

Interim Report of the Commission of Inquiry into the Rapid Depreciation
of the Exchange Rate of the Rand and Related Matters
10 May 2002

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A Introduction

1

1.1 The President appointed the Commission of Enquiry into the rapid depreciation of the rand and related matters. The terms of reference, in summary, are to enquiry into and report on:

- transactions which contributed or gave rise to the rapid depreciation of the rand in 2001 and whether such transactions were illegal or unethical;
- whether any of the transactions involved collusion and resulted in any improper gain or avoided loss;
- exchange controls.

The Commission is required to advise the President on any relevant recommendations, including

- the effectiveness of exchange controls and other regulatory measures and guarding against the occurrence of such transactions; and
- possible action that could be taken against any person identified as having participated in any such transactions.

This interim report is submitted on 30 April 2002 to the President pursuant to §3 of the terms of reference.

1.2 The process adopted in enquiring into the matters raised in the Terms of Reference was the following:-

- assistants to the Commission were appointed;
- the assistants consisted of a number of firms of accountants and attorneys;
- the assistants were divided into teams, each with a designated task;
- the investigations resulted in evidence being led in public before the Commission in compliance with section 4 of the Commissions Act, no 8 of 1947;
- the evidence consisted broadly of the following:-
 - experts who had the requisite knowledge, experience and expertise to testify on different aspects of the enquiry;
 - representatives of the South African Reserve Bank (“Reserve Bank”) and the National Treasury;
 - Mr Kevin Wakeford, the bank (Deutsche Bank) and the corporates (Sasol, Nampak, M-Cell and Billiton) mentioned by him in his statement to the President of 8 January 2002;

- some of the authorised dealers.

1.3 The evidence which, to the present knowledge of the Commission, must still be given is that of

- the remaining authorised dealers;
- three assistants to the Commission who will testify on the results of the investigations of the various teams of assistants;
- the Reserve Bank on particular issues raised during the hearings.

1.4 The intention of the Commission is to complete the evidence during May 2002, if all goes well, and to furnish the President with a final report by no later than 30 June 2002.

1.5 The Interim Report does not make any findings or recommendations. It would be premature and improper to do so before all the evidence has been heard and evaluated.

1.6 The Interim Report deals only with a limited number of topics testified to by the experts who gave evidence at the request of the Commission during the first two weeks that the Commission heard oral evidence. The witnesses included a foreign expert, Mr Bob McCauley, Deputy Chief Representative, Representative Office for Asia and the Pacific Hong Kong, of the Bank of International Settlements; well-known economists employed by South African banks such as Mr Rudolf Gouws, the Chief

Economist and Director of Rand Merchant Bank, Dr Iraj Abedian, the Director and Group Economist of Standard Bank, Dr A Jammie, Director and Chief Economist, Econometrix (Pty) Ltd, Mr Christo Luüs, the Chief Economist, Absa Group Ltd; central bankers, Dr Chris Stals, the previous Governor of the Reserve Bank and Mr Tito Mboweni, the Governor of the Reserve Bank; and Mr Trevor Manuel, the Minister of Finance and Ms Maria Ramos, the Director-General, National Treasury.

- 1.7 The Interim Report covers their evidence on the rand and forex markets, locally and globally, and factors which in their view might have contributed to the rapid depreciation of the rand.
- 1.8 Parts B, C and D of the Interim Report, suitably amended by the additional evidence not canvassed in this report, will form an integral part of the final report.

PART B

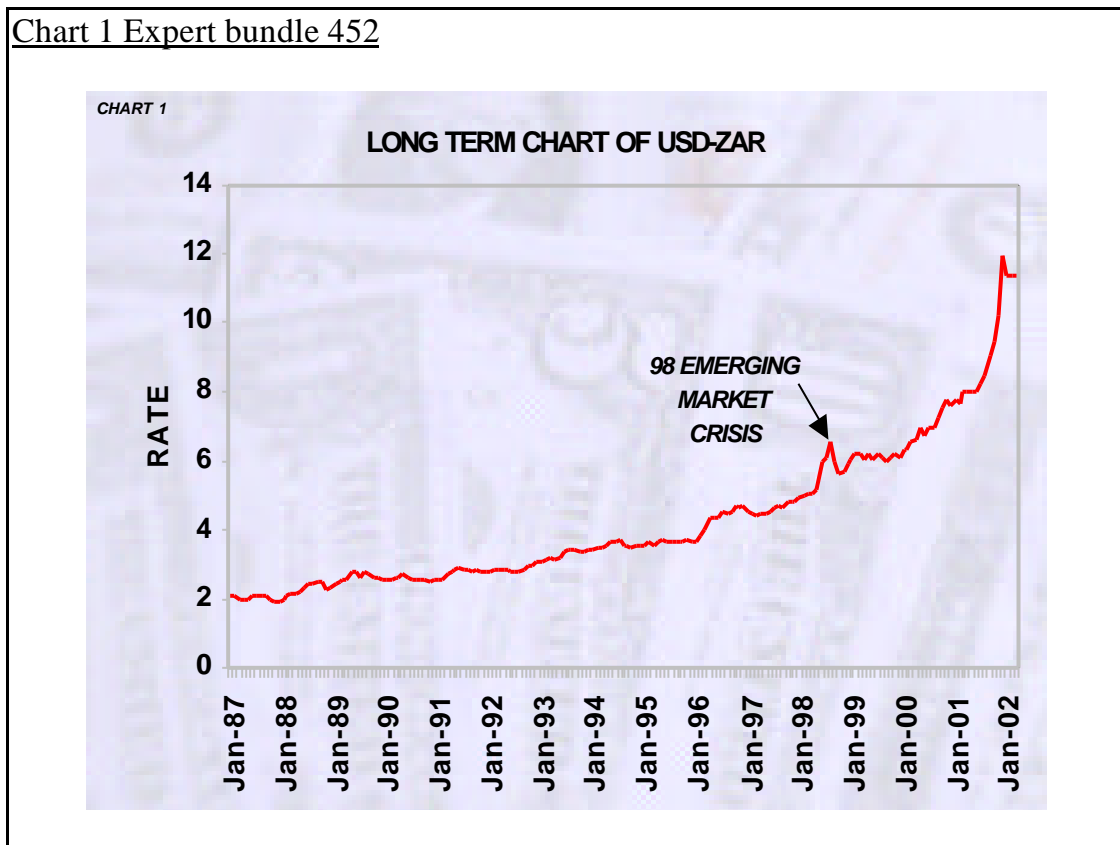
The performance of the rand

The history of the rand

2

- 2.1 In the long term, the rand has moved in one general movement in favour of weakness as against the US dollar.¹

Chart 1 Expert bundle 452



¹ Glynos Expert bundle 423

2.2 The general experience during the past twenty years with the floating exchange rate system, specifically with regard to the fluctuation in the exchange rate, was the following:

- The exchange rate often fluctuated quite a lot over the short term, but followed a more rational path over the long term.
- The depreciation process never followed a smooth path and has been described as a “staircase” adjustment process, with a periodic run down a flight of stairs to a new level. The exchange rate of the rand against the US dollar tended to remain relatively stable for periods of up to two years, to be followed by a rather steep downward adjustment over a short period of time to a new (lower) level.
- In the circumstances, markets at times over-reacted. Market interest rates rose to extremely high levels, and the rand depreciated by more than the inflation differential – hence the need for a period of consolidation and stabilisation after every sharp depreciation of the rand.²

Highlights of the performance of the rand before 2001 were:-

2.2.1 Most of the rand’s history incorporated a dual exchange rate system. The financial rand acted as a shock absorber

²

Stals [Expert bundle 170, 171](#)

for the commercial rand traded at a significant discount of between 15% and 55% to the commercial rand over the thirty years that this mechanism was in place.

- 2.2.2 On different occasions during the 1970's the commercial rand was fixed to the US dollar or to the British pound and fluctuated in line with the value of these currencies. In September 1975, specifically, government devalued the rand against the pound by 18%.
- 2.2.3 In the late 1970's the commercial rand was allowed to float freely against all currencies and in 1980 hit its highest level ever of USD 1.35 to the rand.
- 2.2.4 During the debt standstill crisis in the 1980's both the commercial and financial rands plummeted, with the rand losing over 30% of its real trade weighted value in a matter of months. The only comparable decline of such magnitude in the real effective exchange rate of the rand was witnessed in November and December 2001.
- 2.2.5 For a period of eleven months after the abolition of the dual exchange rate system on 10 March 1995 the unified rand was stable at around R 3.60 to the US dollar.

- 2.2.6 1996 marked a “sell-off” of the rand with the rand losing 20% of its value reaching R 4.50 against the US dollar by June 1996.
- 2.2.7 Around September/October 1997, the world witnessed the start of the so-called Asian crisis. The contagion arising from this crisis hit all emerging markets in May 1998 and the rand was materially affected, as with currencies of many other developing countries.
- 2.2.8 Having declined by over 20% in real terms in 1998, the rand regained some of its composure through 1999, trading in a broad band between R5.50 and R 6.40 to the US dollar during that year.
- 2.2.9 The long slide in the rand began with the rand trading at R 6.12 at the turn of the new millennium.³
- 2.3 Over the twenty-one month period from the beginning of 2000 to 11 September 2001 the rand maintained an almost consistent and fairly well-defined declining trend against the US dollar.

