

believe that the gradual or sudden removal of such controls would lead to a gradual or sudden further depreciation of the rand; the partial lifting of exchange controls over the years has probably made the enforcement of the remaining measures much more difficult; and remaining exchange controls are rendering the rand a weak currency because of the fear that comprehensive exchange controls may again be implemented at any time.⁵⁶

(3) Short term

The role of the Reserve Bank

17 Exchange Rate Management

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

⁵⁶

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

Macro-economic concerns:

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

Micro-economic concerns:

- reduce volatility of exchange rate;
- prevent loss of confidence: fear that decline may lead to expectations of further decline and lead normal players to back away from the market;
- prevent “disorderly” market as reflected in “gapping” of successive bid–ask spreads, widening of bid-ask spreads and an absence of a sense of two way risk.⁵⁷

17.2 The instruments to manage an exchange rate are:

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

Open mouth policy

This is almost universally used by policy makers. A person in authority, such as the minister of finance or the governor of the central bank, makes a statement about the exchange rate with the object to influence the exchange rate, for example, “I think a strong dollar is in the interest of the US economy”.⁵⁸

Intervention to support currency

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

⁵⁸ McCauley gave this example: “... in the Philippines last August, the President....said that she thought that 50 pesos to the dollar was a pretty good exchange rate for the peso. It was then trading at more like 55 and strangely enough by the end of the year it was down to close to 50.” Record 68

17.3 Raise interest rates to defend currency

Until quite recently, it was generally accepted that if a currency was under pressure, an effective way to defend the currency was to raise interest rates. But it may be hard to influence the exchange rate in a particular way: high interest rates can hurt growth and many investors associate growth with a strong currency and high interest rates may lead to a sale of bonds. The limits to the effectiveness of this kind of response were shown in the United Kingdom in 1992 and in the case of Europe in the past 15 months. The market has come to the conclusion, according to McCauley, that “the best thing for a currency is the prospect of growth returning to that economy and so raising interest rates or only slowly lowering them, might actually perversely hurt the currency rather than help it. So that is a pretty radical notion I have to admit, one that goes very much against the text books and everything they teach central bankers but there has been a suspicion out there that that is the way it is working actually.”⁵⁹

17.4 Tighten capital (exchange) controls

Exchange controls can take various forms, such as restrictions on borrowing lower yielding foreign currencies, on non-resident borrowing of local currency; and on residents purchasing foreign currency. The tightening of non-resident borrowing of local

currency can immediately lift the domestic currency. The downside is that the longer term effects of such a policy are harder to gauge and there is an argument that by tightening exchange controls, you actually curb inflows.⁶⁰

The Reserve Bank

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

⁵⁹ McCauley Record 78

⁶⁰ McCauley Record 79 - 80

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

Reserve Bank policies

- 19 In January 1979 the Government accepted this recommendation of the De Kock Commission of Enquiry into the Monetary System and Monetary Policy in South Africa: “The Commission recommends a unitary exchange rate system under which an independent and flexible rand finds its own level in well-developed and competitive spot and forward foreign exchange markets in South Africa, subject to Reserve Bank ‘intervention’ or ‘management’ by means of purchases and sales of foreign exchange (mainly US dollars), but with no exchange control over non-residents and limited control over residents”. The De Kock Commission further recommended: “...whatever other objectives it (the Reserve Bank) might also have from time to time, intervention (in the foreign exchange market) should ordinarily be a smoothing operation.” It was only after 1994 when South Africa could afford to commence phasing out exchange controls that the South African forex market reached the full status envisaged by the De Kock Commission and the “managed floating exchange rate” system for the rand was fully applied.⁶²

⁶¹ Mboweni, Bundle SARB (7) 5-7

⁶² Stals, Expert Bundle 167-9: 179

- 20 On various occasions in the past the Reserve Bank intervened in defence of the rand. As the Reserve Bank did not have adequate foreign reserves, the obligations to deliver foreign exchange into the market were converted into forward obligations. The Reserve Bank, for example, sold US dollars into the spot foreign exchange market in order to support the exchange rate of the rand and then swapped the US dollars back onto its forward book by buying US dollars spot and simultaneously selling them forward. According to the Reserve Bank Act, all profits and losses in respect of providing forward cover are for the account of Government. Over the years, huge losses were made owing to the existence of the NOFP.
- 21 In 1998 the Reserve Bank intervened in defence of the rand in two distinct ways: by use of the forward book, increasing the NOFP to USD 23 billion and by raising interest rates from 14% in June 1998 to 25.5% in August 1998.⁶³
- 22 By 2001 the Reserve Bank and the National Treasury had changed course.

