2002-05-07: Statement by Lambertus Van Zyl of the South African Reserve Bank on the consequence of the decision to apply exchange controls on South African authorised dealers in respect of transactions with non-residents

1. The statements by the Governor of the South African Reserve Bank, Mr T T Mboweni and the General Manager of the Exchange Control Department of the Bank, Mr A M Bruce-Brand have dealt extensively with the decision by the Reserve Bank to enforce existing exchange controls on South African Authorised Dealers in respect of transactions with non-residents. The reasons for and objectives of the 14 October 2001 statement by the Reserve Bank were explained by Mr Mboweni, while Mr Bruce-Brand explained the Exchange Control implications.

2. A number of other witnesses to the Commission have mentioned the 14 October 2001 statement as a factor contributing to lower turnover in the domestic Rand foreign exchange market as well as the sharp decline in the Rand's exchange rate in the closing stages of 2001. While Mr Mboweni in his statement before the Commission, acknowledged that the 14 October 2001 statement could have contributed to a decline in liquidity or turnover in the domestic Rand foreign exchange market, the purported causality between turnover and the value of the Rand is not clear to the Reserve Bank at all. We would strongly suggest to the Commission that any suggested causality is an oversimplification and that it should not be accepted by this Commission.

3. It is instructive to look at different periods of Rand weakness in an effort to determine what causality, if any, may exist between either an increase or decrease in turnover in the domestic Rand foreign exchange market and the exchange rate of the Rand (see Graph 1). For purposes of the following examples, I have used the total turnover in the domestic Rand foreign exchange market. Strictly speaking it would be more correct to focus on turnover in the spot plus outright forward market as foreign exchange swaps do not directly affect the spot exchange rate (see Graph 5). This more correct methodology, however, would not, in my opinion, materially affect my conclusion, because the different components of turnover tend to move in the same direction and by roughly the same magnitude (see Graph 1). In 1996 the Rand depreciated from an average of USD1 = ZAR3.6410 in January to USD1 = ZAR4.2057, in April. This was a depreciation of 15,5% (see Graph 3). Over the same period the average daily turnover in the domestic Rand foreign exchange market increased by almost 42% from USD3,019 billion to USD4,284 billion (see Graph 4). Total turnover by non-residents increased by some 79% from USD0,683 billion to USD1,223 billion. It

would appear as if a sharp depreciation of the Rand at the time coincided with an increase in turnover and particularly, an increase in turnover by non-residents.

4. In 1998 the Rand again depreciated sharply (see Graph 1). Having traded at a monthly average of USD1 = ZAR4.9357 in February, the Rand fell by 26,4% to an average of USD1 = ZAR6.2386 in July (see Graph 3). Over the same period total average daily turnover increased by some 139% from USD3,093 billion in February to USD7,395 billion in July (see Graph 4). Once again turnover with non-residents increased, this time by 213% from USD1,323 billion in February to USD4,138 billion in July. Over different periods the increase in turnover was even more pronounced as it peaked at a level in excess of USD11 billion in June 1998.

5. While one could easily use different months and arrive at different average turnovers and exchange rates, one cannot deny that in these previous periods of Rand weakness sharp depreciations of the Rand coincided with considerable increases in turnover in the domestic Rand foreign exchange market, and in particular with non-residents.

6. I am certainly not arguing that increases in turnover inevitably lead to a much weaker Rand, as indeed one cannot argue that decreases in turnover would inevitably lead to a weaker Rand (see Graph 3). Turnover in the domestic Rand foreign exchange market increased significantly early in 1999 without a sizable depreciation of the Rand. In January 1999 average daily turnover was USD6,855 billion. By June 1999 the average daily turnover had increased by almost 33% to USD9,089 billion (see Graph 1). Over the same period the average daily exchange rate depreciated by a relatively small percentage of 1,7% from USD1 = ZAR5.9835 in January to USD1 = ZAR6.0883 in June.

