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

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

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

[1] Factors which in general affect an exchange rate

1

1.1 Exchange rates and inflation

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

1.2 Exchange rates and export prices

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

1.3 Exchange rates and interest rates

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

1.4 Exchange rates and portfolio shifts

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

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

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

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

1.5 Leads and lags

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

1.6 Exchange rates and contagion

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

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

into contact with the bug or someone having the bug. As the term is used in financial markets, however, there need be no contact. One must distinguish between contagion based on (1) trade links, (2) similarity and (3) profit or loss of investors. The *first* is clearly observable; the *second* reflects perceptions of investors; and the *third* suggests that risk arises from the character of the issuer of the financial instrument. Contagion through 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 markets 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.[5]

[2] Determinants of the rand exchange rate

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

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

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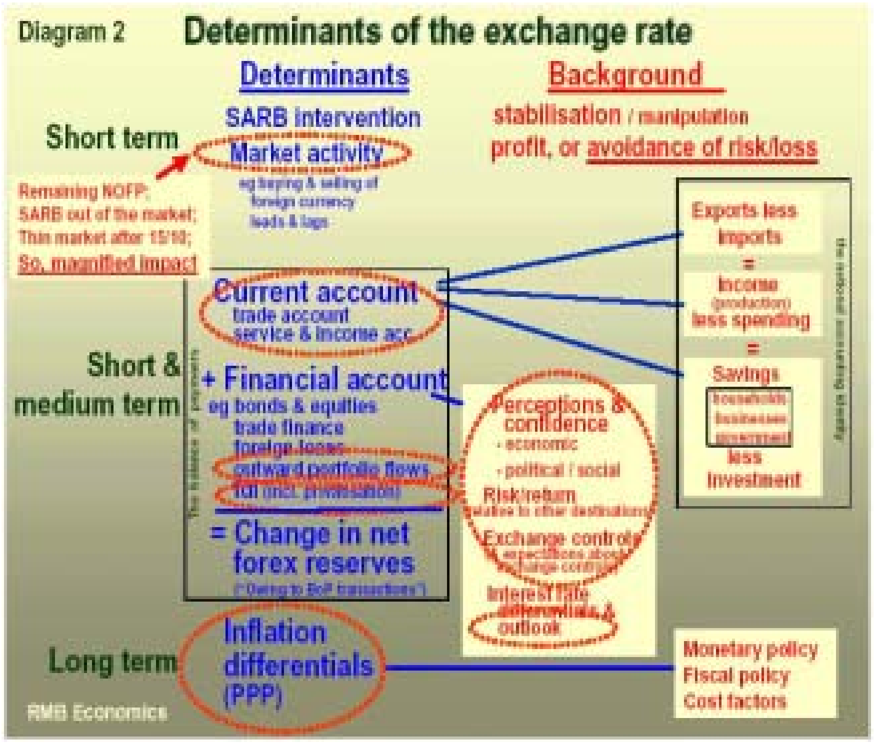
5 McCauley Record 50 - 55

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

3

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

Slide 2 Expert Bundle 118



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

(1) Long term: Inflation differentials

(2) Short & medium (a) macro-economic factors;

(b) perceptions/sentiment

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

(b) speculation

(1) Long Term

Inflation differentials

4

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

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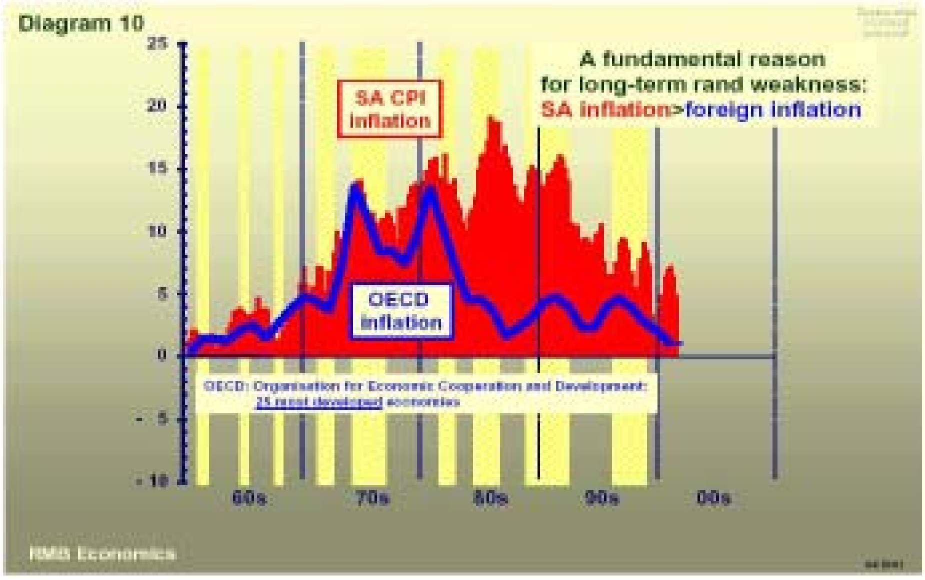
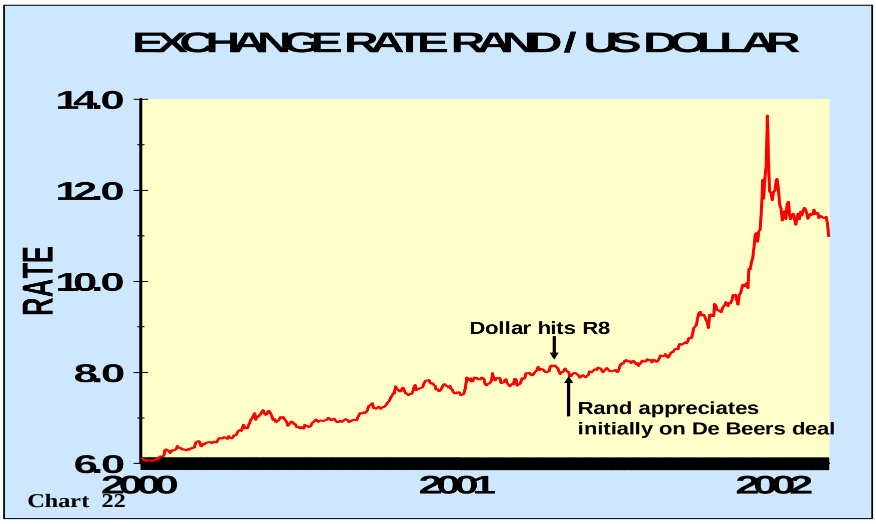
[7] Gouws Expert Bundle 115; Stals Expert Bundle 170; Dr A Jammine, Director and Chief Economist, Econometrix (Pty) Ltd, Expert Bundle 301

