

Real Effective Exchange Rate Dynamics in Malawi and South Africa

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ABSTRACT This study investigates the main determinants of real effective exchange rate in Malawi and South Africa. In our empirical analysis, we conducted unit root and cointegration test in order to determine the time series properties of the data and establish whether there is a long run relationship between real effective exchange rate and explanatory variables. Having ascertained that almost all variables are integrated of order one and cointegrated, an error correction model is formulated and estimated for the two real effective exchange rate equations using the Ordinary Least Square (OLS) method.

The empirical results for both Malawi and South Africa are highly supportive of the real exchange rate model. In particular, we find a negative and significant relationship between real effective exchange rate and the degree of openness for both countries. On the other hand, while there is an inverse relationship between real effective exchange rate and government consumption in the case of Malawi, a positive relationship between real effective exchange rate and government consumption obtains in the case of South Africa. Additionally, whereas there is a positive relationship between real effective exchange rate and international capital flows in the case of Malawi, a negative relationship obtains in the case of South Africa. However, results from both countries indicate a positive relationship between real exchange rate one hand and excess domestic credit and lagged real effective exchange rate on the other hand. They also indicate a negative relationship between real effective exchange rate and nominal devaluation in both countries.

The study yields some policy implications. First, it has been learnt that excessive domestic credit causes the real exchange rate to appreciate for both countries. This therefore calls for prudent fiscal and monetary policy measures. Such measures include mopping out excess liquidity from the market to stem the growth of money supply. For both countries, the most powerful policy is just an intermediate policy and can only be successful if there is fiscal discipline. With fiscal discipline there can be no excess liquidity. Second, the study has found that policies aimed at eliminating trade restrictions depreciate the REER. One policy implication that can be

drawn from this finding is that the government should continue implementing trade liberalisation policies that it had already started in 1988.

Furthermore, developments in the external sector of the economy (changes in terms of trade, degree of openness and international capital flows) which are not under the control of domestic authorities seemingly contribute more to changes in real effective exchange rate. The policy implications are that the government ability in influencing the behaviour of real effective exchange rate is limited. This is because the ability of a small open economy like that of Malawi to insulate itself from external shock is limited, at best. In the long-run however, appropriate structural changes and conducive competitive policy could be designed and implemented. These may include export diversification (to counter deteriorating terms of trade in specific commodities) and implementing measures to limit market imperfection.

Based on the available evidence, it can be concluded that macroeconomic fundamentals play a vital role in explaining changes in real effective exchange rate in both Malawi and South Africa.