Understanding the past and future of the rand

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In 1959 when the FM was first published the US dollar cost South Africans the equivalent of 71 SA cents. Equivalent indeed because the ZAR itself was only to make its first appearance in 1960. We now have to pay about 15 rand for a dollar, or about 21 times more than we did back then. But we also pay a lot more for everything else we buy. The basket of goods that make up the consumer price index (Headline CPI) has increased by about 93 times since 1960. Yet Americans too are laying out many more dollars for their stuff than they did then. Their CPI is up nearly 9 times since 1960. [1]

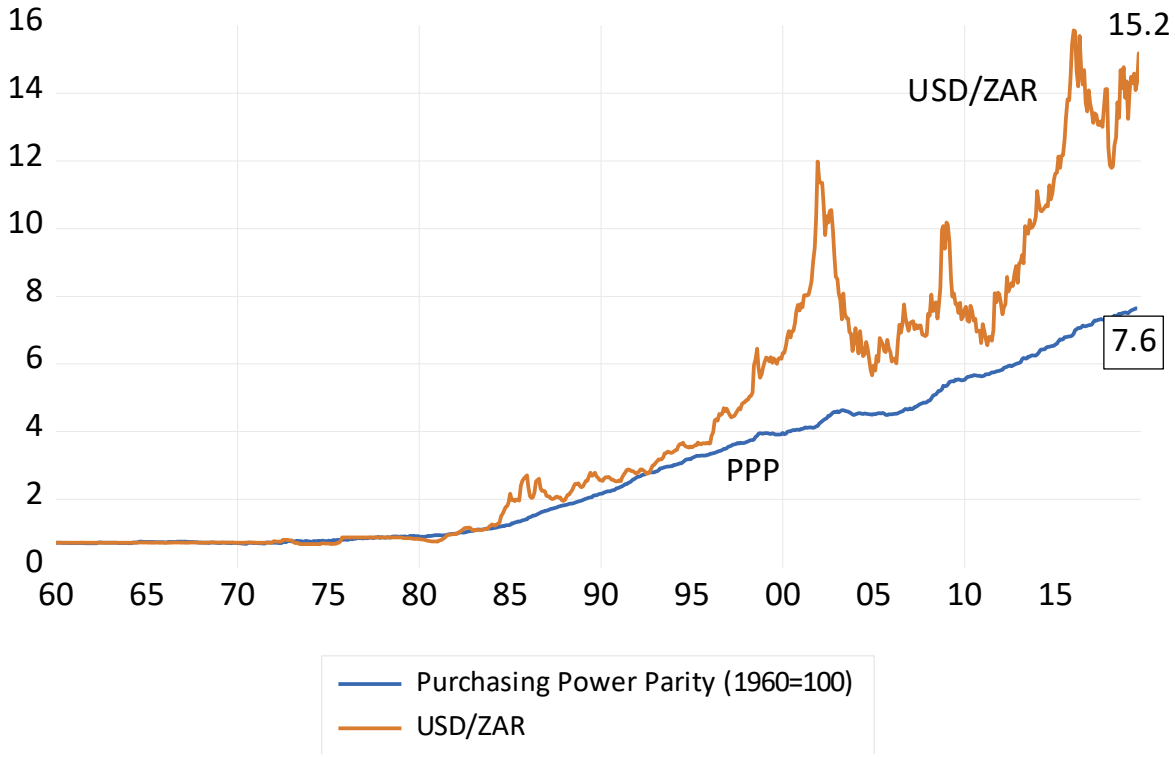
[1] The cover price of the first FM was two shillings. Hence two shillings out of twenty shillings per pound = 24 pence = 1/10 of a pound. 240 pennies or one SA pound was made equal to two rand on conversion to a decimal system in 1960 and so two shillings for the FM became 20 cents. That is 1/10 of R2 = 20 cents in 1960. Had the FM price increased as much as consumer prices in general in SA since then (by 92 times (20*92) the cover price would now be R18.40.. The current cover price of the of 29.50 has increased by 147 times since 1960. It has become more expensive in real terms 147/92 or 1.6 times more expensive than it was. Hopefully the quality has improved by more than 1.6 times making it a better buy today than it was in 1959. How would one measure the quality of the FM? Print- in colour – more content – better content perhaps – better photos – better quality paper. Adjusting prices for quality as well as changing consumer preferences makes the CPI itself a arbitrary measure of prices. We are not comparing like for like when goods and services are more expensive but offer more – especially when digitally enhanced. Hence we may well be underestimating quality improvements and so overestimating inflation. If so real growth and real productivity gains would appear healthier than they do. It is instructive that the Fed target for inflation is 2% p.a. not zero. This is to account for underestimating quality gains.

Average prices in SA have thus risen about 10.7 times faster than average prices in the US. Had the exchange value of the rand for US dollars simply tracked these different inflation trends, a USD would now cost a mere 7.6 rands. (0.71*10.7=7.6) This, is known as a purchasing power parity (PPE) exchange rate and if relevant, would have meant that a rand bought you now about as much by way of goods and services in the US as it did in South Africa.

SA travelers and importers know very well that the rand now buys significantly less abroad than it does at home-about 7.6/15 or roughly 50 per cent less than it did in 1960. Or alternatively - from the perspective of a SA exporter – or a foreign tourist paying rands – a dollar now buys about 50 per cent more in SA than it does abroad. (provided the offer is priced in rands- not dollars)

