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PROMOTING DIALOGUE ON TRADE REFORM IN SOUTH AFRICA

Trade, Industrial Policies and the Exchange rate

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The Economic Impact of the Rand

Introduction

Thank you for inviting me to open this forum on the exchange rate and the economy. As the public debate of the past year has shown, society's views on the exchange rate, its movements, and its level are wide-ranging and often contradictory. Importers and consumers like a strong rand. Exporters often favour a weaker currency. Strong and weak currencies carry implications for economic growth, for the evolution of job creation and destruction, and the long-run distribution of income. At the same time, it is critically important that the exchange rate not be given too much credit for determining economic outcomes. Other factors often carry more economic importance, for instance movements in interest rates, long-run productivity development, or demographic change. And, in order to put in place an exchange rate policy that works for this society, we need to recognise and acknowledge the factors that constrain our small and relatively open economy.

We need to start by reminding ourselves of where we come from. The economic and political exclusion of apartheid meant that the majority of the population's economic life was determined by others, and left the majority destitute whenever possible. Mining and agriculture were the two sectors open to the majority, and were in any event undergoing a slow but inexorable shift to higher productivity and less labour intensity. The lack of integration with the rest of the world meant there was no great exporting manufacturing base to absorb labour. At the same time, there was little investment in housing and other parts of community infrastructure – and no services. Public infrastructure, from electricity to transport, was limited and costly. There were no capital inflows. The exchange rate was strong. As the 1990s approached, fiscal deficits and inflation soared – together, as they always do. The real exchange rate was uncompetitive, driven up by a strong nominal currency, tight capital controls, and rampant wage and price inflation.

What has happened since? In a nutshell, fiscal and monetary policy have stabilised the economy, resulting in low inflation, low public debt levels, and low interest rates. Both the private and public sectors could borrow from domestic and foreign creditors to finance investment and higher consumption at sustainable rates. While mining and agricultural sector employment fell, stabilisation and stronger growth rates in the late 1990s resulted in job growth in the public sector and much of the private sector. The economy expanded in areas of services, retail and wholesale trade, finance, construction, community infrastructure development, and others – areas where there had been severe under-investment for one reason or another for several decades.

Our tradable goods sectors, meanwhile, had to contend with import competition, new overseas markets, and the need to quickly become more competitive and productive. Integration resulted in slow aggregate growth in manufacturing of close to 1% in the 1990s, strengthening to 2.5% for the 2000s, and in the latter half growth averaged about 4% per year. Sub-sector performance showed large variations. The 2000s were characterised by growth in all sectors of the economy. Some grew faster than others.

Importantly, the investment rate of the economy rose as macroeconomic stability became entrenched and expectations about future economic growth improved. Gross fixed capital formation, driven by the private and increasingly the public sector, rose from 15% of GDP to over 20%. This generated a current account deficit because our savings was not high enough to finance all the investment. I will return to this issue later.

Macroeconomic policy facilitated these shifts, by reducing the cost of borrowing, providing greater certainty to investment decisions, and cushioning economic growth from an increasingly volatile international financial environment. From the Russian and Asian crises of the late 1990s, to the Argentine crisis of 2001, to the recent global collapse of finance, prudent fiscal policy, credible monetary policy and an exchange rate that was allowed to absorb capital flows shocks have helped to sustain economic growth and jobs. 1998, prior to the managed float of the rand, was the last time domestic interest rates rose above 25%. The average prime interest rate in the 1980s was 16.5%, for the 1990s it was 18.9%, and for the 2000s it was 13.2%. The respective economic growth rates were 1.7%, 1.6% and 3.5%.

As high inflation has given way to lower inflation in response to trade reform and sustainable macroeconomic policy, the real exchange rate has fallen steadily. On the same index basis, the real rand has fallen from 118 in 1990 to 100 in 2000 and an average of 101 in 2009.   The nominal value of the rand against a basket of our trading partner currencies (before we take away inflation) was 60% below its average level in the 1990s. The current level of the R/$ exchange rate of R7.35 compares with an average level of R3.90 in the 1990s and R6.11 in 1999. Clearly, the average level of the spot exchange rate is not the cause of our poor export performance. With lower inflation, our real exchange rate depreciation would have been much closer to the nominal.

