

Micro-economic concerns:

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

7.2 The instruments to manage an exchange rate are:

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

Open mouth policy

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

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<sup>34</sup> McCauley Expert Bundle 60 - 61

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

### Intervention to support currency

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

### 7.3 Raise interest rates to defend currency

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

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

#### 7.4 Tighten capital (exchange) controls

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

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<sup>36</sup>

McCauley Record 78

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McCauley Record 79 - 80

### The Reserve Bank

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

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Mboweni, Bundle SARB (7) 5-7

### Reserve Bank policies

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

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<sup>39</sup> Stals, Expert Bundle 167–9; 179

- 10 On various occasions in the past the Reserve Bank intervened in defence of the rand. As the Reserve Bank did not have adequate foreign reserves, the obligations to deliver foreign exchange into the market were converted into forward obligations. The Reserve Bank, for example, sold US dollars into the spot foreign exchange market in order to support the exchange rate of the rand and then swapped the US dollars back onto its forward book by buying US dollars spot and simultaneously selling them forward. According to the Reserve Bank Act, all profits and losses in respect of providing forward cover are for the account of Government. Over the years, huge losses were made owing to the existence of the NOFP.
- 11 In 1998 the Reserve Bank intervened in defence of the rand in two distinct ways: by use of the forward book, increasing the NOFP to USD23 billion and by raising interest rates from 14% in June 1998 to 25.5% in August 1998.<sup>40</sup>
- 12 By 2001 the Reserve Bank and the National Treasury had changed course.

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<sup>40</sup> Jamine, [Expert Bundle 309,310](#)

## 13 Inflation targeting

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

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

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<sup>41</sup> Mboweni, Bundle SARB (7) 9

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

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

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

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

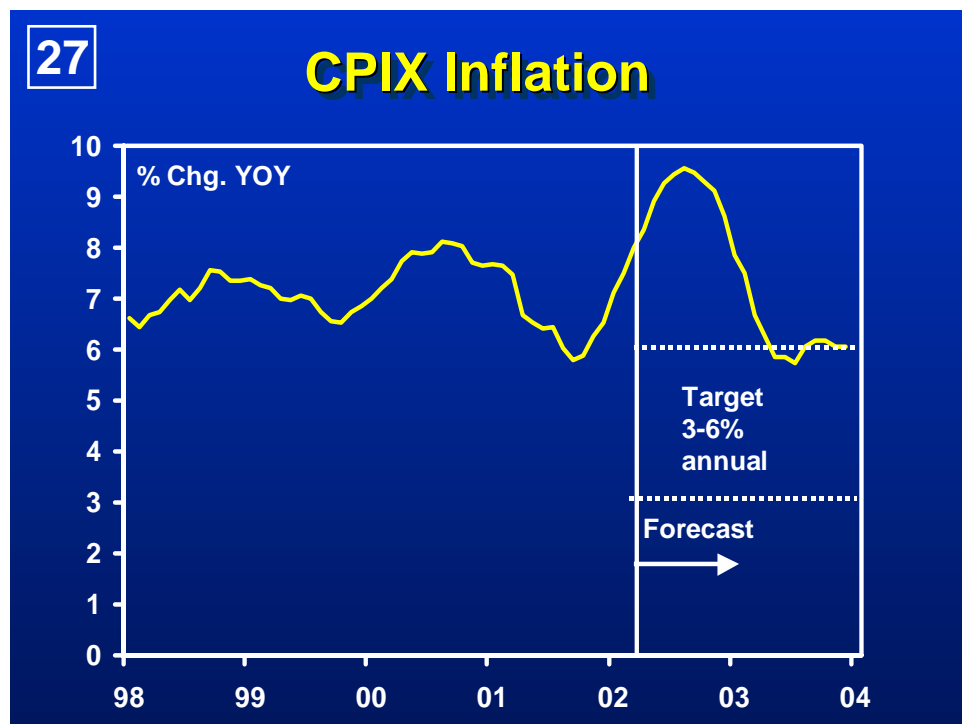
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<sup>42</sup>

Stals, [Record 286](#)

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

Slide 27 O'Neill Bundle 28



<sup>43</sup> Evidence of O'Neill, [Record 1462](#)

<sup>44</sup> Evidence of O'Neill, [Record 1488](#)

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

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

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

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

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<sup>45</sup> Evidence of O'Neill, Record 1496

