How currency markets work and why the rand is falling

By Fatima Bhoola

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Given that South Africa operates within a flexible exchange rate regime, the value of the rand, like any commodity, is determined by the market forces of supply and demand. The demand for a currency relative to the supply will determine its value in relation to another currency.

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Theoretically, the demand for a floating currency - and hence its value - changes continually based on a multitude of factors. In the case of the rand, its current weakness can be attributed to a myriad of structural problems facing the local economy.

The main determinants of a currency's value include demand for a country's goods and services. This is closely linked to the growth and national income of its main trading partners. Equally important is the domestic interest rate. If it is high it is likely to attract foreign capital, causing the exchange rate to strengthen. But high inflation can wipe out the benefit of high interest rates to foreign investors.

Additional factors

Additional factors serve to drive the currency down. These include a current account deficit. The current account deficit gets bigger when a country spends more on foreign trade than it is earning and has to borrow capital from foreign sources to make up the difference. This implies that a country requires more foreign currency than it is getting through sales of exports, and it supplies more of its own currency than foreigners demand for its products. This excess demand for foreign currency leads to depreciation in the value of a currency.

Factors such as political instability and poor economic performance can reduce investor confidence. This inevitably forces foreign investors to seek out stable countries with strong economic performance. Thus, a country that is perceived to have positive attributes will attract investment away from countries perceived to have more political and economic risk.

There is a further complication to currency movements. The buying and selling of currencies is no longer driven only by the need to facilitate trade but also by the demand for currencies as financial assets. This means that currencies are bought and sold like any other asset. Decisions by traders - to buy or sell a currency - can have a marked effect.

The impact of the turmoil in China

South Africa's currency lost 26% of its value in the six months after turmoil gripped Chinese markets in June 2015. This was when the People's Bank of China surprised markets by executing a 2% devaluation of the yuan and changing the way it traded its currency. The aim was to weaken the yuan to boost its export competitiveness.

This, coupled with slower economic growth, has aggravated the situation for South Africa as well as other African countries that rely on oil and mineral exports to China. Emerging markets most exposed to lower growth prospects and subdued commodity prices have seen the sharpest falls.

The rand is expected to remain under pressure with many analysts predicting that it will fall further in 2016. It is not alone. Many other emerging market currencies have been dealt the same fate. But the rand is substantially weaker than it might have been. The sudden reshuffling of the finance ministry was seen as weakening one of the country's key macroeconomic institutions and continues to undermine market confidence.

Implications of the weak rand

The weak rand has a number of implications for the country's growth prospect. Firstly, the weakening currency carries the risk of pushing up inflation because imported goods are more expensive. This means that the South African Reserve Bank faces a difficult decision. It can keep interest rates low but then faces even higher inflation. This will only devalue the rand further.

If the central bank takes more aggressive action by raising interest rates, it risks stifling growth in an economy that is only growing at 1.5%.

The rand's weakening could not have come at a worse time for South Africa. The country is suffering from the worst drought since 1992 which has increased food costs and pushed the farming industry into recession. The price of white corn, a staple food in southern Africa, has more than doubled on the South African Futures Exchange in the past year.

With large parts of the economy already in recession, coupled with worsening debt levels and the threat of credit-rating downgrades, it looks like the economy will contract. This implies that Finance Minister Pravin Gordhan has limited room to boost spending.

The weak rand will also see the cost of imported goods for consumers rise. In addition, while the rest of the world benefits from record low oil prices, the country's weaker currency means it will not able to take full advantage of this and may face higher fuel prices in the near future.

On the flip side, the weaker rand does have some benefits. It is helping mines stay afloat. And gold mines could make profits again as the gold price has held up more than the prices of other minerals. There may also be a boost in tourism. The weaker rand may also have short-term benefits for sub-Saharan countries importing substantial volumes from South

Africa.

Finally there may be a boost for local exporters. But this could be stifled by the rise in the price of imported raw materials which will contribute to higher costs of production for manufacturers.

Is the rand over-traded?

In 2013 the South African rand was ranked as the 18th most-traded currency in the world. Surprisingly, while South Africa accounts for only 0.3% of the world's daily foreign exchange market turnover, the rand accounts for 1.1% of worlds daily currency trading.

This difference is largely due to the daily trade taking place outside South Africa by non-residents. This is partly a result of virtually no exchange control restrictions for foreigners trading the rand but many in place for South Africans who wish to trade in foreign currency.

This has been highlighted as a further problem faced by the central bank in trying to influence the value of the rand.

Read the original article on The Conversation Africa.