

A weak rand and exchange controls

In two months in early 1996, the rand fell approximately 14% in value compared to the US dollar. There were two main causes for this, one good and one bad. The good one was the reduction in import tariffs and export subsidies; it was a one-off and did not affect the *real* exchange rate. The bad one was excessive expansion of the monetary base, which explained and still explains the trend and volatility of inflation and the falling real exchange rate. There was also a third factor, rumour, which is not fundamental but influences timing and short-term expectations about future government policy.

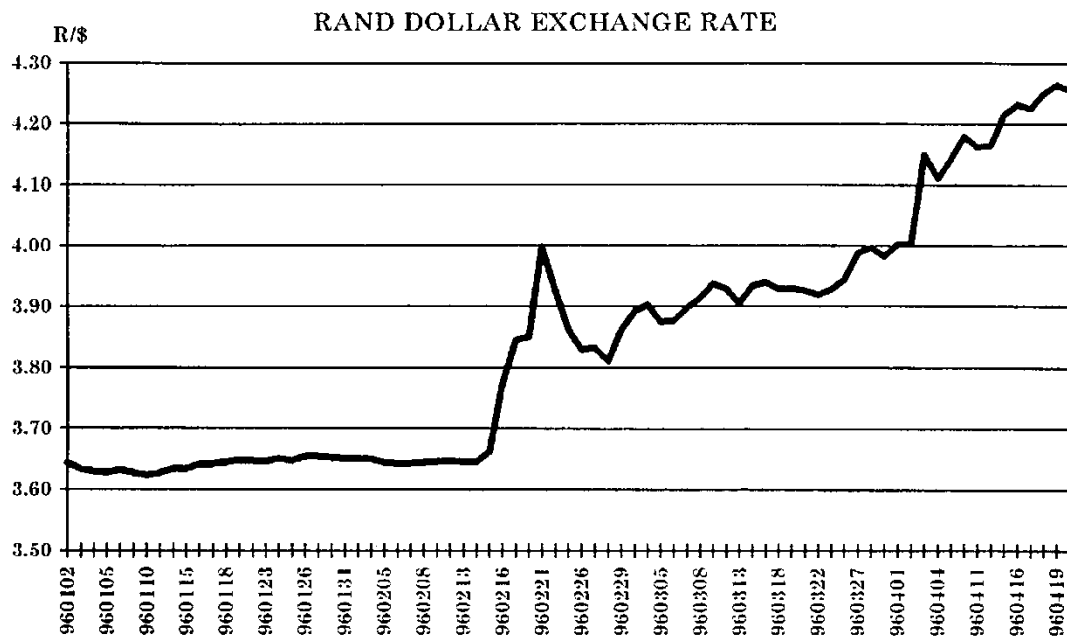
Exchange rates

The demand for any currency is determined by the size of the market in which it is used for exchange, and by its expected value compared to other assets. (The term “other assets” includes other currencies.) Demand is thus determined by a huge number of decentralised activities, each of which is a small proportion of the total, and has only a small impact on demand in total.

When looking at supply of the currency, however, the situation is quite different. In South Africa, as in most other countries, the central bank has a statutory monopoly in the supply of currency. The Reserve Bank is the only body in South Africa that can supply actual currency, and it can quickly make huge changes in that supply. In practice, it does make huge changes, which is why the supply of rands is persistently growing more quickly than demand.

As the quantity of rands increases faster than demand, the market value of each rand falls, which is the same as saying that prices of goods and services (in general) go up. This is price inflation. Not all prices change at the same time or rate. The price of each good is determined by its own demand and supply situation compared to other goods as well as to the rand. Some prices can rise faster than inflation, while others can rise more slowly or even fall. The same is true of other currency prices compared to the rand. The rand is stronger than some currencies but weaker than others, and definitely weaker than the dollar.

The supply of rands is increasing much faster than the supply of dollars. We cannot say the same for demand in domestic exchange, but the expectation of rand weakness makes the rand an inferior investment currency and reduces its demand for investment purposes. Thus, increases in expected rand supply can reduce the willingness to hold rands, which is what we observe.



This is where the element of rumour becomes interesting. Investors, like everyone else, do not act on reality but on their perception of reality. Further, they act today based on their expectations of what tomorrow will bring. When government policy-makers are appointed or make announcements, investors make assessments of what this will mean for the future. A policy-maker's credibility, integrity, and expected behaviour are all incorporated into investors' expectations, and discounted by the markets.

