, be ruled out if the Rand continues to depreciate. If so, we are set for an adjustment to domestic final demand that could be more painful than we would like.

I do not believe it is possible to predict currency movements consistently over time. But, hopefully, with some luck, the Rand has already depreciated sufficiently to meaningfully reduce the current account deficit. Improvements in South Africa's trade balance data in recent months, at least, give reason for optimism. Time will tell.

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