Diagram 10 Expert Bundle 122



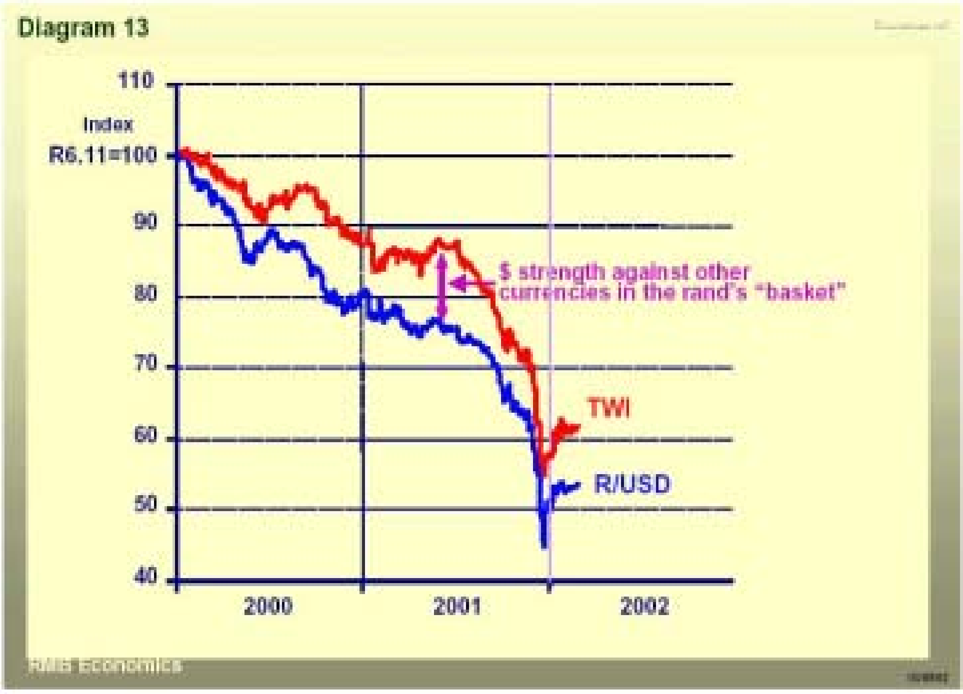
4.2 The slide in the value of the rand, in this phase, began in 2000. During 1999 the rand traded at about R6 to the US dollar, but by the end of 2000 it was trading close to R8 to the dollar, a depreciation of approximately 33%:

Chart 22 Expert Bundle 371



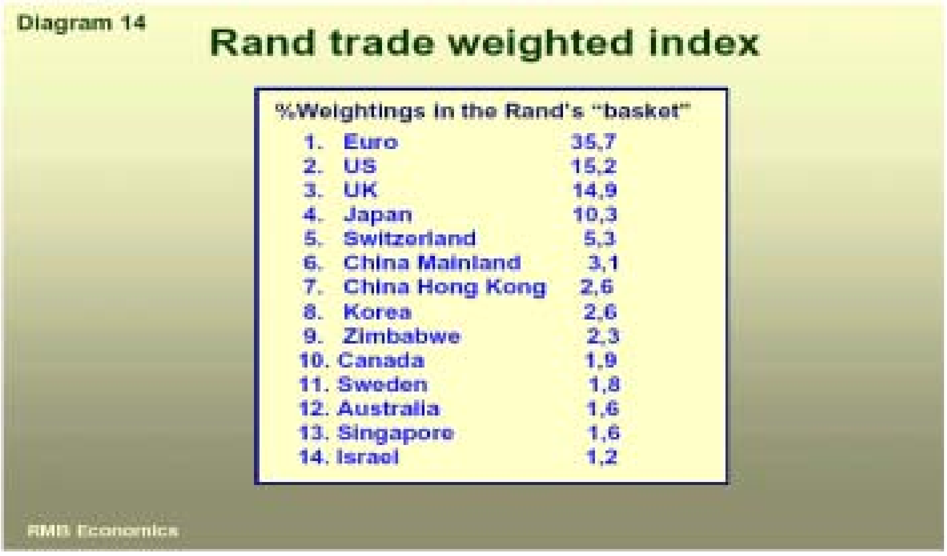
The Commission did not investigate the decline in 2000. One thing seems clear and that is that at least until September 2000 the decline could at least partly be explained by the strength of the US dollar. The strength of the dollar against the trade weighted index (TWI) is shown in this diagram:

Diagram 13 Expert Bundle 124



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

Diagram 14 Expert Bundle 124



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

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

5

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

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

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

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

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

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9 Mboweni Bundle SARB (07) 16

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

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

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

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

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

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

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

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

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[12] Mboweni, <u>Bundle SARB (07) 17</u>
[13] Mboweni, <u>Bundle SARB (07) 17, 20</u>

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

5.8 The following accounts are worthy of detailed analysis:-

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

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

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

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

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

Fourth quarter R41.7 billion[16]

5.8.2 <u>The financial account of the balance of payments</u>

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

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

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

(1) <u>Direct investment</u>

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

[16] Mboweni <u>Bundle SARB (7) 23</u>

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

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

(2) Portfolio investment

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

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

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

(3) Other investment

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

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

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

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18 Mboweni Bundle SARB (7) 25

19 Mboweni Bundle SARB (7) 26

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

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

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

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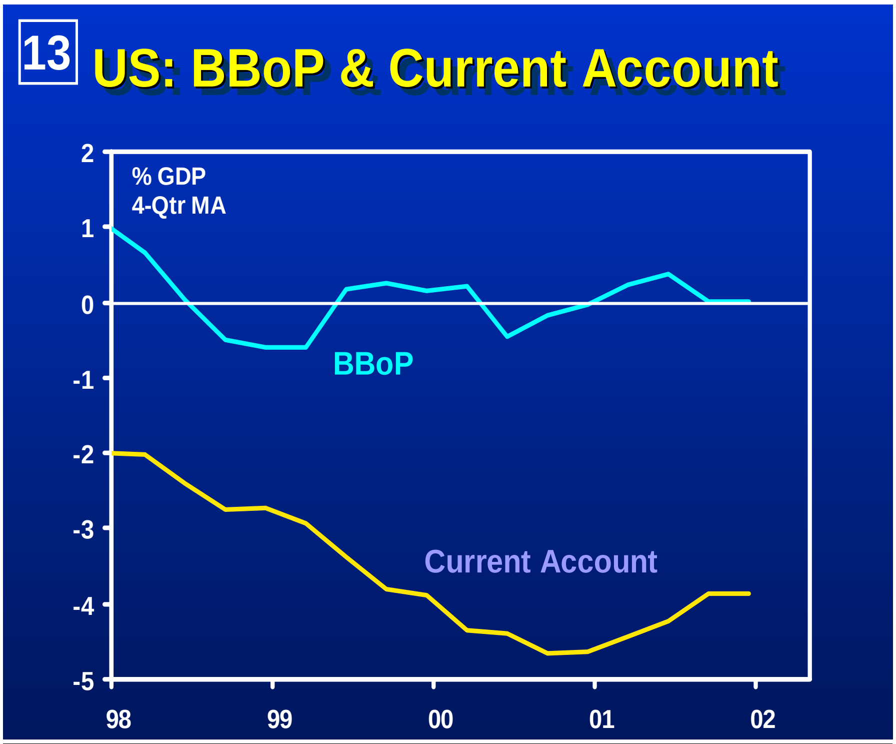
[20] Mboweni, Bundle SARB (7) 29

