

## EXECUTIVE SUMMARY

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## **EXECUTIVE SUMMARY**

### **I BACKGROUND**

#### **A Terms of reference**

1 The President of the Republic of South Africa appointed the Commission of Inquiry into the rapid depreciation of the Rand and related matters.

2 The Terms of Reference<sup>1</sup> are to enquire into and report on whether between 1 January and 31 December 2001:

- any person or any other juristic entity, directly or indirectly, entered into, concluded or caused any transactions which contributed or gave rise to the rapid depreciation of the value of the rand during the relevant period relative to other currencies, and whether any such transactions were illegal or unethical;
- any of the transactions in question involved collusion and resulted in any improper gain or avoided loss;

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<sup>1</sup> See Annexure A Part A

- in respect of any of the transactions in question, any authorized dealer in foreign exchange deviated from the terms and conditions of its appointment;
- in respect of any of the transactions in question, existing regulations and/or restrictions on the export of capital from South Africa were contravened;
- in respect of any of the transactions in question, regulations and/or restrictions on the maximum period within which exports proceeds must be repatriated to South Africa were contravened;
- in respect of any of the transactions in question, transactions were entered into that were in contravention of the letter or spirit of the exchange control regulations.

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

- the effectiveness of the current administrative system of ensuring adherence to exchange controls and other regulatory measures in guarding against the occurrence of such transactions; and
- possible action that could be taken against any person or juristic entity identified as having participated in any such transactions.

4 An interim report was submitted on 30 April 2002 to the President pursuant to paragraph 3 of the terms of reference. The Interim Report did not make any findings or recommendations. Parts B, C and D of the Interim Report, suitably amended by additional evidence form an integral part of this Final Report.

B The Commission's interpretation of the terms of reference

5 The Terms of Reference as provided by the President to the Commission, in essence, require an investigation which is focused on analysing *transactions*<sup>2</sup> which contributed to or gave rise to the rapid depreciation of the rand in 2001.

6 Whereas every transaction which is concluded in the forex market has a potential effect on the price of a currency, a transaction which would contribute or give rise to a depreciation of the rand would be one which resulted in an outflow of foreign currency or had a negative impact on the foreign reserves. The net movement of the currency on a particular day would not determine the effect of a specific transaction on the currency. Preventing an appreciation of the currency is regarded as tantamount to causing a depreciation of the currency.

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<sup>2</sup> See §1.1 of the terms of reference, Annexure A Part A

7 The extent of the impact of a transaction on the price of a currency is considered to be determined by:

- the size of the transaction relative to the volume of trading on a particular day;
- the liquidity in the market; and
- the conjoint influence of the transaction with other transactions, as well as other factors<sup>3</sup> which influence the market.

8 It was transactions as described above that were the subject of the Commission's work.

9 The Commission had no difficulty with interpreting the notion of illegality in the Terms of Reference. For the purposes of this Inquiry, a transaction was regarded as illegal if it was in contravention of any applicable legislation.

What was more problematic was what was meant by "unethical transactions". The Commission had difficulty with interpreting the notion of "unethical transactions". In the context of the foreign exchange ("forex") market, a transaction as described in §'s 6 and 7 above, was considered to be unethical, albeit legal, when it was

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<sup>3</sup> See Subsection F §27-54 hereof.

contrary to one definition of ethics in the Shorter Oxford English Dictionary: “the rules of conduct recognised in certain limited departments of human life”. The Commission procured evidence of the “rules of conduct” in the forex market. While there were differences of opinion on what conduct would be regarded as unethical, the following conduct can safely be assumed to be unethical:

- a failure to adhere to the recommendations of the ACI contained in the Model Code relating to gifts, gambling, personal account trading, confidentiality and misinformation and rumours;<sup>4</sup>
- breaches of confidentiality falling short of insider trading;
- price manipulation through rumour mongering;
- spreading rumours deliberately to trigger market “stock losses”; and
- “position parking”;<sup>5</sup>

A transaction as described in §’s 6 and 7 above, was regarded as contrary to the “spirit of exchange controls”<sup>6</sup>, albeit legal, when it ran contrary to the recognised and generally accepted purpose of exchange controls, which, inter alia, includes the protection of the foreign reserves of the country.

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<sup>4</sup> See §’s 1 – 3 Part G

<sup>5</sup> See §8 Part G

<sup>6</sup> See §1.3.4 of the Terms of Reference, Annexure A Part A

- 10 The resulting gain or avoidance of loss in respect of transactions was considered in the following context. Making a gain or profit or avoiding a loss is what participants in the forex markets do in the ordinary course of their participation in the market. It is, however, difficult to establish when making a gain or avoiding a loss becomes “unacceptable.” Leaving aside contraventions of exchange control, the one activity in which it may be contended that the gain made is unacceptable is that of the naked short who transacts in the market, without any underlying transaction, in order to make a turn or profit on the bet that the rand would continue to depreciate.
- 11 As any number of the millions of forex transactions which were concluded in 2001 could have led to the depreciation of the rand, the Commission’s interpretation of §1 of the Terms of Reference is that it must enquire into and report on whether any *particular* transactions contributed or gave rise to the rapid depreciation of the rand. One must not underestimate how difficult it is to do so in a market with a turnover of between approximately USD5.5 billion and USD10 billion a day and in which 5.6 million transactions were reported to the Reserve Bank in 2001 – and that total does not reflect *all* the transactions.

C The Process of Inquiry<sup>7</sup>

12 The Commission appointed assistants to investigate matters raised in the Terms of Reference.

13 Experts who had the requisite knowledge, experience and expertise on the rand and forex markets, locally and globally, and on factors that in their view might have contributed to the rapid depreciation of the rand, were requested to testify before the Commission.

14 Mr Kevin Wakeford and the parties mentioned by him in his report to the President of 8 January 2002 were called upon to testify before the Commission.

15 The South African Reserve Bank, the National Treasury, the authorised dealers and other relevant witnesses were also called upon to testify on matters pertaining to the Terms of Reference.

16 All the evidence was led in public before the Commission in compliance with section 4 of the Commissions Act, no 8 of 1947, save for two hearings which were held in camera.

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<sup>7</sup> See Part A: The Investigation

## D Scope of the investigation

### Period covered

- 17 As per the Terms of Reference, the period 1 January 2001 to 31 December 2001 was considered.
- 18 Investigations, other than those on specific alleged transactions, were focused on the period September to December 2001 while not ignoring the rest of the year, because the major part of the depreciation of the rand occurred during this period.<sup>8</sup>

### The transactions population

- 19 The transaction categories that are concluded globally are spot, forward, swap and option transactions. Spot, forward and option transactions affect an exchange rate. Swap transactions, on the evidence presented to the Commission, do not have an impact.<sup>9</sup>

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<sup>8</sup> See generally Parts J and K  
<sup>9</sup> §1.2 Part C

- 20 Each one of the millions of transactions in the global rand market has the potential to impact on the value of the rand. Foreign exchange transactions arise, inter alia, from investment, hedging, trade, financing or capital transactions, including dividend payments.<sup>10</sup>
- 21 The daily turnover of global forex transactions in all currencies was approximately USD 1.2 trillion in 2001. Forex trading in South Africa was 0.6% of global trading in 2001. The daily turnover in *South Africa* in April 2001 was USD 8 billion. The rand is an internationalised currency with the bulk of off-shore trading taking place in London and to a lesser extent in New York.
- 22 The *global* trading in the rand in April 2001 was USD 11.3 billion, made up as follows:
- USD 3.3 billion: off-shore/off-shore;
- USD 3.5 billion: on-shore/on-shore;
- USD 4.5 billion: on-shore/off-shore.<sup>11</sup>
- A total of 5.6 million foreign currency transactions concluded in *South Africa* were reported to Exchange Control during 2001. Many more transactions took place.<sup>12</sup>

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<sup>10</sup> §3 Part K

<sup>11</sup> See §'s 1 and 2 Part C

### Scope limitations

- 23 The scope of the Commission's work was limited to transactions:
- between South African residents, including authorised dealers (on-shore/on-shore); and
  - between South African residents and non-residents (on-shore/off-shore).
- 24 Transactions between non-residents (offshore/offshore transactions) were excluded because there is no record of those transactions in South Africa and the Commission had no power offshore to investigate those transactions<sup>13</sup>.
- 25 The Commission, through the Reserve Bank, requested the Bank of England to supply it with information on transactions between non-resident banks (offshore-offshore transactions). The Commission was advised by the Bank of England that, due to practical problems with

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<sup>12</sup> See §16.3 Part I. The 5.6 million transactions did not include:  
- the off-shore/off-shore transactions; and  
- all the on-shore/on-shore transactions.

<sup>13</sup> See §25 Part C

regard to obtaining the information from the non-resident banks, no meaningful information could be provided<sup>14</sup>.

E The rand in 2001<sup>15</sup>

26 The rand declined in value from R7.60 to the US dollar at the beginning of 2001 and reached an all-time low of R13.84 to the US dollar on 21 December 2001. There were two distinct periods of the decline:

- for the period 1 January to 31 August 2001 the rand depreciated by 10.7% or an average of 1.3% per month;
- from 1 September to 31 December 2001 the rand weakened by 42%, an average of 10.5% per month.<sup>16</sup>

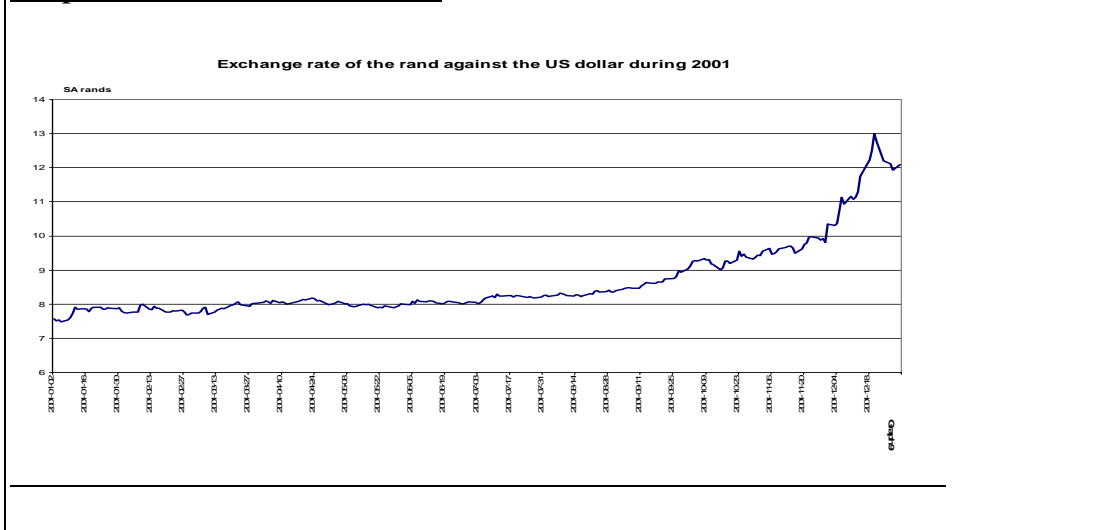
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<sup>14</sup> See §2.6 Part C

<sup>15</sup> See generally Part B

<sup>16</sup> See §2 Part B

Graph 9 Bundle SARB (07) 65



F Context of the forex markets

27 Before attempting to identify the possible causes for the depreciation of the rand in 2001, it is considered essential to obtain a basic understanding of the context in which currencies, and particularly the rand, is traded, and what is considered to determine the price of a currency.

