Statement regarding South Africa's exchange rate policy and practices

Issued by Senator The Honourable O P F Horwood, Minister of Finance

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After consultation with the Reserve Bank and other interested parties, the Government has decided to accept the Interim Report of the Commission of Inquiry into the Monetary System and Monetary Policy in South Africa. As recommended by the Commission, a gradual and systematic process of changing South Africa's exchange rate policy and practices will be initiated immediately. The **eventual** aim of this process will be a unitary exchange rate system under which an independent and flexible rand finds its own level in well developed and competitive spot and forward foreign exchange markets in South Africa. In this system the movements of the rand will be managed through Reserve Bank "intervention" by means of purchases and sales of foreign exchange (mainly US dollars), and there will be limited exchange control applicable only to residents.

This eventual exchange rate system will therefore be one of "managed" and not "free" floating. In the nature of the case this will also imply that the rand will then no longer be pegged to the US dollar. The rand will then be an independent currency with an exchange rate largely determined by the state of South Africa's own balance of payments and domestic economy and not by the fortunes of another country's currency or by another country's economic or political developments.

Under the present international system of floating exchange rates it is obviously impossible for South Africa to maintain exchange rate stability with all other currencies. Our choice is either to float with the US dollar or another important currency or with a "basket" of currencies, or to float **independently** in accordance with our own interests. The Government has chosen **independent** floating as the eventual system. In the past this choice was not open to South Africa, because our foreign exchange market was not yet sufficiently developed. But we have now reached a stage where it is feasible and in the national interest to develop a foreign exchange market in South Africa in which the rand can move independently under Reserve Bank surveillance.

The Government also accepts the Commission's recommendation that this eventual system cannot be fully implemented at the present stage but can best be attained through a gradual process of adjustment. The manner in which the new exchange rate system will be put into operation and the time scale involved will be determined by the Reserve Bank in close consultation with the Minister and the Department of Finance. In determining the necessary procedures to give effect to the new policy, the Bank will co-operate closely with the authorised foreign exchange dealers. To this end, the Reserve Bank will hold discussions with the authorised foreign exchange dealers tomorrow.

It must further be noted that the Commission has made recommendations with regard to the appropriate exchange rate **system and policy framework** for South Africa and **not** with regard to any specific exchange rate for the future. The Commission is recommending neither a specific devaluation nor a specific revaluation of the rand. The task of deciding in which direction and how far the exchange rate should at any time be permitted or encouraged to move in the market, must be left to the monetary authorities to perform in the light of the prevailing circumstances. The Government subscribes to this point of view.

To give all interested parties full opportunity to make the necessary preparations for the introduction of the first stage of the new exchange rate system, both the foreign exchange market and the stock exchange will be closed on 24 and 25 January. As usual, however, the necessary provision will be made for smaller exchange transactions to avoid unnecessary inconvenience for travellers and others.

To initiate the above-mentioned process of change, the following steps will be taken:

1. For the present the Reserve Bank will still quote predetermined buying and selling rates for US dollars at which it will be prepared to enter into transactions with authorised dealers. These rates will not, however, be kept unchanged for long periods at a time as in the past, but will be adjusted more frequently to changing circumstances. Moreover, as the foreign exchange market becomes more developed and competitive, and improvements are effected in the system of communications between the different authorised dealers and the Reserve Bank, the Bank will lead the system in the direction of more genuine managed floating for an independent rand. As a starting point, the Bank's selling rate will remain at R1 = $1,148 6 and its buying rate at R1 = $1,151 5, with a middle rate therefore of R1 = $1,150 0.
2. In order to develop a broader and more active and competitive foreign exchange market in South Africa, in which the rand can later be allowed to find its own level subject to Reserve Bank intervention, the Reserve Bank will cease to prescribe mandatory buying and selling rates at which authorised foreign exchange dealers must conduct their transactions in US dollars with the public. Subject to the other rulings which will be laid down, authorised dealers will therefore be able to compete freely in the foreign exchange market.
3. To the extent that a need might arise for compensation to authorised dealers for declining profits on foreign exchange transactions under the proposed new system, it would, in the opinion of the monetary authorities, not be unreasonable for the authorised

dealers themselves, in the normal competitive manner, to levy moderate charges on those clients on whose behalf they incur costs in administering exchange control.

4. Authorised foreign exchange dealers will be allowed to maintain reasonable "open positions" in foreign exchange and to deal for their own account in foreign exchange within limits prescribed by the Reserve Bank. The authorised dealers will be requested to submit returns to the Reserve Bank at shorter intervals than in the past, so that their "positions" in foreign exchange can be kept under constant surveillance. In this regard the Reserve Bank, as recommended by the Commission, will prescribe two limits for authorised foreign exchange dealers:

(a) To control the exposures of individual authorised dealers and the banking community as a whole, as well as to protect the official reserves, the Reserve Bank will set an "open position limit" for each dealer for all foreign currencies together (both spot and forward) against rand, which that dealer must observe at the close of trading every day. This limit applies to the difference between the authorised dealer's assets and liabilities in foreign currencies, including **forward** assets and liabilities.

