



17 October 2008

REVISITING OUR ECONOMIC FORECAST MKII: RAND COMES UNDER SERIOUS PRESSURE

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Introduction: a shocking fall in the value of the rand

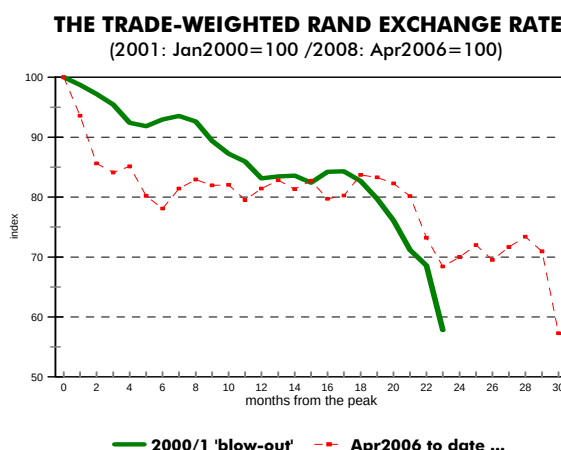
In the current economic climate where agonizing events challenge (and often overtake) views by the day, it is necessary to extend the commentary on the economic outlook provided in last week Friday's *BER Comment* (see www.ber.ac.za). More specifically, the rand's dramatic depreciation on Wednesday evening and yesterday (by close to 20% on a trade-weighted basis)¹, in concert with, but actually sharper than most emerging market currencies *immediately poses the question whether the risk scenario (read: balance of payments crisis triggering an undue tightening of macro-economic policies) is not already underway?*

The short and simple answer is that we don't know, except to say that the probability of this scenario has increased, say from 30% closer to 50%. It is entirely possible that the rand bounces back over the near term given the extreme volatility of the moment. In fact, we remain with our exchange rate forecast put out on Monday (see: www.ber.ac.za). The risk scenario may only materialise should the current rand weakness be sustained and/or deteriorate further.

This may happen if the world economy enters deep recession, commodity prices continue to plunge and investors flee emerging country capital markets in some sustained manner. The SARB will have little option, but to respond with monetary tightening, indirectly to offset the inflationary impulse, but more directly to curtail domestic demand for imports in order to reverse the current account deficit. Tighter fiscal policy is also an option; however, implementation lags and political hurdles make this an unlikely option. While an economy can live with temporarily high inflation an overall balance of payments deficit has to be addressed. Another option would be for the SA government to approach multi-lateral institutions (like the IMF) for temporary balance of payments assistance, which would negate the necessity to tighten macro policies. A range of developing economies is already preparing such plans.

The aim of the present follow-up note is to provide some assessment of the current rand exchange rate depreciation and outlook, as well as to outline the quantum of impacts which may result in the event of a

Figure 1: Current rand depreciation in perspective



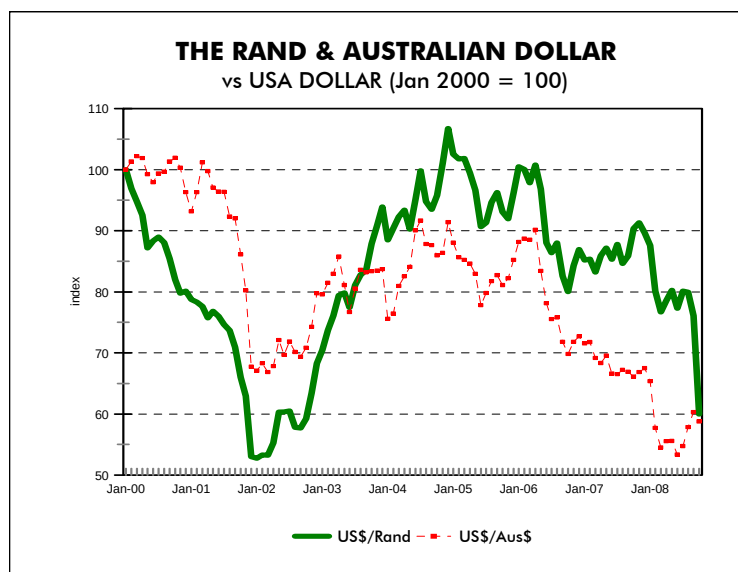
Source: BER

¹ The trade-weighted rand exchange rate has depreciated by 42% between April 2006 and mid-October 2008, similar to the fall between January 2000 and December 2001 (see Figure 1). In the 2006/7 period the rand's depreciation was mainly against the crosses (particularly against the appreciating euro and yen); however, from 2008 much of the depreciation occurred against the US dollar, which began to strengthen; in fact, 80% of the rand's depreciation versus the dollar (April 2006 to mid-October 2008, i.e. close to 40%) occurred in 2008 and more than 55% of this occurred during the first two weeks of October as the dollar benefited from the capital flight from emerging markets. While the rand has weakened substantially since mid-2006, even at current levels, it is not as weak as during 2001 – between end-2001 and April 2006 the trade-weighted rand appreciated by 63%.

crisis scenario. It has to be emphasised, that we remain in the realm of a 'what-if' scenario. The objective remains to provide information that will facilitate planning in what can otherwise only be described as extraordinary. One runs out of appropriate descriptive adjectives.

Figure 1 shows that the decline in the value of the rand since April 2006 came in three step-down phases, with each period characterised by heightened global financial volatility (i.e. 06Q2, 08Q1 and currently). There were periods of stability – final quarter of 2006 through 2007 and the middle quarters of 2008; however, the step-wise depreciations were clearly linked with the deteriorating global financial climate at the time where the rand proved vulnerable given SA's current account financing requirement. Beyond these shorter term movements in the rand exchange rate, the broader link with the commodity cycle is evident from the co-movement with the Australian dollar (see Figure 2). This linkage held during the 2000/1 fallout (the previous world recession) and currently.

