COMMISSION OF INQUIRY

into the

RAPID DEPRECIATION OF THE

EXCHANGE RATE OF THE RAND AND RELATED MATTERS

SANDTON CONVENTION CENTRE 2002.03.04

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CHAIRPERSON: Good morning ladies and gentlemen. This is the first session of the Commission of Inquiry into the Rapid Depreciation of the Exchange Rate of the Rand and Related Matters.

To start the Commission I wish to place on record the terms of reference of the Commission. They are as follows:

1. To enquire into and report on whether between 1 January and 31 December 2001 any person or any other juristic entity directly or indirectly entered into, concluded or caused any transactions, contributed or gave rise to the rapid depreciation of the value of the rand during the relevant period relative to other currencies.
2. Whether any such transactions were illegal or unethical or be it legal.
3. Whether any of the transactions in questions involved any collusion on the part of any person or juristic entity and resulted in any improper gain or avoided loss without in any manner limiting the scope and ambit of this enquiry, whether in respect of any of the transactions in question any -
    1. authorised dealer in foreign exchange deviated from the terms and conditions of its appointment;
    2. existing regulations and/or restrictions on the export of capital from South Africa were contravened;
    3. regulations and/or restrictions on the maximum period within which exports proceeds must be repatriated to South Africa were contravened;
    4. transactions were entered into that were in contravention of the letter or spirit of Exchange Control Regulations.
4. To advise the President on any relevant recommendations including -
    1. the effectiveness of the current administrative system of ensuring adherence to Exchange controls and other regulatory measures in guarding against the occurrence of such transactions and
    2. possible action that could be taken against any person or juristic entity identified as having participated in any transactions.

5. To advise the President of such other period before 1 January 2001 or after 31 December 2002 which the Commission considers necessary to be covered by this enquiry in order fully to report on the subject of this enquiry and lastly to submit interim reports to the President from time to time, the first to be on or before 30 April 2002.

The first witness to give evidence today will be Mr Robert McCauley of the Bank for International Settlements. Mr McCauley?

ROBERT McCAULEY: d.s.s.

CHAIRPERSON: You may sit, Mr McCauley. Mr Potgieter?

EXAMINATION BY MR POTGIETER: Mr McCauley, we have put before you a bundle of documents. Before you take the Commission through your abbreviated CV, have a look at the bundle please. You intend doing a slide presentation. You will find that on pages 1 to 69. There are printouts of the various slides and then also on pages 70 to 92 you will find the slides in a different format, a three slide page version of the document and then your CV on pages 93 to 98, your abbreviated CV on page 99 and an extract from the ACR Model Code on pages 100 to 108. Will you then in the first place take the Commission through your abbreviated CV which you will find on page 99 of the bundle. We will refer to the bundle as the expert bundle. In the first section you will notice, Mr McCauley contains your document. --- Thank you, Mr Potgieter.

Don't be too modest about your accomplishments. It is an impressive CV. --- Let me start by saying how honoured I am to be here on this occasion and I hope I can contribute to the clarity to the debate here in South Africa with my contribution.

I apologise for the length of the presentation but to introduction myself, I am serving the Bank for International Settlements as the deputy representative at the representative office for Asia Pacific in Hong Hong. Our notion of Asia Pacific does not generally include Africa. What we do there in Hong Kong is research on serving chief economist there and we hold meetings among central bankers and others interested in financial stability and among those meetings are meetings that focus particularly on foreign exchange market and these meetings as recently as last month can include central bank governors or those responsible for reserve management or those who actually manage foreign exchange desks at central banks around the world.

My education at the undergraduate level was at the University (indistinct) where I received a Bachelor of Science Degree. I did graduate work at Economics at Harvard University. I have had the pleasure of teaching international finance and the multi national firm and the Graduate School of Business at the University of Chicago and I have also enjoined teaching a course on international banking at Boston University.

In the 20 years of my career, I have consistently worked on the analysis of financial markets and public policy starting first at Federal Reserve Bank of New York where I worked for 13 years ending up as the head of the international finance department. Among my responsibilities at the New York Fed, on two occasions I was the lead economist to an interagency committee of bank supervisors who get together three times a year in Washington to rate country risk including I might say South Africa. I served as assistant secretary to the board of directors of the Federal Reserve Bank of New York. That board of directors had the responsibility of recommending changes in the discount rates to the federal open market committee and I took a lead in 1988 to serve as economist at the joined economic committee of the US Congress where I staged a hearing on the subject on the US Foreign Debt which has only got larger since then by the way. In 1994 I joined the BIS in Basel, Switzerland, and for three years it was my responsibility to write the chapter on foreign exchange markets, developments therein for the flagship annual report of the BIS and in 1998 as soon as the office opened in Hong Kong, I was first in line to leave Basel and go to Hong Kong.

