PART III

F. EXCHANGE CONTROL IN SOUTH AFRICA

The South African Reserve Bank

The SARB was established as the central bank of South Africa in 1921 in terms of the Currency and Banking Act No. 31 of 1920. This Act was replaced in 1944 by the South African Reserve Bank Act No. 29 of 1944. In 1989 the South African Reserve Bank Act No. 90 of 1989 (the SARB Act) was promulgated and is currently still in force as amended from time to time.

The bank has been privately owned since its establishment and presently has in excess of 650 shareholders.

The SARB Act provides that no individual shareholder may hold more than 10 000 shares of the total number of 2 000 000 issued shares. After the payment of certain amounts, amongst others, company tax, transfers to reserve and annual dividend payments which may not exceed ten cents per share, the surplus of SARB earnings is paid to Government.

The SARB Act provides for a Board of Directors with 14 members. The Governor and 3 Deputy Governors are appointed by the President for 5 year terms and are members of the Board. The President also appoints 3 other directors for a period of 3 years. The remaining 7 directors are representatives from various sectors of the economy and are elected by the SARB shareholders for a period of 3 years.

160. The Governor and Deputy Governors manage the day-to day affairs of the SARB.

Historical background to Exchange Control

Exchange controls have been in place in South Africa since 1939. The current governing legislation is set out in the Exchange Control Regulations promulgated in 1961 in terms of the Currency and Exchanges Act No. 9 of 1933.

162. Exchange controls in South Africa were applied more stringently during the apartheid era especially in 1985 when international sanctions, trade boycotts, disinvestment campaigns and the withdrawal of loan funding to South Africa exerted severe pressure on the balance of payments and the domestic economy as a whole.

163. The introduction of a dual currency system was meant to address some of the problems. The Financial Rand system was used for capital account transactions. Any outward transfer of funds other than normal trade related transactions, was subject to prior approval by the exchange control authorities.

After the first democratic elections in 1994 the new Government initiated the process of liberalisation of exchange controls. The first major step in this direction was the abolition of the Financial Rand in March 1995.

Role and Functions of the SARB

The Minister of Finance is responsible for exchange control policy. The SARB implements and administers such policy on behalf of the Government and also acts in an advisory capacity. The SARB and the Government are jointly responsible for determining exchange rate framework policy.

The Gov he ,A of eg wi the Mi ter
nance cco witl he rovi th C tu ion nd fu ther
rud to mic po cy
rn pe od h meml rtf
Com te nance arl im

224 the C pulate SARB' primary ob cti to be
the protection

'th the rrency in th rest of bala ced
sta bl mi rowth th Rep blic'

,A Act mp th im wor describing th
pri ry ob ti ,AR

he AR m perf
fu ties rried mm ci
m nd impl m tary ol cy m
th corne SA cti

ru ry 00 ffi ta
op ry ti
te to AR im ta

T' AR he im
ity th ion to
tribute to ta bl rth.

Oth te uencing fla ch m
ed xt io or exch ng te ctl rg te houg
do rol te of in tion.

Inflation targeting does require nominal exchange rate flexibility because South Africa has adopted a fully flexible exchange rate regime. There is no specific target for the exchange rate.

The SARB does however concern itself with the exchange rate but only to the extent that it has an impact on the inflation process.

The depreciation of the currency directly affects the price of imports in addition to possible secondary effects where high import prices have impacted on wage and other price increases.

The SARB is responsible for achieving the inflation target through the formulation and implementation of monetary policies.

The Monetary Policy Committee (MPC) of the SARB decides monetary policies.

178. The primary instrument of monetary policy available to the SARB is its influence on the level of short term interest rates through its refinancing system, which is called the repo rate.

179. The change in repo rate influences short term market interest rates in two ways: firstly it directly influences the marginal cost of funding of banks and secondly it reflects the SARB's monetary policy stance. Consequently it impacts on other interest rates in the market and can affect the exchange rate through its impact on domestic demand and capital movements.

180. The interest rate is not adjusted to influence the exchange rate but rather to influence in a pre-emptive manner, future inflation.

In the medium to longer term, successful inflation targeting should also contribute to a more stable exchange rate of the Rand.

The independence of the SARB and its autonomy is enshrined in the Constitution though regular consultation between the Bank and the Minister of Finance does take place.