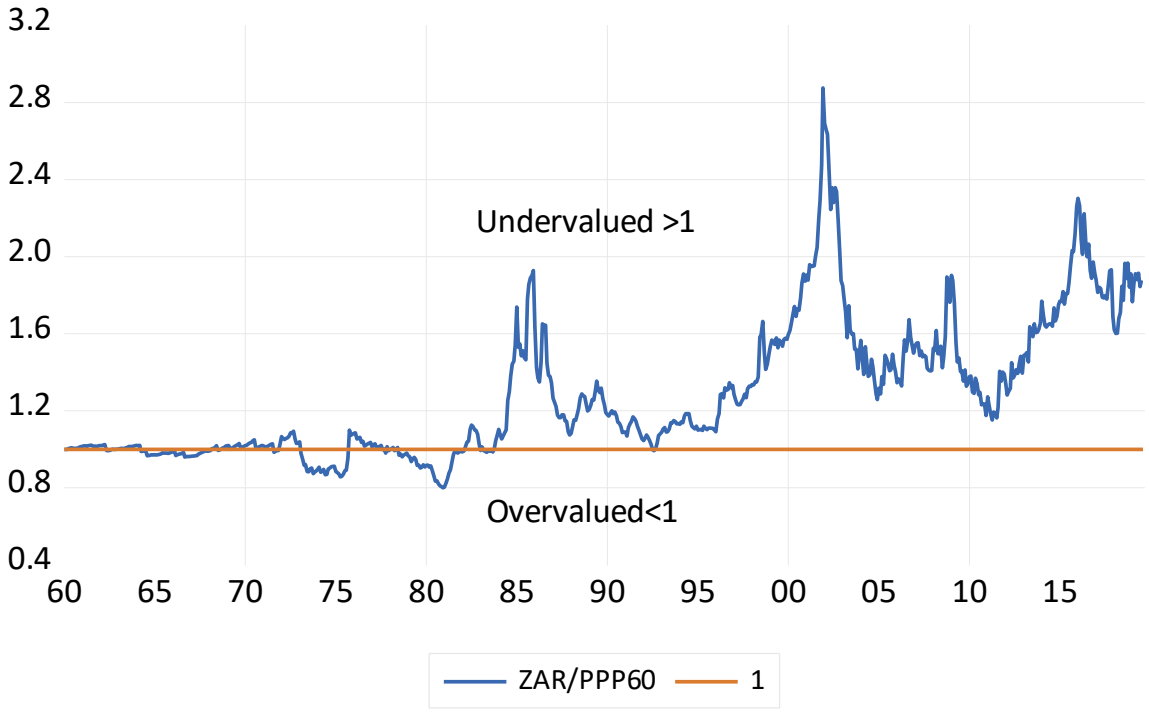
The long-term relationship between PPP and market exchange rates is shown in the figure below. We also show the highly variable relationship between the market and the theoretical PPP value of the USD/ZAR since 1960. This difference may be described as the real exchange rate. As may be seen the rand was most heavily undervalued in 1985, 2001 and 2016. In 2010 it had returned temporarily to almost its PPP value, using 1960 or 1995 as a starting point.

The Market and Purchasing Power Parity (PPP) value of the ZAR 1960-2019



Source; Stats SA, Reserve Bank of St.Louis (Fred) Investec Wealth and Investment

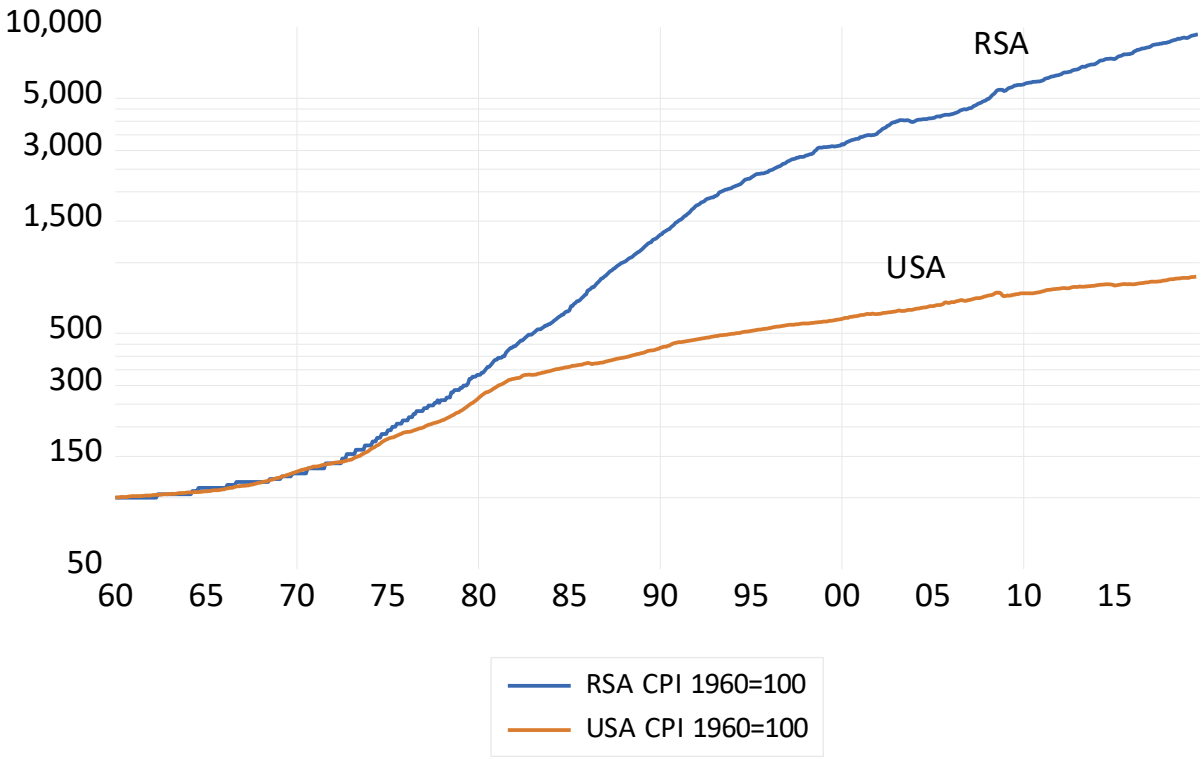
The real USD/ZAR (1960=1) Deviations from Purchasing Power Parity