Thus it is not mere rumour that is causing the market movements in the rand. Rumour can only modify expectations about future policy; and expectations are sustainable only when supported by fundamentals. The significant current fundamentals are: high growth rates in the supply of rands (over 20%), and no credible sign from the Reserve Bank that it intends to reduce this to at least international levels.

This is sufficient to explain the ongoing weakness in the *real* value of the rand, but other factors contributed to the magnitude of the recent drops in market value. Just as government policies (through the Reserve Bank) have caused a real fall in rand value, other government policies have caused the quoted market value to be higher than the real exchange rate. (This is similar to the market interest rate being higher than the real interest rate.) This is not to say that "the market" is fooled by the policies, rather the market adjusts to partially counteract the distorting effects of the policies.

Such policies, including tariffs, export subsidies, and exchange controls have no significant effect on the real exchange rate. Similarly they are useless for controlling perceived balance of payments problems, and are worse than useless for keeping capital in the country. What they can do is reduce the value of domestic and international trade, and to discourage long-term capital inflows.

South African export subsidies ultimately subsidise foreign buyers, thereby raising the demand for rands to purchase the goods. Similarly, import tariffs reduce affordability of foreign goods, and effectively give a subsidy to domestic producers of those goods. Compared to what would have been the case in a free market, export subsidies draw resources out of higher-valued uses in the domestic economy for export; and tariffs draw resources from higher-valued domestic uses to replace imports. In both cases resources are prevented from moving into higher-valued uses and are thus shifted into lower-valued uses. In other words, wealth is destroyed. And in the process special-interest groups are subsidised at the expense of consumers and unprotected producers.

As tariffs, export subsidies, and exchange controls are phased out, the market exchange rate and the real exchange rate move toward convergence. As this implies a fall in the market rate, it encourages exports and discourages imports, thereby partially compensating formerly protected and subsidised producers. Marginal producers of formerly protected goods will shift resources into more highly-valued uses, and production patterns will change better to reflect consumers' desires.

Exchange controls

Even though they are never portrayed as such, exchange controls can also be seen as subsidy to those who are allowed, by the government, to purchase foreign exchange. Those who are not so favoured, or who have difficulty getting permission, are placed at a competitive disadvantage. The disadvantaged include the majority of South Africans (including pension funds) who are not able to diversify their assets adequately, whose employers are weakened by an inability to plan or to expand internationally, and who are hampered by excessive interference from a government that feels protected from international competition.

This last point is important in that the government behaves as if exchange controls protect it from the consequences of ill-advised policies. This is reflected not so much in newly-proposed policies, but rather in a reluctance, or hesitancy, to eliminate old policies -- including exchange controls themselves. Thus we are stuck in a situation where an indefensible set of policies are in place, but the government is paralysed by its uncertainty and misinformation over the effects of removal.

There are no real benefits from exchange controls, but the costs are numerous and high. Controls require exporters to sell their foreign exchange to the Reserve Bank, or seek its permission to use the forex more efficiently. It requires importers and travellers to make special, time-wasting application for the currency needed to carry out their plans. The implication is that the only people who can purchase foreign exchange are those involved in transactions of which the government approves.

This latter point further implies that exchange controls are a violation of human freedom. They are anti-democratic and, for that reason alone, should be abolished immediately. They prevent politically-unfavoured people from making beneficial use of their own money. Being indefensible, and seen as immoral, exchange controls encourage disrespect for the law in otherwise law-abiding people. If the government does not trust people to use their own money as they choose, why should the people trust the government?

This tendency to erode respect for the law imposes huge costs on everyone. It also dissipates confidence in the future of the country, encouraging emigration and *de facto* capital flight. If the government is unwilling to replace this bad policy with good, then the primary effect of exchange controls is to signal the whole world that other bad policies will also continue.

Timing

The Minister of Finance has already announced his intention to phase out exchange controls. The problem is timing. As long as the government fails to say how and when controls will be lifted, markets will (rationally) continue to behave as if the situation is worse than it is. South Africans will continue to doubt the competence and motives of their own government, and will make investment and life decisions accordingly.

Delay in the removal of controls will not stop the current slide in the value of the rand. Only a stronger monetary policy, in which the growth rate of the monetary base is reduced, will provide the appropriate fundamentals.

Conclusion

To stop the erosion of the value of the rand, the Reserve Bank must take direct control of the base money supply. It must, therefore, simplify and make transparent its control procedures.

Secondly, to restore confidence and basic economic freedom, the government must eliminate exchange controls. This must either be done completely and immediately, or a plan released immediately explaining how controls will be phased out gradually over a period of months not years.

This Briefing Paper was written by Richard J Grant, an independent economic consultant.