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The rand after Nene?

A report on the latest round of rand depreciation

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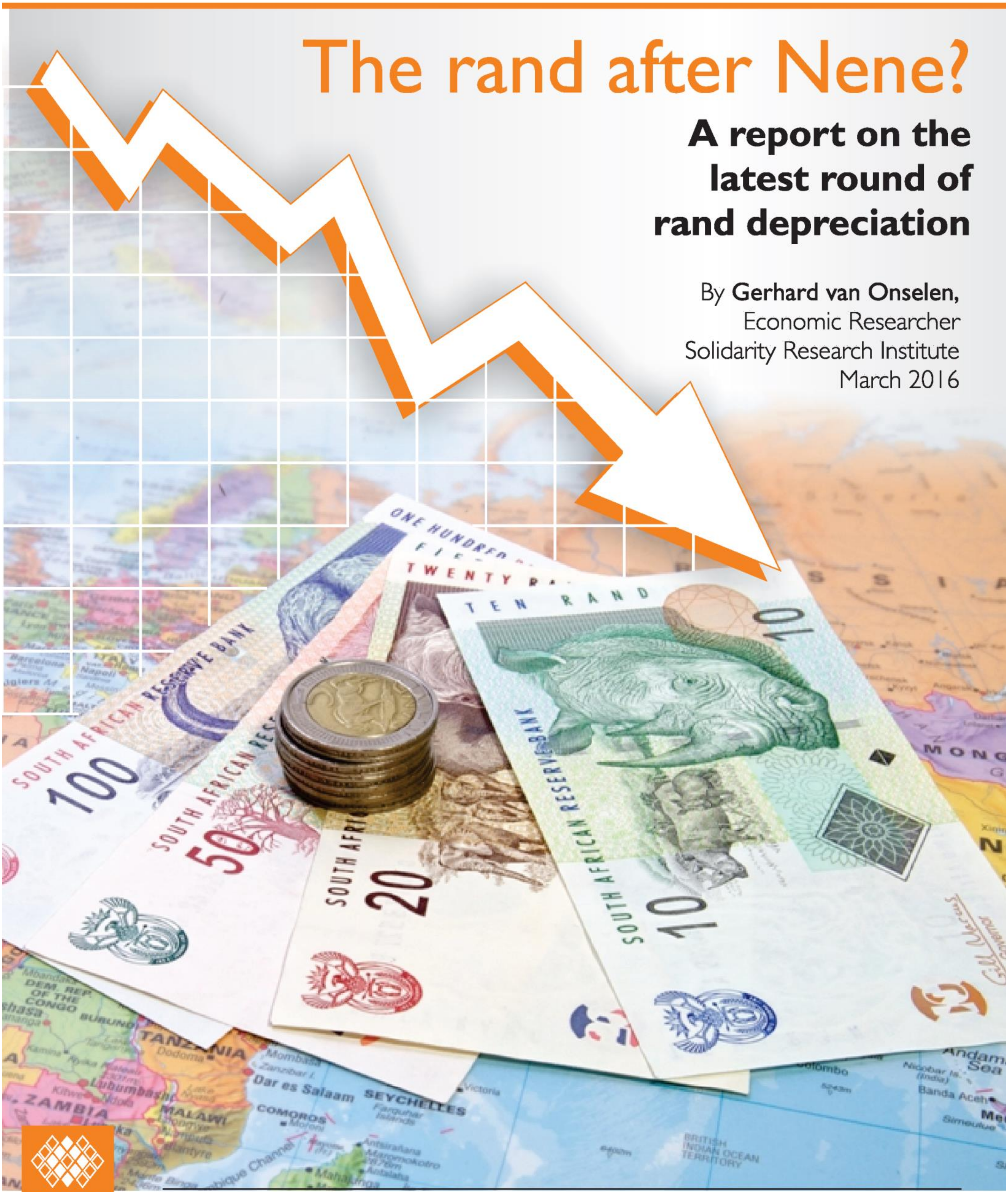

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The rand after Nene - Report in a nutshell

December 2015 is a month that is sure to be remembered for President Zuma's ill-considered decision to dismiss Nhlanhla Nene as minister of finance, a decision that caused substantial upset for the rand on the international currency markets.

The fallout from this event was severe with the rand demonstrating large negative moves against other currencies. This once again placed the weakness of the rand at the forefront of public discourse. The weaker rand also complicated the context in which finance minister Pravin Gordhan had to present his February 2016 budget speech.

The rand regained some of the value it had lost after Nene's dismissal, only to become volatile after the February budget speech. Even before Nene's dismissal, and late February's budget volatility, the rand had been steadily depreciating to the dollar.

