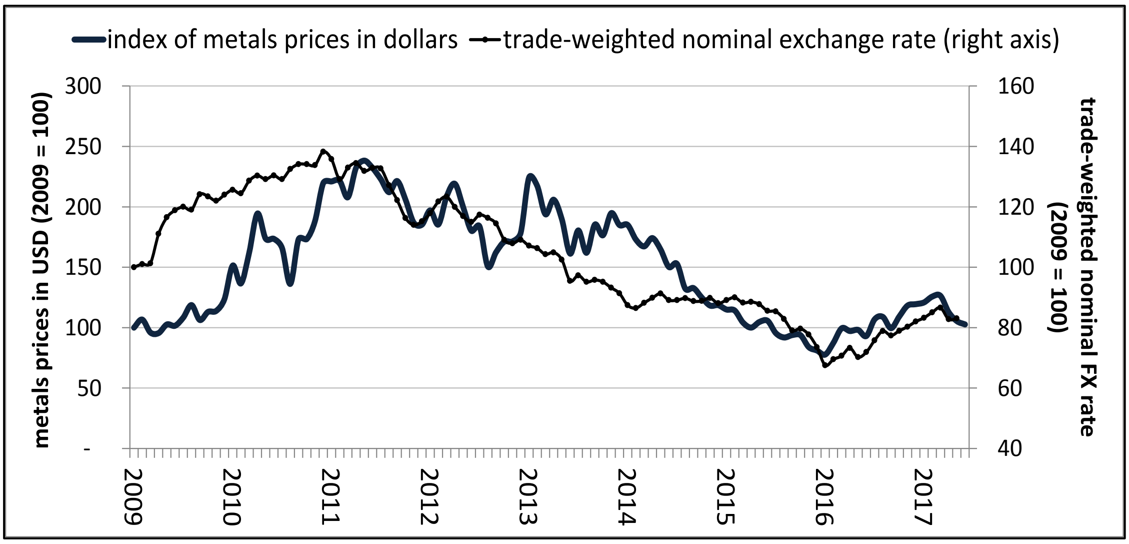
Briefing Note: The exchange rate and the real economy

The appreciation of the rand since early 2016 has mixed impacts on the real economy. On the one hand, it reduces the cost of inputs. On the other, it makes South African products less competitive.

The main factor behind the appreciation of the rand has been the increase in metals and coal prices. As Graph 20 shows, indices of dollar prices for South Africa's main mineral exports – iron ore, coal, platinum and gold – and the trade-weighted nominal exchange rate have been visibly aligned since the global financial crisis. This situation emerges because mining-based products account for over half of South Africa's exports. The exchange rate is also affected by international capital flows, particularly portfolio inflows into the stock and bond market. The risk is that sustained high levels of short-term investment in South Africa reflect the broader asset bubble that is emerging in international exchanges generally.

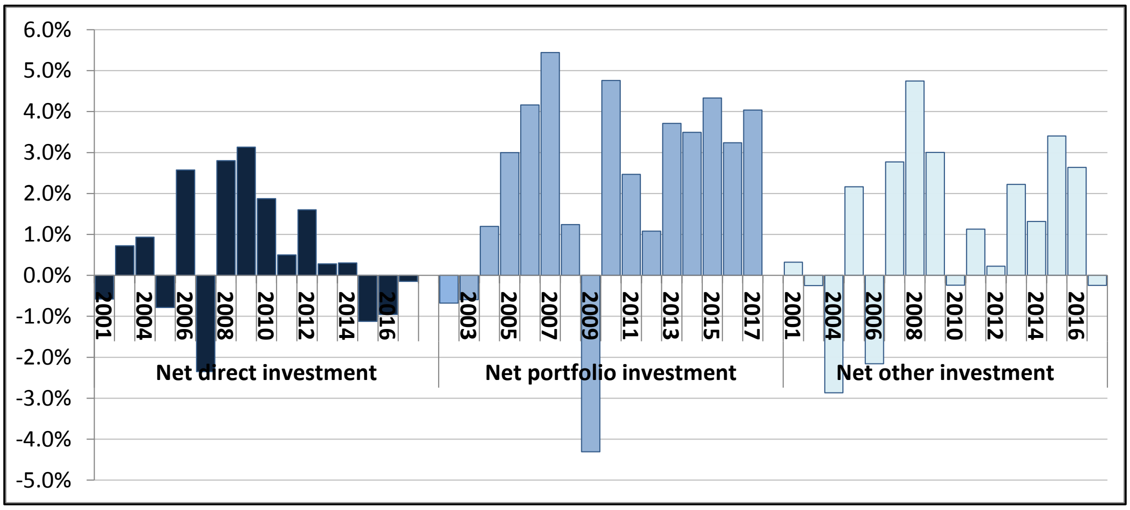
Graph 1. Exchange rates and index of metals prices (2009 = 100)



Source: Calculated from: exchange rate – Reserve Bank; prices of coal and iron ore – IMF; prices of gold and platinum – Kitco.