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

Slide 13 O'Neill Bundle 14

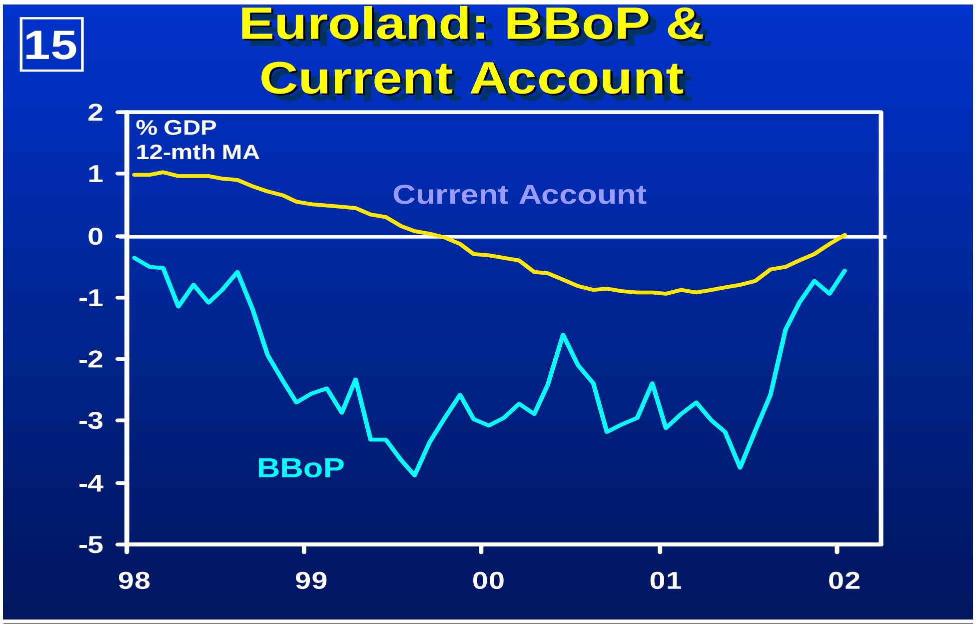


(2) In the early part of the euro's existence, Europe[21] had a small current account surplus. But through 1999 and 2000 Europe ran a large BBoP deficit, at times almost 4% of GDP. Europe failed to attract foreign capital, either FDI or portfolio flows,

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

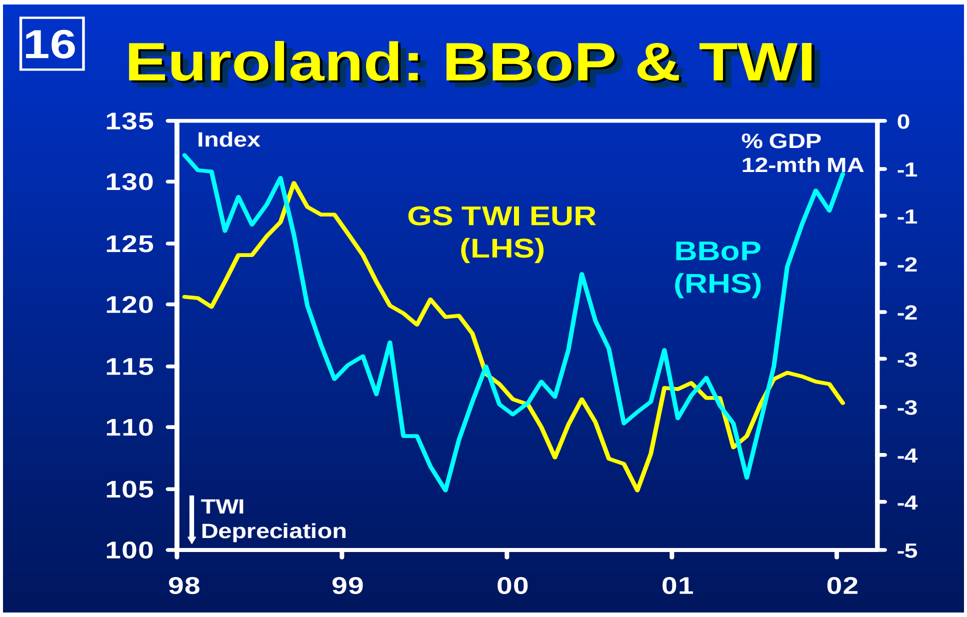
and foreign capital left Europe for the USA and other parts of the world.

Slide 15 <u>O'Neill Bundle 16</u>



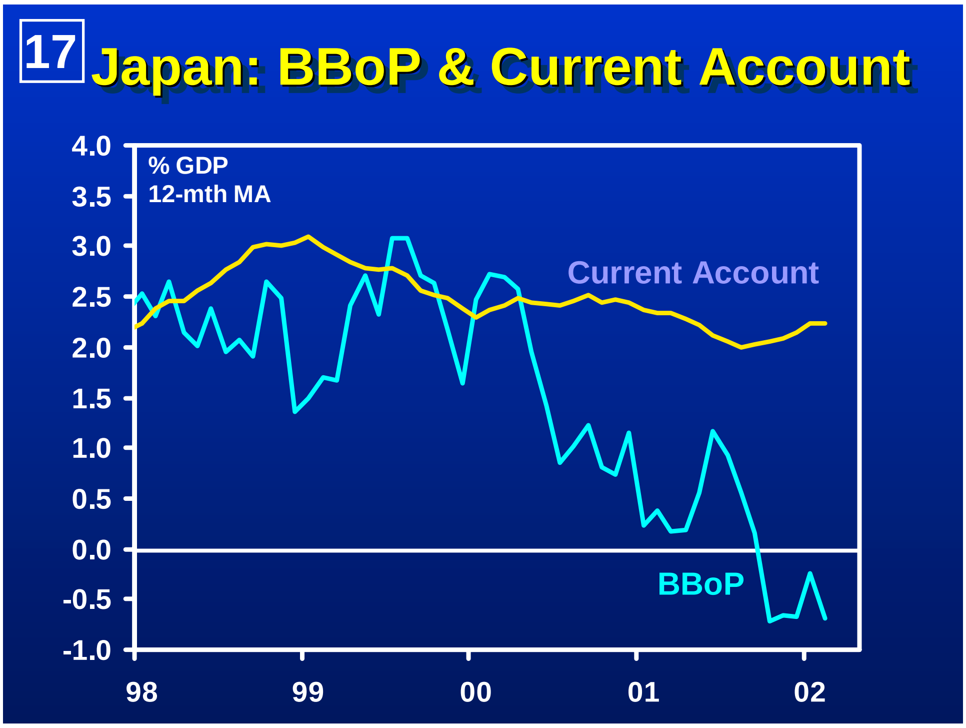
As the BBoP deficit of euro declined, the trade weighted exchange rate of the euro stabilised.

