
**COMMISSION OF INQUIRY INTO THE RAPID DEPRECIATION OF THE
EXCHANGE RATE OF THE RAND AND RELATED MATTERS**

**EXPLANATION BY
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FORWARD POSITION (NOFP)**

This testimony deals specifically with the Commission's request that the South African Reserve Bank (the Bank) should explain the NOFP in more detail. It will touch upon some of the history regarding the forward book and NOFP, the risks emanating from the forward book and NOFP and the reduction of those risks.

Graph 1 highlights the nominal exchange rate of the rand over a long period of time. It emphasises periods of volatility in the exchange rate. It is clear that currency volatility at the time of the rescheduling of South Africa's foreign commitments in 1985 was extreme, and actually exceeded volatility of both the periods of currency depreciation in 1998 and in 2001.

The build-up of the forward book took place after the announcement of the foreign debt standstill in September 1985, at which time the country's foreign debt was close to the level where it was at the end of 2001, amounting to some USD24 billion. At the time the Bank had an NOFP of some USD12 billion, implying that the economy probably had an outstanding uncovered foreign exchange position totalling some USD10 billion (approximately USD2 billion represented debt of the government which is not covered forward). It is important to note that this was not a commitment of one institution, but many South Africans had foreign commitments at the time. It emerged after the debt standstill that there were government agencies and large corporations that had large foreign exchange exposures. The type of crisis that was experienced in 1997 and 1998 in Asia was in fact experienced by South Africa, albeit for different reasons, back in the mid-eighties at the time of the debt standstill. It was in the ensuing years that the Bank provided an additional amount of some USD10 billion's worth of forward cover to the market and by September 1988, the outstanding forward book stood at USD25 billion.

The increase of USD10 billion should be considered relative to the size of the economy at that stage. The dual exchange rate mechanism was also re-introduced in 1985. This implied that non-residents wishing to sell or

purchase an asset in South Africa, had to do so with other non-residents. They were not permitted to deal with South Africans in terms of the dual exchange rate mechanism. Financial flows of non-residents were not recorded in the financial account (or capital account at the time) of the balance of payments, but went through a separate market. Commercial transactions went through the commercial rand, and affected the current account of the balance of payments only.

The country had no access to the international capital markets at the time, including no access to borrowing from the IMF or other official agencies. With the Government unable to borrow foreign currency, the country could only use one mechanism to raise foreign capital: providing forward cover to the private sector to ensure their use of trade credits. In macro economic terms Savings minus Investments must equal Exports minus Imports, which was not so in South Africa's case for a number of years after the debt standstill. These deficits were funded by private sector and government corporations accessing trade credit abroad. In addition, certain private sector and government corporations were able to raise trade credit for longer terms, e.g. for purchases of items such as power generators or aircraft, but the Bank had to provide forward cover for those foreign currency exposures as well.

The large forward book and the NOFP thus became a surrogate for what would have been IMF or other international capital market borrowing. Without the above mentioned limitations, the exchange rate risks that the Government was carrying through the forward book might have been carried in a different format, which would have been better understood by the markets.

Graph 3 explains by means of a numerical example how transactions by the Bank influence the net reserves, the forward book and the NOFP. In the example the net reserves at the start date equal USD5 billion, while the forward book is minus USD8 billion. There is an overall short position or NOFP of USD3 billion. Departing from this initial position, USD1 billion is delivered to the market under forward contracts. Such delivery would reduce the net reserves by USD1 billion to USD4 billion. The forward book would

reduce to USD7 billion, but, most importantly, the NOFP does not change. The only way in which the NOFP can decline, is by buying foreign currency either from the markets or from the Government.

A purchase from the spot market amounting to USD2 billion implies that the net reserves would increase to USD6 billion, while the forward book would have remained unchanged at USD7 billion. This would have accordingly reduced the NOFP to USD1 billion. Delivery of those dollars under the forward book at a later stage would have reduced the net reserves once again by USD2 billion to USD4 billion. However, the forward book would have reduced to USD5 billion, implying an unchanged NOFP at USD1 billion.

Graph 4 highlights the foreign exchange balances of the Bank at different points in time. It is instructive to note that in December 1988 and September 1998 almost the same amounts were outstanding on the forward book and the NOFP. In the interim period, however, the market reacted to many influences and even to rumours, e.g. about the health of Mr Mandela during the period that he served as President of the country. Over the period of some 10 years there was a large risk exposure for Government, carried on behalf of the market, and significant changes in the outstanding balance of the forward book and NOFP.

