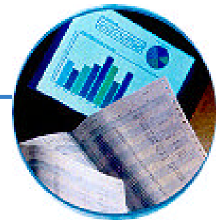

Editors' brief

The return of the rand: Prospects and Implications

Q2 2003

No doubt, the most talked about facet of the South African economy over the last few years has been the behaviour of the exchange rate. The second half of 2001 saw the currency losing value at an unprecedented rate, only to be followed by a rapid appreciation from late 2001 onwards, especially against the US dollar. These developments generated much controversy, which included the appointment of a Commission of Inquiry to investigate alleged improprieties in the local foreign exchange market. More recently the question of the sustainability of the current (or stronger) levels of the exchange rate has been the focus of comment.

The economic backdrop to this change in fortunes of the currency was a global economy that struggled mightily for meaningful and sustainable growth in the face of an uneven and tepid cyclical recovery; the threat of war; and a local economy that remained surprisingly resilient. The period of relatively high and stable growth that the economy has enjoyed until recently has been associated with interest rates that were relatively high – at least compared to other countries. Inflation is plummeting and will in all likelihood be comfortably within the target range next year.

Are the structural adjustments that have taken place in the economy over the last decade or so finally paying off? Are we now seeing a currency that is behaving more like a "normal" currency? Can we expect to see a currency that no longer acts like a one way bet? If so, what are the implications for monetary policy and growth in general? This editors' brief will reflect on these and other issues.

Exchange rate behaviour

In the long run exchange rates mirror the long term fundamentals of the economy. These fundamentals have to do with the underlying competitiveness of the economy. If productivity growth in the country outpaces that of other countries, the exchange rate will tend to rise. If our inflation rate is higher than other countries, the exchange rate will tend to weaken.

In the short term the exchange rate results from efforts to understand and interpret the demand for funds and the readiness of the world's savers and investors to supply these funds. The demand for funds is not likely to shift often and quickly, as opposed to the supply of funds that reflects the attitudes, perceptions and expectations of financial market players. These attitudes, perceptions and expectations range from well founded and rational to the baseless and foolish. But the fact is that these views can shift markets substantially and quickly.

In a perfect world, movements in the currency will accurately reflect the actual fundamentals. In doing so, the exchange rate will fulfil its function of providing correct signals to the economy concerning the price of the local currency relative to the price of other currencies. In practice, though, the world is not perfect and the currency will fluctuate, sometimes wildly so.

The international backdrop

During 2002 and the early part of this year, three major forces ensnared the global economy: firstly, economic growth remained anemic despite aggressive monetary stimulus, especially in Japan and the US. Secondly, monetary policy action was taken against a backdrop of low inflationary pressures. Thirdly, the faltering growth in the

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global and US economies was not helped by the threat of war in Iraq. The war threat created uncertainty and drove interest rates and share prices down.

The official ending of the war in Iraq brought hope of a lasting, benign solution to problems in that part of the middle east, an enduring boost to confidence in especially the US and lower oil prices. On all three counts these hopes were only partially attained.

The exchange rate is the price of the local currency in terms of other countries' currencies. Developments in those countries therefore matter a great deal, as well as the views of investors of opportunities elsewhere in the global economy. A substantial part of the oscillation in the rand's value can be ascribed to similar swings (but in the opposite direction) for the dollar.

The considerable strengthening of the dollar in the late 1990's was partly the consequence of the "bubble" in the US financial markets during that time. Over the five-year period 1997 – 2001, more than $1 trillion was invested by foreign companies in establishing, expanding or acquiring businesses in the US. Foreign investors also invested more than $1.5 trillion in US stocks and bonds. Such huge capital inflows added to the strength of the US economy and the dollar and contributed to the boom in financial markets.

A sizable portion of the capital inflows to the US originated from Europe. The creation of a single currency reduced the possibility of portfolio diversification within Europe itself. Portfolio managers were therefore forced to look at other markets, of which the US was the obvious choice. In addition, European firms, discouraged by low growth in Europe, punitive taxes and rigid and onerous regulation, were looking to the US for growth opportunities and access to technology, marketing and management skills. Under these circumstances, the euro heavily lost value against the dollar, reaching a low of $0.83 in October 2000.

The capital inflows that propelled the dollar higher against most currencies contributed to the widening of the American current account deficit. The deficit accordingly jumped from about 1% of GDP in the mid-1990's to more than 5% in 2003. The trade deficit hit 4.5% of GDP in the first quarter of the year. This number implies that the US economy requires some $1.3bn per day in foreign capital inflows to finance its imported goods. The level of the deficit was seen to be unsustainable by market players – those foreign investors willing to purchase US bonds and stocks for their portfolios.

