Part D: Factors which might have contributed to the rapid depreciation of the rand

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Table of graphs, charts, diagrams and tables contained in Part D (continued)

D Factors which might have contributed to the rapid depreciation of the rand in 2001

[1] Factors which in general affect an exchange rate

1

1.1 Exchange rates and inflation

Inflation is a general rise in prices or a particular fall in the value of the currency in purchasing power terms. The internal purchasing power of a currency and its external value, ie its exchange rate, are broadly related and they tend to move over time together. Historically South Africa has had a faster than average inflation rate *and* the rand has had a declining trend against, for example, the US dollar: those two observations are consistent with the view that the internal purchasing power of a currency is related to its external purchasing power.

1.2 Exchange rates and export prices

Generally, better prices for a country's important exports tend to strengthen its currency. This is particularly true of commodity exporters such as Australia, Canada, New Zealand and South Africa. The exchange rates of those countries over time have tended to rise and fall with their major export prices. If the prices go up, there is generally more export value; producers spend more in foreign currency to buy the domestic currency, which tends to push up the currency on a simple supply and demand basis.

1.3 Exchange rates and interest rates

A currency with above average inflation and that tends to depreciate will tend to have higher than average interest rates. From a non-resident perspective, a higher interest rate compensates roughly and over time for capital losses from currency devaluation. Raising interest rates (in South Africa the repo rate in the first instance) tends to support the domestic currency by making it more attractive to hold and more expensive to borrow or short.[1]

1.4 Exchange rates and portfolio shifts

1.4.1 Mr McCauley expounded the proposition, which he said might not be the average view of economists, that if either residents or non-residents decide that they want assets denominated in a given currency, say the rand, then the tendency will be for that wish to be granted by the rand gaining in value or the underlying assets gaining in value or both. A portfolio shift away from the rand can take different forms – an outright sale of equities or bonds; a

[1] §1.1 to 1.3 are based on the evidence of McCauley Record 45

forward sale of the rand to hedge a long position or to establish a short position.[2]

1.4.2 Mr McCauley gave a sobering perspective on the significance, or rather lack of significance, of South Africa for foreign investors. Each country of the world enjoys a share in the world's portfolio of investments. The allocation to South Africa in that portfolio is less than 1%, probably as little as ¼%. By the time a foreign investor decides what amount to invest in South Africa, it has "really made all the important decisions already".[3]

1.5 Leads and lags

Mr McCauley expressed the opinion that while it may not on the face of it appear to be so, a type of portfolio shift occurs in the financing of imports and exports (leads and lags): every month of lead in payment and lag in receipts represents an outflow of a $^{1}/_{12}$ of trade. The leads and lags phenomenon makes the distinction between goods and financial services seem artificial in practice.[4]

1.6 Exchange rates and contagion

Contagion, as Mr McCauley pointed out, is a medical term and if you are going to catch a bug from somebody you need to come

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2 McCauley Record 45 - 46
3 McCauley Record 47
4 McCauley Record 48

into contact with the bug or someone having the bug. As the term is used in financial markets, however, there need be no contact. One must distinguish between contagion based on (1) trade links, (2) similarity and (3) profit or loss of investors. The *first* is clearly observable; the *second* reflects perceptions of investors; and the *third* suggests that risk arises from the character of the issuer of the financial instrument. Contagion through <u>trade links</u> arises when country A and country B compete in world markets. A depreciation of B's currency can hurt A's competitiveness. A loss of competitiveness can slow exports and economic activity and so lead to pressure for a depreciation in A. Contagion through <u>similarity</u> occurs in at least three circumstances:- <u>economic circumstances</u>: Country A's currency devalues. Investors analyse the economic reasons for the devaluation, identify country B with similar problems, and take their investments out of country B. <u>Asset class</u>: investors may reduce exposure to a whole "asset class" such as emerging markets or a subclass such as EMEA (East Europe, Middle East, Africa). <u>Policy or regime</u>: countries with similar policies or financial regimes are treated similarly. For example, the Argentinean crisis led to higher interest rates in Hong Kong because both had a dollar currency board. Contagion through <u>profit or loss</u>: profits or losses from one exchange rate can permit (force) positioning in (withdrawal from) another exchange rate. For example, in mid-1998, profits from short positions in the Japanese Yen allowed larger short positions in commodity exporters' currencies like the Australian, Canadian and New Zealand dollars and South African rand.[5]

[2] Determinants of the rand exchange rate

2 The exchange rate of the rand is determined by millions of decisions taken daily by

- South African consumers, corporates, foreign exchange dealers, institutional investors and various arms of Government;
- foreign banks, foreign corporates, foreign institutional investors, foreign governments, multi-lateral institutions (such as the International Monetary Fund ("IMF") and the World Bank) and foreign individuals such as tourists and consumers of South African products.[6]

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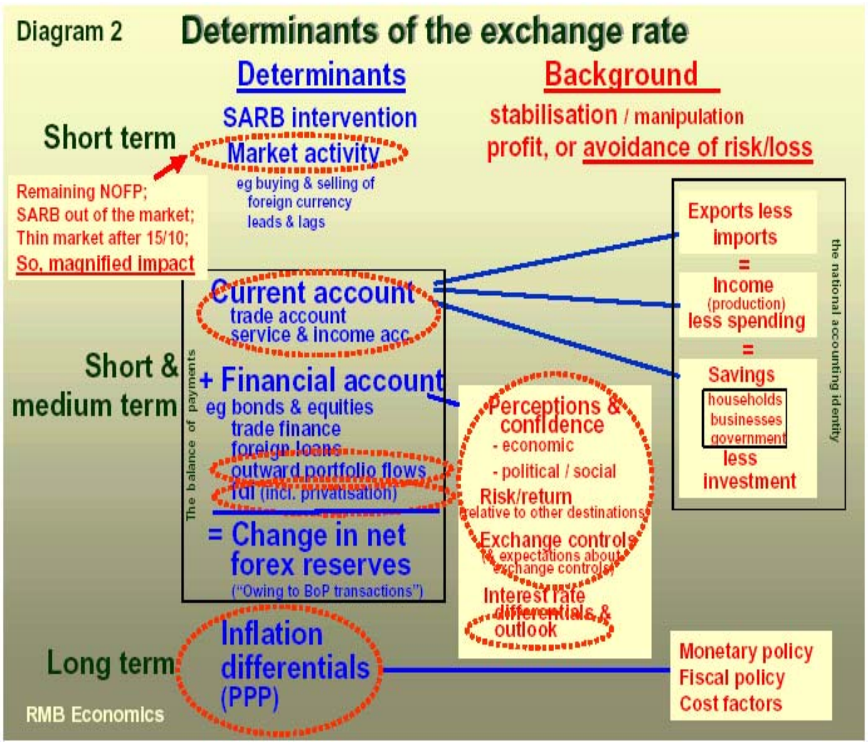
5 McCauley Record 50 - 55

6 Mr R Gouws, Chief Economist, Rand Merchant Bank, Expert Bundle 113

3

3.1 A convenient framework in which to consider the various factors that may have contributed to the depreciation of the rand in 2001 is to have regard to the determinants testified to by Mr Gouws and reflected in this slide:

Slide 2 <u>Expert Bundle</u> 118



3.2 In this report, the order in which the determinants are dealt with are:

(1) <u>Long term</u>: Inflation differentials

(2) <u>Short & medium</u> (a) macro-economic factors;

(b) perceptions/sentiment

(3) Short term: (a) the role of the Reserve Bank;

(b) speculation

(1) Long Term

Inflation differentials

4

4.1 A fundamental reason for the long-term decline of the rand was that the South African inflation rate was higher than that of its trading partners. The reason is that if the internal value of any one currency falls faster than the internal value of another, the external value of that currency would, over time, reflect that difference. So, for example, if the rate of inflation in the United States of America is 1% per annum and in South Africa 9% per annum, the depreciation by 8% will maintain the real value of the rand against the US dollar.[7]

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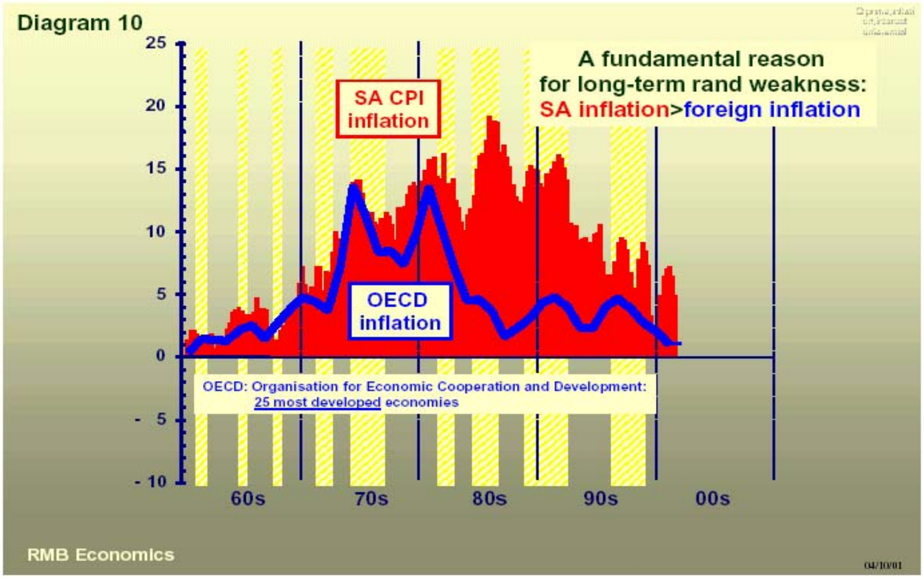
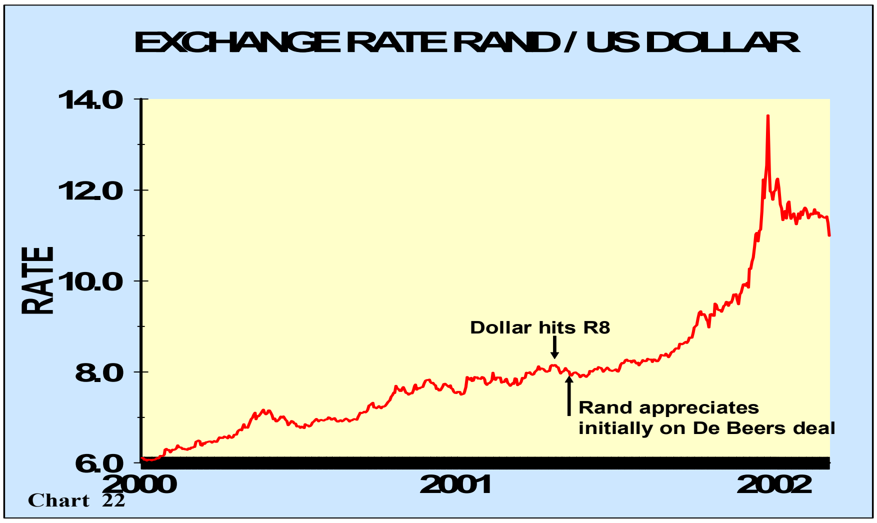
7 Gouws Expert Bundle 115; Stals Expert Bundle 170; Dr A Jammine, Director and Chief Economist, Econometrix (Pty) Ltd, Expert Bundle 301

Diagram 10 <u>Expert Bundle 122</u>



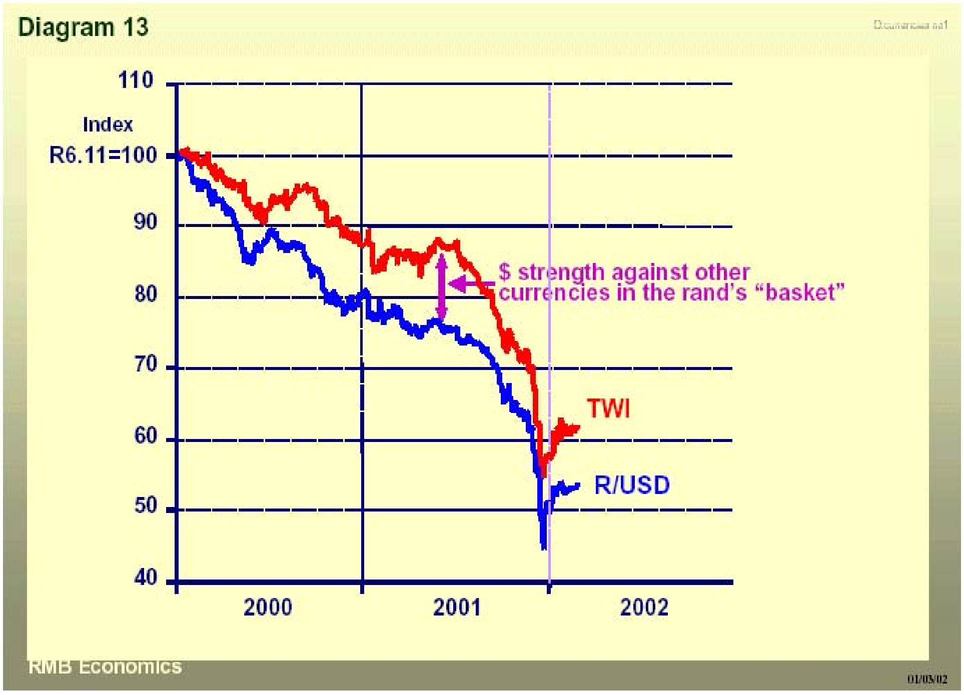
4.2 The slide in the value of the rand, in this phase, began in 2000. During 1999 the rand traded at about R6 to the US dollar, but by the end of 2000 it was trading close to R8 to the dollar, a depreciation of approximately 33%:

Chart 22 Expert Bundle 371



The Commission did not investigate the decline in 2000. One thing seems clear and that is that at least until September 2000 the decline could at least partly be explained by the strength of the US dollar. The strength of the dollar against the trade weighted index (TWI) is shown in this diagram:

Diagram 13 Expert Bundle 124



The TWI is based on weightings determined by the relevant importance of the trade of various countries with South Africa. The percentage weightings in the basket of currencies is shown below:

Diagram 14 Expert Bundle 124

Diagram 14

Rand trade weighted index

%Weightings in the Rand's "basket"

1.	Euro	35,7
2.	US	15,2
3.	UK	14,9
4.	Japan	10,3
5.	Switzerland	5,3
6.	China Mainland	3,1
7.	China Hong Kong	2,6
8.	Korea	2,6
9.	Zimbabwe	2,3
10.	Canada	1,9
11.	Sweden	1,8
12.	Australia	1,6
13.	Singapore	1,6
14.	Israel	1,2

RMB Economics

(2) <u>Short to medium term</u>

(a) <u>Macro-economic factors</u>

5

5.1 An imbalance between the total disposable income and total spending of a country is reflected in the net flow of goods and services into or out of the country. These cross-border movements of goods and services, together with a net movement of international capital to and from the country, influences the demand and supply for foreign exchange in the domestic foreign exchange market.[8] In a market where the exchange rate should be

8 Mboweni <u>Bundle SARB (07) 16</u>

free to find its own level, the supply of and demand for foreign exchange are the main factors deciding the eventual level of the exchange rate. An excess supply of foreign exchange should usually be associated with an appreciation in the exchange value of the domestic currency. Conversely, a shortage of foreign exchange can be expected to cause a depreciation of the exchange rate of the domestic currency.[9]

5.2 Demand for, and supply of, the rand are influenced by the state of the global economy. There was a rapid decline in the performance of the international economy commencing in 2000 and continuing in 2001, the upshot of which was a decline in hard currency liquidity in the market, leading to a downward pressure on the rand.[10]

5.3 The effect of the attacks on the World Trade Centre and the Pentagon on 11 September 2001 was the crash in global equity markets which ensued and, in the words of Jammine: "… increased risk aversion towards emerging markets still further and the rand was once again seen to be in the firing line of this sentiment. Commodity prices plunged in expectation of a dramatic deterioration in global economic growth prospects and this affected the rand

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9 Mboweni Bundle SARB (07) 16

10 Dr I Abedian, Chief Economist, Standard Bank of South Africa, Expert Bundle 276. See, too, for example, Stals, Expert Bundle 173

particularly hard and South Africa was seen as a predominantly commodity based economy. … The rand's depreciation from R8.52 at the time of the terrorist attack to R9.03 at the end of the month, was seen primarily as the function of South Africa's categorisation as an emerging market currency at a time when international investors were bailing out of emerging markets."[11]

5.4 The deterioration in the global economy and the events of September 11, 2001 had a negative effect on the South African economy, and hence on the rand, in two material respects: the flow of capital to emerging markets reduced and after September 11 international fund managers withdrew funds from what they regarded as vulnerable economies in what was described as a "flight to a safe haven".