Source; Stats SA, Reserve Bank of St.Louis (Fred) Investec Wealth and Investment

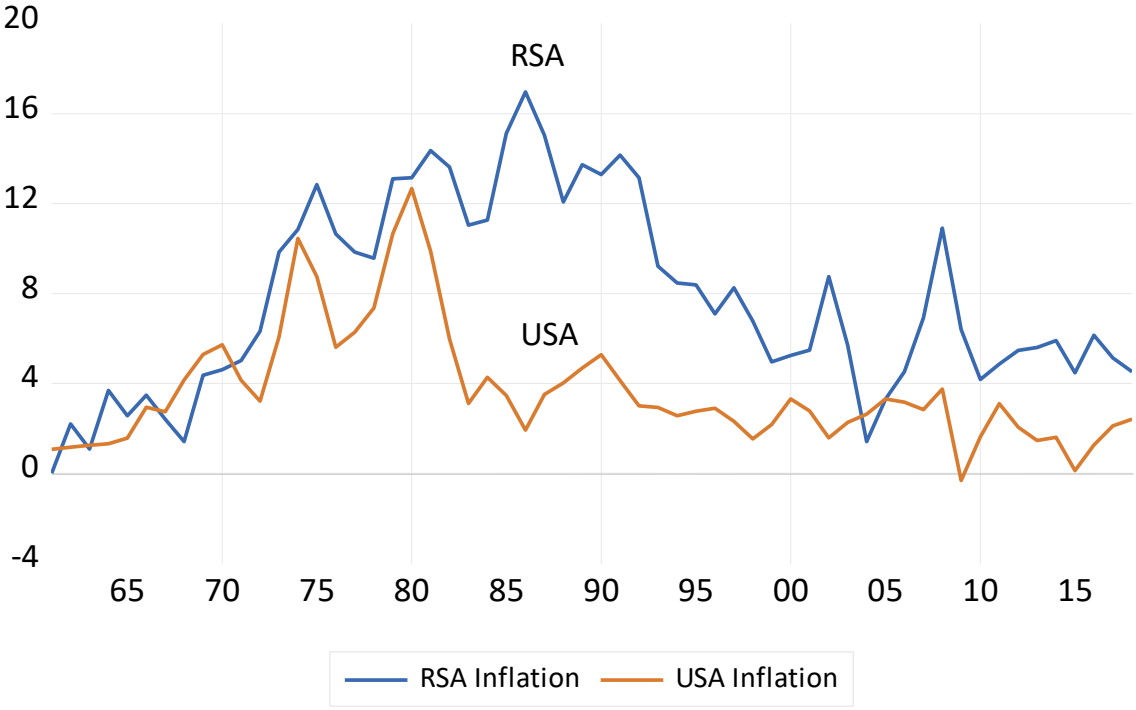
As may be seen the USD/ZAR tracked its PPP equivalent exchange value with the US dollar very closely until 1995. The market exchange rate moved largely in line with differences in SA and US inflation until 1995 and so the real rand was mostly unchanged until then. Thereafter the rand has been consistently undervalued (worth less than its PPP value) though to a highly variable degree. The market value of the rand therefore has on average moved by much more than differences in inflation rates - but again to very variable degrees as the market value of the rand (mostly) fell away though sometimes strengthened, as after 2002 and inflation responded with variable lags. For the history of prices in SA and the US and the behaviour of the USD/ZAR see the figures below.

CPI Trends South Africa and the United States 1960=100 (Log Scale)



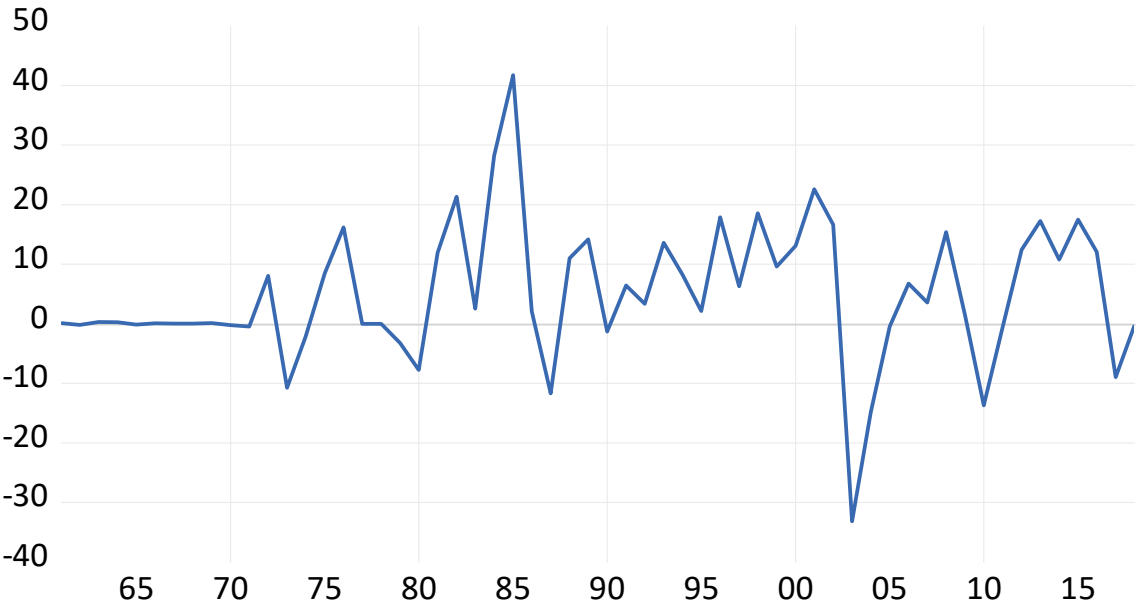
Source; Stats SA, Reserve Bank of St.Louis (Fred) Investec Wealth and Investment

