Province of KwaZulu-Natal

Provincial Treasury

Infrastructure Management and Economic Service (IMES) Unit

Exchange Rate and Currency Depreciation

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1. Introduction

The exchange rate is regarded as one of the most essential indicators used to measure the economic status of a country, along with factors such as inflation and interest rates. It plays a significant role in determining the amount of trade in a country, which is critical in a country like South Africa (SA) whose economic system is predominantly based on free market economic principles (SA info, 2013). Hence, the exchange rate becomes one of the most monitored and analysed high frequency indicators in an economy.

Exchange rates are also controlled by government in some countries depending on a country's foreign exchange regime. For instance, in nations operating under a flexible exchange rate regime, government can intervene by adjusting either their monetary or fiscal policies to achieve the desired economic goals. Brazil, Chile, Columbia and Turkey are among some of the emerging countries which have the ability to intervene on the exchange rates (Alfaro and Kanczuk, 2013).

2. Factors affecting changes in exchange rates

A number of factors are considered to have a significant effect on the exchange rate of a country. Some are universal, and some are a result of country specific risks. Van Bergen (2010) draws attention to six major factors that influence exchange rates, these are: differentials in inflation, differentials in interest rates, current-account deficits, public debt, terms of trade and political stability and economic performance.

2.1 Foreign investment

Foreign investment is defined as the flow of capital from one country to another in exchange for an ownership stake in domestic corporations and/or other domestic assets such as bonds. In general, foreign investors will require obtaining some control through being actively involved in the management of their investment. This is usually beneficial for both parties involved, especially provided that the investor is an expert in the field in which they have invested as they come with valuable skills, knowledge and experience.

The magnitude of foreign investment and its effect on a country's economy has an impact on the value of the domestic currency against other currencies. Late in the year 2013, the US Federal Reserve Bank (Fed) announced its plans of cutting back on the quantitative easing (QE) programme. The QE cut entails a gradual decrease in the monthly purchases of government and mortgage bonds, in the case of the US, by $10 billion dollars per month from $85 billion. The tapering began in December 2013 and is expected to be initiated at all 7 upcoming monetary policy committee meetings till it is ended in December 2014.

2.2 Current account deficits

The current account consists of the balance of trade, i.e. exports minus imports, net foreign income - interest and dividends and net current transfers - foreign aid and workers' remittances (Osakwe and Verick, 2007). A positive current account balance is ideal for a country as this indicates that the nation is a net lender, that is, more money is coming into the country than paid out. A positive balance also increases a country's net foreign assets by the surplus amount whereas a negative value decreases foreign assets (Todaro and Smith, 2011). A current account deficit implies that a country's economy is functioning on borrowed funds. In other words, other countries are essentially financing the economy, and hence sustaining the deficit.

2.3 Terms of trade

The terms of trade (TOT) represent the portion of exports relative to imports. Idyllically, TOT should be a value greater than one, which represents the incoming of capital in the country. In addition, this means the country is accumulating capital and can therefore afford to either consume more or save. Contrary to this, a value less than one means that the country is importing more and therefore spending more than it is making on international trade thereby promoting an increased use of debt if exports cannot be increased to accommodate for the shortfall.

3. Trends in the South African exchange rate

As at the end of March 2014, the South African rand currency has suffered a two year period of weakness against many currencies (SARB, 2014). The most prominent among other currencies was the US (United States of America) dollar ($) as the US is one of SA's major trading partners.

The weakest point in this two year period was in January 2014 where the rand reached a low of R11.25 against the US dollar. This was the lowest recorded rand value since 2008. By the end of January of 2014, the rand had depreciated by 3.5% since the beginning of the year. However, in the two months, before the end of the first quarter of 2014, the rand appreciated by 2.4%. This was nevertheless a period of high rand volatility, with the value ranging between R11.25/$ and R10.60/$.

