



South African Reserve Bank
monetary policy in the
decade 1989 to 1999



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Preface

This book is the third in a series covering broad monetary and other policies under the stewardship of South African Reserve Bank (the Bank) governors. This series started in April 1995 with the publication of two books, covering the periods of governorship of Dr T W (Bob) de Jongh (1967 to 1980) and Dr G P C (Gerhard) de Kock (1981 to 1989).

This third book in the series covers monetary and other policies during the period that Dr C L (Chris) Stals served as Governor of the Bank. Dr Stals assumed duty as Governor on 8 August 1989 and served two consecutive terms of five years in this capacity, that is, until 7 August 1999. This period was characterised by a number of important developments in South Africa; the most important of which was the negotiation of a peaceful political transformation culminating in democratic national elections on 27 April 1994.

A number of important changes in economic policy, and in the focus of monetary and other policies occurred during this period. A singular aim for monetary policy, namely low inflation, was adopted, and this was supported by the formulation and announcement, for the first time, of a mission statement for the Bank, namely “the protection of the internal and external value of the rand”. Through the adoption of a mission aimed singularly at low inflation, any misunderstanding of the role of the Bank in the economy was removed and the Bank steadfastly maintained its aim of reducing inflation to levels comparable with those in South Africa’s major trading partner countries during the period that Dr Stals served as Governor.

The focus of this book is, therefore, on providing an extensive explanation of monetary policy measures and changes during the 1990s aimed at achieving the Bank’s mission. The emphasis is on policy issues facing the Bank during the 1990s and, consequently, the book is not orientated towards explaining all of the manifold functions and activities of the Bank. It is trusted that such an analysis will not only benefit the Bank’s staff, but also students, academics, and banks in South Africa and the rest of the world.

It is appropriate to thank a number of people who assisted in the compilation of this book. Mr T T Mboweni, Governor of the Bank since 8 August 1999, deserves thanks for his initiative to continue with the series of books on monetary policy under the previous governors of the Bank. Discussions with Dr Stals on various aspects were also extremely helpful. His knowledge of, and insights into, the Bank’s policies in the 1990s were highly beneficial, while access to his personal records and articles proved to be invaluable. Dr Stals read the entire manuscript which was most beneficial to the author. The author also benefited from discussions with Drs Ernie van der Merwe,

Chris de Swardt, and Jaap Meijer, and Messrs James Cross and Bertus van Zyl.

It should also be noted that the publication of the book would not have been possible without the financial assistance of the Bank. In addition, the author should like to express his appreciation to his secretary, Ms Marié Smith, for painstakingly typing up all the scripts relating to this book.

About the Author

Dr Roger Malcolm Gidlow was born in the town of Chesterfield in England in April 1943, and obtained both Honours and Master's degrees in Economics as well as a Diploma in Education from the University of Sheffield between 1961 and 1966. He subsequently worked at the Manchester College of Commerce as a lecturer before emigrating to the Republic of South Africa in April 1969. In South Africa he first worked at the University of Cape Town before joining the Old Mutual as an investment economist. He then joined the University of the Witwatersrand in 1975 where he became an associate professor in Business Economics, obtaining his Ph D degree in Economics at that institution in 1979. He joined the service of the Bank in May 1985 as Adviser to the Governor and later, in 1994, he became Principal of the South African Reserve Bank College.

He has written more than a 100 academic articles (approximately 40 of which refereed), and hundreds of newspaper and trade articles, mainly covering banking, mining and commodities, gold and foreign exchange, and monetary and exchange rate policies. These publications, both locally and overseas, have extended over a period of approximately 40 years. Moreover, since working at the Bank, he has written three books covering the Bank's monetary and other policies between 1967 and 1999.

Brief Biography of Christian Lodewyk (Chris) Stals



Christian Lodewyk (Chris) Stals was born in Germiston on 13 March 1935. He grew up on a farm in the Ermelo district and received the first eight years of his primary education at three different schools in Ermelo. He matriculated from the Germistonse Afrikaanse Hoërskool in 1953.

Through extramural studies at the University of Pretoria, he obtained B Com (1956), M Com (1959) and D Com (1968) degrees.

After a short career outside the South African Reserve Bank (the Bank), Dr Stals was appointed on 1 May 1955 as a clerk in the Exchange

Control Department of the Bank. This was followed by a transfer to the Bank's Department of Economic Research and Statistics, where he worked until 1 July 1967, when he was appointed Assistant to Dr T W de Jongh, Governor of the Bank.

Dr Stals was appointed as General Manager of the Bank on 1 February 1975 and as a deputy governor and a member of the Bank's Board of Directors (the Board) from 1 April 1976. This was followed by a promotion to Senior Deputy Governor on 1 January 1981, a capacity in which he served until 31 August 1985.

On 1 September 1985 Dr Stals was seconded to the Department of Finance as its Director-General and on 1 May 1989 he was appointed as Special Economic Adviser to the Minister of Finance.

Dr Stals became Governor of the Bank on 8 August 1989 for a five-year period, which ended on 7 August 1994. In 1994 he was reappointed for a second term of five years as Governor until 7 August 1999. His period as Governor spanned a historic change in the South African political environment. During the first five years of his tenure he had to guide the Bank on a course of monetary stability in an environment of economic sanctions, trade boycotts and disinvestment campaigns applied against South Africa. During his second five-year term, he had to ensure that South Africa made a smooth return to the global economic environment.

Shortly after assuming duties as Governor, Dr Stals had to deliver his first Governor's Address at the annual general meeting of shareholders of the Bank on 29 August 1989. This address stated, among other things, that "through a disciplined monetary and fiscal policy approach . . . it will be possible to reduce the rate of inflation in South Africa over the next few years. The Reserve Bank commits itself to supporting the government in a concerted effort to achieve this outcome." Focusing monetary policy on containing inflation was an important feature of the entire period of ten years in which he was Governor.

The focus on lowering inflation was supported by the introduction of a clear mission for the Bank to protect the value of the rand. However, this policy approach gave rise to heated periodic public debates about whether a different monetary policy focus was necessary, as the attempts at lowering inflation at times resulted in high real and nominal interest rates. Many commentators disagreed with this policy approach. The steadfast implementation of this policy bore fruit: inflation was at 15,5 per cent in August 1989 when Dr Stals took office and was at a rate of only 3,2 per cent when he retired in August 1999.

An outstanding feature of Dr Stals's tenure as Governor of the Bank was the time he devoted to improving the general public's level of understanding of economic issues and, in particular, the implementation of monetary policy. This was evidenced by the numerous audiences comprising people from all walks of life that he addressed during his period of service.

Over and above the positions at the Bank and at the Department of Finance, Dr Stals played a role in numerous other bodies and rendered service to the general community. This included serving on the Board of Governors of the International Bank for Reconstruction and Development, the International Finance Corporation and the Development Bank of Southern Africa, at the International Monetary Fund (IMF) and as Chancellor of his alma mater, the University of Pretoria.

After retirement Dr Stals was appointed to the Board of the Standard Bank Investment Corporation, while devoting time to hobbies such as golf. He also continued his efforts to improve the general public's level of economic literacy and understanding of South African economic policies through public addresses. In May 2003 he was appointed by the African Union as one of seven members of a Panel of Eminent Persons to oversee the African Peer Review Mechanism. He served as Chancellor of the University of Pretoria from 1992 to 2005.

Part 1

Domestic Monetary Policies

The motives behind the South African Reserve Bank's (the Bank) pursuit of monetary stability are explained in Chapter 1 and an assessment is made of the success achieved in this regard. Dr Chris Stals, the Governor, regarded a stable monetary environment as a crucial factor in creating conditions for sustainable economic growth in the long run. Chapter 2 is an explanation of the monetary policies the Bank employed for purposes of achieving greater price stability and in particular the role of money supply targeting is covered. Chapter 3 incorporates a review of the main instruments of monetary policy the Bank utilised in the 1990s in an effort to attain the money supply targets that were adhered to. Chapter 4 pays particular attention to the role of cash reserves as an instrument of monetary policy.

Throughout the Stals era the drive to bring about a materially lower inflation rate was complicated by the weakness of the South African rand against the major currencies in the foreign exchange markets. During Dr Stals's first term of five years as Governor, the South African political situation was characterised by foreign reactions in the form of economic boycotts, sanctions and disinvestment campaigns, which made the task of monetary policy-makers extremely difficult. The task of bringing South Africa back into the fold of a rapidly changing global environment presented a daunting challenge during his second term as Governor.

During the 1990s the external value of the rand experienced a secular downward trend and indeed this had been the case ever since the middle of 1984. In Chapters 5 and 6 the rand crises of 1996 and 1998 are dissected, and the Bank's monetary policy responses are explained.

Chapter 1

The South African Reserve Bank's pursuit of price stability in the 1990s

1.1 Overview

In the 1990s many central banks around the world strived to create monetary stability in their economies, and more particularly a suitably low rate of inflation, and the Bank was no exception in this regard. Over a long period the mandates of central banks had changed, but by the 1990s the obligations of many central banks had become crystallised in their aim to achieve monetary stability. In the case of the Bank, its mission statement spelt out that its primary goal was to protect the domestic and external value of the rand.

1.2 Modern mandates of central banks: To achieve stability in the general level of prices

The earliest central banks were established to provide finance for governments and to help develop banking systems, mainly by means of bringing order to the issue of banknotes. Thereafter, as the practice of central banking developed during the nineteenth century, central banks took on the primary responsibility for protecting the stability of the banking system through its role as a lender of last resort.

Later the mandate given to central banks in legislation passed during the 1930s and 1940s – the era of the Great Depression and the rise of Keynesian economics – typically included both monetary stability, and the promotion of full employment and maximum levels of production. However, in later years, as inflationary pressures gathered steam in the 1960s and early 1970s, the focus of monetary policies pursued by central banks shifted to the maintenance of the domestic value of the currency.

By the 1980s many central banks had been given mandates stressing the objective of safeguarding their countries' currencies. This should not be interpreted as meaning that monetary stability, in complete isolation from the overall economic conditions, had become the sole yardstick for monetary policy-makers. Nevertheless, it did mean that the task of safeguarding monetary stability had come to be regarded by many central banks as their primary function, with 'monetary or price stability' defined as a rate of inflation sufficiently low and sufficiently stable that it did not affect economic decisions. This increasing tendency to emphasise monetary stability was illustrated by developments in South Africa in 1989 and thereafter.

1.2.1 South African position

Immediately on taking office in August 1989, Dr Stals stressed the need for economic discipline in the country. In his Chairman's Address at the annual general meeting of the shareholders of the Bank on 28 August 1989, he asserted that the time had arrived for South Africa to place a high priority on fighting inflation, the seasonally adjusted annualised rate of inflation as measured by the consumer price index (CPI), amounting to 14,3 per cent in the third quarter of 1989. He reiterated this message at a meeting held in Durban in December 1989.¹

He pointed out at that stage that curbing inflation was an obligation faced by the Bank stemming from the South African Reserve Bank Act, 1989 (Act No. 90) (Reserve Bank Act), which stated that "(i)n the exercise of its powers and the performance of its duties the Bank shall pursue as its primary objectives monetary stability and balanced economic growth in the Republic, and in order to achieve those objectives, the Bank shall influence the total monetary demand in the economy through the exercise of control over the money supply and over the availability of credit".

On this basis the Bank had an obligation to the people of South Africa to pursue monetary stability and balanced economic growth. Dr Stals argued that those people who opposed such policies were expecting the Bank to ignore the mandate conferred on it by the Reserve Bank Act. It was therefore the case that at various times, starting in October 1989 with the rise in Bank rate to 13 per cent from 12 per cent and stretching through the 1990s, monetary policies were tightened in circumstances where the Bank perceived that monetary stability was endangered by rising inflation, and sustainable balanced economic growth was disturbed by excessive increases in domestic expenditure financed by large increases in the money supply. The moves to curb inflation in 1989, moreover, came at a time when the domestic economy had already moved into a downward phase of the business cycle starting in the first quarter of 1989.

In the South African context, however, monetary stability did not only refer to the internal purchasing power of money as measured by the rate of inflation, but also to the external value of the currency reflected in the exchange rate. In view of the importance to the economy of importing goods and services, it was almost a precondition that in the fight against inflation it was crucial to stabilise the exchange rate of the rand as far as possible. Against this background there was an undisputable close relationship between changes in the external, and the internal value of the currency. The Bank therefore had responsibility to protect the exchange rate of the rand, and Dr Stals believed that financial discipline and control over the money supply and over the availability of credit were also essential preconditions for the protection of the exchange rate of the rand.²

Dr Stals argued that a suitably low rate of inflation would be one where the rate did not have any material influence on the microeconomic decisions

of businesses and households. However, this did not indicate how low the rate of inflation should be. Nevertheless, a basic guideline applied to South Africa was to assume that a rate of inflation that was visibly out of line with the average rates of inflation in other countries could not be reconciled with the objective of price stability, particularly not in a country that had extensive trade relations with the outside world. Dr Stals therefore argued that the first target for the rate of inflation should be to bring it more in line with the average rate of inflation in the country's major trading partners.³

The Bank also believed that monetary policy alone could not eradicate inflation. Depending on the causes of inflation and the nature of the inflationary process in the economy, a wide array of measures had to be used to contain this problem. At a minimum, fiscal policy should be co-ordinated closely with monetary policy, while some stability in the balance of payments was needed. In addition, responsible wage and salary adjustments were necessary.⁴

For purposes of meeting the mission statement of the Bank, Dr Stals also argued that it would only be possible to apply financial discipline in the economy effectively if an arm's-length relationship remained between government and the central bank.⁵ In particular, in this regard there needed to be strict limitations on the extent to which the budget deficits were, in effect, financed by the Bank.

The Bank also believed that its declared mission of protecting both the domestic and the external values of the rand were complementary. If it could succeed in reducing the inflation rate so that it was more in line with the rates of inflation prevailing in South Africa's main trading partners, this would go a long way towards achieving a more stable external value of the rand.⁶ The Bank, moreover, believed that keeping inflation low became even more important after April 1994 as the South African economy became reintegrated into the world economy, since foreign investors placed a high priority on financial stability in a country.

For some time, particularly during the middle 1980s, the Bank was forced temporarily by internal and external economic and political pressures to shirk its obligations regarding the protection of the value of the currency. It was at that time a matter of surviving a liquidity crisis caused by political actions and reactions inside and outside the country. In effect, during the 1980s a decline in the dollar price of gold, a serious drought and then capital sanctions forced the authorities to continue using monetary policy as a demand-stimulating device. However, by the end of the 1980s Dr Stals took the view that the Bank should become committed, once again, to restoring monetary stability and balanced economic growth. At the same time, however, monetary policies needed to be shaped by the need to ensure that surpluses on the current account of the balance of payments were recorded in order to finance net capital outflows brought about mainly by external financial sanctions.⁷

The start of Dr Stals's governorship of the Bank took place against the background of a marked decline in the growth rate of the South African economy. From early in 1989 the business cycle remained in a downward phase until April 1993, partly due to the lingering effects of sanctions, poor commodity prices, political uncertainties that discouraged investment and the disappointing performance of the world economy. It represented the longest downward phase of the business cycle since the end of World War II in 1945. In 1992 a serious drought also hit the summer rainfall regions of the country. Given these circumstances, together with the onset of a gradual fall in the rate of inflation, the Bank reduced Bank rate from 18 per cent in March 1991 to 14 per cent in November 1992 and to 12 per cent at the end of 1993. Even so, it was reluctant to try and restimulate the economy actively for fear that this could dissipate the progress achieved in reducing the rate of inflation.⁸

This progress was achieved against a background in which monetary policies gradually succeeded in creating a more favourable money supply environment. In 1988 the broadly defined money supply (M3) rose by approximately 30 per cent, whereas by 1992 and 1993 this measure of the money supply had declined to below 10 per cent, although by 1994 it had increased again to around 14 per cent.

In the 1990s certain pressure groups held the view that the Bank's alleged obsession with fighting inflation was the sole factor responsible for the prevalence of high interest rates. This was a false perception. Indeed, at times the Bank added heavily to the supply of funds by, for instance, facilitating an increase in the total M3 money supply of no less than R50 billion from the end of 1993 to the end of June 1995. The Bank ran the risk of refuelling inflation in the process and was criticised for such policies by the International Monetary Fund (IMF).⁹

The Bank did not believe that domestic interest rates should be lowered by creating more money. The route to such lower rates resided in a restructuring of the basic fundamentals of the economy, such as boosting domestic savings, reducing the budget deficit and attracting more long-term foreign investment. Moreover, it was essential that the level of the nominal interest rates should at all times remain above the rate of inflation.

Nevertheless, critics of the Bank's alleged restrictive monetary policies asserted that interest rates, by being kept too high, resulted in a cost of capital which rendered many investment projects non-viable; in other words, the hurdle rate that companies had to beat in order to undertake profitable investments was simply too high and thus undermined economic growth.

1.3 Relationship between inflation and unemployment

Given these criticisms, the question arose why so much emphasis was placed on pursuing price stability in South Africa in view of the tendency of monetary policy to affect both output and prices in the short run. The

answer partly lay in changing views regarding the relationship between inflation and unemployment reflected in the so-called Phillips curve.

For a lengthy period after World War II the monetary policies of central banks around the world were influenced by the notion that a trade-off existed between economic growth and inflation. In those days it was believed that higher economic growth could be achieved at the expense of higher inflation. In 1958 an analysis of this relationship for the British economy was presented in the form of what came to be known as the 'Phillips curve', which showed a century-long relationship between wage inflation and unemployment. As the rate of unemployment rose, the rate of inflation as measured by wage inflation fell. Many analysts concluded on the basis of this experience, which stretched over such a long period, that the curve represented a trade-off of choices facing the government in which the benefits of lower inflation had to be balanced against their costs in terms of higher unemployment; in other words, a trade-off existed between output and inflation.

With the passage of time, however, the Phillips curve came under increasing scrutiny. From the late 1960s onwards the curve began to shift in character as unemployment and inflation started to move up in tandem not only in Britain, but in other industrial countries as well. While it was still accepted that a short-run trade-off existed between output and inflation, in the medium to long term it was increasingly being accepted that rising rates of inflation would be associated with unchanged or lower rates of economic growth; in other words, it was argued that if the money supply increased, prices would not rise immediately, and thus in the short term output could increase along with employment. In the long run, however, prices would fully adjust upwards to the rise in the money supply, and the stimulus to output and employment would fall away.

It was contended that inflation expectations were adjusting to actual inflationary experience. Nominal wage increases were therefore adjusting to reflect expectations of inflation because wage negotiators bargained about the real wages. Unemployment in the long run could therefore no longer be reduced through effecting reductions in the real wage as inflation accelerated in response to easier monetary policies. While real wages were kept up through the bargaining process, the scope for reducing unemployment in the long run disappeared. The view among central bankers spread that in the long run systematic actions on the monetary policy front could only affect the rate of inflation and not the level of output, and such policy should therefore be deployed to that end, especially since inflation had material social, and economic costs attached to it even though these costs were difficult to quantify. The Bank shared this view in the 1990s. Dr Stals maintained that in the longer term there was no trade-off between inflation and economic growth.¹⁰

The growing scepticism about the argument that a trade-off existed between higher growth and higher inflation could also be explained in terms

of rational expectations. The theory of rational expectations certainly had relevance in South Africa and elsewhere. In certain situations, if the Bank were to raise Bank rate, long-term interest rates could immediately decline. Conversely, if Bank rate were lowered, and the markets consequently expected inflation to rise, long-term interest rates would go up immediately; it was long-term rates that were important in determining economic growth. On this basis, a fall in short-term interest rates could not necessarily stimulate the economy, but would push up the inflation rate.

Changes in perceptions about a possible relationship between inflation and unemployment reflected in the fall from grace of the Phillips curve thesis could originally be traced to the writings of Milton Friedman. In a classic article published in 1968 he argued that there was no trade-off between inflation and unemployment. He asserted that there was nothing to be gained from accepting a higher rate of inflation. Any attempt to do this would result in accelerating inflation.

During the 1990s in South Africa a similar view prevailed. Dr Stals argued that monetary policy should not be geared to short-term anti-cyclical objectives, but rather to medium-term financial stability objectives. During the period of economic slowdown at the beginning of the 1990s the Bank did not wish deliberately to attempt to stimulate the economy through monetary policy means. Instead, it was hoping that the economy would be boosted by some external impulse, such as rising commodity prices and/or an internal boost from rising autonomous investments.¹¹

During the de Kock era monetary policy was perceived to be an important instrument of economic policy used mainly for managing total expenditure or overall demand. In the 1980s a decline in the dollar price of gold, a serious drought and capital sanctions forced the authorities to continue using monetary policy as a demand-stimulating device as previously indicated. In the Stals era, in contrast, monetary policy was used primarily as a means of creating greater financial stability in the economy and especially of reducing the rate of inflation.¹²

As part of his anti-inflationary strategy, Dr Stals quickly made it clear that he had a strong preference for interest rates that were positive in real terms. Such a preference also served as an acknowledgement of the relative scarcity of savings in the South African economy at that time, and complemented the need to alter the stubborn inflationary psychosis remaining in the minds and actions of the South African community.

There were also basic objections to the idea of exploiting a putative short-term trade-off between inflation and unemployment for monetary policy purposes. If this were to be the case, monetary policy-makers would run the risk of destabilising the economy and could easily face political pressures to reflate at certain times. For this reason too there was widespread agreement that monetary stability should be the primary aim of monetary policy.

1.4 The costs of inflation

The social and economic consequences of inflation are diverse and difficult to calculate accurately. Nevertheless, inflation, whether anticipated or unanticipated, has numerous ramifications in an economy even at moderate rates. Apart from exerting arbitrary (and arguably unjust) effects on the distribution of income and wealth in a country, high inflation entails some breakdown in the normal functioning of the price mechanism. Inflation tends to erase the signals emanating from the respective prices of goods, services and factors of production. Resources should be guided into different areas of the economy on the basis of relative prices, but this process is hindered by the presence of a high rate of inflation; in other words, the search for relative price information becomes more costly. A producer may temporarily supply more and make unwanted investments in extra capacity because he or she mistakes a general price increase for a relative price increase. Inflation changes people's behaviour, which is reflected in a diversion of resources from their initial use to less productive activities such as the purchase of Persian carpets in an effort to hedge against inflation. With a high and variable rate of inflation, borrowers and savers may not know the real rate of interest. This uncertainty may result in less efficient and/or lower investment which, in turn, reduces the rate of economic growth. Dr Stals made reference to such negative distortions of inflation as one of the justifications for reducing the rate of inflation at the beginning of the 1990s.¹³ The distortions arising from inflation, and a further analysis of inflation can be conducted by distinguishing between anticipated and unanticipated inflation, starting with the costs of anticipated inflation.

1.4.1 Tax distortion effects

Inflation exerts serious effects on company accounts. The most important problem concerns fixed assets and depreciation. The amount allowed in the accounts each year for depreciation reflects the original cost of the equipment. However, under inflationary conditions the cost of such equipment generally rises and its replacement cost, at the end of its life, will be correspondingly higher. The amount allowed for depreciation should therefore rise with the general level of prices. The fact that it does not rise in this manner means that company profits are overstated. Correspondingly, companies pay more tax than they should, and investment may be adversely affected.

Other distortions are caused by the tax system in an inflationary environment. For example, unless tax bands are fully indexed against inflation, an increase in price and wage inflation will push people into higher tax brackets in a progressive income tax system. Dr Stals argued that this increased people's real tax burden.¹⁴ In efforts to suppress the symptoms of inflation governments may resort to wage and price controls, which could lead to shortages in certain areas and a general misallocation of resources, and further inhibit investment. There is also some evidence that countries that enjoy low rates of inflation have relatively low tax burdens; no doubt

partly because of the absence of significant 'fiscal drag'. Again, this could be conducive to economic growth.

Inflation also leads to distortions in the allocation of resources. As already indicated, incentives are created, for instance, for capital to be diverted into inflation hedge assets rather than new productive investments; these investments are adversely affected by the reluctance of investors to make future commitments without knowledge of prices. This tendency may be strengthened by distortions arising from the lack of any effective inflation proofing of the tax system, which discourages new real investments. Dr Stals referred to these financial distortions in the context of the way in which inflation in South Africa had affected the financial markets.¹⁵

Inflation entails many other costs to an economy, such as the need to change prices more frequently and the social costs of economising on the use of non-interest-bearing money. These are 'shoe leather' costs. Since domestic currency loses value, people hold less when inflation is high. More frequent visits are needed to the bank to obtain currency to purchase goods and services. Firms' financial departments expand at the expense of production, consumers spend time and resources delaying payments, and these social costs of inflation rise in line with the inflation rate. The Bank believed that lowering the rate of inflation could boost savings in the economy, since the real rate of return on savings instruments could be raised and any such outcome, in principle, augmented the scope for higher economic growth.

1.4.2 Avoidance cost of inflation

Even more important, however, are the resources devoted to manipulating financial transactions in order to defer payments or accelerate receipts. Such rent-seeking behaviour is individually rational but is collectively an inefficient practice. Inflation leads to a rise in the resources devoted to such financial transactions, which is a pure waste from the point of view of society as a whole. Such a waste is entirely avoidable if the government maintains a stable price level.

Many analysts have argued that inflation avoidance activities in the form of rent-seeking behaviour and the tax distortion effects of inflation constitute the major costs of anticipated inflation. In addition, many analysts have argued that these costs are more than sufficient to outweigh the output costs involved in bringing inflation down so that price stability prevails.

The analysis conducted so far, however, takes account only of the costs linked to anticipated inflation. There are also the costs associated with uncertain and variable inflation. An inflation rate that is volatile generates two types of costs. The first is that uncertain inflation introduces an inflation risk premium into long-term interest rates. Risk-averse investors need to be compensated for bearing the inflation risk; in other words, investors demand a premium on interest rates to compensate them for the uncertainties linked to the inflation rate. This raises the real cost of capital and therefore deters

investment, a factor that was not immaterial on the South African scene in the 1990s where levels of investment were already low.

A second cost arises because the greater the uncertainty about inflation, the more difficult it becomes to distinguish relative from absolute price changes. The additional confusion introduced by volatility of the average price level diminishes the value of the price signals transmitted to consumers and producers alike. This distorts investments as well as probably deterring investments.

1.4.3 Labour market effects

Inflation can exert several adverse effects on labour markets. The existence of a variable rate of inflation will most probably lead to the negotiation of shorter average contract lengths for wage agreements. Consequently, the problem of renegotiating contracts becomes more important and more resources are devoted to this essentially unproductive activity. A variable rate of inflation could well induce risk-averse workers to negotiate a nominal wage that incorporates a premium to cover the possibility that the realised price level may be higher than the expected price level. High levels of uncertainty about inflation can therefore push up the average nominal wage, and hence the real wage, which could put extra upward pressure on prices and encourage employers to retrench workers.

1.4.4 Inflation and economic growth

A low rate of inflation in any particular country does not guarantee relatively high economic growth. Such inflation, however, would normally appear to be a necessary, although not a sufficient, condition for sustained high growth. Countries that enjoy strong economic growth tend to be blessed with a measure of monetary stability. Professor Robert Barro carried out a statistical analysis of the effects of inflation on economic growth drawn from the experience of more than 100 countries over 30 years.¹⁶ His main finding was that an increase in the inflation rate of 10 per cent tended to reduce national growth rates by 0,2 to 0,3 percentage points per annum. By using this result and compound interest it can be shown that a 10 percentage point increase in the inflation rate lowers the level of real gross domestic product (GDP) after 30 years by between 4 and 7 per cent. Dr Stals's views complemented these findings; the Governor arguing that the rising trend in the level of inflation in South Africa in the 1970s and 1980s had contributed to a declining real rate of economic growth.¹⁷

It is considerations of this nature that justified the interest in price stability displayed by many central banks, including the Bank. Nevertheless, these findings indicated that the economic benefits in the form of higher economic growth stemming from lower inflation were not as great as sometimes suggested. Scepticism in this regard was further reinforced by the fact that Barro achieved his results mainly by including many Third World countries that had double-digit or higher inflation rates. He concluded that his results for countries with inflation rates averaging below 15 per cent were not

significant. His findings for countries with inflation rates averaging less than 10 per cent showed practically no relationship with economic growth.

Nevertheless, despite these qualifications, central banks around the world concluded that price stability was the only credible goal that monetary authorities could proclaim and defend, with price stability generally defined as a situation in which expected changes in the price level were not a significant influence on economic decision-making. In the 1990s in the South African context the Bank took the view that removing the negative distortions associated with inflation constituted a prime justification for materially reducing the rate of inflation.¹⁸

Even so, the concept of price stability in itself is somewhat unclear. Central banks focus primary attention on product prices, but movements in asset prices cannot be entirely ignored. While price stability in terms of product prices had been attained or virtually attained in some countries in the 1990s, fast-rising asset values around the world started to raise the question whether the era of price stability would be sustained. In certain countries increasing attention began to be focused on asset price inflation and its implications for product price inflation. Such a focus, however, did not take hold in South Africa because asset price inflation did not appear in a material form. Unlike in other countries, house price inflation did not emerge in South Africa in the 1990s. Instead, product price inflation was the focal point of attention and considerable progress was achieved as revealed in Table 1.

Table 1: Percentage change in prices (1989–1999)

Period	Consumer prices	Production prices
1989	14,7	15,2
1990	14,4	12,0
1991	15,3	11,4
1992	13,9	8,3
1993	9,7	6,6
1994	9,0	8,2
1995	8,7	9,6
1996	7,4	6,9
1997	8,6	7,1
1998	6,9	3,5
1999	5,2	5,7

Source: South African Reserve Bank *Quarterly Bulletin*, various issues

In 1990 international oil prices rose in the wake of Iraq's invasion of Kuwait. This complicated attempts to bring down inflationary pressures, along with such factors as high inflation expectations. Thereafter, however, progress became more visible even though the rand depreciated sharply in 1996

and 1998. The consistent application of a counter-inflationary monetary policy, together with other policy developments such as improved fiscal discipline, trade liberalisation and growing competition in the domestic goods markets, improved industrial relations, and some moderation of the growth in nominal wages had all contributed to a decline in inflation since the beginning of the 1990s.¹⁹ The Bank held the view that by 1994 the progress made in combating inflation was beginning to affect economic growth favourably.²⁰ By 1999 the local inflation rate was approaching levels not far out of line with inflation in South Africa's major trading partners.

Chapter 2

The South African Reserve Bank's monetary policy framework in the 1990s

2.1 Introduction

In Chapter 1 it was emphasised that the main objective of the Bank's monetary policy in the 1990s was to protect the value of the South African currency as far as possible, that is, to work at all times to bring down the rate of inflation. The Bank regarded it as the most important contribution it could make towards economic growth and development. A stable financial environment was regarded as a precondition for sustainable economic development in the long term. South Africa had a long history of double-digit inflation in the sense that from 1974 to 1992 the country experienced inflation ranging between 11 and 19 per cent per annum.

However, although the Bank's monetary policies in the 1990s were ultimately aimed at stabilising the general price level, the process involved in this respect, which is known as the 'transmission mechanism', was complex, time consuming and therefore difficult to manage. Consequently, over the years many monetary authorities, including South Africa, preferred to aim at achieving intermediate targets that had a distinct bearing on the ultimate objective of price stability, but that could be more directly influenced by available monetary policy instruments. Intermediate targets in numerous countries were therefore often employed as an intermediate measure of the effectiveness of monetary policy.

Such intermediate variables had been identified and targeted in different countries over the years with varying degrees of success. Traditionally, the most popular and widely used intermediate targets were the monetary aggregates (money supply) and the exchange rate, although during the 1990s direct targeting of the inflation rate (i.e., without the use of intermediate targets) was also gaining ground. In the case of South Africa, the monetary policy regime (framework) in the 1990s incorporated the use of money supply targets up until 1998.

2.2 Rationale behind money supply-targeting policies

Any targeting of the money supply is based on the belief that the cure for inflation is a monetary one. If the rate of growth of the money supply is controlled effectively over time, the same will apply to inflation. As a supplement to this, the setting of published targets for the growth in the

money supply can be supported on the grounds that it can spread public awareness of the link between the money supply and prices. Published targets may provide some guidance to the business community, consumers and labour interests concerning the authorities' probable monetary policy actions and future policy stance. Advance notification of the intended stance in monetary policy could facilitate appropriate adjustments in wage and salary claims, and in the spending plans of businesses. The introduction of targets for the money supply can also be useful in curbing the propensity of governments to spend public funds, because central banks can emphasise to politicians that public spending in excess of certain levels could entail exceeding the money supply targets if such spending is financed by resort to bank credit. All these considerations encouraged the Bank to adopt money supply-targeting policies, which were first introduced in 1988 on the recommendations of the De Kock Commission of Inquiry Into the Monetary System and Monetary Policy in South Africa.

In general, in the case of targets for monetary aggregates, central banks select that particular monetary aggregate (i.e., M1, M2 or M3) that best serves as an intermediate policy target. The selection of the appropriate monetary aggregates is therefore an empirical issue, and for some countries the narrowly defined monetary aggregate had been considered to be more suitable, while others preferred the broadly defined monetary aggregate (M3). Some monetary authorities have even monitored more than one monetary aggregate. The importance of these intermediate targets comes into play in terms of the growth rate targets that the central banks lay down in regard to these monetary aggregates.

Many central banks had defined a particular target range for these aggregates. Gearing of monetary policy to an intermediate money supply target was a particularly long tradition in Germany. The German Bundesbank was the first central bank to lay down a money supply target in 1975. In South Africa the broad monetary aggregate M3 was identified as the most suitable for money supply-targeting by the Bank. As an example, the target growth range for M3 for 1995 was set at between 6 per cent (the lower limit) and 10 per cent (the upper limit). Progressively, lower targets for the growth in M3 had been applied since monetary targeting was first introduced in South Africa in 1988 as shown in Table 2. This reveals that the growth in the money supply slowed down substantially during the recession of 1989 to 1993 as a result of a restrictive monetary policy stance, the decline in real economic activity and the lower rate of inflation in South Africa. Thereafter, progress proved much more difficult and necessitated the perseverance of a conservative monetary policy. Finally, monetary targeting was abandoned in South Africa early in 1998.

Central banks normally emphasised that their money supply targets or guidelines did not amount to the adoption of a strict money growth rule. The guideline percentages for the growth in the money supply (M3) were not something central banks sought to attain at all costs in all circumstances; in other words, reaching the guidelines was not an overriding short-term

Table 2: M3 targets

Period	Target rate of growth of M3 (per cent)	Actual rate of growth (per cent)
1988 Q4 – 1989 Q4	14–18	23,5
1989 Q4 – 1990 Q4	11–15	12,0
1990 Q4 – 1991 Q4	8–12	14,8
1991 Q4 – 1992 Q4	7–10	8,8
1992 Q4 – 1993 Q4	6–9	5,6
1993 Q4 – 1994 Q4	6–9	5,6
1994 Q4 – 1995 Q4	6–10	14,6
1995 Q4 – 1996 Q4	6–10	14,3
1996 Q4 – 1997 Q4	6–10	15,2

Source: South African Reserve Bank *Quarterly Bulletin*, various issues

intermediate objective of policy. In the case of the Bank, it believed that the art of central banking was not to follow a rigid money supply formula, but to apply the necessary discretion in monetary policies based on changes in all the available monetary data such as bank credit extension, interest and exchange rates, changes in the foreign reserves and in government finances.²¹ Moreover, central banks pointed out that the targets or guidelines should not be viewed as a purely mechanical projection of the money supply growth rate that would materialise during the guideline year. Instead, they were indicative of the growth rate in M3 that the central banks would like to see realised, given the prevailing and expected general economic conditions in their respective countries.

There were some proponents of the use of a more restricted definition of the money supply than M3 to be used as a guideline. At certain times in the 1990s the narrower monetary aggregates expanded more strongly than M3. Some favoured the employment of M0, which includes only banknotes and coin in circulation outside the Bank, plus deposits held by commercial banks with the Bank. This definition, however, was not very useful in South Africa since South Africans did not make extensive use of banknotes and coin in payment transactions. In addition, changes in notes and coin in circulation could be misleading as an indicator of inflationary pressures.²²

The Bank had no specific interest rate target while applying monetary targeting policies. Nevertheless, it held the strong view that nominal interest rates should at all times remain above the rate of inflation and during the entire 1990s this was normally the case.²³

There were various channels through which changes in the money supply could occur, but money was generally created mainly through the extension of credit to the private sector by banking institutions. A policy aimed at

managing the rate of increase in the money supply had therefore to concern itself with the rate of growth in the total claims of the banking sector on the private sector; in other words, central banks needed to monitor carefully the rate of increase in the total amount of bank credit extended to the private sector as part of any policy of targeting the growth in the money supply. This was the case with the Bank during the 1990s.

During the period of money supply targeting the approach adopted by Dr Stals incorporated the notion that the growth in the money supply must be brought down to a level compatible with lower inflation. The provision of annual guidelines for an appropriate increase in the money supply was seen as contributing to a more transparent monetary policy, with major deviations from these guidelines triggering proactive policy actions by the Bank, even though, as previously mentioned, the Bank did not at all times follow a rigid money rule linked to these guidelines.

It needs to be emphasised that central banks, including the Bank, experienced much hassles by adopting money supply targeting, or laying down guidelines for the growth in the monetary aggregates, as the policy was often referred to. Indeed, the Bank preferred to use the term 'monetary guidelines', since this downgraded the concept of strict targets attached to the policy, and talked in terms of the guideline ranges for acceptable growth in the monetary aggregates. Several difficulties were faced in successfully applying such a policy:

- (a) There was no guarantee that the relationships between the money supply and total demand, and the money supply and inflation would in any way be stable or predictable. The behavioural pattern of the monetary aggregates could change over time. There was, therefore, no guarantee that a low rate of growth in the money supply would guarantee low or zero inflation at all times.
- (b) There were uncertainties about the unavoidable time lags that existed between changes in the money supply and the rate of inflation. Empirical analyses in some other countries suggested that this time lag could be as long as two years or more. This factor only complicated the task of deciding on the appropriate stance of monetary policy at any given moment.

In view of the marked lags that existed between changes in the monetary stance of the authorities and observed changes in the inflation rate, the Bank tended to emphasise that the monetary guidelines for the growth in the money supply should not be expected to produce immediate effects on the inflation front. The use of monetary targeting was aimed at gradually reducing the rate of inflation in countries such as South Africa that were experiencing relatively high rates of inflation; removing inflation from the system was to be thought of as a medium-term objective.

- (c) Instability in the demand for money likewise rendered monetary targeting a difficult operational policy in South Africa; in other words, the underlying demand function for money appeared to be unstable. This issue was closely tied up with the problem of the instability of the velocity of circulation of money which changed, among other things, as a result of reintermediation or disintermediation, hoarding and dishoarding, technological advances, and changing payment habits. Often an increase in the velocity of circulation occurred as a result of disintermediation, implying that credit creation was taking place outside the banking system.
- (d) Choice of monetary measure to target: Another problem with money supply targeting concerned the choice of an appropriate monetary measure to use for targeting purposes. It was not easy to determine a permanently suitable measure of the money supply that could be employed. In this regard, reference should be made to what is known in central banking circles as 'Goodhart's Law'. This refers to the notion that any targeted money supply indicator becomes distorted over time and, accordingly, loses its validity such that the central bank can no longer use the indicator as a money supply target. It is this particular factor that induced some central banks to abandon monetary targeting. It was, for instance, suggested in the 1990s that if the Bank decided to abolish exchange controls, the resulting short-term shifts of money in and out of the country could render the various measures of the money supply much more unstable, thereby undermining the credibility of continued money supply targeting in South Africa.

Indeed, even though exchange controls were not totally phased out, the growing financial integration of South Africa with the rest of the world had for some years in the 1990s been complicating the application of monetary policies, and was one important factor accounting for the abandonment of the policy of using guidelines for the growth in the money supply early in 1998. The almost explosive increases in the volumes of the South African financial markets introduced a new unstable element in the income velocity of money, and led to a more unpredictable relationship between changes in the money supply and in domestic price movements. This helped to force the authorities to abandon money supply targets.²⁴ Even before 1998 the Bank had been gradually applying a more pragmatic approach, and was taking a broader view of movements in a whole array of financial developments to guide it in its decisions on monetary policy. The relationship between the money supply and inflation rates became less clear cut under the more liberalised conditions existing in South Africa in the 1990s compared with the 1980s when the economy was much more isolated from external influences.

In the face of the greater foreign capital flows moving in and out of the local economy, these flows exerted a stronger effect on the exchange rate than before which, in turn, affected the economy and the inflation rate. Under these circumstances the relationship between the money supply and inflation was somewhat different from what it had been when the capital account of the balance of payments was less volatile. What is more, Dr Stals pointed out that the introduction of many substitutes for money in the national payment system, such as electronic transfers, credit cards and smart cards, meant that there could no longer be a reliable relation between changes in the money supply and inflation.²⁵

The money supply-targeting policies pursued by central bank in the 1990s to varying degrees emphasised the low profile nature of such targeting. Such targets were not pursued with single-minded purpose; they were flexible targets that were not to be attained under all circumstances as previously mentioned. Other factors also had to be taken into account in shaping monetary policies, which could mean that such targets were not realised.

This was the case in South Africa with its policy of monetary targeting. The Bank normally took into account forecasts for the real growth in the economy in the year ahead, as well as the anticipated rate of inflation. The higher target range of 6 per cent to 10 per cent for M3 in 1995, for instance, took account of an expected relatively high economic growth of 2,5 to 3 per cent.²⁶ The Bank also adopted a view on the likely course of the velocity of circulation of the money supply. Moreover, in setting its monetary guidelines for any one year, it sought to avoid accommodating avoidable inflationary pressures and, indeed, was normally keen to adopt a guideline for the growth in the money supply that was conducive to a fall in the rate of inflation.

The Bank did not always achieve its targets for the money supply and some critics argued that economies were too complex to be based on such a rule-based model. During the second half of the 1990s it became more difficult for the Bank to control the money supply, partly because South African banks had greater access to liquidity through foreign borrowings. Even so, the money supply guidelines remained important, since they conveyed to the general public the resolve of the Bank to bring down the rate of inflation over time. Such success was achieved, since, by 1993, the rate of inflation had declined to a single-digit figure for the first time in South Africa in more than 20 years.

2.3 Recourse to discretionary monetary policies

One alternative to money supply-targeting policies would have been the recourse to exchange rate-targeting policies. However, the exchange rate could not be used as an anchor for monetary policies in the case of South

Africa in the 1990s. The relatively low level of the country's foreign reserves ruled out any effective intervention in the foreign exchange market by the central bank. In addition, volatile movements in foreign capital at times led to undesirable exchange rate adjustments that could not be prevented. Changes in gold production and in the gold price also made the exchange rate an unsuitable basis for an anchor for monetary policies, and the relatively high inflation rate compared to predominantly lower rates in the economies of South Africa's major trading partners forced some regular downward adjustments of the rand exchange rate in order to protect the international competitiveness of the South African economy.²⁷

By the mid-1990s some countries had started to adopt inflation-targeting policies. The Bank, however, was reluctant to adopt this approach in the mid-1990s, arguing that it required a degree of co-operation between government, private businesses, trade unions and the central bank which would be difficult to obtain in South Africa because of the sociopolitical reforms in progress.²⁸ It argued that it would be difficult to reach consensus on the definition of acceptable price stability. Furthermore, it maintained that it would do more harm than good for a country to introduce a formal inflation target that was out of line with the rest of the world. By 1996 countries with inflation-targeting policies had ruling rates of inflation of slightly more than 3 per cent.²⁹

By 1998 the Bank was still not convinced that South Africa had reached the stage where an explicit inflation-targeting policy could be applied due to operational considerations. The adoption of an inflation target implied greater reliance on forward indicators of inflation, and a continuous assessment of the relationship between the instruments of monetary policy and the inflation target. The need to develop more reliable inflation-forecasting models was partly responsible for convincing the Bank that it was not a convenient time to adopt an explicit, low inflation target.

The difficulties experienced in applying money supply and exchange rate targets meant that some countries applied purely discretionary monetary policies without laying down any specific objectives. This involved using a set of indicators rather than simply one indicator to guide monetary policies, and it is this kind of policy that was pursued by the monetary authorities in both the United States (US) and Japan in the 1990s.

Such policies, however, meant that the relevant central banks faced a credibility problem with the financial markets. Economic agents could not easily assess the objectives of monetary policies and the likely reactions to different forms of economic disturbance. They were also not sure whether the central banks would weaken or abandon their commitment to any stated or unstated policy goals. Using a set of indicators likewise ran the risk of inducing monetary authorities to procrastinate and do nothing, especially when the chosen indicators moved in different directions, even

though action on the monetary policy front was required. Such policies were also not particularly transparent.

Although this policy approach was followed by South Africa in 1998, there was nevertheless an overriding objective of bringing inflation in line with the average rate of inflation in the economies of South Africa's major international trading-partner and competitor countries, that is, an implicit inflation target was pursued even before South Africa officially switched to inflation targeting. The global trend was partly towards the use of composite indicators rather than one specific indicator, which policy was being applied in both the US and Japan as indicated previously. It was, moreover, an approach that had already been used in part in South Africa while money supply-targeting policies were being applied. In practising monetary targeting the Bank exercised discretionary judgement in the sense that it sought to attain an optimal combination of growth in the money supply, bank credit extension, interest rates and exchange rate at any given time. Some evidence of the reduced importance of money supply guidelines in South Africa was found in the events that took place in April 1996, when the rise in Bank rate appeared to be principally a by-product of the weakness of the rand at the time rather than in response to movements in the monetary aggregates. This discretionary policy, however, was rather short-lived because on 23 February 2000 the Bank formally adopted inflation targeting as its policy framework. What is more, the Bank regarded these discretionary policies as transitional as it moved from money supply targeting to the introduction of a national inflation target.³⁰ Even in 1999 the issue of inflation targeting was becoming prominent. After more than four years of a persistent "excessive" growth in M3, with a clear downward trend in inflation at the same time, the question arose whether the time had not arrived for South Africa to follow the example set by many other countries and that was to target inflation directly.³¹

Chapter 3

Instruments of monetary policy employed in South Africa in the 1990s

3.1 Overview

Apart from discussing the nature of monetary policies conducted by most central banks in the world, this chapter focuses attention on the main instruments of monetary policy that were utilised by the Bank in the 1990s. Particular reference is made to the role played by the instrument of monetary policy known as the 'accommodation arrangements'. The revised methods of providing accommodation to the banking system that were enacted in the 1990s are explained, along with the nature and importance of money-market shortages in South Africa. Thereafter, the other monetary policy instruments that were in use are also discussed, namely open-market operations, variations in cash reserve requirements, exchange controls, tax and loan accounts, and South African Reserve Bank (SARB) debentures.

3.2 Nature of monetary policy

Monetary policy can be described as consisting of decisions that are formulated and implemented by the monetary authorities (i.e., by the central bank or by the Treasury and the central bank) in their various fields of operations that are aimed at achieving certain ultimate objectives with regard to the country's economy. These ultimate objectives, in turn, are strived for by influencing primarily the volume or composition of domestic expenditure and output in an economy mainly through the appropriate use of the interest rate weapon. Moreover, in the contemporary world, and more particularly in the developed economies of the world, it is now widely accepted that these ultimate objectives crystallise around the aim of achieving broad monetary stability in an economy, which can be defined primarily as an environment in which inflation, if it exists, is sufficiently low so as to be ignored by economic agents.

The mission statement of the Bank adopted in August 1990 made it clear that the ultimate objective of monetary policy was to achieve price stability, that is, to ensure that the internal and external values of the rand were stabilised as far as possible in the medium term. This view of the Bank's prime responsibility was also emphasised by the Interim Constitution of the Republic. Section 196(1) of the Constitution required the Bank to protect the internal and external value of the currency in the interests of stable and sustainable economic growth. The Final Constitution adopted in 1997 similarly ordered the central bank to pursue price stability in the interests of economic growth and a sound economy. In Europe in the late 1990s

the proposed introduction of a single currency carried with it a specific role for the future planned European System of Central Banks (ESCB). The primary role of the ESCB “shall be to maintain price stability. Without prejudice to this objective of price stability, the ESCB shall support the general economic policies of the Community”.

Nevertheless, the suitability of this objective for central banks had only become widely accepted in the previous two decades or so, as explained in Chapter 1. During the 1960s and early 1970s it was generally assumed that employment could be increased by adopting stimulatory economic policies, albeit at the cost of a somewhat higher inflation rate. Since the first oil crisis in 1973, however, which produced an acceleration of inflation in most major economies, this relationship had largely broken down, and later empirical evidence suggested that inflation and unemployment were often positively correlated. It had generally become accepted that monetary policies that promoted higher inflation may well lead to a weaker performance of the real economy. High rates of inflation discourage savings and investment, and thereby damage an economy’s potential for economic growth. Consequently, most monetary authorities around the world had come round to the view that price stability should be the ultimate objective of monetary policy; in other words, price stability was perceived to be conducive to raising the growth rate of an economy. By the 1990s many central banks were trying to maintain price stability by keeping the growth in monetary demand continually and broadly in line with the underlying growth of capacity in the economy. They were, in effect, using price stability as an indicator of stability in their economy as a whole.

Professor Robert Barro carried out a statistical analysis of the effects of inflation on economic growth drawn from the experience of more than 100 countries over 30 years as indicated in Chapter 1.³² His main finding was that a 10 percentage point increase in the inflation rate lowered the level of real GDP after 30 years by between 4 and 7 per cent. It was considerations of this nature that justified the interest in price stability displayed by many central banks.

In most industrialised countries price stability was considered to prevail if the rate of increase in consumer prices was in the range of 0 to 2 per cent. In other countries that suffered from higher rates of inflation, such as South Africa, monetary policy first had to aim to bring down the inflation rate before attempting to stabilise prices in absolute terms.

South Africa’s inflation rate during the period from 1993 to 1997 averaged below 10 per cent and, consequently, its harmful effects on the potential for economic growth may have been minimal. Nevertheless, the ongoing attempts to push the inflation rate lower could still be justified. A low rate of inflation was a key factor in attracting foreign capital which, in turn, affected the growth potential of the economy. Many foreign investors, in assessing the merits of foreign investment in South Africa, placed some emphasis

on the country having an inflation rate that was not far out of line with the average rate of inflation in the economies of its major trading partners. In this respect South Africa still suffered from a relatively high rate of inflation as measured by consumer prices which reflected an inflation differential of about 5 percentage points with its major trading partners at the end of 1997. This pointed to the desirability of further reducing the rate of inflation in the country. In addition, if inflation that was out of step with other countries were tolerated by the South African authorities, the danger existed that it would accelerate over time, bringing economic disadvantages in its wake.

3.2.1 Intermediate objectives and operational variable of monetary policy

Although the monetary policies conducted by many central banks were ultimately aimed at reducing and then maintaining inflation rates at suitably low levels, the process involved in this respect, which is known as the 'transmission mechanism', is complex, time consuming and therefore difficult to manage. Consequently, many monetary authorities preferred to endeavour to achieve intermediate targets that had a marked effect on the ultimate objective, but which could be more directly influenced by various instruments of monetary policy. Intermediate targets were therefore often employed in the 1990s as a means of seeking to render monetary policy effective as regards ultimately achieving a measure of price stability.

Any policy involving the targeting of the money supply is based on the belief that the cure for inflation is a monetary one as explained in Chapter 2. If the rate of growth of the money supply is controlled effectively over time, so will inflation be controlled. In general, in the case of targets for monetary aggregates, monetary authorities selected that particular monetary aggregate, whether it be the M1, M2 or M3 measure of the money supply, that best served as an intermediate policy target. Targeting of the money supply was employed by the Bank, which identified the M3 measure of the money supply as the most suitable for targeting purposes. In Chapter 2 it was explained that guidelines for the growth in the M3 money supply were applied on an annual basis.

However, in order to attain the intermediate and ultimate objectives of monetary policy, central banks had to adopt an operational control framework that specified the operational variables of monetary policy. The most common approach in this respect was one in which the monetary authorities sought to control the money supply through changes in interest rates; in other words, the interest rate was used as a policy (or operational) variable.

This monetary policy framework was the one followed by most central banks, including the Bank, even though the precise effects of changes in interest rates on an economy were by no means perfectly understood even by central banks, partly because of time lags before such changes had

exerted their full effects. In South Africa, as already indicated, controlling inflation was the ultimate policy objective, while the broadly defined monetary aggregate M3 was the intermediate target, although other variables that could affect M3 such as bank credit extension and the exchange rate were also monitored. The Bank, in turn, influenced the level of short-term interest rates through its accommodation policy and this monetary policy instrument was mainly supplemented by open-market operations in order to influence the money supply. Under this form of monetary control the relative emphasis on accommodation, open-market operations and other monetary policy instruments could vary between different central banks. In South Africa this monetary policy framework in the 1990s was known as a 'cash reserve system of monetary control'.

3.2.2 Instruments of monetary policy

It has already been emphasised that in order to attain the requisite level of market interest rates, central banks made use of various monetary policy instruments at their disposal. Two types of policy instruments could be distinguished, namely (1) indirect measures and (2) direct measures. Indirect policy (market-orientated) measures constituted actions taken by the central bank whereby it achieved its monetary policy aims by encouraging market participants to take particular actions as regards their lending and borrowing behaviour as a result of price and interest rate incentives or disincentives brought about in the financial markets. More particularly, these incentives or disincentives arose out of technical intervention by the central bank in the various financial markets. The intervention involved buying and selling specified financial claims such as government stock, Treasury bills, bankers' acceptances and foreign exchange, in order to influence prices and therefore interest rates and exchange rates. In South Africa the best-known examples of indirect (market-orientated) policy instruments included the accommodation policy of the central bank, open-market operations, and the buying and selling operations of the Bank in the spot and forward foreign exchange markets.

Direct (or non-market-orientated) policy instruments refer to those measures taken by the central bank that sought to attain the aims of monetary policy by means of certain rules that prescribed the behavioural pattern of banks, and possibly other financial institutions. These instruments were usually associated with a suspension of market forces, involving either rigid rules of behaviour or the fixing of certain variables. If the market participants concerned did not adhere to these prescriptive rules, they might be liable to prosecution or at least certain penalties. Examples included instructions sent to banks in which they were requested not to exceed a certain amount of lending to domestic private-sector borrowers over a specified period, and instructions that banks must not quote interest rates above or below a certain maximum or minimum level on the various credit and deposit

facilities they made available to customers. Exchange control regulations also formed part of the group of direct monetary policy instruments.

Since the end of the 1970s, and particularly during the 1980s, there had been a definite shift in favour of market-orientated policy instruments across the globe. Reliance on direct credit and interest rate controls in domestic monetary management had consequently diminished in importance. South Africa had likewise conformed to this pattern. This shift in policy was encouraged by the liberalisation of financial markets in the major industrial countries during this period, and it was aimed in part at improving the workings of these markets and at removing exchange controls. Disenchantment with direct policy measures also became very marked because these were ineffective controls. The stage had been reached where non-market-orientated policies were applied only on a limited basis around the world.

Nevertheless, as already indicated, in the past most countries used direct instruments of monetary control. These instruments had a superficial attraction in the sense that at face value they seemed able to achieve given quantitative targets, such as the extension of bank credit. However, they were likely to have serious drawbacks since they were partially ineffective, and not conducive to gains in economic efficiency. Credit ceilings, the most common direct instrument, tended to be inefficient and curbed competition among banks in granting credit. In addition, direct monetary controls were inclined to spawn yet more controls; administrative controls often multiplied as the authorities attempted to thwart efforts to circumvent the initial controls. This led to disintermediation of credit out of the formal banking sector; in other words investors who were so-called primary lenders started to bypass the banks by lending directly to the so-called ultimate borrowers, rather than holding deposits with the banks who then extended credit. This meant that targets such as bank lending that superficially appeared to have been achieved, in reality only masked a declining share of official financial-sector activity in the economy.

The adoption of indirect or market-orientated instruments of monetary policy brought with it a number of advantages. It could depoliticise the allocation of credit and reduce the protection of existing large financial institutions by fostering greater competition in the banking sector. Greater competition tended to decrease the cost of banking services, and fostered the reintegration of the informal with the formal banking sector by encouraging the process whereby 'primary lenders' placed their funds with banks rather than try to lend directly to 'ultimate borrowers'. In general, the use of indirect instruments of monetary policy enabled a central bank to better manage monetary conditions in the economy as a whole, thereby rendering monetary policy more effective.

In South Africa the operational variable attached to the market-orientated monetary policies of the Bank in the 1990s was the general level of interest rates. At the same time, the Bank's prime indirect instrument of monetary policy was its accommodation policy, which was also referred to as its 'refinancing policy'. The key element in the Bank's accommodation policy used to be Bank rate and changes in Bank rate, but modified systems of accommodation were introduced in the 1990s. These modifications are explained in the following section.

3.3 Accommodation policy

3.3.1 Historical background

In the broadest sense accommodation that is granted by a central bank could refer to all forms of credit extension made available by a central bank to parties in the economy, which include banks in the financial system. Central bank accommodation, however, had conventionally referred to credit that was offered to banks at the so-called discount window of the central bank; in other words, it had referred to the refinancing operations undertaken by a central bank at its discount window.

Over the years certain central banks around the world had made extensive changes to the procedures that they employed for extending accommodation to banks that were short of cash. New accommodation procedures had partly reflected the development of new financial market instruments, and had generally been aimed at making monetary policy more flexible, and effective in a complex environment.

The history of accommodation policies adopted by the Bank revealed many changes in the methods and techniques applied, reflecting in part the different aims attached to accommodation policies at different times. Frequent changes in the refinancing rates, and the differentials between these rates also occurred. In the past prominent features of the system were the complicated structure of rates, and the open-ended refinancing system that did not discourage banks from using central bank credit in a liberal way.

Under the accommodation arrangements in force until the beginning of May 1993 there were essentially two ways in which accommodation was provided to the banks. The first was through the rediscounting of Treasury bills at Bank rate, Land Bank bills at a small margin above Bank rate, and liquid bankers' acceptances at a still higher margin above Bank rate. The margins above Bank rate were fixed at the Bank's discretion and the bills had to have a maturity of not more than 91 days.

The second was through the extension of overnight loans to the banks against the security of short-term Treasury bills, and government stock

at a certain rate of interest, and at slightly higher rates when backed by liquid Land Bank bills and liquid bankers' acceptances. Overnight loans were also extended when covered by semi-gilt and gilt-edged securities with a maturity of not more than three years, in which case the collateral was valued at 90 per cent of the market value of the securities offered as collateral.

A number of problems were associated with this accommodation system. The system was complicated because of the wide range of accommodation rates (seven) and the long list of refinancable assets. In addition, central bank credit extended to the banks through the rediscounting of liquid bankers' acceptances at preferential rates represented an open-ended facility because bankers' acceptances could be readily created by banks for their clients, and could easily be tailored to achieve liquid asset status. At the same time, the Bank's verification of the true liquid status of acceptances for the purpose of rediscounting at a relatively favourable rate was a cumbersome procedure, and required an excessive amount of time. On occasions the Bank appeared to doubt whether bankers' acceptances were being used to finance the movement of goods, and thus questioned the self-liquidating character of certain acceptances. What is more, the Bank was exposed to credit risk by the rediscounting procedure adopted to meet cash shortages in the banking system (which necessitated the drawing up of an accommodation agreement) since assets were purchased on an outright basis, and in the event of a default might have to be sold at a loss.

3.3.2 Accommodation arrangements (May 1993 – March 1998)

In view of these shortcomings, in May 1993 this system was replaced with a new system in which accommodation was, once again, granted on the initiative and at the request of banks that approached the Bank for assistance. The clear purpose of the system was to provide the banks with cash balances that were credited to their current accounts kept with the Bank, rather than provide them with money in the more general sense. Under this system accommodation was provided through overnight loans alone at basically two different accommodation rates against two categories of financial assets. In the first category (or tier) accommodation was provided at Bank rate against the collateral of government stock, and Treasury, Reserve Bank and Land Bank bills with an outstanding maturity of not more than 91 days. A second category of these securities with a maturity of 92 days and longer, but shorter than three years, qualified as collateral for overnight loans at a rate of 1 percentage point above Bank rate. This margin was subsequently raised to 1,5 percentage points above Bank rate in March 1995 and then revised downwards to three-quarters of a percentage point on 26 June 1996. Accommodation at the discount window in the first and second categories was furnished immediately, automatically and unconditionally with no questions asked, and to the full

extent of the shortfall in the banks' aggregate cash reserves provided the banks offered the Bank suitable collateral.

Accommodation against collateral of other forms of security, such as bank-endorsed bills and long-term government stock, was made available only in exceptional circumstances and at a discretionary or negotiated rate and for a limited time. It would most probably be the case that any bank requiring assistance in this third category of accommodation was facing acute liquidity difficulties. Banks would borrow suitable assets from other financial institutions to use as collateral for borrowing from the Bank in the first and second categories before resorting to this third category of borrowing which could be an exceedingly expensive form of borrowing. The Bank itself was also very cautious about granting assistance of this kind. In general, it would only render assistance if the troubled bank posed a threat of systemic risk, that is, a threat to the stability of the rest of the banking system. Even under these circumstances the Bank might have refused to offer assistance if the bank was perceived to be insolvent with little or no prospect of lasting recovery. The various accommodation facilities, in effect reflected the various prices of central bank money and such money was only furnished if banks offered suitable collateral, otherwise accommodation facilities could be insufficiently restrictive.

The need for second category accommodation on the part of banks to supplement first category accommodation normally became operative at relatively high levels of shortages of cash in the banking system. It was also usually the case that when such accommodation was needed, the requirement was confined to certain banks and not all the clearing banks. The impact of resorting to second category accommodation with its penalty rate on the general level, and structure of banks' lending and deposit rates should consequently have been limited, but would certainly be in an upward direction. Under such circumstances there would be upward pressures on the interbank call rate and this, in turn, would tend to put upward pressure on other money-market rates. Nevertheless, the major clearing banks would quickly seek to escape from second category accommodation. The banks would do this primarily by selling 'non-eligible' (for accommodation purposes) securities into the market and by bidding more aggressively for interbank and wholesale (corporate) deposits. On a virtually permanent basis the major banks would seek to reduce the danger that they would need second category accommodation by keeping relatively large assets eligible for first category accommodation.

Under this system of refinancing introduced in May 1993 the differential between the interest rates in the first and second categories of accommodation was normally 1,5 percentage points, but this margin could be varied if the Bank deemed it suitable. It might, for instance, be lowered to provide an element of relief for the banks in circumstances where the

shortages in the money market were large and expected to remain large and when at the same time the authorities were unwilling to cut Bank rate.³³

3.3.3 Benefits of changed arrangements

In terms of the arrangements made for accommodation applicable to banks between May 1993 and March 1998, Bank rate was no longer a discount rate but a loan rate and the system was simplified. This system had several advantages. First, the credit risk to which the Bank was exposed when it rediscounted assets was eliminated because assets were no longer purchased outright. Second, the banks that received cash from overnight loans had to hold cash reserves, and liquid assets against increases in their short-term liabilities. The Bank's accommodation policy was likely to have a more immediate effect on the banks' interest rate structures. Third, by abandoning the system of rediscounting assets, the administrative task of the settlements division in the Bank's Johannesburg branch office became easier. This was because assets did not have to be individually discounted, and because the interest rate calculations on loans whenever Bank rate was changed were much easier to make than discount rate calculations on individual bills. Fourth, the new system terminated the open-endedness of accommodation provided through the old system to a considerable degree.