I have published over the years in international and corporate finance. The most relevant in this context, I spent a good part of my time in Basel analysing the effect of the introduction of the euro on foreign exchange markets and Prinson University published a monograph in 1997 the euro and the dollar, it was my view that the euro would not start off as a strong currency as was frequently argued and in 1999 MIT published bullets changing US capital structures in 1980's and 1990's examining particularly the period the last recession in the US and there are many similarities indeed to current events in US financial markets.

With that overlong introduction, Mr Chairman, I am going to move on to the presentation itself.

MR POTGIETER: Mr McCauley, before you proceed, I know it is a bit if a hassle but you have to refer in each and every case when you turn to a new slide, please just indicate that ... the slides have been numbered and I believe that Mr Van Niekerk, the Secretary to the Commission, will assist you in this regard. --- Could you please turn to the second slide?

Let me having introduced myself, permit me to introduce the Bank for International Settlements. Some of you will know all of this. So forgive me.

It was established as an international financial institution established in 1930 and as a number of business lines. My colleagues in the banking department take deposits from central banks, monetary authorities and finance ministries around the world and invest those proceeds in the market and BIS balance sheet accounts for a substantial share of official international reserves, the foreign exchange holdings of entities like the South African Reserve Bank.

That is the profit centre as it were.

The law centre which I represent, is the monetary and economic department and we perform a number of functions including compiling and analysing statistics on international banking but in particular for this discussion, triennial survey every three years survey of foreign exchange turnover around the world. We publish the annual report in a quarterly review analysing events in financial markets and not least the big BIS is a host for meetings of central bankers and others concerned with financial stability and you may know the most famously I suppose is the Basel Committee on Banking Supervision, the Commission of G10 supervisors in the field of banking who have over the years elaborated a court for banks that are internationally active. A court is in the process of revision even as we speak. So that is the Bank for International Settlements.

Mr McCauley, in the second bullet point you referred to deposits accepted by the BIS. Please give the Commission an indication as to the extent of these deposits in relation to global foreign reserves? --- Well, as I said we have something between 5% and 10% of global reserves on our balance sheet that is somewhere between 150 and 200 billion dollars. You know that global foreign exchange reserves are approaching two trillion dollars, that is 200 000 billion dollars. So no one knows those deposits, mind you. We earn them every day. My colleagues in Hong Kong in the dealing room they are able to serve central banks in Asia Pacific which now have a majority reserves in their times and which is part of the reason why the BIS opened an office in Hong Kong.

Okay, you may proceed. --- Please the next, the third slide.

So I would like to give you more or less the outline of my presentation right now and give you an indication of how many slides will concern each topic and my outline is essentially given to me by the Commission. I have taken the liberty of rearranging the order of their questions, but otherwise I tried to stick to the questions that had been posed to me. So I shall introduce you to the global foreign exchange market and its participants. I shall then discuss the rand market and its participants. I will then talk about market norms; the ethics of dealers. I will then give you a very thumbnail sketch of the influences on exchange rates in the market place. I will then address in particular a question of contagion and the finally discuss exchange rate management with a view to responding to the Commission's question about foreign exchange intervention.

Continue Mr McCauley. Before you move off that slide, for the record, Mr McCauley, I have noticed that you are referring there to 68 slides. There are actually 69, the last one containing certain references. Is it correct that the slides have all been numbered, 1 to 69? --- Yes.

And in the case of the slides, the page numbers are exactly the same, they correspond. So if you are going to refer to slide 50, you will find it on page 50 of the expert bundle. --- Precisely.

Now if you permit me I would like to jump forward. My boss used to tell me we are not in the business of writing mystery stories here and with that in mind, I offer you slide 68, Conclusions, and the conclusions the first two sections, one conclusion can be drawn from the first two sections, is that in the global foreign exchange market, the rand market is not big but big enough. The foreign exchange market though unregulated, has developed norms, portfolio shifts including those accomplished through changes in leads and lags in the financing of imports and exports are among the most important short term determinate of foreign exchange rates. Contagion can take a number of forms and finally the argument for exchange market intervention, depends on the goals and the mechanisms through which the instruments might affect the exchange rate. So that is where I am going and with that I would like to go back to slide 4 where I take up the first topic the global foreign exchange market.

