Economics Weekly

18 December 2001

This is the final *Economics Weekly* for the year. Publication will resume on 7 January 2002.

Market review and outlook

Currency market

Inflation – or the internal value of a currency – dictates that a rand today is worth more than a rand tomorrow. This induces consumers to spend sooner because they will expect to pay more for the same item later on.

When considering the external value of the domestic currency – or the exchange rate – it would appear that it has become accepted wisdom that a rand today is more than likely worth more than a rand tomorrow. In other words and in currency traders' parlance, the rand is viewed as "a one-way bet".

Consequently, importers and other users of foreign exchange are biased towards purchasing their currency requirements sooner rather than later because they are unsure as to when the current depreciating spiral will let up. Exporters, in contrast, are reflecting healthy paper gains with each passing day on their foreign earnings so that there is no incentive to repatriate these funds sooner than the maximum regulated 180 days. It is this imbalance that creates the volatile movements in the rand and underpins the rand's weakening bias.

More alarming though is that this trend appears to be turning into a vicious spiral. The rand has depreciated by a weighted average of 19% against 14 of its most important trading partner currencies in the last four weeks, with no one willing to bet on a top. And, as we enter the holiday season the currency market will become more illiquid, with the result that the rand's movement could be even more exaggerated.

Some have welcomed the rand's slide; they have and are likely to profit further from it. Others, however, have less reason to be cheerful this holiday season. Still, it has been a tough year. I suggest you spoil yourself because that luxury sports car you've had your eye on isn't going to be cheaper next year. Also, you'll be helping to prop up an economy facing the ill winds of the global slowdown. That makes you a patriot.

Currency dynamics	7/Dec/01	17/Dec/01	Change
EUR/USD	0.8902	0.9022	1.3%
GBP/USD	1.4338	1.4592	1.8%
USD/JPY	125.53	127.54	1.6%
USD/ZAR	10.9250	12.0625	10.4%
EUR/ZAR	9.7298	10.8815	11.8%
GBP/ZAR	15.5825	17.5973	12.9%
JPY/ZAR	0.0869	0.0946	8.9%
DEM/ZAR	4.9723	5.5753	12.1%
CHF/ZAR	6.5823	7.3915	12.3%
TWER	45.63	42.21	-7.5%

Money market dynamics	Current	Previous
SA prime	13.00	13.50
SA repo rate	9.50	10.00
SAONIA	8.84	8.88
US Fed funds rate	1.75	2.50
EMU 2-week repo	3.25	3.75
UK base rate	4.00	4.50

Emerging market dynamics	7/Dec/01	17/Dec/01	Change
EMBI	737	729	-8
EMBI+	789	783	-6

Equity market dynamics	7/Dec/01	17/Dec/01	Change	2000 high
International				
DJIA	10049	9892	-1.6%	11723
S&P500	1158	1134	-2.1%	1527
NASDAQ	2021	1987	-1.7%	5049
FTSE100	5265	5136	-2.5%	6798
Xetra Dax	5199	5068	-2.5%	8065
Nikkei225	10571	10323	-2.3%	20833
JSE Securities Exchange				
All share	9998	10406	4.1%	9227
Industrial	7796	7853	0.7%	10196
Financial	9117	9124	0.1%	12022
Gold	1589	1868	17.6%	1322

Interest rate dynamics	7/Dec/01	17/Dec/01	Change
US Treasury curve			
2Yr	3.20	3.14	-0.06
10Yr	5.17	5.19	0.02
30Yr	5.58	5.57	-0.01
SA Treasury curve			
5Yr-R150	10.76	12.30	1.54
10Yr-R153	11.32	12.65	1.33
15Yr-R157	11.38	12.68	1.30

FINANCIAL MARKETS

Standard Bank

Ranges for the week: USD/ZAR11.80-12.80, EUR/USD0.88-0.92, GBP/USD1.43-1.47, USD/JPY125.00-130.00.

Bond market

Bond yields have risen sharply, in tandem with the rand's slide. The market is almost 2 percentage points higher than the lows recorded not more than three weeks ago.

