IN THE HIGH COURT OF SOUTH AFRICA

(WITWATERSRAND LOCAL DIVISION)

JOHANNESBURG

CASE NO #

DATE #

In the matter between

Applicant

and

Respondent

BEFORE THE HONOURABLE MR JUSTICE #

ON BEHALF OF THE APPLICANT #

ON BEHALF OF THE RESPONDENT #

INTERPRETER #

SNELLER VERBATIM (PTY) LTD
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COMMISSION RESUMES

COMMISSIONER: Let's begin the afternoon session please. Mr Potgieter?

ROBERT McCAULEY: s.u.o.

EXAMINATION BY MR POTGIETER: Thank you Mr Commissioner. Mr McCauley you were, before the adjournment you were talking about the Jaguar Fund and the Yen. Will you please summarise your evidence on this topic and then continue with the next subject, which is exchange rate management. --- Happy to oblige. Just before we broke, we had been talking about different forms of contagion, some through trade, some through similarity of some variety and some that works through a particular investors' portfolios and things that impinge on those that force them to make adjustments elsewhere and in particular, the argument was that there were portfolios going into late 1998 that would both short the Yen and short the Rand and that the Yen trade went very, very badly as the Yen rallied and that forced these managers to trim back their positions elsewhere. And the process trimming back their position in the Australian Dollar and in the Rand, meant that they had to buy back those currencies and that led to a strong rally in those currencies that parallel bat in the end, for which sort of regular macro economic reasons, would not give you much of an explanation.

Yes, thank you Mr McCauley, will you then proceed. --- We are experiencing technical difficulties, so I will start using the old technology, belts and suspenders I think you call it. The last topic I was asked to address was the question of intervention, should the authorities intervene in the foreign exchange market and I am sort of stepping back from that question and addressing the more general question of exchange rate management which will include the question of intervention.

Yes Mr McCauley the Commissioners of course, do have the printed versions of your slides in front of them. --- Right.

For the record you are now slide 59? --- Precisely.

Please continue to mention the pages as you proceed. --- So the first observation to make is that the authorities in a few countries are indifferent, thank you very much, to the exchange rate. But why they are concerned or what objectives they have as they attempt to manage the exchange rate, differs and I will talk about six different objectives that are all represented around the world in terms of what authorities hope to get out of the exchange rate management and then once you sort of have an idea of what you are trying to accomplish, you then have various tools, various instruments to use to manage an exchange rating and one of those is the intervention. And then can't really decide the question of effectiveness but at least talk some about what, how it is that some of these techniques might or might not be useful in managing the exchange rate. So if you turn to slide 60, we will see the macro economic concerns and the first one in this, addresses the earlier question posed about the relationship between the inflation targeting or concern with inflation more generally, and the exchange rate. And this obviously varies across countries according to the structure of the economy, the degree of openness, that is how large imports and exports are in the economy. It also makes a difference to what extent the consumption basket includes traded versus non-traded goods and that varies in important ways across countries. So the first macro economic concern that might give rise to an attempt to manage the exchange rate in some manner, is to prevent depreciation from raising inflation to some unacceptable level. And actually this could be symmetric as well. There could be concerns in an economy suffering deflation, that a rise in the, the strengthening of the exchange rate could impart further deflationary impulses to the economy, lowering prices even more in an undesirable way. So I have stated this in this forum but it really can be stated symmetrically that whatever your inflation, your hoped for inflation outcome, can be challenged by the exchange rate. Another concern or objective that exchange management is that of competitiveness but this usually works in the opposite direction with the concern that your appreciation, the appreciation of your currency makes your industry uncompetitive. As we discussed before, that can happen, not necessarily because your own currency is rising against the US Dollars say, but it can happen just because your trading partners or your competitors' currencies are falling against the Dollar. So the notion of competitiveness is a multilateral concept, it is not just one exchange rate against another, it is sort of the whole pattern of exchange rate. But many authorities around the world worry when their currencies appreciate or when their competitors depreciate, they worry about whether they need to match them, to keep from losing market share, jobs and so on.