Annual Inflation 1960-2019 South Africa and United States



Source; Stats SA, Reserve Bank of St.Louis (Fred) Investec Wealth and Investment

Annual percentage move in USD/ZAR – Higher numbers indicate weakness

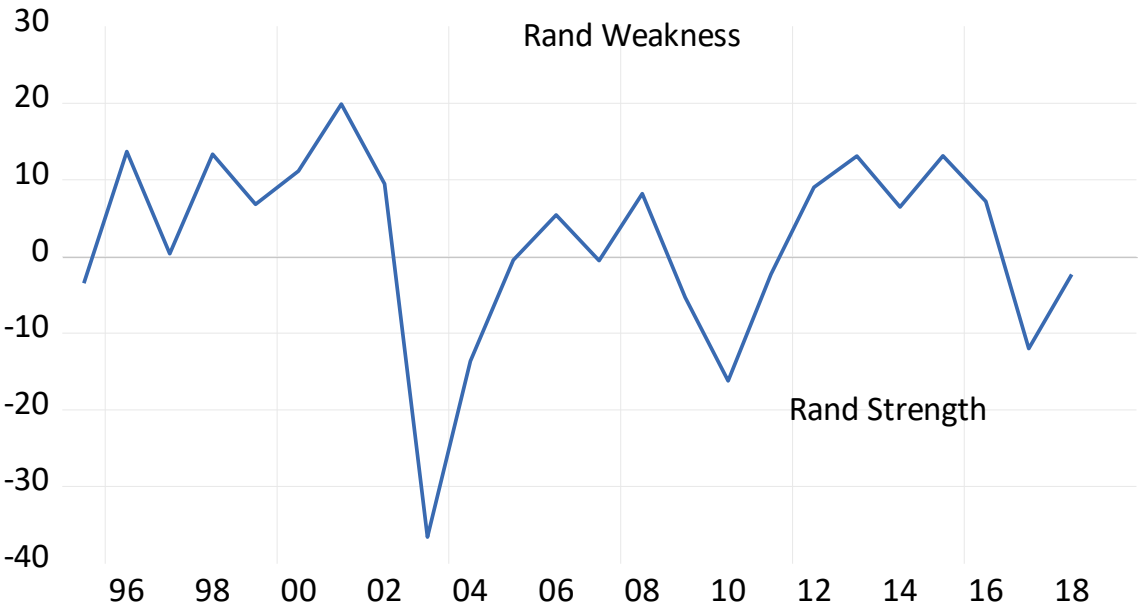


Source; Stats SA, Reserve Bank of St.Louis (Fred) Bloomberg, Investec Wealth and Investment

The figure below charts the differences between annual moves in the USD/ZAR exchange rate and annual differences in inflation rates between SA and the US since 1995. It may be seen that between 1995 and 2001 the rand weakened by significantly more than differences in inflation rates and consistently so. The USD/ZAR blew out in 2001 for reasons that have never been properly explained - but then enjoyed a strong recovery after 2002. A further period of real rand weakness – relative to inflation rates - occurred after 2012 to be followed by some real rand strength after 2016- as the market value of the rand

stabilized, even as SA inflation continued to run well ahead of US inflation.

Differences in inflation SA-US and annual percentage movements in the USD/ZAR



Source; Stats SA, Reserve Bank of St.Louis (Fred) Bloomberg, Investec Wealth and Investment

It therefore needs to be recognized that differences in inflation do not help to explain the behaviour of the rand over any period of up to five years or even longer. It is much more a case of the exchange value of

the rand responding to forces that have been independent of realized inflation in SA, to which prices in SA then react. The exchange rate leads and prices in SA tend to follow.

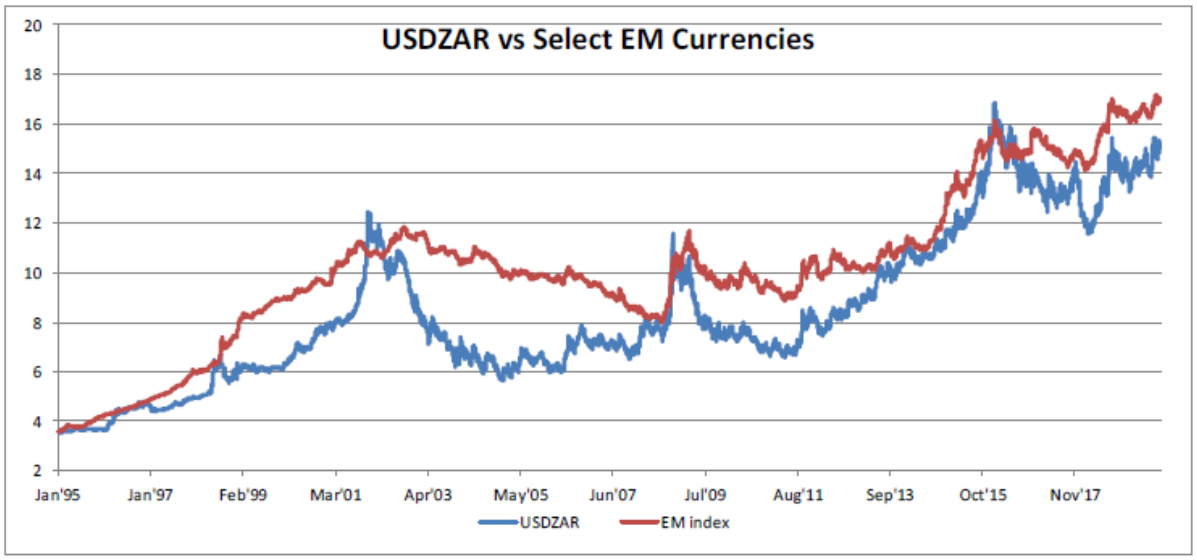
The most direct influence of the highly variable USD/ZAR exchange rate is on the prices of imports and exports. As an economy that is very highly open to exports and imports, all largely priced in US dollars, the exchange rate has an important influence on all prices set in SA. But this direct influence on SA inflation – the weaker the rand generally the more inflation and vice versa - will be influenced further by prevailing trends in global prices, especially the dollar price of oil and other commodity prices. Of further importance for prices and inflation will be the state of the SA economy. The more buoyant domestic demand the more upward pressure on prices and vice versa.

