PROCEEDINGS RESUME ON 5 MARCH 2001

CHAIRPERSON: Morning.

Shall we start the second day of the Commission? Mr Gouws, you are still in the witness-box and still under oath. Mr Brooks, as I understand it, we are on what is now paginated page 120 of the expert bundle.

MR BROOKS: On the diagrams, Mr Commissioner, and on the statement page 114.

CHAIRPERSON: Thank you. I think we were on diagram 6, were we?

MR BROOKS: That is correct.

RUDOLF GOUWS: s.u.o.

EXAMINATION BY MR BROOKS (continued): Mr Gouws, could you please just very briefly not tell the whole story again, just very briefly recap what you told us yesterday just to put us back into the feel of the thing? --- Thank you and Mr Chairman and Commissioners if I could just apologise for the bit of confusion yesterday when I was reading from an older copy of the document. The one that you have got in front of you, is indeed the updated version. If I can maybe just quickly again say the structure of my presentation, I dealt yesterday morning with a framework for .. (intervenes)

CHAIRPERSON: Sorry, Mr Gouws. Can I just deal with cellphones? Can everybody switch cellphones off, please? Sorry, Mr Gouws, continue. --- I dealt with a very simple little framework or two frameworks for looking at the exchange rate. Then I showed some international developments and then what I am going to be dealing with this morning, will be what I call long-run drivers of the currency, namely the balance of payments and inflation differentials. Then I will be looking at the rand's recent fall in a sort of perspective way which I do under three headings and then a conclusion and I have taken the animation out of this just to make it very brief. This was the one framework in which I looked at all of the, at least in theory, those things that one could say have an impact on the currency and then I shared with you a framework for looking at the currency in the short, medium and long term and I tried to isolate the major factors that have an influence on the currency and I pointed out that there were a number of factors in the latter part of last year which impacted negatively on let us call it the soft issues - the perceptions and confidences and so forth and that my conclusion later on in the testimony will be that it did so in an environment in which the liquidity was quite a bit lower than it was before and therefore had a disproportionate impact on the currency. Then I dealt with some recent developments where, and I will spare you the detail of this now, where I then just showed that internationally for instance currencies moved drastically in relation to the sort of this also that we have had and then I just showed here again that for instance over there and over there we have massive movements in this example, the Yen against the US dollar in the past and here I just showed that the fall in the rand last year was indeed massive compared to the performance of a range of other emerging market currencies. But that then brings us to the third section and I am going to kick off by just showing something again about the balance of payments and then trying to relate that to major movements in the exchange rate first over a shorter time horizon i.e. over the last decade and then over a longer time horizon starting in 1960. So to take you back then to the little framework or the second of the two frameworks that I showed yesterday i.e. the balance of payments. It consists of a current account, financial account and the net of the two gives us the change in the net reserves and then I just also made the point that if we have time, one could have dealt then with all of the economy. In fact you cannot speak about the current account truly if you have not looked at the structure of imports and exports. If you have not considered the extent to which and why national output differs from national expenditure, why domestic savings fall short of domestic capital formation and so forth. All of these things have a bearing on the current account which is then one of the two drivers of the foreign exchange reserves which in turn is the driver in the last instance then of the currency. But clearly .. (intervenes)

MR BROOKS: Can I just stop you, please? Please bear in mind that the record will be read at some stage. Now you have referred to diagram 6 but not telling the reader. So if I could just ask you before you refer to a diagram, if you can just say I am again referring to diagram 6 and then you will take us to diagram 6. --- Thank you. I should have done that before. This is then just to show the macro economic relationships which economists call the national accounting identity and how that fits into the broader picture of the balance of payments which then is one of the main drivers of course of the currency. Then a slide which is not in your pack but which I thought is relevant. If we go back to this part of this slide where I show that the difference between domestic savings and domestic capital formation i.e. the total of the nation saves and what it invests as it were. If that is a negative number i.e. if we invest more than we save, then we better try to attract or we have to attract savings from abroad to finance that and I would like to make the point that under the present government, we have made great strides in removing one of the fundamental reasons for the rand's weakness. It still remains but it is a lot less than it was before and I might just explain it this way and if there is a need, I can have these transparencies, these also made copies of for you, sir.

CHAIRPERSON: You must do that.

MR BROOKS: Could I suggest that the slide which is on the screen now, if we could call that 6A or diagram 6A?

CHAIRPERSON: Yes.

MR BROOKS: So Mr Gouws if you could then with reference to that slide, refer to 6A. --- On slide 6A we show that up to 1994 government spending had risen very rapidly in relation to the size of the economy and that of course necessitated a sharp rise in total revenue i.e. the tax burden as it were as measured by total government revenue relative to GDP also rose. But what we also note, and this is important from the point of view of the currency, is that from the early 1980's current expenditure of government started to move away from its current revenue which meant, well the one line is crossed and that area there in fact became the extent to which the government absorb savings that would otherwise have been available to fund domestic investment and therefore made it necessary for us to attract savings from abroad and the extent of that we see at the bottom of the chart where at one stage it became or just before 1994, became as large as almost 8% of GDP. Now the relevance of this I hope will become clearer in the presentation as well. This major let us say it disc saving by the state, was therefore a major reason for the vulnerability of the current account of the balance of payments and therefore all other things being equal, would have meant a more vulnerable currency. Now fortunately under the new government, we have got spending under a much better control, we have improved tax collection, we did not raise tax rates but we have improved tax collection and as a consequence the gap between the two is now very much smaller than it was before. Therefore again all other things being equal, the state is making a lesser or causing a lesser drain on domestic savings and therefore leaving a less imbalance as it were savings investment balance and therefore a better current account and therefore a better exchange rate. Again I think you lawyers would say *cateris paribus*, all other things being equal. Now that one can perhaps explain just quickly the framework for that. The total savings on the previous diagram 6, that is made up of personal savings, corporate savings, government savings and then provision for depreciation or consumption of capital and the fact that this is still negative, means that the state is still making at this stage a negative contribution to total savings therefore causing an imbalance between savings and capital formation and for a given flow of foreign capital, means pressure on the gold and foreign exchanges. Therefore we have to dig into the foreign exchanges as to cover the shortfall that is caused by the fact that the state is a dissaver instead of a saver as it used to be. Now this might sound like criticism of government policy. I actually want to indicate the opposite, namely that by 1994 this was a massive problem and throughout the 1980's, the weakness of the currency I believe at least in some measure, one could relate to what was wrong in the government finances and we are, I think, again this is not in my testimony, but I am certainly very glad that the intention of government remains to distinguish or raise as it were the dissaving in the years ahead. That I think will also stand the currency in good stead. But this is then just a bit of background. If we could return then to the balance of payments and this will be diagram 7 in your pack. Unfortunately, Commissioners, the Reserve Bank's quarterly bulletin will only be published on the 18th of this month. So I am not able to update you with forth quarter numbers but I will, however, give you an indication of what I think those numbers might have been. What we see at the top, is then the quarterly current account surpluses or deficits which you could also take in terms of the analysis of a previous diagram as the difference between savings and investments and what we see is that in the third quarter of last year, we had a very substantial current account deficit, about R6 billion. On that we can now superimpose the financial account. That would then be net capital flows either inflows or outflows and in terms then of the box on the diagram, if you would just bear with me, any way that second framework chart. There we are, diagram 2. The difference between these two must by definition then give us the change in the net gold and foreign exchange reserves. If I might just parenthetically relate this to a household. If a household spends more than it earns, then it would have to borrow the money somewhere and if it cannot borrow the money, then it has to dig into the kitty as it were. So what applies to a household, applies to a nation as well and our guess would be that in the fourth quarter of last year, we had a current account deficit not as large probably as what we had in the third quarter, that we had some form of capital or some degree of capital outflow and that the net of those would have given us at least a small capital outflow ... sorry, a fall in the net gold and foreign exchange reserves which we could then relate to the currency's performance. If I take you back just on the history, these periods which we could summarise as follows: the pre 1994 gitters, the Mandela's Health ... sorry this disappears under this box, the appointment of Mr Manuel which quite erroneously led to people thinking that we will have bad fiscal policy. In fact we had much better fiscal policy since then than we had but at the time it caused a scare. Then the emerging market crises of 1994. All of these episodes are falling gold and foreign exchanges were indeed then also the periods of pressure on the exchange rate of the rand or periods of rand weakness. So if one wants to, and I am not talking about a day to day or month to month basis, but if you want to have a look at fundamentally or periods where the rand was under fundamental downward pressure, you would have to consider all the factors that impact on the current account and the factors that impact on the capital account or as it is now known the financial account and that would then tell us what happened to the gold and foreign exchange reserves. Now what we see is a chart that starts in 1991 and again this is per your request, Commissioners, that I am taking these things back a little bit further in history. So it becomes slightly less relevant to your immediate terms of reference. If we take the current account and the capital account and we put the four quarters together i.e. we have annual figures, then we can now say what happened before that and the long history that I show here then tells us that the period that you have just seen on .. (intervenes)