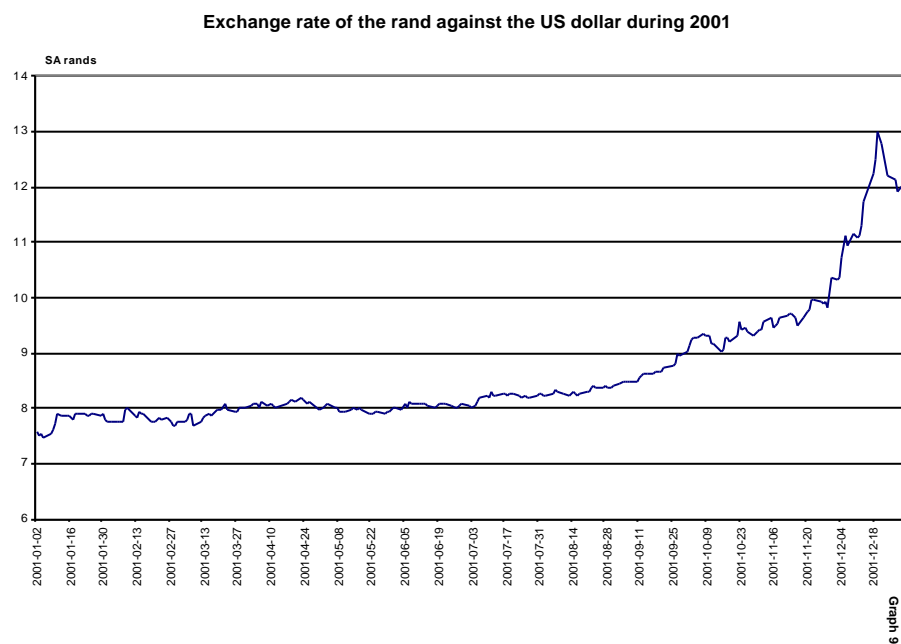
³

The rand in 2001

3

3.1 The decline of the rand is illustrated in the graph below, which shows the exchange rate of the rand against the US dollar during the year 2001:

Graph 9 Bundle SARB (07) 65



The extent of the pace of depreciation of the rand during the period July 2001 to December 2001 is illustrated in the graph below. The term “big figure” is used to refer to the figure before the decimal, i.e. from R 8.00

to R 9.00. These “big figure” movements represent declines of approximately 12.5%, 11% and 40% respectively.⁴

Diagram 15 Expert bundle 125(a)



3.2 During the year 2001, the rand recorded the following exchange rates against the US dollar at during the year:

- moving from around R 7.60⁵ to the US dollar at the beginning of the year, the rand depreciated to over R 8.00 for the first time ever during the second quarter;⁶

⁴ Gouws Record 129, 130

⁵ Mboweni Bundle SARB (07) 283

⁶ Jamine Expert bundle 317

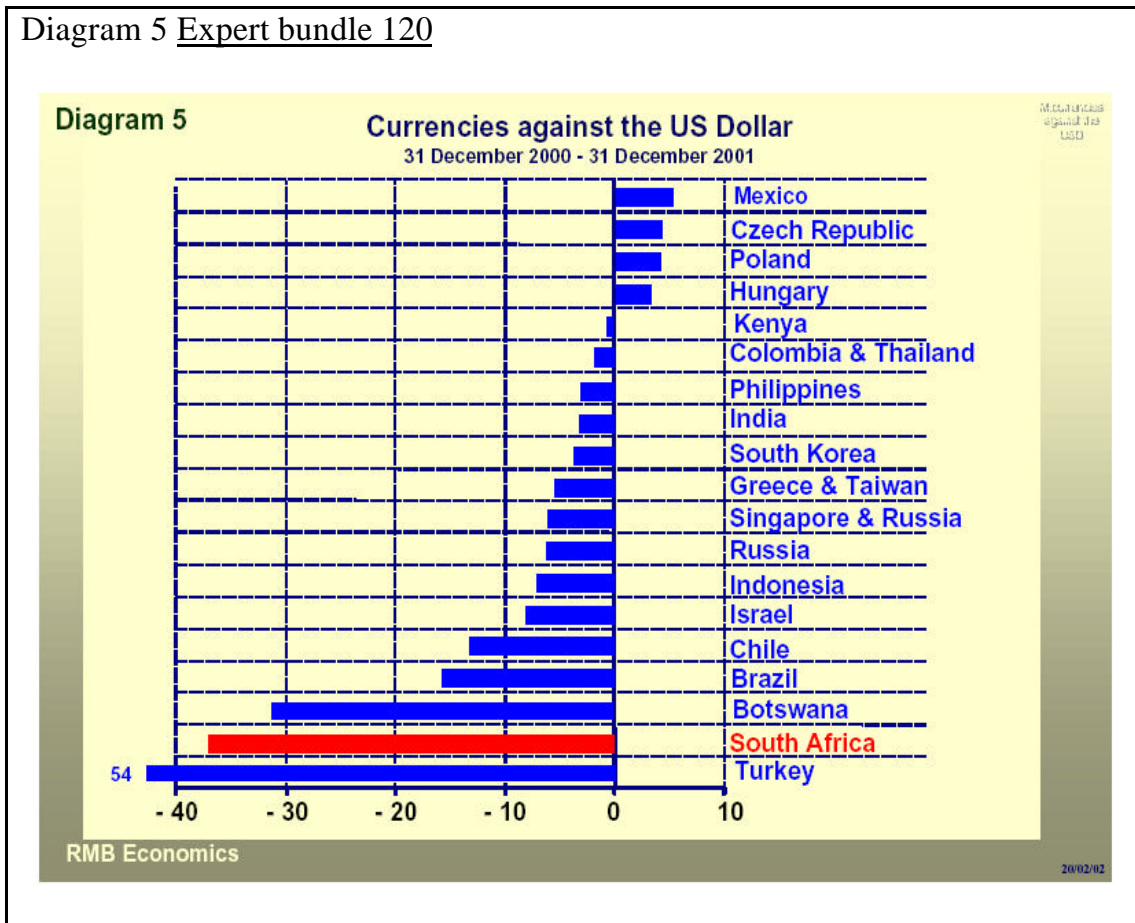
- the pace of depreciation increased with the rand R 8.52 to the US dollar on 11 September, R 9.03 at the end of September and R 9.44 at the end of October;
- by the end of November 2001 the rand had fallen to R 10.27 to the US dollar;⁷
- the rapid depreciation reached its crescendo with the rand hitting a new all-time low of R 13.84 to the US dollar on 21 December 2001.⁸ The markets appeared to have settled down from about 16 January 2002, with the rand appreciating slightly and settling down at a level of between R 11.00 and R 11.50 to the US dollar.⁹

The rand against the dollar compared to other currencies

4

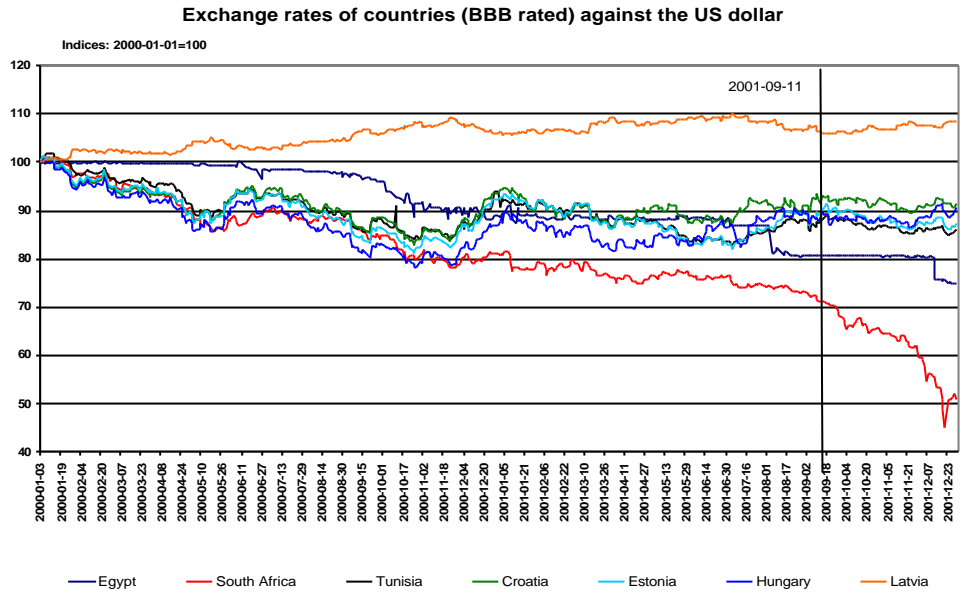
4.1 The weakness of the rand against the US dollar during 2001 compared to other comparable countries is illustrated in the diagram below, indicating that South Africa had become, towards the end of 2001, somewhat of a special case¹⁰:

⁷ Jamine [Expert bundle 336](#)
⁸ Mboweni [Bundle SARB \(07\) 30](#)
⁹ Stals [Expert bundle 175](#)
¹⁰ Gouws [Expert Bundle 114](#)

