

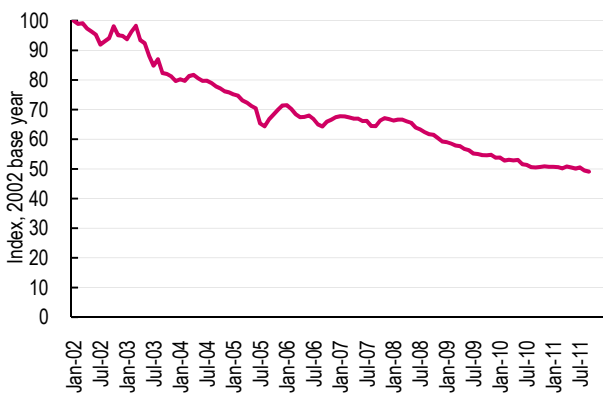
Sub-Saharan Africa: Overvalued currencies Lower FX reserves partially explain recent weakness

- **Falling FX reserves increase depreciation pressure on currencies.** Sub-Saharan Africa's (SSA) dependence on imports, due to its limited manufacturing capacity (manufactured goods make up only 13% of SSA's GDP, but 66% of its merchandise imports), explains why its authorities prefer strong or overvalued currencies. Generally, the FX reserves of SSA oil exporters provide enough firepower to sustain their strong currencies. However, the FX reserves of oil importers (such as Kenya and Zambia) are not as large, limiting their ability to sustain overvalued currencies. Oil-importing Malawi is a case in point, having resisted calls from the IMF to devalue the kwacha (it was devalued by around 10% in August 2011, to MWK165/\$1) and allow for a more flexible currency. Malawi argues that its significant dependence on imported inputs, most notably fertiliser, would mean a weak currency could significantly raise the cost of production, undermining growth. However, Malawi's dire FX shortage indicates to us that the current kwacha/dollar exchange rate is unsustainable. Falling FX reserves increase the pressure on overvalued currencies to depreciate, and Kenya and Nigeria have seen their FX reserves come under pressure for different reasons. Kenya's large and widening current account deficit explains the downward slide of its official reserves (see Figure 5) and +20% depreciation of the shilling YtD. Nigeria's sharp fall in FX reserves in 2010 and the absence of a recovery in 2011, support a potential devaluation of the naira in the near term (see Figure 6).
- **A strong currency hurts resource-intensive countries (Nigeria and Zambia) less than significant exporters of services (Kenya) and manufactured goods.** Real effective exchange rate (REER) analysis is used to determine whether a currency is misvalued, and to assess the competitiveness of a country's exports. We have found the naira, Kenyan shilling, cedi and Zambian kwacha to be overvalued – implying they have not sufficiently depreciated to compensate for the inflation differential between the SSA countries and that of their trade partners. In theory, this suggests the respective countries' exports are uncompetitive, as more dollars are required to purchase their exports than to purchase exports from a country with a weaker currency. However, the negative impact of an overvalued currency is blunted by the fact that SSA exports largely comprise commodities (oil, metals and minerals) that are priced in dollars. So, in our view, the export competitiveness of resource-rich countries, such as Nigeria and Zambia, is not significantly affected if their currencies are overvalued. But exporters of manufactured goods and services are more likely to be hurt by an overvalued currency. As SSA exports are light on manufactured goods (manufactured goods constitute 3% of Nigeria's merchandise exports, 19% of Ghana's [pre-oil] and 8% of Zambia's) this is not a significant issue. However, Kenya has relatively high exposure to manufactured exports (37% of merchandise exports), and is a significant exporter of tourism services, so the negative impact of a stronger shilling would be more pronounced on its exports.
- **The KES still has a significant depreciation risk.** Our REER analysis shows that the Zambian kwacha was the least overvalued, the cedi was the most overvalued, and the naira and Kenyan shilling are both significantly overvalued (Figures 1 to 4). The Nigerian authorities not only prefer a strong naira, but they have the reserves to keep it strong (but maybe not at NGN150/\$1 +/-3%), even after the \$10bn drop in reserves in 2010 (Figure 6). After our projected moderate near-term devaluation of the naira to around NGN155/156/\$1, we think significant naira depreciation pressure could be stemmed with the current FX reserves stock of seven-to-eight months of import cover. Conversely, Kenya's FX reserves position has been deteriorating since late-2009 (see Figure 5), falling almost 10% since they peaked at \$4.1bn in August 2010; while that of Ghana has improved to about \$5bn, from \$2bn at YE08, implying there is more pressure on the Kenyan shilling to weaken. Kenya's precarious FX position explains its appeal to the IMF for balance of payments support. While we note the shilling has appreciated in recent weeks, following the strong dose of monetary tightening in October, we still think there is a high risk of it weakening in the short term compared with other SSA currencies – especially if Kenya's structural imbalances are not reversed by unwinding the expansionary fiscal programme. Our base-case scenario is for the shilling to average at KES94-95/\$1 in 2012. However, we assign a 30% probability to it weakening beyond KES100/\$1 in 2012. The higher risk of depreciation of the shilling, compared with a devalued naira, suggests to us that interest rates may remain higher for longer in Kenya. We are not as concerned about the Zambian kwacha, given its relatively low level of overvaluation and Zambia's relatively sound FX position. The risk to the Zambian kwacha, in our view, is a sharp decrease in the copper price, contrary to consensus projections of stable prices in 2012. We think the improvement in Ghana's FX reserves over the past two years, most recently due to oil coming on stream, will limit any cedi depreciation pressure.