Now it just so happens that every three years the central banks of the world do a census as it were, a survey, of foreign exchange trading. So I know in South Africa you have regular monthly data on transactions volume but most markets, officials and market participants alike remain in the dark as to exactly how much trading is going on in the foreign exchange market in between these triennial surveys which occur in April.

This time around in 2001 no fewer than 48 central banks participated in the survey collecting data and turnover for the month of April. The survey covered both foreign exchange transactions and derivative transactions as well and importantly for this discussion, the survey explicitly has about nine different currencies in 1998 but then 28 in the year 2001 including the rand. So for the first time in 2001 we have some measure of the trading of rand outside of South Africa. Many central banks publish their own results as they compile them. In all the BIS, and this is really to take all the individual national surveys and put them together and it is a little more than just adding things up because a dealer in country A deals with another dealer in country B and you do not want to double count. So you have to eliminate the double counting and that is essentially the role of my colleagues in Basel. Can we see the fifth slide, please?

So what do we learn from this survey in its very broadest measure? What we see is after a stream of increases in foreign exchange trading over the years as far back as the first survey is even, the more partial ones before 1989, we see nothing but growth -growth in transactions that was faster than underlying growth in world trade but in the last three years that actually came to a halt and whether you measure it, however you measure the turnover and one can do it using exchange rates that vary over time or are fixed over time, but however one measures it, one comes to the same conclusion that foreign exchange transactions were actually reduced globally in the period 1998/2001. Could we have the sixth slide, please?

CHAIRPERSON: I think before you do, could you just give us the figure in billions of dollars which you tell us is the daily turnover? If you go back to 2001, could you just place on record what is that figure? --- Approximately 1,2 trillion dollars, Mr Chairman.

Thank you. --- So what does happen? Why do global trading in all currencies fall?

My colleagues have identified several factors that worked here. One is the introduction of the euro which all by itself eliminates transactions say between the French Frank and the Deutschmark.

In addition there was an introduction some years back of electronic trading and it increased its market share and it is not self-evident perhaps why electronic trading in the spot market can actually reduce transactions but think of it this way. The norm for an exchange market is sort of a hot potato market. One bank does a transaction for its customer and has a position but once unload and it typically does to another dealer and that dealer in turn passes it to another dealer as a hot potato and what happens with electronic trading is that it becomes clear where the market is. It is a little box where you see the transactions happening in real time. So the sort of price discovery that occurs in that hot potato trading, is sort of short circuited by the box and the box is operating in just one portion of the foreign exchange market but it nevertheless had an important fact.

A third factor is consolidation of market participants and that has two aspects really. 1. The dealer in the foreign exchange market themselves had the urge to merge and in addition their customers in many cases have also merged and I will sketch why that would reduce volumes in just a moment.

Frankly these explanations are in many ways too good because they suggest that trading should have fallen between 1995 and 1998 as well. The euro had not quite arrived by 1998 was very much in the market and the transaction volumes between French Frank and Deutschmark had already fallen quite a bit even in the run-up to the introduction of the euro and likewise electronic trading had been introduced really back in the mid 1990's.

So the fact that these factors were play in the earlier period and the earlier period did not see a decline in volume, suggested to me that primary emphasis should be placed on the factor of consolidation. Could you please turn to slide 7?

Now there are two aspects to the consolidation in the market for foreign exchange. First of all the number of dealers actually in the market declined and moreover the concentration among them, that is if you take an arbitrary number like 75% of trading and ask them how institutions you need to count down from the top to the institution that gives you the 75% of the total transaction volume, that number too has fallen quite sharply. Could we go to slide 8, please?

Now the number of dealers participating in the survey, fell. You see the numbers there are less than 2 000 in 2001 as opposed to over 2200 in 1998 and over 2 400 in 1995 and if you look at the number of dealers in major centres, you see quite a sharp drop of in the London market, the Hong Kong market, the Singapore market and the Frankfurt market. The DE is Germany. Could you please turn to slide 10?

MR POTGIETER: It is slide 9, isn't it? --- Sorry. Would you please turn to slide 9?

This is the evidence for the last ascertain, the number of dealers in the major centres declining. Could you please turn to slide 10?