Mr Gouws, sorry you are on diagram 8. --- Sorry, I am now on diagram 8 indeed. On diagram 8 what you will then see is that the current account deficits that we have been running recently, are substantial but nothing like what we had in the 1960's and the 1970's. And again that to me is an indication of better macro economic balance in the economy which is also a reflection I believe of a fundamentally healthier whole set of economic policies which I guess one could return to. So this is the history of the current account and I must just explain on the previous chart, these numbers were in billions of rands. On this charge those same billions of rands are expressed as a percentage of the gross domestic product. So we are showing what is the relative size of the saving surplus or current account surplus and savings deficit or current account deficit. Now we can superimpose the movements on the financial account i.e. the net capital in- and outflows and for the most part you will see that the one is a mirror image of the other. That is typically when we run a domestic savings deficit we rely on the rest of the world's willingness to lend us their savings. If we do not, then of course we get a fall in the foreign reserves and therefore pressure on the currency. And I think it is relevant to our current experience that I do just trace back the major events and phases of the capital flows that we had starting with Sharpeville at the beginning of the 1960's. That of course led to an immediate capital outflow. It was also the implementation of exchange controls at the time. Then for a long period in the latter half of the 1960's and early 1970's we had capital inflows. Initially those inflows were mainly of the kind which I think one can say that you like but it is foreign direct investments. Foreigners actually buy shares, controlling shareholding or large shareholding in South African companies were actually starting greenfields operations in South Africa but it also included loans and towards the end of the period, more and more short term loans by the government of the time. And on occasion the scale - that scale there and that scale there is the same. You will see that these blue bars were shorter than the red bars. That means that the capital inflows fell short of the current account deficits. Therefore there must have been downward pressure on the foreign exchange reserves and in fact the rand could not keep its peak. You might recall that up to 1979 the rand was not a free floating currency. It was peaked to the US or on occasion to the pound and then to the US dollar and there we devalued in 1971 and we devalued in 1975 because the overall pressure, the net of this and this, was such that the peak could not be held. So that is more or less what we of course recently went through if we had a peak currency then we might have had to devalue as well not as dramatically of course as the argentine had to do recently. Then the period of capital inflows ceased when the start really or the more obvious start of our political problems commenced in 1976 with the Soweto riots. That led to capital outflows in the subsequent period and the rand started to float in 1979. But that is in a sense incidental to the little analysis. T hen you will see that there was a period of capital inflows but those inflows of the early 1980's were mainly of a short term liability nature i.e. the government Reserve Bank, borrowed short term money abroad in order to be able to fund the current account deficit that we had up there but, and this is also the problem of a banking system and one could look at all sorts of other real world examples of this. If you borrow short but you lend long because we invest long term in the country but we borrowed short, the people then stopped wanting to lend you the money, then you get problems and this is the problem that we got in 1985 with the Rubicon Speech and the debts. We then had to declare a debt standstill because the foreign bankers would happily been lending us that money then suddenly refused to do it on account of the politics of the time and of course the rand as we will see later collapsed in the mid 1980's. Then the De Klerk Reform starting in the early 1990's. I think we all today say it was a good thing. Initially it was perhaps viewed somewhat sceptically and we still had capital outflows. Then the 1994 Elections were followed by a period of capital inflows once more. But in the same way that short term borrowings there made us vulnerable when we had the Rubicon Speech, the fact that these inflows were mainly of a portfolio nature i.e. foreign investment as we heard yesterday from Mr McCauley as well into bonds and equities rather than a more stable flow of foreign direct investment or privatisation receipts, money which in fact could leave overnight. We were therefore by the nature of things more vulnerable through this period since we were running at least small current account deficits and that then perhaps is part of the background to the rand not crises maybe but the rand declines of 1996/1998 and again what we went through late last year. Mr Chairman, this is perhaps at its simplest how I think one can look at the long term trends in the balance of payments and the relevance of political and economic policy issues to the capital account therefore to the reserves and therefore to the currency. However, I would like to look just a little bit in one slide which will be diagram 9, at these developments i.e. the period of capital outflows that we had there and the period of capital inflows that we had starting when the new government took over. And perhaps a simple way of summarising this would be to say that we had capital outflows in the first part of what was in the box on the slide before from 1985 to 1994 because of what was then increasingly being perceived as unstable politics, social unrest, which obviously undermined international and domestic confidence. It triggered financial sanctions and it forced the repayment of foreign debt, bad economic policies in the form of sharply rising poorly managed government spending; sharply rising tax burden; large budget deficits, growing government dissaving as we saw on the slide 6A would that be? Well, it will not be in front of you but the one that I tried to illustrate earlier on.

Yes, 6A. --- 6A, and then of course high and unstable inflation and people do not like to invest in countries with high inflation, all other things being equal because that is typically as we shall see later and as Mr McCauley indicated yesterday, a precursor to currency depreciation and therefore a loss of value of your investment. The capital inflows from 1994 on the other hand, I think one can relate to our political legitimacy following the elections of 1994, the far greater political stability, the removal of financial sanctions, our renewed access to foreign financial markets therefore and then growing economic policy credibility. I attach a great weight to this the fact that we have opened up the economic that we reduced the budget deficit, that we stuck to the policies under Mr Mboweni, of Dr Stals of essentially wanting to lower inflation, of reducing our foreign debt, of following the kinds of policies that gave us investment great ratings and made it possible for us to attract foreign capital. However, the inflows remained essential of a short term portfolio nature and therefore the capital account remained vulnerable. But overall we certainly had a much better position after 1994 than we had before 1994. I would like to turn then, Mr Chairman, from the balance of payments and I will be coming a lot more specific about some of those aspects in section 4 but I would like to turn from there then to something which as I hope I pointed out early yesterday morning, is probably not very relevant but again I was asked to deal with this to your Commission's work and that is inflation differentials and I must say I think we have got a very good summary of the logic behind this from Mr McCauley yesterday. So I can deal with this fairly briefly. So what we are looking at is the bottom part of diagram 2 where we are looking at long term drivers of the currency namely inflation differentials, the extent to which the internal value of the currency depreciates faster or slower than the internal value of other currencies, finds reflection in their relative external values and that would be a function of what our monetary policy looks like relative to theirs, what our fiscal policy looks like in particularly whether we fund budget deficits with bank credit or not which increases the money supply which increases inflation and so forth and a number of other factors. So I turn to diagram 10 in the pack and what we are plotting here is the headline CPI. For the purposes of what I am presenting, it does not actually really matter whether we use the CPI or the CPIX. In this case we have got the headline CPI and .. (intervenes)

CHAIRPERSON: Can you just explain for the record what headline CPI is and what CPIX is? --- Yes, headline CPI is inflation as we used to know. It is measured by Statistics South Africa. It is a vast basket. I would guess of about 2 000 goods and services which measures the price of consumer goods and services over a period or at specific points in time typically in the first week of each month. Some goods are surveyed monthly, some surveyed quarterly and some annually and they measure the general level of prices and the rate of change in that rate in that CPI headline rate is then what we commonly call inflation. However, because monetary policy has as one of its goals the reduction of inflation, you do not want to confuse the as it were the goal with the instrument or with the thermometer because the inflation rate is actually the thermometer measuring the thing that you are trying to fix and therefore if your policy instrument being the level of interest rates is part of what affects the thermometer, then you will get a skew reading. Now I might not be explaining this too well but the point is that if you for instance raise interest rates in order then to have a subsequent impact on inflation, but now the measured inflation rate goes up because you have raised interest rates and interest rates or mortgage bond costs are part of the CPI. Then it will look as if inflation has risen and therefore if you were looking only at headline inflation, you would then have to raise rates even further and then you get onto a treadmill and you will kill the economy. So it is quite correct for the government and the Reserve Bank to have decided to exclude purely for the purposes of monetary policy analysis, the impact of mortgage bond repayments from the headline CPI and that then heals the concept CPIX which literally means CPI less mortgage bond costs. But as I say again from a broad economic point of view, it does not actually matter much which one you use if you are looking at such a long term as I shall now be doing and then what we see on this chart, is that in the 1960's, South Africa had low inflation, let us say 2?% to 3?%. Inflation started to rise. At the end of the 1960's it rose to an all time peak just after the Rubicon Speech and the major fall in the currency which occurred in the mid 1980's. This was a bit of a statistical decline as it were because it had jumped up so much before. I believe the true peak in inflation to actually have been just in the early 1990's. Then one can superimpose on that several other measures of inflation if you want to compare ourselves with other countries. In this case I have used because we have such useful series, the average inflation rate of the so-called OECD area. The OECD is the Organisation for Economic Cooperation and Development based in Paris which is sort of not a club but it is a research organisation to whom all of these economies belong. I certainly hope that South Africa would quality at some stage for that and you can then take this as a proxy for the average inflation of South Africa's trading partners and what is clear is that from the, well maybe throughout this period, but in particularly from the mid 1970's South Africa's inflation rate has exceeded the inflation rate of its major trading partners as proxy here by the average inflation of the OECD area and as Mr McCauley very adequately explained yesterday, that would then be a fundamental reason for the rand's long term weakness. If we as it were print rands faster than they print their currencies, there is more one thing than another, its price typically declines or its value declines which then is the link between the external and the internal value of the currency. Our inflation is higher than that of our trading partners, the currency will typically fall. Now fortunately on diagram 11, you will see that we have, and in my view, been doing the correct things from a monetary policy point of view starting when Dr Stals took over in the late 1980's and fortunately subsequently pursued by Mr Mboweni and the Monetary Policy Committee at the Reserve Bank. Their aim was to reduce this massive gap that existed earlier on between our inflation and that of our trading partners. So if one looks at this alone, there would have been massive reason for the rand to decline in the mid 1980's and there would gradually have been less reason as we moved along. If you look up ahead .. (intervenes)

Just give us some figures for the record. If one takes the peak in the 1980's of our inflation rate, I see it was about 17% or 18%. Is that a good guess or what would you say it was? --- It was in fact, I am not sure why it does not show up there, the worst monthly figure at some point there, I think these are quarterly numbers, the worst monthly figure was 21%.

And what would have been the OECD inflation rate at that time? --- Well, approximately in the order of 4% to 5%.

And what are we reducing to at the moment? What is the differential in the beginning of 2002? --- Ours will now be sort of in the order of 7%. Theirs is in the order of 2?%.

Yes, and what is the inflation target of the government? --- The inflation target that the Reserve Bank has been set, is for the year that we are in now and for the subsequent year, 3% to 6% and for the two subsequent years, 3% to 5%. So the range will be knowing over time.

So at the end of 2005, if all goes well, we might be down to 3%? Is that the most ambitious target but it might be 5%? Is that the way I understand this? --- Ja.

Thank you. --- So taken by itself if that was the only thing to matter as far as the exchange rate is concerned, then the rand should be falling at a gradually slower phase over time. Unfortunately on account of the rand's sharp fall last year, we will now first get, and we have already seen this in the last monthly figure that came out last week, a substantial jump in inflation but thereafter my view is that the Reserve Bank will stick to its guns and that inflation will remain on an essentially long term downward path and this again all other things being equal, will be to the benefit of the exchange rate.

Now when you say to the benefit all other things being equal, does that mean that the exchange rate improves from where it is at the moment or just slows down? --- No, the rate at which it is declining, will slow down.

It will slow down. Thank you.

MR BROOKS: And what has that rate been from the beginning or are you still getting to that? --- That is in fact the object of diagram 12 where I am going to introduce the concept of a purchasing power exchange rate and again, Mr Chairman, I must just point out that this is not a terribly useful measure if you look at it at a point in time. It is only useful if you look at it over the very long term and just to explain how economists would typically arrive at that, you would take for instance an exchange rate at a point in time like in 1975, I am sure perhaps some of the younger people in the room would be surprised to know that there were more dollars to a rand then. In fact we had $1.45 to a rand at that point which means the exchange rate was 0.69 where it is now 10,9 this morning. If you take that exchange rate at a point in time in the past and you multiply that by an equation and that equation you would construct by using some measure of for instance in this case United States prices over South African prices and economics to do these things in far more detailed than we would for instance at the International Monetary Fund or the World Bank or the OECD, would use productivity adjusted wage levels. You can use anything. This is purely just an example and the equation in the end result i.e. the purchasing power exchange rate, would therefore go down if this thing rises faster than that one.

CHAIRPERSON: So you are saying that the SA price index rise faster than USA price index? --- Yes, that price index rises faster than this rises. Then that equation must get smaller over time and you are therefore multiplying a smaller thing into this which will make the result there declined.

