PART THREE

DEVELOPMENTS IN THE FOREIGN EXCHANGE MARKET DURING 2001

INTRODUCTION TO PART THREE

78 Having thus completed my submission on the macroeconomic background to the change in the exchange rate during 2001, this final part of my submission will cover some of the factors which could have contributed to the rand's depreciation during 2001, in particular during the latter part of the year.

BACKGROUND

79 Over a longer period of time, the rand could have been expected to weaken whilst an inflation differential continued to exist between South Africa and its trading partners, by virtue of decisions taken to liberalise exchange controls, as well as by virtue of the policy to reduce the NOFP of the Bank. What is difficult to explain, however, is the speed and the size of the decline which occurred from around mid-year until the 21 December 2001, when the rand hit a new all-time low of R13,84 to the US dollar. This decline is illustrated in graph 9 which shows the exchange rate of the rand against the US dollar.

80 Whilst the Bank certainly focuses on the USD/ZAR rate, we also monitor closely the trade-weighted index (TWI)* of the rand. Given the strength of the US dollar during 2001, the rate of decline in the TWI was somewhat more moderate but, nevertheless, of concern to the Bank. The percentage change in the TWI is illustrated in graph 10 and the

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* TWI or nominal effective exchange rate (NEER) represents an indexed value of the rand against a basket of 14 currencies. The basket and the weight of the currencies included in the basket are based on international trade in manufactured goods.

weights of the currencies included in the basket are reflected in Table 4.

81 The downward pressures on the rand's value arose from concerns regarding South Africa and Southern Africa and some from contagion emanating from other regions. (Developments in Argentina could, for example, have been a factor exacerbating rand weakness.) This conclusion is supported by graphs 11 and 12 which show the rand's performance relative to the exchange rates of similarly rated countries and against those of other emerging-market economies.

REDUCING THE NET OPEN FORWARD POSITION

82 Both the National Treasury and the Bank have expressed their determination to reduce the NOFP as it has been perceived negatively by market participants and commentators, including the International Monetary Fund, the rating agencies and the investment-banking community. I quote from the Public Information Notice dated 9 May 2001 (issued by the IMF) and entitled "IMF Concludes Article IV Consultation with South Africa": "Directors 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." The full text of this Public Information Notice can be found at pages 328 to 332 of the Bundle. I also quote from a statement from the rating agency Standard and Poor's on 31 May 2001: "Although the Bank's foreign exchange reserves have grown steadily since late 1998, external liquidity is unlikely to strengthen substantially in the near term, as the bank continues – whenever market conditions allow it – to mop up inflows to reduce the forward book. Owing to this policy, good progress has been made in reducing the Bank's net open forward position. **…** Looking ahead, the Bank will continue its stated policy of gradually

reducing its net open forward position." Moreover, the oversold forward book, which causes the negative value of the NOFP, has resulted in enormous costs to the fiscus. In fact, the losses on the forward book were the major contributor to the R40,8 billion losses incurred by the fiscus for the period 1978 to 31 December 2001 on the Gold and Foreign Exchange Contingency Reserve Account.*

83 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 has had to buy foreign exchange as prudently as possible to close out the NOFP.

84 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.

85 The wide fluctuations in the NOFP since 1994 are shown in <u>graph 13</u>. This graph shows that, during times when market conditions were deemed to be not conducive, the pace of the reduction of the NOFP was slowed down or the process of reduction was even suspended.

86 During 2001, the Bank purchased foreign exchange proceeds which emanated from a number of large transactions. The bulk of the proceeds from these transactions, therefore, did not directly influence the value of the exchange rate as they would have done if the foreign

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* Any credit or debit balance on the Gold Price Adjustment Account, the Foreign Exchange Adjustment Account and the Forward Exchange Contracts Adjustment Account shall, at the close of each financial year of the Bank or at such other times as the Bank and the Treasury may determine, be transferred to a Gold and Foreign Exchange Contingency Reserve Account established and managed by the Bank on behalf of the Treasury. (Clause 28 of the South African Reserve Bank Act No. 90 of 1989)

exchange proceeds had been sold in the foreign exchange market. Total purchases amounted to around USD 4,4 billion and were related to Government's foreign bond issues and to large corporate transactions.