The post-Nene exchange rate volatility is not the entire story. While it may now seem incredible to believe, a mere five years ago in April of 2011 the rand traded at around R6.60 to the US dollar. Since then, highs of around R16.80 have occurred.

This brief report provides a discussion of some salient points on the current trend of rand depreciation. The report should be read as a supplement to our feature article (by Russell Lamberti) and macro-economic update for 2016Q1 contained in the January–March 2016 edition of the *South African Labour Market Report.*[1]

Summary of salient points

- Since April 2011 the rand has gradually lost considerable value against the US dollar. The rand has weakened from around R6.60 per US dollar to around R15.32 per dollar (14 March 2016), a rand depreciation to the dollar of nearly 60%.

- While adding shock to the rand-dollar exchange rate, Nene's dismissal actually contributed a relatively small part to the overall depreciation trend in force since April 2011.

- The rand has now far surpassed the previous historic lows of around R13 per US dollar, a value last seen during December 2001.

- Since 2000 the rand-dollar exchange rate has displayed significant cyclical volatility. Focussing on the period from 2000 to the present, two major rounds of appreciation and three major rounds of depreciation have occurred.

- A short-term reversal from the post-Nene blowout is likely and appears to be already in progress. Such a reversal is to be expected. However, a reversal from a sudden spike in the rand-dollar exchange rate should not be confused with an overall change in the bias from rand depreciation to rand appreciation.

- The longer current round of depreciation (April 2011 to the present) appears less driven by external economic shocks and more driven by adverse domestic policies and laws. In reality, South Africa's inflation adjusted GDP per capita growth, measured in US dollar, has been largely stagnant since 2007,

[1]Read the complete report at https://navorsing.solidariteit.co.za/wp-content/uploads/sites/19/2016/02/Solidarity-ETM-SA-Labour-Market-Report-2016Q1.pdf .

and is worse than a number of countries facing a weak global economy and with similar exposure to metal and commodity export markets.

- During times of rand depreciation there is frequent mention of the idea that a weaker currency is actually beneficial to the economy. Such arguments rest on the idea that a weaker currency stimulates exports and domestic economic activity.

- While a currency "shock absorber" may indeed serve to temporarily slow down or reverse a falling currency, it cannot circumvent the long-term effects of adverse fiscal and economic mismanagement by governments.

- Ultimately a currency will be reflective of broader domestic economic fundamentals of the country and the currency's issuer. If these are weak, a currency will be biased toward weakness.

- We contend that SA owes a great deal of its current economic woes, reflected by the weakened currency, to adverse economic policies and increasingly damaging government interventions.

- Without a significant deviation from damaging policies and laws, the rand will continue to underperform relative to the currencies of countries with more favourable policies and economic fundamentals.

What does this mean for the ordinary person in South Africa?

For the man on the street a weakening currency holds negative consequences. These include more expensive imports, faster-rising domestic prices, likely interest rate hikes, cost-pressures on businesses, retrenchments, and general insecurity in the labour market. The current round of rand weakness is therefore harmful to most people in SA.

Though there are always external shocks, policies adverse to economic growth are playing the largest part in the weak domestic economy. These are internal factors and they can be reversed by government.

Economies are highly resilient and can recover quickly, returning to much needed robust growth. What is required is a reversal of harmful policies and laws and much less state interference in the economy. Unfortunately, unambiguous mentions of such freedom-driven reforms were largely absent in the February 2016 national budget speech.

1. Introduction: The rand as a tradeable currency

To understand the sudden weakening of the rand in the aftermath of minister Nene's dismissal one has to understand the workings of currency markets. Government issued currencies, of which the rand is one, are traded on extensive currency markets in a way similar to commodities such as oil, gold and maize.

This means there exists a market demand and a market supply for currencies, just like any other commodity. This includes the rand, a currency which is extensively traded on the international markets.

People buy or sell a currency for various reasons. These reasons include import/export transactions, travel, foreign investments, or speculative trading. Being extensively traded, the rand is exposed to market volatility. Panic sell-offs occur frequently on many markets. On the currency markets panics happens when a sizable portion of a national currency is sold in a short period of time.