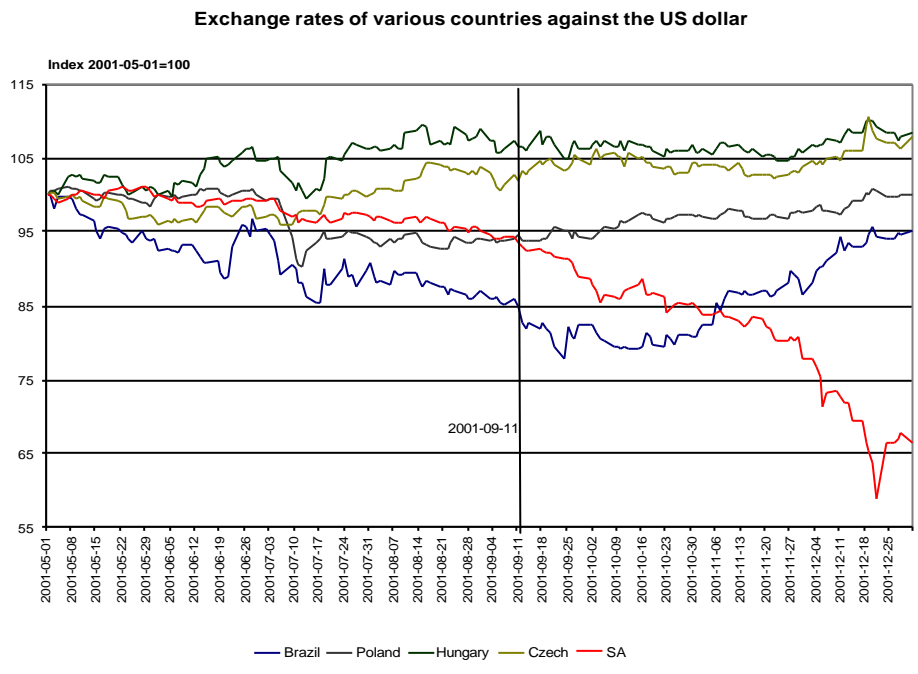
Diagram 5 Expert bundle 120

The graphs below show the rand's performance relative to the exchange rates of similarly rated countries and against those of other emerging-market economies, the thick red line indicating the South African rand:

Graphs 11& 12 Bundle SARB (07) 68-69



Graph 11

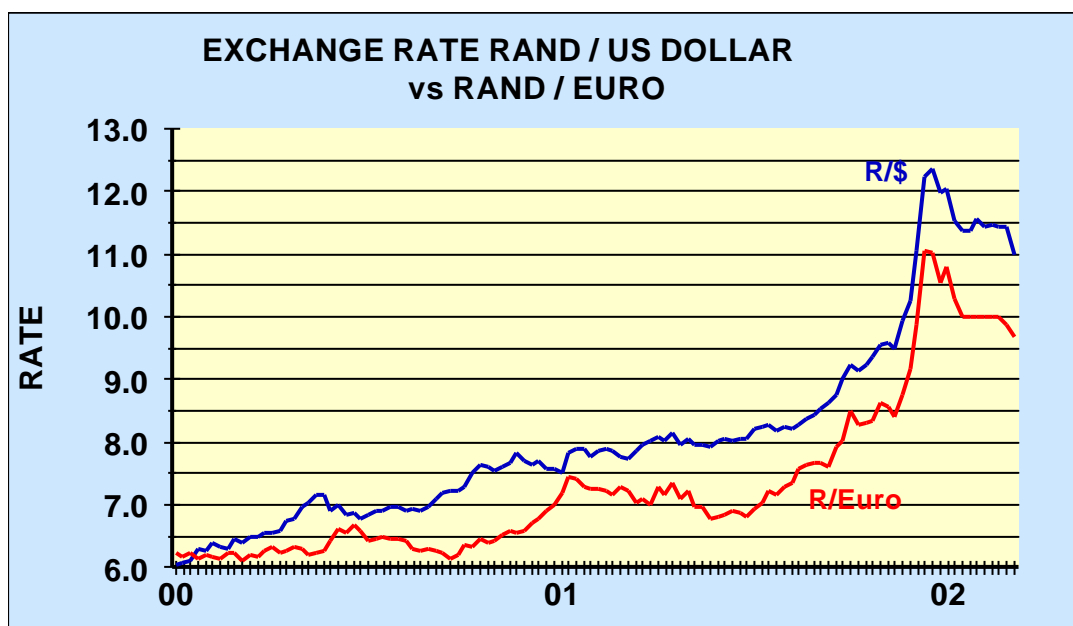


Graph 12

The rand against the euro

- 5 The performance of the rand is usually illustrated against the US dollar. Although the rand/euro exchange rate was no worse in early September 2000 than it had been when the euro was introduced, between September 2000 and November 2000, the rand suddenly began declining against all currencies, especially the euro. This was at a time when the euro began strengthening against the US dollar.¹¹ This is illustrated in the graph below:

Chart 20 Expert bundle 369



C The forex and rand markets, globally and locally

Global Financial Markets

6

6.1 The daily turnover of global foreign exchange (“forex”) transactions in all currencies increased from about USD 600 billion in 1998 to about USD 1.4 trillion (1 400 billion) in 1998 and then decreased to about USD 1.2 trillion in 2001. The primary reason for the decline was the consolidation of players in the forex market. Unlike globally, in South Africa there was no overall concentration of forex dealers.¹²

6.2 The transaction categories that are concluded globally are spot, forward, swap and option transactions.¹³ The swap category is the most frequently used in all currencies globally. Spot, forward and option transactions affect an exchange rate, swap transactions do not.¹⁴ The global counterparties who trade in currencies are reporting dealers, banks, securities dealers, most insurance

¹¹ Jamine Expert bundle 316

¹² Evidence of Mr Robert McCauley, the Deputy Chief Representative, the Representative Office for Asia and the Pacific, Hong Kong, of the Bank for International Settlements (“BIS”): Record 9 – 11.

¹³ As defined in the schedule attached hereto marked “A”.

¹⁴ McCauley Record 14.

companies, pension funds, asset managers, multinational companies, importers, exporters and retail customers.¹⁵ The dealers account for most of the volume of global currency trading.¹⁶

The rand market

7

- 7.1 Unlike trading in major currencies, trading in the rand grew over the period 1998 to 2001, especially in rand terms. Forex trading in South Africa increased from 0.3% of global trading in all currencies in 1992 to 1995, to 0.5% in 1998 and to 0.6% in 2001. The daily turnover in South Africa grew from USD 2 billion in 1992 to USD 8 billion in April 2001.¹⁷
- 7.2 The global daily trading in the rand, for which the off-shore trading component was specifically measured for the first time in April 2001, was USD 11.3 billion, about 75% of which were swap transactions¹⁸. Swap transactions would have had no effect on the exchange rate. Reporting dealers do more than half the trading, other financial institutions such as insurers and pension

¹⁵ McCauley [Record 14](#)

¹⁶ McCauley [Record 15](#)

¹⁷ McCauley [Record 17](#)

¹⁸ McCauley [Record 20](#)

funds do over a third and other companies such as mining companies, multinationals and local importers, do about a sixth.¹⁹

7.3 The rand is an internationalised currency with the bulk of offshore trading taking place in London and to a lesser extent in New York. In April 2001 USD 3.3 billion was traded between two offshore parties (offshore-offshore); USD 3.5 billion was traded onshore-onshore and USD 4.5 billion was traded onshore-offshore, i.e. between institutions in South Africa and those outside South Africa or offshore.²⁰

7.4 It is important to note that, for the USD 3.3 billion traded offshore-offshore:

- there is no record of those transactions in South Africa;
- the Commission has no power offshore to investigate those transactions; and
- the offshore-offshore trading could have affected the value of the rand.²¹

¹⁹ McCauley [Record 20](#)

²⁰ McCauley [Record 21](#)

²¹ McCauley [Record 23-24](#)

South African Forex market

8

8.1 The forex market is the single biggest market, in terms of turnover, of the South African financial markets. Given the openness of the South African economy, this market is an extremely important market. The forex market is essentially an over-the-counter (OTC) market. The primary aim of the forex market is to facilitate international trade and international money and capital movements by providing a market where different currencies can be exchanged for one another. In the South African forex market there are mainly two types of participants: banks authorised by the Reserve Bank to deal in foreign exchange, known as authorised dealers, and brokers. It is the activities of the authorised dealers that are particularly relevant. Authorised dealers are authorised to act as principals in the forex market which means that they can act in their own names and may also run positions in foreign currency. Probably the most important reason for allowing them to run positions and to trade in their own name is to provide liquidity in the market. Liquidity is an important factor underpinning the smooth functioning of the market. Hence the authorised dealers are market makers. Market

makers in the foreign exchange market attempt to make profits by buying foreign currency at a lower price and selling it at a higher price. The difference, or the spread, is the bank's trading profit. The authorised dealers protect themselves during times of excessive volatility in the forex market. Since high volatility is normally associated with uncertain and sharp price movements, authorised dealers will tend to increase the gap or spread between the buying and selling rates. The banks are reluctant to trade during such times by virtue of the fact that the exchange rate could very quickly turn against them, possibly resulting in losses. Authorised dealers, however, are limited to the extent to which they may run open positions and are currently limited to 10% of net qualifying capital and reserve funds.

8.2 During the past decade turnover in the rand market in foreign exchange in South Africa has increased significantly. Increases were particularly noticeable in 1995/6 and in 1998. Both those periods were characterised by crises in emerging markets. The 1998 emerging market crisis was very negative for South Africa from an economic point of view but nevertheless resulted in increased turnover in the foreign exchange market. Since turnover provides a measure of market activity, and also provides a rough proxy for market liquidity, the conclusion is that liquidity in the

rand market in South Africa increased significantly over time by virtue of the increase in turnover.

- 8.3 Liquidity in the forex market has declined. Not only did the turnover decline to lower levels in the last quarter of 2001 compared to the trend of the last few years, but an anecdotal and statistical evidence indicate that the market has become less tight in the sense of widening bid-ask spreads, less resilient, and has lost some of its depth with some transactions being difficult to execute because of the occasional reluctance by market participants to make prices.²²

The environment within which the South African forex market operates

9

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

- Globalisation and the integration of world financial markets had a major impact on the process of exchange rate determination. The South African exchange rate became more exposed and subjected to international

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

developments. In the period about 1995-1999, international investors grouped about thirty emerging market countries together and developments in one or more of those countries affected others. For example, the 1998 crisis was initiated by a financial crisis in the forex market of Thailand, which spread to other East-Asian countries and eventually to countries as far apart as Russia, Brazil and South Africa. In 2001, however, international investors began differentiating between different countries within the group of emerging market economies.

