



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

**... OR DOES IT?**

Many persons are ecstatic at the performance of the Rand over the past year, based on the assumption that a strong Rand means a strong Economy, but

## **DOES IT REALLY?**

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

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Extracts of a study researched and compiled by

**Paynter Trade Services**  
Specialist Tank Investment Managers

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### Executive Summary

The following is an executive summary of the full Study, originally undertaken during 2004, which researches the subject in depth (see our limited introductory offer on the full Rand presentation at the end of this Report).

#### 1) WHAT IS AN EXCHANGE RATE?

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.

#### 2) 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	8.4% p.a.
<b>10 Year History (since abolition of apartheid &amp; Financial Rand)</b>	
Feb 1995 – Feb 2006 Trendline	5.7% p.a.
Feb 1995 - October 2001 Trendline	12.0% p.a.
Floor Rate Trendline	11.2% p.a.

The first question to answer and investigate is:

- What are the actual factors that have caused the Rand to depreciate during the long term, at an average annual rate of 8.4% since 1971?
- Or, inverting the question, recognising that the Rand has been an adjusting mechanism, what have been the causes for the domestic cost of South African produced goods to be consistently higher than production cost of similar goods produced in foreign markets?

#### 3) 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 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		
	1981-2003	1996-2003	Future
<b>Primary Factors (Quantifiable Effects)</b>	<b>20.5%</b>	<b>10.1%</b>	<b>9.0%</b>
Labour Cost	13.7%	6.7%	6.0%
Productivity	6.8%	3.4%	3.0%
<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>13.1%</b>	<b>16.0%</b>

#### 4) 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 2003:

- SA labour cost has **increased** at a higher rate than its international trading partners – **13.7% annually** for 22 years.
- SA productivity has **reduced** while increases were achieved by its trading partners – a differential of **6.8% 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>	\$100
	(Base Rate of R9.00/\$)	
108%	<b>Labour Cost Index</b>	102%
	+	
97%	<b>Productivity Index</b>	105%
	=	
11.0%	<b>Change in Product Cost</b>	-3.0%
	<b>Local Price</b>	
R 999	adjusted change in costs	\$97

Export Price Scenario		
R 999	Base rate of R9.00/\$	\$111
R 999	Strong Rand rate R6.50/\$	\$154
R 999	@ Realistic rate R10.30/\$	\$97

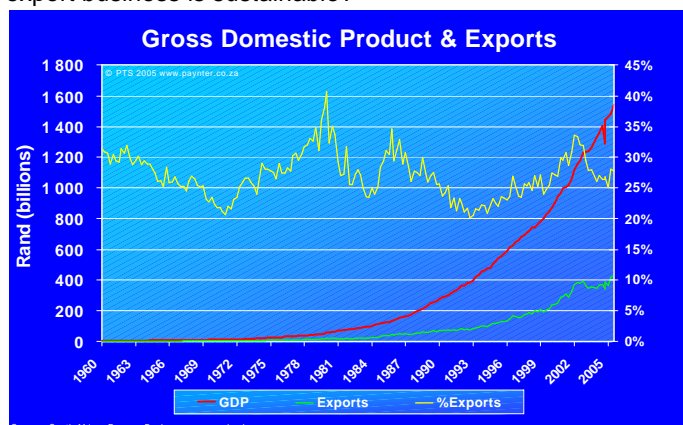
Before looking in more detail at the Rand history and some forecasts, let's see how important the Exchange Rate is to the South African economy by looking at how exports are affected by it or, rather, how dependant is the economy on exports?

## 5) 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 foregoing table and graph reflect South Africa's total Gross Domestic Product for the years 1960 through Q3 2005, the Value of Exports for that period and the percent that Export Values were of total 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 21% in 1992, and then increased consistently to 35% in 2002, a most desirable achievement.
- However, export value percent of GDP has sharply declined during Q1 2002 through Q3 2005 from 34% to 28%.

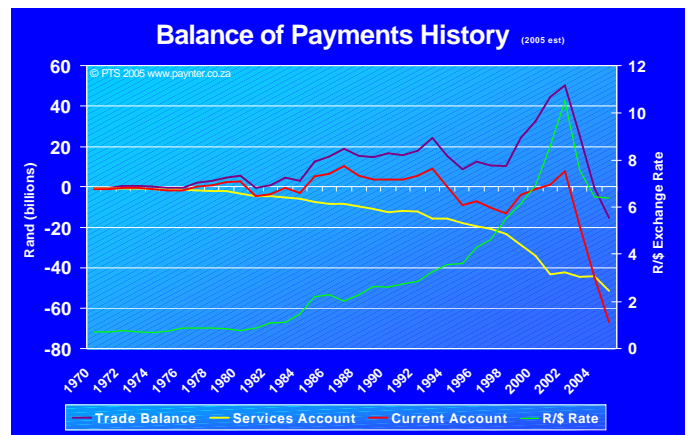
These data, supported by the plethora of reports over recent years by exporters on the devastating effect of the Rand on both past results and future orders, are conclusive evidence of the damage inflicted by the strong Rand on this essential sector of the economy. The next question is:

- What are the knock-on effects of this alarming decline in export performance? Let's have a look at the most critical:

## 6) THE SOUTH AFRICAN ECONOMY

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

This graph reflects historical **Balance of Payments** data in Rands – Trade Account, Services Account and Current Account data – from 1970 through 2005.



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

- From about 1977 through to 1994, Current Account was in surplus, except for 4 years (1981-1984)
- From 1995 to 2001, Current Account was in deficit, the two largest being R10.4bn in 1997 and R12.9bn in 1998
- In 2002, it recorded its first Current Account surplus since 1994 – R3.3bn.
- The next year, 2003, it recorded a Current Account deficit of R18.9bn – the largest ever by 44%, but wait...
- In 2004, it increased by another 135% to record a **Current Account deficit of R44.3bn!**

The major causal factor? – the **strong Rand since mid-Q4 2002**.