Mr McCauley please explain why an appreciation of the currency would undermine the competitiveness of exports? --- Well it is really sort of the reverse story, say you are sitting there a coal producer in Australia and all of a sudden the Australian Dollar goes from US cents 51 to US cents 75, you have some unpleasant choices under those circumstances. You can either lower your Australian Dollar prices in order to sort of maintain your US Dollar prices and take it on the chin in terms of your profit margin or you can try to continue to get the old price that you were getting in Australian Dollar terms for your coal and find that the Japanese power companies for instances are buying from your competitors and you are not moving the coal any more. And a third macro economic concern is when there are debts in an economy that are denominated in foreign currency terms. So if you went into 2001 in South Africa owing a lot of US Dollars, at an exchange rate of eight and you came out of 2001 with the same US Dollar debt at an exchange rate of above ten, suddenly you owe a lot more Rand on those Dollar debts. And particularly when it is the government that has borrowed in foreign currency, this concern may be particularly significant. Let me then turn to the next slide, slide 61 for review of the more micro or market type of concerns that may lead authorities to want to manage the exchange rate. And one thought is that, just don't like volatility in the market and so for instance, left to itself, the market might produce a distribution of exchange rate, changes at a daily frequency. So here is no change in the exchange rate or I say here is a 1% rise in the currency, here is a 1% fall, you might, some authorities see this sort of daily outcome of frequency, it gets them lots of days where the exchange is moving a whole percent. They find that to be unsatisfactory and so they may attempt to limit volatility in some fashion, so that the exchange rate changes a lot more like this. That is a concern over volatility and if you could actually do something in order to reduce the range of outcome so that the exchange rates never moves or hardly ever moves more than 1% in a given day for instance, that would be a concern over volatility and that is how it might change the outcome.

Could you explain why volatility would be bad for the exchange rate? --- Well views differ on this and I am not sure that there is always a well articulated concern for volatility per se. But the way someone once explained, the Bank of Canada used to intervene in order to just keep the thing from moving very much from the previous day and one, that was once explained to me, not by a Canadian by the way, as their attempt, it is like they were worried that they didn't really want people, punters, kind of gamblers in their market and they thought that by limiting the amount of money you could make by taking a position one way or the other in a short period of time, they short of chase those people away to some other market. Whether it would be somebody else's exchange rate, the equity market or the horse racing. That is one sort of half articulated view of why volatility per se is bad. And finally, I will lead that again, I am sorry. Another sort of rationale at sort of the market level for trying to manage the exchange rate is a concern over the possible loss of confidence and this is a word that is easier to use than to find but somehow the concern that the decline kind of feed on itself, that people begin to say: oh well the exchange rate has moved to a level I never imagine it would move to. Gee the chances of it bouncing back must be getting better all the time. That is a short of stabilising expectation sort of case but instead you look at it and say: gee this thing has moved a whole big figure in two days, I am worried that it is going to do that again in the next two days. So that rather than having some anchor of value that you think the exchange rate will kind of revert back to you, instead you will see movement in one direction and you imagine more movement in the same direction. That is the sort of situation that can kind of feed on itself and result in a loss of confidence. And the concern there is that people who would normally be out there to take advantage of a good exchange rate from their standpoint, say exporters, might be saying: well gee this is a really good exchange rate but I think if I wait until next week, it might be even better. So there is no sense hurrying in my sale of Dollars and then you get into that sort of lead and lags talked about before. So that is the kind of concern and there is a sort of third micro concern, it is about disorderly markets and this is a kind of term of art in US rationale for intervention for much of the last 25 years and a disorderly bargain actually sort of defined after a while. A normal foreign exchange market, if you sort of plot over time, and have here the rate, the exchange rate, what you see in normal times is that the thing evolves with a bid ask like this, I apologise over here but essentially this is the sort of pattern you get if you look at exchange rates at high frequency. The success of bids and asks are sort of laddered, you know sort of falling within the previous range. And one notion of a disorderly market is that instead what you get is this sort of pattern where here was a bid ask spread on sort of the last minute and here is the next bid ask spread that is out there in the market and then here is the next one. So rather than being a sort of nice continuous process where you are getting sort of little moves of the kind that the applications of physics to financial markets sort of assume, you are getting sort of discreet jumps in where the market is and you are also seeing the bid ask spread getting wider and wider. So if the bid ask spread is normally you know a tiny fraction of a percent, when the market gets disorderly, the dealers are kind of afraid of taking on the risk of taking a customer's order and the way they deal with that is by widening their bid ask spread, essentially charging more for the service of providing liquidity to the market. So a disorderly market can be this combination of gapping in the bid ask spreads, the widening of the bid ask spread and finally a sense that the market is only going one way. That there is sort of nobody on the other side. Those are kind of defining features of disorderly markets. So those are six reasons now, three macro and three more micro, about why you might care about the exchange rate and now if you then sort of move on and say: okay what do I do if I am worried about the exchange rate, we pass to slide 62. And in sort of descending order of rigor though one could debate the order, is what can be called open mouth policy, sort of a light reference to the usual open market policy that central banks engage in where they put money out against government bonds or in the repo market. So an open market policy is essentially just saying in public: you know I think this is an inappropriate exchange rate or I think a strong Dollar is in the interest of the US economy or this exchange rate seems okay to me but if it moves to fast, I think that is inappropriate. These are the sort of statements and you hear them all around the world all the time. And then.. (intervenes)

