Exchange rates and exchange control

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What is an exchange rate?

An exchange rate is the rate at which the currency of one country is exchanged for the currency of another country. For instance, if one goes to an authorised dealer in foreign exchange and purchases one United States dollar by paying R7,00 then the exchange rate of the rand against the dollar is R7,00 for one dollar.

How are exchange rates determined?

The exchange rate of the rand is basically determined by market forces. For instance, buying and selling rates for dollars quoted by authorised foreign-exchange dealers are based on the supply of and demand for dollars in the market at any given time.

The South African Reserve Bank (the Bank) may, in line with prevailing monetary and exchange rate policy, intervene in the market from time to time by purchasing or selling dollars. When intervening in the market, the Bank does not attempt to bring about any structural change in the economy or to affect longer-term movements in balance-of-payments transactions; it merely intervenes to smooth out unduly large short-term fluctuations in money-market liquidity or the exchange rate. During 1996, for example, the Bank intervened quite heavily in the foreign-exchange market by supplying the market with a substantial amount of dollars when the large demand for foreign exchange threatened to disrupt the market and cause an unwarranted depreciation of the rand.

Factors influencing exchange rates

The balance-of-payments position of a country, or expected changes in transactions with the rest of the world, is the most direct determinant of a country's exchange rate.

Demand for foreign currency arises from importing merchandise goods and the payment for services, or from the redemption of capital obligations. By contrast, the supply of foreign currency emanates from the exporting of goods and services or from an inflow of foreign capital. If, as a result of South Africa's transactions with the rest of the world in a given period, the total inflow of foreign exchange is greater than the outflow, the supply of foreign currency exceeds the demand. Under these circumstances the rand will appreciate, on average, against other currencies.

In addition to the underlying balance-of-payments position, the level of the exchange rate of the rand over the longer term could also be influenced by the inflation differential between South Africa and its main trading partners or international competitors. If the inflation rate in South Africa is consistently higher than that of its major trading partners or competitors, South African producers will lose their competitive edge and South African consumers might be tempted to import goods instead of buying locally produced goods. This will reduce South Africa's exports while the demand for imports will rise, the demand for foreign currency will increase, foreign currency will become relatively scarce and more expensive, and the rand will depreciate against other currencies.

Furthermore, non-economic factors such as political developments, unfounded rumours, speculative transactions and unfavourable perceptions about South Africa may change the exchange value of the rand to a level which does not reflect the balance-of-payments position, nor its comparative purchasing power.

Reason for and purpose of exchange control

The main purpose of exchange control is to:

- ensure the timeous repatriation into the South African banking system of certain foreign currency acquired by residents of South Africa, whether through transactions of a current or a capital nature; and
- prevent the loss of foreign-currency resources through the transfer abroad of real or financial capital assets held in South Africa.

The balance of South Africa's foreign currency is known as the country's foreign-exchange reserves which are primarily earned by means of foreign borrowings as well as the export of goods (including gold) and services abroad.

These foreign-exchange reserves are mainly utilised for the payment of goods and services imported into the country and for the servicing of the country's foreign debt. Foreign-exchange reserves are essential for any country and a lack thereof results in the country concerned not being able to develop properly.

It is important that the available foreign-exchange reserves are applied in the best interest of the country. This means that it is essential that each time any of the foreign-currency reserves are utilised, equivalent value in the form of goods and services, debt reduction or approved foreign assets is received.

Exchange control therefore constitutes an effective system of control to these ends by monitoring the movement of financial and real assets (money and goods) into and out of South Africa, while at the same time avoiding interference with the efficient operation of the commercial, industrial and financial systems of the country.

Liberalisation of exchange controls

After 1994, the South African Government decided on a gradual approach to the phasing out and liberalisation of exchange controls rather than a "big-bang" approach. A phased approach allowed government more time to implement other policy changes in order to achieve the preconditions necessary for a successful liberalisation of exchange controls. Over the years exchange controls have been significantly relaxed in line with improved macroeconomic performance and financial-sector development. Government's gradual process of exchange control relaxation has enabled an orderly process of global reintegration, encouraging South African companies to expand from a domestic base and allowing South African residents to diversify through domestic channels.

This is the fourth in a series of fact sheets on the South African Reserve Bank, compiled by the Research Department: Information Division and distributed by the Executive Management Department: Communications Unit.

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