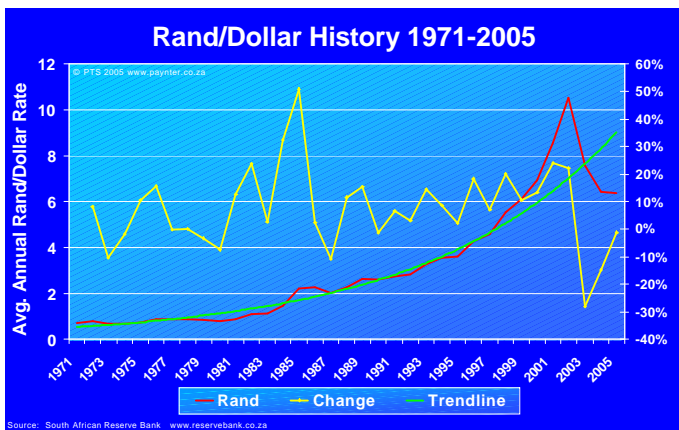
**But what about 2005?** If Q3 2005 Trade Account and Current Account results are used as a benchmark, we can expect a full year **Current Account deficit of about R67bn!** Recognising too that many contracts are negotiated annually, the full effects of “the strong Rand” have not filtered through yet. Furthermore, many companies have lost long term contracts to other economies, perhaps never to regain them, with resultant closure of many SA manufacturing facilities.

Exporters that have some knowledge of the inside story can surely not feel happy about the actual and forecast results and the way 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?

The financing of the potentially large Current Account deficit is cause for 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?

## 7) THE RAND HISTORY 1971-2005

This graph 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 percent 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 **8.4%** for the period **1971 to 2005**. This means that the currency has had to adjust by an average of 8.4% each year for South African goods to be competitive.
- The Trendline from 1971 to 2005 shows the undervaluation extent of the spike in 2001 and overvaluation extent of the counter movement since January 2002.
- This long-term Trendline indicates that the average rate for 2005 should have been **R9.00/\$**.

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.

## 8) THE RAND HISTORY 1995-2006

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 – Feb 2006 Trendline A

**(Red)**

- The Rand trendline since February 1995 to date has been **5.7%** 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 **R8.30/\$**

### Feb 1995 - October 2001 Trendline B

**(Green)**

- Excluding the period of above-mentioned aberrations following October 2001, the trendline depreciation has been **12.0%** per annum.
- This trendline indicates the Rand should presently be **R11.25/\$**

### Floor Rates Trendline C

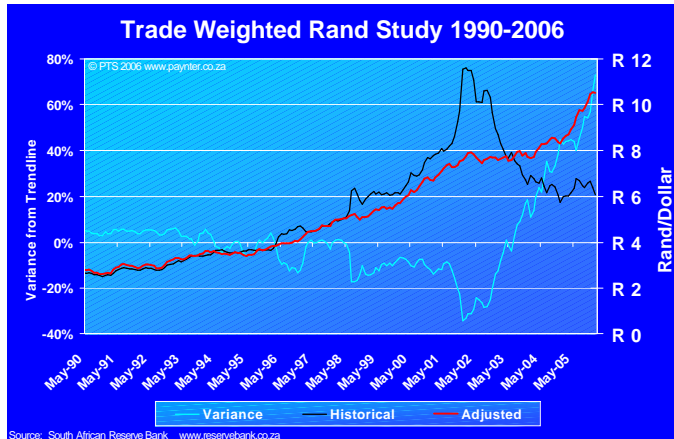
**(Yellow)**

- The absolute floor trendline (based on strongest Rand levels over this period, but excluding the present aberration), gives average depreciation of **11.2%** per annum.
- This trendline indicates the Rand should not be stronger than **R10.00** to the Dollar

## 9) “IT’S ALL DOLLAR WEAKNESS” – BUT IS IT?

Many persons are saying that the Rand's present strength is purely due to Dollar weakness – let's analyse this argument.

The following graph addresses the **Trade Weighted Value of the Rand** and reflects:



- The actual 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 March 2003 when it moved stronger than the Trade Weighted rate of R8.30/\$.
- **the Rand should be R10.52/\$ on a Trade Weighted basis as at January 2006.**

## 10) 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**
- **Competitiveness of the South African economy**
- **Trade Weighted Value of The Rand since 1990**

All these indicate:

- **Intrinsic value** of the Rand in 1<sup>st</sup> Quarter 2006 is within the range **R8.30 - R11.25**, and
- **The Rand will continue to depreciate for the foreseeable future at minimum 5.7% annually – and maybe as high as 16% annually.**

### INVEST RANDS – EARN DOLLARS!

If the Rand's present strength is unsustainable, then surely NOW is the time to look at converting your Rand wealth! If you are able to convert your wealth at current levels, when the Rand's true level is at least R8.30 – **you can't lose!**

And that it is not related to (does not form part of) your R2,000,000 allowance!

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1. An overview of the Foreign Currency Market – how much of daily turnover is actually trade related? Who are the major players?
2. A businessman's simplistic view on basic economics (not these confusing terms used by authorities and economists) – **this is a real gem!**
3. Manufacturing Value Added per Capita, Productivity and Labour Cost History for South Africa and its trading partners
4. The effect that Gold and other minerals have on our exports and overall economy
5. Unemployment history and Employment breakdown by Sector
6. Inflation differentials and exchange rates
7. Other factors that affect our economy more than our trading partners
8. Who you should listen to for the real facts on the exchange rate and the economy

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