<sup>46</sup> Evidence of O'Neill, Record 1490-1493

<sup>47</sup> Mboweni, Bundle SARB (7) 15, 247

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

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

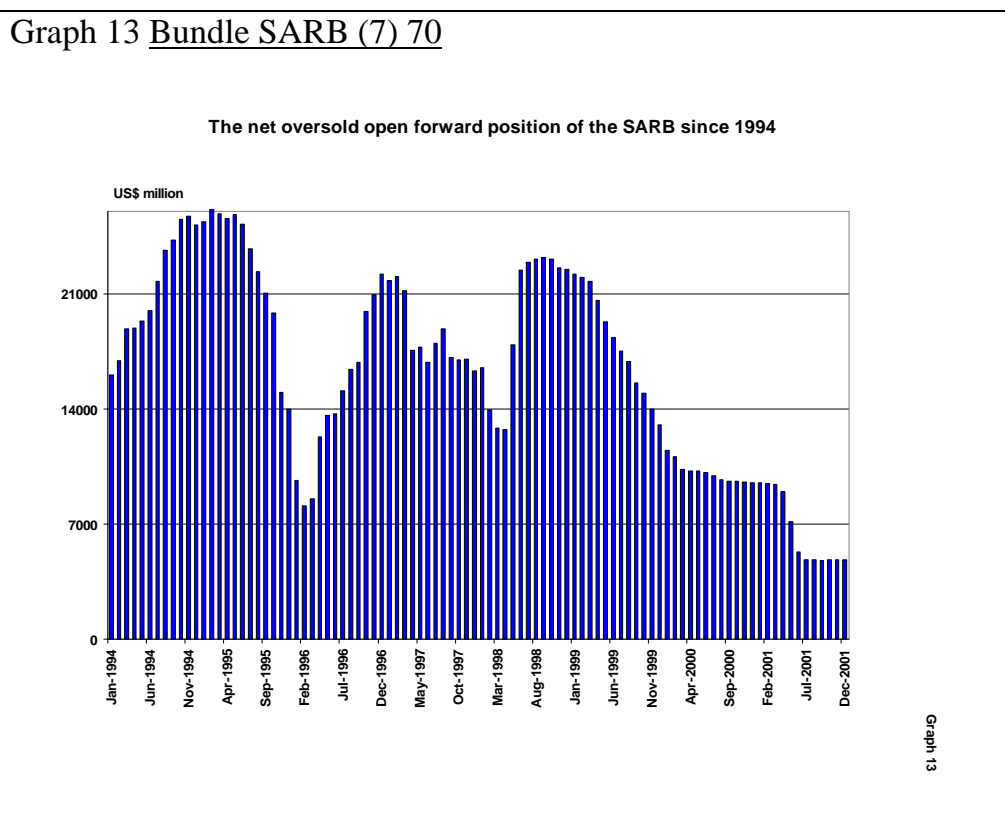
14 NOFP

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

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

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<sup>49</sup> Mboweni, Bundle SARB (7) 33



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

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Mboweni, Bundle SARB (7), 31

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

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

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<sup>51</sup> For example, Gouws [Expert Bundle 126](#); Langley [Expert Bundle 148](#); Luiis [Expert Bundle 213](#).

<sup>52</sup> Abedian; [Expert Bundle 273](#). See, too Jammie, [Expert Bundle 337, 338](#).