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

- South African consumers, corporates, foreign exchange dealers, institutional investors and various arms of government;

- foreign banks, foreign corporates, foreign institutional investors, foreign governments, multi-lateral institutions (such as the International Monetary Fund (“IMF”) and the World Bank) and foreign individuals such as tourists and consumers of South African products.<sup>17</sup>

29 The specific factors which have been presented to the Commission as generally affecting the price of a currency can be summarised as follows<sup>18</sup>.

#### Supply and demand

30 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 which determine the level of the exchange rate of a currency. An excess *supply* of *foreign* exchange is usually associated with an *appreciation* in the exchange rate 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.<sup>19</sup>

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<sup>17</sup> See §2 Part D

<sup>18</sup> See Part D

<sup>19</sup> See §5.1 Part D

## Globalisation

- 31 Globalisation and the integration of world financial markets has had a major impact on the process of exchange rate determination. Dramatic increases occurred in private sector international capital flows. Volumes in the global forex market assumed astronomical dimensions and the ability of central banks to influence market conditions through intervention diminished.<sup>20</sup>
- 32 One of the thrusts of Government's economic policy since 1994 has been re-integration with the global economy. Globalisation is characterised by rising trade and capital flows between countries. Another policy to which the Government is committed, is the liberalisation of exchange controls. To a large extent the Government has been able to manage capital outflows.
- 33 Another consequence of the re-entry of South Africa into the globalised financial markets was the increase in participation by non-residents in the domestic financial markets, and the consequent increase in the sophistication, size and liquidity in these markets.

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<sup>20</sup> See §4 Part C

### Global economic conditions and events

- 34 Demand for, and supply of a currency are influenced by the state of the global economy which has a direct impact on the hard currency liquidity in the market and consequently exercises up- or downward pressure on a particular currency.
- 35 Similarly, the effects of global economic events, such as the attacks on the World Trade Centre and the Pentagon on 11 September 2001, on the financial markets has a direct impact on the behaviour of the forex markets and the underlying currencies.<sup>21</sup>

### Market liquidity

- 36 Market liquidity, which refers to the ease with which a trade may be executed without causing a significant movement in the price, was considered throughout the evidence in the context of the effect that it has on the relative extent of the impact of any particular exchange rate determinant. A decline in liquidity is normally associated with

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<sup>21</sup> See §5 Part D

increased volatility and relatively small transactions could move the currency to a much larger extent.<sup>22</sup>

#### The performance of the other financial markets

- 37 The markets for equities and bonds are organically interrelated with the market for the foreign value of the currency. Thus a well-functioning equities market, underpinned by a well-performing economy is likely to reflect in the forex market in the form of a strengthening foreign value of the currency. Both actual and expected volumes and prices in equities and bonds markets have a direct impact on the forex market.
- 38 To a large extent, the forex markets subsume all the inadequacies of the other financial markets. As a result, developments in the forex markets are generally more pronounced and more socially consequential.<sup>23</sup>

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<sup>22</sup>  
<sup>23</sup>

See Part D  
Abedian Expert bundle §2.9(c) p 262

### The Balance of Payments

- 39 The demand for, and supply of a currency are also influenced by the state and performance of the local economy as represented by the balance of payments.
- 40 The surplus or deficit of the current account of the balance of payments over the in- or outflows of international capital is also perceived as a major source of exchange rate stability.<sup>24</sup>

### Interest rates and inflation

- 41 The internal purchasing power (determined by inflation) of a currency and its external value (exchange rate) are broadly related and tend to move together over time. It has been observed that if the internal value (inflation) of any one currency falls faster than the internal value of another, the external value of that currency would, over time, reflect that difference in a downward trend.<sup>25</sup>

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<sup>24</sup>

See §5 Part D

<sup>25</sup>

See §1.1 and 4.1 Part D

42 In the same way, a country with above average inflation, and a currency that tends to depreciate, will tend to have higher interest rates. Raising interest rates tends to support the domestic currency by making it more attractive to hold and more expensive to borrow or short.<sup>26</sup>

Relative strength of the currencies of major trading partners

43 It has been observed that the performance of a currency like the rand has to be seen in the perspective of the relative strength, for a variety of reasons, of the currencies of the major trading partners of that country. This can be clearly seen when comparing the performance of the trade weighted index of a currency with the performance of the currency in itself.

44 Therefore, while a currency may appear to be strengthening or weakening, this may be caused solely or largely by an actual strengthening or weakening in the currency against which it is quoted, e.g. US dollar.

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<sup>26</sup> See §1.3 Part D

## Contagion

45 Contagion in financial markets can be distinguished from the original use of the word in medical terms in that it does not require any physical contact. In financial market terms contagion can be classified as:

- contagion based on trade links between two or more countries competing in world markets, where the value of the currency impacts on the competitiveness of a particular country's exports and vice versa;
- contagion based on similarity which occurs where there are similarities in the economic circumstances, asset classification or policy or regimes of any two or more countries; and
- contagion based on profit and loss where losses from one exchange rate can permit or force positioning in or withdrawal from another exchange rate.<sup>27</sup>

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<sup>27</sup>

See §1.6 Part D

### Exchange controls and central bank activities and actions

- 46 A central bank can affect the currency through buying and selling transactions in the forex market, just as any other forex transaction.
- 47 A central bank can also attempt to manage the behaviour of the financial markets and thereby the exchange rate through the following instruments:
- “open mouth” policy where a person in authority makes a statement about the exchange rate with the objective of influencing the exchange rate;
  - intervention to support the currency, which can be done quietly through, for example, signals about potential increases in interest rates, or openly through the purchase of the domestic currency;
  - raising interest rates to defend the currency, making the currency more attractive to hold and more expensive to borrow or short; or
  - imposing or tightening exchange controls which can immediately lift the domestic currency, but also has some negative impacts in the longer term.<sup>28</sup>

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See §7 Part D

### Leading and lagging behaviour

- 48 Leads and lags can be considered to be a type of portfolio shift which occurs in the financing of imports and exports.
- 49 An exporter who anticipates a more favourable (declining) exchange rate delays converting export proceeds in the foreign currency into the domestic currency (“lags”). An importer who fears a worse (declining) exchange rate can accelerate payments for imports by buying the foreign currency forward (“leads”).
- 50 It is considered that every month of lead in a payment and lag in receipts represents an outflow of a twelfth of trade, which makes the distinction between goods and financial services seem artificial in practice.<sup>29</sup>

### Dynamics of the trading environment

- 51 The rand is traded by traders employed by the authorised dealers. Typically the treasury of an authorised dealer would be divided into

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<sup>29</sup> See §'s 1.5, 25.3.2 and 25.3.5 Part D

different departments. One of the departments is the front office. The front office is divided into different desks. One of the desks is the forex desk. The spot rand desk and the spot rand trader are the focal point of rand activity in the trading room. A number of factors influence a trader's view of a currency.

One factor is the information which appears on the screen of a service provider such as Reuters in front of the trader. A spot trader will react to the headline on the screen within seconds, the direction of the trade dependent on his perception of the impact of the headline on the direction of the market.

#### Sentiment and perceptions

- 52 It is clear from the evidence that transactions which are aimed at risk management, i.e. hedging transactions, and transactions aimed at profit making, i.e. market making/proprietary trading and pure speculation, are based on medium to short to very short term views of the market participants on the prospects of the rand. These views determine the market sentiment and may not always in the short term be based on complete or accurate information. Sentiment has been widely acknowledged as having an important influence on the general direction of the currency, as well as the sharp movements which may

occur from time to time. Sentiment may also be an important factor considered by longer-term investors when considering the potential risks associated with an investment in South Africa.

- 53 In determining market sentiment, views on, inter alia, the following are considered important:
- actual and prospective economic growth
  - political stability
  - potential inflows of capital from privatisation.<sup>30</sup>

### Speculation

- 54 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, based on the principles of demand and supply operating in an amorphous market. Speculators can help make a liquid market while there is a healthy demand for and supply of a 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

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<sup>30</sup> See §6 Part D

markets speculators will have a greater impact, even with very small transactions.<sup>31</sup>

## II FINDINGS IN RESPECT OF SPECIFIC TRANSACTIONS

### A The Wakeford allegations<sup>32</sup>

55 The four corporates identified by Mr Wakeford as possibly being parties to dubious share placement transactions with Deutsche Bank AG, Johannesburg Branch (“DBJ”) were Sasol, Nampak, M-Cell and Billiton.<sup>33</sup>

56 The information in regard to Billiton was inaccurate as Billiton did not conclude any share placement transactions in 2001.

57 The nature of the share placement transactions of the three other corporates is described in detail in Part E.<sup>34</sup>

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<sup>31</sup> See §'s 17 to 29 Part D

<sup>32</sup> The Wakeford allegations are analysed in detail in Part E.