The level of the current account deficit, relatively subdued returns on equity investment in the US, as well as low interest rates, imply that the US is no longer able to attract the necessary capital flows to finance the current account deficit. The eagerness of international investors to hold US dollar assets evaporated under these conditions. A decline in the price at which foreigners can obtain claims on US assets, i.e. lowering the value of the dollar against other currencies, is required to entice foreign investors back into dollar assets. How long this adjustment will continue is not clear, but there is a consensus view that it may not be over yet.

Given the nature of the global economy and the poor outlook in especially the major economies, the US economy will have to serve again as the locomotive of global growth. The outlook for the US economy, however, remains clouded. An improvement in business investment to spearhead growth, though widely predicted, has so far failed to materialise. US business investment also comes off a high base following the extraordinary burst in investment activity in the late 1990's. Recent events, including September 11, the wave of corporate accounting scandals and the war in Iraq, may represent fundamental factors that will take some time to overcome. Furthermore, capacity utilisation in the US industrial sector is currently at a 20-year low – hardly conducive for new investment. Excess production capacity, together with tepid economic growth and fierce competition, restrain the pricing power of US firms. A lack of pricing power restrains growth in nominal sales, which is typically an important driver of firms' capital expenditure plans. The outlook for the US economy hinges on the outlook for consumer spending. Consumer spending over the last few quarters, however, was quite robust, implying that there is little pent-up demand going forward.

The continuous weakness in the labour market is also weighing negatively on households. Given these factors, it is difficult to see a major surge in growth over the short term.

The recent behaviour of the rand

Wide swings in nominal and real exchange rates are a common phenomenon in emerging markets. On balance, the nominal effective exchange rate of the rand declined by 15% in 2001 and a further 21% in 2002. But between the end of December 2001 and the end of December 2002, the rand recovered by 26% in trade weighted terms. In fact, the rand emerged as the world's best performing currency against the US dollar in 2002, more than retracing the previous year's losses. The rand also recovered ground lost against other major currencies. Much of the recovery only came in the second half of the year when a number of factors began working in the currency's favour. There was, to begin with, a correction of the leads and lags phenomenon that had precipitated the rand's decline in 2001, when perceptions had been rife that the currency was a "one-way bet". Consequently, exporters had been hesitant to repatriate earnings in anticipation of a weaker rand while at the same time importers were attempting to accelerate payments by buying the foreign currency forward. The limited supply of dollars reinforced rand weakness.

The Rand Commission of Inquiry, appointed by President Mbeki to investigate alleged improprieties in the local foreign exchange market, concluded in June 2002 that the depreciation of the rand had been "a reflection of uncertainty, reduced liquidity, a pervasive negative sentiment and a reversal of demand for the rand by foreign institutions".

Other factors cited in the commission's final report to explain the rand's weakness included: dollar strength; the inflation differential; reduced capital flows to emerging markets on the back of a deteriorating global economy and emerging markets contagion; South Africa's proximity to Zimbabwe; a deficit on the current account that was not matched by a surplus on the financial account of the balance of payments; the failure of privatisation proceeds to materialise; the Reserve Bank's NOFP and the Bank's activities in the currency market to try and unwind this position; the Reserve Bank's 14 October 2001 statement that reduced speculative activity in the currency market thereby reducing liquidity and contributing toward rand depreciation; and the Bank's stated policy of non-intervention.

As all these factors came together in the perception that the rand was a one-way bet, herd mentality ensured that market participants revised their decisions accordingly. Hence, perceptions of the rand as a depreciating currency became a self-fulfilling prophecy.

But the stricter enforcement of existing exchange controls brought sanity back to the market during 2002. As the leads and lags phenomenon corrected itself, other factors began reinforcing the recovery of the rand. Monetary policy was tightened in South Africa, while in other major economies interest rates either remained on hold or were trimmed to stave off economic recession.

Simultaneously, global commodity prices rose and, as the excesses of the US economy surfaced, the dollar weakened across the board. In relative terms, the South African economy, with its stable growth rate and sound monetary and fiscal policies, emerged as an attractive safe haven. Positive statements (followed by upgrades later on) about South Africa's credit outlook by international credit rating agencies and the International Monetary Fund, as well as an improvement in South Africa's terms of trade, also aided the recovery in the external value of the rand in 2002.

The return of the rand: is it for real?

Apart from the monetary elements in explaining the strengthening of the rand, a variety of other factors contributed to creating a more stable and certain economic environment, which is a prerequisite for a stable and strong currency.

