



**“A Strong Rand means  
a Strong Economy”**

**... OR DOES IT?**

Many persons have been ecstatic at the performance of the Rand over the past few years, based on the assumption that a strong Rand means a strong Economy, but

## **DOES IT REALLY?**

Have the actual effects been researched? Well, let us do so for you. . .

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*Revised and Expanded*

Extracts of a study researched, compiled and updated by

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# “A Strong Rand means a Strong Economy”

## ... OR DOES IT?

### Executive Summary

The following report is an executive summary of the full Study, originally undertaken during 2004 to research the above question looking at the Rand from an historical point of view using base fundamentals.

Let's start with what is generally known:

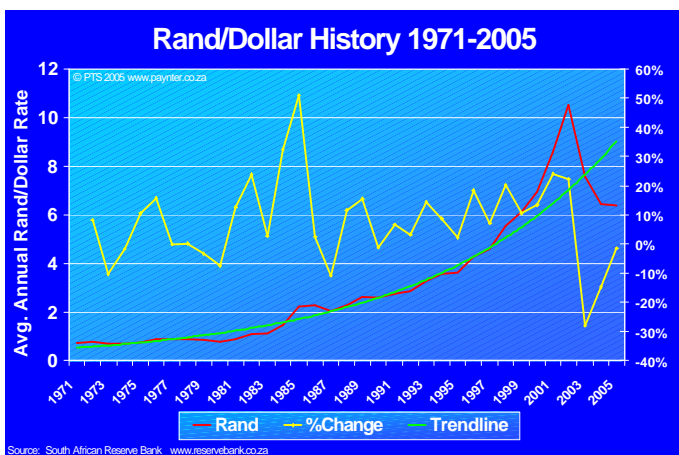
#### 1) HOW HAS THE RAND PERFORMED?

The following is the historical performance of the Rand since 1971 and its more recent performance since 1995

<b>35 Year History</b>	
1971 - 2005 Trendline	6.6% p.a.
<b>10 Year History (since abolition of apartheid &amp; Financial Rand)</b>	
Feb 1995 – Aug 2006 Trendline	4.8% p.a.
Feb 1995 - October 2001 Trendline	11.6% p.a.
“Floor Rate” Trendline	11.0% p.a.

Let's take a look in some detail.

The graph below shows the **Rand's actual performance from 1971 to 2005**, reflecting the *average annual* exchange rate by year, and the trendline for the period, as well as year over year percentage changes.



Taking a look at the long term history of the Rand provides some indication as to what we can expect in the future. So, what can we learn from this?

- The average depreciation per annum is **6.6%** for the period 1971 to 2005. This means that the currency has had to adjust by an average of 6.6% each year for South African goods to be competitive.
- The Trendline from 1971 to 2005 shows the undervaluation of the spike in late 2001 and overvaluation extent of the counter movement since mid-2003.

- This long-term Trendline indicates that the **average rate for 2005 should have been R9.00/\$** – compared with an actual rate of R6.36/\$.

However, this period could be seen to be too long a view considering the considerable structural changes that have taken place over the past 10 years – abolition of apartheid, establishment of a democratic government, scrapping of the Financial Rand and reduction of import duties.

So let's look at the period since the Financial Rand was discontinued in February 1995 and ceased to exercise an abnormal influence on the Rand currency market.



This graph shows the **performance of the Rand since February 1995**, reflecting the daily rate since that date as well as three trendlines computed from this daily rate, based on different scenarios:

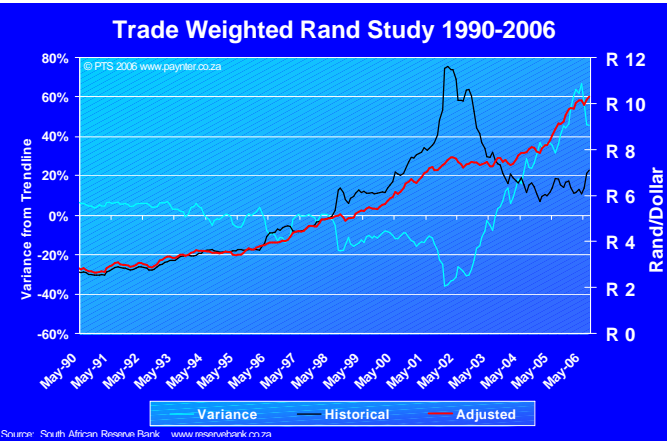
- Feb 1995 – Aug 2006 Trendline A (Red)**
  - The Rand trendline since February 1995 to date has been **4.8%** per annum. This takes into account both the decline in Q4 2001, culminating in the 2 day spike above R13/\$ in December 2001, and the recent extended overcorrection below R7.00/\$
  - This trendline indicates that the Rand should presently be **R8.15/\$**
- Feb 1995 - October 2001 Trendline B (Green)**
  - Excluding the period of above-mentioned aberrations following October 2001, the trendline depreciation has been **11.6%** per annum.
  - This trendline indicates the Rand should presently be **R11.60/\$**