Mr McCauley are you referring to statements by for instance the central banker of a country or minister of finance? Who has this open mouth usually? --- Well it depends. In some countries, it is very much defined where the authority is and other countries not so well defined and sometimes when it is defined, it is the treasury secretary, the finance minister that everyone knows has the power to decide what the policy is and in other cases it is the central bank that really is out in front on that. And then sometimes that is all well understood and the president of the republic will say something as well. That happened in the Philippines last August, the President Aroyho said that she thought that 50 Pesos to the Dollar was a pretty good exchange rate for the Peso. It was then trading at more like 55 and strangely enough by the end of the year, it was down close to 50. So it depends.

Would it mean that statements by a person with some status in the market, would then be regarded in itself, as a mechanism of intervention? --- I would distinguish it from intervention. I am not sure what the commission meant in asking about foreign exchange intervention but I would use that term for something else, that has, that is putting your money where your mouth is and I would distinguish that from sort of the pure mouth case. But sometimes these are used together or successively as we will see. So then that brings us to the second possibility which is indeed intervention, which can be done either quietly or openly. It can be announced or it can be done in such a way that everyone in the market sort of is aware of it as soon as it happens. These are choices. And then sort of the next stage up is moving the interest rate, we talked a little before about how that might help the currency to raise the interest rate or if you are worried about your currency getting too strong, you could consider lowering the interest rate to try to manage it. And then finally, there is more of this in East Asia than many people would guess, you can impose or tighten or even just threaten to tighten exchange controls or capital controls of one variety or another. So those are sort of the choices, that is the toolkit and now we will talk about the, each one of them. Slide 63 takes us to open mal-policy and this is almost everywhere there is open mal-policy. It is very rare that people in authority are not talking about the exchange rate in some fashion or the other and you may know that in the United States it got boiled down to this, almost Montra repetition of the strong Dollars in the interest of the US economy but before that there were other things that were said and there may come a time when that is not said any more. And it may be most affective if there is sort of one person doing it and that is obviously a problem in Europe with the Euro, that there are various voices out there, finance ministers talking about the Euro, the central bankers is talking about the Euro, different Central Bankers from different countries talking in their own language, seeming to say somewhat different things. It may be inevitable in the case of Europe that there are different voices at this point. In Japan there is a guy who used to be called Mr Yen and he has a successor but his successor isn't quite called Mr Yen and it seems like you get a lot of statements out of a lot of different authorities about the Yen. But I think a point to be made here is that if all you ever do is talk about it, then after a while people may stop listening. That kind of appear talk strategy on this is cheap but after a while, it may not be very effective. So if we turn to slide 64, so intervention. And practice clearly varies on this in the Asian Pacific region. The New Zealanders haven't intervened since 1985 which actually preceded their embrace of inflation targeting in 1989. So they were sort of non-interventionists on the currency before they even defined for themselves the inflation target and regime in that case. So they haven't intervened but they continue to borrow money, Dollars mostly to have reserves and continue to have a buffer of reserves and they think about intervening occasionally and they do not exclude intervention. And that is the country sort of around the table in Asia Pacific that is most non-interventionist. Now how can intervention work? This takes us back a little to the exchange rate economics we talked about earlier. There is a school of thought that says the only way that intervention can make a difference, if it sort of changes the conditional probability, the sort of estimated likelihood on the part of the market participants, that the central bank is going to raise the interest rate. So if you are in there supporting your currency, all that does is tell people in the market in a sort of concrete fashion that the chances of your going onto the next stage of raising interest rates higher than it was before you intervened. That is called the signalling effect of intervention and frankly you know, you could do anything, would be a signal if you raised a red flag over the national treasury or over the central bank and that seemed to imply that it is more likely that you are going to raise interest rates if your record eventually showed that that red flag going up made it more likely that you were going to raise interest rates, that could be a signal too and the only thing that intervention perhaps has is there is this, it has got a profit and loss to it over some horizon and so you are putting your money where your mouth is. That may make this way of sort of signalling a little more effective than raising the red flag. But anyway that is a view, it is a widespread view, far from universal though. The other, another view, can accept that signalling mechanism but say: well there is another mechanism too and that is essentially the portfolio effect we talked about earlier. Just the sheer short of weight of the money makes a difference to the exchange rate, even if it doesn't change people's expectations that you are going to move the interest rate, the sheer fact that you are in there, you are buying, is offsetting the result of somebody selling. So that is another possible view.