Economic resilience

The rising resilience of the economy over the recent past is no accident. It rests on four pillars. Pillar one reflects the increase in the country's growth potential, reinforced by structural changes in the composition of GDP and by steadily rising multi-factor productivity. The second pillar points to the increased export diversification of the economy with a declining dependence on commodities. At the same time the economy has become more export orientated, with the export- GDP ratio exceeding 33%. Pillar three signals the country's solid fiscal performance and macroeconomic stability. Deficit and debt numbers are well within what is internationally accepted as being prudent. At the same time social expenditure has increased, the efficiency of tax administration has improved and social stability has been retained. Finally, pillar four reflects the deepening of democracy and social stability as important elements in building a resilient economy. The country's financial architecture is strong, corporate governance is sound and the constitution is respected.

Inflation

Monetary policy in South Africa has gone through a rapid transition over the last number of years. As with many countries in the world, the view that there is a simple relationship between money supply and inflation proved to be incorrect, forcing the country to move away from such a policy regime. The shift to inflation targeting was not without problems – the target rate had to be adjusted when it became clear that it was not going to be met. The inflation-targeting regime, however, is gaining in credibility, with CPIX likely to dip below the upper limit of 6% within a quarter or so. Virtually all forecasts of CPIX for next year point to an inflation rate that will be comfortably within the target range of 3% – 6%. Of course, a rapidly strengthening currency has contributed greatly towards this likely outcome.

Volatility of the rand

The "impossible trinity" put forward by Nobel laureate Robert Mundel, states that it is not possible to stabilise both the inflation and exchange rate if the capital market is open. The SARB therefore is committed to let the rand find its own value, determined by market forces. This does not imply that the exchange rate is completely ignored – any information contained in the exchange rate as far as it impacts on inflation, will be used in determining the stance of monetary policy.

By the same token, excess volatility of the rand remains a problem. Exchange rate volatility, however, is a major problem in many countries in the world, not only South Africa. The volatility in the rand in fact has increased in recent times. The hope is that, as the economy and financial regime normalise, and is perceived to be so by market players, the volatility of the rand will be contained.

It is not surprising that the gradual process toward what we would term "normalisation" in the characteristics of the ZAR has gone greatly unnoticed. As with most events, those that occur over a protracted period of time fail to captivate our attention to the same extent that the immediate bang and brightness of fireworks-stuff does.

In the next section, we attempt to capture and highlight the more obscure developments that have slowly but surely shaped the path of the rand.

The net open position in foreign currency (NOFP)

The net open position in foreign currency or NOFP is no longer a feature of the South African economy, but from 1998 up to April 2003 it was a significant feature that restricted the Central Bank's ability to build up foreign exchange reserves.

An equally significant and closely related consequence of the NOFP was the noose that it placed around the foreign exchange rate of the rand. The knowledge that the Reserve Bank was not able to defend the currency in the event of speculative attack earned the currency the "one-way" bet reputation. This made the currency even more vulnerable to speculative activity, particularly because of the liquidity (ease of entry and exit) of the South African foreign exchange market. Granted, the SARB is able to

use interest rate increases to discourage speculation, but these in turn translate into a subdued economic environment.

The NOFP, which represented the shortfall of the SARB's forward exchange commitments in relation to its net holdings of foreign exchange reserves, arose four decades ago when the introduction of exchange controls or restrictions on capital movements prevented the private sector from insuring against exchange rate changes through the market mechanism. Thus, in the absence of a fully functional forward cover market, the SARB was forced to provide a hedging mechanism against foreign exchange risk. In doing so, however, it developed a forward book that eventually grew beyond manageable proportions.

In particular, it was the Bank's decision to use the forward book facility following the East Asian crisis of 1997/1998, when through contagion, there was rapid capital flight from a number of emerging markets, including South Africa. The inevitable consequence of capital flight is a sharp depreciation in the currency as a result of excessive demand for hard currency. And this increases hedging activity. But, at the time, the Bank considered the forward book to be the lesser of two evils (Governor's 78th Address, 1998), the second being a rapid and prohibitive increase in interest rates to increase the cost of speculation. Higher interest rates followed in any event in 1998, when the Bank did not fully replenish the drained liquidity of the financial system that had occurred through the capital outflows. Consequently, commercial banks had to borrow money from the SARB at the penalty rate, and this put upward pressure on domestic interest rates.

Although the Bank ceased to provide long term forward cover in 1997, it continued to provide short term forward cover (maturity of up to 12 months) up to 1998. It subsequently stopped taking on new forward exchange contracts, participating in the forward market on a swap basis instead. It also continued to intervene in the spot market, buying foreign currency when the opportunity presented itself in order to unwind the NOFP. Because of the Bank's activities in the forward market for foreign exchange, the NOFP had widened to $22bn by early 1999.