The precipitous slide in the rand means that the Reserve Bank (SARB) will in all likelihood miss its 3-6% inflation target in 2002, and perhaps even in 2003. Consequently, the bank will probably seek to contain the risk of spiraling inflation by raising interest rates. And the rate hike need not be excessive to have an impact.

As monetary policy impacts the economy with a lag, there is little the bank can do about restraining price pressures in 2002. Still, the bank will seek to contain the threat of a spiral in inflation (see the *Market Forecast report of 10 December* for our interest rate outlook).

Economic commentary

Domestic economy

The weeks ahead						
Date	Release	Time	Month	Denominator	Expected	Previous
19/12/01	PPI	11h30	Nov	% y/y	8.3	8.5
				% m/m	1.0	1.4
28/12/01	Trade balance	14h00	Nov	ZARbn	0.5	-1.2
04/01/02	M3	08h00	Nov	% y/y	15.8	14.8
	PSCE			% y/y	9.5	10.2
	NOFP			US$bn	4.8	4.8

Manufacturing production held up against an environment of uncertainty and weak global demand in October. Production rose 6.5% y/y, with growth picking up in 19 of the 27 sub-sectors. However, this was probably the realisation of orders placed in previous months ahead of the festive season. While the increase may have been sustained in November, conditions in manufacturing are likely to have remained biased towards weakness thereafter. This is expected to continue into the New Year.

A number of key domestic releases are due over the next three weeks, with PPI for November due out on Wednesday. October's PPI report indicated that the rand's depreciation over the past three months had considerably increased input costs across most domestic production categories. The negative impact of the rand's continued depreciation on the domestic economy is likely to become more evident in November's PPI data, which is due for release on Wednesday. Coupled with the direct negative impact that we expect to again see in the imported PPI component, overall producer prices should stay above the 8% mark for some time. Nonetheless, PPI is expected to have risen a more moderate 1.0% m/m – after rising 1.4% m/m the previous month – bringing the annual rate of increase in producer prices down from 8.5% in October to 8.3% in November because of a positive base effect.

Trade figures for November will be released on 28 December. A R500m trade surplus is expected, even though exports probably eased somewhat in November, on the back of slowing economic activity in South Africa's main trading partner countries. October and November tend to be seasonally strong months for imports, mainly as firms stock in anticipation of the year-end rise in consumer spending. Also, capital investment within the telecommunications and select mining and manufacturing sectors remains brisk, helping to sustain imports. However, the spate of strikes that seriously curtailed port operations across the country late in November and early December will have probably impacted on the inward and outward movement of goods. While it is difficult to estimate exactly how the successive strikes will have impacted on trade flows, it would be safe to assume that both exports and imports will be noticeably lower than in October.

The SARB's release of November M3, PSCE and NOFP figures is scheduled for 4 January 2002. In October, M3 rose 14.8% y/y mainly on the back of an increase in PSCE. Credit extension surged to 10.2% y/y in October. We suspect that the surge in private sector demand for credit may be linked to pre-emptive buying of durable goods ahead of expected price increases. However, low and stable interest rates may also have contributed. Given increased uncertainty over the future course of interest rates we are likely to see some moderation in consumer spending early next year. Still, we expect the current phenomenon to have sustained money supply growth in November. The rand's depreciation against the US dollar during the month, albeit milder than the previous month's, is likely to again have boosted net other assets and liabilities and consequently, together with PSCE, M3 growth.

The SARB's net open position in foreign currency (NOFP) as at the end of November probably remained unchanged at $4.8bn from October. The NOFP has been at this level since July and will probably remain so into the New Year. However, it is likely to decline significantly early in the first quarter of next year, as the bank transfers a portion, or all, of the $1.5bn syndicated loan to the government.