Slide 16 O'Neill Bundle 17



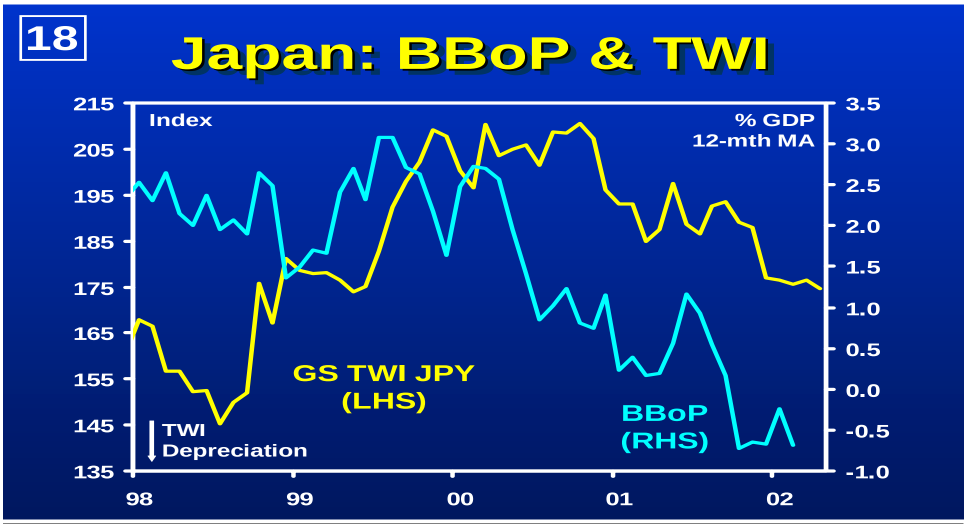
(3) For much of the period 1998 to 2002 Japan had a large current account surplus and a BBoP surplus. (While Japan had a BBoP surplus, the yen strengthened against the US dollar (as shown on slide 1, O'Neill Bundle 2; §1.3 Part C).

Slide 17 O'Neill Bundle 18



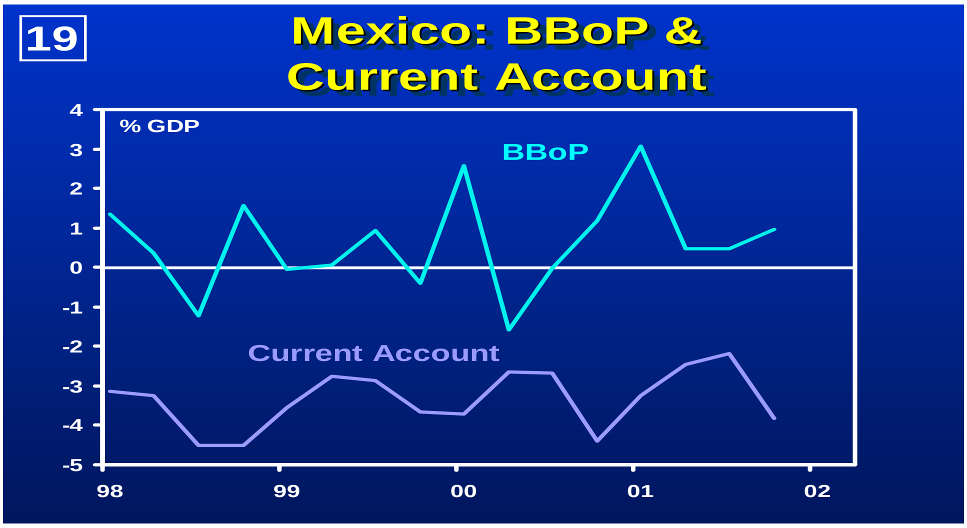
As the Japanese BBoP went into deficit, the value of the yen declined. In short, the strong BBoP surplus is associated with the yen's strengthening, while the BBoP surplus decline is associated with the decline in the value of the yen.