<sup>33</sup> See, generally, Part E

<sup>34</sup> See §'s 15 – 17 Part E

- 58 The hedging, funding and related transactions undertaken by Deutsche Bank in respect of each of the share placements were controversial. The nature of those transactions is described in detail in Part E.<sup>35</sup> Commencing in October 2001 and concluding in May 2002, Exchange Control reviewed those transactions in meetings and correspondence with DBJ.
- 59 Exchange Control's material concerns about the hedging, funding and related transactions put in place by Deutsche Bank in respect of the Sasol, Nampak and M-Cell share placements were that:
- the applications for share placements did not disclose all the related or subsequent transactions which were implemented or were to be implemented, i.e. the hedging, funding and related transactions; and
  - some or all of the hedging, funding and other transactions prejudiced the obligation placed on DBJ to ensure reserves neutrality.
- 60 Exchange Control expressed the view that had it been made aware, at the time the applications were made, that the hedging, funding and

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<sup>35</sup>

See §'s 20-22 Part E

other transactions would be concluded, they would not have approved the share placements.<sup>36</sup>

61 DBJ disputed that Exchange Control should have had any concerns about the hedging, funding and related transactions in that:

- the hedging, funding and related transactions were either specifically approved by Exchange Control or fell within general exchange control approvals; and
- the hedging, funding and related transactions maintained reserves neutrality in that the transactions, considered in total, did not result in a net outflow of rand from South Africa.<sup>37</sup>

62 Furthermore, the two parties disputed whether or not the hedging, funding and related transactions were in breach of administrative law duties.

63 It is common cause between them that, in aggregate, the transactions did not contribute to the rapid depreciation of the rand.

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<sup>36</sup> See §'s 23-24, 28 Part E

<sup>37</sup> See §'s 25 and 26 Part E

- 64 The opinion of the team of assistants appointed by the Commission to investigate the Wakeford allegations was that the hedging, funding and related transactions (in regard to the Sasol and Nampak share placements specifically) had the effect that the foreign currency reserves of South Africa were reduced or depleted by Euro 250 million (Sasol) and £15 million and £5 million (Nampak).<sup>38</sup>
- 65 The question of whether or not DBJ had complied with exchange controls in implementing the hedging, funding and related transactions was canvassed at length in evidence before the Commission over a number of days. The evidence in public ended in a stand-off between Exchange Control and DBJ.
- 66 A separate review process initiated by the Reserve Bank culminated in a Settlement Agreement between Exchange Control and DBJ.<sup>39</sup>
- 67 The material terms of the Settlement Agreement were that DBJ and Exchange Control agreed that the Deutsche Bank group would implement a set of transactions described in Annexure 1 to the Settlement Agreement.

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<sup>38</sup>

See §27 Part E

<sup>39</sup>

Annexure C to Part E

68 The Settlement Agreement addresses Exchange Control's concerns regarding reserves neutrality, while at the same time not requiring the unwinding of any of the share placements asset swaps and related transactions (Clause 2). As and when Sasol and Nampak shares are on-placed and the equity hedge (forward) on those stocks unwind, the Settlement Agreement transactions will be unwound on a pro-rata basis (Clause 3). As security for the undertaking by DBJ to ensure that the Deutsche Bank Group would enter into the transactions, DBJ would deposit R10 million with the Reserve Bank on the business day following signature of the Settlement Agreement. The deposit would be interest free. The deposit would be repaid to DBJ once DBJ provided Exchange Control with documentary evidence confirming completion of the transactions set out in Annexure 1 of the Settlement Agreement.

69 The findings of the Commission in regard to the Sasol, Nampak and M-Cell *share placements* are that, viewed in isolation and excluding the funding, hedging and related transactions, such transactions would be considered legal and in accordance with Exchange Control approvals.<sup>40</sup> Furthermore, the *share placements*, viewed in isolation and excluding the funding, hedging and related transactions, when

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<sup>40</sup> See §18 Part E

implemented, would not have impacted negatively on the forex reserves and consequently would not have contributed to the depreciation of the rand.<sup>41</sup>

70 The findings of the Commission in regard to the Deutsche Bank *hedging, funding and related transactions* with respect to the depreciation of the rand in 2001, are as follows:

- the *Sasol* transactions: on the days the currency conversion was effected, 19 and 20 February 2001, the rand appreciated in value on a net daily basis. However, the currency conversions resulted in an outflow of foreign currency at the time of the transaction to the extent that the rand was exchanged for foreign currency in the local forex market. Based on the Commission's definition of the impact of a transaction on the currency, the currency conversion can be considered to have contributed to the longer term depreciation of the rand in 2001;
- the *Nampak* transactions: the rand appreciated in value on a net daily basis on 26 June and 2 August 2001 but depreciated on 27 June 2001, the days the currency conversions were effected. However, the currency conversions resulted in an outflow of foreign currency at the time of the transaction to the extent that the

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<sup>41</sup> See §18.1 Part E

rand was exchanged for foreign currency in the local forex market.

Based on the Commission's definition of the impact of a transaction on the currency, the currency conversion can be considered to have contributed to the longer term depreciation of the rand in 2001;

- the *M-Cell* transactions: Deutsche Bank utilised its own funds to underwrite the transaction and Deutsche Bank London exchanged R231 million for USD20 million on 8 January 2002.<sup>42</sup> The M-Cell hedging, funding and related transactions were reserves neutral and could not have contributed to the depreciation of the rand in 2001;

71 The findings of the Commission in regard to the legality and ethics of the Deutsche Bank *hedging, funding and related transactions* for the Sasol and Nampak share placements are as follows:

- based on the evidence presented to the Commission, the Commission is not able to make a positive finding on whether DBJ was in breach of exchange controls and its administrative law duties<sup>43</sup>. The legal position is not as clear and unequivocal as the two parties contend. It is presumably for that reason, amongst others, that Exchange Control and DBJ settled their differences concluding the Settlement Agreement;

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<sup>42</sup> See [§ 27 Part E](#)

<sup>43</sup> See [§37 Part E](#)

- the transactions cannot be regarded as unethical in terms of the conduct characterised as unethical in §9 of the Executive Summary;
- Clearly, the intention of approving “share placements” is to allow the financing of off-shore investments using local funds in a controlled manner to protect the reserves of the country.

Therefore, based on the Commission’s definition of what constitutes a breach of the “spirit of exchange controls”, the transactions ran contrary to the “spirit of exchange controls” in that there was a lack of up front and complete disclosure with regard to the transactions and the foreign reserves were depleted to the extent that rand was exchanged for foreign currency in the local forex market.

In a sophisticated and dynamic market place, it is accepted that a financial services provider will be pro-actively looking for new products and services to meet the needs of their clients and, at the same time, maximise revenues. However, through a process like this Commission, all market participants are reminded of their responsibilities towards a sustainable economy and the commitment towards business practices which support the regulatory and other structures implemented by the Government.

72 No evidence was found that the *share placements* and the *hedging, funding and related transactions* satisfied any of the other requirements for a reportable transaction in terms of the Terms of Reference.

B South African corporates

73 The KPMG team found that there were a number of large or unusual transactions of South African corporates that “might have” contributed to the rapid depreciation of the rand.<sup>44</sup>

74 All the transactions, with one possible exception discussed below, appear to have been concluded in the ordinary course of business of the corporates and no evidence was found that these transactions were illegal or unethical or satisfied any of the other requirements for a reportable transaction in terms of the terms of reference.

75 During the week ending 7 December 2001, Equity Diamond Cutting Works (Pty) Ltd (“Equity Diamonds”) bought and sold amounts of USD that were out of proportion to its underlying commitments. These transactions may have contributed to the rapid depreciation of the rand during this week.

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<sup>44</sup> See §11.1(b)-(g) Part J

76 These transactions would be in contravention of exchange controls. The transactions were reported to Exchange Control.

C The activities of financial market participants<sup>45</sup>

77 Based on the Deloitte and Touche team analysis of the activities of market participants in order to identify potential transaction types for further investigation, no evidence was found of specific transactions which may have contributed or given rise to the rapid depreciation of the rand in 2001.

78 The analysis performed indicated that the activities of the financial markets participants reflected a uni-directional response to market factors, primarily regulatory, economic and political. The depreciation of the rand and the extent of the exchange rate spread was a reflection of uncertainty, reduced liquidity, a pervasive negative sentiment and a reversal of demand for the rand by foreign institutions.

79 The analysis concluded that the millions of transactions that make up the market, the combined impact of which reflected a demand for

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<sup>45</sup> Generally, see Part K

foreign currency and an aversion to holding rand, contributed to the rapid depreciation of the exchange rate of the rand.

D Institutional investors – Circular D346

80 On 13 November 2001 Exchange Control issued Circular D346 which permitted fund managers to invest a portion of their funds off-shore. Following on that permission, applications totalling R1.9 billion were received in November 2001 and approved by Exchange Control in December 2001. The approvals expired within 30 days or at the latest 31 December 2001. In order to utilise their allowances before expiry, the institutional investors bought foreign currency to buy shares and/or placed the foreign currency on deposit in anticipation of buying shares in 2002. As a consequence, the foreign currency equivalent of R1.765 billion was bought by institutional investors in an illiquid and volatile market.

81 There was no evidence that these transactions were illegal or unethical, in contravention of exchange controls or satisfied any of the other requirements for a reportable transaction in terms of the Terms of Reference.

III FINDINGS IN RESPECT OF FACTORS OTHER THAN  
TRANSACTIONS

A Factors affecting the rand in 2001

The strength of the US dollar

82 It is important to appreciate that the dollar strengthened against three major currencies (the Japanese yen, pound sterling and euro) – not only against the rand.<sup>46</sup>

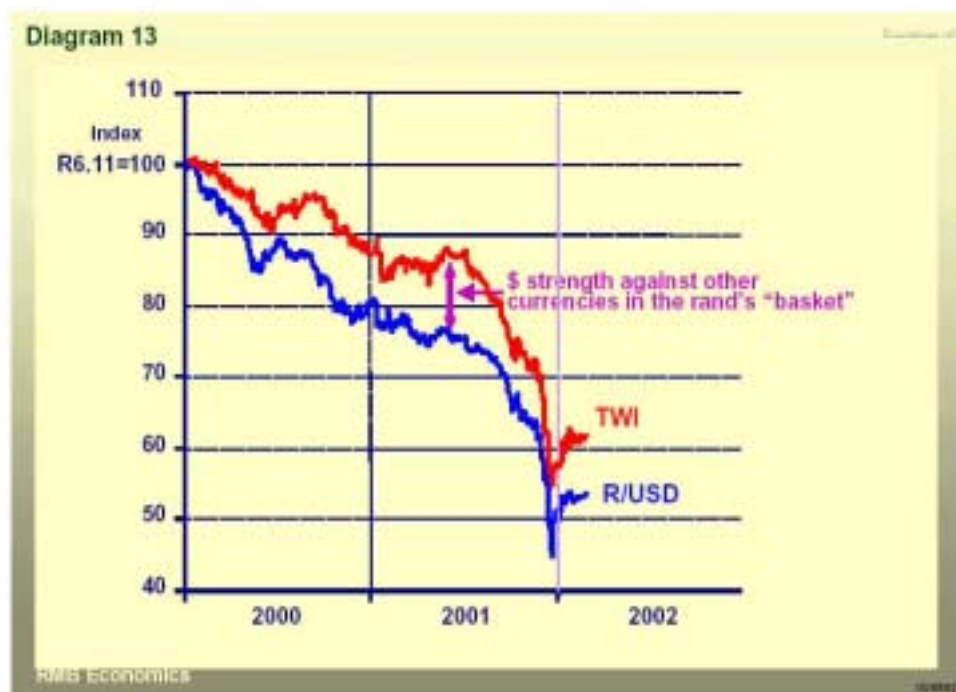
83 The Commission finds that the decline of the rand can partly be explained by the strength of the US dollar.<sup>47</sup>