- Dramatic increases occurred in private sector international capital flows. Volumes in the forex markets of the world assumed astronomical dimensions and the ability of central banks to influence market conditions through intervention diminished.
- The gradual abolition of exchange controls in South Africa introduced an element of greater volatility in the local foreign exchange market.²³

²³Evidence of Dr CL Stals, former Governor of the Reserve Bank, [Expert Bundle 171-2](#)

The impact of globalisation and the liberalisation of exchange controls

10

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

- the appropriate macro-economic fundamentals must be put in place;
- a sound and well regulated financial system must be in place;

- a flexible exchange rate has been chosen to act as a shock absorber against global developments.²⁴

10.2 Increased capital flows have the potential:

- to help fuel faster growth and narrow the gap in living standards;
- to raise investment by supplementing domestic earnings;
- to deepen domestic capital markets and raise growth with a more efficient allocation of resources among competing projects. But increased capital mobility and integration of financial markets has also led to increased volatility, particularly in portfolio flows. For example, private portfolio flows to emerging economies almost halved as a result of the Asian crisis, falling from about USD 135 billion in 1997 to about USD 70 billion in 1998.²⁵

10.3 A gradual approach to the liberalisation of exchange controls has to a large extent enabled the Government to manage the volume of capital outflows and allowed it to adapt the pace and strategy of liberalisation in response to changing circumstance. The pace of liberalisation has taken into account factors such as expected

²⁴

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

²⁵

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

capital inflows, the net open forward position (NOFP)²⁶, foreign reserve levels and a desired path for the real exchange rate. The process of exchange control liberalisation, however, is complex due to the size of the capital flows, the number of players in the market and the number of financial instruments available. Capital inflows to South Africa have proved to be volatile. Imbalances in the forex market are more often than not a consequence of the drying up of capital inflows due to mainly external factors rather than changes in capital outflows due to the effectiveness or ineffectiveness of domestic policies.²⁷

10.4 Following on the liberalisation of exchange control, the capital outflows over the period 22 February 2001 to 31 December 2001 were as follows:

Private individuals in terms of their investment allowances transferred	R 7 billion
Corporates by way of foreign direct investment transferred about	R13.5 billion
Institutional investors acquired foreign portfolio investments of	R 3.8 billion ²⁸

²⁶ NOFP is expressed in US dollar terms and is defined as the sum of the net reserves (gross gold and foreign currency reserves minus foreign loans) of the Reserve Bank and its oversold forward book, i.e. the extent to which the Reserve Bank's future obligations to deliver US dollars are not covered by the Reserve Bank's net reserves.

²⁷ Ramos National Treasury Bundle 34-36

²⁸ Evidence of Mr TT Mboweni, Governor of the Reserve Bank, Bundle SARB (7) 34-35

- 10.5 In the opinion of Mr Mboweni, the Governor of the Reserve Bank (“the Governor”), it is virtually impossible to estimate the exact extent to which exchange control liberalisation has contributed to rand weakness but there can be no doubt, as the figures above show, that it could at times have been an important structural factor.²⁹
- 10.6 The re-entry of South Africa into the globalised financial markets and the opening-up to international competition led to a sharp increase in the participation by non-residents in the domestic financial markets. Non-residents are now responsible for about ? of the turnover of the JSE Securities Exchange SA and about ? of the volumes on the South African Bond Exchange. This has caused share and bond prices, as well as the exchange rate of the rand, to be increasingly influenced by developments in the rest of the world, particularly in emerging markets.³⁰
- 10.7 Transactions by non-residents contributed materially to substantial increases in financial sector activity in the period 1995 to 2001:
- annual turnover on the South African bond exchange increased from R2.0 trillion to R12.4 trillion;

²⁹ Mboweni [Bundle SARB \(07\) 35](#)

³⁰ Mboweni [Bundle SARB \(07\) 35](#); Ramos [National Treasury Bundle 40](#)

- the total value of shares traded on the stock exchange rose from R63 billion to R606 billion;
- in the rand forex market volumes increased from a net average daily turnover of USD 2.7 billion to USD 7.3 billion.

10.8 Transactions of non-residents resulted in greater volatility in capital flows:

- (1) Non-resident net purchases of shares on the JSE Stock Exchange SA (measured in billions of rands) were:

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

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

non-residents contributed materially to greater volatility in the external value of the rand.³¹

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

Factors which in general affect an exchange rate

11

11.1 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.

11.2 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

³¹

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.

11.3 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.³²

11.4 Exchange rates and portfolio shifts

11.4.1 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

³²

§11.1 to 11.3 are based on the evidence of McCauley Record 45

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 forward sale of the rand to hedge a long position or to establish a short position.³³

11.4.2 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”.³⁴

11.5 Leads and lags

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 $\frac{1}{12}$

³³ McCauley Record 45 - 46

³⁴ McCauley Record 47

of trade. The leads and lags phenomenon makes the distinction between goods and financial services seem artificial in practice.³⁵

11.6 Exchange rates and contagion

Contagion, as McCauley pointed out, is a medical term and if you are going to catch a bug from somebody you need to come 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 trade links 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 similarity occurs in at least three circumstances:- economic circumstances: 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. Asset class: investors may reduce exposure to a whole "asset

class” such as emerging market or a subclass such as EMEA (East Europe, Middle East, Africa). Policy or regime: 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 profit or loss: 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.³⁶

Determinants of the rand exchange rate

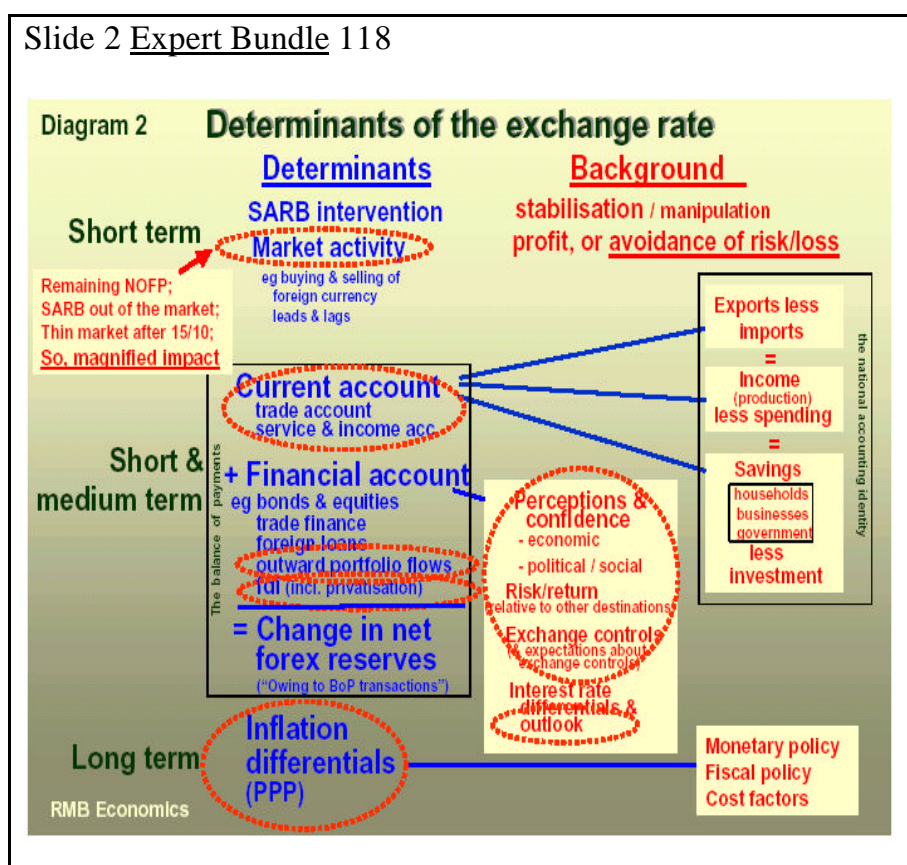
- 12 The exchange rate of the rand is determined by millions of decisions taken daily by
- South African consumers, corporates, foreign exchange dealers, institutional investors and various arms of Government;
 - foreign banks, foreign corporates, foreign institutional investors, foreign governments, multi-lateral institutions (such as the International Monetary Fund (“IMF”) and the World Bank) and

³⁶

foreign individuals such as tourists and consumers of South African products.³⁷

13

- 13.1 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:



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

<u>Long term:</u>	Inflation differentials
<u>Short & medium</u>	- macro-economic factors;
	- perceptions
<u>Short term:</u>	- the role of the Reserve Bank;
	- speculation