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



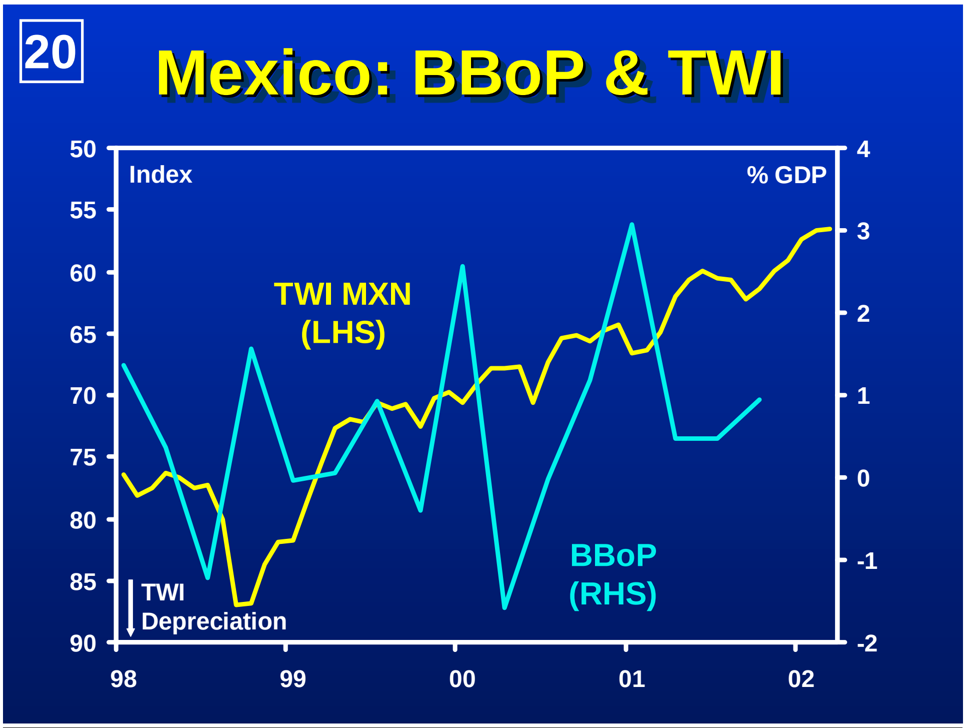
(4) The Mexican peso is one of the few currencies that has strengthened against the US dollar in recent years. The reason is that although Mexico has had a current account deficit, it has had a BBoP surplus, due mainly to large FDI inflows.