87 These transactions contributed to the decline in the NOFP to USD 4,8 billion as at the end of 2001 - such declines are perceived positively in the market as a major negative influence on the currency is being actively addressed.

88 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.

89 To conclude this section, I wish to stress that the reduction of the NOFP was a deliberate policy choice given the undoubted benefit that such reduction would have over the longer term for perceptions toward the rand. Unfortunately purchasing foreign exchange to achieve this end will imply that the rand's ability to appreciate is somewhat constrained. The Bank has and will strive to minimise any negative impact on the market resulting from such transactions to reduce the NOFP. (This issue was also addressed in my 14 October 2001 statement.) Finally, I would also like to add that addressing the issue of the NOFP forms part and parcel of dealing with some of the sad consequences of an unfortunate part of this country's history.

EXCHANGE CONTROL LIBERALISATION

90 Although Mr Bruce-Brand, General Manager of the Bank's Exchange Control Department, in his statement previously delivered to this Commission has already provided an overview of exchange controls, I would like to make some brief comments now in this regard. Perhaps most importantly is the fact that exchange controls are a reality. They were inherited from a past era. It is only with major changes taking place in South Africa over the last decade, that bold steps have been taken to integrate South Africa into a globalising world. In particular, exchange control on residents and non-residents have been relaxed substantially. These steps have met with general acclaim. The policy of gradual liberalisation of exchange controls has also played a role in attracting foreign capital inflows, sometimes with concomitant benefits in the form of technology transfers to South Africa. These inflows were obviously supportive of the rand's value.

91 Details regarding investment flows by Private Individuals, Corporates and Institutional Investors are set forth at pages 333 to 337 of the Bundle. Key figures have been extracted from that document to give an indication of the magnitude of approved investments offshore by residents.

Private Individuals

92 Private Individuals, in terms of their Investment Allowances, transferred approximately R7,0 billion over the period 22 February 2001 to 31 December 2001.

Corporates

93 Corporates, in terms of foreign direct investments, transferred approximately R13,5 billion from South Africa over the period 22 February 2001 to 31 December 2001.

Institutional Investors

94 Since 21 February 2001, institutional investors have been allowed to acquire foreign portfolio investments up to the limits defined by way of foreign currency transfers based on a percentage of the previous year's inflow of funds. Statistics reported to the Exchange Control Department of the Bank show that R3,8 billion had been executed. Even taking the current exchange rate of some R11,50 per US dollar, these flows amount to huge capital outflows in US dollar terms.

95 It is virtually impossible to estimate the exact extent to which exchange control liberalisation has contributed to rand weakness but there can be no doubt, as the figures above suggest, that it could at times have been an important structural factor.

96 THE IMPACT OF GLOBALISATION

96.1 The re-entry of South Africa into the globalised financial markets and the opening up to international competition led to a sharp increase in the participation by non-residents in the domestic financial markets. Non-residents are now responsible for about one-third of the turnover on the JSE Securities Exchange SA and approximately one-eighth of the volumes on the South African Bond Exchange. This has caused share and bond prices, as well as the exchange rate of the rand to be increasingly influenced by developments in the rest of the world - particularly in emerging markets.

96.2 These transactions by non-residents contributed materially to substantial increases in financial sector activity. Turnover on the South African Bond Exchange, for example, increased from R2,0 trillion in 1995 to R12,4 trillion in 2001, while the total value of shares traded on the stock exchange rose from R63 billion to R606 billion over the same period. In the rand foreign exchange market volumes increased from a net average daily turnover of USD2,7 billion in 1995 to USD7,3 billion in 2001.