In 1998, the then Governor of the SARB recommended that the Bank begin reducing its operations in the market for forward foreign exchange alongside the process of exchange controls relaxation. This would enable the development of a forward cover market outside of the SARB. However, he also cautioned that the extrication of the SARB from forward cover activities would not reduce the volatility of the exchange rate. On the contrary, it would increase volatility as it would take away what had, for many years, been a shock absorber in the foreign exchange market.

The forward book still exists but the NOFP does not. Partly through the inflows of privatisation and government's borrowing abroad, the SARB has been able to balance its foreign assets and liabilities positions. In fact, by the end of May, the Bank was able to report a positive NOFP of $735m. This, in essence, means that the Bank's net reserves (assets) more than cover the Bank's remaining forward book position (liability).

This also means that the SARB can now use privatisation proceeds and any other foreign currency flows to shore up its gross reserves while, at the same time, gradually allowing the short term contracts on the forward book to expire. Further relaxation of exchange controls will also obviate the need for the Bank to use the forward book in future, with commercial banks being able to cater for the forward cover requirements of the market.

The build-up of foreign exchange reserves enhances the SARB's ability to smooth out fluctuations in the foreign exchange market without resorting to rapid increases in interest rates that, ultimately, can have a serious, albeit unintended, negative impact on the broader economy. Further, our experience of the 2001 rand crisis and its aftermath are also testament to the economic distortions that can arise from excessive exchange rate movements. The rapid depreciation of the rand during Q4/2001 induced export activity during 2002, but the exchange rate's retracement during the same year that has stretched into 2003 is beginning to quell export activity and dampen economic growth.

Exchange controls

The imposition or tightening of exchange controls is a measure that is at the disposal of monetary and fiscal authorities and which is aimed, primarily, at defending or supporting a currency. In South Africa, exchange controls are determined by government but enforced by the Reserve Bank and, by implication of their daily operations in the market, by the authorised dealers.

The earliest sign of exchange controls in South Africa can be found in 1939. However, the remaining shackles on the free movement of capital in and out of the country date back to 1961. Negative pressures on the capital account of the balance of payments saw the authorities restrict the repatriation of proceeds of non-resident owned securities. This led to the development of a secondary exchange rate known as the "securities rand" which traded at a discount to the official rate. The securities rate was the "price in foreign currency at which blocked balances were being traded between non-residents" (SARB, Exchange Controls, Historical Background).

In 1978, the De Kock Commission recommended the extension of the secondary exchange rate to cover transactions in other assets. This is how the financial rand was born. Also, there were very specific rules and restrictions that guided financial rand transactions in order to prevent these from having any impact on the country's foreign exchange reserves.

Exchange controls were always viewed as an interim measure of currency protection. Consequently, in February 1983 government decided to abolish exchange controls on non-residents. But, for at least another decade, exchange control limitations on the foreign exchange transactions of residents remained in place, moderating and intensifying from time to time as deemed necessary. The financial rand also made another appearance in 1985, following the debt standstill announced by the government. With its abolition in 1995, exchange controls on non-residents were once again removed in totality and none have been placed on them since.

Rather, exchange controls on residents have been gradually relaxed since 1994. In 1995, long term insurers, pension funds and unit trusts were enabled, through the asset-swap mechanism, to exchange 5% of their South African securities/assets for foreign securities. The limit was increased to 10% of assets a year later and extended to include 3% of net inflows of funds generated during the previous calendar year. This relaxation was also extended to fund managers in 1996.

In 1998, the 10% limit was raised to 15% of total assets and the 3% limit to 5%. In 2000, unit trust companies were allowed to transfer 20% of the total assets under their management to foreign investments. The limits on long term insurers, pension funds and fund managers were left unchanged at 15% however, the definition of this share was changed from total assets to total funds under management. The 5% limit pertaining to net inflows of funds generated during the previous calendar year was upped to 10% but remained a portion of the overall limit restrictions.

South African corporates were allowed to remit R20m abroad prior to 1997. Thereafter, the limit was increased to R30m for investments abroad and to R50m for investment into SADC countries. In 1998, these limits were respectively amended to R50m and R250m.

Exchange control relaxation appeared to take a step back in 2001, when the asset swap mechanism was scrapped. Furthermore, at the end of the same year, the facility which enabled institutional investors to transfer 10% of the previous calendar year's net inflows abroad expired.