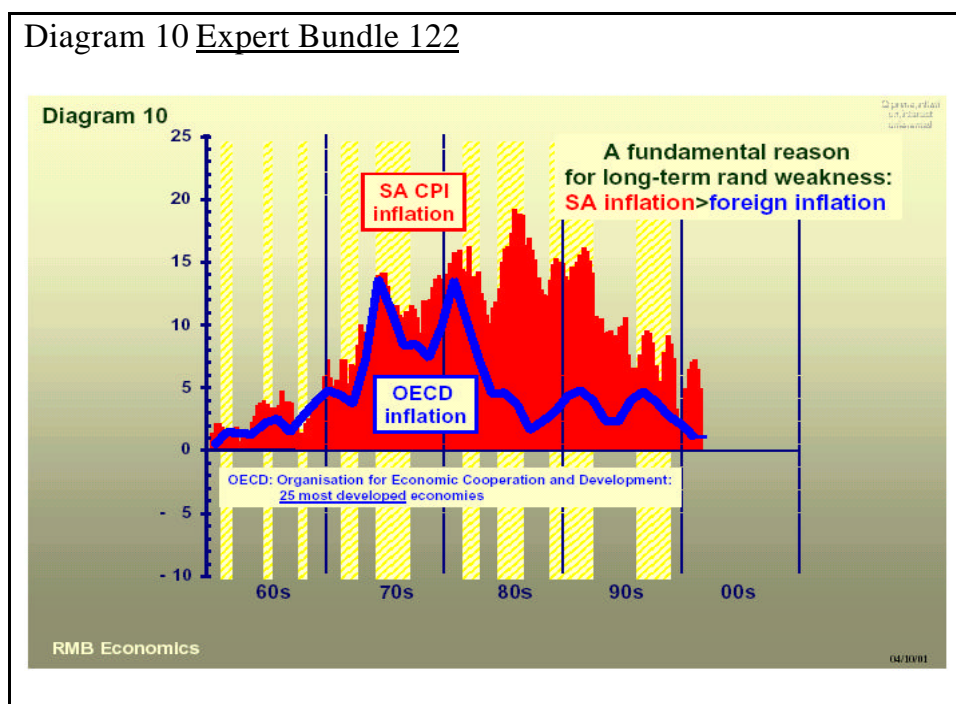
(1) Long Term

Inflation differentials

14

14.1 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.³⁸

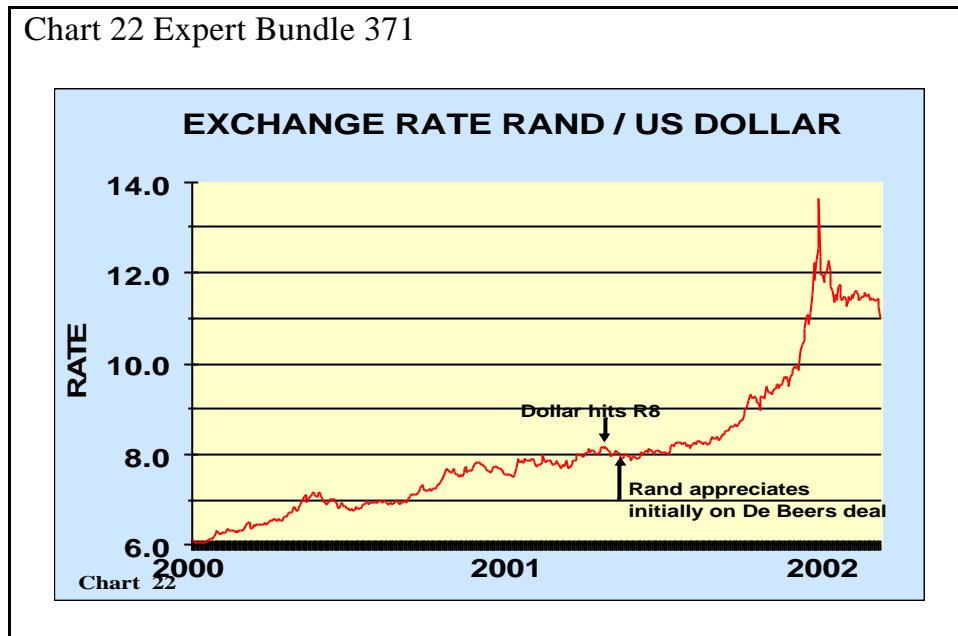


14.2 The slide in the value of the rand, in this phase, began in 2000. During 1999 the rand traded at about R6 to the US dollar, but by the end of 2000 it was trading close to R8 to the dollar, a depreciation of approximately 33%:

³⁸

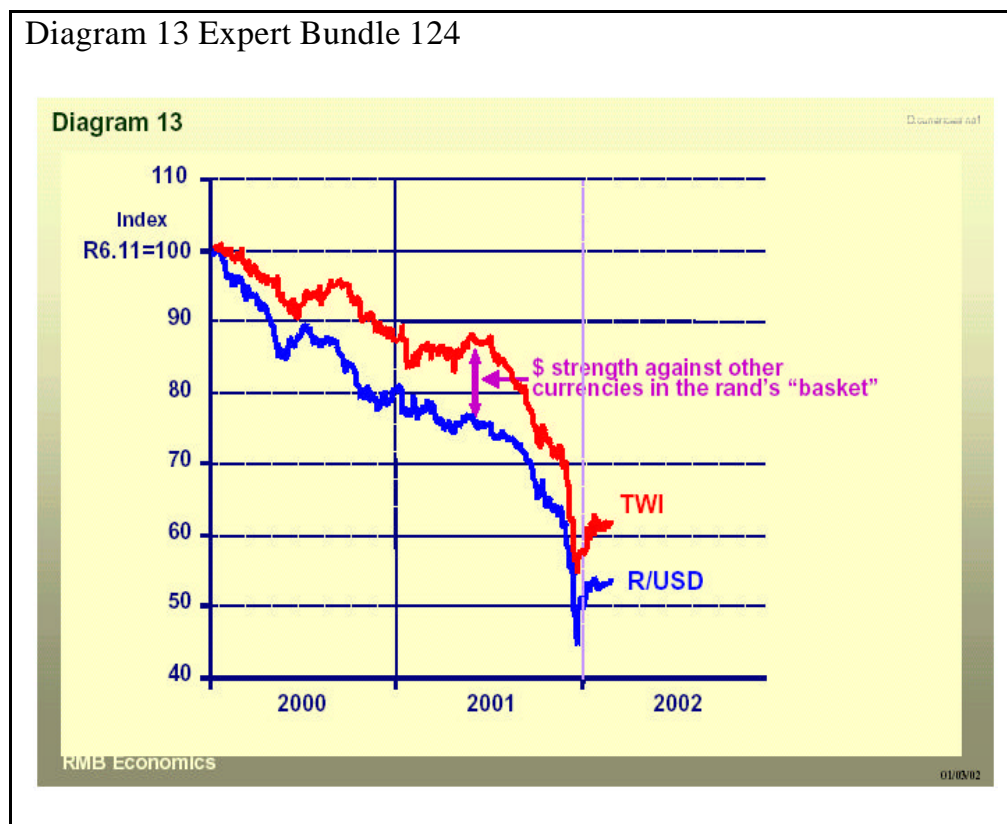
Gouws Expert Bundle 115; Stals Expert Bundle 170; Dr A Jamine, Director and Chief Economist, Econometrix (Pty) Ltd, Expert Bundle 301

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



(2) Short to medium term

Macro-economic factors

15

15.1 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.³⁹ In a market where the exchange rate should be 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.⁴⁰

15.2 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.⁴¹

15.3 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 particularly hard and South Africa was seen as a predominantly commodity based economy. ... The rand's depreciation from R8.52 at

³⁹ Mboweni [Bundle SARB \(07\) 16](#)

⁴⁰ Mboweni [Bundle SARB \(07\) 16](#)

⁴¹ Dr I Abedian, Chief Economist, Standard Bank of South Africa, [Expert Bundle 276](#). See, too,

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.”⁴²

15.4 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 “flight to a safe haven”.

15.5 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 roughly at the same level as at the beginning of the year (R8 to the US dollar).⁴³

for example, Stals, Expert Bundle 173
⁴² Jammie Expert Bundle 321; Mboweni Bundle SARB (7) 16-17
⁴³ Mboweni, Bundle SARB (07) 17

- 15.6 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 payment, however, was not matched by any inflows of international capital into the economy.⁴⁴
- 15.7 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 exchange, a depreciation in the exchange rate of the rand could be expected as a normal market reaction.⁴⁵
- 15.8 The following accounts are worthy of detailed analysis:-

⁴⁴ Mboweni, Bundle SARB (07) 17, 20

⁴⁵ Mboweni Bundle SARB (07) 17; Stals Expert Bundle 173-174.

The services account in the current account of the balance of payments.⁴⁶

15.8.1 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 than 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
Fourth quarter	R41.7 billion ⁴⁷

15.8.2 The financial account of the balance of payments

The financial account summarises the international capital flows and covers all transactions associated with changes

⁴⁶ 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.

⁴⁷ Mboweni Bundle SARB (7) 23

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.

15.8.3 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. 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.⁴⁸

(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 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 2000.⁴⁹

⁴⁸

(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 2001.⁵⁰

15.9 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 circumstances such as these, a depreciation in the exchange value of the rand could be expected as a normal market reaction.”⁵¹

⁴⁹ Mboweni Bundle SARB (7) 25

⁵⁰ Mboweni Bundle SARB (7) 26

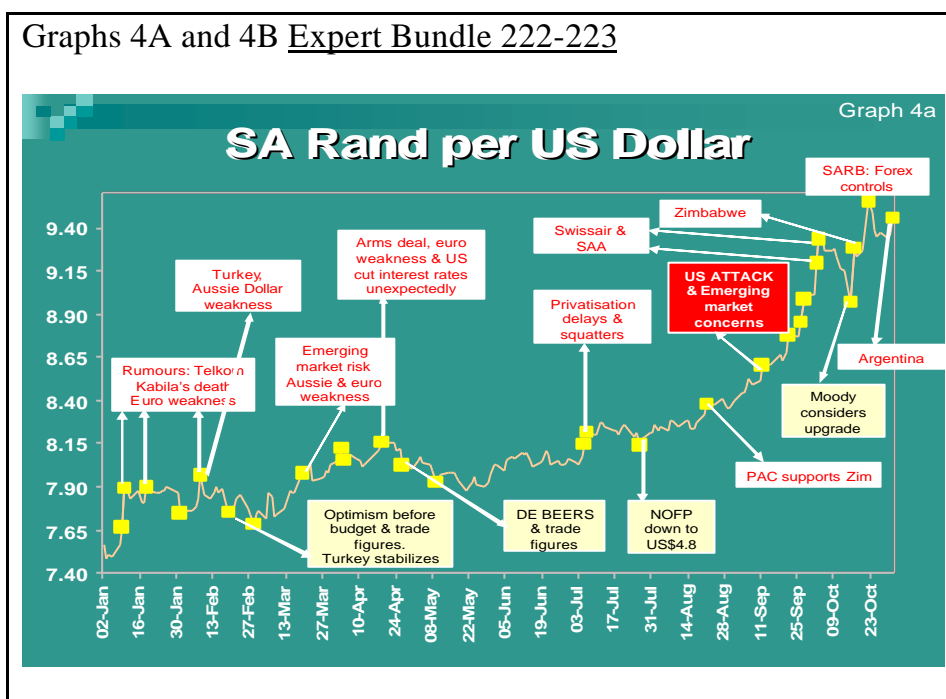
⁵¹ Mboweni, Bundle SARB (7) 29

Perceptions

16

16.1 A number of witnesses testified that during the latter half of 2001 there was a negative perception about South Africa and its currency, the rand. The Governor, for example, 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.⁵² 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 properly⁵³. The factors, negative and positive, which might have impacted on the rand are shown graphically:

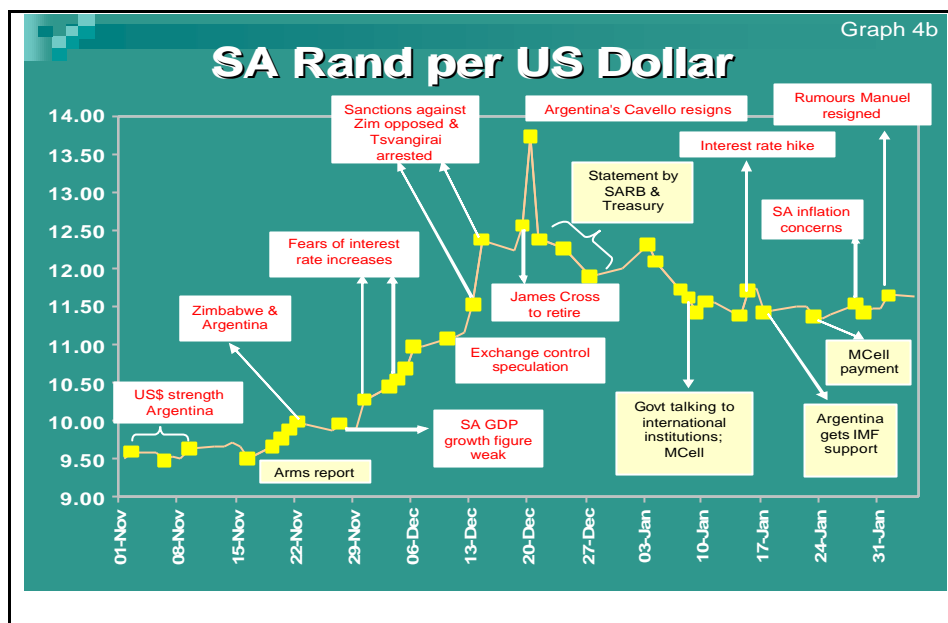


52

Mboweni, Bundle SARB (7) 38

53

Evidence of Mr CW Luüs, Chief Economist, ABSA Group Ltd, Expert Bundle 210, 211



16.2 Privatisation

Conservative estimates had put the foreign currency inflows from privatisation in the 2001/2002 budget as 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."⁵⁴ Dr Jammie 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".⁵⁵

16.3 Exchange Controls

A view is that the exchange control regulations which are still in force potentially deter foreign investment because foreigners

⁵⁴

Abedian Expert Bundle 275-6

⁵⁵

Jammie Expert Bundle 315. See, too Luüs, Expert Bundle 211-212

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 currency because of the fear that comprehensive exchange controls may again be implemented at any time.⁵⁶

(3) Short term

The role of the Reserve Bank

17 Exchange Rate Management

17.1 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:

⁵⁶

Luis Expert Bundle 213; see, too, Gouws, Record 94

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;

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.⁵⁷

17.2 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”.⁵⁸

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 rates 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.

⁵⁸ 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

17.3 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 rates 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.”⁵⁹

17.4 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.⁶⁰

The Reserve Bank

- 18 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

⁵⁹ McCauley Record 78

⁶⁰ McCauley Record 79 - 80

responsible for determining the framework of policy. The day-to-day implementation of that policy is the function of the Reserve Bank.⁶¹

Reserve Bank policies

- 19 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.⁶²

⁶¹ Mboweni, Bundle SARB (7) 5-7

⁶² Stals, Expert Bundle 167-9: 179

- 20 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.
- 21 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 USD 23 billion and by raising interest rates from 14% in June 1998 to 25.5% in August 1998.⁶³
- 22 By 2001 the Reserve Bank and the National Treasury had changed course.

⁶³ Jamine, [Expert Bundle 309,310](#)

23 Inflation targeting

23.1 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.

23.2 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.⁶⁴ 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

⁶⁴

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 instrument 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 andwhether 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.”⁶⁵

23.3 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.”

23.4 Partly because of the move to inflation targeting and partly because of the Government’s exposure to the NOFP, the Reserve

⁶⁵

Stals, Record 286

Bank did not use the forward book to finance intervention in support of the rand in 2001.⁶⁶

23.5 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 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 2001.⁶⁷

⁶⁶ Mboweni [Bundle SARB \(7\) 15, 247](#)

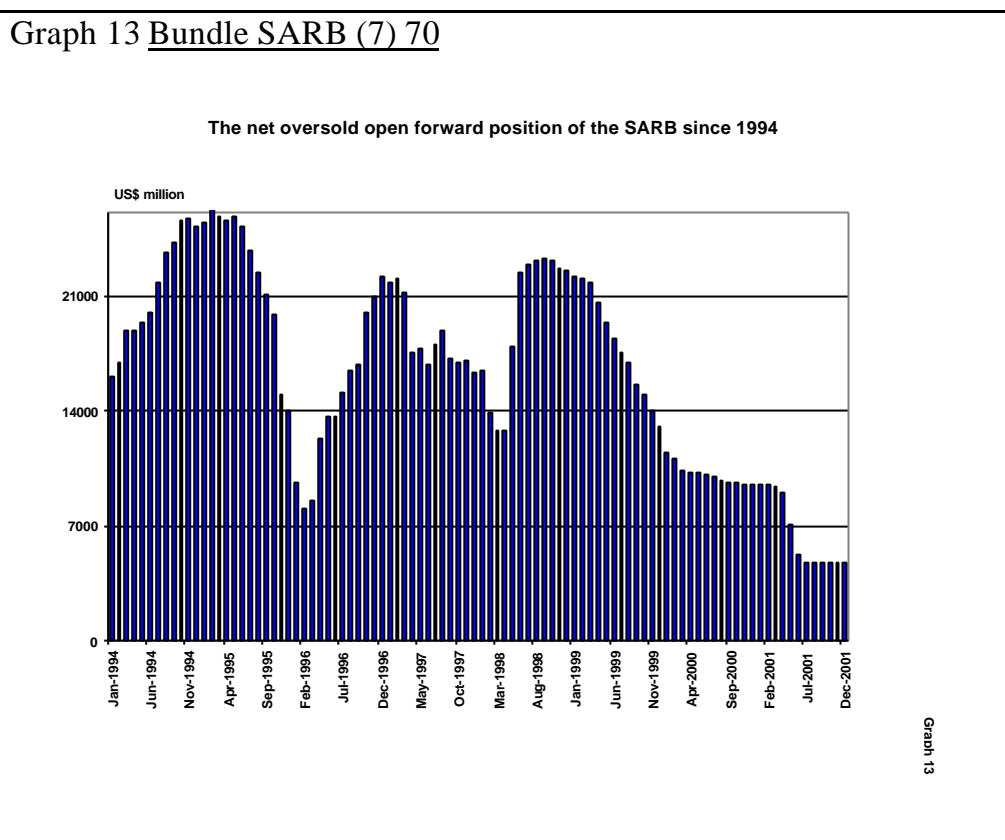
⁶⁷ Gouws, [Expert Bundle 125](#); Mr M Langley, former Head of Foreign Exchange, Credit Agricole Indosuez, Johannesburg, [Expert Bundle 148](#); Jammie [Expert Bundle 339](#); Mr G Glynos, chief market analyst, Standard & Poor's MMS SA, [Expert Bundle 424](#)

24 NOFP

24.1 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 USD 23 billion in 1998 to USD9.4 billion.

24.2 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 USD 4.4 billion and were related to Government’s foreign bond issues and to large corporate transactions. The NOFP, accordingly, declined to USD 5.3 billion at the end of quarter two; USD 4.7 billion at the end of quarter three and USD 4.8 billion as at the end of 2001.⁶⁸ The Reserve Bank’s success in implementing the policy is shown in this graph:

⁶⁸

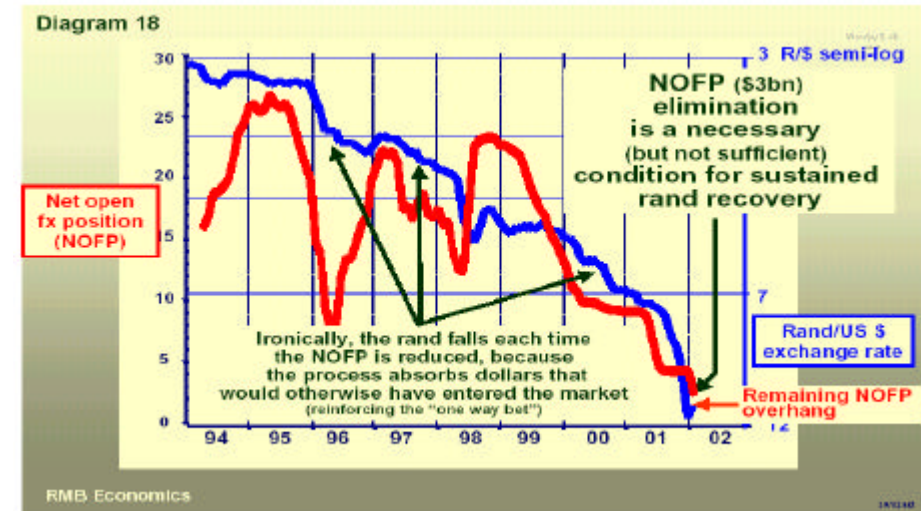
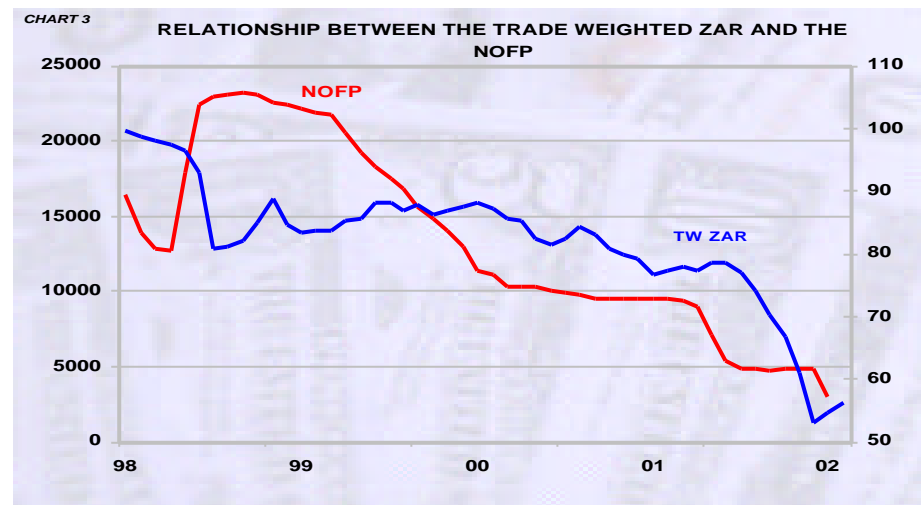


24.3 The policy of reducing the NOFP has been praised by the IMF, the rating agencies and the investment banking community. For example, on 9 May 2001 the IMF stated: “Directors [of IMF] commended the authorities for the significant recent progress made in reducing the net open forward position (NOFP) 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”.⁶⁹

24.4 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.⁷⁰ 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."⁷¹

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

⁷⁰For example, Gouws [Expert Bundle 126](#); Langley [Expert Bundle 148](#); Luüs

Graph 18 Expert Bundle 126Chart 3 Expert Bundle 455

24.6 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.”⁷²

24.7 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 USD 23.2 billion at the end of September 1998 to USD 4.8 billion. Given the negative perceptions resulting from the NOFP, the Reserve Bank reduced 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."⁷³

- 24.8 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

⁷² Mboweni, Bundle SARB (7), p 32 – 33

⁷³ Mboweni, Bundle SARB (7), 340

Commission leaves one with the impression that the statement was either not read properly or ignored.

24.9 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.”

24.10 The Government did indeed increase its foreign borrowings in 2001, including a syndicated loan of USD 1.5 billion, and the Reserve Bank was able to reduce the NOFP to USD 2.9 billion as at the end of January 2002.⁷⁴

25 The meeting of 14 October 2001 and the circulars that followed

25.1 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 on 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 counterparty, other than a correspondent bank, supporting documentary evidence must be obtained confirming that such non-resident counterparty has a legitimate South African exposure resulting from an accrual, investment or asset denominated in rand.”⁷⁵

- 25.2 In about late 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 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.”⁷⁶

⁷⁵ Mboweni, Bundle SARB (7) 42, 43, 340, 342; Evidence of Mr AM Bruce-Brand, General Manager Exchange Control Department, Bundle SARB (6) 22

⁷⁶ Evidence of Bruce-Brand, Record 568, Bundle SARB (6) 224-5

25.3 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.⁷⁷

25.4 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.

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.”⁷⁸

⁷⁷ Mboweni, Bundle SARB (7) 43

⁷⁸ Bruce Brand, Bundle SARB (6) 18, Record 558-9

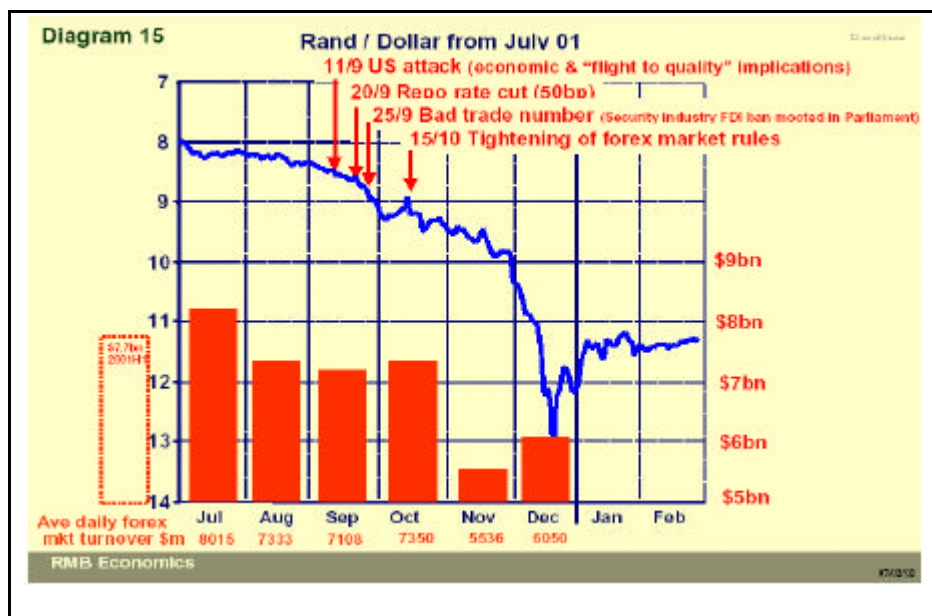
25.5 The Reserve Bank surmises that while consultation between it and the forex market was taking place following on the statement of 14 October 2001, "... some off-shore banks might have decided, as a precautionary measure, to avoid finding themselves in contravention of exchange control rules, to reduce the level of activity in South Africa's foreign exchange markets. This may well have contributed to a decline in liquidity ...".⁷⁹

25.6 The average net daily rand forex market turnover declined from USD 8 billion in July 2001 to USD 7.4 billion in October 2001 to USD 5.5 billion in November 2001 and then increased to USD 6.1 billion in December 2001. This is graphically demonstrated as follows:⁸⁰

Diagram 15 Expert Bundle 125

⁷⁹ Mboweni, Bundle SARB (7) 44

⁸⁰ Mboweni, Bundle SARB (7) 44; Gouws, 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 USD 3.6 billion to USD 2.3 billion respectively.⁸¹

25.7 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 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.”⁸²

25.8 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’.⁸³ 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 USD 200 to USD 300 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.’⁸⁴

25.9 During a volatile forex market, such as South Africa experienced in the fourth quarter of 2001, ‘... many smaller players, that are normally active in calmer market conditions, simply withdraw from a

⁸¹ Mboweni, Bundle SARB (7) 44

⁸² Mboweni, Bundle SARB (7) 45

⁸³ Luüs, Expert Bundle 213

⁸⁴ Abedian, Expert Bundle 273 See, too, Glynos, Expert Bundle 432

volatile market resulting in a sharp decrease in liquidity.”⁸⁵ 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.⁸⁶

25.10 In about the first two days after the meeting of 14 October 2001 the rand depreciated. 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 ...”⁸⁷ Once the market understood the import of this statement, the rand continued to depreciate. The volumes dropped because of the reduced number of market makers 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. Compliance officers of foreign banks probably advised their banks not to trade in the rand until they understood the statement

⁸⁵ Langley Expert Bundle 141

⁸⁶ Mr P De Villiers, Global Head of Foreign Exchange Trading, Investec Bank, Record 363

of 14 October 2001 and could satisfy themselves that they were able to comply with the exchange control regulations.⁸⁸

25.11 There has been much evidence given by the authorised dealers on the impact of the meeting of 14 October 2001 and the circulars issued thereafter. The evidence has not yet been concluded and will accordingly be canvassed in detail in the final report.

Speculation

Introduction

26 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 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,

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De Villiers Record 388

based on the principles of demand and supply operating in an amorphous market.⁸⁹ 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.”⁹⁰ 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 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

⁸⁸ De Villiers [Record 383](#)

⁸⁹ Stals, [Expert Bundle 177](#)

⁹⁰ Luüs, [Expert Bundle 214](#)

case in the rand market in November [2001] and particularly in December, speculators will have a greater impact, even with very small transactions.”⁹¹

27 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 the 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.⁹²

28 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.⁹³ A “pure short seller” or “naked short”, by contrast, is an institution such as an investment fund that has no ongoing business in

⁹¹ Ramos, Record 718

⁹² Mboweni, Bundle SARB (7) 38-39

⁹³ McCauley Record 28

South Africa and which “could put on the short basically looking to profit if the rand goes down”.⁹⁴

29 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.”⁹⁵ 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 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.”⁹⁶

30 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

⁹⁴ McCauley Record 29

⁹⁵ De Villiers Record 367-8

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.⁹⁷

- 31 The fourth point that a number of witnesses made was that it would be extremely difficult to determine the effect of speculative transactions on the exchange rate.⁹⁸ A total of approximately 5.6 million foreign exchange transactions took place in 2001.⁹⁹ 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 2001.¹⁰⁰ Dr Stals made a similar point. He said that in a market with a turnover of at times more than USD 10 billion per day, it would be

⁹⁶ De Villiers Record 376

⁹⁷ Abedian Expert Bundle §2.8 p 261

⁹⁸ Mboweni Bundle SARB (7) 38

⁹⁹ Ms Ramos Record 701

¹⁰⁰ Gouws Expert Bundle 117

extremely difficult to discover and identify individual transactions with malicious intentions.¹⁰¹

32 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.