The question then arises. If it is not inflation driving the exchange value of the rand from day to day, month to month or year to year – what are the major forces at work driving the exchange rate? Clearly it is not the international trade in goods and services (the trade balance- largely in balance) that dominates the supply and demand for foreign exchange in SA.

The major force acting on the SA balance of payments and the flows of foreign currency through the currency market is the trade in assets, not in goods and services. The value of the rand responds to large and variable flows of capital -the buying or selling financial assets across the frontier. Such decisions reflect expectations of future returns or income flows. The more attractive are the return and growth prospects for owners of SA domiciled assets – equities, bonds and real estate - the more capital flows in and vice versa- and the exchange value of the rand responds accordingly to these flows. These flows as in all asset markets dominated by expectations of future returns, that are

inherently highly variable. They also have much to do with the strength of the US dollar against its peer currencies. The stronger the dollar vs the Euro, pound, Swiss Franc and Yen the weaker are emerging market (EM) currencies likely to be – including the rand – that tracks other emerging market exchange rates very closely. See figures below that show these links to global force and that show that compared to a representative basket of EM currencies the rand has gained ground on them since 1995.

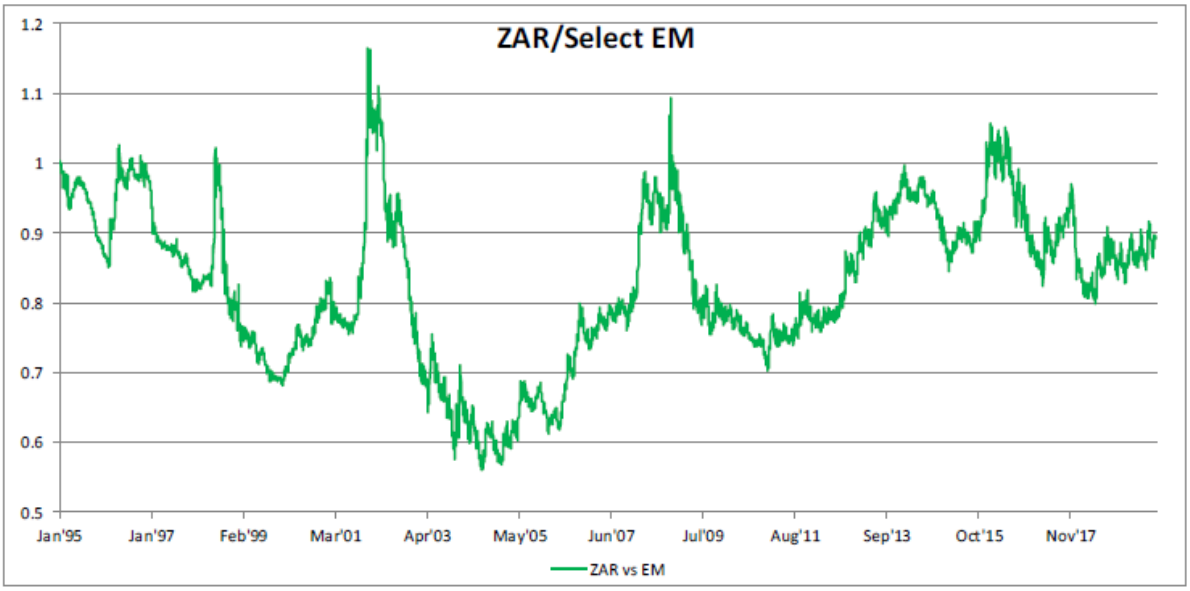
The USD/ZAR exchange rate compared to a basket of EM/USD exchange rates (1995=1)



*Select EM currencies: Turkey, Russia, Hungary, Brazil, Mexico, Chile, Poland, India, Malaysia.

Source: Bloomberg & Investec Wealth & Investment

Ratio of USD/ZAR to USD/EM exchange rates (1995=1) Higher numbers indicate relative rand weakness