Under this system accommodation did, in effect, become more restrictive, because bankers' acceptances were no longer discounted at the discount window. At the time of the change, the Bank believed that tight monetary policies should continue to be applied and, in line with this thinking, probably wanted to restrict accommodation even more in order to gain better control over the growth in the money supply. At that stage, the government's budget deficits were high, and the Bank could have been fearful that it might be called on to partially monetise the deficits indirectly as a result of banks' buying new government stocks, and then taking them to the discount window to gain liquidity.

As part of this system, the availability of government paper for accommodation purposes was increased by means of increased issues of Treasury bills at certain times and represented a structural change. The Treasury bill and, to a lesser extent, short-term government stocks were made the major instruments of paper for accommodation purposes, and this meant that the rate on such bills had to be set at market-related levels to ensure that sufficient amounts of Treasury bills could be issued.

3.3.4 Nature of the repo tender system introduced in 1998

The system of accommodation introduced in May 1993 was replaced in March 1998 with a new more flexible set of accommodation facilities created in the form of regular repurchase transactions between the Bank and its banking clients. The latter system was known as a 'repo system' and was

similar to the one in use by the Bank of England, and central banks in Italy, Germany and Australia.³⁴ This was an alternative and distinctive system of accommodating shortfalls in banking liquidity at the borrowing window of the Bank by means of repurchase agreements relating to various securities that were tendered by the banks to the Bank on a daily or intraday basis for purposes of acquiring liquidity.

The repo rates could change on a daily or intraday basis in line with the results of the daily or intraday repo tenders, with this repo rate exerting a major influence on the interest rates of banking institutions, including overdraft and mortgage rates. In effect, this repo system facility entailed daily or intraday repo tenders being submitted by the banks to the Bank, where fluctuations in the repo rates could be expected to lead to a more flexible structure of interest rates than that prevailing under the previous Bank rate system. Key bank lending rates such as the prime overdraft rate, and the mortgage rate would change more than had occurred in previous periods. The repos normally had a maturity of seven days, but on occasion the maturities were expected to be longer. Thus the fixed Bank rate as main operational instrument was replaced with a floating repo rate, reflecting changes in underlying money-market conditions.

Under the new system the amounts offered on tender by the Bank were usually equal to the projected liquidity needs of the banks; in other words, the Bank normally financed the total liquidity shortage by means of the repos. However, sometimes the new repo system was operated in such a manner that the tenders were not accepted in full. Fixed amounts of assistance were announced beforehand and offered at the daily or intraday tenders, at times leaving the banks short of cash on occasions, which could only be replenished by borrowing from the Bank at a penalty rate fixed by the Bank and that was, in effect, the equivalent of the previous Bank rate. This was a new marginal lending facility. This new system therefore introduced a differential between the lower repo rates, and the higher penalty rate or Bank rate, and a narrowing of this differential in rates could be an important indicator of a pending rise in Bank rate, and vice versa in the case of a widening of this differential. The new Bank rate should at the same time normally have formed a ceiling for overnight money-market rates.

This marginal lending facility was available to banks to bridge temporary liquidity shortfalls not catered for under the repo tenders as already indicated, and was available on an overnight basis or for a few days. No limit was placed on the use of the facility, provided the banks presented the required collateral. To begin with, this facility was made available using the first- and second-tier assets as collateral which were employed under the previous accommodation system.

Under this new system the range of securities the banks could use at the daily or intraday repo tenders was broadened to include all government stocks. This widening of the range should have been particularly helpful for

those local banks that had taken over the function of marketing government stocks from the Bank from April 1998 onwards and, in effect, had become market makers in such stocks.

One implication of this new repo system was that banks concentrated more attention on their cash management practices. The repos had a maturity of one week, whereas previously the Bank system lent assistance on an overnight basis in the form of loans. Moreover, as explained shortly, short-term interest rates were more flexible under the new system and there was no floor interest rate facility offered by the Bank; in other words, banks' surplus funds could not be deposited with the Bank at a predetermined interest rate, which served as a floor for other short-term interest rates. A more active interbank market should therefore have developed, since banks would be reluctant to borrow from the Bank for a week under the repo system when their need for such cash could quickly disappear. The absence of a floor interest rate structure would also operate in the same direction. A more active interbank market would mean that rates in this market were more responsive to changes in banking conditions, and would therefore give a better signal to the central bank of general monetary conditions.

3.3.4.1 Implications for interest rates and the rand

Under these new arrangements the domestic environment for interest rates was bound to change significantly. For one thing, the huge money-market shortages and pressures on banking liquidity that characterised South Africa for most of 1996 were unlikely to recur under the new accommodation system. Relatively high shortages of liquidity in the banking system should have caused the repo system to be bypassed in the sense that banks, rather than carry on driving the repo rate upwards through their tendering for funds from the Bank, should at some point have sought to acquire cash from foreign sources.

In addition, under the new arrangements money-market interest rates were expected to prove to be more variable, with greater flexibility introduced into the workings of the money market, although it should not have been expected that the new repo system would lead to a permanently lower level of interest rates. This new accommodation system was more market-orientated than the previous system, furnishing the financial markets with more scope to shape movements in interest rates. Rigidities in money-market rates were exacerbated under the previous system which allowed banks unlimited access to overnight loans from the central bank at a fixed Bank rate, provided they had the necessary collateral. Under the previous system short-term interest rates did not respond immediately to changes in the overall liquidity situation in the banking system; in other words, the size of the money-market shortage did not have a material effect on interest rates. In circumstances where the money-market shortage was

rising, banks did not normally raise their interest rates if they expected Bank rate to remain unchanged. This, in turn, meant that suitable monetary signals were not always forthcoming under the previous system when banking liquidity tightened.

Moreover, the Bank's influence on liquidity in the banking system had at times been less effective since roughly the middle of 1994 when the remaining financial sanctions on the country disappeared. South African banks then had access to an external source of finance, and did at times become less dependent on the accommodation facilities offered by the Bank which, as a result, lost some influence over short-term interest rates.

Under the new repo system interest rates were not influenced by the Bank in the somewhat inflexible manner that prevailed under the previous somewhat rigid Bank rate system. The new dispensation also meant that the overdraft rates, and other key bank interest rates would most probably be set by the market-determined repo rate rather than the old Bank rate. Moreover, more flexible interest rates would emit clearer signals to the monetary authorities concerning monetary conditions. All this meant that monetary policies would reflect market forces to a greater extent than had previously been the case. The repo system would demystify and depoliticise the Bank rate instrument to some extent, but such a system would not absolve the Bank from its responsibility of still influencing interest rates.

The desirability of creating a more flexible interest rate environment was partly due to the process of financial liberalisation which was under way, as well as the reintegration of the South African economy into the world economy. The progressive relaxation of exchange controls since 1995 had resulted in increased volatility of foreign capital inflows and in the exchange rate. In order to act as a more effective buffer against these fluctuations it was important that short-term interest rates were more sensitive to such changes on the external front.

One of the motives behind the new system was the attempt by the authorities to generate greater stability in the external value of the rand by creating a more flexible interest rate environment. More specifically, such an environment should have led to greater foreign capital inflows as interest rates rose, and therefore any weakness in the rand should become better contained. Ideally, under the new system more flexible money-market rates should have helped to stave off an attack on the rand without the same need for intervention in the currency market by the Bank. Numerous countries had moved away from large-scale intervention in foreign exchange markets, and had come to rely on domestic liquidity management as the most important tool for monetary policy. This was the direction in which the Bank was moving at that juncture.

One implication of the new arrangements therefore could have been reduced intervention in the forward exchange market by the Bank for purposes of supporting the spot rand rate. This would have helped to reduce the size of the outstanding commitments of the Bank to sell dollars forward in the forward market, other things remaining equal. At that point, however, exchange controls were still restricting banks from holding sufficient amounts of foreign balances to enable them to provide adequate amounts of forward cover for the needs of importers and exporters. Although the Bank was keen to extricate itself from the forward foreign exchange market, it could not do so before the banks were in a position to fill the vacuum.

Since the implementation of the new refinancing system in 1998 various deficiencies had been identified, which complicated the functioning of the system. Turmoil in the international financial markets adversely affected the South African foreign exchange market, and drained liquidity from the South African money market. In this situation, the Bank had to keep the domestic market tight by reducing the amount of liquidity made available to the banks at the daily repurchase facility, which forced the repo rate and other domestic interest rates to extremely high levels.

Another deficiency concerned the spread between the repo rate and the interbank rate, which was judged to be too large, leading to limited participation in the daily repo tender. Participation in the tenders became largely limited to the four big banks. This meant that although the repo rate was a leading short-term interest rate indicator, it reflected only the liquidity position of participating banks. It was therefore concluded that a smaller spread between the repo and the interbank rate should ensure wider participation in the daily repo auctions, providing a better indication of liquidity conditions in the market. Such a smaller spread was accordingly introduced in the second half of 2001.

In addition, over time the monetary authorities became dissatisfied with the floating repo rate system introduced in March 1998 and later changed it to a fixed rate system. As noted previously, the floating rate system was introduced partly to allow the banks to signal their underlying liquidity positions to the Bank, while at the same time allowing the Bank to send signals relating to its intentions on the monetary policy front. However, in practice the banks did not participate in the signalling procedures in the way that was intended in the sense that they seemingly did not always reveal their true liquidity positions. This same problem arose for some other central banks that started with floating repo rates, but then returned to fixed repo rates.

The operation of a floating repo system proved to be particularly unsatisfactory during periods when interest rates were rising. Once the

markets anticipated higher rates, they could become confused. This uncertainty led to greater volatility in interest rates. The uncertainty, in turn, stemmed in part from speculation in the markets as to how high the Bank would allow interest rates to go. There was also a danger that the floating repo rate system might generate greater exchange rate uncertainty, which would exacerbate lead-and-lag operations in the local foreign exchange market.

The Bank concluded that because it was the final creator or destroyer of banking liquidity, it was the best judge of the state of liquidity at any given time and how it would change. In addition, it should be the best judge of the level of interest rates that was necessary for its inflation target to be reached, and this should be signalled to the market in an unambiguous manner. In line with this reasoning, the authorities concluded that a fixed repo rate system should furnish such an unambiguous signal to the markets.

3.3.5 Sources and implications of money-market shortages

The aggregate amount of refinancing assistance that was extended to the banks by the Bank on a daily basis was known as the 'money-market shortage' and the amount of this shortage was published daily. The size of this shortage on any particular day reflected independent developments in the banking system as regards flows of liquidity, where the latter may well have been affected in part by actions undertaken by the Bank in the markets separate from its refinancing operations, or lack of action by the Bank in providing cash reserves in other ways than through accommodation. The daily shortages in the money market in particular were reflected in the borrowings made by the major clearing banks in South Africa at the daily tenders with the Bank under the new accommodation system introduced in March 1998, as well as resort to the marginal lending facility of the Bank. These borrowings were made necessary by the need to meet deficits that were faced by certain banks arising out of the daily cheque clearance system.

The clearing of cheques on a daily basis involved settling net claims between the banks themselves, as well as between the banks, on the one hand, and the government and the Bank, on the other. Settlement of the resultant debit and credit positions of the banks themselves, and between the banks and the government and Bank would normally mean that one or several clearing banks would become overdrawn on their current accounts. This came about because the clearing banks did not keep much, if any cash, in these accounts above what they were legally forced to do, in view of the absence of interest on most of these funds, and the fact that the accommodation rates were not normally prohibitively expensive. Since access to the central bank's refinancing facilities was automatic and unconditional to any amount, this further encouraged banks to avoid maintaining excess cash balances with the Bank. The banks that

were in debit at the daily clearing would accordingly seek to obtain financial assistance from the Bank.

Roughly 85 per cent of banking business in South Africa in the 1990s was conducted by the four big commercial banks and they were the dominant clearers. On this basis it must have been expected that these banks would be by far the biggest users of the accommodation facilities at the Bank. Clearing banks would attempt to avoid undertaking significant repos with the Bank arising out of deficits at the daily cheque clearings by borrowing from other banks. Nevertheless, the dominant clearing banks as a whole regularly sought short-term finance from the Bank for liquidity requirements from the settlement process. It was only when the shortages in the money market rose to around R6 billion or more that some of the smaller clearing banks could become noticeable borrowers from the Bank.

There were, however, occasions when non-clearing banks could seek accommodation from the Bank. There were times when a non-clearing bank might run short of cash reserves due to the expansion of its bank deposit liabilities. In their efforts to accommodate customers, as well as remain fully invested, banks could often extend loans in anticipation of inflows of loanable funds from deposits or money-market sources. Loans to the non-monetary private sector added to the deposit liabilities of banks, but not to their cash reserves. It was therefore the case that a non-clearing bank might not possess enough cash reserves to meet its reserve requirements against the new deposits, especially because it most probably held little excess cash reserves. It then entered into repos with the Bank, and possibly borrowed at Bank rate in order to meet its reserve requirements. Sudden and large increases in money-market shortages, however, were most unlikely to emanate from these circumstances. It could be argued in certain situations that if banks needed cash reserves from the Bank because of their expansion of bank credit, this pointed to a Bank monetary policy that was not sufficiently restrictive. In other circumstances a non-clearing bank could seek accommodation because rates in the wholesale markets had been bid up aggressively by the clearing banks who had entered into repos with the Bank on a large scale and borrowed at Bank rate. Lack of ready funds in the wholesale market might then induce the non-clearing bank to seek accommodation from the Bank.

Naturally, the rates quoted on retail and wholesale deposits by the four big banks did, to some extent, reflect the cost of their repos with the Bank as well as Bank rate assistance. These rates which they quoted for deposits, however, were not always equal, indicating that a degree of competition for deposits did exist in this area between the four big banks, although competition for funds in the interbank market had been blunted to some extent by the ever-present indebtedness of the big four in aggregate to the Bank. Nevertheless, the rates that these four big banks quoted inevitably affected the rates quoted by other smaller banks. At the same time it was

the case that if the big four were extensively relying on assistance from the Bank and did not actively seek to reduce their tenders and borrowings from the Bank by bidding up rates for deposits in the market, they could find that their deposit rates became somewhat uncompetitive vis-à-vis other banks outside the big four.

A large money-market shortage at any particular time was likely to push the banks into seeking accommodation from the Bank, involving the use of the marginal lending facility with its less favourable interest rates under the repo system introduced in 1998. Moreover, large money-market shortages could indicate that the Bank was keen to see market interest rates higher than they were, and that the next move in official rates by the Bank was more likely to be upwards than downwards. However, large money-market shortages were by no means guaranteed to precipitate an increase in Bank rate, even though repo rates would have risen. Large shortages in the money market under normal circumstances were unlikely to be sustained for long periods. Accommodation from the Bank could always provide temporary relief for acute shortages of liquidity, but with the passage of time banking liquidity was likely to improve. This might have involved a rise in Bank rate, but it was not inevitable.

Instead, the shortages tended to be volatile in nature, reflecting the instability of the forces that either boosted or drained cash reserves from the South African banking system, such as fluctuations in the balance of payments. The shortages were likewise difficult to forecast on a short-term basis from one week to the next.

Over the years there had been certain factors at work which, by themselves, had served to reduce the levels of shortages in the money market. The lifting of financial sanctions against the country, particularly after April 1994, boosted banking liquidity for a while. In effect, the increased availability of foreign finance from April 1994 until early in 1996 rendered the commercial banks less reliant on the Bank for accommodation than would otherwise have been the case. Foreign liabilities of banks, including on-lending of foreign funds to clients, had risen from R10,8 billion at the end of 1992 to R24,7 billion at the end of May 1995. A similar influence on the need for accommodation was created when in 1993 the government decided to open bank accounts called 'tax and loan accounts' with the four big commercial banks. Previously, the government had kept its banking accounts solely with the Bank.

There were, nevertheless, various factors that could cause the money-market shortage to reach very high levels. One was large shifts of funds from the banking system to the banking accounts kept by the government with the Bank. Such movements in funds might in particular have emanated from tax payments that occurred, for instance, when provisional taxpayers

fulfilled their obligations in respect of provisional tax. Large issues of government stocks could also on occasion drain liquidity from the banking system. These various outflows could be troublesome, but large shortages of liquidity in the banking system arising from these sources did become less likely once the government started to keep bank accounts with the four big commercial banks in 1993. This meant that large amounts of funds flowing to the government could be either partly or wholly channelled into these accounts, which comprised part of the private banking system, rather than being placed in the government accounts at the Bank where the money was no longer “in circulation”.

One regular factor that increased the money-market shortage was the outflow of the notes and coin from the banking sector on both sides of month-ends as wages and salaries were paid, leading to increased shopping and settlement of accounts. There were particularly large increases in notes and coin in circulation during the last few days before Christmas, as well as during periods leading up to the start of school holidays and long weekends.

Another factor that could lead to a draining of banking liquidity was a sudden large outflow on the capital account of the balance of payments, which, against the background of restrictive exchange controls, induced the Bank to intervene in the foreign exchange market on a significant scale by selling dollars and buying rands. In the process this caused the net gold and foreign exchange reserves of the banking system to decline. Under these circumstances the banks bought foreign exchange from the Bank and, for purposes of paying for this currency, they may have needed to enter into repos with the Bank and possibly to borrow rand from the Bank since they were unlikely to possess the necessary cash in their accounts kept at the Bank. Such a set of circumstances arose during April 1996 under the previous accommodation system when the rand fell sharply against the dollar, and on 30 April 1996 the money-market shortage reached a record R10,8 billion compared with a previous record of R8,8 billion.

It should be noted, however, that the flows in the foreign exchange market only affected money-market liquidity if the transactions originated in the banking system. Any foreign exchange flows arising from transactions by the government therefore had no effect on the money market if such transactions flowed via the government accounts kept at the Bank, because such accounts were not classified as part of the banking system. This was in contrast to the case of tax and loan accounts which were kept by the government with the leading commercial banks.

As previously noted, it was not necessarily the case that a large money-market shortage reflected the excessive creation of credit by banks. Any lack of restraint in the lending and money creation of banks essentially reflected a Bank monetary policy that was too permissive.

A large increase in the money-market shortage placed upward pressure on short-term interest rates, partly because the banks scrambled to borrow in the markets to minimise their use of accommodation at the Bank which was expensive, and partly because high levels of shortages in the money market led to speculation that Bank rate would be increased. Extensive use of repos and borrowings by the banks with the Bank might also have led to a dearth of trading in the Treasury bill market since the banks could use large amounts of Treasury bills for purposes of entering into the repo transactions with the Bank, and borrowing funds under the marginal lending facility.

3.3.6 Steps to reduce money-market shortages

The Bank could ease its monetary policy stance and in the process reduce money-market shortages that existed at any particular point in time. This could be done, *inter alia*, by

- (a) increasing the net gold and foreign exchange resources by buying foreign exchange from the market, either from the banks or, through the banks, from the clients of the banks. This practice, however, was particularly difficult to execute if the money-market shortages that prevailed were directly due to weakness of the rand as a result of shortages in the foreign exchange market. In buying the foreign exchange, the Bank would either credit the current accounts of the banks held at the Bank, or write out cheques drawn on itself in favour of the banks' clients which would boost the banks' cash balances with the Bank as a result of the clearance of the cheques at the daily clearing. The banks would then use the new cash balances they had acquired to reduce the amount of accommodation they required from the Bank;
- (b) increasing the Bank's net claims on the government sector by buying government bonds from the Treasury with the latter then spending the new money it received which added to the liquidity of the banking system. Alternatively, the Bank itself could buy government stocks in the market, thereby pushing cash into the system;
- (c) transferring balances from the government's accounts with the Bank to the tax and loan accounts kept by the government with the major private banks. This again boosted the liquidity of the banking system;
- (d) arranging for the Corporation for Public Deposits (CPD) to place funds in the market. The function of the CPD was to serve as a repository for short-term temporarily idle funds of bodies and organisations in the public sector including government departments and provincial administrations. The funds that were deposited with the CPD were mostly invested in short-term financial instruments such as Treasury bills and short-term government stocks. Thus, the CPD might have government

stocks in its portfolio that were maturing, and the Bank might arrange for the redemption proceeds to be invested in the market, rather than reinvested in government stocks; and

- (e) currency swaps with banks could be undertaken under which banks could sell dollars to the Bank for rands, and the dollars so deposited were, in turn, bought forward from the Bank at some predetermined exchange rate in the future with rands being sold back to the Bank. Such deposits would have been for short periods, but could have been rolled over if necessary.

All these steps to reduce shortages in the money market were tantamount to increasing the money supply. Accordingly, if the money supply was already growing at a rate that exceeded the money supply target, the Bank would be very hesitant about reducing the money-market shortage at its own initiative.

There were some advantages from a monetary policy point of view in having money-market shortages that stayed relatively high. Such shortages helped the Bank to keep a rein on the extension of bank credit by the banking sector, because such shortages squeezed the profit margins of banks and therefore, to some extent, discouraged the extension of new bank credit. High money-market shortages also encouraged banks to use more of their funds for the purchase of assets that could be employed for repos and borrowings with the Bank and this again acted as a constraint on the expansion of bank credit.

At the same time, such conditions served to widen the spread between Treasury bill rates and bankers' acceptance rates in the money market. Heavy concentrations of eligible paper in the form of Treasury bills in the portfolio of private banks could prevent markets in such instruments from being truly free and active at certain times.

3.3.7 Relationship between money-market rates and accommodation rates

Under the new operational procedures for accommodation introduced in March 1998 it was expected that certain banks would normally need to borrow limited funds at Bank rate under the new marginal lending facility, albeit only for a day or so. It was therefore the case that under the new arrangements, Bank rate usually formed a kind of upper limit to the overnight money-market rate. This was because when liquidity positions were well balanced, no bank would normally pay higher rates in the interbank market than it had to pay to the Bank under the marginal lending facility. However, when bank liquidity was in short supply, and considerable funds had already been borrowed under the marginal lending facility, it was conceivable that overnight money-market rates might on occasions exceed Bank rate.³⁵ Under such conditions upward pressures on short-term

interest rates could then force the hands of the authorities as regards raising Bank rate.

Nevertheless, over extended periods the structure of South African banking, as well as that of the South African money market, invariably meant that market interest rates traded below Bank rate to a significant degree and even below the repo rates in a neutral environment where interest rates were concerned. The four big commercial banks recognised that they would always be borrowers in aggregate from the Bank, because the latter conducted its monetary policies with a view to perpetuating money-market shortages. The big banks therefore accepted the shortages as largely given, and assuming there was a neutral expectational environment where interest rates were concerned, the banks did not normally bid aggressively against one another to obtain short-term funds from the market, and thereby reduce their reliance on repos with the Bank. This often meant that short-term interest rates traded at levels below the repo rates.

3.3.8 Importance of accommodation for monetary policy

Accommodation policy was a key instrument of monetary policy in South Africa during the 1990s, and indeed was the dominant monetary policy instrument in use. It consisted of deliberate variations in the terms and conditions on which accommodation was granted. Any such variation altered the stance of monetary policy. In South Africa accommodation was granted immediately, automatically, unconditionally and to the full amount of the shortfall in the banks' aggregate cash balances as previously indicated. This meant that variations in the interest cost of accommodation clearly constituted the only way in which the terms and conditions of accommodation could be changed. Bank rate and the repo rates were therefore varied to have an effect on the general level of interest rates in the economy, and had an effect on aggregate spending, prices, the money supply and the balance of payments.

As a broad generalisation it was the case that the influence of the accommodation rates charged by the Bank on short-term interest rates in the money market was marked. This stemmed from the fact that the Bank was the ultimate monopoly supplier of cash reserves to the banking system which, as previously explained, regularly needed cash assistance from the Bank on a daily basis. The repo and Bank rates clearly had a profound influence on the interbank call rate, and this affected other short-term rates of interest which then impacted, to some extent, on long-term rates.

This meant that as a matter of policy, shortages in the money market should not be allowed to disappear completely since under those circumstances the accommodation rates became irrelevant because the banks were no longer seeking finance from the Bank, and short-term interest rates might fall sharply. It was therefore not surprising that no elimination of the shortages

in the money market occurred in the 1990s. This was a deliberate policy on the part of the central bank.

It would, however, be an oversimplification to conclude that the Bank determined the level and structure of interest rates at all times. Instead, the various interest rates were determined basically by supply and demand in the relevant financial markets, with the central bank influencing these rates as an integral part of its monetary policy. More particularly, while the central bank was able to influence the level of short-term rates directly, it could not directly control long-term bond market rates.

At the same time, while the Bank had control over the repo rate, it had to accept that the quantities of high-powered money, and the level of banks' cash reserves were determined by operations in the financial markets. The Bank could not simultaneously control the repo rate and aim for a specific quantity of high-powered money and cash reserves in the banking system. It chose to control the repo rate.

Changes in repo rates and Bank rate were not regarded by the Bank as its sole instrument of monetary policy. Other instruments, such as open-market operations and changes in cash reserve requirements, could supplement Bank rate policy, and could, on occasion, be used as precursor to a change in the accommodation rate. In certain countries such instruments fulfilled a more important role than in South Africa. However, in assessing the possibilities for an enhanced role for such instruments in South Africa, it should be noted that they may have been of limited effectiveness on the interest rate front, and could have introduced distortions in the banking system.³⁶

3.4 Other monetary policy instruments

3.4.1 Relationship between refinancing policy and other monetary policy instruments

It has already been indicated that the Bank did not view changes in Bank rate and the associated other refinancing rates as the sole instrument of monetary policy. In this respect the refinancing (accommodation) policy was supplemented by the use of other instruments of monetary policy. More specifically, it was supplemented by the use of open-market operations and, to a much lesser extent, by public debt management policies. Changes in the cash reserve requirements could also be resorted to if need be as part of the arsenal of monetary policy instruments at the disposal of the central bank. These instruments were basically used to support the Bank's accommodation policy which was the prime instrument employed by the Bank in the 1990s; in other words, these other instruments were used primarily for "making the central bank's accommodation policy effective". All the instruments of monetary policy, moreover, were geared to curbing

the growth in the M3 measure of the money supply, such that it was in line with the target laid down for this measure of the money supply.

The Bank also employed a group of external policy instruments to support its general monetary policy objectives. At times the Bank made use of its foreign credit lines to supplement its foreign exchange reserves, and intervene in the foreign exchange market by selling foreign currencies to try and eliminate what it perceived to be excessive volatility in the rand exchange rate. Such operations, as already noted, destroyed cash reserves in the hands of domestic banks, thereby affecting the shortages in the money market. This had a direct contractionary effect on the money supply, and might have exerted an indirect effect by influencing the creation of credit by banks. Foreign borrowings and intervention by selling in the foreign exchange market therefore supplemented the other instruments of monetary policy. The Bank could, of course, also from time to time intervene in the market by buying foreign exchange, which would have the effect of increasing domestic liquidity.

What is more, exchange control regulations were in force in South Africa in the 1990s with a view to protecting the foreign reserves and the exchange rate. Such controls represented an instrument of monetary policy, since in the absence of such controls more reliance would have to be placed on the other instruments of monetary policy to support the exchange rate, and protect the foreign reserves. Over the years numerous changes had been made in the controls, often in response to fluctuations in the balance-of-payments position. However, these controls were progressively being phased out by the second half of the 1990s, and their importance was steadily diminishing. The controls on non-residents were abolished in March 1995, and significant relaxations in the controls on residents were subsequently introduced during the rest of 1995 and 1996, and thereafter. These included a doubling of the local borrowing facilities of foreign-controlled firms operating in South Africa. Restrictions on outflows of capital by South African corporates were also eased by initially allowing the transfer from South Africa of up to R20 million in respect of any new investment project in foreign countries which had been approved by the exchange control authorities. In addition, a dispensation was created whereby limited foreign investments by South African financial institutions could be undertaken, while permission had been granted for corporates to offset foreign import commitments against export proceeds.

This programme of progressively phasing out exchange controls received a further boost in July 1997 when relaxations in the controls over the corporate sector, financial institutions and resident individuals were introduced. More specifically, from 1 July 1997 registered South African taxpayers in good standing over the age of 18 were allowed to invest R200 000 abroad. Further general concessions on the exchange control front were introduced in 1998 and 1999.

These moves to phase out exchange controls had major implications for the future conduct of monetary policies in South Africa. More specifically, the phasing out of exchange controls was going to further increase the importance of refinancing policy, and the supplementary instruments such as variations in cash reserve requirements and open-market operations.

3.4.2 Public debt management

Public debt management makes reference to changes in the size, the composition by type of security, the maturity structure, and the ownership of the debt of the public sector that is outstanding and, more particularly, the outstanding debt of the central government. Public debt management therefore includes the important facet of new borrowing operations undertaken by the government sector and, in particular, the ways in which budget deficits are financed.

3.4.2.1 Ways of integrating public debt management with monetary policies

Public debt management could, in principle, be used as an instrument of monetary policy in a variety of ways. First, it might be employed, in close co-ordination with the central bank's own open-market operations, in support of the central bank's accommodation policy in order to make the Bank's accommodation rates effective. Thus, side by side with open-market sales of government stocks by the central bank which were designed to drain liquidity from the banking system, the government might reduce its budget deficit by raising taxes. Second, the government might, for example, agree to borrow from overseas sources for the specific purpose of strengthening the country's foreign reserves position, and providing the central bank with resources for intervention in the foreign exchange market to support the currency.

Third, the government might occasionally agree to borrow amounts in excess of its budgetary deficits (i.e., engage in temporary "overfunding") in order to exert a direct and immediate depressing influence on the money supply, even though this created a new budgetary burden in the form of higher interest rate payments flowing from the larger public debt. To have such an impact, such borrowing had to come from domestic non-bank private-sector parties whose money holdings were counted as part of the money supply. It should then also be noted that such borrowing, which drained liquidity from the banking system, could easily lead to requests by the banks for extra accommodation from the central bank.

In all such cases the deliberate use of public debt management as an instrument of monetary policy entailed some modification of the debt management behaviour of the Treasury. In some countries public debt management policies constituted an important aspect of monetary policy. This was based on the argument that the day-to-day management of the public debt exerted an important influence on the money supply, interest

and exchange rates and actual spending. In the local context the De Kock Commission, which issued its report in 1984, argued that sales of government securities for public funding and debt management purposes and sales of government securities in open-market operations for monetary policy purposes influenced the cash balances of banks in a basically identical manner. It therefore argued in favour of close co-ordination of these two sets of operations. Close co-ordination was to come from intimate and regular consultations between the Treasury and the Bank.³⁷

Under such a monetary policy framework it was considered important for the central bank and the Treasury, working together, to monitor the size of the fiscal deficit before borrowing in order to ensure that such deficits could, as far as possible, be financed from the capital market without undue resort to bank credit. It was also considered to be important under this approach to monitor closely the maturity structure of the public debt. In this last respect excessive reliance by the government on short-term borrowing could have resulted in banks holding relatively large amounts of short-term government securities. The banks could then have adopted a more expansionary approach to lending on the assumption that, if necessary, they could use their excess Treasury bills, and short-term government securities with the central bank to undertake repos or use them as collateral for new loans with the central bank. Under this approach as well, as previously indicated, the Treasury might become willing at times to borrow in excess of its own financing requirements for the express purpose of draining liquidity from the banking system.

In the case of South Africa there were moves during the 1980s to integrate public debt management policies with monetary policies more closely. In subsequent years, however, public debt management came to be in the hands of the Treasury, and the Bank had largely to take this as a given in conducting its monetary policies. To a large extent, the Treasury could no longer be regarded as part of the 'monetary authorities', and in the course of the 1990s public debt management was not used systematically as an instrument of monetary policy in South Africa, even though the Treasury and the Bank consulted and co-operated with each other.

This state of affairs was not peculiar to South Africa. In numerous countries public debt management was not integrated with monetary policies. Several considerations helped to explain this situation. Numerous governments had granted central banks independence in respect of the formulation and implementation of monetary policies, while in other cases central banks had been given specific mandates to pursue price stability, which had been in line with their preferences. Some governments were therefore keen to exercise control over public debt management policies without being influenced materially by central banks as a means of asserting their independence in this area. Some governments might well have not wanted to be seen as being dictated to in any way by central banks in the area

of public debt management in an environment where some central banks enjoyed independence in the monetary policy arena. In addition, some governments, including that of South Africa, were confronted with large debts and budget deficits in the 1990s, and tended to be preoccupied with managing their fiscal burdens. They could therefore have possessed little inclination to try and integrate public debt management with central banks' monetary policies.

3.4.3 Open-market operations

'Open-market operations' refer to the purchase or sale by the central bank in the market of any kind of asset in which it deals, whether it be government securities or other securities, or bankers' acceptances or even foreign exchange. The aim behind these operations was to affect banking liquidity either positively or negatively. Open-market operations involving the purchase of securities by the central bank were usually undertaken for the specific purpose of injecting cash reserves into the domestic banking system. In contrast, open-market sales would be made for draining cash reserves from the banking system. Such operations would therefore affect the money-market shortages, other things remaining equal as explained previously. Prior to 1914 virtually the only central bank to carry out open-market operations was the Bank of England, but in the intervening period such operations had become a vital instrument of monetary policy for most central banks. Whereas public debt management policies constitute an unimportant supplement to the accommodation policies of the Bank in the 1990s open-market operations were far more important.

Such operations, for instance, were particularly important during 1995 when the Bank sought to absorb surplus liquidity created by the relatively large net inflows of capital from abroad. In the process the Bank's own portfolio of government stock declined from R8,8 billion at the end of 1994 to R4,8 billion at the end of 1995.

3.4.3.1 The goals of open-market operations: Defensive and dynamic

In the pursuit of various policy goals, central banks always have to keep in mind the fundamental objective of trying to contain inflationary pressures, and thereby create an environment conducive to greater economic growth. However, only a limited portion of a central bank's open-market operations is likely to be channelled directly towards that particular goal. Central banks are responsible on a day-to-day basis for stabilising the money and capital markets, and avoiding sharp changes in interest rates and liquidity conditions. In the 1990s a substantial portion of the open-market operations of central banks, including the Bank was devoted to making small adjustments in credit conditions and interest rates in order to keep the banking system functioning smoothly. These technical adjustments in market conditions are often referred to as 'defensive open-market

operations'. Their basic purpose in the Stals era was to preserve the status quo, and to keep the pattern of interest rates and banking liquidity roughly intact.

In contrast, when the central banks, including the Bank, were more concerned about the pursuit of their broader monetary policies, they would engage in dynamic open-market operations. These operations were designed to upset the status quo, and to change money and credit conditions to a level the central bank believed was more consistent with its broad goals pertaining to monetary policies.

3.4.3.2 Distinction between “open-market operations” and “open-mouth” operations

There were occasions when the Bank conducted so-called open-mouth operations, either as a supplement to open-market operations or independently of such operations. Open-mouth operations involved the Bank in furnishing the markets with a clear message with the intention of trying to change or reinforce perceptions in the market; in other words, they referred to what was known as ‘monetary policy signalling’. For instance, the Bank might verbally have indicated that it believed that interest rates were too low and might supplement this with appropriate open-market operations to drain cash from the banking system. It was also the case that open-mouth operations might be directed towards the foreign exchange market, and be supplemented by appropriate intervention in that market. Over the years the Bank became more willing to communicate with the press and the markets, and ‘open-mouth’ operations therefore became more important.

The signals that were sent out needed to be clear. The danger always existed that market participants would misinterpret open-market operations undertaken by central banks. The best way to guard against this was to make the setting of policy objectives and the actual monetary stance as open and transparent as possible.

3.4.3.3 Types of open-market operations

Unlike the position in some other countries open-market operations only became prominent in South Africa starting in the early 1980s. These operations by the Bank could be conducted in a variety of assets including Treasury bills, Land Bank bills, Land Bank promissory notes, bankers’ acceptances, and government stocks. Variations in the amounts of Treasury bills offered at the weekly tenders by the Bank could also be resorted to as a means of influencing money-market conditions on a short-term basis. Nevertheless, for some time the bulk of open-market operations consisted of transactions in government stock; the market for such securities being far larger than in the case of other securities such as Treasury bills. Long-term government stocks were the main vehicle employed by the Bank to

conduct open-market operations. There was only a limited market in short-term government paper, partly because banks kept such paper to comply with liquid asset requirements.

During the 1990s open-market operations were extended to include repurchase agreements under which tenders were invited on occasion from the banks for the sale of assets to the Bank for temporary periods before being bought back. Such repurchase agreements could be conducted using various securities, but typically were undertaken employing government or public corporation stocks. The Bank could also undertake repurchase agreements by selling assets to financial institutions for repurchase at a later date.

The Bank undertook transactions involving repurchase agreements with other local banks, and they did not exert a direct influence on the money supply. Instead, the direct impact of such transactions was concentrated on the cash reserves of the banks, and this impact on bank cash balances was reversed as soon as the reverse operation took place. It is not surprising therefore that repurchase agreements were usually reserved for situations in which the Bank wished to counteract temporary or seasonal influences on the cash base of banks. Transactions involving repurchase agreements did not form part of any dynamic open-market operations undertaken by the Bank.

In addition, foreign exchange swaps were executed occasionally to drain excess liquidity from the money market. Under this arrangement foreign exchange was sold spot to the banks for rand against a forward repurchase and was placed on deposit with the Bank where interest was earned. In effect, a portion of the Bank's reserves shifted from a spot position to a forward position. Such operations were, for instance, used actively from April to November 1991 to help eliminate short-term fluctuations in the liquidity of the local money market. Under different circumstances it was possible for the Bank to pump liquidity into the banking system by buying dollars on a spot basis in exchange for rands and selling the dollars on a forward basis in return for rands.

The Bank, unlike many other central banks, did not use Treasury bills and/or repurchase agreements as its main instrument of open-market operations. Instead, it preferred to buy and sell long-term government bonds to boost or drain liquidity from the market as already indicated. This preference was partly accounted for by the relatively undeveloped state of the local Treasury bill market, which therefore precluded extensive open-market operations in this market by the Bank. This preference was also explained by the regular need to drain liquidity from the system on a medium- to long-term basis. This, in turn, created a particular need to sell government stocks. In contrast, repurchase agreements were most suitable in circumstances where there was a temporary need to boost or drain liquidity from the banking system.

Moreover, repurchase transactions in rand assets in South Africa were not used actively, partly because of uncertainties that existed about the legal status of the credit risk involved in such transactions. Two conflicting legal pronouncements had been made in South Africa on this issue. In one case it was concluded that the buyer of the securities under a repurchase transaction had to meet any losses incurred as a result of the counterparty being unable to buy back the securities. In the other case it was concluded that the seller of the securities had to bear any losses which were incurred.

3.4.3.4 Issue of SARB debentures

As part of the new accommodation procedures introduced in March 1998, the Bank announced that it intended to start issuing its own debentures as a supplementary facility for banking institutions to invest short-term funds. It was anticipated that SARB debentures, when issued, would become acceptable financial instruments for the purpose of undertaking regular repurchase transactions between the Bank and the rest of the banking sector. These debentures, in effect, were designed to provide an additional investment facility for surplus short-term funds that may become available in the market.³⁸ They constituted a new form of open-market operation instruments at the disposal of the Bank.

3.4.4 Variations in cash reserve requirements

Variations in cash reserve requirements for banks (discussed in more detail in Chapter 4) could be used along with open-market operations as a supplement to the Bank's refinancing policies. Indeed, from its inception in 1921 the Bank had imposed cash reserve requirements on the banks.³⁹ An increase in the cash reserve requirements against some or all the liabilities of banks raised the banks' required minimum total cash reserves, and thereby curbed the ability of banks to create more credit. Cash reserve requirements, however, were based on the liabilities of banks at certain dates or during a certain period, and such liabilities would only be reported by the banks at some future date. Increases in cash reserve requirements were therefore likely to take effect only after a certain time lag, but could restrain and curb the growth in the money supply. The opposite effects materialised, moreover, if the cash reserve requirements were lowered.

There were, however, several drawbacks to the use of cash reserve requirements as an instrument of monetary policy. For one thing, they were slow to take effect as already mentioned. Variations in cash reserve requirements were also a crude weapon, because even small changes in the requirements could release or bottle up amounts of cash that were disproportionately large in relation to existing shortages of liquidity in the banking system. In view of these considerations it was not suitable to rely on manipulation of cash reserve requirements for purposes of management on a day-to-day basis of banking liquidity.

Moreover, another weakness was attributed to cash reserve ratios. It was often argued that they imposed an unfair 'tax' on banks which aided their competitors. Cash reserve requirements squeezed the interest margins of banks since in South Africa most cash reserves held at the Bank attracted no interest. Such requirements therefore put downward pressure on banks' deposit rates and upward pressure on the interest rates banks charged on borrowings. This encouraged the banking business to be conducted outside the banking system in the grey market. During the course of the 1980s the Bank lowered the cash reserve requirements on more than one occasion, partly with a view to addressing this issue of the tax on the banking system.

Later on, and more particularly in 1998, the role of cash reserve requirements did change in South Africa in the sense that the Bank started to use them as an instrument whereby excessive volatility in interest rates on a day-to-day basis could at least be reduced. Under the accommodation system in force before March 1998 cash reserve requirements had to be maintained at the legally specified minimum levels on every day during the maintenance period by the banks. Under the accommodation system introduced in March 1998 the averaging principle was introduced; in other words, the cash requirements had to be adhered to on an average basis over the maintenance period, which was one month and not every day. This meant that under the new dispensation the banks had more flexibility in managing their liquidity, since they were able to run down their cash reserves at the Bank, say early in the month, and then rebuild them later in the month in order to meet their overall cash reserve requirements. In effect, by allowing banks to utilise their cash balances both as working balances and to meet their cash reserve requirements, excessive volatility in interest rates on a day-to-day basis could be minimised.

3.4.5 Tax and loan accounts

Finally, in discussing the monetary policy instruments used by the Bank in the 1990s, reference can be made to the tax and loan accounts that were kept by the Exchequer with certain domestic private banks instead of being maintained with the Bank. These accounts derived their name from the fact that they could be credited with the proceeds of taxes paid by the non-bank private sector to the government, and with the proceeds of the government's borrowings from local private investors outside the banking system.

Tax and loan accounts were partly used for purposes of neutralising the impact on banking liquidity of inflows and outflows of funds related to government accounts. They allowed payments by parties in the private sector to the government sector to be made without causing the banking system to lose cash reserves, and they allowed payments by the government to private sector entities to be undertaken without boosting

banking liquidity. This arose because the tax and loan accounts were kept within the banking system and, consequently, payments by, for instance, taxpayers, to the government did not affect banking liquidity if the government deposited the cheques into tax and loan accounts kept by the latter with private banks. This was in sharp contrast to the impact of such tax payments on banking liquidity if the government deposited the cheques in the accounts it kept at the Bank. Such accounts were classified as outside the established banking system. Before the tax and loan accounts were introduced in South Africa in 1993, large fluctuations in banking liquidity occurred on occasions as funds flowed in and out of government accounts the government kept exclusively at the Bank.

Tax and loan accounts had another role to play as well. Transfers from, or to, the accounts of the government with the private banks to, or from, the government's accounts with the Bank could be undertaken for purposes of neutralising the unwanted effects on banking liquidity brought about by factors other than the financial operations carried out by the government, such as receiving large tax payments from the private sector. For instance, if the net gold and foreign exchange reserves fell significantly, thereby draining liquidity from the banking system, the government could arrange to transfer funds from its accounts at the Bank into the tax and loan accounts it kept with the four main commercial banks. In the process banking liquidity was boosted, which offset the previous loss of liquidity caused by the fall in the net foreign reserves.

In this respect, however, it should be noted that the usefulness of tax and loan accounts as an instrument of monetary policy did decline with the passage of time as the management of public sector cash flows improved. As already explained, movements of funds between the government's tax and loan accounts kept at banks and the accounts at the Bank influenced the liquidity of the banking system. However, by the late 1990s in an attempt to improve its cash management, the government normally no longer held large deposits with the Bank but, instead, kept the bulk of its funds with the commercial banks. This meant that it was not so easy to shift funds between the Bank and the commercial banks for purposes of fulfilling monetary policy aims.

Tax and loan accounts, which could be regarded as a special form of open-market operations, conferred another benefit, since they made monetary policy signals easier to read where market participants were concerned. In the past, when the Bank was active in the financial markets, particularly with the sale of Treasury bills and government stock, the markets did not always know whether the Bank was neutralising flows in and out of the Exchequer account, or whether it was financing part of the government's borrowing requirements, or was taking steps on the monetary policy front.

Under the new system, in which flows of funds between the private banks and the Bank were reduced and the amount of accommodation the banks need from the Bank fell, the latter's operations in the markets became more focused on open-market operations in managing money-market liquidity, and it was easier for the Bank to transmit its aims to the market. The aims of monetary policy became more visible. Finally, it should be noted that the government received interest on its tax and loan accounts, which was not the case with balances it kept in accounts at the Bank.

Chapter 4

The role of cash reserves in the South African banking system in the 1990s

4.1 Introduction

Since the establishment of the Bank in 1921 the Bank had acted as custodian of the cash balances of other banking institutions. It had performed this function partly for purposes of prudential banking requirements, that is, to protect the liquidity, solvency and safety of banks. However, the credit-creating capacity of banks had also been materially influenced by the amount of cash reserves that they had been required to keep with the Bank according to law. Consequently, adjustments in the cash reserves of banks had also been used as an instrument of monetary policy as mentioned in Chapter 3.

The justification of cash reserve requirements in the South African context was also based on the notion that banks were special institutions that obtained a banking licence from the Registrar of Banks, and were required to become special members of the central bank “club” by virtue of the requirement that they must hold an interest-free cash reserve with the Bank. In exchange for this obligation, they received access to the “lender of last resort” facilities of the Bank.

The legal cash reserve requirements in force in South Africa had taken different forms at different times. As from February 1991 the cash reserve balances had to be maintained in terms of section 71 of the Deposit-Taking Institutions Act of 1990 until March 1993 when the Act was renamed the Banks Act (Act No 94 of 1990), and section 71 was repealed. It was then decided to include the cash reserve requirements in section 10A of the Reserve Bank Act.

4.2 Changes in cash reserves in the 1990s

Until early June 1992 all deposit-taking institutions had to hold a minimum cash reserve equal to 4 per cent of their short-term liabilities to the public. This required minimum cash reserve included vault cash held by each institution. However, as from the date of certification of the monthly statements DI310 for the month of June 1992, each registered deposit-taking institution was required to maintain in a special deposit account with the Bank an additional cash reserve equal to 1 per cent of its total short-term liabilities as determined in terms of section 71 of the Reserve Bank Act. In total, banks from that date onwards were forced to hold a minimum

cash reserve equal to 5 per cent of their total short-term liabilities to the public. Interest at a rate of 2 per cent below the rate on the latest weekly tender issue of 91-day Treasury bills was to be paid on the daily balances in the special deposits account, up to the limit of 1 per cent of each bank's latest applicable figure for outstanding short-term liabilities.

This move came against a background in which the gold and foreign exchange reserves of the Bank increased by around R2,5 billion in the first five months of 1992 which helped to raise liquidity in the money market, and created a situation in which banks were making only limited use of accommodation from the Bank. Short-term rates of interest had declined significantly, and projections made at the time indicated that there could be a further substantial addition of liquidity to the money market until the end of August 1992. The Bank was therefore fearful that for a temporary period short-term interest rates could decline further to levels that would not be sustainable, and to levels below the prevailing rate of inflation. In order to accommodate these anticipated short-term fluctuations in money-market conditions, which could have led to volatile fluctuations in money-market interest rates, the Bank therefore decided to provide various additional facilities to banks for the investment of surplus short-term funds. This included a rise in cash reserve requirements. At the time the Bank believed these measures would enable the authorities to maintain orderly market conditions, while being consistent with the macroeconomic policy objectives of the monetary authorities.⁴⁰

In contrast, during most of 1993 money-market conditions were relatively tight, mainly due to a decrease in the Bank's net foreign assets (including gold). At the same time, however, an increase in notes in circulation and a decrease in the financing of the Land and Agricultural Bank by the monetary authorities, as well as an increase in government deposits with the Bank in certain months also supported these tighter conditions. The Bank prevented money-market conditions from becoming too tight by injecting additional liquidity into the domestic money market, partly by lowering the minimum cash reserve requirements that banks had to comply with in both May and August 1993. These reductions released approximately R2,2 billion of cash reserves previously held with the Bank.

It was also the case that in 1993 a new simplified basis for the calculation of the banks' minimum cash requirements was introduced. The new basis included all the liabilities of the banks without making any distinction between short-, medium- and long-term liabilities. Banks were, however, allowed to deduct from their total liabilities their issued share capital and accumulated reserves.⁴¹

The next change in cash reserve requirements came about in March 1998 when a new averaging provision was introduced in the application of the minimum cash reserves that banks had to maintain at the Bank as

mentioned in Chapter 3. In effect, from that date banks no longer had to maintain the required minimum cash reserves with the Bank on a daily basis. Instead, they were allowed to meet the cash reserve requirements on the basis of an average amount calculated over each maintenance period of one month. This allowed banks automatic recourse to their cash balances with the central bank on a daily basis as long as the average level of reserves during the maintenance period equalled or exceeded the minimum cash reserve requirement. From March 1998 these balances at the central bank could accordingly be used to supplement unexpected shortages of funds.⁴²

This meant that under this new dispensation banks had more flexibility in managing their liquidity, since they were able to run down their cash reserves at the Bank early in the month, and then rebuild them later in the month as noted in Chapter 3. In effect, by allowing banks to utilise their cash balances both as working balances and to meet their cash reserve requirements, excessive volatility in interest rates in the money market on a day-to-day basis should have been minimised.

At the time of this mutation the minimum cash reserve requirements for banks stood at 2 per cent of the value of their total liabilities (as adjusted) on which no interest was paid, plus 1 per cent of their short-term liabilities (as adjusted) on which interest was paid. At the end of 1997 banks were required to hold approximately R12 billion in total as a minimum cash reserve balance with the Bank in terms of these reserve ratios. If the vault cash holdings of banks of R6,2 billion at the end of 1997 were subtracted from this total, this left approximately R6 billion available for the averaging provision.

Unfortunately, different reserve requirements on different deposits can distort the application of an average cash reserve requirement. In March 1998 the Bank therefore decided to simplify the system of cash reserve requirements by applying only one reserve ratio of 2,5 per cent on total liabilities (as adjusted), beginning from the maintenance period starting on 23 April 1998. According to liability positions at the end of 1997, this meant that the total cash reserve requirements of the banks were reduced by about R500 million to R11,5 billion. However, after 23 April 1998 no interest was paid on any part of the minimum cash reserve balances.⁴³

4.3 Role of cash reserves as an instrument of monetary policy

Variations in cash reserve requirements for banks in the 1990s could be used along with open-market operations as a supplement to the Bank's refinancing policies as already mentioned in Chapter 3. Indeed, from its inception in 1921 until the 1990s the Bank had imposed cash reserve requirements on banks. Such requirements, however, could vary considerably from one country to another. An increase in the cash reserve

requirements against some or all of the liabilities of banks (normally the short-term liabilities of the banks to the public) raised the banks' required minimum total cash reserves, and thereby curbed their ability to create more credit. Cash reserve requirements, however, were based on the liabilities of banks at certain dates or during a certain period, and such liabilities would only be reported by the banks at some future date. Increases in cash reserve requirements were therefore likely to take effect only after a certain time lag but, nevertheless, could be employed to squeeze banks' cash reserves and curb the growth in the money supply. The opposite effects materialised, moreover, if the cash reserve requirements were lowered.

There were, however, several drawbacks to the use of cash reserve requirements as an instrument of monetary policy. They were, for instance, slow to take effect and these cash reserve ratios were alleged to impose an unfair "tax" on banks, which distorted their operations and aided their competitors as previously mentioned.

In certain countries central banks had dispensed with statutory cash reserve requirements altogether, or had reduced them to very low levels, but this did not occur in South Africa. The authorities found it useful to retain these requirements, because changes in such regulations could be useful in handling sudden, large and sustained increases or decreases in the banks' holdings of cash, which might, for instance, stem from balance-of-payments developments that affected the foreign reserves position. In these circumstances, the effective management of the change in the cash reserves by means of open-market operations on its own might have proved to be unsatisfactory.

The respective roles of open-market operations, on the one hand, and variations in cash reserve requirements, on the other, as instruments of monetary policy had long been discussed. Whereas some analysts had suggested that central banks should make greater use of cash reserve requirements as an alternative or supplement to open-market operations, central banking authorities, including the Bank, had generally been opposed to the active use of variations in cash reserve requirements.

At times the instruments of monetary policy employed by the Bank were supplemented by the use of cash reserve requirements. These were originally introduced partly for purposes of prudential banking requirements, as previously noted. They were later used as a supplementary instrument of monetary policy from time to time. Nevertheless, the minimum cash reserve requirements diminished in importance as an instrument of monetary policy in the 1980s, because the South African monetary authorities placed a greater emphasis on open-market operations.

The same pattern also emerged in other countries during the 1990s. In that period there was a general tendency to simplify reserve requirements

and lowering reserve ratios. At the same time marked differences existed between countries in the actual pattern of the minimum reserve balances. When South Africa's requirements were compared to those of the rest of the world in the 1990s, it was important to take account of the following considerations:

- (a) Reserve balances held with central banks in some countries attracted interest and not in others.
- (b) Differences existed in different countries as regards the borrowing facilities available to banks at their central bank. Banks that enjoyed generous borrowing facilities would find that they needed lower cash reserves, and therefore found high cash reserve requirements more onerous.
- (c) Differences existed in liquidity fluctuations in national money markets. Where marked fluctuations in liquidity occurred, legal minimum cash reserve requirements could prove to be more onerous.
- (d) The fees charged by central banks for services differed. High cash reserve requirements would seem less onerous if a central bank provided its services for small fees rather than no compensation at all.

4.4 Payment of interest on reserve balances

Originally, when central banks became the banker for commercial banks it was argued that they should not pay interest on reserve deposits because it served to emphasise the fundamental differences between central banking and commercial banking. Nevertheless, in the 1990s a number of central banks did pay interest on reserve balances and, it could be argued that they were in a position to afford to do this. A significant part of the resources of the Bank were provided by the banking system through the cash reserve requirements. In April 1997 these resources amounted to approximately R6,6 billion (R4,04 billion on the Reserve no. 1 account and R2,58 billion on the interest-bearing Reserve no. 2 account).

The De Kock Commission recommended that the Bank be authorised to pay interest on reserve balances. This recommendation was accepted in the sense that the Reserve Bank Act was amended accordingly in 1984. The Bank, however, did not take advantage of this new flexibility to pay interest on cash balances until 1992, and then only on a limited basis. With the introduction of the new accommodation procedures in March 1998, and in an effort to simplify the cash reserve requirements, a single reserve ratio (2,5 per cent of total liabilities) was announced. This was accompanied by a decision to do away with the payment of interest on any part of the minimum cash reserve balances as previously indicated. At the same time, a decision to issue SARB debentures for the management of bank liquidity

did, however, compensate banks partially for the loss of interest that they earned on part of their cash reserves before the above changes took place.

The Bank had never been a keen supporter of the idea of paying interest on cash reserve requirements. Apart from considerations of profitability, the central bank did not regard itself as being in competition with the private banks for deposits, and this had made it somewhat reluctant to pay interest on such funds, particularly if the interest rates had been market related. Moreover, the penalty incurred by banks in meeting the cash reserve requirements had diminished. During the 1980s the requirements were reduced, as already indicated, while the concession that vault cash of banks could be included as part of their cash reserves for requirement purposes similarly worked in the same direction. The Financial Institutions Amendment Act of 1985 permitted the banks to include the monthly average of their daily holdings of “vault cash” (their holdings of notes, coin and gold coin in vaults, tills and automated teller machines) in their holdings of cash reserves for meeting the cash reserve requirements.

Chapter 5

The South African Reserve Bank's handling of the 1996 rand currency crisis

5.1 Overview

Much volatility was present in the South African financial system in 1996, and this was reflected in particular in the fall of the external value of the rand. The measure of overall financial stability established over three years from 1993 to 1995 in the form of an average inflation rate of about 9 per cent was disturbed in 1996 by a depreciation in the external value of the rand of more than 20 per cent from the end of 1995 up to the end of October 1996. During this period monetary policies had to be geared to pressures on the balance-of-payments front, the vulnerability of the economy to external pressures and vacillating foreign investor sentiment being vividly displayed at that juncture. The events of 1996 were out of the Bank's control, and revealed the complications for monetary policies arising out of the strategy of gradually relaxing exchange controls on residents.

5.2 Causes of the fall in the rand

For roughly a year before the rand started to weaken in the middle of February 1996, the currency had been remarkably stable, trading for significant periods in the region of R3,65 to the dollar. During this period the country enjoyed a kind of honeymoon with the rest of the world. Indeed, bearing in mind the higher inflation rate prevailing in South Africa at the time compared with that of its main trading partners, the real trade-weighted value of the rand had appreciated by 5,1 per cent from the end of May 1995 up to the middle of February 1996.

The sudden fall in the external value of the rand in February 1996 marked the start of a progressive decline in the currency which took it to roughly R4,45 to the dollar near the end of April 1996; a fall of roughly 18 per cent, and in terms of its average trade-weighted value a decline of about 17 per cent. After a brief recovery for a week or so the rand fell further in the first part of May reaching R4,52 to the dollar on 9 May 1996. The rand began to stabilise in the area of R4,35 to the dollar during the rest of May 1996, and remained fairly stable until renewed weakness in the currency emerged in the middle of July 1996, which caused the rand to weaken to around R4,55 to the dollar by the middle of August. The initial fall was ascribed to perceptions that the rand was becoming overvalued on purchasing power parity grounds, as well as speculation that exchange controls on residents were set to be relaxed, while the currency was further undermined by

rumours about President Mandela's health, and fears that he could resign at that stage from his position as President.

By April these uncertainties had been compounded, thereby putting further downward pressure on the rand. The spectre of anticipated further relaxations in exchange controls was still influencing the markets, while the resignation of the Minister of Finance, Chris Liebenberg, around the end of March created further nervousness in the markets. Rumours about the possible resignation of the Governor of the Bank, Dr Stals, also circulated. Moreover, during late April strike action by the Confederation of South African Trade Unions (Cosatu) created yet more unease among foreign investors. In a world in which militant trade unionism was becoming an anachronism, international capital was arguably becoming skittish about committing finance to a country where the reputation of the labour movement was being tarnished. In explaining the fall in the rand at that time, some analysts also made reference to South Africa's refusal to sever its political friendship with Libya and Cuba. Moreover, early in May fears that the National Party could withdraw from the Government of National Unity further weakened the currency. In sum, these various factors illustrated once again the vulnerability of the South African economy to external shocks.

To be more specific, the drop in the rand during the February to early May period of 1996 was in part attributable to a reversal in the leads and lags position on the balance of payments, as well as to substantial sales of local bond investments by foreigners, which occurred against the background of a deficit on the current account of the balance of payments which had amounted to approximately R12,7 billion in 1995 compared with R2,2 billion in 1994. Foreign investors purchased roughly R3,4 billion of government and semi-government bonds on a net basis in the first six weeks of 1996, compared with R4,8 billion in the whole of 1995. However, in the subsequent period to the end of April they sold more than R2,5 billion of stock, while at the same time remaining net buyers of equities. This selling was, in part, most probably stimulated by the weak fiscal position of the government reflected in a budget deficit amounting to around 5 per cent of the GDP, and its failure at that stage to address this issue by resorting to a programme of privatisation of state assets. In addition, international bond markets were somewhat weak early in 1996. In contrast foreigners remained net buyers of South African equities throughout the first four months of 1996. On this basis the weakness of the currency was bound up in part with an absence of sufficient fiscal reform.

The emergence of adverse leads and lags influences was reflected in part in pressures in the forward exchange market. During 1995 South African banks had funded their books to a significant extent by borrowing offshore at rates based on the London Interbank Offered Rate (Libor), plus forward cover charges and some risk premium cost for South African borrowers.

Following the sharp depreciation in the rand, the cost of raising funds offshore became exorbitant as the premium on forward dollars rose, and became out of line with interest rate differentials due to the strong demand for forward dollars on the part of importers. As a result, banks switched to local funding which, in turn, exerted downward pressures on domestic banking liquidity.

Despite the sharp rise in the forward premiums on the dollar, the strong demand for forward dollars caused the commitments of the Bank on the forward exchange account to rise substantially. This occurred as banks catered for the strong demand for forward dollars on the part of importers by buying spot dollars, and then undertaking swap transactions with the Bank by selling spot dollars and buying dollars forward with rands. These transactions were boosted, moreover, by the Bank's attempts to intervene in the spot market by obtaining dollars in the forward market; in other words, the Bank would first sell dollars in the spot market, and then conduct a swap transaction by buying spot dollars and selling forward dollars. These swap transactions therefore had the effect of boosting domestic liquidity by partly neutralising the drain of liquidity caused by the Bank's sale of dollars in the spot foreign exchange market. These swap transactions on the part of the Bank prevented short-term interest rates from rising as significantly as they otherwise would have done. This, in turn, depressed the rand in the sense that higher short-term interest rates should have attracted more short-term capital inflows from abroad.

It is also possible that a downgrading of foreign investors' expectations for growth in the economy also induced some disinvestment. By the early months of 1996 there were signs that a downward phase of the business cycle could be in the offing, and growth projections for 1996 and beyond were beginning to be downgraded in certain quarters. Some foreign investors were beginning to express concern about the relatively poor growth prospects, and their implications for rising unemployment and possible sociopolitical instability.

South Africa had a low rate of domestic savings at that time. Since, by definition, all investment must be financed by savings, South Africa could only sustain a high economic growth rate by attracting significant foreign savings and in the longer term by raising the domestic savings rate as well. In 1995 South Africa pushed up its gross domestic fixed investment rate by 10 per cent and this reached 19,3 per cent of GDP. Although still well below the level required to sustain rapid economic growth, this rise in investment already produced a domestic savings shortfall equivalent to 2,6 of GDP. Only a very small part of the foreign capital inflow that financed this shortfall consisted of genuinely long-term capital.

Against this background it was widely argued that it was imperative that economic policy become focused on creating conditions that would attract

significant amounts of foreign capital, especially long-term capital, as well as boosting domestic savings. This pointed to the desirability of a significant shrinkage in state consumption spending and borrowing, lower income taxes, low inflation, positive real interest rates and privatisation. In the face of these prerequisites the implementation of policy reforms had been in the right direction, but not to an adequate extent. Foreign investors arguably, to some extent, therefore lost confidence that South Africa would become a fast growth economy and this was reflected in the weakening of the rand.

5.3 The Bank's view

There was a need to place the decline in the rand in 1996 into perspective. In a world of floating currencies where daily foreign exchange trading was well above US\$1 000 billion and was dominated by capital flows, periodic bouts of currency instability had become commonplace. Such instability, moreover, affected the large industrial countries, as well as the less developed countries. As an example, the Japanese yen declined by roughly 22 per cent against the American dollar between June and September 1995 and remained weak on balance into 1996.

By late April 1996 the Bank had, nevertheless, taken the view that the fall in the currency had been overdone. It argued that the depreciation after the end of March 1996 no longer reflected underlying economic fundamentals such as inflation rate differentials, interest rate levels and the overall balance-of-payments situation; in other words, the rand had become undervalued.

