SOUTH AFRICAN RESERVE BANK

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Exchange rates and tariffs

Introduction

Ladies and gentlemen, thank you for the opportunity to address you today. I am grateful to former President Kgalema Motlanthe and his Foundation for convening this forum, and it is a pleasure to be with you all here in the beautiful Drakensberg.

The theme chosen for my address – exchange rates and tariffs – speaks to both an old problem and a new one. The old problem is the alignment – and misalignment – of exchange rates. This remains a subject of perennial interest in global macroeconomics, with each decade marked by its own controversies. The new problem is tariffs, which is new in the sense that, until this year, we lived in a world where all the leading countries favoured openness to trade, and had done so for decades. We no longer live in that world. What does this mean for our economy?

Exchange rate effects of tariffs

Let me start with the relationship between tariffs and the exchange rate, and specifically with the textbook account. The textbook says that, when a country imposes tariffs on trade, it will make itself more expensive. For instance, tariffs on cars or fridges make imports costlier and allow domestic producers to charge higher prices.[1] Furthermore, as people reduce their consumption of traded goods, they supply less currency to foreign exchange markets, which tends to strengthen the local exchange rate.[2]

Economists like to talk about the real exchange rate, which is the exchange rate adjusted for the difference in inflation between two countries. The textbook account makes it pretty clear that tariffs tend to appreciate a country's real exchange rate, by moving both the domestic price level and the exchange rate itself.[3]

At the beginning of this year, it seemed the simple textbook account was all we needed to understand the world. The new United States (US) administration moved quickly towards much higher tariffs. The dollar promptly appreciated; by some measures, it hit a multi-decade high in January.[4] US inflation also started to edge up, and the differentials with major trading partners began widening. All this made the US more expensive to trade with.

The twist, however, is that from January onwards, the dollar has weakened. Depending on the measure used, it has depreciated by around 7−8% from its January peak. There isn't much evidence that foreigners are dumping their US assets, but there is evidence that they are hedging their dollar positions more aggressively.[5] We must also bear in mind that the dollar has been relatively strong over the past few years, so it made sense that it would correct towards more normal values, not least because US interest rates have eased lower.

One implication of all this is that 2025 has been a better year for emerging markets than many had feared. The adverse scenario for emerging markets was a wicked mix

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[1] Ralph Ossa "In a world of trade tensions, what do tariffs really do?" 11 April 2025. Available at: https://www.wto.org/english/blogs_e/ce_ralph_ossa_e/blog_ro_11apr25_e.htm

[2] For instance, see this post by Greg Mankiw (author of a famous introductory economics textbook): https://gregmankiw.blogspot.com/2025/03/kevin-hassett-forgets-econ-101.html

[3] Davide Furceri et al. "Macroeconomic consequences of tariffs" October 2018. Available at: https://www.imf.org/-/media/Files/News/Seminars/2018/ARC2018/s4-furceri.ashx

[4] For instance, the US Federal Reserve compiles nominal and real broad dollar indices which go back to 2006; both hit their highest recorded values in January 2025.

[5] Hyun Song Shin et al. "US dollar's slide in April 2025: the role of FX hedging" 20 June 2025. Available at: https://www.bis.org/publ/bisbull105.pdf

of a strong dollar, high US interest rates, and tariffs that hurt our export industries. While we still have the tariffs to grapple with, the other factors have been more favourable.

For South Africa, it has been a year marked by rising terms of trade, a stronger and less volatile rand, and lower domestic interest rates across the yield curve. Given the risks involved, this is one of the more positive outcomes we could have hoped for. It is a relief that things did not turn out worse.

The exchange rate and growth

We cracked open the textbook earlier to check the standard relationship between tariffs and the exchange rate, so let us now do the same for the economic effects of an exchange rate appreciation. The way this subject is usually introduced in economics classes is through the Mundell−Fleming framework. This simple and elegant model demonstrates that currency depreciation boosts growth, given certain assumptions. The short version is that a cheaper currency leads to importing less and exporting more, which expands aggregate output. Equivalently, a stronger currency is considered growth negative.

Once again, the reasoning is clear, but the textbook conclusion seems to be at odds with the facts. Should rand appreciation really be viewed as bad news? It is puzzling, because for much of the past 10 years or so, we have generally had a weaker exchange rate, yet this has coincided with extremely low growth.

Indeed, back in the late 2000s, it was often argued that South Africa's real exchange rate was too strong and too volatile.[6] This indicator has since become significantly weaker and less volatile.[7] If you consider indicators of purchasing power parity, such as the simple Big Mac Index, you see that for the rand to have the same buying power in the US as it does here, the exchange rate would need to be around 50−60% stronger.[8] More sophisticated measures of purchasing power parity suggest that equal

[6] Ricardo Hausmann. "Final recommendations of the International Panel on ASGISA" May 2008 Available at: https://growthlab.hks.harvard.edu/files/growthlab/files/161.pdf

[7] For instance, the Bank for International Settlements' real effective exchange rate (REER) measure was 27% stronger for the period 1994−2014 versus 2014−2025, and the standard deviation of the series was about 10 percentage points higher.

[8] https://www.economist.com/interactive/big-mac-index

buying power would require an exchange rate close to R8 per dollar.[9] It seems clear that the rand has been cheap, yet this has not triggered more growth. As far as I can tell, the main effect has been to stop people talking much about the real effective exchange rate.