As Graph 21 shows, foreign direct investment has fallen sharply relative to the GDP, but both portfolio and other investment – mostly loans – have remained robust. Direct investment is generally considered more important for the real economy, since it comes with support for production and marketing. In contrast, portfolio investments typically relate to financial transactions and may aggravate asset bubbles, while higher dependence on foreign debt, included under other investment, entails higher repayments in the future. Moreover, increased institutional ownership of listed companies arguably pushes their management toward a shorter-term profit horizon as they try to sustain high share prices to satisfy financial investors.

Graph 2. Net foreign investment by functional classification as a percentage of GDP, year to first quarter, 2003 to 2017

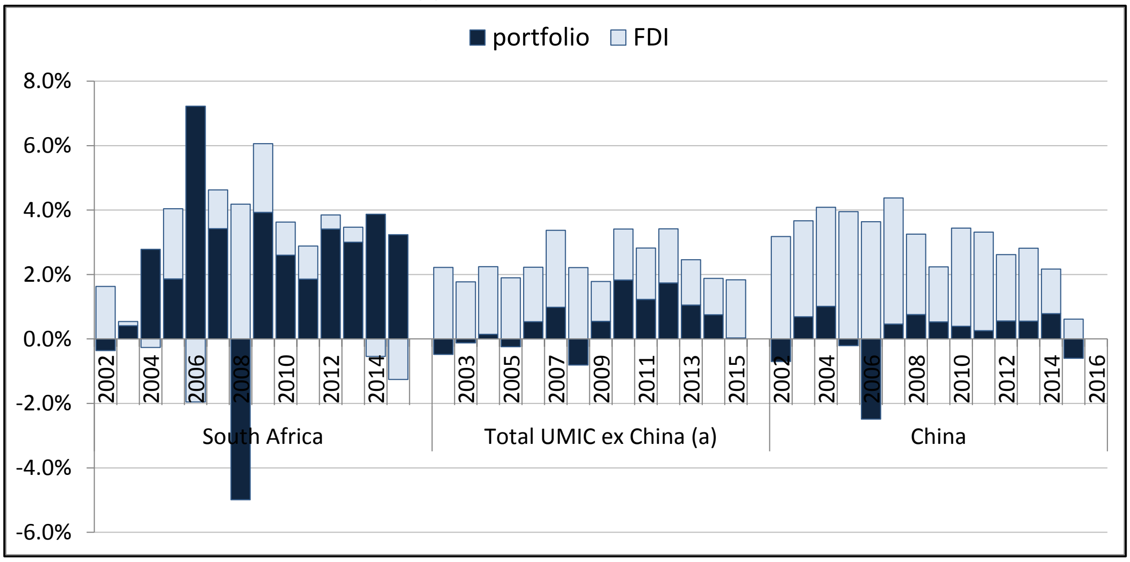


Source: Calculated from Reserve Bank, interactive dataset.

The decline in foreign direct investment reflects increasing investor uncertainty, which can lead investors to substitute short-term, liquid resources for fixed investment, as well as the shedding of assets by the mining companies since the end of the commodity boom in 2012. In the event, the returns on assets across the real economy remain lower than the normal rates for South African financial holdings.

The recent trends return South Africa to its position as a (relatively minor) financial centre, with significant portfolio flows but only limited direct foreign investment. As Graph 22 shows, relative to GDP South Africa has long had higher short-term capital inflows than other upper-middle-income economies.

Graph 3. Net foreign portfolio and direct flows as percentage of GDP, South Africa and other upper-middle-income economies



Note: (a) Sample consists of 32 countries including South Africa and China. Source: Calculated from World Bank, World Development Indicators. Electronic database. Series on foreign direct investment, portfolio investment and GDP in current U.S. dollars. Downloaded from www.worldbank.org in September 2017.