⁶³ Jamine, [Expert Bundle 309,310](#)

23 Inflation targeting

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

23.2 The evidence of the Governor was that inflation targeting is a monetary policy framework implying the targeting of the inflation rate directly. Other intermediate variables influencing inflation such as money supply, credit extension or the *exchange rate* are not targeted directly, although they still play an important role in the determination of inflation. In the medium to longer term, successful inflation targeting should contribute to a more stable exchange rate for the rand.⁶⁴ Dr Stals said in evidence that he supported the concept of inflation targeting but that “... in any central bank the Governor has in his drawer much more than just an inflation target in mind because ... in economics everything depends on everything else and the inflation target or the inflation result will be affected by a lot of other things that you just cannot ignore because ... the Reserve Bank does not fix prices everyday and therefore it does not

⁶⁴

Mboweni, Bundle SARB (7) 9

control inflation directly. It affects inflation through its operations in the money market, in the exchange rate environment, in the interest rate structure, in the liquidity of the banking system. So these are the operational instrument that you have to use and have to apply and have to take account of every day even if you have a fixation on inflation at the end of the day andwhether that target of yours is the money supply or the level of interest rates or the amount of liquidity in the banking system or the bank credit extension or the exchange rate, they are all very much inter-related in a circular process – the one affects the other.”⁶⁵

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

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

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

⁶⁵Stals, Record 286

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

23.5 The policy of non-intervention was made public by the Reserve Bank on a number of occasions in 2001 at a time when the rand was in decline. For example, in the Governor's statement of 14 October 2001, it was said that "...with the adoption of an inflation-targeting monetary policy framework, [the Reserve Bank] no longer has any intermediate policy targets or guidelines such as the exchange rate or growth in the monetary aggregates. The authorities are committed to continue allowing the value of the rand to be determined by the market, but are concerned that excessive volatility in the foreign exchange market negatively influences inflation, business decisions and the economy as a whole." Participants in the forex market formed the view that in the absence of support for the rand by the Reserve Bank, the rand would continue to depreciate. The policy of non-intervention became an element of the "one-way bet" view of the rand which infected the forex market in 2001.⁶⁷

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

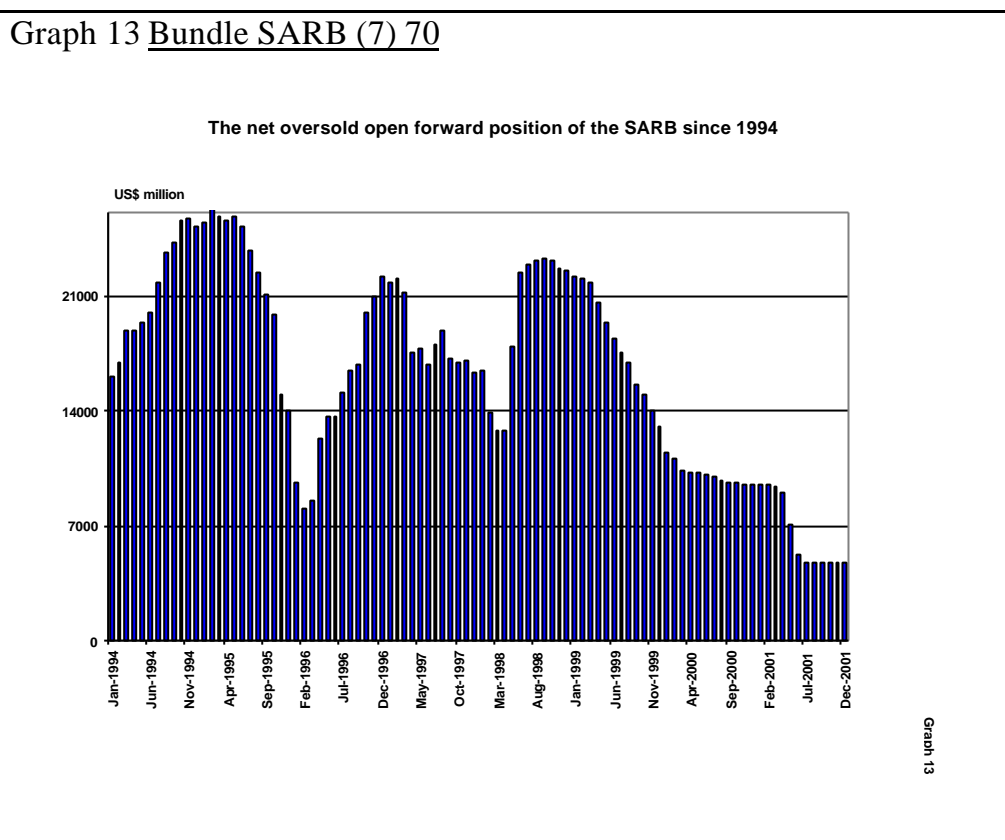
⁶⁷ Gouws, [Expert Bundle 125](#); Mr M Langley, former Head of Foreign Exchange, Credit Agricole Indosuez, Johannesburg, [Expert Bundle 148](#); Jammie [Expert Bundle 339](#); Mr G Glynos, chief market analyst, Standard & Poor's MMS SA, [Expert Bundle 424](#)