COMMISSIONER: Do you mean they are central bank buyers? --- Yes. I mean it is tricky to measure right, because the central bank is likely to come into buy at a time when left to its own devices, the market is taking the thing down. So how do you measure even whether it is effective or not. How do you sort of construct the hypothetical of what would have happened after the central bank's intervention. You can imagine that this is not easy to argue under the best of circumstances and reasonable people differ on this. I would suggest that the portfolio effect might be stronger when you are talking about say the Korean one US Dollar than when you are talking about the Euro against the US Dollar just because the market and all the assets in Korea are kind of smaller in, so that what you do with the intervention is, you sort of, you are taking away local currency assets from people in the market and you are giving them foreign currency assets. You are buying in your own currency and you are putting out some Dollars that you had been holding in your reserves. So you are sort of changing the balance of assets in the two currencies and if the two assets are sort of perfect substitutes, then you have no effect. But to the extent that they are not, then you can have an effect through intervention. So this might work better in smaller markets than, a given amount might work better in a smaller market at least. And then there is a question, I guess you could pose this question before, sort of if you are going down these steps in sort of order of open mouth intervention, there is always the question of when do you move from one to the next and sometimes if you do a lot of intervention, after a while they decide that you are not really prepared to do anything else and they could push you harder. But you know it depends on the context. So the table on slide 65 shows .. (intervenes)

MR POTGIETER: Mr McCauley .. (intervenes) --- Please.

I have heard the concept: keep the markets guessing. What would the effect be should a central bank in a country, in advance, indicate to the market that it will not intervene to support the currency? --- Well the Canadian style of intervention to which I referred which the Canadians no longer do, was perfectly predictable. It was like they had a little rule book down at the Bank of Canada and there are probably central banks around the world who are quite predicable in what they do. I would say most finance ministries central banks do not have a, have not signalled to the market some very predicable response of theirs to any particular exchange rate development. So you know, for the ECB, the European Central Bank there it is a new institution and there were a lot of people wondering: well can they ever get their act together enough to intervene at all and they eventually did do so a couple of years ago but .. (intervenes)

