PROCEEDINGS RESUME

MR BROOKS: Mr Gouws Commissioners will also give evidence with reference to slides. You have a bundle of documents in the file before you, it is the second sub-bundle and there are slides 1 to 24.

CHAIRPERSON: I see these documents are not paginated. I think that after the adjournment and before we carry on tomorrow we should just paginate these following on from the previous last page which was 108.

MR BROOKS: Very well.

CHAIRPERSON: So that we have one expert bundle numbered throughout.

MR BROOKS: Unfortunately the documents were received late on Friday and early this morning, additional documents.

RUDOLPH PETRUS GOUWS d.s.s.

CHAIRPERSON: You may be seated.

EXAMINATION BY MR BROOKS: Mr Gouws would you please briefly take us through your CV? --- I obtained a masters degree in economics from the University of Stellenbosch in 1971. I worked at two other banks. In the early seventies I became chief economist of the Nedbank Group in 1979. I joined Rand Merchant Bank in 1986 as the chief economist and director of the company. I am since the beginning of this year an extraordinary (?) professor of economics at the University of Stellenbosch. I am a member of the National Economic Development and Labour Council's Monetary Policy and Government Finance Chamber and I chair the Economic Policy Committee, of Business South Africa, which is the umbrella body of organised employer bodies in South Africa.

Mr Gouws thank you. Mr Gouws, you have provided us with a statement on the evidence you will be giving, with reference to slides. Could I please ask you to take us through your statement with reference to those slides. --- Thank you Commissioners. With your permission I will just read the introduction and summary from the prepared pages which I have provided to the Commission and then I will be doing the presentation in a sort of casual way after that.

"The request to me was to describe and explain a number of economic concepts and inter relationships to provide a long-term historical backdrop and to describe the role of economic policies in the long run course of the exchange rate. At the request of the Commission much of the presentation is therefore not strictly relevant to its terms of reference but is rather meant to provide background information and add to general economic understanding. However, my brief was also to describe and explain the specific economic setting in which the pressure on the rand developed late last year. Of direct relevance to the commission's work, is therefore the conclusion which you will find in section 4.1 of the testimony, that there was an extraordinary, let us call it, confluence of factors and forces that impacted on the currency from early September onwards.

Firstly some of these affected the currency via their impact on the current account of the balance of payments, but more importantly did so via their negative impact on confidence and on expectations on capital flows. Secondly a sudden reduction after mid October in an already low level of market liquidity meant that market participants' efforts to protect themselves against currency depreciation had a disproportionately large impact on the exchange rate.

While it is possible that some market participants may have taken, perhaps illegal or unethical advantage of the prevailing circumstances, the sharp decline in the currency was the result of economic political policy and confidence factors and forces that had built up over a number of months. These impacted on the currency via thousands of decisions by market participants. To attribute the fall in the currency to any specific transactions would therefore be very difficult and perhaps pointless in the light of the magnitude and the complexity of the developments late last year."

The testimony is divided into five sections .

Sorry, Mr Gouws can I just ask you, whilst reading from your statement, the last paragraph, you said that what contributed was these factors that built up over a number of years and in your statement you also have a reference to - "and not the actions of a few market players". --- Hmm.

Now, you did not state that in your evidence. Did you purposely, did you just miss that or did you purposely not refer to that? --- I am not sure that I am with you, unless the copy I am reading from is an earlier draft of my paper.

Oh I see.

CHAIRPERSON: The copy we have got has got this phrasing "and not the actions of a few marketplaces". I think you would have the later, I might have an earlier copy here for some reason or other.

MR BROOKS: Can I just show you. --- May I just explain Commissioner, my secretary typed out - printed out a few copies for distribution later this morning, and she might have done so from an earlier version.

I see, well, just look at the ... (intervenes) --- Oh.

The third paragraph the third line you say:

"The sharp decline in the currency was the result of economic political policy and confidence factors etcetera, and not the actions of a few market players."

--- Ja.

Is that statement correct, because you did not refer to that statement in your evidence. --- This is indeed the version that I put forward.

Thank you. --- What I have is an earlier one I am afraid.