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<sup>46</sup> See §1.3 Part C

<sup>47</sup> See §4.2 Part D

Diagram 13 Expert Bundle 124, Part D p 10

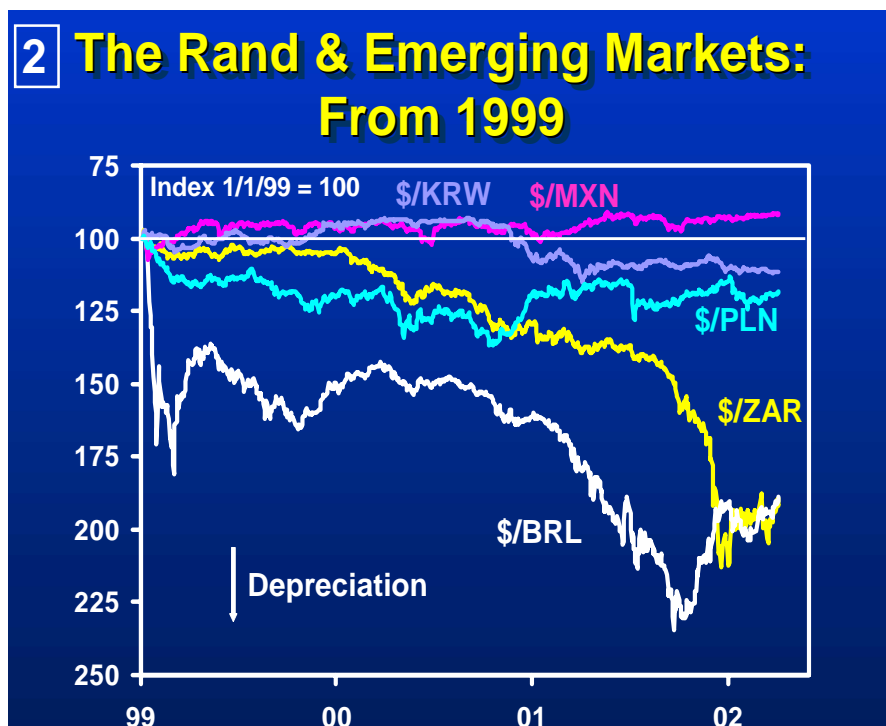


The rand compared to similar currencies

84 The Commission finds that it was not only the rand that depreciated in 2001. The rand performed as well, or as badly, as other similar currencies until about the last quarter of 2001. When one measures the performance of the rand:

- against other *emerging market* currencies, such as the Brazilian real, Korean won, Polish zloty and Mexican peso, the rand was not weaker until about September 2001;<sup>48</sup>
  - against other *commodity* currencies, such as the Australian dollar, the New Zealand dollar, the Norwegian krone and the Swedish krone, the rand performed as well, until September/October 2001.<sup>49</sup>
- It was only in the fourth quarter that the rand became a special case.<sup>50</sup>

Slide 2, O'Neill Bundle 3, §3.2 Part B

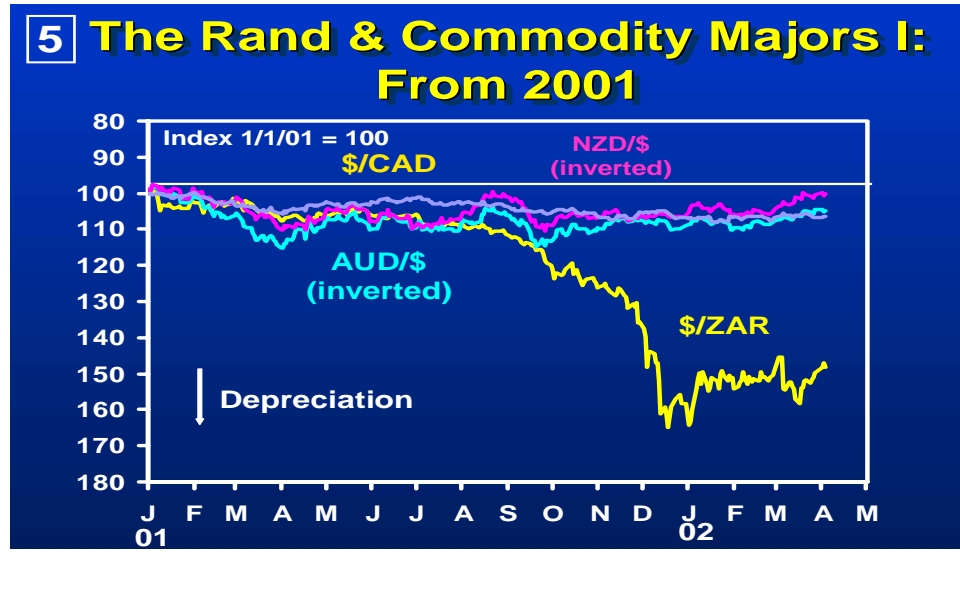


48 See [§3.2 Part B](#)

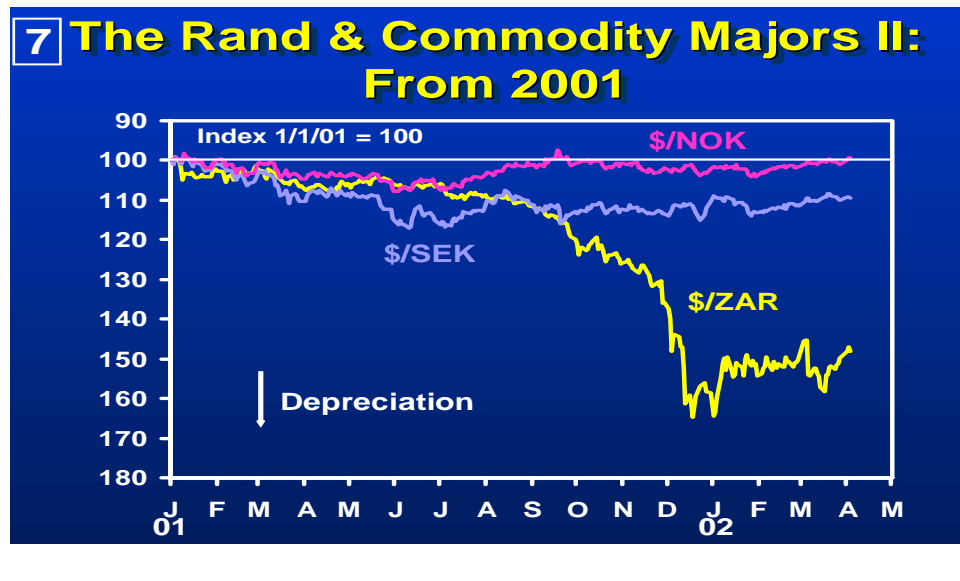
49 See [§3.3 Part B](#)

50 See [§3.1 Part B](#)

Slide 5, O'Neill Bundle 6; §3.3 Part B



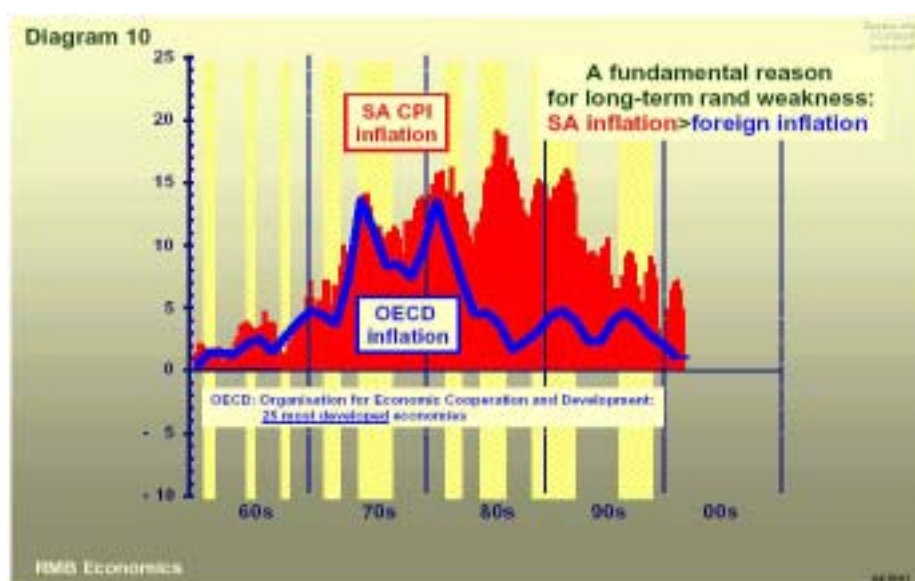
Slide 7, O'Neill Bundle 8; §3.3 Part B



## Inflation Differential

85 The Commission finds that 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.<sup>51</sup>

Diagram 10 Expert Bundle 122; Part D §4.1



## Global Economy

86 There was a decline in the performance of the global economy commencing in 2000 and continuing in 2001.

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<sup>51</sup> See §1.1 and 4 Part D

87 The Commission finds that the deterioration in the global economy had a negative effect on the rand in at least two respects:-

- there was a decline in hard currency liquidity in the market, and
- the flow of capital to emerging markets, including South Africa, reduced.<sup>52</sup>

### Contagion

88 The Commission finds that one of the reasons for the negative sentiment which added to the downward pressure on the rand was contagion through similarity. South Africa and Argentina, for example, are grouped together as emerging markets. Consequently, South Africa and its currency, the rand, were negatively impacted by the Argentinean crisis in 2001. A further way in which contagion operated negatively for the rand was by South Africa's proximity to Zimbabwe.<sup>53</sup>

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<sup>52</sup> See §'s 5.2 and 5.4 Part D

<sup>53</sup> See §'s 1.6 and 6.1 Part D

The Balance of Payments and the flight of capital after 11 September 2001

89 The effects of the attacks on the World Trade Centre and the Pentagon on 11 September 2001 were inter alia:

- a crash in global equity markets;
- increased risk aversion towards emerging markets;
- fund managers withdrew funds from what they regarded as vulnerable economies in a flight to a safe haven (ironically the United States of America ).<sup>54</sup>

90 In quarter 4 total domestic expenditure exceeded 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 South Africa.<sup>55</sup>

91 The imbalance on the financial account of the balance of payments changed from a surplus (or an inflow of capital) of R4.7 billion in quarter 3 to a deficit (or outflow of capital) of R1.5 billion in quarter 4.