Graph 18 Expert Bundle 126

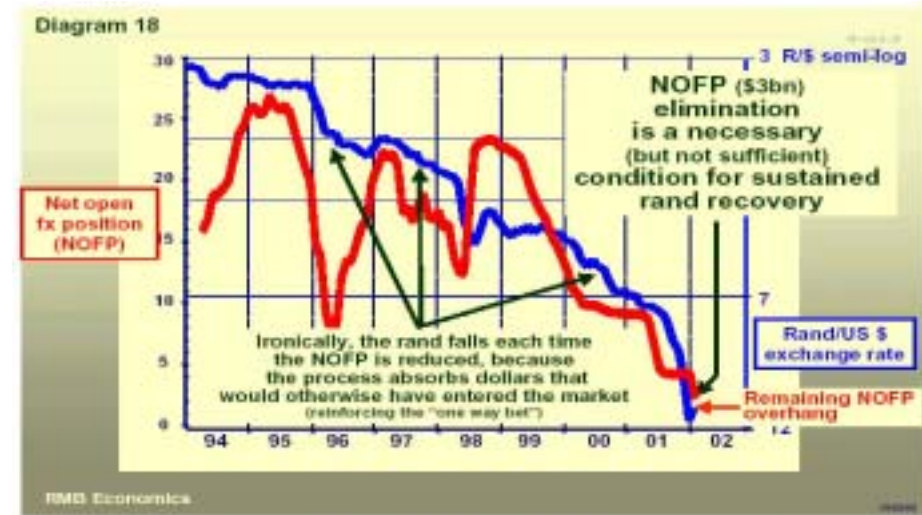
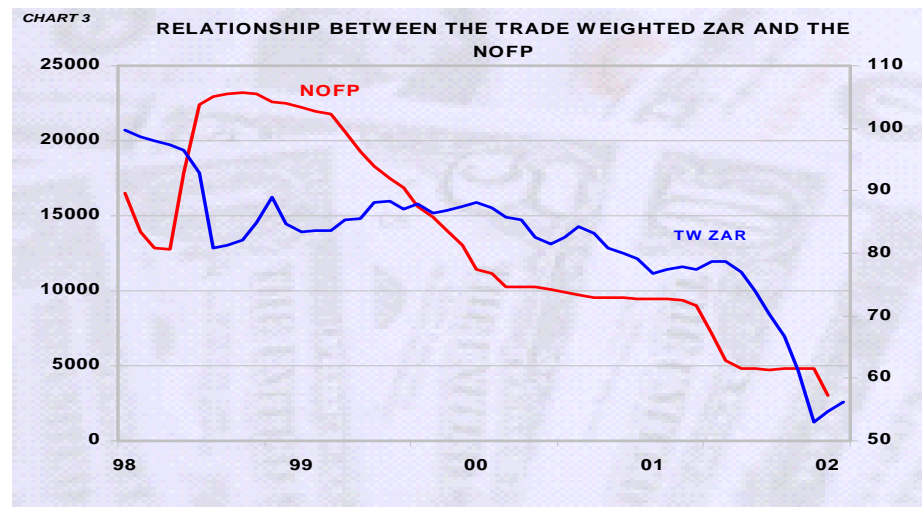


Chart 3 Expert Bundle 455



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

“Given the losses on the forward book and negative perceptions from market participants and commentators on the one hand and the

potential impact on the currency of reducing the forward book on the other, the Bank had a difficult choice to make. In the long-term interest of South Africa, it was decided to place emphasis on reducing the NOFP. The Bank had to buy foreign exchange as prudently as possible to close out the NOFP.

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

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

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

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<sup>53</sup>

Mboweni, Bundle SARB (7), p 32 – 33

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

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

In future, the Reserve Bank will not intervene by purchasing foreign exchange from the market for purposes of reducing the NOFP. The NOFP will be expunged from cash flows derived from the proceeds of Government's off-shore borrowings and privatisation.”<sup>54</sup>

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

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<sup>54</sup>

Mboweni, Bundle SARB (7), 340

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

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

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<sup>55</sup> Ramos, National Treasury Bundle 57, 66

<sup>56</sup> Statement of Minister of Finance on 24 May 2002: Record 1759-1760

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

15.1 The evidence of the Governor was that the issue of enforcing existing exchange controls had been extensively discussed in the Reserve Bank and with National Treasury over a long period of time. The Reserve Bank was aware of the various explanations of the rand's weakness in recent years. The explanations included exchange control liberalisation, the Reserve Bank buying spot foreign exchange to reduce the NOFP and the decisions by importers and exporters to lead or lag their foreign exchange payments and sales. The impact of these more fundamental and legitimate factors influencing the exchange rate was acceptable to the authorities. Of more concern were comments from the market that speculative transactions, particularly by non-residents, were adding to volatility and rand weakness. The Reserve Bank was informed that investors and other emerging markets, with less liquid financial markets, were using South African markets as a proxy hedge for weakness in other countries. The Reserve Bank had no choice but to either abolish the remaining exchange controls in total or to apply the existing rules and regulations equitably to all. The Reserve Bank became increasingly

concerned that excessive volatility in the forex market during the third quarter of 2001 negatively influenced inflation, business decisions and the economy as a whole. Accordingly, a meeting was called on Sunday, 14 October 2001 between the Reserve Bank and the chief executive officer and head of treasury of major South African and foreign banks registered in South Africa. What was conveyed to the banks, and which is material for present purposes by the Governor, is what is contained in the statement of 14 October in these terms:

“The Reserve Bank stands ready to take appropriate firm steps against trading activities inconsistent with existing rules and regulations. The enforcement of existing rules serves to ensure that only legitimate transactions take place in the foreign exchange market. This does not restrict, for example, the ability of a non-resident investor to either hedge or repatriate the sale proceeds of an investment in South Africa. It does, however, exclude the financing of short rand positions in the domestic markets, which is consistent with the requirement that domestic borrowing by non-resident investors is subject to certain restrictions. This communication should not be construed as an attempt to restrict the activities of banks in the South African markets, provided they adhere to the existing rules and regulations. Normal commercial and financial transactions remain unaffected.” On 16

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

“To ensure that the provisions of the various sections of exchange control rulings are applied uniformly by all authorised dealers, in particular when dealing with non-residents in the forward and other derivative foreign exchange markets, we deem it necessary to reiterate certain fundamental principles in this regard.

It is incumbent upon authorised dealers to ensure that their overseas counterparties are fully conversant with the rules applicable to dealing in the domestic forward and other derivative foreign exchange markets. It follows, therefore, that when dealing with a non-resident counterparty, other than a correspondent bank, supporting documentary evidence must be obtained confirming that such non-resident counterparty has a legitimate South African exposure resulting from an accrual, investment or asset denominated in rand.”<sup>57</sup>

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

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

compliance officer was called upon to confirm in writing “that all transactions concluded by our clients and our dealers within the preceding 14 business days have been in compliance with the applicable rules and regulations.”<sup>58</sup>

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

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

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

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

<sup>59</sup> Mboweni, Bundle SARB (7) 43

21.5.4 **Forward exchange contracts with non-residents –**

Foreign currency may be sold forward to non-residents, provided that such non-resident counterparties have legitimate South African exposures resulting from an accrual, investment or asset denominated in Rand.”<sup>60</sup>

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

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

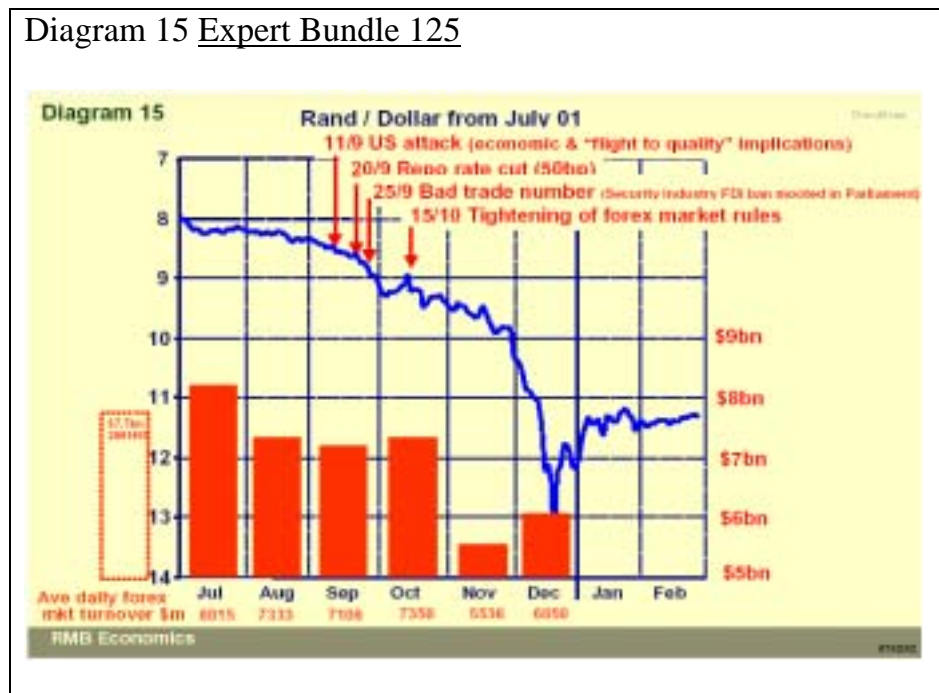
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<sup>60</sup> Bruce Brand, Bundle SARB (6) 18, Record 558-9

<sup>61</sup> Mboweni, Bundle SARB (7) 44

<sup>62</sup> Mboweni, Bundle SARB (7) 44; Gouws, Expert Bundle 125

Diagram 15 Expert Bundle 125



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

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

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

<sup>63</sup>

Mboweni, Bundle SARB (7) 44

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

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

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

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<sup>64</sup> Mboweni, Bundle SARB (7) 45