G. LEGAL FRAMEWORK OF EXCHANGE CONTROL

The Currency and Exchanges Act

The Currency and Exchanges Act is the foundation of exchange control in South Africa. Section 9 (1) of the Act provides that:

> *"the Governor-General (the President) may make regulations in regard to any matter directly or indirectly relating to or affecting or having any bearing upon currency, banking or exchanges."*

Exchange Control Regulations

The Exchange Control Regulations are promulgated in terms of the Currency and Exchanges Act. The Regulations were promulgated on 1 December 1961 and amended from time to time.

The control over South Africa's foreign currency reserves as well as the accruals and spending thereof is vested in the Treasury. The Treasury is defined as the Minister of Finance or an officer in the Department of Finance who by virtue of the division of work in that Department, deals with any matter on the authority of the Minister.

Orders and Rules

From time to time the Minister of Finance issues Orders and Rules under the Exchange Control Regulations. The Orders and Rules contain various orders, Rules, Exemptions, Forms and Procedural Arrangements.

The Exchange Control Rulings

The Exchange Control Rulings are issued by the Exchange Control Department of the SARB and contain certain administrative measures as well as permissions, conditions and limits applicable to transactions in the foreign exchange market which may be undertaken by Authorised Dealers.

188. The Rulings are amended from time to time by way of Exchange Control Circulars.

189. Authorised Dealers may deal with applications for foreign exchange received by them if the applications fall within the parameters outlined in the Rulings without reference to the Exchange Control Department.

The Exchange Control Manual

190. The Exchange Control Manual was first issued by the SARB in October 1990 to assist Authorised Dealers, their customers ~~and other~~ interested parties, by providing a general understanding of the purpose, scope and operation of the exchange control system in South Africa and in the CMA.

191 The Manual serves only as a general guideline and does not replace or supersede the Exchange Control Regulations, Orders and Rules or the norms and policies as applied by the Exchange Control Department.

Authorised Dealers

Certain banks have been appointed by the Minister of Finance to act as Authorised Dealers in the foreign exchange market. Such appointment gives them the right to buy and sell foreign exchange subject to conditions and within the limits prescribed by the Exchange Control Department of the SARB. Authorised Dealers are not the agents of the Exchange Control Department but act on behalf of their customers.

Applications to the Exchange Control Department

193. Applications by customers of Authorised Dealers in forex which fall outside the scope of the Rulings must be referred to the Exchange Control Department for adjudication. The Exchange Control Department deals with each application on its own merit taking into account the information on record with the Exchange Control Department and within the parameters of detailed policy and norms. The records kept by the Exchange Control Department date back to 1939.

194 The decision of the Exchange Control Department including any conditions, if imposed, is furnished in writing to the Authorised Dealer and conveyed by it to the applicant.

195. The responsibility for ensuring that the execution of the transaction complies with any terms and conditions laid down by the Exchange Control Department lies with the applicant, though the application is made through the Authorised Dealer.

196. In certain circumstances, as for instance market sensitive transactions, the Exchange Control Department will entertain applications directly from the applicant.

197. Where approval is refused, resubmission is possible when a more senior official will review the application. In certain instances the department will grant an interview with the applicant and the Authorised Dealer during which the policy and norms are explained.

H. PURPOSE OF EXCHANGE CONTROL

The reason for the exchange control exist in order:

198.1 to ensure the repatriation into the South African banking system of all foreign currency acquired by residents of South Africa whether of a current or of a capital nature;

198.2 to prevent the loss of such foreign currency resources through the transfer abroad of real or financial capital assets held in South Africa;

198.3 to effectively control the movement into and out of South Africa of financial and real assets (money and/or goods) while at the same time not interfering with the efficient operation of the commercial, industrial and financial systems of the country.

198.4 to avoid undue pressures on the country's gold and foreign exchange reserves, which in turn would result in serious domestic inflation, a weakening of the country's terms of trade with the rest of the world, the impoverishment of the domestic population, the retardation of the domestic economic growth rate and the distortion of the Rand equivalent of the South African foreign debt.

The Removal of Exchange Control in South Africa

The first democratic government ushered in by the elections of 1994 has paid particular attention to exchange controls in South Africa.

The South African Government decided on a gradual approach to the elimination of exchange control as opposed to what is termed a "big-bang" approach. A phased approach allowed Government more time to implement other policy changes in order to achieve the preconditions necessary for a successful abolition of exchange control.

