Statement on proposed changes to forward cover arrangements

Issued by Dr Gerhard de Kock, Governor of the South African Reserve Bank

8 December 1988

Gradual withdrawal of Reserve Bank from forward market

With the approval of the Minister of Finance the Reserve Bank will in the months ahead revert to the policy of orderly withdrawal from the forward market in foreign exchange that was interrupted in August 1985.

It will be recalled that such a withdrawal formed part of the recommendations relating to the foreign exchange market made by the Commission of Inquiry into the Monetary System and Monetary Policy in South Africa and accepted by the Government in August 1983.

The steps announced by the Minister of Finance at that time were designed to promote the development of a proper forward market in foreign exchange that was well integrated with the spot market and that functioned without the daily support of the Reserve Bank. The main advantages of such a market would be (1) that it would help to produce realistic spot and forward exchange rates, coupled with realistic interest rates, and (2) that it would greatly reduce and eventually eliminate the losses incurred on forward exchange transactions for the account of the Treasury.

In August 1985, however, the Reserve Bank had to discontinue its planned withdrawal from the forward market due to circumstances surrounding the proclamation of the foreign debt "standstill" at that time. Since then the Bank has provided substantial forward cover to the foreign exchange market by means of swaps based on the current spot rate for a maximum period of twelve months.

In the event, the outstanding forward sales balance of the Reserve Bank has increased substantially – partly due to debtors covering their foreign currency liabilities under the debt standstill and partly due to the large rise in payment commitments for imports since the middle of 1987.

As a result of the rise in the value of the US dollar against the rand during the first ten months of 1988, the Reserve Bank incurred severe but unavoidable losses on the forward cover book during that period. These losses were for the account of the Treasury and ultimately of the South African taxpayer. They also forced the Reserve Bank into the involuntary creation of cash reserves for the banking system and thereby contributed to the excessive increase in the money supply during this period.

To facilitate its gradual withdrawal from the forward market and to support the orderly operation of the spot and forward markets, the Reserve Bank will resume paying the gold mines in US dollars for their production delivered to the Bank so that they may place these dollars into the domestic market within the time limits prescribed in the Exchange Control rulings – at present seven days. The proceeds of the gold sales will be credited to dollar denominated accounts of the mines to be created in the books of the Reserve Bank and will be transferred to authorised dealers in foreign exchange from these accounts on instructions from the mines. The mines will also be allowed to sell the dollar yield of their known future gold production forward within specified limits.

The exact timing of the gradual withdrawal of the Reserve Bank from the forward market will be determined in conjunction with the banks involved. To avoid disruptive changes in interest and exchange rates the process will have to be gradual, and the Bank will retain the right to intervene in the forward market at its discretion at any time for normal central banking purposes.

For the time being the Reserve Bank will continue its present practice of providing forward cover by way of swap transactions to authorised dealers in foreign exchange to cover their overbought or oversold positions in respect of recognised commitments or claims in foreign currencies of their clients. A limit will be placed on these facilities, however, and the limit for each authorised dealer will be gradually reduced in terms of an agreed time schedule.

Preferential rates of forward cover against documentary evidence of foreign trade credits

In the meantime, as a temporary measure designed to counter the tendency for South African importers and exporters to switch from expensive foreign to cheaper domestic sources of finance, the Reserve Bank will be prepared to provide forward cover *at preferential rates,* through banks, for credit lines to fund imports. Such cover will, however, only be available against documentary evidence of the use of foreign credit lines, and provided that the maturity date of such cover matches the maturity date of the relevant underlying foreign finance. Such documentary evidence will normally be a usance letter of credit opened through the bank and providing for negotiation of the usance drawing by the foreign bank.

Similarly, exporters will be encouraged to use pre-export finance through the forward market at preferential rates. As in the case of imports, such cover will only be provided against documentary evidence of the use of foreign credit lines and provided that the maturity date of such cover matches the maturity date of the relevant underlying foreign finance. Normally, forward cover would not be required in the case of pre-export finance, but "offsetting" contracts will be allowed in respect of trade credit lines to fund exports, thereby enabling exporters to offset their currency risk for the period of such finance.

Long-term cover

(i) In order to encourage the use of longer-term finance for imports of capital goods the Reserve Bank will, with immediate effect, entertain requests for longer-term forward cover, which can also be denominated in other freely transferable international currencies in addition to the US dollar. This cover will be offered for the full period of such long-term finance (or the remaining period in the case of existing finance) and will match the maturity date of the underlying finance transactions. The cover will be offered at market-related rates.

(ii) To facilitate the conversion of funds caught in the debt standstill to longer-term loans as set out in clause 12 of the Memorandum to the Second Interim Arrangements letter, the Bank will also entertain requests from South African borrowers for long-term forward cover to coincide with the maturity profile for such loans. This cover will be restricted to US dollars only, but will also be available upon request for conversions already made prior to this announcement.