Now the concentration as I said has risen and that is because you get major players that have merged. One thinks of Union Bank of Switzerland, Swiss Bank Corporation, two major forces in the foreign exchange market that merged their operations in the three years before April 2001. Likewise JP Morgan and Chase or Deutsche Bank and Bankers Trust, in all of these cases transactions that formally occurred between the merger partners, became internalised in the larger banking firm. So transactions go out of the market and instead remain within a corporation.

Interesting enough in Australia and South Africa where there is no change in the overall concentration of dealing, in both cases I believe it is quite concentrated in a handful of major dealers, the trading in the Australian dollar and the rand actually rose. So that gives a further piece of evidence for the view that consolidation is really the driving force in the decline in global foreign exchange transactions. Could you please go to number 11?

There you see the number of banks doing three quarters of the turnover declining particularly in the three years 1998 to 2001. All this is based on the simple survey done by central banks and compiled by the BIS. Could you please go to chart 12?

Now I would like to shift the focus a bit to talk about what actually gets traded in the foreign exchange market and then I will discuss who is actually trading in the foreign exchange markets.

The first two instruments traded globally, let me define terms. A spot transaction is a transaction for value two days from now equivalent value two currencies. It sounds simple though it can involve time zones and alike but the essence of a transaction in the spot market is an exchange of equivalents. The next instrument is the forward instrument and that is like a spot transaction. Only it is for a value date further in the future. It could be a week. It could be a month. It could be year. It could be several years. So essentially again currencies of equal value on those dates are exchanged. So it remains as a promise between the two counterparties until that day actually arrives.

CHAIRPERSON: So the value is fixed in advance? --- Yes, the value is fixed in advance and the exchange .. the rate of exchange between the two currencies in the forward transaction, will typically be different from the rate of exchange in the spot transaction and it will reflect without going into too much detail, the difference in the interest rates in the two currencies.

The final instrument to introduce is the option .. no, excuse me. The next instrument is really just a combination that as a matter of convenience market participants combine a spot transaction and a forward transaction in the same two currencies and that is called a swop.

MR POTGIETER: Before you move on to the option, the two days referred to in the first bullet, would that be two business days? --- Yes.

Finally now the option is the right but not the obligation to make a trade at some future date or before some future date at an agreed upon exchange rate. So since that the right but not an obligation to make the exchange, it has the character of an insurance contract. Could you please turn to slide 13?

So we interrogate the data collected by almost 50 central banks and asked which of these instruments is most used. Now the answer appears on this slide. The swops, the compound instruments are the most frequently used instrument in all currencies globally. Forwards are not so much used and actually it turns out that many times market participants that really want to have a forward, will do a swop and then dispose of the spot leg of that, reverse the spot leg of it. So they really do a swop and a sort of opposite spot transaction in order to be left with the forward.

MR POTGIETER: Mr McCauley, would all of these transactions, the spot, the forward and the swop, potentially affect the exchange rate of countries? --- Well, of these three the answer is yes for two and no for one and the spot and the forward have in principle similar affects on the exchange rate whereas the swop since it has basically a spot transaction for instance a purchase of euro against dollar spot and then that is reversed in the second leg of the swop. So the opposite transaction have not, since it combines transactions that are basically of opposite affect, in principle the swop taken in isolation would not affect the exchange rate.

It would be neutral in this regard? --- It would have two legs of equal and offsetting affect. Could you please turn to slide 14?

Now who is in this market dealing?

Well we do not break things down perhaps as in precisely the way that you might wish, but this is what we know that first of all the respondents to the survey, the reporting dealers, and these are parts of larger organisations typically and those larger organisations we might call banks, we might call them security firms, we might call them investment banks, in a few cases we even call them insurance companies.

MR POTGIETER: Would the reporting dealers include what we know in this country as the authorised dealers? --- Yes, I believe that would be the same group in this country. But I have to confess I am not best evidence on that.

Then there is a category other financial institutions. That would be most insurance companies, pension funds, mutual funds, unit trusts and alike and then there is the sort of non-financial customer base and that may be what you think of as the big participant in the foreign exchange market but that would be multi-national firms, it would be exporters, it would be importers, it would even be you or me when we are getting our foreign exchange to travel. Could you turn to slide 15, please?

In common with the number markets, it turns out that the market, the participants in the centre of the market themselves, the dealers, account for most of the volume. This is through equally in deposit markets, international banking, in the US treasury market as well. There is nothing surprising about the finding. Most of the transactions actually happen among sort of the professional in the market and the next largest group is the other financial institutions and they tended to grow over time as institution investors have become more active in managing their money and finally perhaps the players you think of first in the foreign exchange market, the gold mining companies, they actually are the smallest, come from the smallest share of transaction volume.