Figure 2: Co-movement of the rand and the Australian dollar versus US dollar

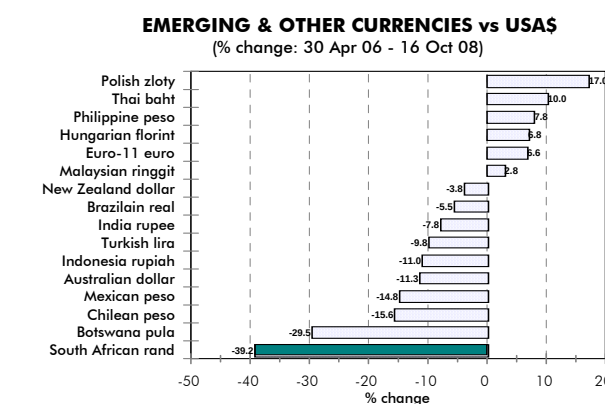


If we accept that the world economy has entered recession and will remain there over the short term and that the financial climate remains hostile, it follows that the rand may remain under pressure. However, as noted in last week's *Comment*, once we get beyond the apex of the current financial turmoil, including the real economic shocks to unfold over the near term, the fundamental positive outlook for commodity demand and prices is likely to re-assert itself, which should then again benefit commodity-based currencies like the rand.

Implications: Fasten your seat belts

One has to accept that the recent developments have a negative bearing on the economic outlook. While the rand typically behaves as a shock absorber (this we experienced in 2001/2), the current situation may be different. Firstly, the global downturn is much more vicious compared to 2001; secondly, the domestic economy was firmly embarked on an economic upswing phase of the business cycle by 2001/2 (i.e. 2-3 years into the upswing) whereas the local economy is currently experiencing quite an abrupt end to that historically robust economic upswing. The cheaper rand should boost manufacturing exports and commodity export earnings, as well as stimulating manufacturing output via import replacement. Some of this may be happening; however, the recession unfolding in local manufacturing suggests a weak impulse at this stage. Both global and domestic demand is weak limiting the options for manufacturers.

Figure 3: Rand's competitiveness has increased



Source: BER

In short, we remain with our baseline forecasts released on Monday, forecasting overall real GDP growth to slow down to 2.1% next year; targeted inflation to moderate to 7½% allowing interest rates to start falling from the second quarter. This view discounts a world economic recession, with G7 GDP growth contracting by 0.3% during calendar 2009 and a sharp fall in commodity prices. *However, as noted last Friday:*

"The biggest risk to this domestic outlook would be interest rate hikes on the back of undue balance of payments pressures leading to a destabilising depreciation of the rand exchange rate."

Concluding remarks: Macro dynamics in a risk scenario

The macro-economic outcome of a sharp drop in SA's terms of trade, higher local inflation (for longer due to exchange rate depreciation), further increases in interest rates, combined with the adverse impact on export demand tied to a global recession is likely to be worse from a short-term growth and employment perspective. The technical requirement of two consecutive quarters of absolute decline in the level of real GDP to qualify as a 'recession' is immaterial; the reality will be higher inflation, hikes in interest rates, employment cutbacks and the re-assessment of capital spending plans in the private business sector, more serious reductions in consumer spending (with adverse wealth effects from declining asset prices, including the housing market, adding insult to injury), lower business and consumer confidence and a substantial slowdown in credit utilisation marking what can only be described as a recession. The growth numbers released on Monday (*Table 1*) will be too optimistic.

The impact is likely to be very negative for the domestic market. The consumer sector and – to a lesser extent – private fixed investment spending will be under severe pressure. An improvement in net exports – mainly due to a sharp fall in imports (on the back of a weaker currency and the sharp slowdown in real GDE) – should counter the negative impact on overall GDP growth, fixed investment and employment creation. The net export effect would have been more potent in a stronger global growth environment.

The outcome from such an adjustment in the local economy will be a reduction in the current account deficit in relation to GDP, which should then be sustainable. Combined with a return in capital inflows the rand should recover, inflation will decline and the interest rate hikes will be reversed inducing a recovery in overall economic growth.

Table 1 (*next page*) contains the BER's baseline forecast. Also visit our website: www.ber.ac.za for more detailed updated forecasts.

Table 1: Baseline BER forecast of key economic variables: 2008/10

SA economy: October 2008 (Revised forecast)	2007	2008F	2009F	2010F
Real GDP growth	5.1	3.4	2.1	4.2
Real HCE growth	7.0	2.6	1.8	4.1
Real GC growth	5.0	4.7	4.3	4.2
Real GDFI growth	14.8	10.4	2.4	6.5
Real GDE growth	6.0	3.7	2.3	5.1
Real export growth	8.3	1.6	1.0	4.6
Total employment growth	2.7	1.7	0.7	1.9
Target inflation	6.5	11.5	7.4	5.7
PPI inflation	10.0	15.9	9.5	6.4
Prime interest rate (eop)	14.50	15.50	13.50	13.00
R157 bond yield (eop)	8.44	8.96	8.50	8.60
R/\$ exchange rate (Q4)	6.77	8.46	9.17	9.62
R/€ exchange rate (Q4)	9.81	11.85	12.49	12.60

HCE: Household Consumption Expenditure; **GDFI:** Gross Domestic Fixed Investment; **GC:** Government Consumption

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