**“Floor Rate” Trendline C (Yellow)**

- The absolute “floor rate” trendline (based on strongest Rand levels over this period, but excluding the present aberration), gives average depreciation of **11.0%** per annum.
- This trendline indicates the Rand should not be stronger than **R10.45** to the Dollar

**2) “BUT IT’S DOLLAR WEAKNESS” – OR IS IT?**

There is a large contingent out there saying that the Rand's present strength is purely due to Dollar weakness – let's analyse this argument, by looking at the **Trade Weighted Value** of the Rand.



The above graph reflects the following:

- The actual Dollar/Rand exchange rate from 1990 to date (**Black Line**)
- The Deviation of actual Trade Weighted Value from regressive trendline Trade Weighted Value over the same period (**Blue Line**)
- An adjusted Rand exchange rate, computed by taking the actual exchange rate and adjusting it by the Deviation factor (referred to above), determined on a Trade Weighted Index basis (**Red Line**).

By applying this Deviation Factor to the actual Rand exchange rates, we can establish what **the Rand's trendline rate would be** for the period from 1990 **based on international competitiveness with trading partners**, that is, recognising currency movements of *all* the economies of South Africa's trading partners in relation to the Rand. The revealing results are:

- the Rand has been overvalued since July 2003 when it moved stronger than the Trade Weighted rate of R7.60/\$
- the Rand should be **R10.30/\$** on a Trade Weighted basis as at July 2006.

**3) THE BURNING QUESTIONS**

The initial questions to answer and investigate are:

- What are the actual factors that have caused the Rand to depreciate during the long term, at an average annual rate of 6.6% since 1971?
- How have these factors changed over the past years, and especially more recently?

- What can be expected for the future?

**4) WHAT IS AN EXCHANGE RATE?**

To try and investigate these questions, let's first ask: “What is an Exchange Rate?” Why does a currency appreciate or depreciate? This is an essential baseline to any currency study.

Fundamentally, an exchange rate is the **adjusting factor (an economic mechanism)** between a domestic economy and that of its trading partners, so that **exported goods and services exported remain competitive and goods produced for local consumption are not threatened by cheaper imports** - the exchange rate compensates for product cost differentials, and other factors that affect international trade competitiveness.

**5) INTERNATIONAL COMPETITIVENESS**

The Domestic Supply Chain Cost of any product and its ultimate Value Added can be reduced to its essential elements - **Labour Cost** and **Productivity**

If there are differentials in underlying Labour Cost and Productivity between two countries producing the same product, the essential adjusting mechanism to enable these countries to continue to trade (whether export or import) at competitive prices is **the exchange rate**. International trade succeeds or fails through this essential gear working efficiently, or not!

Below is a summary of the yardsticks whereby we can compare **South Africa's competitiveness with its trading partners** - broken down into Quantifiable, Semi-definable and Indefinable Effects:

	Annual Differentials		
	1981-2004	1996-2004	Future
<b>Primary Factors (Quantifiable Effects)</b>	<b>21.6%</b>	<b>8.5%</b>	<b>8.0%</b>
Labour Cost	13.9%	6.7%	6.0%
Productivity	7.7%	1.8%	2.0%
<b>Secondary Factors (Semi-definable Effects)</b>		<b>2.0%</b>	<b>5.0%</b>
AIDS Pandemic			?
Black Economic Empowerment			?
Emigration of Skilled Labour/Professionals			?
<b>Structural Factors (Indefinable Effects)</b>		<b>1.0%</b>	<b>2.0%</b>
Infrastructure Inefficiencies (Transportation/Energy)			?
Crime and Security Factors			?
Immigration Burden Costs			?
Illiteracy			??
Unemployment Burden Costs			?
Delivery Costs (remoteness from major markets)			?
<b>Total</b>		<b>11.5%</b>	<b>15.0%</b>

**6) THE RESULTANT GEAR**

The above table reflects the competitive situation that impacts on the Rand Exchange Rate using data that we have gleaned for the South African economy and its trading partners. It reflects the average annual performances for 1981 through 2004:

- SA labour cost has increased at a higher rate than its international trading partners – **13.9% annually** for 23 years.
- SA productivity has reduced while increases were achieved by its trading partners – a differential of **7.7% annually** for 22 years.