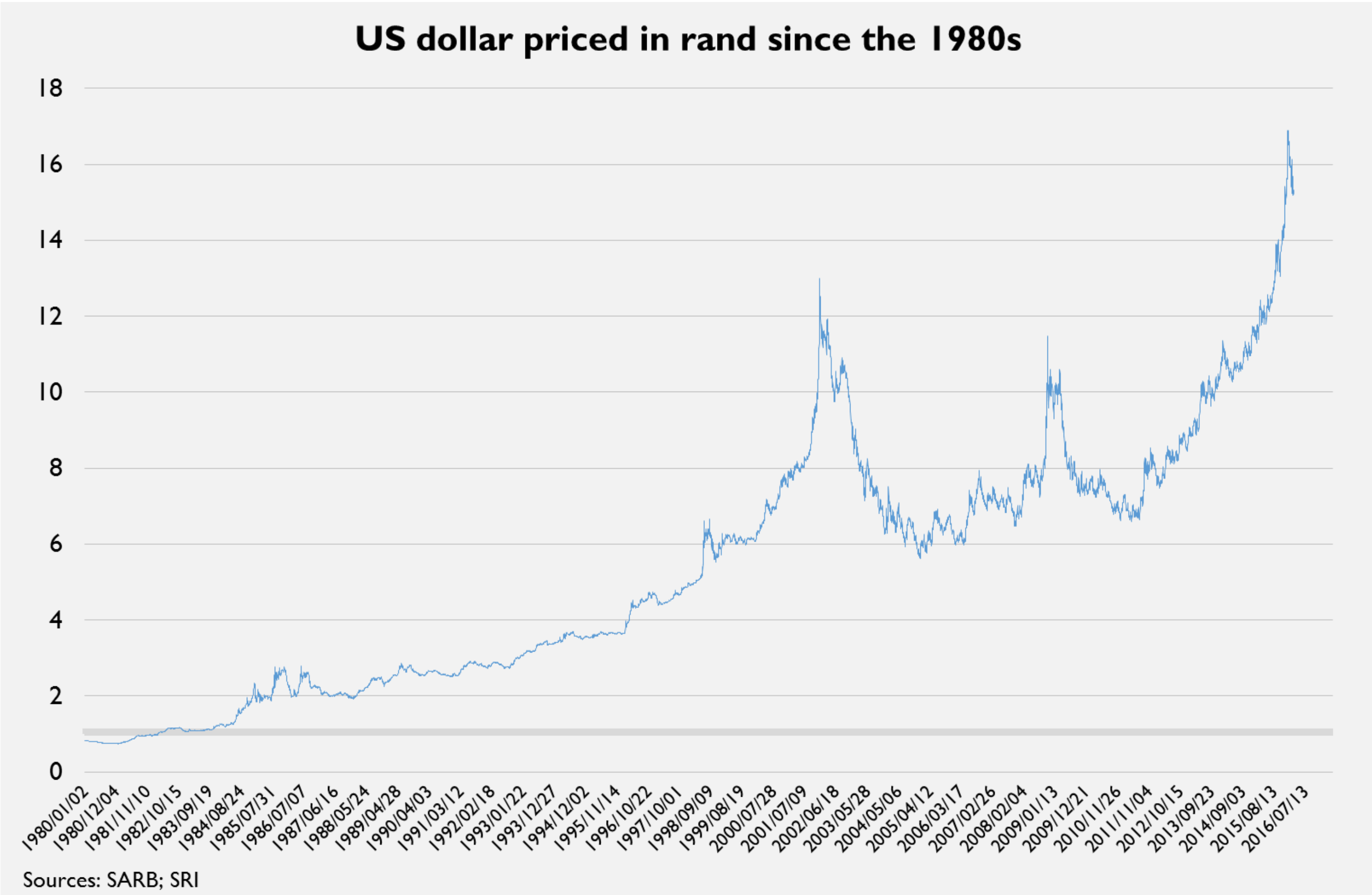
During a panic sell-off a currency can lose much of its value relative to other currencies. This is reflected by a worsening of the currency's exchange rate relative to the other currencies against which the trading occurs.

Another way a currency loses value relative to other currencies is through government currency creation, where additional units of currency are created through a central bank and its influence on the national banking system. This effectively amounts to money being printed out of thin air, which makes existing units of the currency less valuable.

Minister Nene's sudden dismissal by President Zuma set off a panic sell-off of the rand. Nonetheless the largest part of the current trend of rand depreciation (since April 2011), as we pointed out earlier, cannot be attributed to Nene's dismissal.