5.5 In the first half of 2001, despite the global downturn, domestic income grew and gross domestic expenditure was less than national disposable income. Consequently, South Africa had a surplus of exports over imports. At the same time there was an inflow of capital into the economy. Given an ample supply of foreign exchange during this period, the exchange rate of the rand showed limited variation and by the end of June 2001 was

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[11] Jammine Expert Bundle 321; Mboweni Bundle SARB (7) 16-17

roughly at the same level as at the beginning of the year (R8 to the US dollar).[12]

5.6 In the second half of 2001, domestic spending exceeded total national disposable income: excess spending over income lifted total spending to a level 1.1% higher than national disposable income in the third quarter and 0.3% higher in the fourth quarter. The excess of total domestic spending over total national disposal of income was expressed in a deficit on the current account of the balance of payments. This imbalance created a need in the forex market for an inflow of international capital in order to limit downward pressure on the exchange value of the rand. The deficit on the current account of the balance of payments, however, was not matched by any inflows of international capital into the economy.[13]

5.7 When a deficit on the current account of the balance of payments is not accompanied by an inflow of capital, the deficit is widely perceived as a major source of exchange rate instability. Where the demand for foreign exchange exceeds the supply of foreign

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[12] Mboweni, Bundle SARB (07) 17

[13] Mboweni, Bundle SARB (07) 17, 20

exchange, a depreciation in the exchange rate of the rand could be expected as a normal market reaction.[14]

5.8 The following accounts are worthy of detailed analysis:-

<u>The services account in the current account of the balance of payments</u>.[15]

5.8.1 The shortfall on South Africa's services account with the rest of the world widened considerably from the first to the second quarter of 2001. This higher deficit was related to inward movements of foreign direct equity investment giving rise to dividend payments on non-resident shareholdings. Investment income received from offshore equity investments made by South African companies also increased, but to a smaller extent that the increase in dividend payments. The overall deficit on the services and income account widened from a seasonally adjusted and annualised value as follows:

First quarter	R37.2 billion
Second quarter	R47.1 billion
Third quarter	R48.6 billion

14 Mboweni <u>Bundle SARB (07) 17;</u> Stals <u>Expert Bundle 173-174</u>.

15 The balance on the current account of the balance of payments is the sum of exports and imports of goods and services out of and into South Africa. The current account consists of two accounts: the trade account and the services account. The services account records income payments and receipts, such as dividends, interest and employee compensation, transportation fees for goods and passengers, travel services and other services.

Fourth quarter R41.7 billion[16]

5.8.2 The financial account of the balance of payments

The financial account summarises the international capital flows and covers all transactions associated with changes of ownership in the foreign assets and liabilities of an economy. Three broad categories of investment are distinguished:

- direct investment;
- portfolio investment; and
- other investment.

5.8.3 The imbalance on the financial account of South Africa's accounts with the rest of the world changed from a surplus (or an inflow of capital) of R4.7 billion in the third quarter of 2001 to a deficit (or outflow of capital) of R1.5 billion in the fourth quarter.

(1) Direct investment

Foreign direct investment ("FDI") flows into South Africa are reflected in an increase in direct foreign liabilities. Direct investment is that category of international investment which reflects the objective of an investor in one country to obtain a lasting interest in another country.

[16] Mboweni Bundle SARB (7) 23

Non-residents invested direct investment capital into the South African economy during the first three quarters of 2001, but this changed to an outflow of R1.9 billion in the fourth quarter. South African companies increased their holdings of foreign direct investment assets by R5.4 billion during the fourth quarter of 2001, mainly by acquiring a dominant interest in the equity capital of foreign companies.

On a net basis, i.e. offsetting changes in direct foreign assets against changes in direct foreign liabilities, FDI changed from an inflow of R3.6 billion in the third quarter of 2001 to an outflow of R7.3 billion in the fourth quarter, thus contributing to the weakness of the rand.[17]

(2) Portfolio investment

Portfolio investment includes investment in equity and debt securities not classified as direct investment. Non-resident investors increased their holdings of domestic equity securities by R7.9 billion during the fourth quarter of 2001 but simultaneously reduced their holdings of domestic bonds by R10.1 billion. The net outward movement of portfolio capital totalled R3.4 billion in the

[17] Mboweni Bundle SARB (7) 23-25

fourth quarter. This raised the total net value of international portfolio capital outflows to R67.6 billion for the calendar year 2001 as a whole, compared with net outflows of R13.8 billion in 2000.[18]

(3) Other investment

Other investment is the category of the international capital that includes all transactions not covered by direct investment and portfolio investment and consists of trade credits, short-term and long-term loans and cross-border bank deposits. On a net basis, other foreign investment amounted to an outflow of R29.3 billion in 2001.[19]

5.9 The Governor summed up the impact of macro- economic factors on the rand in 2001 as follows:

"….the macro-economic scene in South Africa in the fourth quarter of 2001 was characterised by total domestic expenditure exceeding total disposable income. The excess of total domestic expenditure over total disposable income was expressed in a deficit on the current account on the balance of payments which was not matched by an inflow of foreign investment capital into the economy. In fact, capital left the country during the fourth quarter of 2001. This is a very significant factor for the exchange rate's behaviour during that period. Under

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18 Mboweni Bundle SARB (7) 25

19 Mboweni Bundle SARB (7) 26

circumstances such as these, a depreciation in the exchange value of the rand could be expected as a normal market reaction."[20]

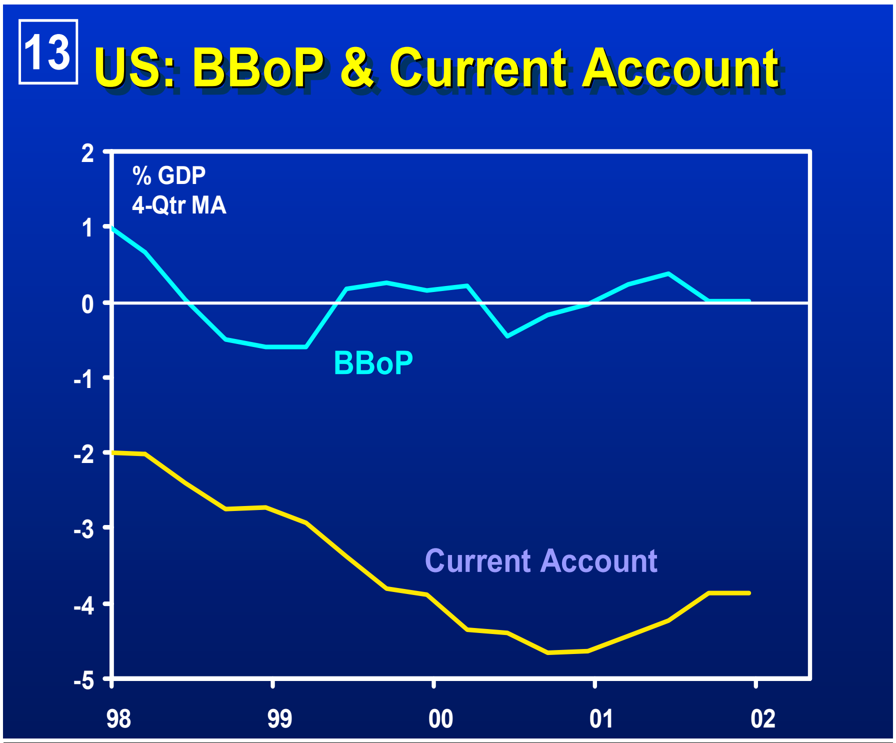
5.10 Dr O'Neill's evidence was that the balance of payments of a country should equal zero. The surplus on the one side should be exactly the same as the deficit on the other side. If one has a surplus in the current account, one should have a deficit in the capital account. The capital account includes net FDI, net portfolio flows (bonds and equities), short-term money flows and the central bank foreign exchange reserve changes. In total, those accounts should equal the current account. Dr O'Neill spoke about a concept known as the "broad basic balance of payments" (BBoP). BBoP is defined as the current account plus net FDI plus net portfolio flows. The general proposition is that a country with a BBoP deficit is likely to have a weak currency and a country with a BBoP surplus is likely to have a strong currency:-

(1) The USA current account balance of payments has deteriorated to such an extent that its deficit is about 4% of GDP, the highest it has been since the early 1970's. Despite that deficit, the US dollar has strengthened against many other currencies because the American BBoP has remained in surplus. The reason for the surplus is that the USA has

[20] Mboweni, Bundle SARB (7) 29

attracted large amounts of capital both in terms of portfolio flows and FDI. Those capital flows have more than off-set the US current account deficit.

Slide 13 <u>O'Neill Bundle 14</u>

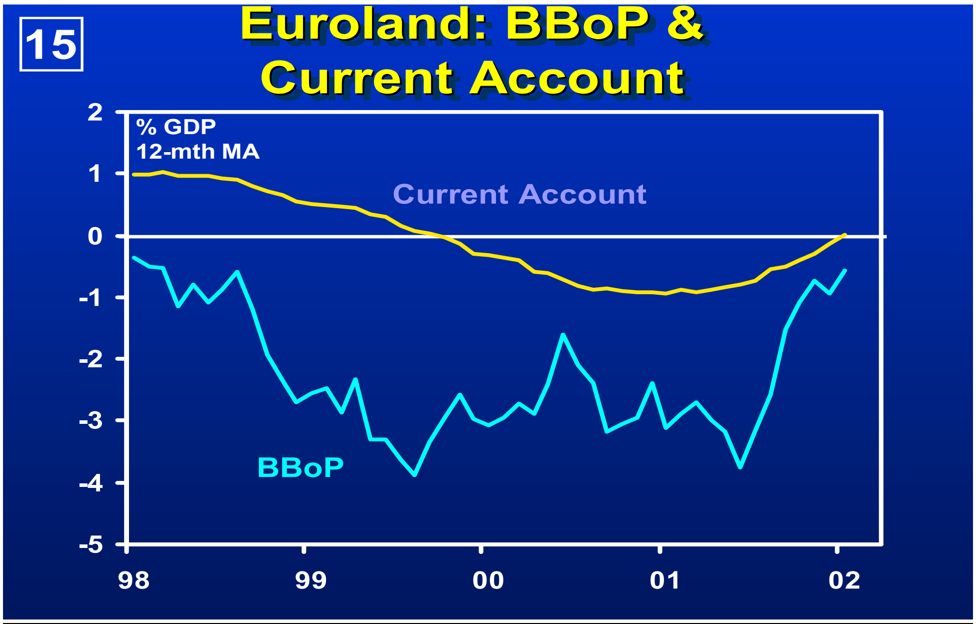


(2) In the early part of the euro's existence, Europe[21] had a small current account surplus. But through 1999 and 2000 Europe ran a large BBoP deficit, at times almost 4% of GDP. Europe failed to attract foreign capital, either FDI or portfolio flows,

21 For the purposes of this discussion, Europe is equated with the euro zone.

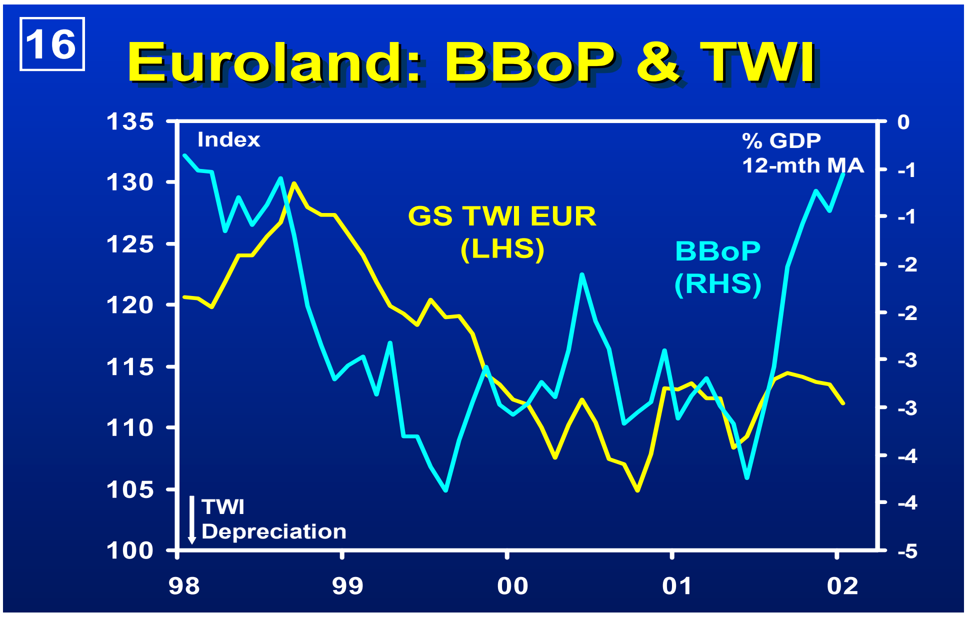
and foreign capital left Europe for the USA and other parts of the world.

Slide 15 O'Neill Bundle 16



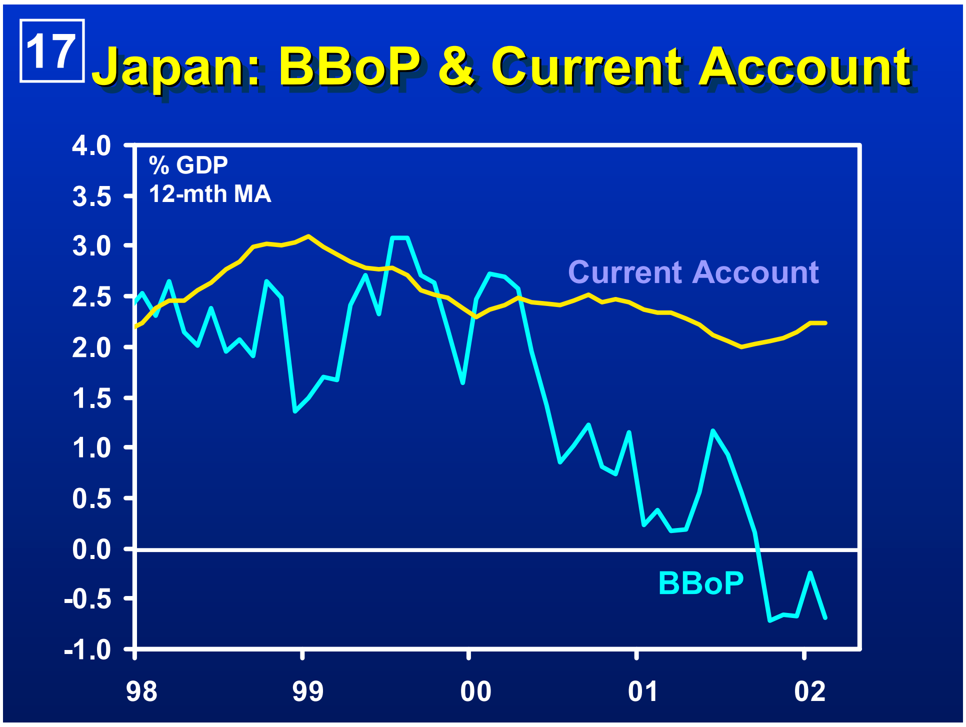
As the BBoP deficit of euro declined, the trade weighted exchange rate of the euro stabilised.

Slide 16 O'Neill Bundle 17



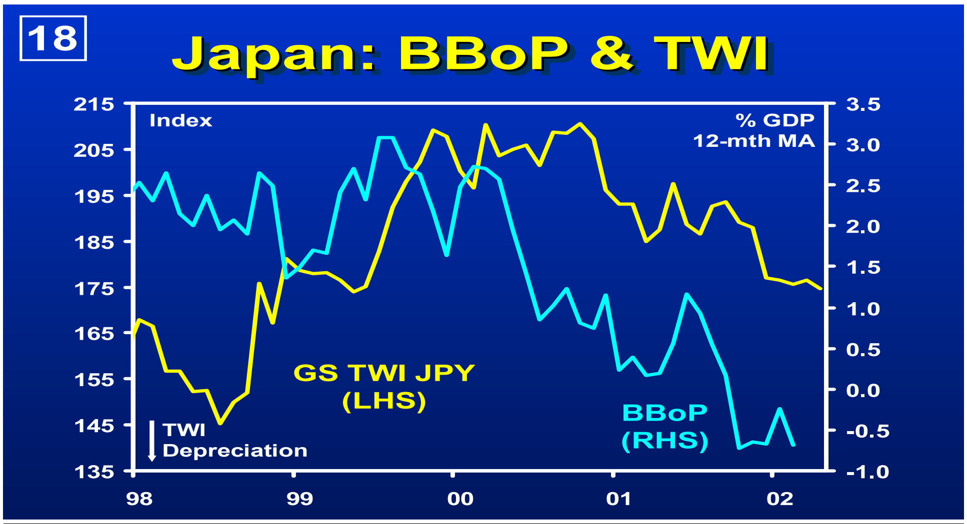
(3) For much of the period 1998 to 2002 Japan had a large current account surplus and a BBoP surplus. (While Japan had a BBoP surplus, the yen strengthened against the US dollar (as shown on slide 1, O'Neill Bundle 2; §1.3 Part C).

Slide 17 O'Neill Bundle 18



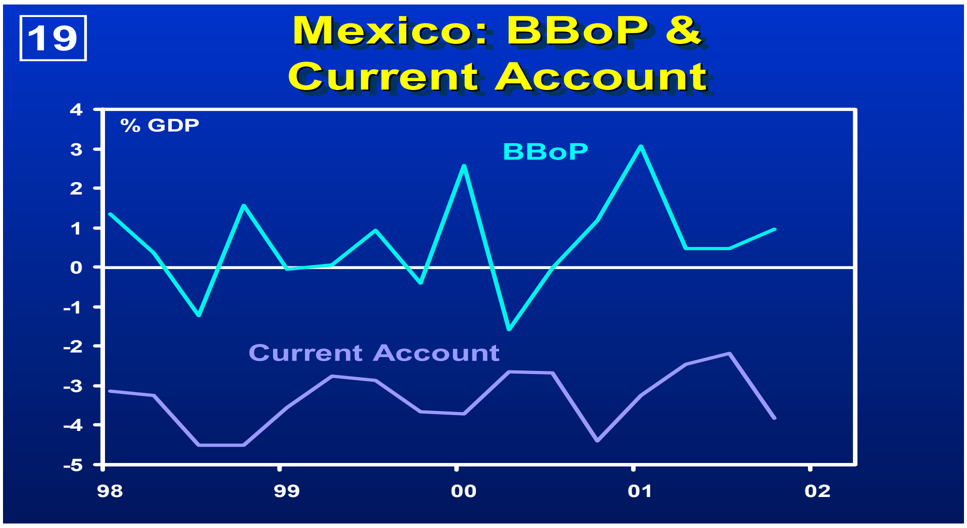
As the Japanese BBoP went into deficit, the value of the yen declined. In short, the strong BBoP surplus is associated with the yen's strengthening, while the BBoP surplus decline is associated with the decline in the value of the yen.