Slide 19 <u>O'Neill Bundle 20</u>



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

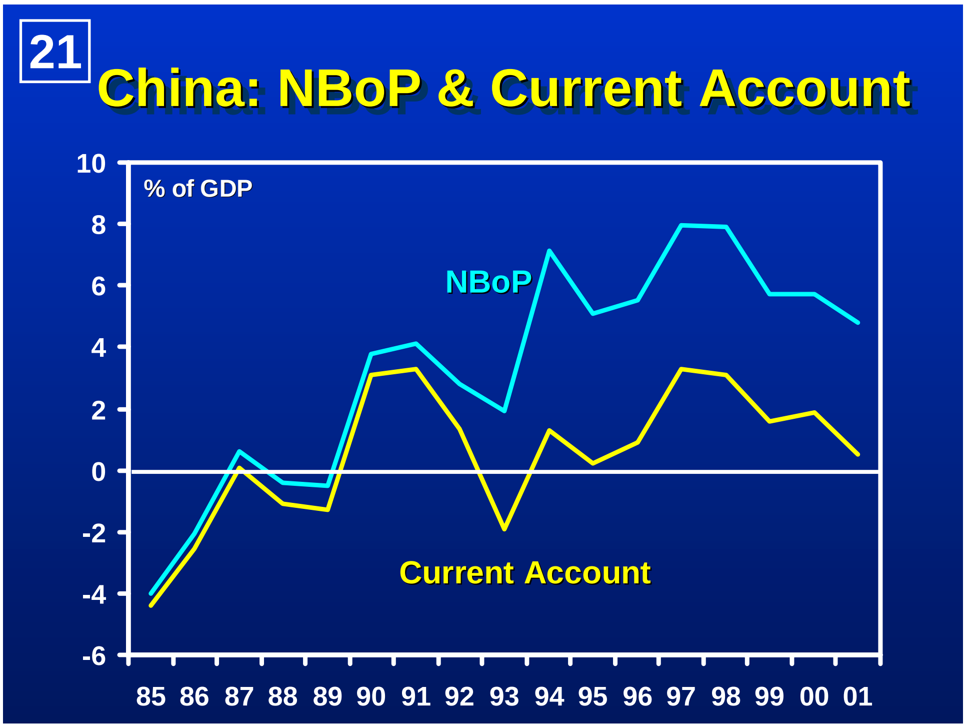
Slide 20 <u>O'Neill Bundle 1</u>



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

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

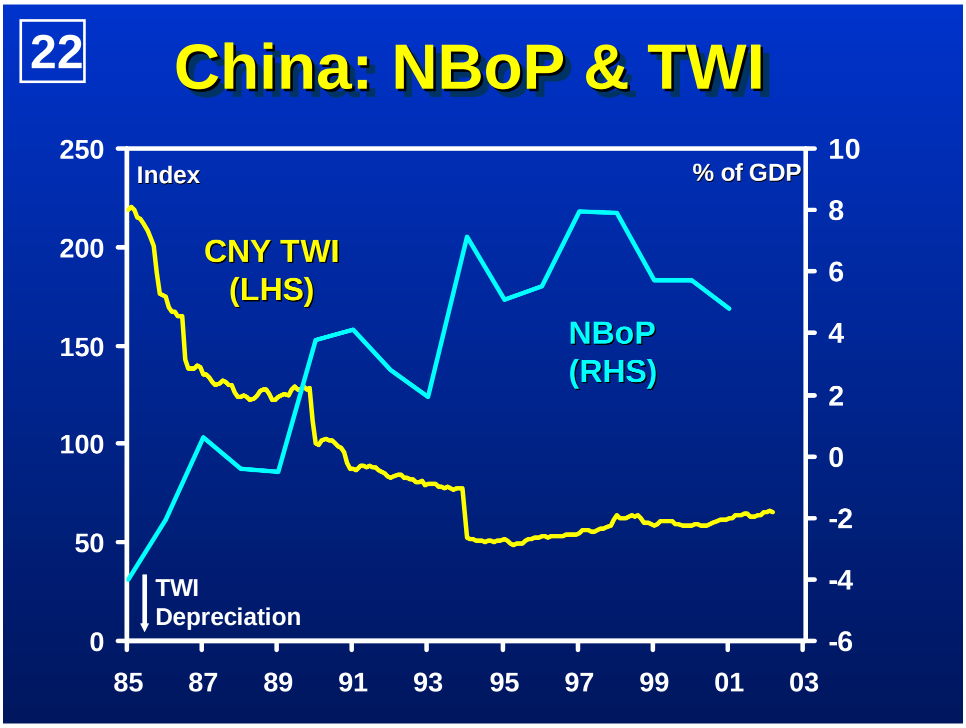
Slide 21 O'Neill Bundle 22



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

22 Evidence of O'Neill, Record 1478-1480

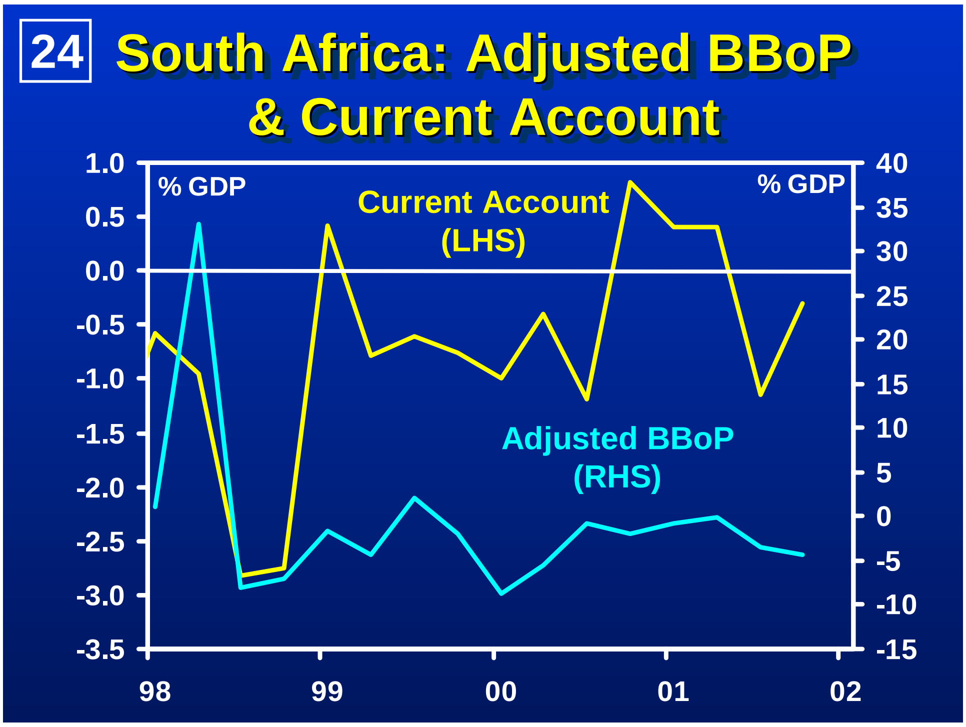
Slide 22 O'Neill Bundle 23



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

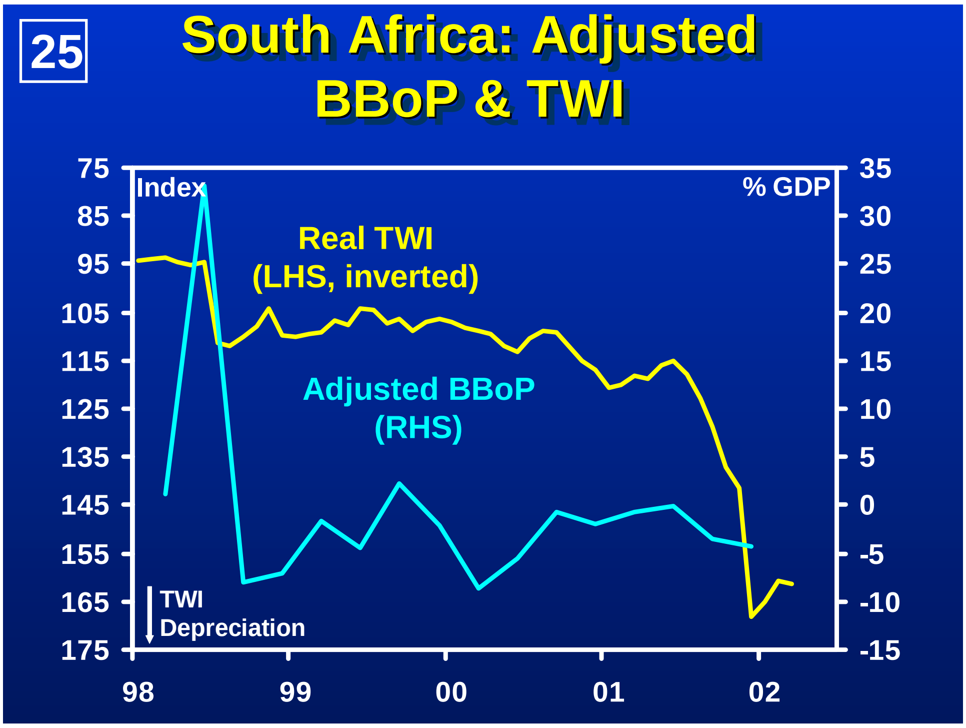
the adjusted BBoP has been significantly in deficit since 1998.