However, we note that REER analysis has its shortcomings, such as:

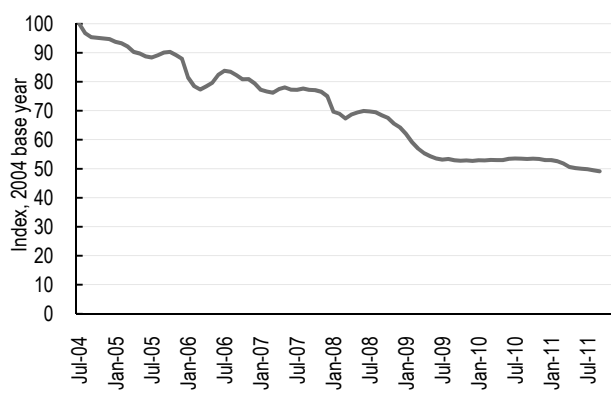
- REER analysis is based on the assumption that a currency’s value is determined by the ratio between a country’s price level and that of its trade partners. But, overall price indices contain both tradable and non-tradable goods, which may be subject to different inflation rates. Much of the REER variations across countries can be explained by fluctuations in the prices of non-tradable goods vs tradable goods, especially in developing countries, such as those in SSA.
- As well as the prices of tradable goods, exchange rates are affected by barriers to trade, capital flows and technological developments. The price dampening effect of technological progress or productivity gains by SSA’s trading partners could translate into REER appreciation in SSA, especially as SSA’s price indices mostly comprise non-tradable goods.
- Choosing a base year can be challenging, especially for countries with significantly fluctuating inflation rates, such as Kenya. Our selection of base years was premised on the years when the current account was, or was near to, balanced. A lack of pre-2000 price index data disallowed a longer sample period. We also found that Nigeria’s current account data differed depending on the source.