What is the essential compensating mechanism for the SA economy to remain competitive? What can be done to offset these higher costs?

*The Exchange Rate!*

Without this gear reacting regularly, SA exporters would not be competitive overseas, and local manufacturers serving the domestic market would not be able to compete with imports from other countries.



With respect, the Governor's recent use of the Rand to reduce imported inflation, so that he meets his 3-6% inflation target, is a misuse of this economic mechanism. An exchange rate is to adjust the pricing of exported and imported products and services between one country and another – not the domestic pricing of products and services!

South Africa	(Illustrative data used)	United States
R 900	<b>Domestic Price</b> (Base Rate of R9.00/\$)	\$100
108%	<b>Labour Cost Index</b>	102%
97%	<b>Productivity Index</b>	105%
	=	
11.0%	<b>Change in Product Cost</b>	-3.0%
R 999	<b>Local Price</b> adjusted change in costs	\$97
<b>Export Price Scenario</b>		
R 999	@ Base rate of R9.00/\$	\$111
R 999	@ Strong rate R6.50/\$	\$154
R 999	@ Realistic rate R10.30/\$	\$97

But how important are exports to the South African economy? And how are they affected by the Exchange Rate?

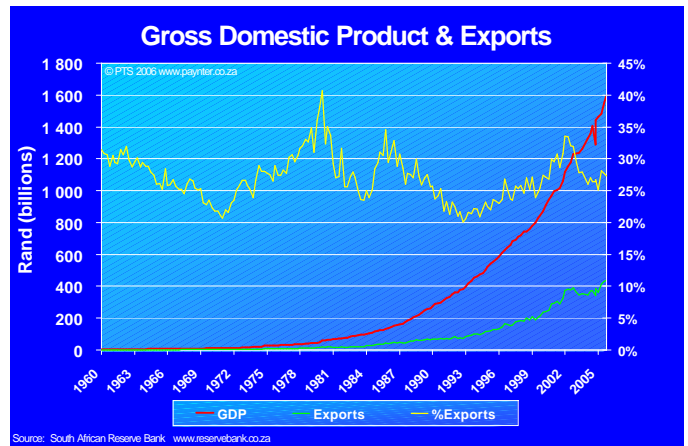
**7) HOW IMPORTANT ARE EXPORTS?**

As already stated in this presentation, competitiveness of South African exports must be maintained through the adjusting mechanism of the Rand exchange rate. The question then is:

- How important are exports to the South African economy?

How important is it that the Rand acts as an adjusting mechanism to maintain international competitiveness so that export business is sustainable?

The next graph reflects South Africa's total Gross Domestic Product for the years 1960 to 2005, the Value of Exports for that period and the percent that Export Values were of GDP.



In general terms, Exports represent about 30% of GDP in recent years, but looking at the detail:

Export value as a percent of GDP hit a 40 year low point of 20% in 1992, and then increased consistently to 34% in 2002, a most desirable achievement.

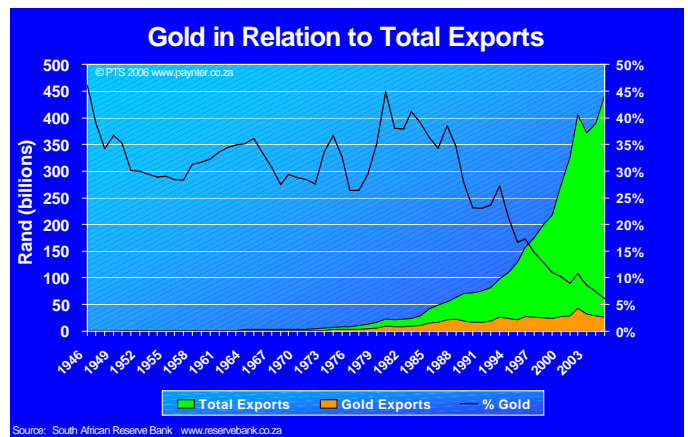
However, export value percent of GDP has sharply declined during Q1 2002 through Q4 2005 from 34% to 27%.

These data, supported by the plethora of reports over recent years by exporters on the devastating effect of the Rand on both past results and future orders, are conclusive evidence of the damage inflicted by the strong Rand on this essential sector of the economy. The next questions are:

- What are the knock-on effects of this alarming decline in export performance?
- What about the recent bullishness in Gold and commodities – has this not offset the decline in other exports?