But in the market where there is a depreciation of the currency, should a central banker in such a case signal to the market that the central bank will not intervene? What signal does that send to the market and what would the likely consequences be? --- Well I guess it depends on what you, how effective you think the intervention would be. If you put yourself in a world where the intervention doesn't give you any information about the likely change in interest rate policy by the authorities and you don't think the portfolio effect is meaningful or reliable, then I suppose, looking like you are not going to intervene, is not particular consequential. So it really depends on how you think the world works. As an empirical matter as I say, I don't think many central banks or finance ministries have in a sense promised the market not to intervene. So this table combines real data, that is the actual reports by the central bank in Hong Kong, Japan, Australia, with some guess work by a foreign exchange kind of consulting firm, their office in Singapore. So they have sort of a running count what they understand to have been intervention by the central banks of the named economies and, so that sort of gives you one sample for one period of time. This is sort of between March 2000 and December of 2001, a certain amount of guess work rather than hard data involved with most of the countries. But probably not too far off. So these are their guesses in some cases and the central banks own reports in other cases of how often the central bank is in the market buying or selling Dollars basically. In the case of Japan they bought some Euros too but the rest are intervening in Dollars. And what you see is the behaviour ranges from the very active central banks in the Philippines and Taiwan who seem to be in the market once a week, to the fairly, to the completely inactive, the New Zealanders with a group Japan and Korea, Hong Kong surprisingly enough and Thailand, you know fairly rare appearances in the market, if there is something like 260 working days in the year and you are in the market, 2% that is sort of like five times a year, you are in the market. The Australians have said that over the long haul, they tend to be in the market less than 5% of the day. So that is something like ten, 15 days a year the Reserve Bank of Australia characterises its own behaviour over the long time, as intervening. So clearly as an empirical matter, this varies. I don't have the US or the ECB on here. The US intervention has gotten rarer in recent years, whether because of the strength of the Dollar or policy remains to be seen, the ECB and the US would be sort of less than Japan, sort of in the one, in the 1% range or perhaps even lower. So that is what is done elsewhere for your consideration. So then we pass from intervention to slide 66, to the question of should you raise the interest rate to defend the currency.

<u>MR GANTSHO</u>: Chairman, Mr McCauley, let's turn the question around that Mr Potgieter asked. What are the constraints to intervening by the

Central Bank, when a currency is being attacked by supporting that currency. Leave aside the interest rate intervention. What are the drawbacks or constraints to that kind of intervention? --- Forgive me, let me make sure I understand your question.

Intervening by supporting the currency. --- Yes.

Buying the currency in other words. What are the constraints to such a policy? --- What are the constraints? Well you would like it to work. No-one likes to look ineffectual and central bankers and finance ministers are pretty normal people that way, and it is always hard to know ahead of time whether it will do the trick and it is almost impossible to tell after the fact what effect it has. So if there is that set of concerns, will I be wasting my time and then I suppose there is the question, will I be wasting money that enters into it. There is also a question for some, do I have the money and these East Asian countries that were on the table, many of them have very, very sizeable reserves indeed in relation to anything you want to measure it against, national product or the size of the monetary base or whatever. So questions of effectiveness, will you lose on it, do you have the wherewithal to do it in the first instance.

MR POTGIETER: If you don't have the foreign reserve, would it make sense under specific circumstances to borrow money, to strengthen your reserves? Then using these reserves to intervene? --- I would have to say that many countries do. Some combination of the central bank and the finance ministry and in some cases both, go out into the market to borrow foreign currency to add to the reserves. So that is a strategy widely followed. The new Zealanders do it and try to sort of minimise the cost of that by trying to get as close to the same return on the money that they are borrowing, as they are paying on it and that is clearly a constraint. If you are the Philippines, you are out in the market, you have to pay 4% or 5% for the privilege of borrowing money from the market and then putting that money back into the market in effect by buying treasury securities or whatever you invest your reserves in. So that sort of strategy has a cause to it which is the difference between the rate of which you are borrowing the money and the rate of which you are lending the money and that difference depends basically on your credit standing in the market and in extreme cases I think the Bank of England actually is able to sell some securities in foreign currency and invest the proceeds and actually make a positive spread on it, so that the cost of reserves can even, for a highly creditworthy economy, be negative.

