

PART II

D. THE FOREIGN EXCHANGE AND RAND MARKETS GLOBALLY
LOCALLY

Global Financial Markets

48. The daily turnover of global foreign exchange transactions in all currencies increased from about USD600 billion in 1998 to about USD1.4 trillion (1 400 billion) in 1998 and then decreased to about USD1.2 trillion in 2001. The primary reason for the decline was the consolidation of players in the foreign exchange market. Unlike globally, in South Africa there was no overall concentration of foreign exchange dealers.⁶
49. The transaction categories that are concluded globally are spot, forward, swap and option transactions.⁷ The swap category is the most frequently used in all currencies globally. The global counterparties who trade in currencies are reporting dealers, banks, securities dealers, most insurance companies, pension funds, asset managers, multinational companies, importers, exporters and retail customers.⁸ The dealers account for most of the volume of global currency trading.⁹
50. In the opinion of Dr O'Neill, the global foreign exchange market has been very peculiar since the commencement of the European Monetary Union ("EMU"). Many historical norms appear to have changed:-

50.1 the US Dollar has strengthened against three major currencies,

Evidence of Mr Robert McCauley, the Deputy Chief Representative, the Representative Office for Asia and the Pacific, Hong Kong, of the Bank for International Settlements ("BIS"): Record 9 – 11.

⁷ See Definitions in Annexure 1

⁸ McCauley Record 14

⁹ McCauley Record 15

the Japanese Yen, Pound Sterling and Euro, despite the existence and deterioration of the US current account balance of payments - the Dollar should have weakened, not strengthened;

from mid-1999 until late 2000 the Japanese Yen strengthened against the Dollar at a time when there was effectively no growth in the Japanese economy;

the Euro has been weak.¹⁰

The Rand market

51. Unlike trading in major currencies, trading in the Rand grew over the period 1998 to 2001, especially in Rand terms. Forex trading in South Africa increased from 0.3% of global trading in all currencies in 1992 to 1995, to 0.5% in 1998 and to 0.6% in 2001. The daily turnover in South Africa grew from USD2 billion in 1992 to USD8 billion in April 2001.¹¹
52. The global daily trading in the Rand, for which the off-shore trading component was specifically measured for the first time in April 2001, was USD11.3 billion, about 75% of which were swap transactions¹². Reporting dealers do more than half the trading, other financial institutions such as insurers and pension funds do over a third and other companies such as mining companies, multinationals and local importers, do about a sixth.¹³
53. The Rand is an internationalised currency with the bulk of offshore trading taking place in London and to a lesser extent in New York. In April 2001 USD3.3 billion was traded between two offshore parties (offshore-offshore); USD3.5 billion was traded onshore-onshore and USD4.5 billion

¹⁰ See Annexure 6

¹¹ McCauley Record 17

¹² McCauley Record 20

¹³ McCauley Record 20

was traded onshore-offshore, i.e. between institutions in South Africa and those outside South Africa or offshore.¹⁴

54. During 2001 one authorised dealer, Standard Bank of South Africa Ltd (“SBSA”), through its international banking division, Standard Corporate and Merchant Bank (“SCMB”), alone, in its forex dealing room, transacted approximately 5 000 transactions per day, with an approximate value of USD2 billion in about 40 currencies. Rand-based transactions with a potential influence on the spot exchange rate accounted for about 15% of those transactions.¹⁵

55. It is important to note that, for the USD3.3 billion traded offshore-offshore:

there is no record of those transactions in South Africa;

the Commission has no power offshore to investigate those transactions; and

55.3 the offshore-offshore trading could have affected the value of the Rand.¹⁶

56. The Commission asked the Reserve Bank to request the Bank of England to supply it with information on off-shore/off-shore transactions. Information was sought on the local gross average daily turnover (purchases and sales) in US Dollars of spot, outright forwards and swaps in the foreign exchange market in the Rand. The Bank of England was also requested to state, in its opinion, what specific transactions, actions, events, factors or omissions played a part in the rapid depreciation of the Rand in 2001. The Bank of England was unable to furnish the information requested, save for the profile of the Rand trading month by month