It had been decided by Government to proceed with the liberalisation of exchange control in the following sequence :

201.1 firstly, the abolition of exchange control on all current account transactions (import and export of goods and services) which has been done;

201.2 secondly, the abolition of exchange control on non-residents which has also been done;

201.3 thirdly, gradually becoming more lenient in the approval of applications for direct foreign investment by South African corporates. This is an ongoing process;

201.4 fourthly, allowing institutional investors to acquire foreign assets to diversify their total portfolio investments. This is also ongoing;

201.5 fifthly, to release immigrants' blocked funds which are funds or assets of an immigrant that are not transferable from South Africa and are physically controlled by an Authorised Dealer.

Remaining Exchange Controls in South Africa

Certain exchange controls remain. For the purpose of this report the relevant controls are the following:

202.1 foreign investments by South African corporates;

202.2 share placements by South African corporates;

202.3 foreign loans from outside the CMA;

202.4 import and export transactions by Authorised Dealers on behalf of South African importers;

202.5 forward exchange contracts with South African residents and non-residents;

202.6 customer foreign currency accounts.

Net Open Forward Position

The NOFP arose at a time in the history of this country when sanctions were in place against apartheid and the economy was marked by isolation from the rest of the world, low domestic savings and low foreign reserves.

In this environment the SARB had a mandate to intervene in the foreign market and was for many years responsible for providing cover against exchange rate fluctuations on behalf of the Government.

As early as the 1980's, attempts were made to extricate the SARB from the forward market but due to the prevailing political conditions this was not possible.

After the debt standstill in 1985, residents were increasingly reluctant to hold offshore debt because of the losses suffered on revaluation of foreign debts when the exchange rate depreciated by about 30% in 1985.

The strict exchange control requirements at the time prevented any resident from holding foreign currency and banks were permitted to do so within strict limits. In these circumstances the SARB provided forward cover to residents in respect of their offshore exposure.

208. The forward cover mechanism was used to encourage long term borrowing offshore as well as access to short term offshore finance. It was thus used to enable corporate South Africa to access international credit lines. These credit lines were to a large extent related to trade.

209. As a result of this, during the 1980's and the 1990's, the SARB was an active participant in the foreign exchange market firstly and initially by virtue of the responsibility to assist with the development of a foreign exchange market in South Africa but later to assist in achieving a relatively stable exchange rate. The SARB has on various occasions over the years intervened in defence of the Rand. As the SARB did not have adequate foreign reserves, the obligations to deliver forex into the market were converted into forward obligations. Such interventions took place in 1996 and also in 1998.

210. The forward book of the SARB reflects all unsettled future foreign exchange commitments of the SARB. Since the forward book was used among others to provide cover to residents in respect of the offshore loans, this resulted in an oversold or negative balance on the forward book. This oversold balance implies that the SARB's commitment to deliver foreign currency at future dates, is greater than its future commitments to buy or receive foreign currency.

211 The second reason for using the forward book is that it is also used as a way to underwrite intervention. The bank for example, sold US dollars into the spot foreign exchange market in order to support the exchange rate of the Rand and then swapped the US dollars back onto its forward book by buying US dollars spot and simultaneously selling them forward. Profit

and losses in respect of providing forward cover are for the account of the Government.

Huge losses were incurred by the Government due to the existence of the NOFP. The NOFP is the difference between the forward book and the net results of the SARB which is for the Government's account.

It is on account of the exposure of Government in this regard and the consequent losses as well as inflation targeting that the SARB did not intervene in support of the Rand in 2001.

Both the National Treasury and the Bank have expressed a determination to reduce the NOFP as it has been perceived negatively by market participants and commentators, including the International Monetary Fund, the rating agencies and the investment banking community.

Given the losses on the forward book and negative perceptions from market participants and commentators on the one hand and the potential impact on the currency of reducing the forward book on the other, the Bank had a difficult choice to make. In the long term interest of the country, it was decided to place emphasis on reducing the NOFP. The Bank has had to buy foreign exchange as prudently as possible to close out the NOFP.