This conclusion, however, could be challenged. As already indicated, concerns about political developments in South Africa, to some extent, explained the fall in the rand in the first half of 1996. When the financial rand system was in operation, political worries on the part of foreign investors became reflected in the financial rand discount. With a unitary rand system this political factor arguably became reflected in the discount between the rand-dollar exchange rate, and the level of the rand indicated by purchasing power parity considerations. It can be argued that it was unrealistic to expect the rand to trade in line with its purchasing power parity level, when a significant degree of political uncertainty appeared set to plague South Africa for some time. Some discount factor should have been expected to emerge, which would fluctuate with shifts in political confidence.

Expecting the rand to trade in line with purchasing power parity values in 1996 could also be questioned in the light of structural factors affecting the balance of payments on the current account. By 1996 the serious staffing problems that were being encountered by the Bank's Customs and Excise Department had created a situation that some commentators alleged made South Africa akin to a "free port"; in other words, goods were being smuggled into the country on a large scale and customs duties were being evaded. The consequent boost to imports was given a further boost by the

abolition of import surcharges in November 1995. The greater penetration of imports had been reflected in the rising ratio of imports as a percentage of the GDP from 22,6 per cent in 1992 to 27,7 per cent in 1995, although it must be borne in mind that the economy accelerated from 1993 onwards.

Meanwhile, on the export side General Export Incentive Scheme (GEIS) export payments were being phased out, while the export base of the economy had been undermined somewhat by a fall of more than 60 tons in gold production in 1995 to around 522 tons, while production had fallen further in the first few months of 1996. Moreover, past experiences of bouts of rand weakness in the 1980s showed that there was no guarantee that the fall in the rand would be followed by any meaningful recovery.

5.4 The Bank's response

Another factor inducing the Bank to take action arose from the loss of foreign reserves. For roughly the two-and-a-half months to the end of April 1996 the Bank had sold foreign exchange on a net basis in excess of R5 billion in order to provide liquidity in the foreign exchange market and in its efforts to "lean against the wind" to support the rand. In April alone, the gross foreign reserves of the Bank fell by R2,3 billion to R11,7 billion, while its "other liabilities" rose by nearly R1 billion. This drained liquidity from the domestic money market helping to cause the money-market shortage to reach a record R10,9 billion at the beginning of May 1996, while placing upward pressure on short-term interest rates.

The Bank was also aware that the depreciation of the rand would put upward pressure on the inflation rate, and it was very keen to moderate such pressures, because otherwise the potential benefits for exporters and local manufacturers that had to compete with imported goods, would prove to be short-lived.⁴⁴ In view of these considerations and the doubts about whether the government would introduce fiscal measures such as a programme of privatisation to support the rand, the Bank raised Bank rate by 1 percentage point to 16 per cent from 29 April 1996, despite the signs that the economy was starting to slow down.

It could be argued that the 1 percentage point rise in Bank rate may have proved to be insufficient. Central banks in other countries had on occasions responded to currency crises by raising interest rates sharply. However, interest rates in South Africa were already high, and the causes of the rand weakness resided partly in the political arena. In September 1992 the Bank of England had raised interest rates sharply at the time of the sterling crisis, but it was not effective, and within a matter of days rates were lowered. In Mexico rates were raised from around 14 per cent to over 70 per cent following the peso crisis in late 1994, only to be subsequently lowered to roughly 35 per cent with no impact on the currency.

The challenge facing the Bank at that stage was to turn the rand depreciation into a beneficial event, which required both monetary and financial discipline. Monetary restraint alone might well have been insufficient to arrest the inflationary impulses flowing from the depreciation of the rand. The Bank, moreover, remained committed to the overall objective over time of reducing the rate of inflation to a level that was roughly in line with the average rate of inflation in the economies of the country's main trading partners.⁴⁵

There was understandably concern that the benefits stemming from the fall in the rand would be eroded over time by accelerating inflationary pressures.⁴⁶ However, the reduction in inflationary psychology and the more competitive economic conditions prevailing in South Africa by 1996 as a result of reductions in tariffs, the abolition of import surcharges and the elimination of certain price controls, meant that the fall in the rand could provide the economy with a competitive advantage which would be better sustained than happened in the 1970s and 1980s; in other words, the gains from the lower currency might not be automatically offset by higher inflation. In the lower inflationary environment prevailing then, depreciation of the currency could have proved to be a viable tool of economic management.

Such considerations seemingly influenced the thinking of the government when it issued its new medium-term economic strategy on 14 June 1996. The "new plan for growth" document pointed out that in real terms the effective exchange rate of the rand was roughly 12 per cent below the value in January 1996. It revealed that in order to maintain the competitive advantage created by this depreciation of the rand, the objective of the authorities was to keep the real effective exchange rate of the rand at a competitive level. Although short-term fluctuations may at times be unavoidable, it stressed that monetary and other policy measures would be geared towards the attainment of long-term stability in the real effective exchange rate, thereby providing the stable environment needed for a concerted expansion of export industries. Although not mentioned in the strategy, keeping the exchange rate at the lower competitive level ruling by the middle of 1996 would also facilitate the further piecemeal relaxation of the exchange control regulations, and deter speculation against the rand. At its lower real value, the rand could arguably be expected to continue depreciating in line with the inflation rate differential between South Africa and its main trading partners, and some analysts even recommended that the currency should depreciate by marginally more than the inflation rate, although the Bank did not subscribe to this view.

5.5 Further rise in interest rates: May 1996

Although the rand-dollar exchange rate stabilised in the area of R4,35 to the dollar in the immediate aftermath of the rise in Bank rate in April 1996, the

shortages in the money market remained high, thereby providing no relief for the banks suffering from a squeeze on their profit margins, even though the net foreign reserves of the Bank rose marginally in May. Against this background the major financial institutions announced a further 1 percentage point increase in their prime overdraft rates to 20,5 per cent and home loan rates to 20,25 per cent in May 1996, even though there was no increase in Bank rate. It was rare for the banks to raise their own rates without a concomitant increase in Bank rate, and this move by the banks attracted criticism in certain quarters, with the Competition Board deciding to mount an inquiry into whether the banks were colluding in raising their rates.

Dr Stals said at the time that there was insufficient pressures on the Bank to justify a hike in Bank rate. He claimed that while the market was tight, money-market rates were at that stage in line with Bank rate, and therefore in the eyes of the Bank it was not justified to increase the rate, although the Bank was watching the situation from day to day.

In raising their own rates at that stage, the commercial banks were trying to return their margins to the same levels as existed before the sharp depreciation in the rand which set in around the middle of February 1996. The banks' margins had been squeezed by an increase in borrowing rates of about 2 percentage points since February, a situation that was exacerbated at the time by the banks' practice of borrowing large amounts of short-term funds on the mistaken assumption that interest rates were due to fall. While raising their own rates, the banks wanted Bank rate to remain at 16 per cent in order to widen their margins. The banks, in raising their rates, were also aware that if the money-market shortages stayed at around R8 billion or more by the end of May 1996, they could be forced to borrow more from the Bank at the penal rate associated with second-tier accommodation. This danger arose because roughly R3,5 billion of short-term government stocks held by the banks matured at the end of May, and thus would no longer be available for borrowing from the Bank under the first tier of accommodation. Although the banks would have more cash, they would have fewer eligible assets to use to obtain first-tier accommodation.

5.6 The Bank's handling of money-market shortage

Some commentators argued that in view of the large money-market shortages that built up in April and May 1996, the Bank did not do enough to prevent funds from being drained from the banking system. If more action had been taken in this direction, the money-market shortages would have been smaller and upward pressure on interest rates would have been reduced.

One possibility would have been for the government to stop selling government stocks for a while, or slow down the selling of such stocks, and allow the funds to be deposited in the tax and loan accounts held with

the major commercial banks rather than allow the funds to be deposited with the Bank. If under these circumstances the statutory limitations on funds held in the tax and loan accounts had been exceeded, it was argued that the limitations should have been suspended temporarily.

However, a slowing down in the government programme of selling government stocks would not have been easy since the government worked out a timetable for sales on a monthly basis, and it was reluctant to hold back sales for even a month, given the large size of the budget deficit that had to be financed on an ongoing basis. In addition, the Bank itself was reluctant to undertake such action, because this would have moderated the upward pressure on interest rates, and may have weakened the rand at a time when it was already under severe pressure.

The Bank did actually take steps to run down government deposits held with the Bank. Since May 1996 the Bank had arranged that all government deposits such as those obtained from tax payments that were usually held in an account at the Bank were, instead, kept in government accounts at commercial banks. By September 1996 government balances kept at the Bank were at an absolute minimum.

Another possibility open to the Bank would have been to reduce the cash reserve requirements applicable to the banks on a temporary basis. This again would have assisted in keeping the money-market shortage at more moderate levels. The Bank, however, was not keen on frequent adjustments in cash reserve requirements, since they tended to be reserved for occasions when the Bank wished to undertake a fundamental shift in monetary policies.

5.7 Rand weakness and the future of exchange controls

The predicament of the rand in the first few months of 1996 raised anew the issue of whether the Bank should have allowed the rand to appreciate in real terms in the months before February 1996. This policy aided the fight against inflation, but arguably enhanced the vulnerability of the rand to the vicissitudes of flows on the capital account of the balance of payments. The risks in this regard were particularly high in the sense that a substantial part of the net capital inflows of R20 billion in 1995 consisted of purchases of quoted securities on the Johannesburg Stock Exchange (JSE), which are notorious for being volatile, and potentially short-term in nature. In view of the performance of the rand in the first few months of 1996, there was speculation at the time that the policy of the Bank might in future incorporate greater efforts to avoid any perceived overvaluation of the rand as regards the real trade weighted value of the currency.

It should, however, be borne in mind that more aggressive intervention by the Bank in the foreign exchange market to buy dollars and keep the

value of the rand down during the second half of 1995 and early in 1996 was inhibited by the realisation that this would add to the money supply and possible inflationary pressures. Intervention did take place and caused the country's foreign exchange reserves to rise by more than R9 billion between July 1995 and January 1996. Even stronger intervention would only have augmented the problems on the monetary control front. This did, however, leave open the possibility of relaxing exchange controls on domestic residents as a means of moderating upward pressures on the rand, and such action was under consideration at that stage.

The Bank took the view that there were good fundamental reasons for the exchange rate to weaken from the "high" levels prevailing in early 1996. Nevertheless, it was regarded as unfortunate that this adjustment took place so suddenly, and so swiftly over such a short period. Moreover, by April 1996 the Bank believed that the rand had become undervalued.⁴⁷ However, defining the correct exchange rate for the rand had become exceedingly difficult in the context of huge flows of international capital.

This perceived undervaluation, to some extent, encouraged the Bank to try and support the rand. However, in this respect the South African monetary authorities were criticised, for example, by the IMF for leaning too heavily against the wind in 1996. The IMF was of the opinion that the exchange rate of the rand should have been allowed to depreciate even more in 1996 through less intervention in the forward market, while interest rates should have been raised to an even higher level. The difference between the Bank and the IMF on this issue was, however, not so much one of principle, but rather of degree.⁴⁸

The antics of the rand in early 1996 also emphasised the intimate relationship at that stage between the exchange rate and exchange control policies. At the time some analysts argued that as long as exchange controls remained in force, speculation about the imminent further relaxation or abolition of the controls would continue to bedevil the currency, causing it to remain weak. Such commentators argued that the authorities should at least set, and publish a timetable for the lifting of the remaining exchange controls on the grounds that this would curb speculation in the foreign exchange market. Some proponents of the "big bang" approach even argued that the roughly 20 per cent fall in the rand by early May 1996 was discounting the abolition of the controls, which could therefore be quickly abolished without risking a further sharp fall in the currency. They argued that under the gradualist approach favoured by the authorities, the country was bearing the costs of exchange control abolition in the form of a weak exchange rate for the rand without deriving the benefits arising from removal of the controls. Some analysts argued that necessary reforms such as privatisation would be speeded up if exchange controls were abolished, because in these circumstances the markets, through their impact on the exchange rate

and interest rates, would be better able to pressurise the government into making bolder reform moves.

The Bank asserted that a timetable for the removal of the remaining exchange controls would only intensify currency speculation, and further undermine the position of the rand. The Bank believed that it was unwise to make any moves towards dismantling the controls when the markets were already in turmoil, fearing it would precipitate further weakness, partly because it would be perceived by the markets to indicate that the Bank was willing to see the rand drop further. It believed that any such moves would have to await a return of stability to the markets, whereas opponents argued that such stability was unlikely to return while exchange controls remained in force, because under such circumstances speculation about the future course of the rand would remain rife.

Certain other critics of the Bank's policy on the rand and exchange controls at that time took the view that the weakness of the rand was a direct result of the partial deregulation of the foreign exchange market through the scrapping of the exchange controls on non-residents in March 1995. This liberalisation allegedly had allowed capital flight to develop, which had left the rand in a defenceless position. They therefore urged a clampdown on capital exports through, for instance, the reimposition of exchange controls on non-residents.

The Bank, however, was strongly opposed to such a move. Exposing the country to the volatility of international capital markets was the price to be paid for financial reintegration with the rest of the world with its attendant benefits.⁴⁹ Any reimposition of exchange controls on non-residents would have been in direct conflict with the worldwide trend towards the liberalisation of exchange controls, would have undermined the country's international credit status, and curbed the country's scope for attracting foreign investment which was critically needed in view of the low domestic savings rate. The administrative difficulties in applying the previous financial rand system, which was in force from September 1985 to March 1995, also discouraged any thoughts of reintroducing such controls.

The Bank in any case took the view that it was no longer possible to drop exchange controls, and then reintroduce them as soon as there was an exodus of capital from the country. That is what happened in 1985, but under entirely different circumstances and it should not be repeated. The Bank believed that such controls had to be dismantled, carefully making sure that each step in the liberalisation process was permanent, and that the risk of having to reimpose exchange controls was not created.

In view of this reasoning it was not surprising that the afflictions of the rand early in 1996 did serve to put back moves to relax exchange controls, which

had been under active consideration at the beginning of 1996. At that time the Bank had tentatively drawn up several proposals for gradual relaxation of the controls, but the proposals were put on hold because of the pending departure of the Minister of Finance, Chris Liebenberg, from his post.

The steps reportedly envisaged at that time included further relaxations in respect of companies that wished to invest abroad, even though the Bank had already adopted a more relaxed posture on applications to the exchange control authorities. In addition, individuals would be granted some dispensation for investing off-shore, while the blocked capital of emigrants would be freed up via a special blocked rand bond. At maturity the cash could be transferred abroad. Moreover, relaxations on institutions would be allowed. The latter would be permitted to participate in new foreign-denominated bond issues by public-sector entities in a manner similar to that allowed when the government issued a eurosterling issue during 1995. On top of this, the financial institutions would be allowed to invest a certain limited percentage of their cash flows off-shore.

In line with a changed strategy, the Bank indicated in May 1996 that the liberalisation of exchange controls would in future be undertaken by means of smaller steps, in other words, exchange controls would be relaxed by means of less drastic action carried out on a more regular basis. It was hoped that this would avoid the build-up of strong market expectations that had afflicted the rand in previous months, and would therefore help to protect the rand from future damage. If any move threatened to weaken the rand it would not be undertaken.

In line with this approach, further relaxations in the exchange controls were announced in the middle of June 1996. The steps included the relaxation of the access of foreign-controlled companies to domestic credit. The borrowing limit of such firms in the domestic market was doubled. A wholly owned non-resident entity could now borrow up to 100 per cent of its shareholders' equity. Meanwhile, the limit on asset swaps of institutional investors, namely insurance companies, pension funds and unit trusts was raised from 5 per cent of total assets to 10 per cent. Institutional investors were also allowed foreign currency transfers during 1996 of up to 3 per cent of their net inflow of funds during the 1995 calendar year, subject to the overall limit of 10 per cent mentioned previously. In addition, upward adjustments to existing exchange control limits on holiday and gift allowances were made.

These exchange control concessions were facilitated by some return of stability to the rand in the foreign exchange market; the currency trading between R4,30 and R4,40 to the dollar from roughly the middle of May 1996 into July. In May foreigners purchased bonds in the amount of R944 million compared with net sales of R2,2 billion in April, and net equity of R649 million compared with R319 million in April. A return of some foreign investor confidence in the rand was displayed early in July by the floating

of two eurorand bond issues totalling R400 million; one by the World Bank and the other by Deutsche Bank. This was particularly encouraging, since reports indicated that during the decline of the rand earlier that year, the eurorand market did not experience substantial selling of such bonds. This stability of the rand was also partly due to the intervention policy of the Bank at that time. The Bank was keen to promote more stable conditions partly because this could help to restore the confidence of foreign investors.

5.7.1 Renewed weakness of the rand: July 1996

This stability in the rand, however, proved to be short-lived, since renewed weakness set in around the middle of July 1996 causing the currency to weaken from roughly R4,33 to the dollar to around R4,55 to the dollar in the middle of August. This bout of weakness illustrated the difficulties facing the Bank in gradually abolishing exchange controls without materially undermining the rand.

It was, once again, shown that sustained net foreign capital inflows could prove to be elusive while the process of dismantling the exchange controls slowly proceeded. The danger was that from time to time speculation about further relaxations in the controls would crop up, and immediately cause foreign capital to flow out of the country accompanied by an intensification of adverse leads and lags. Such events coming against the background of a deficit on the current account of the balance of payments, albeit one that was diminishing, would then cause the rand to weaken, especially in view of the limited foreign reserves of the Bank.

This is how one could, in part, interpret the sudden new fall in the rand during July. The drop was sparked off mainly by rumours that, as part of the programme of phasing out exchange controls, an imminent withdrawal of the Bank from the forward rand-dollar market could be expected, which would imply a weakening of the rand. This weakness was then exacerbated by reports that the Bank had lost much more money earlier in 1996 than previously thought through its attempts to support the rand by selling dollars forward. This raised more doubts about the willingness of the Bank to continue providing forward cover for rand-dollar transactions. The Bank, in an effort to allay market fears, indicated that it would continue to retain a limited presence in the forward market, but this hardly helped the rand.

In this period the rand was further undermined by the fears of foreign investors regarding the close partnership of the African National Congress (ANC) with Cosatu and the South African Communist Party (SACP), as well as doubts concerning the ability of the government to implement its new economic restructuring programme. Nevertheless, the danger existed that rumours about possible further relaxations in exchange controls would feed on themselves, and further harm the currency. As the rand weakened new pressures for further relaxations in exchange controls were threatening to emerge.

Money, for instance, was pouring into the international unit trusts amounting to a net R426 million in June 1996 alone. However, under the regulations in force at that stage, these trusts were only allowed to invest 10 per cent of these funds in foreign investments. The Unit Trust Association was therefore pressing for a more liberal dispensation in this regard, arguing that local investors should be able to invest in "international" unit trusts which could invest 100 per cent of their funds overseas in line with the dispensation allowed to investors holding life assurance international policies. Meanwhile, the South African Fund Managers Association, which represented portfolio management companies, was complaining about the complete lack of scope for such companies to invest abroad, which it deemed to be unfair and discriminatory. The stockbroking community was also reported to be unhappy because of their inability to offer their clients offshore investments. There were indeed reports that moves were afoot to challenge these various barriers to foreign investment by making submissions to the Constitutional Court.

5.7.2 New cycle of rand weakness: October/November 1996

After trading in the area of R4,45 and R4,55 to the dollar for roughly two months, the South African rand plunged below R4,60 to the dollar on 25 October for the first time ever, and fell in the ensuing two weeks or so to a low of roughly R4,76 to the dollar before recovering to roughly R4,60 at the end of November 1996. This particular bout of weakness started in the middle of October at the time of the arrival in South Africa of the managing director of the IMF, Mr Camdessus. This visit sparked off rumours that the government aimed to raise a new loan from the IMF, and simultaneously make further relaxations in the exchange controls, or at least use the occasion of this visit to announce further relaxations in the controls.

This bout of weakness in the rand was caused in part by the same basic set of factors that had precipitated the previous period of weakness in the middle of July 1996. On that occasion rumours about possible relaxations in the exchange controls sparked off the move and the same kind of forces were at work again in October 1996. The market ignored the IMF's claims that the rand was undervalued, and the indications from the Bank that the recent fall in the foreign reserves, and the weakness of the currency had put back the programme for abolishing the remaining exchange controls.

The authorities argued that these developments in the foreign exchange market in South Africa called for even greater conservatism regarding the abolition of exchange controls. The weakness with this approach, however, was that it ran the danger of encouraging even more procrastination on the part of the government in taking steps to make the country more investor friendly.

According to some analysts, the lesson to be learnt from the 1996 weakness in the rand was the urgent need to embark on action that would facilitate the abolition of exchange controls rather than to set back the whole process. In this respect the privatisation programme needed to be speeded up, an exchange control and tax amnesty allegedly needed to be granted to South Africans who had illegally exported capital during the past 35 years so as to encourage a return of flight capital, the burden of taxation on investment incomes in South Africa should be reduced, and some programme needed to be devised to deal with the problem of blocked rand balances.

However, such analysts conceded that even if agreement on these measures could be reached, they could only be undertaken by the government, and they argued that it was therefore the responsibility of the latter to “take the bull by the horns” in this respect, and create the circumstances in which the exchange controls could be more quickly phased out, and the speculation against the rand quelled. Whatever happened to exchange controls, however, one important lesson learnt from the 1996 crisis was that for as long as the international regime of floating exchange rates prevailed, South Africa had to learn to live with virtually constant adjustments in the foreign value of the rand.⁵⁰ The process of gradually removing exchange controls, the continuing process of political reforms in South Africa, and the influence of volatile external developments presented an extremely difficult challenge for the Bank to maintain financial stability in the South African economy.

By the beginning of 1997 the cycle of rand weakness had been reversed. The net buying of domestic quoted securities by foreigners became a prominent feature, no doubt influenced in part by the greater credibility of domestic monetary policies, which had helped to bring enhanced stability for the rand by that time. The improvement in foreign investor sentiment, however, was most probably influenced by other factors as well, and in particular the improvement in trading systems in the equities market during the previous year or two.

Chapter 6

The predicament of the rand in 1998 and its implications for monetary policies

6.1 Overview

This chapter analyses in some detail the exchange rate and general monetary policies pursued by the South African monetary authorities in 1998. The background to the crisis that befell the rand in May 1998 is explained, along with the policy responses of the authorities to a situation on the external front which was again beyond the control of the Bank as the sentiment of foreign investors deteriorated. The repercussions of these policies are adumbrated, and their effectiveness is analysed. In particular, the impact of the monetary policy stance on the rand, the domestic economy and inflows of foreign capital is assessed. In the process the vulnerability of the rand at that time is stressed, notwithstanding the alleged undervaluation of the currency based on purchasing power parity considerations at the time.

6.2 Introduction

Since roughly the middle of 1994 the stance of foreign investors towards investments in quoted South African shares changed with net buying on balance being the order of the day. The JSE in effect took its place as one of the emerging equity markets, which was attracting attention from international investors. This supplemented a situation where foreigners had been net buyers of South African bonds on balance since 1985, some indication of this trend being shown Table 3.

Table 3: Transactions by non-residents on the JSE and the Bond Exchange of South Africa (R millions)

Transaction	1990	1991	1992	1993	1994	1995	1996	1997
Net purchases of shares	-4 472	-4 110	-471	2 809	185	4 812	5 254	26 201
Net purchases of bonds	1 464	2 023	784	1 521	1 103	1 871	3 383	14 778

Source: South African Reserve Bank *Quarterly Bulletin*, various issues

Investment in the share and bond markets of developing countries by foreign investors had represented one of those important shifts in investment patterns that emerge from time to time, and which could have proved to be still in its infancy. Despite the greater risks attached to such equity and bond investments, as shown by the economic crisis in South East Asia in

1997, these emerging markets generally had been proving to be attractive, because developing countries as a group had been growing much faster economically than their industrialised counterparts. Many of them had been embracing new policies aimed at instituting free-market principles, lowering inflation rates, reducing budget deficits, privatising state industries and encouraging foreign investment.

The South African markets for bonds, and more especially equities, would appear to have been aided initially by a positive rerating following the collapse of various markets in South East Asia in 1997. In the wake of this Asian crisis investors around the world were making a clear distinction between crisis-stricken Asia, and the world's other leading emerging markets. According to the Institute of International Finance, the total flow of private capital into emerging markets contracted sharply in 1997 to US\$171,5 billion from US\$199,6 billion in 1996. However, this decline was almost entirely due to the Asian crisis, with the five most affected economies (i.e., Indonesia, the Philippines, Malaysia, South Korea and Thailand) recording a combined net outflow of foreign capital of roughly US\$12 billion after a net inflow of US\$93 billion in 1996. In contrast, flows to other leading emerging markets rose in 1997, and this included South Africa where specifically strong net buying of local shares by foreigners of R26 billion was recorded. Some commentators argued at the time that positive fundamentals in South Africa such as a falling inflation rate, and the prospect of a business cycle upswing in 1999, would ensure that foreign portfolio investments would be sustained.

Unfortunately, the danger all along had been that this buying of South African-quoted securities would not continue unabated, even though the buying accelerated in the first few months of 1998, the net buying of equities reaching R19 billion in roughly the first four months, while net purchases of local bonds by foreigners amounted to around R16 billion in the same period. An internal or external development, or both, had posed the risk that sentiment towards South Africa could suddenly deteriorate, and this is exactly what happened starting in the wake of renewed turmoil in emerging markets around the world in May 1998.

6.3 Emerging-markets malaise

The sudden downward pressures on the rand during May 1998 were partly due to the undermining of foreign investor sentiment towards South Africa brought about by attacks on the position of the Bank, which generated fears that the Bank's autonomy might be diluted. On top of this, regional economic problems in East Asia were continuing on an ongoing basis, and appeared to be intensifying. Having endured currency crises, banking crises and debt crises, countries in the region were starting to face unemployment crises, and a second wave of currency depreciations in the region was feared. The broad-based surge in exports that countries in East

Asia needed in order to rekindle economic growth had not yet occurred, despite the sharp falls in the values of their currencies.

Most of the spotlight in Asia in May 1998 was focused on Indonesia, which seemed as though it might implode from within due both to economic and political instability, but investors around the world were also increasingly harbouring fears about China, and in particular its currency, the yuan. Any material Chinese devaluation would have dealt a massive blow to efforts aimed at stabilising markets and economies in the Asian region, since it would have exerted strong downward pressures on other currencies, and quite possibly sparked a series of competitive depreciations in Asia. Yet another trouble spot, moreover, existed in another part of Asia. India's resort to detonating nuclear bombs in May 1998 was perceived to be an open provocation where Pakistan was concerned. The major powers viewed this action as reckless action, and investors' nerves became even more frayed when Pakistan responded in kind. In short, the turmoil in East Asia and some other emerging-market economies created a dangerous situation for South Africa in the sense that the country became contaminated by the troubles in emerging markets with foreigners fearing that the rand could be among the next emerging-market currency dominoes to fall.

It cannot be concluded, however, that the economic crisis that gripped South Africa at that time originated solely from financial contagion in other emerging markets. The economy did not start to take a beating simply because of forces beyond the country's control. Underlying home-grown fundamental problems characterised the South African economy at that time which became visible once the rand came under pressure, but these problems could not be attributed to the actions of the Bank.

6.3.1 Fragile balance-of-payments position

There was a structural weakness in the South African economy. This took the form of a low level of investment to GDP which was around 17 per cent, and an even lower savings rate of roughly 13 per cent, which limited the potential for economic growth to a maximum of around 3 per cent at the best of times. At the same time the excess of domestic investment spending over gross domestic savings showed up in current-account deficits on the balance of payments at virtually all stages of the business cycle. These deficits were being partly financed by volatile portfolio capital inflows and particularly investments in quoted bonds, a situation that rendered the rand highly vulnerable to mutations in the sentiment of foreign investors. It only required net capital inflows to fall to levels below the prevailing deficits on the current account for the rand to start coming under pressure.

During the first quarter of 1998 the overall balance-of-payments position was strong. Measured on a seasonally adjusted annualised basis, the deficit on the current account declined from R14,1 billion in the fourth quarter of

1997 to R8,6 billion. Moreover, large net inflows of foreign capital of more than R11 billion allowed the Bank to intervene in the foreign exchange market to buy up dollars. The Bank's own gross gold and foreign exchange reserves therefore increased from R28,4 billion at the end of 1997 to R32,8 billion on 31 March 1998. In line with the further relaxation of exchange controls, private banking institutions also increased their holdings of foreign exchange, and at the end of the first quarter of 1998 the country's total gross foreign reserves totalled R45 billion, which was sufficient to cover roughly three months of imports. These favourable external developments, however, were suddenly reversed in May 1998 when inflows of foreign portfolio capital into South Africa in the form of rand-denominated bond investments in particular turned negative. In May non-residents sold R3 billion of South African bonds on a net basis, followed by a further R4 billion in June 1998. Indeed, whereas during the first four months of 1998 non-residents increased their holdings of South African bonds by R16,3 billion, during the next five months, that is, from May to September, non-residents reduced their holdings of South African bonds by R22,4 billion.⁵¹

6.4 The authorities' policy response

Faced with acute pressures on the rand in the foreign exchange market during May, the Bank embarked on a policy of trying to support the rand by substantial sales of dollars out of the foreign reserves, as well as intervention in the forward exchange market. This led to a dramatic fall in the country's gold and foreign exchange reserves. While the gross foreign reserves of the Bank rose marginally from R32,7 billion to R32,8 billion in May 1998, the use of foreign credit lines rose from R9,2 billion to R17,1 billion, while the Bank's commitments to selling dollars forward rose by US\$5,1 billion to US\$17,9 billion, partly because the remaining exchange controls at that time made it impossible for private banks to meet the growing demand for forward cover in the foreign exchange market. In June further sharp falls in the external foreign reserves position materialised. While the foreign reserves position and foreign credit lines outstanding hardly changed, the net commitments of the Bank to sell dollars forward increased to US\$22,5 billion.

It is not possible to estimate what effect the Bank's intervention in the foreign exchange market had on the rand at the time, or by what percentage the rand would have depreciated if the Bank had not intervened. The substantial depreciation of the rand that nevertheless occurred attracted much press comment. The Bank claimed that criticism of its intervention operations during May 1998 was unjustified since it was not castigated for its actions in the early months of 1998 when it bought dollars to prevent the rand from appreciating. The Bank asserted that two-way intervention was necessary since it would have been criticised if it had only been buying dollars, and not selling them as well when the rand came under pressure.⁵²

However, such criticism did not appear to surface during 1996 when the rand was previously under pressure, and the authorities intervened less aggressively to support the currency. At that stage intervention by the Bank was designed largely to lean against the wind by ironing out excessive volatility in the rand exchange rate.

As already indicated, the Bank's intervention, however, did not stop the rand from weakening, and in late May the Bank tightened monetary policies by allowing the "floating" repo rate to rise to 18 per cent from 14,8 per cent. It also raised the marginal lending facility rate from 18,8 per cent to 33 per cent, while cutting back on the amount of liquidity offered at the tenders. This was followed by a further tightening in monetary policies starting in the third week of June in the midst of further turmoil in the foreign exchange market as the rand continued to weaken. The flexible repo rate thus jumped to 20,4 per cent, while the marginal lending facility rate rocketed to 40 per cent, with the Bank reluctant to furnish the full liquidity needs of the banks through the repo system. The overall result was that the prime overdraft rate of banks rose by roughly 6 percentage points to 24 per cent in roughly two months to early in July against the background of an approximate fall in the nominal effective value of the rand exchange rate of more than 20 per cent from the beginning of May 1998 up to early July.

6.4.1 Currency speculation against the rand

The authorities justified the tightening in monetary policies and the intervention in the local foreign exchange market on the grounds that the rand should be protected in order to minimise the inflationary consequences stemming from any weakness in the currency. The authorities argued that they could not guarantee low interest rates or overall financial stability in the new environment of worldwide integrated financial markets.⁵³ Moreover, once the rand started to fall sharply, the desire existed to contain the inflationary pressures so that the longer-term objective of reducing the rate of inflation could still be achieved.

In addition, the efforts to support the rand were justified on the grounds that the downward pressures on the currency were partly attributable to speculation in the currency market. Attempts to restore stability in the domestic markets in general, therefore, justified taking measures which reversed this state of affairs.

An element of such speculation was almost certainly present. Against the background of the turmoil in numerous emerging markets around the world, and particularly the weakness of certain Asian currencies, it was safe to conclude that some foreign operators had been focusing attention on other currencies that were perceived to be vulnerable and that included the rand. The progressive relaxation of the domestic exchange controls in prior years had certainly facilitated speculation against the rand by South African

exporters. The extension of the previous 7-day limit on holding currencies by exporters to 180 days had improved exporters' scope to delay repatriation of their export proceeds. The evidence that foreigners had been resorting to domestic bank credit to finance purchases of domestic bonds on a significant scale early in 1998 also suggested that some operators may well have been borrowing rands later in 1998 to speculate against the currency. Moreover, the Bank's brief large-scale intervention in May and June 1998 drained the foreign reserves, and this might have encouraged speculation against the rand. In particular, by that time the Bank had started to publish monthly figures regarding its exposure on forward exchange account, and the release of figures showing a substantial increase in this exposure quite possibly precipitated some speculation against the rand.

Nevertheless, it cannot be assumed that speculators were primarily responsible for the plight of the rand in the second quarter of 1998, given the fundamentally weak position of the currency stemming from current-account deficits, which were being financed by net capital inflows that could only be described as 'hot' money flows. The emerging-markets malaise had understandably raised concerns on the part of foreign investors about the future of the rand as already indicated, and investor sentiment was further undermined by the attacks at that stage on the position of the Bank, which generated fears that the Bank's autonomy might be diluted. These developments probably generated disinvestment from the country.

The sharp rise in the domestic repo rate should have had some effect in curbing speculation, since this move reduced the arbitrage gap between the forward rand-dollar rates and money-market rates. Forward premiums on the dollar had soared in line with importers' strong demand for forward dollars, and this had created an opportunity for banks to borrow rands and then buy forward dollars, and in the process reap a profit while weakening the rand. Moreover, the sharp rise in the premiums on forward dollars was encouraging South African traders to repay foreign trade finance loans, and switch to domestic credit which had become cheaper. The rise in domestic interest rates should have blunted this practice.

However, even if speculative forces entirely explained the predicament of the rand at that stage, which was not the case, there was no guarantee that the strategy of raising domestic interest rates would shake out all the speculators, and restore complete stability to the rand. Countless examples in history can be cited of central banks raising domestic rates sharply, but failing to avoid a currency depreciation or devaluation, the classic case being that of the Bank of England in September 1992, when it intervened heavily in the market to support sterling, and combined this with a dramatic increase in domestic interest rates, which failed to turn the tide.

The local monetary authorities were hoping that the drastic steps on the monetary front that were undertaken would prove to be effective, and

allow the repo rates to fall again. Eventually, the rise in prime overdraft and mortgage rates did help to stabilise the position, but this delayed any upturn in the domestic business cycle which many commentators, before the emergence of the foreign exchange market crisis, had been anticipating would materialise late in 1998 or early in 1999. Prime overdraft rates and mortgage rates rose quickly. This did help to stabilise the position in time, but delayed any upturn in the domestic business cycle as already noted. The prime overdraft rate, which had risen to 25,5 per cent by the third quarter of 1998, declined again to a level of below 20 per cent by the second quarter of 1999.

Some analysts argued that the great danger that loomed at the time the Bank started to support the rand in May 1998 was that the markets would conclude that the authorities were seeking to support an overvalued currency by imposing high interest rates which were unsustainable, because of domestic political and economic conditions. At that time South Africa was arguably facing a position of fundamental disequilibrium in which pedestrian economic growth existed side by side with deficits on the current account of the balance of payments, albeit relatively low ones, and exceedingly high domestic interest rates where the deficits on the current account were vulnerable to further deterioration, partly because of the trend towards falling international commodity prices. Critics argued that the country had an overvalued currency which was being used, to some extent, as an inflation anchor. From the perspective of the fundamental disequilibrium, the economy arguably required a fall in interest rates, rather than a rise, since this would have weakened the rand even more, and stimulated exports while the economy would have received a general boost.

The Bank, however, argued that such policies would have generated higher inflation and greater monetary instability with a higher level of interest rates, which, in turn, could have impaired the long-term growth capacity of the economy. It believed that the rand was not fundamentally overvalued, and was instead caught up in a crisis affecting capital flows emanating from the emerging-markets arena.

6.5 Monetary policy and domestic economic conditions

In 1998 the Bank remained dominated by the objective of curbing the rate of inflation, and indeed most of its actions on the monetary front were seemingly geared towards achieving this objective, despite the existence of high levels of unemployment, and substantial spare capacity in the economy. High domestic interest rates were maintained in the second half of 1998 with a view to keeping inflation in check and the result had been that the economy entered a period of receding growth. After slowing down during the first half of 1998 the real GDP fell by a substantial 2,3 per cent on an annualised basis during the third quarter of 1998, and a continuation of

weak conditions looked likely in the fourth quarter and stretching well into 1999, partly because the full effects of the rise in interest rates in 1998 had still to come through. Even so, the economy still managed to grow by ½ per cent as measured by the real GDP in 1998 as a whole.

After the outflow of non-resident funds had begun in May 1998, rand liquidity in the South African banking system was systematically reduced, mainly by the selling of US dollars by the Bank to private banks to enable them to meet the demand for both increased spot and forward foreign exchange operations. As the daily domestic liquidity needs of the banks increased, however, the Bank refrained from replenishing all the liquidity lost through the outflow of capital.⁵⁴

The authorities maintained that their highly restrictive monetary policies after April 1998 had been forced on them by negative developments in the international financial arena. This was true, but some observers argued that the new repo (accommodation) system pushed domestic interest rates higher than would have been envisaged under the old Bank rate system as part of the Bank's efforts to support the rand in the foreign exchange markets and curb inflationary pressures.

Underlying conditions in the South African financial markets began to improve noticeably during September and October 1998, in line with more settled conditions in the international financial markets. The trade-weighted value of the rand consequently appreciated by roughly 15 per cent between the end of August, and the end of November 1998. The rand did nevertheless remain vulnerable to any further internal and/or external developments which precipitated any new outflows of capital on the balance of payments.

Some of the Bank's critics, as previously mentioned, argued that throughout most of 1998 the South African economy was suffering from a "fundamental disequilibrium". They asserted that the economy was experiencing hardly any economic growth at a time of large unemployment, and general spare capacity in the economy reflected, for instance, in the degree of spare capacity in the manufacturing industry, while the current account of the balance of payments remained in deficit. Claims that the rand was an overvalued currency could be challenged on the grounds that the rand was undervalued on purchasing power parity grounds. Unfortunately, the purchasing power parity criterion was an imperfect measure of the competitiveness of an economy at any particular time. At the same time real rates of interest had been at high levels, which hindered any meaningful recovery in the economy, and had been kept at these levels in an effort to support the rand and dampen inflationary pressures. Interest rates in real terms had indeed been at unprecedented levels. The real yields on local bonds in August 1998 amounted to around 15 per cent if one compares the nominal yields with producer price inflation of around 4 per cent. Likewise,

the real yield gap between South African and American bonds was also at historically record-high levels of around 11 per cent at that time. Some analysts therefore argued that from the perspective of the slack domestic economy the authorities should not have raised interest rates so sharply in order to protect the rand. A lower interest rate differential, however, ran the risk of undermining the rand further, threatening financial stability and impairing longer-term prospects for economic growth. The Bank was well aware of this threat.

6.6 Growth prospects of the South African economy

In the midst of the currency crisis in the middle of 1998 the official stand in South Africa was that the country could still enjoy good economic growth in 1999 if the international environment proved to be favourable. Although the situation was highly uncertain, the official viewpoint was that 3 per cent growth was still possible in 1999. Other analysts projected growth of at least 2 per cent in 1999 compared with previous projections of 3 to 4 per cent and a Growth, Employment and Redistribution (GEAR) projection of 4,9 per cent. All these projections were based on the assessment that the sharp rise in interest rates in the middle of 1998 would outweigh the positive influence on growth of the sharp depreciation in the rand, but at least interest rates would gradually fall back towards the levels prevailing before the rand started to slide. As it turned out to be, interest rates remained at the extremely high levels for only a few months before starting to decline towards the end of 1998 and early in 1999.

Even so, these projections possibly took little account of the deteriorating international economic position as major economies such as the US slowed down, deflationary forces gathered pace in Japan, and the turmoil in South East Asian economies showed no signs of abating. The impact of the weak rand was bound to be blunted somewhat by weak international commodity prices, and the highly competitive international economic environment brought about by the substantial fall in Asian currencies, and the slowdown in world economic growth. The deficit on the current account of the balance of payments could have fallen, but the growth in merchandise exports would be inhibited by these negative influences as previously indicated, and the rand remained vulnerable to any adverse developments. A phase of materially stronger economic growth in South Africa was normally preceded by an upturn in the world economy, and a sustained rise in the foreign reserves of the country; conditions that did not exist in 1998.

Moreover, domestic interest rates had risen again in late August 1998 with the prime overdraft rate reaching 25,5 per cent and any quick fall was far from guaranteed. The danger of further international currency turmoil could have entailed yet another rise in interest rates if the Bank continued to attempt steadfastly to support the rand in the face of further weakness. Some analysts also noted that in the meantime little or no account was

being taken of the possibility that domestic interest rates were being kept at punitive levels in order to reduce the amount of forward exchange losses that were being incurred by the Bank on maturing forward exchange contracts now that the rand had fallen sharply in value.

It should also be noted that the sudden sharp increase in domestic interest rates in the middle of 1998 probably imparted a major shock to both consumers and the business sector. The demand for bank credit was likely to be checked materially, even if interest rates fell back quickly to the level prevailing before the rand started to come under pressure.

Moreover, quite apart from the direct effect of rising interest rates on economic activity, account must also be taken of the depressing influence of the slump in values on the JSE during 1998. The fall of roughly 40 per cent in the All-Share Index (Alsi) between May and August 1998 was deflationary in itself since it probably curbed both private consumption and investment spending. Weaker levels of spending brought about by this factor thus supplemented the direct negative effects of higher interest rates and helped to unleash a recession in the economy.

During 1998 the exceedingly high domestic interest rates were justified on the grounds that the inflationary consequences of the fall of the rand needed to be minimised against the background of continued expansion in the M3 measure of the money supply, this growth amounting to 19,1 per cent in the year to July 1998, and 14,6 per cent in the year to December 1998. The authorities took the view that the challenge for monetary policy was to effect adjustments, even though they might be unpopular, and even if they came into direct conflict with the contemporary needs of the real economy at the time.⁵⁵ Looked at from the perspective of the macroeconomy, however, some observers claimed that high interest rates were restricting the scope for growth at a time when the economy was already depressed. If interest rates fell, it was argued that the rand would fall, other things remaining equal, thereby providing some boost to the economy. At the same time, some observers argued that the inflationary consequences could have been moderate, given the weak state of the economy, and the difficulties facing businesses in passing on price increases, as well as the heightened competitive pressures present in the South African economy arising out of its economic reintegration with the outside world.

The average rate of inflation worldwide in 1998 was around 5 per cent, and the disinflationary forces were so strong in some countries that commentators were beginning to detect deflationary forces in the offing in other countries besides Japan where the economy contracted at an annual rate of 3,3 per cent in the second quarter of 1998. These international trends helped to moderate the imported inflation pressures stemming from the sharp fall in the external value of the rand during 1998. Some of the price pressures emanating from this fall should have been absorbed by

foreign suppliers of goods to South Africa because of the depressed world economic environment.

This relatively benign inflationary outlook was, unfortunately, threatened by developments in the labour market. In its *Quarterly Bulletin* for September 1998 the Bank pointed out that the annual rate of increase in remuneration per worker in the private sector had risen from about 8 per cent in the first quarter of 1997 to 10,8 per cent in the fourth quarter, and 19 per cent in the first quarter of 1998. This trend was worrying since continued growth in nominal unit labour costs at such a high rate could rapidly have eroded the improvement in the international competitiveness of domestic producers which had resulted from the depreciation of the rand.

This highlighted the acute dilemma faced by the authorities in conducting monetary policies in 1998. The competitive edge attained by the decline in the rand ideally should be retained, but to achieve this interest rates were arguably maintained at levels that were inappropriate from the perspective of the level of domestic economic activity. Some analysts argued that monetary policies had been too restrictive during most of 1998, but it was clearly undesirable that the monetary policy mechanism alone was being relied on to deal with the problems at that stage on the balance-of-payments front. The more speedy implementation of structural economic reforms, such as privatisation and deregulation of the labour market, could have generated greater confidence on the part of foreign investors, strengthened the balance of payments on capital account, improved the competitive position of the economy, and thereby permitted some fall in interest rates. The same results could have flowed from a determined bid to reduce the burden of taxation to below 25 per cent of the GDP, this limit being one of the fiscal norms recommended by the IMF.

The Bank's resort to very high levels of domestic interest rates and the simultaneous attempts to support the rand did help to yield relatively benign inflation figures. The rate of increase in consumer prices measured over a 12-month period increased from 5,0 per cent in April 1998 to 9,1 per cent in September before receding to 9,0 per cent in October 1998, while the rate of increase in the overall producer price index rose from 2,3 per cent in March 1998 to 4,3 per cent in October. Looking further ahead, moreover the prospects for lower inflation were improved by the slowdown of the growth in the M3 money supply in the first half of 1999 when it moved into the lower end of the 6 to 10 per cent guideline range. The Bank's focus on containing inflation throughout the financial markets turmoil of 1998 was bearing fruit.

6.7 Impact of monetary policies on capital inflows

During the economic crisis of 1998 the authorities had, in effect, justified the sharp rise in domestic interest rates partly on the grounds that a

premium needed to be paid to foreign investors to discourage them from disinvesting from South Africa, while encouraging others to invest in the local economy. However, the impact of monetary policies on capital inflows was more complex than this analysis might suggest.

Keeping real interest rates at very high levels meant that South Africa had been attracting short-term foreign capital in the principal form of foreign bond finance at the expense of long-term foreign capital, and these inflows did simultaneously influence local rates on bonds. Foreigners reduced their holdings of South African bonds by R26,1 billion in the last eight months of 1998, but during January and February 1999, non-residents increased their holdings by R2,4 billion.⁵⁶ However, it could be argued that there was a trade-off between attracting portfolio foreign investment in the form of quoted bond investments, and foreign direct investment. Equity capital from abroad in direct form could have been discouraged by high real interest rates and weak conditions in the economy. The same applied, to some extent, to portfolio equity capital from abroad. It could also be argued that the weak rand exchange rate during the middle of 1998 was attracting direct foreign equity capital in the form of buy-outs of minority shareholders in South African companies by foreign companies (e.g., the buy-out of minority shareholders in Ingwe and Trans Natal by Billiton, the purchase of Blue Circle by the French-owned company Lafarge and the buy-out of Samancor minority shareholders by Billiton).

Even attracting portfolio foreign equity capital into South Africa was far superior to bond investments by foreigners. Foreign buyers of South African equities typically had a longer-term perspective than is the case with foreign investors in local fixed-interest stocks. A great proportion of the buying by foreigners was concentrated on local industrial shares in 1998, whereas previously the orientation was much more directed towards gold-mining shares, which were much more volatile in nature with foreign investors often buying them for short-term speculative purposes. A weak rand was clearly negative for bonds, because of the boost to inflation which this imparted, the consequent danger of a fall in bond prices in terms of rands, and the reduced external value of the bonds stemming from a weak rand in the foreign exchange market. In contrast, many foreign investors held South African shares with significant rand hedge qualities attached to them, and such counters offered some protection against a falling rand. In short, monetary policies during 1998 involving very high interest rates incurred the disadvantage of attracting certain inflows of foreign money which could move out at the stroke of a pen, and over which the Bank had no control.

However, the stringent monetary policies at that time could still be justified on the basis that they would contribute towards a lower rate of inflation, and therefore in the long run would attract more foreign capital in general. This conclusion was partly based on the reasoning that the exchange rate risk attached to foreign investments in South Africa would be reduced if the

differential between the inflation rate in South Africa, and the inflation rate in its main trading partner countries was narrowed or eliminated.

6.8 Prospects for a return of foreign investor confidence

It was argued in certain quarters that the short-term solution for the South African economic crisis in 1998 could only come from a return of confidence of the international financial markets in rand investments, and especially a return of confidence in South African bond investments by foreigners, which paved the way for a fall in domestic interest rates. In this respect certain fundamental factors did appear to be positive for the bond market. Conservative fiscal and monetary policies pointed to medium-term declines in the rate of inflation, backed by disinflationary trends in the outside world, even though in the short term the rate of inflation was pushed up by the weakness in the rand in 1998. This view was also supported by the slowdown in the local economy which portended a limited demand for capital funds. Further cuts in interest rates in industrial economies were a possibility, which should have helped to stabilise the financial markets in emerging-market economies, and thereby help to restore some foreign investor confidence in South Africa.

Even so, a return of confidence in the local bond market on the part of foreigners could have taken some time to materialise, even though long-term bond yields were around 19 per cent in August 1998. The effective default by Russia on part of its debts in August 1998, the fear of further defaults by Russia in future, and the dramatic collapse of the rouble in foreign exchange markets galvanised many international investors to exit from emerging markets. This was far more important than the Mexican crisis of 1994–95, or Asia's ongoing turmoil since the middle of 1997. The shock had been so great that emerging markets might be largely ruled out as regards foreign bond investments for a lengthy period.

The negative posture of foreign investors towards the bond markets of developing countries had been further heightened by the ongoing currency turmoil afflicting emerging markets. The collapse of the Russian rouble placed downward pressures on other currencies in Eastern and Central Europe, and ignited fresh fears about the currencies of Latin American economies, which had high foreign debt burdens. On top of this, the Hong Kong dollar, and the Chinese yuan remained under suspicion. The ongoing currency depreciation warfare in 1998 was undermining the confidence of foreign investors towards bond markets in general in emerging-market economies, and had been negatively affecting foreign investor attitudes towards the South African bond market.

Foreign investors could have been lukewarm towards investments in rand-denominated bonds, because of the precarious position of the rand. In 1998 the prime overdraft rate in South Africa rose from 18 per cent to

25,5 per cent in roughly four months, but this did not prevent the currency from falling sharply and, indeed, it would have declined even more if monetary policies had not been tightened. Many foreign investors could have been fearful that these high domestic interest rates would not be sustainable for long, because of political and economic considerations, and therefore might well have been anticipating that once a downward cycle in interest rates set in, the rand would tend to fall once again.

Such an outcome was not inevitable since, for instance, the current account of the balance of payments could have improved in the course of 1999. Nevertheless, the rand remained vulnerable, and this was likely to deter some new foreign investments in the bond market for the time being, especially since domestic interest rates had started a downward trend towards the end of 1998.

The upshot of this analysis is that a marked revival of the buying of bonds by foreigners could have been delayed for some time, these investors selling a net R22,4 billion of such bonds between May and September 1998. If a material fall in domestic interest rates had to be preceded by strong new inflows of foreign capital, a high level of rates could have remained in force for some time, and ushered in a protracted downturn in the economy. Fortunately, however, rates did start to ease late in 1998 despite ongoing sales of domestic bonds by foreigners and, as previously indicated, net bond purchases were recorded early in 1999.

Financial stability returned relatively quickly to South Africa. By early 1999 liquidity conditions were easing in the banking sector, and interest rates were declining significantly. Unlike in many other countries, the banking system of South Africa had managed to survive the turbulence of 1998 without any major failure, and without requiring an approach to the IMF for special financial assistance.⁵⁷ The handling of the crisis generally proved to be a success.

6.9 Purchasing power parity values: Implications for the rand

The thesis offered by some analysts that the rand had been overvalued in 1998 was challenged in many quarters by reference to the purchasing power parity value of the rand, which was claimed to be a vital guide to the sustainable level of the rand against other currencies over time. Indeed, the purchasing power parity value had been suspected by some commentators of being one of the main criteria used by the Bank in the past in deciding whether to intervene in the foreign exchange market, and support the rand when it was under pressure.

Although market forces materially dictated the rand's movements on a daily basis, the argument put forward was that in the past the Bank had often

intervened in the market in an attempt to ensure that the rand remained reasonably stable in real terms against a basket of foreign currencies comprising South Africa's main trading partners. This policy allegedly had been based on the notion of relative purchasing power, which emphasised that the equilibrium exchange rate was inversely proportional to the relative price levels of the domestic country to those of its trading partners; in other words, the equilibrium exchange rate was directly proportional to the relative purchasing power of the domestic currency compared with foreign currencies. This meant that the nominal trade-weighted value of the rand had often been declining at a rate that roughly reflected the differential in the rates of inflation between South Africa and its main trading-partner countries.

This state of affairs did materialise at times during the 1990s. However, in this period no deliberate policy actions were taken to try and maintain a stable real exchange rate for the rand against a basket of foreign currencies. It was the Bank's view that it could not fix the exchange rate of the rand at any pre-determined level. It could only lean against the wind, and intervene at times of short-term disruptions in the foreign exchange market.

It was the case that the real effective exchange rate of the rand had indeed shown remarkable stability (although not complete stability), on balance, for long periods since 1970. This was in contrast to the experiences of certain other currencies at times such as the dollar in the first half of the 1980s. This relative long-term stability of the real effective value of the rand had only been interrupted during the gold price boom years of 1979–80, during the years of intensified political disturbances between 1984 and 1986, during 1996 and again during 1998.

However, this situation could not be attributed mainly to the Bank's intervention in the foreign exchange market. Instead, it might be partly explained in terms of a lack of major structural changes affecting the balance of payments over this period, and the actual dates chosen for recording the behaviour of the rand.

The main explanation, however, might well have resided in the importance of differential price movements. South Africa's inflation rates were consistently, and materially higher than those of its principal trading-partner countries for many years. This could have caused relative price level movements to overwhelm all other factors, such as changes in world commodity prices that could have exerted an autonomous influence on their own on the nominal and real exchange rates; in other words, the nominal exchange rate had been falling steadily over the years reflecting the inflation rate differential in such a way that the real effective exchange rate was kept roughly constant for much of the time.

Although the exchange rate in real terms had remained remarkably stable for many years, any policy of explicitly seeking to keep the exchange rate

stable in real terms would have incurred difficulties for the Bank. It would have suffered from limitations, given that South African exports were primarily commodity exports, whose dollar prices did not closely reflect inflation trends in the country, but instead, were determined in international markets. Any such policy would have had to be suspended at times when the foreign exchange reserves of the country had been under noticeable pressure, and the scope of the Bank to intervene and sell dollars to curtail any fall in the rand had been limited. It might also have had to be modified if a permanent shift in the balance-of-payments position occurred.

Expecting the rand to trade consistently in line with purchasing power parity values could be questioned in the late 1990s in the light of global trends in currency values. In a world of floating currencies where daily foreign exchange trading was around US\$1 400 billion and was dominated by capital flows, periodic bouts of currency instability had become commonplace. Such instability affected the large industrial countries as well as the less developed countries. As an example, the Japanese yen declined by roughly 22 per cent against the American dollar between June and September 1995, and remained weak, on balance, throughout 1996 and the first quarter of 1997. There was no reason to suppose that currency instability would not engulf the rand at certain times, even though the sharp rise in the foreign reserves during 1997, and early in 1998 provided the Bank with more scope to intervene in the market to support the rand for a time.

It could be argued that it was unrealistic in the late 1990s to expect the rand to trade consistently in line with its purchasing power after exchange controls on non-residents had been abolished, and the controls on residents were progressively being phased out. When the financial rand system was in operation, political worries on the part of foreign investors became reflected in the financial rand discount. With a unitary exchange rate system for the rand this political factor should at times have become reflected in the discount between the rand-dollar exchange rate, and the level of the rand which was indicated by purchasing power parity considerations. It could also be argued that the rand could not be expected to trade consistently in line with its purchasing power parity level when a significant degree of political uncertainty pervaded the South African scene. Although the ANC government had abandoned much of its previous socialist thinking on economic matters, it still suffered from a degree of scepticism among both domestic and foreign investors which would persist until it established a track record of ongoing commitment to sound monetary and fiscal policies, and free market economic policies in general. One lingering worry was the possible reaction of the South African Government in the event that the world economy, and the local economy weakened markedly. Under such circumstances the government might have discarded its free market-orientated policies in favour of more socialist policies. This again arguably had negative implications for the rand at that stage.

By the late 1990s some discount factor could also be expected to emerge as the exchange controls on residents were progressively removed. This trend was bound to create a situation in which movements on the capital account of the balance of payments became even more important. At times when the rand was perceived to be vulnerable this would cause capital outflows on the part of residents to be significant, and exert downward pressures on the rand. In short, developments on the capital account of the balance of payments suggested that a relatively stable real effective exchange rate could be more difficult to attain. Some analysts argued that in the light of these political and economic considerations, the rand should have traded at a discount of roughly 10 per cent to that indicated by purchasing power parity calculations.

Expecting the rand to trade in line with purchasing power parity values could also be questioned in the light of structural factors affecting the balance of payments on current account. On the export side GEIS export payments were being phased out by the Treasury, and the export base had been undermined somewhat by a fall in gold production, while on the import side penetration of the domestic market by foreign suppliers had been enhanced by the evasion of customs duties.

Part 2

Other Domestic Policies

While the Bank's domestic monetary policies in the 1990s were aimed at reducing the rate of inflation, this constituted a key area of the Bank's activities, and elicited much interest on the part of the public. It was nevertheless the case that other functions of the Bank that were directed at the domestic scene, were of some importance. Part 2 of this book reviews these other domestic policies starting in Chapter 7 with the highly sensitive role of the Bank as a lender of last resort to the banking system. The responsibilities of the Bank in possibly granting support to banks that got into difficulties is explained in this chapter.

In Chapter 8 the relationship between the Bank and the government in the 1990s is the focus, and special reference is made to changes in the relationship that took place. Changes in the role of the Bank as a banker to the government are outlined along with the function of the Bank in handling new issues of government stocks for the Treasury. This is followed in Chapter 9 by an analysis of the work undertaken by the Bank Supervision Department in promoting and achieving the prudential conduct of banking business with a view to establishing a financially sound banking system. Finally, in Chapter 10 the main developments in the national payment system are reviewed.

Chapter 7

Central bank assistance to banking institutions in the 1990s

7.1 Overview

It is widely recognised that central banks have a vested interest in maintaining sound banking systems where profitable and well-managed banking institutions operate. It is therefore normal in most countries to find that special relationships exist between central banks and private banking institutions. These relationships arise as a result of bank supervision work undertaken by central banks, discount window (borrowing) facilities furnished by central banks, national payment and settlement arrangements, and lender-of-last-resort assistance granted to private banks by central banks.

The task of acting as a lender of last resort was first taken on by the Bank of England in roughly the middle of the nineteenth century, and thereafter it came to be regarded as an essential feature of the activities of a central bank. The possible granting of special assistance by the central bank to banks that found themselves in serious difficulties is now automatically accepted as a duty by most central banks, and it is this responsibility that is explained in some detail in this chapter with special reference to the Bank. The Bank had originally taken on this function when it was formed in 1921, and throughout its existence found it necessary to offer assistance to certain banks on a number of occasions.

7.2 Relationship between central banks and private banking institutions

In all countries there is an intimate relationship between the central bank as the creator of base or central bank money, and other recognised banking institutions that act as the conduit through which the money-creation process is extended. This relationship is, in the first instance, cemented by almost daily contact through discount window (lending) operations, clearing and settlement arrangements, and central bank intervention and operations in the financial markets such as the foreign exchange and government stock markets.

These normal ongoing relations between a central bank and other banking institutions are, however, supplemented by other contacts. In many countries, including South Africa, the central bank has been handed the function of bank regulation and supervision. In addition, most central banks are responsible for providing special assistance to banks in distress, albeit

at their own discretion. In other words, they fulfil the function of acting as a 'lender of last resort'. Banking is a risky business. Although the authorities responsible for bank supervision may be highly efficient, from time to time, certain banks can be landed in a situation where they experience some degree of financial distress.

Although central banks do their utmost to prevent default in banking institutions, the safety of a bank can never be fully guaranteed. When any individual bank gets into difficulties the central bank is often faced with challenging options as it weighs up its responsibilities for maintaining financial stability in the overall banking system, its responsibilities for maintaining monetary stability, and its scope for acting as a 'lender of last resort' if this is deemed to be a suitable response.

In such circumstances the first course of action that is open to the central bank is one of benign neglect. That is to say, it can allow the institution to be liquidated, and let its shareholders and depositors suffer the consequences stemming from the liquidation. In many cases this is the best course of action to adopt, provided that the rest of the banking system is not adversely affected by the erosion of public confidence in banks. If confidence is undermined, it is possible that a "run" on banks in general could emerge leading to the collapse of the whole banking system.

A second course of action could be one of damage limitation. In this case the central bank furnishes special support to the afflicted bank to enable it to recover from its difficulties. This is the option often adopted by central banks when the collapse of a large bank threatens to undermine confidence in other banks, and threatens the stability of the entire banking system.

A third course of action could be one of mitigation of consequences; in other words, allow the institution to be liquidated, but provide some special assistance to the depositors of the bank to alleviate the burden associated with the bank closing its doors. This alternative may be adopted by a central bank or government when the main concern is the protection of depositors, and where the affected bank is too small to pose a systemic risk to the rest of the banking system.

It is always difficult for a central bank to determine the appropriate course of action in any particular circumstances. Moreover, any move that is decided on will normally place the central bank in a no-win situation, that is, the central bank will be criticised in certain quarters for whatever decision it takes.

There are, however, some general guidelines that are universally applied by central banks when deciding on whether to extend financial assistance to a bank in distress, which are based on the particular circumstances surrounding the affected bank. The nature of the assistance furnished by

central banks does therefore differ from case to case, and the general approach of central banks can differ from country to country.

7.3 Experiences of support for banks around the world in the 1990s

During the 1990s numerous banking systems in different countries came under stress stemming from difficulties afflicting particular banks. Assistance in such circumstances often involved not only help from central banks, but also governments. When central banks provide assistance from their own resources, this involves the creation of money. This would happen, for instance, if a central bank granted a loan to a bank that was in distress. In other circumstances where government funds were utilised to provide assistance to banks in a number of countries, which happened on several occasions in the 1990s, taxpayers' money was required for this purpose. From the perspective of governments the use of central bank resources to help afflicted banks can be preferable, since it avoids recourse to government budgets, and there may be public opposition to state assistance to distressed banks. Any assistance may not be available immediately, since the government may require parliamentary approval for any such funding. This would create problems if the funding was required immediately. Central banks often provided assistance to an individual bank in an effort to avoid the danger of systemic risk that could lead to a collapse of the whole banking system. At the same time such action protected the government in the sense that it was absolved from any responsibilities for making budgetary provision for the afflicted bank.

In some cases, however, both central bank and government support operations could be undertaken simultaneously. A good example of this strategy occurred in Finland which experienced a major banking crisis. In September 1991 a major Finnish commercial bank (Shopbank) ran into problems and was heavily supported by special loans from the Bank of Finland. The total injection of funds by the central bank amounted to 15,6 billion Finnish marka, (equal to R10,6 billion). In 1992 Shopbank was transferred to a government-funded agency for 6 billion Finnish marka and the Bank of Finland suffered losses of more than 9 billion Finnish marka in the exercise.

