

Exchange Rates and Devaluation

Presentation to RICS Botswana

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Structure

- The mechanics of exchange rates
- Exchange rates & competitiveness
- Why devalue?
- Impact of devaluation



Exchange Rates

- Value of Pula determined in relation to basket of currencies (ZAR, SDR) with fixed weights.
- Weights reflect trade patterns, changed rarely, kept secret
- Exchange rate of pula vs. the basket can be changed (=re/devaluation, crawling peg)

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Exchange Rates

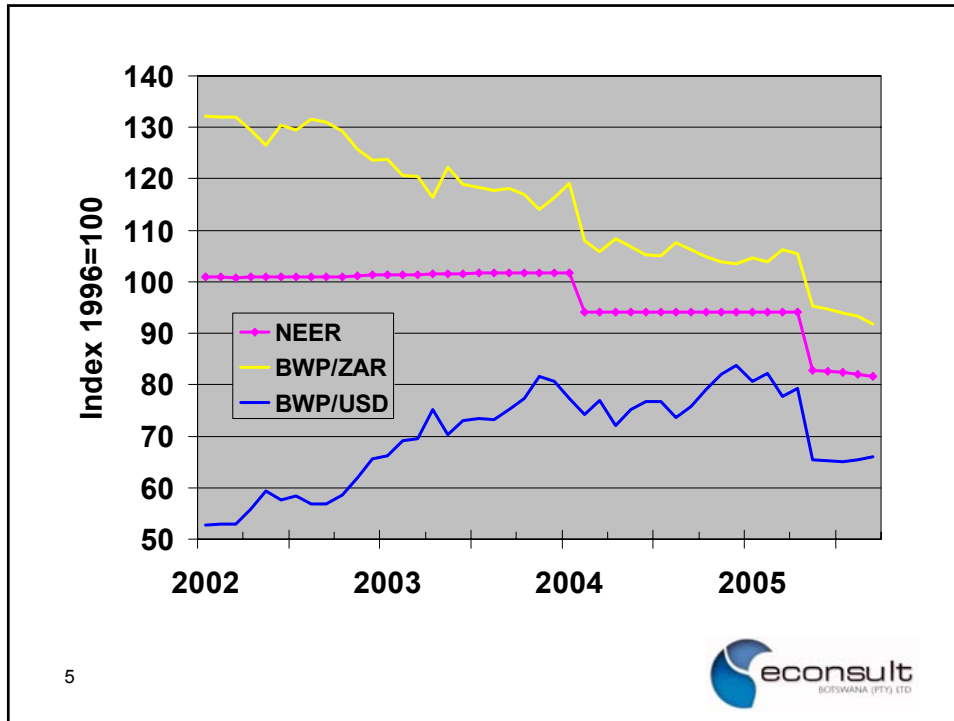
- Nominal Effective Exchange Rate (NEER)

$$\left(\frac{BWP}{ZAR}\right)^{\alpha} \cdot \left(\frac{BWP}{SDR}\right)^{\beta} = K$$

- weighted average of bilateral exchange rates
- Bilateral exchange rates (e.g. pula-rand) move on cross-rates (e.g. rand-dollar)
- Bilateral rate movements (BWP/ZAR, BWP/SDR) in opposite directions and cancel each other out – hence NEER constant - unless re/devaluation

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Competitiveness

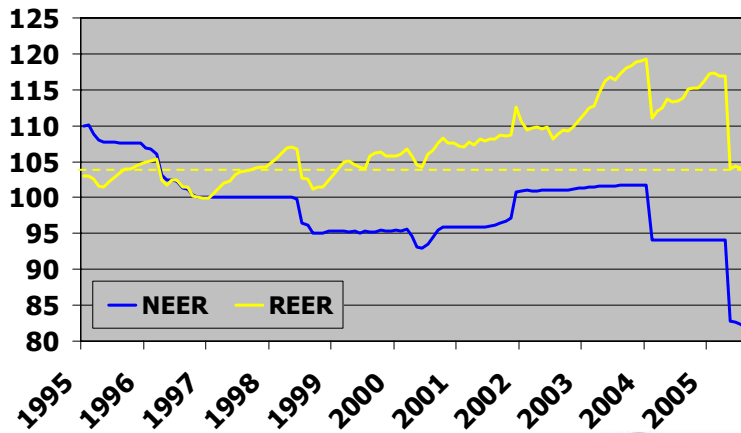
- Real Exchange Rate
 - Relative domestic and foreign prices adjusted for nominal exchange rate

$$REER = \left(\frac{P^d}{P^f \cdot XR} \right)$$

- Competitiveness declines (REER rises) if:
 - domestic prices rise faster than foreign prices
 - exchange rate appreciates
 - Botswana's problem is the former

