

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

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

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

(b) Speculation

Introduction

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

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<sup>85</sup> Evidence of Ms Beck referred to in Part J §8.3 below and in Record 1617

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

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<sup>86</sup> Stals, [Expert Bundle 177](#)

<sup>87</sup> Luüs, [Expert Bundle 214](#)

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

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

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

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<sup>88</sup>

Ramos, Record 718

<sup>89</sup>

Mboweni, Bundle SARB (7) 38-39

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

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<sup>90</sup> Evidence of Parker, [Nedcor Bundle 18-19](#)

<sup>91</sup> Evidence of Lane, [NIB Bundle 18](#)

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

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<sup>92</sup> Evidence of Bester, FirstRand Bundle 14-15

<sup>93</sup> Evidence of De Villiers, Investec Bundle 34-35

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

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<sup>94</sup> Evidence of Woollam, [BoE Bundle 5-6](#)

<sup>95</sup> Evidence of Coulter, [JP Morgan Bundle 9](#)

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

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

For SCMB, it is important to understand the distinction between speculation and market making in the context of foreign exchange and other related markets. Speculation involves adopting the view as to the likely movements in the exchange rate and acting, or not acting, on that view. By contrast, a market maker is a bank that, in all liquidity conditions, commits itself to provide bid and offer prices to both the inter-bank market and to its clients. Market making involves the purchase and sale of foreign currency with the intention of making a margin return, while not holding significant positions for extended periods. By far the majority of SCMB's foreign exchange business in the rand is done on the basis of it being a market maker, in other words as a provider of liquidity. The bank has historically, and for 2001, adopted a

conservative approach to the size of its currency positions. It operates well within the internal limits set by the SBCA board, which in turn are significantly lower than those allowed by the Reserve Bank.<sup>96</sup>

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

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<sup>96</sup> Evidence of Potgieter, Standard Bank Bundle 45-47

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

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

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

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<sup>98</sup> McCauley [Record 28](#)

<sup>99</sup> McCauley [Record 29](#)

<sup>100</sup> De Villiers [Record 367-8](#)

a negative connotation probably refers “... to the long directional trading where traders take the long-term position of shorting the rand against the dollar and they do it for large amounts.”<sup>101</sup>

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

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

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<sup>101</sup>

De Villiers Record 376

<sup>102</sup>

Abedian Expert Bundle §2.8 p 261

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

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

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

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

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

### 25.1 Authorised dealers

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

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

### 25.2 Non-residents

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

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<sup>107</sup> Mboweni Bundle SARB (7) 39

<sup>108</sup> Memorandum of Reserve Bank Bundle SARB (7) 104

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

### 25.3 Importers and Exporters / Leads and lags

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

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<sup>109</sup> Mboweni, Bundle SARB (7) 40-42; McCauley, Expert Bundle 58

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

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

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

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

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<sup>111</sup> Bruce-Brand Bundle SARB (6) 19-20

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

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

31 December 1998	USD995m
31 December 2000	USD1 981m
31 December 2001	USD2 625m. <sup>113</sup>

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

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<sup>112</sup> Mboweni Bundle SARB (7) 39-40

<sup>113</sup> Mboweni Bundle SARB (7) 40

represents an outflow of  $\frac{1}{12}$  of trade. The leads and lags phenomenon makes the distinction between goods and financial services seem artificial in practice.<sup>114</sup>

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

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<sup>114</sup>

McCauley Record 48, Expert bundle 49

have every reason to accumulate deposits in such accounts.<sup>115</sup>

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

**Table 1 Expert Bundle 453**

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

<sup>115</sup>

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

For the year 2000:

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

For the year 2001:

<u>Spot rate on</u>	<u>Forward rate</u>	<u>Actual spot</u> <u>rate on</u>	<u>Percentage</u>
<u>01/01/2001</u>	<u>on 01/12/2001</u>	<u>01/12/2001</u>	<u>Difference</u>
7.5625	7.8095	10.255	23.10% <sup>116</sup>

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

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<sup>116</sup> Glynos Expert Bundle 453

judgment on the expected future development of the price of the currency.<sup>117</sup>