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<sup>54</sup> See §'s 5.3 and 5.4 Part D

<sup>55</sup> See §5.9 Part D

- Foreign direct investment (“FDI”)

On a net basis, offsetting changes in direct foreign assets against changes in direct foreign liabilities, FDI changed from an inflow of R3.6 billion in quarter 3 to an outflow of R7.3 billion in quarter 4, thus contributing to the weakness of the rand.

- Portfolio investment

The net outward movement of portfolio capital totalled R3.4 billion in quarter 4.<sup>56</sup> This raised the total net value of international portfolio capital outflows to R67.6 billion in 2001 as a whole compared with net outflows of R13.8 billion in 2000.

- Other investment

On a net basis, other foreign investment amounted to an outflow of R29.3 billion in 2001.<sup>57</sup>

92 The Commission finds that, in fact, capital *left* the country in the fourth quarter of 2001, thereby putting further downward pressure on the rand.

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<sup>56</sup> See §5.8(2) Part D; §6 Part J; §10.2.5.2-3 Part K  
<sup>57</sup> §5.8 Part D

The Broad Basic Balance of Payments as an indicator of rand performance

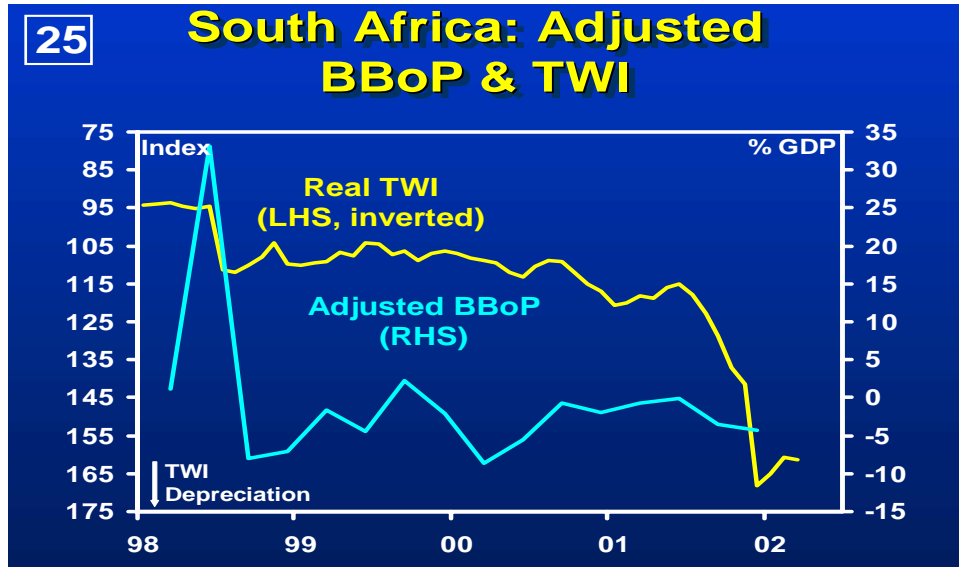
- 93 The impact of the weaknesses in the current account, foreign direct investment and portfolio investment on the rand is best illustrated by the correlation between the performance of the rand and the “broad basic balance of payments” (“BBoP”).<sup>58</sup>
- 94 A country with a BBoP deficit is likely to have a weak currency and a country with a BBoP surplus is likely to have a strong currency. So, for example, despite having a large current account balance of payments deficit, the US dollar has strengthened against other major currencies because the USA BBoP has remained in surplus. In order to take into account the South African net open forward position (“NOFP”), one speaks of an adjusted BBoP (the current account plus FDI plus portfolio flows plus the change in the NOFP).
- 95 As illustrated by the adjusted BBoP which has been in deficit since 1998, the rand has depreciated in value:<sup>59</sup>

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<sup>58</sup> BBoP is defined as the current account plus net FDI plus net portfolio flows.

<sup>59</sup> See §5.10 Part D

Slide 25, O'Neill Bundle 26; Part D p30



### Privatisation

96 It was conservatively estimated that foreign currency inflows from privatisation in 2001 would be about R18 billion. The actual inflows were R2.3 billion. Investors saw privatisation as a litmus test of the Government's commitment to investor friendly economic policies.

97 The Commission finds that the non-occurrence of privatisation transactions to the anticipated extent had perceptual and actual capital

inflow consequences, which resulted in further downward pressure on the rand.<sup>60</sup>

Reserve Bank's policy of non-intervention

98 The Reserve Bank took the entirely justifiable decision not to use the forward book (as it had done in 1998) to finance intervention in support of the rand in 2001. The policy of non-intervention was made public by the Reserve Bank. Participants in the forex market then formed the view that in the absence of support for the rand by the Reserve Bank, the rand would continue to depreciate.

99 The Commission finds that the policy of non-intervention became an element of the “one-way bet” view of the rand.<sup>61</sup>

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<sup>60</sup> See §6.5 Part D

<sup>61</sup> See §13.6 and 13.7 Part D

NOFP<sup>62</sup>

100 The Reserve Bank and National Treasury took a decision to reduce the NOFP. The decision was made public. Total purchases of foreign exchange by the Reserve Bank in 2001 amounted to USD 4.4 billion. The decline of the NOFP (which had been USD 23 billion in 1998) during 2001 was as follows as measured at the end of each quarter:

Quarter 1 : USD 9.4 billion

Quarter 2 : USD 5.3 billion

Quarter 3 : USD 4.7 billion

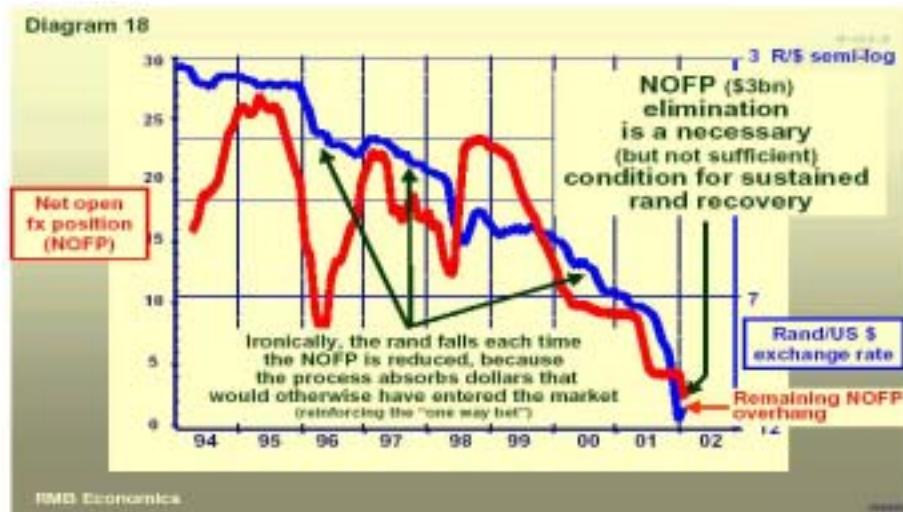
Quarter 4 : USD 4.8 billion.

101 The apparent correlation between the reduction of the NOFP and the depreciation of the rand is shown in this graph:

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<sup>62</sup> 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.

Graph 18, Expert Bundle 126; Final Report Part D §14.5 p50



102 The Reserve Bank's commitment – commendable as it was – to reduce the NOFP (by buying US dollars) contributed to the perception that the rand was a one-way bet.

103 In the statement of 14 October 2001, however, the Reserve Bank made it clear that it would no longer intervene by purchasing foreign exchange from the market for purposes of reducing the NOFP. The NOFP would instead be expunged by using cash flows derived from the proceeds of Government's off-shore borrowings and privatisation.

From then on the NOFP should not have been seen as an element of the one-way bet.<sup>63</sup>

- 104 The Commission finds that the mere existence of the NOFP is viewed negatively by the forex markets and thus continues to contribute to a longer term depreciation of the rand. The manner in which the NOFP was reduced during 2001, through “mopping up” foreign currency from the forex markets, contributed to the depreciation of the rand.

The meeting of 14 October 2001 and the communications that followed

- 105 The Reserve Bank became concerned about comments from the market that speculative transactions, particularly by non-residents, were adding to volatility and rand weakness. The decision was then taken – and conveyed to the authorised dealers at a meeting on 14 October 2001 – that the Reserve Bank would take appropriate steps against trading activities inconsistent with exchange control rules. Existing rules would be enforced to ensure that only legitimate transactions would take place in the forex market. What was targeted was the financing of short rand positions in the domestic markets, which was inconsistent with the

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<sup>63</sup>

See [§14 Part D](#)

requirement that domestic borrowing by non-resident investors was subject to certain restrictions.

106 In about the first two days after the meeting of 14 October 2001, the rand appreciated. On 16 October 2001 the Reserve Bank issued Circular D342, in which it was stated inter alia that "...when dealing with a non-resident counter-party, other than a correspondent bank, supporting documentary evidence must be obtained confirming that such non-resident counter-party has a legitimate South African exposure resulting from an accrual, investment or asset denominated in rand."

107 By 19 October 2001 it was clear that non-residents could continue trading in the spot market.

108 On or about 25 October 2001 non-residents banks were informed of the requirement that the compliance officer of a non-resident bank was obliged to sign a "compliance letter" certifying that all transactions were in compliance with exchange control rules and regulations.