24 NOFP

24.1 The Reserve Bank and the National Treasury took a decision to reduce the NOFP. The decision was made public and implemented. By the end of the first quarter of 2001 the NOFP had been reduced from USD 23 billion in 1998 to USD 9.4 billion.

24.2 The Reserve Bank reduced the NOFP, in its words, by “buying foreign exchange” or, in the words of the rating agency, Standard and Poor, by “mopping up inflows”. Total purchases in 2001 amounted to about USD 4.4 billion and were related to Government’s foreign bond issues and to large corporate transactions. The NOFP, accordingly, declined to USD 5.3 billion at the end of quarter two; USD 4.7 billion at the end of quarter three and USD 4.8 billion as at the end of 2001.⁶⁸ The Reserve Bank’s success in implementing the policy is shown in this graph:

⁶⁸

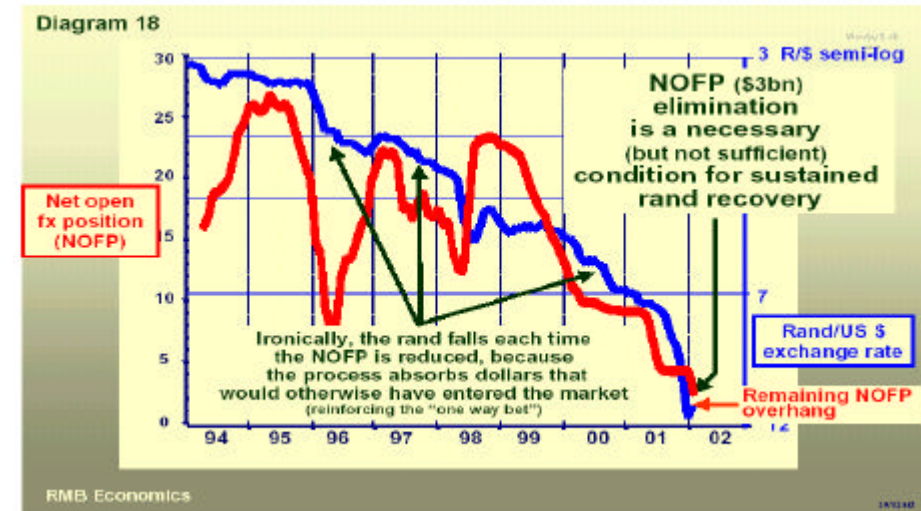
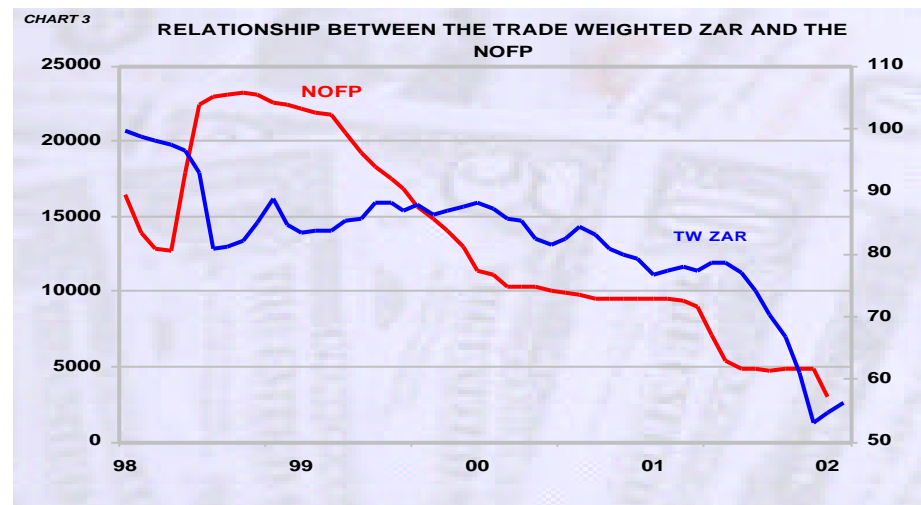