COMMISSIONER: You were on slide 66. --- Slide 66 is raise interest rates to defend the currency. Now this is, as I described served on old central bankers, you open up the book and there it is, as the advice currency under pressure, raise the interest rate. So it is generally thought to be effective but it can have limits, that the limits were illustrated by the case of the Bank of England in 1992, they committed to holding an exchange rate against the Deutsche Mark and they were under attack and at one point in September of 92, they raised interest rates in a big step like three percentages point I think, all at once and what happened after that was kind of disheartening to those who had pursued this strategy because the stock market started rising and the stock market seemed to be betting that all these high interest were about to go away, that they couldn't sustain it and sure enough they did not sustain it. So there was a case where this, you know well regarded central bank, doing the sort of standard thing the play book tells you to do when your currency is under attack and in the end it got them nothing. And sort of the Monday morning review of this suggested they had two things going against them. One was that the UK economy was in recession and this was a problem because the interest rate policy being set in Frankfurt, reflected an economy that was not in recession. So there was that basic problem. And so raising interest rates in a recession, doesn't seem like something you are likely to sustain and then the second problem was that most of the household debt in the UK took the form of mortgages and the higher bank rate that the Bank of England was using to defend the Pound, was going to show up in the bills sent out by the mortgage banks, by the high street banks and the building societies rather, to two-thirds of the households in the UK. So you have now got a policy that says you are raising interest rates in a recession and moreover you are about to, in effect have a tax increase in the form of a higher mortgage payment by the households of the UK, most of whom debt was sort of fixed against the short term rates, rather than the longer term rates. So basically those sorts of forces, it is now thought, kind of worked against the effectiveness of this policy, even though the government went down that road and seemed willing enough. And more recently there have been some real second thoughts on this whole subject and it is illustrated by the case of Europe in the past say 15 months, faced with the common, in some ways challenge of the collapse of the tech business and slower world growth. On the one side of the Atlantic you have the federal reserve lowering interest rates aggressively in the course of the year 2001. On the other side you have the European Central Bank seeming to resist to lower interest rates kind of waiting to see the inflation drop before they would do it and generally seeming like they were less worried about whether the European economy got back to a growth path than their counterparts across the Atlantic. Without judging sort of who is getting the policy right, I am just saying that people in the market begin to think that really, the best thing for a currency is the prospect of growth returning to that economy and so raising interest rates or only slowly lowering them, might actually perversely hurt the currency rather than help it. So that is a pretty radical notion I have to admit, one that goes very much against the textbooks and everything they teach central bankers but there has been a suspicion out there that that is the way it is working actually. And that suspicion may be stronger in the case where the capital flows to a give country, are more in the way of equity than sort of people playing the interest rate differentials. If the way you are borrowing or getting in money from the rest of the world is people attracted by your interest rates, then it would seem sensible that a higher interest rate would make you more attractive as earlier said. But if the way you are getting money from the rest of the world is that they are buying your equity, then it may seem that an interest rate policy designed to help the currency, is actually not going to help corporate profits and not going to help the stock market and not going to make your shares more attractive to foreign investors. So places like Korea where the way the money comes into Korea is very much into the stock market, people sort of wonder at times whether the interest rates work in the way that we were taught. All that said, it is also the case that even if you think that the interest rates work in a qualitative sense, there is still the question of sort of how much is enough and there you can get into some tough tactical points. My colleague Bill White who used to be the deputy governor of the Bank of Canada, he said there were times when they sort of didn't want to raise interest rates and would do the intervention and watch the Canadian Dollar fall and then at some point they would say: enough of this and then they would raise interest rates. But they had waited so long by then, that they had to come in with a big stinker of an interest rate hike in order to really impress the market that they were serious. So there can be questions of timings and tactics even if you think the basic mechanism works in the advertised fashion. So that brings us to slide 67, we are getting close to the end ladies and gentlemen. And here the question is tighten capital controls as a way of trying to manage the exchange rate. Now capital controls or as you call them exchange controls, can take various forms. You can for instance restrict your domestic residence from borrowing in foreign currencies and particularly when your interest rates are higher than those abroad, you may have your corporate sector tempted to borrow in the Dollar and so you may restrict that. You can also make it difficult of impossible for non-residence to borrow your currency or equivalently to short your currency and you can also restrict the ability of your residence to buy foreign currency to some amount or another. So how do these work? Well what one observes typically that when you tighten there is the sort of immediate impact of tightening the non-resident ability to borrow or short your local currency. Typically you get a pop-up in the market when you do that. The Bank of Thailand did that a couple of years ago. The Bank of Indonesia did it a year or so ago and the typical, immediate response is in the direction of strengthening the currency. Now the longer term effects of such a policy are much harder to gauge and there is certainly an argument that by putting in such controls or tightening such controls, that you actually curb inflows. Now you may say: well we are just going to do this, we are not going to do anything else, but people in the market may worry that having done one thing, you are more likely to do another. There is also the consideration that in general people think that such policies become harder to enforce or less effective over time. One way of measuring the effect of such policies is the difference between interest rates on shore and interest rates off shore and that is a standard measure of the effectiveness of such controls. So I draw your attention to the conclusions again on slide 68. In the huge global foreign exchange market the Rand market is not a big one but it is big enough and though unregulated, the foreign exchange market has development norms, portfolio shifts, including those accomplished through variations in the financing of imports and exports, can have an important effect on especially short run evolution of a currency's value. A contagion is a strange phenomenon that several forms and finally the argument for exchange rate intervention depends on sort of what you are trying to accomplish in the first place and how you think the world works. So that Mr Chairman, I close my presentation.

