Response to Reviewer comments: On the rand: A trade-off between exchange rate pass-through and the trade balance?

# General comments

The paper is short and easily readable. The paper flows and the ideas are set out clearly. However, the effects of the exchange rate on the trade balance have been studied before using a similar methodology (see Anderson et al. (2010), Ncube et al. (2013), Edwards et al. (2008)). The paper does not highlight how it innovates from these papers nor mentions (references) their contribution to the literature.

**Response**: we have referenced and included these papers in the main text.

The paper’s title is also a bit misleading given the little attention pass-through receives. There is no mention of the size of exchange rate pass-through to inflation and the mapping of exchange rate pass-through to the trade balance is not clearly set out. A more suitable title would be: On the rand: A re-examination of trade balance effects. As such, it would be difficult to accept the paper in its current form.

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

# Specific comments

# Introduction

* There has been a divergence from the NGP over the last years and a lot of emphasis placed on the NDP. The paper needs to bring in the NDP to justify the policy angle of the exchange rate too. **Response**: We have addressed this by including an extensive footnote (3) on p. 2.
* What is meant by “competitive exchange rate”? This term has been overused by many studies without reference about what it actually means. Does it mean an ever-depreciating exchange rate? Does it mean a level of the exchange rate that is in line with fundamentals (what fundamentals?)? **Response**: We have added a footnote (2) on p. 2 which now explains this.
* There seems to be a word missing in paragraph 4 page 2:” …has been both a positive and a negative,…”. **Response**: This has been addressed.
* The author(s) claim that there exists a trade-off between higher inflation and a more competitive exchange rate in the long-run: There should be a reference or this should be clearly shown empirically. **Response**: On p. 2 of the paper we quote the document underlying the New Growth Path. More specifically, on p. 2 the document talks about a trade-off between a competitive currency that supports growth in production, employment and exports and a stronger Rand that makes imports of capital and consumer goods cheaper.

# Exchange pass-through

* It is not that “obvious” that a rand depreciation would have adverse effects on consumer prices. It could be that pass-through is close to zero. This depends on many factors such as menu costs, import composition, consumption composition and substitution effects. **Response**: On p. 3 we now say: “A depreciation of the Rand *may* have adverse effects on South African consumer price inflation. (…). We then included a footnote (4) which addresses the point raised by the referee.
* Par 3, page 3: Delete from “These estimates are larger…” until the end of that paragraph. This point has been made in the previous paragraph and is only a repetition. **Response**: This has been addressed.
* Footnote 3: This would imply that lower pass-through should also be disputed unless it is argued that the link between pass-through and monetary policy credibility is non-existent. **Response**: This footnote has been rewritten and now states: “For a study about the credibility of the SARB’s inflation targeting regime see Kabundi and Schaling (2013).”

# Data and descriptive statistics

* The author(s) argue that the “rand translates into a higher inflation rate” – how high is high? **Response**: We have changed the text to: “The literature review above indicates that a weaker Rand tends to push up the inflation rate”.
* Typo in par 1 page 4: “So **their** appears to be…”. **Response**: This has been addressed.
* The sample size needs to be updated. **Response**: This has been addressed. We now say: “We use quarterly data from 1994Q1 to 2011Q4 (**T = 72**) (…)”
* What are the non-adjusted series that needs to be updated? **Response**: This is the method used to seasonally adjust series. We have also included a footnote that explains this.

# Model and test procedure

* Omit “the most powerful”. Superfluous comment. **Response**: This has been addressed.
* State why you want to use the unit root tests and how it applies to the empirical methodology. **Response**: We use the unit root test to determine the order of integration of series. In this case all series are integrated of order one, hence the regression in levels might be spurious unless the series are cointegrated. Therefore, the current framework can exploit both long-term relationship between variables and the short-term dynamics. We use the VECM to reconcile the equilibrium relationship and the short-term deviations. This is in fact what we say in the main text.
* No need to say the “American definition” when you define the rand. **Response**: This has been addressed.
* Why are the units for USAGDP bigger than SAGDP in Figure 1? **Response**: SA GDP is expressed in domestic currency and not in dollar terms.
* What is the correlation coefficient of Figure 2? **Response**: Figure 2 has been dropped per request of Referee A.

# Empirical results

* The equation has an income elasticity and exchange rate elasticity but does not have a price elasticity. What informs this exclusion? **Response**: The estimation is based on a theoretical model as in Yusoff (2007).
* Do the results change when you control for other factors? What other controls have been used? **Response**: See our response above.
* While it might be correct to say that “the SA economy is substantially linked to economic performance abroad” this is not what is shown in this paper. Rather, trade is substantially linked to economic growth abroad. **Response**: We now say: “We can conclude that the SA economy is substantially linked to economic growth abroad”.
* Footnote 9: It would be interesting and worthwhile to see if the arguments in this paper are supported by export and import elasticities from other authors. **Response**: We have expanded footnote 10 now to also say: “The results in this paper are supported by those of Edwards and Lawrence (2006) who find that a 1 percent depreciation is estimated to raise the value of exports relative to imports by approximately 0.7 percent.”
* It is a bit of a sweeping statement to infer, from this study, that methods of currency devaluation, as used by China, could work for South Africa. What are the costs associated with such strategies and what are the quantifiable benefits? Does South Africa even have enough reserves to do so? **Response**: We have deleted this sentence.