This initial support by the Bank of Finland did not succeed in averting a major banking crisis in the country, and the Finnish government had to intervene. In 1992 it established a government guarantee fund, capitalised with taxpayers' money for more than 80 billion Finnish marka (R50,5 billion) to provide assistance to banks in distress. Other Nordic countries such as Denmark and Norway have experienced similar banking problems, and provide further interesting case studies of central bank and government support operations for banking institutions.

Further examples of public support for banks in cases of serious pressures on banking systems as a whole can be found in the Savings and Loan Associations debacle in the US in 1989; in the major banking crisis that developed in Mexico after the collapse of the peso in December 1994, and the banking crisis that engulfed Japan during the late 1990s. In Mexico the central bank created, and partly financed a saving protection fund (FOBAPROA) to provide additional capital for banks in the form of subordinated debt. FOBAPROA was partly funded by the Bank of Mexico, partly by the government of Mexico, and partly by aid funds made available to the country by foreign governments (mainly the US and Canada).

The South African monetary authorities also had to cope with certain cases of bank failure during the 1990s. Several smaller banking institutions in particular were forced into liquidation or were compelled to accept curatorship over their affairs, and at the time some of these banking problems attracted much public interest.

7.4 General rules for central bank lender-of-last-resort assistance to banks

There can be no fixed rules for central bank assistance to private banking institutions. There were no objective criteria that could be applied in such situations. The considerations varied from time to time and case to case. The judgement that had to be made was invariably a difficult one. The potential commitment of central bank and/or government funds to offer relief to financial institutions in distress was not a move that was undertaken lightly. However, a refusal to extend support, which subsequently turned out to have been needed, might ultimately have proved to be far more costly than prior support for the ailing bank.

It has already been noted that support to failing banks did not always come from the central bank alone. As previously noted, special guarantee or support funds had been set up in a number of countries involving joint central bank/government support. Examples of this were FOBAPROA in Mexico, and the government guaranty fund in Finland. These special organisations were being funded by governments and central banks, that is, with taxpayers' funds, and with newly created money provided by the central bank. In many countries there were also various public schemes for depositor protection in respect of funds placed by the general public with banks. No such organisations or deposit insurance schemes, however, existed in South Africa or in numerous other countries. In these latter cases the responsibility for handling banking crises rested squarely with the central bank, albeit working closely with the government.

In the case of central bank support some general rules could be derived from the practices followed by such institutions around the world:

- (a) Financial assistance was applied very sparingly and, as a general rule, only when a particular banking problem provided a threat of contagion to the whole banking system. The Bank took the view that the problems of banking institutions that posed no threat to the banking system should rather be left to be resolved by the management, shareholders and clients of the affected institutions without any intervention from the central bank.
- (b) Protection of depositors was a major consideration that had to be taken into account, especially by central banks that had to operate on their own in an environment where there was no system of bank deposit insurance.
- (c) Confidence in the banking system must be preserved, but this must be done without providing open-ended support for mismanagement, fraud or internal inefficiencies in banks.
- (d) Financial assistance emanating from the central bank (and/or the government) must, as far as possible, serve to protect depositors and not shareholders of banks.
- (e) In order to assist a bank in overcoming its problems, the central bank might extend a loan at a nominal rate of interest, or perhaps provide guarantees for raising low interest rate loans from other institutions.
- (f) The assistance must be conditional on remedial action being taken by the afflicted bank that would lead to recovery, and might often require a change of ownership, of senior management and even mutations in the structure of the affected institution. The Bank had often stated that it would only provide special assistance to a bank where there was a reasonable chance that the bank could recover from its ailment in a relatively short period.
- (g) The possibility of exit for the central bank from the assistance programme must exist once the afflicted institution had recovered financially, and investor confidence in the institution had been restored.
- (h) It might be necessary to keep the assistance package secret, particularly if disclosure could be counter-productive, and defeat the objective of the exercise.

The Bank derived its powers and duty of acting as a lender of last resort from the provisions of the South African Reserve Bank Act of 1989. In terms of this Act the Bank could grant secured loans and advances to a bank experiencing liquidity difficulties. In terms of this Act the Bank was not allowed to disclose information of deals entered into with any individual banking institution.

It should be clearly understood that the Bank's policy in its role as a lender of last resort was not the domain of the Registrar of Banks. Instead, it was the domain of the Governor and deputy governors of the Bank. Lender-of-last-resort support was given to banks experiencing funding difficulties on a short-term basis, and longer-term liquidity support and/or solvency support which was referred to as "life boat" support.

The objective of lender-of-last-resort support by the Bank was twofold: (1) to provide some breathing space to an institution facing short-term funding problems in order to enable it to implement corrective measures; and (2) to prevent illiquidity from precipitating a situation of insolvency, and to prevent the contagion effect of bank runs.

The basic precondition for the provision of lender of last resort was the judgement of the Bank that the failure of an illiquid banking institution, if it were deprived of liquidity assistance, would damage the stability of the banking system as previously mentioned. However, there were a number of other preconditions if lender-of-last-resort support were to apply. These included the stipulation that the institution had a sufficient margin of solvency and had sought other reasonably available sources of funding before seeking lender-of-last-resort assistance.⁵⁸

The policy outlined above applied to the provision of liquidity to locally incorporated banking institutions. In contrast, it was not normally the Bank's policy to extend lender-of-last-resort support to branches of foreign banks operating in South Africa. It was normally expected that the parent bank of a foreign branch would provide sufficient funding to enable the branch in South Africa to meet its obligations.⁵⁹

In general, the policy adopted by the Bank was one of avoiding as far as possible any failures of banks and, particularly, big banks. This was epitomised by the support given to Bankorp between 1985 and 1995 in order to avoid any failure of that bank. This large-scale assistance included the provision of cheap loans that were extended to Bankorp; the funds from these loans being profitably invested by Bankorp in domestic government bonds. Despite severe criticism, the assistance to Bankorp eventually proved to be successful. It avoided a major crisis in the South African banking system in a very difficult economic environment, and ended in an eventual take-over of the Bankorp Group by Absa Bank.

The Bank also aided several other ailing banks in the 1990s, but despite some shared features, none of the packages was as extensive or long term as that of Bankorp. In all cases the Bank sought to ensure that, as far as possible, assistance granted to banks had a neutral effect on the money supply in the medium or longer term.

In the case of smaller banks the response of the Bank could be different. As regards the troubled Cape Investment Bank, in 1990 the Bank in its capacity as lender of last resort refrained from granting assistance to the bank because of fraudulent transactions within the organisation and, instead, arranged for the bank to be wound up. However, the Bank did protect, to a limited extent, the smaller depositors with Cape Investment Bank by means of a special assistance scheme. In terms of this scheme all depositors who individually had deposits of no more than R5 million received full repayment of their deposits. This scheme therefore fulfilled the role of an informal limited deposit insurance scheme.⁶⁰ Financial problems were also experienced by Alpha Bank in 1990, which resulted in the institution being placed under curatorship in September 1990.

7.4.1 Secrecy of lender-of-last-resort assistance

In reality, over time there have been countless instances where support has been forthcoming from central banks for other banks facing difficulties where no details of the support facilities have been made available. This came about because of the common practice among central banks not to disclose such information.

When a central bank does offer special assistance to a bank, this problem of transparency arises. In such circumstances the knotty issue emerges of the extent, if any, to which the general public should be made aware that a specific banking institution was relying on assistance from the central bank for its survival. Disclosure of such information could prove to be fatal where such an institution was concerned. A run on that particular institution could be precipitated, and this could lead to the forced liquidation of that bank.

Central banks, as already indicated, usually try to keep the fact that they are providing systemic support secret at the time. The Bank took the view that disclosure of assistance provided to a bank could force such a bank into liquidation. There could be circumstances where the markets would be reassured by knowing that a central bank was providing support for a bank. Very often, however, the opposite would be true. If people knew that the central bank was sufficiently concerned about systemic risk, and that it had judged it necessary to provide support for a bank or banks, that could lead to a wider loss of confidence. People would wonder how far that support would be extended, and the central bank could rapidly find itself in the position where it was underwriting much, if not all, the liabilities of the banking system. It could then be extremely difficult for the central bank to disengage.

7.5 Issue of bank deposit insurance

In some countries bank deposit insurance schemes exist, and during the 1990s a debate arose concerning the question of whether such facilities

should be introduced in South Africa, since it was argued that they could prevent runs on banks, and thus eliminate banking scares.

Any deposit insurance scheme, in effect, involves the collection of a small premium from depositors to protect them from losses arising out of a closure of a bank. Deposit insurance facilities can be criticised on the grounds that they pose a moral hazard; in other words, the existence of such facilities can encourage the managements of banks to engage in risky banking business, because if the bank gets into difficulties and has to be closed, the depositors will be covered by the deposit insurance scheme. Such schemes can also encourage depositors to disregard risk aspects, and place their funds with high-risk banks paying high interest rates based on the premise that if the banks fail they will still get their money back.

Such considerations influenced the thinking of the Bank in the 1990s. Nevertheless, during this period an informal deposit insurance scheme of limited scope did come into operation. This was offered by the Bank in the form of insurance on bank deposits up to R50 000. This insurance facility, however, was not guaranteed in all cases and was a financial burden faced by the Bank.⁶¹

Chapter 8

The South African Reserve Bank's relationship with government

8.1 Introduction

In reviewing the historical relationship between the Bank and the government, attention will more precisely be focused on the relationship between the Bank and the Treasury, with particular reference to events in the 1990s. Some important mutations occurred during this period which altered the Bank's position vis-à-vis the Treasury and the government. These changes, however, took place in a cordial atmosphere. Tensions, which at certain times can exist between governments and central banks, did not feature in South Africa in the 1990s.

Central banks everywhere fulfil the functions of being a banker, agent and adviser to their respective governments. In the case of the Bank a close relationship was maintained between the Bank, on the one hand, and the government, on the other, during the 1990s. During that period the Bank administered the accounts of the central government, as well as the accounts of a variety of statutory public and semi-public bodies, institutions and organisations. On occasion the Bank assisted the government financially to deal with budget deficits, and acted as adviser, agent and representative of the government in various ways. This entailed the rendering of advice on monetary and financial matters, administering the exchange control regulations, and handling the weekly tenders for Treasury and Land Bank bills. It also entailed assisting the government in the formulation and implementation of macroeconomic policy. The Bank also took care of various aspects of South Africa's dealings and relations with the IMF. Nevertheless, although it was a close relationship, the relations between the Bank, and the government did change during the 1990s.

8.2 Government banking accounts with the Bank

In keeping the banking accounts of the central government, the provincial administrations, government departments, the Public Investment Commissioners, independent and self-governing states, and various other bodies, the Bank had traditionally performed the same functions as a commercial bank usually performed for its customers. It accepted their deposits of cash, cheques or drafts, and undertook the collection of the cheques and drafts drawn on other banks. The Bank supplied them with the cash required for salaries and wages, and other cash disbursements, and also debited their accounts with the amounts of cheques or vouchers drawn by them on it and presented for payment by other customers.

By the early 1990s, however, the number of such accounts kept with the Bank had dwindled. All the accounts of the provincial administrations, for instance, had been transferred to commercial banks. This reflected the downgrading of general banking business by the Bank, a trend that was encouraged by the expenses incurred in running accounts for the provincial administrations. Such business was not profitable for the Bank. What is more, the commercial banks could offer these entities better facilities.

Some key accounts, however, remained with the Bank. The Customs and Excise account was run by the Bank on behalf of all the member countries of the Southern African Customs Union, while the Exchequer and Paymaster General accounts of the government were still kept at the Bank in the 1990s.

In the early 1990s the Bank enjoyed a large degree of independence vis-à-vis the government; a state of affairs that could be ascribed to three factors. First, the high credibility enjoyed by the Bank in both domestic and foreign circles strengthened its relationship vis-à-vis the government. Second, the new emphasis in international circles on the desirability of independence for central banks enhanced the Bank's position. Third, South Africa's political system was in transition. The De Kock Commission in the 1980s had emphasised the desirability of close co-operation between the Bank and the Treasury. In contrast, during the Stals era the Bank was more inclined to be somewhat detached from the Treasury.

8.2.1 Privatisation of government accounts

Various benefits were to be derived by having the Bank operate as the banker for the government. It was, for instance, convenient and economical for the government to centralise its banking accounts at the Bank.

Nevertheless, despite such benefits steps were taken in the first half of the 1990s to privatise part of the accounts of the government that were held at the Bank. Finance Minister Derek Keys introduced legislation in Parliament in May 1993 that allowed a portion of government funds to be placed with the four main commercial banks. These were known as a "tax and loan accounts" as previously referred to in Chapter 3. From 1993 onwards it therefore became the case that the government used not only the Exchequer and Paymaster General accounts, which it kept with the Bank to handle its inflows and outflows of funds, but also accounts kept with the four main commercial banks.

8.3 Reasons for privatising

At times before the change took place, the balance on the Exchequer account reached well in excess of R10 billion, and reducing this balance meant that the shortages in the money market, and the corresponding

accommodation the Bank provided to the banks was lower than would otherwise have been the case. The need for the banks to obtain funds from the Bank was reduced, because part of the state funds previously kept with the Bank were deposited with the commercial banks following the change. Fluctuations in funds flowing between the private banking system and the Bank diminished, thereby creating a more stable banking environment. Many of the central bank's actions in the money and capital markets were in response to massive flows of funds between the private banking system and the central bank. Since more funds were kept in the banking system through the partial privatisation of the state's accounts, this work undertaken by the Bank in the markets was reduced.

Liquidity in the banking system should ideally reflect accurately the supply and demand for money in the private sector. Before the introduction of the tax and loan accounts these fundamentals were obscured by flows of funds to, and from the government sector, because the Bank was the sole banker to the government. A large intake of cash through tax receipts would remove money from the banking system, and cause a shortage in the market. By contrast, a major redemption of stock would cause banking liquidity to rise. Apart from sending the wrong signals to the market, large movements in government flows complicated the Bank's open-market operations. Moreover, it created volatility in interest rates, which made it more difficult to predict the best time to raise funds for government.

The introduction of tax and loan accounts was designed to eliminate these problems. The accounts allowed the government to conduct a substantial part of its banking with the banks themselves, thus keeping flows within the private sector, and causing minimal disruption to the money market. Another advantage of the system was that the government was able to earn interest on the deposits with banks, and from the perspective of the government this was an important consideration. This kind of system was used by numerous countries, including Australia, Canada, Germany, Switzerland and the US.

The most important advantage of the move, however, was that it made monetary policy signals easier to read where market participants were concerned. Previously, when the Bank was active in the financial markets, particularly with the sale of Treasury bills and government stock, the markets did not always know whether the Bank was neutralising flows in and out of the Exchequer account, or whether it was financing part of the government's borrowing requirements, or was taking steps on the monetary policy front.

Under the new system, in which flows of funds between the private banks and the Bank were reduced, and the amount of accommodation needed by the banks from the Bank declined, the latter's operations in the markets became more focused on open-market operations in managing

money-market liquidity, and it was easier for the Bank to transmit its aims to the market. The aims of monetary policy became more visible.

At the same time, under the new system the Bank undertook sustained monitoring of the flow of funds to and from the tax and loan accounts. This was done because of the impact at times of such fund flows on banking liquidity and interest rates.

8.3.1 Role of the Bank as agent of the government

The number and variety of services rendered by central banks as agents of governments continued to vary in the 1990s. Nevertheless, many central banks were entrusted to some extent with the management of the national debt in their respective countries. In particular they handled new issues of government stocks by governments.

This was one of the services that was provided by the Bank for most of the 1990s and, more particularly, by the Money and Capital Market Department. This service, however, was terminated in April 1998. While it operated the service the Bank received subscriptions from investors for marketable government loans by tapping them into the market under a system of what was known as tap issues. On occasion the Bank also issued government stocks for the Treasury by means of tender issues. It also used to provide advice and information regarding the state and trend of the money and capital markets, as well as the terms on which new government loans could be issued or old loans converted.

In addition, throughout the Stals era the Bank continued to handle the issue of Treasury bills through the weekly Treasury bill tender. In this way it contributed towards the efficient management by the Treasury of its cash flows.

8.3.2 The South African Reserve Bank management of government borrowings

The Bank's handling of new issues of government stock, while it lasted, incorporated a system under which it was given a remit at budget time in which it was told by the Treasury how much money to raise for the government in the forthcoming fiscal year. In order to facilitate this task monthly meetings were held between the Bank and the Treasury to decide on the level and nature of government securities which were to be issued.

To be precise, the process of financing government deficits and debt involved three institutions, namely (1) the Department of Finance, (2) the Bank and (3) the Department of State Expenditure. Together these three institutions managed and monitored state debt through the State Debt Management Committee. Members of this committee were in daily contact with one another, while operational actions were considered at a weekly

meeting. Once a month another meeting was held when the Departments of State Expenditure and Finance presented the financing needs of the government, while the Bank reported on market conditions. The aim of this meeting was to determine the expected cost and terms attached to the available finance for the next month. Throughout the Stals era the Bank sought to improve funding procedures for the government.

8.3.3 Treasury bill tenders: Money market

In funding the central government's short-term borrowing requirement, the Bank's Money and Capital Market Department conducted tenders for Treasury bills every Friday morning; these bills being issued in maturities of three, six and nine months. The tenders were received on screen in Pretoria and the certificates computer-printed and issued in Johannesburg. The 91-day bill proved to be the most popular Treasury bill instrument.

8.3.4 Government stock: Capital market

As regards longer-term borrowing operations, in the past the Bank not only tapped government stock into the market, but also promoted active trade by writing options, and trading continuously both ways in the stock and the options markets. It was prepared to quote two-way prices at virtually all times, since it was keen to promote the liquidity of the government stock markets, although it did at times widen the spread between its buying and selling prices. In bear market conditions the Bank was, on balance, a buyer of put options and a seller of call options. The premium earned on the latter helped to offset the premium paid on the former. In contrast, in bull market conditions the Bank was, on balance, a seller of put options and a buyer of call options, with the premium earned on the former helping to offset the premium paid on the latter. In general, the Bank was a much more active buyer of put options than call options because of the government's need to sell large amounts of government stocks to fund its budget deficits. In its financial year to March 1995 the Bank's monthly options volume averaged R7 billion, compared with R6,4 billion in its 1993–94 financial year.

Prior to April 1998 the Bank was involved in trading in the secondary bond market for a number of years. During the 1990s (prior to 1998) its annual turnover (purchases and sales) in bonds increased markedly. For instance, the turnover rose from nearly R60 billion in the year to March 1992 to almost R251 billion in the year to March 1993 alone. This resulted in a number of benefits. In particular, market depth and liquidity in the bond market improved which, in turn, encouraged more participation in the market by foreign investors. Furthermore, the government was probably being funded at relatively lower rates than would have been the case without a more active secondary market. In its capacity as marketing agent in respect of government stock, the Bank depended on an efficient market to accommodate the government's borrowing requirements at the lowest possible cost.⁶² At the same time, the Bank was better informed about

developments, and the conditions in the bond market because of its active participation in secondary market trading.

A portion of the Bank's dealings in bonds in the 1990s was conducted on behalf of its subsidiary, the Corporation for Public Deposits. This entity pooled the short-term investible funds of government departments, and agencies and of the Public Investment Commissioners, a body that manages the pension funds of the public sector. It could also buy Treasury bills at the weekly tenders if the demand for bills was relatively low.

8.4 Role of private banks as market makers in government stocks

During the late 1990s active consideration was given to a change in the arrangements for the marketing of government stocks. The end-result was that the government in effect from April 1998 ended the role of the Bank as its agent in selling government stocks. Instead, the government appointed banks (local and foreign) in the private sector to manage its sales of government stocks; in other words, private banks, which had the necessary qualifications such as R1 billion of capital and were members of the Bond Exchange, became market makers of governments stocks.

8.4.1 Reasons for allowing banks to market government stock

Some analysts argued that this was justified because of the conflict of interest between the Bank acting in the market as the government's broker in selling stocks, and acting in the government stock market on its own behalf by buying or selling government stocks for monetary policy purposes. The government had a vested interest in selling government stocks for the lowest possible interest rates. However, from a monetary policy angle, at times the Bank was keen to drain liquidity from the banking system and push up interest rates by selling government stocks in the market, thereby draining rands from the system, and thus lowering government stock prices. Under such circumstances the twin roles of the Bank in acting as the government broker in selling its stocks, and conducting monetary policy were in conflict. It followed from this that if the role of the Bank as a government broker was transferred to private market securities dealers, such as banks, this would strengthen the ability of the Bank to pursue open-market operations more purposefully for monetary policy reasons, and such policy would become more transparent. It could also be argued that if the Bank relinquished its role as the government's broker, this would lead to further separation of the Bank from government, and would provide evidence of the commitment of the government to allowing the Bank to conduct apolitical and prudent monetary policies.

The government, as already indicated, decided to introduce arrangements for private financial institutions such as banks to take over from the Bank

the function of formal market making in government bonds. The Bank was never entirely comfortable with the dual role it performed as monetary authority, on the one hand, and as market maker in government bonds, on the other hand. Moreover, the Bank was virtually the only central bank in the world that quoted two-way prices for government stocks and it, no doubt, took the view that this was not a normal function for a central bank.

Both the Ministry of Finance and the Bank believed that formal market makers in government bonds from the private sector should be used, partly because they perceived that this would lead to a more liquid and competitive system of marketing government bonds which would, in turn, cause interest rates on such bonds to drop as investors perceived the risks involved in buying bonds to be lower. The appointment of market makers also brought the marketing of government stocks in line with international best practice. This method of selling government stocks was particularly well entrenched in industrial countries.

Another important benefit of the new system was increased transparency. This emerged under the new system because under the old arrangements the Bank traded government stocks in opaque dealings in the market which left buyers unclear as to whether they were buying new or previously issued bonds.

The Bank's loss of its function of handling government stock issues was not an unprecedented event. The responsibility for handling government stock sales was taken away from the Bank of England by the new Labour government in Britain in May 1997, and handed over to the Treasury. This move, however, was criticised in certain quarters partly on the grounds that all the expertise in managing government debt resided with the Bank of England. It was also argued that switching the function to the local Treasury would lead to a lack of co-ordination, since the Bank of England would still oversee the government stock market.

8.5 Foreign exchange services rendered by the central bank

Central banks perform certain other special agency services for governments. In the case of the Bank it acted as the agent of the Treasury in applying exchange controls; in other words, the Bank administered the exchange controls as agent of the Treasury. Many other central banks in developing countries performed a similar function.

Apart from operating government banking accounts, another banking service rendered by the central bank was that of providing the government with the foreign exchange required to meet its servicing of foreign debts or its purchases of goods and services abroad, or buying any surplus foreign exchange which might accrue to the government from foreign loans, grants

or other sources. In countries where the government carried large foreign debts, these governments required large amounts of foreign exchange to meet interest and principal repayments abroad, and the central banks had to obtain the requisite foreign exchange from their own reserves, by purchases of the currency in the foreign exchange markets, or by new foreign loans.

In the case of the Bank all such transactions influenced its balance sheet and the same applied to other central banks. The government's purchase of foreign exchange from the Bank, for instance, caused the Bank's assets in the form of foreign exchange to decline, but simultaneously its liabilities dropped by an equivalent amount as the size of the government's deposits with the Bank fell.

In some countries central banks rely heavily on governments for foreign exchange in the sense that such banks are not allowed to borrow overseas in their own names. Foreign borrowings instead are made on behalf of the central bank by the government, and then placed with the central bank. In some cases this reflects legal restrictions faced by the central bank, while in other instances it can reflect the consideration that the government may be able to borrow at finer rates than the central bank. It should also be noted that in certain countries such a constraint on the operations of central banks reflects the fact that the foreign reserves held by the latter are owned by their respective governments. The Bank did not face any such restrictions, and certainly in the apartheid era such arrangements would have been most unsuitable in view of the sanctions imposed by foreign interests on the public sector in general in South Africa.

8.6 Financial assistance granted to government

History is full of examples of inflation and currency depreciation resulting from excessive credit creation by the banking system on behalf of the state. In fact, experience has shown that heavy government borrowing, either directly from the central bank or indirectly through open-market operations and rediscounts, is the easiest means, and sometimes the only means, of bringing about substantial inflation. In this respect, therefore, it has not just been a coincidence that the degree of expansion of central bank credit for government purposes invariably has borne some relationship with the extent of currency depreciation.

In the interests of making advances to the state or buying government securities difficult, in the early 1920s the newly formed Bank was allowed only to buy, or make advances against government securities, and Treasury bills of not more than six months' maturity, and to invest sums not exceeding its capital and reserves in government securities of not more than two years' currency. In contrast to some other central banks, the Bank has never kept a large percentage of its assets in the form of government

securities. At the end of 1998 the figure amounted to approximately 10,5 per cent. The large budget deficits that were recorded in the 1990s were largely financed from non-bank sources.

8.6.1 Public debt burden in South Africa

The rising level of the public debt burden in South Africa in the 1990s was important from the perspective of the Bank, because such rising levels of debt could conceivably have undermined the conservative monetary policies of the Bank. This arose because the rising debt burden put upward pressure on interest rates, since the deficits were financed in the capital market to a large extent, while the Bank could have been fearful that it would face pressures to monetise part of the deficits, and in effect print money by buying government stocks. The Bank would have been reluctant to do this because of its opposition to inflationary policies, and in the 1990s co-operation between the Bank and the Treasury acted as a guard against this danger. What is more, the Bank faced legal limitations on financing the budget deficits since the Reserve Bank Act of 1989 limited the extent to which the Bank was allowed to hold government stock to the paid up value of the Bank's capital and reserves, plus one third of its liabilities to the public. From the Bank's perspective, therefore, it would have been most unfortunate if substantial budget deficits had precipitated official attempts to change the legal position of the Bank as regards providing the state with financial assistance, and in the process threatened to undermine the anti-inflation position of the Bank. This fortunately did not happen, although the high budget deficits at times constrained the Bank when trying to lower interest rates.

The Bank also took the view that the high budget deficits had other deleterious consequences, although it admitted that the severe recession between 1989 and 1993 necessitated the maintenance of an expansionary fiscal policy stance.⁶³ It took the view that the deficits before borrowing in the early 1990s had already been stretched far beyond the limits of sound fiscal policy, and if maintained at levels of around 7 to 9 per cent of GDP, would have contributed to the crowding out of the private sector, and a further contraction of the macroeconomic growth potential of the country.⁶⁴

At the same time it is worth noting that apart from legal constraints, the ability of governments in industrial countries to print money by resorting to finance from the banking systems had been eroded somewhat by the 1990s by the liberalisation of global markets, and especially the abolition of exchange controls. If the threat of default by inflation looked remotely likely, currencies would weaken, bond prices fell and the cost of government financing went up in such countries. In the contemporary world one important aspect of autonomy for a central bank concerns its ability to resist financing budget deficits by printing money.

8.7 The role of the central bank in the development of domestic financial markets

Central banks are not expected to finance specific economic sectors. This constraint on their activities, however, does not prevent them from facilitating the development of domestic financial markets. This can be justified on the grounds that it promotes a more efficient allocation of savings and investment in the economy, while facilitating open-market operations undertaken by a central bank. The Bank believed that efficient financial markets were essential for the implementation of efficient monetary policies.⁶⁵ More developed financial markets in a particular country may also attract more foreign capital into the economy.

Over many years the Bank supported and contributed to the development of the money and capital markets in South Africa. The Bank was, for example, instrumental in the creation of the National Finance Corporation (NFC) way back in 1949. The NFC represented the first specialised money-market institution in the country, and paved the way for the development of an active inter-bank market in call money, and short-term surplus cash funds of the public and private sectors. South Africa was known for its sophisticated and well-developed financial markets, and the role of the Bank in fostering the development of these markets had become less active. Even so, in the 1990s the Bank did extend limited assistance to help in the formation of the South African Futures Exchange. A committee under the chairmanship of Dr Stals reported on this issue of such a market prior to its formation. The Bank supported efforts to formalise the South African bond market, which resulted in the licensing of the Bond Exchange of South Africa (BESA) in May 1996. Greater competition and international participation in the South African financial system were also brought about by allowing foreign banks to open branches in South Africa in May 1995. Also during the 1990s the Bank continuously analysed developments in the financial markets.

Chapter 9

The South African Reserve Bank and bank supervision work in the 1990s

9.1 Introduction

Apart from the function of seeking to attain price stability, the Bank had another key duty in the 1990s, which was to ensure that South Africa had sound and well-functioning banking institutions. In the 1990s banking institutions shared with the central bank the responsibility of providing money that could be used in their daily activities by the public of South Africa. A modern market-orientated economy cannot function without money, and banks had this very special responsibility to hold, manage and invest the money supply of the total community, and to transfer money between and invest the money supply of the total community. To carry out this special responsibility, banks were called on to comply with certain minimum financial disciplines and were subject to regular surveillance by the Bank Supervision Department of the Bank. Supervision was aimed at promoting, and achieving the prudential conduct of banking business with a view to establishing a financially sound banking system as an essential link in a financially strong overall financial system.

The major argument in favour of banking supervision was to limit the risk that depositors would suffer losses, and by so doing maintain the confidence of the general public in banks. This naturally meant that the supervisory function focused attention on the individual bank. Nevertheless, supervision also had to take account of the danger that problems residing within one bank could have wider systemic repercussions on other parts of the banking system. In the 1990s a greater need for bank supervision work arose, because of the realisation of the importance of supervision of individual banks.

Through its Bank Supervision Department which was set up initially back in 1987, when the Bank took over responsibility for bank regulation and supervision from the Treasury, the Bank worked very closely with the private banks to ensure that

- (a) banks had adequate capital provided by the shareholders;
- (b) banks applied efficient risk management procedures within their own organisations;
- (c) the boards of directors of banks, their auditors and top management all shared in the responsibilities of these institutions, and
- (d) banks co-operated with the Bank in the implementation of monetary policy, and in achieving the objectives of monetary policy.

9.2 Capital-adequacy requirements

The maintenance of bank solvency was a key element in the achievement of the overall objectives of bank supervision. Accordingly, capital adequacy was recognised as an important and integral part of prudent banking in the 1990s. The capital of a bank serves a number of purposes. It furnishes a permanent source of revenue for the shareholders of a bank and funding for a bank. It is also available to bear risk, absorb losses and to provide a base for further growth. Banking supervision therefore emphasised the importance of an adequate capital base for banking institutions by laying down capital-adequacy requirements.

The most important financial requirement for a banking institution related to capital adequacy. During the 1990s banks were required to maintain a minimum amount of share capital and unimpaired reserves. A bank's capital and reserves acted as a first line of defence if losses were incurred, causing shareholders rather than depositors to first lose their money. This therefore encouraged shareholders to demand prudence from the managements of banks in their extension of credit and other business. In South Africa minimum capital requirements in terms of the Banks Amendment Act, 1994 (Act No 26 of 1994) were set at the higher of R50 million, or a specified percentage of the bank's risk-weighted assets and off-balance-sheet activities.

The minimum amount of share capital and reserve funds to be held against an asset or activity was determined by the corresponding level of risk; in other words, the capital required to back a specific asset was obtained by taking the average daily amount of the book value of the asset or activity in the relevant quarter, and multiplying this by the risk weighting applicable to the asset or activity. The risk weighting generally varied between 0 and 10 per cent. A zero rating applied to assets such as cash and Treasury bills, but fixed property other than bank premises carried a weighting of 25 per cent. The overall capital requirement percentage was phased in rising from 4,5 per cent of assets in 1991 to 5 per cent in 1992, 6 per cent in 1993, 7 per cent in 1994 and 8 per cent from 1995. In effect, the proposals of the Committee of Banking Regulations and Supervisory Practices of the Bank for International Settlements (the Basel Directives), which were issued in 1988, had been incorporated in these requirements.

At the same time, at least half the required capital had to consist of so-called primary share capital and unimpaired reserve funds, meaning capital obtained through the issue of ordinary shares or non-redeemable non-cumulative preference shares, and general or special reserves that had been disclosed as such in the financial statements of the deposit-taking institution. The remainder could be secondary share capital and reserve funds, meaning cumulative preference shares and loan capital obtained by way of debentures, as well as general or special reserves that had not been disclosed in the financial statements.

9.3 Liquidity requirements

Apart from capital requirements, the bank supervisors in the Bank focused attention on another key prudential issue, namely that of the liquidity position of a bank. The ability of a bank to meet its obligations on time, especially in respect of the repayment of interbank borrowings and customer deposits, was vital if confidence in a bank was to be retained.

In South Africa for purposes of meeting liquidity requirements, rules were laid down in the 1990s for meeting certain minimum cash reserve and liquid asset requirements, and in this respect a distinction could be made between short-, medium- and long term liabilities. However, in terms of the South African Reserve Bank Act of 1989 for cash reserve requirements, and the Banks Act of 1990 for liquid asset requirements, no such distinction was made. In terms of the 1990 Banks Act cash reserves constituted part of the minimum liquid asset requirements, and included the total amount of banknotes and coin in the vaults and automatic teller machines of the bank, as well as deposits with the Bank. Liquid assets included credit balances with the Bank, Treasury bills, liquid Land Bank bills and government stock with a maturity of up to three years. As regards liquid assets, the Banks Act 90 of 1990 specified that banks must keep 5 per cent of their total liabilities in the form of liquid assets.

9.4 The role of bank management

By its nature banking business involves taking risks. Various classes of risk can be distinguished, namely operational and control, liquidity, interest rate, currency, credit, investment and capital. A prerequisite for sound banking is that these risks are assessed properly and managed prudently. Risk management is first and foremost a responsibility of bank management, and bank supervision aimed to improve the management of risks by banks. The Bank Supervision Department of the Bank aimed to create a supervisory environment that promoted sound risk management in banks. A bank's success or failure to a great extent depended on the experience, capability, judgement and integrity of its board of directors and senior executives. Very often when a bank failed it was due at least in part to weaknesses at these levels.

Banks were regulated by the Banks Act of 1990 which was implemented in February 1991. This Act emphasised risk management as the basis for supervision of banks to a considerably greater extent than was previously the case. Supervisors under the Registrar of Banks therefore basically reviewed the risk management of the institutions, and satisfied themselves that the risk managers within the institutions had proper procedures and information to determine and manage the various risks to which each institution was exposed. To this end, various returns had to be completed and submitted to the Registrar such as the balance sheet, off-balance-sheet activities, income statements, capital adequacy and large exposures. These returns were deemed necessary to unbundle the risks, focus on

individual risks, components of risks and sensitivity to various risks, and act as a catalyst to involve management and the board of directors of each bank in the process of risk management.

Banks reported extensively on their credit risks and on their non-performing assets. However, limits on banks' large exposures were not enforced rigorously, being left essentially to the discretion of the board of directors. In contrast, in the European Union (EU) guidelines recommended that no single exposure should exceed 25 per cent of a bank's capital and reserves. South Africa's conditions of concentrated economic power rendered the implementation of a 25 per cent exposure limit somewhat unsuitable.

Bank supervision departments of central banks identified management as a key player in the supervision field. The management team of a bank was the single most important factor determining the success or otherwise of a particular institution. When the partnership between the key players and the responsibilities of the key players were considered, the importance of the individuals comprising management became apparent. The managing director led the process, but relied heavily on the management, and the personnel in the organisation. In any bank the risk management process started when a prospective employee was screened for employment, or for promotion to a senior position, with a view to ensuring that only fit-and-proper people were employed to perform the risk management function.

By definition, management was appointed by the board, which delegated the powers and responsibilities required to adhere to, and implement, the policies laid down by the board. To enable the board to decide on appropriate policy, it was the responsibility of management and the board members to formulate policy proposals for consideration by the board.

It was imperative that the members of management were also fit-and-proper persons capable of fulfilling their responsibilities. On the one hand, the fit-and-proper concept encompassed appropriate ethical standards such as integrity, with which management was required to comply. By implication, past behaviour involving fraud, gross negligence or misuse of a position of trust could have indicated that a person was not fit and proper to be appointed as a member of the management of a bank. On the other hand, the phrase referred, *inter alia*, to the appropriate knowledge, skills, experience and judgement that a member of the management of a bank was required to possess.

The management team was also responsible for appointing the internal auditors, who assisted management in ensuring that there was compliance with laid-down policies and procedures. It was, however, also important that the internal auditors maintain a certain measure of independence in the sense that they should be able to gain direct access to the board of directors via the audit committee, if the need arose. Management was responsible for the day-to-day management of the affairs of a bank. In the course thereof, management performed the detailed risk management

and, accordingly, required a high degree of competence in identifying and managing the different risks to which the bank was exposed. Management was a vital cog in the system of checks and balances that was in place to ensure that the concepts of accountability, and risk management could be applied effectively. As regards the Bank Supervision Department it was committed to facilitating the optimisation of risk management by banks.

It was also important to note that the Registrar of Banks was responsible for the regulation and supervision of mutual banks in terms of the Mutual Banks Act, 1993 (Act No. 124 of 1993) which was implemented on 3 January 1994. On 31 December 1995 the following mutual banks operated in terms of this Act: Community Bank, Credit and Savings Help Bank (Cash Bank), GBS Mutual Bank (former Grahamstown Building Society), Bophuthatswana Building Society, Venda Building Society and TNBS Mutual Bank (former Transkei National Building Society).

9.5 Partnership between key players in the risk management process

There were indeed six key players involved in the risk management process of a bank, and the partnership that existed between the key players became clear when the responsibilities of each key player were identified. These key players and their responsibilities are depicted in Table 4.

The board of directors, who carried the ultimate responsibility, was responsible for setting policy and monitoring compliance therewith. Management, in turn, implemented the approved policies and made policy proposals. The audit committee/internal audit function assisted the board and management by monitoring the implementation of, and compliance with, laid-down policies and internal controls to ensure, *inter alia*, that there was proper disclosure by management. In contrast, the external auditors evaluated the effectiveness of risk-management policies and controls, and compliance with such policies and controls.

Table 4: Risk management: A partnership between key players

Key players	Responsibility
Board of directors	Policy
Management	Implementation
Audit committee/Internal audit function	Compliance
External auditors	Opinion
Investing public	Awareness
Supervisory authority	Improve risk management

The investing public took responsibility for their decisions about investing in banks by understanding who was taking the risks (agency versus principal),

and by applying prudent investment procedures and criteria. They were supported in this role by the media, financial analysts and rating agencies, which analysed and commented on the information supplied by banks. The regulatory and supervisory authorities were responsible for creating an environment that would facilitate the optimisation of the quality and effectiveness of risk management in the banking system.

In addition to these key players, the shareholders – as ultimate financial stakeholders in a bank – were subject to the discipline of the market. It was important that they played a constructive and active role in a bank. It was the shareholders who ultimately decided on board appointments and, through the board, decided indirectly on the appointment of management, internal auditors and external auditors.

In sum, bank regulation and supervision in South Africa in the 1990s were focused on effective risk management within each banking institution. However, the Bank Supervision Department alone could not guarantee the safety, solvability or profitability of any bank. This was, and always would be, the responsibility of the board of directors and the management of each bank.

However, in the 1990s the Bank Supervision Department sought to relieve distress in any bank in an optimal manner in order to cause the least possible harm to depositors, and the central bank. In addition, the department at all times tried to prevent, as far as possible, the practice of illegal deposit-taking in order to contribute towards a stable banking system. To this end, a number of key prosecutions took place. It also participated in several investor education campaigns such as participating in radio and television programmes, and gave support to the South African Law Commission which was required to draft anti-money laundering legislation for the country.

9.6 Methodology of supervision: On-site versus off-site

There are two alternatives available to a central bank in performing its banking supervisory duties. One alternative is an off-site approach where the banks submit a comprehensive set of statutory returns to the regulatory authority (i.e., the central bank). The latter analyses the data so obtained together with data from other sources. The central bank then forms an opinion on each individual bank as a whole, based almost wholly on this data, and with minimal contact with the bank except to solve queries on the data.

The alternative is on-site supervision during which a bank submits statutory returns mainly related to prudential requirements, and the Bank Supervision Department visits the banks on a regular basis to perform inspections (examinations). The department forms an opinion of the bank based on the

information gathered during the inspections (examinations), and based on discussions with the banks' service management.

There was an international move to on-site supervision during the 1990s, and although the Bank, and more specifically the Bank Supervision Department, had performed off-site supervision in the past, its new approach involved combining the best of both approaches. This combined method involved primarily off-site supervision, and limited on-site supervision in the form of quarterly meetings with banks and annual trilateral discussions between a bank's audit committee, its external auditors and the supervisors, as well as annual presentations to the boards of directors, top management, risk managers and external auditors.

This latter approach allowed information supplied by a bank to be verified, and allowed in-depth on-site investigations to be undertaken by external auditors or other experts. Moreover, the duties of all key players were highlighted continuously, and communication was promoted through interaction.

9.7 Relationship between the Bank and bank supervision

During the 1990s an arms-length distance was established between the Bank and its Bank Supervision Department. The head of the department was known as the 'Registrar of Banks', and he enjoyed independence from the Bank in adopting policies for the soundness of the local banking system. In addition, the Registrar reported to the Minister of Finance. On a practical day-to-day basis, however, close relations existed between the Registrar and the Bank. Some distance between the Bank and the Bank Supervision Department became desirable because of unavoidable conflicts that arose at times between the need for action by the Registrar against misbehaving banks, and the access which banks had to the accommodation facilities of the Bank.⁶⁶

The Bank's responsibility for conducting banking supervision was one that entailed certain disadvantages. It gave support, for instance, to the unfounded perception of the general public that the authorities would provide an unqualified guarantee for the safety of deposits with all registered deposit-taking institutions. It was argued that the central bank with its power to create money would always bail out depositors of banks that experienced difficulties, especially because of its supervisory responsibilities.⁶⁷ During the 1990s these sorts of considerations led to a debate at times on whether bank supervision should be part of the central bank function in South Africa.

Bank supervision work had traditionally been perceived to be a central bank function, and the Bank took the view in the 1990s that this policy approach should be adopted in its own case. This was based on several considerations. Bank supervision personnel were traditionally central

bankers, and might well prefer to stay with the Bank. Any transfer of bank supervisors to an independent agency outside the central bank might result in a reduction in banking supervisory capacity. In addition, the safety net arrangements of the Bank such as lender-of-last-resort facilities were closely intertwined with the responsibilities of the Bank Supervision Department. Furthermore, bank supervision work improved the conduct of monetary policy, because identified problems in the banking sector served as an early indicator of deteriorating conditions in the macroeconomy in general.

It was also recognised that containment of a banking crisis could often depend more on the actions of the central bank than the bank supervisory authority. In making such interventions, however, the central bank may be forced to deviate from its chosen path of pursuing the stability of the currency.⁶⁸

Chapter 10

Central clearance and settlement facilities for private banks

10.1 Introduction

Central banks, including the Bank, had a role to play in maintaining and improving a country's payment system. This involved the clearing of payment instruments, providing an adequate supply of currency, and preserving confidence in the value of the currency. A well-functioning and efficient payment system was vital to stimulate business and commerce. If cheques and other payment instruments could not be cleared in a timely fashion or the public could not get the currency that it needed to carry out transactions, business activity would be severely curtailed. The result might well have been large-scale unemployment, and a decline in both capital investment and the country's rate of economic growth. In this chapter the main focus of attention is the system of clearing cheque and other payment instruments; interbank settlement and the associated national payment system; and the role played by the Bank in this area.

10.2 The function of central clearance and provision of central bank settlement facilities

The function of central clearance and settlement was first developed by the Bank of England in the middle of the nineteenth century after the other banks in the country had for years followed the practice of keeping balances with the Bank due to the fact that it was the principal bank of note issue, and the government's banker. It was in 1854 that a plan was adopted for settling the monetary differences arising out of cheque transactions between the various banks at the end of each day. The clearing was done by transfers between their respective accounts at the Bank of England. Thereafter, it was gradually taken up by many other banks of issue which developed into central banks, and with the passage of time it came to be regarded as an automatic function of a central bank.

Although not usually regarded as a particularly important function, central clearance and settlement was looked on as a necessary or natural function of a central bank. As central banks became the custodians of the cash reserves of the commercial banks, it was an easy and logical step for them to assume the duty of acting as a settlement bank, or a clearing house for the other banks. As the holders of the cash balances of the commercial banks, the central banks were specially qualified to speedily and efficiently

arrange for the clearance of cheques and other payment instruments between the banks.

The principle of settling the differences between various banks at the end of each day's clearing, by transfers between their respective accounts at the central bank, was essentially simple in nature. As an example, assuming that there were three commercial banks in a country, namely Banks A, B, and C. Suppose that on a particular day Bank A had R100 million of cheques drawn on it by its clients using cheques and presented to Bank B, while the latter had R90 million of cheques drawn on it by its clients, these cheques being deposited with Bank A. Bank A owed Bank B R10 million, and this payment would be effected by means of a cheque in favour of Bank B written out by Bank A and drawn on its account at the central bank. The differences between Bank A and Bank C and Bank B and Bank C as regards the value of cheques written out would be settled in a similar manner utilising their accounts at the central bank.

This process involved clearing, or netting, as well as settlement, in which the gross or net obligations between two or more entities were calculated, and then settled by a transfer of the amount of funds due from each obligor. There was therefore a distinction between clearing and settlement. 'Clearing' involved adding up the values of the cheques written out, and calculating the amounts owed by various banks to one another. 'Settlement' involved the transfer of the net or gross amounts of funds owed by various banks. In practice, wide differences could exist between clearing and settlement systems in different countries.

The basic distinction was between net and gross settlement systems. A *net system* was one where transactions were concluded during the day, but it was not until the end of the day, or some other defined netting or settlement period, that obligations were netted and settled with a single transfer of funds. In a 'gross system' on the other hand settlement took place for each transaction that was undertaken.

10.3 Significance of central clearance and provision of central bank settlement facilities

The Bank had a keen interest in the maintenance of an orderly payment and money transmission system, and the clearing and settlement mechanism in place played a key role in this regard. It has already been indicated that as the commercial banks kept cash reserves on deposit with the central bank and thus had accounts with that institution, it followed that settlements between the banks could most easily, and conveniently be effected through the accounts they kept at the central bank. Over a period there was seldom a substantial difference between the amounts of cheques and drafts drawn on any bank and presented by other banks on behalf of their customers for

payment, and that of cheques and drafts on these banks received by its own depositors. In contrast, the daily differences in the clearings between such banks might be considerable, and such differences could best be settled by means of debit and credit entries in their respective accounts with the central bank. In the South African context, if the clearing went heavily against certain banks at any one time and the credit balances of these banks with the Bank fell below the minimum prescribed by law, these banks could borrow from the central bank for a few days hoping that the clearing would swing in their favour again soon. This was the fundamental reason why banks borrow from the Bank. The Bank was the ultimate source of liquidity to the financial system, and performed this function by acting as a short-term lender of funds. Banks would attempt to avoid significant borrowings from the Bank arising out of deficits at the daily clearings by borrowing from other banks in the interbank market. Nevertheless, the banks as a whole regularly borrowed from the Bank, which need arose from the settlement process.

The Bank provided the great bulk of daily accommodation to the settlement banks, which numbered more than 20 and, in particular, the four big banks as a result of the daily clearings that could go against certain clearing banks, and lead to a cash shortage for the banking system as a whole. In contrast, accommodation provided to non-clearing banks was small.

There were, nevertheless, times when the banks ran short of cash reserves due to the expansion of their bank deposit liabilities. In their efforts to accommodate customers as well as remain fully invested, banks could often extend loans in anticipation of inflows of loanable funds from deposits or money-market sources. Loans to the non-monetary private sector added to the deposit liabilities of banks but not to their cash reserves. It was therefore the case that certain banks may not possess enough cash reserves to meet their reserve requirements against the new deposits, especially because they did not normally hold large excess cash reserves.

10.3.1 The benefits of central clearance and provision of central bank settlement facilities

While the process of effecting settlements between banks through the accounts kept with the central bank was a comparatively simple operation, it was one that was of great convenience to the banking community. Large debtor positions accumulated in the course of a day that far exceeded the amount held by commercial banks in their cash reserve accounts. It was also significant from the viewpoint of economising on the use of money in banking operations, especially where the central bank had branches in various parts of the country, and used its branches for the purpose of local settlements. The process of netting the settlement amounts, when properly performed, significantly reduced the total value transferred, and the number

of payment transactions. It thus tended generally to strengthen the banking system of a country by lowering operating costs and liquidity requirements.

The system of clearing and settlement was also a means whereby the central bank could test at any one time the degree of liquidity in the banking system, a matter that was crucial for the central bank to know about from day to day. Moreover, the process of central clearance and provision of central bank settlement facilities afforded the central bank a valuable means of ascertaining the relative trends in the operations of individual banks.

10.4 The vulnerability of the Bank in the settlement process

The function of central clearance and provision of central bank settlement facilities for claims of deposit-taking institutions on one another had been performed by the Bank since September 1921. However, since 1973 cheques had been cleared at the Automated Clearing Bureau (ACB) and not at the Bank, which meant that in the 1990s the Bank was only an institution of central settlement, and not one that was involved in central clearing. This overall function developed in South Africa in three stages involving, (1) a manual system, (2) an automated system and (3) the system in the 1990s which could be called a 'fully automated national payment system'.

The manual system operated before 1973 where cheques and other payment instruments held by the various clearing banks against one another were cleared or exchanged in a clearing house in which representatives of each of these banks gathered daily at specified times. In centres in which the Bank had a branch office, the Bank itself served as the clearing house.

The second stage started when the ACB was established in 1973, and the clearing procedures changed materially. The bulk of the country's cheques and other payment instruments were from then on cleared through the ACB's electronic clearing facilities in Johannesburg, Cape Town, Port Elizabeth and Durban. Late every afternoon cheques and other payment instruments deposited with banks were transported to ACB and processed in an automated manner. This computer system kept a tally of cheques and other payments by customers of Bank A and deposited at Bank B and vice versa. The net amount that Bank A had to pay over to Bank B or vice versa was then communicated to Bank A, Bank B, and to the Johannesburg money market of the Bank early the next morning. The Bank would then debit the paying bank's current account, and credit the receiving bank's current account in the books of the Bank. Settlement was therefore on a deferred basis on the next day at about 09:00. If a bank could not make the payment due to a shortage of funds, and could not attract enough deposits to cover the liability, it had to borrow funds from the Bank through

the accommodation window. This was undertaken against the security of high-quality paper.

Under these arrangements a principal worry had been the danger of non-settlement by a bank or banks at the daily cheque clearance. The failure of a bank to obtain funds in the interbank market or the lack of high-quality paper to use as collateral for loans from the Bank might have led to non-settlement and chaos in the market. Without settlement, hundreds of thousands of transactions might have been put on hold. Since the next round of transactions typically depended on the successful conclusion of the previous round of transactions, non-settlement could easily have led to systemic risk. Systemic risk is the domino effect that results when one bank is unable to meet its obligations and other banks consequently default on their obligations, posing a threat to the whole financial system, which could collapse.

The system described in the preceding paragraphs was known as a 'multi-lateral net settlement system', and it involved huge sums of money. On one day alone in April 1993 the value of the domestic clearing reached almost R73 billion. This represented approximately 20 per cent of the annual GDP, and was 45 times greater than the average balances held by banks with the Bank during that month.

The objective of the ACB was to process cheques and other paper instruments on an automated basis. The ACB originally used magnetic ink character recognition (MICR) techniques, and later also implemented code line clearing (CLC) techniques. The ACB provided the banks with data relative to clearing through direct transmission. Previously this was also provided on magnetic tape. After processing, cheques and other instruments were delivered to the banks on which they were drawn, and were returned to the drawer in due course. Electronic payments such as direct debit orders were also processed through the ACB. The system in operation in the 1990s for electronic payments was known as the 'Electronic Funds Transfer System' (EFTS). It handled approximately 20 000 million debits and credits per month. Small-scale manual clearing of certain categories of payment instruments was, however, still done at commercial banks in rural areas.

10.4.1 Settlement system and exposure of the Bank

Until about 1992 the Bank had adopted essentially a fairly low profile with regard to the development of the clearing and settlement system. Involvement was mainly as a participant and then largely through the provision of funding rather than expertise. However, it subsequently became more aware of a number of issues that surrounded the clearing system and settlement process.

During the year ended 31 March 1995 a payments system division was established in the Bank with the primary goal of ensuring the overall effectiveness, and integrity of the national payment system in South Africa. It set out to define a vision of the ideal payment system for South Africa, and the containment of systemic risk became a major incentive for re-aligning the national payments system. In addition, revision of the existing national payment system was desirable since severe pressure on this system was being exerted by a substantial increase in all financial market transactions, and a greater participation by non-residents.

The possibility existed that a settlement bank would fail to meet its interbank obligations as previously noted. If a particular bank got into difficulties and faced a run it might not have been able to meet its interbank commitments at the daily settlement. The central bank was always concerned about the stability of the banking system as a whole, that is, systemic risk, and therefore had an interest in the settlement system and its functioning. Lack of confidence in one bank could have affected the whole banking system including the settlement system. In effecting interbank settlements the Bank was faced with a *fait accompli*, because the net amounts owed by various banks at settlement were based solely on cheque and other non-cash transactions which had previously taken place. What is more, both the settlement banks, and the Bank had little knowledge of the net amounts that would be owed each day. Indeed, this was only known on the morning following the clearing of the previous day's transactions.

The daily settlement system regularly led to a situation where a bank or banks needed accommodation from the Bank. If this happened any such bank provided suitable assets as collateral for the accommodation provided by the Bank. It was, however, possible that a particular bank required levels of accommodation that could not be completely secured by suitable eligible assets held by the bank. In those circumstances the Bank, in the interest of the stability of the overall banking system, might be obliged to extend accommodation without full collateral from the bank involved, and the Bank would be exposed.

The Bank might have found it difficult, if not impossible, to refuse to extend accommodation without collateral under such circumstances, even though it was legally obliged under the Banks Act of 1989 not to extend loans on an unsecured basis. There would have been utter chaos in the financial system if a settlement default arose, and the huge non-cash payments involved had to be unwound. This would take a week or more to be completed. In the meantime the settlement default would most probably have led to a run on the bank in difficulties, and could have posed a systemic risk to the entire banking system.

The risk exposure faced by the Bank from the settlement system was small, but the settlement risk had grown due to the growth in trading values. In most cases where a bank faced liquidity difficulties it should still have been able to offer some kind of assets as collateral for loans from the Bank, even though such assets would not normally have been regarded as eligible for accommodation. Moreover, a bank should have quickly become aware of the danger that it was running out of normally eligible assets which it could use as collateral, and would therefore have sought to raise funds from domestic sources, or borrow abroad and sell the foreign exchange to the Bank for cash.

Even so the Bank faced the risk of exposure. This was especially true if the bank requiring the assistance was facing not simply a liquidity problem, but also a solvency problem. Under those circumstances the Bank could still have found it almost impossible to refuse to extend assistance, because of the potential implications of a settlement default.

The Bank had a vital interest in the stability of the workings of the payment system. It had taken the position that financial intermediaries and market participants should preferably control their own credit and market risks, and that they must work together with the Bank to reduce risks in the payment system. Improvements in the workings of the clearing system, and settlement process were constantly being sought. One possibility would have been the payment of market-related interest rates on all cash reserves held with the Bank, which might have led to a much larger base of reserves that were held by the banks with the Bank. Another possibility would have been to reduce or eliminate the exposure risk of the central bank by means of liquidity-pooling and loss-sharing arrangements among banks aimed at ensuring settlement in the face of difficulties faced by a particular institution. The willingness of certain banking institutions, particularly the larger ones, to co-operate in this manner, however, was very much open to question, since they might well have argued that they themselves would never face major settlement difficulties.

Against this background, the authorities concluded that the nature of the settlement system itself needed to be changed to be aligned with international developments. Numerous other countries operate a same-day settlement system, and this was the nature of the new system that was introduced, which was distinct from the next-day settlement system which was in force in South Africa from 1921 to 1998. The new stage in the development of the central clearance and settlement facilities in South Africa involved emphasis being placed on a “same-day” settlement system as opposed to the “next-day” settlement system that had been in force in South Africa since 1921. Details relating to this system are outlined in the following section.

10.5 The new national payment system initiative

During November 1995 a document containing a strategic framework for the reform of the South African national payment system was formally accepted by Dr Stals and Dr D C Cronjé, Chairman of the Council of South African Banks (COSAB). This document was the product of a collaborative effort between the Bank and the banking sector, and was developed over a period of 18 months, using experts from several disciplines and consulting various stakeholders. The strategic framework document covered all aspects of the payment system. The complete process, from the moment an end-user issued an instruction to pay another person, through to the final settlement between banks at the Bank, was addressed.

The situation where settlement obligations were only known the next morning as previously explained was unacceptable to the Bank. In order to reduce the risk of unexpected surprises in the payment system, a new settlement system was introduced in March 1998 that operated as the South African Multiple Option Settlement (SAMOS) system and provided for settlement options that were either immediate settlement or delayed settlement. SAMOS went a long way towards bringing interbank settlement practices in South Africa on a par with internationally accepted standards.

Immediate settlement took place under the real-time gross settlement system for certain transactions. This system provided for intraday settlement which meant that settlement would take place on the same day the transaction was entered into. Large payments involving different banks were now no longer routinely channelled through the normal stream, for net settlement the next morning, but were settled one at a time (or in small groups obeying strict criteria) during the day. The paying bank had to possess either enough surplus funds in its cash reserve contra accounts with the Bank or enough collateral with the Bank (deposited at the Central Depository), before each payment was effected in the books of the Bank. Once such payment was made, it was irrevocable.

These arrangements in particular, as indicated, made accommodation for large payments. Payments with a high value were removed from the routine low-value stream. An analysis of the ACB payment stream revealed that under the old arrangements payments with an individual value in excess of R1 million represented only 0,4 per cent of the total number of payments, but constituted more than 90 per cent of the total value processed. It could be seen from these figures that the payments most likely to present a risk to the national payment system constituted a tiny fraction of the overall transactions. Under the new arrangements large payments would not be made by cheque or another non-cash instrument, but only through electronic transfers with real-time settlement.

Delayed settlement operated through netting stacks from March 1998 until June 1999, where settlement took place during the day or at the end of the day. From June 1999 netting stacks were replaced with the continuous processing line. Under this system, settlement continuously took place as long as the bank had the necessary collateral available for obtaining liquidity in the system. In the case of insufficient collateral, the payment would be placed in a stack until the necessary liquidity was available in the system. This system was used for the high-volume debit or credit electronic transactions with a low value, as well as card payments, salary payments and the paper-based stream of transactions that would always be present.

In addition to this, the new payments arrangements made allowance for large payments increasingly being initiated by the paying bank rather than the receiving bank. This was called “credit-push”, a practice whereby the payer initiated the transfer of funds to the payee; in other words, money would have to be available upfront. This was in contrast to the system that operated before March 1998 where a cheque was regarded as a “debit-pull” instrument, with a payment instruction that required the recipient (or its bank) to collect funds from the remitter, effectively causing the collecting bank to “pull” the funds through the payment system.

Shortfalls in settlement transactions between banking institutions could be financed in the local market or in the foreign market. Local financing options that were available included

- (a) the interbank market where a bank in need of funds could obtain a loan from another bank that had surplus funds available;
- (b) intraday loans made available by the Bank under the SAMOS system;
- (c) liquidity on the reserve account at the Bank which became available during April 1998;
- (d) the repo system where banks tendered for the available loan funds at the Bank; and
- (e) the marginal lending facility, which replaced the old overnight accommodation system. All outstanding amounts on the settlement accounts of the various financial institutions would automatically be financed at the end of the day through this facility at very high penalty rates which were known as the marginal lending rates.

The introduction of the SAMOS system of settlement in South Africa did not, however, eliminate all risks in the payment system. Bank failures could still occur. However, cutting a failing bank out of the system would be much easier without having to unwind numerous semi-processed transactions and with fewer problems for other banks. The depositors of a bank that failed, however, would still suffer as much financial loss under the new system as under the old one. The advantages of the new settlement system lay with other banks' clients who would not be affected and with the taxpayer, who would not have to foot part of the bill of a bank that failed.

It was clear that the new national payment system promised enhanced facilities for the containment of systemic risks, and a high level of international acceptability and competitiveness. This would also help South Africa to stand its ground in comparison with payment systems in other parts of the world.

The added advantages of the new system included

- (a) monitoring of settlement exposures on an intraday basis which made it possible to check on the liquidity of bank positions at any time of the day;
- (b) management of interbank settlements on an intraday basis, which made it easier to see if a bank was running out of collateral or had insufficient funds to settle obligations;
- (c) dynamic collateral management: under the new arrangements the calculation of loans that were needed by banks during the day was undertaken automatically under the SAMOS system, and the funds were made available immediately; and
- (d) direct access to the settlement, loan and collateral accounts of the Bank which was the link which made management of the liquidity positions of banks easier.

In the context of the new national payment system, the Bank had responsibility for ensuring that the interests of all stakeholders in the system were served and ensuring, as far as possible, that the settlement processes functioned smoothly. It also sought to ensure that the standards of the local national payment system were in keeping with international standards, and that the agreed principles and practices of the payments system were adhered to by all parties concerned.

Part 3

Exchange Control Policies

The administration of exchange controls carried out by the Bank on behalf of the government in the 1990s remained the most controversial aspect of the work performed by the Bank. Calls for the abolition of exchange controls came from various quarters throughout the 1990s, with these controls becoming increasingly anachronistic in the light of the domestic political developments, and the trend towards the abolition of exchange controls in other countries. This was threatening to undermine South Africa's international competitive position as regards its ability to attract foreign capital.

In the administration of exchange control, the Bank acted as an agent for the Treasury where the final responsibility for all exchange controls was vested. For good reason, the Bank had the duty to advise the Treasury on exchange control policies, and was perceived to be the main architect of the programme of gradual abolition of the controls.

Chapters 11, 12 and 13 review the progress made by the Bank in reforming the financial rand system in the early 1990s, explain the problems the Bank encountered at that time in eliminating the system, and thereafter plot the strategy adapted for scrapping the exchange controls on non-residents in March 1995. In these three chapters the strides made in progressively removing the exchange controls on residents after March 1995 are outlined, and the rationale for the Bank's gradualist approach towards the removal of these controls on residents is put forward.

Chapter 11

The issue of the financial rand: Hurdles to the removal of the system in the early 1990s

11.1 Overview

In the early 1990s the implementation of the exchange control system by the Bank, acting as an agent for the Minister of Finance, incorporated in part the strategic objective of making the exchange controls both more user-friendly and more effective. From time to time the majority of limits contained in the exchange control rulings were increased; partly to compensate for inflation in foreign countries, and to take account of the depreciation in the rand. Even at that juncture, however, from time to time Dr Stals let it be known that once the circumstances were sufficiently favourable, attention should be focused on liberalising the entire exchange control apparatus.

The South African monetary authorities had let it be known by the early 1990s that ideally they would have liked to have abolished the exchange controls over non-residents at that juncture. Independent august bodies such as the World Bank expressed support for such a move. In 1990 Dr Stals asserted that a merging of the financial rand and commercial rand systems would be desirable once non-residents again accepted South Africa as an attractive place for foreign investment.⁶⁹ Following the political initiatives of the State President in February 1990, the discount on the financial rand began to narrow, and by the middle of 1991 the prospects for the eventual dissolution of the financial rand system had improved when the discount fell to around 6 per cent. Thereafter, the discount increased once more, thereby posing new difficulties in the way of reform in the foreign exchange arena. The purpose of this chapter is to explain developments in the financial rand market in the early 1990s, and outline the obstacles that lay in the path of removing the mechanism at that juncture.