Table 1: Percentage change in the exchange rate of the rand, March 2013 to February 2014

	31 Mar 2013 to 30 Jun 2013	30 Jun 2013 to 30 Sep 2013	30 Sep 2013 to 31 Dec 2013	31 Dec 2013 to 28 Feb 2014
Weighted average*	-6,8	-3,5	-3,8	-2,4
Euro	-8,9	-4,7	-5,4	-1,9
US dollar	-7,2	-1,3	-3,5	-2,3
Chinese yuan	-8,3	-1,6	-4,6	-0,9
British pound	-7,6	-6,9	-5,7	-3,5
Japanese yen	-2,5	-2,4	3,5	-5,4

* Against a basket of 15 currencies

Source: SARB (2014)

Table 1 illustrates how the rand performed against major international currencies. As can be seen, the rand depreciated on a quarterly basis. The rand has however been gaining strength; it gained significant strength and closed at R10.33 on Friday the 26th of May 2014 (table2).

Table 2: The volatility of rand and changes in other high frequency indicators, 2012 to May 2014

	Annual average 2012	2013	since 1 Jan 2014	% deviation* from 1-year average	5-year average	current level	since 1 Jan 2014
Exchange rate & Equities							
USD/ZAR	8.2	9.6	10.71	-9.9	-26.8	10.33	1.5
USD/Euro	1.3	1.3	1.37	3.4	0.0	1.36	1.1
Nominal effective exchange rate	66.5	57.4	50.9	-11.3	-26.4	52.8	2.3
Real effective rand index	109.4	97.0	97.0	-11.3	-0.7	104.0	-1.6
JSE All Share index	35 058.4	39 656.0	47 362	19.4	63.0	49 953	7.2
Dow Jones Industrial index	12 965.3	15 015.9	16 287	8.5	46.2	16 606	1.0
Cost of capital & risk spread							
Repo rate	5.3	5.0	5.10	2.0	-31.4	5.50	10.0
3 month Jibar	5.4	5.1	5.62	9.5	-25.0	5.80	58.3
R186 bond yield	7.9	7.7	8.45	9.4	-1.0	8.04	-22.2
EMBI South Africa spread	207.5	232.7	241.1	3.6	0.7	205.0	-39.0
EMBI Global spread	342.3	318.2	336.1	17.9	-9.6	300.7	-30.5
Commodity prices							
Platinum	1 552.5	1 486.7	1 434.3	-3.5	-6.5	1 478.8	8.4
Gold	1 668.9	1 411.7	1 293.9	-8.3	2.5	1 293.2	7.2
Oil	111.9	108.8	108.1	-0.6	16.9	111.2	3.4
Portfolio flows (cumulative R billion)							
Bonds	92.4	26.0	-1.0				
Equities	-3.1	-1.5	17.3				
Total	89.3	24.5	16.2				

**Deviations are the percentage changes from the average over the period.*

***For interest rates the change is shown in basis points.*

National Treasury, My 2014

Some of the factors which have been identified as contributing immensely to the weakness of the rand, especially in this year, include the cutback in quantitative easing[1] by the US, the declining terms of trade, the long-drawn-out platinum sector strike, and higher than expected current account deficits. As much as currency depreciation largely originates from adversative events, it does also have favourable effects on a country's economy especially trade (SARB, 2014).

3.1 Foreign investment and the value of the rand

The abundance of foreign capital had kept the South African rand strong, allowing the country to operate beyond its means (du Preez, 2014). The decline in the demand for foreign assets by the US has resulted in a decline in the demand for the

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[1] Quantitative easing refers to - a monetary policy action which involves the purchasing of government securities or other securities in the market.

rand from the largest economy worldwide. This has contributed to the rand's weakness and this is expected to be the case as the tapering continues.