Slide 18 <u>O'Neill Bundle 19</u>



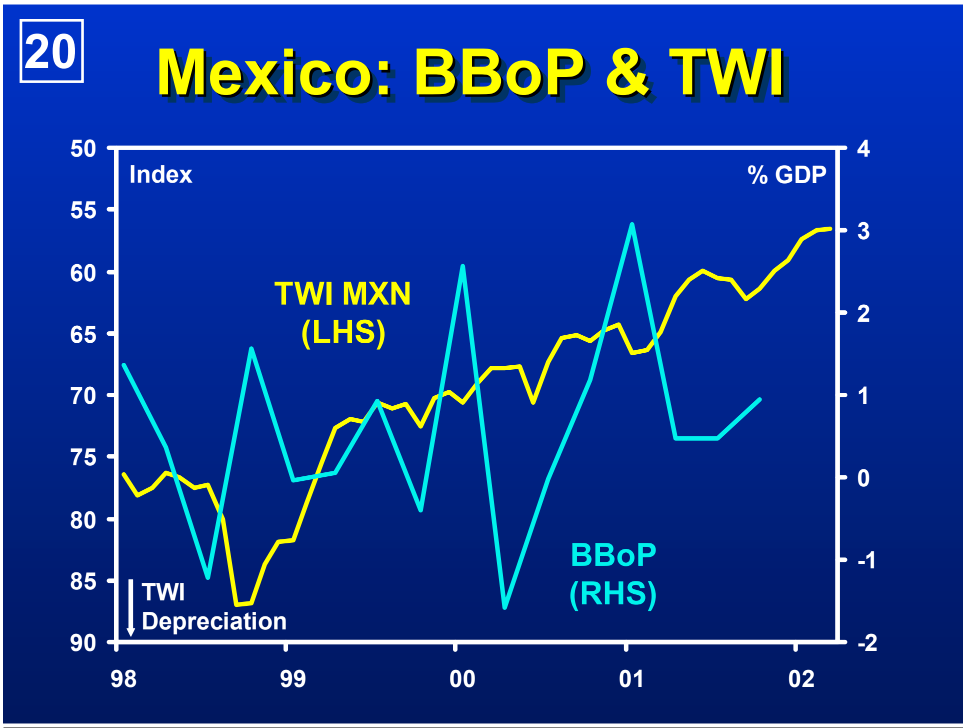
(4) The Mexican peso is one of the few currencies that has strengthened against the US dollar in recent years. The reason is that although Mexico has had a current account deficit, it has had a BBoP surplus, due mainly to large FDI inflows.

Slide 19 O'Neill Bundle 20



The consequence is that the peso has appreciated against the TWI.

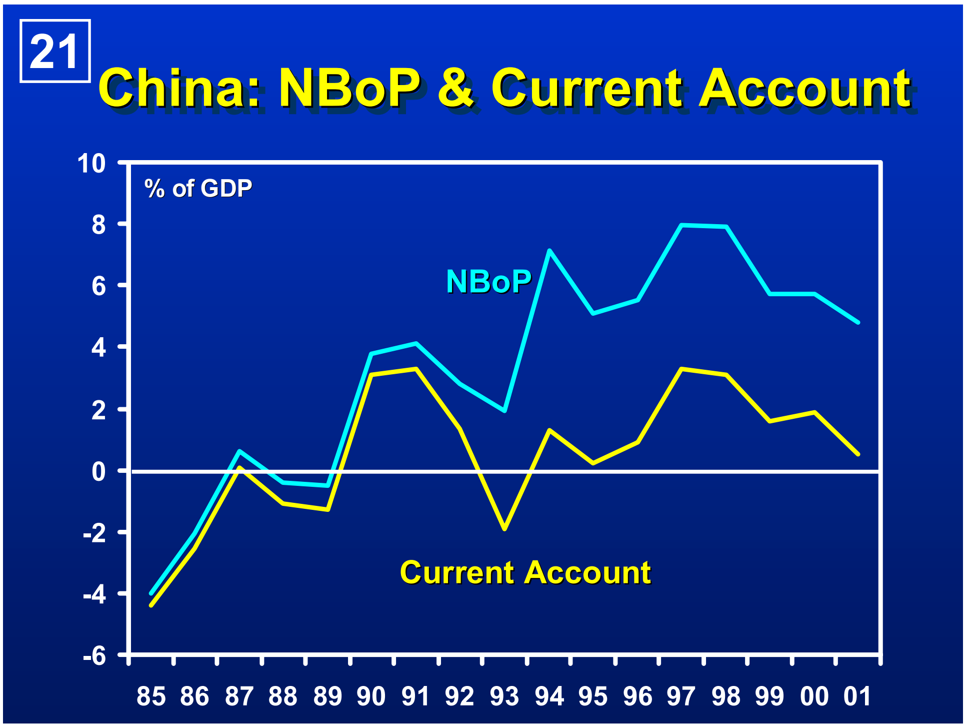
Slide 20 O'Neill Bundle 1



(5) China does not have liberalised financial markets. It is not generally possible for residents of China to buy foreign bonds or foreign equities and it is not possible for foreign residents to buy and sell Chinese equities or bonds. China does not have a completely open capital account. The concept of narrow balance of payments ("NBoP") is thus used. NBoP consists of the current account and FDI (and excludes portfolio flows). China has a large NBoP surplus because it has attracted

massive FDI: in 2002 China may attract FDI in excess of 5% of GDP.

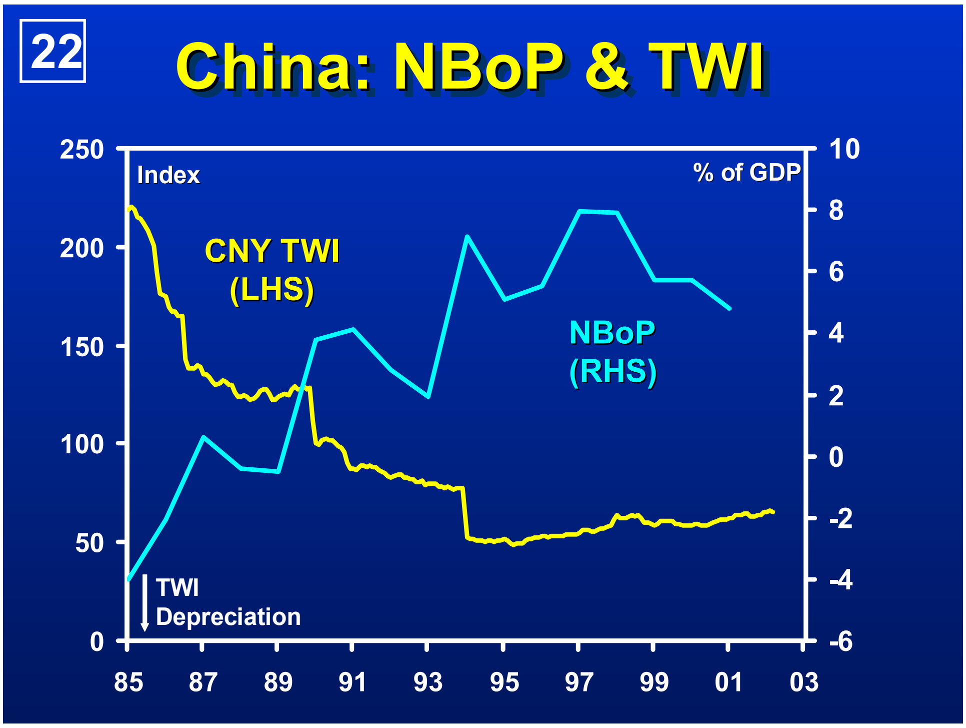
Slide 21 O'Neill Bundle 22



The result is that since about 1995 there has been a slow steady appreciation of the Chinese yuan or oemnimbi. The Chinese currency would probably have strengthened more if it had not been for the large accumulation of foreign exchange reserves by the Chinese authorities.[22]

22 Evidence of O'Neill, Record 1478-1480

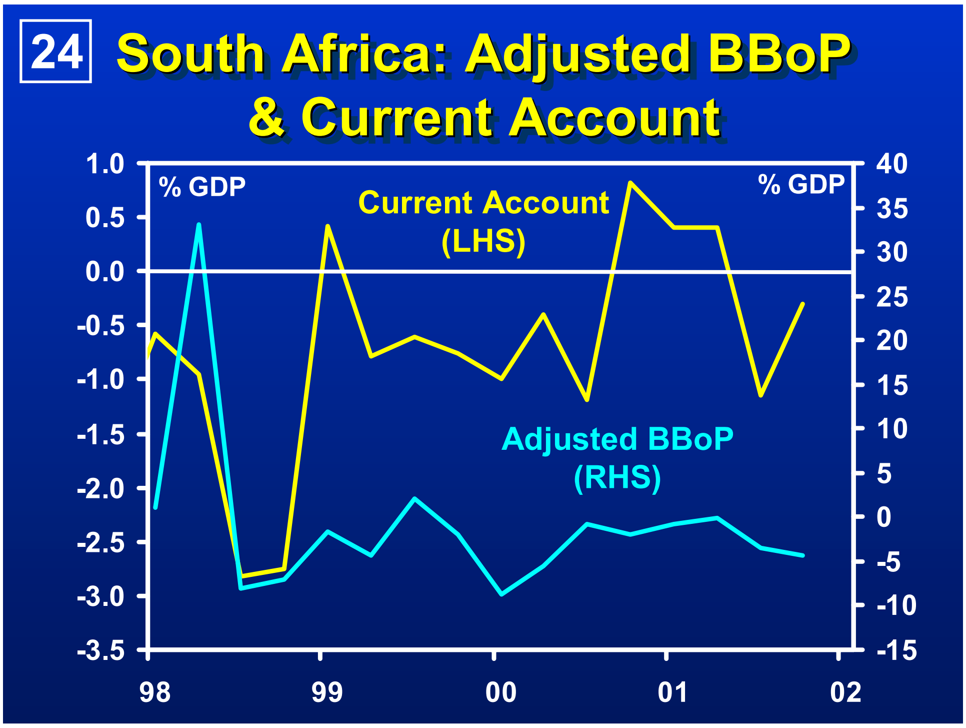
Slide 22 <u>O'Neill Bundle 23</u>



(6) Because of the NOFP, it is very hard to talk about the South African balance of payments in the same way as one does of other countries. Dr O'Neill therefore referred to the adjusted broad basic balance of payment or adjusted BBoP. Adjusted BBoP is the current account plus FDI plus portfolio flows plus the change in the NOFP. (The reduction in the NOFP is in effect the same as a large commercial outflow.) By and large, South Africa's current account balance has been very respectable for the past few years. However, when one takes into account the NOFP,

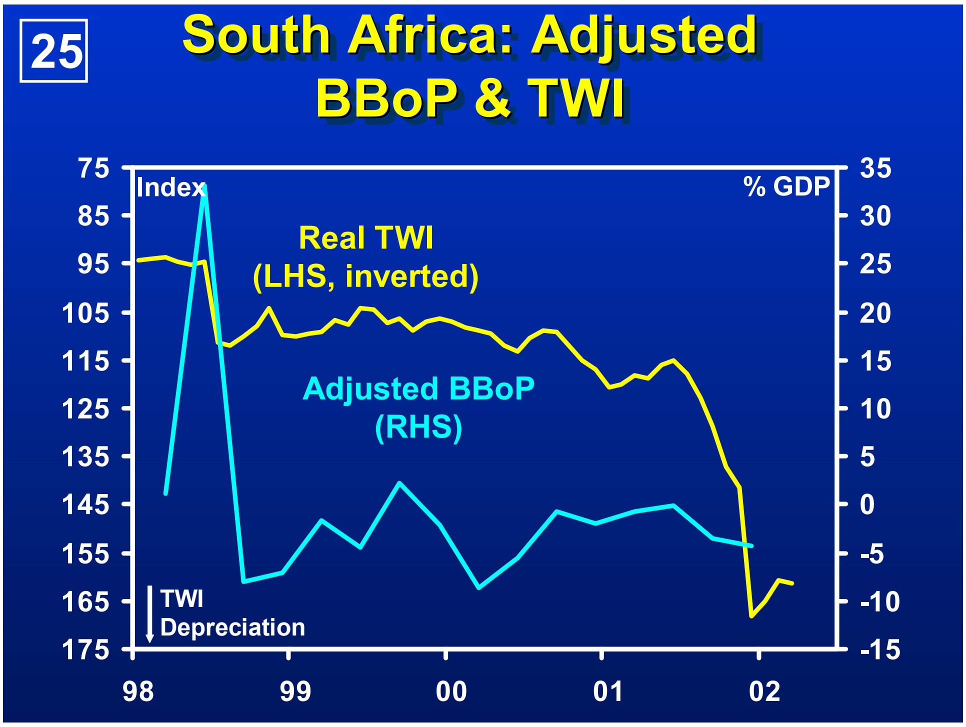
the adjusted BBoP has been significantly in deficit since 1998.

Slide 24 O'Neill Bundle 25



Having regard to the deficit in the adjusted BBoP it is *not* surprising that the rand depreciated in 2000. What *is* surprising is that it did not do so sooner.

Slide 25 O'Neill Bundle 26



An analysis of the accounts making up the adjusted BBoP quarter by quarter in 2001 shows that the adjusted BBoP as a percentage of GDP was:

Q1	Q2	Q3	Q4
-0.7	-0.1	-3.4	-4.3

It is absolutely no surprise, therefore, that the rand fell sharply in quarters three and four. The inference is that there were large capital outflows.[23]

(b) Perceptions/sentiment

6

6.1 During the latter half of 2001 there was a negative perception about South Africa and its currency, the rand. The Governor testified that regional instability, particularly in Zimbabwe, could have played some role in the weakening of the rand from May 2000 and also from June 2001. Other factors which the Governor said were regularly mentioned in the market were perceptions about unemployment, HIV/Aids, crime, the lack of progress with further privatisation, labour reform and investment incentives.[24] In the joint press statement by the Governor and the Minister of Finance of 21 December 2001 it was stated: "Increased risk aversion and growing negative sentiment towards the emerging markets have been further

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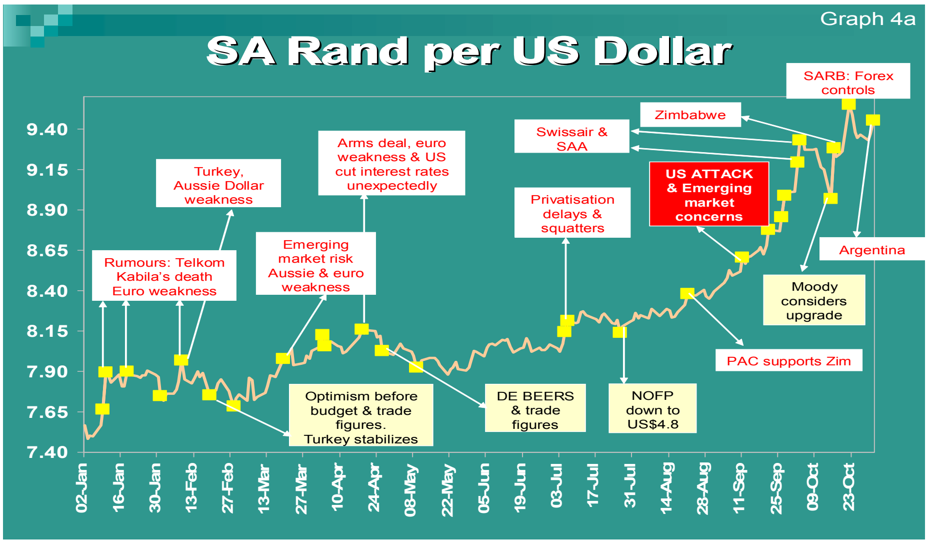
23 Evidence of O'Neill, Record 1480-1484

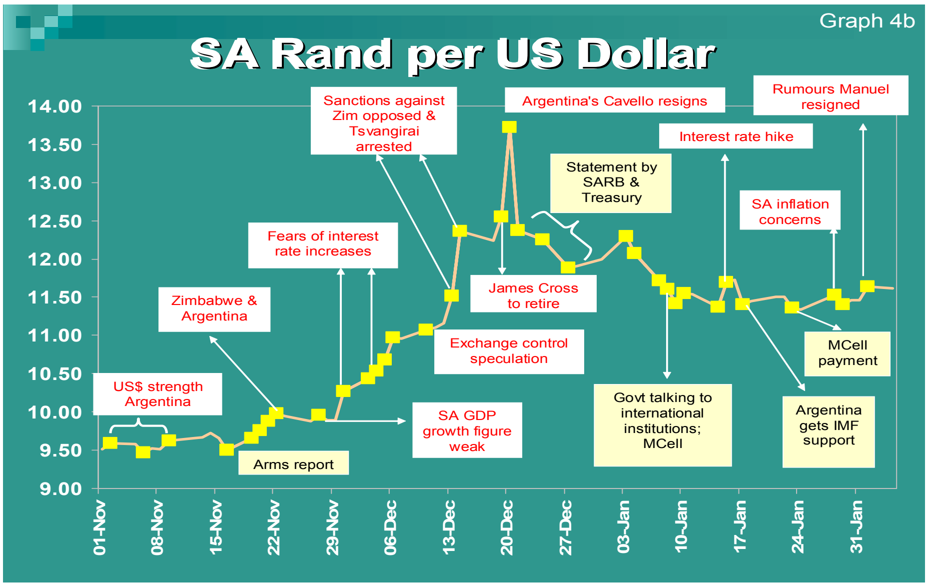
24 Evidence of Mboweni, Bundle SARB (7) 38

fuelled by the Argentinean crisis. In our region, events in Zimbabwe have also impacted negatively."[25] Mr Luüs, in addition to the factors mentioned by the Governor, added others, some of which were high and rising levels of unemployment, threatening socio-economic stability; a perceived lack of labour market flexibility, compounding the unemployment problem and being detrimental to higher productivity growth; low savings and fixed capital formation levels, constraining the economy's long-term growth potential; dissatisfaction amongst poverty stricken people because of growing economic illiquidity; the civil service was considered to be bloated and inefficient; the country's infrastructure, notably railways and roads, was not being maintained properly[26]. The factors, negative and positive, which might have impacted on the rand are shown graphically:

[25] Bundle SARB (7) 347
[26] Evidence of Mr CW Luüs, Chief Economist, ABSA Group Ltd, Expert Bundle 210, 211

Graphs 4A and 4B Expert Bundle 222-223





6.2 Mr Dykes[27] testified that sentiment played an important role in the rand's weakness in 2001. Negative sentiment towards South Africa was based partly on the Zimbabwe crisis and the emerging

27 Chief Economist for the Nedcor Group, Nedcor Bundle 7. See, too, the evidence of Bester, FirstRand Bundle 18; De Villiers, Investec Bundle 36, Woollam, BoE Bundle 9; Morrison, Deutsche Bank Bundle 12; Potgieter, Standard Bank Bundle 47-49; §39 Part D

market woes in the form of Argentina and Turkey. In regard to Zimbabwe, contagion played a significant role in the minds of both foreign and domestic investors. There were, generally unspoken, fears that what had happened in Zimbabwe would be repeated in South Africa at some point in the future. Any hint of a threat to property rights – such as the episode regarding foreign participation in the private security industry – provokes investor fears. The situation in Argentina and problems in Turkey and Indonesia, increased risk aversion during the year. However, the situation was different to that of 1998 when contagion spread from Asia to Russia to South Africa and on to Latin-America.