MR POTGIETER: Mr McCauley just before you sit down, you may need the clip chart for this one. I think you are aware of the statement made by the Governor of the South African Reserve Bank in October reinforcing exchange control. Now I do not expect you to involve yourself in the domestic affairs of the country in this regard but during consultation you did have an interesting perspective, that I thought the Commission should be aware of, to the effect that statements such as this one, may have reduced liquidity but it also took out people who sold short in the market. Could you just explain that? --- Well such a policy as I have indicated in one of the later slides, has sort of an immediate effect, assuming the policy is sort of effective in its implementation. I mean you can say you are going to do something and not do it but assuming you say you are going to do it, and you proceed to do it, I think you get several effects. To the extent that there were shorts in, that were outstanding on your currency and to the extent that the tightening of the controls forces those short positions to be closed out, then presumably via the portfolio effect as to the way the money effect, then you relieve pressure on the exchange rate and that can lead to this short term pop that is often observed at such times. So that is the one effect and the other effect may be that you are scaring people away from the market over some horizon who might have been there otherwise. I think typically what you will find in the wake of such measures is that the transaction volume may fall in the market and the sense of the liquidity of the market, there may be a change thereto, that the market is less liquid. And a market being less liquid, sort of by definition, means that a given transaction can have a larger effect in such a market. So to the extent that you focus on general liquidity, you can get a decline in liquidity after such a measure and that, considered all by itself, can give you a larger reaction to subsequent transactions that go through the market. But I mean, yes the question is whether a less liquid market sort of explains a subsequent decline in the exchange rate and I guess that is a bit problematic. A less liquid market may mean that whatever flows go through, have more effect but that leaves the flows and their balance between supporting the currency and depreciating the currency, sort of left unexplained.

Would it be fair to say that whether a statement such as that had a negative effect on the currency, would depend on the facts? One can't make a general statement in this regard. --- I think, yes I mean the size of the initial pop for instance, may depend on how large were the short positions that have to be closed out under the new regime for instance. It is often forgotten that when the Malaysian Central Bank on September 1 1998 announced that they were imposing capital controls and that the Malaysian Ringgit subsequently appreciate considerably after that. That is often forgotten. So there is the question of the size of that initial pop and then the question of how much liquidity has been reduced in the market as a result of the new regime and yes, I think there are serious questions of fact there.

Then in the last place Mr McCauley you refer to four very minor errors in the slide printouts. Do you wish to correct them? The Commissioners may want to make a few notes on that? Do you have them there with you? --- Yes, perhaps we could.. (intervenes)

Ja, could you just have a look.

MS QUNTA: Could I just go back to that question that was asked now, before you go onto another one. You were asked the question relating to the announcement by the Reserve Bank on 14 October and you indicated that it will certainly make the market less liquid but whether or not it would have an impact on the exchange rate to the extent that it would depreciate the Rand, would be a bit problematic, that is the word you used. And then you were asked another question from Marius Potgieter and I am not sure whether Marius meant with that question whether that statement, the latter statement was general and that it depends on the fact. Were you referring to that particular statement or something else?

MR POTGIETER: As I understand it Mr McCauley one can't without investigating the facts, one won't know what the effects of such a statement would have been. It depends on the facts.

MS QUNTA: So are you in effect disputing what he is saying.

MR POTGIETER: No I am not disputing, I am just asking questions. I am not disputing anything.

COMMISSIONER: You are saying Mr McCauley got a general proposition and it depends on the facts, what applies to the general proposition.

