

non-residents contributed materially to greater volatility in the external value of the rand.<sup>31</sup>

D Factors which may have contributed to the rapid depreciation of the rand in 2001

Factors which in general affect an exchange rate

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11.1 Exchange rates and inflation

Inflation is a general rise in prices or a particular fall in the value of the currency in purchasing power terms. The internal purchasing power of a currency and its external value, ie its exchange rate, are broadly related and they tend to move over time together. Historically South Africa has had a faster than average inflation rate *and* the rand has had a declining trend against, for example, the US dollar: those two observations are consistent with the view that the internal purchasing power of a currency is related to its external purchasing power.

11.2 Exchange rates and export prices

Generally, better prices for a country's important exports tend to strengthen its currency. This is particularly true of commodity

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<sup>31</sup>

exporters such as Australia, Canada, New Zealand and South Africa. The exchange rates of those countries over time have tended to rise and fall with their major export prices. If the prices go up, there is generally more export value; producers spend more in foreign currency to buy the domestic currency, which tends to push up the currency on a simple supply and demand basis.

### 11.3 Exchange rates and interest rates

A currency with above average inflation and that tends to depreciate will tend to have higher than average interest rates. From a non-resident perspective, a higher interest rate compensates roughly and over time for capital losses from currency devaluation. Raising interest rates (in South Africa the repo rate in the first instance) tends to support the domestic currency by making it more attractive to hold and more expensive to borrow or short.<sup>32</sup>

### 11.4 Exchange rates and portfolio shifts

11.4.1 McCauley expounded the proposition, which he said might not be the average view of economists, that if either residents or non-residents decide that they want assets denominated in a given currency, say the rand, then the

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<sup>32</sup>

§11.1 to 11.3 are based on the evidence of McCauley Record 45

tendency will be for that wish to be granted by the rand gaining in value or the underlying assets gaining in value or both. A portfolio shift away from the rand can take different forms – an outright sale of equities or bonds; a forward sale of the rand to hedge a long position or to establish a short position.<sup>33</sup>

11.4.2 McCauley gave a sobering perspective on the significance, or rather lack of significance, of South Africa for foreign investors. Each country of the world enjoys a share in the world's portfolio of investments. The allocation to South Africa in that portfolio is less than 1%, probably as little as ¼%. By the time a foreign investor decides what amount to invest in South Africa, it has “really made all the important decisions already”.<sup>34</sup>

### 11.5 Leads and lags

McCauley expressed the opinion that while it may not on the face of it appear to be so, a type of portfolio shift occurs in the financing of imports and exports (leads and lags): every month of lead in payment and lag in receipts represents an outflow of a  $\frac{1}{12}$

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<sup>33</sup> McCauley Record 45 - 46

<sup>34</sup> McCauley Record 47

of trade. The leads and lags phenomenon makes the distinction between goods and financial services seem artificial in practice.<sup>35</sup>

#### 11.6 Exchange rates and contagion

Contagion, as McCauley pointed out, is a medical term and if you are going to catch a bug from somebody you need to come into contact with the bug or someone having the bug. As the term is used in financial markets, however, there need be no contact. One must distinguish between contagion based on (1) trade links, (2) similarity and (3) profit or loss of investors. The *first* is clearly observable; the *second* reflects perceptions of investors; and the *third* suggests that risk arises from the character of the issuer of the financial instrument. Contagion through trade links arises when country A and country B compete in world markets. A depreciation of B's currency can hurt A's competitiveness. A loss of competitiveness can slow exports and economic activity and so lead to pressure for a depreciation in A. Contagion through similarity occurs in at least three circumstances:- economic circumstances: Country A's currency devalues. Investors analyse the economic reasons for the devaluation, identify country B with similar problems, and take their investments out of country B. Asset class: investors may reduce exposure to a whole "asset

class” such as emerging market or a subclass such as EMEA (East Europe, Middle East, Africa). Policy or regime: countries with similar policies or financial regimes are treated similarly. For example, the Argentinean crisis led to higher interest rates in Hong Kong because both had a dollar currency board. Contagion through profit or loss: profits or losses from one exchange rate can permit (force) positioning in (withdrawal from) another exchange rate. For example, in mid-1998, profits from short positions in the Japanese Yen allowed larger short positions in commodity exporters currencies like the Australian, Canadian and New Zealand dollars and South African rand.<sup>36</sup>

#### Determinants of the rand exchange rate

- 12 The exchange rate of the rand is determined by millions of decisions taken daily by
- South African consumers, corporates, foreign exchange dealers, institutional investors and various arms of Government;
  - foreign banks, foreign corporates, foreign institutional investors, foreign governments, multi-lateral institutions (such as the International Monetary Fund (“IMF”) and the World Bank) and

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<sup>36</sup>

foreign individuals such as tourists and consumers of South African products.<sup>37</sup>

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- 13.1 A convenient framework in which to consider the various factors that may have contributed to the depreciation of the rand in 2001 is to have regard to the determinants testified to by Mr Gouws and reflected in this slide:

