Investec

SA Economics

Rand Note

5th June 2019

Confusing messages out of the ANC on Reserve Bank independence stalls rand's nascent recovery, as the
apparently moots printing money

The down case has been split into a domestic event driven only down case, and a down case of both international and domestic events

		Q1.19	Q2.19	Q3.19	Q4.19	Q1.20	Q2.20	Q3.20	Q4.20
Domestic (lite) Down case 25%	Rand/USD (average)	14.01	15.50	17.50	17.75	16.90	16.00	15.50	15.25
	Repo rate (end rate)	6.75	7.00	7.75	7.75	7.50	7.50	7.50	7.50
25%+12%=37%	Partial expropriation of (certain groups') private commercial sector property (including productive land) without compensation. Business confidence remains depressed, marked rand weakness, significant load shedding and weak investment growth. SA **sub-investment grade Moody's rating in 2019**, but substantial repair avoids further marked downgrades. SA experiences a mild, credit rating downgrade related, recession. However, modestly strengthening global demand and elevated commodity prices help lessen the longer-term impact of domestic disturbances. Sedate global monetary policy normalisation occurs – a severe global risk-off environment is avoided, with neutral to global risk-on.								
		Q1.19	**Q2.19**	**Q3.19**	**Q4.19**	**Q1.20**	**Q2.20**	**Q3.20**	**Q4.20**
International & (worse) domestic Down case 12%	Rand/USD (average)	14.01	16.00	18.00	18.50	19.60	18.00	17.50	17.25
	Repo rate (end rate)	7.00	7.25	8.00	8.50	8.50	8.50	8.50	9.00
	Expropriation of private commercial sector property (full or partial, and including productive land) without compensation, plus wide scale land grabs, title deeds not transferred to individuals - nationalisation. Confidence and investment depressed, marked rand weakness, significant strike action and widespread electricity (water and other services) load shedding. SA sub-investment grade, increased chance of further credit downgrades. Faster than expected global (US) monetary policy normalisation, general market risk-off, global sharp economic slowdown (commodity slump), marked escalation of US-China trade war, short global financial crisis (SA V shaped recession). Material risk of further credit rating downgrades to junk.								

Note: Event risk begins Q2.19, but is mainly felt from Q3.19. Source: Investec

- After managing to strengthen to R14.40/USD, R16.22/EUR and R18.24/GBP earlier yesterday in a winning streak from 29th May, the domestic currency then lost all of these gains, reaching R14.83/USD, R16.70/EUR and R18.83/GBP on an announced change in the ANC stance to one of potential interference in the Reserve Bank's independence.

- Specifically, the Secretary General of the ANC announced that "the ANC NEC Lekgotla agreed to expand the mandate of the South African Reserve Bank beyond price stability to include growth and employment, It also directed the ANC Government to consider constituting a task team to explore quantity easing measures to address intergovernmental debts to make funds available for developmental purposes" sic.

- The announced move to printing money - "quantity" (quantitative) easing - was met with a negative market reaction as fears of hyperinflation and a Zimbabwe/Venezuela style economic collapse came to mind. While the Finance Minister, Mr Mboweni, scrabbled to deny these statements on the SARB, the rand has failed to recover substantially.

- Mr Mboweni was seen to immediately react with a twitter statement of "Government sets the mandate for the SARB. There is no quantitative easing thing here. The primary mandate of the SA Reserve Bank is to protect the value of the currency in the interest of balanced economic growth and development".

- Others in the ANC are reported to have also disagreed with the party's Secretary General, with Enoch Godongwana said to have stated "(t)he statement that suggests that the ANC is intending to set up a committee to investigate the need or otherwise for quantitative easing is inaccurate."

- Mr Godongwana is reported to have added "(i)n this regard the finance minister and the Governor of the Sarb will continue to assess our economic performance and coordinate macroeconomic policy in the interest of balance and sustainable economic growth. The matter is therefore closed".

- The announcement, and counter announcements on the SARB's independence, come at a poor time for the rand, which typically sees material risk from the second quarter of each year to the end of the third quarter, with the advent of the sell-in-May-and-go-away season for emerging market portfolio assets, as global markets risk concerns are amplified.

- With the bulk of global markets' wealth held in the Northern hemisphere, markets tend to become risk averse during the Northern Hemisphere's summer vacation period, with investors switching to perceived less risky investments (typically selling EM portfolio assets), and often returning to 'higher yielding/high risk' markets in September/October.