96.3 Transactions of non-residents also resulted in greater volatility in capital flows. For example, non-resident net purchases of shares on the JSE Securities Exchange SA at first increased from R5,3 billion in 1995 to R26,2 billion in 1996 and R40,6 billion in 1999, before declining to R17,4 billion in 2000 and R29,8 billion in 2001. Their net purchase of bonds on the South African Bond Exchange were even more volatile. At first these net purchases also increased from R3,4 billion in 1996 to R14,8 billion in 1997. Then foreigners on a net basis sold bonds to the value of R9,8 billion in 1998, and bought back R14,3 billion in 1999. They again became net sellers of bonds to the amount of R20,2 billion in 2000 and R25,9 billion in 2001. These sharp fluctuations in portfolio investments of non-residents contributed materially to greater volatility in the external value of the rand.

CURRENT ACCOUNT OF THE BALANCE OF PAYMENTS

97 Developments on the current account of the balance of payments were discussed in part two of this statement when I pointed out that the third and fourth quarters of 2001 saw the current account of the balance of payments slipping into deficit. This development obviously added to the demand for foreign exchange and technically speaking could have contributed to the downward pressures on the value of the rand.

RISK AVERSION

98 Risk aversion reflects a particular stance of investors in international markets in respect of the amount of risk they are willing to take. When investors move into risk-aversion mode, they tend to avoid taking on additional risk and typically reweight their portfolios towards less risky asset classes, for example, US Treasury bonds. The onset of the period of rapid depreciation in the rand's value coincided with an increase in risk aversion, as reflected in the JP Morgan Emerging Markets Bond Index's (EMBI)* spreads over comparable US Treasuries. See Graph 14 – JP Morgan Emerging Markets Bond Index spread over comparable US Treasuries

99 The increase in risk aversion could also have played a role in the outflows experienced via non-resident sales of South African bonds and equities. The extent of this risk aversion was understandably worsened by the tragic events of in America on 11 September 2001. It was only in early December that this EMBI* spread tightened significantly indicating a reduction in risk aversion. (This reduction in spread also reflected a reweighting of the index which accorded Argentina a lesser weight.)

POSSIBLE FURTHER FACTORS CONTRIBUTING TO RAND WEAKNESS

100 Further to the factors already stated, this statement would be incomplete if no reference was made to a number of other possible causes of rand weakness. These other factors, which we believe may have contributed to rand weakness, are based on discussions with the Bank's correspondent banks and interactions with foreign investors. Regional instability, particularly in Zimbabwe, could have played some role in the

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* The EMBI is a total-return index tracking mainly sovereign US dollar denominated bonds issued by emerging markets. The EMBI is an index calculated by JP Morgan and provides a benchmark for investors in this market.

weakening of the rand from May 2000 and also since June 2001. Much as it is known that South Africa cannot be compared to Zimbabwe, it seems to be a factor influencing residents' and non-residents' perceptions towards the currency. Other factors that are regularly mentioned in the market are perceptions about unemployment, HIV/AIDS, crime and the lack of progress with further privatisation, labour reform and investment incentives.

101 These factors certainly fall outside the control of the Bank, but they should be mentioned as possible factors contributing to negative perceptions regarding prospects for the country and thus towards the currency. Some South Africans are nervous because of these factors and use the available opportunities to diversify their assets. This is true for individuals as well as corporates. Foreigners also become wary of investing here and, needless to add, South Africa has to face fierce competition to attract foreign investment to its shores.

102 Market perceptions are a significant contributor to decision-making and consequently directly influence the judgement that would underpin specific trading behaviour in the foreign exchange market.

SPECULATIVE ACTIVITY

103 Introduction

Speculative activity is not only difficult to define but it is also extremely difficult to determine the effect of such transactions on the exchange rate. If it implies transactions entered into based on a view of the future value of a currency, then most foreign exchange transactions would have a speculative element in them. For example, a decision to hedge against currency risk by an importer may be based on an exchange rate forecast and the resulting forward purchase of US dollars would have an impact on the rand's exchange rate. If speculative activity is defined to include only transactions by certain parties which are not based on some fixed (firm) and ascertained commitment, then a narrower set of transactions would obviously be caught within this definition.

104 **Residents**

104.1 **Authorised dealers**

South African authorised dealers are allowed to trade the rand for their own account in the interbank market. Their activity adds liquidity to the market enabling customers to execute transactions easily. Whilst both resident and non-resident clients ran overbought positions in foreign currency against rand, the South African authorised dealers, who are on the other side of these positions, did not run huge positions against rand. The authorised dealers' aggregate open positions amounted to less than 1 per cent of their net qualifying capital in 2001. The statutory limit for these positions is 10 per cent of net qualifying capital.

