**Response to Report: “On the Rand: Trade-­‐off between Exchange Rate Pass-­‐Through and Trade Balance”**

First of all we look like to thank the referee for his/her helpful comments.

The finding of the paper is interesting and relevant: It demonstrates that there is an effect of the Real Effective Exchange Rate (REER), SA GDP and US GDP on the Trade Balance (TRB). In that sense the title is slightly misleading and I suggest that it be adjusted. The paper states that although a depreciation of the REER feeds through to inflation, it also causes a long-­‐term improvement in the TRB. Hence, there is a trade-­‐off. However, it cites other studies to support the claim that a depreciation causes inflation and therefore does not really address the issue itself. If it wants to do so, it should include CPI or PPI in its analysis – maybe add one of them to the VECM? Then one could with the help of impulse-­‐responses consider the effect of REER on inflation. If the author(s) do so and still find that a trade-­‐off exists, then they should also tell the reader what to make of the trade-­‐off. It is one thing to say there is a trade-­‐off, but which side of the trade-­ off should we go? Should we take higher inflation or a better trade balance? Hence, what do these findings imply for policy? If the authors augment the analysis to also include inflation, then the title can stand as it is.

However, if the author(s) do not want to change the analysis itself, then the title should be amended to something like ‘The exchange rate, the trade balance and the J-­‐curve effect”.

**Response**: We have changed the title to “The Exchange Rate, the Trade Balance and the J-curve Effect in South Africa”

On page 4, first paragraph the author(s) note that not only does a weaker exchange rate (it should actually be a weaker Rand, as an exchange rate cannot be stronger or weaker) increases inflation, it also increases price competitiveness. That in turn increases net exports and SA’s GDP. Of course the author(s) could also note that there is a possibility that the improved SA GDP could, through a Phillips curve effect push inflation further up.

**Response**: We have included a footnote (7) on p. 5 which mentions this.

On page 7, first paragraph, the author(s) note that the error correction term equals -­‐0.38. They conclude that “It takes approximately 3 quarters or less than a year for full correction to take place, which is relatively slow.” This statement is not entirely correct. If the original shock equals 1, then whereas the adjustment in the first period is 0.38, it is not 0.38 in the second period, but 0.38x0.62 (i.e. 38% of what remained of the deviation after the first period’s correction. Thus after a year, the total adjustment is 0.8526 (i.e. 0.38+0.2356+0.1461+0.091). Of course, this will strengthen the point that the authors make that the adjustment is very slow; it is even slower than they thought!

**Response**: On p. 7 we now say: “After a year, the total adjustment is 85%, which is relatively slow.”

In terms of the empirical analysis: how was the number of lags used in the VECM selected? Using information criteria, or was the number merely restricted to one lag?

**Response**: This is explained in Section 3.2, we used the Schwarz information criterion

On page 8 the author(s) comment on the statistical significance of the lags of the change variables, for instance noting that SA GDP is statistically insignificant. That is fine, but they should also just strengthen these findings by conducting a VECM Granger causality analysis.

**Response**: There is little we can get from Granger Causality. The choice of exogenous variables is based on theory as per Yusoff (2007). However, here we provide some results, which we have not included in the main paper.

Granger Causality Test

|  |
| --- |
| Pairwise Granger Causality Tests |
| Date: 03/27/14 Time: 16:48 |
| Sample: 1994Q1 2011Q4 |  |
| Lags: 1 |  |  |
|  |  |  |  |
|  Null Hypothesis: | Obs | F-Statistic | Prob.  |
|  |  |  |  |
|  SAGDP\_SA does not Granger Cause TRADEB\_SA |  71 |  4.28321 | 0.0423 |
|  TRADEB\_SA does not Granger Cause SAGDP\_SA |  0.11416 | 0.7365 |
|  |  |  |  |
|  REER does not Granger Cause TRADEB\_SA |  71 |  0.54280 | 0.4638 |
|  TRADEB\_SA does not Granger Cause REER |  0.59537 | 0.4430 |
|  |  |  |  |
|  USAGDP does not Granger Cause TRADEB\_SA |  71 |  1.12215 | 0.2932 |
|  TRADEB\_SA does not Granger Cause USAGDP |  0.00065 | 0.9798 |
|  |  |  |  |
|  REER does not Granger Cause SAGDP\_SA |  71 |  0.65343 | 0.4217 |
|  SAGDP\_SA does not Granger Cause REER |  0.02056 | 0.8864 |
|  |  |  |  |
|  USAGDP does not Granger Cause SAGDP\_SA |  71 |  4.18257 | 0.0447 |
|  SAGDP\_SA does not Granger Cause USAGDP |  2.42237 | 0.1243 |
|  |  |  |  |
|  USAGDP does not Granger Cause REER |  71 |  0.35545 | 0.5530 |
|  REER does not Granger Cause USAGDP |  3.82291 | 0.0547 |
|  |  |  |  |
|  |  |  |  |