When you talk about there, when we read the record we are not going to remember what your "rooi liggie" was shining on. --- I apologise. Let me rephrase and I think it is in the text as well, I hope, that the purchasing parity exchange rate, and this is one of many you could calculate would be the result of taking unexchanged rate at some point in the past when you assume the exchange rate to have been in some sort of equilibrium that you multiply by an index of, in this case US prices over an index of South African prices and if the SA price index rises faster than the US price index, then arithmetically or mathematically of course the purchasing for our exchange rate would decline which is exactly what it did and that line therefore shows that again all other things being equal, if the rand was $1 or 0,69 in 1975 and if the difference between these two rates have changed, the only thing .. (intervenes)

When you say these two .. (intervenes) --- Sorry, the US price index and the South African price index, if those two were the only things to matter in this equation, the rand should now be let us say or R6,00 should be equal to one dollar. Now if we listen to Mr McCauley yesterday, his calculation on the cappuccino index gives him about four which is somewhere over there and so forth. So there are various ways that you could do this. So again just to summarise, if inflation differentials were the only thing that matter and if this was some form of correct exchange rate in 1975, the rand would now be fairly valued if it was at R5,78 in this example. Now we can superimpose on top of that the actual exchange rate and what you see at the end of that line is the $11,65 average which the rand was in December, I think, and what is clear is that there is a fairly good fit to the line but that on occasion the rand would be higher and on occasion it would be lower. And just to give you an idea in the time of the Rubicon Speech, debt standstill, the difference between the or the biggest difference there was 65%. Here it is 50% and one could now compare that with Mr McCauley's cappuccino index or for instance with the Big Mac index of the economist magazine where they, as far as I can recall t heir last calculation was 70% and I do not think this is something that one should take too seriously, but it is a little model that they use. They price absolutely homogenous product. That is a hamburger made by McDonald's everywhere in the world and they calculate what they should cost and in this case ours is about 70% undervalue. Mr Chairman, the point about the slide is that there is a good fit to these lines and therefore if South Africa were to continue with the policies of gradually reducing our inflation, this blue line shape will continue to change and I must point out that this is a semi-log scale. That ten cents becomes R1; R1 becomes R10; R10 becomes R100 over the same distance. So if that blue line goes down very quickly, it means that our inflation rate is a lot higher than American inflation. If it falls more slowly as it has been doing, then these two start to come closer together and I think we should just, and this is again not immediately germane to what the Commission is doing, but I think we must just hope that the Reserve Bank sticks to its guns to try and change the shape of this line over time. That is that there is a convergence between our inflation and that of our trading partners.

CHAIRPERSON: What you were showing with your red light is that you would hope that the blue line flattens out? --- Yes, and that the two meet each other because meet they will again one day but that they meet not because the blue line falls because for the blue line to fall, it would mean our inflation must accelerate and that we do not want and I will come back to that later on and we perhaps do not want the red line to rise up as sharply as this again because that will decimate large parts of our manufacturing and industrial sectors of the economy but you want the two to converge essentially because the blue line is falling more slowly and the red some sort of stability returns to the red line. Again and maybe this is not for minuting or for the press because they will think I am alarmist, but I did a little sum. If you take the average decline of these two lines over time, it is 8% per annum and if you continue that rate of decline, and there by 2032 we will be at a R100. We will in fact crack that line about over there and it will be R100 to a dollar but that is now ... I am certainly quite hopeful that that is not going to be the case. Mr Chairman, so that then just a look at inflation differentials and how they impact on the currency and what is apparent from diagram 12, is that we now diverge very substantially from this theoretical statistical concept called the purchasing power parity and most economists would therefore conclude, including even ourselves, if we have to travel abroad and you find out how expensive things are or foreigners when they come here they say how cheap things are. That indeed the rand sit somewhere quite a bit below its purchasing power parity. I then would like to turn to what I think will become now more relevant to what the Commission is looking at and that is the rand's recent fall in perspective and I kick off with events since July of last year. I will, however, go back just a step just to put things in perspective to the beginning of 2000 on diagram 13 and I must just perhaps quickly explain the concept of an index here. If we take the R6,11 which is where the rand was at the beginning of 2000 and we make that equal to 100, then we see that by now the rand had fallen by nearly 50%. That is the 6 became just about 12 at its worst there and this is then the history of the rand against the dollar in 2000 and then through to 2001. On top of that, and I will have to show it now and I will be coming back to this later on when we discuss the effective exchange rate or the real effective exchange rate of the rand. I just have to introduce the concept of a trade weighted index which again is a statistical concept. This is the rand against a basket of currencies because the authorities of course want to know what is happening with the rand. Now if you are looking at the rand merely against the US dollar and the dollar had to be particularly strong as it has been, then the rand's depreciation against the dollar, would exaggerate the weakness of the currency. So from an analytical point of view the authorities correctly want to look at some form of trade weighted index and this is then what the red line plots and you will see that in fact in the early part of last year up to July .. (intervenes)

MR BROOKS: Mr Gouws, sorry may I interrupt you. The reader of the record is not going to have your red light. --- Oh.

Could I ask you, I know it is going to complicate your evidence and it is a lot easier to flash your red light on the screen for us looking at it, but I am worried about the reader of the record. Could I ask you to put your red light away which is going to force you to explain what is on the screen? And it is going to make the reading of the record a lot easier for the Commissioner's within three months' time or whatever, to read the record and make or give a report. So if I could ask you to put that in your pocket. --- That will give a new definition to the concept of a one-armed economist. I will certainly find that most difficult but let us try. So what one sees on the chart is that in the first half of 2001, the trade weighted index which is the red line on diagram 3, was actually appreciating but then the rand actually depreciated against literally everything and the difference between the two, the red line and the blue line, would then be of course a measure of the dollar's strength against the other currencies in the rand's trade weighted basket. On diagram 14, you will see the weights which the Reserve Bank economists used to construct such a trade weighted index and you will see that the Euro now that all the currencies of Europe had been unified, has the biggest weighting of more than a third. The United States with a weighting of 15% and so on.

CHAIRPERSON: Just explain to us how the weighting is arrived at? --- There are various ways of constructing these weightings. This is a so-called, if I am not mistaken a trade weighted index where the Reserve Bank economists which study the importance of the trade with various economies and the weighted sum of the imports and exports would then be used to establish how important a country is to South Africa. For instance we export a great deal more to the United States than we do to Israel at the bottom of the slide and those percentages is then an effort to indicate the relative size of the trade with those countries. I should just perhaps point out that strictly speaking one should have an import trade weighted and an export trade weighted index which I am not going to bother you with because it is not really relevant to what we are discussing here in South Africa's case and export trade weighted index, one which attaches the weights in terms of our exports would have a far bigger dollar weighting on account of many of South Africa's exports for instance gold being denominated in dollars whereas an important one would have a bigger or a smaller dollar weighting and in particular will have a bigger Euro weighting because more of our imports come from Euroland. But this is then a weighted average of imports and exports which are used for these weightings. So this would then be just an extension of diagram 13. It is actually the same thing. This just shows that what we are now going to be looking at in the subsequent slides, will be the period that commenced when the rand was R8,04 to the United States dollar in the beginning of July of last year through to the present and again you will see that that index number would then be 75,4 at the start of that period.

Mr Gouws, which diagram is that which we have on the screen now? --- Well, this is just a little extension of diagram 13 with the trade weighted index removed and a little box added which tells us just where we are. It is not really relevant. It is just to help the Commission to know what we are looking at now. So we start in the beginning of July of last year and if we now explode, and again I apologise that this is not part of the record, otherwise the thing would have been very thick. This is just by way of background.

Mr Gouws, sorry. You say this is an extension of diagram 13? --- Well, this is going to be, sorry I should have numbered these better. Let me just tell you where we are. This will be .. (intervenes)

CHAIRPERSON: You are now going to diagram 15? --- It will be diagram

15 indeed.

MR BROOKS: Now we already have a ... oh I see. --- Yes.

Oh is this the built up of diagram 15? --- Yes, I am building up towards diagram 15 with this slide.

So we have diagram 15 on the screen and you are going to refer to that now? --- Yes, this is diagram 15. But it will not be there in exactly this form. This is just to give you an indication of the acceleration in the rand's decline last year in dealer jargon. South Africa lost one big figure in three months in the third quarter from July to September. We lost one big figure. That is we went from R9,00 to R10,00 in the subsequent two months. Then we lost almost four big figures in a short space of 20 days up to the weakest point there that you will see later on in the more fuller version - that you will see on 20 December.

CHAIRPERSON: What is a big figure? --- Sorry, I big figure is literally before the decimal i.e. we went from R8,00 to R9,00. From R9,0 to R10,00 the first time in the space of three months and the second time in a space of two months.

Yes.

MS QUNTA: Excuse me Mr Gouws. Can you give us that in percentages, please? I seem to recall that at one stage you gave percentages. It would be more useful - certainly for me. --- Okay. From R8,00 to R9,00 and now the clever friends of mine would have to help. If we move from 8 to 9, I guess that would be 1/8 movement. That will be 12?% declined in the space of a month. Then we had another 12? .. no, then we had less, 11% decline. That is we fall from 9 to 10 in the space of two months and then four big figure 4/10 would be a nearly 40% decline in the space of 20 days. So what we are measuring on the left-hand scale is the actual rand/dollar exchange rate. That is how many rands there are to a US dollar and I like to use the convention of an inverted scale. I should perhaps just explain that, Mr

Chairman, that I would like to see the rand .. (intervenes)

Sorry, what is the number?

MR BROOKS: 15.

CHAIRPERSON: He is building up to .. (intervenes)

MR BROOKS: We are building up to diagram 15. This is the start of diagram 15.

Yes? --- I would like to think of the rand falling when it is falling as it were. So I would like to invert the scale which is what we have got there. If it falls from, if it weakens from R8,00 to a dollar, to R9,00 to a dollar, I would like to just draw it the other way around so that we actually see the rand falling. Okay, then we are actually now at the start of what will eventually become diagram 15 and what I am going to trace without being able and I have to be honest that I am not able to say which of those events had what kind of impact and what I will be arguing towards, is that the combined impact of all of these things which in fact led the rand to come under the pressure that it did and I would like then to start off with 11 September attack on the World Trade Centre which had several consequences. The first of that was an economic consequence in that it worsened what was already then a US recession for the month or three after that. The US certain went into a deeper down swing. Commodity prices in general fell. That is metals' prices, the prices of things that South Africa exports. We will illustrate that on the subsequent slide. And there was also a so-called flight to quality implications. That is the currencies ourselves more than others but the currencies of many emerging markets in fact suffered as the .. just the uncertainty of perhaps there being a world war or whatever led to people seeking the security of for instance in this case United States treasury bonds rather than what they considered to be riskier investments elsewhere. To look at the economic effects, sorry is this part of the record.

No. --- Sorry, Mr Chairman why it is not, I can make you a copy of this. This is not usually relevant to the findings but I shall make a copy of that as well.

