EFFICIENT GROUP

ECONOMIC COMMENTARY

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Newsletter

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DRIVERS OF THE SOUTH AFRICAN RAND

We recently updated our South African rand exchange rate model. The need for a new model was evident because we realised that smart non-linear models cannot capture enough variation (volatility) to effectively forecast the fluctuation in our currency. Our updated model shows that the South African rand could realistically trade around R14.50 to one American dollar in the short term. Although it has traded at R12.90 in the medium to long term, taking into account the drivers of inflation and sentiment, a more accurate rate should be closer to R13.20.

The reason for the update in our model is quite simple: Unlike the American dollar to the euro exchange rate that moves at a relatively stable rate in both the short and long term on exchange rates, the South African rand can sporadically depreciate by up to 10% in a single day. Then it can gradually appreciate again, or simply depreciate by 10% again. We did research on this and it has shown that a better way to forecast the medium to long term rate of the rand is to consider the fundamentals inflation and sentiment (demand and supply).

A country's currency is linked to inflation. Therefore it can be compared to the inflation of other countries. If inflation in South Africa increases faster than the inflation in other countries, the value of South Africa's currency decreases quicker as a result of this. South Africans can then buy less with the South African rand than other citizens can do with their currencies. This is commonly referred to as purchasing power. In the long term, purchasing power can include other fundamental factors, like sentiment, as well. We can take the current South African market as an example. Due to a lack of leadership and accountability in government, as well as extremely poor economic policies, confidence has eroded to a point where few people want to do business in South Africa. It then becomes more difficult to grow the economy especially through gross fixed capital formation (investments) which can easily flow out of an open economy. Outflows (or slower inflows) places a larger demand on imports and American dollars and we then need to import specific goods and services. In the end, a higher demand for American dollars places upward pressure on the price of dollars. This then results in the South African rand depreciating.

Besides purchasing power, it is also important to understand that sentiment can also reflect future prices. Like a share price considers market sentiment about future earnings, a country's currency reflects sentiment about a country's ability to grow in the future. Or in other words, it produces favourable returns in the long term. For this reason, sentiment plays an important role in South Africa's currency. In the current political climate, sentiment continuously deteriorates the environment in which returns can be created (as they have done since 2015). When market sentiment reduces, the currency of a country depreciates. The following factors reduce market sentiment about future growth (earnings):

+ Corruption and state capture;
+ Dismissal of key ministers;
+ Attack of the independent South African Reserve Bank; and
+ Uncertainty of private property rights.

If we take the drivers of inflation and sentiment into account in our model, which is based on purchasing power parity and sentiment, a more accurate exchange rate will be closer to R13.20, although it has traded at R12.90 in the long term. However short term volatility could keep the rand at R14.50.

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