(b) To place an adequate limit on the amount of foreign exchange held outside the official reserves, the Reserve Bank will impose a second limit on each authorised dealer, namely a "spot against forward" limit. By this is meant a limit on a dealer's net **current** assets held in cover of net **forward** sales.

The Reserve Bank will base these limits for each authorised foreign exchange dealer on the latter's size (its capital base) and on its turnover in foreign exchange. Initially these limits will be relatively narrow, but it will be the intention of the Reserve Bank to expand them as soon as practicable in order to promote the aims of the new policy. Further details in this regard will be communicated to authorised dealers by the Governor of the Reserve Bank.

5. To provide further impetus to the development of a more active and competitive foreign exchange market, steps will be taken to expand the volume of foreign exchange transactions outside the Reserve Bank. The Government accepts the Commission's recommendation that the Reserve Bank should continue to market South Africa's gold bullion and to sell the dollar proceeds into the market as and when necessary. The Bank will also continue to handle the proceeds of its own borrowings as well as of loans by the central government. The Reserve Bank, in consultation with the Minister and the Department of Finance, will furthermore examine the practicability of channeling through the authorised dealers at least a portion of the receipts of sales of Krugerrands and diamonds, as well as of foreign loans to public corporations and municipalities, which at present accrue directly to the Reserve Bank. These steps should contribute greatly to the expansion of the supply of foreign exchange in the market outside the Reserve Bank and therefore to a better balance in the market. But clearly the effect of any such action on the Reserve Bank's cash foreign exchange reserves must be borne in mind.

6. The Commission's recommendations with regard to the forward exchange market will be implemented by the Reserve Bank as rapidly as possible. As pointed out by the Commission, however, the development of an active and competitive forward exchange market will have to proceed gradually. Initially the forward market will therefore still be administered by the Reserve Bank to a large extent. But the forward margins will in future be determined on a variable and increasingly more market-related, rather than a fixed, basis. As a first step the Reserve Bank will in future no longer quote a fixed **charge or commission** to be **paid** by both importers and exporters for forward cover and which therefore implies two different prices for the same forward dollars, namely one for importers and another for exporters. In future the Reserve Bank will quote **one** (middle) price for forward dollars of any specific maturity, instead of two as at present. This should help to attain a more balanced two-way cover in the forward market and therefore to limit the losses which the Reserve Bank incurs on behalf of the Government on forward transactions.

To begin with, the Bank's forward margin on US dollars will be set at a dollar discount (or rand premium) of 2 per cent per year, which would imply a middle rate for forward dollars with a maturity of one year of R1 = $1,170 0. This forward dollar discount or forward rand premium largely reflects the fact that dollar interest rates are at present higher than those in South Africa.

7. Authorised dealers will also be encouraged to "marry" forward sales and purchases as far as possible and, within the imposed limits, to cover their **net forward** foreign liabilities by holding **spot** foreign assets. To the extent permitted by the reserves, the Reserve Bank will endeavour to increase these limits in due course in order to encourage the development of a forward exchange market in South Africa.

8. In order to stimulate foreign borrowing by the private sector in the interest of more rapid economic growth, the intermediation of authorised foreign exchange dealers, to extend forward cover facilities to any foreign loans negotiated by the private sector with exchange control approval. Such cover will be provided only in respect of the rand-dollar exchange risk and preferably for a period of one year at a time.

9. The Commission's recommendation that the Reserve Bank should in future extend forward cover on foreign loans by public corporations and certain other bodies in the public sector only on the rand-

dollar leg of such transactions, leaving it to these bodies themselves, as in the case of private firms, to cover themselves in an overseas forward market against the exchange risk between the dollar and any other curency in which their loans might be denominated, is accepted in a modified form. Forward cover will still be provided to these bodies by the Reserve Bank, but the rate on forward cover against liabilities in the stronger currencies of the world, such as the German mark or the Swiss franc, will in future be set at a higher level than that in respect of the US dollar and other less strong currencies. The Reserve Bank will from time to time determine these rates in consultation with the Treasury.

10. The Commission's short term recommendations in respect of a more developed and formal dual exchange rate system than the present one (as a transitional measure) will not be fully implemented at this stage. Certain adjustments to the existing dual exchange rate system in South Africa will, however, be made. The official exchange rate will be known as the "commercial rate" and will be determined in the manner indicated above. The present "securities rand" will be transformed into a "financial rand" by expanding the uses to which it can be put by non-residents. As in the case of securities rand at present, the exchange rate for the financial rand will be determined by supply and demand. This adjustment must be viewed as a transitional measure and a further step in the direction of the long-term objective, namely a market-related unitary exchange rate for the rand.