MR POTGIETER: Mr McCauley, visually it is very clear but would it be possible for you to put in percentages, if not immediately perhaps during the tea adjournment onto slide 15? --- I could provide you with that information. Slide 16, please.

So let me summarise. The big news, not a complete surprise in the 2001 survey was that global foreign exchange trading had declined. Not a big surprise, because there had already been lots of signs including lay offs of foreign exchange traders and I think what lies behind that is partly the modification as they say of the business, the fact that the electronic trading is, it is another case of the machine eating the man but in addition the fact that there were large mergers of market participants, that also eliminated transactions from the market place.

I might say that consolidation is also on the side of the customers themselves. So think of the case of Jeep, that is to say Chrysler being acquired by Daimler-Benz. Formerly there would be foreign exchange market transactions that came from the sale of a Jeep in Germany or the sale of a Mercedes in the United States. At least in principle now all of those transactions can be internalised in that single multi-national Daimler-Chrysler's treasury. So the consolidation on that side which has been a major theme of international business of course in the past several years, that also has reduced the demand by the underlying non-financial customers for foreign exchange transactions.

So that is the global perspective and I now propose to pass on to slide 16 and the rand market and its players and proceeding by comparison and contrast, we will see that things are quite different here in the rand. I should not say here in the rand since the rand is traded elsewhere as well, but in the case of the rand, we will see important differences i.e. the transaction volume actually growing the same sort of distribution of underlying transactors in the rand market but again a difference in the instruments of choice in the rand market will see that the swops are even more important in the rand than they are in currencies foreign exchange markets as a whole.

MR POTGIETER: Would it be correct to say that one should read the second bullet point on slide 16 and also your next slide on page 17 with the slide on page 5 where you set out the global foreign exchange trading in all currencies between 1998 and 2001? --- Yes, precisely. The structure of this presentation is to start off sort of with the perspective of the moon, looking at the globe and then come to earth and examine the rand which you still need an international perspective on the rand, but you can at least let some of the globe pass out of sight and yes we are proceeding in parallel here to the extent possible.

So to introduce the rand market and its players, it is again a different story on the transactions volume and also to consider trading in South Africa which is not the same as trading in the rand because there are transactions in South Africa that did not include the rand, for instance dollar against euro, and also there are transactions outside of South Africa that involve the rand. So we are talking about quite a different thing to talk about transactions volume in South Africa but focusing on that, this market has grown relative to that in the rest of the world .. I am sorry we should still be back on slide 16, the second bullet there. The foreign exchange rate in South Africa has gone from a third of a per cent of global trading in 1992 to 1995 to a half per cent in 1998 and 0,6% in 2001. So now we may pass to slide 17, please.

Now what I would like to measure in this slide is rand trading wherever it happened. But as I indicated at the outset, we only this year for 2001 rather, have transactions in the rand outside of South Africa measured. So I am forced in a partial measure here in order to get a perspective over time in what has happened to trading in the rand. So here we exchanged trading in South Africa in the rand and what we see again irrespective of the way we measure it or rather we take exchange rates as they were just at that moment in time or rather we sort of impose a fixed exchange rate, say the April 2001 exchange rate between the dollar and the rand. However we look at it, the rand trading in South Africa has grown and has grown quite sharply particularly in rand terms. May we pass to slide 18, please?

MR POTGIETER: Just before you do that. This is rand trading in South Africa. --- Yes.

Do you say then that prior to 2001 we do not have figures of rand trading offshore? --- That is correct.

Is that correct? --- Yes.

And since 2001 where does the figures come from? --- Well, again the .. all the other central banks in the world agreed to ask their dealers in London and New York how much rand trading they are doing instead of leaving the rand sort of in this other currencies category, pull the rand out of that category and gave it an explicit line in the reporting form.

And would you explain the bottom block there on slide 17? --- The blue bars essentially measure transactions in the rand at the exchange rate prevailing in April 2001. So that would be more or less at R8,00 per dollar, I believe, and whereas the red bars measure the rand trading in 1998/1995 and 1992 at the then prevailing exchange rate. So the red bar would give you a larger trading in 1992 because the exchange rate then might have been three and a half rather than eight. So you get a sharper picture of the growth at a single exchange rate because the trend in the value of the rand has been going down while the trading in the rand has been going up and those two things offset each other if you allow the measure to be taken at the changing exchange rate. But if you impose a single exchange rate, you see t he underlying trend in the trading more starkly.