11.2 Introduction

In principle, there were still strong grounds for concurring with the conclusion of the De Kock Commission that under more normal circumstances, South Africa's interests were best served by a unitary exchange rate system. Nevertheless, the authorities had indicated that the system should be retained under the circumstances facing the country in the early 1990s. The arrangements served as a cushion in the event of any sudden panic flight of capital abroad.

It is true that the system had a limited influence in attracting foreign capital inflows and, strictly speaking, this could not occur through the financial rand market since any purchases of financial rand by foreigners matched equivalent sales. The main purpose of the system, however, had never been to attract foreign inflows, but rather to prevent outflows being financed from the limited amount of foreign reserves available to the country. It was also the case that the administration of the system had proved to be onerous because of abuses of the arrangements and, to some extent, the resultant arbitrage transactions undermined the cushion the system provided against capital outflows.

Several other countries in the developing world had abandoned multiple exchange rate practices over the years, but any dissolution of the system in South Africa in the early 1990s was complicated by the danger that this could have been in conflict with the objectives of monetary policy. The Bank was placing a strong emphasis on curbing inflationary pressures in the interests of fostering greater financial stability. This objective could have been impaired by any sudden removal of exchange controls over non-residents if this was accompanied by a meaningful fall in the commercial rand rate. It was in any case important to appreciate that any material curbing of the rate of inflation in South Africa could have greatly improved the prospects for removing the exchange controls on non-residents since a low inflationary environment should have boosted the interest of foreigners in investing in South Africa. Moreover, any move to scrap the financial rand system was also hindered by a number of other factors at that stage.

11.3 Implications of foreign debt standstill

The financial rand system was reintroduced in 1985 as part of the standstill arrangements in respect of the country's foreign debt in an effort to apply fair and equal treatment to all South Africa's foreign creditors, that is, equity and bond investors and loan lenders alike. In the various rescheduling foreign debt arrangements provision had been made for lenders trapped with loans inside the standstill net to convert their short-term claims at their option into financial rand for either investment in South African equities, or for liquidation through the financial rand system. Under these arrangements foreign creditor banks could sell their standstill claims, some of which were denominated in foreign currencies, for rands in the commercial rand market. Their rand receipts were then credited to a financial rand account and the creditor banks could then sell the financial rand for dollars in the financial rand market, or convert the financial rand into South African equities. Such debt-equity swaps had amounted to US\$1,2 billion by the end of 1992.

At the end of 1991 South Africa's total foreign debt amounted to US\$18,1 billion, of which US\$6,0 billion represented debt subject to the standstill arrangements. At that stage the amount of standstill debt had probably fallen to about US\$5,5 billion, partly due to semi-annual scheduled

repayments and this amount, at least in theory, was eligible for the debt-equity switch or conversion into financial rands for selling abroad.

Given these circumstances, it was important to appreciate the possible effects of any material reduction in the discount on the financial rand on the amount of remaining loans within the standstill net. Creditors with foreign debt caught inside the standstill net in general had been reluctant to take out their money through the financial rand system (or through the sale of these loans in the secondary debt market). Their reluctance stemmed from the penalty of a wide discount on the financial rand. Any significant narrowing of the discount from the level of roughly 37 per cent prevailing at the end of 1992 would have meant that the penalty was reduced. Under those circumstances the incentive to switch out of the standstill net would have risen, but this could then have caused the discount to widen again in line with pressures from the sales of financial rands for dollars.

The prospects for any removal of the two-tier exchange rate system did therefore partly depend on the behaviour of foreign creditors holding standstill assets which, in turn, was related to the size of the discount on the financial rand. What is more, if conditions were propitious for the lifting of the standstill debt mechanism, the same could have applied to the financial rand mechanism as well and vice versa. If the attitudes of foreign bankers were conducive to the lifting of the debt standstill arrangements, this suggested that conversion of foreign debts into financial rand could have been small, while foreign investor interest in South African-quoted securities and unlisted equity investments could have been positive, and reflected in a relatively low discount on the financial rand.

This close interrelationship between the financial rand and debt standstill mechanisms only strengthened the case for scrapping the financial rand system under conditions where the discount on the financial rand was relatively small. Under such circumstances the danger of large short-term capital outflows in the wake of any scrapping of the financial rand system would be minimised. Any such low discount was only likely to materialise for any meaningful period of time if bank creditors with foreign loans caught inside the standstill net were happy to refrain from taking out their money through the financial rand mechanism.

These conditions, however, did not guarantee a smooth switch to a unitary exchange rate system. Ideally, any such policy change would have materialised at a time when the country's access to foreign reserves was sufficiently high to be able to meet any possible short-term capital outflows. The country's foreign reserves had been increasing in previous years. From June 1989 to September 1992 the total net foreign reserves of the monetary banking sector increased from a negative R3 152 million to R1 207 million. Even so, the level of the gross foreign reserves of around R10 000 million at that time were still less than three months of imports,

which was the target the Bank was aiming for. A further improvement in this position, and a substantial narrowing of the discount on the financial rand appeared to be prerequisites before consideration was given to the lifting of exchange controls over non-residents.

South Africa's renewed access of to the IMF, and its facilities would have strengthened the foreign reserves position. Under those circumstances the authorities would have been able, in the case of a serious balance-of-payments need, to apply for substantial temporary funding. At the same time, such access to IMF resources could have facilitated any scrapping of the financial rand system since this should have improved South Africa's credit status, and enhance the willingness of foreign bank creditors to retain their exposures in this country.

11.4 Implications of growing financial rand balances

The marked fall in the financial rand rate during the course of 1992 to a discount at times of more than 40 per cent vis-à-vis the commercial rand rate was partly directly attributable to the increasing pace of direct foreign investments undertaken by South African companies. Some of these investments were made via the financial rand market. The consequent sale of financial rand for dollars weakened the rate while contributing to a rise in financial rand balances. This had created another obstacle in the way of dismantling exchange controls over non-residents.

In terms of long-standing arrangements, foreign direct investments made by South African firms had to be approved by the exchange control authorities which abided by certain criteria in deciding whether to approve such investments. Many of these investments had been financed by the cash resources of local firms. This meant that such firms had to apply to the exchange control authorities for permission to use financial rands for purposes of making foreign investments. Following the lifting of sanctions in the early 1990s, South African corporations found many new opportunities to acquire foreign investments within the framework of the then existing exchange control policy.

It is these investments that helped to depress the financial rand rate in the course of 1992. This had furnished support for share prices reflected in the net buying of equities by foreigners on the JSE since around the beginning of September 1992, after a long period of net sales by the foreign sector. These foreign investments financed through the creation of financial rands posed a problem for the exchange control authorities.

The greater the creation of financial rand, the greater the supply of financial rand balances that emerged and the higher the discount, other things remaining equal. This rendered it more difficult to scrap the financial rand system. The increment in these financial rand balances ended up being

held by non-residents and the interest payments on these balances were transferred abroad through the commercial rand market. This entailed an ongoing drain on the foreign exchange reserves of the country, while these reserves did not benefit, in the first place, from the initial investment in financial rand balances by non-residents.

The size of financial rand balances held on deposit with South African banks had risen considerably over the years, reaching nearly R7 000 million by October 1992 compared with roughly R300 million in the second half of 1988. These balances constituted a new dimension to the financial rand market. The rise in these balances had not stemmed from investments abroad by South African entities alone; transactions involving emigrant allowances and conversions by non-residents of dollar loans subject to the debt standstill orders into financial rand also played a part, but they did not appear to be important. The major reason for the increase in these balances, however, came from disinvestment transactions by non-residents who placed the proceeds of their equity and bond sales on deposit with South African banks, pending the eventual sale of the financial rand to another non-resident.

At the same time, the ability of the financial rand market to absorb this large inflow of new financial rands was facilitated by improvements in political perceptions held by foreign investors since early 1990, consequent hopes of an improvement in the financial rand rate, and indications that certain domestic banks might have marketed financial rand investments to foreign investors.

The amount of liquidity in the financial rand market encouraged the Bank in March 1992 to decide for the first time to intervene in this market at times of rising foreign reserves.⁷⁰ In this way the Bank could partly offset the effects of its intervention in the foreign exchange market on overall money-market liquidity. Intervention by the Bank in the financial rand market could also reduce the amount of the outstanding financial rand balances and influenced the discount, although the Bank made it clear that it had no preconceived target for the financial rand rate nor for the discount on the currency. However, in the face of declining reserves since August 1991, the Bank's ability to intervene in the financial rand market was severely restricted.

In the course of 1992, as the political situation deteriorated, the pressure to withdraw foreign investment from South Africa increased again. Foreign investors also became skittish about the implications of ongoing foreign investments by South African firms. Foreign investor confidence in South Africa was seemingly being undermined by the weakness of the financial rand rate, thereby rendering it more difficult to attract significant buying of South African bonds, and equities by the foreign sector. Foreign investors also complained about the volatility of the financial rand rate;

a feature that might have been generated in part by the nervousness surrounding the potential impact of ongoing foreign investments by South African companies.

11.4.1 New exchange control measures

Faced with these problems, the authorities instituted several new measures at the beginning of December 1992. In view of the severe reaction of the financial rand market to foreign investments by South African corporates, parties involved in foreign investments already approved by the exchange control authorities, but not yet executed, were requested to make use of foreign financing to effect the required payments. They could no longer use the financial rand market to finance foreign investments. As regards any new foreign investments, assuming they were approved by the exchange control authorities, they would for the main part have to be funded by foreign loans with repayments being met from income generated by the new investments.

The Bank's Exchange Control Department had also been instructed to handle requests by South African companies for new foreign investments with circumspection. In instances where requests fell within the laid-down policy parameters, and which could be seen to be of more immediate benefit to the country in the short term, approval could still be granted. However, those that might only have a longer-term benefit would have to be held in abeyance. The Bank warned that some companies that were already waiting for responses from the exchange control authorities would have their requests to undertake foreign investments turned down.

These new arrangements carried several negative connotations. The negotiation of foreign loans by South African corporates would be more cumbersome than using the financial rand market. Problems relating to South Africa's overseas borrowing limits would become more prominent. Authorities in some industrial countries applied limits on foreign loan exposures of their banking systems to any specific country. Increased foreign borrowings by South African corporates could have meant that foreign borrowings by other South African entities, such as the government and public corporations, were reduced. At the same time, however, any such increased borrowing by South African companies would have been limited. Numerous foreign investment projects were likely to be abandoned under the new restrictive dispensation. Foreign investments in African countries by South African companies would be particularly difficult to undertake. Borrowings from international banks to finance such investments would entail high risks, which foreign banks would have been reluctant to finance.

On the positive side, these new arrangements should have been conducive to some narrowing of the financial rand discount. At the same time, the growth in financial rand balances should have been curbed. Non-resident

investors should have become more convinced that the monetary authorities were striving to avoid actions that would contribute to the destabilisation of the financial rand market and the confidence of such investors in making local investments would hopefully improve.

Even so, the size of these financial rand balances could have remained a problem for some time to come. From the perspective of dismantling the financial rand system it was highly desirable if not essential, that the growth of these balances was terminated, and followed by a sizeable reduction. This outcome would have been facilitated if the Bank, on balance, could have intervened in the financial rand market, by selling dollars and buying financial rands. Such intervention would be crucially affected by the trend in the foreign reserves, rises in the latter facilitating such intervention in the financial rand market.

11.5 Fixed interest securities markets: Implications for exchange control

In the previous comments in this chapter reference was made to two specific obstacles in the way of any imminent removal of exchange controls over non-residents, namely the debt standstill and the large outstanding balances of financial rand. Given the circumstances existing at that juncture, reference should be made to one other potential obstacle related to developments in the domestic fixed-interest securities markets.

In the 1980s crucial factors affecting the financial rand market and the prospects for any dismantling of the system were the level and direction of the international gold price, and the South African gold share market. These factors had become less important; the decline in the gold price and role the yellow metal played in the South African economy, together with the virtually continuous net selling of gold shares by foreign investors during the 1980s, accounted for this. In its place the local and international fixed interest securities markets had come to exercise a much more prominent role in the context of the workings of the financial rand system.

Foreign investors had started to exert a meaningful influence on the South African fixed-interest securities market. Moreover, the scope for scrapping exchange controls on non-residents would be adversely affected if low positive real rates of interest should have prevailed at the long end of the market and, more particularly, if negative real rates should have emerged.

The strong net selling of South African equities by foreigners over the years had been counterbalanced by foreigners' substantial buying of fixed-interest stocks quoted on the JSE. Such net purchases amounted to R2 911 million in 1989, R1 464 million in 1990 and R2 023 million in 1991 alone. Roughly 50 per cent or R12 000 million of Eskom stock alone by 1992 was believed to be held by foreign investors. The tendency had been

for non-resident investors to buy such securities on a long-term basis, and this buy-and-hold strategy had been in sharp contrast to the general posture adopted by foreigners in the case of gold shares. The foreign buyers of South African fixed interest securities appeared to have been mainly attracted by the high running yields, and potential capital gains had been less important. It was therefore argued that foreign investors in local gilts and semi-gilt securities could prove to be much stronger holders than traditional foreign investors in gold shares, thereby rendering the capital account less vulnerable to outflows of stock exchange funds if the financial rand system was scrapped.

The situation, however, could change if the financial rand system was eliminated at a time of low positive or negative real rates on fixed interest stocks. In the absence of the financial rand mechanism foreign investors would no longer be able to buy at a discount. If at the same time, the high real positive interest rates in industrial countries persisted, the relatively low returns on local fixed interest stocks would most probably have led to the drying up of foreign buying, and precipitated a net outflow of stock exchange funds by foreigners from the fixed interest securities market.

For long periods interest rates on fixed interest stocks in South Africa were negative in real terms, a situation that could partly be ascribed in part to exchange controls, which had prevented domestic financial institutions from investing abroad while allowing foreigners to purchase local fixed interest stocks at a discount. By the early 1990s monetary policies in South Africa emphasised the desirability of retaining a structure of positive real interest rates at all stages of the business cycle. Such a policy should at least have facilitated the eventual dismantling of exchange controls over non-residents, a move that would have been in line with the international trend towards the free movement of foreign capital.

Chapter 12

Implications of intervention in the financial rand market

12.1 Overview

In Chapter 11 it was revealed that in March 1992 the Bank announced that it would henceforth intervene in the financial rand rate for the first time since exchange controls on non-residents had been introduced in 1961. This move took the markets by surprise, and heralded a potentially important milestone in the development of the financial rand market, and in exchange control policy at that time.

The purpose of this chapter is to explain the motivations behind this step and the repercussions of the new policy area. As part of this review, the crucial relationship between the financial rand system and the debt standstill mechanism is delineated, and the future of these arrangements is discussed in the light of the new intervention policy in the financial rand market announced at that stage. The relationship between this intervention policy and exchange control policy is also explained.

12.2 Introduction

The foreign exchange market measures announced by the Bank in March 1992 represented further reform in the field of exchange rate policy, and a change in direction towards a more liberalised financial environment. The Bank's decision taken in March 1992 to start intervening in the financial rand market pointed to the ultimate possible discarding of this exchange control mechanism, and in the meantime could have served to attract new, albeit limited, interest in investment in South Africa by foreigners.

In the period since September 1985, when the financial rand system was reintroduced, the Bank studiously avoided intervention in the financial rand. The financial rand rate was allowed to find its own level without any participation by the Bank. This policy partly reflected the low level of the foreign reserves, which severely restricted the scope for any intervention by the Bank which would have involved, on balance, the net sales of dollars designed to improve the financial rand rate over time. Foreign bank creditors with loans inside and outside the standstill net would also have been unhappy to see the low foreign reserves of the country depleted further due to such intervention in the financial rand market. They could have argued that if the Bank had dollars to spare to intervene in the financial rand market, it should equally have been prepared to step up repayments

on loans in the standstill net. Foreign debt repayments outside the standstill net could therefore have mounted under such circumstances.

The times had, however, changed by 1992. The amount of foreign loan funds originally blocked in the standstill net in September 1985 amounted to US\$13,6 billion, but by 1992 had dropped to less than US\$6 billion. Foreign creditors had generally become more relaxed as the country's foreign debt level had receded to less than US\$20 billion. Moreover, the gross gold and foreign exchange reserves of the monetary banking sector, which amounted to less than R6 700 million early in 1989, had reached nearly R10 000 million by early 1992.

12.3 Motivations behind intervention

The Bank's move to intervene in the financial rand market would appear to have been based on a number of considerations. For one thing, intervention in the financial rand market furnished the Bank with an additional instrument of monetary policy. Such intervention affected domestic liquidity and therefore the level of interest rates. There had been a substantial increase in liquidity in the months before the intervention started, partly as a result of a continuing rise in the Bank's net gold and foreign exchange reserves. The country's reserves in this respect showed an increase of R1,4 billion in 1991, and during the first two months of 1992 they rose by another R1,4 billion. Although financial rand balances were owned by foreigners, they still formed part of the domestic banking system. The Bank's intervention in this market, which involved the net sale of dollars and purchase of financial rand, enabled it to drain money-market liquidity.

Such intervention, however, was likely to be limited and, consequently, the impact on domestic liquidity would likewise have been small. Nevertheless, this intervention promised to have favourable financial effects on the Bank. Although the gross foreign reserves would fall if the Bank sold dollars into the financial rand market, the net foreign reserves of the monetary banking sector would rise. Financial rand balances were counted as part of the short-term foreign liabilities of the monetary banking sector, and purchases of these balances by the Bank in the financial rand market reduced these liabilities by more than the fall in the gross reserves. This arose out of the discount on the financial rand rate vis-à-vis the commercial rand rate. Each sale of US\$100 from the reserves extinguished R360 of financial rand deposits at a financial rand rate of R3,60 to the dollar, but would have cost the Bank only R290 at a commercial rand rate of R2,90 to the dollar. The net foreign reserves of the monetary banking sector, defined as gross reserves minus short-term foreign liabilities, therefore, rose while the Bank reaped a profit assuming it was a net seller of dollars into the financial rand market.

These book profits would be transferred to the Forward Contracts Contingency Reserve Account of the Treasury with the Bank and would thus be used to counteract the net forward exchange losses that had accumulated over many years by the Bank. The rise in the net foreign exchange reserves therefore boosted the M3 measure of the money supply, but this would be offset by the decline in the forward losses shown in the Bank's books. These potential financial benefits, however, were of little importance in explaining the Bank's new intervention stance in the financial rand market. Apart from creating a more stable exchange rate environment in this market, the most important motive appeared to have been the desire to narrow the discount of the financial rand rate vis-à-vis the commercial rand rate, an objective that could potentially be achieved by selling dollars in the financial rand market. The Bank made it clear, however, that it had no preconceived target for the financial rand, nor for the discount on the currency. Such intervention, moreover, could partly offset the effects on overall money-market liquidity of its intervention in the commercial rand market to buy dollars at times. The Bank, however, had no rigid aim of pursuing a neutral intervention policy whereby it sold dollars in the financial rand market which exactly offset its purchases of dollars through intervention in the commercial rand market.

Intervention involving the sale of dollars would lead to a fall in financial rand balances. Local banking sources claimed that financial rand balances totalled around R4 billion early in 1992, having risen substantially in the previous year or two. This reported increase in financial rand balances occurred through non-residents partly disposing of equities and bonds, and was probably motivated by speculation that the financial rand system would be abolished in the not-too-distant future. Non-residents had most probably been building up short-term rand balances with the intention of selling them at a profit if the system were scrapped. By intervening in the financial rand market the Bank would be able to reduce the size of these financial rand balances, thereby rendering it easier to scrap the financial rand system at some future date. However, in the face of declining foreign reserves since August 1992, the Bank's ability to intervene in this market was severely restricted.

Foreign trade and financial sanctions against the country were also being lifted, and the Third Interim Debt Arrangements with foreign creditors had to be re-negotiated before the end of 1993. These foreign debt standstill arrangements could possibly have been lifted at the same time that the financial rand system was abolished. Intervention in the financial rand market designed to narrow the discount, which was becoming a prospect, would render it easier to discard the financial rand system, and therefore the debt standstill as well. Such moves would have represented a further step towards the normalisation of South Africa's relations with the international

financial community. South Africa's credit status would then improve along with its access to foreign capital. Foreign banks would no longer need to set aside provisions on loans extended to South Africa, and the lifting of the debt standstill should therefore have led to an improvement in the terms on which foreign funds become available. This could have manifested itself partly in a reduction in the spread over Libor that South Africa had to pay for foreign loans. Early in 1992 new loans originating from the debt standstill net were lent out at an agreed 7/8ths of 1 per cent above Libor, and such a spread was usually requested by foreign banks for new foreign loans outside the net. In the absence of the standstill arrangements the spread over Libor for new loans could have declined.

12.4 Standstill dollars and the financial rand system

In the previous section it was argued that a narrowing of the discount on the financial rand would have facilitated the removal of both the financial rand system, and the debt standstill. In this section the interrelationship between these two mechanisms is explained, and the reasons are adumbrated why a fall in the discount on the financial rand would have rendered it easier to eliminate these mechanisms. As part of the various interim debt arrangements provision had been made for lenders trapped with loans inside the standstill net to convert their short-term claims at their option into financial rand for either investment in South African equities, or for liquidation through the financial rand system. Under these arrangements foreign creditor banks could sell their standstill dollars for rands in the commercial rand market. Their rand receipts would then be credited to a financial rand account, and the foreign creditor banks could then sell the financial rand for dollars in the financial rand market, or convert the financial rand into equities. Against this background if the Bank intervened in the financial rand market by acting as a net seller of dollars, and the discount on the financial rand narrowed, foreign banks with funds inside the net would be given an opportunity to get rid of their standstill loans at a better price. Such intervention in the financial rand market could therefore have led to a fall in the amount of loans tied up in the standstill net, and facilitated the removal of the standstill at some future date.

This, in turn, would have facilitated the scrapping of the financial rand system. The close inter-relationship between the exchange controls on non-residents, and the debt standstill suggested that the financial rand system, and the standstill arrangements could have been eliminated at roughly the same time. If this procedure was not adopted and one of the two mechanisms alone was scrapped, indictments would have been levelled to the effect that foreign loan lenders and equity and bond investors in South Africa were not being treated equally. By contrast, if the standstill alone was lifted and the financial rand system retained, this would have only entailed reverting back to the position which prevailed between 1961 and 1983.

What is more, any fall in the discount on the financial rand, aided by Bank intervention, made it easier to scrap the financial rand system. Under such circumstances the danger of large short-term capital outflows in the wake of any removal of the mechanism would be minimised. Any low discount could only materialise for any meaningful period if bank creditors with foreign loans caught inside the standstill net were happy to refrain from taking out their money through the financial rand mechanism. A clear strategy on the part of the Bank could therefore be mapped out. Intervention in the financial rand market designed to assist in narrowing the discount would facilitate the possible removal of both the standstill arrangements, and the financial rand system at some date in the future.

12.5 Weaknesses associated with intervention strategy

Such a strategy, however, was not guaranteed to succeed in meeting its objectives. For one thing, intervention in the financial rand market designed to boost the rate would be strewn with pitfalls if the fundamental trend was not in the same direction. The history of intervention by central banks in the foreign exchange markets had shown convincingly that such intervention could only be expected to be successful if it helped to reinforce existing market trends. In the face of a large discount on the financial rand and no discernible improvement in the rate, any intervention in the financial rand market to sell dollars would have been in defiance of existing market realities, and could have proved to be futile. The intervention would have had to be on a limited scale, and it would have encouraged the offshore dealers in financial rands to take positions in the market at the expense of the Bank. What is more, as soon as the Bank scaled down its intervention or pulled out, the financial rand rate would have weakened, other things remaining equal, and this would have further encouraged speculative buying of dollars in the market, thereby adding to the downward pressures on the financial rand.

This was not the only potential problem. Assuming the discount on the financial rand narrowed materially from the level of roughly 17 per cent at the end of March 1992, there were grounds for arguing that the amount of loans that would be converted from the standstill net into financial rands for disinvestment from South Africa or investment in local equities could be very limited. In the improved political environment prevailing at that time many foreign creditors with standstill dollars could have been willing to retain their South African exposures. Some foreign banks would have extended new loans to South Africa since the standstill had been introduced, which was a sign of their confidence in not only retaining, but enlarging, their exposure to this country. When the discount on the financial rand narrowed to less than 10 per cent at times during 1991, there was only limited evidence of banks wishing to convert loans into financial rands.

Many foreign banks might well have been unwilling to incur even small losses in view of the extent of the problems plaguing international banks

at that juncture. The profitability of banks in countries such as the United Kingdom (UK) and the US was under severe pressure, mainly due to escalating bad debt provisions. Foreign creditors would also no doubt be mindful of the difficulties in converting financial rands into dollars due to the thin trading conditions in the financial rand market.

This virtually ensured that any significant sales would quickly lead to a weakening in the financial rand rate, and a rise in the discount. The flexibility at the disposal of foreign creditors, moreover, was not as great as appeared at first sight. Many foreign loans subject to the standstill orders, which had been repaid by the original South African borrowers, had been re-lent by the creditor banks to local parties rather than allowing the dollars to remain invested with the Public Debt Commissioners. In some cases these new loans were long term in nature, and this meant that the foreign creditors could not switch these loans into financial rand at that juncture.

In sum, a significant fall in the financial rand discount was not guaranteed to lead to a material drop in the size of the standstill dollar loans. If these loans were not reduced in this manner obstacles would remain in the way of lifting the standstill.

12.6 Financial rand intervention and foreign investment

Although the authorities were hoping that the Bank's intervention in the financial rand market would bring about a smaller discount between the financial rand and the commercial rand, it was unlikely that they had any preconceived target range for this discount. There were indeed times when the Bank withdrew completely from this market. The Bank had indicated that its operations in this market would rather be determined by the rate of increase in its foreign exchange reserves. Over time the authorities would have been able to gauge the extent of the intervention needed to influence the rate. If they found that the financial rand discount could be narrowed without much loss of dollars it could step up its intervention in order to further narrow the discount.

Such intervention, however, was often light. It wished to avoid losses on intervention, and it might have been reluctant to help finance any large disinvestments out of South Africa. Moreover, the Bank would have found it hard to disguise its intervention in the relatively thin financial rand market, especially since it would normally only deal with South African banks who were dealers in financial rand, and not foreign dealers, even though some trading in financial rand still took place off-shore.

In so far as intervention in the financial rand market contributed towards greater stability in the rate for financial rand, this would complement the recent intervention policy in the commercial rand market. The steep fall in the nominal value of the effective exchange rate for the commercial rand

had been arrested since roughly the middle of 1988. Since that time the decline had been much more modest and the fluctuations more modest partly because of more active intervention. By 1992 the commercial rand, although floating, was more heavily managed than it was between September 1983 and the middle of 1988.

This new intervention policy in the financial rand market on the part of the central bank could have generated fresh interest in South African quoted bonds, and equities for several reasons. First, the financial rand market had been exceedingly volatile at times. Movements of 10 per cent or so in the rate on a single day had not been exceptional. This might well have served to reduce the interest of some foreigners in South African equities when combined with the other hassles facing investors using the financial rand mechanism. Intervention in this market designed, in part, to reduce the volatility of rates could thereby increase the interest of non-residents in South African quoted securities.

Second, this intervention policy was geared towards the buying of financial rands since this would lead to an appreciation in the financial rand rate, and would yield foreign exchange profits for the Bank. This prospect of an appreciation in the financial rand rate could have been exploited by foreign investors who could buy South African shares with financial rands, and hold them until the discount narrowed materially, thereby reaping capital gains.

Third, the new intervention policy should have led to greater integration between the financial rand and commercial rand markets, which could have entailed some weakening in the commercial rand rate, and consequent support for rand hedge stocks. Since the Bank was expected to be a net seller of dollars in the financial rand market, this would have meant that its foreign reserves would not be as high as would have otherwise been the case. This, in turn, suggested that the Bank might have supported the rand, to a lesser extent, in the commercial rand market, which pointed in time to a commercial rand rate that could have been marginally lower, than would otherwise have been the case. Such an outcome could have been positive for rand hedge stocks.

Fourth, the ultimate objective of the authorities was to gradually work towards the abolition of the financial rand system and the merger of the two currencies.

The creation of greater stability in the financial rand market could have been an important motive behind this new intervention policy. It did mean, however, that the financial rand market would no longer purely reflect the sentiments of foreign investors towards South Africa; a useful gauge of foreign investor opinion may have been impaired. Questions might also have been raised as to whether better means of disposing of the foreign reserves could have been employed rather than intervening in the financial

rand market. The obvious alternative would have been to relax the exchange controls on residents.

12.7 Exchange controls and utilisation of foreign reserves

Such proposals, however, exaggerated the loss of dollars that were likely to be incurred by the Bank from intervention in the financial rand market. The amount of dollars involved would probably only have allowed exceedingly minor relaxations in the exchange controls unless the foreign reserves had risen significantly. At that time, the gross foreign reserves of nearly R10 000 million still did not cover three months of imports, which was the target of the authorities. Even if the balance-of-payments position was sufficiently strong to allow exchange controls on domestic residents to be relaxed, there were other difficulties associated with such a policy. The authorities had repeatedly indicated that any dismantling of exchange controls would be piecemeal in character, involving, first of all, the removal of exchange controls on non-residents, which could well be simultaneously accompanied by the lifting of the debt standstill arrangements. Moreover, the presence of these arrangements complicated any moves to relax the exchange controls on residents at that stage. It could be perceived to be somewhat incongruous to relax exchange controls on residents, while controls on non-resident investors in South African quoted and unquoted securities remained in place in the form of the financial rand system, and South Africa's foreign creditors were subjected to a partial foreign debt standstill. Foreign banks could have argued that their South African loans would be prejudiced by relaxations in exchange controls favouring domestic financial institutions. They could have argued that if the balance-of-payments position was strong enough to allow such institutions to invest abroad, the debt standstill arrangements should have been relaxed if not lifted as well.

Chapter 13

Reform of the foreign exchange market: Abolition of the financial rand system – March 1995

13.1 Background to the move

By 1994 South Africa's international financial relations were rapidly becoming normalised and expanded. This was illustrated, first of all, by the final debt rescheduling agreement in January 1994, and later with the re-establishment of South Africa as a borrower in the international capital markets. After having acquired credit ratings by three commissioned international rating agencies, a global bond issue of US\$750 million was made by the government in December 1994. This integration with the international financial community received a further boost shortly thereafter when the exchange controls on non-residents were abolished, a move that was facilitated by the final debt rescheduling agreement early in 1994.

13.2 Implications of foreign debt standstill arrangements

The financial rand system had been reintroduced in 1985 as part of the standstill arrangements in respect of South Africa's foreign debt in an effort to apply fair and equal treatment to all its foreign creditors, that is, equity and bond investors and loan lenders alike. In the various foreign debt interim arrangements, provision had been made for foreign lenders trapped with loans inside the standstill net to convert their short-term claims at their option into financial rand for either investment in South African equities, or for liquidation through the financial rand system as previously indicated. Under these arrangements foreign creditor banks with dollar-denominated loans could sell their standstill dollars for rands in the commercial rand market. Their rand receipts would then be credited to a financial rand account, and the creditor banks could then sell the financial rand for dollars in the financial rand market, or convert the financial rand into South African equities. Such debt-equity swaps had amounted to US\$1,2 billion by the end of 1992 alone.

It should also be noted, however, that many loans trapped in the debt standstill were rand-denominated, but convertible in foreign currency. The debt standstill restricted the convertibility of these loans. Most of these loans were covered in the forward exchange market with the Bank, and explained why the Bank could not disengage and eliminate its forward book as long as the debt standstill applied. The conversion of debt standstill claims into financial rand claims for these loans did not require a sale of dollars by foreign creditor banks. Instead, it only required a reclassification of a rand amount from a debt standstill liability for South Africa to a financial rand liability.

Given these circumstances, it was often argued in the early 1990s that the financial rand system, and the foreign debt standstill arrangements would be eliminated simultaneously. If this procedure was not adopted and one of the two mechanisms alone was scrapped, indictments could be levelled to the effect that foreign loan lenders and equity and bond investors were not being treated equally.

This constraint on the unilateral scrapping of the financial rand system, however, was removed under the terms of the final debt accord reached with foreign creditors early in 1994. Under this final accord the South African authorities were given scope to remove the financial rand system if the authorities deemed this to be suitable, and such circumstances subsequently arose in March 1995. Under this accord the remaining debt inside the standstill net was to be repaid in tranches up to August 2001, and at the time of the accord the debt blocked in terms of the standstill arrangements had fallen to US\$5 billion compared to US\$14 billion when the debt standstill had been originally introduced in September 1985.

The behaviour of foreign creditors with loans inside the standstill net in the months preceding March 1995 also encouraged the authorities to believe that the risks associated with scrapping the two-tier exchange rate arrangements were small. As the discount on the financial rand narrowed, there were few signs that foreign creditors were converting their foreign loans into financial rand for subsequent disinvestment from the country.

13.3 Factors precipitating the scrapping of the financial rand system

The scrapping of the financial rand system in March 1995, which occurred against the background of a sound balance-of-payments position, came suddenly and proved to a significant extent to be a non-event, since the new unified exchange rate for the rand initially appreciated against the dollar rather than weakening as had been widely expected. The successful management of this reform of foreign exchange market arrangements in South Africa certainly did nothing to discourage the authorities from contemplating further reforms in the exchange control arena, and proved to be the prelude to further changes in this regard later in 1995.

The authorities had been arguing for some time that the political changes in South Africa, culminating in the first fully democratic elections in April 1994, had been rendering the underlying conditions for the abolition of the exchange controls on non-residents more favourable.⁷¹ The dismantling of the siege economy in the wake of the disappearance of the old apartheid order had undermined the underlying rationale for the retention of the financial rand system.

Approximately a year before the system was terminated, the Bank had laid down the conditions that it considered suitable for the eventual scrapping of the financial rand system. These conditions included a discount on

the financial rand of 10 per cent or less; a level of foreign reserves that was equal to three months of imports; and a lower level of financial rand balances. It was perceived that fulfilment of these conditions would make it possible to scrap the two-tier exchange rate arrangements with minimal disruption to the foreign exchange market.

Some analysts alleged that these conditions would never be attained. They argued that if the confidence of investors in the political and economic situation improved, the discount on the financial rand would narrow, but the financial rand balances would rise as foreign speculators bought the financial rand in anticipation of a dismantling of the two-tier exchange rate arrangements and consequent gains from holding financial rands. They also argued that raising the foreign reserves to levels such that they covered three months of imports would require that they rose by about 150 per cent to R20 billion from the level of R8 billion which prevailed around the middle of 1994. This was a tall order.

These analysts were proved right in the sense that the foreign reserves, although potentially buttressed by new credit facilities that had become available to the Bank since the elections in April 1994, had only risen to roughly R12 billion by March 1995 although the Bank had also established foreign credit lines of about R16 billion, while the financial rand balances had remained high at around R6 billion. The crucial variable that induced the authorities to act, as regards the timing of the scrapping of the financial rand system in the middle of 1995, was the discount on the financial rand compared with the commercial rand rate. This discount had narrowed from roughly 22 per cent at the end of June 1994 to about 3 per cent prior to the elimination of the system in March 1995.

The combination of a weakening in the commercial rand rate – and a strengthening of the financial rand rate in previous months had brought this about – and this helped to make a mockery of those predictions that the scrapping of the financial rand system would be followed by a significant decline in the unified commercial rand rate, although later in 1996 adverse pressures did arise. The parallels between the demise of the financial rand arrangements in March 1995, and the removal of the exchange controls by the UK in October 1979 were striking. In that case the premium in the investment dollar premium market fell from 20 to 1 per cent in roughly six months, and precipitated the dissolution of the investment dollar premium market. In the case of the financial rand system, the near disappearance of the discount on the financial rand had a similar effect.

Several other countries in the developing world had abandoned multiple exchange rate practices over the years, but any dissolution of the system in South Africa had been complicated by the danger that this could conflict with the objectives of monetary policy. For years the monetary authorities had been placing a strong emphasis on curbing inflationary pressures in the interests of fostering greater financial stability. This objective could have been impaired by any sudden removal of exchange controls over

non-residents if this had been accompanied by a significant fall in the commercial rand rate. Under such circumstances import prices would have risen, and a boost would have been imparted to general inflationary pressures. The sharp narrowing of the discount on the financial rand by March 1995 had materially reduced this danger.

As already indicated, this narrowing of the financial rand discount was instrumental in persuading the authorities to remove the financial rand mechanism. Market forces had created a situation in that the Bank and the Treasury had little choice but to move and accept the verdict of the markets. Frenzied speculation, and a build-up in adverse leads and lags on the capital account of the balance of payments on fears that a unitary rand would weaken had reached the stage where market stability could probably only be restored by scrapping the system. What is more, with the discount so low, the authorities could hardly not act, because this would have created the impression that they were hesitant and fearful of the consequences of a unified currency; in other words, the credibility of the authorities was at stake. Market circumstances further encouraged the authorities to act in the sense that the US dollar was weak against other major currencies at the time, which suggested that the rand could trade reasonably steady against the US dollar, if not improve, if a unitary exchange rate system were reintroduced.

13.4 Repercussions of the move

The Bank expected that the administrative burden attached to implementing exchange controls would be eased by scrapping the controls on non-residents. In addition, it was expected that the new unitary commercial rand rate would prove to be less volatile than the old financial rand rate, since the latter market was small and therefore more susceptible to wide swings compared with the commercial rand market. Nevertheless, the authorities expected that the performance of the new unitary rand would be determined basically by the balance-of-payments position, and the Bank's currency management policy, with the central bank's exchange rate policy continuing to be shaped by emphasising a market-determined exchange rate under floating rate conditions.

However, in the wake of the scrapping of the financial rand system, capital flows were bound to exert a more powerful influence on the position of the unitary commercial rand. The local financial markets were now going to be influenced to a greater extent by foreign investors' perceptions and actions. Under the new circumstances, if the government were to pursue economic policies that were deemed to be inappropriate or unfriendly to foreign investors, the financial markets would exert more pressure on the government through the impact they could exert on the share and bond markets, as well as the balance of payments and the unitary rand.

The financial markets indeed proved to be instrumental in influencing the timing of subsequent relaxations in exchange controls. The strong initial

performance of the unified rand proved to be the harbinger of strong net foreign capital inflows in the rest of 1995 along with rising net foreign reserves. Net capital inflows of R14 billion had already occurred in the nine months to March 1995, and for the whole of 1995 these foreign inflows reached roughly R20 billion. These inflows proved more than sufficient to cover the deficit on the current account of the balance of payments that had re-emerged during the second half of 1994 for the first time in roughly ten years. The scrapping of the financial rand system, by boosting confidence and making it easier for foreigners to invest in South Africa, most probably contributed to the inflows of foreign capital after March 1995, and therefore facilitated the start of the process of relaxing exchange controls on residents. The net buying of South African equities by foreigners, for instance, accelerated after March 1995, and for several months reached an annualised rate of more than R7 billion. The relaxation of exchange controls on non-residents started with reform of the forward exchange market arrangements in April 1995, and the introduction of an asset-swap system for financial institutions in July 1995. Under this initiative local insurance companies, pension funds and unit trusts were henceforth allowed to undertake asset swaps in the form of quoted equity investments with foreign investors subject to certain conditions.

In fact, the Bank was starting to face management problems in respect of handling higher levels of domestic liquidity even before the scrapping of the financial rand system. At times this was reflected in a significant fall in accommodation that was furnished by the central bank to the banks on a daily basis. In order to avoid major breaches in its guidelines for the growth in the money supply as measured by the 6 to 10 per cent target growth rate for M3 and avoid new inflationary pressures, the markets in the second half of 1995 began to anticipate possible further relaxations in the exchange control regulations. It might have been expected that such speculation about further relaxations of exchange controls would have discouraged capital inflows because of fears of a fall in the rand exchange rate. Such an impact on foreign capital inflows, however, did not become noticeable until February 1996.

Speculation about possible further relaxations in the exchange controls also partly emanated from the fact that the abolition of the financial rand system in March 1995 had been a smooth transition; it was a non-event. This convinced some people that the abolition of the remaining exchange controls could be quickly implemented without disruption. The Bank, however, did not subscribe to this view, arguing instead that careful preparation leading up to the abolition of the financial rand system would also be necessary before the remaining controls could be terminated. This preparation, moreover, could take a long time.⁷²

Chapter 14

Risks and rewards of abolishing the remaining exchange controls in South Africa

14.1 Overview

By 1995 a profound restructuring of the South African economy was under way as it, once again, became reintegrated with the outside world. As part of this process, the country had to reappraise its remaining exchange control system following the scrapping of the controls on non-residents in 1995 and had to decide what the optimal exchange control regime would be in the new South Africa.

There were strong grounds for believing that South Africa would derive numerous benefits from the abolition of its remaining exchange controls and, indeed, an essential condition for materially greater foreign investment in the country might well have been a liberalised capital account of the balance of payments. The scope for speedily removing the remaining exchange controls, however, was crimped by political and economic uncertainties in the country and, more particularly, the danger that substantial capital outflows could cause the rand to drop sharply in value, thereby fostering new inflationary pressures.

The purpose of this chapter is to explain the benefits of a more open capital account, which were perceived by the authorities to stem from eliminating the remaining exchange controls after March 1995 when the controls on non-residents had been abolished, and to explain the changes in economic policies which would facilitate this process. The case for a “big bang” approach to the removal of exchange controls is reviewed as an alternative to the approach of the Bank which incorporated a gradualist approach to the lifting of the controls in the 1990s.

14.2 Potential benefits of an open capital account for South Africa

Moves towards the removal of exchange controls in numerous countries over the years had been encouraged by the perceived benefits of an open capital account. However, capital account convertibility in South Africa was likely to be sustainable only if supported by appropriate macroeconomic, financial and structural policies, and the conditions prevailing in the 1990s were not ideal in this respect.

Nevertheless, in the case of South Africa several efficiency and welfare gains would be associated with the removal of exchange controls. First,

free capital flows would allow the South African economy to attain efficiency gains created by specialisation in the production of financial services. As with trade in goods, countries find it more efficient to import than to produce certain financial services in the absence of exchange controls. Second, capital account convertibility could promote dynamic efficiency in the financial sector. Increased competition from abroad would force domestic producers to become more efficient, and could have stimulated innovation and better productivity.

In the absence of exchange controls, liquidity on the JSE would improve in the sense that the ongoing accumulation of domestic shares into the tight hands of local financial institutions would abate, and some institutional holdings could be sold to finance foreign investments. This could improve the marketability of blue chip shares, thereby encouraging some overseas investors to accumulate meaningful portfolio holdings in leading South African companies. If exchange controls were abolished, a greater number of foreign investors would participate in the domestic financial markets in general which could increase their liquidity and that, in turn, could attract more foreign investors and enable the country to gain access to foreign capital at a cheaper rate. At the same time, the elimination of exchange controls would lead to greater competition facing the JSE since domestic investors would be able to buy foreign shares. The absence of exchange controls in general could promote a more competitive economy since the large conglomerates who dominate the economy would be able to sell off some of their holdings to foreign investors, and invest themselves overseas.

Third, capital account convertibility would allow South African residents to hold internationally diversified asset portfolios, which would reduce the vulnerability of their income streams, and wealth to domestic financial and real shocks. If no exchange controls had existed during the 30 odd years before 1995, both private and institutional investors would have diverted part of their resources to the purchase of foreign assets. The dependence of the economy on domestic sources of income would have been relatively lower, while the bulk of the earnings from these foreign investments would presumably have been repatriated. This, in turn, would have boosted service receipts on the balance of payments. As time passed, the proportion of the national income which stemmed from foreign sources should have risen, the invisibles account of the balances of payments strengthened, and the proportion of foreign currency earnings that originated from the precious metals industries should have fallen. In this way the economy would have become more diversified. In the circumstances developing in the second half of the 1990s the removal of exchange controls might well have resulted in South Africa becoming the international financial centre for Africa. Under a liberalised capital account South Africa would have been able to assume the role of financing some of the economic development of Africa via capital outflows to a greater extent, although this would have been limited by the relatively low levels of gross domestic savings. In the 1990s the outflows of

capital to other African countries should not have proved to be destabilising, since most African capital markets were relatively small.

Without exchange controls, the ability of people to escape from the exploitation of a particular government would be greater, thereby checking such a government's power to exploit in the fields of such as taxation. Monetary and fiscal policies in general would have to become more circumscribed given liberalised capital flows where the rand was concerned. Stricter limits would be placed on the scope for the authorities to implement policies that international investors view as inadequate. Excessive fiscal expansion would be quickly punished by the market by means of a weaker exchange rate, and rising interest rates. A liberalised capital account could therefore buttress the central bank in its efforts to contain inflationary pressures.

In addition, from the Bank's perspective, the cumbersome system of exchange controls constituted a great administrative burden for the Exchange Control Department of the Bank. The removal of the exchange controls would have been beneficial to the Bank from an administrative perspective.⁷³ Even the policy of progressively relaxing the exchange controls had administrative benefits. For example, the number of applications received by the exchange control department in the year to 31 March 1998 decreased by 48 per cent as a result of the abolition of certain exchange controls.⁷⁴ At the same time, the burden faced by banks would also diminish.

Lastly, the removal of exchange controls by the late 1990s could have facilitated South Africa's access to international financial markets and reduced borrowing costs. For a lender to extend credit over the medium term, the expected yield on the loan must cover any potential default on, or disruption to, debt-service payments. Thus, if, in a crisis, a country was expected to tighten exchange controls or impose limits on debt service payments during the period of the loan, lenders may either refrain from lending or incorporate a risk premium into their lending rate. In general, it was difficult to believe that South Africa could significantly boost its economic growth over the longer term without much greater access to foreign capital, and such capital could have become available if exchange controls were abolished. At the very least the removal of exchange controls in the late 1990s should have rendered the country more attractive to foreign investors, although other deterrents such as high labour costs, and tax rates would still have prevailed.

The complete liberalisation of exchange controls was arguably important because of the signal of confidence it would convey. Although foreign investors no doubt understood that exchange controls applied to South African residents alone after March 1995, the very existence of controls was seen in some quarters as a vote of no confidence in the economy. Their

existence was also a signal to foreign investors that exchange controls were an available and accepted tool of economic management that could be extended to include foreign investors once again. It was highly dubious to argue that the existence of exchange controls would not deter foreign investment into South Africa as long as there was a guarantee that foreign investors can remit their current income. In short, South Africa stood to garner numerous benefits from the removal of exchange controls.

14.3 A “big bang” approach to the abolition of exchange controls

Some commentators favoured the immediate abolition of exchange controls after March 1995, arguing that if the exchange rate fell sharply because of pressures from people taking money out of the country, these people should still be allowed to do so. This, however, begged the question as to how South Africa could abolish such controls without incurring major economic disruption in the form of a materially lower exchange rate, a higher inflation rate and higher domestic interest rates, and sustain a position in which exchange controls did not have to be reintroduced. The Bank believed that a new foreign exchange crisis arising out of the abolition of exchange controls would be highly detrimental to South Africa's interests.⁷⁵ Such economic disruption could only have been avoided if capital was not exported on a large scale following the dismantling of such controls. In this respect it should be noted that while exchange controls represented the only obstacle for many domestic investors in shifting funds abroad, from the perspective of foreign investors exchange controls might have represented only one of several impediments to investment in South Africa. This suggested that gross capital outflows following the complete lifting of exchange controls could well have been large, while the gross inflows would have been unpredictable, and might have been significantly smaller.

The economic disruption in the form of higher inflation following the complete abolition of exchange controls might have been severe despite the fact that the economy had excess capacity, and suffered from high unemployment in the second half of the 1990s. Any premature wholesale abolition of exchange controls would have backfired on the authorities if the pressure of public opinion, outraged by sharp rises in interest rates falls in the exchange rate and declines in real wages, compelled the authorities to reintroduce such controls.⁷⁶ Any such development, in turn, would have severely impaired the credibility of the central bank, and government in the eyes of foreign investors.

The authorities also believed that many distortions had been created by exchange controls regarding the exchange rate, interest rates, wage and salaries, and in the international competitive position of South African producers. These distortions had to be corrected, but it was questionable whether it would be socially and politically tolerable to force the necessary

painful adjustments on the economy in a short period of time with a “big bang” removal of the exchange controls.⁷⁷

The Bank's involvement in the forward rand-dollar market was also an inhibiting factor to a big bang approach. The large oversold forward book of the Bank pointed to possibly large losses being incurred on its forward exchange account if exchange controls were abolished in one fell swoop, and the rand fell in value against the dollar. It was also the case that only a handful of private banks actively participated in the forward rand-dollar market, and the sudden abolition of exchange controls might have led to volatile conditions in the forward market. The Bank therefore had to follow a policy of creating the necessary environment from which it could withdraw its forward market interventions without unduly disrupting the foreign exchange market.

14.4 Preconditions for abolishing exchange controls in South Africa

Various studies of the South African economy indicated that it had suffered from ongoing flights of capital to foreign pastures by both the personal and corporate sectors during the previous two decades or so, while anecdotal evidence suggested that these outflows still persisted in the 1990s. These outflows, partly linked to domestic political uncertainties, had weakened the balance-of-payments position, eroded the tax base, and impaired the scope of the economy to grow. The scope for the elimination of exchange controls in South Africa in the second half of the 1990s would therefore have been improved further by greater political stability in the country since the downward pressures on the foreign reserves, and the exchange rate should have been materially eased if not reversed under such circumstances.

Any radical change in the exchange control arena would have ideally materialised in circumstances where the country's access to foreign reserves was sufficiently high to be able to meet any possible short-term capital outflows.⁷⁸ The gross foreign reserves of South Africa, which stood at roughly R11 000 million at the end of October 1994, had often been below the equivalent of three months of imports, which was the target the Bank was aiming for, but by July 1997 had risen to roughly R28 billion which covered around eight weeks of imports.

Net outflows of foreign capital had constituted a major constraint on the growth performance of the economy for long periods since 1985. Over the period from 1985 to 1993 roughly R50 billion of funds left South Africa in the form of capital outflows not related to foreign exchange reserve transactions. Roughly R16 billion of net capital outflows occurred in 1993, and another R1,1 billion in the first quarter of 1994.

However, under the new political dispensation which prevailed after April 1994 the removal of financial sanctions promised to usher in an entirely new era as regards foreign capital flows, although the repayment of

standstill debt still lingered after 1994. Agreement on a final rescheduling of South Africa's foreign debt which came into force early in 1994, the commencement of aid programmes to the country by certain industrial countries, and the attainment of an investment grade rating from Moody's credit rating agency in the US by both the government and Eskom helped to generate a substantial improvement in the capital account position during 1994, which persisted in 1995. The improvement in this account since the middle of 1994 was such that in March 1995 the financial rand system was abolished, thereby removing all exchange controls on non-residents, and this was followed in subsequent months by continued net inflows on the capital account of the balance of payments, until outflows again materialised at times during 1996.

Full convertibility on the capital account would have been more easily engineered if it had been supported by appropriate macroeconomic and financial policies. Such policies would ideally have incorporated measures to reduce the differences between domestic and external financial market conditions. Apart from strengthening the fiscal position, South Africa would ideally have needed to consider limiting the use of taxes on financial income, wealth and transactions in order to reduce any incentives to move funds abroad. If South Africa had become a markedly more attractive place for making money, capital was more likely to stay. Many foreign investors had started to focus virtually all their attention on the country's economic policies. These had been made more appropriate, but arguably not to the extent that the need for exchange controls had withered away. A sound domestic financial system was also desirable, while a further reduction in the rate of inflation would also have been beneficial.

14.4.1 Privatisation of state assets

The new government did announce that it had plans to restructure and strengthen government finances partly through the privatisation of state assets. This was welcomed because a privatisation programme could have stimulated new inflows of foreign capital, thereby facilitating the removal of exchange controls.

In this respect, though, the series of small privatisations that occurred were of limited value. From the perspective of boosting the fiscal position, and improving the prospects for the elimination of exchange controls, maximum benefits would have been reaped only if the large public utilities such as Telkom, Eskom and Transnet were denationalised. A partial privatisation of Telkom indeed took place in April 1997. These utilities were low-risk investments with large cash flows which had already been commercialised, and it was such privatised concerns that would have attracted major interest from foreign investors, although they would have needed to be restructured as joint stock companies before their sale. There was a strong demand among international securities houses, banks and

institutional investors for shares in freshly privatised public utilities such as telecommunications businesses in the 1990s. The latter in particular were perceived by international investors as having good growth prospects, while several governments were encouraging international investors to take a leading role in financing expansion of their telecommunications sectors. Investments in local public utilities by foreigners should have been particularly favoured since the economy was expected to grow more rapidly in the second half of the 1990s while substantial social development needs had to be addressed.

A major feature of the South African equity market was the lack of investment opportunities in utility shares unlike in many other emerging markets. The privatisation of utilities in numerous developing countries had presented attractive opportunities for foreign and local investors, while providing governments with funds to reduce debt and interest burdens. If South Africa, as part of its privatisation drive, had included utilities as part of the list of sales of assets, this would have furnished a boost for portfolio investment in the country by foreigners, and would have rendered it easier for exchange controls on domestic residents to be relaxed, because any outflows of funds by South African investors could have been counter-balanced at least in part by inflows of foreign money for the purchase of utility shares made available through privatisation.

14.5 Speed in scrapping exchange controls

Even though South Africa had started to enjoy greater political stability after 1994, and had adopted policies that facilitated the opening up and the sustainability of full convertibility on capital account, the issue still arose as to how quickly to remove exchange controls. To some extent, this was dependent on balance-of-payments developments, whether financial support from international bodies such as the IMF was available, and whether the authorities in South Africa would have been keen to take advantage of any such finance which might be forthcoming. Some countries had successfully sustained an open capital account after abruptly scrapping capital controls. Such an approach in South Africa might have enjoyed more credibility in the eyes of foreign investors, especially if it had been accompanied by the dismantling of the whole apparatus of exchange controls, since it could have convinced such investors that exchange controls would not be re-introduced.

The abolition of exchange controls in one fell swoop could have diminished the flight of capital from South Africa in the wake of a fall in the unitary exchange rate and a rise in domestic interest rates. It could therefore have precipitated large inflows of new foreign capital within a short period, as well as encouraged the return of previous "flight capital" which had left the country in previous years. In contrast, a gradualist approach to the elimination of exchange controls might not have led to a quick inflow of new

foreign capital, since foreign investors could expect further liberalisation of exchange controls and a consequent weakening in the rand and might thus have delayed bringing funds into the country; in other words, some investors might have held off because of fears that an exchange rate risk still remained.

It could be argued, however, that liberalisation of the capital account would have been facilitated if exchange controls were gradually phased out which was the chosen route.⁷⁹ A number of industrial countries that had removed exchange controls did so on a piecemeal basis, and this was the proposed strategy in South Africa in the sense that exchange controls on non-residents had already been removed and the dismantling of controls on residents started to slowly take place after March 1995. This policy preference was partly based on the consideration that the long-standing presence of exchange controls had meant that large sums of capital earmarked for repatriation abroad had built up over the years. Releasing such funds on a piecemeal basis as exchange controls were relaxed was considered to be prudent, since it reduced the risk of widespread economic disruption stemming from weakness in the exchange rate and higher interest rates. Any abrupt removal of all the exchange controls might well have necessitated much tighter monetary policies than were being applied at that stage.

The Bank and the Treasury, as already indicated, were committed to dismantling the remaining exchange controls on a gradual basis, with the pace of the relaxations dependent on the extent of inflows of foreign capital from the rest of the world, and the level and quality of the foreign reserves. It was envisaged that the controls would be progressively eliminated in line with the creation of an environment in which the fundamentals were in place for such an elimination.

The fundamentals in this regard included a reduction in the pressures to take funds out of South Africa and an improved position as regards capital inflows. The right fundamentals also included an improved competitive position of the economy such that businesses had less incentive to shift their operations to neighbouring territories. A rise in productivity would therefore have lessened the desire to shift funds out of the country.

It should, however, be noted that the Bank regarded the removal of exchange controls as a one-way process that should not be reversed, even if international capital flows went against the country. It argued that the continued integration of South Africa in the world financial markets would force a greater use of electronic communication. The emergence of a global electronic network for trade (e-commerce), financial transactions (e-payments) and money transactions (e-money) made the retention of exchange controls on the current account or capital transactions more difficult and less effective.⁸⁰

Chapter 15

Initial programme for phasing out the remaining exchange controls after March 1995

15.1 Overview

Following the removal of exchange controls on non-residents in March 1995, the authorities had repeatedly stressed that the exchange controls on residents would remain in force for some time. Nevertheless, a progressive phasing out of these controls was planned over time, and a start was made in this respect from 1995 onwards. It was recognised that huge backlogs had developed over the many years of exchange controls, reflected in a considerable pent-up demand to invest abroad on the part of South African residents, and in particular private and institutional investors. The management of this entire process of phasing out the remaining controls was a knotty and controversial issue and was illustrated by the ongoing debate concerning the respective merits, and demerits of scrapping the controls immediately in a “big bang” approach, or phasing out the controls on a gradual basis.

The purpose of this chapter is to focus critical attention on the case for a “big bang” approach by emphasising that there was a need in the 1990s for a review of South Africa’s regulatory regime before exchange controls could easily be abolished. The country’s regulatory environment in the mid-1990s was not conducive to the speedy abolition of exchange controls. Thereafter, attention is focused on the features of the programme to phase out the exchange controls on residents, as well as the reforms which were adopted in this area. It is asserted that there were strong arguments in favour of a programme which was based on a piecemeal approach with relaxations being made primarily in the initial stages on investments abroad carried out by South African corporates and financial institutions. It is also pointed out that the daunting problem of controls over emigrants’ blocked funds ranked low in the priority list of relaxations.

15.2 Introduction

The scrapping of exchange controls on residents after 1995 was expected to prove to be a much more protracted and tricky process than the removal of exchange controls over non-residents. Introducing concessions on residents could have precipitated a major source of capital outflows. The incidence of capital flight at times from South Africa during the previous two decades or more had reflected the pent-up strong desire on the part of residents to place funds in overseas centres. High levels of taxation and crime in South Africa, currency weakness and lingering political uncertainties continued to encourage the movement of funds overseas.

Following the removal of the dual currency (financial rand) system the authorities were facing pressures to eliminate the controls on residents, and several steps in this direction were taken over time. Apart from removing certain economic distortions in the economy and encouraging foreign capital inflows, the elimination of controls over residents promised to open up new foreign investment opportunities, and should have boosted the rate of return on capital funds in the hands of South Africans.

The strategy for liberalising the exchange controls over residents under the circumstances of a unified exchange rate, however, had to be planned carefully, since there was little information available about the precise propensity of residents to place funds abroad. Nevertheless, any strategy for liberalising the controls would have been materially facilitated by structural adjustments in the economy, which incorporated a programme of large-scale privatisation of state assets, lower income taxes and a strengthening of the fiscal position. Getting rid of exchange controls would be affected by the magnitude of new foreign investments which flowed into the country from such structural adjustments.

Pressures to eliminate exchange controls progressively also stemmed from the new Constitution which was adopted following the democratic elections in April 1994. Reports circulating during the second half of the 1990s indicated that several cases were set to be brought before the Constitutional Court which challenged the propriety of the exchange controls. Such challenges could have taken various forms. First, under the rulings in force at that stage the exchange control authorities had the power to enter a house or company premises without a search warrant unlike the police. In this respect the exchange control authorities employed their own squad of investigators which could be employed in part for such duties. This right of the authorities could be argued as being incompatible with the "right to privacy" provisions incorporated in the new Constitution, and therefore could have been challenged in the court.

Second, the exchange control authorities had the right to question people about alleged infringements of the regulations, and if the latter refused to reply the silence was treated as evidence that the accused had contravened the exchange control regulations. This would appear to have been in conflict with the "right to remain silent" entrenched in the new Constitution.

Third, the whole apparatus of exchange controls could be challenged on the grounds that they infringed on human rights which were a key aspect of the Constitution. Once an individual had met his or her commitments to the state in the form of taxes, it could be strongly argued that he or she should be able to dispose of his or her income as he or she saw fit, which should have included the right to transfer money abroad if he or she so desired. In some quarters the abolition of exchange controls was perceived to be a concession which would primarily benefit rich whites. However, everybody was deemed to be equal in a non-discriminatory society under the new Constitution, and yet exchange controls could be labelled as inherently discriminatory in nature.

Challenges mounted against the exchange control regulations of a country on the grounds that the latter were unconstitutional was not a new phenomenon. In Zimbabwe a similar challenge was launched in the 1980s, and the court ruled in favour of the exchange control authorities. The difference in South Africa's case, however, was that the new Constitution spelt out more clearly the rights of the individual, and the chances of a successful challenge against the existing exchange control regulations was accordingly greater.

A key issue concerned the speed at which the controls should be removed, as mentioned in the previous chapter. The authorities had repeatedly stated that the approach would be a gradual one lasting at least a few years with no specific time frame. This stance, however, was criticised in some quarters, partly because the piecemeal abolition of exchange controls discouraged capital inflows, and encouraged speculation against the rand on expectations that such a policy would lead to an ongoing depreciation of the rand as capital controls were relaxed. It was debatable whether South Africa could enjoy sustained net inflows of foreign capital while the process of dismantling the exchange controls slowly proceeded. From time to time in the second half of the 1990s speculation about further relaxations in the controls erupted, and this had immediately caused foreign capital to flow out of the country. Such events, if they continued, threatened the position of the rand since they came against the background of expected deficits on the current account of the balance of payments. It was also argued in some quarters that such a piecemeal approach ran the danger of encouraging more procrastination on the part of the government in taking steps to make the country more investor friendly, and thereby delaying the removal of exchange controls.

Partly for these reasons some analysts recommended a big bang approach to the removal of exchange controls accompanied by appropriate structural adjustments in the economy. Unfortunately, advocates of this approach disregarded the regulatory and supervisory environment which existed in South Africa in the 1990s which rendered any such strategy highly problematical.

15.3 Regulatory and supervisory environment and the removal of exchange controls

Few analysts questioned the long-term benefits of getting rid of the exchange controls in South Africa. However, under the then prevailing regulatory regime in South Africa, the country was ill prepared for the abolition of exchange controls. Other things remaining equal, it would have exposed the financial sector in general in South Africa to new competition from the foreign sector for which it would not be fully prepared; in other words, the abolition of exchange controls through a big bang approach at that stage would have led to an unequal playing field between domestic and foreign financial institutions.

Under legislation prevailing in the second half of the 1990s, for instance, a local unit trust could not allow its funds to be managed separately by an outside management team. Hence, a unit trust that invested part of its assets in foreign securities under the more liberal dispensation, which came into force in March 1997, had to manage the foreign investments itself, and was not allowed to let this function be undertaken by a foreign manager who could most probably render such services more efficiently. Consequently, if exchange controls had been abolished at that time domestic unit trusts would have found themselves at a disadvantage compared with foreign unit trusts which would have been better able to attract funds for overseas investment from South African investors.