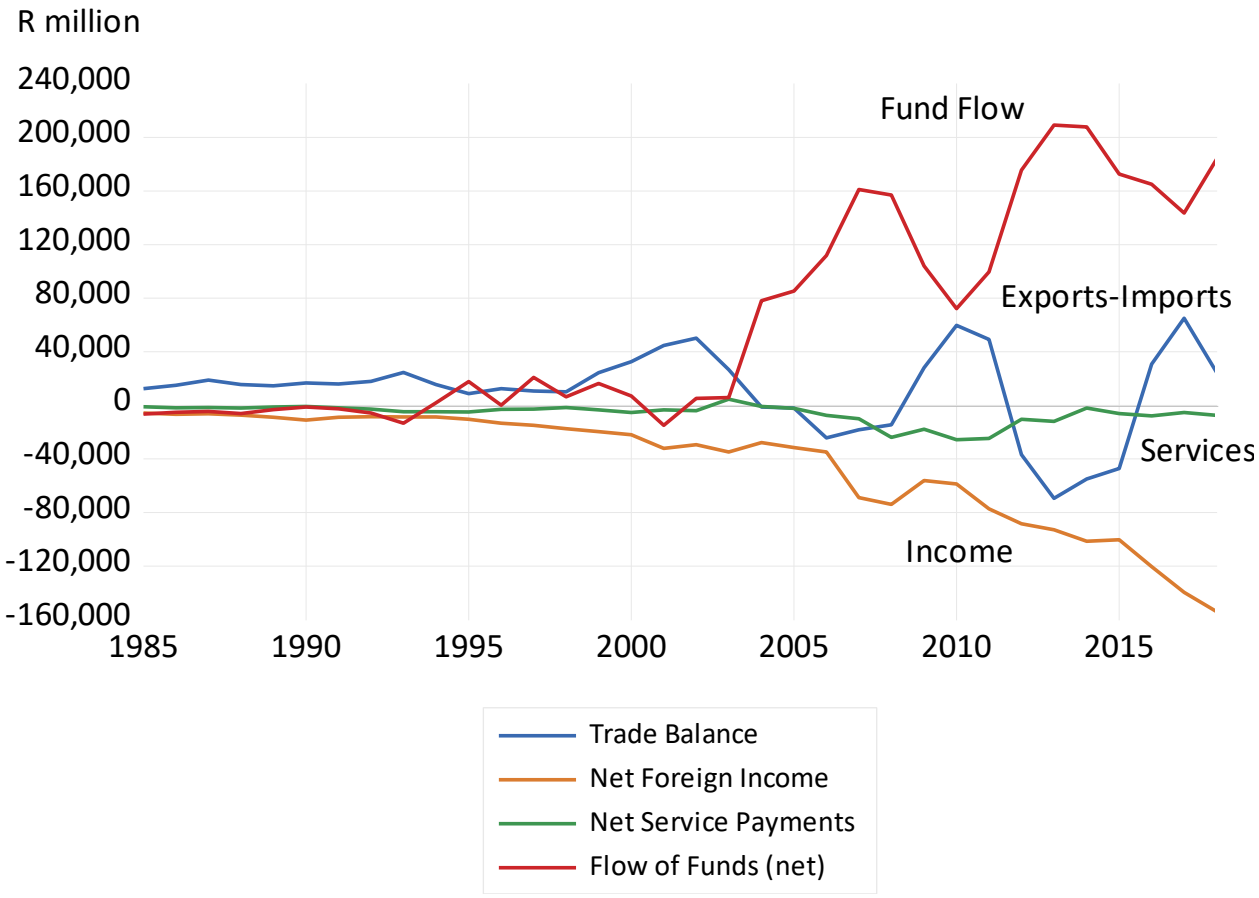


*Select EM currencies: Turkey, Russia, Hungary, Brazil, Mexico, Chile, Poland, India, Malaysia.

Source: Bloomberg & Investec Wealth & Investment

In the figure below we break down the SA balance of payments flows since 1985. As may be seen the net financial flows from abroad (inflows less outflows) have expanded dramatically since 2000. It indicates that the South African economy has become increasingly dependent on flows of foreign capital. South Africans have been funding their spending (lack of savings) by giving up at a price, an increasing share of their assets (equities) and debts (largely RSA debt) to foreign owners. The growing net flow of incomes abroad (dividends and interest payments) reflects the change in ownership patterns.

The SA Balance of Payments. Key elements

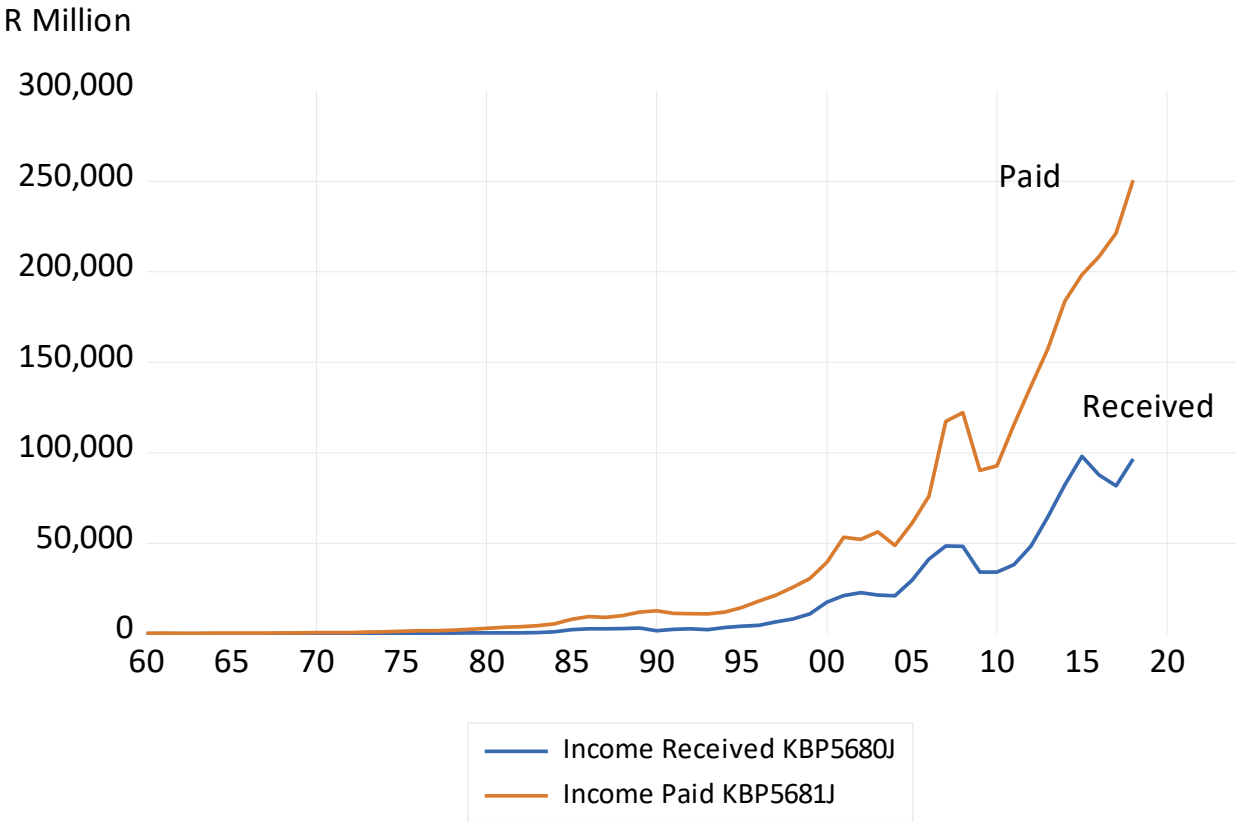


Source; SA Reserve Bank Data Base, Investec Wealth and Investment

It is of interest to note that while the flows of dividends and interest payments to and from SA have become markedly less favourable, the increasing market value of SA assets held abroad has kept pace with the value of SA assets owned by foreigners. SA pays out dividends and interest at a higher rate than is typically received from investments in developed market assets, hence the un-favourable balance on income accounts. But this has been made up by the growing market value of

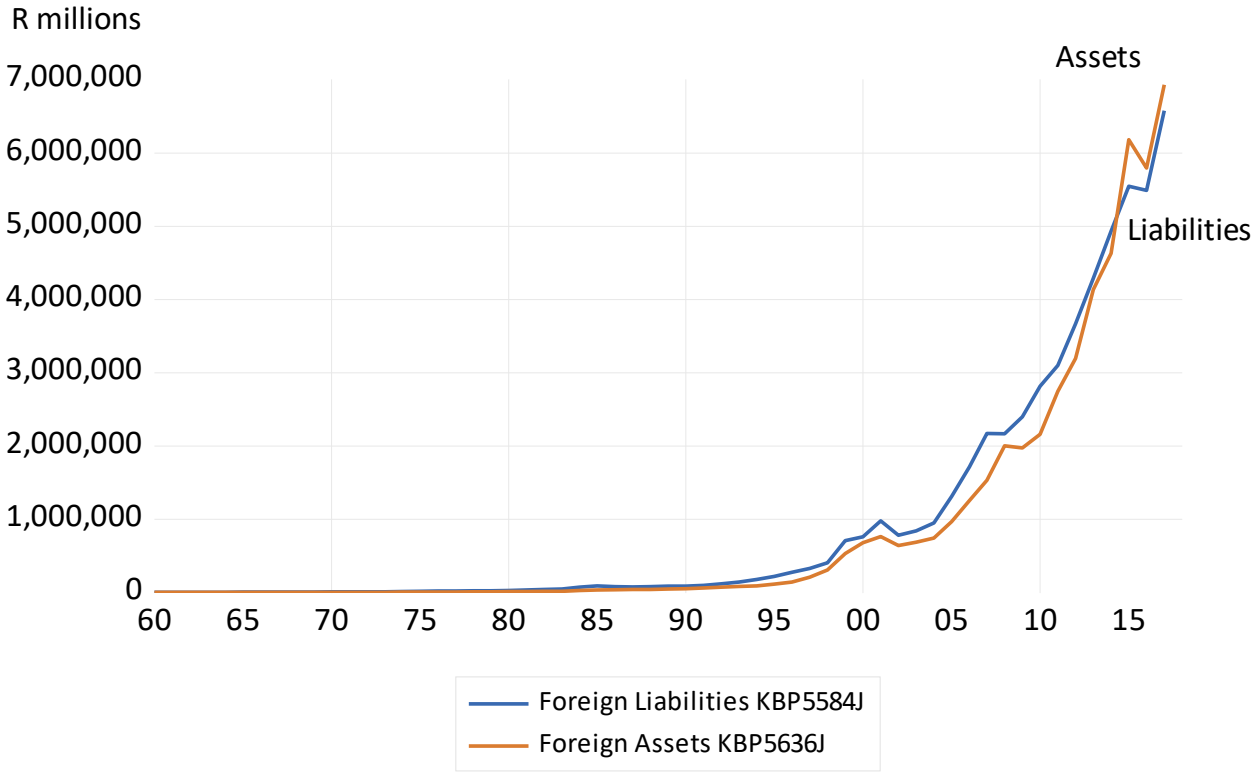
some of the investments made by SA companies. Especially that made by Naspers in now extraordinarily valuable Chinese internet company Tencent – that trades at a high value and low dividend yield.

SA Balance of Payments. Income payments and receipts



Source; SA Reserve Bank Data Base (Series identified) Investec Wealth and Investment

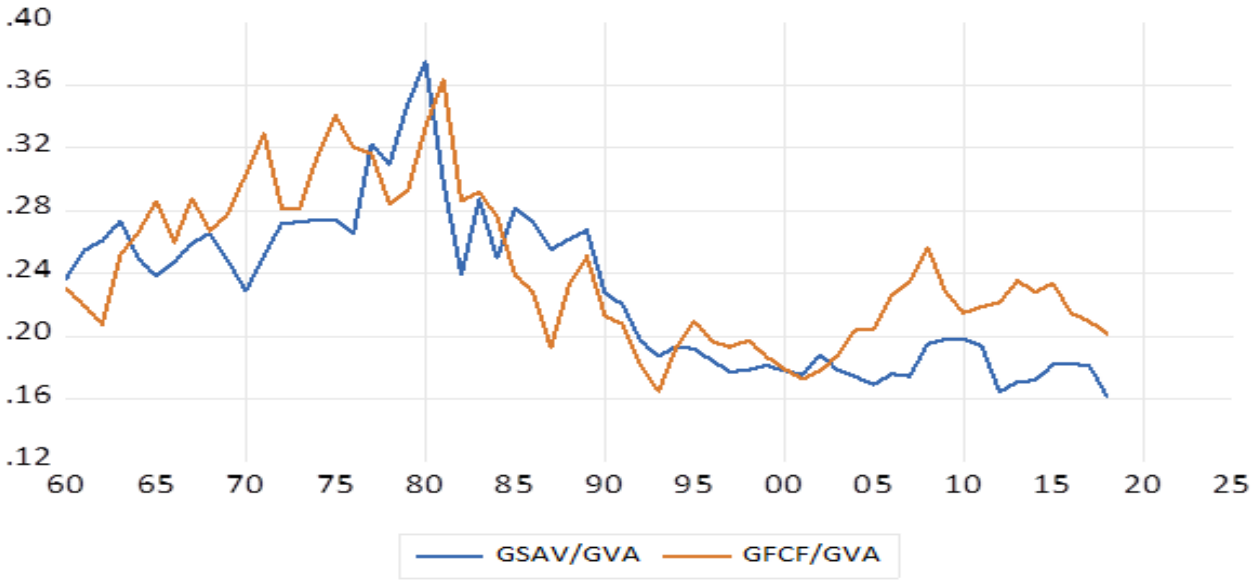
SA Balance of Payments; Foreign Assets and Liabilities