109 The banks indicated that between 35% and 45% of foreign counterparties acknowledged compliance in the manner required.<sup>64</sup>

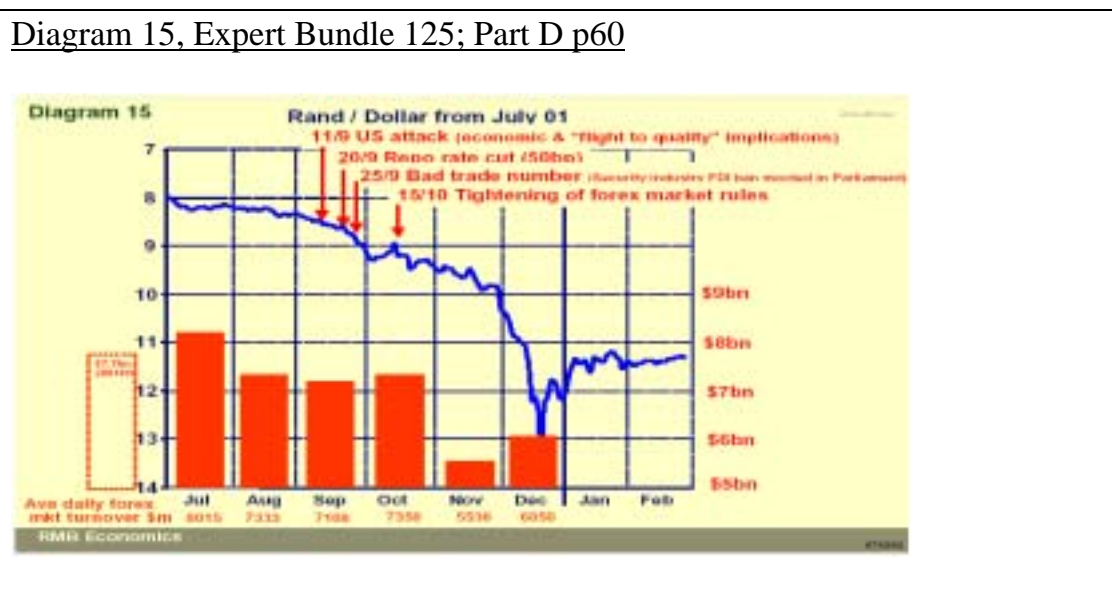
110 The statement of 14 October 2001 and the follow-up Circular D342 and the notice of 25 October 2001 was followed by a decline in the average net daily rand forex market turnover from:

USD 8 billion in July 2001 to

USD 7.3 billion in October 2001 to

USD 5.5 billion in November 2001 and then increased to

USD 6 billion in December 2001.



64

See §15.11 Part D

- 111 The decline in liquidity and the volatility in the market in the last quarter are common cause between the Reserve Bank and the authorised dealers.
- 112 What is in issue is the causality between turnover and volatility in the market and the depreciation of the rand.
- 113 In general, the authorised dealers unanimously testified that the stricter enforcement of exchange controls on non-residents and/or the confusion which arose from differences in the interpretation of the communication, following the 14 October 2001 statement and Circular D342, resulted in an immediate liquidity drain as a result of market participants ensuring compliance with the circular. Further perceived consequences were the expansion of the second-tier rand market outside of South Africa, widening of bid offer spreads and a decrease in the pool of market participants. The increased risk of holding rand resulted in a preference to avoid being long rand. In a nervous illiquid market panic quickly takes hold and nobody wished to get “stuck in a position”. The predominant rational was “get out” of any positions and the market moves were that much more pronounced. For these reasons, the banks considered the circular to be one of the many factors, which contributed to the depreciation of the rand as it drew attention to

concerns about the market but did not prevent ongoing speculation against the rand.

114 The Reserve Bank contended that the statement of 14 October 2001 did not contribute to the rapid depreciation of the rand.

115 The Reserve Bank disputed that there was a causal link between turnover and the value of the rand by referring to periods prior, and subsequent, to 2001 when there was no such link. For example, in 1998 the rand depreciated from USD1 = R 4.90 in February 1998 to USD1 = R 6.20 in July 1998, a depreciation of 26.4%, at a time when the total average daily turnover increased by some 139% from USD3 billion in February 1998 to USD7.4 billion in July 1998.<sup>65</sup>

116 There was, however, a general view expressed by economists and authorised dealers that the effect of the 14 October statements and the communications that followed was negative for the rand in that it drained liquidity from the forex market by a stricter application of exchange controls, and the decline in the spot market might well have contributed to the size or speed of the depreciation of the rand.<sup>66</sup> It was

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<sup>65</sup> For other examples see [§15.14 Part D](#)

<sup>66</sup> See [§15.8 Part D](#)

viewed that with the 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”;<sup>67</sup>

117 The Commission finds that the 14 October 2001 statement and Circular D342 changed the behaviour of market participants and were amongst many factors which contributed to the decline in liquidity and increase in volatility in the forex markets, thereby contributing to the depreciation of the rand.

118 The Commission, furthermore, finds that the 14 October 2001 statement and Circular D342 reduced the activities of speculators in the market, but did not fully achieve the originally intended purpose of stemming the rapid depreciation of the rand.

#### Negative Sentiment

119 The Commission finds that market sentiment in 2001 and particularly during the last quarter was negative towards the rand. In addition to the factors mentioned earlier, such as Zimbabwe, Argentina, exchange controls and the lack of privatisation, there were negative perceptions,

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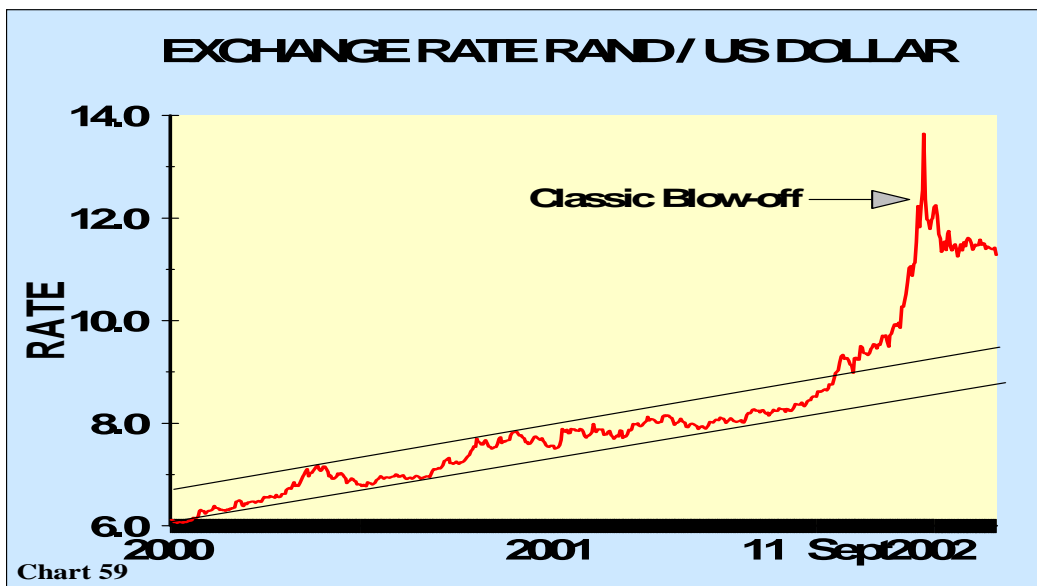
<sup>67</sup> See [§15.13 Part D](#)

for example, about unemployment, HIV/Aids, crime and a lack of labour market flexibility.<sup>68</sup>

The “blow-off” of October to December 2001

120 The depreciation of the rand from the beginning of 2000 until September 2001 was within a defined upward channel. The rand then entered uncharted territory, a “blow-off”:

Chart 59 Expert Bundle 421; Part D p97



121 The forex market became volatile. One month historical volatility of the rand’s exchange rate against the US dollar increased from a level of

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<sup>68</sup> See §6.1 – 6.4, 41 Part D

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.<sup>69</sup>

- 122 During this period the authorised dealers' profits from forex activities increased significantly.<sup>70</sup>

The explanations for the “blow-off” as provided in evidence

- 123 The probabilities are that everyone who traded in the rand in the last quarter of 2001 took the view – or speculated – that the rand would continue to depreciate and acted in accordance with that view, thereby further depressing the value of the rand.
- 124 One must be wary of condemning all speculation without an understanding of what it entails. If speculation implies transactions entered into based on a view of the future value of a currency, then most forex transactions have a speculative element in them. In the banking industry in South Africa, speculation is understood as the adopting of a view as to the likely movement in the exchange rate of a

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<sup>69</sup> See [§15.7 Part D](#)

<sup>70</sup> See generally [Part H](#)

currency and acting on the view with the intent of making a profit or preventing a loss. Transactions fitting that definition are transacted daily. Speculative activities of that kind are conducive to a liquid and efficient financial market. Authorised dealers view profit making from proprietary trading and market making as not unethical or improper. In the Commission's view, what may be offensive is the conduct of a "market user" who is not a "market maker" or the conduct of a "pure short seller" or "naked short" who trades in the rand, with no underlying transaction, looking to make a profit if the rand goes down.<sup>71</sup>

125 One view is that the steep decline in the value of the rand in quarter 4 was due to "speculators ... in the financial services industry both domestically and abroad" and "pure currency speculators" in the rand to an estimated volume of USD 200 million to USD 300 million per day.<sup>72</sup>

126 But it is not only the conduct of "pure speculators" or "naked shorts" which must be scrutinised:-

- *Authorised dealers* are allowed to conduct proprietary trading, i.e. to trade the rand for their own account in the inter-bank market.