CHAIRPERSON: Yes, let us move on. You were saying that your testimony is divided into five sections? --- Yes. It is divided into five sections. In the first one I will be putting forward two frameworks for thinking about exchange rate movement. In the second one I will be showing some recent international developments. In the third one I will be considering what I have called there some long run drivers of the currency under two headings. Firstly the balance of payments and then the second one also inflation differentials. In the fourth one I will be putting the rand's recent fall into perspective which I will then do under several headings. The first one would be a listing of, and a linking to the exchange rate movements in so far as one can do that, of the events since July of last year. The second I will then deal with trends and what economists call the real effective exchange rage and then in the third one I will be looking at the links between the rand and foreign direct and investment and then finally I will be drawing a number of conclusions.

Thank you. --- Is it okay if I sat sir?

CHAIRPERSON: Yes, whatever makes you comfortable. --- Thank you. I will kick off then with what I have called a little framework for thinking about the exchange rate and let us then perhaps consider what some of these forces might be that has an impact on the currency and Mr Chairman I apologise for the perhaps pedantic level at which the first slide is done.

In the first place I would perhaps just make the point that what happens to the currency is literally the result of millions of decisions that are taken by a variety of players. First would be individuals. Not just whether they buy important goods or not, but literally any transaction that they do very indirectly and at least in theory has an impact on the country's balance of payments which I will explain later on and also of course what they do with their capital, whether they prefer to keep their savings domestically, whether they prefer to diversify their portfolios with some international assets.

Then South African corporates. Exporters, as we heard from the previous expert witness, and I must just say to you I thought what he did will in fact shorten what I will be saying to some extent. I think he has covered the ground very well from my point of view. Whether exporters decide to accelerate or take longer over bring back export proceeds, whether importers decide to take cover or not and then decisions which corporates take about foreign direct investment.

Then the actions of local banks, as we have also heard this morning, and that you will be doing, I am sure, in the course of the next few weeks. Then institutional investors, whether they decide to use up the limits that they are allowed to do in terms of international investment or not and then a range of things which the Government does, that is whether it borrows abroad or not, how quickly it privatises, what sort of capital that brings into the economy, what its tax policies are the extent that those impact on domestic and foreign investors' decisions to invest in the country or not, the expenditure, for instance the arms transactions and then socio- and political decisions which have an impact on the environment in which players find themselves.

So those then the decisions taken by South Africans, we can now say more or less the same thing about foreign participants and again, as I am grateful to Mr McCauley for he has explained quite a bit of the intricacies of this. Clearly decisions which foreign banks take whether they want to be in our market at all or not, and if they are, what sort of transactions they do.

Foreign corporates whether they invest in our country or not. Foreign institution investors whether they want to hold South African assets or not. Foreign governments whether they become involved in which ever ways with our country, whether they provide aid, or whatever might play a role and then multi-lateral institutions, the international monetary fund, the IMF and so forth.

I could expand on this if I needed to, and then of course foreign individuals whether they come to South Africa as tourists or not, would be one example. Whether they buy South African as opposed to Chilean grapes or wine or whatever. So those would be then two sort of broad sets of players that have an impact on the currency. The way in which it does so, if one could add it simplest then say would also depend on the micro structure of the market, the depth and liquidity of the foreign exchange market, the existence or not of exchange controls, and one might add expectations about exchange controls. For instance if individuals up there thought that exchange controls were going to be lifted, they could have one of two reactions. They might wait a while before they then make use of that or they might fear that it could lead to a depreciation of the currency and they might therefore want to in fact get money out as quickly as they can and vice versa. You can say if they thought exchange controls were going to be tightened, they might want to get money out as quickly as possible. So there are lots of ways in which these things have an impact on the decisions on which those players take and which those players take. Then finally one could add to that, and we have heard a lot about that from Mr McCauley earlier on, the Central Bank's actions or not in the market, the approach that it takes whether it is merely using the open mouth policy as it were, or whether it intervenes directly or whether it raises or lowers interest rates, all of those things would play a role as well, and I will becoming back to that in the course of the presentation. But Mr Chairman I think sort of super-imposed on all this is something which economists have great difficulty in, as it were, quantifying and putting a value to and this is confidence, perceptions, anxieties and fears which have an impact on decisions which those players take and which those players take, and I would then be indicating later one that towards the end of last year there was a considerable build-up of those sorts of things which then impacted on the decisions which many people or institutions took. So this then a very simplistic little way perhaps then of looking at things that impact, or might impact on the currency. We could now go further and economists would typically then try to give substance to this by saying how do these decisions manifest themselves over time. And what I have done there is to say that there are certain determinants which at least in theory you can identify and behind each of those I have said what is the background to each of those determinants. And they can play a role in the short, the medium or the long term. And if we could then kick off with the short-terms and then just returning to the question of Reserve Bank intervention and again Mr McCauley dealt with that adequately, I am not going to spend time on that. The motivations could be many, but typically it would be more stabilisation than it would be manipulation. I think there was a time in South Africa where we perhaps had a lot more active manipulation than we have had in the recent past, or it could be merely stabilisation. And then all sorts of market activity, again we heard from Mr McCauley on that, which could take many many forms, the buying and selling of foreign currency whether exporters decide to accelerate or slow down, the bringing back of the export proceeds, which would then be a form of - or forms of leads and lags and many other forms of market activities. And the background to those decisions could be to make a profit on the part of market participants for my money, Chairman, it is more often than not a question of hedging or a question of avoiding of risk or avoiding of losses or trying to reduce the risks of doing business. So those would then be some of the short-term factors.