- The risk for SA with its already weak government finances, and now poor government statistics for April, is that the country is edging closer towards a Moody's rating downgrade, particularly as Moody's now counts Eskom's debt as SA governments', as SA guarantees Eskom's debt and likely also as government is now making the coupon payments on this debt.

- Moody's issued a stark warning in May 2019 that South Africa could face a lower credit rating (one of sub-investment grade versus its current investment grade) if policies do not sufficiently address rising sovereign debt, fiscal overspending in relation to revenue and economic growth.

- Specifically Moody's said "in the absence of effective policy change, the sovereign's credit profile will most likely continue to erode, with fiscal strength weakening and growth remaining low. Fading prospects of policies that will sustain fiscal and economic strength, alongside any signs of diminishing resilience to shocks, would put downward pressure on the country's rating."

- The SARB independence is seen by Moody's as "policies that will sustain fiscal and economic strength", particularly, Moody's adds, "(t)he central bank's adherence to its inflation and financial stability mandate supports effective macroeconomic policy", and the SARB's independence from government, or other, interference in its policies is seen as a key rating strength.

- Indeed, a loss of SARB independence may not only result in a credit rating downgrade for SA, but could also see a massive negative impact on foreign portfolio investment, key funders of SA's government debt, and so cause massive sales of portfolio assets and concomitant substantial rand weakness, aiding higher petrol prices, as occurred last year.

- Moody's says that "South Africa's large pool of domestic investors and the maturity and currency structure of its debt mitigate government liquidity risks", supports its current investment grade rating, but risks of high and hyperinflation, and extreme currency depreciation are disincentives to foreigners holding these portfolio assets of South Africa.

- Standard & Poor's rating agency highlights that the financing of SA's current account "remains vulnerable to changes in investor sentiment because it is predominantly funded through volatile portfolio and other investment inflows. Such inflows can be susceptible to changes in foreign investor sentiment and emerging market appetite."

- Moody's has also said "(w)e expect that the government will continue to pursue greater control of corruption or "state capture" and reform policy, which will support a gradual recovery in growth." The Secretary General of the ANC's comments on potential interference in the SARB mandate is however seen by markets as contradicting these expectations of Moody's.

- In order to support South Africa's investment grade credit rating from Moody's the agency additionally requires that "(w)ith the recent election over and Cyril Ramaphosa affirmed as president, we now await further news regarding the composition of the incoming administration and the policies it will pursue to address South Africa's key credit challenges."

- "Those challenges are material and … (include) … rebuilding South Africa's institutions following the years of misgovernance by the Zuma administrations". Globally Central Banks are seen to need independence and the SARB's independence is seen as one of the remaining institutional strengths in SA which partially supports SA's investment grade credit rating from Moody's.

- Quantitative easing essentially involves more than merely printing money, simplistically it involves a Central Bank taking over some of the holdings of the government's debt from the holders (essentially private sector banks) and paying out the perceived value of the debt (electronic creation of money) to these previous holders of the debt.

- Successful quantitative easing is done under highly controlled circumstances (when interest rates are at near/zero), and is not open to any forms of corruption or 'state capture'. Markets are still smarting from allegations of state capture and corruption in South Africa from various commissions.

- Quantitative easing is done to provide liquidity to the markets under extreme market constraints, and not to lower governments debt burdens. Quantitative easing is seen as both a temporary, and monetary, phenomenon, and is not used to increase the ability of a government to embark on further debt increases and/or state expenditure.

- Additionally, for South Africa to push its interest rates to zero would remove the risk-premium required on its portfolio assets to compensate for currency and country risk. Cutting SA’s interest rates towards zero (eroding or removing this risk premium) would see, massive foreign portfolio outflows and currency depreciation, extremely high petrol price and living cost increases.

- Moody’s concludes “(w)ith the election over, we expect South Africa's (Baa3 stable) new government, when formed, will put forward policies to continue tackling the country's main credit challenges – low growth, steadily rising debt, leveraged state-owned enterprises and weakened institutions.” This includes moving away from state capture and not weakening institutions.

- Absent these successful reforms, Moody’s rating agency has indicated quite clearly that SA could instead face a loss of its investment grade dual currency sovereign long-term debt rating, to below that of its current Baa3-rated peers. The SARB has indicated such a loss of the credit rating will push money market rates up substantially and so the repo rate.

- Mr Mboweni is also reported to question “(w)hat is this obsession with the South African Reserve Bank? I am now reaching a point of total exasperation with this continued attacks and obsession with the South African Reserve Bank. I have explained on many occasions the purposes and functions of the South African .. (Re)erve Bank. What is the issue?”