104.2 **Importers and exporters**

104.2.1 Other residents are not allowed unfettered access to the foreign exchange market. Besides residents diversifying their assets abroad, they do have a further impact on the exchange rate in the manner they lead and lag their payments abroad and accruals from abroad. This does not refer only to cashflows in and out of South Africa but also to decisions regarding the hedging of future transactions. 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 amounting to almost the same. Even if a small portion of these sizeable amounts is involved in leads and lags, it is obvious that it could have a noticeable effect on the exchange rate. In a sense, importers and exporters are 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.

104.2.2 It is evident from information furnished to the Bank by the authorised dealers that there was a gradual increase in the foreign exchange balances of South African corporates at the authorised dealers (so-called customer foreign currency accounts which are referred to as "CFC" accounts) over time. At the end of 1998, for example, these balances amounted to USD 995 million and increased to USD 1 981 million at the end of December 2000. During the year 2001, these balances increased by a further USD 644 million to a balance of USD 2 625 million on 31 December 2001. This could be interpreted to mean that exporters were lagging the sales of foreign exchange proceeds. This in itself may not imply that exporters were not adhering to the 180 days dispensation in terms of exchange controls. It is noteworthy in any event that no significant changes occurred in the last six months of 2001. Details regarding the outstanding aggregate balances on CFC accounts for the year 2001 are included at page 338 in the Bundle.

104.3 **Non-residents**

104.3.1 Owing to the relatively free access that non-residents, particularly banks, enjoy in the USD/ZAR foreign exchange market, they are certainly in a position to speculate on the rand. The estimated overbought position in foreign exchange of non-resident banks with authorised dealers increased by about USD 2,0 billion from the end of June 2001 up until the end of August 2001.

(See <u>Graph 15</u> – Overbought (long) US dollar positions against rand of non-residents)

104.3.2 Some of this amount might represent speculation but it is impossible to determine how much, as there are various other reasons why non-resident banks might buy foreign exchange against the rand. They or their customers could choose to invest in South Africa on a hedged basis, which is acceptable. South Africa has the mixed blessing of having more liquid financial markets than many 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. That is, on the assumption that emerging markets' currencies will move in the same direction, the rand could be sold to provide a hedge to the currency risk in other emerging markets. This would, however, be in contravention of exchange control rules since there are no underlying South African commitments.

104.3.3 Some of these 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 own account. This is also contrary to the existing exchange control rules since there is no underlying commitment.

104.3.4 Foreign investors have very sizeable exposures to South Africa. Even though it is reported that most foreign investors in equities do not hedge the currency risk, it cannot be guaranteed that some of them do not. Thus, it is quite plausible that a portion of the USD2,0 billion, mentioned above, represents legitimate hedging by foreign investors who became concerned about the rand's weakness.

104.3.5 Against this background, however, it is still possible to underestimate the role of non-resident banks in the rand foreign exchange market. These banks trade rand very actively and they represent some 55 percent of the total turnover in the rand foreign exchange market. It is perhaps worth pointing out that, despite the fact that most of the activity of non-resident banks takes place in the swap market, they were net buyers of rand in the spot and forward market during 2001. It is possible, however, that aggressive trading by non-resident banks could scare South Africans into following their lead. This conclusion provided the rationale of the Bank's 14 October statement to ensure that only legitimate transactions take place.

EVENTS SURROUNDING THE 14 OCTOBER 2001 STATEMENT BY THE RESERVE BANK AND CULMINATING IN THE JOINT STATEMENT ISSUED ON 21 DECEMBER 2001

105 A copy of the statement of 14 October 2001 is enclosed at pages 339 to 341 of the Bundle. The concomitant exchange control circular D342 as well as a resulting letter sent by the Authorised Dealers to their correspondent banks are also to be found at pages 342 to 345 of the Bundle.