Exogeneity Test

|  |
| --- |
| VEC Granger Causality/Block Exogeneity Wald Tests |
| Date: 03/27/14 Time: 16:51 |  |
| Sample: 1994Q1 2011Q4 |  |
| Included observations: 70 |  |
|  |  |  |  |
| Dependent variable: D(TRADEB\_SA) |  |
|  |  |  |  |
| Excluded | Chi-sq | df | Prob. |
|  |  |  |  |
| D(SAGDP\_SA) |  0.303557 | 1 |  0.5817 |
| D(REER) |  5.972848 | 1 |  0.0145 |
| D(USAGDP) |  2.018117 | 1 |  0.1554 |
|  |  |  |  |
| All |  8.346425 | 3 |  0.0394 |
|  |  |  |  |
| Dependent variable: D(SAGDP\_SA) |  |
|  |  |  |  |
| Excluded | Chi-sq | df | Prob. |
|  |  |  |  |
| D(TRADEB\_SA) |  3.675261 | 1 |  0.0552 |
| D(REER) |  0.036351 | 1 |  0.8488 |
| D(USAGDP) |  8.716663 | 1 |  0.0032 |
|  |  |  |  |
| All |  13.61186 | 3 |  0.0035 |
|  |  |  |  |
| Dependent variable: D(REER) |  |
|  |  |  |  |
| Excluded | Chi-sq | df | Prob. |
|  |  |  |  |
| D(TRADEB\_SA) |  1.017923 | 1 |  0.3130 |
| D(SAGDP\_SA) |  0.401817 | 1 |  0.5262 |
| D(USAGDP) |  0.247250 | 1 |  0.6190 |
|  |  |  |  |
| All |  1.391506 | 3 |  0.7075 |
|  |  |  |  |
| Dependent variable: D(USAGDP) |  |
|  |  |  |  |
|  |  |  |  |
| Excluded | Chi-sq | df | Prob. |
|  |  |  |  |
| D(TRADEB\_SA) |  0.817144 | 1 |  0.3660 |
| D(SAGDP\_SA) |  0.642078 | 1 |  0.4230 |
| D(REER) |  0.535638 | 1 |  0.4642 |
|  |  |  |  |
| All |  1.926148 | 3 |  0.5879 |
|  |  |  |  |
|  |  |  |  |
|  |  |  |  |

Lastly, what about some impulse-­‐response and variance decomposition analyses? It could make the story more interesting and given that the paper is short, there is certainly some space for it.

**Response**: We have included both in the paper.

**Smaller issues**

1. Figure 2 just repeats two of the graphs of Figure 1 – so cut the repetition. Also, the author(s) state that one can see the inverse relationship between REER and TRB, as depicted in Figure 2. That might be true for the late 90s and early 2000s, but after 2003 TRB seems to go in one way only, while REER seems to display a more or less cyclical pattern – hence I see no inverse relationship in the graph after 2003 (this of course does not preclude it from being there in the regression – all I am saying is that it is not evident from the graph). **Response**: We have deleted Figure 2.
2. Page 2, second paragraph from the bottom, line three: ‘short’ misses a ‘t’. **Response**: This has been corrected.
3. Page 3, third paragraph, fifth line: “The find…” should be “They find…” **Response**: This has been corrected
4. Page 4, first paragraph, sixth line, “So, their…” should be “So, there…” **Response**: This has been corrected.
5. The flow between the first and second paragraph on page 4 really needs some attention. Also note that the font size between the first and second sentence of the second paragraph differs. **Response**: This has been addressed. We now say: “Our analysis focuses not so much on the pass-through but on the ‘positive’ of a real deprecation.”
6. At the bottom of page 4: “We US GDP…” should be “We use US GDP…” **Response**: This has been corrected.
7. On page 5 it states “units of foreign currency (USD)”. The “(USD)” should be cut, as the REER is not stated in dollars. **Response**: This has been corrected.