Various other anomalies would have arisen if the exchange controls were quickly abolished, and served to highlight the desirability of a study being undertaken of the whole legislative dispensation applicable to domestic financial institutions to ascertain such anomalies, and arrange for them to be removed. This would have been a time consuming process since once any changes in legislation were agreed on, it could have taken at least another 18 months before the legal dispensation was altered.

The supervisory environment might also have needed to be changed in the sense that the banking supervision apparatus could have been a priority for some strengthening before the exchange controls were removed. In this respect, some analysts argued that the systemic risk in banking would have been higher following the abolition of exchange controls since domestic banks would have been able to deal in foreign currencies to a much greater extent unless strict limits on open positions remained in force, while foreign capital flows in general would have been higher, and more volatile with a liberalised capital account which would have led to more abrupt fluctuations in money-market shortages. Even if restrictions on net open positions of banks had remained in force these limits might have been circumvented by dealing in derivative contracts in offshore markets in an environment where exchange controls had been dismantled. This meant that the danger of a bank or banks getting into difficulties would have been higher in the absence of exchange controls; in other words, one bank might fail causing problems for other banks, and creating greater instability in the banking system as a whole. It was debatable whether the banking supervisory regime was adequate to deal with the greater foreign exposures which banks could have undertaken in such an environment. As a result, the supervisory regime might have needed to be improved so that the daily exposures of banks in foreign markets could have been effectively monitored.

Banking problems could have been the product of numerous factors. Nevertheless, a study by the Bank for International Settlements in the mid-1990s revealed that such problems in certain developing countries in the previous 15 years or so stemmed in part from inadequate preparation for financial liberalisation which left bank supervisors to face new risks before the supervisory framework had been adequately strengthened.

These comments relating to the regulatory and supervisory environment did furnish some support for the policy of gradually eliminating the exchange controls in South Africa which the authorities favoured. However, this policy raised other issues, one of which concerned the appropriate sequencing of exchange control removals. This subject is covered in the rest of this chapter.

15.4 Initial steps taken to liberalise exchange controls on residents

The first form of liberalisation, following the abolition of exchange controls on non-residents, came in April 1995 and involved steps to alter the workings of the forward exchange market in South Africa. The Bank was keen to withdraw at least partially from the forward rand-dollar market, and with this in mind, initiated reforms so that forward cover for rand-dollar transactions related to exports and imports would in future be left to banks to furnish, while the Bank would confine itself to providing cover for certain categories of foreign loans which are raised abroad. In effect, following the changes which came into effect in April 1995, two different forward exchange rates came into existence, one quoted by the banks themselves, and one quoted by the Bank. In this way market forces came to play a greater role in determining the exchange rate of the rand for forward cover transactions.

However, any more substantial disengagement from the forward rand-dollar market on the part of the Bank required that a dispensation be created in which the banks had greater access to relevant deposit markets in order to cater for the forward exchange requirements of clients. This necessitated that the controls on foreign asset and liability holdings of banks be liberalised, steps which were only taken during the second half of 1996 and thereafter.

Another initial step to phase out the remaining exchange controls gradually, following the abolition of the financial rand system, related to foreign companies with operations in South Africa. For many years such companies had faced certain restrictions relating to dividend payments made by the subsidiaries in South Africa, while foreign companies had needed to get the prior approval of the exchange control authorities when extending new loans to their South African subsidiaries. There were also constraints imposed on such companies in respect of loans raised in the domestic capital market.

Certain concessions in this latter area were instituted in June 1996. At that stage the local borrowing capacity of companies, 25 per cent or more of which were owned by non-residents, was doubled. This meant, for example, that an entity which was wholly owned by non-residents was forthwith able to borrow up to 100 per cent of its effective capital instead of only 50 per

cent. In March 1997 the threshold of 25 per cent was raised to 50 per cent, which was a further concession to numerous foreign companies operating in South Africa.

It remained unclear, however, whether there would be a subsequent complete removal of the restrictions on the use of debt capital in South Africa by foreign companies. In view of the relatively high burden of total corporate tax rates at that stage, any scrapping of the restrictions on the use of debt capital would have created a strong incentive for foreign companies operating in South Africa to step up their use of debt capital rather than equity capital for tax reasons. In order to avoid an undue loss of tax revenue, the authorities might have felt that the restrictions on the use of debt capital should be further liberalised but not abolished. This consideration, however, had become less important following the decision in the March 1995 budget to scrap the 15 per cent non-resident shareholders' tax, since the incentive to use equity capital should have become greater other things remaining equal.

Liberalisation in the area of forward exchange and restrictions on foreign-owned companies operating in South Africa was, moreover, supplemented by other moves to dismantle the exchange controls further. At the beginning of July 1996 the Bank announced that in future it would allow foreigners buying property in South Africa to take out a South African bond equal to the amount of cash they were investing in the country. Previously, foreigners had been limited to South African bonds equal to 50 per cent of the amount they were investing. This concession partly reflected the fact that foreigners were becoming a growing group of active investors in South African property, particularly at the upper end of the market. At that stage also certain controls on residents began to be relaxed, which in particular affected the dispensation for foreign investments by the South African corporate sector and financial institutions.

15.5 Foreign investments by South African corporates

The pressures on the Bank to relax the exchange control regulations on South African companies wishing to invest abroad had mounted in the previous few years as the country became reintegrated with the international trading and financial communities. New foreign investment opportunities were opening up for local companies. In particular, growing trade and investment links between South Africa, and its neighbours in other African countries had induced the authorities to take steps to improve the dispensation available to South African corporates for investment abroad.

South Africa's exchange control regime in the mid-1990s severely inhibited foreign investments by local companies, and dated partly from mutations in the exchange controls announced at the beginning of December 1992. At that time the Exchange Control Department of the

Bank was instructed to handle requests by South African companies for new foreign investments with circumspection as explained in Chapter 11. In instances where requests fell within the laid-down policy, and could be seen to be of benefit to the country in the short term, approval could still be granted, although the financing of the investment would most probably have to take the form of raising international loans. Access to the financial rand market for investments abroad was virtually precluded. At the same time, it was specified that those requests for foreign investments that might only have a longer-term benefit would have to be held in abeyance.

These arrangements carried several connotations. The negotiation of foreign loans by South African corporates was more cumbersome than using the financial rand market, and this problem had remained after investment through the commercial rand market became the alternative financing mechanism following the scrapping of the financial rand system. Problems relating to South Africa's overseas borrowing limits had become prominent.

Authorities in industrial countries applied limits on foreign loan exposures of their banking systems to any specific country. The danger existed that increased foreign borrowings by South African corporates could well have meant that foreign borrowings by other South African entities such as the government and public corporations were reduced.

Numerous foreign investment projects were abandoned under this restrictive dispensation. In particular, foreign investments in African countries by South African companies had proved particularly difficult to undertake. Borrowings from international private banks to finance such investments entailed high risks which banks were reluctant to finance. The entry by the mining houses into African mining ventures and further expansion by South African banks into Africa were somewhat blunted by these restrictions.

This proved to be especially frustrating for various African governments that were keen to attract South African capital into their economies. Foreign trade volumes between South Africa and the rest of the continent were growing significantly, but the trade balance was heavily weighted in South Africa's favour, and there was little reason to suppose that this position would alter in the foreseeable future since African countries were turning to South African supplies in the post-sanctions era to take advantage of lower prices.

African countries, nevertheless, were keen to see their balance-of-payments positions improve along with their economies by means of new foreign investments. For these reasons they ideally wanted to see South Africa's exchange controls at least relaxed so that South African corporates could invest in their economies. In the wake of the elimination of the financial rand system in March 1995, the process of gradually dismantling the remaining

controls on residents had therefore included relaxations on the restrictions stifling foreign investments by South African corporates.

Prior to June 1996, companies wishing to invest offshore had to demonstrate an immediate benefit to South Africa. This requirement was relaxed in June 1996, when a slightly longer-term view of the benefit to the country might be an acceptable motivation for an application as far as the exchange control authorities were concerned. Indeed, in the case of investments in African countries, and in particular the Southern African Development Community (SADC), this concession was introduced as early as the middle of 1995. Moreover, before June 1996 the funding of foreign investments had to take place abroad with no recourse to South Africa as previously indicated. Thereafter, a more flexible approach was to be adopted in the sense that where the total cost of an investment offshore did not exceed R20 million, consideration would be given to allowing the funds to be transferred from South Africa. Henceforth, the balance would have to be financed abroad by means of foreign borrowings with no recourse to, or guarantee being provided from, South Africa.

In March 1997 further concessions were granted to South African companies. At that stage they were permitted to transfer up to R30 million from South Africa to finance approved investments abroad compared with the previous limit of R20 million. In addition, under the new regulations announced at that stage South African companies investing abroad, with exchange control approval, were allowed to raise offshore financing based on the strength of their local balance sheets. This implied that recourse to South African companies was now possible in the event of defaults where such foreign investments were concerned. Moreover, as part of the concessions announced at that stage, South African companies were allowed to retain currency earnings from such as exports for up to 30 days of accrual instead of 7 days under the old regulations.

15.6 Foreign investment in the Southern African Development Community region

The removal of exchange controls on African investments might well have resulted in South Africa, and more particularly Johannesburg, becoming the international financial centre for Africa. Under such a liberalised capital account South Africa would have been able to assume the role of financing some of the economic development of Africa via capital outflows. This prospect provided an incentive for relaxations that promoted this outcome, namely where countries of the SADC countries were concerned, as already indicated.

By the mid-1990s a number of the member countries of SADC were embarking on programmes to progressively liberalise their exchange control regulations. In the case of South Africa no exchange controls were

by then applied to current-account transactions, and no restrictions existed on capital movements by non-residents as previously indicated. South Africa did, however, still apply strict and extensive controls on the outward investment of capital by residents even though they had been recently relaxed. These controls also applied to investments by South African residents in other African countries, with the exception of the members of the Common Monetary Area (CMA) Agreement which comprised South Africa together with Lesotho, Namibia and Swaziland.

In certain SADC countries the process of liberalising the exchange controls had gone much further than in South Africa, and this was starting to be reflected in pressures by certain SADC members on South Africa to liberalise its exchange controls further, especially as regards investments by South African residents in SADC countries.

Investors in certain African countries in the SADC region, such as Botswana and Mauritius, were increasingly investing in South African bonds and equities on the JSE. This reflected the fact that in certain SADC countries exchange controls on foreign portfolio investments by individuals and financial institutions had been scrapped, unlike in South Africa where only financial institutions were allowed to invest abroad, and this had to be executed largely via asset swaps, a feature that is explained later on in this chapter. These investments by SADC investors in South Africa were draining liquidity from stock exchanges in the relevant countries, and were adding to balance-of-payments outflows at a time when the foreign trade balances of these countries were already in deficit vis-à-vis South Africa. The result was that certain members of SADC were reportedly pressing for the Republic to relax its exchange controls in a preferential manner by allowing private investors and institutions to freely invest abroad on stock exchanges in SADC countries.

In the course of 1995 South Africa relaxed its exchange control regulations on African investments as previously indicated in the sense that South African companies wishing to make direct investments in SADC countries henceforth received more sympathetic treatment from the exchange control authorities in Pretoria. The result was that the South African exchange control authorities approved 35 applications for direct investments by local firms in Africa in the four months to October 1995; 85 per cent of which involved investments in the SADC region.

SADC countries wanted to intensify this trend and there were strong arguments supporting their proposals that South Africa should allow portfolio investments in the SADC region by South African investors. Such a relaxation of South Africa's exchange control regulations would have constituted a public relations triumph in the sense of demonstrating that SADC members were serious about promoting financial and economic cooperation in the region.

What is more, the stock exchanges in SADC countries, excluding the JSE, were small and the risks to South Africa's balance of payments from capital outflows would have been tiny. The market capitalisation of the 12 stock exchanges in SADC in aggregate amounted to US\$264 billion at the end of 1994, of which the JSE accounted for US\$260 billion.

From the perspective of South Africa, any such relaxation in its exchange controls had to ensure that its remaining exchange controls were not undermined. For instance, if South African investors were allowed to buy shares on the stock exchange in Gaborone, steps would have to be taken to ensure that such investors did not subsequently sell the Botswana shares to foreign investors, say in London. In addition, any such preferential relaxation of its exchange controls could not occur before South Africa consulted the other members of the CMA who applied similar exchange controls to those of South Africa.

Any such moves would, however, be in harmony with the two-speed approach of South Africa to phasing out its exchange controls affecting corporates which gave preference to investments in other African countries. In accordance with these guidelines concessions on the exchange control front were introduced in March 1997. At that stage South African companies were permitted to transfer up to R30 million from South Africa to finance approved investments abroad compared with a previous limit of R20 million as previously mentioned. In the case of approved new investments in member countries of the SADC countries, other than Namibia, Swaziland and Lesotho where funds already flowed freely, the new limit was R50 million. South African financial institutions were at the same time, given permission to invest on a limited basis in securities listed on stock exchanges in SADC countries, other than Namibia, Swaziland and Lesotho where no restrictions applied.

15.7 Foreign investments by domestic financial institutions

Irrespective of the degree to which direct foreign investments by local companies were boosted through relaxations in the exchange control regulations, one focal point of attention related to other domestic residents, and in particular domestic financial institutions. Indeed, some new dispensation for foreign investments by such institutions proved to be a top priority of the authorities by the mid-1990s. These institutions had for years favoured a more liberal dispensation for foreign investments against the background of their burgeoning cash flows, and the shortages of scrip on the JSE.

In contrast to the less stringent arrangements regarding direct foreign investments, the exchange control authorities for many years placed a virtual prohibition on portfolio or non-direct foreign investments by South African residents, that is, investments in stock exchange securities or other assets

in foreign undertakings in which South African residents had no controlling interest. This prohibition applied to financial institutions and other corporate undertakings, as well as individuals and other non-corporate bodies.

The Final Report of the De Kock Commission issued in July 1985 recommended a progressive relaxation of controls on residents.⁸¹ This was to commence with the granting of permission to registered insurers, pension funds and mutual funds to invest say 10 per cent of the net annual additions to their funds in foreign securities approved by the Registrar of Financial Institutions. In due course it was also envisaged by the Commission that similar provisions could be applied to other financial institutions and corporate bodies such as mining houses. Naturally the timing of such liberalisations would have depended on the state of both the balance of payments, and the domestic economy. Eventually, if circumstances were sufficiently favourable, the Commission envisaged that the prohibition on portfolio investments abroad by individuals, and other non-corporate bodies could also be relaxed.

The prospect of such relaxations starting with concessions for foreign investments by domestic financial institutions was torpedoed by the resort to a partial debt standstill in 1985, the reintroduction of the financial rand system, and the extreme pressures on the capital account of the balance of payments from 1985 onwards. Nevertheless, the cash flows of these financial institutions had continued to grow. The average annual growth in the book value of assets of long-term insurers, private pension funds and unit trusts had amounted to more than 20 per cent during the previous decade or more, and the total cash flows of these financial institutions on an annual basis was approaching R50 billion by the mid-1990s. The problem of allocating the huge ongoing increases in the cash flows of these institutions had accordingly become even more pertinent in the intervening years. This feature was reflected in the strength of blue chip shares on the JSE.

Permission for financial institutions to invest abroad via a unified commercial rand market obviously partly depended on balance of payments and foreign reserve trends, but a start was made via the introduction of an asset-swap system in July 1995. At that point the Bank introduced proposals whereby local financial institutions in the form of pension funds, insurance companies and unit trusts were allowed to undertake foreign investments by way of swap transactions with foreign investors.⁸² Making this a priority over allowing individuals to invest abroad had been supported by various considerations. First, it was argued that granting permission for domestic financial institutions to invest abroad was the most effective means of increasing the liquidity of the domestic equity market. Such increased liquidity could then have exerted a positive effect on the level of foreign investment in the local equity market. Second, it was argued that it would be much easier for the central bank to monitor foreign investments

undertaken by a limited number of domestic financial institutions than would be the case with individuals. Third, it could be argued that by reducing or eliminating the controls on institutions, this in effect amounted to furnishing concessions for individuals whose savings were mainly tied up with these financial institutions. Fourth, it was the case that the exchange controls had effectively prevented domestic institutional investors from investing abroad, whereas some private businesses and individuals had seemingly flouted the regulations, and parked funds in overseas centres over the years. This effective ban on foreign investments by institutional investors certainly ensured that pressures from this sector for relaxations had been strong. South African insurance companies alone held assets valued in the region of R365 billion at the end of 1994, and they had indicated that ideally they would like to hold roughly 10 per cent or R35 billion of this portfolio in foreign assets. Any such relaxations could therefore occur in stages with quotas allocated to the institutions which were raised over time.

In deciding on relaxations of the exchange controls on institutional investors before making concessions to private investors, the Bank thought that it would be safer for South Africans, unused to international investments after 35 years of exchange controls, to invest overseas via heavily regulated financial institutions such as unit trusts and insurance companies rather than allow them to invest directly abroad themselves.

There were, however, other arguments that pointed to a different conclusion, namely that the relaxations of the exchange controls on individuals might have been made ahead of financial institutions. Some observers were uneasy about lifting the controls on domestic financial institutions since they visualised that these bodies could play a part in the financing of the reconstruction and development programme. There was also the difficulty of defining a financial institution. By simply including pension funds, insurance companies and mutual funds this was an arbitrary delineation. Apart from banks, mining houses in some respects were financial institutions. In addition, there were other categories that were being excluded on this definition which felt as though they were suffering from discrimination. These included investment trusts and other financial companies. For instance, the South African Fund Managers Association, which represented portfolio management companies, was complaining about the complete lack of scope for such companies to invest abroad, which it deemed to be unfair and discriminatory. There were indeed reports that moves were afoot to challenge these various barriers to foreign investments by making submissions to the Constitutional Court. However, if all these entities were to be granted a dispensation for investment abroad, the remaining exchange controls would have been undermined.

By allowing only pension funds, insurance companies and mutual funds to invest abroad, it was likely that they would offer foreign currency investment opportunities for individuals and others via the financial products they offered in the market place. Several insurance companies had already launched new products of this nature to take account of the more liberalised

exchange control environment prevailing after July 1995, and in particular the introduction of asset-swap facilities. This meant that the remaining exchange controls which affected individuals in particular were being circumvented to some extent albeit legally. The new dispensation would also have reopened the debate about the alleged favourable treatment of insurance companies vis-à-vis banks and building societies, since even more funds could have been attracted away from the latter towards the insurance sector. Even in some industrial countries where exchange controls had almost entirely been eliminated, wide-ranging covert controls remained in force in the form of restrictions on foreign investment by long-term savings institutions such as mutual funds, pension funds and insurance companies. This called into question the prospects for any total abolition of exchange controls on financial institutions, and indeed the Finance Ministry was believed in the late 1990s to be considering the imposition of prudential rules on foreign investments by local financial institutions in line with regulations in force in certain other countries.

These arguments suggested that it might have been preferable to allow individuals to invest abroad before financial institutions received such a dispensation. Such private individual investment flows could still have been monitored by the banks on behalf of the central bank, and this would most likely have been preceded by more liberal limits on allowances for foreign holidays by individuals.

However, in reality this did not happen; the case for preferential treatment of individuals was being regarded as somewhat weak. In the middle of July 1995 the Bank undertook a modest relaxation of the exchange controls by permitting insurance companies, pension funds and unit trusts to invest a portion of their assets overseas by means of asset swaps as already mentioned. This meant that these institutions could exchange part of their equity portfolios with foreign institutions seeking to invest in South Africa, with a limit of 5 per cent of total assets which could be held in foreign assets. In June 1996 this limit was raised to 10 per cent and within this limit insurance companies, pension funds and unit trusts could invest 3 per cent of their 1995 cash flows directly in foreign equities. In addition, subject to the overall limit of 10 per cent of total assets, an extra 2 per cent of the net inflow of funds of insurance companies, pension funds and unit trusts for the calendar year 1996 could be invested during 1997 in securities listed on stock exchanges in SADC countries, other than Namibia, Swaziland and Lesotho where no restrictions applied. By the end of 1996 roughly R20 billion in asset swaps had been approved by the authorities, which was still less than 5 per cent of the total assets of the financial institutions.

15.7.1 Exchange controls on individuals

The pressures for further relaxation of the controls over financial institutions, however, soon built up. Money, for instance, soon began to

pour into the “international” unit trusts amounting to a net R216 million in June 1996. However, under the new regulations introduced at that time these trusts were only allowed to invest 10 per cent of these funds in foreign investments. The Unit Trust Association therefore began pressing for a more liberal dispensation in this regard, arguing that local investors should be able to invest in “international” unit trusts that could invest 100 per cent of their funds overseas.

Exchange control concessions for individuals came later in July 1997. At that stage registered South African taxpayers in good standing over the age of 18 were allowed to invest a limited amount of capital abroad, the figure being set at R200 000. In addition, individuals were allowed, after approval by the exchange control authorities, to invest in fixed property (e.g., holiday homes and farms) in SADC countries. Taxpayers could alternatively hold foreign currency deposits with authorised foreign exchange dealers within a defined limit if they did not want to invest abroad directly. The R200 000 limit was subsequently raised to R400 000 in the February 1998 budget, R500 000 in the February 1999 budget and R750 000 in the February 2000 budget.

15.7.2 Investment pool

Some analysts suggested that in the initial stages following the abolition of exchange controls on non-residents in 1995, relaxations of controls on residents could have been made by allowing both financial institutions, and individuals to undertake portfolio investments abroad at a different and less favourable rate of exchange than the commercial rand rate by creating a separate foreign exchange market for such investments. This would initially have involved the creation of a limited pool of foreign funds made available for this purpose. Such a pool could have been set up largely from a portion of the existing foreign reserves, which would have formed the basis of a separate market for foreign investments. In addition, foreign investments held abroad by South African residents could have been repatriated back to South Africa via this market.

Such a mechanism would most probably have provided resident investors with access to foreign capital at a premium currency rate, which would have been a useful market indicator of how much money was seeking to leave South Africa. This approach would have mirrored the investment dollar premium market which was operated by the UK authorities from 1947 to 1979.

However, apart from the shortage of foreign reserves such arrangements could have created serious administrative problems, arising out of illegal arbitrage transactions, similar to those which at times plagued the workings of the financial rand market. It would have involved setting up an entirely new exchange control mechanism which might have been unworkable.

Moreover, even if it was workable the exchange control authorities would have experienced a sharp learning curve as the new system was introduced, and irregularities were discovered. It could have taken a number of years before suitable rules were in place to make the control system effective, and by that time the system might no longer have been needed. It was therefore difficult to believe that the authorities would favour such arrangements.

One possible alternative arrangement would have been to allow domestic residents to invest abroad through the medium of a domestic bank subject to restrictions. The latter would have held the dollars on behalf of the customer, and the dollars would therefore have counted as part of the foreign reserves of the monetary banking system with the facility granted for residents to sell such dollars to other residents. Under this system South African residents would have been given a rand hedge investment, but would have been unable to keep funds overseas themselves. Such an arrangement, which was already in operation in Zimbabwe at that time, would not therefore have eradicated capital flight, but it would have been a move in the direction of liberalising the exchange controls on residents.

The Bank, however, was reportedly not in favour of introducing such a dispensation. The creation of such dollar (foreign currency) accounts at local banks could easily have forced the authorities to start pegging domestic interest rates to those of the dollar, undermining the policy of monetary targeting in force at the time, and could have led to the 'dollarisation' of the rand.

15.8 Treatment of blocked rand balances

The authorities argued that the ongoing weakness of the rand that was recorded in 1996 called for greater conservatism for a time regarding the issue of relaxations in exchange controls. Such caution was arguably justified even though the weakness with this approach as previously mentioned, was that it ran the danger of encouraging more procrastination on the part of the government in taking steps to make the country more investor friendly.

The lesson to be learnt from the decline of the rand in 1996 was arguably the need to undertake steps that would facilitate the resumption if not the abolition of exchange controls rather than put back the whole process. In this respect, the privatisation programme could possibly have been speeded up, and an exchange control and tax amnesty possibly granted to South Africans who had illegally exported capital during the past 35 years so as to encourage a return of flight capital. In addition, the burden of taxation on investment incomes in South Africa could possibly have been reduced, and some review of the regulatory and supervisory framework needed to be undertaken. In addition, some programme needed to be devised to deal with the problem of blocked rand balances.

The problems posed by these blocked balances were daunting. They referred to funds owned by South African emigrants who had been forced by the exchange control regulations to retain funds in South Africa when they emigrated. The great bulk of these balances had emerged from the time that exchange controls were introduced on residents in May and June 1961, up until the mid-1990s but some of the balances apparently originated from as far back as the time of World War II (1939–1945) when exchange controls were temporarily introduced by South Africa on capital transactions with non-sterling area countries.

The size of these blocked rand balances was not clearly known, but it was generally assumed that they ranged between R10 and R20 billion. Ascertaining their exact size was difficult because some emigrants had funds tied up in inter vivos trusts, while some of the blocked rand assets were in properties, and stock exchange securities whose market value fluctuated.

What was almost certain was that if the exchange controls were suddenly lifted, the great bulk of these balances – which were owned by tens of thousands of individuals – would be transferred out of the country. These blocked rand balances belonged to people who had largely, if not entirely, cut their ties with South Africa, and would therefore have been converted into foreign currencies if the rand was made fully convertible on the capital account. Since the size of these balances was larger than the foreign reserves of the country of about R10 billion at that time, they posed a major problem.

Partly for this reason and partly because the government was keen to discourage emigration, particularly of skilled workers, the authorities indicated that relaxations on blocked balances or their entire removal would be one of the last steps to be undertaken as part of the programme of abolishing exchange controls.

From a humanitarian viewpoint there was a case for arguing that some concessions on blocked rands were justified. Some emigrants were reportedly struggling financially, since they relied on the income they received from these balances which were not blocked, and this income had fallen sharply in foreign currency terms because of the weakness of the rand.

There had therefore been suggestions put forward for either converting these balances into so-called emigrant securities which matured in, for instance, five years' time, at which point they could be converted into foreign currencies, or establishing a timetable according to which a portion of the balances could be transferred out of the country on an annual basis. Such suggestions, however, were seemingly rejected by the government for the reasons alluded to previously when explaining the official desire to tackle blocked rand balances as the last of a series of liberalising measures.

Nevertheless, some programme to deal with these balances was arguably needed since it was difficult to visualise these balances being completely liberalised in one fell swoop.

15.9 Controlling domestic liquidity and the future of exchange controls

In line with the reintegration of the South African economy into the international financial system, the country enjoyed large net inflows of foreign capital in 1995 after a decade of persistent large net outflows of such capital. These inflows more than financed the deficit on the current account of the balance of payments and therefore facilitated a rise in the net foreign reserves. However, at the same time, they created difficulties in respect of domestic monetary management, since these inflows helped to boost the money supply at a time when the latter was rising at a faster rate than the target for 1995.

In 1996 the position was reversed. Against a background of continuing deficits on the current account of the balance of payments net foreign capital inflows fell sharply, and the rand depreciated by more than 20 per cent on a trade-weighted basis against other currencies. However, during the first half of 1997 the position reverted to that prevailing in 1995. Exceptionally strong net inflows of foreign capital contributed to a sharp rise in the foreign reserves, reflected in an unprecedented increase of R7,4 billion in the foreign reserves of the Bank to a record R21,8 billion in May 1997. Once again, this created problems in regard to the management of domestic liquidity created by these capital inflows.

At that stage some local analysts were beginning to argue along the lines that the government needed to pursue policies explicitly aimed at limiting the domestic effects of large capital inflows assuming the latter persisted. These could have included more aggressive foreign exchange market intervention to counteract upward pressures on the rand exchange rate, and extra measures to boost government savings and reduce the budget deficit. A more radical response would have been to try and curb some capital inflows through selected capital controls on such inflows.

Many governments in emerging-market countries had tried at least one of these policies in response to rising capital inflows. Some governments, particularly in East Asia, had tried all three methods, but they had met with mixed success.

Intervention involving the purchase of dollars, which was aimed at preserving a nominal exchange rate peg or keeping the average real value of the currency in terms of other currencies roughly constant, would have had inflationary effects since domestic currency would have been created in the process. The inflationary consequences could only have been avoided if

the monetary effects on the economy were sterilised by, for example, sales of government stocks into the markets by the central bank and/or currency swaps with local banks. Such tactics had been employed by the Bank in May 1997 to mop up some of the liquidity created by the purchase of a 30 per cent stake in Telkom by two foreign utilities at that time. Unfortunately, sterilisation of this kind could have ended up feeding the problems it was intended to solve by pushing up domestic interest rates, and thus encouraging further, possibly more speculative, inflows of foreign capital.

A tightening of fiscal policy was an alternative strategy for trying to choke off capital inflows. Such a tightening would have meant that the budget deficit was reduced which would have led to lower domestic interest rates, other things remaining equal, and thereby curbed capital inflows from abroad. However, political pressures and the time needed to implement changes in taxes and expenditures made fiscal policy a cumbersome tool for responding to rapid inflows of foreign capital in South Africa at that stage. A further lowering of the budget deficit would have been particularly difficult to engineer at that time, since steps were taken to reduce it in the March 1997 national budget, while the economy was in a downward phase of the business cycle, and further steps to curb the deficit could speed up the downswing.

As regards the resort to capital controls on inward flows of funds, this measure had been adopted in certain countries. Restrictions on short-term foreign borrowings by domestic banks in countries such as Chile and Malaysia did help to reduce the risks associated with the surge in capital inflows into those countries in the early 1990s.

Capital controls on inflows of foreign funds, however, were in general not to be recommended. They tended to be ineffective in limiting inflows for any length of time and create distortions. The bulk of capital inflows into South Africa in 1997 consisted of purchases of fixed-interest stocks and shares on the JSE. Any restrictions on such inflows could not only have dampened inflows, but precipitated huge outflows, and deterred further inflows for many years. Such developments could have been most unwelcome.

Exchange controls on capital inflows would have been particularly inappropriate for South Africa at that stage, since the country still applied exchange controls on capital outflows by residents. There was little point in introducing controls on inflows when capital outflows could not be freely undertaken. Before considering such controls on inflows, exchange controls on outflows needed to be abolished.

The inflows of foreign capital in 1997 in any case did not persist. Starting in May 1998 the authorities were confronted with material outflows of foreign capital which occurred in line with a marked deterioration of fortunes of emerging-market economies in general.

Chapter 16

Implications of further relaxations in exchange controls

16.1 Introduction

In the 1998/99 national budget presented on 11 March 1998 a number of important further relaxations in exchange controls that continued the process of gradually phasing out the remaining controls were announced. These moves were generally welcomed, and raised expectations that further concessions could be announced in due course, especially since the relaxations introduced since 1995 that applied to residents had not created any noticeable adverse pressures on the balance of payments. The moves announced since 1995 meant that significant progress towards eliminating exchange controls in their entirety had been achieved by March 1998. Meaningful concessions were made in respect of foreign investments by individuals, institutional investors and the corporate sector.

The various measures applied meant that the South African economy was becoming ever more integrated with the world economy, which had important implications for macroeconomic policies. Under Dr Stals's leadership the Bank believed that a country that exposed itself to the moods and perceptions of international fund investors and financial traders operating in a technologically integrated global market system could no longer ignore international norms set for financial discipline, prudent management, sound government and internal stability. Integration into the world financial system for South Africa held benefits such as access to a massive pool of excess savings in the economies of the world, but also required that the country adhere to the disciplines imposed by the global market economy.

16.2 Factors influencing new relaxations in exchange controls

Several factors played a part in encouraging the authorities to make further concessions in March 1998 as part of the programme of gradually phasing out exchange controls applicable to residents. In 1997 the capital account of the balance of payments was characterised by large inflows which substantially exceeded the deficit on the current account of the balance of payments. In particular, purchases of South African bonds, and equities by foreign investors totalled a net R41 billion in 1997, which were more than double the cumulative inflows of R17 billion for the previous three years. The foreign reserves of the country consequently increased sharply: the gross

gold and foreign exchange reserves of the Bank rose from R10,3 billion in December 1996 to R30,0 billion at the end of February 1998. In addition, the net oversold position of the Bank on its forward exchange account declined from US\$22 billion in December 1996 to around US\$14 billion at the end of February 1998; an improvement that could be attributed in part to the relative stability of the rand exchange rate.

These balance-of-payments developments were highly positive from the perspective of paving the way for new relaxations in the exchange control regulations. The caution that continued to be displayed by the authorities in this regard, however, was attributable in part to the prospective material increase in the deficit on the current account of the balance of payments in 1998 and 1999.

16.3 Relaxations on current-account transactions

After the introduction of the March 1998 measures there were virtually no remaining restrictions on current-account transactions with the exception of certain discretionary expenditures such as gifts, and foreign travel where limits were still applied to support the remaining restrictions on capital outflows. Nevertheless, as part of the new measures announced in March 1998 South African residents travelling abroad were allowed a maximum allowance of R100 000 per person of 12 years and older (previous limit R80 000) and R30 000 per child under the age of 12 years (R25 000) per calendar year.

16.4 Relaxations on capital account transactions

Certain further limited concessions were granted to non-residents in the March 1998 budget in respect of their ability to borrow in domestic markets. Before that budget organisations with a foreign shareholding in excess of 50 per cent were subject to certain restrictions on local borrowings. This threshold was raised to 75 per cent. This was supplemented by more important relaxations in respect of local companies wishing to invest abroad.

16.4.1 South African corporates

Under the new regulations of March 1998 South African corporates were allowed to retain currency earnings from exports for up to 180 days as from the date of shipment or date of service rendered. This concession was welcomed by exporters, since it furnished them with increased flexibility as regards the cash management of their foreign currency receipts, and should have boosted the earnings of some exporting companies marginally. However, this concession could not be of benefit to cash-strapped exporters such as the gold-mining industry at that stage.

This relaxation in the regulations was most probably motivated in part by the hope that greater numbers of exporters would sell their dollars forward for rand since holding dollars abroad for up to six months entailed greater uncertainty about the rand value of the proceeds. Any greater forward sales of dollars would reduce the net oversold position of the Bank on forward exchange account, which was to be welcomed. By contrast, this new concession did mean that the country's balance-of-payments position became more exposed to leads and lags influences, which would add to downward pressures on the rand at times when the rand was weak, other things remaining equal. There was, however, the possibility that the new repo rate system introduced in March 1998 would help to attract more foreign capital, which would counteract any tendency for the rand to become more volatile in value after the 180-day rule had been introduced in respect of export proceeds.

South African companies, moreover, were henceforth permitted to transfer up to R50 million from South Africa to finance approved investments abroad, compared with a previous limit of R30 million. This was a small concession which, no doubt, reflected the fears of the authorities that if the limits were raised substantially at that stage, large outflows of corporate funds would take place, thereby straining the balance-of-payments position. In the case of approved new investments in member countries of SADC, other than Namibia, Swaziland and Lesotho where funds already flowed freely, the investment limit was raised from R50 million to R250 million. This concession, however, was not expected to boost investment in neighbouring countries to any great extent.

16.4.2 Dual stock exchange listings

One exchange control item that had effectively prevented foreign companies from listing on the JSE was lifted in the March 1998 budget statement. In the interests of promoting regional economic development it became possible for companies quoted on the JSE and other stock exchanges in SADC countries to dual-list. In future such dual listings would be allowed on application subject to the consent of the Minister of Finance provided the listing by a company in the southern African region on the JSE did not involve raising more than R250 million.

There was a strong interest from some foreign companies in areas such as Africa to list on the JSE. This new facility would therefore boost the stature of the exchange, and help to entrench Johannesburg as the financial capital of the southern African region, but the pressures to raise the R250 million limit in future could have been strong.

16.4.3 South African institutional investors

Before March 1998 qualifying financial institutions, in the form of pension funds, insurance companies, unit trusts and regulated fund managers,

were permitted to invest up to 10 per cent of their total South African assets abroad under swap arrangements as previously mentioned. Similarly, during the calendar year 1997, qualifying institutions were permitted to invest offshore up to 3 per cent of the net inflow of funds during the calendar year 1996. In addition, an extra 2 per cent of the net inflow of funds during 1996 could be invested during 1997 in securities listed on stock exchanges in SADC countries other than Namibia, Swaziland and Lesotho where no restrictions applied.

The limit of 10 per cent of total South African assets that could be invested in foreign assets via swaps was raised to 15 per cent in March 1998. During 1998 direct offshore investments using cash of up to 5 per cent of the net inflow of funds for the calendar year 1997 would be permitted, subject to the overall limit of 15 per cent of total South African assets previously referred to. What is more, subject to the overall limit of 15 per cent of total South African assets, an extra 10 per cent of the net inflow of funds during the calendar year 1997 could be invested during 1998 in securities listed on stock exchanges in SADC countries.

From July 1995 to February 1998 it was estimated that the Bank had approved asset swaps involving financial institutions in the amount of R77 billion, while around R38 billion had been transacted. Nevertheless, it was expected that this system would become redundant in time, since the Financial Services Board was believed to be preparing to introduce prudential investment guidelines for financial institutions relating to foreign investments. These guidelines could have been in line with the new limit of 15 per cent of total assets of insurance companies, pension funds and unit trusts, which could be invested abroad, but there could have been different requirements for different asset class managers. For example, pension funds could have faced a 15 per cent prudential requirement, while certain unit trusts might have enjoyed a 100 per cent limit.

Meanwhile, the authorities still resisted the introduction of corporate asset swaps to complement the existing asset swap mechanism for financial institutions. This most probably was accounted for by two considerations. First, corporate asset swaps were less easy to monitor than asset swaps for financial institutions where the transactions took place on the basis of stock exchange prices. Second, corporate asset swaps would have been mainly designed to be long-term investments involving the purchase of business units that might not have been easily sold if the other partner in the swap transaction suddenly decided to sell out of its investment.

16.4.4 South African resident private individuals

From 1 July 1997 registered South African taxpayers in good standing over the age of 18 were allowed to invest R200 000 per person offshore. Subject to the same criteria, such individuals were allowed to invest up to

R400 000 in foreign assets under the new concessions introduced in 1998. The outflows of capital by private investors amounted to only R793 million in the seven months to February 1998, and this limited response had made it easy for the authorities to lift the limit.

These concessions were unlikely to give a material boost to capital outflows from this sector. In view of the relatively high level of domestic interest rates, and the high level of international share prices at that time, it was unlikely that resident private individuals would step up their foreign investments. The low ratio of domestic savings relative to incomes in South Africa, and the large indebtedness of individuals pointed to continued limited investment in foreign markets by individuals. Individuals who held foreign currency deposits in the name of a local bank incurred charges for this service, which probably dampened the enthusiasm for such investments, while individuals were liable to South African taxes as regards the income from such investments. Even capital gains arising out of depreciation of the rand against foreign currencies were subject to tax in South Africa, if the tax authorities concluded that the investor had been deliberately seeking capital gains. Some diversification into foreign assets had in any case been undertaken over many years by residents despite the presence of exchange controls, and foreign investment in an environment of volatile exchange rates in the international arena posed certain added risks.

16.5 Future life of remaining exchange controls

The moves announced in the March 1998 budget, together with previous relaxations, meant that substantial progress had been made towards eliminating exchange controls in their entirety. There were grounds for arguing that the remaining exchange controls could possibly have been speedily abolished after March 1998, provided that prudential investment requirements for local financial institutions were introduced, and a special dispensation was furnished to tackle the problem of blocked rand balances. Domestic and foreign investor sentiment could have been improved through bold moves to dismantle the remaining exchange controls.

This, however, was not the approach of the authorities. They continued to assert that the future programme for the removal of the remaining controls would remain a gradual one, with relaxations dependent on a continuation of net capital inflows from the rest of the world. Although the foreign reserves had improved considerably since the beginning of 1997, the authorities still appeared to take the view that the reserves were still not large enough to warrant a big bang approach to the removal of exchange controls. Since the capital account of the balance of payments was somewhat volatile, and the rand was vulnerable arising partly out of deficits on the current account of the balance of payments, which was being financed by net capital inflows, the process of phasing out the remaining exchange controls was more complicated than assumed in some quarters.

During the latter half of 1998 and the first half of 1999 the focus of exchange control policy began to be partially centred on the issue of South African companies that wanted to migrate to the London Stock Exchange from South Africa. At that stage permission was granted by the Treasury for certain large local companies such as South African Breweries and Old Mutual to shift their primary stock exchange listings to London from Johannesburg, but a greater exodus of companies to London was thwarted by the reservations of the Finance Ministry concerning mass emigration of some of South Africa's most dynamic companies to the London Stock Exchange. The fact that the moves to migrate to London partly stemmed from the existence of exchange controls, which restricted the ability of South African companies to invest abroad, only served to highlight the distortions that exchange controls continued to exert on the South African economy.

Part 4

Other Externally Orientated Policies

Apart from the management and implementation of policies regarding exchange controls, other policies relating to external financial relations in the 1990s were focused, in part, on the management of South Africa's foreign debt. This was particularly crucial up to 1994 in view of the foreign financial sanctions that were in force; this subject is covered in Chapter 17. This is followed by a review of the country's exchange rate policies, including forward exchange in Chapters 18 and 19 respectively, while the management of the Bank's gold and foreign exchange reserves is analysed in Chapter 20. The final chapter looks at the shifting nature of the Bank's gold sales policies in the 1990s in the light of the changing circumstances of the gold markets and the South African gold-mining industry.

Chapter 17

The management of South Africa's foreign debt in the 1990s

17.1 Introduction

At the beginning of the 1990s economic policy in South Africa was dominated by the country's external economic relations, and more particularly the international actions against South Africa in the form of trade and capital sanctions. The sanctions imposed on South Africa in 1985 in the form of onerous foreign debt repayments were a burden that remained until 1994, when a new relationship emerged as regards South Africa's economic and political relations with the outside world. The burden of repaying foreign debt constituted an important constraint on the balance of payments, and occurred during the early 1990s at a time when South Africa did not benefit from any material windfall in the form of strong international commodity prices. Indeed, when Dr Stals became Governor in August 1989 the country was suffering from a deterioration in its terms of trade, which had set in from the middle of 1988.

Nevertheless, despite the international actions taken against South Africa by its foreign creditors, the South African reaction had been to protect the country's credibility, and creditworthiness with the international financial community as far as possible. The foreign debt crisis that developed in 1985, and forced the debt standstill at the end of August 1985 was perceived by the authorities to be a liquidity crisis, and not a solvency crisis. Unlike many other countries in the developing world, South Africa was not forced into a moratorium on its foreign debt, because of an over-borrowed position. In this respect it was in an entirely different situation to that of many other developing countries that were forced into debt rescheduling arrangements during the 1980s and 1990s. South Africa was forced into this position because of a mismatch between relatively large short-term foreign liabilities, mostly relating to the private-banking sector in South Africa, and a relatively small amount of official foreign reserves available at the time.⁸³

The foreign debt standstill of August 1985 represented a watershed in South Africa's affairs in the international financial arena. Under the First Interim Debt Arrangement announced in August 1985 it was stipulated that more than half (US\$13,6 billion) of South Africa's foreign debt would be frozen inside the net, and not be released for repayment on maturity. Interest payments on this debt were, however, still to be made to foreign creditors at the commercial rand exchange rate. All foreign debt outside

the net (US\$10 billion) was to be paid on maturity. Foreign creditors were, however, given the choice of removing their debt inside the net to outside the net by converting short-term debt into three-year payable debt.

The Second Interim Arrangement in 1987 provided for the repayment of US\$1,4 billion of debt within the net, and for foreign creditors to convert debt into ten-year conversions outside the net. Subsequently, the Third Interim Arrangements, announced in October 1989, allowed for the repayment of a further US\$1,7 billion of debt within the net over the next four years to the end of 1993. At that stage outstanding debt in the net could be converted into longer-term debt after negotiations with the monetary authorities so as to avoid an unfavourable bunching of maturities in the future. In a final debt rescheduling agreement reached in late 1993, it was agreed that the remaining affected debt of around US\$5 billion would be redeemed in instalments over the eight-year period from 1994 to 2001 by means of six-monthly instalments. These redemptions would be spread out over a seven-year period in order to lighten the burden of the repayments.

What is more, in the various interim debt arrangements, provision was made for lenders trapped with loans inside the standstill net to convert their short-term claims at their election into financial rand for either investment in South African equities or for liquidation through the financial rand system. Under these arrangements foreign creditor banks could convert the commercial rand equivalent of their debt standstill dollars into a financial rand account and then sell the financial rand for dollars in the financial rand market at the ruling financial rand exchange rate, or convert the financial rand into equities. Such debt equity swaps amounted to US\$700 million by the end of 1990.

South Africa's total foreign debt at the end of 1990 amounted to US\$19,4 billion, of which US\$6,6 billion or 34 per cent represented debt subject to the standstill arrangements. The amount of US\$6,6 billion had fallen steadily over time, partly due to semi-annual scheduled repayments, and the amount at that stage was eligible for the debt-equity switch or conversion into financial rands. Moreover, the remaining foreign debt had been rescheduled, and by the end of 1990 less than 40 per cent of the outstanding amount of the foreign debt was short term, compared with almost 70 per cent in 1985. At that juncture South Africa's foreign debt amounted to only about 70 per cent of the country's annual exports, compared with 254 per cent for the developing countries of the western hemisphere. In the early 1990s further progress was recorded in reducing the total foreign debt of the country, and by the end of 1993 it stood at US\$16,7 billion.

The periodic reviews and revisions of the debt arrangements were aimed at retaining good relationships with the country's foreign creditors. The willingness to meet all interest commitments on the country's foreign debt,

and to make periodic capital repayments on the foreign debt subject to the standstill arrangements, were prompted by the same desire to retain good relations with the country's foreign creditors. South Africa wanted to retain the friendship of the international banking community in the belief that at some time in the future the international banks would, once again, become lenders to South Africa. This was fully vindicated in later years, after the political reforms of 1994, as the banks started to offer foreign credit facilities again both to the Bank and to other banks.

In addition, the country never pleaded for debt forgiveness, acknowledging its commitment to repaying all of its foreign debt. The maintenance of such good relations was also important, because South Africa's access to international official institutions such as the World Bank, and the IMF for financial and technical assistance was blocked at that time.

17.1.1 Rand-denominated foreign debt

The management of the foreign debt of the country explained so far in this chapter has referred in particular to foreign currency-denominated foreign debt. In addition, however, South Africa did shoulder the burden of other foreign debt, which was classified 'as rand-denominated debt'. This debt mainly comprised domestic equities, and government and Eskom bonds held by foreigners, together with blocked rand balances held by emigrants, and financial rand balances held by non-residents. This debt was subject to financial rand and blocked rand exchange control regulations, but did not form any part of the debt subject to the standstill arrangements.

When converted into dollars at the appropriate commercial rand rates of exchange, this debt increased from US\$5,2 billion in 1989 to US\$9,1 billion at the end of 1993, partly reflecting the attractions of high-yielding government bonds for foreigners. This debt, however, did not pose any meaningful balance-of-payments problems, since any disinvestment from government bonds by the foreign sector took place via the financial rand mechanism up until March 1995, and therefore did not affect the commercial rand rate. Instead, the burden of foreign debt resided mainly with the foreign currency-denominated debt items.

17.2 The burden of foreign debt

The foreign pressures on the South African economy in the form of capital and trade sanctions, foreign disinvestment pressures, and attempts to isolate South Africa from global technological innovations had been ongoing phenomena since 1985. They supplemented other external negative economic factors over which the authorities had little or no control, such as a deterioration in the terms of trade, and increases in the prices of essential imports such as oil. At the end of the 1980s the economy suffered from a structural weakness. In the wake of any meaningful revival in the economy

it was possible that the volume of imports would surge, while the growth in exports could be anaemic or totally absent. This meant that the current account of the balance of payments could have deteriorated substantially and quickly, and brought into question the ability of the country to carry on repaying its foreign debt.

In view of the unwillingness of foreign banks to extend new loans, South Africa had to run balance-of-payments surpluses on its current account in order to repay foreign debts. In the absence of these surpluses the country would have had no alternative but to default on its international commitments. Historically, the volume of foreign investment had tended to adjust to the balance-of-payments position on its current account rather than the other way round; the former being the sensitive and the latter the insensitive factor. The position had become reversed. At the same time cyclical trends in the South African economy became less closely tied to the gold price as a result of the outflows on the capital account of the balance of payments after 1985.

17.2.1 Transfer problem

The repayment of foreign debts through the mechanism of surpluses on the current account of the balance of payments meant that South Africa faced a transfer problem. This was not a unique situation. It had, for instance, historical parallels with the position of Germany in the inter-war period. In 1918, at the end of World War I, the Versailles Treaty imposed onerous obligations on Germany in the form of reparation payments, which vastly exceeded the country's holdings of foreign reserves. In order to earn sufficient foreign exchange to meet these reparation payments, Germany adopted appropriate exchange rate, and demand management policies to record foreign trade surpluses. In effect, it made reparation payments in the form of the export of goods and services.

In the early 1990s South Africa was in a similar position, with the difference that instead of reparation payments, the country faced debt repayments. The economy had experienced large ongoing net capital outflows since 1984. Over the five years from 1985 to 1989 the total net capital outflows from South Africa, including the so-called unrecorded transactions on the current and the capital accounts of the balance of payments amounted to R26,8 billion. Over the same period the cumulative surplus on the current account amounted to R23 billion. This meant that the balance of the capital outflows had to be financed out of the foreign reserves. Over the longer period from 1985 up to the middle of 1994, the total net capital outflow from the country amounted to about R50 billion. The consequent need to shift more resources into export- and import-competing sectors so as to generate current-account surpluses had been achieved largely through a decline in the external value of the rand, together with cautious demand management policies.

Apart from letting the exchange rate weaken, the authorities had no alternative but to adopt more restrictive economic policies when the balance-of-payments position deteriorated markedly. At times the great temptation existed to make use of more direct controls in the form of import and exchange controls to address the balance-of-payments problem, and credit ceilings and interest rate controls to restrict inflation. However, throughout the 1990s the authorities refrained from such undesirable practices.⁸⁴

The debt crisis also promoted a greater awareness of the importance of domestic savings. For South Africa it had become imperative not only that the country save more, but also that the country's savings be used in a more productive way. This awareness induced greater financial discipline into both fiscal and monetary policies. The Treasury made it a target of its fiscal policies that the demands of the budget on the money and capital markets were restricted, while in the monetary policy arena the importance of positive real rates of interest at all times was made even more evident.⁸⁵

The financial sanctions also highlighted the desirability of maintaining a resilient domestic banking system. Any occurrence of material domestic banking problems would have run the great danger of intensifying the outflows of capital on the balance-of-payments front. This in turn could have necessitated that monetary policies be tightened further, thereby damaging the scope for economic growth even more.

Fears sometimes arose that the burden of foreign debt repayments would prove too much to handle and thereby make it impossible for the country to meet all its foreign financial obligations. In 1989, for instance, speculation arose to the effect that the declining surplus on the current account of the balance of payments would create just such a crisis.⁸⁶ This, however, did not happen, because the necessary adjustments came about through the application of conventional restrictive demand management policies, and a weaker exchange rate. The authorities perceived that the country had no alternative but to meet its obligations as regards the repayment of foreign debt without actually defaulting.⁸⁷ This commitment forced the Bank to persist with a restrictive monetary policy stance that transmitted the pressures of the balance of payments into a more restricted growth performance of the domestic economy.

17.3 Effectiveness of sanctions

The various sanction measures did not all meet with the same degree of success. In retrospect it could be seen that the more specific trade sanctions applied on exports of strategic goods to South Africa, for example, military equipment, met with more success than the general boycott of South African exports. After all, from 1984 to 1991 South Africa's exports of merchandise goods continued to rise in volume terms at an average

rate well above the rate of expansion in total world trade. Moreover, South Africa's exports rose by 6 per cent on average over the six years to 1993.

As far as financial sanctions were concerned, the withdrawal of loan funds was much more harmful. However, South Africa was not the only developing country in the world that was adversely affected by the reversal of international capital flows in the 1980s. In the end, more than 70 countries experienced serious balance-of-payments problems, because of the decline in the flow of funds from the industrial to the developing parts of the world. It is therefore impossible to conclude that all the financial sanctions faced by South Africa were necessarily politically motivated actions.⁸⁸

In general, the multifarious sanctions imposed on the country were highly negative, but their impact could still be exaggerated. In this respect it is vitally important to appreciate that the Stals era was characterised by the absence of any major external stimulus, emanating from a boom in international commodity prices. From the end of 1945 to 1980 South Africa had periodically benefited from booms in global commodity prices. In contrast, throughout the 1990s South Africa's commodity-based economy received no such external windfalls, and numerous commentators mistakenly suggested that the commodity sectors were in long-term decline, which required painful readjustments in the local economy. Time was not on the side of Dr Stals, since roughly two years after his retirement South Africa began to benefit from a massive boom in international commodity prices across the board.

In the process of managing its foreign debt under the standstill arrangements in force after 1985, South Africa became less vulnerable to foreign pressures on its balance of payments. It acquired a foreign debt profile which placed potential South African borrowers in a favourable position for a return to the international capital markets, once a new political dispensation had unfolded in South Africa. Gradually, South Africa's foreign credit ratings began to improve. After having declined from number 29 in the world in 1984 to as low as 57 in 1987, South Africa's rating, according to a leading investor journal, rose gradually to number 45 in March 1992.⁸⁹ The strategy adopted by South Africa in the management of its foreign debt after 1985 was partly based on the assumption that the country would at some point in the future return to the international financial community and, once again, have normal access to the money and capital markets of the world.⁹⁰ When this set of circumstances materialised after April 1994, several benefits were realised since the economic growth rate had increased, and deficits on the current account of the balance of payments could be financed without recourse to the IMF or other short-term official foreign borrowings. In addition, the foreign reserves were bolstered, and a start was made with abolishing exchange controls. The final rescheduling of the debt standstill arrangements at the end of 1993 allowed the authorities to

start focusing attention on the removal of the financial rand system, which became possible in March 1995.

The change in circumstances surrounding South Africa in 1994 was dramatic. In the 18 months from June 1994 up to the end of December 1995, the total net inflow of capital into South Africa exceeded R30 billion. This reversal made it possible for the economic growth rate to improve gradually from 1,3 per cent in 1993 to 2,7 per cent in 1994, and to 3,3 per cent in 1995. The capital inflows therefore relieved the balance-of-payments constraint that had previously restricted growth to below 1 per cent per annum. However, despite the inflow of foreign capital into the economy after 1994, South Africa's foreign debt relative to GDP remained modest according to international standards. The country's total foreign debt, including rand-denominated debt, rose from US\$29,7 billion at the end of 1994 to US\$38,8 billion at the end of 1998.

Chapter 18

Exchange rate policy for the rand in the 1990s

18.1 Overview

The formulation of exchange rate policies in South Africa in the 1990s was the responsibility of the Treasury, but the Bank was responsible for implementing them. Fundamental mutations in exchange rate policies, therefore, were not strictly speaking the province of the Bank, although in respect of its intervention transactions in the foreign exchange market the Bank enjoyed some autonomy.⁹¹

18.2 Case for a floating rand rate

Floating exchange rate arrangements in the 1990s were not confined to major industrial countries. Numerous developing countries also functioned with floating rate systems. South Africa was but one of a string of countries that had adopted such an exchange rate regime in the previous decade or earlier. Certain structural characteristics determined the desirability or otherwise of floating exchange rates, which related to the degree of nominal flexibility in wages and prices. These structural characteristics of economies influenced the desirability of being at one or another point along the spectrum, with purely floating rates at one end, and completely fixed rates at the other end.

Fixed exchange rates are likely to be more desirable the more open the economy is in the sense of being subject to external shocks and the more integrated it is with its neighbours. Fixed exchange rates require that adjustment to real or monetary shocks take place solely through changes in prices and wage levels or through factor mobility. In contrast, under floating rates some of the adjustment can occur through nominal appreciation or depreciation of the exchange rate. Therefore, flexibility in prices and wages is crucial under fixed rates for minimising the costs of real or monetary macroeconomic disturbances. During the 1980s and early 1990s, South Africa had limited flexibility in this respect, partly because of the high concentration in the ownership of industry, and partly because of upward pressure on wages exerted by trade unions and the shortages of highly skilled labour.

At the same time, economies that were large producers of primary commodities, such as South Africa, were more likely to face external real or monetary shocks resulting from major changes in the prices of mineral

commodities. For a country such as South Africa shifts in the terms of trade could have had severe consequences for output or inflation. Exchange rate flexibility provided an important means of cushioning such shocks. In the 1990s, during the Stals era, the continuous fall in gold production, and the weakness in the dollar price of gold were best accommodated by a floating rand system. South Africa's exchange rate policy in the 1990s dovetailed with that of other countries with similar structural characteristics, such as Australia and New Zealand who faced significant variability in their terms of trade. Both these countries adopted floating exchange rates in the 1980s in the face of deteriorating terms of trade.

18.3 Past trends in commercial rand rate

The resort to a system of floating for the rand in September 1983 was followed within a short period by dramatic movements in the value of the currency vis-à-vis other foreign currencies. These were precipitated by adverse balance-of-payments developments, especially on the capital account which, in turn, were mainly linked to political developments. The magnitudes of some of these currency movements are shown in Table 5.

Table 5: Effective nominal exchange rate of the rand, 1979 = 100

Period	Nominal value	Percentage change
End of 1984	57,38	–
End of 1985	39,53	-31,1
End of 1986	42,58	+ 7,7
End of 1987	42,88	+ 0,7
End of 1988	36,28	-15,3
End of 1989	34,63	- 4,5
End of 1990	32,22	- 6,9
End of 1991	30,18	- 6,3
End of 1992	28,87	- 4,3

Source: South African Reserve Bank *Quarterly Bulletin*, various issues

In more recent years the nominal value of the rand, which represented the weighted average exchange rate of the rand against six key foreign currencies (i.e., US dollar, pound sterling, Deutschmark, yen, lira and Dutch guilder) had declined at a more moderate rate compared with the mid-1980s. This decline in the nominal value of the rand, moreover, had been accompanied by a parallel, albeit less pronounced, fall in the real effective exchange rate. Indeed the latter rose moderately between 1990 and 1992 as shown in Table 6.

Table 6: Real effective exchange rate of the rand, 1979 = 100

Period	Real average value for period	Percentage change
1984	97,01	–
1985	74,09	-23,6
1986	77,05	+ 4,0
1987	89,09	+15,6
1988	86,00	- 3,5
1989	85,05	- 1,1
1990	89,06	+ 4,7
1991	92,00	+ 3,3
1992	93,02	+ 1,1

Source: South African Reserve Bank *Quarterly Bulletin*, various issues

The real average value of the rand was calculated by adjusting the percentage change in the nominal effective value of the rand against the six key foreign currencies for the differential in inflation rates between South Africa, and its main trading-partner countries. Whereas the nominal value fell by 61,4 per cent between the end of 1983 and the end of 1989, the average real rate declined by 30,1 per cent during the same period. Over the period, from 1979 to 1990 inclusive, the decline in the real effective exchange rate of the rand amounted to roughly 20 per cent, and this highlighted the competitive advantage bestowed on South African producers vis-à-vis foreign competition during that period of time, assuming that the rand was neither overvalued nor undervalued back in 1979.

However, thereafter the real rate stopped falling for a time and, in fact, increased somewhat. Over the 19 months from 31 December 1990 to 31 July 1992, the average weighted value of the rand in nominal terms depreciated by 7,9 per cent. This was slightly less than the difference in the rates of producer price inflation in South Africa and its major trading-partner countries. The result was a modest appreciation of 1,6 per cent over this period in the real average value of the rand weighted in terms of a basket of the six currencies of its major trading partners. This was in line with a much less steep fall in the nominal value of the trade-weighted value of the rand since roughly the middle of 1988.

However, from roughly August 1992 onwards the net foreign reserves started to come under pressure once more in the face of escalating capital outflows, which more than counterbalanced the ongoing surpluses on the current account of the balance of payments. During 1993 these adverse balance-of-payments pressures were reflected in a more pronounced fall in the external value of the rand. In the first nine months of 1993 the nominal effective exchange rate of the rand against the basket of the currencies of South Africa's major trading partners depreciated by around 12,5 per cent,

and after adjustment for the differential in producer price inflation in South Africa and in the relevant other countries, the real effective exchange rate of the rand fell by more than 7 per cent during this period.

This showed that under circumstances where the net foreign reserves were falling significantly, the floating aspect of the floating exchange rate regime came to the fore, and the external pressures were taken on the exchange rate to a greater extent. Conversely, when the reserves were rising, the Bank was able to exercise a greater influence over the exchange rate, and the nominal trade-weighted value of the rand could be allowed to fall entirely or largely to reflect the differential in inflation rates.

18.3.1 The influence of gold

Changes in exchange rate policy in the 1990s had been facilitated by trends in the gold-mining industry. The trend, established in the 1980s, for the economy to become less dependent on gold earnings continued. In 1980 44,5 per cent South Africa's export earnings were attributable to gold, whereas by 1991 this had dropped to 25,5 per cent. By 1997 this figure had dropped to less than 20 per cent. The influence of gold on the commercial rand rate had been declining, and expectations were that this could diminish further and, indeed, this did occur in the 1990s.

During the previous two decades or so changes in exchange rate policies could have been interpreted as responses to a changing economic environment. As the underlying economic structure had mutated over time, the nature of the optimal exchange rate regime had varied. The diminishing role of gold in the 1980s had facilitated the moves towards greater management of the rand exchange rate. The strategy on occasions of allowing the real trade-weighted value of the rand to rise marginally, and therefore not allowing the currency to decline on a nominal basis fully in line with inflation rate differentials meant that fluctuations in the gold price did not influence the rand exchange rate under such circumstances. In the face of declines in the dollar price of gold there was no longer any automatic cushion for the gold-mining industry in the form of downward adjustments in the exchange rate. Exchange rate policy no longer automatically served to support any specific sectors of the economy in times of trouble.⁹² By the early 1990s the gold-mining industry was therefore operating in an entirely different environment, and had been forced to focus more attention on improvements in productivity in order to weather the depressed levels of the gold price existing at the time.

18.4 Criticisms of exchange rate policy

Towards the end of 1989 the Bank issued an unequivocal mission statement in which it accepted that its sole responsibility at all times was to protect the internal and external value of the currency. In order

to achieve this objective, the Bank regarded it as essential that the rate of increase in the money supply should be reduced to below the rate of inflation, interest rates should be positive in real terms, the country's available gold and foreign exchange reserves should be raised to the equivalent of about three months' imports, and the real exchange rate of the rand should remain relatively stable. These objectives were regarded as minimum conditions for the creation of a stable financial environment, and for a gradual reduction in the unacceptably high rate of inflation. It was argued that unless monetary policy could succeed in reaching these minimum goals, long-term economic growth at an optimum rate would not be sustainable. Exchange rate policy in the 1990s was therefore a crucial adjunct of prevailing general monetary policies.

The prevailing policy at that time of allowing the rand exchange rate to float, subject to intervention by the Bank to smooth out undue fluctuations, and not having a predetermined objective for the exchange rate of the rand, had certain advantages over discretionary changes in exchange rates undertaken from time to time, since adjustments in the floating exchange rate were made regularly, and the determination of the exchange rate was somewhat removed from the area of political debate. Adopting a rigid exchange rate rule such as keeping the real exchange rate of the rand roughly constant could have been incompatible with the money supply targets laid down by the Bank. Under such a policy the maintenance of a roughly stable real exchange rate of the rand would have entailed intervention in the foreign exchange market, which could have resulted in the creation or diminution of the money supply such that money supply targets were breached.