In 1995 the dual exchange rate mechanism was abolished, implying that purchases and sales by non-residents of any assets in South Africa have since then been channelled through the unitary exchange rate. Foreign exchange flows emanating from such transactions therefore became available to be purchased by the Bank, influencing the NOFP. A large inflow from the purchase of bonds or shares by non-residents would make a difference to the net reserves, implying that the Bank could start reducing its forward book and NOFP. After the abolition of the dual exchange rate in March 1995, there was significant euphoria and the Bank was able to make a significant reduction to the NOFP in a matter of 12 months. By March 1995 the NOFP was USD25,8 billion and by March 1996 it had been reduced to USD8,5 billion.

Graph 5 shows the reduction in risk between March 1995 and March 1996. What actually happened was the risk position that Government had been carrying with the NOFP at USD25 billion, was reduced mainly by purchasing foreign exchange from the market. The proceeds of Government bond issues abroad were purchased, and the balance was purchased from the market. The result was that the market carried significantly more risk in March 1996 than it was carrying in March 1995. This significant transfer of risk to the market almost inevitably influenced the exchange rate of the rand and it depreciated sharply in 1996, owing partly to speculative activity.

In an effort to counter such speculative activity, the Bank in 1996 increased the forward book to USD22 billion, in other words it sold about USD14 billion into the market. In taking such action, it stopped the depreciation of the rand, although the rand declined from R3,50 = USD1, to R4,80 = USD1, before appreciating to about R4,50 = USD1, after the Bank finished this intervention. That means that a large amount of risk, amounting to some USD14 billion, had been taken on again by the Bank on behalf of the Government. However, this only contained the depreciation from R3,50 = USD1 to R4,50 = USD1.

Then in 1997, after this episode, the Bank was again successful in reducing the NOFP by almost USD10 billion. That came from portfolio inflows, the purchase of shares and bonds by non-residents. However, in 1998 the emerging markets crisis occurred, and South Africa appeared to be used as a surrogate hedge for investors and speculators who had exposures to other emerging market countries with less liquid financial markets. Although little factual information is available, the impression was that South Africa had been used as a surrogate hedge by market participants. They sold the rand in order to try and recover some of the money lost in other emerging markets.

Again the Bank reacted, this time in two ways. Firstly, it sold slightly more than what it had bought, to the tune of about an extra USD1 billion. Secondly, interest rates were hiked by 7% in real terms. However, these actions only resulted in containing the depreciation from a level of around R5,00 = USD1, to a peak of some R6,84 = USD1, before it returned to level of around R5,80 =

USD1. This implied returning the NOFP to exactly the situation ten years before, almost to the last billion dollars.

Subsequent to this episode, there was a shift in the Bank's policy. A decision was taken to reduce the NOFP to zero. The IMF was highly critical of the country for having intervened by means of the forward book, and the advice was to reduce the NOFP. This advice was followed and the NOFP was reduced by around USD9 billion in 1999, from USD22 billion in December 1998 to USD13 billion in December 1999. During that year the exchange rate actually appreciated by 0,6 per cent on a trade-weighted basis. With no change in the exchange rate, the market accepted the risk back from the Bank.

However, despite regional instability, the Bank continued reducing the NOFP, from USD13 billion in December 1999 to USD9,5 billion at the end of 2000. That was a small reduction compared to the year before, but because of regional events the markets were unwilling to accept more risk at a reasonable price. The rand depreciated on a trade weighted basis by 12,4% during the year 2000.

Then came the year 2001, which is the subject of this inquiry. In the first quarter of the year there was hardly any reduction in the NOFP. The reduction came towards the end of the first half of the year (in the second quarter), mainly from the proceeds of the Anglo American Corporation/De Beers Mining Company restructuring.

Viewing the risks that were being transferred from the market to the Bank, the Government and the taxpayer and back to the market and comparing them with the real flows in our economy, the real flows in the economy pale into insignificance. South Africa's financial account had a surplus of R9 billion in 2000, while it had a current account deficit of around R3,7 billion. Capital inflows amounted to R7 billion in 2001, while the country had a current account deficit of round R1,7 billion. This implies that a net amount of around R6 billion flowed into South Africa in both those years. The Anglo American

Corporation/De Beers Mining Company restructuring transaction amounted to approximately R24 billion and this amount represents approximately 10% of the forward book exposure at its peak of USD28 billion in March 1995.

It is important to consider the size of the NOFP vis-à-vis the underlying economic transactions. If the Bank had not taken on the USD10 billion worth of risk in 1985, there would have been an enormous depreciation of the rand at the time. This is confirmed by the depreciation in the currency right at the end of this period with the reduction in the NOFP. A position of USD10 billion in those days was equal to about one third of the trade of the country, while USD10 billion today is equal to only about one sixth of the trade of the country.