If we then consider the short and medium term factors, they would typically fall in the broad realm of the balance of payments and balance of payments has two broad or two accounts. The first is the current account, which in its turn, as you can see there has a trade account and a service and income account. The trade account would trace what happens to imports and exports or various kinds, gold and so forth. All of that is part of the broad trade account and then the service and income account which measures all the invisibles, things like tourism receipts, dividend flows, interest flows, insurance flows, or whatever, if you are paying insurance to a foreign insurance company, and a variety of other, let us call them invisible flows of either payments for services or payment for income. It could also for instance include foreign workers in South Africa, what is transmitted to their relatives abroad and so forth. So that is the current account.

The second part of the balance of payments is the financial account and there again one could go into a lot of detail. I just mentioned some of the main headings, those would be for instance purchase of bonds and equities, whether trade finance is done domestically or done aborad. Foreign loans, whether the Government or other players are borrowing abroad or not. Whether South Africans decide to invest in assets abroad and then foreign direct investment which would include privatisation receipt. Those would be some of the headings under which one could consider the financial account.

Mr Chairman, I must just perhaps point out here that this is still very much at the general level. I will be getting into more detail later on.

Then of course the nett of the current account and the capital account is then, or gives us the change in the bottom line or the change in the nett gold and foreign exchange reserves in terms of the Reserve Bank jargon, so-called owing to balance of payment transactions. They could also be affected by valuations. That is if the fold price goes up and the gold that is in the vaults of the reserve bank is valued at a higher price, then that could also change the value of the gross reserves for instance, but at this stage I am just limiting myself to the change in the nett foreign exchange reserves.

Now if we look at the current account, and again without inflicting national accounts 101 lecture on you Chair, current account would then be at its broadest definition the difference between exports and imports of goods, non factor services for instance. That by definition would be equal in the - let us call it the national accounting identity to the difference between what the nation produces or what it generates as income on the one side and what it spends. And by definition it would also be the difference between what a nation saves on the one side and what it invests or what it does by way of capital formation.

Why I show this sort of very simplistic little identity here is just again to point out that - or maybe just to say why economists are for the most part wrong when they are forecasting the exchange rate is that literally everything that happens in the economy, all economic activity in some way or other has an impact at the end of the day on the current account and as we shall see a range of other things has an impact on the financial account.

If we then think about the financial account it is driven essentially by what you can call perceptions and coincidence, and that could be under the broad heading or business confidence, it could be political and social confines and fears anxieties and so forth. Then it would be risk and return, and again relative to destinations elsewhere. So for instance if the risks on investing in South Africa is seen to be by either South Africans or foreigners as exceeding potential returns that can be had from investing in the country, then clearly they will decide rather not to be involved here, especially if it looks poor relative to other destinations.

Then exchange controls - and as I have pointed out earlier on, expectations about exchange controls, and I will not belabour that point.