- The Finance Minister adds "(l)et us stop shouting at business and embrace them as partners in economic growth, investment and job creation. Let us embrace all farmers, black and white to grow agriculture." This appears to be in response to the ANC’s apparent other faction’s narrative on WMC (White Monopoly Capital), and now also apparently quantitative easing.

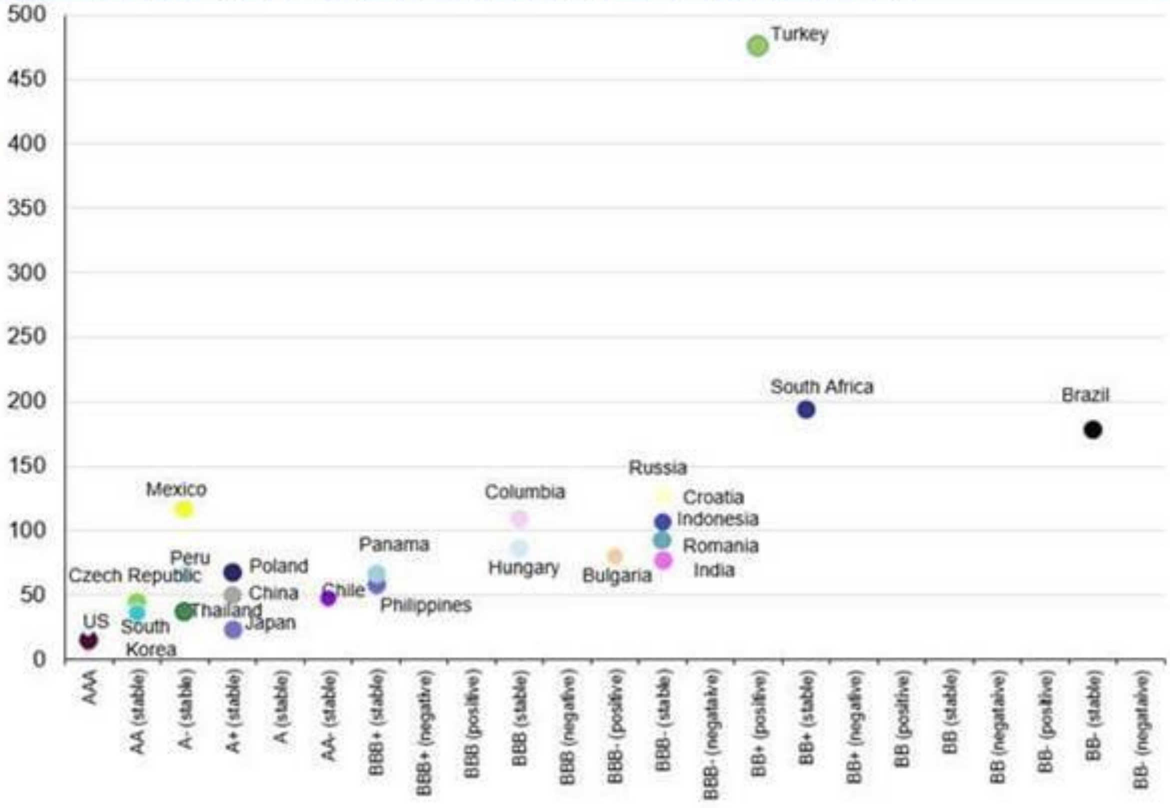
- Inconsistent communications from the ANC are causing confusion and consternation in the markets, and indeed will further damage business confidence and so job creation in South Africa. Should business feel under threat, and attack, its confidence in the environment to do business tends to plummets and so too then does fixed investment and job creation.

- Subsequent to Mr Mboweni and Mr Godongwana statements, the rand has appreciated only slightly, to R14.62/USD, R16.46/EUR and R18.56/GBP today as markets still fear the realisation of the views on the SARB from the ANC’s announcement. The rand is unlikely to recover from this quickly.

- Indeed, the rand’s gains of the past several days are mostly wiped out, and it could instead have appreciated further on the decline in global risk aversion as the US is seen to near a rate cut. Now however, the increasing chance of a July petrol price hike cut has diminished (rand strength can lower petrol prices), and so possibly also the realisation of a July interest rate cut.

- Looking forward, SA faces another climb back from what has proved to be an ‘intraday special’, as opposed to a ‘midnight special’. Meanwhile a number of businesses continue to lose confidence in SA (as evinced by depressed readings of the BER indicator), and so unemployment rises. Government cannot sustainably create jobs, only the private sector can.

Credit Default Swaps and S&P local currency long-term sovereign debt ratings



Source: Bloomberg