6.3 In reply to the question posed by Goldman Sachs to 30 of its clients: "What is the biggest change that would be positive for the rand?" 21% said Zimbabwe, 14% said Aids and 10% said crime. It follows that 40% of the responses related to Southern African related concerns. [28]

6.4 The authorised dealers, in their replies to the Questionnaire[29] in describing what factors influenced the rapid depreciation of the rand in 2001, referred, inter alia, to poor emerging market sentiment; emerging market contagion; economic problems in

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[28] See <u>§36 Part D</u> below

[29] See <u>§41 Part D</u> below

Argentina; Zimbabwe and South African political factors. There was "generally poor market sentiment". The common factor influencing the rapid depreciation of the rand amongst the representative offices of the foreign banks was the political and economic instability in Zimbabwe.[30]

6.5 Conservative estimates had put the foreign currency inflows from *privatisation* in the 2001/2002 budget at R18 billion. The actual proceeds were only R2.3 billion. In Dr Abedian's words: "This had both perceptual and forex inflow implications. The rand had to be priced accordingly."[31] Dr Jammine emphasised the importance of privatisation from the point of view of foreign investors: they "saw privatisation almost as a litmus test of the government's commitment to investor friendly economic policies".[32]

6.6 A view is that the *exchange controls* which are still in force potentially deter foreign investment because foreigners believe that the gradual or sudden removal of such controls would lead to a gradual or sudden further depreciation of the rand; the partial lifting of exchange controls over the years has probably made the enforcement of the remaining measures much more difficult; and remaining exchange controls are rendering the rand a weak

30 See §42 Part D below
31 Abedian Expert Bundle 275-6
32 Jammine Expert Bundle 315. See, too Luüs, Expert Bundle 211-212

currency because of the fear that comprehensive exchange controls may again be implemented at any time.[33]

(3) Short term

(a) The role of the Reserve Bank

7 Exchange Rate Management

7.1 Mr McCauley testified that few countries are indifferent to the exchange rate. While the objectives of managing an exchange rate differ, there are six established objectives of exchange rate management:

Macro-economic concerns:

- prevent depreciation from raising inflation to unacceptable levels;
- prevent depreciation from undermining competitiveness of exports and thereby undermining incentive to invest in export industry;
- prevent depreciation from ballooning debts denominated in foreign currency, particularly those of government;

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33 Luüs Expert Bundle 213; see, too, Gouws, Record 94

Micro-economic concerns:

- reduce volatility of exchange rate;
- prevent loss of confidence: fear that decline may lead to expectations of further decline and lead normal players to back away from the market;
- prevent "disorderly" market as reflected in "gapping" of successive bid–ask spreads, widening of bid-ask spreads and an absence of a sense of two way risk.[34]

7.2 The instruments to manage an exchange rate are:

- "open mouth" policy;
- intervention;
- moving interest rates;
- imposing or tightening capital (exchange) controls.

Open mouth policy

This is almost universally used by policy makers. A person in authority, such as the minister of finance or the governor of the central bank, makes a statement about the exchange rate with the object to influence the exchange rate, for example, "I think a strong dollar is in the interest of the US economy". [35]

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34 McCauley Expert Bundle 60 - 61

35 McCauley gave this example: "… in the Philippines last August, the President….said that she thought that 50 pesos to the dollar was a pretty good exchange rate for the peso. It was then trading at more like 55 and strangely enough by the end of the year it was down to close to 50." Record 68

Intervention to support currency

Intervention can be done quietly or openly. Intervention may take place in different ways, for example, by sending the signal that interest rate hikes are likely to follow or through the portfolio effect by the central bank buying the domestic currency, which has the effect of offsetting the result of somebody selling the currency. This is particularly effective in a smaller country. The constraints of intervention by a central bank supporting the local currency are, for example, the concern that the intervention will be ineffectual and a waste of money, and the size of reserves – the central bank must have the wherewithal (reserves) to be able to support the domestic currency.

7.3 Raise interest rates to defend currency

Until quite recently, it was generally accepted that if a currency was under pressure, an effective way to defend the currency was to raise interest rates. But it may be hard to influence the exchange rate in a particular way: high interest rates can hurt growth and many investors associate growth with a strong currency and high interest rates may lead to a sale of bonds. The limits to the effectiveness of this kind of response were shown in the United Kingdom in 1992 and in the case of Europe in the past

15 months. The market has come to the conclusion, according to McCauley, that "the best thing for a currency is the prospect of growth returning to that economy and so raising interest rate or only slowly lowering them, might actually perversely hurt the currency rather than help it. So that is a pretty radical notion I have to admit, one that goes very much against the text books and everything they teach central bankers but there has been a suspicion out there that that is the way it is working actually."[36]

7.4 Tighten capital (exchange) controls

Exchange controls can take various forms, such as restrictions on borrowing lower yielding foreign currencies, on non-resident borrowing of local currency; and on residents purchasing foreign currency. The tightening of non-resident borrowing of local currency can immediately lift the domestic currency. The downside is that the longer term effects of such a policy are harder to gauge and there is an argument that by tightening exchange controls, you actually curb inflows.[37]

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36 McCauley Record 78
37 McCauley Record 79 - 80

The Reserve Bank

8 The Reserve Bank was established in 1921 as the central bank of South Africa in terms of the Currency and Banking Act, 31 of 1920. That Act was replaced in 1944 by the South African Reserve Bank Act, 29 of 1944. In 1989 a new Act was introduced, the South African Reserve Bank Act, 90 of 1989 ("the Reserve Bank Act"), which is still in force. In terms of the Constitution of the Republic of South Africa, 108 of 1996, ("the Constitution") and in terms of a 1996 amendment to the Reserve Bank Act, the primary object of the Reserve Bank is to protect the value of the currency of the Republic in the interest of balanced and sustainable economic growth in the Republic. The Reserve Bank enjoys an important degree of autonomy for the execution of its responsibilities in respect of domestic monetary policy. As far as exchange rate policy is concerned, however, the Reserve Bank and the Government are jointly responsible for determining the framework of policy. The day-to-day implementation of that policy is the function of the Reserve Bank.[38]

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[38] Mboweni, Bundle SARB (7) 5-7

Reserve Bank policies

9 In January 1979 the Government accepted this recommendation of the De Kock Commission of Enquiry into the Monetary System and Monetary Policy in South Africa: "The Commission recommends a unitary exchange rate system under which an independent and flexible rand finds its own level in well-developed and competitive spot and forward foreign exchange markets in South Africa, subject to Reserve Bank 'intervention' or 'management' by means of purchases and sales of foreign exchange (mainly US dollars), but with no exchange control over non-residents and limited control over residents". The De Kock Commission further recommended: "…whatever other objectives it (the Reserve Bank) might also have from time to time, intervention (in the foreign exchange market) should ordinarily be a smoothing operation." It was only after 1994 when South Africa could afford to commence phasing out exchange controls that the South African forex market reached the full status envisaged by the De Kock Commission and the "managed floating exchange rate" system for the rand was fully applied.[39]

[39] Stals, Expert Bundle 167–9; 179

10 On various occasions in the past the Reserve Bank intervened in defence of the rand. As the Reserve Bank did not have adequate foreign reserves, the obligations to deliver foreign exchange into the market were converted into forward obligations. The Reserve 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. According to the Reserve Bank Act, all profits and losses in respect of providing forward cover are for the account of Government. Over the years, huge losses were made owing to the existence of the NOFP.

11 In 1998 the Reserve Bank intervened in defence of the rand in two distinct ways: by use of the forward book, increasing the NOFP to USD23 billion and by raising interest rates from 14% in June 1998 to 25.5% in August 1998.[40]

12 By 2001 the Reserve Bank and the National Treasury had changed course.

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40 Jammine, Expert Bundle 309,310

13 Inflation targeting

13.1 A new monetary policy – inflation targeting – was introduced on 6 April 2000. Since then, the emphasis, in compliance with the Constitution, has been on domestic price stability, i.e. the reduction of inflation to lower levels in order to contribute towards balanced and sustainable economic growth.

13.2 The evidence of the Governor was that inflation targeting is a monetary policy framework implying the targeting of the inflation rate directly. Other intermediate variables influencing inflation such as money supply, credit extension or the *exchange rate* are not targeted directly, although they still play an important role in the determination of inflation. In the medium to longer term, successful inflation targeting should contribute to a more stable exchange rate for the rand.[41] Dr Stals said in evidence that he supported the concept of inflation targeting but that "… in any central bank the Governor has in his drawer much more than just an inflation target in mind because … in economics everything depends on everything else and the inflation target or the inflation result will be affected by a lot of other things that you just cannot ignore because … the Reserve Bank does not fix prices everyday and therefore it does not

41 Mboweni, Bundle SARB (7) 9

control inflation directly. It affects inflation through its operations in the money market, in the exchange rate environment, in the interest rate structure, in the liquidity of the banking system. So these are the operational instruments that you have to use and have to apply and have to take account of every day even if you have a fixation on inflation at the end of the day and ….whether that target of yours is the money supply or the level of interest rates or the amount of liquidity in the banking system or the bank credit extension or the exchange rate, they are all very much inter-related in a circular process – the one affects the other." [42]

13.3 In the Monetary Policy Review of the Reserve Bank dated March 2001 it was stated:

"Inflation targeting requires nominal exchange rate flexibility. In South Africa's case a fully flexible exchange rate regime has been adopted. This means that there is no specific target for the exchange rate. It does not however mean that the Reserve Bank is not concerned about the exchange rate, as exchange rate changes do feed into the inflation process. A depreciation of the currency directly affects the price of imports. Then there are the possible second-round effects where higher import prices feed into wage and other price increases."

13.4 It is the view of Dr O'Neill that inflation targeting is very important for South Africa and the rand has great relevance in the

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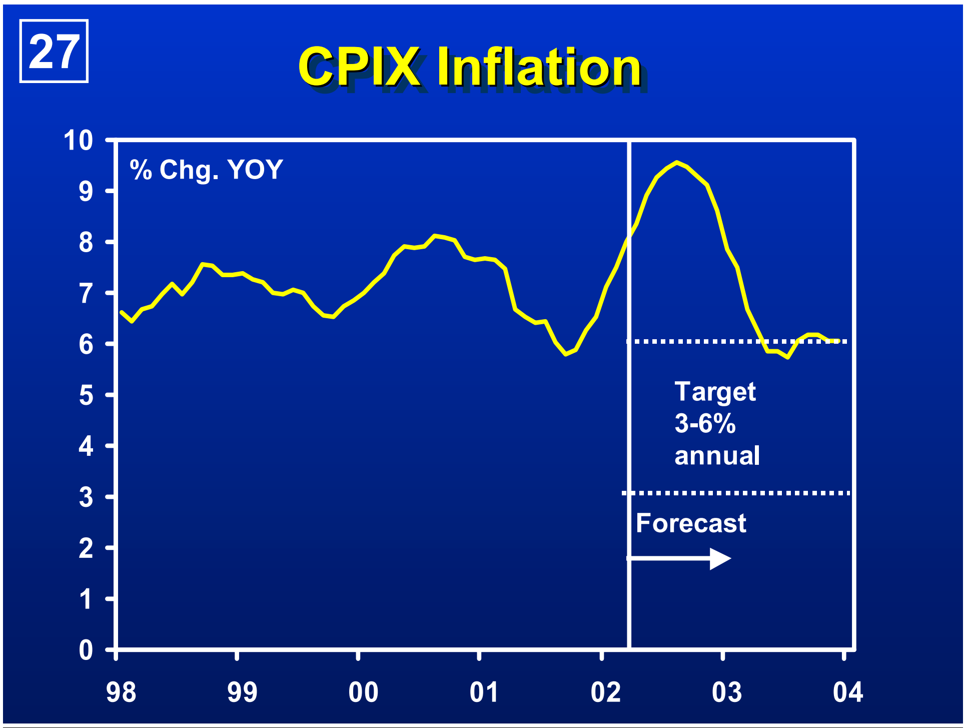
[42] Stals, Record 286

context of inflation targeting. But the importance of the rand separately from inflation targeting from a global and analytical perspective is somewhat overstated.[43] The slide below shows how CPIX inflation has performed against target. What happened in the operation of the policy of inflation targeting is a lot more important than the topic of the rand. Policy should be focussed on inflation, not the rand. The target of 3-6% annual inflation should be achievable over the next 12 to 18 months.[44]

Slide 27 O'Neill Bundle 28



43 Evidence of O'Neill, Record 1462
44 Evidence of O'Neill, Record 1488

13.5 The price of crude oil is included in the way CPIX is arrived at in South Africa. Different crude oil price scenarios have different outcomes for CPIX. In the opinion of Goldman Sachs, the fair value of the rand is R7 to the US dollar and the price of crude oil should be USD20 to the barrel. If those assumptions are met, South Africa will meet its inflation target.[45] South Africa, however, has no control over the price of crude oil. In most other countries which have inflation targeting, the price of crude oil is not included in the calculation of the target inflation rate for these reasons:

- crude oil prices are not under their control; and
- in the past, large movements in oil prices impacted consumer price inflation but did not have lasting underlying inflation consequences.[46]

13.6 Partly because of the move to inflation targeting and partly because of the Government's exposure to the NOFP, the Reserve Bank did not use the forward book to finance intervention in support of the rand in 2001.[47]

13.7 The policy of non-intervention was made public by the Reserve Bank on a number of occasions in 2001 at a time when the rand

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45 Evidence of O'Neill, Record 1496

46 Evidence of O'Neill, Record 1490-1493

47 Mboweni, Bundle SARB (7) 15, 247

was in decline. For example, in the Governor's statement of 14 October 2001, it was said that "….with the adoption of an inflation-targeting monetary policy framework, [the Reserve Bank] no longer has any intermediate policy targets or guidelines such as the exchange rate or growth in the monetary aggregates. The authorities are committed to continue allowing the value of the rand to be determined by the market, but are concerned that excessive volatility in the foreign exchange market negatively influences inflation, business decisions and the economy as a whole." Participants in the forex market formed the view that in the absence of support for the rand by the Reserve Bank, the rand would continue to depreciate. The policy of non-intervention became an element of the "one-way bet" view of the rand which infected the forex market in 2001.[48]

[48] Gouws, Expert Bundle 125; Mr M Langley, former Head of Foreign Exchange, Credit Agricole Indosuez, Johannesburg, Expert Bundle 148; Jammine Expert Bundle 339; Mr G Glynos, chief market analyst, Standard & Poor's MMS SA, Expert Bundle 424

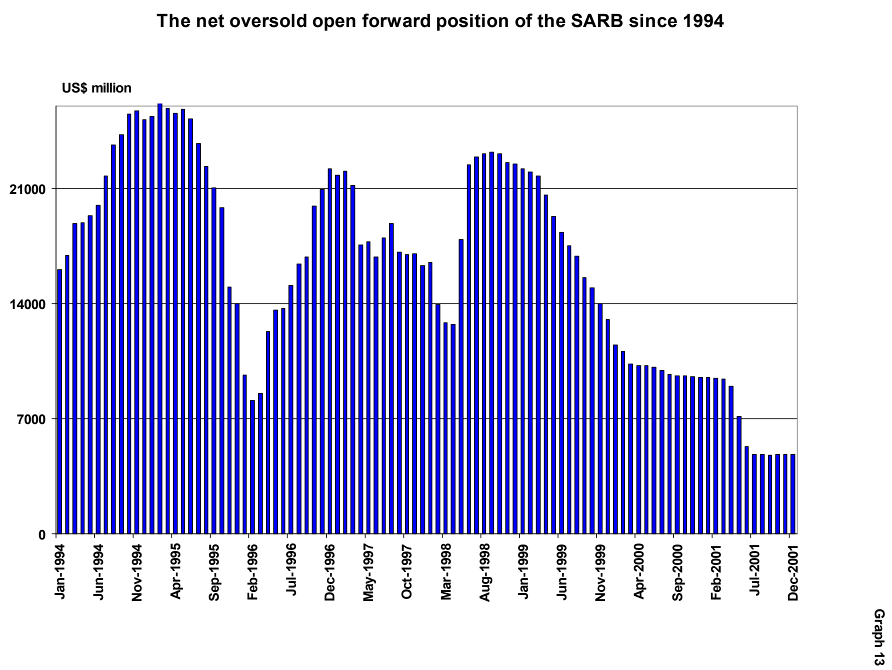
14 NOFP

14.1 The Reserve Bank and the National Treasury took a decision to reduce the NOFP. The decision was made public and implemented. By the end of the first quarter of 2001 the NOFP had been reduced from USD23 billion in 1998 to USD9.4 billion.