The Bank has stated that it has been conscious of the risk of doing this and has tried to manage this risk by buying US dollars selectively. When market conditions deemed it not to be conducive, the pace of the reduction of the NOFP was slowed down or the process of reduction was even suspended. This is shown by the wide fluctuation in the NOFP since 1994. [77]

77 See Annexure 19

Impact of the NOFP on the Exchange Rate

Expert witnesses / economists from the various Authorised Dealers who gave evidence before the Commission as well as the Authorised Dealers themselves (check if Authorised Dealers are also mentioned in NOFP) submitted that the NOFP contributed to the depreciation of the Rand during 2001.

218. The SARB admitted that during the course of 2001, the Bank purchased foreign exchange proceeds which emanated from a number of large transactions. Their total purchases during the period covered by the Terms of Reference amounted to approximately USD 4.4 billion and were generated by Government's foreign bond issues and two large corporate transactions.

These purchases contributed to the decline in the NOFP to USD 4.8 billion at the end of 2001.

If the proceeds of these large transactions had been allowed to flow through the market the Rand could have appreciated significantly.

The SARB has argued that any negative impact on the exchange rate of the Rand is offset by the positive perceptions in the market in that a major negative influence on the currency is being actively addressed.

The specific reductions for 2001 are in the first quarter, USD 9.4 billion, second quarter, USD 5.3 billion, third quarter, USD 4.7 billion and fourth quarter, USD 4.8 billion. As at 12 March 2002, the NOFP stood at USD 2.9 billion.

THE 14 OCTOBER STATEMENT BY THE GOVERNOR OF THE SARB

Consideration of the impact of the statement issued by the Governor of the Reserve Bank on 14 October 2001 falls outside the Terms of Reference of this Commission. However, in view of the fact that it had been repeatedly mentioned by expert witnesses and Authorised Dealers as a factor that they believed contributed to the depreciation of the Rand, the Commission is of the view that it is necessary to deal with it in some detail.

In the course of 2001 and on account of the volatility of the exchange rate of the Rand, the SARB was informed by players in the foreign exchange market that speculative transactions, particularly by non-residents were adding to volatility and Rand weakness. It was informed that investors and other emerging markets with less liquid financial markets were using the South African market as a hedge for the weakness in other countries.[78]

The SARB either had a choice of abolishing the remaining exchange controls or to apply the existing rules and regulations equitably to all.

The Bank became increasingly concerned that excessive volatility in the foreign exchange market during the 3rd quarter of 2001, exacerbated by the tragic events of 11 September 2001, negatively influenced inflation, business decisions and the economy as a whole and therefore issued a statement on 14 October 2001.[79]

227. Part of the statement read:

78 See Annexure 20
79 Mboweni, Record, p 661

"The Reserve Bank stands ready to take appropriate firm steps against trading activities inconsistent with existing rules and regulations. The enforcement of existing rules serve to ensure that only legitimate transactions take place in the foreign exchange market. This does not restrict, for example, the ability of a non-resident investor to either hedge or repatriate the sale proceeds of an investment in South Africa. It does, however, exclude the financing of short Rand positions in the domestic markets, which is consistent with the requirement that domestic borrowing by non-resident investors is subject to certain restrictions. This communication should not be construed as an attempt to restrict the activities of banks in the South African market, provided they adhere to the existing rules and regulations. Normal commercial and financial transactions remain unaffected. "[80]

228. The statement mentioned the NOFP as follows:

"The net open foreign currency position (NOFP) declined from USD 23,2 billion at the end of September 1998 to USD 4,8 billion. Given the negative perceptions resulting from the NOFP, the Reserve Bank reduced its position by purchasing foreign currency in a domestic foreign exchange market, which may have contributed to the depreciation of the Rand over this period."[81]

229. The statement further advised that Government would not intervene in the foreign exchange market.

"In future, the Reserve Bank will not intervene by purchasing foreign exchange from the market for purposes of reducing the NOFP. The NOFP will be expunged from cash-flows derived from

80 Statement is contained in Annexure 20

81 Mboweni, Record, p 340 and 341

> *the proceeds of government's offshore borrowing and privatization.*[82] *The bank believed that applying the existing rules and regulations to exclude speculative trading from our foreign exchange markets will reduce volatility in the Rand's exchange rate and would be to the benefit of non-resident investors in South Africa."*

230. Before the SARB issued the statement, it invited the chief executives of domestic and foreign banks which have a presence in South Africa to a meeting on Sunday 13 October 2001. The chief executive of each institution was accompanied by the head of treasury in that institution.[83]

The purpose was to inform chief executives of the SARB's intention to issue the statement and the statement.