Slide 24 <u>O'Neill Bundle 25</u>



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

Slide 25 O'Neill Bundle 26



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

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

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

(b) Perceptions/sentiment

6

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

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23 Evidence of O’Neill, Record 1480-1484
24 Evidence of Mboweni, Bundle SARB (7) 38

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

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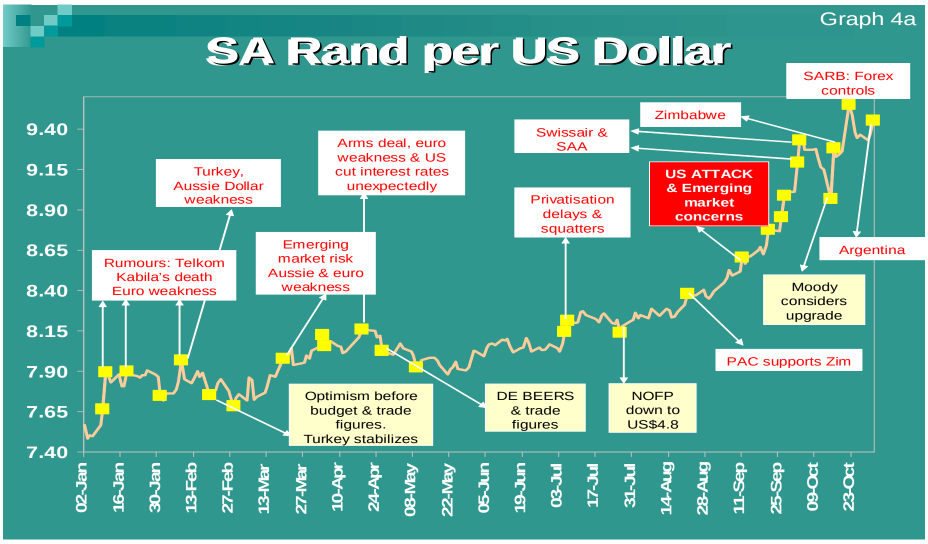
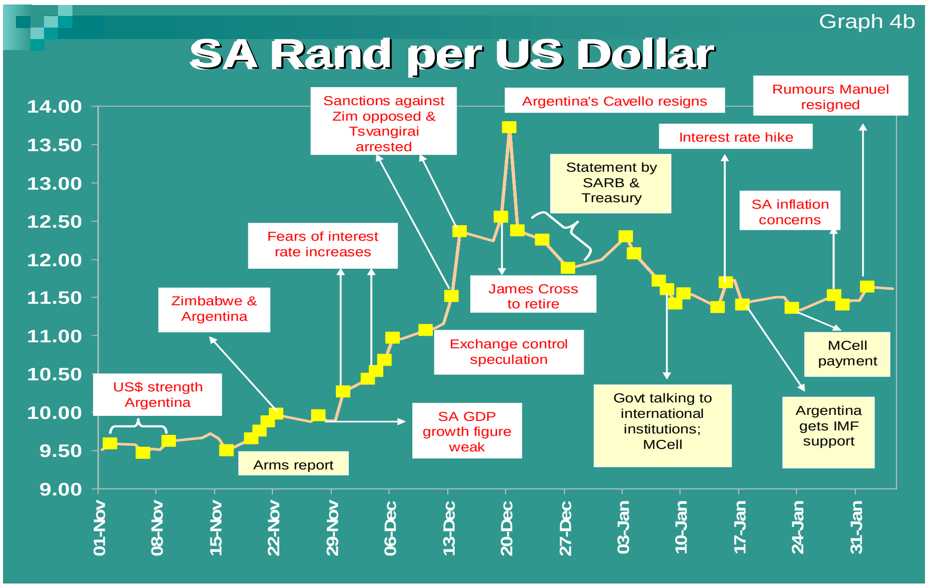
25 Bundle SARB (7) 347

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

Graphs 4A and 4B Expert Bundle 222-223





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

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

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

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

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

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[28] See <u>§36 Part D</u> below
[29] See <u>§41 Part D</u> below

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

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

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

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

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

(3) <u>Short term</u>

(a) <u>The role of the Reserve Bank</u>

7 <u>Exchange Rate Management</u>

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

<u>Macro-economic concerns</u>:

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

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33 Luüs <u>Expert Bundle 213;</u> see, too, Gouws, <u>Record 94</u>