14.2 The Reserve Bank reduced the NOFP, in its words, by "buying foreign exchange" or, in the words of the rating agency, Standard and Poor, by "mopping up inflows". Total purchases in 2001 amounted to about USD4.4 billion and were related to Government's foreign bond issues and to large corporate transactions. The NOFP, accordingly, declined to USD5.3 billion at the end of quarter two; USD4.7 billion at the end of quarter three and USD4.8 billion as at the end of 2001.[49] The Reserve Bank's success in implementing the policy is shown in this graph:

[49] Mboweni, Bundle SARB (7) 33

Graph 13 Bundle SARB (7) 70



14.3 The policy of reducing the NOFP has been praised by the IMF, the rating agencies and the investment banking community. For example, on 9 May 2001 the IMF stated: "Directors [of IMF] commended the authorities for the significant recent progress made in reducing the net open forward position (NOFP) of the Bank. Nevertheless, they noted that the NOFP remains an important source of external vulnerability, and that it needs to be further reduced as market conditions permit".[50]

50 Mboweni, Bundle SARB (7), 31

14.4 The experts from the private sector, whether economists or traders, were not critical of the policy. But all agreed that the Reserve Bank's commitment to reduce the NOFP by buying US dollars contributed significantly to the perception that the rand was a one-way bet.[51] As Dr Abedian said: "… The SARB's single minded focus was on eliminating the NOFP … This of course meant a one-sided intervention in the spot market. The SARB was in principle selling rands and buying hard currency, thereby adding to the net demand for hard currency and putting downward pressure on the rand. Moreover, in pursuit of closing down its NOFP, the SARB seemed to be inclined to fully capture once-off inflows such as the De Beers deal, thereby eliminating any upward pressures on the value of the rand. This proved a consistent policy approach over the period 1999-2001. However, this approach had a significant impact on hardening positions against the currency. Speculative positions against the rand were therefore by and large risk free. In essence, most, if not all, market players believed that even the SARB was neither inclined nor in a position to do anything that would strengthen the currency."[52]

14.5 The apparent correlation between the reduction of the NOFP and the decline in the value of the rand is shown in these two graphs:

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[51] For example, Gouws Expert Bundle 126; Langley Expert Bundle 148; Luüs Expert Bundle 213.

[52] Abedian; Expert Bundle 273. See, too Jammine, Expert Bundle 337, 338.

Graph 18 Expert Bundle 126

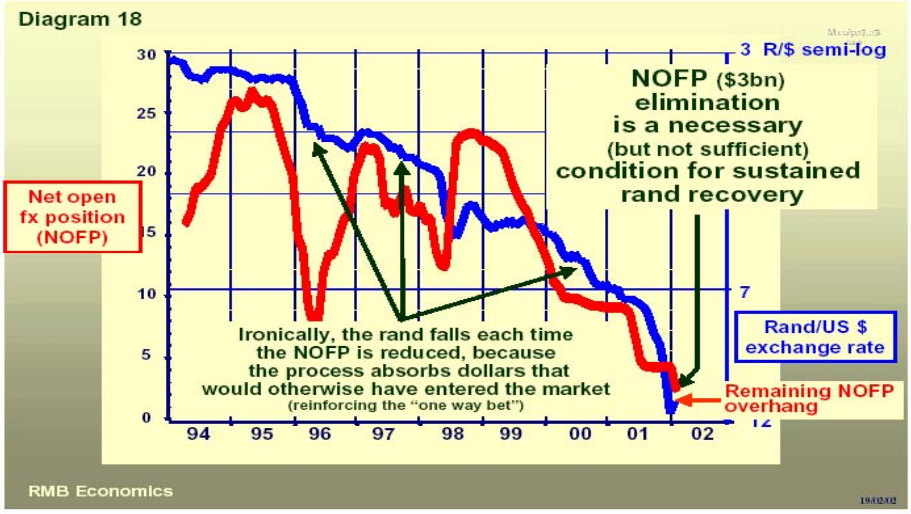
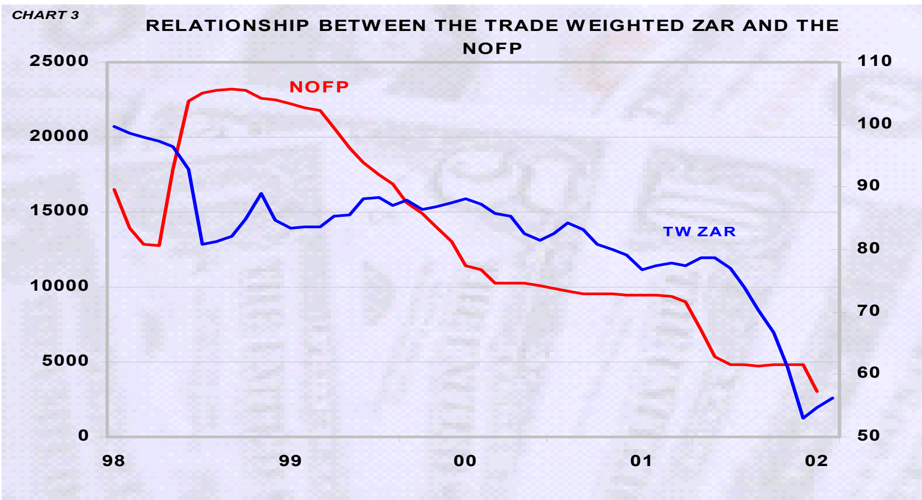


Chart 3 Expert Bundle 455



14.6 The Reserve Bank does not have a different view. The evidence of the Governor was:

"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 South Africa, it was decided to place emphasis on reducing the NOFP. The Bank had to buy foreign exchange as prudently as possible to close out the NOFP.

It is quite possible, however, that this eminently defensible goal of reducing the NOFP could have contributed at times to the sentiment that the rand's value is a one-way bet. To reiterate, the Bank was indeed conscious of this risk in pursuing its goal and strove to manage this risk by buying US dollars selectively. …..

Had the Bank allowed the proceeds of these large corporate transactions to flow through the market, the rand could have appreciated significantly. The market had been expecting a sizeable amount of the foreign exchange proceeds accruing to South African shareholders to be sold off for rand in the market, which expectation initially provided some support for the rand. Upon confirmation that the bulk of such proceeds were to be the subject of a once-off transaction with the Bank, for the purpose of reducing the NOFP, market perceptions of rand weakness could have been reinforced."[53]

14.7 On 14 October 2001 the Governor issued a statement which dealt, inter alia, with the NOFP in these terms: "The net open foreign currency position (NOFP) has declined from USD23.2 billion at the

53 Mboweni, Bundle SARB (7), p 32 – 33

end of September 1998 to USD4.8 billion. Given the negative perceptions resulting from the NOFP, the Reserve Bank reduced this position by purchasing foreign currency in the domestic foreign exchange market, which may have contributed to the depreciation of the rand over this period.

The South African Government's exposure to foreign currency risk, including the NOFP, as a percentage of GDP, is now on par with those prevailing in certain G10 countries. With the NOFP at a more comfortable level, any perceived vulnerability has declined significantly. The Reserve Bank is consequently in a position to alter its approach in dealing with the NOFP.

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 the proceeds of Government's off-shore borrowings and privatisation."[54]

14.8 Had investors and analysts read the statement of 14 October 2001 with the necessary care, they would have realised that as the Reserve Bank would no longer "mop up" US dollars in the forex market to reduce the NOFP, the NOFP should not be considered an element of the one-way bet. The evidence before the Commission leaves one with the impression that the statement was either not read properly or ignored.

54 Mboweni, Bundle SARB (7), 340

14.9 On 21 December 2001 the Governor of the Reserve Bank and the Minister of Finance issued a joint statement. One of the matters addressed in the statement was the NOFP: "The NOFP is down to $4,8 bn from $23,86 [bn] in September 1998. In January 2002, Government will be drawing down the full $1,5 bn syndicated loan, further contributing to reducing the NOFP, which is expected to be expunged entirely during 2002. This will be achieved utilising funds available from Government borrowing and proceeds from privatisation, and not from any purchases of foreign exchange in the market."

14.10 The Government did indeed increase its foreign borrowings in 2001, including a syndicated loan of USD1.5 billion, and the Reserve Bank was able to reduce the NOFP to USD2.9 billion as at the end of January 2002.[55] The NOFP at the end of March 2002 was still USD2.9 billion and "has ceased to be the major concern to the international investment community."[56]

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[55] Ramos, National Treasury Bundle 57, 66

[56] Statement of Minister of Finance on 24 May 2002: Record 1759-1760

15 The meeting of 14 October 2001 and the communications that followed

15.1 The evidence of the Governor was that the issue of enforcing existing exchange controls had been extensively discussed in the Reserve Bank and with National Treasury over a long period of time. The Reserve Bank was aware of the various explanations of the rand's weakness in recent years. The explanations included exchange control liberalisation, the Reserve Bank buying spot foreign exchange to reduce the NOFP and the decisions by importers and exporters to lead or lag their foreign exchange payments and sales. The impact of these more fundamental and legitimate factors influencing the exchange rate was acceptable to the authorities. Of more concern were comments from the market that speculative transactions, particularly by non-residents, were adding to volatility and rand weakness. The Reserve Bank was informed that investors and other emerging markets, with less liquid financial markets, were using South African markets as a proxy hedge for weakness in other countries. The Reserve Bank had no choice but to either abolish the remaining exchange controls in total or to apply the existing rules and regulations equitably to all. The Reserve Bank became increasingly concerned that excessive volatility in the forex market during the third quarter of 2001 negatively influenced inflation, business decisions and the economy as a whole. Accordingly, a meeting was called on Sunday, 14 October 2001 between the Reserve Bank and the chief executive officer and head of treasury of major South African and foreign banks registered in South Africa. What was conveyed to the banks, and which is material for present purposes by the Governor, is what is contained in the statement of 14 October in these terms:

"The Reserve Bank stands ready to take appropriate firm steps against trading activities inconsistent with existing rules and regulations. The enforcement of existing rules serves 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 markets, provided they adhere to the existing rules and regulations. Normal commercial and financial transactions remain unaffected." On 16

October 2001 the Reserve Bank issued Circular D342, in which it was stated, inter alia:

"To ensure that the provisions of the various sections of 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 markets. It follows, therefore, that when dealing with a non-resident counter-party, other than a correspondent bank, supporting documentary evidence must be obtained confirming that such non-resident counter-party has a legitimate South African exposure resulting from an accrual, investment or asset denominated in rand."[57]

15.2 On about 25 October 2001, an "important notice" was issued to authorised dealers. In terms of the notice, the compliance officer of a non-resident bank was required to sign a compliance letter. The Reserve Bank and a working committee of the ACI, an organisation representing forex dealers, accepted the wording of the compliance letter. In terms of the compliance letter, the

[57] Mboweni, Bundle SARB (7) 42, 43, 340, 342; Evidence of Mr AM Bruce-Brand, General ManagerExchange Control Department, Bundle SARB (6) 22

compliance officer was called upon to confirm in writing "that all transactions concluded by our clients and our dealers within the preceding 14 business days have been in compliance with the applicable rules and regulations."[58]

15.3 The Reserve Bank believed that applying the existing rules and regulations to exclude speculative trading from the forex markets would reduce volatility in the rand's exchange rate and would be to the benefit of non-resident investors and South Africans alike.[59]

15.4 The exchange controls which the Reserve Bank sought to enforce were these:

"21.5.3 **Forward exchange contracts with South African residents** – Foreign currency may be sold forward to South African residents, provided that the facilities are required to cover a firm and ascertained foreign exchange commitment due to a non-resident. Foreign currency may be purchased forward from South African residents, provided that the facilities are required to cover a firm and ascertained foreign currency accrual due from and payable by a non-resident.

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58 Evidence of Bruce-Brand, Record 568, Bundle SARB (6) 224-5

59 Mboweni, Bundle SARB (7) 43

21.5.4 **Forward exchange contracts with non-residents –** Foreign currency may be sold forward to non-residents, provided that such non-resident counterparties have legitimate South African exposures resulting from an accrual, investment or asset denominated in Rand."[60]

15.5 The Reserve Bank surmises that while consultation between it and the forex market was taking place following on the statement of 14 October 2001, "… some off-shore banks might have decided, as a precautionary measure, to avoid finding themselves in contravention of exchange control rules, to reduce the level of activity in South Africa's foreign exchange markets. This may well have contributed to a decline in liquidity …".[61]

15.6 The average net daily rand forex market turnover declined from USD8 billion in July 2001 to USD7.4 billion in October 2001 to USD5.5 billion in November 2001 and then increased to USD6.1 billion in December 2001. This is graphically demonstrated as follows:[62]

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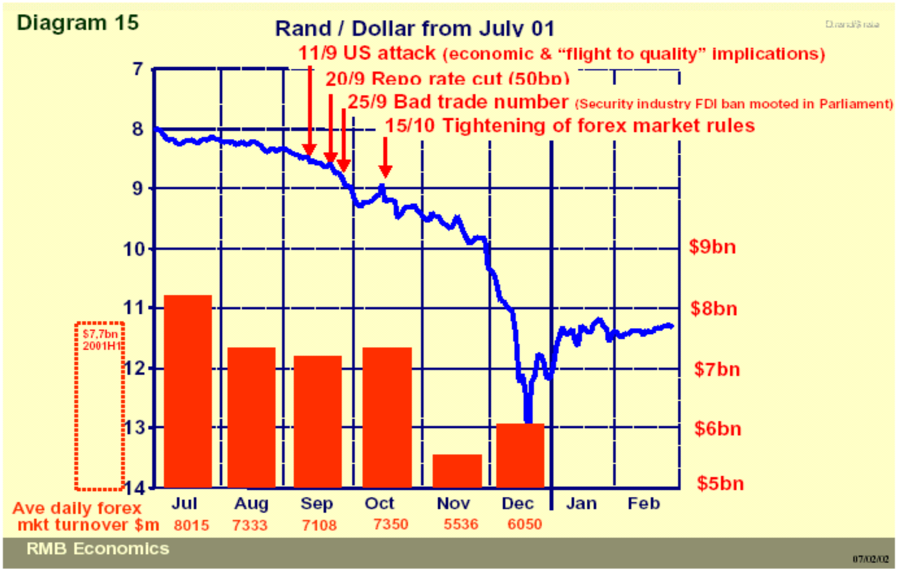
60 Bruce Brand, Bundle SARB (6) 18, Record 558-9

61 Mboweni, Bundle SARB (7) 44

62 Mboweni, Bundle SARB (7) 44; Gouws, Expert Bundle 125

Diagram 15 Expert Bundle 125



The most significant decline was in the swap market where the average daily net turnover declined from an average level of USD5.8 billion in the first ten months to an average USD4.3 billion for the last two months. The turnover of non-residents – the most significant participants in the market – declined from USD3.6 billion to USD2.3 billion respectively.[63]

15.7 The Governor expressed the view that liquidity in the forex market could have been affected by the statement of 14 October 2001. He went on to say:

"The issue of liquidity also arises when considering volatility. One-month historical volatility of the rand's exchange rate against the US

63 Mboweni, Bundle SARB (7) 44

dollar increased from a level of 9.1% in the first nine months of 2001 to an average of 20.5% for the last quarter. These volatilities reached a high of 55% at the end of December 2001. It is, however, not possible to attribute changes in these variables to a single reason or event but it is possible that the interpretation of the 14 October 2001 statement could have been a contributory factor."[64]

15.8 A view that was expressed by a number of economists was that the effect of the statement of 14 October 2001 on the rand was negative. For example, Mr Luüs said: "On 14 October 2001 the SARB drained liquidity from the foreign exchange market by a stricter application of foreign exchange regulations. This measure worsened the rand's slide".[65] Dr Abedian testified that the immediate impact of the statement of 14 October 2001 was to "scare away the pure speculators (mainly off-shore) from the market, thereby reducing liquidity in the overall market by another USD200 to USD300 million per day. In an already thin market, this contributed considerable additional pressure on the rand. With these volumes out of the market and no speculators active in the market, the conditions were so much more favourable for a run on the currency."[66]

15.9 During a volatile forex market, such as South Africa experienced in the fourth quarter of 2001, "… many smaller players, that are

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64 Mboweni, Bundle SARB (7) 45

65 Luüs, Expert Bundle 213

66 Abedian, Expert Bundle 273 See, too, Glynos, Expert Bundle 432

normally active in calmer market conditions, simply withdraw from a volatile market resulting in a sharp decrease in liquidity."[67] Foreign financial institutions, based mainly in London and to a lesser extent in New York, have entered the South African forex market. When volatility is at its highest, however, a number of new entrants leave the market.[68]

15.10 In about the first two days after the meeting of 14 October 2001 the rand appreciated. This was "… a natural consequence of traders sitting on-shore and off-shore that were holding long dollar positions, getting out of their long dollar positions by selling those positions and buying rand until they were confident that they understood what the implications of the circular were …"[69] Once the market understood the import of this statement, the rand continued to depreciate. The volumes dropped because of the reduced number of market markers in the market. The market makers which left the market were the foreign market makers. The probable reason for their withdrawal from the market was that a compliance officer of a foreign bank is in a very responsible position. He would not certify that a forex transaction was not for speculative purposes unless he was satisfied about the truth of the averment.