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

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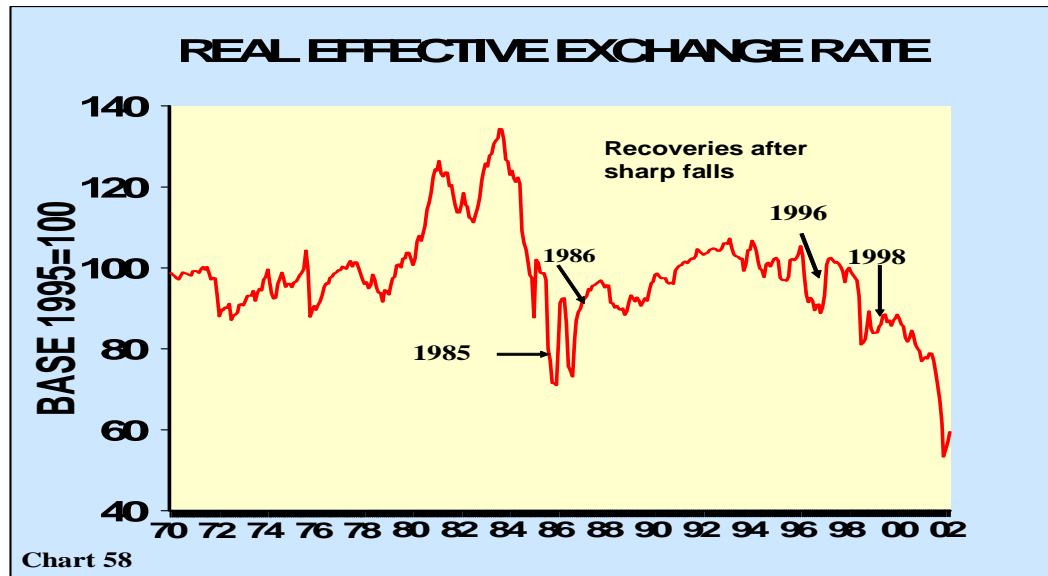
28.1 Dr Jammie is of the view that the leads and lags phenomenon was exacerbated by panic by importers and glee by exporters who deliberately held off repatriating dollars for as long as possible. He sees in an asymmetric trend for a protracted period of time in which the demand for dollars by importers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

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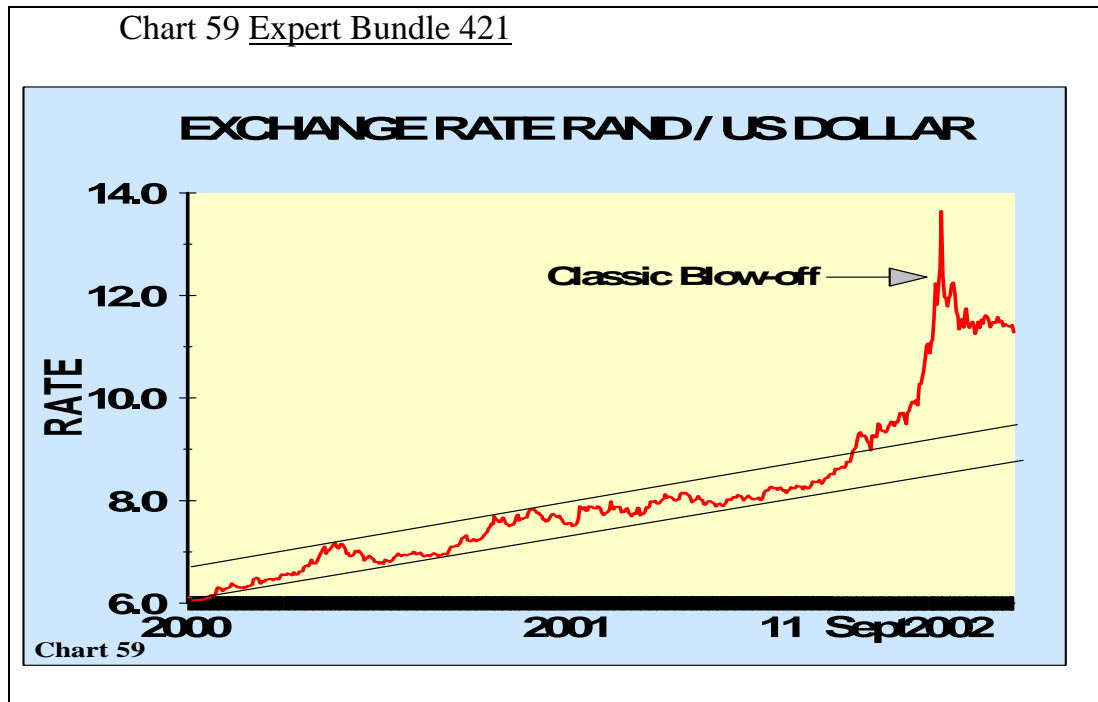
<sup>117</sup> Memorandum of Reserve Bank [Bundle SARB \(7\) 104](#)

<sup>118</sup> Memorandum of Reserve Bank [Bundle SARB \(7\) 104](#)

Chart 58 Expert Bundle 420



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



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

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

<sup>119</sup>

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

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

[3] The experts’ conclusions<sup>121</sup>

(1) Mr Gouws

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

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<sup>120</sup> Abedian Record 422

<sup>121</sup> The evidence of the experts is dealt with in the order in which they gave evidence.