Mr McCauley, in your heading you say "Rand trading in South Africa grew, however, measured". The words between brackets through April 2001. --- Yes, I wanted to remind and I can neglect this, but in this slide I wanted to remind you that this is a survey as a moment in time, actually 18 trading days in April 2001 and I did not want to leave you with the impression that any data on this slide demonstrate what happened through the end of the year. Again that transaction volume since April, I am not best evidence on that.

CHAIRPERSON: But this slide is saying that the daily turnover is 8 billion dollars as at April 2001. --- Rand trading in South Africa, exactly. Yes, Mr Chairman. If we could pass to slide 18.

Let us slip at this point. The conclusion of the BIS compilation again importantly including reports from London and New York. I do not think there is too much rand trading in Hong Kong or Singapore. So the global trading in the rand in April 2001, was running at the rate of 11,3 billion per day and it will be now that figure that I will slice up by instrument and by counterparty and as elsewhere, swops represented the biggest share of trading in the rand but with this difference that swops are actually larger in the rand, account for relatively larger share of overall transactions. Coincidentally 8 billion dollars of the total. 11,3 billion dollar rand trading about three quarters, 75%, whereas in the global for exchange market as you may recall from the previous slide, it was more like 60% that swops accounted for. So it is a somewhat higher use of swops in global rand trading and it is not obvious to me why that is so.

CHAIRPERSON: if I can just clear this up. That first bullet point is 11,3 billion? --- Yes.

To that we must add the 8 of the previous slight. Is that right? --- No, the 11,3 includes the 8.

Does it include the 8? --- Yes, that is global not offshore but global.

Global. --- I will come to slicing up that global total into the strictly onshore/offshore and the strictly offshore.

Thank you. --- But I am going to ask you to wait for that, Mr Chairman.

CHAIRPERSON: We will wait. --- Slide 19, just gives the visual confirmation of the preponderance of swop transactions in the rand and if we could go to slide 20, passed to rand trading counterparties and that is basically similar to the global foreign exchange market reporting dealers to more than half. Other financial institutions represent the next biggest chunk and the sort of where did you account for by the sort of non-financial customers represent something like a sixth of the total market. Could we pass to slide 21, please?

That looks very much like the parallel slide for the global foreign exchange trading in all currencies if you flip back and forth. It is hard to distinguish them.

Now let me pass, Mr Chairman, to offshore trading in rand on slide 22. The rand it turns out, and this was I think well understood by the professionals in this market even before this survey evidence came in to confirm it. But it turns out and we can say it is fairly precisely that the rand is quite an internalitionalised currency with significant trading outside of South Africa. As noted daily rand in South Africa it was running at about 8 billion dollars a day in April 2001 while the global total is 11,3. So we want to distinguish now as I mentioned earlier between the sort of onshore/onshore and the onshore/offshore and the offshore/offshore. That is not too barbaric a set of usage but .. if we pass to slide 23?

MR GANTSHO: Just before you pass, Mr McCauley, is it coincidental that the daily rand trading in South Africa at 8 billion dollars equals the swop share of global rand trading at 8 billion as well? Should I read anything in that coincidence? --- Mr Commissioner, it is precisely a coincidence and it certainly is not the case that all the transactions in South Africa are swop transactions for instance.

So this represents my second attack on this, Mr Chairman, and Mr Commissioner and Madam Commissioner, and I might be forced to revise this as I look at the numbers a third time but this is the way it looks now. We already knew by the difference between the 8 billion and the 11,3 billion that that implied the sort of outside of the measurement here in South Africa had to be 3,3 billion dollars in transactions every day and so that is the offshore bar on the right-hand side in the yellow colour and taking the South African Reserve Bank numbers on the transactions here in South Africa and taking out of that the transactions that are dealer reports here either with the dealer abroad or with a non-financial customer or a financial customer abroad, taking the sum of dealers here trading with somebody outside of South Africa, that is the bar in the middle some four and a half billion dollars of trading a day between dealers here in South Africa and either their counterparts abroad perhaps in some cases even affiliated counterparts abroad or unaffiliated customers and alike. So that turns out to be biggest chunk of the market which when you think about it we are talking about a foreign exchange market which is sort of for exchanges is a relation between two currencies issues by two different countries. Perhaps it is not surprising that the largest single category of transactions is between entities in South Africa and those abroad.