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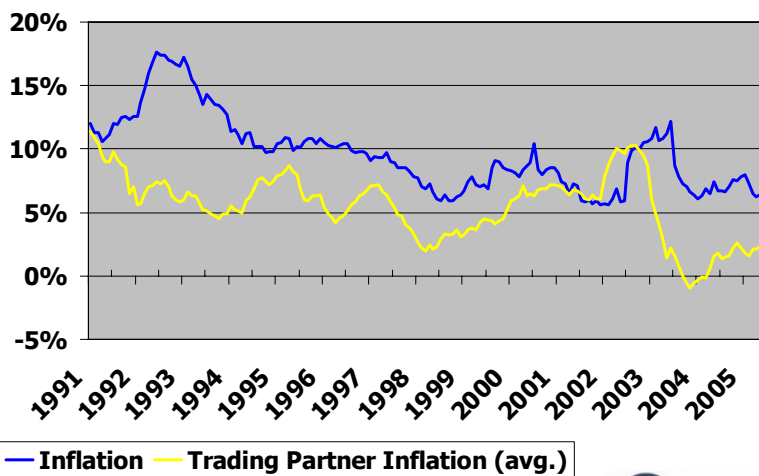
Real & Nominal Effective Exchange Rates 1995-2005



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Inflation – Botswana and Trading Partners



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Competitiveness

- Botswana prices high relative to trading partners/competitors
- Relative prices determined by costs of what is produced in Botswana (value added)
- Botswana net costs (= incomes) high relative to value of what we produce
- Costs have to be reduced *either* by reducing incomes *or* increasing productivity

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Sectoral effects

- Tradeables (exports or import substitutes)
 - includes, goods, some services
 - prices determined internationally
 - low profits/returns
 - investment discouraged
- Non-tradeables
 - most services, property
 - prices determined locally (high)
 - high profits/returns
 - (over) investment encouraged
- Wrong incentives!

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Why Devalue?

- Economic growth in Botswana MUST be export-led (small domestic market)
- International/historical evidence very clear – e.g. China, E. Asia vs. Latin America
- Must be competitive to export
- Exchange rate a crucial determinant of competitiveness (along with domestic costs)

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Impact of Devaluation

- Doesn't higher inflation erode the initial impact on competitiveness?
 - only partially – impact on inflation always less than 100%
 - e.g. 2004 devaluation of 7.5% added 2%-4% to inflation
 - 2005 devaluation of 12% added 4%-5% to inflation
 - some competitiveness gains remain

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Impact of Devaluation

- Initial (short-term):
 - Higher import costs (-)
 - Higher inflation (but small effect) (-)
 - Reduced real wages and incomes (-)
 - Profit squeeze in import-intensive sectors (-)
 - Profitability of tradeables sectors improves *vis a vis* non-tradeables (+)
 - Improved international competitiveness (+)
 - Higher government revenues (+)

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Impact of Devaluation

- Medium term
 - Support for exports and diversification
 - Support for higher economic growth, but
 - Devaluation a necessary but not a sufficient condition for higher growth
 - Need to deal with underlying cost factors
 - Crawling peg should eliminate need for further devaluations
 - Choices: compete or stagnate

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Impact on Property Sector

- Relative to some other sectors, property likely to be disadvantaged, especially in short run
 - devaluation aims to enhance exports & import-competing sectors vs. non-tradeables
 - recent over-investment in property
 - now, higher costs, reduced profits
- Medium-long term: higher economic growth will support all sectors, including property

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“There is a strong association between [growth] acceleration episodes and trade. Episodes are correlated with strong growth in the economies of a country’s trading partners, export growth, and a competitive real exchange rate. Exports were also facilitated by REER depreciations pointing to the importance of careful management of competitiveness regardless of the exchange rate regime” *(IMF, 2005, Sustaining Growth Accelerations and Pro-poor Growth in Africa)*

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