One explanation for this missing growth relationship is that a currency sometimes reflects larger developments in a country, in the same way that a share price speaks to the heath of a company. If a country looks good, investors are impressed, and the currency appreciates. By the same token, if they lose confidence, they sell. When you have good news stories, such as structural reforms, fiscal discipline and effective governance, you get growth, and at the same time you get currency gains. When you have bad news stories, such as state capture, unsustainable debt growth and junk status, growth weakens and the currency follows suit. This reminds us that while a competitive exchange rate is indeed a valuable policy good, it is no panacea. Worse still, a currency can be undervalued for all the wrong reasons, in which case the standard benefits do not apply.

Another consideration is that growth benefits from imports as well as exports.[10] It is really not the case that exporters are always winners, importers are losers, or that countries should compete to import as little as possible – even if that mercantilist thinking gains some traction from time to time.

For a start, export industries often benefit from imported components, and much the same goes for most other industries. Indeed, capital goods for investment are often imported, and almost all economies will find it more efficient to buy these items on global markets rather than develop them domestically. For instance, most airlines acquire their planes from Boeing or Airbus. This may help explain why many emerging markets tend to invest more when their currencies are stronger, and this extra investment raises growth.[11]

[9] This references the World Bank's purchasing power parity (PPP) conversion factors: For South Africa, they estimate a factor of 7.4 in 2024, which means that for PPP to hold, the rand should have traded at 7.4 to the US dollar last year, rather than its actual exchange rate of 18.3.
[10] Lawrence Edwards and Ayanda Hlatshwayo. "Exchange rates and firm export performance in South Africa" January 2020. Available at: https://www.wider.unu.edu/sites/default/files/Publications/Working-paper/PDF/wp2020-1.pdf
[11] Steve Brito et al. "Real Exchange Rates, Economic Complexity, and Investment" 10 May 2018. Available at: https://www.imf.org/en/Publications/WP/Issues/2018/05/10/Real-Exchange-Rates-Economic-Complexity-and-Investment-45867

That does not mean you should aim for the strongest exchange rate possible, of course. But it does suggest a balanced approach that also considers the benefits of imports.

South Africa's exchange rate policy and dynamics

As you know, in South Africa we have long applied a policy of exchange rate flexibility. We came by this the hard way: we used to intervene in the exchange rate, and we got burnt, losing billions of dollars and credibility as well, because the interventions did not achieve their goals.

Our policy of flexibility has worked well for us. The exchange rate acts as a shock absorber for the economy, repricing assets and tradables to keep locals competitive, even during events like commodity price movements. Because South African households and firms do not hold a lot of foreign currency debt, sharp declines in the rand do not create financial instability – which has been a major problem in some other economies. And the South African Reserve Bank has been able to build credibility around its inflation target, ensuring that rand movements do not pass through to inflation at a high rate.

All that said, there are still some aspects of our exchange rate regime that are hard to enjoy. One is the trend of depreciation. Everyone remembers when the rand was stronger – at seven to the dollar, for example, compared to seventeen now. Another is volatility. While we still do not have much evidence that volatility disrupts economic activity in South Africa, South Africans certainly like to joke about how the rand has more mood swings than a teenager, or that it is the drama queen of emerging market currencies.

Our commitment to a free-floating exchange rate is now 27 years old – we started in 1998 – and I would like to suggest that we are now outgrowing some of this drama and settling down to a more mature stage of life.

One of the key drivers here is the shift towards permanently lower inflation. As many of you will know, this year we expressed a preference for inflation to settle at the bottom of our 3−6% target range. As we have often argued, our inflation rate is out of line with our peers and competitors. Most advanced economies target 2%. Emerging markets used to be much higher, but nowadays they commonly target rates between

2% and 4%, with a middle-income median of 3%. We have stuck with a 3−6% target range for 25 years – a quarter of a century – but this range is too high and too broad. It has left us as inflation outliers.

Unfortunately, if you aim for a high inflation rate, you end up raising prices faster than other countries. The implication is that you need your currency to depreciate, to compensate and keep the real exchange rate stable. The result is a kind of 'damned-if-you-do, damned-if-you-don't' trap: either you get a perennially weaker currency, with all its disappointments, or you don't, and you lose competitiveness.

This no longer applies if you have an inflation close to that of your peers – as we now do. To give a clear example, there used to be a large gap between our inflation rate and the US inflation rate. In 2016, it was 5 percentage points. Last year, the difference was less than 1 percentage point, and it is expected to stay small. Under these circumstances, the exchange rate should behave differently too.

I would also like more people to recognise that rand volatility has declined. Option-implied volatility is now at long-term lows. Yet, outside of financial markets, most people still believe the rand is a highly volatile currency. The only problem with this view is that it no longer describes the facts in front of us.

A last point I would like to see more widely recognised is, back in 1998, we had negative foreign exchange reserves. That made us vulnerable. We filled in that hole during the 2000s, and we have gradually grown reserves since. I am not sure if it is widely appreciated how much stronger our position has grown. In August, we surpassed US$70 billion for the first time. While that is partly a story about gold prices, it is not just about gold. For the first time, we satisfy all the major reserve adequacy metrics, including the International Monetary Fund's own measure. Alongside our positive net international investment position, our external position is arguably as strong as it has ever been. If the rand gets uncomfortably strong, we would be happy to accumulate more reserves.

Conclusion

Ladies and gentlemen, to conclude, global conditions are clearly challenging. The domestic environment has its challenges too. Fortunately, it is not all bad news. So far this year, global conditions have changed in ways that are, unexpectedly, quite supportive of emerging markets, with a weaker dollar, stronger terms of trade, and lower interest rates. South Africa has shared in these benefits. You asked me to talk about exchange rate conditions, and I have explored how an exchange rate shapes output, and how our South African policy conversation has evolved over the years. We have travelled a long road, but a welcome destination is now in sight. South Africa's external position has strengthened markedly. So, when people tell you the rand is a weak and volatile currency, encourage them to think again.

Thank you.