In addition, maintaining a roughly constant real exchange rate could have been totally inappropriate in the face of real shocks to the economy such as a marked change in the gold price, or sudden large outflows of capital. Under such circumstances the maintenance of a roughly constant real rate might not have been compatible with a comfortable overall balance-of-payments position.

What is more, South African exchange rate policy was starting to come under greater scrutiny in the early 1990s. Some analysts believed that the then prevailing policy was not sufficiently rigid, because the nominal trade-weighted value of the rand was allowed to fall, reflecting the fact that local producers' cost of production was rising at a faster rate than those of overseas competitors. They argued that the nominal value of the rand should have been held stable, thereby implying that the real trade-weighted value of the rand would have to rise meaningfully. Such a policy was based on the benefits to be derived on the inflation front through an even slower rise in import prices, which could also have acted as an additional discipline on local producers by creating a greater awareness of the need for a rise in overall productivity in South Africa. Such a policy would also

have curbed the potential losses to be incurred by the Bank on the forward exchange account.

This policy could have led to balance-of-payments difficulties. If South Africa's inflation rate remained above that of its main competitors, the appreciation in the real exchange rate could have ushered in balance-of-payments crises which rendered the policy unsustainable, because of a diminished competitiveness of the economy. The decline in gold production, for instance, could have been even more dramatic.

It could be alleged that exchange rate policy at the time was more accommodative of importers than exporters; a state of affairs that would have been exacerbated if the nominal trade-weighted value of the rand was kept stable. This would have arisen because the depreciation in the nominal trade-weighted value of the rand was based on the producer price indices in South Africa, which were recording relatively low rates of inflation at the time, rather than the consumer price indices. If the depreciation in the rand had been based on the consumer price indices, the nominal trade-weighted value of the rand would have declined more significantly, thereby benefiting exporters, and squeezing importers.

At the same time, the maintenance of a relatively stable nominal trade-weighted value of the rand would have discouraged exports, hitting the mining industry in particular, and hindering any economic upswing. Many hopes were pinned on an expansion in exports as the route whereby South Africa could emerge from the recessionary conditions prevailing in the early 1990s, and enjoy positive growth once again.

The Bank believed that such a policy would have required painful adjustments in the domestic economy to enable South African manufacturers to remain competitive. Structural adjustments, including reductions in real wages, would have been necessary, which were not viewed by the Bank as politically or socially feasible.⁹³

Other commentators were advocating the exact opposite of such a policy to keep the nominal trade-weighted value of the rand relatively stable. In some quarters, including certain financial institutions, more substantial depreciation of the rand was perceived to be the key to the resumption of export-led economic growth; in other words, the nominal trade-weighted value of the rand should have been allowed to fall by more than the differential in inflation rates between South Africa and its major overseas competitors. This was indeed what happened during the first nine months of 1993.

In some quarters a three-pronged economic strategy was favoured, involving a more aggressive depreciation of the currency, the liberalisation of import tariffs, and the continuation of tight monetary policies. A more

popular proposed strategy was simply to allow the currency to depreciate more quickly as a means of stimulating economic growth.

Some advocates of currency depreciation argued that the rand was indeed overvalued at that time. According to a study conducted by the South African Chamber of Business in 1991, South African manufacturers on average incurred a 15 per cent cost disadvantage to those in the Organisation for Economic Co-operation and Development countries, while their cost disadvantage to manufacturers in newly industrialising countries was even greater. Meanwhile, a report issued by the South African Foreign Trade Organisation in August 1992 stressed that uncompetitive prices constituted a major obstacle to growth in South African exports.

There were, nevertheless, strong grounds for opposing the calls for ongoing depreciation of the rand in real terms, partly because at times this did occur. Assertions of over-valuation were open to dispute. There had been times when if the Bank had allowed the rand to float freely in the foreign exchange market, it would have tended to appreciate in value, and this did indeed happen at certain times. The Bank's foreign reserves rose by roughly R1 billion in July 1992 alone, partly reflecting its purchase of dollars in the market. Certain direct policy measures introduced by the government should have served to boost export competitiveness. The new value-added tax (VAT) system at that time encouraged exports by allowing the deduction of VAT paid on capital and intermediate inputs, even though no VAT was charged on the finished product that was exported. The newly introduced GEIS at that time involved phasing out tax allowances, but replacing them with cash payments to specific targeted export industries. In addition, the Industrial Development Corporation introduced a R500 million scheme in April 1991 to provide low interest rate finance for the establishment of new export industries. In short, an outward-looking strategy was already being pursued which was focused on facilitating export-led growth in the economy.

On top of this, in the post-sanctions environment new export markets were opening up to South African products, and old markets were being reclaimed. The volume of manufactured exports rose by 21 per cent in 1991, following an increase of 19,5 per cent in the previous year, while the volume of merchandise imports rose by 6,5 per cent and 3,5 per cent in those two years respectively. This successful performance could partly be ascribed to a competitive level of the exchange rate.

Opponents of such a significant currency depreciation, including the Bank, argued that in the interests of future economic development South Africa must remain open to foreign competition, and South African producers must be exposed to international pressures for improved productivity, greater efficiency and a higher quality of products. They argued that ongoing currency depreciation would simply allow inherent weaknesses in the local production structure to persist. Some analysts asserted that

the South African industry was not sufficiently geared to exporting. On this basis the problem was not the level of the exchange rate, but the degree of export awareness of industry in general. A survey conducted by the Department of Trade and Industry of 608 manufacturers in 1992 showed that 43,3 per cent manufactured only for the local market, while 42,3 per cent exported less than 10 per cent of their production.

It was also questionable whether a larger depreciation of the rand would have been conducive to attracting foreign capital inflows. A 10 per cent devaluation of the rand alone could have boosted the domestic inflation rate by approximately 3 percentage points. Apart from undermining the long-standing policy of curbing the rate of inflation, such a development would have increased the differential between local inflation rates, and those in South Africa's main trading-partner countries. If this remained unchecked, further future external weakness in the rand would have been on the cards, which could have discouraged inflows of foreign capital which arguably needed to be stepped up if the growth rate of the economy was to be enhanced. From the perspective of attracting new foreign capital into South Africa, a material reduction in the rate of inflation could have been vitally important.

It was particularly questionable whether the authorities would have been prepared at that juncture to risk undoing the success achieved in the previous three years or so in moderating the underlying inflationary pressures afflicting the economy. The decline in the rate of growth of the broad money supply, the recession in the domestic economy and the ending of the drought, with its attendant benefits for food prices, all pointed to a forthcoming further decline in the rate of inflation. This prospect could have been jeopardised by any sudden material fall in the external value of the rand.

Dr Stals argued that aggressive depreciation of the rand ignored the impact of the exchange rate on the cost of imports into the country, and the ultimate effect that increases in the prices of imported goods must have on the cost of production of South African manufacturers. He argued that a depreciation of a currency could only bring enduring advantages to the economy provided that the escalation of domestic cost rises caused by the depreciation could be successfully avoided. This normally required very restrictive domestic monetary and fiscal policies with high interest rates, and positive financial saving by government.⁹⁴

18.5 Difficulties experienced in attaining relative stability under floating rate conditions

Although market forces materially dictated the rand's movements on a daily basis, intervention by the Bank occurred from time to time mainly to smooth out fluctuations as previously mentioned. There was no attempt to

keep the rand reasonably stable in real terms against a basket of currencies comprising South Africa's main trading partners, although such a result was achieved over certain periods.

At one stage intervention operations, however, did amount to more than smoothing out operations. After April 1994 up until early in 1996 the Bank accumulated dollars by intervention in the foreign exchange market to prevent the rand from appreciating markedly. This policy had the benefit of enabling the Bank to boost its foreign reserves and facilitated the process of starting the trend towards relaxation of exchange controls. In contrast, intervention in the foreign exchange market to buy dollars, and sell rands clashed directly with the Bank's commitment to control the growth in the money supply, the addition to banking liquidity created by such operations not being easily neutralised by mutations in domestic monetary policies.⁹⁵

In contrast, when the foreign exchange reserves of the country came under noticeable pressure, the scope of the Bank to intervene, and sell US dollars to curtail the fall in the rand was limited. The floating aspect of the exchange rate arrangements for the rand did, if anything, become more prominent in the wake of the scrapping of the financial rand system in March 1995. Under the new dispensation volatile capital flows played a more important role in the unitary commercial rand market. The rand exchange rate was therefore determined to a greater extent by these capital flows, and not so much by the relative competitiveness of domestic producers. The Bank's influence over this market similarly was declining by 1995 as turnover in the foreign exchange market escalated. However, even before 1995 foreign exchange transactions arising from international capital flows, hedging, arbitrage and position-taking had increased significantly. The ratio of the value of net turnover in foreign exchange to the value of South Africa's exports and imports fluctuated between a level of 14 to 15 times the value of foreign trade between 1989 and 1992 before rising to 19 in the first half of 1993.⁹⁶

This more volatile outcome concerning the impact of capital flows on the rand, however, was by no means certain. The real effective exchange rate of the rand had shown remarkable stability (although not complete stability), on balance, for much of the period since 1970 due to natural market forces. This was in contrast to the experience of certain other currencies at times such as the dollar in the first half of the 1980s. This relative long-term stability of the real effective value of the rand had only been interrupted during the gold price boom years of 1979–80, and during the years of intensified political disturbances between 1984 and 1986, and again during 1996 and 1998.

This situation could not be attributed to the Bank's intervention in the foreign exchange market. Instead, it might have been explained in terms of a lack of major structural changes affecting the balance of payments over this period, and the actual dates chosen for recording the behaviour

of the rand, although one structural feature had been the progressive fall in gold output. The main explanation, however, might well have resided in the importance of differential price movements. South Africa's inflation rates had been consistently and materially higher than those of its principal trading-partner countries for many years. This could have caused relative price level movements to overwhelm all other factors such as changes in world commodity prices that could on their own have exerted an autonomous influence on the nominal and real exchange rate; in other words, the nominal exchange rate had been falling steadily over the years, reflecting the inflation rate differential in such a fashion as to keep the real effective exchange rate roughly constant.⁹⁷

18.6 Later modifications in South African exchange rate policies

As Governor of the South African Bank, Dr Stals used his valedictory annual address to shareholders on 26 August 1998 to announce marked mutations in policy towards the rand. These changes involved the Bank adopting a more hands-off approach towards management of the rand; a move that pointed to a possibly more volatile exchange rate for the rand in future.

The new policy was to be applied on two fronts. First, the Bank claimed that in a world of volatile capital movements and widely fluctuating exchange rates, an asymmetrical exchange rate policy that allowed for depreciation in the rand from time to time, but never permitted any meaningful appreciation of the currency, could no longer be defended, and represented a structural weakness in the economy. For good reason, in the past the Bank had been quick to absorb any oversupply of foreign exchange in times of balance-of-payments surpluses, but was reluctant to sell foreign exchange in times of deficits on the balance of payments. The exchange rate of the rand therefore seldom appreciated, and often depreciated quite sharply. For instance, as recently as the first quarter of 1998, the Bank had intervened aggressively in the market, partly to keep the rand from strengthening, with the result that the net foreign reserves rose by a substantial R12,2 billion in the 15 months to 31 March 1998. The average value of the rand hardly changed during that period.

The Bank believed that under conditions pervading the world by 1998, and particularly the presence of financial globalisation, this policy furnished an open invitation to currency speculators who were offered a one-way bet in the South African market. The Bank therefore believed that like all other prices, the exchange rate of the rand must at times be allowed to decline, and at other times to rise.

The second aspect of the change concerned exchange control policy where further relaxations were envisaged. The Bank believed that in this new world of integrated and liberalised financial markets it was desirable

that countries allow changing underlying market forces to function properly. In order to achieve this objective, it was believed that it was not only necessary for the central bank to hold more foreign exchange reserves, but also that the private sector, including the private banking sector, own more liquid foreign assets. The argument was that once accumulated, such assets could serve as a useful buffer between external market disturbances and the Bank. In other words, the process of exchange control liberalisation must eventually allow all South African residents to acquire not only long-term, but also short-term foreign assets. The Bank argued that only under those circumstances would it be sensible for it to reduce its role in the spot and forward foreign exchange markets.

The intention on the part of the authorities to allow the rand to float more freely fitted in with the aims of the new repo system used for accommodating the daily liquidity needs of the banks. Under the new repo system introduced in March 1998 a more flexible set of interest rates was designed to provide greater protection for the rand when it was under pressure, with a consequent reduced need to intervene in the foreign exchange market by the Bank. This complemented the aim of allowing the rand to be subject to less intervention by the Bank when it was rising in value.

18.6.1 Weaknesses of the new approach

The new intervention stance, made possible partly by previous exchange control relaxations, was seemingly motivated by the desire to curb speculation by operators in the foreign exchange market when the rand was weak. By introducing a new element of uncertainty it was no doubt hoped that the new policy stance would discourage some speculators, such as hedge funds, from taking short positions in the rand; hedge funds having allegedly operated extensively in the local market at certain times. Estimates of hedge fund resources ranged up to US\$400 billion, and many of these 4 000 to 5 000 unregulated offshore funds specialised in emerging markets. This US\$400 billion was more than the World Bank's estimate for the outstanding bond market debt of developing countries. The funds of these hedge funds were so big that they could impose major shocks on economies such as those of South Africa.

It might, however, be argued that a more hands-off approach to management of the rand exchange rate was unlikely to deter these funds, and the new intervention policy could have led to greater speculation in the foreign exchange market since the rand could have proven to be more volatile. Leads and lags operations, for instance, could easily have become more prominent. Speculators thrived on such volatility.

Another motive behind the change in policy concerned efforts to change market perceptions about the rand by indicating that in future the rand could rise in value against other currencies, even though the rand was

under adverse pressures at the time of the mutation in exchange rate policy in August 1998. At that time, the rand had fallen sharply against the background of a crisis in emerging markets, centred in particular on South East Asia and Russia, while commodity prices in general had weakened materially. The exchange rate of the rand, measured on a trade-weighted basis against a basket of the currencies of South Africa's major trading partners, depreciated by 21,1 per cent from 31 December 1997 up to 18 August 1998.

An appreciating currency would have created problems of its own if the strength was based on volatile capital flows rather than economic competitiveness. It could have created problems for export industries, and sow the seeds of a deterioration in the current account of the balance of payments, which would eventually cause the currency to weaken which, in turn, would have generated speculative pressures against the rand. Currency volatility could also have undermined business confidence. The avoidance of significant appreciations in the rand could at least have reduced uncertainty for the exporting sectors.

This new policy might also have hindered attempts by the authorities to build up the foreign reserves position. Additional drawings made by the Bank, and private banks on foreign credit facilities enabled the consolidated banking sector to increase its total gross foreign reserves by R13,3 billion in the second quarter of 1998 to reach a total of R58,3 billion at the end of June 1998. This was a level sufficient to cover the value of four months' imports. Nevertheless, the net foreign reserves position of the banking sector was much less favourable due to the heavy short-term foreign borrowings which had been undertaken.

It should also be noted that the new policy, by permitting wider swings in the rand exchange rate, might also have led to larger fluctuations in the size of the oversold forward exchange book of the Bank. An appreciating currency might have encouraged traders to avoid buying forward dollars, thereby reducing the size of the oversold forward book of the Bank, whereas as soon as the currency started to decline markedly, there could have been a rush to buy dollars on a forward basis, thereby increasing the size of the oversold forward book of the Bank.

The policies pursued since the launch of the new exchange rate regime did, however, show that they still resembled in important respects the policies pursued previously. In particular, the Bank still intervened in the foreign exchange market. In March 1999, for instance, the Bank announced that it would gradually reduce the outstanding amount on the forward exchange account, and increase its foreign reserves by discrete intervention in the foreign exchange market to buy dollars. Some of the specific fears expressed relating to this new policy proved to be unfounded. The new policy, for instance, did not prevent the foreign reserves from rising, the gross holdings of gold and foreign exchange of the Bank rising from R31,6 billion in December 1998 to R45,6 billion in December 1999.

Chapter 19

Forward exchange policies (1989–1999)

19.1 New policy of withdrawal from the forward market

In the late 1980s the overall balance-of-payments position remained vulnerable due to ongoing problems on the capital account of the balance of payments. In 1988 total capital outflows not related to reserves amounted to R6,2 billion compared with R2,8 billion in 1987, a substantial part of this outflow consisting of unfavourable leads and lags in foreign receipts and payments, including a shift of trade financing from foreign to domestic sources.

Part of this process involved a switch from foreign trade credits by South African parties to the use of US dollars tied up in the standstill net with the Public Investments Commissioners (PIC). Foreign banks, in effect, had been encouraging South African borrowers to utilise dollars held with the PIC, rather than take up new foreign trade credits, by offering them rates on such funds that were lower than those that applied to new trade finance. Outflows on the capital account stemming from the repayments of foreign trade credits, the use of PIC funds, and straight switching to domestic sources of trade finance were unfortunate features, since such trade credits were virtually the only source of foreign capital available to South Africa at that time.

In an effort to discourage such practices, the Bank announced in December 1988 that it would henceforth be prepared to provide forward cover at preferential rates, through banks, for credit lines to finance imports. Such cover was, however, only available against documentary evidence of the use of foreign credit lines, and provided that the maturity date of such cover matched the maturity date of the relevant underlying foreign finance. Similarly, exporters were to be encouraged to use pre-export finance through the forward market at preferential rates offered by the Bank.

This new policy caused the Bank to face increased commitments on a net basis to sell dollars forward on its forward exchange account. This arose because of the substantial use that was made of these facilities; in the fourth quarter of 1989 alone sales of such cover averaged about R1,7 billion per month.⁹⁸ Nevertheless, despite these new commitments, the Bank announced in December 1988 that it would henceforth rely on a policy of orderly withdrawal from the forward market in foreign exchange by means of running down its net commitments to sell dollars forward on its forward

exchange account. This policy was subsequently adhered to throughout the years from August 1989 to August 1999 when Dr Stals was Governor of the Bank. This policy had first been initiated in September 1983, but was discontinued in August 1985 due to circumstances surrounding the proclamation of the foreign debt standstill at that time.

19.1.1 Burden of forward exchange losses

The Bank's desire to withdraw as far as possible from the forward exchange arena stemmed in part from the losses that it had incurred on the forward exchange account over the years since the mid-1970s. These losses had been a worrying state of affairs, both for the central bank and the government; the anxiety of the latter arising from the fact that losses on foreign exchange transactions incurred by the Bank were for the account of the Treasury. At the end of March 1987 these aggregate losses were reported to be in excess of R3 billion.

At the same time, these losses had over time led to an involuntary increase in the creation of central bank credit, which had served to increase the money supply. The Bank regularly sold US dollars to banks on a forward basis at higher exchange rates than those at which it bought US dollars in the spot markets to meet its forward commitments. This led to the creation of high-powered money by the Bank, and this was classified in the money-supply statistics as part of the "net other assets".

The Bank had furnished forward cover for rand-dollar transactions for banks, since the rand had been linked to the US dollar in October 1972, and forward cover facilities in general ever since exchange control regulations made it impossible for the private banking sector to develop, and maintain a fully functioning forward foreign exchange market. This policy was continued during the Stals era, and could only be reduced as the exchange control restrictions on private banking institutions were gradually lifted. In addition, public corporations and municipalities were able to obtain forward cover from the Bank for interest payments on foreign loans, and for the repayment of foreign loans.

The losses on the forward exchange account originated from the unbalanced nature of the Bank's forward exchange book, and in particular its perennial commitments to selling US dollars forward, which exceeded its commitments to buying dollars forward. This short position in dollars meant that when the rand fell markedly against the dollar, the Bank was especially liable to incur losses in meeting its net commitments to selling dollars forward.⁹⁹ There was no obvious way in which the Bank could cover its exposed position. Limited holdings of foreign currencies, and the desire to avoid additional downward pressures on the rand had discouraged the Bank from closing out its exposed positions by buying spot dollars.

There were occasions, however, when the Bank recorded profits on its forward exchange account. For example, weakness of the dollar against the rand enabled the Bank to show surpluses on its forward book for the period from 1 April 1990 up to 31 January 1991. Such occurrences, however, were the exception.¹⁰⁰

19.1.2 Obstacles to the development of the forward market

The Bank's policy during the Stals era of seeking to withdraw gradually from the forward rand-dollar market would not have been possible without certain minimum reforms that were gradually affected over time, and that will be explained later in this chapter. Even with these reforms, however, numerous problems still complicated the attainment of a fully-fledged, and efficient forward market in South Africa. Indeed, the problems in this regard were more daunting at the end of the 1980s than they were in the first half of that decade when the Bank attempted to withdraw from the market. These problems related to the size of swap lines, the barriers presented by exchange controls, and the impact of the foreign debt standstill.

As regards the problem of swap lines, it had been a long-standing practice for the Bank to provide forward cover by way of swap transactions conducted with authorised dealers in foreign exchange. These swaps enabled these dealers to cover their overbought or oversold positions in respect of recognised commitments or claims in the foreign currencies of their clients. Under the foreign exchange control regulations then in force, the banks were not allowed to hold spot foreign exchange balances as cover against forward foreign exchange commitments. The so-called swap lines of the banks with the Bank had increased during the 1980s, partly due to debtors covering their foreign currency liabilities under the partial debt standstill arrangements, and partly due to the rise in the value of South Africa's imports, which led to increased forward cover requirements on the part of importers.

The Bank's previous plan of withdrawing from the forward market in the early 1980s had incorporated a three-year period during which the banks' swap lines were to be withdrawn progressively. In view of the larger size of these lines that existed at the beginning of the 1990s, it was clear that any phasing-out process could take longer.

As regards exchange controls, the absence of such controls would have been beneficial for the smooth functioning of the forward foreign exchange market. Apart from the restriction on banks' foreign currency, without exchange controls counterparties for forward deals could have been found more easily, and the market would have been more liquid.

The controls that specified that forward deals must be backed by fixed and ascertainable foreign commitments or accruals were, for instance,

inhibiting features. The liquidity of the market would have been improved if a resident or non-resident had been allowed to take out rand-dollar cover on any expected accrual or commitment. In the early 1990s, for instance, forward cover could only be taken out once a dividend had been declared by a company. If it had been permissible to take out forward cover before the dividend had been announced, greater use of the forward market should have ensued, since participants would have been better able to avail themselves of expected trends in the exchange rate.

Such concessions, however, would have encouraged speculation in the forward market, and would have brought into question the relevance of all the remaining exchange restrictions on forward rand-dollar dealings. Such concessions, moreover, might not have reduced the imbalances that could characterise the forward market in the face of one-way expectations in respect of the rand.

The third problem in withdrawing from the forward market on the part of the Bank related to the impact of the foreign debt standstill. A smoothly functioning forward rand-dollar market implied that South African banks faced no serious impediments in operating in overseas markets for purposes of conducting deposit transactions, as an alternative to swap transactions with the Bank, to cater for the forward cover requirements of their clients. Under the circumstances prevailing at the beginning of the 1990s this assumption was unrealistic. The imposition of capital sanctions by the international banking community at that time meant that South African banks were largely barred from raising foreign short-term credits.

In the context of developing a private forward rand-dollar market that was operated by the banks following the withdrawal of the Bank, these circumstances would have created serious problems when the market was "one way" in the sense that participants anticipated that the rand would appreciate.

Exporters would then have wanted to take out forward cover, while importers would have desisted from covering. The excess supply of forward US dollars would have needed to be catered for by banks undertaking deposit transactions under which they borrowed dollars from foreign banks, sold for rands and then invested the funds in the local market for the period of cover granted to their clients. On maturity the dollars received from clients would have been used to repay the foreign loans. At the beginning of the 1990s this borrowing option was not available to any significant extent.

Against this background it was likely that the forward rand-dollar rates would have become distorted when the market was one-sided, amid expectations that the rand would strengthen. The premiums on the US dollar could have narrowed, which would have harmed exporters who used the forward market, while imports could have been boosted by such a narrowing of the premiums. Non-residents could also have been

encouraged to place deposits in South Africa on a covered basis to take advantage of low premiums.

In principle, such distorted forward rates could have been eliminated by interest arbitrage operations by foreign investors. Suppose that the premium on the US dollar against the rand narrowed to say 2 per cent, while one-year interest rates in the US were 10 per cent, and the equivalent rates in South Africa were 16 per cent. Under these circumstances there would have been a strong incentive for such investors to borrow dollars, sell for rands and invest for one year, while taking out one-year forward cover to convert their rands back into dollars. These arbitrage operations should have continued until the forward premium on the dollar rose back to the level where it was in line with the interest rate differentials.

In practice this was most unlikely to occur. Such arbitrage operations by foreign investors were limited partly by the lack of interest in the rather small South African money and foreign exchange markets, and partly by inhibitions stemming from local foreign exchange control regulations.

Distortions that emanate from restrictions on the availability of foreign credits would have been supplemented by the influence of relatively small money and capital markets in South Africa. Banks would have found it difficult to undertake deposit transactions to cover the forward cover needs of large importers due to the difficulties in borrowing substantial amounts of rands, which it would then have converted into dollars.

The consequent emergence of forward rand-dollar rates that diverge from interest rate differentials could have led to large, and unpredictable fluctuations in the forward rates. This, in turn, could have rendered it particularly risky for banks to participate actively in the forward market, and could therefore have discouraged them from operating with a high profile in this area. Such an outcome would have been unfortunate since there was already only a handful of banks that actively participated in the forward rand-dollar market.

19.2 Withdrawal of preferential forward cover rates

A reduction in the imbalance on the forward exchange account of the Bank was aided by the Bank's decision in September 1991 to discontinue its policy of providing forward cover at preferential rates through the banks on new foreign trade credit lines used to finance imports, as well as credits in the form of pre-export finance. The granting of such preferential forward cover rates had been instituted in December 1988, as previously indicated, and illustrated the preference of the authorities at the time to increase their exposure on forward exchange account by encouraging importers to use foreign trade finance rather than raise domestic funds which would have threatened to bring about a slower growth in the economy. The authorities

had indicated that this was a temporary measure designed to boost the short-term capital account of the balance of payments, which was suffering at the time from the switching of trade credits from foreign to domestic sources. At that time foreign trade finance was the only significant source of new foreign capital.

In contrast, by the end of 1991 the position on the capital account had improved materially. During the 12 months ended 30 June 1991 the total outflow of capital not related to reserves amounted to only R1,6 billion compared with R2,9 billion in the whole of 1990. Moreover, the total net outflow of capital not related to reserves declined from R2,1 billion in the second quarter of 1991 to only R0,1 billion in the third quarter. This improvement in the position on the capital account was also to a material extent attributable to a strengthening on the short-term capital account associated with the increased availability of trade finance to South African enterprises from abroad.

These developments facilitated the Bank's withdrawal of the preferential forward cover rates in September 1991, but the move was also motivated by other considerations. The preferential arrangements had become a "bureaucratic headache" as importers applying for the preferential rates had to provide documentary evidence that new trade credits were being used. This did not pose problems in respect of trade finance provided by banks, but in the case of suppliers' credits and straight inter-company finance, difficulties were created because banks had to notify the exchange control authorities of the particulars of each such deal.

In addition, the system was potentially liable to abuse. The existence of two different forward cover rates for the same maturities, one of which was quoted by the Bank, meant that parties searched for avenues to undertake profitable arbitrage between the two markets. In this respect there was an analogy with the history of the two-tier exchange rate system, and the abuses it spawned after its reintroduction in August 1985.

19.3 New forward exchange arrangements (1995)

The environment in which the Bank operated in the forward market began to change as the 1990s unfolded. This shift occurred against the background of the far-reaching political mutations that took place in South Africa between 1990 and 1991, the potential further impact of these changes on South Africa's international financial relationships, and the stated aim of the authorities gradually to abolish the exchange controls applicable to residents. It was therefore clear that the Bank's involvement in the forward foreign exchange market warranted some reassessment by 1995. This was especially the case, since the Bank, on balance, had continued to record losses on its forward exchange account, which were for the account of the Treasury. Moreover, a unitary exchange rate system for the rand was

introduced in March 1995, and the Bank had indicated that this would lead to a reconsideration of its position in the forward exchange market.¹⁰¹

In the early 1990s any proposals to change the forward market arrangements would have been complicated by the low level of the net foreign reserves, which would have encouraged adverse leads-and-lags influences, and the expectation that the rand would weaken significantly following any abolition of the financial rand mechanism. These circumstances, however, changed during 1994 and 1995. The Bank's gross foreign reserves improved from R7 084 million in June 1994 to R12 400 million in May 1995, while the commercial rand actually appreciated in value in the immediate aftermath of the elimination of the financial rand system in the middle of March 1995. Sentiment towards the rand, therefore, improved somewhat at that stage, and this facilitated some restructuring of the forward exchange market.

Any changes in the Bank's role in the forward market at that stage, with a view to extricating the Bank largely if not entirely from the market, and therefore markedly decreasing the size of the oversold forward dollar book, could potentially have reduced the level of the Bank's gold and foreign exchange reserves, depressed the value of the rand in the foreign exchange market, and pushed up domestic interest rates. This was something that the Bank had indicated it would not readily accept. The signs at that stage were that the Bank was seeking gradually to withdraw from the forward market so that the negative implications for domestic financial stability were minimal.

Any attempt at a "big bang" approach, involving a sudden total withdrawal by the Bank from the forward market, could have led to a sharp decline in the foreign reserves of the Bank as well as the commercial rand exchange rate, as already indicated. This was because any rise in the cost of forward cover for importers stemming from such a withdrawal by the Bank would have discouraged inflows of foreign capital, while any such move would also have meant that the Bank would have been buying dollars in the spot market to meet its commitments on maturing forward exchange contracts.

Under the new strategy that was put into action in April 1995, the Bank aimed at maintaining a significant presence in the forward market by means of the introduction of a new two-tiered forward exchange market. However, the new market structure did not amount to a crisis move as happened in 1988 when importers using the forward market were offered a material subsidy at the expense of the Treasury, which had to meet the losses stemming from this subsidy under the preferential forward rates scheme. Instead, the new market structure introduced in 1995 represented an important interim step designed to diminish the involvement of the Bank in the forward market, and therefore reduce the Bank's oversold forward dollar book.

19.3.1 Nature of the new arrangements

Under the new arrangements adopted in April 1995, it was accepted that forward cover for transactions such as the financing of imports of capital goods, foreign capital issues by South African companies, funds swapped from inside to outside the foreign debt standstill arrangements, as well as foreign loan funds affected by the foreign debt arrangements, would still be provided by the Bank. Moreover, where losses were incurred, they would remain for the account of the Treasury. In essence, under these new arrangements the Bank provided forward cover at the market's initiative in cases where documentary evidence was available of off-shore finance being used, and this constituted one leg of the new two-tier forward market. The Bank regularly quoted forward rates for such transactions in this primary market.

This cover was initially provided at forward rand-dollar rates which incorporated a premium over the spot exchange rate, reflecting the interest rate differential between the dollar and the rand, while taking no account of the additional margins paid by South African parties that raised foreign finance;¹⁰² in other words, the forward rates continued to incorporate a subsidy to importers who could get forward cover from the Bank at cheaper rates than they would if the forward rates reflected the additional margins over Libor which South African borrowers of Eurodollars had to pay.

The Bank defended this arrangement at the time on the grounds that if the forward rates reflected this additional margin, and hence importers paid more for forward cover from the Bank, such importers would be less inclined to borrow foreign funds to finance imports and, instead, would make greater use of domestic credit. In this way the capital account of the balance of payments and the foreign reserves position would have deteriorated, other things remaining equal. One important defect with these arrangements, however, was that while they subsidised importers, they penalised exporters. If the forward premiums had been higher, exporters would have obtained a better rate on forward sales of dollars, and in this way exports would have been boosted. Within a few months these arrangements were therefore altered. The large net inflows of foreign capital that materialised in the course of 1995, together with the stability of the rand, enabled the Bank to reduce progressively the subsidy it offered to importers who took out forward cover. Apart from benefiting exporters, the elimination of the subsidy, by pushing up the cost of forward cover for importers, reduced the Bank's exposure to losses on forward exchange account.

The second leg of the new two-tier arrangements comprised a secondary forward market operated by the private banks in which the Bank, at least for

the time being, intervened on its own initiative. In this market importers and exporters who did not utilise foreign finance to support their activities were able to take out forward cover at market rates. In addition, forward cover in respect of foreign interest and dividend payments became available at this stage through this second leg of the forward market. From that date foreign investors who held local properties, shares, gilts, money-market instruments and rand deposits were also able to obtain forward cover via this secondary market.

The new forward exchange facilities available to foreign investors holding South African securities, and other investments no doubt reflected the desire to make foreign investment more attractive. In addition, they probably reflected an appreciation that under the previous arrangements such cover was at times offered by banks unwittingly since they could not always know for sure why foreigners were asking for forward cover.

19.3.2 Repercussions of the new arrangements

These changes, as already indicated, took effect in April 1995. At the time it was expected that in due course the Bank would disengage largely, if not completely, from this secondary market, leaving it with the obligation of furnishing cover in the primary market only where foreign finance was involved on the initiative of market participants; in other words, the Bank eventually would only provide cover in this market where foreign currency-denominated loans were raised in conjunction with the forward exchange transactions, and even in this market the role of the Bank would be at least materially reduced.

Given the nature of the new arrangements, it was not surprising that premiums in the secondary forward market became mostly higher than the premiums at which the Bank provided forward cover against documentary evidence of off-shore finance in the primary market, the difference amounting at times to about 0,5 per cent. This situation materialised for two reasons. First, the facility previously offered by the Bank in furnishing forward cover for all transactions was no longer available. Second, there was a greater demand for forward cover by importers and foreign investors covering dividend and interest payments over exporters in this secondary market. These higher forward premiums in the secondary forward market meant that exporters who sold dollars in this market obtained a better rate than that available in the primary market, while importers in this market paid more although the additional cost at times was small. This was one of the advantages of the new system.

In contrast, the new arrangements, by creating differences in forward rates in the two markets, opened up opportunities at times for arbitrage by banks through the purchase of forward dollars in the primary market, thereby increasing the forward book of the Bank, and the sale of these dollars in the secondary market at a profit. Similar arbitrage operations under the previous

preferential forward cover system, which was operated between 1988 and 1991, partly accounted for the decision of the authorities to abandon that system. The huge volumes of daily turnovers in the local foreign exchange market, amounting to more than R30 billion, rendered it virtually impossible for the authorities to detect such arbitrage. This was an ongoing problem with the new system. In addition, these new arrangements contributed at times to a more volatile situation as regards the daily money-market shortages, which had to be accommodated by the Bank. Some forward exchange deals were not renewed with the Bank as they matured and, consequently, they had to be transacted in the secondary forward market. This meant that when they matured, the banks bought dollars from the Bank and sold rands to the Bank, thereby draining liquidity from the banking system, and reducing the foreign reserves. Conversely, any consequent rise in short-term interest rates should have encouraged capital inflows, which would have countered at least to some extent the money-market shortage, and the fall in foreign reserves.

It was to be expected that under the new arrangements the authorised dealing banks would make greater use of their foreign cash holding limits, which totalled around US\$850 million at the time of the changes in 1995, in order to provide cover through deposit transactions, especially if the Bank started to disengage from the secondary forward market; in other words, banks would increasingly provide cover for importers in particular by borrowing rands, selling for dollars, and then investing the dollars abroad, and then transferring the dollars to the importers on the maturity dates specified in the forward deals.

In effect, the greater use of foreign cash holding limits by banks in time meant that the limits imposed by exchange control should ideally be reviewed. The result was that the limits faced by banks on foreign currency holdings which they could hold offshore were raised significantly during the second half of 1996 to around US\$1 400 million. This move was primarily designed to provide the banks with more leeway to hold foreign currency to meet forward exchange commitments to their clients. This move therefore constituted a further important step towards developing a fully-fledged private forward market in which the Bank played little or no role. A much bigger step in this direction was taken in January 1998 when the limits were scrapped altogether.

In so far as the Bank disengaged largely, if not entirely, from the secondary forward market, the oversold forward dollar book of the Bank should have declined materially, the forward premiums on the dollar against the rand in this market could have risen, and the spot rand rate could have weakened. Once the forward market in general was functioning with reduced Bank intervention in it, it would have been possible to review the exchange control rules and regulations pertaining to the forward market with a view to relaxing, if not abolishing, the controls on access to the forward market.

As a first step towards relaxing the exchange controls applicable to forward foreign exchange operations, in October 1995 the authorities revoked the regulation that forced exporters who sold on credit to take out forward cover within seven days of shipping the goods. This measure had been introduced in 1986. By forcing exporters to sell their US dollars in the forward rand-dollar market, the excess of commitments on the part of the Bank to selling dollars forward over commitments to buying dollars forward was reduced. However, by late 1995 the rand was stable, its exposure on forward exchange account was falling, and there must have been expectations that this exposure would fall further in so far as the Bank reduced its presence in the secondary forward market. These circumstances therefore created a favourable background to the removal of a restriction that exporters rightly regarded as irksome and discriminatory, since importers were not likewise forced to cover their commitments in the forward market.

19.4 Reduction in oversold forward book

When the new forward exchange system was introduced in 1995, the Bank no doubt anticipated that, as it progressively disengaged from the secondary forward market, the oversold forward book of the Bank would decline; in other words, the net commitment to selling forward US dollars would drop. In practice this decline did occur for a time after the new arrangements had come into force, even though the Bank was still a participant in the secondary forward market.

This materialised partly as a result of the Bank being able at times to buy forward US dollars in the secondary forward market by means of a swap, and then sell them at a profit in the primary forward market. At times the premiums on forward US dollars in the secondary forward market were lower than those in the primary forward market. This situation arose for a time in 1995 out of market perceptions that the rand would remain stable, which induced importers, along with other operators to stop taking out forward cover while exporters sold dollars forward for rands.

In 1995 and the first few weeks of 1996, the Bank reduced its participation in the forward exchange market fairly rapidly. The Bank's net commitments to selling US dollars forward, which at one stage amounted to well over US\$20 billion, declined to only around US\$8 billion at the end of February 1996. However, in line with the decline in the rand, which started around the middle of February 1996, the forward book increased again by approximately US\$4 billion up to the end of April 1996, and further increases were recorded in subsequent months.¹⁰³

This increase in the size of the Bank's oversold forward book reflected intervention in the forward market by the Bank to support the rand. Against the background of the Bank's limited foreign reserves of around R10 billion,

the Bank intervened by undertaking swaps with the foreign exchange dealing banks involving the purchase of spot dollars, and the sale of forward dollars. The spot dollars so acquired were then used to support the rand in the spot market. The Bank's increased exposure on forward exchange account thereby increased the financial risk faced by the government arising out of possibly higher losses on forward exchange account. However, this danger had to be weighed against the consequences of smaller intervention in the forward market, which would have meant that the rand would have weakened even more accompanied by lower foreign reserves, and probably even higher interest rates.

Some curbing of the growth in the oversold forward book of the Bank was, however, made possible in November 1996 when the Bank terminated its involvement in the foreign currency forward market for transactions with a maturity of longer than 12 months. This step formed part of the Bank's strategy to distance itself progressively long term from the forward market, while encouraging the development of a private market for forward transactions in which the Bank might intervene on its own initiative from time to time.¹⁰⁴

19.5 Merging of primary and secondary markets

It was indicated that when the new two-tier forward exchange market was introduced in 1995, the Bank's plans incorporated an eventual withdrawal from the secondary forward market, and at least a reduced role in the primary forward market. In this way the Bank's exposure on forward exchange account would have been materially reduced over time, as previously indicated.

However, running two separate markets in forward exchange was not free of problems. On occasion illegal arbitrage transactions between these two markets did take place because of wide differences in the forward rates in the two markets as previously mentioned. At other times the differences between the two market rates could be small. The alternative therefore open to the Bank was to merge the two markets by pulling out of the primary market, and arranging for all transactions to be conducted in the existing secondary forward market where the Bank could intervene on its own initiative. Under such circumstances the forward exchange rates quoted by the Bank would be in line with market rates.

By only intervening at its own initiative in one forward market, the Bank might well have been able to reduce its role in the forward market more speedily than it could under the prevailing arrangements. At that stage the Bank intervened in two markets where participants in the primary forward market could approach the central bank for forward cover, which enhanced the commitments the Bank faced in this regard. By only intervening in one market where it did not quote prices but, instead, intervened on its

own initiative, the Bank would have enjoyed greater flexibility. This might well have been possible without materially affecting the price of forward cover for importers and exporters. A decision to turn to a more simplified single forward exchange market system was therefore implemented during 1997, and a private forward market developed among authorised dealers, and their clients in which the Bank participated from time to time on its own initiative.

19.6 Distinction between the Bank's short- and long-term forward book

As far as management of the forward exchange book of the Bank was concerned, a clear distinction had to be made between the short-term commercial forward book, and the long-term forward book. For many years intervention in support of the rand had usually impacted on the net foreign reserves position of the Bank, and on the size of the oversold short-term commercial forward book, which referred to forward exchange transactions undertaken by the Bank with authorised dealers with a maturity of one year or less. However, the major portion of losses incurred on forward exchange account, which had to be met by the Treasury, emanated from the long-term forward book.

'Long-term forward cover' referred mainly to cover provided to the public corporations on foreign loans raised by these organisations. In an effort to encourage long-term foreign borrowings by the parastatals and bolster the foreign reserves, forward cover had long been offered by the Bank to these state entities at subsidised rates. The changes in forward exchange arrangements introduced in 1995 largely involved scaling down the Bank's role in the provision of short-term forward cover for a variety of transactions. The changes therefore largely impacted on the short-term forward book, but not the long-term book where the bulk of forward exchange losses were concentrated.

The Treasury had long been pondering over the issue of the provision of long-term forward cover to parastatals, and there had been much speculation concerning possible government moves to stop offering forward cover for long-term borrowings raised by parastatals. Such facilities had originally been withdrawn in 1987, but were reinstated in 1988, partly in order to strengthen the foreign reserves position, but at less attractive rates to the borrowers than had previously been the case.

The government's indecisiveness on this issue had been based on fears that if long-term forward cover was abolished, parastatals such as Eskom would be much less likely to tap into long-term foreign funds, since they would not be prepared to face the currency risk on uncovered loans, and the capital account of the balance of payments would accordingly weaken. At the same time any greater reliance by parastatals on the domestic

capital market would push up domestic interest rates including those on new issues of government stocks.

These were understandable concerns. Even so, numerous observers believed that the government's moves to disengage from the provision of long-term forward cover for parastatals were long overdue. Although there might have been occasions when balance-of-payments pressures justified such a dispensation, they argued that as a general policy this facility should not have been available. Billions of rands in extra government debt resulted from the losses incurred on forward cover to parastatals, thereby exacerbating the government's debt problems. Moving out of this market would therefore have strengthened the government's debt position. Moreover, an improved debt position could have aided inflows of foreign capital in the sense that such a position could well have encouraged more foreign investors to buy South African gilt and semi-gilt securities. Consequently, during the year ended 31 March 1998 the Bank, on instructions from the Minister of Finance, stopped providing long-term forward exchange cover to parastatals.

19.7 Advantages of using the forward book as an instrument of exchange rate policy

The Bank had been involved in the rand-dollar forward exchange market for many years, and this oversold position had been accumulated over a long period, but especially since the early 1980s when the Bank started to support the rand in the spot market by first selling spot dollars, and then intervening in the forward exchange market involving the buying of spot dollars, and the forward sale of dollars. Such intervention therefore involved the Bank in buying spot dollars, and selling dollars forward in a swap deal, the spot dollars then being sold in the spot market by the Bank to support the rand. This only increased future commitments to sell dollars forward, and such intervention policies caused the imbalance on forward exchange account to move up further.

There were only a limited number of countries in the world with large exposures on forward exchange account, and South Africa was one of them. The use of the forward exchange market as a means of supporting a currency rather than borrowing foreign funds for this purpose could be the preferred option since it was less transparent, and did not reduce the net foreign reserves of a country. In South Africa's case, moreover, the use of the forward market as a means of supporting the spot rand rate was favoured in the 1980s and the early 1990s, mainly because financial sanctions at that time precluded the resort to foreign loans.

The most obvious advantages of using the forward book as an instrument of exchange rate policy on the part of the Bank were that, during periods when the rand was under downward pressure, the exchange rate was

less volatile than would otherwise have been the case along with domestic interest rates and the rate of inflation. There were occasions when South Africa was faced with huge uncertainty, and strong downward pressures on the rand aggravated by speculators shorting the currency, and the Bank's intervention in the forward foreign exchange market helped to moderate these downward pressures on the exchange rate. In the absence of such intervention, the rand would have weakened further against the dollar in the spot market as well as the forward market, the fall in the latter market raising the cost of foreign trade finance which, in turn, would have induced even more switching of trade finance from foreign sources to domestic sources, thereby further pushing up domestic interest rates. Moreover, without such intervention the greater fall in the rand would have contributed towards a temporary increase in the rate of inflation as a result in particular of rising import prices.

The use of Bank intervention in the forward market in this way did not in any way reduce the importance of conducting sound monetary and fiscal policies to protect the value of the rand. The authorities argued that the forward book was not used as a substitute for sound monetary and fiscal policies. It was, nevertheless, argued that the forward book facility had all along been a useful instrument to absorb speculative pressures on the rand. It had been argued by the authorities that it was less costly (than would otherwise have been the case) to allow some of the adverse pressures on the exchange rate to be absorbed in the forward book rather than allow the rand to drop more sharply in value against other currencies.

The effective exchange rate of the rand, both nominal and real, fluctuated markedly during the 1990s. In the absence of the shock-absorbing role of the forward book, the exchange rate movements, which did take place, would have been more pronounced. The authorities argued that this would have detrimentally affected the South African economy and investor confidence, especially since domestic interest rates would have been even more volatile.

The Bank regarded its forward book operations as a set of government-backed insurance facilities for protection against exchange rate risks. This forward exchange policy did bring about a transfer of the exchange rate risk from certain sections of the private sector (importers, exporters and borrowers of foreign funds) to taxpayers in general through the budget. The Bank argued that the key question was whether this transfer of risk brought with it on a net basis a macroeconomic social advantage to the overall community, or whether the final net cost exceeded the social advantages of the insurance scheme.¹⁰⁵

The cost of achieving financial stabilisation in South Africa at times of rand weakness had been concentrated, to some extent, on the Bank's forward book. In the case of other countries that had been afflicted at

times by exchange rate disruptions, the cost of the financial stabilisation had remained partly vested in the private sector, since no similar forward exchange policies had been pursued. However, under such circumstances costs had also had to be faced by national governments, to some extent, since some private-sector institutions had collapsed under the burden of huge exchange rate losses.¹⁰⁶

The Bank also argued that there was justification for the continued use of the forward book operations, because South Africa still had certain exchange controls in force. The phasing out of exchange controls would have aided the development of a fully-fledged private forward exchange market in South Africa in which the Bank did not have to participate. The exchange controls at that time hindered the development of such a market by, for instance, curtailing the role of foreign banks in the provision of rand-dollar forward cover. Given the presence of a fully-fledged competitive forward exchange market, foreign banks would have been able to borrow rands in South Africa, which at that stage could not be undertaken because of exchange control regulations, which could have been sold for dollars, and invested for specific periods to meet the requirements of clients who wanted to buy dollars forward.

The desirability of intervening in the forward market to support the rand was brought into sharp focus in May and June 1998 when the rand came under adverse pressure, and the Bank's net commitments to selling US dollars forward increased by around US\$3,6 billion to roughly US\$20,9 billion. At that time the Bank justified its intervention by arguing that it would have been criticised if previous dollar-buying operations when the rand was strong were not followed by dollar selling when the rand weakened, although such criticism did not appear to surface during 1996 when the rand was previously under pressure, and the authorities did not intervene aggressively to support the currency.

In 1998 the Bank also argued that the turmoil in the foreign exchange market caused by the East Asian financial crisis would be reversed sooner or later. This was correct in 1999 when the Bank again started to reduce its net oversold forward foreign exchange position.

Chapter 20

The South African Reserve Bank's management of the gold and foreign exchange reserves in the 1990s

20.1 Overview

In respect of the management of foreign reserves during the 1990s, the Bank managed these reserves as a principal player, since it owned them and they were reflected as an asset on its balance sheet. The Bank was fairly autonomous where the management of South Africa's gold and foreign exchange reserves was concerned.¹⁰⁷

There were, however, certain peculiarities: for instance, the interest income derived from the reserves, and the interest expenditure stemming from the Bank's foreign liabilities were accounted for in the Bank's income statements. Changes in the valuation of the foreign reserves were for the account of the government. In this chapter the duties and practices of the Bank in the management of South Africa's foreign reserves in the 1990s are explained.

20.2 Introduction

The function of managing the foreign reserves of a country usually resides with the central bank, since the bulk of the reserves would normally be in the hands of such a bank. In the case of South Africa, its gold and foreign exchange reserves were mainly held by the Bank. In August 1997 the Bank held roughly R25 billion in foreign reserves, while the rest of the banking system held about R8 billion entirely in foreign currency form.

For years the foreign exchange holdings of private banking institutions in South Africa were restricted largely to working balances held abroad for normal operational purposes. A limit was placed on the amount of foreign assets each bank may hold. This, in effect, meant that the open foreign currency positions of banks had not been allowed to exceed certain percentages of their capital and reserve funds, but within limits banks could keep cash abroad in their nostro accounts. This had basically been an exchange control limit designed to protect the Bank's own foreign exchange reserves. In January 1997, however, these limits were liberalised and the total foreign exchange working balance limit for banks was increased in aggregate from US\$700 million to US\$1 480 million. This change was aimed at promoting the role of the banks in furnishing forward exchange facilities for their clients, and this consideration prompted the authorities in September 1997 to announce that the limits on foreign currency positions

of banks would be scrapped entirely as part of the ongoing programme of phasing out exchange controls, even though restrictions would apply to the type of foreign assets they could hold.

The central government also kept small foreign exchange working balances abroad and there were grounds for believing that the government might have preferred to have held larger foreign balances. The government brought the proceeds of foreign loans into South Africa, changing the foreign currency into rands. Substantial amounts were later changed back into foreign currency to pay foreign suppliers for goods and services delivered to government departments. The government might have felt that it was inappropriate to bring the proceeds of foreign loans into the country only to take them out later, and in the process incur a loss because the rand had weakened.

Under a completely free-floating exchange rate system there would, in theory, be no need for a country to keep foreign reserves, because the exchange rate mechanism would ensure that the foreign exchange market was cleared on a daily basis. In effect, there would be no buying or selling of foreign currency by the central banks in the foreign exchange markets. Clearly, the need for foreign reserve management would at least be very limited under such a system. In practice, however, there is virtually no country that allows the exchange rate mechanism to clear the foreign exchange market. The central banks therefore need foreign reserves to help smooth out fluctuations in the foreign exchange market and the holding of such reserves requires that they be managed.

20.3 Importance of managing foreign reserves

The management of foreign reserves is important for a number of reasons. Efficient management of such reserves minimises risks, and boosts returns. The Bank could generate significant income streams from the proper management of its foreign reserves.

In addition, the management of the foreign reserves could complement overall monetary policy objectives. For instance, the central bank may want to boost its foreign exchange reserves in order to intervene in the foreign exchange market to support its currency, but at the same time it does not want to raise interest rates, or preside over an expansion of the money supply brought about, for example, by inflows of foreign capital. Under these circumstances it could enter into gold swaps to derive the necessary foreign exchange, while at the same time retaining control over the domestic monetary situation, since gold swaps do not boost domestic liquidity.

In other circumstances the Bank might have intervened to support its currency in the foreign exchange market, and in the process drained

liquidity from the domestic banking system, and lost foreign reserves. In an effort to relieve these pressures, the central bank may then undertake foreign exchange swaps with domestic banks in terms of which it swaps domestic currency for dollars, thereby boosting its depleted foreign reserves, while injecting some liquidity into the domestic banking system. In this way monetary policy objectives have been accomplished by means of specific management of the foreign reserves, namely by undertaking currency swaps.

Events during the first eight months of 1996 vividly illustrated how the management of the foreign reserves could support general monetary policy objectives. In the face of the sharp decline in the external value of the rand, the Bank intervened to sell dollars by drawing down its foreign reserves, and raised foreign credits and intervened in the forward market in order to moderate the fall in the currency. In this way it made the inescapable adjustment of the economy to the deficit on the balance of payments more palatable by moderating the upward pressures on the inflation front. The foreign reserves were drawn down in anticipation that the deficit on the current account of the balance of payments would shrink, and the rand would eventually stabilise; in other words, drawing down the reserves was a substitute for raising Bank rate.

From the perspective of general monetary policies the management of the foreign reserves took on special significance during the second quarter of 1997 when the proceeds of roughly R5,6 billion from the partial privatisation of the telecommunications company Telkom entered the banking system. This sale of Telkom boosted the foreign reserves by R5,6 billion and simultaneously boosted the money supply by a similar amount. In view of the authorities' desire to curb the expansion in the money supply, there was an obvious need to drain liquidity from the banking system.

In this respect several possibilities presented themselves. One option was for the Bank to enter into foreign currency swaps with the banks, whereby the latter bought US dollars from the Bank, and sold rands to the Bank for a specified period after which the transaction would be reversed. Another possibility was for the Bank to scale down the number of maturing forward exchange contracts that it renewed by entering into new contracts. By scaling down such contracts, the Bank lost US dollars, but simultaneously drained rands out of the banking system. These options were used to cope with the boost to domestic liquidity at that time. However, they were constrained by the need to conserve the foreign reserves in the light of the decision to relax the exchange controls from July 1997 onwards.

Another reason that accounts for the importance of managing the foreign reserves relates to the need for a country to seek to have foreign reserves that are adequate to serve as a settlement for a country's transactions with the rest of the world. One of the aims of managing foreign reserves by a central bank is to ensure that as far as possible the country is always

in a position to honour its foreign obligations. Any failure to honour such obligations will obviously threaten to undermine the country's foreign credit status. After April 1994, the foreign reserves position began to improve as sanctions were lifted. The Bank, however, remained acutely aware of the need to manage its foreign reserves in a way such that the resort to a fresh debt moratorium was avoided.

Despite these considerations it was the case that where many developing countries were concerned, including South Africa, at times the management of foreign reserves had tended to have a lower priority than the management of their foreign liabilities. Substantial repayments of foreign debts, in the wake of attempts by foreign creditors to reduce their exposure to South Africa, drained the country of foreign reserves, despite the recording of ongoing surpluses on the current account of the balance of payments from 1984 to 1994. The period from 1989 to 1994 was therefore one in which much time and effort were spent on the management of South Africa's foreign liabilities.¹⁰⁸ Even in 1996 the country continued to be bedevilled by problems on the capital account, although somewhat different in nature from those previously in existence. Many countries were in the position where relatively low foreign reserves existed side by side with heavy foreign debt burdens, and often in such cases the denomination of their foreign currency assets reflected the currency composition of their foreign liabilities.

During the 1990s the foreign exchange liabilities and assets of the Bank were to some extent managed together. During this period much attention was paid to the management of the Bank's forward exchange exposure. This exposure was dollar-denominated, and this helped to encourage the Bank to hold a high proportion of its foreign exchange reserves in dollars.

In the early 1990s South Africa struggled with low foreign reserves and at the beginning of 1990, for instance, restrictive monetary policies were in part justified by the desire to effect a substantial improvement in the foreign reserves position.¹⁰⁹ Indeed, by mid-1989 the level of gold and other foreign assets was largely exhausted. Although a remarkable recovery took place over the subsequent three years to 1992, some further replenishment in the foreign reserves was thereafter essential to restore adequate financial stability.¹¹⁰ Higher foreign reserves would have, *inter alia*, contributed towards a more stable exchange rate for the rand, since intervention in the foreign exchange market by the Bank would have been more feasible, while the demands on the economy in the new political environment would have been met more easily.¹¹¹ The minimum target of the Bank was gross foreign reserves, which were equivalent to three months of imports, but for much of the 1990s the Bank struggled to reach such a level. This position moreover was aggravated in the early 1990s by the inability of the country to tap IMF facilities.

The pressures on the foreign reserves were, for instance, again acute in 1993 and early in 1994. South Africa's net foreign reserves declined by

about R8,5 billion in 1993 fuelled by a net foreign capital outflow of about R14,5 billion, with the trade-weighted value of the rand falling by 8,7 per cent. If short-term foreign borrowings by the Bank were deducted from the gross foreign reserves held by it and private banks, the net foreign reserves of the country were negative early in 1994. The Bank intervened on a significant scale to support the rand during 1993, and early 1994 making use of short-term foreign credit facilities made available to it as foreign sanctions began to be lifted. Its resources were also boosted by the government's resort to a R2,8 billion IMF loan in December 1993. This was again made possible by an easing of sanctions pressures.

The Bank's support for the rand at that juncture and its willingness to allow the foreign reserves position to deteriorate markedly were partly based on the belief that the pressures on the balance of payments would abate in the course of 1994 as the capital account of the balance of payments improved. This did occur, thereby enabling the Bank to redeem its short-term foreign borrowings, and replenish its foreign reserves position after April 1994.

The Bank's action relating to the balance-of-payments position paid off. In the absence of Bank support for the rand, made possible by the easing of foreign financial sanctions, the rand could well have collapsed in 1993 and early in 1994, thereby rendering the economy vulnerable to intensified inflationary pressures. However, if the pressures on the capital account had persisted beyond April 1994, such a fall in the rand would probably have been inevitable since the country's net official gold, and other foreign reserves were basically exhausted at that stage. The re-emergence of net foreign capital inflows was most welcome, but management of the foreign reserves had to take account of the fact that the bulk of the inflows were short term in nature.

The Bank had succeeded in increasing its net foreign reserves from a zero level in April 1994 to more than R10 billion in August 1995; the rise being in the form of foreign exchange holdings. By the end of 1995 this figure had risen to more than R15,5 billion. This amount, however, was hardly sufficient to cover six weeks of imports, and it remained the policy objective to increase the reserves to a much higher level rather than engage in a premature and impetuous relaxation of the remaining exchange controls.¹¹²

It could have been argued that South Africa's best interests might have been served by more emphasis being put on relaxing the exchange controls at that point. However, the increase in the foreign reserves had been achieved on the back of short-term capital inflows from abroad, which could have been reversed quickly. What is more, many potential foreign investors had advised the Bank to apply caution with the programme of exchange control liberalisation.¹¹³

The relaxation of exchange controls had already occurred mainly through the removal of the financial rand system in March 1995. This had furnished

one of the motives of the authorities for building up the level of the foreign reserves, because following the abolition of this system foreign investments in South African securities denominated in rands became convertible into foreign exchange under the unitary exchange rate system, and this meant that the foreign reserves would be affected adversely if sales of these securities took place, and the Bank intervened in the market to sell dollars.

The improvement in the foreign reserves position, moreover, came to an abrupt end early in 1996. During February 1996 alone the gross (and net) gold and foreign exchange reserves held by the Bank declined by R733,9 million to roughly R14,7 billion. This, however, was followed by a major improvement in 1997, when relatively large net capital inflows exceeded a smaller deficit on the current account, and enabled the Bank to build up its gross foreign reserves from R10,3 billion at the beginning of 1997 to R28,4 billion at the end of the year. The foreign capital inflows were bolstered in part by the successful conclusion by the Bank of a three-year syndicated loan facility amounting to US\$1,75 billion in July 1997.

20.4 Modern management of foreign reserves

Up until the mid-1970s the foreign exchange reserve management activities of central banks in general were confined largely to the holding of US government Treasury bills and other similar investments, and little attempt was made to hedge these investments. In the case of the gold reserves of central banks there was generally complete passivity regarding these holdings. Traditionally, gold had done little but take up storage space in central bank vaults. Central banks were largely inactive where their gold holdings were concerned. This was partly through choice, but mainly it reflected the moves made by the US, certain other countries and the IMF to try and demonetise gold following the introduction of the two-tier gold marketing system in March 1968, and later the collapse in 1971 of the Bretton Woods system of fixed but adjustable exchange rates. In the wake of the growing differential between the official and free market prices of gold, these entities put pressure on the major central bank holders of gold to freeze their holdings. This behaviour at least created the superficial impression that official gold was of no further use for central banks and was therefore being demonetised.

By the end of the 1970s, however, an increasing number of central banks were starting to spread their wings. They started to build up portfolios in a number of currencies as a multi-currency reserve asset system emerged in which the dollar was no longer such a dominant reserve asset. Foreign currency reserves of many central banks continued to expand, and by the mid-1980s greater sophistication in foreign currency management emerged along with increasing pressure on foreign reserve managers in central banks to make their assets perform to better effect. The advent of floating exchange rates and the consequent swings in rates, as well as the desire of generating a higher income from their foreign portfolios, had

pressurised central banks into more active management of their foreign exchange reserves.

By the mid-1980s these pressures also began to manifest themselves in respect of the gold holdings; pressures which also emanated, to some extent, from the poor performance of gold at that stage in terms of its price compared with the boom between 1976 and 1980. The value of gold as a hedge against inflation came to be questioned in an era of low inflation in the 1980s. Central banks increasingly sought means to mobilise and generate some kind of return from their gold holdings, although the pressures were not as great as they were in the case of foreign currency holdings.

During the 1990s this trend towards more aggressive management of foreign reserves by central banks gained further momentum, a process that was assisted by several influences. The foreign reserves of central banks in aggregate totalled around US\$2 000 billion by the middle of 1999, the level of these reserves steadily increasing during the decade of the 1990s. The trend towards ever-greater foreign reserves in the hands of some central banks had caused them to come to the conclusion that they could afford to broaden their investments, and take on somewhat higher risks.

What is more, central banks tended to monitor closely the actions of one another. Whatever their political allegiances, central banks formed a closely knit community, and they observed what other central banks were doing with their foreign reserves. This tended to encourage central banks to emulate what other central banks were doing in the field of management of foreign reserves.

In the case of EU the euro currency began to replace the national currencies of 11 countries in 1999. This meant that the national central banks in Europe, which were part of the euro system, now kept foreign reserves that were no longer needed to defend their currencies in the foreign exchange markets, since these currencies had been replaced with the euro. The corollary of this was that these national central banks had foreign reserves at their disposal that were no longer needed at short notice, and therefore they had more scope for investing these reserves in more risky channels.

In addition, the shift towards more active management of foreign reserves was encouraged by some governments, always eager to find non-vote-sensitive ways of raising money. Some countries had been actively encouraging their central banks to invest their reserves in higher-risk outlets in an attempt to boost returns. Higher returns generated by central banks from more active management of their foreign reserves benefited governments in the form of higher profits that were transferred to them.

Most central banks were very secretive about their policies relating to the management of their foreign reserves. Nevertheless, during the 1990s many actively managed their foreign exchange reserves. They took positions according to their views of the currencies in which they had investments, and the outlook for long- and short-term interest rates in those reserve centres. Portfolio management of foreign exchange reserves could make a meaningful contribution to the profits of central banks and, indeed, could be viewed by the senior management of a central bank as one of the important ways in which it could influence its profits.