Source; SA Reserve Bank Data Base (Series identified) Investec Wealth and Investment

These growing inflows of foreign capital after 2002 were linked to changing macro-economic trends. Gross domestic savings began to fall well short of capital formation after 2002. The relative shortage of domestic savings made for greater dependence on foreign savings to fund additions to the capital stock. It may be seen that the rate of savings and capital formation in SA (savings, capex/Gross Value Added) declined precipitately after 1980 and the gold booms of those days. But after 2000 capex has held up better than savings. Better for growth but not for exchange rate stability. (see figure below)

South Africa, Ratio of Gross Savings (GSAV) and Capital Formation (GFCF) to Gross Value Added (GVA)



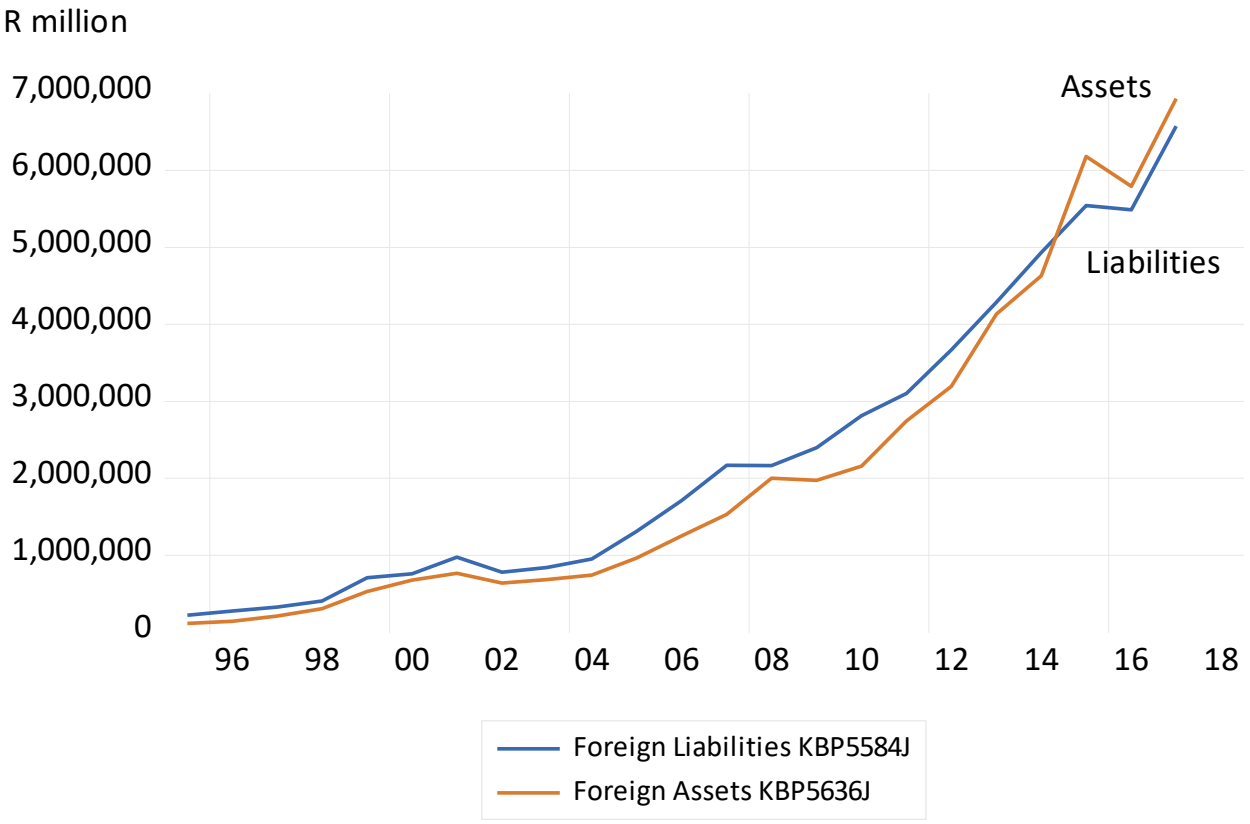
Source; SA Reserve Bank Data Base Investec Wealth and Investment

Before 1995 and but for a brief interlude between 1983 and 1985 very strict controls on capital flows to and from SA were maintained. Very few dollars flowed in or out of the balance of payments. These controls were lifted on foreign investors in 1995 and the application of exchange control applied to South African firms and companies came to be progressively relieved after 1995. And the flows of capital have responded as we have seen – enough to dominate the direction of the ZAR. And to greatly add to the risks of exporting and importing given the deviations from PPP.

What does the future hold for the ZAR and how should it be managed? One would suggest SA's continued dependence on foreign capital hence consistent exchange rate instability and unpredictability must be anticipated. Managing exchange rate instability calls for realism about its inflationary consequences and the ability to control the direction of prices over any short run period of a year and more. Domestic monetary policy settings should best ignore the temporary impact of exchange rate shocks on inflation- positive or negative. Ignore negative exchange rate shocks and their impact on prices, over which interest rates and monetary policy may have very little ability to offset, without causing grave damage to the domestic economy.

A flexible exchange rate helps an economy to absorb these shocks that by forcing prices higher (lower) depress domestic spending. Raising interest rates when the rand is shocked lower simply depresses demand further and further reduces the growth prospects for the economy and so discourages capital inflows. The focus of monetary policy should be on managing domestic demand and ensuring that domestic spending neither adds to nor depresses prices. It should ignore exchange rate shocks.

The primary task for economic policy more generally is to reduce the risks of investing in SA and so create conditions that would encourage supplies of capital (from all sources, domestic and foreign) and demands for it that help sustain growth. Faster growth can lead flows of capital and a stronger rand. Faster growth and less inflation that comes with a stronger rand should be the primary objective of economic policy.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