Figure 1: Trade-weighted exchange rate index, real – NGN



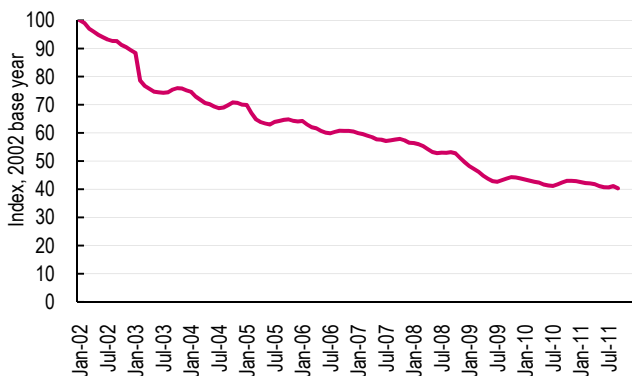
Source: Renaissance Capital estimates

Figure 2: Trade-weighted exchange rate index, real – KES



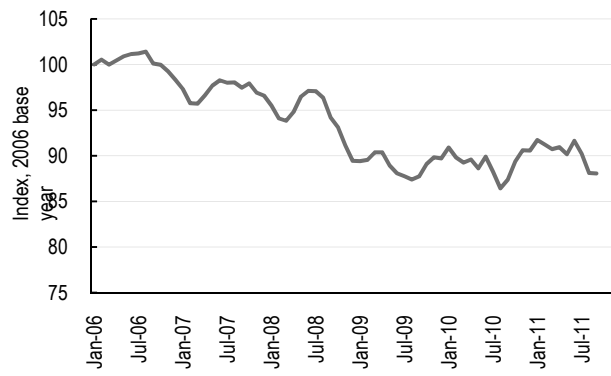
Source: Renaissance Capital estimates

Figure 3: Trade-weighted exchange rate index, real – GHS



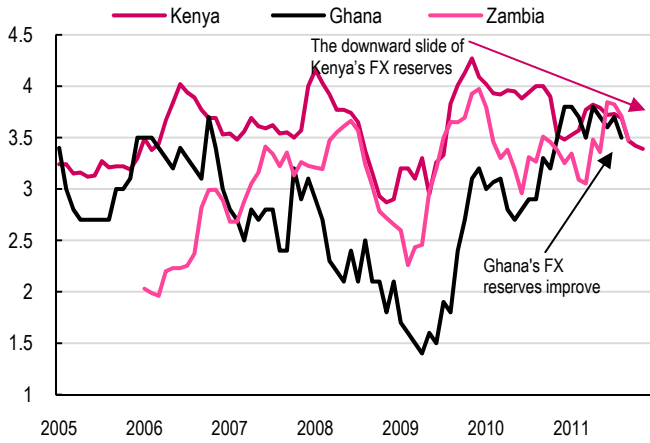
Source: Renaissance Capital estimates

Figure 4: Trade-weighted exchange rate index, real – ZMK



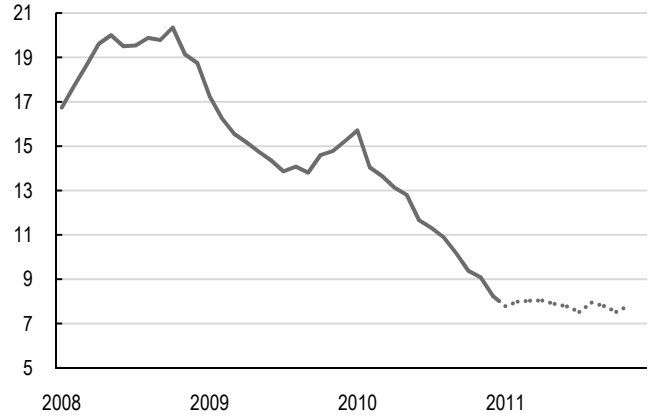
Source: Renaissance Capital estimates

Figure 5: Official FX reserves, months of import cover



Source: Central banks, Renaissance Capital estimates

Figure 6: Nigeria's FX reserves, months of import cover



Source: Central Bank of Nigeria, Renaissance Capital estimates

Disclosures appendix

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Renaissance Capital research team

Head of Equity Research	David Nangle	+7 (495) 258-7748	DNangle@rencap.com
Deputy Head of Equity Research	Milena Ivanova-Venturini	+7 (495) 258-7916	MIvanovaVenturini@rencap.com
Research COO	Ben Carey	+44 (207) 367-8224	BCarey@rencap.com
Head of South African Research	Gerhard Engelbrecht	+27 (11) 750-1454	GEngelbrecht@rencap.com
Head of Turkish Equity Research	Yavuz Uzay	+44 (207) 367-7982	YUzay@rencap.com
Head of Sub-Saharan African Research	Nothando Ndebele	+27 (11) 750-1472	NNdebele@rencap.com

Name	Telephone number	Coverage
Equity Strategy		
Charles Robertson	+44 (207) 367-8235	Global
Ovanes Oganisian	+7 (495) 258-7906	Russia
Herman van Papendorp	+27 (11) 750-1465	South Africa

Name	Telephone number	Coverage
Macro and Fixed income research		
Charles Robertson	+44 (207) 367-8235	Global
Ivan Tchakarov	+7 (495) 258-7770 x7400	Russia/CIS
Mert Yildiz	+44 (207) 367-7735	CE3/Turkey
Anastasiya Golovach	+38 (044) 492-7382	Ukraine/Belarus
Vladlen Andryushchenko	+7 (495) 258-7770 x4908	Russia/CIS
Mikhail Nikitin	+7 (495) 258-7789	Russia/CIS
Rita Tsovyan	+7 (495) 258-7770 x4516	Russia/CIS
James Lewis	+7 (495) 258-7770 x4427	Russia/CIS
Natalia Suseeva	+7 (495) 258-7770 x4082	Russia/CIS
Elna Moolman	+27 (11) 750-1462	South Africa
Busi Radebe	+27 (11) 750-1473	South Africa
Mamokete Lijane	+27 (11) 750-1471	South Africa
Yvonne Mhango	+27 (11) 750-1488	Sub-Saharan Africa