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67 Langley Expert Bundle 141
68 Mr P De Villiers, Global Head of Foreign Exchange Trading, Investec Bank, Record 363
69 De Villiers Record 388

Compliance officers of foreign banks probably advised their banks not to trade in the rand until they understood the statement of 14 October 2001 and could satisfy themselves that they were able to comply with the exchange control regulations.[70]

15.11 In the Questionnaire,[71] the authorised dealers were asked the following questions:

"4.6.2.5 The extent to which your organisation's procedures to ensure compliance with Excon differed pre and post 13 October 2001?

4.7 Provide detail on compliance certificates received by your organisation from non-resident banks before and after 13 October 2001. Provide reasons for any changes in the provision of compliance certificates before and after this date." The major authorised dealers canvassed these issues at some length in their evidence before the Commission:-

15.11.1 Absa

Absa's evidence was that the "stricter enforcement of Circular D342 in mid-October [2001]"[72] resulted in an immediate liquidity drain when market

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70 De Villiers Record 383

71 The Questionnaire is the one sent by the Deloitte & Touche team to authorised dealers referred to in Part K.

72 Evidence of Balt, Absa Bundle 14-15

participants complied with the Circular. The result was an expansion in the second-tier rand market outside South Africa, the widening of bid/offer spreads and a decrease in the pool of market participants. After 14 October 2001, the number of participants dealing directly with the rand market makers decreased, resulting in a decrease in turnover and the widening of bid/offer spreads. The market became imbalanced due to the lower liquidity. As a consequence, the risk of holding rand became unacceptable and caused a severe reduction in foreign exchange supplied to the market.

15.11.2 Nedcor

Nedcor testified that the Circulars dated 15 October 2001, D341, and 16 October 2001, D342, differed in some respects from what had been understood at the meeting with the Governor on 14 October 2001. The perceived differences caused confusion amongst both domestic and international participants and reduced market participation and therefore liquidity. Foreign banks generally were not happy with the measures being taken. Some of them sought legal advice, which was that the banks should not submit the required compliance letters. The Circulars were one of the many factors which contributed to the depreciation of the rand as they drew attention to concerns about the market but did not prevent ongoing speculation against the rand. When the Reserve Bank re-confirmed that non-residents were free to hedge in circumstances where the rand was extremely volatile, the concern was that whereas non-residents had not hedged the underlying exposures in large volumes previously, this might turn out to be the case thereafter. The markets therefore became increasingly nervous. Under the circumstances, some foreign players re-assessed their involvement in the rand market, further exacerbating illiquidity.[73]

15.11.3 FirstRand

In the view of FirstRand Bank, Circular D342 was issued with good intentions, but did not achieve the desired results. The market incorrectly interpreted

[73] Evidence of Parker, Nedcor Bundle, 19-20

the Circular as a re-introduction of exchange controls, despite the Reserve Bank's clear message that it was merely reiterating the current exchange control rules. The Circular contributed to a reduction in liquidity due to the lack of clarity of its interpretation. This was another factor adding to increased volatility in the rand currency markets at the time.[74]

15.11.4 BoE

BoE contended that one of the factors that led to the rapid depreciation of the rand was "the D342 Circular and the uncertainty that it generated concerning Reserve Bank policy".[75]

15.11.5 Investec

The evidence of Investec was that one of the seven most important factors which influenced the depreciation of the rand was "the introduction of SARB Circular D342 on 15 October 2001, which caused a massive decrease in liquidity in the market". The introduction of Circular D342 dated 15

74 Evidence of Bester, FirstRand Bundle, 21-22
75 Evidence of Woollam, BoE Bundle, 8-9

October 2001 and Circular D345 dated 7 November 2001 created substantial negative sentiment in the market. Circular D342 was perceived to involve a tightening of exchange control regulations, while circular D345 was seen as a re-introduction of exchange control as the dispensation allowing authorised dealers to accept US dollars as collateral from foreign borrowers of securities was removed. There was also great confusion and local authorised dealers were uncertain whether they were able to continue making markets to foreign counter parties. This uncertainty and lack of confidence in the currency caused a marked decrease in liquidity as well as a drastic increase in intra-day volatility at a time when the market required liquidity and stability.[76]

15.11.6 JP Morgan

Prior to 14 October 2001, JP Morgan was an active market maker in spot and forward forex transactions. The market was characterised by high levels of activity as a result of the presence of

[76] Evidence of de Villiers, Investec Bundle, 36, 38

numerous other market makers in Johannesburg, London and New York. This ensured that pricing spreads in the market were kept at a relatively low level. Following the release of Circular D342 on 16 October 2001, market participants, particularly off-shore players, were initially uncertain about its implications and application, resulting in many off-shore institutions ceasing or reducing their market making activities in spot rands. This in turn significantly reduced liquidity in the market and pricing spreads accordingly began to widen considerably. The release of D342 did not, in itself, cause a depreciation of the rand. Initial uncertainty concerning the implications and application of the circular led to illiquidity and a widening of trading spreads. The adverse effect of other factors on the rand was exaggerated by these more illiquid trading conditions.[77]

[77] Evidence of Coulter, JP Morgan Bundle, 16-17

15.11.7 Deutsche Bank

Deutsche Bank is of the view that Circular D342 could have had the effect of changing the market structure and as result the conduct of participants in the markets.[78]

15.11.8 SCMB

On 15 and 16 October 2001 authorised dealers communicated with their overseas counterparties and informed them of the reinforcement of the rule that only counterparties that have confirmed South African exposures, resulting from an accrual investment or asset denominated in rand, could hedge the transaction in the South African forex market and that authorised dealers need to view applicable documentary evidence within 14 days after dealings took place. During this period non-resident banks assessed their positions and foreign bank dealings almost came to a halt.

A debate followed during the next three days between authorised dealers, the ACI and the

[78] Evidence of Morrison, Deutsche Bank Bundle, 13

Reserve Bank in order to establish which transactions were affected and the treatment of transactions originated by South African authorised dealers with non-resident market making banks. By 19 October 2001 it was clear that foreigners could continue trading in the spot market.[79] On 25 October 2001 the bank conveyed to all its correspondent banks the requirements agreed between ACI and the Reserve Bank, which included a reference to the certificate which had to be signed by the compliance officer of a non-resident bank.

In the following weeks, the bank was inundated with calls from non-resident banks seeking further clarity. Banks who had legitimate transactions were concerned about the negative effects of the events being interpreted as a general tightening of exchange control rules.

15.11.9 The bank has contacted all non-resident bank account holders and taken steps to obtain the compliance certificates required. About 55% of

[79] Evidence of Van Zyl, Record 1694

foreign banks have not provided their compliance certificates. Where the compliance certificates have not been forthcoming, the bank has reported the instances to SARB.[80]

Since October 2001, off-shore banks reconsidered their activities in the South African market. Many banks were no longer prepared to risk non-compliance with South African exchange control rules and restricted trades to underlying South African assets, with a result in drop in turnover and market making activities. This caused a shrinkage in turnover, now restricted to trade related and confirmed capital transactions, and a distinct difference between the activities of local authorised dealers and their off-shore counterparties, with a real possibility of a two-tier market developing.[81]

15.12 A summation of the replies received from the authorised dealers by Deloitte & Touche to the Questionnaire is that non-resident banks, unwilling to contract subject to the compliance obligations of D342, ceased their market making activities in spot rand. The

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80 Evidence of Potgieter, Standard Bank Bundle 41-43

81 Evidence of Potgieter, Standard Bank Bundle 50

majority of the material authorised dealers were active market makers in the foreign exchange market before 14 October 2001. The majority did not change this role after 14 October 2001. However, some authorised dealers found their market making role increased as non-resident banks withdrew from the market.[82]

15.13 Dr O'Neill's evidence was that he arrived in Johannesburg on the morning of 15 October 2001. It bothered him that in the context of inflation targeting, so much attention was being given to exchange controls. It made him nervous about the commitment to inflation targeting.

Dr O'Neill was further of the view that since 14 October 2001, turnover in the spot market declined and that decline might well have contributed to the size or speed of the depreciation of the rand.[83]

15.14 The Reserve Bank mounted a spirited defence of its decision of 14 October 2002 by calling the advisor to the Governor, Mr L van Zyl, to testify. He made the following points:-

(1) The purported causality between turnover and the value of the rand is not clear to the Reserve Bank at all. The Reserve Bank

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82 Pages 23-24 of the DT Report referred to in Part K
83 Evidence of O'Neill, Record 1499 -1500

suggests that any causality is an over-simplification and that it should not be accepted by the Commission.

One should look at different periods of rand weakness in an effort to determine what causality, if any, may exist between either an increase or decrease in turnover in the domestic rand forex market and the exchange rate of the rand. For purposes of the following examples, the Reserve Bank has used the total turnover in the domestic rand foreign exchange market. Strictly speaking, it would be more correct to focus on turnover in the spot plus outright forward market as forex swaps do not directly affect the spot exchange rate. This more correct methodology, however, would not materially affect the Reserve Banks conclusion, because the different components of turnover tend to move in the same direction and by roughly the same magnitude. These are the examples:-

(a) In 1996 the rand depreciated from an average of USD1 = R3.6410 in January to USD1 = R4.2057 in April, a depreciation of 15.5%. Over the same period the average daily turnover in the domestic rand forex market increased by almost 42% from USD3.019 billion to USD4.284 billion. Total turnover by non-residents increased by some 79% from USD0.683 billion to USD1.223 billion.

(b) In <u>1998</u> the rand depreciated sharply from USD1 = R4.9357 in February to USD1 = R6.2386 in July, a depreciation of 26.4%. Over the same period total average daily turnover increased by some 139% from USD3.093 billion in February to USD7.395 billion in July. Turnover with non-residents increased by 213% from USD1.323 billion in February to USD4.138 billion in July.

(c) In January <u>1999</u> average daily turnover was USD6.855 billion. By June 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 = R5.9835 in January to USD1 = R6.0883 in June.

(d) The rand averaged USD1 = R11.5467 in December 2001, fluctuating significantly and briefly depreciating to USD1 = R13.84, 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 far more stable, trading at an average exchange rate of USD1 = R11.4847.

(2) The Reserve Bank suggests that had it not acted in October 2001 to limit dealing without a firm and ascertainable commitment or

approval in the domestic rand foreign exchange market, the outcome in November and December 2001 might have been much worse. Non-residents would probably not have bought the rand when the currency fell on a surplus demand for foreign exchange. It seems much more likely, based on past experience, that had non-residents' activities not been curtailed, they would also have sold the rand when they perceived the currency to be weak, leading to much more volatility and possibly a greater depreciation. It should be borne in mind that by 14 October 2001 the rand had already started depreciating rapidly (see diagram 15 paragraph 3.1 hereof).

(3) In 2001 non-residents bought South African bonds and equities to an amount of R4.203 billion. From the beginning of January to the end of August 2001, net purchases of equities and bonds by non-residents amounted to R11.914 billion. In the remaining four months of 2001, this turned to net sales of R7.710 billion. The net sales occurred from the very first business day of September 2001. Net sales of South African equities and bonds by non-residents amounted to R5.510 billion. (Since the beginning of 2002 non-resident portfolio investments into South African equities and bonds have again turned positive. From the beginning of January 2002 to the end of April 2002 non-residents

have purchased South African equities and bonds to an amount of R8.712 billion. This inflow has probably contributed to the rand's recent stronger performance, notwithstanding the fact that turnover in the domestic rand forex market in March 2002 was still lower than in the months prior to October 2001.)

The Reserve Bank submits that the statement of 14 October 2001, which had been extensively discussed prior to its issue, was carefully conceived and did not contribute to the rapid depreciation of the exchange rate of the rand.[84]

16 The issue of Circular D346 on 13 November 2001

16.1 Institutional investors, eg pension funds, long-term insurers, unit trusts and fund managers, may make off-shore investments up to a specified portion of their total assets under management, which is limited to a percentage of the inflow into the fund concerned during the previous year. Institutional investors tended to take out their allowances in tranches, beginning after the release of the annual Exchange Control Circular, normally close to the budget speech day, continuing through the second quarter of each year.

16.2 On 13 November 2001, Exchange Control issued Circular D346 which permitted an additional class of institutional investor,

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84 Evidence of Van Zyl, Bundle SARB (9) 8-12

namely, fund managers, to invest a portion of their funds off-shore. Following on that permission, applications totalling R1.9 billion were received in November 2001 and approved by Exchange Control in December 2001. The approvals expired within 30 days or at the latest 31 December 2001.

16.3 In order to utilise their allowances before expiry, the institutional investors bought foreign currency to buy shares and/or placed the foreign currency on deposit in anticipation of buying shares in 2002. SCMB Securities (Pty) Ltd obtained an extension to use its allowance until 14 December 2002.

16.4 As a consequence, the foreign currency equivalent of R1.7 billion was bought by institutional investors in an illiquid and volatile market. The rand fell from R10.25 on 1 December 2001 to R11.97 on 31 December 2001 and reached a low of R13.81 on 21 September 2001.[85]

(b) Speculation

Introduction

17 The first point is that speculators have a necessary role to play in the forex market. Dr Stals said that in a well developed market there is a

[85] Evidence of Ms Beck referred to in Part J §8.3 below and in Record 1617

need for short, medium and long-term investors and for buyers and sellers of a variety of spot and forward instruments. The speculator has an important part to play in an effective price discovery mechanism, based on the principles of demand and supply operating in an amorphous market.[86] Mr Luüs testified that speculators are usually required for the efficient functioning of markets. He quoted Marc Levinson, who stated in his book, Guide to the Financial Markets: "Although speculation is often derided as an unproductive activity, it is essential to the smooth functioning of the market. By buying and selling contracts with great frequency, speculators vastly increase liquidity, the supply of money in the markets. Without the liquidity that speculators provide, the futures market would be less attractive to hedgers because it would be more difficult to buy and sell contracts at favourable prices."[87] Ms Ramos said in her evidence that not all speculation is bad. Speculators can help in making a healthy market. She added a word of caution by referring to what John Maynard Keynes said in 1939 in his seminal work, The General Theory of Employment, Interest and Money: "Speculators may do no harm as bubbles on a steady stream of enterprise. But the position is serious when enterprise becomes the bubble on a whirlpool of speculation." Ms Ramos added that it is a matter of balance: "Speculators can help make a liquid market while there is a healthy demand for and supply of assets or

86 Stals, Expert Bundle 177
87 Luüs, Expert Bundle 214

currency, and where the burden of the spread is tight. The deeper the more liquid the market, the more likely it will be that speculators will be bubbles on a steady stream. However, in thin markets or in one-sided markets, as was the case in the rand market in November [2001] and particularly in December, speculators will have a greater impact, even with very small transactions."[88]

18 The second point is that speculative activity is difficult to define. As pointed out by the Governor, if speculation implies transactions entered into based on a view of the future value of a currency, then most forex transactions would have a speculative element in them. If speculation is defined to include only transactions which are not based on some fixed and ascertained commitment, then a narrower set of transactions would be caught within the definition.[89]

19 Some of the authorised dealers in evidence canvassed the activity of "speculating" in the rand. *Nedcor's* evidence was that it did not regard profits or losses generated or sustained by the bank from trading in the rand to be unethical or improper in any way. In order to provide a service as a market maker, it is important to be correctly positioned for anticipated moves in the currency. This entails assuming risk. The bank permits speculative risk taken on a conservative scale. "Speculative"

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88 Ramos, Record 718

89 Mboweni, Bundle SARB (7) 38-39

implies assuming a risk position with a view to making a profit, the outcome of which is uncertain. This is not only applicable to currency traders but involves exporters, importers, institutions and individuals.[90] *NIB* testified that it did not believe that profit made from trading to be unethical. The bank has to make profits. NIB would describe speculation as betting on the future price of a defined asset. Speculation per se is not an unethical practice simply because once a trader has made a bet there is every chance that he or she could incur a loss. When there is a risk of making a loss, the speculation cannot be improper. Market makers essentially provide liquidity to a select client base. In order to facilitate this practice market makers will enter into directional positions based upon the assumptions of market needs via the supply and demand. Speculators are defined as "market users" as opposed to "market makers".[91] *FirstRand* defined speculation as the purchase or sale of anything with the objective to profit from a change in market prices or to avoid a loss due to such changes, usually with a short-term view. Speculation by residents in foreign currency against the rand should have had no net effect on currency reserves because the profit remains in rand. It would seem that any large scale speculation against the rand, other than transactions within the ambit of exchange control, would have

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90 Evidence of Parker, Nedcor Bundle 18-19

91 Evidence of Lane, NIB Bundle 18

to be undertaken by non-resident banks or through non-resident banks and not by residents because of exchange control.[92] *Investec* expressed the opinion that a speculator can be defined as anyone who uses the market to gain from a position with or without there being any other underlying transaction. The decision to hedge or not to hedge an underlying exposure is in itself speculative. Speculators provide the liquidity necessary to ensure that whenever a hedger requires a hedge position, the market is able to absorb his trade without undue disturbance to the current price. Speculators are confined mainly to professional traders.[93] *BoE* testified that ordinarily the expression "market maker" means any person who buys and sells in the relevant financial market. Any trading in forex or related markets from an unmatched position and directed at making a profit based on an anticipated movement in the markets, necessarily involves an assessment on the basis of available information of the direction of such movement. By their nature, one cannot be certain whether any particular assessment of future markets will be correct. In that sense, any such involvement entails an element of speculation. All trading activity in a commodity, whether it be a currency, a financial instrument or otherwise, where that commodity is purchased for re-sale, is ordinarily undertaken with a view

92 Evidence of Bester, FirstRand Bundle 14-15
93 Evidence of De Villiers, Investec Bundle 34-35

to re-sell at a profit and would not be undertaken if the assessment was that the commodity could only be resold at a loss. There is therefore no difference between "market-making" and "speculation" in the context of forex and related markets. The word "speculation" is frequently used in a pejorative sense to convey that particular trading activities are in some way improper or unethical, but in that sense it has no clear or defined meaning.[94] It was *JP Morgan's* submission that the concept of "speculation" is not helpful in differentiating accurately between different forms of commercial activity. All commercial activity, including investment and risk management, involves an element of risk. The assumption of risk necessarily connotes an element of uncertainty as to whether a particular result will eventuate. Engrained in the notion of uncertainty is a speculative view been taken by an investor or risk management.[95] *SCMB* does not regard profits made from proprietary trading, market making, or other trading in the rand to be unethical or improper in any way. Those activities are necessary economic activities. If South African banks did not provide those services or activities, the void would be filled by international banks operating in London and other financial centres to the detriment of the South African economy.