**8) WHAT IS THE EFFECT OF GOLD?**

What about the bullishness of gold and other commodities – is this the reason for the Rand's strength and, more importantly, will this not support the Exchange Rate and the economy going forward? Let's take a look at this argument.



The above graph tells us the following:

- From 1946 to early 1970s, Gold Exports represented around 30-35% of Total Exports.



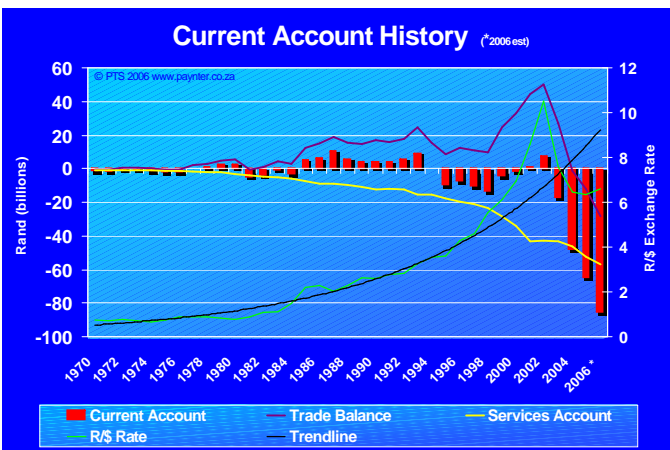
- By Gold's price peak in 1981, Total Exports had increased more than seven times and Gold Exports by more than eleven times, Gold now making up 45% of Total Exports!
- Since the mid-1980s, Total Exports have steadily increased in Dollar terms
- Over this period, however, Gold Exports have **steadily decreased to just 6% of Total Exports** – and this, despite the Gold price (in Dollars) having *more than doubled* in the last 6 years!

So what effect does Gold have on our total economy? The truth is that, apart from lingering remembrance of a commodity-based economy – VERY little!

Furthermore, has it escaped worthy attention the extent of closure of gold mines and precious metal mines due to the strong rand? And, as concerning, the abandoning of plans to proceed with new metal exploitation ventures?

**9) EXTERNAL TRADE BALANCE WORSENING!**

As a consequence of declining exports (and of escalating cheaper imports challenging domestic manufacture), here's Part 1 of the real shocking news about where the South African economy is heading:



This graph reflects historical Annual Trade, Services and Current Account data in Rand from 1970 through to 2006 (est), plotted together with the Rand/Dollar Exchange Rate, and its long-term trendline.

What does this tell us about the economy's performance?

- From about 1990 through to 2003 the Trade Account was in surplus reaching a peak in 2002.
- During this period Current Account has fluctuated between R10bn surplus and R20bn deficit.
- Since the Rand fell below its Trendline, the situation has steadily deteriorated – and at an increasing rate.
- The last 2 years have seen increasing record Trade deficits, with 2005 full year being the worst ever!
- Based on preliminary data (see next section for more details) 2006 is estimated to record a **deficit of R112bn!**

Exporters that have some knowledge of the inside story can surely not feel happy about the actual and forecast results and the direction the economy is heading, nor the lack of concern

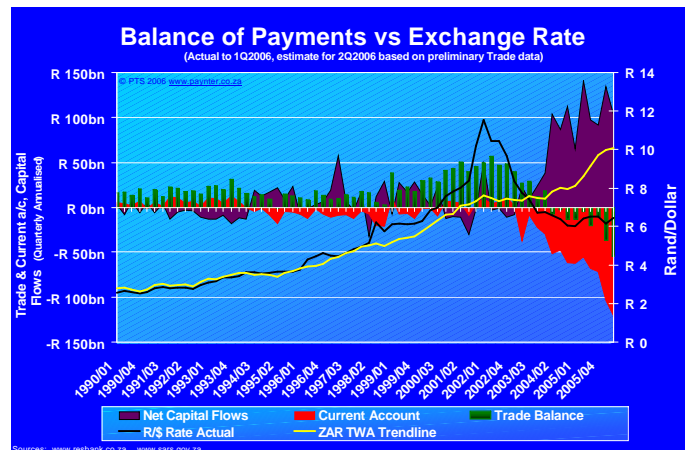
of persons in responsible positions about the effects of the strong Rand on export performance and thus the whole economy?

Recognising too that many contracts are negotiated annually, the full effects of "the strong Rand" are now starting to filter through. Furthermore, many companies have lost long term contracts to other economies, perhaps never to regain them, with resultant closure of many SA export manufacturing facilities.