Notwithstanding this, progress of a different kind was made in the relaxation of exchange controls. It was announced in 2001 that South African companies would be allowed to directly invest R500m abroad (previously R50m as per a 1998 announcement). For investments into Africa, the limit was raised to R750m (previously R250m for the SADC region only). In 2002, the latter was amended to R2bn. Earlier this year the limit on investments outside of Africa was upped to R1bn.

In the 2003 Budget, the government announced a shift away from outright exchange controls and toward prudential regulations. Hence, it was announced that institutional investors are allowed to invest abroad, on approval, up to existing foreign asset limits. These are 15% of total assets for long term insurers pension funds and fund managers and 20% of total assets for unit trust companies.

South African residents have also witnessed a gradual relaxation of exchange controls over the years. In 1997, residents were permitted to invest up to R200 000 abroad. This limit was increased to R400 000 in 1998 and to R500 000 in 1999. In 2000, the limit was raised to R750 000.

In 2003, it was announced that emigrants' funds in excess of the emigration allowance, that is, in excess of R750 000, and placed in so-called "blocked accounts" would be unwound. The unwinding of such accounts, however, is subject to a forfeit. Amounts up to R750 000 are eligible to exit the country without charge but amounts in excess of this limit are subject to an exit charge of 10% of the additional amount wishing to exit.

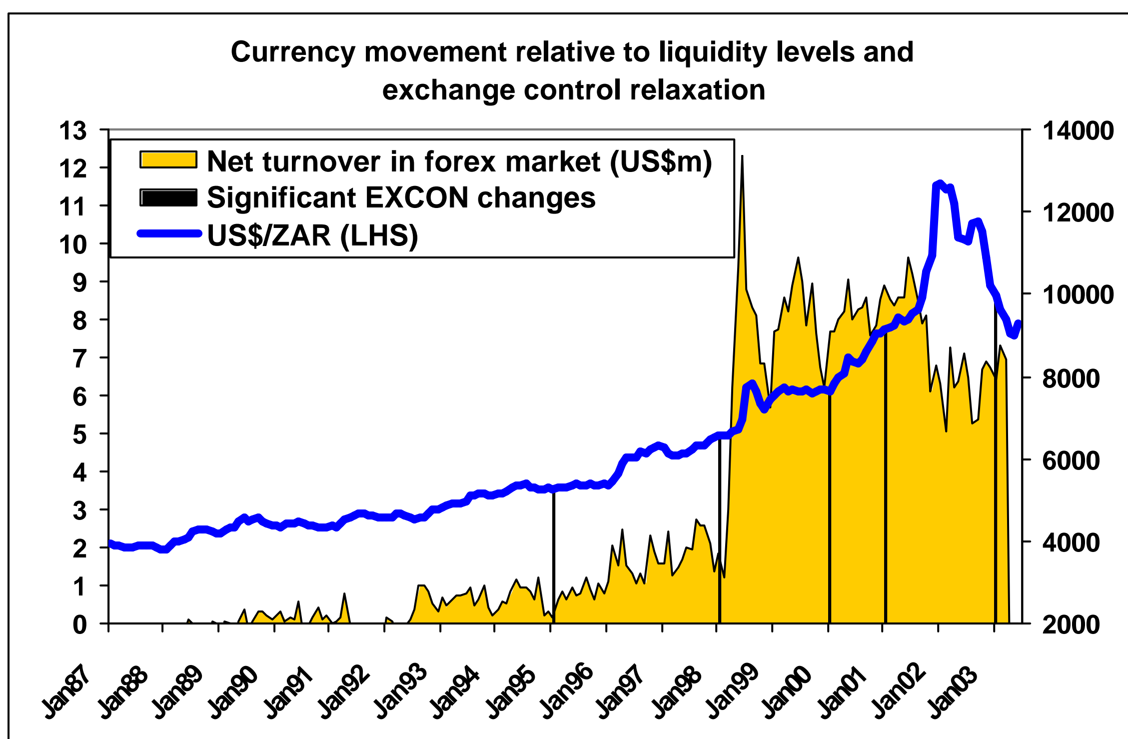
Residents' travel allowances continue to be restricted – currently R160 000 per annum per adult. In addition, foreign exchange may only be purchased up to two months prior to the departure date and on presentation of a flight ticket.

Much of the progress made in relaxing exchange controls has come from the realisation that these are difficult to enforce. Also, partial controls appear more difficult to administer than total controls, since they are subject to legislative loopholes and misinterpretation.