24.3 The policy of reducing the NOFP has been praised by the IMF, the rating agencies and the investment banking community. For example, on 9 May 2001 the IMF stated: “Directors [of IMF] commended the authorities for the significant recent progress made in reducing the net open forward position (NOFP) of the Bank. Nevertheless, they noted that the NOFP remains an important source of external vulnerability, and that it needs to be further reduced as market conditions permit”.⁶⁹

24.4 The experts from the private sector, whether economists or traders, were not critical of the policy. But all agreed that the Reserve Bank's commitment to reduce the NOFP by buying US dollars contributed significantly to the perception that the rand was a one-way bet.⁷⁰ As Dr Abedian said: "... The SARB's single minded focus was on eliminating the NOFP ... This of course meant a one-sided intervention in the spot market. The SARB was in principle selling rands and buying hard currency, thereby adding to the net demand for hard currency and putting downward pressure on the rand. Moreover, in pursuit of closing down its NOFP, the SARB seemed to be inclined to fully capture once-off inflows such as the De Beers deal, thereby eliminating any upward pressures on the value of the rand. This proved a consistent policy approach over the period 1999-2001. However, this approach had a significant impact on hardening positions against the currency. Speculative positions against the rand were therefore by and large risk free. In essence, most, if not all, market players believed that even the SARB was neither inclined nor in a position to do anything that would strengthen the currency."⁷¹

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

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

Graph 18 Expert Bundle 126Chart 3 Expert Bundle 455

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

“Given the losses on the forward book and negative perceptions from market participants and commentators on the one hand and the potential impact on the currency of reducing the forward book on the other, the Bank had a difficult choice to make. In the long-term interest of South Africa, it was decided to place emphasis on reducing the NOFP. The Bank had to buy foreign exchange as prudently as possible to close out the NOFP.

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

Had the Bank allowed the proceeds of these large corporate transactions to flow through the market, the rand could have appreciated significantly. The market had been expecting a sizeable amount of the foreign exchange proceeds accruing to South African shareholders to be sold off for rand in the market, which expectation initially provided some support for the rand. Upon confirmation that the bulk of such proceeds were to be the subject of a once-off transaction with the Bank, for the purpose of reducing the NOFP, market perceptions of rand weakness could have been reinforced.”⁷²

24.7 On 14 October 2001 the Governor issued a statement which dealt, inter alia, with the NOFP in these terms: “The net open foreign

currency position (NOFP) has declined from USD 23.2 billion at the end of September 1998 to USD 4.8 billion. Given the negative perceptions resulting from the NOFP, the Reserve Bank reduced this position by purchasing foreign currency in the domestic foreign exchange market, which may have contributed to the depreciation of the rand over this period.

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

In future, the Reserve Bank will not intervene by purchasing foreign exchange from the market for purposes of reducing the NOFP. The NOFP will be expunged from cash flows derived from the proceeds of Government's off-shore borrowings and privatisation."⁷³

- 24.8 Had investors and analysts read the statement of 14 October 2001 with the necessary care, they would have realised that as the Reserve Bank would no longer "mop up" US dollars in the forex market to reduce the NOFP, the NOFP should not be considered an element of the one-way bet. The evidence before the