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

(2) Dr Stals

31 Dr Stals summed up his views as follows:-

- (1) The South African exchange rate is determined by forces of demand and supply. The system of a managed float is by its nature unstable. Volatile movements in the exchange rate can be expected from time to time.
- (2) The nominal exchange rate of the rand against other currencies will over time depreciate more or less by the inflation differential between South Africa and its major trading partners.

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<sup>122</sup>

- (3) Globalisation led to an integration of financial markets on a worldwide basis. There has been a big increase in international capital flows. Turnovers in foreign currency markets assumed astronomical dimensions. South Africa participated in those developments and removed or relaxed exchange controls to an important extent. All those developments contributed to a more volatile exchange rate for the rand.
- (4) In the second half of 2001 various adverse external and domestic developments led to a deterioration in the South African balance of payments and therefore to a decline in the supply of foreign exchange.
- (5) Without any official support, shortages developed in the market for foreign exchange with a strong concurrent pressure on the rand to depreciate.
- (6) There was a growing perception in the market that the rand would continue to depreciate. Protective action by importers and expedient conduct by exporters squeezed the market even further. In December 2001 there were signs of panic in the market because of the shortage of liquidity.
- (7) The reduction in the NOFP may have contributed to the woes of the rand. The role of the NOFP in the depreciation of the rand has, however, been exaggerated in the media and in the market.

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

(3) Dr Abedian

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

- (1) Net demand for the rand had diminished substantially.
- (2) Policy uncertainty and an implicit policy re-think influenced the market.
- (3) A one-way bet on the currency had taken root.
- (4) No obvious defence for the currency was evident.
- (5) Liquidity in the market was diminishing from mid-year on and reached low levels during the fourth quarter of the year.
- (6) Global and environmental factors continued to weigh adversely on the currency.
- (7) The market conditions were ripe for a run on the currency.

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<sup>123</sup>

Stals Expert Bundle 183

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

- (1) A perfectly legitimate large transaction by one of the major market players might have led to the emergence of a herd mentality resulting in the run on the rand.
- (2) It is technically possible that one may execute a deal fully aware of the full-scale domino effects and one does so in order to benefit via a major deal already in contract. Such a situation was particularly more feasible when the pure speculators were driven out of the market by November 2001.
- (3) There were uncoordinated numerous market transactions that culminated in a self-fulfilling prophecy leading to a severe overshooting in valuation of the currency. Deals of this kind might well have had no motive other than well-considered business logic, yet the impact or outcome was identical to either of scenarios 1 and 2.<sup>124</sup>

(4) Mr Bruce-Brand

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

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<sup>124</sup> Abedian Expert Bundle 282, 283

factors mentioned by the various witnesses influenced the exchange rate of the rand – which would make the task even more difficult for him.<sup>125</sup>

(5) Mr Mboweni

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

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

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

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<sup>125</sup>

Bundle SARB (6) 24

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

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(6) Ms Ramos

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

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

costs of globalisation.

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

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

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

The Minister of Finance spoke of a complex set of factors which

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<sup>127</sup> Ramos, National Treasury Bundle, 58-59

<sup>128</sup> Ms Ramos Record 735-6

were at play.<sup>129</sup>

(7) Dr O'Neill

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

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

<sup>129</sup>

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

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

- (1) The foreign exchange markets have been generally very peculiar since 1999 since the introduction of EMU. Lots of currencies, including the most important in the world, the dollar, and the euro specifically, have behaved very differently than the consensus expected.
- (2) The US dollar has been and remains peculiarly strong because of lots of capital inflows including foreign direct investments and portfolios [into the USA].
- (3) Until late 2001 the rand was not independently weak from the general weakness which other currencies showed against the dollar.
- (4) Policy should concentrate on inflation targeting and not on the rand. If policy was supplemented and intensified with its inflation

<sup>130</sup>

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

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

- (5) If South Africa wants a strong rand, South Africa needs to have a BBoP surplus so that it will not be subject to the vagaries of sentiment. The way to achieve that is to attract more foreign direct investments and more portfolio flows.
- (6) The events of late 2001 suggest that with foreign exchange controls, one either has no controls or one has complete controls. But, if one has partial controls, it is confusing and very hard for people to understand except those very close to monitoring them and implementing them. It is also often taken as a sign of lack of confidence in other targets and in particular if there is an inflation targeting regime in place. It was not obvious to Dr O'Neill what purpose foreign exchange controls serve. In his view, if the removal of exchange controls was done in the context of specifically targeting more foreign direct investments and enhancing a greater broadening of the understanding of the inflation targeting regime, he believes that the abolition of exchange controls will lead to a significant inflow and strengthening of the rand.<sup>131</sup>

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

(8) Standard Corporate and Merchant Bank (“SCMB”)

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

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

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

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

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

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

The views of the authorised dealers

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

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

<sup>133</sup> Pages 40-41 of the DT report referred to in Part K.

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

The views of the representative offices

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

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

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P50 of the DT report referred to in Part K.