MR POTGIETER: Mr McCauley, in the three bars on slide 23, should then be added up to the 11,3 billion to get the global rand trading? --- Yes, sir I am worried because I am well-aware that there are accountants in the house and we all know the difference between an accountant and an economist is that the economist cannot be relied upon to do some addition and subtraction correctly. So I stand to be corrected but it should add up to 11,3 billion dollars and that leaves as a residual the onshore/onshore. That is the transactions reported to the South African Reserve Bank by dealers with their customers, with each other and with pension funds, assurance companies and alike here in South Africa.

CHAIRPERSON: Mr McCaley, I think because you are the first witness, you should explain the offshore transactions again so that we can understand that those do not pass through South Africa at all? --- Right that could be for instance a City Bank New York dealing with Nadvest London for instance or it could be two banks in London perhaps even more likely.

South Africa would not have a record of that transaction at all? Is that not correct? --- Mr Chairman, you are correct. It was not until the rest, the central banks involved in the survey sort of put their own banks through the extra hoop of reporting the rand transactions that that information becomes available to the world and to South Africa.

MR POTGIETER: And Mr McCauley could the yellow bar there the offshore transactions affect the exchange rate of the rand? --- Yes. Could we move on to .. (intervenes)

Will you please explain that? --- Well, there is sort of nothing in principle different about this offshore transaction. So if you accept that onshore transactions of the spot and forward variety might affect the exchange rate and I give you no place to .. (speaking simultaneously) denying that the same transaction that takes place in London makes no difference.

So all transactions in the rand and in all cases it could potentially affect the exchange rate? --- Absolutely and the offshore market that started earlier in the world economy, was the so-called eurodollar market going back to the 1960's and so it was really a previous generation of people at the Federal Reserve who had to come to grips with the idea that two foreigners transacting offshore might be affecting the value of the greenbag.

Would that be in order to investigate the rapid depreciation of the rand during 2001, the Commission would also have to investigate the yellow bar, the offshore transactions? --- I suppose that it depends on the nature of the investigation. If you have some questions, if you sort of would like to get at those sort of transactions, if you are asking other questions, you might not need to. Not sure is the short answer. Could we pass then to slide 24, motives for offshore trading?

The original offshore deposits in US dollars were set to by the Russians who were anxious to put their dollar somewhere where the US treasury could not get its hands on them and so at times the offshore market has this aura to it of people up there trying to stay outside the reach of the law and a friend of mine uses the analogy of offshore radio. I am not sure whether you have them in South Africa but if you have ever been in Los Angeles there are these radio stations that had been out of Tiwana from Mexico, that violate all the rules, too many commercials per hour, too high wattage. This is offshore radio. It is radio that sort of gets into your hears but your government does not have any handle on it. And offshore banking has some of that character, it is fair to say.

So let me address the general case. Offshore activity say in the dollar is interesting to market participants because of the courts that the US authorities place on US dollar transactions in the United States and these courts can be for instance reserve requirements which are much lower now than when the eurodollar market got going. There are also taxes, income taxes, transaction taxes sometimes, deposit insurance, all of these things can make it interesting specifically where you have got a transaction that is a foreigner who owns the dollars and they are ultimately going to be lent to some other foreigner. They can sort of meet in London and remove themselves from any of the US laws and regulation that might impose courts on them.

And also there can be risk of operating in a particular jurisdiction.

Again in the case of the United States, the US treasury has on occasion frozen the assets of four countries in the United States - the (indistinct) asset freezed at the late 1970's, comes to mind. And so that is an instance of sort of country risk where the fact that the laws of the United States govern the transaction in New York city, it might be something that you wish to avoid. So that is the sense of country risk. But there might also be a centre for offshore trading that comes, that is not really a preference for offshore trading *per se*. If you think for instance of an insurance company that has as its regular banker a bank that does not have any operation here in South Africa, and I know many major internationally active banks and so if you are a client of one of those that are not, you might well wish to deal with your regular bank and that might happen offshore. So let me give some examples of offshore rand trading on slide 25.

A mult-national firm that has either assets in or a stream of profits coming from its South Africa operations may wish to hedge that. They have a pretty good idea in terms of its budget of the expected profits from its South African subsidiary and it may wish to sort of nail down the value of that in the reporting currency dollars or euro or whatever by selling the rand forward.

Also portfolio investors - those who are sitting on a certain value of shares or even gilt-edged bonds here in South Africa, may wish to hedge up the exchange rate risk in those instruments.