Ultimately, foreign exchange controls deter fixed direct investment and may raise the cost of capital. Thus, in deciding to gradually relax foreign exchange controls, South Africa has aligned itself with global best-practice. However, the decision to opt for gradual relaxation rather than to adopt a "big-bang" approach (that is, the complete and immediate scrapping of all capital controls) arises from the attempt to create minimal disruption to the domestic financial markets and hence the currency.

Indeed, if we graph the dollar/rand exchange rate against the net average daily turnover on the foreign exchange market (denominated in USD) and, simultaneously identify the major turning points in foreign exchange controls policy, we are able to identify inter-relationships.

Firstly, significant relaxation of exchange controls has co-incided with a visible pick-up in the net average daily turnover on the foreign exchange market. To some extent, this has levelled off in recent years. However, in part, this follows the SARB's



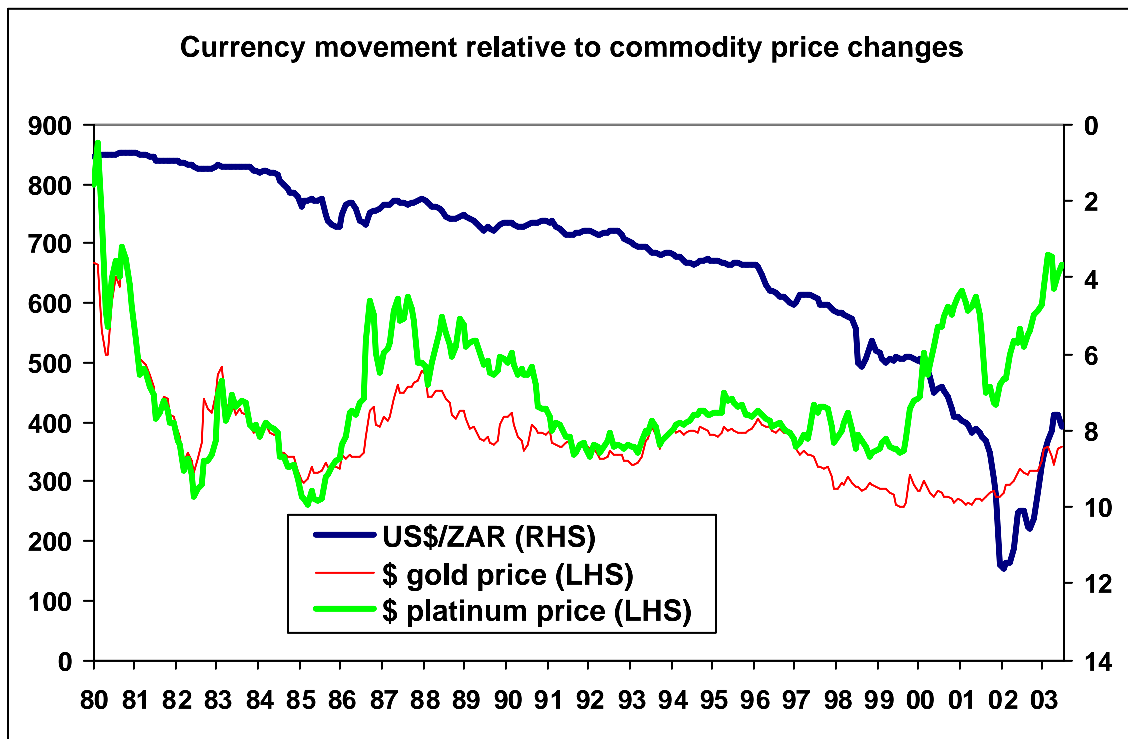
announcements in Q4/2001 relating to the more vigorous enforcement of existing exchange controls when the rand was in crisis.

Secondly, increased exchange rate volatility is also more discernible under both conditions of increased net turnover and exchange control liberalisation. One might argue, however, that the further relaxation of exchange controls announced in the 2003 Budget has had, to date, minimal detrimental and visible impact on the exchange rate. However, we would point out that this probably needs to be contextualised within the broader prevailing global economic scenario. That is, poor economic performance in some of the major economies has, without the aid of exchange controls, discouraged the attractiveness of foreign investments. Further, to some extent, the recent changes to exchange controls still need to filter through. However, we also need to recognise that the domestic macroeconomic environment within which the more recent loosening of exchange controls has occurred is significantly better than that which prevailed in 1995, 1998 and 2001.