The reason for expanding the possible uses to which the present securities rand can be put, is to promote the participation of foreign capital and skills in the South African economy. The present securities rand system in the nature of the case discourages such participation. Securities rand can at present only be used by a Non-resident to purchase quoted securities and the special Non-resident bonds of the Government. Funds for investment in unquoted securities and other capital assets at present have to enter the country at the official exchange rate, following which repatriation at that rate is blocked and is only possible at the securities rand rate (except if the funds in question are first invested for seven years in the above-mentioned Non-resident bonds of the Government). Repatriation at the securities rand rate entails substantial losses for the foreign investor, since the securities rand generally stands at a discount, at present of more than 40 per cent, against the official rate. By permitting non-residents in future to use financial rand for investments in certain other assets and not only in quoted securities, a strong incentive will be provided to them to invest more funds in South Africa, particularly since the dividends on their investments will be remitted at the commercial rate.

Capital flowing in along this route will not normally benefit the reserves directly, because one non-resident will in effect be buying financial rand from another non-resident, but will create new economic activity, employment and technical advancement. These matters are urgent national objectives to which the Government wishes to grant a high priority. Of particular significance is also the fact that any outflow of capital by means of financial rand will not harm the reserves.

The transformation of securities rand into financial rand will proceed gradually and under the management and guidance of the Reserve Bank. After consultations between the Reserve Bank and the authorised foreign exchange dealers, further details in regard to the new uses of financial rand will be made available. As recommended by the Commission, any expansion of these possible uses will be restricted to the purchase of a proprietor's interest in the broad sense of the term, as distinct from the provision of loan funds. In respect of all kinds of loan capital, the commercial exchange rate will be applicable. The Commission's recommendations with regard to investments by non-residents through the medium of financial rand is, however, accepted with the proviso that such investments will at this stage only be permitted after approval by the Reserve Bank.

The Commission's further recommendation that the proposed financial rand market be opened also to residents in an evolutionary manner, will not be implemented at this stage for administrative reasons. The financial rand market will therefore remain restricted to non-residents. Except for the above-mentioned adjustments and certain other small changes which will be announced later, exchange control will therefore be maintained in its present form for the time being.

11. As recommended by the Commission, Regulation 3(1)(f) of the exchange control, which restricts domestic borrowing by foreign controlled companies in accordance with a prescribed formula and which is considered by many to be a deterrent to both domestic economic expansion and the inflow of new foreign capital, will in future be applied selectively on a more flexible basis. Enterprises which desire to expand their productive capacity in South Africa, and also new foreign controlled undertakings, will under certain conditions be permitted to exceed these limits on a temporary basis.

The Government's acceptance of the main principles contained in the Commission's Interim Report must be viewed against the background of the official policy of economic growth with financial discipline. The application of this policy has now reached the stage where greater emphasis must be placed on more rapid economic growth. The Government accepts the Commission's point of view that in short-term economic stabilisation policy in South Africa the main emphasis should fall on conservative monetary and fiscal policy and general financial discipline, and that exchange rate policy can never be a substitute for such policy and discipline. In the long run, conservative fiscal and monetary policies aimed at making the rand a strong currency, will also have the most beneficial effects on the rate of real economic growth and on internal and external economic stability in South Africa. But the Government also accepts the Commissions recommendation that exchange rate policy should form an important part of official economic strategy designed to achieve the optimum combination of economic growth, balance of payments equilibrium and internal economic stability. And given the success of the official restrictive fiscal and monetary policy of the past three years, it is evident that greater emphasis must now be placed on economic growth.

Of particular importance to the Government in this regard is the consideration that under the present pegging system domestic economic policy objectives, such as the attainment of an adequate rate of economic growth and reasonally high levels of employment, often have to be accorded a lower policy priority than the defence of the existing fixed rand-dollar exchange rate. The implementation of the new system should afford the monetary authorities more independence in the application of domestic monetary and fiscal policies. Under the new system it should be possible for the authorities to follow a more consistent and effective anti-cyclical or growth policy by allowing the exchange rate to appreciate or depreciate to the extent necessary.

The introduction of the new exchange rate system therefore opens the way for the monetary authorities to apply such further measures aimed at promoting growth as may prove to be necessary. It is only about two months before my next Budget, when the economic situation and policy as a whole will again be reviewed. In the meantime, however, I consider it desirable to announce a further expansionary measure which I believe can contribute significantly to a higher growth rate without adding to inflation.

I believe that relief should be given to the tight cash position of many companies, and that companies in general should be helped to repay certain forms of costly financing. I therefore wish to announce that the repayments of loan levies on companies for the 1973 and 1974 income tax years will be advanced. The total amount for the two years taken together, including interest, will amount to nearly R160 million. Repayment will be made as soon as possible after 15 February this year. In the light of the exceptional success of the Government's loan programme to date, these repayments will not only assist in bringing the Government's financing of its budget deficit more in line with the targets set in my latest Budget, but will also improve the liquidity of companies and enable them to effect certain savings in financing costs, which to that extent should have an anti-inflationary influence on the price level of their products.

The general economic situation will be kept under close surveillance and, where necessary and desirable, further steps to promote sound economic growth will be taken in both the monetary and fiscal fields.