Only two banks, both foreign, raised concerns. The first was Citi Bank which raised a concern that the SARB action could result in the development of the offshore market, over which the Reserve Bank would have no jurisdiction.

The second bank that raised a concern was Deutsche Bank which argued that the SARB was focusing on the wrong target to enforce existing rules and that the target may be somewhere else.[84]

Following the statement issued by the Governor on 14 October 2001, the Exchange Control Department issued an Exchange Control Circular D 342 to the Authorised Dealers on 16 October 2001.[85]

---

82 Witness Bundle, SARB, Vol 7, p 341
83 Mboweni, Record, p 662
84 Mboweni, Record, p 662 and 663
85 The Circular is contained in Annexure 21

235. The Circular requested Authorised Dealers to ensure that their overseas counterparties are fully conversant with the Exchange Control Rules applicable.

236. The Circular read as follows:

> *"To ensure that the provisions of the various Sections of the Exchange Control Rulings are applied uniformly by all Authorised Dealers, in particular when dealing with non-residents in the forward and other derivative foreign exchange markets, we deem it necessary to reiterate certain fundamental principles in this regard."*
>
> *"It is incumbent upon Authorised Dealers to ensure that their overseas counterparties are fully conversant with the rules applicable to dealing in the domestic forward and other derivative foreign exchange market.*
> *It follows, therefore, that when dealing with a non-resident counterparty, other than a correspondent Bank, supporting documentary evidence must be obtained confirming that such non-resident counterparty has a legitimate South African exposure resulting from an accrual, investment or asset denominated in Rand. Where the required supporting documentary evidence is not available at the time of entering into a transaction, such documentation must be presented within 14 days for endorsement. In the case of correspondent Bank, a written confirmation every two weeks to the effect that all transactions have been executed within the ambit of the aforementioned rules, signed by the compliance officer, is acceptable. Copies of the endorsed supporting documentation as well as the written confirmations must be retained for inspection purposes.*

Trading operations may continue to be undertaken by non-residents in the domestic markets in respect of their assets, liabilities or future firm and ascertained commitments and/or accrual."[86]

The purpose of the Circular was to bring to the attention of the Authorised Dealers the Governor's statement and to explain its contents. The Circular is a restatement of the Rules and Regulations.

The Reserve Bank Market Working Committee under the chairpersonship of the advisor to the Governor, Mr Lambertus van Zyl, held various subsequent meetings with the working committee established by the Authorised Dealers and finalised the wording of the compliance letter requested from the correspondent Banks.

With regard to the Exchange Control Rules and Regulations, it had also been decided to bring pertinent matters to the attention of non-resident counterparties. A notice for the attention of relationship managers, compliance officers and dealers was then issued through ACI to all Authorised Dealers for distribution to their foreign correspondent Banks. [87]

It was stated in a notice that the measures taken by the SARB on 14 October are not retrogressive in nature and represent an application of existing rules and regulations.[88]

This notice read in part:

The South African Reserve Bank has decided to ensure that existing exchange rules and regulations should be applied. After consultation with the Reserve Bank, the South African Authorised

86 Witness Bundle SARB, p 6, 215
87 Bruce-brand, Record, p 568 – the notice is extracted at Witness Bundle SARB Vol 6, p 224
88 Bruce-brand, Record, p 568

Dealers decided to inform their correspondents abroad of the requirements to deal in the South African foreign exchange market. We are of the opinion that the measures being applied are not retrogressive in nature and represent an application of existing rules and regulations. The authorities have no intention of generally denying non-residents access to the foreign exchange market, but believe that in the interest of fairness, existing rules should not only be applied to resident and non-resident investors in South Africa as is currently the case, but also to non-residents who have only a trading interest in the South Africa foreign exchange market. It should also be clear that the rules and regulations apply very specifically to the financing of short Rand positions in the foreign exchange and domestic financial markets."[89]

It appears that notwithstanding the explicit emphasis in the notice that the South African authorities remain committed to the orderly and gradual process of relaxation of exchange control and that the statement was in effect a restatement of existing exchange controls, it was misinterpreted by market participants. The SARB Governor stated in his evidence to the Commission that in some instances this misinterpretation was deliberate.[90]

Misinterpretation relates to the fact that instead of regarding it as a stricter enforcement of existing exchange controls, it was interpreted as a tightening of such controls.