Some commentators point to the level of the rand in 2001, at the height of the Argentine crisis, as the appropriate level for South Africa. They measure the level today as an appreciation from that low. This hardly seems reasonable as a basis for analysing the level today, and of course constructive analysis would not do so. Measured by the nominal exchange rate – the rand/dollar rate – our economy is more competitive today than it was on average for the decade (and much more so than in the 1990s). The sharp depreciation in the rand in 2001 should be understood for what it was – a movement that protected and sustained the economy from the need to raise interest rates very high and force the economy to contract.

The weakening of the exchange rate has been a long-term phenomenon associated with the softer commodity price trend evident before the early years of this decade and South Africa's poor growth in productivity.

It has also been supported by policy. Prior to 2000, the monetary and fiscal authorities used a forward book – future agreements to provide foreign currency at a specific rand value – to sustain the value of the exchange rate, despite continuous downward pressure. Inflation targeting and the move to a floating exchange rate allowed the rand to depreciate, while reducing the inflation that was appreciating the real exchange rate. The forward book was closed in 2004, and foreign currency reserve purchases were strengthened, to sustain a competitive exchange rate. National Treasury allocated interest-bearing instruments to the Reserve Bank, plus additional funds, to enable the build up of foreign reserves. All of this was made possible by stronger economic growth and higher tax revenues.

In 2005, we shifted policy to move toward a fiscal surplus in order to increase saving and ramp up the sustainable financing of foreign currency reserves. The rand was very strong at the time, driven by rising commodity prices and capital inflows. Lower inflation and a larger fiscal surplus would have helped to weaken the nominal and real value of the currency.

South Africa's present economic difficulties started long before the 2008 crash of global financial markets. The spiral of high oil prices, high food prices, sharply increasing construction prices, and supply shortages, leading to second-round rises in wages and broader consumer prices, started in early 2006. Domestic overheating and rising import prices from oil and food drove up domestic inflation, and despite repeated warnings from the monetary and fiscal authorities to cool consumption, monetary policy needed to respond to prevent further economic damage.

Let me be very clear here. The monetary and fiscal responses in the 2000s, and in response to the rising inflation of 2006 and 2007, protected South Africa's whole economy – including its exporters. By appreciating the real exchange rate, spiralling inflation would have made traded goods even less competitive. At the same time, the monetary response ensured that high interest rates wouldn't be permanent. High inflation begets permanently high interest rates. In short, without the monetary response, South Africa would have had a collapse in both traded and non-traded goods and services.

Over this period, the exchange rate depreciated from about R6.10 per dollar in January 2006 to R7.40 in January 2008. This was the right direction for the rand to go.

- Was it sufficient to allow an increase in exports and rebalance production to traded goods and services? The data shows that exports picked up.

- Should the rand have depreciated much more? The answer to that is a question of balance. You would answer yes if you were willing to accept higher inflation and permanently higher interest rates.

- Would all of this result in a permanent structural shift in the economy towards greater traded goods and services production? Yes, if domestic inflation didn't rise by the extent of the depreciation.

- Would it result in a higher level of GDP? Yes, but only if the rise in net exports outweighed the losses from a higher interest rate. In short, keeping inflation as low as possible – or rapid increases in labour productivity – is the prerequisite for depreciation to result in both a rise in traded goods and services production and a short-term rise in overall GDP.

Up to now I have largely abstracted away from the story about capital inflows to the economy. We can tell the story about the long-run trends in the exchange rate without too much recourse to capital flows. That is not to say they haven't been important. They certainly have, not least as enabling our mismatch between investment and saving, and hence a higher rate of economic growth than would otherwise have been possible. Most of the capital coming into South Africa has been in equities and has lowered the cost of capital for those firms – many of them commodity exporters.

Flows have also been important when they disappear entirely, as in 1998, 2001 and 2008. Capital inflows have, on balance, financed our current account deficit and enabled the rand to recover from global crisis induced lows. And capital flows have been volatile and resulted in large swings in the short-run value of the currency.

But that is different from arguing that capital inflows have somehow caused deindustrialisation of the South African economy. The long-term trends in the exchange rate don't support that argument, unless you somehow believe that all of South Africa's manufacturing and export capacity was created precisely at the time when the rand was R13 to the dollar in 2001.