There is also a certain amount of offshore activity related to the fact that various entities who sold rand denominated bonds in Europe largely, I think, to retail investors in Germany and the low countries and finally for instance hedge funds. That is loosely regulated investment funds that often relies part of their strategy on going long and short particular assets and sometimes employing a considerable amount of leverage that is to say one way or the other borrowing quite a bit of the money they are operating with. Hedge funds so defined or proprietary trading desk which are basically very similar entities that exist within regulating entities like large internationally active banks that is proprietary in the sense that they are dealing with their own capital for their own account rather than doing customer transactions. These kinds of entities too may wish to do an offshore transaction that might be at times to go along the rand and might at other times wish to go short the rand.

<u>CHAIRPERSON</u>: Mr McCauley, I think those expressions which you have used, could you explain them to us to go short and to go along? --- Certainly. Let me give you an example of the long. Say you are a proprietary trading desk and your analysis tell you to expect rands stability against the US dollar over some horizon of a month or three months for instance and then you compare the rand interest rates to the US dollar interest rates and you see that there is a difference say 10 percentage points between those two interest rates. Well, that might make it interesting for you to in effect make a deposit in rand in order to harvest that interest differential and in the process hoping not to lose that interest differential to an exchange rate change. But that sort of transaction I describe as a deposit say in a bank in rand but that can be constructed the equivalent transaction can be constructed in the foreign exchange market itself with somewhat greater ease and less strain on the balance sheet. So that would be an instance of an offshore entity going along the rand and these trades, the trade that I have just described to you, you may hear referred to as carry trades. You carry referring to the fact that there is positive carry that you are paid in interest rate terms to take that position. If it all works out, you might walk away with that whole interest differential if the rand remain stable and you put on that along position.

Now a short position by contrast would be similar to borrowing the rand and selling them spot against the dollar and then hoping to be able to buy back the rand at some time in the future at a more favourable exchange rate from your standpoint than you sold it the rand at.

<u>CHAIRPERSON</u>: So would you go short if your assumption is that the rand is going to decline in value? --- You need a little more than that given the interest differential, you need to think that the rand is going to decline more than so the interest differential would suggest, more than the forward rate is different from the spot exchange rate. But suffice to say that different players at different times are excluding both strategies.

And on slide 26 then I just have plotted for you BIS data on the outstanding volume of the rand denominated bonds that were sold as I say largely to retail investors on the continent of Europe. Some of these were sold as 30 year zero coupon bonds where you sort of buy the bond for R9,00 or R12,00 and look to get back R100,00.

So these were the fact that they were retailed for such instruments in rand, is sort of basically good news for South Africa to the extent that markets here all would have tendered a lower interest rate and long term interest rates in South Africa but the people that actually sold these bonds at the world bank do not actually want the rand liability and so there had been a series of complicated transactions and as part of that series of transactions, the investment banks will be hedging these outstanding bonds and so that generates an offshore activity as well.

If we can then turn to slide 27, I just want to draw out I think what we sort of already got into, the distinction between hedgers and sort of pure shorts and this is a moral distinction. This is just a factual distinction. So you can see a difference between say a multi-national that has basically a long position in South Africa has taken dollars or euros and invested those in a factory here and becomes worried at a certain point about the rand and wants to hedge that long exposure in the rand or you can see similarly how there can be non-residents who bought say shares on the stock exchange here or government bonds here and they basically have a long position in the rand and at times they would want to take out the exchange rate risk from that investment and those are people who would call hedgers.

The short transaction they are doing, say selling the rand forward against the dollar, is related to another transaction that they have done and in some measure cancels some of the exposure that the first transaction gave them. So these are people called hedgers whereas a pure short seller might be some investment funds that basically has no ongoing business with South Africa at all and they could put on the short basically looking to profit if the rand goes down and that kind of market operator we would call a short seller or naked short to distinct them from the hedger.

Sometimes I have described it fairly simply but it can be more difficult to tell in practice and of course sometimes short sellers will describe themselves as hedgers. Famously the very term for investment funds that engage in short strategies, hedge funds, is meant to suggest to you that in some sense they are hedgers as well. It would not do to call them by their real name, I suppose.

If we pass then to .. (intervenes)

MR POTGIETER: Mr Chairman, Mr McCauley is now going to move on to market norms for behaviour. Do you want to take the tea adjournment now or shall we press on?

CHAIRPERSON: If this is convenient, we can adjourn now. The Commission adjourn for 15 minutes.

PROCEEDINGS ADJOURN