Though there was no tightening of exchange control or rules, there was a new requirement that Authorised Dealers procure from correspondent non-resident banks a written statement, a letter of compliance letter from the compliance officer of the banks, that a firm and ascertainable commitment or accrual existed prior to entering into any foreign exchange

89 Bruce-Brand, Witness Bundle SARB, Vol 7, pg 344
90 Mboweni, Record 664

transaction. The Authorised Dealer previously had this obligation but the written certificate was not required.

Witnesses to the Commission argued that the statement reduced liquidity in the market. Foreign banks could have decided as a precautionary measure to avoid finding themselves in contravention of exchange control rules, and reduced their level of activity in South Africa's foreign exchange market.

However in his evidence the Governor of the SARB stated that:

> *"the causality could have been the other way, i.e. sharp movements in the Rand's value could have created uncertainty leading to the widening in the bid- offer spreads and a reduction in liquidity*".

247. In terms of the figures reported to the SARB, the net daily turnover in the Rand foreign exchange market had declined from an average level of USD 7.4 billion in October 2001 to USD 5.5 billion in November 2001 but increased again to a level of USD 6.1 billion during the week of 15^{th} December 2001.

248. The most significant decline was in the stock market where the average daily net turnover declined from an average level of USD 5.8 billion in the first ten months of 2001 to an average USD 4.3 billion for the last two months. The turnover of non-residents – the most significant participants in this market – declined from USD 3.6 billion to USD 2.3 billion respectively. [91]

While it is accepted that turnover alone is not a perfect measure of liquidity, it does represent a reasonable proxy. When assessed together

91 Bruce-Brand, Record

with a widening of a bid-offer spread from 50 points to, at times, 1000 points, it does appear that liquidity in the foreign exchange market was affected.[92]

The issue of liquidity also arises when considering volatility. One month historical volatility of the Rand's exchange rate against the US dollar increased from a level of 9.1% in the first 9 months of 2001, to an average of 20.5% for the last quarter.[93]

251 These volatilities reached a high of 55% at the end of December 2001

252. As a result of the concern by the Minister of Finance and the Governor at the rate of depreciation, they issued a joint statement on 21 December 2001. The statement focused on the solid macro economic fundamentals and on the prudent policies being employed. The statement's concluding paragraph read as follows:

> *"In this uncertain environment, many experts and commentators have emerged, all with views and policy advice. While constructive input from stakeholders is always appreciated, it is important to point out that much of the volatility is driven by sentiment and opportunism. It is in times such as these that we should respond as a country, with full confidence in ourselves and the policies we have adopted."*

It was argued by expert witnesses that the statement was problematic in the following ways:

253.1 it led to confusion in the foreign exchange market generally and specifically among non-resident banks;

[92] See volume 9 Lambertus Van Zyl
[93] Mboweni, Witness Bundle, SARB, Vol 7, p 45

253.2 it made the foreign exchange market illiquid as a result of the exit of non-resident banks and traders.

The 14th October statement, liquidity and depreciation of the Rand

Witnesses sought to make a direct link between the lack of liquidity and the depreciation of the Rand. They argued that in an illiquid market, even small transactions that would not normally affect the exchange rate in a liquid market, affected the exchange rate in December. They therefore blame the depreciation in the exchange rate of the Rand on the Reserve Bank's action in issuing the statement of 14 October 2001.

From the evidence heard by the Commission, there was a significant reduction in liquidity in the latter part of 2001. [94]

It is clear from the evidence placed before the Commission that liquidity was reduced in the latter part of 2001.[95]

Both Abedian and Glynos acknowledged though that the 14 October 2001 statement removed "pure" speculators from the market which was one of the intentions of the 14 October 2001 statement by the SARB. It wanted to ensure that both resident and non-resident banks complied with all Exchange Control Regulations.