¹⁴ McCauley Record 21
Evidence of WJ Potgieter, Standard Bank Bundle 18

¹⁶ McCauley Record 23-24

through 2001, benchmarked to total BIS-reported Rand turnover for April 2001

South African Foreign Exchange Market

57. The foreign exchange market is the single biggest market, in terms of turnover, of the South African financial markets. Given the openness of the South African economy, this market is an extremely important one.
58. The foreign exchange market is essentially an over-the-counter ("OTC") market. The primary aim of the foreign exchange market is to facilitate international trade and international money and capital movements by providing a market where different currencies can be exchanged for one another.
59. In the South African foreign exchange market there are mainly two types of participants: banks authorised by the Reserve Bank to deal in foreign exchange, known as Authorised Dealers, and brokers. It is the activities of the Authorised Dealers that are particularly relevant.
60. Authorised dealers are authorised to act as principals in the foreign exchange market which means that they can act in their own names and may also run positions in foreign currency. Probably the most important reason for allowing them to run positions and to trade in their own name is to provide liquidity in the market. Liquidity is an important factor underpinning the smooth functioning of the market.
61. Market makers in the foreign exchange market attempt to make profits by buying foreign currency at a lower price and selling it at a higher price. The difference, or the spread, is the bank's trading profit. The Authorised Dealers protect themselves during times of excessive volatility in the foreign exchange market. Since high volatility is normally associated with

uncertain and sharp price movements, Authorised Dealers will tend to increase the gap or spread between the buying and selling rates.

62. The banks are reluctant to trade during such times by virtue of the fact that the exchange rate could very quickly turn against them, possibly resulting in losses. Authorised Dealers, however, are limited to the extent to which they may run open positions and are currently limited to 10% of net qualifying capital and reserve funds.
63. During the past decade turnover in the Rand market in foreign exchange in South Africa has increased significantly. Increases were particularly noticeable in 1995/6 and in 1998. Both those periods were characterised by crises in emerging markets. The 1998 emerging market crisis was very negative for South Africa from an economic point of view but nevertheless resulted in increased turnover in the foreign exchange market. Since turnover provides a measure of market activity, and also provides a rough proxy for market liquidity, the conclusion is that liquidity in the Rand market in South Africa increased significantly over time by virtue of the increase in turnover.
64. Liquidity in the foreign exchange market has declined. Not only did the turnover decline to lower levels in the last quarter of 2001 compared to the trend of the last few years, but anecdotal and statistical evidence indicate that the market has become less tight in the sense of widening bid-ask spreads, less resilient, and has lost some of its depth with some transactions being difficult to execute because of the occasional reluctance by market participants to make prices.¹⁷

Information is derived from the memorandum prepared by the Reserve Bank Bundle SARB(7) 91-108

The environment within which the South African foreign exchange market operates

65. A number of developments in recent years contributed to a more market-orientated exchange rate system and increased volatility in the Rand exchange rate:-

65.1 Globalisation and the integration of world financial markets had a major impact on the process of exchange rate determination. The South African exchange rate became more exposed and subjected to international developments. In the period about 1995-1999, international investors grouped about thirty emerging market countries together and developments in one or more of those countries affected others. For example, the 1998 crisis was initiated by a financial crisis in the foreign exchange market of Thailand, which spread to other East-Asian countries and eventually to countries as far apart as Russia, Brazil and South Africa. In 2001, however, international investors began differentiating between different countries within the group of emerging market economies.

Dramatic increases occurred in private sector international capital flows. Volumes in the foreign exchange markets of the world assumed astronomical dimensions and the ability of central banks to influence market conditions through intervention diminished.

The gradual abolition of exchange controls in South Africa introduced an element of greater volatility in the local foreign exchange market.¹⁸

¹⁸ Evidence of Dr CL Stals, former Governor of the Reserve Bank, [Expert Bundle 171-2](#)

The impact of globalisation and the liberalisation of exchange controls

66. The overall thrust of the Government's economic policy since 1994 has been the pursuit of growth, job creation and redistribution, supported by reintegration with the global economy. While there are risks associated with it, globalisation offers the potential for sustained and broad-based improvement in living standards. Globalisation is characterised by rising trade and capital flows between countries. The Government has chosen a policy of gradual liberalisation of exchange controls based on a set of key-policy and structural requirements:-

the appropriate macro-economic fundamentals must be put in place;

a sound and well regulated financial system must be in place

a flexible exchange rate has been chosen to act as a shock absorber against global developments.¹⁹

67. Increased capital flows have the potential:

to help fuel faster growth and narrow the gap in living standards;

to raise investment by supplementing domestic earnings;

to deepen domestic capital markets and raise growth with a more efficient allocation of resources among competing projects. But increased capital mobility and integration of financial markets have also led to increased volatility, particularly in portfolio flows. For example, private portfolio flows to emerging economies almost