Mr Gouws, could we make that, if you could just make a note there please, the slide you are referring to now will be diagram 15A. --- In fact let me, with your permission, if we went back to .. okay let us do that. On this slide I simply show that the gold price was under substantial downward pressure from 1996 onwards sort of tried to stage a recovery through the course of last year but it has really only been in recent weeks that it has headed up towards the 300 dollar level. It actually did not sustain any sort of rise after 11 September. Unfortunately for South Africa, metals' prices, and in this case again we used this as a proxy for South African export prices, weakened substantially and they weakened up to well into December of last year and also under the fear that 11 September attack on the US would be a precursor to a deeper recession in the US and elsewhere and therefore had an impact on ourselves or would have an impact on ourselves and other commodity producing economies. Also that it would extent the weakness in South Africa's export volumes and the blue line you can see how that already had moved into negative terrain or be it slight in the third quarter of last year i.e. South Africa's export volumes suffered the consequences of an international recession already at that point and the fear was that a deeper international recession would indeed cause weaker commodity prices, weaker exports and therefore have an impact on the current account of South Africa's balance of payments and via that of course on the exchange rate. So this is one of a range of factors, economic factors that one can look at. I might just say that the strength of the rand in recent days can again very partially I guess be ascribed to the hope that the world economy is recovering; that commodity prices have in fact bottomed and that things from a current account point of view for South Africa might not turn out that badly. But that is really a surmising. So then to come back to diagram 15, the first of the range of factors that I will be showing, is what I have showed is the attack on the US on 11 September.

CHAIRPERSON: Before we move beyond 11 September, there is a declining of value of the rand from R8,00 at the beginning of July to 11 September. Do you see that? --- Yes.

Do you not have an explanation for that? --- Well, there was dollar strength also. If you recall my earlier chart, I think it might have shown still in the early part of that phase that you are looking at and I am not allowed to point at it, the first two months there, there would have been a measure of dollar strength as well as rand weakness. But again just bear in mind that in that third quarter, there was what I showed you earlier on, namely quite a substantial current account deficit. That is we needed foreign exchange to cover the shortfall between our current payments abroad, export, service payments and so forth and what we received from abroad and those inflows were not sufficient. So there was a tiny downward pressure if you recall my earlier slide. In fact let me take you .. if I can just take you back there. It would be .. (intervenes)

It should be diagram 7, as I understand it. --- Correct. It will be diagram 7. You will see a tiny, it might not be that apparent on there, but there was a tiny decline in the net reserves in the third quarter meaning that the capital inflows were insufficient to cover the current account deficit at the time and that might explain partly the weakness prior to 11 September. Then the next event that one might isolate would be the reduction in interest rates by the Reserve Bank on 20 September. Now let me immediately say that I was in support of that interest rate reduction. The Reserve Bank to my mind at the time correctly viewed international interest rates as being in decline. The US had been cutting interest rates since the early part of the year and they did so quite aggressively around the time of the or subsequent to 11 September attacks. So I think we were quite justified in reducing our interest rates as well and whether there is a direct relation between the two, is difficult to say, but what is apparent is that the rand did slide immediately after that interest rate reduction. Then on 25 September the Central Statistical Services announced a pretty bad trade number. It was still in surplus but it was a much smaller trade surplus than we had before and that then I think started to cast a bit of doubt about or doubt upon the state of the current account of the balance of payments especially since people now knew and read in the newspapers all the time that the world economy was going into recession and therefore that is going to be bad for our exports and we had a bad trade number. So that might have caused doubts about the trade aspect and then I must just mention at the same time more or less in that same week, it might have been the same day, there was something that even got reported in the economist magazine that parliamentarians were saying that, you know, we do not want foreigners to invest in our security industry and it sort of started to raise doubts about how serious we were about wanting to attract foreign direct investment. I am not pronouncing on whether that is a good or a bad thing but certainly if it made it into the economist magazine, people say now they cannot be too serious about the FDI if they prescribed to us what we are allowed to invest in and then on 13 October and effectively .. (intervenes)

<u>MR BROOKS</u>: 15 October? --- Ja, well I think the notice went on the 13th but the Monday was the 15th. So it was as of the Monday the tightening of foreign exchange market rules and I must stress that this was tightening. It was not the reimposition or imposition of new exchange controls but there was then what I am sure you will be hearing a lot more about in the course of the next few weeks, a tightening or a more vigorous policing of foreign exchange market rules and that to my mind can be linked directly to what you will see at the bottom part of diagram 15, namely a substantial reduction in the average daily foreign exchange market turnover which had been in the

order of just over 7 billion for the previous months - the average 7,7 billion in the first half of the year. It was over 8 billion in July and then contracted pretty quickly after that and again I am now not .. (intervenes)

Well, what your diagram shows is that after that announcement in October, the foreigners pulled out their investments. --- No, that is not what it shows.

Yes. --- It might show a little bit as well but this is the daily turnover in the foreign exchange market. It is what Mr McCauley referred to yesterday the three definitions that he had and I would presume that much of this was an onshore/offshore transactions because a number of foreign banks simply exited the South African market. So the liquidity in the market in fact reduced .. (intervenes)

Dropped dramatically. --- It dropped after that. So the market became substantially thinner subsequently. There might be other reasons for this as well but I think it is generally acknowledged that there was a direct linked between the two and one then also sees if you look at diagram 15, the immediate weakness of the currency following that announcement.

CHAIRPERSON: These daily foreign exchange market turnovers, where did you get these figures from? From the Reserve Bank? --- Well, my statistician gets them from the Reserve Bank people. It is published indeed by the Reserve Bank in the monthly release of Money and Banking Statistics.

Is that where your statistician got that from? --- And from websites of the Reserve Bank as well where they give the breakdown of the different kinds of statistics.

MR GANTSHO: Mr Gouws, would you kindly mention what exactly was tightened in those foreign exchange controls and specific controls that were tightened that you can perhaps mention? --- I can perhaps say that I am grateful to Mr McCauley for the expression that I learned yesterday that he is not best evidence on something. In this case I am not best evidence in this case but it is the statement of the Reserve Bank in which they said that bankers needed to make sure that there was an underlying verifiable transaction and of course a large number of these transactions it was very difficult to relate them directly to an underlying transaction and especially foreign bankers simply could not then be bothered and they exited the market. So that then led to a reduction in the daily volume and therefore if you had other things which I will now indicate that happened at the same time, they would therefore have a magnified impact on the market. But again I must apologise I am not best evidence on this. The other bankers, I know my own colleagues they will be saying something more about that in their evidence. So we can remove from diagram 15 here then the chart but I will leave just for your background the actual numbers at the bottom of the slide which then now becomes diagram 16 and we can add a number of other factors that played a role. And again before it sounds as if I am criticising the Reserve Bank, I am in support of the Reserve Bank not trying to defend at all cost a predetermined exchange rate of the currency. It is just that maybe through this period, the Reserve Bank suggested very often that there was no way that they were going to intervene in this market. So throughout this period all other things being equal, market participants would then say the Reserve Bank is not going to be intervening in the market and therefore the rand then seemed to them to be more of a one-way bed especially if a number of other things were then negative as well. Again, and this is not, I think it is somewhere in the text but I think some form of subtle intervention by the Reserve Bank and perhaps not such a very strong stressing of this, perhaps would have helped the situation to some extent.

Mr Gouws, I would have asked you what does it mean this intervention? Can you take us back to what Mr McCauley said. I think he dealt quite extensively with intervention. --- Well, that would be the Reserve Bank buying and selling in the spot market or in the forward market foreign exchange or a variety of other measures that they can take to try and weigh in against an underlying or not an underlying but a trend in the market and it could be for various goals. I indicated I think in my diagram 2 it could be either manipulation which I think would be foolish because we do not have a high level of reserves to be able to do so or it could be just stabilisation - just showing your hand every now and then. These are subtle things which might perhaps have been done.

That is what Mr McCauley referred to? --- That is exactly what he referred to.

Thank you. --- Then as I said if you just go back ... sorry, I am not allowed to do this. 25 September, the bad trade numbers, so the point is that some doubt started to emerge about the current account and then on top of that we had at the end of October the announcement that the privatisation of Telkom was not going to take place any more in this fiscal year. So therefore a large amount of foreign capital that we had banked upon that would enter the economy via the financial account and would therefore offset other outward flows or would offset a current account deficit was not going to take place any more and I think with good reason given that the world Telekom market was very badly affected by 11 September and so forth, one could understand this, but none the less it had the impact of casting doubt upon the health of the financial account of the balance of payments and it did something else and that is then to make it clearer that it would take longer for the net open forward position of the Reserve Bank to be extinguished and that therefore the net open forward position of the Reserve Bank would continue to absorb surplus dollars. I am going to come back to diagram 16 in the form of diagram 19 but I am first going to move on to explain something about the net open forward position to diagrams 17 and 18.

CHAIRPERSON: Just before we move off this diagram, that red line that you have drafted, it is merely to indicate the downward movement? It is not a separate graph in any way? --- No, sorry the red line is perhaps not correctly drawn. It is not a graph. It is just an indication that throughout that period the Reserve Bank often made it clear that or on occasion made it clear that they did not have a preconceived notion of what the exchange rate should be but their ultimate aim as I believe it should be, should be the fighting of inflation, the meeting of inflation target. It is just that in that environment, of course it meant that people were almost assured that the Reserve Bank would not intervene.

MR BROOKS: Mr Gouws, how did the Reserve Bank make that known that they were not going to intervene? In public .. (intervenes) --- Public. Yes, in speeches, in remarks to the press for instance I would presume. Again I want to make it quite clear that fundamentally I agreed with the Reserve Bank's approach that they should not try with limited reserves to try and pitch for a specific exchange rate. It is just that if you are so completely hands off, then it removes any doubt in peoples' minds that there would be intervention.

CHAIRPERSON: Mr Gouws, just going back to that slide. When you say that the NFP continued to absorb surplus dollars. Now is that a statement of fact in relation to that period? Was the Reserve Bank buying back dollars for the period that we are dealing with, say roughly July to December? --- I cannot say for sure exactly what the nature of the operations were. What I would say is that I was in agreement with the other part of the statement on the 13th of October, namely that only privatisation receipts and foreign loan flows would be used to reduce the forward book and that other potential inflows would indeed be allowed to flow into the market and that would be supportive of the currency were those inflows to occur. That was a policy statement which I think was a wise thing to say at the time. Unfortunately the other factors then seemed to overwhelm this and we saw what we saw on the currencies. But I am actually not able to answer that question properly.

What I am debating with you is: are we dealing with a perception issue in that second block or are we dealing with a statement of fact? --- No, we are certainly dealing with a perception issue in the sense that if the knowledge is there and that will become clear I hope on diagram 16 and 17 that the forward book is still out there and that is something that the Reserve Bank has said we want to get shot off.

Yes. --- By a point in time later this year but if it was going to take longer to disappear, then the knowledge of that overhang is certainly then yet another thing in the mind of the participants in the market that indeed those rands or those dollars would not be there to defend the currency. They are going be "opgeslurp". They are going to be absorbed in reducing the forward book and that along with the other factors that I have mentioned the Reserve Bank not intervening and so forth, then created the mindset of the rand being a one-way bed.