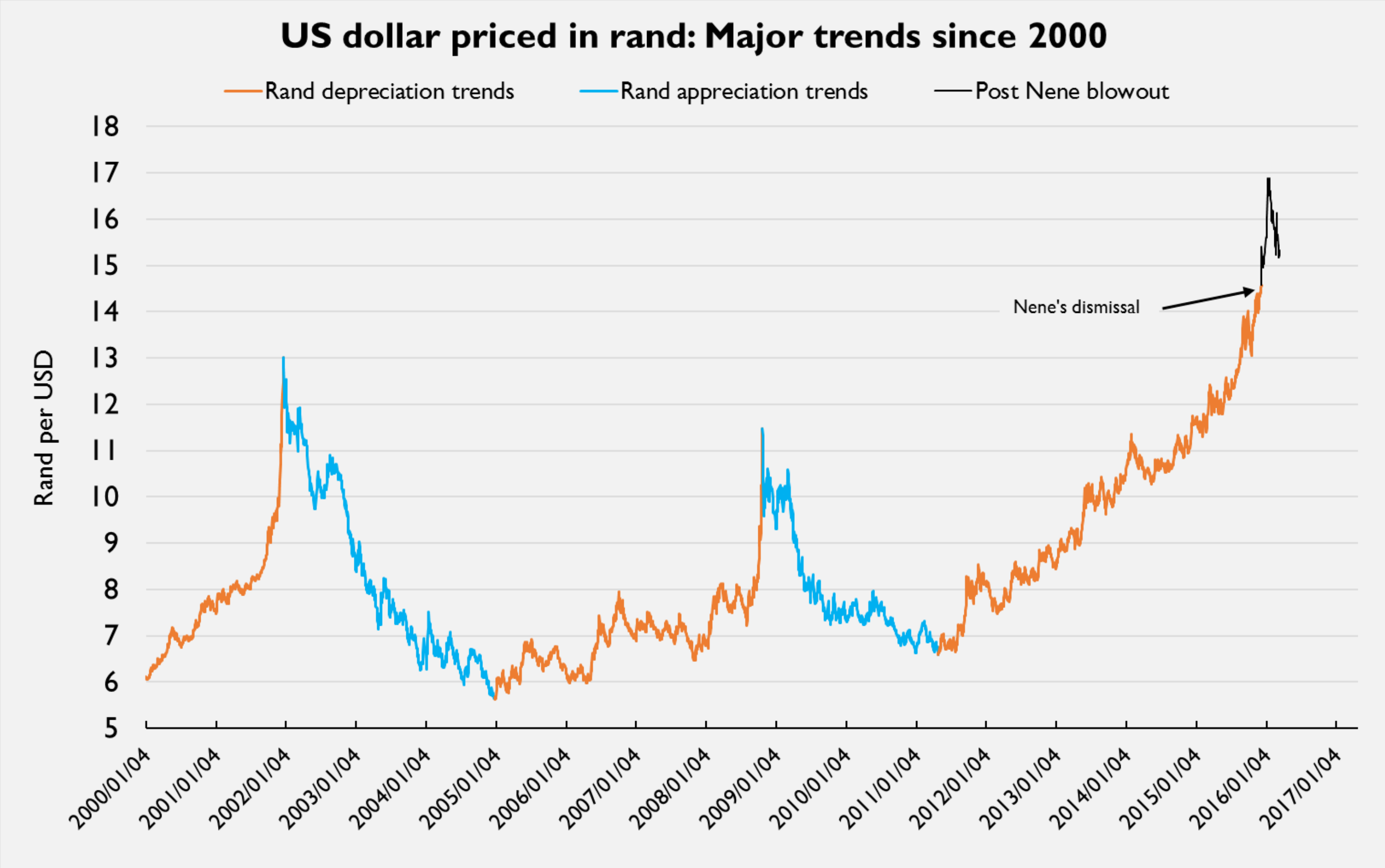
2. Historic overview of the USD-ZAR exchange rate

The following long-term chart illustrates movements in the rand-dollar exchange rate. During the 80s and 90s, a significant depreciation to the US dollar occurred. Since 2000 the rand-dollar exchange rate has displayed increasing cyclical volatility.



Focussing on the period from 2000 to the present, two major appreciation trends and three major depreciation trends occurred.

The rand gained value to the US dollar over the periods 2002Q1-2004Q4 and 2008Q4-2011Q1. The rand weakened to the dollar over the years pre-2000-2001Q4, 2005Q1-2008Q3 and 2011Q2 to present. Presently the rand is in a round of depreciation. The following chart outlines these major rounds of appreciation and depreciation.



Sources: SARB; SRI

Steep upswings in the exchange rate suggest external economic shocks played a significant role in the tail of the pre-2000-2001 depreciation and 2005Q1-2008Q3 depreciation. This appears to be less the case with the latest round of depreciation.