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

⁷³ Mboweni, Bundle SARB (7), 340

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

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

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

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

25.1 The evidence of the Governor was that the issue of enforcing existing exchange controls had been extensively discussed in the Reserve Bank and with National Treasury over a long period of

time. The Reserve Bank was aware of the various explanations of the rand's weakness in recent years. The explanations included exchange control liberalisation, the Reserve Bank buying spot foreign exchange to reduce the NOFP and the decisions by importers and exporters to lead or lag their foreign exchange payments and sales. The impact of these more fundamental and legitimate factors influencing the exchange rate was acceptable to the authorities. Of more concern were comments from the market that speculative transactions, particularly by non-residents, were adding to volatility and rand weakness. The Reserve Bank was informed that investors and other emerging markets, with less liquid financial markets, were using South African markets as a proxy hedge for weakness in other countries. The Reserve Bank had no choice but to either abolish the remaining exchange controls in total or to apply the existing rules and regulations equitably to all. The Reserve Bank became increasingly concerned that excessive volatility in the forex market during the third quarter of 2001 negatively influenced inflation, business decisions on the economy as a whole. Accordingly, a meeting was called on Sunday, 14 October 2001 between the Reserve Bank and the chief executive officer and head of treasury of

major South African and foreign banks registered in South Africa. What was conveyed to the banks, and which is material for present purposes by the Governor, is what is contained in the statement of 14 October in these terms:

“The Reserve Bank stands ready to take appropriate firm steps against trading activities inconsistent with existing rules and regulations. The enforcement of existing rules serves to ensure that only legitimate transactions take place in the foreign exchange market. This does not restrict, for example, the ability of a non-resident investor to either hedge or repatriate the sale proceeds of an investment in South Africa. It does, however, exclude the financing of short rand positions in the domestic markets, which is consistent with the requirement that domestic borrowing by non-resident investors is subject to certain restrictions. This communication should not be construed as an attempt to restrict the activities of banks in the South African markets, provided they adhere to the existing rules and regulations. Normal commercial and financial transactions remain unaffected.” On 16 October 2001 the Reserve Bank issued Circular D342, in which it was stated, *inter alia*:

“To ensure that the provisions of the various sections of exchange control rulings are applied uniformly by all authorised dealers, in particular when dealing with non-residents in the forward and other

derivative foreign exchange markets, we deem it necessary to reiterate certain fundamental principles in this regard.

It is incumbent upon authorised dealers to ensure that their overseas counterparties are fully conversant with the rules applicable to dealing in the domestic forward and other derivative foreign exchange markets. It follows, therefore, that when dealing with a non-resident counterparty, other than a correspondent bank, supporting documentary evidence must be obtained confirming that such non-resident counterparty has a legitimate South African exposure resulting from an accrual, investment or asset denominated in rand.”⁷⁵

25.2 In about late October 2001, an “important notice” was issued to authorised dealers. In terms of the notice, the compliance officer of a non-resident bank was required to sign a compliance letter. The Reserve Bank and a working committee of the ACI, an organisation representing forex dealers, accepted the wording of the compliance letter. In terms of the compliance letter, the compliance officer was called upon to confirm in writing “that all transactions concluded by our clients and our dealers within the preceding 14 business days have been in compliance with the applicable rules and regulations.”⁷⁶

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

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

25.3 The Reserve Bank believed that applying the existing rules and regulations to exclude speculative trading from the forex markets would reduce volatility in the rand's exchange rate and would be to the benefit of non-resident investors and South Africans alike.⁷⁷

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

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

21.5.4 **Forward exchange contracts with non-residents** – Foreign currency may be sold forward to non-residents, provided that such non-resident counterparties have legitimate South African exposures resulting from an accrual, investment or asset denominated in Rand.”⁷⁸