Is the situation that we are now dealing with on this slide particularly from say 13 October but it could be from 11 September? Isn't this a market which is right for speculation because to take up your expression of a one-way bed. Isn't this precisely when speculators would climb into a market in order to make money and they received continued decline in the value of the currency? --- It may well be that. My own interpretation would be it is the kind of market in which people are scared of losing the value of their exports. If they do not keep the money abroad for longer because the rand is going to decline or if you do not take cover if you are an importer, you are going to have to pay more. So it depends on your point of view whether you see it as a speculation or whether you see it as an avoidance of risk or of potential or a reduction of risk and an avoidance of loss.

I am going back to probably your first or second slide. You are saying that what you think what happened was more an avoidance of a risk situation rather than making a gain? I mean that was your view. --- It became a risky situation to have an exposure to rand and to have it a future of your company dependent on the rand/dollar exchange rate, you are unedged.

It is 11:15. Shall we have the tea adjournment?

MR BROOKS: Yes, thank you.

CHAIRPERSON: Let us adjourn for 15 minutes.

PROCEEDINGS ADJOURN:

ON RESUMPTION

RUDOLF GOUWS (s.u.o.)

MR GINSBURG: If I may attempt to elucidate one of the questions which you asked Mr Gouws just before the adjournment relating to the net open forward position.

CHAIRMAN: Mr Ginsburg you are representing the South African Reserve Bank are you?

MR GINSBURG: Yes I do Mr Chairman.

CHAIRMAN: Yes.

MR GINSBURG: What I would like to do with your permission very briefly please is to hand to yourself and your co-commissioners a copy of the Governor of the Reserve Bank's statement dated 14 October 2001 in which the Governor deals with the method which will be adopted in future of dealing with and adducing the net open forward position. I have handed Mr Gouws a copy of that statement and would direct his and your attention to the second page and the second paragraph thereof. I am sorry that I have not paid you the courtesy of handing you a copy, I will do so immediately. --- Mr Commissioner could we insert this in the records at pages 130 and 131. (Inaudible).

MS QUNTA: Can I just get clarification Mr Chairman?

CHAIRMAN: Yes.

MS QUNTA: This statement you handed to us is this the statement as was referred to by Mr Gouws?

MR GINSBURG: Yes.

MS QUNTA: And the statement that caused the selling of the Mark or in his view. Is this the statement?

MR GINSBURG: It is the statement that he refers to dated I think he said 13 October.

CHAIRMAN: I think just read onto the record that paragraph.

MR GINSBURG: If I may read into the record the paragraph to which we wish to make reference, it reads as follows

"In future the Reserve Bank will not intervene by purchasing foreign exchange from the market for the purposes of reducing the NOFP. The NOFP will be expunged from cash flows derived from the proceeds of government off shore borrowings and privatisation. Accordingly it is no longer deemed necessary to publish a special monthly report on the forward book and the NOFP. In line with international practise this information will be published monthly on the Reserve Bank's internet site in accordance with the specifications of the IMF's special data dissemination standards."

And perhaps Mr Gouws would like to comment on the contents of that paragraph. --- Mr Chairman as I tried to indicate earlier on it is certainly something which I think was to be welcome in that the market therefore knew that other flows would not be absorbed as it were and could find their way into the market, so I do not have any problem with that. My point however is that since the privatisation delays which are indicated there on diagram 16 or that those, the delay in the Telkom privatisation in particular then meant it would take that much longer to reduce the NOFP and it might be useful if I therefore just shared with you the content of diagrams 17 and 18 to indicate the importance of this.

CHAIRMAN: But I just think from Mr Ginsburg's point of view that is what you wanted to place on record.

MR GINSBURG: Yes thank you very much Mr Chairman, and I am sorry to have to interrupt.

CHAIRMAN: Pleasure. You can stay where you are. --- The green line on diagram 17 is the total outstanding forward book of the Reserve Bank. Now it rose - let me explain this way, the forward book is the total outstanding amount of forward cover provided by the Reserve Bank over time. The net open forward position would be the difference between the forward book, that total amount of outstanding forward cover provided by the Reserve Bank and the so-called net reserves, that is the assets which the Reserve Bank holds on a net basis and it gets a little bit complicated but it is the gross reserves of the Reserve Bank that is the total amount of the foreign exchange and gold holdings that they have got, less the Reserve Bank's short time foreign liabilities, that provides us with the concept of net reserves and if you subtract the net reserves from the total forward book which is a liability of theirs you are left with the net open forward position of the Reserve Bank also then known as the NOFP. Now what we have on the bottom right-hand side of this is then the remaining NOFP overhang and I think as Mr Ginsburg was probably inferring or not inferring trying to imply and I think that is quite correct, that is now a much smaller problem than it used to be because the overhang was massive before and maybe a good way of explaining this is to say that the big increases in the green line, that is the outstanding forward book those occurred at points where the Reserve Bank at the time used the forward market to raise spot dollars. Now I am again not best evidence on exactly how this works but this is in fact then forward cover they provided, if it had not been for that then the rand at that time would have been under greater downward pressure than it was but that landed them then with a very substantial potential liability, if the currency turned out to be lower later then of course they suffer a loss to that extent which is for the account of the government. So that is how the, as it were the forward book arose. Now what one can say about the role of the NOFP, well before I do that let me then superimpose on this the actual rand/dollar exchange rate. Now Ms Qunta asked earlier on about the percentage change in the currency a better way and that would have helped her at the time because I could not just for technical reasons do it on that slide but I can on this slide is to plot not just the rand on an inverse scale like I have done there but to on diagram 18 but to in fact plot it semi-logarithmically, that means that you can actually judge the extent or the speed of the decline by looking at the slope of the line. I hope that is sort of clear. And the point then I would like to make is that the NOFP which is currently US$2.99 billion, the elimination of that is a necessary but clearly not a sufficient condition for sustained rand recovery and even though Mr Ginsburg is correct that the Reserve Bank policy has been since mid October that only those flows will go towards reducing the NOFP that is still a big black cloud as it were hanging out there and the elimination of that is a condition for sustained rand recovery. But now the irony of this is that the rand falls each time the NOFP is reduced. Because if we reduce the NOFP that is used dollars that would otherwise have been able to go into the market then it is not there to as it were support the currency, so as I put it there on diagram 18 ironically the rand falls each time the NOFP is reduced because the process absorbs dollars that would otherwise have entered the market re-enforcing the one way bet. But let me just qualify the word bet there, let us call it the one way risk, it is just that is the sort of phrase that people often use. It just makes it that much more likely that there is less foreign exchange to support the currency. So I hope this slide perhaps puts these things into perspective. So we need to get rid of the NOFP for the rand to sustainably recover but the process of doing that in fact undermines the currency. That is the irony of the situation that we are left with having allowed it to built up in a way that it did before. My understanding is that the NOFP increased over 98/99 as you show it there, that pinnacle, the last pinnacle in as way of as a method of dealing with it the rand crisis during the Asian contagion period is that correct? --- (No audible answer).

So did that not contribute in a way to the decline in the rand? --- Well what one can say is that with the wisdom of hindsight that that sort of - that we are suffering the decline in the currency now that we would have suffered then had we not increased the forward book at the time. This is a legacy in a sense. You could not escape the reality that the currency was under pressure and again I must stress at the time I was a supporter of the Reserve Bank's operations at the time, but now with the wisdom of hindsight one can say that we are now in a sense paying the price for that and it is only once the NOFP is completely expunged that this one sponge, sorry for that word play, will then have disappeared.

Isn't the conventional wisdom at the moment that it is correct for the Reserve Bank to be reducing the NOFP as it has been doing since 1998, isn't that so? And your thesis is that merely by doing that it adds or contributes to the decline in the value of the rand. --- Yes with the rider that Mr Ginsburg correctly pointed out that it is not an at all cost situation any more. NOFP is now much smaller than it used to be and therefore we do not have to use every single penny that comes in to do it, we can be, to do what the Reserve Bank announced in October that they would do. The problem is if the privatisation process had been accelerated rather than slow down then we could have, the red line could have fallen to zero and then at least this overhang is out of the way. And I think that is, it is not to be underestimated the role that that played through this period.

Thank you. Let us move on, we must finish before lunch. --- We will.

MR GINSBURG: Sorry just to correct the record, I am told by Mr Potgieter that the next statement is already page 130 and further, so could we then please renumber the Mboweni statement to page 129A and 129B.

MS QUNTA: 129?

CHAIRMAN: A and B. All right let us go on to page 127.

MR GANTSHO: Sorry we have an expert witness here, I am interested in his expert opinion as to how else could this net open forward position be eliminated other than by expunging the rand sorry the dollars out of the market? Do you have an alternative opinion perhaps in that? --- Well there would be sort of two obvious ways, the one would be to borrow heavily abroad and that is then to convert this liability into another form of liability and extinguish the one but then you sit with the other. What the government I think correctly decided is to do that but on a very moderate scale, so they have borrowed via for instance the syndicated loan recently and part of that has gone if not all of it to reducing the NOFP, so - but I certainly would not be a supporter of a large scale loan from the IMF or you know a big borrowing for that purpose because you know evil day is sort of just put off or in fact it is given in another form. So in a way it is a bit of a pain we must take. The preferable route is to have proceeded far faster with privatisation that you then get a genuine foreign investment inflow which you could use for that and Mr Ginsburg what he read to us there were in fact you know the two options. I would have personally, I think we would have been far better off you know if originally if our privatisation process had got off you know to a far quicker start but as it then happens because of the, you know the International Telecom Market crash and so forth it had become more difficult. Or then which will take much longer, is simply to create and I am sure we do not have time to discuss all of that now, the circumstances which would make South Africa a much more attractive country to attract FDI which would then include things like corporate tax rate, our labour dispensation, a range of other things, but that - it is a long term remedy.

CHAIRMAN: That is long term. All right let us move on please. --- Then something that I think will be very difficult to quantify the impact of. It is also so and I fortunately for my relations with people in government I cannot remember exactly who said it, somebody in government said you know it is really only the wealthy who worry about the rand falling because perhaps their imported Porsches or whatever would cost more and others stressed the positive aspects of the currency depreciation which I agree with currency depreciation if properly handled and I will come back to that in the next section, can be to the economy's benefit but in the minds of some people and

I must say I think some uninformed people in the market it looked as if the government actually could not, not not be bothered but as if they were trying to downplay the importance of this. Now if you see that along with the other things mentioned there it again increased in the minds of people in the market the risks and therefore it appears that the government is not that worried then you know maybe we should take cover or we should hedge ourselves.

Where would we find these comments? --- I would have to dig for them but certainly I can recall somebody in government saying at some point and it was quoted you know, it is only wealthy people who worry about the rand declining.

It is just that you know you have said there that the (inaudible) stressed it would not intervene in the forex market and then this is another question of comments. Now there should be some record of that in the media. Somewhere it would have been published what you are relying on there. Has our bank got a service that we can look at to actually place on record what those comments are and include it in the bundle. Is that possible for you to do that? --- I could do that.

Thank you. --- Scared of landing myself in hot water with that but it is germane.

