NOTES BY TOM ALWEENDO, DURING NES BREAKFAST MEETING NAMPOWER CONVENTION CENTER, 17 AUGUST 2004

I have been asked to talk to you this morning about ‘the exchange rate’ and against my better judgment I agreed to do so. Specifically, the question everyone is asking is whether it is not high time that the monetary authorities do something to depreciate the exchange rate through monetary policy operations. At the center of the argument for action to depreciate the exchange rate is the negative effect a high exchange rate has on the export sectors of the real sectors.

At the risk of stating the obvious, let’s all establish and agreement that an exchange rate is a price of one currency in terms of another currency. Therefore, like other prices, exchange rates are determined by the interaction of supply and demand. This interaction will sometimes results into a depreciation or appreciation of a currency. Intervening in this process is in itself an interference with the free market concept, where the market is supposed to be efficient, guided by an invisible hand. I am, however, happy that there are now a number of market players who understand that the market is not always perfect and that there is sometimes a justifiable need to intervene in order to correct the market.

In order for us to appreciate the exchange rate today, let us look at the movement in the exchange rate over the last fourteen years. In 1990, the average NAD/US$ exchange rate was NAD2.59 and the average inflation was about 15%. By 2000 the exchange rate has depreciated by more than 100% to NAD6.87. In 2002 the exchange rate reached a record low of NAD10.52. During 2003 the exchange rate started to appreciate and most people were not expecting an appreciation, but were expecting depreciation. Because of this mismatch in expectation and what transpired, the effect of the appreciating exchange rate is made to sound much worse than it really is.

Those who argue that the monetary authority should do something to depreciate the currency, suggest two methods. Firstly they say that the central bank should reduce interest rate and secondly the central bank could buy US$. With the first method, the local currency will become less attractive and there will be less funds flowing into the local economy and hopefully this will translate into a weaker exchange rate. This all sounds well but may only work as long as the inflation is kept in check. The last think you want to do is to reduce interest rate without reference to the inflation, and to be forced to hike interest rates soon afterwards. We have also noticed that last year the monetary authorities reduced the interest rate, but capital continued to flow into the South African capital market and the exchange rate continued to appreciate. Clearly, cutting interest rates is not in itself an effective way to move the exchange rate.

The option to buy foreign currency is also appealing but it has its own downside if not handled properly. When buying foreign currency, the ultimate effect is that you would have injected into the local market an equivalent amount in local currency. Given the prevailing liquidity position in the market, such injection of liquidity into the market might have to be removed at a cost, and given the current interest rate differential, that cost could be as high as 8%. You are also probably aware of experiences where central banks wasted huge amount of financial resources trying to defend a desired exchange rate. The result in most cases was speculation on the currencies. It is therefore not a cost-free exercise to say that the central bank must buy US$.

An important issue is therefore whether policymakers should respond to exchange rate movements when they formulate monetary policy. There is ample evidence that suggest that for central banks to respond to either an appreciation or depreciation will transmit unnecessary volatility into inflation and therefore the real economy. In my view, we should recognize the fact that the exchange rate is not mechanically related to the interest rate. The exchange rate is subject to shocks and these shocks are an indication that the exchange rate conveys information in its own right. It will also mean that the exchange rate will have an impact on the economy apart from what comes through its response to shifts in the monetary policy instrument.

Here I am not suggesting that the exchange rate is not an important factor when considering monetary policy actions. Indeed, the exchange rate is important price information in the economy and policymakers should form a view about the movement in the exchange rate as part of the holistic approach in policy setting. However, we must avoid the oversimplification of the linkage between the exchange rate and the interest rate.

A related question that is being asked now and then is whether a country should prefer a weaker or stronger exchange rate. The general answer usually goes like this: if you are a mostly exporting country, you should prefer a weaker exchange rate because you will be competitive in terms of price. On the other hand, if you are mostly an importing country, you should prefer a stronger exchange rate, again on the account of price competitiveness.

To my mind, this is a generalized answer, at best, and it leaves out a number of realities. For example a weaker currency is generally associated with expectation of higher inflation. We are also well aware of the danger of inflation and to therefore rely on a weaker exchange rate for price competitiveness may only be beneficial in a very short term. For long term prosperity a country will be better off to rely on its total factor productivity levels.

Lastly, ladies and gentlemen, I now want to answer the questions I was asked: “Are there economic reasons to celebrate the strong NAD?” My short answer to that question is maybe and maybe not.

I thank you.