And then finally interest rate differentials and outlook. For instance, and Mr McCauley made the point very well, if short-term interest rates are increased in South Africa, then for instance South African companies might decide to do their financing here than - or abroad rather than here and that could lead to a capital inflow. On the other hand high interest rates might make the country look unattractive as a growth prospect. That could have an impact there on foreign direct investment, also higher interest rates could make the potential returns on South African bonds look unattractive, in which case we will get less money in there, we might even lose capital. So there are a range of possibilities that one could, or aspects that one could discuss when you are talking about interest rates, the differential between our interest rates and interest rates abroad and also the outlook for interest rates. But again perhaps we will come back to that later on.

So those then are things that in this very simplistic way of sort of desegregating the forces would have an impact on the currency in the short or medium term. The third would be one which again Mr McCauley mentioned, I think, broadly the correct analysis,and that is inflation differentials. If, as he pointed out, we, as it were, at the end of the day printed rands faster than anybody else printed their currencies than the rand, because there is more of it, will be worth less than those currencies would be, and there would therefore be over the long term a fairly close correlation between the internal value of the currency as measured by the inverse of domestic inflation and the external value of the currency as measured by the exchange rate, and whether it is so or not will then depend, right-hand bottom side there, on what sort of monetary policy we follow, what sort of fiscal policy we have and so forth, and I might just say that for a long time in the past, up to 1989, we followed monetary policies that were conducive to high inflation. We followed fiscal policies that is - well, it manifested in large budged deficits which were funded with the large part of - or a large part of it which was funded with credit from the Central Bank or from private sector banks which then inflated the money supply, which made our inflation higher and which then found a reflection in a depreciating exchange rate.

So Mr Chairman, what we have then got is a very simplistic little model that says there are factors that we can identify that have an impact on the economy in the short term. We have got a whole set of factors, both the broad economy, that has an impact on the current account, a range of things, many of them related to perceptions and confidence and outlook for returns and risks and so forth that have an impact on the capital account, all of which then plays a role in determining what the gold and foreign exchange reserves do, which as I will show later on, has then a bearing on the exchange rate. And then in the very long term, and I think least useful to the work that the Commission is doing, the inflation differentials but which I will cover nonetheless.

If we could then just come to the most recent experience, I have circled there things that one can say played a role, and this is now preliminary to what I will be doing later on in the presentation to look specifically at some factors that played a role late last year, but just at this point to say in terms of this little model what market participants saw late last year, was a current account that was going into deficit, they saw that South Africans would rather perhaps invest abroad than on the margin than in their own country, or they wanted to diversify their portfolios, they recognised that we are not getting a lot of foreign direct investment. They also saw, especially in late October, that the South African Government's privatisation programme, if not stalled, then had slowed down, the Telkom privatisation which was going to be a large flow of funds in the current year was not going to take place any more. Those things, I think, contributed to perceptions and confidence to which one could add all sorts of other things, Zimbabwe and so forth, that I will be returning to later on.

Also the outlook for South African interest rates, especially bond rates, had perhaps not, if not turned negative, then it would have changed for the worse, in that we already had a very long bull run or reduction in long-term interest rates in which lots of capital profits were made by foreign players in our markets and they did not, of course at that stage then think that the South African market offered that much opportunity which then probably had an impact there on the bond and equity flows and the of course underlying all this we still know that even though our inflation is a lot lower than it was before, and I shall illustrate that later one, we still have quite a substantial margin of our inflation above that of our trading partners. So all of these things sort of, I guess, stem people negative towards the currency and then that happened in an environment in which market participants knew that there is still, and again I will be coming back to that later on in more detail, that there is still a remaining nett open forward position of the Reserve Bank, which absorbs a large part of whatever inflows there are via the capital account. It was also made clear by the Reserve Bank on several occasions that it is not going to intervene directly in the market which then again made the rand appear to market participants to be somewhat of a one-way bet, and then also after the 13th - it was the Friday or the 15th, the Monday, of October, a thinner market as we - as I shall show later on. And in that environment all of these negative perceptions could then have a magnified impact on the currency and that would be then the sort of central little thesis that I will be putting forward later on in the presentation.