Just at the moment it is vague and there is no evidence before us of it. I would like some substantiation of these comments that were made during the course of last year. If Mr Brooks could follow that up with Mr Gouws afterwards.

MR BROOKS: I will. --- then against this background if you were an exporter of course you should not break the foreign exchange rulings but you would try to take as long as possible to bring your foreign exchange in because it looks as if the rand is more likely to fall than to rise and similarly with importers. Then we can just continue on the 20 November it was then sort of confirmed that we actually do probably have a current account problem in that a trade deficit whereas before we had trade surpluses, trade deficit was announced and against the background of a world economy going into recession and therefore exports weakening it creates further concerns about the balance on the current account and then from late November let us call it Zimbabwean and an Argentinean contagion. We heard yesterday from Mr McCauley how a contagion can work. I will not deal with that but it sort of again created uncertainty in the minds of people operating in these markets. Then at the beginning of December the Reserve Bank announced that we in fact had a substantial deficit on the current account in the third quarter. Now again at that stage the news coming from the world economy was uniformly bad in that US going into recession, Europe slowing down and so forth, therefore concerns about a commodity producing economy like ourselves and especially we then knew that we had a substantial current account deficit in the third quarter and then of course on top of what I mentioned earlier on about average daily market turnover, December is of course what with a lot of people being away it is a seasonally thin market and then in the minds again of some people Mr Cross's retirement at the Reserve Bank might have played a role as well. It was misread perhaps by some on the day because the rand was then falling very rapidly as perhaps indicating, and I have got no evidence, if you ask me to provide this, I would not be able to provide that, but this was certainly talk at the time, I got phone calls on holiday about this, what was going on, also from abroad and it was purely him retiring for health reasons. All of which built up to a situation where by 20 December the rand had reached the worst point indicated there on diagram 19. Then that weekend Mr Manuel and Mr Mboweni I think put out a very sensible statement in which they reaffirmed that they are not going to reimpose exchange controls, that they are sticking to the broad path of economic policy and I think that did have an impact on sentiment. Then your commission was announced early in January by which time the currency had already recovered substantially, then just about at the same time there was better news on the financial account front in that the M Cell announcement which was not sort of a true privatisation but in the form of a loan, I cannot actually explain exactly how the transaction works, that that sort of brought a bit of succour I guess to the market and then the Reserve Bank followed on 15 January with the raising of the repo rate which you can see as a reversal of the, if you go back along that blue line back to 20 September as the reversal of the repo rate cut of September, plus then another 50 basis points so we had a tightening of monetary policy. Now again, and there I would agree with the Reserve Bank it was not done as it might have been done in the old days as direct support to the currency, it was done to send out the message that the Reserve Bank would not condone secondary inflation effects from such a currency depreciation, but nonetheless as you can see on the chart it did also or it was indeed followed by a strengthening of the currency. Mr Chairman and commissioners, these are I guess some of the things I think one could find many others, some of them are clearly in the realm of almost speculation. What I have tried to do is to create a sense of the atmosphere and of the sort of news with which the market was being - had to absorb at the time all of which together may have contributed then to the circumstance in which the currency declined in the way that it did. We turn to diagram 20, I will just make a quick interim summary then. To my way of thinking the impact of any single factor is impossible to determine. If you had to ask me but how can you say that that has this influence, I must say I do not know how I can say that but what I would say is that it is the confluence of a range of factors and forces which then brought about what we see there and they are as I point out a range of domestic and international factors impacted negatively on sentiment and expectations about capital flow and then a number of factors led to a sharply reduced market liquidity in which the factors just above that, I used the cursor then, I am cheating a bit Mr Brooks, in which they could then have a magnified impact on the currency and my conclusion would be that in these circumstances any action by market participants to protect themselves against rand depreciation would have had a disproportionately large impact on the currency. All right then what I would like to turn to is trends in the real effective exchange rate. If I - this would be an earlier chart which we simply copied here again. This is diagram 21 where we show with the blue line the US - the rand US$ exchange and the red line the trade weighted index which is also known as a nominal trade weighted index for nominal effective exchange rate, there are various names that are applied to this. If we now want to construct what economists call a real effective exchange rate you would take that index, the index represented by the red line and you would multiply that by a quotient and that quotient would be or would have above the line an index of South African prices and below that an index of prices abroad or inflation abroad. Now clearly if our inflation rises more rapidly, that is the red number at the top rises more rapidly than the blue number below it then clearly you are multiplying the nominal trade weighted index with the thing that is getting bigger and therefore the real effective exchange of the rand would rise. Now it might not seem very relevant but let me perhaps try and explain why this concept is used by economists. The point is now let us say you are a South African exporter and you find yourself in a situation like in the first half of 2000 where the exchange rate is, trade weighted index is going more or less sideways. If South Africa inflates more rapidly than the countries to whom you are exporting then your costs are rising more rapidly than the prices of the things that you are selling abroad, therefore your competitiveness declines, you become less competitive because your costs arising faster than your - the prices that you receive and the currency is not falling to compensate for that.

That means that in this little example in the first half of 2001 the real effective exchange rate which is then the measure of competitiveness would actually be rising and it would signify a loss of competitiveness and it is that which at the bottom of diagram 22 or in diagram 22 which we now want to explain. So I have repeated Mr Chairman the little formula at the bottom of the slide but I am taking you back to the beginning of the 1970's and we are indeed then plotting here this so-called real effective exchange rate of the rand. And what is immediately obvious are the big swings in that particularly. The sharp fall in the middle of the 1980's. What happened then? The rand was falling a lot faster than the - even the extent to which our inflation exceeded that of our trading partners, so there was a big gain in competitiveness. It was the only good thing to follow from the Rubicon speech and the dead standstill is the gain in competitiveness to South African exporters and companies competing against imports. And the way one can illustrate it like this and here this is purely for illustrative purposes. I have taken what you saw earlier on where we looked at the purchasing power - oh sorry I must again explain that slide is not part of the evidence, I will make copies of the testimony as you have got it but it is really just for illustration.

Mr Commissioner could we make this slide 22A. --- so if for instance the rand falls faster, that is the red line, falls faster than the blue line then there is a gain in competitiveness. This is the logic of the little charge. So if you are an exporter and you sit where that - the arrow on the top left is, then you are going to have a competitive advantage at that point and it is then indicated by this real effective exchange rate declining at the bottom of the slide and the same thing happened in the last couple of years as we can see. Then it might then become your slide B. We take the same thing and we say when the rand rises as it did at the end of the 1970's and early 1980's or if it falls more slowly than its purchasing prior parity rate as it did in the early 1990's, late 1980's then we have a rise in this real effective exchange rate and we have a loss of competitiveness. Now this might I am sure it probably is, irrelevant to what your commission is looking at but I hope to try and make it relevant. The point is that the rand fell very sharply in relation to inflation differentials in the mid 1980's that imparted a competitive benefit to the economy but that was lost again in the second half of the 1980's because we allowed inflation to rise. This is why an economist like myself is in support of the Reserve Bank's monetary policy that we try to avoid that mistake again. As I point out there this must be avoided by appropriate anti-inflationary policies. We do not want the real effect of exchange rate to rise again. And if you look at the line at the bottom there, we would now say that the rand is very substantially undervalued.

Sorry we are now on slide 22. --- Sorry I am now on slide 22, please just ignore, if I am allowed to point out that red writing should not be on the slide.

(Inaudible). --- I do not think it is actually on your printed copy.

We chopped your finger off and took the arrow away. --- The mouse as well. Okay the little ... (intervenes).

(Inaudible) you are referring to we can read it while you stand there. --- I apologise. The nominal effect of exchange rate, the tiny writing that you see up there should not be on the slide and if I am not mistaken it is not actually on your copy.

It is not on the diagram. --- Okay so that is irrelevant. And what I am trying to indicate there is that the rand indeed is now at a competitive level, that is South African exporters should be doing well, companies that compete against imports should be doing well as well, but what one should also say is that a large part of the decline in the rand in recent years, as signified or indicated then by that blue line declining on the bottom right hand side of the chart was the ... (intervenes).

Diagram 23. --- Of diagram 23 is indeed the result of to my way of thinking the correct policy approach by the government and well sorry before i get there let us just make this point on diagram 23 that a decline in this real effective exchange rate of the rand such as we have at the moment and such as we had in the early 1980's helps exports or exporters and import competing industries, however to maintain the benefit the inflationary consequences must be contained. And gain this is why I am in support of the Reserve Bank's broad approach to monetary policy because otherwise we feel only the pain and none of the gain of such a currency depreciation but again one can overstate the positive consequences of a currency depreciation and as I point out on diagram 23 currency depreciation raises the cost of capital equipment and other inputs and the cost of servicing foreign debt and, and that will then bring me to the last part of the presentation, it is also a symptom as well as a cause of weak flows of foreign direct investment and if I may explain that. Countries such as ourselves which have had to rely on short term portfolio flows and I must just say that we had to rely on that, beggars cannot be choosers, if that is all we can get then that is what we must have and we must not try with exchange controls or whatever to try to keep those flows out, countries such as those in fact therefore have a potentially more vulnerable currency because we are not attracting foreign direct investment flows, so it is a symptom of our not attracting FDI and it is also a cause because investors look at the country and they say if this is a country of perennial exchange rate declines then it means that my investment in that country is going to be worth less in three and five years down the line so that is a disincentive and also of course a depreciating currency has - reduces the dollar or foreign exchange value of the income streams that are generated by such FDI flows. So a declining currency such as we have had is obviously a mixed blessing and we must from a policy point of view treat it well and that means try to avoid its inflationary consequences. Mr Chairman that brings me then to again back to the exchange rate and I hope to the business at hand of the commission to say, to look then at the rand and foreign direct investment a little bit more closely. So what we are plotting on diagram 24 is the ratio of total domestic savings to the gross domestic product, and if I may remind you total domestic savings is the sum of what household save, their retained earnings or profits of the corporate section, it is the savings by government, in our government's case dis-savings negative number and provision for depreciation as it is also known, the consumption of fixed capital. Those four items sum towards then gross domestic savings. Now clearly if a nation does not save then it also cannot invest and as I pointed out earlier on a large part of the reason for the fall in savings in South Africa was under the old government before 1994 the dis-saving by government, a massive negative numbers. Now is that relevant to the work of the commission is because that created a propensity for the currency to decline via its impact on the savings balance and as we saw earlier on the savings balance is equal to the current account surplus or deficit. Now of course in the second half of the 1980's and the early 1990's we had to run savings surpluses in the economy because the rest of the world wanted the savings back that they lent to us in the times of those savings deficits that you see on the left-hand bottom side of the chart and then from 1994 with the new political dispensation we were again to start attracting foreign capital to supplement our poor domestic savings record. Now to come back to the currency, how were those domestic savings deficits funded and I am now using the work of Mr Geoff Lewis the economist at the World Bank. He shows in a recent paper of which I can supply you the name and references, South Africa attracted foreign direct investment equal to less than 1% of our gross domestic product through the period in question. However some South American countries attracted foreign direct investment to the tune of 2?% to 3%, Malaysia, the Philippines, Thailand 3% to 5%, Hungary, Czech Republic 4% to 5%. Now if we have a look at the exchange rate performance and I know this is an extremely simplistic way of looking at it and making as if there is only one cause which clearly there is not, those countries had a depreciation of between 22% and 64%, on average 40% over that period whereas South Africa that had to rely on portfolio flows which were a) insufficient and b) volatile and of the nature that it caused doubts about the underlying health of the balance of payment, we suffered of course the depreciation that we know which was substantially in excess of there. So it would just seem to me that, not that it is this commission's work but that clearly we should be putting a huge amount of effort into trying to understand why it is that South Africa does not attract FDI and that that would give us a far better in my way of thinking Mr Chairman, a far better understanding of the longer term underlying pressures on the currency than perhaps some other factors would. That is as far as then the formal presentation is concerned. I might then just for the record read the little conclusion.

