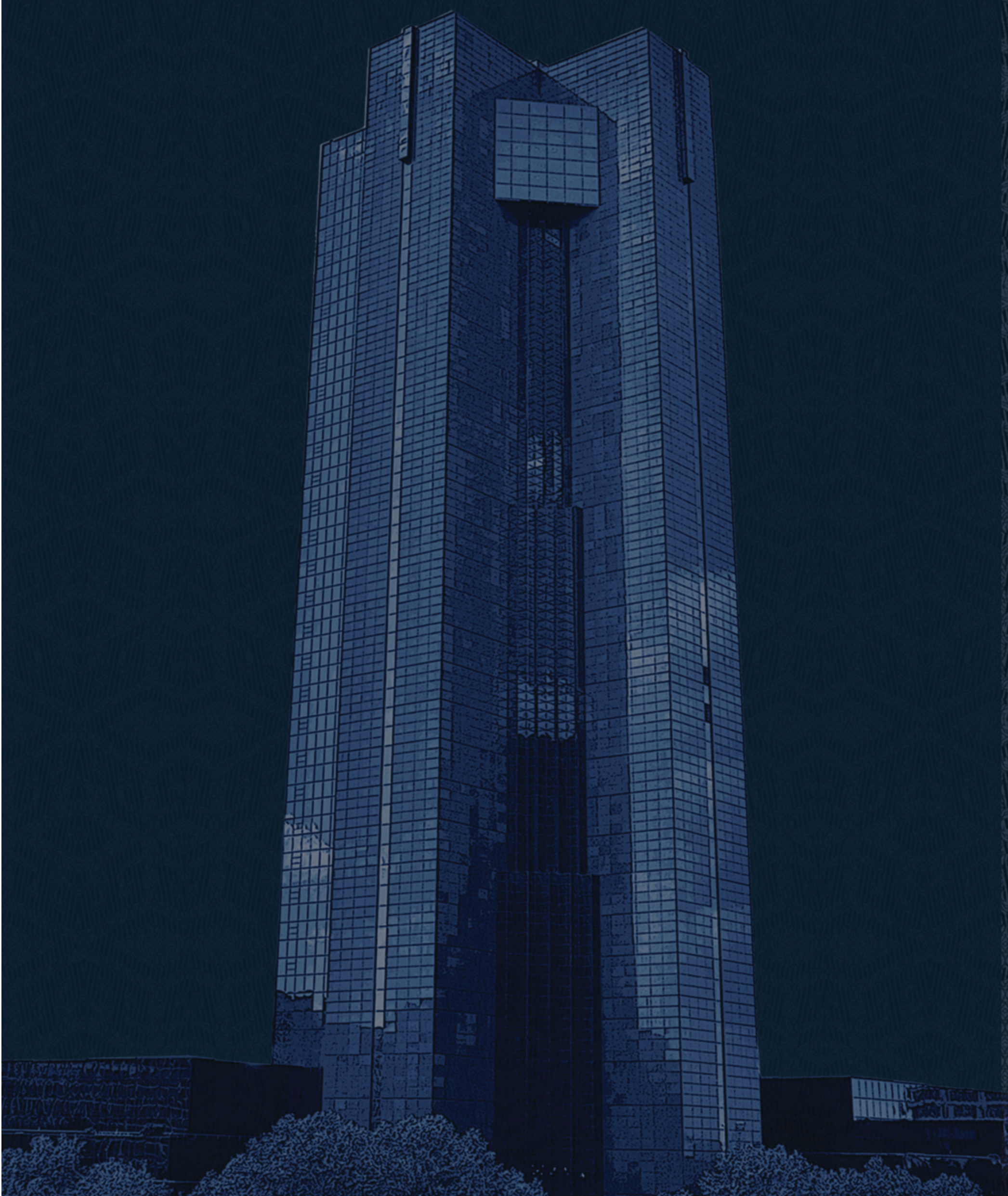
South African Reserve Bank

Exchange rates and exchange control



4

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 that does not reflect the balance-of-payments position, nor its comparative purchasing power.

Exchange rates and exchange control

Exchange controls were first introduced in South Africa in 1939 in the form of the Emergency Finance Regulations adopted by the Sterling Area to prevent large capital outflows, possibly to areas not in the interests of the then British Empire and to protect the foreign reserves of its members. The objective of these measures was to retain a free movement of funds between the members of the Sterling Area, but to prevent a currency outflow to non-Sterling Area countries. The Sterling Area exchange controls were gradually removed after World War II.

Although South Africa has had exchange controls since 1939, the current governing legislation is set out in the Exchange Control Regulations promulgated in 1961 in terms of the Currency and Exchanges Act, 1933 (Act No. 9 of 1933).

At times the South African exchange controls were tightened or relaxed depending on domestic and international circumstances. In some cases exchange controls were extended in reaction to political incidents that led to capital outflows not based on underlying economic fundamentals. Since 1961 exchange controls in South Africa were, by and large, intended to protect the domestic economy from the adverse effects of non-economically motivated capital outflows.

South Africa has substantially reformed its exchange control policies since the democratic elections in 1994. The Financial Rand mechanism was finally abolished in March 1995 and since then non-residents have, by and large, been free to transact in South Africa. The country has gradually liberalised exchange controls, by increasing foreign exposure limits for institutional investors, progressively increasing foreign asset limits for individuals, and permitting South African firms to raise capital and expand their operations abroad. The authorities' main objective has been to move toward a system based approach of prudential limits and supervision, and away from a rigid system of quantitative controls.

However, the above mentioned reforms have resulted in the exchange control regime remaining largely intact despite South Africa having been fully reintegrated into the world economy. Thus far a gradual approach has been adopted when liberalising exchange controls mainly as a result of these controls having permeated the entire economy since their introduction in 1961.

The name of the Exchange Control Department was changed to the Financial Surveillance Department on 2 August 2010.

The Financial Surveillance Department of the Bank is, therefore, responsible for the day-today administration of exchange controls in South Africa. The Minister of Finance has also appointed certain banks to act as Authorised Dealers in foreign exchange. This appointment gives these banks the right to buy and sell foreign exchange, subject to conditions and within limits prescribed by the Financial Surveillance Department. Authorised Dealers are not agents for the Financial Surveillance Department but act on behalf of their customers. Policy is determined by the Minister of Finance (or even government or Cabinet in the broader sense). The Bank, therefore, merely acts as an adviser to the Minister of Finance.

Comments about the suitability or otherwise of the current system of exchange controls in South Africa are often misdirected. It is often stated that the Bank should abolish exchange controls, but decision-making about the abolition of exchange controls has not been entrusted to the Bank.

While exchange controls are often viewed as an impediment to the optimal functioning of the domestic economy, the complete removal thereof continues to remain the objective of the South African authorities. It will, however, be necessary, to ensure that cross-border foreign exchange transactions continue to be recorded and monitored, even after such removal.

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 Strategy and Communications Department.

Available: http://www.reservebank.co.za

For further information on the content or to obtain printed hard copies:
Click on the **contact us** icon to submit your request

To access an electronic copy of this fact sheet:
Click on **Publications and Notices > Fact sheets**

The content of this fact sheet is subject to change at any time.

Last updated: March 2015