MS QUNTA: We will leave for now. --- If I could try to restate my position as clearly as possible, it would be this that typically the immediate impact of such measures is a short term appreciation of the currency, that may reflect the sort of weight of money being removed as short positions are closed out. Then there are sort of longer term affects which may be to leave certain players less inclined to transact in the market or even to invest in the underlying assets and that may reduce liquidity. The reduced liquidity more or less by definition means that a transaction of a given size, can have a bigger effect but does not explain sort of why the transactions are coming in with sort of in one direction, enough to explain a subsequent declined, just sort of all by itself.

COMMISSIONER: Any further questions? Mr Potgieter?

MR POTGIETER: Do you want to refer to those corrections Mr McCauley. --- Ja I would say on slide 20 all currencies should be separated. On slide 42.. (intervenes)

COMMISSIONER: You are going too fast for us.

MR POTGIETER: Slide 20? --- Slide 20, all currencies should be separate and slide 42 give should be replaced by gave.

Just refer to the bullet points on the particular slides. --- I am sorry about that Mr Chairman.

COMMISSIONER: Just take us to slide 20, you lost me. Slide 20, which bullet point must we change? That is just the all currencies as two words. --- Yes please.

Right thank you and then? --- Then slide 42 give should be gave.

MR POTGIETER: That is the third bullet point. --- Third bullet point thank you.

Right. And then? --- That is all, thank you.

Is that all?

COMMISSIONER: Any questions from the Commission?

MS QUNTA: I wanted to go back to what you said right at the beginning of the presentation, where you mentioned a certain instrument that were used. I think it was slide 18, where you deal with (indistinct) and it may be not a fair question because you have already explained that you don't quite understand why in South Africa and I recall that you said it is 75% of the time swops are used whereas in other countries it is less than 60%. Now your original slide, I think you amended this slightly. I noticed that because I have seen your, because I have read over the weekend your earlier slide but be that as it may but what we put, I know that you don't know, but are you able to speculate why and I know you know a little bit about our market. And if you can't answer, just say that. --- No you have, I am certainly not best evidence on this. There are other people in this room no doubt who have better answers than I but one way of looking at the swop is a way of moving liquidity around from one institution to the other and so it, one place to look would be whether the exchange controls themselves somehow create incentives for (indistinct) that activity. It can also be that the, to a considerable extent, the banks that sort of have the liquidity which would be the banks with big deposit basis here, are more different than in some markets from the banks with whom the ultimate customers want to deal and so there is more need to get liquidity from one set of institutions to another. But you have a sharp eye Madam Commissioner in noting that I did have a speculation in an earlier draft of the presentation. I removed it not because I thought it would give offence but because I thought others would have a better idea and I would do you the most service by simply noting the difference in passing. I certainly don't mean to suggest that there is anything sinister about the difference at all.

No that is fine. I am not suggesting that.

<u>COMMISSIONER</u>: Are there questions from anyone else in this room in regard to this witness?

<u>MR LOXTON</u>: Mr Chairman I don't want to ask a question, I want to get a direction from you.

<u>COMMISSIONER</u>: Yes.

<u>MR LOXTON</u>: Are you going to permit people here who represent interested (indistinct) to put questions through you from time to time, to witnesses?

<u>COMMISSIONER</u>: Yes in terms of the regulations, an interested party has the right to cross-examination.

<u>MR LOXTON</u>: But always through to Mr Chairman or.. (intervenes)

<u>COMMISSIONER</u>: No, the regulation talks about the right of cross-examination. So although that may not be what you want to do, you can

ask questions, so long as you can show an interest.

MR LOXTON: Thank you Mr Chairman.

COMMISSIONER: Pleasure Mr Loxton. Anyone else? Thank you Mr McCauley you are then excused, I know you are catching a plane tonight. On behalf of the Commission, thank you very much for coming from Hong Kong and spending time with us. We appreciate your input. --- You are welcome Mr Chairman, thank you.

NO FURTHER QUESTIONS

All right, Mr McCauley is excused. The next witness is Mr Gouws?

MR POTGIETER: Yes Mr Commissioner I call Mr William Gouws, and Mr Commissioner while Mr Gouws is setting up shop, Mr Gouws is an economist and he gives evidence as an expert in regard to a number of economic and exchange rate inter-relationships and he will deal with the role which the economic policies play in the long run course of the exchange rate. I call Mr Gouws.