Statement with regard to the further development of the foreign exchange market in South Africa

Issued by the Honourable O.P.F. Horwood, Minister of Finance

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In its *Interim Report on Exchange Rates in South Africa* the Commission of Inquiry into the Monetary System and Monetary Policy in South Africa (the De Kock Commission) in November 1978 recommended an 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, subject to Reserve Bank 'intervention' or 'management' by means of purchases and sales of foreign exchange (mainly US dollars), but with no exchange control over non-residents and only limited control over residents."

In January 1979 I announced that these recommendations had been accepted by the Government, and immediately thereafter a start was made with the proposed evolutionary process of developing the foreign exchange market. Since then, good progress has been made on this road. In February 1983 an important further step was taken when the Government decided to abolish exchange control over non-residents. The next step now is to improve the technical functioning of the foreign exchange market still further with a view to paving the way for the possible further simplification and relaxation of exchange control at a later stage when the time is judged propitious.

As has already been indicated, the Reserve Bank will, in the implementation of this policy, introduce certain new exchange market arrangements as from 5 September 1983. I can now announce that these new arrangements will be the following:

The spot foreign exchange market

1. The Reserve Bank will in future pay the South African gold mines in US dollars instead of rand for gold supplied to the Bank. As in the past, the gold mines must sell the gold they produce to the Reserve Bank and the Bank will continue to handle the marketing of the gold. Like any other exporter, the mines will be required to sell all the US dollars paid to them to an authorised foreign exchange dealer in South Africa within seven days of receiving payment. Arrangements have already been made with the Chamber of Mines and the various mining houses to ensure that this transition takes place as smoothly as possible.

2. The Reserve Bank will no longer quote a spot exchange rate but will influence the exchange rate by technical "intervention" in the foreign exchange market, partly with a view to smoothing excessive fluctuations. Subject to such Reserve Bank "management," the exchange rate will be determined by demand and supply. The authorised exchange dealers will, of course, continue to quote exchange rates. The Reserve Bank will, on request, be prepared to quote a market-related exchange rate to its own clients, e.g. government departments.

3. The Reserve Bank's "intervention" in the market will take the form of purchases and sales of US dollars from and to authorised exchange dealers, normally at the Bank's initiative, at the prices they are quoting or at other prices agreed upon. In this way the Bank will counteract exchange rate movements in the market that it deems undesirable. The Bank reserves the right at any time to place a limit on the amount of any single spot exchange transaction it will be prepared to enter into at a given exchange rate, but the Bank may, of course, enter into as many subsequent transactions as it deems desirable. In addition, the Bank will not enter into any transaction for an amount smaller than US $1 million at a time.

The forward exchange market

The forward exchange market developed more slowly than the spot exchange market, mainly because the Reserve Bank was always willing to make exchange rate cover available to the market for unlimited amounts in the form of forward exchange contracts. These forward contracts were made available at the Reserve Bank's own spot rate, adjusted by a premium or a discount which was determined by the Bank itself and which was mostly equal to the difference between dollar and rand interest rates at that stage.

This system of providing forward cover has several important disadvantages:

Firstly, the Reserve Bank bears the exposure risk in respect of exchange rate changes for the account of the Treasury, in so far as the Bank does not have a "balanced" forward book;

Secondly, the forward and spot exchange markets are not integrated and exchange rate expectations, which are reflected in the forward book, do not influence spot exchange rates; and

Thirdly, forward exchange rates are not determined by market factors.

These problems cannot all be eliminated immediately. The following changes which will also take effect on 5 September 1983, should, however, encourage the further development of the forward exchange market and are aimed at the eventual establishment of an independent forward exchange market outside the Reserve Bank:

1. Authorised exchange dealers will henceforth no longer obtain exchange rate cover from the Reserve Bank in the form of forward exchange contracts, but will only be able to enter into swaps with the Bank in order to cover their forward positions in the market. A banking institution which, for example, sells forward US dollars to a client, will first buy the required dollars in the spot market and then sell them spot and buy them forward, preferably again in the market. If the banking institution is unable to conclude this second leg of the transaction in the market, it may approach the Reserve Bank to enter into a swap with the Bank. The buy-back transaction will therefore ensure that the banking institution will at a fixed future date be in a position tc obtain the required dollars at a predetermined price for delivery to his client in terms of the original forward contract. In this way forward exchange transactions will also influence the spot exchange rates and the two markets will be effectively integrated.

2. As in the past, the Reserve Bank will make available forward cover to authorised exchange dealers for periods up to 12 months and will, for the time being, also still quote margins (premiums or discounts on spot exchange rates) for such forward cover transactions on the Reuter Monitor. All forward cover transactions with authorised exchange dealers will, however, take the form of swaps. The Bank reserves the right to place a limit at any time on the amount of any single forward exchange transaction which it will be prepared to enter into at a given exchange rate, but the Bank may, of course, enter intc as many subsequent transactions as it deems desirable. The Bank will also not enter into any transaction for an amount smaller than US $1 million at a time.

3. In order to limit the Treasury's risk arising from the provision of forward cover, agreement has been reached with authorised exchange dealers that the Reserve Bank will allocate a quota to each dealer for the maximum net amount such a dealer can buy from or sell forward to the Bank by means of swaps. For the first year, i.e. from 5 September 1983 until 31 August 1984, the total amount of this exposure for all the authorised exchange dealers together has been fixed at US $10 000 million. On 1 September 1984 the amount will be reduced by one third and on 1 September 1985 by another third. The Reserve Bank's obligation to supply forward cover to authorised exchange dealers will therefore fall away on 31 August 1986. Thereafter, the Bank may, of course, still decide to intervene in the forward exchange market on its own initiative, but will be under no obligation to do so.

4. During the interim period the Reserve Bank will co-operate with the authorised exchange dealers to find methods to encourage the development of the forward exchange market outside the Reserve Bank. As a further step in this direction gold mines will already at this stage be permitted to sell in the forward exchange market part of their expected proceeds from the sale of gold, for a maximum period of 12 months.

5. These changes in the technical operations of the forward exchange market do not affect the forward exchange cover which the Reserve Bank, on behalf of the Treasury, supplies for periods of longer than twelve months to public corporations and government bodies. Such cover will continue to be provided to the entities in question on the same terms as before.

The Reserve Bank will remain active in the foreign exchange market, and will, particularly in the beginning, participate in the market, either directly or through the exchange brokers, in order to minimise transitional problems. Authorised exchange dealers and the mining houses have also been requested to keep the Bank fully informed at all times of developments in the market.