Graph 6 has been compiled from BIS and IMF figures. It demonstrates that the risks carried in the NOFP were not unlike the risks of many other countries. Looking at the forward book of the Bank in isolation is an incorrect approach, as it is necessary to consider the external currency risks of governments, in other words their off-shore borrowing, the position of the central bank and any derivative transactions. In South Africa's case there are no derivative transactions, so government borrowing plus the NOFP equals the foreign exchange risk. There are many countries where foreign currency liabilities for account of their governments exceed the level of their reserves.

Considering the reserves as published, and not only the net reserves, it is clear in Australia's case that their external debt as of June 2000 (the last published figures) was some USD27,6 billion. Their international reserves were USD16,7 billion, implying that their liabilities exceeded their assets. Expressed as a percentage of their gross domestic product, it was equal to 2,8% of GDP. At the same date South Africa had external debt of close on USD8 billion and international reserves of USD7,4 billion on a gross basis. Including the NOFP, which at that point in time was much higher than today at around USD10 billion, it came to 8,5% expressed as a percentage of South Africa's GDP. However, many other countries had similar exposures. Canada's exposure was 16,9% of their GDP, Spain was at 5,2%, Italy at

18,3% and Portugal at 7,8%. Belgium at 17,8%, Greece at 27,8%, Egypt at 17,4%, Tunisia at 46%, and so on.

Relatively speaking South Africa was not out of line, but a skewed picture emerges when the Bank's balance sheet is considered in isolation. As the markets considered the Bank's balance sheet only, the Bank did not use the instrument of intervention again in 2001.

In using intervention, your bark has to be as good as your bite. If foreign currency is being sold and it does not achieve immediately the intended objectives, the policy must be continued. The markets have to believe the policy if the central bank gets involved in selling foreign currency either from reserves or through the forward book in an effort to influence the exchange rate. In South Africa's case the market knew unequivocally that the IMF had highlighted the NOFP as a vulnerability on numerous occasions and expressed the opinion that the position be bought back. Moreover, the stated policy was to close out the NOFP as and when circumstances permitted. So the simple answer was whatever the Bank sold, would have to be bought back. Therefore, intervention in this context would have been a completely blunt instrument. This is why the Bank did not choose intervention as a policy option during 2001.

Graph 7 again highlights Australia's position. In viewing the exchange rate of the rand against the dollar and on a trade-weighted basis, it is important to form an idea of the management of foreign currency risks by the governments of other countries over the same period of time. In April 1998, the Reserve Bank of Australia held AUD21,5 billion in reserves against an outstanding forward book of just over AUD2 billion and therefore, a net position of some AUD19,3 billion. Post-April 1998 the Australian dollar also depreciated considerably. The Reserve Bank of Australia moved the forward book up from AUD2 billion to AUD29 billion, bringing their net position from some AUD19 billion to close to AUD6,7 billion. This means that they intervened with about AUD12,4 billion over this period. They intervened to take risk out

of the market, in other words, their government appears to have taken additional foreign exchange risk after April 1998.

South Africa followed an exact opposite approach in this period. South Africa transferred to the markets around USD15,8 billion worth of risk. The government in Australia appears to have taken on additional risks, while South Africa proceeded in a completely opposite direction. This is actually a huge success story for South Africa. Had the NOFP been increased, rather than decreased, recent losses on the forward book would have been absolutely horrendous today. Perhaps the most important fact is that the foreign exchange liabilities of the government have been significantly reduced over the last two and a half years. To compare the path of the dollar/rand exchange rate to that of other countries, a full analysis would have to be made of whether or not government foreign exchange liabilities had increased or decreased in the countries concerned during the period in question.

Considering Graph 1 again, it is clear that sharp exchange rate fluctuations have occurred during the past 20 years. One such period was 1985, but, strictly speaking, it cannot be compared to 2001 owing to the dual currency system at the time.

Moreover, in terms of total market size and global exposure, the two periods cannot be compared, as the country was completely isolated from global events because non-residents could not deal in the rand market after September 1985. If they wanted to buy or sell a rand, they had to do that amongst one another by means of the financial rand exchange rate, which usually traded at a discount of around 30% to the commercial rand exchange rate. The conditions were therefore completely different and non-residents could not use the rand as a proxy hedge for emerging market risk at all. South Africa was not exposed to globalisation in any way. The country was isolated globally and external forces on the rand would have been fairly limited. It should be noted, though, that there was a period from February 1983 to September 1985 when the dual exchange rate had been abolished. During this period the rand's exchange rate experienced increased volatility,

which contributed to the decision in 1985 to reintroduce a dual exchange rate system.

H/ADVISOR/Misc/Historic perspective on the NOFP of the SARB by JH Cross