Evidence of Mr TA Manuel, Minister of Finance, National Treasury Bundle 83-85

halved as a result of the Asian crisis, falling from about USD135 billion in 1997 to about USD70 billion in 1998.²⁰

68. A gradual approach to the liberalisation of exchange controls has to a large extent enabled the Government to manage the volume of capital outflows and allowed it to adapt the pace and strategy of liberalisation in response to changing circumstance. The pace of liberalisation has taken into account factors such as expected capital inflows, the net open forward position (NOFP), foreign reserve levels and a desired path for the real exchange rate.
69. The process of exchange control liberalisation, however, is complex due to the size of the capital flows, the number of players in the market and the number of financial instruments available. Capital inflows to South Africa have proven to be volatile. Imbalances in the foreign exchange market are more often than not a consequence of the drying up of capital inflows due to mainly external factors rather than changes in capital outflows due to the effectiveness or ineffectiveness of domestic policies.²¹
70. Following on the liberalisation of exchange control, the capital outflows over the period 22 February to 31 December 2001 were as follows:
- | | |
|---|------------------------------|
| Private individuals in terms of their investment allowances transferred | R 7 billion |
| Corporates by way of foreign direct investment transferred about | R13.5 billion |
| Institutional investors acquired foreign portfolio investments of | R 3.88 billion ²² |

²⁰ Evidence of Ms M Ramos, Director-General, National Treasury, National Treasury Bundle 25-26

²¹ Ramos National Treasury Bundle 34-36

²² Evidence of Mr TT Mboweni, Governor of the Reserve Bank, Bundle SARB (7) 34-35

71. In the opinion of Mr Mboweni, the Governor of the SARB, it is virtually impossible to estimate the exact extent to which exchange control liberalisation has contributed to Rand weakness but there can be no doubt, as the figures above show, that it could at times have been an important structural factor.²³

72. 'The re-entry of South Africa into the globalised financial markets' and the opening-up to international competition led to a sharp increase in the participation by non-residents in the domestic financial markets. Non-residents are now responsible for about 1/3 of the turnover of the JSE Securities Exchange SA and about 1/6 of the volumes on the South African Bond Exchange. This has caused share and bond prices, as well as the exchange rate of the Rand, to be increasingly influenced by developments in the rest of the world, particularly in emerging markets.²⁴

73. Transactions by non-residents contributed materially to substantial increases in financial sector activity in the period 1995 to 2001:

annual turnover on the South African bond exchange increased from R2.0 trillion to R12.4 trillion;

the total value of shares traded on the stock exchange rose from R63 billion to R606 billion;

in the Rand foreign exchange market volumes increased from a net average daily turnover of USD2.7 billion to USD7.3 billion.

74. Transactions of non-residents resulted in greater volatility in capital flows

74.1 Non-resident net purchases of shares on the JSE Securities

²³ Mboweni Bundle SARB (7) 35

²⁴ Mboweni Bundle SARB (7) 35; Ramos National Treasury Bundle 40

Exchange SA (measured in billions of Rand) were:

<u>1995</u>	<u>1996</u>	<u>1999</u>	<u>2000</u>	<u>2001</u>
5.3	26.2	40.6	17.4	29.8

- 74.2 Net purchases by non-residents on *the South African bond* exchange were even more volatile. Net purchases increased from R3.4 billion in 1996 to R14.8 billion in 1997. Non-residents then sold bonds to the value of R9.8 billion in 1998 and bought back R14.3 billion in 1999 on a net basis. In 2001 non-residents again became net sellers of bonds in the amount of R20.2 billion in 2000 and R25.9 billion in 2001. The sharp fluctuations in portfolio investments of non-residents contributed materially to greater volatility in the external value of the Rand.²⁵

International Capital Flows

75. Joseph Yam, chief executive of the Hong Kong Monetary Authority in 1999, stated that international capital flows are essential to effective financial intermediation and play a vital role in economic development. But he noted that as the Asian financial crisis had demonstrated, the increasing volume, velocity and volatility of capital flows have the potential to distort, disrupt or even destabilise domestic financial markets²⁶. Speaking after the currency crisis in Hong Kong in 1998 he urged that countries need to grasp the opportunities produced by globalisation but must also manage the risks that they bring with them in ways that strengthen, rather than undermine economic fundamentals. Commenting on the Asian financial crisis in 1998 he had the following to say:

²⁵

Mboweni Bundle SARB (7) 36

²⁶

Speech delivered by Joseph Yam, Chief Executive of the Hong Kong Monetary Authority, at the Credit Suisse First Boston Asian Investment Conference on 26 March 1999