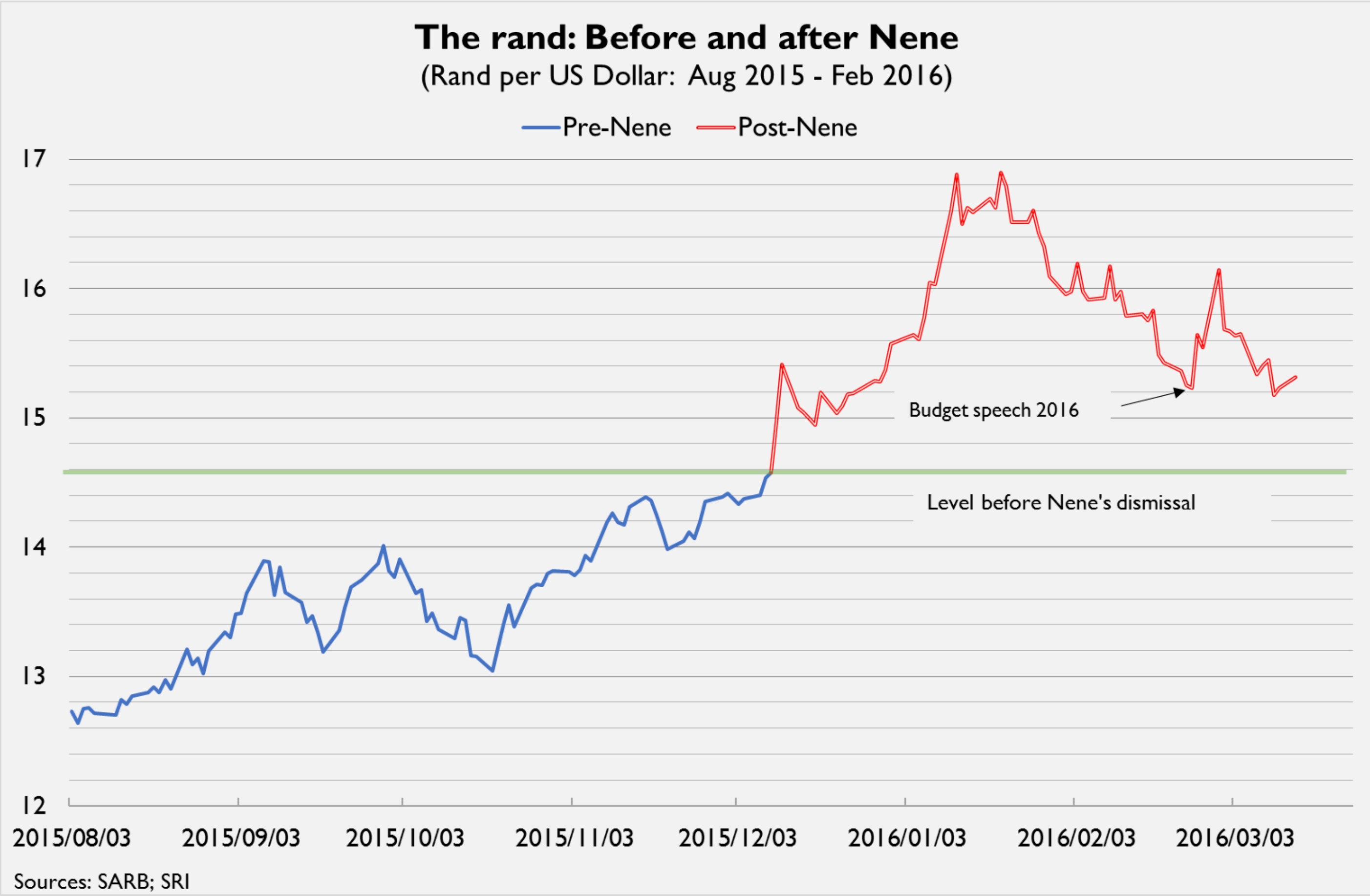
The 2008-2009 devaluation is owed largely to the financial crisis of the late 2000s. During the crisis the rand devalued sharply against the dollar as emerging market currencies came under strain and were sold off, but it recovered fully afterward.

In a similar way, a sharp devaluation occurred over the period of 2000-2001, which was also followed by a strong recovery. Reasons for the 2000-2001 devaluation include among others the fallout from the Dot-com (NASDAQ) stock market crash, the 9/11 terrorist attacks in New York, as well as actions by the South African Reserve Bank (SARB).[2]

[2] Changes in the SARB's stance on exchange controls and a commitment to dollar purchases to cover forward foreign currency positions played a role here.

2.1 The post-Nene fallout

Minister Nene's dismissal sent shock waves across the currency markets, plunging the rand into a significant short-term depreciation. Over a mere couple of days the rand devalued from around R14.60 per US dollar to a closing high of R16.89 per US dollar. This amounted to a temporary rand depreciation of nearly 14% to the US dollar, a highly volatile move, even for volatile currency markets.



Some measure of stability was restored only after President Zuma's reinstatement of Pravin Gordhan as minister of finance (reversing an earlier decision to instate a largely unknown member of parliament, David van Rooyen, as minister of finance).

The rand has since recovered somewhat from the post-Nene blowout and is currently trading back below R16 per US dollar. The fallout from Nene's dismissal succinctly testifies to the rand's potential for volatility.

While minister Nene's dismissal has placed the rand and its recent losses back at the forefront of public discourse, it played a relatively small part in a longer underlying trend of rand depreciation in force since April 2011.