The strong Rand has been a double-edged sword, damaging manufacturer's export and domestic markets. True that this state of affairs forces innovative reductions in costs, but when these have been exhausted, the economic mechanism – the Rand exchange rate – is needed to maintain secondary sector business, so essential to this economy – but this has failed, through the Authorities stated support of a "strong Rand" to stimulate foreign inflows with a view to achieving inflation targets.

**10) ACHILLES HEEL – BALANCE OF PAYMENTS**

Part 2 of the real shocking news is shown in the following graph – a deteriorating Balance of Payments:



This graph gives a more detailed snapshot of the more recent history – Quarterly Balance of Payments data in Rands – Trade Account, Current Account, plus Financial Inflows data – from 1990 through 2005, plotted together with the Rand/Dollar Exchange Rate, and the Trade Weighted Average Trendline.

Again, we see the relatively healthy state of affairs until the Rand fell below its Trendline in 2003, with the Trade Account falling into deficit and the Current Account deteriorating rapidly, with Q1 2006 recording a record R104.3bn deficit! **So what can be expected for the balance of 2006?** Based on preliminary data available:

- Based on preliminary data, Q2 2006 Trade Account has recorded a **R13.6bn deficit** – more than 4 times the total deficit for Jan-Sep last year!
- If Q2 2006 Services Account deficit remains the same as the prior quarter, this economy is likely to have sustained a Current Account **deficit of R120bn** (quarterly annualised) – **almost double that for Q1 2005!**
- This forecast deficit represents around **7.5% of GDP**, a jump from 6.4% for Q1 2006 – alarming for any economy;

and certainly quite unsustainable by this one!

- The Capital Account inflows to fund increasing deficits have been sufficient to date, but the tide is turning with outflows escalating, and the Rand already starting to react.
- We anticipate that when actual Q2 2006 Balance of Payments data is issued in September 2006, that the Rand will respond by weakening even further.

The financing of the potentially large Current Account deficit is cause for great concern, especially in that the Authorities refer to it as “a healthy state of affairs.” The fact is that it is presently being funded by “foreign call funds”, and these offshore investor funds (in the bond and money markets particularly) can and will be recalled immediately the Rand depreciates to any extent! From where will the long term funding be secured thereafter, and how will its incremental interest cost burden be met?

### **11) OVERVIEW – WHERE NOW AND WHERE TO?**

The purpose of this abbreviated summary (a portion of the extensive study on the Rand, which we originally researched during 2004) is to indicate to readers the direction of thought, and appropriate weighting placed on basic fundamental economic data, in order to assess on a rational scientific basis where the Rand can be expected to move in the future. Our science is a collaboration of 3 sets of data:

- **Historical Trendline of the Rand since 1971**
- **Trade Weighted Value of The Rand since 1990**
- **Competitiveness of the South African economy**

**All these indicate:**

- **Intrinsic value of the Rand in 3<sup>rd</sup> Quarter 2006 is within the range R8.15 - R11.60**, and
- **Economic Factors will combine to force a correction of the Rand back to its intrinsic value indicated above**, and
- **The Rand will continue to depreciate for the foreseeable future at minimum 4.8% annually – and maybe as high as 15% annually.**

So now we have an indication of where the Rand is now and where it is most likely to go before equilibrium is reached. That still leaves one very big question:

### **12) WHEN AND HOW QUICKLY WILL IT ADJUST?**

It's all very well knowing that the Rand is overvalued, but has it bottomed out yet? How long is it likely to take to adjust back to real value? Is it likely to adjust strongly, and if it does, by how much?

Is it possible to answer these questions? We had not thought so, until we discovered the most advanced forecasting technology available and started applying its uncanny abilities to the Rand. And since October 2005, the track record looks like this:

Period		Accuracy			
From	To	Days	Weeks	Months	Average
24/10/2005	16/01/2006	77.9%	74.2%	100%	84.0%
24/10/2005	27/01/2006	83.0%	80.7%	100%	86.8%
24/10/2005	06/03/2006	84.1%	86.5%	100%	88.2%
24/10/2005	22/05/2006	80.6%	87.6%	100%	86.9%
24/10/2005	14/07/2006	81.0%	86.8%	100%	89.0%

So, yes it is possible to forecast the Rand with an average accuracy of 89% over short, medium and long terms. And this is now available to you.

If you are affected by the fluctuations of the Rand in any way, and need to know where you are likely to be the next few days, weeks, or month – this will give it to you at a glance!

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