Capital flows and also asset prices need to be considered explicitly in monetary policy and broader macroeconomic decision making. These complicate understanding of the link between money supply and inflation, and increase the probability of banking crises and international contagion. The financial crisis in the US and the Asian crisis in 1998 featured both asset price bubbles and capital flows.

What to do about the exchange rate?

So if the average nominal value of the rand is more competitive than it has been in recent decades, and if we understand that domestic costs play a large role in determining the real exchange rate and our competitiveness, what do we need to do about the exchange rate?

On balance, the managed float of the currency has been to trend downwards, moderated and at times reversed by swings in capital flows. Over the longer term, the real exchange rate needs to depreciate to support competitiveness of the economy. This needs to occur through moderation of the nominal exchange rate, lower inflation, and much stronger productivity growth in sectors exposed to international competition. Our fiscal exit strategy to lower dissaving and the inflation targeting framework remain the macroeconomic prerequisites for achieving those aims. Higher inflation and high fiscal deficits and borrowing will never make the economy more competitive because they reduce saving and appreciate the real exchange rate.

The Commission on Growth and Development, chaired by Professor Michael Spence, showed that high growth countries have employed policies to counteract exchange rate appreciation to support competitiveness. However, the Commission also stressed that a depreciated exchange rate is not a silver bullet for export promotion. Complementary policies are needed to limit the impact of the exchange rate on inflation and to raise economy-wide productivity, including responsible macroeconomic policies, good quality education, infrastructure development, effective enforcement of competition and well designed regulatory frameworks. Product and factor market rigidities need to be removed to facilitate demand and production adjustments to changes in relative prices. This underlines the need for microeconomic reforms that enhance the competitiveness and flexibility of the economy.

Volatility of the exchange rate remains a concern insofar as it makes it difficult for small and medium sized exporters to invest in production capacity or for importers to plan for the costs of capital goods or consumption goods. Larger firms, and those involved in both importing and exporting, are less concerned about the exchange rate. This points to the need for more targeted intervention in helping firms manage the overall costs of hedging – this would be a more fruitful strategy than attempting to balance the costs and benefits of a larger macro approach.

We need to find ways of moderating volatility over suitable timeframes, primarily by supplying sufficient financing for foreign reserve purchases by the Reserve Bank. Financial policy must also facilitate the development of hedging instruments and the deepening for foreign exchange - and financial markets more generally, while gradual accumulation of additional foreign reserves enhances the market's assessment of South Africa's creditworthiness and the central bank's ability to smooth excesses in rand volatility.

Some commentators have proposed a fixed exchange rate regime as the solution for South Africa, but this would be very hard to implement and carries a range of economic costs. Such a regime would require South Africa to give up its monetary sovereignty and adopt the same monetary policy stance to the country whose exchange rate is being targeted, even if it is not appropriate for domestic economic conditions.

Moreover, the exchange rate would no longer be a shock absorber for changes in the terms of trade. If we had had a fixed rate regime at the time of rising imported food prices, our domestic inflation rate would have been much higher and South Africans much poorer. As the Greek experience clearly shows, bad economic management and lack of productivity magnify the eventual crisis caused by inappropriate fixed exchange rate regimes.

Let me conclude by making a couple of summary points.

First, to say something sensible about the rand it is important to take a longer term view of exchange rate levels. Production capacity does not spontaneously come into and out of existence as the rand moves from month to month.

Second, the domestic inflation rate is as important for the real exchange rate as is the nominal value of the rand. The notion that we can let domestic inflation loose and become more competitive is simply wrong.

Third, while it is important that we focus on raising our exporting capability, we should be conscious of the tradeoffs involved when we argue for the use of macroeconomic policy to achieve these aims. Overall economic growth is unlikely to be higher in the short and medium term as we move to lower fiscal deficits and/or higher fiscal surpluses and lower inflation. Sustainable real depreciation is not costless and we need to have integrity to acknowledge that.

Finally, as a society we need to recognise that change is important and necessary. Macroeconomic policy cannot simply throw a lever and make us more competitive. Continuous learning, re-skilling, adaptation and creativity at the microeconomic level is the only way to achieve and retain competitiveness in a rapidly evolving world economy.

Thank you.