32.1 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.¹⁰²

An authorised dealer, being a market maker, can be given a position by virtue of a deal being struck. The position which he is

¹⁰¹

Stals Expert Bundle 177

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.¹⁰³

32.2 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 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

¹⁰² Mboweni Bundle SARB (7) 39

¹⁰³ Memorandum of Reserve Bank Bundle SARB (7) 104

commitment to the transactions) that the statement of 14 October 2001 was issued.¹⁰⁴

32.3 Importers and Exporters / Leads and lags

32.3.1 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 nostro¹⁰⁵ account balance pending conversion. To assist in identifying those funds separate sub accounts in the name of the customer were opened in 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 to 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 to 180 from the date on which such funds were first credited to the CFC account.¹⁰⁶

32.3.2 An exporter who anticipates a more favourable exchange rate delays converting export proceeds in the foreign

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

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”).

32.3.3 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 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.¹⁰⁷

32.3.4 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:

¹⁰⁵ A nostro account is the foreign currency account of a local bank with an overseas bank.
¹⁰⁶ Bruce-Brand [Bundle SARB \(6\) 19-20](#)
¹⁰⁷ Mboweni [Bundle SARB \(7\) 39-40](#)

31 December 1998	USD 995m
31 December 2000	USD 1 981m
31 December 2001	USD 2 625m. ¹⁰⁸

32.3.5 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 represents an outflow of $\frac{1}{12}$ of trade. The leads and lags phenomenon makes the distinction between goods and financial services seem artificial in practice.¹⁰⁹

32.3.6 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

¹⁰⁸ Mboweni Bundle SARB (7) 40

¹⁰⁹ McCauley Record 48, Expert bundle 49

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 have every reason to accumulate deposits in such accounts.¹¹⁰

32.3.7 The probability that importers would hedge their purchases of foreign currency (lead) and exporter 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%	

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:

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

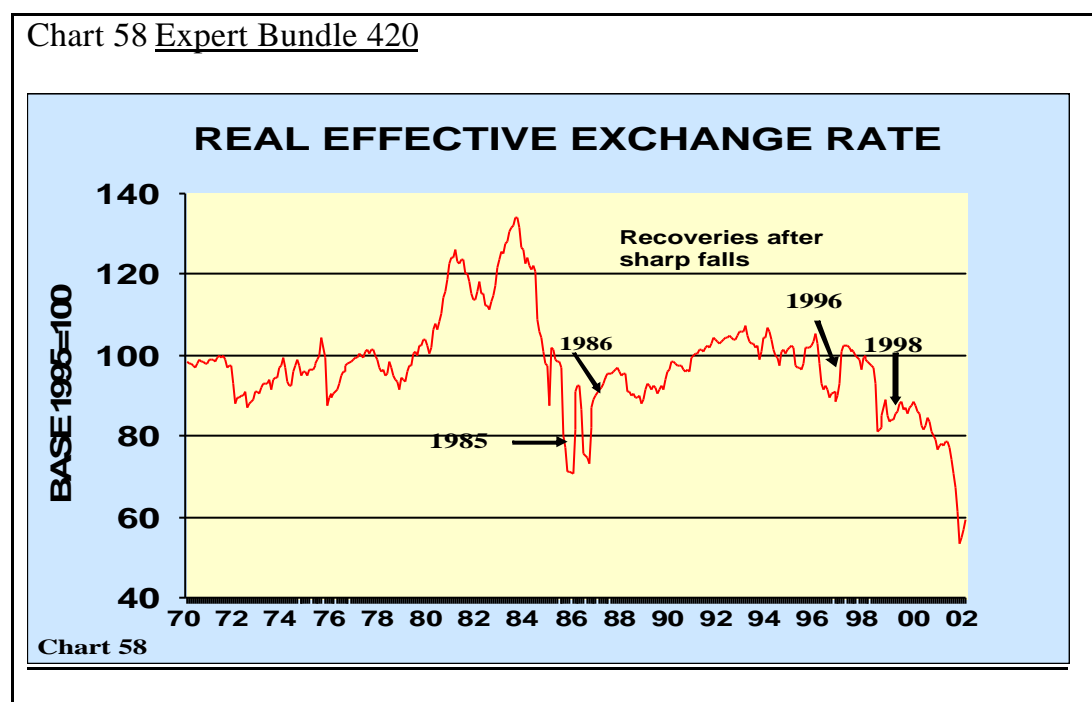
For the year 2001:

<u>Spot rate on</u>	<u>Forward rate</u>	<u>Actual spot</u> <u>rate on</u>	<u>Percentage</u>
<u>01/01/2001</u>	<u>on 01/12/2001</u>	<u>01/12/2001</u>	<u>Difference</u>
7.5625	7.8095	10.255	23.10% ¹¹¹

- 33 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 judgment on the expected future development of the price of the currency.¹¹²
- 34 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.¹¹³
- 35 Dr Jammie 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

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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:



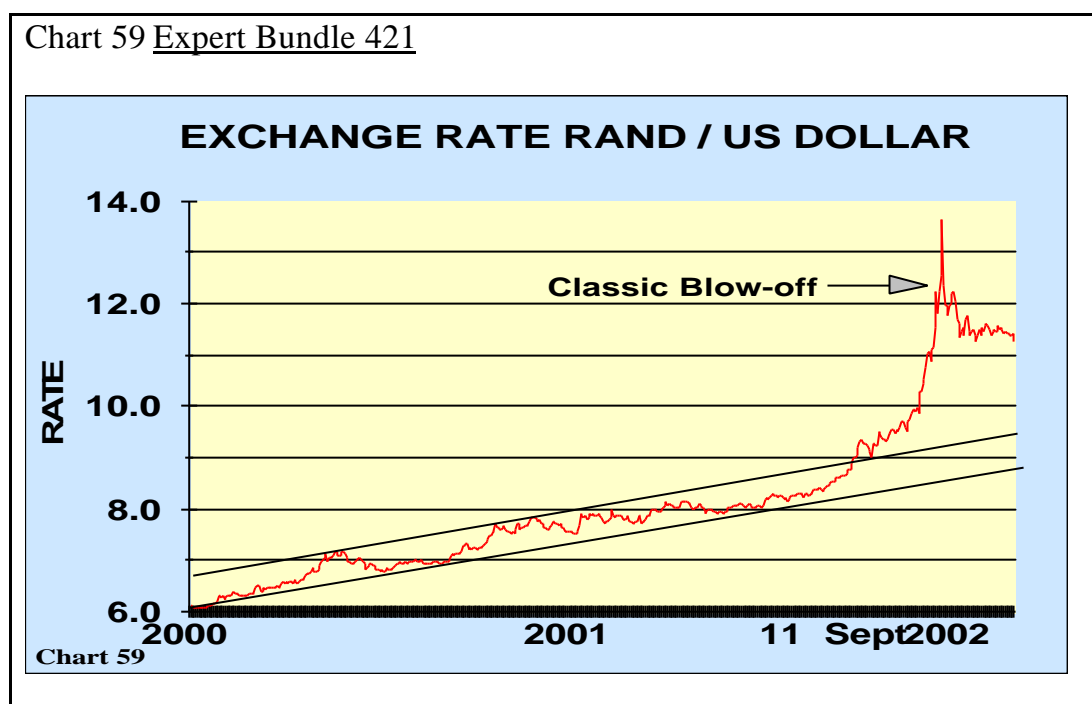
In November, and particularly, December 2001 the rand, according to Dr Jammie, entered a “blow-off” phase. The entire depreciation of the rand against the dollar from the beginning of 2000 until September 2001 saw the depreciation of the rand occurring within a clearly defined upward channel. However, once the dollar had broken the upward channel on the upside, it was apparent that the currency was in

¹¹² Memorandum of Reserve Bank Bundle SARB (7) 104

¹¹³ Memorandum of Reserve Bank Bundle SARB (7) 104

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 be Jammine is shown in the following chart:



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.¹¹⁴

36 Dr Abedian's evidence was that there were "pure currency speculators" in the rand to an estimated volume of USD 200 to USD 300 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 guesstimated amount of possibly as high as 300 million dollars per day."¹¹⁵

The experts' conclusions¹¹⁶

(1) Gouws

37 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

¹¹⁴ Jammie Expert Bundle 343-345; Abedian, Expert Bundle 260-261

¹¹⁵ Abedian Record 422

magnified after mid October 2001 by a lower level of market liquidity 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 2001.¹¹⁷

(2) Stals

38 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.

¹¹⁶

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

- (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.¹¹⁸

(3) Abedian

39 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.

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 2.¹¹⁹

(4) Bruce-Brand

40 Mr Bruce-Brand testified that he was not able to isolate any transactions

¹¹⁹ Abedian Expert Bundle 282, 283

which caused, contributed and/or gave rise to the rapid depreciation of the value of the rand. Furthermore the numerous economic and political factors mentioned by the various witnesses influenced the exchange rate of the rand – which would make the task even more difficult for him.¹²⁰

(5) The Governor

41

41.1 The conclusion that 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 pressures 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.

41.2 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.

¹²⁰

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

- 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.¹²¹

¹²¹

(6) Ramos

42

42.1 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.

42.2 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 redistribution and provides a safety net against the potential social costs of globalisation.

- 42.3 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.
- 42.4 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.¹²²
- 42.5 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

¹²²Ramos, National Treasury Bundle, 58-59

year. There were lots of things happening at the same time.”¹²³

The Minister of Finance spoke of a complex set of factors which were at play.¹²⁴

¹²³ Ms Ramos Record 735-6

¹²⁴ Manuel Bundle National Treasury 87