<sup>65</sup> Luüs, Expert Bundle 213

<sup>66</sup> Abedian, Expert Bundle 273 See, too, Glynos, Expert Bundle 432

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

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

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<sup>67</sup> Langley [Expert Bundle 141](#)

<sup>68</sup> Mr P De Villiers, Global Head of Foreign Exchange Trading, Investec Bank, [Record 363](#)

<sup>69</sup> De Villiers [Record 388](#)

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

15.11 In the Questionnaire,<sup>71</sup> the authorised dealers were asked the following questions:

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

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

15.11.1 Absa

Absa’s evidence was that the “stricter enforcement of Circular D342 in mid-October [2001]”<sup>72</sup> resulted in an immediate liquidity drain when market

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<sup>70</sup> De Villiers Record 383

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

<sup>72</sup> Evidence of Balt, Absa Bundle 14-15

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

15.11.2 Nedcor

Nedcor testified that the Circulars dated 15 October 2001, D341, and 16 October 2001, D342, differed in some respects from what had been understood at the meeting with the Governor on 14 October 2001. The perceived differences caused confusion amongst both domestic and international participants and reduced market participation and therefore liquidity. Foreign banks generally were

not happy with the measures being taken. Some of them sought legal advice, which was that the banks should not submit the required compliance letters. The Circulars were one of the many factors which contributed to the depreciation of the rand as they drew attention to concerns about the market but did not prevent ongoing speculation against the rand. When the Reserve Bank re-confirmed that non-residents were free to hedge in circumstances where the rand was extremely volatile, the concern was that whereas non-residents had not hedged the underlying exposures in large volumes previously, this might turn out to be the case thereafter. The markets therefore became increasingly nervous. Under the circumstances, some foreign players reassessed their involvement in the rand market, further exacerbating illiquidity.<sup>73</sup>

### 15.11.3 FirstRand

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

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<sup>73</sup>

Evidence of Parker, Nedcor Bundle, 19-20

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

15.11.4 BoE

BoE contended that one of the factors that led to the rapid depreciation of the rand was “the D342 Circular and the uncertainty that it generated concerning Reserve Bank policy”.<sup>75</sup>

15.11.5 Investec

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

The introduction of Circular D342 dated 15

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<sup>74</sup> Evidence of Bester, FirstRand Bundle, 21-22

<sup>75</sup> Evidence of Woollam, BoE Bundle, 8-9

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

#### 15.11.6 JP Morgan

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

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<sup>76</sup> Evidence of de Villiers, Investec Bundle, 36, 38

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

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<sup>77</sup> Evidence of Coulter, JP Morgan Bundle, 16-17

15.11.7 Deutsche Bank

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

15.11.8 SCMB

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

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

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<sup>78</sup>

Evidence of Morrison, Deutsche Bank Bundle, 13

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

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

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

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<sup>79</sup> Evidence of Van Zyl, Record 1694

foreign banks have not provided their compliance certificates. Where the compliance certificates have not been forthcoming, the bank has reported the instances to SARB.<sup>80</sup>

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

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

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<sup>80</sup> Evidence of Potgieter, Standard Bank Bundle 41-43

<sup>81</sup> Evidence of Potgieter, Standard Bank Bundle 50

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

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

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

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

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

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

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

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

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

- (b) In 1998 the rand depreciated sharply from USD1 = R4.9357 in February to USD1 = R6.2386 in July, a depreciation of 26.4%. Over the same period total average daily turnover increased by some 139% from USD3.093 billion in February to USD7.395 billion in July. Turnover with non-residents increased by 213% from USD1.323 billion in February to USD4.138 billion in July.
- (c) In January 1999 average daily turnover was USD6.855 billion. By June the average daily turnover had increased by almost 33% to USD9.089 billion. Over the same period the average daily exchange rate depreciated by a relatively small percentage of 1.7% from USD1 = R5.9835 in January to USD1 = R6.0883 in June.
- (d) The rand averaged USD1 = R11.5467 in December 2001, fluctuating significantly and briefly depreciating to USD1 = R13.84, on an average daily turnover of USD6.051 billion. In February 2002 average daily turnover had declined by 19.4% to USD4.876 billion, but the rand was far more stable, trading at an average exchange rate of USD1 = R11.4847.
- (2) The Reserve Bank suggests that had it not acted in October 2001 to limit dealing without a firm and ascertainable commitment or

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

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

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

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

## 16 The issue of Circular D346 on 13 November 2001

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

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

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<sup>84</sup> Evidence of Van Zyl, Bundle SARB (9) 8-12