106 The issue of enforcing existing exchange controls had been extensively discussed in the Bank and with National Treasury over a long period of time. This issue was for instance discussed at a strategic planning session of the Governors from 1 to 3 March 2001 as shall appear from an extract of the minutes of that session inserted at page 346 of the Bundle. The Bank was aware of the various explanations for the rand's weakness in recent years. These would include exchange-control liberalisation and the Bank buying spot foreign exchange to reduce the NOFP. Over shorter periods, there is no doubt that the decisions by importers and exporters to lead or lag their foreign exchange payments and sales play a pivotal role in causing volatility. The impact of these more fundamental and legitimate factors influencing the exchange rate was and is certainly 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 Bank was informed that investors in other emerging markets, with less liquid financial markets, were using South African

markets as a proxy hedge for weakness in other countries. The Bank really had no choice but to either abolish the remaining exchange controls in total or to apply the existing rules and regulations equitably on all.

107 The Bank became increasingly concerned that excessive volatility in the foreign exchange market during the third quarter of 2001, exacerbated by the tragic events of 11 September 2001, negatively influenced inflation, business decisions and the economy as a whole and, therefore, issued a statement on 14 October 2001. It was stated that "the 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 requirements 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 market, provided they adhere to the existing rules and regulations." The Bank believed that applying the existing rules and regulations to exclude speculative trading from our foreign exchange markets would reduce volatility in the rand's exchange rate and would be to the benefit of non-resident investors and South Africans, alike.

108 Notwithstanding the explicit emphasis that "the South African authorities remain committed to the orderly and gradual process of relaxation of exchange controls", the statement appears to have been somewhat misinterpreted by some market participants. They seemed to have read into the statement that the stricter enforcement of existing exchange controls amounted to an effective tightening of such controls. It was subsequently noted that many market participants, both locally and

offshore, became sensitive regarding issues relating to exchange controls. The Bank had been in communication with the foreign exchange market in order to explain the rationale behind the statement of 14 October 2001. Whilst such consultations were under way, some offshore banks might have decided, as a precautionary measure to avoid finding themselves in contravention of exchange-control rules, to reduce their level of activity in South Africa's foreign exchange markets. This may well have contributed to a decline in liquidity, which is discussed below. It should be noted, however, that the causality could have been the other way; that is, sharp movements in the rand's value could have created uncertainty leading to a widening in bid-offer spreads and a reduction in liquidity.

109 In terms of figures reported to the Bank, net daily turnover in the rand foreign exchange market has declined from an average level of USD7,4 billion in October 2001 to USD5,5 billion in November but increased again to a level of USD6,1billion during December. (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 this market - declined from USD3,6 billion to USD2,3 billion respectively.) Despite these lower activity levels in the domestic foreign exchange market, it is perhaps too early to establish conclusively that turnover has declined on a sustainable basis, especially given that December turnover figures tend to be somewhat distorted in the South African foreign exchange market during the holiday period.

110 Whilst it is accepted that turnover alone is not a perfect measure of liquidity, it does represent a reasonable proxy. When assessed together with the widening of bid-offer spread from 50 points to, at times, 1 000 points, it does appear that liquidity in the foreign exchange market could have been affected. 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 per cent in the first nine months of 2001, to an average of 20,5 per cent for the last quarter. These volatilities reached a high of 55 per cent 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 plausible that the interpretation of the 14 October 2001 statement could have been a contributory factor.

111 As indicated earlier, it is similarly difficult to be definitive about the degree of speculative activity in the foreign exchange market. Whilst such activity cannot be excluded as an explanatory factor of the rand weakness, the rate of the depreciation of the currency may well have given rise to legitimate hedging transactions.

112 The Minister of Finance and I were concerned by the rate of depreciation and issued a joint statement on 21 December 2001. This statement focused on the solid macro-economic fundamentals and on the prudent policies being employed. The statement's concluding paragraph read as follows: *"In this uncertain environment, many experts and commentators have emerged, all with views and policy advice. While constructive input from stakeholders is always appreciated, it is important to point out that much of the volatility is driven by sentiment and opportunism. It is in times such as these that we should respond as a country, with full confidence in ourselves and the policies we have adopted."*