2.2 Gradual currency decline preceding Nene's dismissal

Since 2011Q2 the rand had weakened from around R6.60 per US dollar to around R15.50 per dollar, a rand depreciation of nearly 60% to the dollar. The rand has now far surpassed previous historic lows of around R13 per dollar, a value last seen during December 2001.

Macro-economic realities, such as a weak demand for commodities, a stronger dollar and weak global growth are adding pressures onto the local currency, but are not solely to blame for the rand's persistent continual decline since 2011.

While external macro-economic challenges do indeed play a role, a worsening domestic policy environment is causing a great deal of the current rand weakness. This worsening policy outlook is largely driven by regulatory uncertainty, policies hostile to free enterprise, threats to property rights and severe restraints on the labour market.[3]

For the ordinary person in South Africa a weakening currency holds negative consequences. With a weak currency comes more expensive imports, rising local prices, likely interest rate hikes and margin pressures on businesses.

In spite of this, some ascribe net benefits to a weaker currency. These benefits, they suggest, flow from the effects caused by more rand for exports along with incentives to industries producing goods and services locally which compete with imports. In section 3.1 we argue that such net benefits, if they occur at all, are mostly isolated, exaggerated and short-lived; and not beneficial to the economy on the whole as is often suggested.

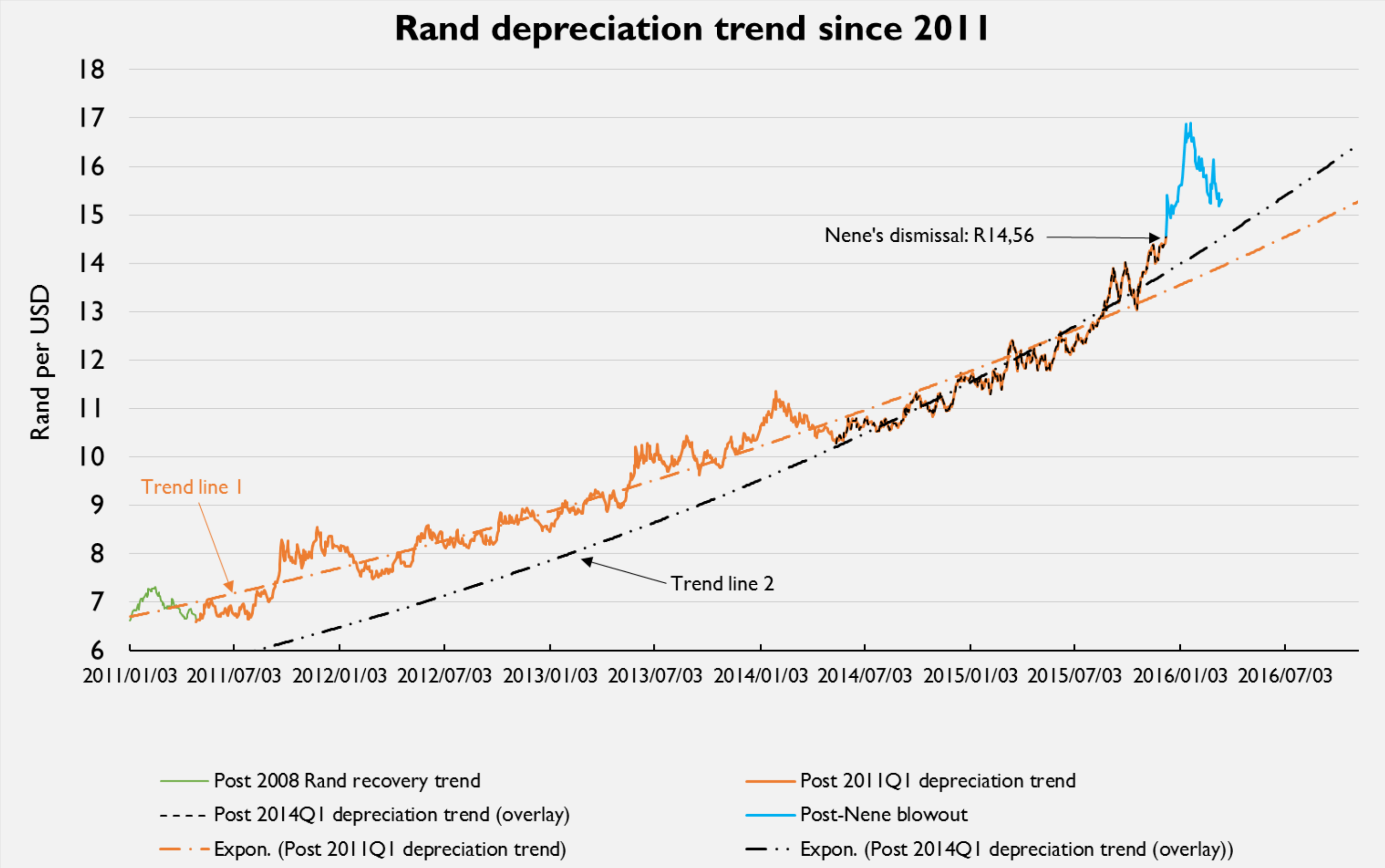
2.3 Reasons for the post April 2011 depreciation