⁷⁷ Mboweni, Bundle SARB (7) 43

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

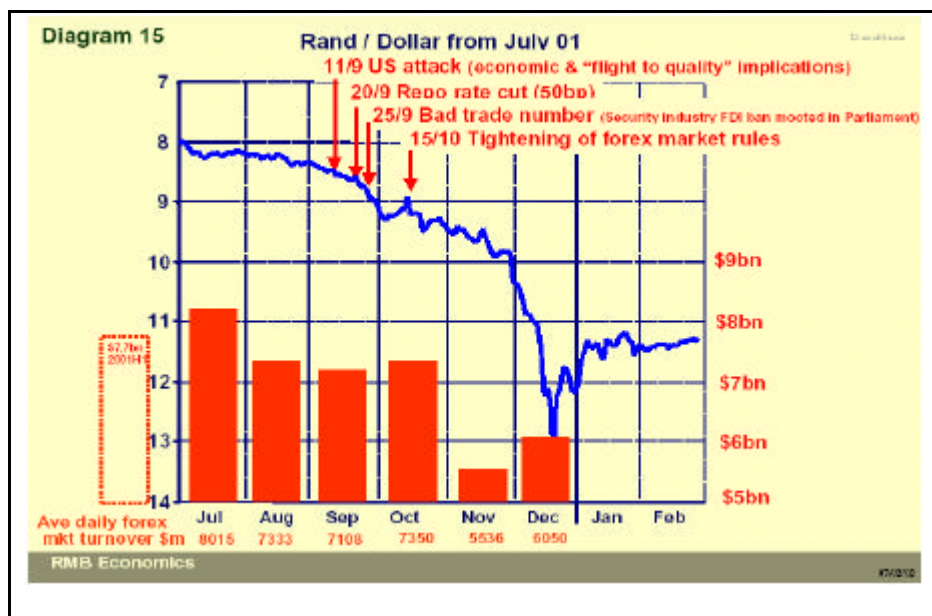
25.5 The Reserve Bank surmises that while consultation between it and the forex market was taking place following on the statement of 14 October 2001, "... some off-shore banks might have decided, as a precautionary measure, to avoid finding themselves in contravention of exchange control rules, to reduce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

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

Diagram 15 Expert Bundle 125

⁷⁹ Mboweni, Bundle SARB (7) 44

⁸⁰ Mboweni, Bundle SARB (7) 44; Gouws, Expert Bundle 125



The most significant decline was in the swap market where the average daily net turnover declined from an average level of USD5.8 billion in the first ten months to an average USD4.3 billion for the last two months. The turnover of non-residents – the most significant participants in the market – declined from USD 3.6 billion to USD 2.3 billion respectively.⁸¹

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

“The issue of liquidity also arises when considering volatility. One-month historical volatility of the rand’s exchange rate against the US dollar increased from a level of 9.1% in the first nine months of 2001 to an average of 20.5% for the last quarter. These volatilities reached a

high of 55% at the end of December 2001. It is, however, not possible to attribute changes in these variables to a single reason or event but it is possible that the interpretation of the 14 October 2001 statement could have been a contributory factor.”⁸²

25.8 A view that was expressed by a number of economists was that the effect of the statement of 14 October 2001 on the rand was negative. For example, Mr Luüs said: ‘On 14 October 2001 the SARB drained liquidity from the foreign exchange market by a stricter application of foreign exchange regulations. This measure worsened the rand’s slide’.⁸³ Dr Abedian testified that the immediate impact of the statement of 14 October 2001 was to ‘scare away the pure speculators (mainly off-shore) from the market, thereby reducing liquidity in the overall market by another USD 200 to USD 300 million per day. In an already thin market, this contributed considerable additional pressure on the rand. With these volumes out of the market and no speculators active in the market, the conditions were so much more favourable for a run on the currency.’⁸⁴

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

⁸¹ Mboweni, Bundle SARB (7) 44

⁸² Mboweni, Bundle SARB (7) 45

⁸³ Luüs, Expert Bundle 213

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

volatile market resulting in a sharp decrease in liquidity.”⁸⁵ Foreign financial institutions, based mainly in London and to a lesser extent in New York, have entered the South African forex market. When volatility is at its highest, however, a number of new entrants leave the market.⁸⁶

25.10 In about the first two days after the meeting of 14 October 2001 the rand depreciated. This was “... a natural consequence of traders sitting on-shore and off-shore that were holding long dollar positions, getting out of their long dollar positions by selling those positions and buying rand until they were confident that they understood what the implications of the circular were ...”⁸⁷ Once the market understood the import of this statement, the rand continued to depreciate. The volumes dropped because of the reduced number of market makers in the market. The market makers which left the market were the foreign market makers. The probable reason for their withdrawal from the market was that a compliance officer of a foreign bank is in a very responsible position. He would not certify that a forex transaction was not for speculative purposes unless he was satisfied about the truth of the averment. Compliance officers of foreign banks probably advised their banks not to trade in the rand until they understood the statement

⁸⁵Langley Expert Bundle 141⁸⁶Mr P De Villiers, Global Head of Foreign Exchange Trading, Investec Bank, Record 363

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

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

Speculation

Introduction

26 The first point is that speculators have a necessary role to play in the forex market. Dr Stals said that in a well developed market there is a need for short, medium and long-term investors and for buyers and sellers of a variety of spot and forward instruments. The speculator has an important part to play in an effective price discovery mechanism,

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De Villiers Record 388