258. Glynos has stated that he believes the Reserve Bank's statement of 14 October 2001 was successful in scaring off speculators.[96]

94 See Graph 3 in SARB Volume 9
95 See Gouws Bundle, p 125
96 Glynos, Record, p 467

259. During cross examination by Counsel for the Reserve Bank, witnesses for FirstRand Bank Limited and Investec conceded the following with regard to the 14 October statement and Circular D342 respectively:

that Circular D342 was drafted by Authorised Dealers in response to the 14 October statement by the Governor of the Reserve Bank and was in effect a collaborative effort between the Reserve Bank and the Authorised Dealers. It was presented to the Reserve Bank for its final approval and only thereafter made public;

that the meaning of the Circular was unambiguous and easily understood by a reasonable Authorised Dealer and foreign correspondents;

259.3 that the wording of the compliance letter to be signed by non-resident banks was a collaborative effort between the SARB, (resident Authorised Dealers) and the Association of Commercial Authorised Dealers (ACI)[97];

made compliance with Exchange Control Regulation easier in that unlike a previous requirement (B7) where confidential information including the names of parties and the details of the transaction had to be forwarded by non-resident banks to the resident Authorised Dealer, only a written confirmation every two weeks to the effect that all transactions have been executed within the ambit of foreign exchange rules signed by the compliance officer was now acceptable;

259.5 removed the limitation that South African Authorised Dealers

97 Testimony of Jurie Bester, Head of Risk and Audit services for FirstRand Bank Limited, Record, p 1369 to 1374

could only deal with foreign banks and not foreign corporates and individuals.[98]

J. IMPACT OF ILLIQUIDITY IN THE MARKET ON THE EXCHANGE RATE OF THE RAND

The evidence of Mr Robert McCauley presented to the Commission confirmed that in a market where liquidity has been reduced, more often that not, a transaction of a given size can have a bigger effect than it has in a normal liquid market but that there is not necessarily a direct link between lack of liquidity and depreciation of a currency. Lack of liquidity therefore cannot on its own constitute an explanation of depreciation of the Rand. Referring to the statement of 14 October he stated that:

> *"….. to the extent that you focus on general liquidity, you can get decline in liquidity after such a measure and that, considered all by itself, can give you larger reaction to subsequent transactions that go through the market….yes the question is whether a less liquid market sort of explains a subsequent decline in the exchange rate and I guess that is a bit problematic. A less liquid market may mean that whatever flows go through, have more effect but that leaves the flows and the balance between supporting the currency and depreciating the currency sort of left unexplained."*[99]

In some instances the impact could be positive for example, if there are short positions that have to be closed out after a new measure is taken, the currency may appreciate. He illustrates this by indicating that when the Malaysian Central Bank on 1 September 1998 announced that they were imposing capital controls, the Malaysian Ringit appreciated

98 Pauline Trollop, Global Head of Treasury Compliance, Investec, Record, p 1421 to 1425
99 McCauley, Record, p 82

considerably after that. The specific circumstances in each case will determine the impact on the exchange rate.

The Reserve Bank also led evidence which questioned a simplistic linking of lack of liquidity with depreciation of the currency during 2001. Mr Lambertus van Zyl, former General Manager International Banking Department and currently advisor to the Governor, stated that there is no consistent relationship between changes in turnover in the domestic Rand foreign exchange market and the level of the exchange rate of the Rand. He illustrated this by looking at both the long term and short term causal link. For the purposes of the example, the total turnover in the domestic Rand foreign exchange market was used.

In 1996 the Rand depreciated from an average of USD1/ZAR3.6410 in January to USD1/ZAR4.2057, in April. This was a depreciation of 15,5%.[100] Over the same period the average daily turnover in the domestic Rand foreign exchange market increased by almost 42% from USD3.019 billion to USD4,284 billion[101]. Total turnover by non-residents increased by some 79% from USD0,683 billion to USD1,223 billion. It would appear as if a sharp depreciation of the Rand at the time coincided with an increase in turnover and particularly, an increase in turnover by non-residents.

264 In 1998 the Rand again depreciated sharply. Having traded at a monthly average of USD1 = ZAR4.9357 in February, the Rand fell by 26,4% to an average of UDS1 = ZAR6.2386 in July[102]. Over the same period total average daily turnover increased by some 139% from USD3,093 billion in February to USD7,395 billion in July[103]. Once more turnover with non-residents increased, this time by 213% from USD1,323 billion in February

100 See Graph 3 in Volume 9
101 See Graph 4 on p 17 of SARB Volume 9
102 See Graph 3 on p 17 of SARB Volume 9
103 See Graph 4 on p 17 of SARB Volume 9

to USD4,138 billion in July. Over different periods the increase in turnover was even more pronounced as it peaked at a level in excess of USD11 billion in June 1998.