The current round of depreciation (2011Q2-present) appears less driven by external shocks. Predominantly, the adverse internal economic realities amid weak external conditions are contributing most to the present decline.

Over this period a gradual depreciation instead of sudden shocks was observed. This suggests a more gradual decline of the currency. The post-Nene breakout was an exception to this, but as was indicated before, it added only a moderate number of percentage points' depreciation to an already weakened currency.

The two trend lines displayed on the following graph provides an estimate of the course the latest round of rand depreciation could follow if the current rand depreciation trend remains intact.

[3] Refer to Russell Lamberti's article *The failure of government's economic policies* in the January-March edition of the *South African Labour Market Report* available at: https://navorsing.solidariteit.co.za/en/solidarity-etm-south-african-labour-market-report-for-quarter-1-2016/.



Sources: SARB; SRI

Considering the weak macro-economic fundamentals and adverse policy environment, discussed at length in the most recent January–March 2016 edition of the *South African Labour Market Report*, we expect the bias towards rand depreciation to continue in line with weak domestic economic fundamentals.

A short-term reversal from the post-Nene blowout (the light blue area in the chart) is likely and appears to be already in progress, halted somewhat by the February budget speech and the political strife around minister Gordhan thereafter. Such a reversal is to be expected. However, a reversal from a sudden panic spike in the rand-dollar chart should not be confused with an overall change in the longer term bias toward rand weakness.

To recover to the level before Nene's dismissal, the rand would have to recover to around R14.60 per US dollar. A true deviation from the existing depreciation trend would only be signalled by an improvement where the rand firstly breaks below the two trend lines shown on the chart and follows up the breakthrough with a continual strengthening against the dollar from there onward.

In the absence of significantly positive external factors (or large policy-directed depreciations of other currencies) this would require a significant improvement in the South African policy environment.

3. The benefits of a weakened currency, myth or reality?

During times of currency depreciation it is often suggested that the depreciation would be beneficial as it will stimulate exports and domestic production in lieu of imports.

3.1 Is rand weakness beneficial?

It certainly is correct to argue that an increased demand for local products and services (local exports) may arise among foreigners when the rand is weak. Foreigners will find many local products and services cheaper when denominated in their own currencies and may be driven to increase their purchases of these products.

Under such conditions, local producers of exportable products and services would be expected to increase their output to meet the increase in foreign demand. This, it is suggested, stimulates the supply of locally produced goods and services to foreigners. In addition, it is often argued that more expensive imports will benefit the local producers of products competing with imports.

What is disputable is the supposed general benefits arising from a weaker currency as well as the idea that a weak currency supports local producers. A number of relevant factors follow.

First, consider that the benefits of a weakened currency are isolated, flowing mainly to a small minority of individuals or businesses. People earning their incomes in a foreign currency along with those few exporters not significantly dependent on more expensive imported inputs may initially benefit from a weakened currency.

Even then, most of these individuals and businesses are not excluded from the later adverse effects of a weakened currency. These effects include higher prices of imported goods and higher prices for local goods.

Higher import prices will contribute to price inflation and pressure on wages. Higher wage payments and higher input costs, among other things, will increase margin pressures on businesses. Such businesses will become conservative in their spending.

In addition, increased price inflation may cause the SARB to raise interest rates, which will increase the cost of credit. This will restrict spending among many businesses and individuals reliant on debt.

Price inflation and higher import prices also reduce the living standards of many people. Most consumers suddenly cannot afford to consume certain products or services to the same degree they used to consume them before the depreciation, which requires a painful adjustment.

Central to the matter is the point that before any supposed benefits can arise, the currency has to depreciate. Depreciation does not occur without the infliction of pain on a great number of people making use of a currency.

3.2 The shock absorber

In times of currency weakness the weak rand is often likened to a "shock absorber" for the economy and a cushion against global volatility. In recent statements SARB governor Lesetja Kganyago likened the weakening rand to a shock absorber for the economy. The SARB's prevailing contention is that the decline of the currency should be allowed to run its course.

