exchange rate movements

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Exchange rate movements have a strong influence on a country's level of economic activity. Exchange rate volatility introduces an element of risk and hence the level of investment that firms are willing to make. Whether this result holds is more of an empirical question. This is especially true given the ambiguous results from theoretical models.

Some of the factors that have contributed to the volatility of the South African currency include increased capital inflows, which have been mainly short-term portfolio investments, with a significant proportion of the daily rand trade being driven by foreign portfolio and speculative flows. Commodity prices have also had their hand in determining movements in the country's currency, with gold and platinum accounting for roughly 25% of South Africa's exports, making them strong determinants of the exchange rate.

In an economy-wide exercise carried out by the EGDI, the impact of an exchange rate appreciation induced by a mineral boom was analysed. The results show an unsettling relationship between the traded and non-traded sectors of the economy reminiscent of the 'Dutch disease' – a term that does not necessarily refer to the 1960s version of the disease as it happened in Holland, but to its more recent usage. Here it is seen as a generic descriptor of the structural changes that an economy undergoes as a result of a booming sector which is associated with a real exchange rate appreciation and the subsequent challenges faced by the traded sector.

Almost all traded sectors are negatively affected whilst the non-traded sectors thrive, employment goes up and the country experiences a small increase in GDP. This raises questions about what the position of the economy will be when the mineral price boom is over. Will manufacturing sectors that have shrunk or remained stagnant during the boom be able to recover sufficiently to replace the earnings lost when commodity prices fall?

The problem relates to a context where it would be desirable to diversify into higher value goods and services for global markets (domestic and export) – which obviously requires year-on-year growth.

In looking at the impact of exchange rate volatility and the level of the exchange rate on firms, several distinctions can be made between three aspects of exchange rate movements:

1. The volatility of the exchange rate in the short run (i.e. the day-to-day movements of the exchange rate);
2. The level of the real exchange rate; and
3. The volatility of the level of the exchange rate, which speaks to the larger swings in the exchange rate over time. This way of conceptualising exchange rate movements highlights the switching between depreciation episodes and apprecia tion episodes.

From a recently completed firm survey, one gets a sense of how these changes in the exchange rate affect firms. Volatility seems to affect strategic decisions in the short run (the question becomes to hedge or not to hedge); the level tends to affect decisions of where to locate production, locally or abroad and where to target output (foreign markets or domestically); and the volatility of the trend seems to affect investment decisions, since the return on investing for export in a period of currency weakness following a strong depreciation can be eroded in a subsequent appreciation phase.

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