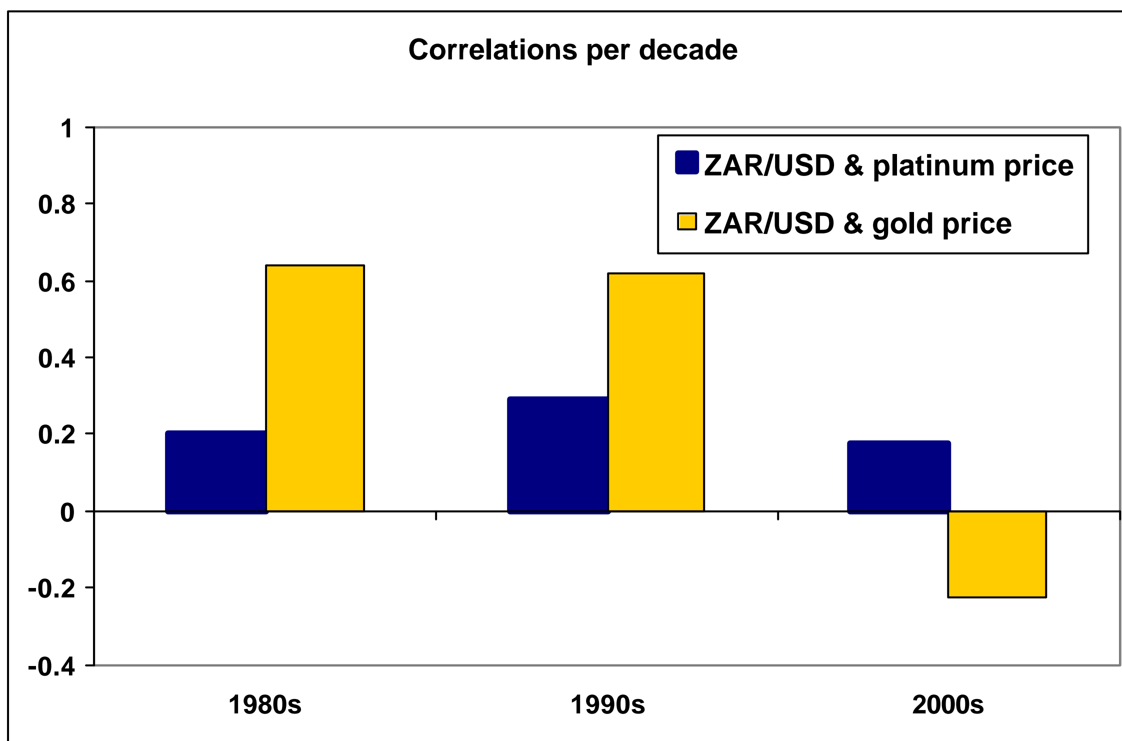
Without going into too much detail, we can cite some examples. In 1995, the country was just beginning to embark on a thorough clean-up of its fiscal position. In 1998, the country was still reeling under the impact of the Asian-led emerging market crisis, with investor disinterest and diffidence (risk aversion) dominating. By 2001, although much fiscal progress had been made, this had not yet truly begun to filter through to the social strata, with delivery being the predominant obstacle. Furthermore, the inflation-targeting framework shaping monetary policy since 2000 was starting to run into difficulty. By the start of 2003, however, the country was beginning to reap the benefits of fiscal restraint and tight macroeconomic management through the recognition of its improved credit rating status by major credit rating agencies.

Furthermore, a number of additional factors helped sustain the exchange rate, namely attractive, relative interest rates, a weak USD, resilient economic performance and, more recently, the closure of the NOFP.

Clarifying the myth of the influence of commodity prices on the exchange rate



It is often speculated that movements in the prices of key commodities, in other words, commodities that are of significant importance to an economy, have a bearing on the movement of the exchange rate.



Historically, gold has played an important role in the foreign exchange earnings of South Africa, accounting for as much as 45% of total current account earnings in the early 1980s. Since then, the importance of gold mining to the South African economy has, however, diminished, with gold earnings only accounting for about 11% of total current account earnings in 2002. This is the result of increased trade liberalisation and diversification that has spurred the growth of manufactured (value-added) exports, which is to be encouraged to reduce the country's exposure to the vagaries of the movements of commodity prices. In addition, commodities are finite resources.

We also recognise (refer to the first graph above) that platinum has in recent years become an increasingly significant export commodity of the country. We therefore posed the question whether platinum has replaced gold as a key exchange rate determining factor. But our graph shows that the ZAR exchange rate plunged at the end of 2001, even as the dollar price of platinum soared higher. At the same time, the moderate decline in the gold price over the period was probably insufficient to single-handedly spur the rand crisis. More recently, a mild recovery in both the gold and platinum price has coincided with exchange rate strength, but again, we do not believe these phenomena have been sufficiently strong to support the currency.

