Global Economic Uncertainties and Exchange Rate Shocks

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Transmission Channels to the South African Economy

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Foreword

The global economic growth developments post-financial crisis were characterised by elevated bouts of economic and financial regulation policy uncertainty over and above political uncertainty. South Africa is a small open economy susceptible to the direction of global developments. This book explores and covers the policy and academic research gaps due to global and domestic economic developments during the period post-global financial crisis. Various chapters contained in the book utilise a variety of relevant and up-to-date statistical and econometric techniques to derive policy insights and implications of the global and domestic developments.

The book explores and quantifies three main issues. First, the book shows the transmission of direct and indirect channels of global and domestic macroeconomic uncertainties. Second, various chapters in the book present evidence of the counterfactual scenarios of what would have happened in the absence of these global and domestic macroeconomic uncertainties. The counterfactual scenario approach is ideal to demonstrate the relative importance of indirect economic policy uncertainty channel in accentuating the direct shock effects via the propagation channels. Third, the book shows that the concurrence of the exchange rate volatility and other macroeconomic policy uncertainties tends to reinforce the negative effects of these shocks on real economic activity. Furthermore, the effects of the negative shocks differ depending on whether the exchange rate volatility and macroeconomic policy uncertainties are persistent or transitory.

The analysis contained in the book distinguishes between externally and domestically generated uncertainty shocks. Such distinction enables the proper identification of the channels involved in the transmission mechanisms which also assists in the design of policy interventions. Evidence contained in the book shows that domestically generated policy uncertainty should be minimised as much as possible as it directly transmits and propagates the negative shock effects on real economic activity. This evidence is particularly important given the theoretical assertions and empirical evidence which suggests that heightened macroeconomic uncertainty in general through the “wait and see strategy” induces revisions and the postponement of investment and spending plans with detrimental effects on macroeconomic performance.

Furthermore, the book fills existing policy and academic research gaps by showing how elevated financial regulatory policy uncertainty may neutralise the effects of accommodative monetary policy settings as was the case during the domestic recession in 2009. For instance, evidence contained in book shows that the lending rate spreads which is the main channel of the monetary policy transmission may increase due to elevated financial regulatory policy uncertainty. This impedes the transmission of accommodative monetary policy rates to households and firms to support macroeconomic performance.

At the same time, the book dedicates a number of chapters to offer timely research concerning the expected effects of the US Federal Reserve (US Fed) policy normalisation on the interest rate differential and the exchange rate effects. Evidence in the book shows that US Fed policy normalisation process induces spillovers into the South African economic policy uncertainty with implications for the monetary policy responses.

The book provides a collection of timely and relevant empirical analysis and evidence that show that global and domestic macroeconomic uncertainties matter. Domestic economic activity will be cushioned and benefit from low macroeconomic policy uncertainty.

Berlin, Germany

Dr. Ernst Welteke
Former President of the Bundesbank

Preface

This book focuses on macroeconomic uncertainty issues impacting the South African economy. These issues are important for the macroeconomic performance. We divided the book into three main parts. The three parts fill existing gaps from the policy commentary, policy and academic research through offering insights into the transmission channels of elevated foreign economic policy and GDP growth uncertainty. In addition, the book examines the effects of the exchange rate shocks and the extent of *contractionary exchange rate depreciation effects*. The book examines if the depreciation leads to the redistribution of income from workers to producers and the effects on the marginal propensity to consume. The book shows the extent to which elevated macroeconomic uncertainty impacts real economic activity directly and indirectly. From a methodological perspective, the book shows through applying the counterfactual approach that economic policy uncertainty indirectly accentuates the effects of other economic shocks by acting as a propagation channel. These uncertainties' direct and indirect effects vary between those induced by shocks from foreign economic policy uncertainties and domestic macroeconomic uncertainties. At the same time, the book shows that foreign economic policy uncertainty shock effects are amplified by prevailing foreign GDP growth uncertainties. The book brings together a collection of empirical analysis that shows that domestic uncertainties matter as much as foreign economic macroeconomic uncertainty.

The first part of the book deals with the spillovers of foreign economic policy and GDP growth uncertainties into South Africa. This part of the book begins the analysis by examining the role of foreign economic policy uncertainty and the impact of foreign GDP growth uncertainty shocks. This is because foreign and domestic economic policy uncertainties induce the risk on-off activities, impact business and consumer confidence. Heightened economic policy uncertainty can destabilise economic prospects if not addressed. As a result, the book examines the channels which are not limited to equity and debt capital flows in transmitting the effects of heightened foreign economic policy uncertainties and GDP growth uncertainties on the domestic economy. At the same time, the book shows that foreign economic policy uncertainty shock effects are amplified by the prevailing foreign GDP growth uncertainties.

The second part of the book focuses on the exchange rate and domestic macroeconomic uncertainty effects. This includes showing the extent to which domestic macroeconomic uncertainty explains the slow and volatile economic recovery. We show the extent to which the uncertainty channel accentuates the effects of shocks to the real economy, and as a possible explanation of volatile and weak economic activity accentuated by the uncertainty that characterised the economic landscape after 2009Q4. Further, it shows the effects of financial regulatory policy uncertainty and the role of the South African economic policy uncertainty channel. We also show that the regulatory uncertainty effects are accentuated by elevated interest rate margins and South African economic policy uncertainty dynamics.

The third part of the book offers insights into the effects of the expected US Fed monetary policy tightening on South African monetary policy settings, financial and real economic variables. Hence, we investigate what is likely to happen (rather than what happens) to the South African economy when the US is expected to normalise its policy rate. This includes performing the counterfactual analysis to determine how the expected Federal Funds rate (FFR) normalisation shock will affect the evolution of the South African repo rate, the exchange rate, economic growth and other key macroeconomic variables. We show the impact of the expected US monetary policy normalisation on the South African economic policy uncertainty. Does the expected US monetary policy normalisation impact the South African economic policy uncertainty changes asymmetrically?

The book extends the analysis by dissecting the influence of various exchange rate aspects. Evidence shows that the pricing to market strategy matters because exporters can mitigate the pass-through of the exchange rate during depreciation and appreciation episodes. In addition, we show that the exchange rate risk impacts exports to selected destinations and quantify the proportions that are neutralised by the risk effects. Thus, the exchange rate risk or volatility tends to reduce the full effects and benefits of the depreciation on exports growth and revenues. Furthermore, we examine the asymmetric effect of the exchange rate depreciation or appreciation shocks on future exchange rate volatility. The book decomposes aggregate exchange rate volatility into transitory and permanent components to determine the role of South African economic policy uncertainty in transmitting permanent and overall exchange rate volatility shocks to total exports growth. What would have happened to the South African exports growth response to positive exchange rate volatility shocks in the absence of South African economic policy uncertainty?

We conclude that the book serves as reference text for economic agents, which include policymakers, market commentators and academics alike. The issues tackled in the book capture those effects not clearly extracted and these represent a missing component that should accompany empirical analysis during policy deliberations and their implications. It offers empirical support that reviews and validates the policy implications and determines changes in relationship linked to economic theories.

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