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<sup>71</sup> For a detailed discussion on "speculation" see §'s 18-22 Part D

<sup>72</sup> See §28.3, 29, Part D

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.<sup>73</sup>

- *Non-resident banks* trade rand very actively and represent some 55% of the total turnover in the rand forex market. It is because the Reserve Bank believed that non-residents were trading contrary to the exchange control rules (ie there was no underlying commitment to the transactions) that the statement of 14 October 2001 was issued.<sup>74</sup> In the investigation conducted by KPMG on behalf of the Commission, there was no indication that non-resident banks were responsible for the depreciation of the rand in November and December 2001. Non-resident banks were buying rand and selling US dollars to the authorised dealers for 28 out of 42 business days in November and December 2001. However, there was a demand for US dollars in the market which did not reduce over this period. This fact - and not a large scale selling of rands by non-resident banks – put pressure on the rand.<sup>75</sup>
- An *exporter* who anticipates a more favourable exchange rate can delay converting export proceedings in the foreign currency into the

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<sup>73</sup> See [§25.1 Part D](#)

<sup>74</sup> See [§25.2 Part D](#)

<sup>75</sup> See [§7.3 Part J](#)

domestic currency (“lags” its payment). An *importer* who fears a worse exchange rate can accelerate payments for imports by buying the foreign currency forward (“leads”). An exporter is entitled to retain foreign currency earnings in respect of the export of goods for 180 days from the date on which the funds were first credited to a CFC account.<sup>76</sup> With the continuous weakening of the rand in recent years, it has become common knowledge that any delay in repatriation of foreign currency is likely to make currency gains over and above trade profit.<sup>77</sup> The probabilities are that as the rand was seen as a one-way bet, prudent importers bought foreign currency forward and gleeful exporters delayed repatriating foreign currency. Even if exporters delayed for 180 days, acting lawfully, the negative impact on the rand would have been significant. In quarter 2 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 were involved in leads and lags, it would have had a noticeable effect on the exchange rate.<sup>78</sup>

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<sup>76</sup> In certain circumstances, the period can be 570 days: §17.4(1) Part I

<sup>77</sup> See [§25.3.6 Part D](#)

<sup>78</sup> See [§25.3 Part D](#)

127 The Commission finds that there is not sufficient evidence to conclude on whether unacceptable speculation was a cause or contributing factor to the rapid depreciation of the rand in 2001.

128 Into the cauldron that the forex market became in quarter 4, went the following brew:

- a deficit on the current account on the balance of payments;
- the double whammy that the deficit was not matched by an inflow of foreign investment capital *and* capital left the country: from an inflow of capital from R4.7 billion in quarter 3 to an outflow of capital of R1.5 billion in quarter 4;
- knowledge of the Reserve Bank's policy on non-intervention;
- the thinner forex market after 14 October 2001.

Adding fuel to the fire was the pervasive negative sentiment. The rand was seen as a one-way bet. Panic set in. A herd mentality prevailed. Each transaction based on the view that the rand *would* depreciate became an element of a self-fulfilling prophecy. Everyone acted in the same way, but there was no evidence of collusion or acting in concert. The impact on the rand was nevertheless the same. Common sense asserted itself only after the joint press release of the Minister of Finance and Governor of the Reserve Bank on 21 December 2001.

#### IV FINDINGS IN RESPECT OF EXCHANGE CONTROL<sup>79</sup>

##### A The effectiveness of the administration of exchange controls

129 Exchange control policy is determined by the Minister of Finance. The Exchange Control Department of the Reserve Bank (“Exchange Control”) is responsible for the day-to-day administration of exchange control. Although the authorised dealers are not the agents of Exchange Control but act on behalf of their customers, they are considered to be jointly responsible with Exchange Control for the administration of exchange controls.

130 The KPMG team which investigated the effectiveness of the current exchange control administration identified strengths and drawbacks.

131 The strengths of the current system are:

- Exchange Control has effective controls for ensuring the validity of applications and for ensuring that it has received all the applications submitted by authorised dealers;

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<sup>79</sup> See, generally, Part I

- a response to an application requires dual control before being given to the authorised dealer to enhance control over and consistency of approvals;
- the electronic feeding of cross-border foreign exchange data from authorised dealers should help to provide timeous and complete information for balance of payments statistics;
- imports/export undertakings have removed a substantial amount of the paperwork that used to be the responsibility of authorised dealers; and
- authorised dealers have implemented processes to ensure compliance with exchange control rules and are responsible for about 99.5% of forex transactions.<sup>80</sup>

132 The drawbacks of the present system relate, inter alia, to export proceeds and CFC accounts; double counting; shorting the rand; staff competence; transfer pricing; weaknesses in the audit by external auditors of compliance by corporates with exchange control rules; submission of applications; compliance with approved conditions; inconsistency of approvals; accuracy of data; communication by Exchange Control, smaller transactions.<sup>81</sup>

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<sup>80</sup>

See [§17.3 Part I](#)

<sup>81</sup>

For more details, see [§17.4 Part I](#).

- 133 The major authorised dealers commented that:-
- Exchange control rulings are open to conflicting interpretations.
  - The current requirement for the presentation of paper based documentation to support cross-border payment transactions is not necessarily effective and is open to abuse.
  - The accurate matching of multiple debit transactions against credit transactions against CFC accounts can be problematic.
  - Difficulty has been experienced in enforcing compliance by non-resident banks with Circular D342 of 15 October 2001.
  - There is insufficient consultation by Exchange Control with authorised dealers before Rulings are made.
  - It is considered impossible to ensure that non-residents comply with Exchange Control because non-residents are allowed to trade with any authorised dealer in South Africa and may have accounts with more than one authorised dealer.
  - The administration of CFC accounts in order to control the 180 day rule is cumbersome.
- 134 The best judge of whether or not the exchange control system is effective is Exchange Control. The evidence of Exchange Control was that exchange controls are effective provided that all role players fulfil their obligations in both the spirit and the letter of the existing rules and

regulations. By and large the experience of Exchange Control is that that is the norm.

135 There were relatively few difficulties reported with the approximately 5.6 million forex transactions which were reported to Exchange Control during 2001. Difficulties, in the main, were limited to share placements. The number of transactions successfully implemented in 2001 bears testimony to the fact that exchange controls operate efficiently and effectively within the policy parameters set by the Minister of Finance.<sup>82</sup>

136 Exchange Control responded to the comments and recommendations of the authorised dealers, for example, as follows:

- authorised dealers report to Exchange Control when they do not receive the compliance letters from non-resident banks; in the interim it is allowing transactions to proceed in order not to interfere unduly with the smooth operation of the forex market in South Africa; compliance letters continue to be called for and non-receipt must still be reported to Exchange Control;

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<sup>82</sup>

- a minor inconsistency or an unclear point in exchange control rules does not render the administration of exchange controls in their totality ineffective;
- authorised dealers have the opportunity to air their views on any issue relating to exchange controls at the Liaison Committee, which meets quarterly under the chairmanship of the General Manager of Exchange Control;
- every effort is made by the Reserve Bank to implement exchange controls in order to facilitate the commercial transactions of the South African economy;
- a degree of flexibility is applied in the implementation of exchange controls; and
- if, in some instances, flexibility leads to uncertainty, it is a price worth paying.<sup>83</sup>

137 In view of their responsibilities for exchange control, the effectiveness of the processes and procedures of the authorised dealers can be summarised as follows:

- the major part of the work (about 99.5%) is done efficiently by the authorised dealers.

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<sup>83</sup>

See §'s 15 & 16 Part I

- contrary to the impression that might have been created in the Commission, there is a high degree of co-operation between Exchange Control and the authorised dealers;
- Exchange Control, which holds regular inspections of the authorised dealers, did not contend that the authorised dealers were not complying with their exchange control obligations;
- in general, the authorised dealers have exchange control departments which are internally and externally audited and Exchange Control conducts inspections; and
- where breaches of exchange control occurred during 2001, the breaches were reported to Exchange Control<sup>84</sup>
- relatively few difficulties were reported to Exchange Control in 2001. The breaches were not material and did not have a negative impact on the rand.<sup>85</sup>

138 The Minister of Finance summed up the evidence before the Commission by stating that it does "... not seem to point to any systemic gaps in Exchange Control Regulation."<sup>86</sup>

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<sup>85</sup>

See §1.3.4 of the Terms of Reference

<sup>86</sup>

Statement of Minister of Finance on 24 May 2002, Record 1759

- 139 The Commission finds that, generally, the administration of exchange controls appears to work well and is effective. There was no suggestion before the Commission that any authorised dealer in foreign exchange deviated from the terms and conditions of its appointment.<sup>87</sup>
- 140 There was not enough evidence regarding compliance with the 180 day repatriation rule for the Commission to make a conclusive finding.<sup>88</sup>
- 141 It does not follow, unfortunately, that because there is no *proof* that the 180 day period was not exceeded, that in fact exporters did *not* exceed 180 days in repatriating funds. As the KPMG team found, an exporter can illegally exceed the 180 days retention limit in the CFC accounts by opening CFC accounts with more than one authorised dealer and by then moving the foreign currency between the different CFC accounts. Exchange Control has no direct control over export proceeds until they are deposited in a CFC account or sold to an authorised dealer. Exchange Control will not know when an exporter's off-shore client pays for the goods. Neither will Exchange Control know whether the exporter has complied with a 30 day trial limit within which such export proceeds have to be credited to a CFC account or sold at spot. It

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<sup>87</sup>

See [§1.3.1 of the Terms of Reference](#)

<sup>88</sup>

See [§1.3.3 of the Terms of Reference](#)

is not practical for Exchange Control or the authorised dealers to monitor this and reliance has to be placed on exporters.<sup>89</sup>

**B** Liberalisation of exchange controls<sup>90</sup>

142 The Minister of Finance testified that, 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.

143 The Government has chosen a policy of gradual liberalisation of exchange controls based on a set of key policy and structural requirements:-

- It is imperative that the appropriate macro-economic fundamentals be put in place. These include credible and sustainable fiscal and monetary policies; pro-growth trade and investment policies and a Government spending programme that promotes redistribution and provides a safety net for the poor against the potential social costs of globalisation;

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<sup>89</sup> See §17.4(1) of Part I

<sup>90</sup> See §'s18-23 of Part I

- In an environment of global integration with large and rapid shifts in capital flows, it is essential for a sound and well-regulated financial system to be in place; and
- The Government has chosen to follow a flexible exchange rate to act as a shock absorber against global developments.

144 The evidence of the experts and authorised dealers was generally supportive of the Government's policy of gradual liberalisation of exchange controls.

145 The events of the fourth quarter of 2001 raise doubts about the effectiveness of enforcing and managing exchange control, particularly in relation to off-shore participants in the rand market. It also suggests that with foreign exchange controls, one either has no controls or one has complete controls.

146 Evidence indicated that the abolition of exchange controls may lead to either a significant inflow and strengthening of the rand or a significant outflow and weakening of the rand. The latter will partly result from the expatriation of "blocked funds". In the Commission's view, one of the ways of dealing with the blocked funds may be to convert them to government bonds which have a predetermined repayment schedule. In

pursuing this option, the full implications thereof, including any potential resulting negative perceptions, as was experienced elsewhere, must be considered carefully.

147 The *KPMG team* was of the view that there were at least four good reasons to abolish exchange control:

- off-shore investors see exchange control as a major deterrent for fixed direct investment;
- in terms of their mandate, certain off-shore fund managers are not allowed to invest in countries having exchange controls;
- domestic corporates are often charged higher fees and rates to raise funds off-shore than would have been the case without exchange control; and
- off-shore listings by South African companies are often a consequence of the limitations on off-shore investments.