Indeed, if correlations are calculated between the movement of the gold price and the USD/ZAR exchange rate per decade – beginning with the 1980s – as well as for the movement in the platinum dollar price and the ZAR/USD exchange rate, some interesting facts are noted.

Starting with the relationship between the exchange rate and gold we note that the correlation in the movements of the two indicators remained strong in the 1990s, although it began weakening. We also note that the available data for the current decade show that gold has become a less significant influence on the ZAR/USD exchange rate.

In contrast, the correlation, per decade, between the dollar price of platinum and the ZAR/USD exchange rate has intensified over the past 22 years. However, since these correlations remain significantly below 1 – which symbolises perfect correlation – we would argue against the myth that commodity price movements have been significantly behind the rand's recovery following the 2001 crisis.

All of the above elements potentially impact on the rand and move the currency in a particular direction. The force of the impact nevertheless may change. The rand may also become de-linked from certain phenomena. For example, it recently appeared that the rand became de-linked from capital flows when the currency appreciated in spite of capital outflows from the country.

The above developments are also important in the sense that they contributed to South Africa more and more being viewed as a "normal" economy by international financial markets. Being viewed in such a light contributes to the rand being a "normal currency" – a currency that can move both up and down rather than being seen as a one-way bet.

The interest rate / exchange rate nexus

A reduction in interest rates does not necessarily and automatically lead to a lower exchange rate. In fact, the issue of how exchange rates react to monetary changes has not been settled. One view about the relationship between exchange rates and interest rates argues that lowering interest rates lowers the return that an investor obtains by investing in the country and therefore increases capital flight. Also, by reducing interest rates, it can be made less costly for speculators to take short positions in a currency – thus encouraging speculation. Slack monetary policy may lead to a reduction in confidence and consequently depreciation in the exchange rate.

A second view argues that lowering interest rates can actually lead to a strengthening of the currency. Low interest rates improve the financial position of debtors, reduce bankruptcies and lower default probabilities. Even though lower interest rates on their own might make investment in local currencies less attractive, lower default probabilities and riskiness may encourage foreign investors, resulting in capital inflows and exchange rate appreciation.

The above points emphasise that there is a high level of uncertainty in predicting where the exchange rate may go. Not only is the relation between the interest rate and the exchange rate complex, it may "switch regimes" depending on a bewildering set of circumstances prevailing at that point of time. Given the "normalizing economy" argument raised earlier, an appreciation of the rand cannot be ruled out.

The direction the currency will take over the short and medium term depends on the balance reached among a number of factors, some discussed earlier. Some of the more important factors that may cause the rand to appreciate include:

- sustained weakness in the US dollar
- relatively strong local growth
- relatively (compared to the rest of the world) high interest rates.

Factors that may cause the currency to depreciate include:

- aggressive cuts of interest rates
- heightened uncertainty, leading to investors, for whatever reason, to avoid South Africa
- a widening current account deficit that is perceived to be unsustainable.

Less quantifiable, but of equal importance, are perceptions of the rand. If it is believed the rand is a weak currency, these beliefs may become self-fulfilling.

The interest rate, the exchange rate and growth

The interaction between the interest rate and the exchange rate will also have implications for the nature and composition of growth in the quarters to come. If the exchange rate moves strongly downward in response to cuts in interest rates, it is likely that a sizable portion of growth will be generated by exports. A relatively weaker rand will make imports more expensive, raising the spectre of renewed bouts of inflation. With exports and imports reacting faster than private consumption expenditure, overall (GDP) growth may pick up quicker in this scenario.

If the exchange rate response to cuts in the interest rate is weak, the internal dynamic of the economy (GDE gross domestic expenditure) will have to drive medium term growth. Because consumption expenditure tends to react somewhat slower than exports, it is likely that GDE will tend to lag GDP to some degree. Exports will suffer, but inflation will be lower and import competing firms will do better.

The timing of further interest rates is an issue, but less so from a medium term perspective. More aggressive rate cuts over the next few months, compared with more aggressive cuts only next year, will not alter the growth performance of the economy as seen over the medium term (say the next 8 quarters) very much.

More aggressive rate cuts, nonetheless, can be motivated from three points of view. Firstly, with the local economy slowing down rather rapidly, postponing rate cuts may lead to a boom-bust type of scenario. This should be avoided. Secondly, if the rand, as we anticipate, remains relatively strong notwithstanding rate cuts, the growth pickup, as argued above, will initially lag to some extent a recovery that includes a strong export component. A somewhat more aggressive approach to interest rate reductions may be required. Thirdly, given the uncertainty inherent in the future, it may be wise to be more aggressive earlier on if conditions allow rather than to wait. Who knows what next year will bring?