Name	Telephone number	Coverage
Banking		
David Nangle	+7 (495) 258-7748	EMEA
Milena Ivanova-Venturini	+7 (495) 258-7916	Central Asia
Yavuz Uzay	+44 (207) 367-7982	Turkey
Svetlana Kovalskaya	+7 (495) 258-7752	Russia
Armen Gasparyan	+44 (207) 367-7795	CEE
Kirill Rogachev	+7 (495) 258-7770 x4015	Russia
Ilan Stermer	+27 (11) 750-1482	South Africa
Naeem Badat	+27 (11) 750-1431	South Africa
Nothando Ndebele	+27 (11) 750-1472	Sub-Saharan Africa
Adesoji Solanke	+234 (1) 448-5300 x5384	Sub-Saharan Africa

Name	Telephone number	Coverage
Chemicals/Engineering/Building materials		
Mikhail Safin	+7 (495) 258-7770 x7550	Russia/CIS

Name	Telephone number	Coverage
Consumer/Retail/Agriculture		
Natasha Zagvozdina	+7 (495) 258-7753	Eastern Europe, Russia/CIS
Ulyana Lenvalskaya	+7 (495) 258-7770 x7265	Eastern Europe, Russia/CIS
Konstantin Fastovets	+38 (044) 492-7385 x7125	Ukraine
Robyn Collins	+27 (11) 750-1480	South Africa
Richard Ferguson	+44 (207) 367-7991	Global
Roman Ivashko	+7 (495) 258-7770 x4994	Russia/CIS
Jeanine Womersley	+27 (11) 750-1458	South Africa
Lauren Beale	+27 (11) 750-1424	South Africa

Name	Telephone number	Coverage
Telecoms/Transportation		
Alexander Kazbegi	+7 (495) 258-7902	Global
Ivan Kim	+7 (495) 258-7770 x5620	Russia/CIS, Africa
Alexandra Serova	+7 (495) 258-7770 x4073	Russia/CIS
Johan Snyman	+27 (11) 750-1432	South Africa

Name	Telephone number	Coverage
Oil and gas		
Daniel Barcelo	+7 (495) 258-7770 x4824	Global
Ilya Balabanovsky	+44 (207) 367-7905	Russia/CIS
Ildar Davletshin	+7 (495) 258-7770 x4971	Russia/CIS
Dragan Trajkov	+44 (207) 367-7941	Africa, MENA
Gerhard Engelbrecht	+27 (11) 750-1454	South Africa
Farid Abasov	+44 (207) 367-7983	Central Asia

Name	Telephone number	Coverage
Metals and mining		
Rob Edwards	+44 (207) 367-7781	Global
Boris Krasnojenov	+7 (495) 258-7770 x4219	Russia/CIS
Andrew Jones	+44 (207) 367-7734	Russia/CIS
Ekaterina Gazadze	+44 (207) 367-8274	Central Asia
Jim Taylor	+44 (207) 367-7736	South Africa
Vasilij Kuligin	+7 (495) 258-7770 x4065	Russia/CIS
Christina Claassens	+27 (11) 750-1460	South Africa
Emma Townshend	+27 (21) 794-8345	South Africa
Leavitt Pope	+852 3972-3832	Asia-Pacific
Matthew Whittall	+852 3972-3835	Asia-Pacific

Name	Telephone number	Coverage
Media/Technology/Real estate		
David Ferguson	+7 (495) 641-4189	Russia/CIS, Africa
Anastasia Demidova	+7 (495) 258-7770 x4040	Russia/CIS, Africa
Johan Snyman	+27 (11) 750-1432	South Africa
Adriana Benedetti	+27 (11) 750-1452	South Africa

Name	Telephone number	Coverage
Utilities		
Derek Weaving	+44 (207) 367-7793	Russia/CIS
Vladimir Sklyar	+7 (495) 258-7770 x4624	Russia/CIS

Name	Telephone number	Coverage
Luxury goods and tobacco/Beverages		
Rey Wium	+27 (11) 750-1478	Global/South Africa
Ryno Truter	+27 (11) 750-1497	South Africa

Name	Telephone number	Coverage
Quantitative analysis		
Renda Rundle	+44 (207) 367-8240	South Africa

Name	Telephone number	Coverage
Paper		
Adriana Benedetti	+27 (11) 750-1452	South Africa

Name	Telephone number	Coverage
Medium cap/Transport/Construction/Building materials		
John Arron	+27 (11) 750-1466	Africa

Name	Telephone number	Coverage
Regional research		
Yavuz Uzay	+44 (207) 367-7982	Turkey
Mbithe Muema	+254 (20) 368-2316	East Africa
Anthea Alexander	+263 (772) 421-845	Southern Africa
Ruvimbo Kuziwanza	+263 (7) 88-317 x8795	Southern Africa

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