By the 1990s this more active management style had generally reached the stage where numerous central banks allowed a portion of their foreign exchange reserves to be managed independently by appropriate private financial institutions such as commercial banks. This became the case where the Bank was concerned, such a policy having been started during 1999 when some US\$500 million was placed with five offshore fund managers. These managers were given a conservative, short-term benchmark based on the London interbank offered rate against which to perform. The fund managers had also been given tight guidelines as to how the money may be invested and they were, for instance, banned from investing in equities, and could only use the derivatives market to hedge themselves against their existing exposures. This new policy was based on the consideration that in an increasingly complex world of foreign exchange management, specialist traders in the field may generate higher returns for central banks than could be garnered by the banks themselves.

In the early 1990s some developing countries with substantial foreign reserves were adopting even bolder investment strategies. Some set aside portions of their reserves for higher risk, higher return investments. According to Dean and Pringle in their book on central banks, in some countries as much as one third of their total foreign reserves were believed to be invested in relatively illiquid assets, including investments in equity and real estate.¹¹⁴ Such investments would have been regarded by central banks in former times as entirely unsuitable.

The principle behind active management of foreign reserves was illustrated by the Bank's policy. Two of the Bank's portfolios began to be actively managed from 1 April 1996. The so-called currency portfolio and gold portfolio received initial allocations of US\$300 million, and one million fine ounces of gold respectively. The performances of the two portfolios were measured against the benchmarks of three month American Treasury bills, and the three-month gold lending rate. The International Banking Department of the Bank was successful in outperforming the benchmarks in the currency and gold portfolios over each three-month period between 1 April 1996 and 31 March 1997 as reflected in Table 7:

Table 7: Currency and gold portfolio performances (1 April 1996 to 31 March 1997)

Currency portfolio	Performance of portfolio percentage per annum	Benchmark percentage per annum	Portfolio outperformed benchmark by
1 April to 4 July 1996	5,460	5,290	0,170
5 July to 3 October 1996	6,710	5,250	1,460
4 October 1996 to 3 January 1997	5,500	5,010	0,490
In January 1997 the method of measuring the currency portfolio was changed to one based on an index, the calculation of which was approved by the Bank for International Settlements. The figures below therefore reflect the growth in the index of the benchmark portfolio and the actual portfolio.			
4 January to 3 April 1997			
Gold portfolio	Performance of portfolio percentage per annum	Benchmark percentage per annum	Portfolio outperformed benchmark by
1 April to 4 July 1996	4,320	1,500	2,820
5 July to 3 October 1996	1,916	1,313	0,063
4 October 1996 to 3 January 1997	2,610	1,900	0,710
4 January to 3 April 1997	4,927	1,179	3,748

20.4.1 Gold-lending operations

The more active management of the Bank's foreign reserves was also illustrated by the Bank's decision in May 1999 to place a small portion of its gold reserves on deposit with foreign bullion banks and thus, in effect, lend out some of its gold on the international markets. This supplemented the practice of borrowing gold on occasion.

The amounts that were lent out did not exceed 10 tons, which was less than 10 per cent of the Bank's gold reserves of around 125 tons and the sale of this gold on the open market should have had virtually no effect on the gold price. The amounts lent out were also very small when compared with the total size of the international gold-lending business. Some analysts reckon that the total amount lent out by central banks by late 1999 amounted to around 5 500 tons.

The Bank perceived the decision to make gold deposits with bullion banks as having become part of the normal management of its foreign reserves,

with the interest earned on these deposits contributing towards the income of the Bank. The Bank, however, pointed out that if the interest rates on these deposits fell, then it was quite possible that the Bank might refrain from rolling over maturing deposits, since the lower return might not justify the credit risk of continuing to make such deposits.

The decision to lend out gold to foreign bullion banks was also supported on the grounds that the Bank had, in any case, for a number of years been involved in making gold deposits available to local manufacturing jewellers via the banking system against the security of government stock. This lending to the local market was similarly very small, but assisted in the development of the South African jewellery manufacturing industry.

Even so, this move by the Bank was not supported in all quarters. Some analysts argued that it could prove to be the “thin end of the wedge” in the sense that the Bank could in time increase its gold-lending operations, and serve to depress the price of gold, albeit marginally. In addition, critics argued that lending out gold sent the wrong signal, and undermined the Bank’s credibility if it opposed gold sales by other central banks as well as the IMF. They argued that the Bank could hardly criticise other central banks for selling gold when indirectly it sold gold itself via gold deposit activities.

20.5 Currency composition of foreign exchange reserves

Some reference to this subject has already been made. It was not entirely true that in managing their foreign reserves central banks were strongly in favour of holding hard currencies. If that was the case, central banks would have held huge amounts of Swiss francs and Japanese yen during the 1990s. In reality the US dollar was the most popular reserve currency, partly because of the vast trade conducted in dollars, and the liquidity of dollar investment markets. The liquidity of foreign exchange reserves was vitally important.

According to IMF data, the dollar represented 58,9 per cent of world foreign exchange reserves at the end of 1996 compared with 56,6 per cent the year before. The Deutschemmark’s share had declined gradually to 14 per cent at the end of 1996 from a peak of about 18 per cent in 1989, while the yen’s share had slipped to about 6 per cent in 1996 from nearly 9 per cent in the early 1990s.

The traditional rule for the currency composition of foreign exchange reserves was that these reserves should be weighted by the currency composition of imports or, indeed, that of liabilities in general. This helped to explain the heavy weighting given to the US dollar in the composition of South Africa’s foreign exchange reserves. More specifically in the 1990s the

Bank adhered to the principle that the currencies in which foreign assets ought to be held should be determined by the currency composition of the Bank's oversold forward book which was in dollars. At the end of March 1998, 97 per cent of foreign currency reserves were held in dollars.¹¹⁵

Such a dollar holding policy, however, did suffer from certain weaknesses, even though it was financially prudent. It was only a hedge against one of the two types of price risks affecting the import bill, namely the exchange rate risk. Such a policy provided no hedge against changes in the relative prices of South Africa's imports; in other words, if the world price of oil rose relative to all other prices, South Africa could not preserve the purchasing power of its foreign reserves simply because the bulk was kept in dollar form, although the same conclusion applied if other currencies were held. Furthermore, keeping the reserves mainly in dollars did nothing to protect the earning power of South Africa's exports, and the latter were generally a more important influence on the country's capacity to buy imports than its international reserves.

20.5.1 Composition of foreign reserves

Apart from deciding on the composition of its foreign exchange reserves, central banks also had to determine the composition of their total foreign reserves, namely gold and foreign exchange. Certain central banks owned no gold in the 1990s, but the great bulk of such institutions did keep holdings of the yellow metal and had to decide what the proportion of their total reserves would be kept in metal form. In this respect, for many decades, South Africa had retained a large proportion of its foreign reserves in gold, but by March 1998 this had fallen sharply to around a 16 per cent holding, which was an all-time low point at that time, despite the fact that the country was still an important gold-producing country. Some indication of these changes is revealed in Table 8 which covers the period from 1980 to 1998.

Table 8 reveals that since around 1995 the Bank was primarily interested in building up official foreign exchange reserves. The objective in respect of gold was to keep the reserves relatively stable.

This change in policy reflected the fall off in gold production over the years, which continued throughout the 1990s, the disappearance of sanctions pressures, the uncertain prospects for the gold price, and the diminished role of gold in the international monetary system. Over many years many other central banks had similarly reduced the proportion of their foreign reserves that they keep in gold. In this respect it should also be noted that the IMF was believed to prefer central banks to keep the bulk of their foreign reserves in foreign exchange form.

Table 8: Composition of the South African Reserve Bank's foreign reserves (R millions)

At the end of year	Foreign exchange	Gold	Total
1980	413	4 854	5 267
1981	511	3 194	3 705
1982	519	3 309	3 828
1983	915	3 250	4 165
1984	342	4 046	4 388
1985	816	3 632	4 448
1986	807	3 708	4 515
1987	1 235	4 904	6 139
1988	1 853	3 079	4 932
1989	2 433	2 883	5 316
1990	2 580	3 625	6 205
1991	2 463	5 689	8 152
1992	3 021	6 083	9 104
1993	3 458	5 634	9 092
1994	5 967	5 120	11 087
1995	6 397	5 401	11 789
1996	4 402	5 903	10 305
1997	22 134	5 183	27 317
1998	25 523	6 059	31 582

Source: South African Reserve Bank *Quarterly Bulletin*, June 1998

Since 1991 the increase in reserves was accumulated mainly in new foreign exchange holdings. The proportion of foreign reserves of the country that was kept in gold could possibly have declined even further in future years, since the Bank had lost its previous dominant position, which it held in respect of the handling of the country's gold sales. Since the beginning of 1998 the Bank had only fulfilled a residual role in the area of gold sales, the bulk of these sales having been taken over by the Rand Refinery on behalf of the gold-mining industry. Other things being equal, this mutation in the gold sales responsibilities of the Bank suggested that the proportion of the total reserves held in gold by the Bank might fall further, since the Bank no longer automatically received all the newly mined gold from the gold mines. The latter could prove disadvantageous if the gold price rose markedly.

The yellow metal served South Africa well in its hour of distress during the 1980s, and the early 1990s. Faced with hostile elements in the outside

world it always found sales outlets for its gold. Gold provides a country with the comfort of possessing a usable international reserve asset that does not represent the liability of any other country. This quality makes gold freely usable at all times. What is more, the ease with which reasonable amounts of gold could be converted into usable foreign exchange assets by means of gold swaps facilitated the use of gold as a reserve asset by the central banks of the smaller countries.

The liberalisation of the world's private markets for gold meant that by the early 1990s South Africa exploited these markets in various ways. This included regularly selling its relatively large production in the spot gold market and by making use of large amounts of gold swaps out of its foreign reserves. It also included arranging pre-shipment advance payments against future sales, by operating in options and forward markets, and by allowing individual South African gold producers to borrow against their future production.¹¹⁶

Nevertheless, by the 1990s gold had largely lost its function as a means of settlement among central banks. It was rare for gold to be transferred among central banks in settlement of outstanding balances. What is more, the mobilisation of gold by the Bank and other central banks in the 1990s was hampered by the steady decline in the dollar price of gold.

20.5.2 Valuation of foreign reserves

Numerous central banks brought realised, and unrealised foreign exchange gains and losses to the profit and loss account without special treatment. In contrast, some other central banks place foreign exchange revaluation gains in reserves or a revaluation account, with the Bank belonging to this latter category. Normally foreign exchange assets and liabilities were valued at current market exchange rates, but often subject to the overriding principle of valuation at the lower of cost or market price.

In the case of gold reserves some central banks, including South Africa, valued gold on the basis of the prevailing market price, but many countries simply ignored changes in the market price of gold by utilising a historical price set in foreign currency (frequently the US dollar or the special drawing right). In a number of cases this practice created large hidden reserves that became tempting targets for finance ministries which ordered central banks to sell gold, while the profits accrued to the governments.

20.5.3 Target for foreign reserves

The Bank did not have a target figure for total reserves alone. Instead, it judged the adequacy of its foreign reserves using the yardstick that its reserves should be a multiple of the monthly import bill. Specifically, it aimed for reserves that covered at least three months of imports. This, however, was an old-fashioned criterion to use and it could be argued that it was an

irrelevant criterion in view of the fact that flows on a daily basis in the local foreign exchange market were dominated by capital movements. In an era of high mobility of foreign capital the ratio of foreign reserves to imports fell short as a measure of the adequacy of foreign reserves. Nevertheless, South Africa's foreign reserves, which had at times in past years covered less than two months of imports and in July 1990 represented only slightly more than one month of imports, had been especially low in view of its open economy, the volatile nature of much of its exports and its volatile capital account. Fortunately, by the late 1990s the position was more comfortable, with the foreign reserves covering three months of imports by March 1998. In the case of the Australian central bank the target was to have sufficient foreign reserves to give it the capacity over a cycle to intervene in the foreign exchange market in the manner deemed to be suitable. One new way of judging the adequacy of foreign reserves was to look at reserves as a proportion of broad money supply. This measure gave some idea of the extent to which monetary expansion was backed by hard currency. The foreign reserves-to-import ratio was also deficient in the sense that it made no distinction between "earned" and "borrowed" foreign reserves, which was particularly important for central banks of smaller countries.

20.6 Foreign reserve asset management for smaller central banks

20.6.1 Importance of building up foreign reserve assets

Smaller countries needed reserves that they owned (i.e., non-borrowed reserves) more than larger countries, which were usually not so exposed to international trade. In the early 1990s it was the case that a relatively small country such as South Africa could not rely on external financing to cover any overall balance-of-payments shortfall. This meant that in order to have the security of an adequate level of foreign reserves, smaller countries such as South Africa needed owned reserves, and not borrowed reserves.¹¹⁷ Dr Stals made the point that an adequate level of foreign reserves held by the central bank was a prerequisite for almost every country that sought to employ the savings of other nations to develop its economy, that is, attract foreign capital inflows.¹¹⁸ There were strong grounds for arguing that a small country needed foreign reserves earned through its own productive efforts and accumulated through its own virtuous savings, before it would get access to the savings of other countries. In addition, each country should strive to acquire enough foreign reserves to cover the potential overall balance-of-payments variances that could be reasonably expected. Such reserves would hopefully be sufficiently large to inspire confidence among foreign investors.

The foreign credit rating of a country was influenced in part by the level of its foreign reserves and the quality of those reserves. This was one of the problems that had beset South Africa in the past. Although its

foreign reserves rose after April 1994, they were still perceived at times to be relatively low, with the increase at times primarily taking the form of “borrowed” reserves.

Such considerations helped to explain the large increase in demand for foreign reserves by smaller countries over the years. They had come to appreciate that although the social cost of earning, and holding an adequate level of owned (not borrowed) reserves might seem to be high, because it could require curbing domestic demand, it was, in fact, a key to attracting an inward flow of capital, and deriving the benefits of access to international capital markets.

In practice, foreign exchange reserves of central banks were held in part with leading commercial banks in the principal financial centres of the world. These were supplemented by deposits kept by certain leading central banks with the Bank for International Settlements (BIS), while other funds could be held in investments such as Treasury bills, and other liquid investments.

20.6.2 The case of South African

In the case of the Bank, it operated current, call and deposit accounts at various European and American banks, as well as certain central banks, while some of these banks, in turn, had similar accounts with the Bank. The diversified nature of South Africa’s foreign exchange reserves reduced the influence of exchange rate movements on the value of foreign reserves. The bulk of the Bank’s foreign exchange assets, however, were held in US dollars, mainly reflecting the fact that the Bank’s forward exchange book was oversold in dollars as previously mentioned. Moreover, the Bank only invested funds with banks who were prepared to offer it credit facilities.

20.7 Use of foreign credit lines by the Bank

Apart from holding deposits with various foreign banks, from the mid 1990s the Bank began to add to credit lines with certain private foreign banking institutions which included bullion and correspondent banks, and at various times borrowed funds from these banks to bolster the cash component of the foreign reserves. These reserves were also augmented at times by gold swap agreements conducted by the Bank with certain banks. The Bank was one of the few central banks in the world that made extensive use of foreign credit lines. Historically, this practice had been facilitated by the Bank’s relatively large gold holdings, and the importance of South Africa as a gold producer.

In the late 1970s and the 1980s South Africa’s foreign credit lines were severely curtailed as a result of actions taken by foreign banks, based largely on political considerations. Indeed, during this period the Bank had to rely largely on gold swaps as a means of raising short-term foreign credits. However, from the mid 1990s onwards foreign credit lines were built up

once more. At the end of March 2000 a total of R27,3 billion in foreign credit facilities was available to the Bank, compared with R18,7 billion at the end of March 1995, with R22,5 billion representing committed lines on which it paid a commitment fee. In building up foreign credit lines, the Bank paid a commitment fee of one third of 1 per cent on most of those lines it did not utilise. The Bank paid this fee to ensure that it retained the lines, which might be needed in the event of severe balance-of-payments problems. These credit facilities, if utilised, consisted of gold loans, pre-export finance against forward sales of gold, and money-market loans.

20.7.1 Types of credit lines

In the case of gold loans, gold was borrowed from a foreign bank, the metal could be sold for dollars in the market, and the loan repaid in gold at a later date. It was, however, much more likely that after the gold had been borrowed from a bank, it would be swapped out with that same bank for foreign currency on the understanding that the swap would be reversed at a later date, and the gold loan was then repaid.

Gold loans were attractive from the Bank's perspective, because they were relatively cheap, and the swap costs incurred were for the account of the Treasury. Gold loans, however, were less accessible than pre-export financing loans for the Bank. In the case of pre-export financing loans, foreign loans were raised on the understanding that the loans would be repaid out of the proceeds from future sales of gold. Such loans were trade finance-related, self-liquidating, and attractive for foreign banks in the sense that they needed to be backed with limited reserve requirements. Since the beginning of 1998 such pre-export financing loans had, however, been replaced to some extent with money-market loans in line with the reduced role of the Bank in the area of gold sales.

20.7.2 Use of credit lines

The Bank's private credit lines were in a sense an alternative to official credit lines in the form of IMF finance, although much smaller in magnitude. Large private lines might have discouraged the government from seeking IMF funds at times of balance-of-payments difficulties, while a perceived reluctance by the government to tap into IMF finance might have encouraged the Bank to build up large private credit lines at certain times. IMF loans, of course, could entail some forfeiting of economic policy sovereignty, unlike with private credit lines.

It could have been argued that the sharp rise in the Bank's private foreign credit lines in the 1990s may partly have reflected concerns that the government could be reluctant to utilise IMF facilities if the balance-of-payments position weakened materially. The authorities denied this. It was argued that these foreign credit facilities were not intended to replace the IMF as an important source of support in times of serious balance-of-payments problems. Negotiations with the IMF could be very tedious and

cumbersome, and involved political issues over which the Bank had little control. The foreign credit facilities established by the Bank in the 1990s therefore provided it with a buffer that could be used in times of need, pending the outcome of negotiations between the government and the IMF for standby facilities.¹¹⁹

In this regard, however, the more important influences encouraging the Bank to build up its credit lines were the deficits on the current account of the balance of payments which were being financed largely by volatile capital inflows, and the progressive phasing out of exchange controls. The attempt to curb the Bank's exposure on forward exchange account also partly accounted for the build-up in the credit lines.

During the first few months of 1997 the Bank modified its policy on making use of short-term foreign credit lines to shore up its foreign reserves. It began drawing on its credit lines, even though the foreign reserves were rising. This was undertaken at least partly because the Bank was seeking to reduce its role in the forward rand-dollar market by not renewing so many swaps; in other words, when some of the swaps matured, the Bank sold dollars under the swaps using funds from its credit lines, but did not renew the swaps by entering into new contracts to buy spot dollars and sell dollars forward. Such a policy also led to a tightening of banking liquidity. Normally, when forward contracts matured, the Bank bought the dollars in the spot market, before delivering them to meet the maturing contracts, thereby boosting domestic liquidity. By raising dollars by drawing down its foreign credit lines the Bank avoided any boost to banking liquidity.

Moreover, during July 1997 when the rand started to weaken modestly because of a fall in the dollar price of gold and currency turmoil in South East Asia, which encouraged foreigners to sell rand, the Bank drew down some of its credit lines, but did not sell dollars extensively in the market. Instead, it drew down its credit lines in order to boost the gross foreign reserves. The aim of this exercise was to demonstrate to the market that the Bank had ample foreign reserves that it could draw on, if necessary, to support the rand. The aim therefore was to discourage foreign investors from selling rands.

The modifications in the policy of tapping short-term foreign credit lines meant that from February 1997 the outstanding lines that were utilised increased and reached R17,1 billion in May 1998. However, during 1997 and the first half of 1998 six instalments totalling R2,9 billion were repaid to the IMF in terms of the Compensatory and Contingency Financing Facility.¹²⁰

Chapter 21

Management of South Africa's gold sales

21.1 Overview

When Dr Stals became Governor of the Bank in 1989 the gold sales undertaken by the Bank were dictated to by exchange control regulations. In terms of these regulations, all gold produced in South Africa had to be sold to the South African Treasury within 30 days of production. This was a long-standing requirement, and the Treasury had appointed the Bank as its agent for this purpose. The Bank had handled the marketing of gold for South Africa since 1926. The Bank, therefore, bought the gold from the local producers and, with the approval of the Treasury, determined the gold marketing policy for South Africa.

21.2 The Bank's marketing policy

In a speech delivered in September 1986 Dr Stals, who was at that stage attached to the Department of Finance, stated that gold sales undertaken by the Bank were predicated on three basic principles.¹²¹

21.2.1 Gold sales

First, the mines were paid the full market price for all the gold produced by them and sold to the Bank. The mines were paid the average of the previous two gold fixings in London for gold that was delivered to the Bank. The gold was either sold by the Bank or added to its reserves with a view to selling at a profit over time. The Bank never accepted discounts on the market price, and this meant that other central banks could not buy gold from the Bank at a discount. Indeed, the Bank would not sell gold directly to another central bank, preferring such institutions to buy through the free market. It would also not agree to any automatic bidding price formula. In addition, the Bank normally sold gold in amounts of 8 000 fine ounces, but flexibility in this regard was allowed, and would depend on the circumstances that prevailed at the time of the sale.

In February 1996, to assist the gold-mining industry with its cash flows, the Bank changed the general procedure for purchasing gold at the Rand Refinery from buying gold only as "good delivery bars" to buying doré bars, which were only partially refined bars. This mutation implied buying the gold approximately two days earlier than would otherwise have been the case.

South Africa had traditionally pursued a policy of only selling gold in the spot market, but by the mid-1980s the central bank had started to undertake

some spot purchases when it was deemed that this could be of some benefit in smoothing out temporary lapses in demand, or counteracting disruptive influences in the market. This policy was continued during the 1990s, and on occasions the Bank's purchases of gold helped to arrest downward movements in the gold price, with the Bank subsequently selling the gold at a profit.

21.2.2 Cash settlement for gold sales

The second basic principle dominating gold sales and outlined by Dr Stals was that the Bank always sold gold only for cash settlement. The value date was fixed at the time of negotiating each transaction, and the gold was delivered on the value date after confirmation had been received from the foreign correspondent bank of the Bank that payment had been made. Gold was sold to derive foreign exchange, and there tended to be a close correlation between the physical volume of gold sales and movements in the foreign exchange reserves of the Bank. When the foreign reserves were falling, the Bank tended to sell South Africa's entire new gold production, possibly supplemented by small sales of gold out of its reserves and/or gold swaps. In contrast, when the foreign reserves were rising, some gold production might be withheld from the market, and added to the foreign reserves, while previous gold swap transactions could be unwound, and the gold added to the foreign reserves.

The Bank did not follow any rigid gold sales policy. Medium-term sales policies were crucially influenced by South Africa's overall balance-of-payments position, while day-to-day sales were influenced by movements in the dollar price of gold. Nevertheless, the Bank had historically maintained a high proportion of its foreign reserves in the form of gold. At times this percentage exceeded 95 per cent. This preference for relatively high gold reserves was strengthened for a time after 1985 by the sanctions campaign against South Africa, which raised the possibility that South African assets held in certain banks abroad could have been frozen by foreign parties. This only added to the reluctance of the Bank to be exposed on the foreign currency front and, instead, keep high gold reserves as far as possible in its own vaults in Pretoria.

In the course of the 1990s, however, policies relating to management of the gold reserves changed. Keeping a relatively high proportion of the foreign reserves in gold came to be perceived as less important, and the result was that by 1997 the gold reserves constituted only around a quarter of the total foreign reserves of the Bank, and by 1999 the percentage figure had fallen below 20 per cent.

To some extent, the removal of sanctions against South Africa accounted for this shift in policy, but other factors played a part as well. The poor performance of the gold price in dollar terms in the course of the 1990s

encouraged the Bank to scale down its exposure to gold, and a similar influence was also exerted by the diminished role of gold in the international monetary system. In addition, keeping a relatively high proportion of the foreign reserves in gold had been historically prompted in part by the reasoning that the country should be seen to have faith in its principal export product. This consideration, however, was losing some of its validity in the 1990s, since gold exports as a proportion of total export receipts fell from roughly 44 per cent in 1980 to 16,5 per cent by 1995. Simultaneously, gold production in the country steadily declined from around 700 tons in 1989 to 464 tons in 1998 and a further decline materialising thereafter. This fall diminished the importance of gold sales conducted by the Bank from a balance-of-payments perspective.

21.2.3 Gold sold to principals

The third important principle adumbrated by Dr Stals was that the Bank only sold gold directly to principals and not through any agencies, intermediaries or brokers, with the exception of the London bullion market where gold was offered at the daily fixings through the bullion dealers by the Bank. In all other cases gold was sold on a principal-to-principal basis, and only by means of direct negotiations by telephone, telex or letter. The Bank never entered into long-term contracts, or committed itself to selling gold in any pre-determined quantities to any specific buyers or groups of buyers.

The Bank had a list of approved buyers representing recognised and established dealers in centres around the world and regular users of gold. This involved the sale of South Africa's gold through three different markets. First, some gold was sold through the London market where the members of the market acted as agents for South Africa in selling gold at the daily fixings. Regular shipments of gold were made to the Bank of England, and subsequently the gold could be sold on the London market through the various bullion dealers. Second, South Africa sold gold to members of the Swiss gold pool. Third, the Bank received and considered offers from a number of other approved buyers. Gold sold through the London market was normally delivered at the Bank of England, and most of the other transactions which took place with other dealers such as the Swiss banks also involved gold kept with the Bank of England.

21.3 Role of gold swaps

A notable feature of gold sales policies in the 1980s had been the increased use of gold swaps. The Bank at times needed a facility to use part of its gold reserves to raise foreign exchange without selling more gold in the market. A gold collateral loan could serve this purpose, but the presence of so-called negative pledge clauses relating to government, and other public sector loans of South Africa ruled out that possibility. The more suitable alternative was the resort to gold swap transactions. These involved a spot

sale combined with a simultaneous agreement to repurchase gold at an agreed price at a specific future date. On occasion the gold was sold on maturity rather than bought back, depending on the state of the gold market at the time, and the foreign reserves position of the Bank. Traditionally, gold swaps had involved utilising existing gold reserves, but during the 1980s swaps had been increasingly resorted to in circumstances where the Bank wished to reduce sales in the spot market when the price of gold was weak, while simultaneously seeking to boost foreign exchange liquidity.

Even so, swaps were undertaken with a restricted number of foreign banks who were gold dealers, and who could normally be relied on to co-operate with the Republic if the Bank wished to roll over gold swaps. This policy ensured that the Bank faced no problems with rolling over gold swaps at the time of the debt crisis in the middle of 1985.

Gold swaps served the purpose of furnishing the Bank with additional foreign exchange reserves, which could be substantial, in a manner that did not increase the liquidity base of the domestic banking system, and therefore did not come into conflict with any tight monetary policies which the Bank might be pursuing. Such swaps could often be undertaken when the balance of payments was in deficit, and such swaps did not hinder the balance-of-payments adjustment. Proceeds from gold swaps could also be employed to execute a more effective intervention policy in the foreign exchange market if this was deemed to be desirable.

From the perspective of the Bank it should also be borne in mind that gold swaps could be preferential to borrowing funds from abroad, because the cost of entering into gold swaps, which was reflected in the lower price at which the gold was swapped initially, and the higher price at which it was bought back, was for the account of the Treasury. In the case of foreign borrowings the Bank itself had to meet the interest payments.

During the first half of the 1990s gold swap operations at times remained an important facet of management of the gold reserves in line with adverse balance-of-payments pressures which prevailed. In contrast, during the second half of the 1990s such operations faded in importance. The Bank curbed the resort to gold swaps during this latter period by avoiding any commitment of the gold reserves to new swaps, while cancelling gold swaps when they matured by selling the gold in the market for foreign currency. Thus, by the end of 1998 all outstanding gold swaps had been terminated.

This shift in policy reflected several considerations. First, after April 1994 the position on the foreign reserves front began to improve in line with a strengthening of the position on the capital account of the balance of payments, and the renewed availability to the Bank of foreign credit line facilities as sanctions disappeared. The improved external position in effect

meant that there was no longer any need to gain access to foreign liquidity by conducting gold swaps.

Second, the preference at that time for building up the proportion of the foreign reserves held in foreign currency form encouraged the Bank to sell gold under maturing gold swaps, and add the currency received to the foreign exchange reserves. As previously indicated several factors were inducing the Bank to bolster the foreign currency element of the foreign reserves.

Third, the curtailment of the Bank's involvement in handling the country's gold sales which began to occur at the end of 1997, likewise encouraged the Bank to complement this move by curbing its gold swap operations. Under the new gold sales arrangements the Bank no longer automatically received as much gold from the mines, and this pointed towards reduced scope for the Bank to undertake gold swaps.

The termination of gold swap operations also contributed towards a situation in which the level of gold reserves held by the Bank became more stable. Thus, in the financial year to 31 March 2000 the level of these reserves remained virtually constant at around 4 million fine ounces, whereas in the year to 31 March 1998 these gold holdings rose from 3,6 million ounces to 3,94 million ounces.¹²²

21.4 Changes in the marketing of South African gold

During Dr Stals's era as Governor the Bank was active in the spot, forward and gold option markets in its efforts at marketing newly produced gold, and did this on a profitable basis. Indeed, in trading gold the Bank focused particular attention on profitable trading in the metal. Nevertheless, as South Africa became reintegrated with the outside world in the course of the 1990s, its various international financial relations became subject to a state of flux, a situation that was illustrated by mutations in South Africa's gold sales arrangements which materialised at the end of 1997. Before these changes took effect the Bank's role as the dominant seller of South Africa's gold production had been under review by a joint committee comprising representatives of the Chamber of Mines, the Bank and state departments. The main result of this review was that the role of the Bank in selling the country's gold production, which dated back to 1926, was significantly downgraded in line with a liberalisation of the procedures for gold sales.

This joint committee investigated the broad question whether the Bank should continue to sell gold on behalf of the industry, or alternatively the gold-mining industry should be responsible for handling the sale of its own gold. The industry had not appeared to be united on the issue. At least one group (Randgold) had indicated that it was keen to refine its own gold,

and sell it abroad independently of the Bank. Other groups appeared to be reluctant to step in this direction. Nevertheless, the domestic status quo in respect of gold sales arrangements did change as previously indicated. Under the new arrangements the mining houses were allowed to market their own gold, although the Bank did continue to sell gold for any mines that preferred to use this channel.

21.4.1 Changing circumstances surrounding gold sales

The changed arrangements stemmed in part from the profoundly altered circumstances in which South African gold sales took place in the 1990s. These sales policies had been shaped by historical factors which had partly disappeared.

For decades the Treasury had appointed the Bank as its agent for marketing the country's gold output in line with a similar policy which had been adopted by some other central banks. Moreover, under the Bretton Woods system of fixed but adjustable exchange rates set up in 1946 gold still served as a common denominator of the world's monetary system, and the price of gold was fixed in terms of all currencies. Central banks became intimately involved in gold trading under that system. The gold market at that stage was seen as a central bank market. It was the central banks comprising the eight members of the Gold Pool that ensured, through their own interventions, that the price of gold remained stable in the free market at around US\$35 per fine ounce from October 1961 until March 1968. At that time numerous central banks were major holders of gold, and transfers of gold holdings between these banks took place.

Some of these features had disappeared by the 1990s. Gold no longer served as a common denominator for currencies, and the dollar price of gold was no longer fixed. The Gold Pool arrangements had disappeared approximately three decades ago, and gold trading between central banks had become rare. During the 1990s net sales of gold by central banks were the norm despite the ongoing rise in dollar reserves of such institutions. These various developments had reduced the importance of a centralised system operated by the South African Bank for the marketing of the country's gold.

The importance that used to be attached to the orderly marketing of the country's gold output through the Bank had also diminished. The dependence of the country on gold had decreased markedly over the years. The proportion of total export receipts emanating from gold declined from 44,5 per cent in 1980 to 17,9 per cent in 1996, while production during this period fell from 675 tons to 495 tons. This latter production figure represented only around 25 per cent of production in the world at large. Given these circumstances the stabilising influence which the Bank could exert on the world gold market by marketing the bulk of the country's gold production had become slight.

What is more, the importance of keeping gold as a war chest in the foreign reserves portfolio of the Bank had diminished. The political situation in South Africa had changed to such an extent that it had become unlikely that political relations with outside powers could become so strained that any steps would be taken by foreign powers to freeze the country's assets. A high percentage holding of gold as part of the foreign reserves had therefore become less essential by the late 1990s, and the centralised control of gold sales through the Bank to achieve this objective had consequently assumed less importance from this perspective. Moreover, although some other central banks in developing countries handled gold sales for domestic producers, no such dispensation was provided by central banks in industrial countries.

The underlying circumstances in which gold sales took place had therefore been transformed, thereby justifying mutations in the arrangements for sales. Nevertheless, another important factor which precipitated the change in the gold sales procedures was the programme to progressively phase out exchange controls in South Africa. The centralisation of the marketing of gold through the Bank had in effect been part of the exchange control apparatus. Such marketing had been designed in part to avoid as far as possible a situation developing in which gold was smuggled out of the country in contravention of the exchange control regulations. The partial dismantling of this system of marketing the country's gold in late 1997 partly reflected the failure of exchange control regulations to prevent gold being smuggled out of the country, but more importantly it reflected the efforts of the authorities to progressively abolish the exchange control regulations.

21.4.2 Increased role for the Rand Refinery

One implication of the new gold sales dispensation was an enhanced role for the Rand Refinery. For instance, direct sales of gold by the Rand Refinery for the period from 1 April 1997 to 31 March 1998 amounted to 33,25 per cent of total gold production.¹²³ The selling of gold for years had partly been undertaken by the Chamber of Mines through the Rand Refinery. The Refinery had been allowed for many years to sell small pieces of gold in shapes and forms approved by the Department of Finance, and with an overall weight of one kilogram or less, together with the Krugerrand. No formal restrictions had ever been applied to the sales operations of the Rand Refinery, but there was an understanding with the Treasury that sales by the Refinery would not exceed one third of the annual gold production of the country. Even so, this gave the Refinery considerable leeway, and in 1996 it exported 140 tons of gold in various product forms such as kilo and tola bars which represented roughly 28 per cent of the country's output at that time.

Under pressure from its shareholders (i.e., the mining houses) the Rand Refinery had sought to boost its profitability during the 1990s. This aim,

together with the disappearance of international trade sanctions, had therefore prompted the Refinery to boost its production of commercial gold bar products, which could be sold at small premiums to the ruling international gold prices. In 1996 the 140 tons sold by the Refinery consisted of 1 kilogram bars or less of different grades for the European, Asian and Turkish markets, tola bars for the Middle Eastern and Indian markets, gold coin blanks and Krugerrands, gold grain and granules for overseas jewellery makers, and specialised gold products such as gold potassium cyanide for niche markets.

Indeed, by 1997 the role of the Rand Refinery was even greater than the official regulations pertaining to its sales activities indicated at that time. Even before the new changes in the gold sales arrangements which came into force in December 1997, the Refinery was believed to already exceed the one third sales limit in the sense that it upgraded gold for clients who had already been sold overseas by the Bank in standard bar form. This gold was upgraded into the form of commercial bar products for a small Refinery fee, and this business in reality meant that the Refinery was in a sense already selling more than 50 per cent of the country's gold production.

It was partly for this reason that the previous sales limit applicable to the Rand Refinery had been scrapped as part of the liberalisation process undertaken in December 1997. Under the new circumstances the Refinery was thus able to sell these gold bar products directly to customers, and obtain a premium that was higher than the previous toll Refinery fee it charged.

21.4.3 Residual role for the Bank

It was to be expected that the gold-mining industry would not want to rely entirely on itself, and the Rand Refinery to sell its gold on overseas markets under the new sales arrangements which came into force in December 1997. The industry still wanted the Bank to act as a back stop at times when the industry could not sell most or all of the gold through the Rand Refinery in small bar form. The market for gold value added products was volatile in nature which meant that the Refinery could not be relied on at all times to sell the gold-mining industry's entire output. The Bank did therefore retain some residual function in the area of gold sales. Nevertheless, its role in selling standard 400 ounce gold bars was considerably reduced compared with the situation before December 1997. During 1998 it was selling around 200 000 ounces of gold each month for the industry.

This could have had possible ramifications on the country's access to foreign credit. Many of the Bank's foreign credit facilities were obtained from foreign banks who help to handle the sale of gold by the Bank. Once the latter had lost its dominant position over the sale of South Africa's gold, this could possibly have led to a decline in the foreign credit facilities available to the Bank, but this did not occur.

At the same time the dismantling of the previous dominant position held by the Bank in respect of the handling of the country's gold sales did have implications for the management of the foreign reserves. Other things remaining equal, it suggested that the proportion of the total reserves held in gold by the Bank could fall over time, since the latter would no longer automatically receive as much gold from the mines. The Bank, however, did stress that it would not be reducing its gold holdings at that stage as a consequence of the relaxation of the controls over the marketing of the country's gold. This policy decision no doubt was influenced by the weakness of the international gold markets at that time. The change in marketing arrangements also suggested that the Bank's management of the foreign reserves could become more active in future along with its role in monitoring foreign capital flows in and out of the country, and indeed this was already happening with regard to the foreign reserves.

The changed procedures for gold sales did not by themselves fundamentally alter the position of the gold-mining industry in South Africa. Nevertheless, it should have led to a marginal increase in the earnings of the industry, other things remaining equal, and it was hoped that the changes could prove to be positive in the sense that it could lead to a change in the mindset of the industry. As a result of the changes the industry had greater control over the selling of its gold. It could therefore become more market orientated by seeking to find and promote markets for gold products.

21.5 Domestic gold sales and loans by the Bank

Very limited sales of gold by the Bank were made in the domestic market in the 1990s. These sales took on two forms. First, periodic sales of 99.99 per cent fine gold by the Bank to the South African Mint took place when the Mint sought gold for the purposes of producing proof gold coins and/or medals. A market-related price was charged, and the Mint also bore the cost of the operation including the upgrading of the gold.

Second, sales of gold to the jewellery and dental industry and to other permit-holders were effected by the Bank through the Rand Refinery, and were settled on a monthly basis. A daily price was quoted for purchases from the Refinery, and was derived from converting the average fixings in the London bullion market on the previous day at the Bank's rand-dollar exchange rate.

21.5.1 Promotion of the gold jewellery industry

The supply of gold to the jewellery industry took place via the Rand Refinery. The Bank offered a gold loan scheme for manufacturing jewellers, with the first loan granted back in November 1989. These loans were made available to qualifying jewellers via the commercial banks in South

Africa. Under this facility 9 397 ounces of gold were outstanding on 31 March 1998.¹²⁴

Prior to this facility, a manufacturing jeweller purchased work-in-progress gold and paid for the metal in rand. This meant that work-in-progress gold was being financed at prime overdraft rates.

The implementation of a gold loan scheme meant that manufacturing jewellers were able to gain access to work-in-progress gold at bullion lending rates quoted by the Bank plus the margin charged by the commercial banks. It was hoped that this facility would encourage the development of a viable gold jewellery export industry in South Africa.

Broad Overview of the Stals Era

Dr Stals's reign as Governor of the Bank comprised a story of two halves; it was an era with two distinct contrasting periods. The first from August 1989 to April 1994 was characterised by highly negative economic influences with the Bank operating, to some extent, in a siege-type environment totally out of its control. The balance of payments was a virtually constant headache with ongoing large capital outflows emanating mainly from financial sanctions having to be financed by recurring surpluses on the current account of the balance of payments, where these surpluses were not aided by buoyant commodity prices. The state of the external accounts exerted a profound influence on monetary policies. This naturally curbed the scope for economic growth, and this factor combined with others led to a severe protracted downswing in the economy starting in March 1989, and lasting roughly until the first quarter of 1993. At the same time, however, the environment for financial stability was improved in the sense that some success was achieved in curbing the growth of the money supply, and reducing the rate of inflation.

The second period started after the democratic elections in April 1994, and was characterised by a better environment for economic growth. A new business-cycle upswing had indeed become established in the second quarter of 1993, and thereafter aggregate real GDP recorded successive years of expansion. Growth initially accelerated from 1,5 per cent in 1993 to 2,5 per cent in 1994 and 3,5 per cent in 1995, before slowing down to 3 per cent in 1996, 2,5 per cent in 1997 and 0,5 per cent in 1998.

After April 1994 the financial sanctions previously imposed on the country withered away, and net capital inflows from abroad became the order of the day, albeit proving volatile. This meant that deficits on the current account of the balance of payments became possible, and the scope for economic growth was enhanced. The mutations in the external environment were reflected in adaptations in the field of management of the foreign reserves with the Bank placed in the position where it could start to rebuild the foreign reserves. At the same time it became possible to scrap exchange controls on non-residents, and progressively relax the controls on residents. Even so, Dr Stals remained committed to progressively reducing the rate of inflation, and in 1995 monetary policy was tightened in order to contain the inflationary potential of strong net inflows of foreign capital.

While Dr Stals deserved much credit for the success in the fight against inflation, particularly since he took office at a time when the possibility of hyper-inflation in South Africa could not be ruled out, he was fortunate in a number of respects. In the industrial countries the battle against inflation had largely been won and this set an example for stronger anti-inflationary policies in South Africa.

Moreover, some major political developments assisted him in this fight against inflation. On 15 August 1989, a week after Dr Stals had become Governor, Mr F W de Klerk succeeded Mr P W Botha, initially as Acting State President before being formally elected on 14 September 1989. Unlike his predecessor, Mr de Klerk left monetary policy to the technocrats and informally established the independence of the central bank. This facilitated Dr Stals as regards his determination to fight inflation, the Governor himself being strongly in favour of independence for the Bank, and a somewhat detached relationship with the Treasury. Meanwhile, in 1994 Dr Stals was reappointed for a second five-year term by the new South African Government which also respected and strengthened the independence of the Bank.¹²⁵

At a gala dinner on 7 August 1999 in honour of his retirement, Dr Stals listed what he regarded as the “Twelve Commandments of Central Banking”. His first commandment was that a “true central banker will always be against inflation”, while his twelfth and most important commandment was that a “good central banker is always against inflation”.¹²⁶

While recording progress on the inflation front, despite problems at times in curbing the growth of money, the Stals era was one of relatively low economic growth. However, in this regard it should be noted that growth was hampered by slow implementation of structural economic reforms, and other negative economic features, totally out of the control of the Bank. The Bank could not be held directly accountable for economic growth; rather it was responsible for creating a monetary environment conducive to growth.

In 1948 a prominent South African economic historian, Professor C W de Kiewiet, referred to the country's historical progress as characterised by “economic windfalls, and political disasters”. As regards the economic windfalls, the historian was referring to the discovery of diamonds in the 1860s, emergence of a large gold-mining industry starting in the late 1880s, later on the discovery of platinum deposits, and the rise in the price of gold in the 1920s and 1930s. All these events spurred economic growth in South Africa. Subsequently, after World War II the country again experienced economic windfalls from time to time such as the development of the Orange Free State and Evander goldfields in the 1950s, the surge in international commodity prices between 1950 and 1970, and the boom in the prices of precious metals between 1976 and 1980.

The relatively low economic growth recorded in the 1990s was partly attributable to the lack of any substantial economic windfall. The economy was bedevilled by weak international commodity prices at times, with the dollar prices of gold declining steadily on balance throughout the period. The bear market of nearly 20 years in the gold price ended in September 1999, roughly a month after the retirement of Dr Stals from the Bank. In addition, domestic gold production dropped dramatically along with jobs in the industry, affected by dwindling volumes of ore milled, and declines in

the grade of ore. Easily accessible and payable ore deposits became largely exhausted during the 1990s, while new deposits were found at levels deep below the surface, which raised the limits at which mining operations could profitably take place. Domestic monetary policies had little to do with the decline in gold mining in the 1990s, and the same conclusion could be reached for the manufacturing industry, where unit labour costs rose on average by nearly 10 per cent per annum from 1991 to 1998, despite the disinflationary pressures in the economy. This raised the effective costs of labour, and reduced competitiveness in manufacturing. An even more important negative influence, however, was the sanctions campaign, and in particular financial sanctions imposed by the international banking community. These disappeared after April 1994 as previously mentioned, but they were replaced in a sense by adverse market developments at times during the second half of the 1990s.

In the globalised world that developed in the 1990s emerging-market economies such as South Africa were shown to be highly vulnerable to shifts in international capital flows. The rand crises of 1996 and 1998 served as a warning that the international capital markets could damage the local economy when it was perceived to be beset by 'unfriendly' investor domestic policies. Disinvestment from the South African bond markets by foreigners was in particular a problem at times after 1995, and emphasised that the country ideally needed to adopt structural economic reforms aimed at creating a more investor friendly environment for domestic and foreign investors. This, however, was largely outside the domain of the Bank.

Another decisive negative influence from an economic growth perspective was the decline in savings and investment as a percentage of GDP during the early 1990s. From a peak value of nearly 28 per cent in 1982 the ratio of gross domestic fixed investment to GDP contracted to a low of 15½ per cent in 1993 before rising modestly to roughly 17 per cent in 1998. The national savings, as measured by the ratio of gross domestic savings to gross domestic product, deteriorated from 17 per cent in 1995 to a low of 13 per cent in the fourth quarter of 1998. Other structural impediments to economic growth also existed in the 1990s.

The most obvious way of easing the constraint of low domestic savings and investment on economic growth would have been structural reforms such as cuts in direct taxes and speedy privatisation which created a more investor-friendly environment in South Africa and thereby attracted greater inflows of foreign capital. Such reforms could also have rendered it possible for the Bank to speed up the dismantling of exchange controls. On several occasions Dr Stals emphasised the need for a stable and sound investor-friendly environment.

The emphasis on reducing the rate of inflation and the progress achieved in this direction in the 1990s did at least serve to create conditions which were conducive to higher economic growth in the longer term. Some critics argued that this policy was pursued with too much zeal, especially since the

economic gains to be derived from inflation rates below 10 per cent could have been minimal. By contrast, driving inflation to low levels in line with the country's principal trading partners could be justified on the grounds that such an inflation rate would have meant that there was no longer a need for the rand exchange to weaken to compensate for the inflation rate differential between South Africa and overseas. This, in turn, might have created a more stable rand, which could have been conducive to attracting greater inflows of foreign capital.

During Dr Stals's reign the monetary environment was at times highly volatile, often influenced by volatile international movements. This volatility reflected on occasions in sharp movements in domestic interest rates. This led to the criticism that businesses were destroyed, and investment planning made more difficult. In defence of the Bank, however, it should be noted that the sharp rises in interest rates which on occasion materialised reflected the buoyancy in the growth of the money supply, and more importantly sudden bouts of intense weakness in the rand exchange rate. Moreover, fluctuations in interest rates were still less volatile than those in the 1980s.

In conducting its monetary policies, the Bank believed that interest rates should be determined primarily by market forces operating through efficient financial markets. For this reason the Bank played an active part in promoting the development of relatively free and efficient money and capital markets. Nevertheless, occasions arose when it was deemed to be desirable to intervene in the markets, particularly when it was judged that reversible short-term developments could lead to short-term fluctuations in interest rates.

In the period up to April 1994 the effectiveness of the Bank's monetary policies was undermined to some extent by international sanctions, which blunted the incentives created in the market by monetary policy actions. Movements in the rand, for instance, did not exert the same impact on the balance of payments which would have occurred in the absence of sanctions. Nevertheless, adapting to sanctions would have been much more difficult if market-orientated monetary policies had not been adopted, since market incentives were required to shift resources into the balance-of-payments sectors. After April 1994 the Bank had to take more account of conditions in international financial markets when deciding on the appropriate monetary policy stance. These external conditions could suddenly shift, and yet the local authorities had no control over them.

The secular weakness of the rand in the 1990s, which was almost entirely outside the sphere of influence of the Bank, materially affected the operations of the Bank. It impacted on monetary policy, exchange rate policy and in particular forward foreign exchange policy, management of the foreign reserves, and exchange control policy. At the same time, however, the diversification of the country's export base, particularly as regards manufactured exports, which occurred in the 1990s, could be attributed in part to weakness of the rand.

Notes

Part 1 : Domestic Monetary Policies

Chapter 1: The South African Reserve Bank's pursuit of price stability in the 1990s

¹ C L Stals, "The End of 1989: The End of a Decade" (Address at the Annual Gala Dinner of the French Chamber of Commerce and Industries of Southern Africa, n.p. 1 December 1989), 6.

² Ibid., 9.

³ C L Stals, "Curbing Inflation: Is Monetary Policy Enough?" (Address at a "Conference on Research Economics, Business Economics and Manpower", Vista University, Port Elizabeth, 30 November 1992), 2.

⁴ C L Stals, "Monetary Policy as an Anti-Inflationary Tool" (Address at the 13th Annual Investment Conference of Frankel, Kruger, Vinderine Inc., Johannesburg, 20 February 1990), 3.

⁵ C L Stals, "Economic Liberalisation and Growth Without Inflation" (Address at the "Investment in a Post-Apartheid South Africa Conference", organised by Smith New Court, London, 12 November 1990), 16.

⁶ C L Stals, "Monetary Policy and the Balance of Payments" (Address on the occasion of the Annual Dinner of the Cape Town Branch of the Institute of Bankers in South Africa, Cape Town, 30 November 1990), 4.

⁷ C L Stals, "Monetary Policy and the Balance of Payments" (Address at the "Financial Mail Investment Conference", Johannesburg, 26 October 1989), 3.

⁸ Stals, "Curbing Inflation: Is Monetary Policy Enough?"

⁹ C L Stals, "Interest Rates in South Africa: An Overview of the Factors Influencing Interest Rates, and the Rationale Applied by the Reserve Bank in Adjusting Short Term Interest Rates" (Address at a meeting of *The Weekend Argus*/Seeff Trust Investors Club, Cape Town, 1 November 1995), 9.

¹⁰ Stals, "Monetary Policy as an Anti-Inflationary Tool", 2.

¹¹ C L Stals, "Economic Prospects and Monetary Policy" (Address at a Business Dinner arranged by the South African Chamber of Business, Johannesburg, 20 June 1991), 7.

¹² C L Stals, "Changing Accents in Monetary Policy" (Address at the 85th Anniversary Dinner of the Institute of Bankers in South Africa, Johannesburg, 14 November 1991), 1–3.

¹³ C L Stals, "Monetary Policy and Inflation" (Address at the "Financial Mail Investment Conference", Johannesburg, 1 November 1990), 6.

¹⁴ C L Stals, "The Need to Fight Inflation in South Africa" (Address at a Luncheon arranged by Annabel's 100 Club, n.p. 26 June 1991).

¹⁵ C L Stals, "Aspects Related to the Regulation of South African Financial Markets: A Reserve Bank Perspective" (Address at the "SAFIA Conference on Financial Regulation", Johannesburg, 12 September 1990), 5.

¹⁶ R Jarro, *Quarterly Bulletin* (London: Bank of England, May 1995), 30–46.

¹⁷ Stals, "Monetary Policy as an Anti-Inflationary Tool", 2.

¹⁸ Stals, "Monetary Policy and Inflation", 6.

¹⁹ The global trend towards greater price stability also aided this trend.

²⁰ South African Reserve Bank, *Annual Economic Report* (Pretoria: South African Reserve Bank, 1994), 5.

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²¹ C L Stals, "Monetary Policy and Inflation" (Address at the "Financial Mail Investment Conference", Johannesburg, 1 November 1990), 10.

²² C L Stals, "Money Supply Guidelines for 1996" (statement, Pretoria, 24 April 1996), 6–7.

²³ Stals, "Money Supply Guidelines for 1996", 12.

²⁴ C L Stals, "National Monetary Policy Priorities and Financial Globalisation: The South African Experience" (Address at the Fourth Annual Emerging Markets Roundtable arranged by Euromoney Conferences, Hong Kong, 21 September 1997), 9.

²⁵ C L Stals, "Monetary Policy and Inflation Targets" (Address at the Annual General Meeting of the South Africa/Canada Chamber of Business, Johannesburg, 2 May 1996), 3.

²⁶ South African Reserve Bank, *Annual Economic Report* (Pretoria: South African Reserve Bank, 1995), 34.

²⁷ C L Stals, "Monetary Policy and the Financial System in South Africa" (Address at the Conference on Banking and Finance in Southern Africa, Somerset West, 25 May 1993), 5–6.

²⁸ C L Stals, "Money Supply Guidelines for 1994" (Pretoria, 25 March 1994), 2.

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³⁰ Stals, "Monetary Policy Challenges in South Africa", 12.

³¹ C L Stals, "Inflation Targeting as an Anchor for Monetary Policy in South Africa" (Address at a Breakfast Meeting of the Johannesburg Branch of the Institute of Bankers in South Africa, Johannesburg, 17 March 1999), 5.

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³² R J Barro, "Inflation and Economic Growth", *Quarterly Bulletin* (London: Bank of England, May 1995), 166–175.

³³ This was illustrated by the cut in the second-tier accommodation rate in June 1996. On the 25th of that month Absa bank surprised the other banks by announcing a 1 percentage point cut in its prime overdraft rate to 19,5 per cent after weeks of public criticism concerning the decision of the banks to raise their rate by 1 percentage point in May, even though the Bank rate had not been increased at that stage. Later on that same day, the Bank cut the rate it charged on loans granted under the second tier of accommodation from 17,5 per cent to 16,75 per cent without simultaneously lowering the Bank rate. Although the Bank took the view that the rate of growth of credit and the money supply at that stage did not warrant a reduction in the Bank rate, it was prepared to offer some marginal support to the downward trend in short-term interest rates at that stage by reducing the rate it charged on second-tier loans made available to the banks at the discount window. The move reduced the pressures on the profit margins of the banks at a time when the banks only possessed a limited amount of acceptable short-term paper used as collateral for borrowing at the discount window. The cut by the Bank was therefore designed to be a signal to the banks that it would welcome any move by the banks to follow the example of Absa, and cut their prime overdraft rates. Such a move indeed occurred the next day as the other banks came under competitive pressure to fall in line with Absa.

³⁴ For details of the new system, see South African Reserve Bank, "Discussion Paper on Monetary Policy Operational Procedures" (Pretoria: South African Reserve Bank, October 1997).

³⁵ Ibid.

³⁶ For a more detailed discussion of these issues see J H Meijer, "Reserve Bank Accommodation: The Money Market Shortage and Monetary Policy", *Absa Bank Economic Research Paper* (Pretoria, March 1997), 34.

³⁷ De Kock Commission of Inquiry into the Monetary System and Monetary Policy in South Africa, "The Monetary System and Monetary Policy in South Africa: Final Report of the Commission of Inquiry into the Monetary System and Monetary Policy in South Africa" (RP70/1984), 203.

³⁸ South African Reserve Bank. "Issue of Reserve Bank Debentures" (statement, Pretoria, 15 October 1998).

³⁹ At the beginning of 1998 the basic cash reserve requirement on banks in South Africa was fixed at 2 per cent of total liabilities. In addition, there was a supplementary reserve requirement of 1 per cent of the short-term liabilities of a bank on which interest was paid by the Bank at 50 basis points below the weekly Treasury bill rate.

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⁴¹ C L Stals, "Statement on Cash Reserve Requirements for Banking Institutions" (Pretoria, 4 August 1993).

⁴² C L Stals, "Monetary Policy and Reserve Bank Accommodation Procedures" (Pretoria, 7 March 1998), 15.

⁴³ Ibid., 16.

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⁴⁵ C L Stals, "Monetary Policy and Inflation Targets" (Address at the Annual General Meeting of the South Africa/Canada Chamber of Business, Johannesburg, 2 May 1996).

⁴⁶ C L Stals, "The Role of Monetary Policy" (Address at the "Conference on Growing the South African Economy", arranged by the Bureau for Economic Research of the University of Stellenbosch, 8 November 1996), 8–9.

⁴⁷ C L Stals, "Recent Adjustments in the Foreign Exchange Market" (Address at the "Tenth National and Second ECSAFA Congress of Chartered Accountants", Durban, 8 May 1996), 7.

⁴⁸ C L Stals, "National Monetary Policy Priorities and Financial Globalisation: The South African Experience" (Address at the "Fourth Annual Emerging Markets Roundtable" arranged by Euromoney Conferences, Hong Kong, 21 September 1997), 9.

⁴⁹ Stals, "Exchange Control: Just How Critical Is It?" (Address at the Europe–South Africa Business and Finance Forum, Cannes, 17 June 1996), 10–14.

⁵⁰ Stals, "National Monetary Policy Priorities and Financial Globalisation", 9.

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⁵² C L Stals, "The International Financial Crisis and South Africa" (Address at a Finance Week Business Breakfast, Johannesburg, 18 June 1998), 8–9.

⁵³ C L Stals, "The Importance of Credit Extension for Macroeconomic Financial Policy" (Address at a Breakfast Meeting of the Institute of Credit Management, Johannesburg, 29 October 1998), 9.

⁵⁴ C L Stals, "Statement at the 78th Annual General Meeting of Shareholders of the Reserve Bank" (Pretoria, 25 August 1998), 23–24.

⁵⁵ C L Stals, "The Challenges to Monetary Policy in Increasingly Volatile International Markets" (Address at a Conference on the South African Economy in a World of Volatile Financial Markets, arranged by the Bureau for Economic Research of the University of Stellenbosch, Johannesburg, 25 May 1999), 8.

⁵⁶ C L Stals, "Statement on Monetary Policy" (Pretoria, 10 March 1999), 3.

⁵⁷ C L Stals, "The Challenges to Monetary Policy in Increasingly Volatile International Markets", 9.

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⁵⁸ South African Reserve Bank, *Bank Supervision Department Annual Report* (Pretoria: South African Reserve Bank, 1999), 14–15.

⁵⁹ *Ibid.*, 17.

⁶⁰ C L Stals, “Proposed winding up of Cape Investment Bank” (statement, no publication details).

⁶¹ C L Stals, “The Importance of a Sound Financial System in South Africa” (Address at the Official Opening of the New Head Office Building of Investec Bank Limited, 21 May 1991), 1.

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⁶³ South African Reserve Bank, *Annual Economic Report* (Pretoria: South African Reserve Bank, 1993), 49.

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⁶⁸ C L Stals, “Achieving the Objectives of Financial Markets Regulation”, 9.

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⁷² C L Stals, “Risk Exposures for Borrowing Countries in the International Capital Markets” (Address at the “Conference of the South African Issuers and Investors Forum”, Johannesburg, 24 March 1995), 9.

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⁸² C L Stals, "Statement on Exchange Control and on the Forward Foreign Exchange Market" (Pretoria, 13 July 1995), 2.

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⁸⁶ Stals, "The Economic Outlook for South Africa", 10.

⁸⁷ C L Stals, "Monetary Policy Objectives for 1990" (Address at a meeting of the Seeff/Cape Times Breakfast Club, Cape Town, 26 April 1990), 3.

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⁹⁶ South African Reserve Bank, *Annual Economic Report* (Pretoria: South African Reserve Bank, 1993), 30.

⁹⁷ Dr J H Meijer expounded on this argument in an Address entitled "Monetary Policies: The Reserve Bank's Exchange Rate Policy" at the GATT Conference held in Fourways on 4 October 1994.

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⁹⁸ E J van der Merwe, "Forward Cover Transactions of the South African Reserve Bank", *Quarterly Bulletin* (Pretoria: South African Reserve Bank, March 1990), 34.

⁹⁹ This can be illustrated by an example. Assume that the Bank entered into three months' forward exchange contracts to sell dollars with a bank at a specified rate of $R3,50 = \$1$ involving \$100 000 (R350 000). On the maturity date it is assumed that the Bank opts to buy the foreign exchange from the spot market at the prevailing exchange rate which is, say, $R4 = \$1$, which compares with a spot rate of, say, R3,50 to the dollar at the time the forward contract was taken out. Under the forward contracts the central bank will be paid R350 000 for the \$100 000 it delivers to the commercial bank, but in the spot market it must pay out R400 000 to obtain \$100 000. This means that it incurs a loss of R50 000 on forward exchange account, while the money supply rises by R50 000.

¹⁰⁰ C L Stals, "The Outlook for Monetary Policy and Interest Rates" (Address at the 14th Annual Investment Conference arranged by Frankel, Kruger, Vinderine Inc., 12 February 1991).

¹⁰¹ C L Stals, "The Need for Foreign Capital to Support Economic Growth" (Address at the "Financial Mail Conference on Investment in 1995", Johannesburg, 28 October 1994), 11.

¹⁰² The Bank quoted its forward rates for dollars as a premium on the spot rand/dollar rate reflecting interest rate differentials between the rand and the dollar, and more particularly the fact that South African interest rates were higher than dollar interest rates, for example, assuming the spot rand was selling for R4,40 to the dollar while the three months forward rand rate was R4,43, then the 90-day forward rand rate would be quoted at a discount of 300 points. Alternatively, this premium could be expressed as an annualised percentage deviation from the spot rate. The percentage premium on the dollar could be computed with the following simplified formula:

$$\text{Forward Premium} = \frac{\text{Forward Rate} - \text{Spot Rate}}{\text{Spot Rate}} \times \frac{12}{\frac{\text{Forward Contract Length in Months}}{12}}$$

Thus, in the above example the three months' forward dollar rate stands at a 2,7 per cent premium on the spot rate, this being obtained by using the formula:

$$\frac{4,43 - 4,40}{4,40} \times \frac{12}{3} = 0,27$$

¹⁰³ C L Stals, "Recent Adjustments in the Foreign Exchange Market" (Address at the "Tenth National and Second ECSAFA Congress of Chartered Accountants", Durban, 8 May 1996).

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¹⁰⁷ C L Stals, "The Role of the Central Bank in the Economic Development Process in South Africa" (Address at a meeting of the Munich Association of International Affairs (n.p., 16 June 1992), 6.

¹⁰⁸ C L Stals, "Issues in Reserve Management: A South African View" (Address at the "City of London Central Banking Conference", 25 January 1993), 3.

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¹¹² C L Stals, "The Changing Pattern of South Africa's International Financial Relations" (Address at a Businessmen's Breakfast arranged by the Union of Orthodox Synagogues of South Africa, Johannesburg, 31 August 1995), 10.

¹¹³ Stals, "The Changing Pattern of South Africa's International Financial Relations", 8.

¹¹⁴ M Dean and R Pringle, *The Central Banks* (New York: Viking, 1994), 180–181.

¹¹⁵ South African Reserve Bank, *Report of the Operations of the South African Reserve Bank for the year ended 31 March 1998* (Pretoria: South African Reserve Bank, 1998), 113.

¹¹⁶ Stals, "Issues in Reserve Management: A South African View", 10.

¹¹⁷ Stals, "Issues in Reserve Management: A South African View", 6.

¹¹⁸ City of London Central Banking Conference, *Central Banking Journal III*, no. 4 (Spring 1993), 47.

¹¹⁹ C L Stals, "Remarks by Dr Chris Stals, Governor of the South African Reserve Bank, at the signing of a Syndicated Medium Term Revolving Credit Facility made available to the Reserve Bank by a Group of Thirty-Four International Banking Institutions" (Address, London, 22 July 1997).

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¹²² South African Reserve Bank, *Report of the Operations of the South African Reserve Bank for the year ended 31 March 1998* (Pretoria: South African Reserve Bank, 1998), 110.

¹²³ *Ibid.*, 111.

¹²⁴ P Mohr, "The Governors and Deputy Governors of the South African Reserve Bank 1921–2001", *South African Journal of Economic History* 16 (September 2001), 125–126.

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¹²⁵ P Mohr, "The Governors and Deputy Governors of the South African Reserve Bank 1921–2001", *South African Journal of Economic History* 16 (September 2001), 126.

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