3.2 Current account deficit and the value of the rand

In comparison with other emerging countries such as India (3.7%), Indonesia (3.3%) and Brazil (2.4%), SA (6.4%) had one of the highest current account deficits as a percentage of GDP in third quarter of 2013 (Mashego, 2013). The country, however reported a decline in the deficit (5.1%) in the fourth quarter of 2013, leading to an average annual deficit of 5.8% (Lings, 2013). This was still larger than the 2012 deficit of 5.2%.

The improvement in the current account in Q4 2013 was highly attributed to the improvement in exports, travel receipts and a decline in imports. However, a current account deficit of such magnitude makes SA an unfavourable investment destination as a result of the riskiness it presents. International investors are therefore prone to purchasing less South African bonds and equities which leads to a decline in the demand for the rand, consequently weakening the currency.

3.3 Effects of Terms of Trade (TOT) and the value of the rand

Data from the SARB shows that South Africa incurred a trade deficit of R11.389 billion in March 2014. This was a result of the imports of R91.65 billion compared to exports of R80.26 billion. Exports declined by R2.51 billion or 3% between February 2014 and March 2014. Imports on the other hand surged by R9.52 billion or 11.6% over the same period (Tarboda, 2014). Cumulatively, South Africa experienced a trade deficit of R27.69 billion in the first quarter of 2014, compared with a deficit of R21.61 billion in last quarter of 2014.

The widening of the trade deficit can be largely attributed to the on-going platinum mining sector strike. For over four months, since 23 January 2014, workers in the platinum sector companies Lonmin, Anglo American Platinum and Impala Platinum have been on strike over the demand for a minimum wage of R12, 500. The trade balance went from a surplus of R647.47 million in February 2014 to a deficit of R11.3 89 billion in March 2014. This sudden change demonstrates how the strike action in the platinum mining sector is affecting the national terms of trade (Maswanganyi, 2014). Initially the demand for platinum increased, which would have increased the demand for the local currency, however the shortage of supply of platinum means foreign importers of platinum no longer need to purchase the rand and for that reason the rand depreciated .

4. Adverse effects of a weak exchange rate

- ***Imported Inflation:*** a weak currency means the domestic importers pay more local currency per foreign currency. This translates to a higher cost of purchasing foreign goods, higher production costs and higher unit costs. These higher costs, especially for retailers and manufacturers, need to be filtered into pricing which is not ideal for consumer demand as it declines.
- ***Low Consumption Expenditure:*** According to SARB (March 2014), weaker exchange rate was the main driver of the increase in the price of petrol, which increased by a cumulative 75 cent per litre in February and March this year. Higher fuel and food prices have adversely affected South African citizens which are already debt-laden. Consumption expenditure is therefore lower and hence GDP.
- ***Low savings rate:*** Following the Keynesian transmission mechanism, weaker rand results to imported inflation, thus leading to lesser disposable income available for households to either spend on consumption or to save.
- ***High debt dependency:*** The SARB maintains that consumers are spending an estimated 76% of their income on servicing debt. Weaker rand inherently exacerbates the situation by reducing consumers' disposable income, thus driving cash stressed consumers to debt traps.

5. Favourable Effects of a weak Exchange Rate

- ***Increased Export Demand:*** In theory, a weak rand makes domestic exports cheaper which results in greater demand for export goods and services. In reality however, this transmission mechanism is not instant. It depends largely on the elasticity of exports demand and the reaction of domestic prices to the weaker rand. Provided export demand is quick to react to the cheaper exports and domestic prices do not increase hastily, a weak currency is beneficial. The shift from a trade deficit in Dec 2013 to a surplus in Feb 2014 is evidence that the weak rand is starting to benefit SA exports.
- ***Increased Employment:*** Increased export demand requires greater productivity, which is either obtained from using current resources such as human capital and machinery more efficiently or increasing the amount of these resources. In the short term, no significant change can be expected in sectors such as agriculture, manufacturing and construction because of contracts entered into by traders. One sector where a weak rand benefits almost instantly is tourism.

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Province of KwaZulu-Natal

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