The above shows that in the specified previous periods of Rand weakness, sharp depreciations of the currency coincided with significant increases in turnover in the domestic Rand foreign exchange market, and in particular with non-residents. This does not mean that increases in turnover would normally lead to a weaker Rand nor that increases in turnover would inevitably lead to a weaker Rand.

Turnover in the domestic Rand foreign exchange market increased significantly early in 1999 without a sizable depreciation of the Rand. In January 1999 the average daily turnover was USD6,855 billion. By June 1999 the average daily turnover had increased by almost 33% to USD9,089 billion. Over the same period the average daily exchange rate depreciated by a relatively small percentage of 1,7% from USD1 = ZAR5.9835 in January to USD1 = ZAR6.0883 in June.

Over shorter periods the link between turnover and the exchange rate is also uncertain.[104] For instance, the Rand averaged at USD1 = ZAR11.5467 in December 2001, fluctuating significantly and briefly depreciating to USD1 = ZAR13.84, on an average daily turnover of USD6,051 billion. In February 2002 average daily turnover had declined by 19,4% to USD4,876 billion, but the Rand was more stable, trading at an average exchange rate of USD1 = ZAR11.4847.

While much of the focus of economists giving evidence before the Commission was on the depreciation of the Rand after 14 October, the

104 See Graph on p 3 hereof

Rand had been on a steady depreciating trend since the beginning of the year, accelerating in July.[105]

FINDINGS

Statutory Duty of the SARB

The statutory duty of the SARB is to intervene and administer exchange control policy and protect the value of the currency in the interest of balanced and sustainable economic growth in South Africa.

The volatility in the foreign exchange market during the third quarter of 2001 negatively influenced inflation, business decisions and the economy as a whole. The SARB's decision to issue the statement of 14 October 2001 was necessary. It was a measured statement which called on market participants to observe existing Exchange Control Regulations. It was careful to set out which transactions were legitimate and indicated that it would enforce existing exchange control measures. It went further and indicated that it had no intention of restricting the activities of banks in the South African market and more importantly reassured participants that it would not intervene in the market by purchasing foreign exchange for the purposes of reducing the NOFP.

From the evidence placed before the Commission, it is difficult to understand how Authorised Dealers, resident and non-resident, and other participants could not understand the 14 October statement or Circular D342. It may be that both South African and non-resident banks and commentators did not like the statement. This is no basis however for suggesting that the statement was confusing.

105 See Graph on p 33 hereof

The SARB took a range of steps to ensure that market participants understood the rationale for the statement.

There was only one change, not in policy, but in compliance with existing policy namely the written confirmation by a compliance officer of a non-resident bank to the effect that transactions were in accordance with South African Exchange Control Regulations. But even this measure, as the evidence shows, was a simplification of the same requirement in that it reduced the number of details that had to be provided.

The Commission is further of the view that no basis exists for linking the issuing of the 14 October statement and Circular D342 on the one hand and the depreciation of the Rand in 2001 on the other. There is no doubt that liquidity significantly reduced in the foreign exchange market after the issuing of the statement. There was no evidence placed before the Commission which showed a consistent link between lack of liquidity and contributed to the depreciation of the Rand either in 2001 or historically. Cogent evidence was placed before the Commission which shows the contrary.

What the action of the Reserve Bank resulted in, was to remove pure speculators and other participants who probably were not complying either with the letter or the spirit of Exchange Control Regulations. It may be that non-residents who felt unhappy about having to complete the compliance letter also decided not to trade in the South African market.

It seems to the Commission that if the Reserve Bank had not taken the step it did, the volatility would have continued and possibly increased and the currency may have depreciated further. Glynos states that given the conditions in the market during the third and fourth quarter of 2001, market talk and expectations were that the Rand would be approximately R20,00 to the US Dollar.[106]

277. The action of the Governor of the Reserve Bank more than likely contributed to halting the slide of the Rand. This can be seen by the fact that the Rand has stabilised and appreciated while the levels of liquidity have remained low at least insofar as figures are available from the Reserve Bank for February 2002.

106 Glynos – Witness Bundle, p 433