148 In his closing remarks to the Commission on 24 May 2002, the Minister of Finance re-affirmed the Government's commitment to a gradual process of exchange control liberalisation that takes into account critical sequencing considerations.

- 149 Timing and sequencing are critical. The IMF has stated that it considers the present pace of exchange control liberalisation in South Africa to be appropriate.
- 150 Prudent liberalisation must consider factors such as the sequencing of economic reform and the strengthening of the balance of payments. As such, it is not possible to set a time table for the gradual relaxation of exchange controls, rather such a policy will be monitored and reviewed continuously.
- 151 There is another benefit to a gradual approach to liberalisation and that is that gradualism may produce internal and external criticism about the slow pace of reform, but it has also avoided policy reversals in the face of currency crises. A gradual approach to exchange control liberalisation has enabled the Government to deliver a policy message which is consistent and certain.<sup>91</sup>
- 152 The Commission finds that there is no call for the tightening of exchange controls nor is there an absolute call for the big bang approach to the abolition of exchange controls. The Government's

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<sup>91</sup> §'s 53 and 54 are based on §'s18 – 23 Part I

gradual approach to the liberalisation of exchange controls is therefore supported by the Commission.

## V RECOMMENDATIONS

### A Recommendations regarding transactions which were considered to have contributed or given rise to the rapid depreciation of the rand in 2001

153 In the light of the agreement reached between Deutsche Bank and the Exchange Control to address the negative effects of the hedging, funding and related transactions on the reserves, the Commission recommends that no further action be taken in this regard. However, the Commission makes important recommendations in §160 of the Executive Summary on what principles should apply to an application by an authorised dealer to Exchange Control to make a foreign direct investment.

154 Exchange Control should take appropriate action in relation to the Equity Diamonds transactions and report to the President in due course on the action taken.

**B Recommendations regarding factors other than transactions**

155 The following are some of the lessons that South Africa could learn from the events of 2001 in so far as they had an impact on the rand.

156 One must understand that South Africa has an open economy and it is inevitable that from time to time there will be turbulence. The events of late 2001 were one of the times.<sup>92</sup> In following a gradual approach to capital account liberalisation, the Government has had to make a number of macro-economic policy decisions to avoid potential economic instability and rising inequality. These decisions include following a flexible exchange rate to act as a shock absorber against global developments. Exchange rate adjustments help cushion the economy from external trade and capital flow shocks and mitigate the impact of economic contraction, especially in respect of the poor.<sup>93</sup>

157 One should appreciate that some of the factors that depressed the rand were not under the control of South Africa:

- the strength of the US dollar;

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<sup>92</sup> Evidence of Minister of Finance, Record 1756

<sup>93</sup> Evidence of Ms Ramos, National Treasury Bundle 59

- the low inflation rate of the 25 most developed countries;
- the downturn in the global economy;
- the events of 11 September 2001 and their consequences, for example the flight of capital from emerging markets such as South Africa.

158 South Africa was penalised by the contagion affect. Merely by association with other countries, such as emerging market countries, or by its proximity to Zimbabwe, South Africa was tainted. Complicated, complex and difficult as it may be to do so, South Africa should make itself distinguishable from those countries and campaign to persuade foreign investors that it is unreasonable to lump South Africa with countries which are not politically or economically on a par with South Africa. South Africa must place a healthy distance – metaphorically speaking – between itself and those countries.

159 Government should identify those factors which fall within its bailiwick and address them insofar as it is possible to do so within its broad macro –and microeconomic framework:-

- Inflation

While the South African inflation rate is higher than that of its trading partners, the rand will continue to depreciate. The

Government is committed to inflation targeting as a monetary policy with a view to reducing inflation.<sup>94</sup>

The effect of changes in the exchange rate on the rate of inflation should not be ignored.<sup>95</sup>

- Privatisation

The non-occurrence of privatisation to the anticipated extent in 2001 had perceptual as well as capital inflow consequences for the rand. The Government remains committed to a programme of privatisation. Any major foreign investments made in South Africa in accordance with the privatisation programme will benefit the rand in the future. Having committed itself to privatise, the Government should be *seen* to be carrying out that policy. If for some reason the policy cannot be carried out in the originally intended manner, the reasons for non-implementation should be communicated pro-actively and convincingly.

- Exchange Controls

The Government is committed to a gradual liberalisation of exchange controls. As that policy is implemented, and controls removed, the negative perception of foreign investors towards exchange controls, should change to the benefit of the rand. As was

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<sup>94</sup>

§13 Part D

<sup>95</sup>

See evidence of Dr Stals, Expert Bundle 179

experienced in October 2001, the change in behaviour of market participants based on a perception that in enforcing existing exchange controls a reversal of the policy of liberalisation had occurred, may be negative for the rand. In future, all reasonable steps should be taken to ensure clear communication to avoid the creation of such a perception.

- NOFP

Since the policy of reducing the NOFP by off-shore borrowings and privatisation was announced on 14 October 2001, the NOFP should no longer have a negative influence on the rand. According to the Minister of Finance the NOFP stood at USD2.9 billion at the end of March 2002 and "...has ceased to be of major concern to the international investment community".<sup>96</sup>

The perception may, nevertheless, be that while the NOFP exists, that there is a risk that the exchange reserves will at some future point in time be negatively affected. Once the NOFP is eliminated, that risk will fall away. The Commission therefore recommends that the NOFP be eliminated as soon as possible through borrowings (and the borrowings could then be eliminated by privatisation proceeds).

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See [§14.10 Part D](#)

- Foreign investment

The rand would benefit from the inflow of capital that would follow on foreign investment. The most attractive is FDI because of its long-term nature. Having dealt with the macro-economic reforms, the focus of the Government now is on micro-economic reforms aimed inter alia at strengthening the balance of the payments through the promotion of exports and attracting longer-term capital flows such as equity investment and FDI. This, in turn, will provide the foreign currency flows necessary to support further capital account liberalisation.<sup>97</sup> The Commission supports this approach.

C Recommendations regarding the effectiveness of the current system of ensuring adherence to exchange controls<sup>98</sup>

160 The following principles should apply to an application by an authorised dealer to Exchange Control to make a foreign direct investment:-

(1) An authorised dealer is not an uninformed layman. An authorised dealer is assumed to have a working knowledge of the purposes and policies of Exchange Control. An authorised dealer must use its

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<sup>97</sup>

Statement of the Minister of Finance, Record 1758

<sup>98</sup>

See §1.4.1 of the Terms of Reference, Annexure A Part A

knowledge, experience and common sense in applying exchange controls.

- (2) The relationship between the regulator, Exchange Control, and authorised dealer is based on trust. In applications of the kind in question, an authorised dealer must trust Exchange Control to exercise its discretion properly. And, Exchange Control is entitled to trust an authorised dealer to make full disclosure to it of all material information on which it is required to exercise its discretion to grant an application to make a foreign direct investment.
- (3) There should be no doubt in the mind of any authorised dealer what Exchange Control means by South Africa's reserves. For exchange control purposes, the reserves are the total gold and foreign exchange reserves of South Africa. That much is known to anyone who reads the Reserve Bank's Quarterly Bulletin, which one assume authorised dealers do as a matter of course.
- (4) An authorised dealer who makes application for a foreign direct investment must take into account that:-
  - one of the purposes of exchange controls is to prevent the loss of foreign currency resources through the transfer abroad of real or financial capital assets held in South Africa;

- one of the pre-conditions to the grant of an application to make a foreign direct investment is that the transaction, such as a share placement, when implemented, must not have a negative impact on South Africa's total foreign exchange reserves;
  - any related transaction which is concluded consequent to the share placement transaction, such as a hedging or funding transaction, must share one of the characteristics of a share placement, i.e. the transaction must be reserves neutral, otherwise – and this is a statement of the obvious – one of the purposes of exchange controls would be frustrated.
- (5) By their nature, applications to make foreign direct investments will vary. There is no standard formula for the application or the approval by Exchange Control. If an authorised dealer has any doubt about the requirements of Exchange Control or the extent of its duty to make disclosure, it should consult Exchange Control. It is to the benefit of the authorised dealer, its client and the Reserve Bank that any doubts, ambiguities or concerns are addressed at the time of the application rather than in a protracted review process.

161 The Commission recommends that:

- where the Regulations, Rulings and Circulars (“exchange control rules”) do not clearly spell out the duties and obligations of authorised dealers and corporates, clarity should be sought and given;
- where the exchange control rules are ambiguous, the ambiguities should be dealt with by Exchange Control, if necessary with the assistance of the person referred to in §162 below;
- routine and smaller transactions should be excluded from scrutiny by the application of materiality tests;
- Exchange Control should consider giving reasons in appropriate cases when an application is refused;
- authorised dealers should send more senior members of management to Liaison Committee meetings and engage in meaningful debate with Exchange Control on their concerns;
- Exchange Control must strive for consistency in the approval of applications for foreign direct investments;
- an application for foreign direct investment must make full disclosure of all transactions, for example, in an application based on a share placement, the share placement transactions *and* the associated transactions, such as hedging, funding and related transactions must be disclosed by the authorised dealer to Exchange Control;

- when in doubt as to the requirements of Exchange Control or the extent of its duty to make full disclosure, an authorised dealer must consult Exchange Control at the time of the application;
- the 180 day period itself should be reconsidered and the administration, monitoring and auditing of CFC accounts and the Form 178 system should be reviewed in order to make the system more effective;

162 The Commission recommends that the comments and recommendations conveyed to the Commission should be addressed by all parties concerned, specifically Exchange Control and the authorised dealers.

163 An independent person should be appointed to facilitate the resolution of disputes which arise from time to time between Exchange Control and authorised dealers, possibly with the power to adjudicate such disputes.

164 With regard to the issue of unacceptable speculation, the Commission recommends that this complex area should be investigated further by the person referred to in §163 in conjunction with Exchange Control, in order to develop monitoring processes which will ensure that these

practices can be identified and addressed appropriately on an on-going basis.

D Recommendations regarding any other periods considered necessary to be covered by the inquiry

165 The Commission does not consider it necessary to extend the inquiry to any period before or after 1 January 2001 to 31 December 2001 as the benefits derived there from will not justify the additional costs and efforts required. The Commission would rather recommend that the issue of the exchange rate be viewed with a forward looking perspective, applying the lessons learnt from and recommendations made by this process.