According to media reports Kganyago said in September, 2015 that:

> A further fall in the rand is not necessarily a bad thing and the currency should be allowed to play its role as a shock absorber. […] Our assessment of the South African economy is that the risk to the economic outlook is on the downside. It doesn't follow that the depreciation of the rand is a bad thing for South Africa, if anything, it should spare the export sector.[4]

In February 2014, ahead of the budget speech, former SARB governor Gill Marcus reportedly remarked that:

> South Africa follows a flexible exchange rate approach precisely because the exchange rate is the shock absorber, which is doing its job. […] "The other element of it is that your imports become more expensive, as we have seen. It is an opportunity again for South African business to look at what its production is like. Is there a possibility of import substitution that takes place?[5]

If the above statements are to be believed, the latest round of rand depreciation (associated with the shock absorber) will simultaneously improve the balance between imports and exports in favour of local exporters and curtail the reliance on imports.

In addition, more expensive imports apparently provide incentives to improve the competiveness of local producers. In this context currency depreciation is again suggested as beneficial. Some problems with this view have already been presented in Section 3.1.

In the case of a weakened currency the shock absorber may work as follows: An increase in demand for products and services by foreigners, will coincide with an increase in the demand for the rand. As foreigners increase their purchases of local goods and services along with purchases of the rand the rand will eventually regain value relative to other currencies.

Note that the shock absorber also works in reverse. When a currency strengthens "too much" relative to other currencies the local economic participants will be incentivised to import relatively cheaper products from other countries. This requires selling the local currency for foreign currencies. In such cases the shock absorber would bring about decreasing exports, increasing imports, and an eventual depreciation of the currency.

Such shock absorber effects are a normal economic function seen with a currency with a floating exchange rate – one which is freely traded. Freedom is normal – restrictions on free trade (free trade includes currency trades) are abnormal.

Consequently, the shock absorber should indeed be allowed to run its course to coordinate the fair value of currencies, products and services across borders. Ultimately, fair value is determined by economic fundamentals and shock absorber effects cannot reverse poor fundamentals in the long run.

If a country's economic fundamentals are poor, its currency will eventually reflect those fundamentals, in spite of shock absorber effects. In any case, our contention is that it is much better for policymakers to focus on removing restraints on the improvement of fundamentals rather than the supposed "shock absorbing" benefits of a weaker currency.

Lastly consider that most governments exercise a great deal of control over their national currencies and can depreciate a currency by creating more of it out of thin air. Taken to the extreme, if currency weakness were really beneficial in general, governments could employ it at will by running the currency printing presses to infinity.

[4] http://www.fin24.com/Economy/Further-rand-weakness-not-all-bad-Sarb-governor-20150906
[5] http://www.fin24.com/Budget/Gordhan-Weak-rand-a-shock-absorber-20140226

Overt calls for currency depreciations, and its more destructive policy extreme: direct money printing, are rarely heard in reality. This is because a weakening currency does not hold any real benefit to an economy in general. If that had been the case governments or banks would have printed nations into prosperity a long time ago.

4. Conclusion

While global economic headwinds, lower commodity prices, a stronger dollar, and weak global growth are adding pressure to the South African economy along with the currency, these external economic headwinds are not the main reasons for the weak currency.

In the long term a currency reflects the economic fundamentals of the issuer. These fundamentals are mainly domestic, not external. Governments, in large part, shape these policy environments that can stimulate or stifle real economic growth.

In SA's case, by far the most of the damage done to the economy, reflected by a weaker rand, can be traced directly to a mounting number of self-inflicted policy wounds. Regulatory uncertainty and policies adverse to economic growth are mostly to blame here. Russell Lamberti, head strategist at ETM Analytics, summarises this view in his latest article published in the *Solidarity-ETM Labour Market Report*.

> Every country has unique challenges and opportunities. However in South Africa's case neither high inequality nor commodity exposure is sufficient to explain the poor performance of the South African economy. And weak growth in the major global economies has not hampered many major emerging markets to remotely the same extent as is claimed it has South Africa.
>
> South Africa's challenge seems to be overcoming anti-business policy, heavy state intervention and excessive regulation. What stands out in South Africa particularly is regulatory uncertainty, threats on property rights, escalating BEE rules, chronic mismanagement of large state-owned companies, and among the most restrictive labour laws in the world.

A weakening rand is harmful to most people in South Africa. Import prices escalate, inflation rises, businesses become conservative, labour becomes expensive, living standards decline, and indebted people pay more for debt.

Without a reversal from these damaging policy directions, the rand will continue to weaken relative to the currencies of countries with more freedom, reflected in more prudent policies and less restricted commercial environments.

In this sense the control is in government's hands. Damaging policies can be reversed. Better policies can be drafted. What is needed is a commitment to sensible, freedom-minded reforms and less state interference in the economy. Allowing people to trade and create wealth freely is the best policy for growing the economy and restoring the currency.