So, if we could then move from there to some recent international developments, and to illustrate these, and I guess there are many ways that one could look at this, I will have three slides. The first will show a long-term development of the U.S. dollar against the Deutsche mark, the second will show more recent developments of the Euro and the Yen against the dollar and the third one will show the extent of the rand's decline against - or relative to the way other currencies performed in the course of last year.

And I am not sure that this is quite relevant Chairman to your work here, but I hope it is. What I have done is to create an index with 1967 equal to 100 of the Deutsche mark/dollar exchange rate and now just maybe parenthetically when we talk about the mighty dollar, the fact of the matter is that for all of this period up to 1995 the dollar was actually a weak currency, if we look at it relative to for instance here the Deutsche mark. Just for interest sake plot it on there when we had who as Central Bank governors or federal reserve chairman in the United States and then there where we had which president and the blue guys are the republicans and the red ones the democrats. Do not read too much into that please. And then just to point out that the United States of course in the late sixties and the first half of the seventies were fighting the Vietnam war. Mr Linden B. Johnson and his so-called great society, both of those, and perhaps the cold war we do not know, contributed to quite substantial fiscal profits in the United States, that is budged deficits, as well as to an inflation rate which was substantially higher in the 1970's in the United States than inflation in this case in the United States. So much so that the - remember we still had a fixed exchange rate regime up to 1973, up to there, that Germany revalued against America at the end of the 1960's, and then throughout the seventies we had major fiscal and inflation problems in the U.S. That was interrupted for a while by the sharply higher interest rates under Mr Paul Vulco which certainly led to a sharply higher exchange rate, and there was maybe also some intangible factors. Let us call it a sort of a Reagan euphoria, if you like. That was followed for the subsequent years by, let us call it the twin deficits, that is a Government budget deficit which was pretty substantial and then also a large current account deficit. And those two then undermined confidence in the U. S. dollar and must have contributed to the decline that is illustrated there.

And then since the early Clinton years, then a substantial appreciation again of the U.S. dollar on account then of many things, but let us call one of them then the productivity, a miracle big capital inflows into the U.S. and despite the fact that the U.S. was still running through this period a substantial current account deficit, the dollar actually appreciated. So in my earlier model they are current account deficit, but big capital inflows and therefore if they had reserves they are the world's reserve currency. We had an upward push to the exchange rate.

And I think if you just look at the scale one can see that there are actually very substantial swings, even in as big a currency as the United States.

Then I am going to look then a little bit more closely at the period since 1994/1995 and now the scale is going to reverse, because now I am going to show those currencies or the Yen and the Euro, because we have actually created a sort of a statistical Euro, because it did not yet exist, against the dollar. And therefore through this period we had a falling Euro and we had a falling Yen. Now the experience to which Mr McCauley referred earlier in his presentation, for instance there in 1995, a very substantial fall, perhaps almost as big as what we had late last year in the Yen against the dollar in the second half of 1995, a very substantial appreciation in the Yen again late 1998 and I guess lots of other things that one could say about these currencies, but this is then perhaps just broadly to make the point that currencies do move quite substantially internationally.

Unfortunately our currency was particularly weak through last year. This slide shows the percentage move in the rand through the course of last year, that is from the beginning of 2000 - sorry beginning of 2001 to the end of 2001 and you will see that we were, apart from Turkey, the worst performer of all of these currencies. So clearly something very substantial must have happened to the currency which we will then be looking at in the course of the presentation.

So Mr Chairman ... (intervenes)

MR BROOKS: Mr Commissioners I see it is the end of the second section, I do not know whether you would like us to continue with the third section.

CHAIRPERSON: We have got Mr Gouws for tomorrow morning.

MR BROOKS: yes.

CHAIRPERSON: Are you still available for tomorrow morning? --- Yes sir.

Shall we adjourn until 10:00 and Mr Gouws will complete by lunchtime won't you?

MR BROOKS: Oh yes, long before lunchtime, Mr Gouws by about 11:15 tomorrow? --- I could just add Mr Chairman I (pause - background discussion)

CHAIRPERSON: Well, if it is convenient to you we will adjourn until tomorrow morning.

MR BROOKS: This is the end of A section

CHAIRPERSON: We will start at 10:00 tomorrow morning.

MR BROOKS: Thank you.

PROCEEDINGS ADJOURN

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