7. Over shorter periods the link between turnover and the exchange rate is also uncertain (see Graph 2). For instance, the Rand averaged USD1 = ZAR11.5467 in December 2001, fluctuating significantly and briefly depreciating to USD1 = ZAR13.84, on an average daily turnover of USD6,051 billion. In February 2002 average daily turnover had declined by 19,4% to USD4,876 billion, but the Rand was far more stable, trading at an average exchange rate of USD1 = ZAR11.4847.

8. In summary, it would appear as if there is no consistent link between changes in turnover in the domestic Rand foreign exchange market and the level of the exchange rate of the Rand to the US Dollar.

9. Perhaps there is a different perspective which merits consideration. Had the Reserve Bank not acted in October 2001 to limit dealing without a firm and ascertainable commitment or accrual, in the domestic Rand foreign exchange market, might the outcome in November and December 2001 not have been much worse? I do not think that non-residents would have bought the Rand when the currency fell on a surplus demand for foreign exchange. In 1996 and 1998 non-residents were perceived to lead the charge when the Rand depreciated by selling the currency short to the detriment of the exchange rate. Why would non-residents have gone against the trend in 2001? It seems much more likely that, had their activities not been curtailed, they would also have sold the Rand, when they perceived the currency to be weak, leading to much more volatility, and possibly a greater depreciation.

10. It should be borne in mind that by 14 October 2001 the Rand had already started depreciating rapidly (see Graph 2). I am of the opinion that it is highly likely that had the authorities not decided to apply existing exchange controls the Rand would in any case have succumbed to the surplus demand for foreign exchange. As indicated earlier, non-residents would quite possibly have felt free to join the trend by selling the Rand short for trading purposes. The outcome for the exchange rate may well have been far worse and the question then would have been why the Reserve Bank and National Treasury had done nothing.

11. As the decision of 14 October 2001 impacted on the activities of non-residents in particular, it is instructive to consider not only the activities of non-residents in the domestic Rand foreign exchange market but also their transactions in South African equities and bonds. The objective is to determine whether the decision of 14 October 2001 not only influenced the turnover in the domestic Rand foreign exchange market, but also portfolio investments by non-residents (see Table 1).

12. In calendar year 2001, non-residents purchased South African bonds and equities to the amount of ZAR4,203 billion. These flows, however, and in particular purchases and sales of bonds, were quite volatile throughout the year. Notwithstanding

this volatility, from the beginning of January 2001 to the end of August 2001, net purchases of equities and bonds by non-residents amounted to ZAR11,914 billion. In the remaining four months of the year this turned to net sales of ZAR7,710 billion. The big change occurred in September 2001 with net sales of South African equities and bonds by non-residents of ZAR5,510 billion. Thus non-resident portfolio investments in South Africa turned noticeably negative a month before the statement of 14 October 2001 and could hardly have been caused by it. These net sales occurred from the very first business day of September 2001 and can also not necessarily be linked to the tragic events of 11 September 2001 or the decision by the Reserve Bank to decrease the repo rate by 50 basis points in September 2001.

13. It is interesting to note that since the beginning of 2002 non-resident portfolio investments into South African equities and bonds have again turned positive after the sell-off experienced in the last four months of 2001. From the beginning of January 2002 to the end of April 2002 non-residents have purchased South African equities and bonds to the amount of ZAR8,712 billion. This inflow has no doubt contributed to the Rand's recent stronger performance, notwithstanding the fact that turnover in the domestic Rand foreign exchange market in March 2002 was still lower than in the months prior to October 2001.

14. In concluding, I believe it is appropriate to refer back to the statement made by the Governor of the South African Reserve Bank to this Commission, which statement is contained in SARB Volume 7. In particular I wish to refer to that portion of the statement concerning the events surrounding and leading up to the statement of 14 October 2001, in which the Governor explained that the contents of that statement had been extensively discussed prior to its issue. That statement was carefully conceived and I do not believe that it contributed to the rapid depreciation of the exchange rate of the Rand.

Thank you very much