Have you got the text? --- So my conclusion Mr Chairman would be having been fairly stable during 1999 when South Africa attracted large portfolio capital inflows the rand depreciated steadily during 2000 and the first half of 2001. Against this background most market participants came round to the view that the currency was weak and they therefore became more likely to take decisions to help protect themselves against further currency weakness. There was therefore a weakening bias in the currency by the time the extraordinary confluence of factors and forces started to exert and influence from early September onwards. Some of these affected the currency via the influence on the current account. For instance the International Economic Recession, more importantly most of these affected the currency by their negative impact on confidence and on expectations about capital flows. The role of these factors became magnified after mid October by a lower level of market liquidity following the Reserve Bank's announcement that foreign exchange control rulings were to be policed more rigorously. Some market participants may have as has been suggested taken advantage of the prevailing circumstances but 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 a number of specific transactions would therefore be very difficult and perhaps pointless in the light of the magnitude and complexity of the development since early September last year.

Now you have not read the full text of this statement but this statement was prepared by you is that correct? --- Yes.

And would you for the purposes of the record just confirm the content thereof is to the best of your knowledge true and correct. --- It is sir.

No further questions.

CHAIRMAN: Any further questions from the lawyers present in the room?

MS QUNTA: (Inaudible). I would like to start with the last question Mr Gouws,, your last answer about your statement. You were asked by Mr Brooks whether, what you say in the statement is true and correct. You have made various, what I think in statement, you have given us some extremely useful and educative background in the sense of how an economy works and so on and then in section 4 you have looked at the rand's fall in perspective. Now I understood that you were asked by the commission to give us a background against which we can comply with our terms of reference which strictly speaking does not deal with historical or much of the factors that you have indicated but they are useful - in fact they are valuable I want to use the word valuable. Now when you come to section 4 which deals with the rand's fall in perspective I presume that you realise that I wonder if you can use the word true and correct, it is not your words it is Mr Brooks's words, but you have indicated on several occasions that perhaps what you are doing there is in the realm of speculation rather than giving factual statements. Now in the light of that would you still say what you say in here is true and correct? Because that is quite important for us in terms of taking, weighting your evidence which is evidence really relating to a background rather than factual situations. --- Mr Chairman if I may respond immediately by saying I think Ms Qunta is perfectly right, you cannot ever be correct on economic matters. I mean my career is living proof of that if I may say. I actually do not know in many of these cases and I did say on record that the number of these things it is in the realm of speculation in that I surmise that for instance the cut of the repo rate in late September had some sort of influence on the exchange rate but there is no way that you can prove these things. Economics is by its nature a very soft science in which some economists have said everything depends no everything else. I cannot and I would then therefore retract if that was my response to Mr Brooks, it is not correct any of the stuff, it is analytical.

MR BROOKS: Sorry what I put to the witness was to the best of his knowledge. We can reply the record. To the best of his knowledge the facts and explanation which he has gathered, that which he has put in this statement is to the best of his knowledge true and correct.

CHAIRMAN: It is just a confirmation of his views rather than reading out the statement, it was a shorthand way of giving it.

MR BROOKS: Yes it is a confirmation of what is set out in this. It does not mean to take it any further than that. To put it on oath really.

MS QUNTA: I do not want to be pedantic and delay but it is very very important because all of this is going to go onto the record. To some extent the commission is going to rely on some of the comments made by Mr Gouws. Now I take your point Mr Brooks but I think what you are trying to establish is that the statement that we have, because it was not read into the record, it is his statement, that is what I think you are trying to say.

MR BROOKS: Yes.

MS QUNTA: But that is not the same as saying the facts contained within, these are facts. Because they are facts which is easily ascertainable in economics, they are facts, but section 4 deals with speculation and that is all I am trying to establish and Mr Gouws has agreed with me. I am not trying to delay things but it is very crucial that that goes - that is corrected.

MR BROOKS: Mr Commissioner that is why I added these words "to the best of his knowledge".

CHAIRMAN: I understand the import of the evidence.

MS QUNTA: I now want to come to your views on the statement by the Reserve Bank because it has been discussed yesterday and I am sure that it is going to be raised again in the course of this week and I am certain certainly next week by the Reserve Bank. Now we were handed a statement here which was the governor's which we had not seen before but which is very useful because it actually talks about what you indicated. If the, and this is the question of clarification from you, if the market is thin, the first question I have in relation to that is how does that specifically impact on the depreciation of the rand, how does it depreciate the rand. I would like the mechanics if it is possible for you to give that to me. --- Again Mr Chairman, Ms Qunta I am not best evidence on this but I think logic just says that if you have a market in which the turnover is half of what it was the month before or an equally sized transaction a sell order or rands or a by order of dollar it would have - it is proportionately that much larger in relation to the total activity that is going on at the time and therefore can be expected to have a larger influence than it did the month before. I mean you can take it, you can look at lots of other examples, non outside of the foreign exchange market and I perhaps put my mind to that if - yes I should be able to think of an example, but if there are very few buyers and very few sellers in a market and there is one person who actually wants that product, be it a property on the coast or whatever, that market will rise a great deal, as if there are larger properties, lots of buyers, lots of sellers then one transaction will have a proportionately smaller impact and this is the point that during December or after October you not only have a thinner market because there were far fewer, especially foreign participants who were put off by you know having to go through the hassle of or the hoops of getting things signed and proved and so forth, but you also had a seasonally thin market then any given transaction would have had a proportionately large impact.

But would that impact necessarily be negative. Could it be negative or positive or is it always ... (intervenes). --- It could be negative and positive but that is the point about my presentation that the overwhelming set of circumstances at the time were negative a) the Reserve Bank said it was not going to intervene. The NOFP was still there, the privatisation inflows were not going to be there, the world economy was in recession, export markets are going to be weak, commodity prices are falling, all of those things point to one thing only and that is a currency that is going to rather fall than rise and there is now a thin market and you have got one buy order for dollars is going to have a disproportionately large impact on the currency. Were the other circumstances positive then you would be quite right, then the rand would have appreciated a great deal, but a thin market coupled with a whole series of negative factors would give you the result that we had in the market.

The evidence that we heard from Mr McCauley yesterday is slightly different from yours. He indicated that while it is correct that that statement by the Reserve Bank could have thinned the market or did thin the market, the thinning of the market does not explain the rapid depreciation and you have indicated that in 20 days the rand fell by 40%, that is quite significant. You have also indicated that the turnover was half, but you have given us a figure that from one month to the next it was from 8 to 6, that is not half, that is actually minus 2 million and then it fell to 6 in December. So perhaps you can say from July when you first tracked to October it then goes to 5, but you will agree with me that from 8 to 6 is not significant and you actually used the term significant. --- Well it is very significant, in a market in which the average was more or less 8 billion, 7.7 in the first half and 8 in July and then 7 and a bit before then, such a reduction in liquidity is very significant and again I have to say I am not the best evidence on this. The people who actually operate in the markets I think in the course of the next few weeks will be able to explain that far better than I could but I am assured by people in the markets that that is indeed the case.

The statement from the Reserve Bank and I have just had the opportunity to read it, it does not deal with the tightening of exchange control it says "the enforcement of existing rules" and it is, they indicate that they will take steps against trading activities inconsistent with existing rules and regulations, so nothing new happened except that they stated that they will enforce existing rules and why would you think that the foreign traders in the market would exit on account of a statement which to objectively looking at it is really not a significant statement, because all the Reserve Bank is saying is this, there are rules and we are going to make sure that they are enforced and observed. --- Well again my colleagues, people actually operating in the market would be able to answer that a great deal better than me. But as I say I am told by my colleagues and you will see that in the course of the next few weeks that that indeed was the case, that a lot of foreign banks because they now were sort of having to, to put it that way, to go through hoops to have a far larger administrative burden they would far operate, far rather than operate in other markets than in this markets and their not being there, then actually meant that there was a smaller overall turnover in the market which then brought about the circumstance that you saw. But I am not qualified I have to clear to explain exactly what the decisions by foreigners, you know how those were taken, what the exact considerations were. But it is shown up in the numbers that the volume did decrease significantly after the announcement.

Okay. I am also interested in your confluence, the confluences factors that you have referred to and you have used them on diagram 16 - 15, 16 and 17 and most of those factors that you have raised deal with what the Reserve Bank did or what it did not do and with - well with the Reserve Bank if I can just go to that essentially. Is it your view or your opinion that the - what you term reduction of risk by market players, is it your view that that did not play any role on the rand, whether it is positive or negative during that period that we are talking about, do you exclude that there could have been transactions there that had an impact over and above the factors that you have mentioned? --- Not at all but as I say in economics everything depends on everything else. Those decisions were taken the background. Exporters delayed as far as they could up to 180 days, the repatriation of their earnings. Importers took cover as quickly as they did and whatever other transactions took place, all of those things took place against a background which is this confluence of factors and it certainly is not my contention that it is all the Reserve Bank's fault. The Reserve Bank essentially did what I thought they should do and not target a specific value of the currency but what they - they made is clear in a way so often that it then became market participants then thought to themselves but they will not intervene and therefore there is nothing weighing in against all of these other confluence of factors and forces and as we have just pointed out the statement of mid October did indeed lead to a number of foreign players exiting the market so it is, so what I am trying to say, perhaps not very well, it is the sum of all of those things and all of the interactions that brought this about. It is certainly the decision of an exporter to delay its export proceeds. It is what made that, well it is what brought that about and maybe I am making - I hope I am making that clearer.

No I understand what you are saying but you see my question is, you have sketched the background against which certain players in the market could have taken certain decisions including engaged in certain transactions which would have had an effect on the exchange rate. My question to you was therefore do you exclude that those transactions whether they are correct or incorrect, whether they are legal or illegal, unethical, that is not my point, if those transactions are looked at could they have had a contributing impact or could they have caused some impact on the exchange rate or are you saying that they played no role in the exchange rate during that period. --- They absolutely played a role. If I may refer you to my first diagram which shows all those boxes. It is the decisions of all of the people right and all of the people on the left of that, the domestic and the foreign players, it is those transactions that they entered into on account of a range of other things that brought this about. They are mechanism or the conduit through which this has an impact on the currency. I mean otherwise the currency would not have fallen. It requires a transaction for the currency to rise or fall but those decisions are taken against a background and it is the complex of all of those things that I am trying to elucidate.