Key economic statistics			
	September	October	November
Gold and forex reserves (USDbn)	7.5	7.5	7.5
Trade balance (ZARm)	2.2	-1.2	
CPI (%y/y)	4.4	4.0	
CPI-X (metro and urban) (%y/y)	5.8	5.9	
PPI (%y/y)	7.8	8.5	
M3 (%y/y)	14.47	14.82	
PSCE (%y/y)	9.64	10.15	

International economy

The Federal Reserve delivered another interest rate cut last week following its last FOMC meeting of the year. The federal funds rate is now at 1.75% and could hit lower levels next year if the economic slowdown demands it. Particularly, further employment sacrifices could force the Fed's hand. The central bank cautiously acknowledged recently positive economic data pointing to a rebound in demand, referring to it as "preliminary and tentative". However, as with previous rate cuts, the Fed pointed out that risks remain tilted towards economic weakness.

It is likely that the economy's downward momentum will persist over the next six months. In a worse case scenario, the slowdown in consumer spending will intensify – after the recent respite – as a result of higher unemployment, causing further turbulence. In a more positive scenario, the Fed's aggressive easing, together with low inventory levels and low commodity prices (particularly oil) could generate a sharp economic upturn. This is because lower interest rates enable consumers and businesses to refinance debt at lower costs, boosting their ability to spend and invest.

The National Association of Purchasing Managers, however, reports that manufacturers expect a slow rebound in the second half of next year. This is leading to cuts in investment spending across most sectors, especially agriculture, entertainment, mining, construction, transportation and utilities. Also, the recent uptick in consumer demand for durables like autos is seen as borrowing against future demand, which consequently seems set to weaken. These factors suggest more negative economic data in the first half of next year, with a moderate recovery developing in the second.

The European Central Bank recently revised its economic forecasts for 2002. The central bank foresees economic growth of 0.7% and inflation of 1.1%. The sharp decline in French consumer inflation for November, released last week, together with the bank's revised inflation projections, indicate that price pressures are slowing faster than originally anticipated. This bodes well for monetary policy in Euroland, which may shift its focus towards encouraging growth in the New Year.

At the EU Summit last week, EU leaders indicated they are confident the bank will lower interest rates further. The European Banking Federation also sees the ECB cutting interest rates in the first half of next year to help boost economic growth. ECB

President Wim Duisenberg has indicated that national deficits (as a percentage of GDP) are growing too close to the 3% limit and that this could narrow the bank's scope for paring interest rates.

Still, it is unlikely that interest rates in the Eurozone have hit bottom. The ECB's next monetary policy meeting is scheduled for 3 January 2002. We do not expect the bank to trim rates at that meeting, but a rate cut before the end of the first quarter of 2002, probably in the region of 25 basis points, is probable.

The inflation picture is looking very positive in the UK, enabling further interest rate cuts, if required. The Bank of England's targeted inflation measure, RPIX, as well as producer prices for November indicate that overall prices are slowing rapidly. The bank's mandate is to ensure that RPIX remains within 1%, either way, of the 2.5% target so that, should inflation fall below 1.5%, the central bank would have to take appropriate action to prop up prices. RPIX in November fell to 1.8% y/y. The fact that RPIX has been below the BoE's 2.5% inflation target for over two years opens the door for looser monetary policy aimed at sustaining growth.

The Bank of Japan's Tankan business survey fell to -38 in December from -33 in November, indicating that the economy continues to worsen, albeit gradually. A negative reading shows that the majority of respondents were pessimistic about business conditions. Business sentiment is deteriorating on the back of lower demand for exports and deteriorating domestic consumer spending. This is likely to lead to the contraction of capital expenditure next year.

Tight business conditions and debt write-offs by commercial banks have already led to an increased rate of bankruptcies. In November, bankruptcies were nearly 16% higher than the previous year. The picture is likely to deteriorate as bankruptcies have a ripple effect on related businesses.

Economic indicators	GDP (%q/q)		CPI (%y/y)	
	Q2	Q3	Oct	Nov
US	0.3	-1.1	2.1	1.9
Japan	-1.2	-0.5	-0.8	
EMU-12	0.1	0.1	2.4	2.1
Germany	-0.0	-0.1	2.0	1.7
UK	0.4	0.5	1.6	0.9

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