94 Evidence of Woollam, BoE Bundle 5-6
95 Evidence of Coulter, JP Morgan Bundle 9

SCMB, as a matter of policy, does not condone engaging in the following types of conduct, which it regards as improper:

- the execution of a large client deal in times of high volatility and low liquidity and which the bank has reason to believe will have an exaggerated effect on the exchange rate;
- the practice of front running, which occurs when a bank or trader makes a monetary gain by acting in advance of a known transaction or order, which may influence the exchange rate; and
- the exploitation of electronic dealing or broking systems generating artificial exchange rate behaviour.

For SCMB, it is important to understand the distinction between speculation and market making in the context of foreign exchange and other related markets. Speculation involves adopting the view as to the likely movements in the exchange rate and acting, or not acting, on that view. By contrast, a market maker is a bank that, in all liquidity conditions, commits itself to provide bid and offer prices to both the inter-bank market and to its clients. Market making involves the purchase and sale of foreign currency with the intention of making a margin return, while not holding significant positions for extended periods. By far the majority of SCMB's foreign exchange business in the rand is done on the basis of it being a market maker, in other words as a provider of liquidity. The bank has historically, and for 2001, adopted a conservative approach to the size of its currency positions. It operates well within the internal limits set by the SBCA board, which in turn are significantly lower than those allowed by the Reserve Bank.[96]

20 In their replies to the questions put to them by Deloitte & Touche,[97] most authorised dealers stated that speculation is often used in a pejorative sense, implying that speculative activities are in some way improper or unethical. This they said is unjustified and choose rather to define speculation as adopting a view as to the likely movement in the exchange rate of the currency and acting on that view with the intent of making a profit or preventing a loss. They believe that speculation in fact has a positive effect on the markets as a result of the liquidity that speculators bring to the market. All agreed that according to their definition of speculation they do engage in speculation but that this is in no way unethical, improper or illegal. The consensus among the material authorised dealers was that profiting from proprietary trading and market making was in no way unethical or improper. They asserted that these activities are necessary economic activities that are conducive to a dynamic, liquid and efficient financial market.

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96 Evidence of Potgieter, Standard Bank Bundle 45-47

97 See Part K for the role played by Deloitte & Touche in the investigation on behalf of the Commission. §20 is based on p 22 of the DT report.

21 Mr McCauley drew a distinction between "hedgers" and what he called "pure short sellers" or "naked shorts". The former class of person would include a multinational company that has a long position in South Africa: it has bought dollars and invested the dollars in a factory in South Africa. If it becomes concerned about the value of the rand, it would hedge that long position by selling the rand forward against the dollar.[98] A "pure short seller" or "naked short", by contrast, is an institution such as an investment fund that has no ongoing business in South Africa and which "could put on the short basically looking to profit if the rand goes down".[99]

22 Mr De Villiers defined speculation as any transaction in which a trader acts as principal. Market-making can be viewed as speculation because the market-maker trades as principal and has to provide a price for a currency to a counter party. The price will be speculative in nature because "you will move it up and down according to what you perceive that the counter party is going to do with you."[100] Day-to-day speculation in the form of market making and technical trading is a necessary function for any market. It helps a market to be efficient and obviously helps people who needs hedges to hedge properly and cheaply. Speculation which has

98 McCauley Record 28
99 McCauley Record 29
100 De Villiers Record 367-8

a negative connotation probably refers "… to the long directional trading where traders take the long-term position of shorting the rand against the dollar and they do it for large amounts."[101]

23 The third point is one made by Dr Abedian. He testified that financial markets are neither efficient nor socially optimal. They are structurally prone to short-lived as well as prolonged "bubbles" in which prices and quantities could deviate from private and socially optimal levels. Information plays a vital role in such markets. As such, financial markets are largely vulnerable to information manipulation, rumours and speculation. Given costly and imperfect information, a large number of players in these markets may adopt a "herd mentality", following bigger players who can afford the investment in information gathering or will have the critical mass to obtain information. Institutional arrangements for remuneration are commonly and justifiably "performance-orientated". Despite a variety of checks and balances in the financial markets, such remuneration frameworks tend to exacerbate the vulnerability of these markets to short term bubbles.[102]

24 The fourth point that a number of witnesses made was that it would be extremely difficult to determine the effect of speculative transactions on

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101 De Villiers Record 376
102 Abedian Expert Bundle §2.8 p 261

the exchange rate.[103] A total of approximately 5.6 million foreign exchange transactions were reported to Exchange Control in 2001.[104] Mr Gouws expressed the view that to attribute the fall in the rand to a number of specific transactions would be very difficult and perhaps pointless in the light of the magnitude and complexity of developments since early September 2001.[105] Dr Stals made a similar point. He said that in a market with a turnover of at times more than USD10 billion per day, it would be extremely difficult to discover and identify individual transactions with malicious intentions.[106]

25 It seems to the Commission that one should distinguish between two classes of transactions, as identified by the Governor:-

- transactions entered into based on a view of the future value of a currency; and
- transactions which are not based on some fixed and ascertained commitment.

In the former class of transactions, would fall the transactions of authorised dealers, non-residents and resident importers and exporters.

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103 Mboweni Bundle SARB (7) 38
104 Bruce-Brand Bundle SARB (9) 5
105 Gouws Expert Bundle 117
106 Stals Expert Bundle 177

25.1 Authorised dealers

South African authorised dealers are allowed to trade the rand for their own account in the inter-bank market. This form of forex trading is known as "proprietary trading". During 2001 the authorised dealers did not run huge positions against the rand. Their aggregate open positions amounted to less than 1% of their net qualifying capital in 2001. The statutory limit for those positions is 10% of net qualifying capital.[107]

An authorised dealer, being a market maker, can be given a position by virtue of a deal being struck. The position which he is left with holding and which could be sizeable, may take some time to unwind and can even be rolled in to the forward market. Decision-making in this regard will be influenced by regulatory limits, internal limits and the view on the rand.[108]

25.2 Non-residents

The Governor expressed the view that, owing to the relatively free access that non-residents, particularly banks, enjoy in the US dollar/rand forex market, non-residents are in a position to speculate on the rand. South Africa has the mixed blessing of

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107 Mboweni Bundle SARB (7) 39

108 Memorandum of Reserve Bank Bundle SARB (7) 104

having more liquid financial markets than most other emerging markets. Consequently, in times of international crisis, South Africa's financial markets could be used as a proxy hedge for exposures to other emerging-market countries. Some of the non-residents view the rand as an international hedge currency and, through their established emerging markets trading desks, are prepared to trade the rand on a proprietary basis, that is for their own account. Non-resident banks trade rand very actively and represent some 55% of the total turnover in the rand forex market. It is because of the belief that non-residents were trading contrary to the existing exchange control rules (ie there was no underlying commitment to the transactions) that the statement of 14 October 2001 was issued.[109]

25.3 Importers and Exporters / Leads and lags

25.3.1 To enable the main bankers of major corporates to cope with the flow of foreign currencies, a system was devised whereby the funds were administered by the banks as part of their nostro[110] or vostro account balance pending conversion. To assist in identifying those funds separate sub accounts in the name of the customer were opened in

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109 Mboweni, Bundle SARB (7) 40-42; McCauley, Expert Bundle 58

110 A nostro or vostro account is the foreign currency account of a local bank with an overseas bank.

the bank's nostro accounts (shadow) administration. Those accounts are known as the Customer Foreign Currency (CFC) accounts. In March 1998 the exchange control requirement to repatriate foreign currency earnings in respect of the export of goods and services within 30 days was extended 180 days from date of shipment or date of service rendered. In September 1998 the CFC account system was amended to allow the retention of foreign currency earnings in respect of the export of goods for 180 days from the date on which such funds were first credited to the CFC account.[111]

25.3.2 An exporter who anticipates a more favourable exchange rate delays converting export proceeds in the foreign currency (eg US dollars) into the domestic currency (eg rands) ("lags" its payment.) An importer who fears a worse exchange rate can accelerate payments for imports by buying the foreign currency forward ("leads").

25.3.3 According to the Reserve Bank, in the second quarter of 2001, the total exports of goods and services from South Africa, at a seasonally adjusted annualised rate, amounted to some R328 billion, with imports of goods and services

[111] Bruce-Brand Bundle SARB (6) 19-20

amounting to almost the same. Even if a small portion of those amounts was involved in leads and lags, it could have had a noticeable effect on the exchange rate. Importers and exporters are thus in a position where they can legitimately take sizeable positions by virtue of their views on the rand's prospects. They have the same impact on the rand as pure speculative activity.[112]

25.3.4 The Reserve Bank draws the inference that exporters were lagging the repatriation of foreign currency (albeit possibly within the 180 day period) from the fact that there was a gradual increase in the forex balances of South African corporates in their CFC accounts as at:

31 December 1998	USD995m
31 December 2000	USD1 981m
31 December 2001	USD2 625m.[113]

25.3.5 Mr McCauley expressed the opinion that while it may not on the face of it appear to be so, a type of portfolio shift occurs in the financing of imports and exports (leads and lags): every month of lead in payment and lag in receipts

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112 Mboweni Bundle SARB (7) 39-40

113 Mboweni Bundle SARB (7) 40

represents an outflow of $^{1}/_{12}$ of trade. The leads and lags phenomenon makes the distinction between goods and financial services seem artificial in practice.[114]

25.3.6 Dr Abedian expressed the view in his evidence that while there might have been good technical reasons for extending the period of repatriation from 30 days to 180 days, exporters no doubt find it profitable to retain their earnings for as long as possible. With the continuous weakening of the currency in recent years, it has become common knowledge that any delay in repatriation is likely to make currency gains over and above the trade profit. It is important to note that had it not been for the predictable one-way direction of the currency value, exporters would normally choose to "take cover" for their CFC holdings so as to hedge against any potential appreciation of the rand. Expenses involved in such hedging would have forced them to retain their hard currency deposits only on an as-needed-basis and no longer. However, in view of the downward trend of the value of the rand, CFC accounts have become profitable operations for exporters and they

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[114] McCauley Record 48, Expert bundle 49

have every reason to accumulate deposits in such accounts.[115]

25.3.7 The probability that importers would hedge their purchases of foreign currency (lead) and exporters would delay repatriating their rands from off-shore (lags) is supported by the analysis done by Mr Glynos in this table:

Table 1 Expert Bundle 453

Table 1 **Forward points on the ZAR relative to the spot rate**

	Column 1	Column 2	Column 3	Column 4
	Spot rate on 01/01/2000	Forward rate as of 01/03/2000	Forward rate as of 01/06/2000	Forward rate as of 01/12/2000
Forward points as of 01/01/2000 (Bid)	6.1425			
3 month forward points	795	6.222		
6 month forward points	1480		6.2905	
12 month forward points	2850			6.4275
Actual spot rate on respective dates		6.34	6.975	7.6175
Difference		0.1180	0.6845	1.1900
% terms		1.90%	9.80%	15.60%
	Spot rate on 01/01/2001	Forward rate as of 01/03/2001	Forward rate as of 01/06/2001	Forward rate as of 01/12/2001
Forward points as of 01/01/2001 (Bid)	7.5625			
3 month forward points	790	7.6415		
6 month forward points	1480		7.7105	
12 month forward points	3280			7.8905
Actual spot rate on respective dates		7.715	8.0225	10.255
Difference		0.7350	0.3100	2.3645
% terms		0.90%	3.90%	23.10%
	Spot rate on 01/06/2001	Forward rate as of 01/09/2001	Forward rate as of 01/03/2002	
Forward points as of 01/06/2001 (Bid)	8.0225			
3 month forward points	1370	8.1595		
6 month forward points	2680		8.2905	
12 month forward points	5090			
Actual spot rate on respective dates		8.4526	11.38	
Difference		0.2931	3.0895	
% terms		3.50%	27.10%	

115 Abedian Expert Bundle 269

In each case the actual spot rate on the forward date was higher than the forward rate. Take, for example, the twelve month forward points:

For the year 2000:

Spot rate on 01/01/2000	Forward rate on 01/12/2000	Actual spot rate on 01/12/2000	Percentage Difference
6.1425	6.4275	7.6175	15.60%

For the year 2001:

Spot rate on 01/01/2001	Forward rate on 01/12/2001	Actual spot rate on 01/12/2001	Percentage Difference
7.5625	7.8095	10.255	23.10%[116]

26 Another fairly common way of speculating involves "short-selling". This amounts to a market participant selling a currency which he does not own, in anticipation that when delivery needs to take place, the currency can be bought in the market at a lower price, basing his

[116] Glynos Expert Bundle 453

judgment on the expected future development of the price of the currency.[117]

27 Another type of speculator is the offshore investor who has bought South African Government bonds and wishes to hedge his currency exposure and so sells rand forward.[118]

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28.1 Dr Jammine is of the view that the leads and lags phenomenon was exacerbated by panic by importers and glee by exporters who deliberately held off repatriating dollars for as long as possible. He sees in an asymmetric trend for a protracted period of time in which the demand for dollars by importers is abnormally low while at the same time the supply of dollars by exporters is abnormally low. That is why the rand has tended to overshoot and then recover in its downward slump during sell offs such as those seen in 1985, 1986, 1996, 1998 and 2001:

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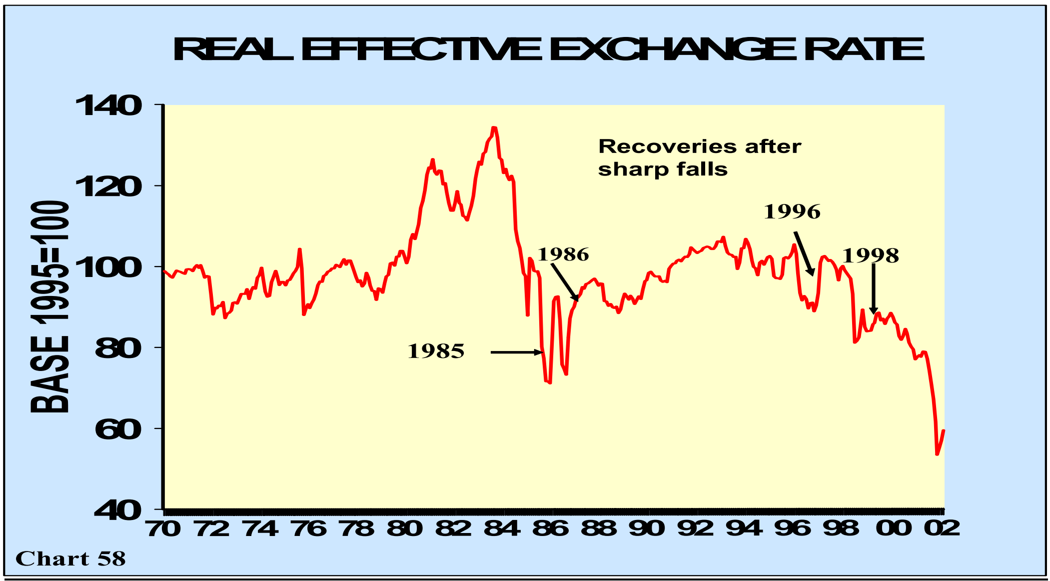
117 Memorandum of Reserve Bank Bundle SARB (7) 104

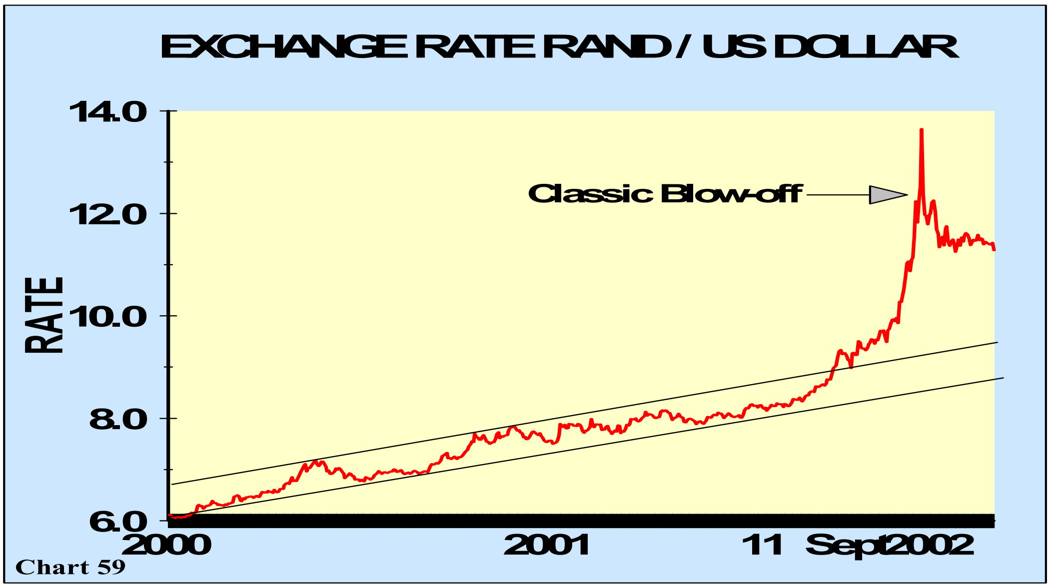
118 Memorandum of Reserve Bank Bundle SARB (7) 104

Chart 58 Expert Bundle 420



28.2 In November, and particularly, December 2001 the rand, according to Dr Jammine, entered a "blow-off" phase. The entire depreciation of the rand against the dollar from the beginning of 2000 until September 2001 saw the depreciation of the rand occurring within a clearly defined upward channel. However, once the dollar had broken the upward channel on the upside, it was apparent that the currency was in unchartered territory and would keep running upwards in an ever dramatic fashion against the dollar until the movement blew itself out. The channel referred to by Jammine is shown in the following chart:

Chart 59 Expert Bundle 421



28.3 Dr Jammine stated that even though the depreciation of the rand until about October 2001 could be justified somehow on economic and political grounds, the move in November and especially December 2001 defied the bounds of normal economic and political analysis and logic. He suggested that some people must have profited enormously at the time and that those speculators were found in the financial services industry both domestically and abroad.[119]

29 Dr Abedian's evidence was that there were "pure currency speculators" in the rand to an estimated volume of USD200 million to USD300

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119 Jammine Expert Bundle 343-345; Abedian, Expert Bundle 260-261

million per day. He said: "I highlight here that there is no way by definition to quantify it, but my discussion with the trade both inside and outside the country is that this volume had grown by September last year to an estimated or guestimated amount of possibly as high as 300 million dollars per day."[120]

[3] The experts' conclusions[121]

(1) Mr Gouws

30 Mr Gouws came to the conclusion that against the background of a steady depreciation of the rand during 2000 and the first half of 2001 most market participants came to the view that the currency was weak and it is likely that they took decisions to help protect themselves against further weakness. There was, therefore, already a weakening bias in the currency by the time the extraordinary confluence of factors and forces started to exert an influence from early September 2001 onwards. Some of those affected the currency via the influence on the current account; most affected the currency via the negative impact on confidence and on expectations about capital flows. The role of these factors became magnified after mid October 2001 by a lower level of market liquidity

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120 Abedian Record 422

121 The evidence of the experts is dealt with in the order in which they gave evidence.

following the Reserve Bank's announcement that foreign exchange control rulings were to be policed more rigorously. Some market participants may have taken advantage of the prevailing circumstances, but the sharp decline of the currency was the result of economic, political, policy and confidence factors and forces that had built up over a number of months. To attribute the fall in the rand to a number of specific transactions would be difficult and perhaps pointless in the light of the magnitude and complexity of developments since early September 2001.[122]

(2) Dr Stals

31 Dr Stals summed up his views as follows:-

(1) The South African exchange rate is determined by forces of demand and supply. The system of a managed float is by its nature unstable. Volatile movements in the exchange rate can be expected from time to time.

(2) The nominal exchange rate of the rand against other currencies will over time depreciate more or less by the inflation differential between South Africa and its major trading partners.

122 Gouws Expert Bundle 117

(3) Globalisation led to an integration of financial markets on a worldwide basis. There has been a big increase in international capital flows. Turnovers in foreign currency markets assumed astronomical dimensions. South Africa participated in those developments and removed or relaxed exchange controls to an important extent. All those developments contributed to a more volatile exchange rate for the rand.

(4) In the second half of 2001 various adverse external and domestic developments led to a deterioration in the South African balance of payments and therefore to a decline in the supply of foreign exchange.

(5) Without any official support, shortages developed in the market for foreign exchange with a strong concurrent pressure on the rand to depreciate.

(6) There was a growing perception in the market that the rand would continue to depreciate. Protective action by importers and expedient conduct by exporters squeezed the market even further. In December 2001 there were signs of panic in the market because of the shortage of liquidity.

(7) The reduction in the NOFP may have contributed to the woes of the rand. The role of the NOFP in the depreciation of the rand has, however, been exaggerated in the media and in the market.

As long as the Reserve Bank enters into forward foreign exchange cover transactions for South African residents in respect of "firm, ascertained and documented" commitments, increased or declines in the NOFP will be neutral as far as supply and demand conditions are concerned in both the markets for foreign exchange and for domestic rand liquidity.[123]

(3) Dr Abedian

32 Dr Abedian summed up the "bottom line impact" of the factors analysed in his report and evidence as follows:

(1) Net demand for the rand had diminished substantially.

(2) Policy uncertainty and an implicit policy re-think influenced the market.

(3) A one-way bet on the currency had taken root.

(4) No obvious defence for the currency was evident.

(5) Liquidity in the market was diminishing from mid-year on and reached low levels during the fourth quarter of the year.

(6) Global and environmental factors continued to weigh adversely on the currency.

(7) The market conditions were ripe for a run on the currency.

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[123] Stals Expert Bundle 183

Dr Abedian identified three possible scenarios for the rapid depreciation of the rand in December 2001:-

(1) A perfectly legitimate large transaction by one of the major market players might have led to the emergence of a herd mentality resulting in the run on the rand.

(2) It is technically possible that one may execute a deal fully aware of the full-scale domino effects and one does so in order to benefit via a major deal already in contract. Such a situation was particularly more feasible when the pure speculators were driven out of the market by November 2001.

(3) There were uncoordinated numerous market transactions that culminated in a self-fulfilling prophecy leading to a severe overshooting in valuation of the currency. Deals of this kind might well have had no motive other than well-considered business logic, yet the impact or outcome was identical to either of scenarios 1 and 2.[124]

(4) Mr Bruce-Brand

33 Mr Bruce-Brand testified that he was not able to isolate any transactions which caused, contributed and/or gave rise to the rapid depreciation of the value of the rand. Furthermore the numerous economic and political

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[124] Abedian Expert Bundle 282, 283

factors mentioned by the various witnesses influenced the exchange rate of the rand – which would make the task even more difficult for him.[125]

(5) Mr Mboweni

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34.1 The conclusion that Mr Mboweni, the Governor, came to was that the exchange rate obviously came under a great deal of pressure in the latter half of 2001. If developments in the balance of payments are taken into account, as well as the other issues mentioned by him, including the fact that market participants would tend to trade according to the view that the rand was vulnerable, thereby adding further pressure to the rand, the depreciation in the value of the rand was not altogether unexpected. Admittedly the severity and the speed of the decline were surprising and of great concern.

34.2 It is the view of the Reserve Bank that the best defence of a currency is prudent macro-economic policies accompanied by structural and micro-economic reforms, where appropriate.

34.3 The Governor defended the Reserve Bank's role in 2001 by stating:

[125] Bundle SARB (6) 24

- given the inflation targeting monetary policy framework under which the Reserve Bank operates, it was not considered appropriate to hike interest rates in defence of the currency;
- it was not considered appropriate to intervene in the forex market to support the value of the rand by means of the forward book;
- on 14 October 2001 it was felt appropriate to enforce existing exchange controls on non-residents to ensure that only legitimate transactions took place in the forex market;
- contained in the statement of 14 October 2001 was a very positive announcement regarding future purchases of foreign exchange to reduce the NOFP;
- in a joint statement issued by the Governor and the Minister of Finance on 21 December 2001 the positive economic fundamentals were reiterated.[126]

126 Mboweni Bundle SARB (7) 46

(6) Ms Ramos

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35.1 Ms Ramos said that the Government has had to make policy choices in a complex and often unforgiving world. At the centre of the range of policy choices lies the principle that South Africa is an open economy. In that environment it is inevitable that from time to time there will be turbulence. The policy makers must be confident that the policy choices they have made and the good performance experience for the economy of the past five or six years will support the ongoing growth and sustainable development that the South African economy needs.

35.2 The Government has had to ensure that the appropriate macro-economic fundamentals are in place. Far-reaching reforms of the fiscal framework and management of public finances have been undertaken. Monetary policy has been consistent in tackling the distortionary impact of high inflation. Trade reform and financial market development have increased the flow of foreign currency to South Africa. Government's spending has been re-prioritised to increase spending on social services, which promotes re-distribution and provides a safety net against the potential social costs of globalisation.

35.3 In an environment of global integration, it is essential for a sound and well regulated financial system to be in place. Government has achieved this through an ongoing financial market reform aimed at keeping South African financial market standards consistent with international practice.

35.4 Government has chosen to follow a flexible exchange rate to act as a shock absorber against global developments. Exchange rate adjustments helped cushion the economy from external trade and capital flow shocks, and mitigate the impact of economic contraction, especially in respect of the poor.[127]

35.5 There was no single or dominant cause for the depreciation of the rand. Ms Ramos said: "There were a number of variables at play at the same time and certainly in our attempts to try and understand what was going on, we have been unable to say what caused it was A and not B. It was a complex set of issues not least of which is the confidence that South Africans have in their own country and their own economy and so it has been difficult for us to say that there was one set of issues that led to the exchange rate depreciation that we saw last year. There were lots of things happening at the same time."[128] The Minister of Finance spoke of a complex set of factors which

[127] Ramos, National Treasury Bundle, 58-59
[128] Ms Ramos Record 735-6

were at play. [129]

(7) Dr O'Neill

36 In mid-April 2002, Goldman Sachs asked thirty clients four questions. Twenty-nine clients replied. The clients were multi-currency asset managers in London and New York, hedge funds, corporations with commercial exposure in South Africa and one or two individuals. The group is representative of the global financial community. The questions and answers were:

Question	Answer
1. Are you bullish/bearish about rand	31% bullish 69% bearish
2. Do you think the monetary and fiscal policy is good or bad?	59% good 41% bad
3. Do you think the framework has improved/deteriorated in the past year?	52% improved 48% deteriorated
4. What is the biggest change that would be positive for the rand?	[A] More open markets (i.e. remove exchange controls): 21% [B] Open more FDI:

[129] Manuel Bundle National Treasury 87

	14% [C] Zimbabwe: 21% [D] Aids: 14% [E] Crime: 10% [F] NOFP/other: 21%[130]

37 Dr O'Neill came to the following conclusions:-

(1) The foreign exchange markets have been generally very peculiar since 1999 since the introduction of EMU. Lots of currencies, including the most important in the world, the dollar, and the euro specifically, have behaved very differently than the consensus expected.

(2) The US dollar has been and remains peculiarly strong because of lots of capital inflows including foreign direct investments and portfolios [into the USA].

(3) Until late 2001 the rand was not independently weak from the general weakness which other currencies showed against the dollar.

(4) Policy should concentrate on inflation targeting and not on the rand. If policy was supplemented and intensified with its inflation

130 Evidence of O'Neill, O'Neill Bundle 33, Record 1500-1502

targeting, some of the problems surrounding the rand would probably go away.

(5) If South Africa wants a strong rand, South Africa needs to have a BBoP surplus so that it will not be subject to the vagaries of sentiment. The way to achieve that is to attract more foreign direct investments and more portfolio flows.

(6) The events of late 2001 suggest that with foreign exchange controls, one either has no controls or one has complete controls. But, if one has partial controls, it is confusing and very hard for people to understand except those very close to monitoring them and implementing them. It is also often taken as a sign of lack of confidence in other targets and in particular if there is an inflation targeting regime in place. It was not obvious to Dr O'Neill what purpose foreign exchange controls serve. In his view, if the removal of exchange controls was done in the context of specifically targeting more foreign direct investments and enhancing a greater broadening of the understanding of the inflation targeting regime, he believes that the abolition of exchange controls will lead to a significant inflow and strengthening of the rand.[131]

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131 Evidence of O'Neill, O'Neill Bundle 34, Record 1503-1504

(8) Standard Corporate and Merchant Bank ("SCMB")

38 The exchange rate of the rand is determined primarily by the actual and expected level of net demand, which is demand for the currency minus the supply of it.

39 In the view of SCMB, the following factors may have negatively influenced the exchange rate for the rand during 2001:

- the global economy was on a path of gradual slow-down with a possible recessionary outcome even before 11 September 2001;
- the downturn of the global equity market in the telecommunication and aviation sectors contributed to a delay in the Telkom and SAA privatisation plans thereby reducing the prospects for the inflow of foreign currency;
- negative developments in emerging economies such as Turkey and Argentina;
- the possible use by exporters of the full extent of the 180 day period causing additional leads and lags in the foreign exchange market;

- the reinforcement of the rules pertaining to non-resident dealings by the Reserve Bank in October 2001 may have had the effect of further draining liquidity in an already thin market;
- the Reserve Bank's non-interventionist approach appears to have influenced perceptions in the market of a continued decline in the value of the rand;
- political and economical turmoil in neighbouring Zimbabwe;
- the reduction of the NOFP;
- Press comment on the outflow of dividends from South African companies listed off-shore.

40 Participants in the forex market saw the rand hitting all-time lows virtually every day and a certain amount of panic prevailed as relatively small amounts of import demand influenced the exchange rate. Inter-bank spreads between buying and selling rates were quoted as high as 1000 basis points (normally 100 basis points). These conditions had not previously been experienced in the South African market as the Reserve Bank would, under such conditions and in terms of their then existing policies have provided the necessary liquidity.[132]

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[132] Evidence of Mr WJ Potgieter, Director and Head, International Banking Division, SCMB, a division of Standard Bank of South Africa Limited ("SBSA"), Standard Bank Bundle 47-49

The views of the authorised dealers

41 In the Questionnaire, the authorised dealers were requested by the DT team to describe inter alia the specific transactions, actions, events, factors or omissions influencing the rapid depreciation of the rand in 2001. Their responses are summarised in the following table:

Table 4, DT Report p 40[133]: Details underlying reasons shown in figure 11	
Cause	Details provided
Zimbabwe	Land invasions in Zimbabwe, lack of South African government criticism of Zimbabwe, fear of Zimbabwe style land invasions in South Africa, fear of influx of refugees from Zimbabwe, indications that Zimbabwe's upcoming presidential election was unlikely to be fairly contested.
Emerging markets/ Argentina	Poor emerging market sentiment, emerging market contagion, economic problems in Argentina, specific events in Argentina (e.g. resignation of president).
September 11	The events of September 11, terrorist attacks in the US, war on terror, flight to quality post September 11.
Privatisation	Speculation regarding delays in privatisation, actual delays in privatisation
trade deficit	Balance of payments concerns
SARB policies	Circular D342, comments by Reserve bank staff (including Governor), closing out of NOFP, resignation of James Cross, use of

133 Pages 40-41 of the DT report referred to in Part K.

Table 4, DT Report p 40[133]: Details underlying reasons shown in figure 11	
Cause	Details provided
	De Beers inflows to offset against NOFP, speculation regarding relaxation of exchange controls, statements regarding defence of the currency.
Withdrawal of market makers/ liquidity	Illiquid market, market makers withdrawing at times of high volatility, foreigners withdrawing, clamp down by SARB on speculation causing lack of liquidity.
leads and lags/ investor panic	Use/abuse of 180-day rule, exporters delaying foreign exchange repatriations, panic setting in exacerbating Rand collapse.
Dividend repatriations	Offshore listed companies repatriating dividends to overseas shareholders in foreign currency.
Political factors	Negative view of South African Government performance, government's Aids policy, government corruption, poor performance of President Mbeki.
General market sentiment	Generally poor market sentiment.

<u>The views of the representative offices</u>

42 The common factor influencing the rapid depreciation of the rand amongst the representative offices was the political and economic instability in Zimbabwe. Other top ranking factors included the listing abroad of large South African corporations and the continued dividend

flows from South Africa which did not inject foreign currency into South Africa in exchange for the dividend flows. The disaster of 11 September 2001 was listed as an influencing factor. It was felt that this led to volatility in global equity and currency markets. Exchange control regulations were also considered to have contributed to the depreciation of the rand.[134]

[134] P50 of the DT report referred to in Part K.