And are you able then to ascribe a specific percentage of what those transactions would have had and what the other factors that you have mentioned, are you able to do that. Are you able to say this contributed 10% that contributed 50%? --- Then I certainly would not be able to answer yes to a question about correct because that would be totally impossible I am afraid. The one is the conduit in a way for the other in my way of thinking. There might have been some autonomous transaction which were taken, people wanting to make a profit which is the business of what a lot of people are into, but to ascribe a percentage to that or a course to that I would not be able to do that and I do not think any other analyst would.

Thank you.

<u>CHAIRMAN</u>: Questions?

<u>MR GANTSHO</u>: No further questions.

MR : No further questions.

CHAIRMAN: No questions?

MR BROOKS: No further questions.

CHAIRMAN: Thank you very much for your assistance, we really appreciate it. We will adjourn until 14:00. Might I make a suggestion about this record which is going to come in each day ...

COMMISSION ADJOURNS

What does that mean? --- To stay within your, you enter into the markets and you close out the position that you have. If you are long on Dollars you would have to sell them, if you are short, you will have to buy them back. You would have to bring that 25 or whatever the limit is that you have, that is now putting you at a loss of 500 000, you would have to reduce that position to nil. So you would have no, it doesn't stop you from actually taking the selfsame position immediately after you have closed it out because now you start from nothing again, but then you must also bear in mind that you have a daily stop loss limit which is now in effect. So you can take the same position twice, lose the same amount of money, then that is it. Your day is over.

Your day is over. What do you do then? --- Put your feet up and watch the carnage.

You are not allowed to continue trading? --- Hypothetically that would happen. You will find that in the major trading banks, that this is not going to hold true, that there is somebody standing behind the trader that is making the decisions, that says: carry on. Run that position, I know your limit is 25, I know you have got 50, keep them. I know your loss is a million, stay with it. There is somebody that will be behind the trader, that is making that decision. Or he is saying: that is enough, let's get out. That's too much. So they are there as part of, they must be there for compliance purposes. You must have stop loss limits. There must be a point where you say that is it, and no more.

It is a mechanism to control. --- It is a mechanism of control that is instituted by your risk management department because you make sure that your dealers don't become runaway renegades.

COMMISSIONER: Those figures I realise are illustrative but that profit target for the year of 20 million, is that something like a norm for the industry in South Africa or what? --- Your major banks, it will probably be more than that.

And what age would the trader be who is required to make that profit target? --- It depends.. (intervenes)

Is it a young person? Twenties, thirties, what are we looking at? --- You cannot allow the responsibility of the Rand to a too young individual.

So is it an experienced person who would have that sort of profit target? --- There are major banks where the Rand traders are over 40 years old. There are major banks that have traders that are under 30 years old. It is a very responsible position and your best dealer in the room is doing the Rand.

MS QUNTA: Is that the case abroad? --- No.

What happens abroad? What is the average age of traders abroad? --- You would probably find it is younger.

What age? --- Twenties.

Okay. --- You know they, usually you know you progress and you can't spend any length of time on a trading desk.

So you have the same lifestyle as a model more or less? --- Ja, you become old and decrepid, I mean.. (intervenes)

At 25? --- To go through what happened last year, you can't do that day in, day out. You know you want to, you cannot do it. It is just not possible.

COMMISSIONER: You mean because it is stressful? --- It is extremely stressful, particularly for a market maker.

What is contributing to the stress? --- We will get into the detail of how the different stress levels will increase in different circumstances.

Are you going to take us through that? --- I will get to that.

All right, let's get to that then, thank you. --- Point 76 we have dealt with the typical trader mandate. Point 77 on the top of bundle 1-4-1.

In a volatile market conditions, traders are exposed to extreme stress, particularly those involved in market making and servicing customers. The reasons are as follows. Market makers are expected to continue to quote prices and this is extremely difficult in a market that is devoid of any logical reason for what is happening to the currency. Customers expect traders to transact with them, regardless of the market conditions. It is then extremely difficult for traders to close out these positions in the market and many smaller players that are normally active in calmer market conditions, simply withdraw from a volatile market resulting in a sharp decrease in liquidity. Many traders will justifiably argue that there is no amount of money that would fairly compensate them for trading in extremely volatile conditions. To continue to trade day in and day out under the conditions Rand traders found themselves during late 2001, is stressful in the extreme.

MR POTGIETER: And you are going to deal with that later? --- I will deal with it in more detail later.

Yes. --- Traders that are unable to cope with stressful conditions or make bigger than usual losses, may be given a break on a less stressful desk or may face the end of their trading career. Factors affecting traders views. Market research. Larger banks have extensive research capabilities which usually include leading economists. Smaller banks have limited research capability and rely on outside research resources. Many banks publish their weekly, monthly and annual view on financial market conditions which include a recommendation on the Rand. There are also independent research institutions which publish similar research material. Econometrics is an example of this. Traders will refer to their own bank's research as well as other published research, in order to form views of the market. Corporate desks will contact customers to convey the research to them. This may result in customers wishing to trade.

Can you explain that please? --- The major banking groups and, usually will publish, or will publish a paper on an expected move in the Rand, based on certain events. Whether there is a deluge of figures that have come out recently, that indicate that it might move in a certain direction. That there is pending transactions or there is inherent problems because of underlying problems in a certain country. And they put out and they will explain exactly what they mean and below this they will then put a recommendation: we suggest that this is what you do because this is where the currency is going to move to. This is used as a marketing tool for these major banks, that they will phone the corporate customers and say: before this hits the market, we want you to be the first one to know that this is coming out. So if you want to react on it, you have heard it first. It does and sometimes these reports, sometimes they are balanced but invariably, in the case of the Rand, the slant is 70 30 against the Rand and they will put out these publications which could have an impact on the next move in the Rand. Global and domestic events. Events that are happening in a country itself, have an impact on the traders views. Example are local businesses moving their operations offshore and the possible impact on the Rand. All Rand traders have a view on what is happening with the movement of all these companies offshore. It might look good in the short term with the expected inflow of capital and Dollars into the economy but the longer term implications means there is flows that go out of the country in the form of dividends and they just look at it as further disinvestment from the country. And it just goes, as part of that process of one of those variables that they consider when formulating an overall view on the Rand. Unexpected events such as 11 September have dramatic consequences for financial markets.

What could happen typically on a day such as when news like 11 September news appear on the screen? --- Different people will have different perceptions because people might view it as Dollar negative and some might view it as, initially it would be viewed as Dollar negative.

Now who takes that decisions.. (intervenes) --- Now when you take

Dollar negative.. (intervenes)

Who takes that decision for the trader? --- The trader makes it. He has got to make a decision as that news comes out.

And how long does he have to take this decision? --- Seconds.

Seconds? --- Again you want to be first. You don't want to be the second one hit, trying to hit a price or trying to chase because there might be something that is behind you or you might know of something or it might have a direct impact on the position that you are currently running.

Would five minutes be too late? --- Yes.

And what sort of amounts are we talking about? --- When we talk, it depends what we are talking about. Internationally the amounts are substantial. Hundreds of millions of Dollars as a position. Domestically you probably find the banks are running, I have got to try and guess what major banks are running those positions but you know, possibly up to $50 million at a time. Maybe a little bit more. Now as we explained before, in the Rand market, you can call one counter party in $3 million. If you divide that into 50, you have got to see how many calls you have got to make to actually just get out at a break even point. I am not suggesting that every bank runs in that bigger position but if there is one single counter party out there that is running the position of that size, the knock on effect of him liquidating his position, is going to trigger another series of events.

Mr Langley we are dealing with the spot Rand trade at the moment, is that not so? --- Correct.

Now on a day such as 11 September, what are the type of transactions? Are there only spot transactions? --- No, there is never only spot transactions. The spot desk is just one desk in a treasure operation.

So would that mean then.. (intervenes) --- That happened, all markets will react instantaneously. The interest rate market will move because there is going to be a perception of what might happen. Your stock exchange has collapsed which might mean that the Americans, who are very dynamic in actually reacting to new like that, you might get Allan Greenspan moving immediately on interest rates and lowering them, to try and instil confidence, immediately in the financial sector. It is all about the perception of what the person is in charge of the monetary policy in that country is doing to combat an event that actually happens.

Does it mean that when news like this breaks, that a trader may find himself in circumstances where he has to conclude a number of deals, a series of transactions, literally within seconds or a minute or so.. (intervenes) --- Yes.

Involving large amounts? --- Your dealer board will light up like, that toy that we talked about and the hub of activity will go from zero to 100 on a scale immediately. Because everybody reacts. Invariably most of them are not, the first move is not necessarily the correct move. It is people reacting to a news item and then they calm down, they take a step backwards, they have got a position and then you would probably find another subsequent move happens. Because you have got to try, as a headline comes out, you must react. It might not necessarily be the correct, your judgment might not be the right one of the event that has just taken place.

Please proceed. --- Ongoing adverse events that can impact on the currency, example the continuing Zimbabwean crisis and the South African reaction thereto. This has an ongoing, it is part of that, one of those variables that you consider when you take in a risk position in a currency and we look at our government stance on, that they have adopted to the crisis in Zimbabwe and it is, for a long, long time we never did anything, we never said anything. So the market views that as negative. We are not actually taking a stance. We are not saying yes, we are not say no, we are saying nothing. So the market must now develop its own perception of why we are saying nothing. So it will develop a perception and it will be a negative perception.

Domestic as well as offshore market? --- Correct. Offshore will look at it as in saying that is Zimbabwe, it is right next to South Africa, now by implication, if there is trouble there, there is going to be a knock on effect that is going to impact on South Africa, which is going to then have broader implications for the domestic economy, whether they are in the form of refugees or people coming down here and increases in crime level, unemployment, whatever. It is just, they will make up a story that will fit the view that they are going to sell to their customers, to generate a particular trade.

Okay, proceed. --- Political and social conditions. Political and social actions, decisions and conditions in the country go a long way to determine the sentiment towards a currency. Fiscal and monetary policy. Actions and decisions also effect the sentiment towards the currency. For example exchange control enforcement, interest rate monetary policy.

There was an incident, after the Rand started going, getting into trouble in September October last year and the Reserve Bank highlighted the point that certain exchange controls are still in force. Now all the Reserve Bank did was reiterate again what were the exchange controls with regard to foreign banks trading in the inter-bank domestic market. And the inter-bank market made a big ho-ha of that statement and what were the implications of it. But the exchange control debate will go on and rage on until exchange controls are abolished and it will be a factor in the Rand and part of those variables that the Rand trade considers when he takes a position.

Rumours have a definite influence on the Rand market despite the fact that the same old rumours usually keep surfacing. Persons that wish to create reaction in a currency probably initiate these rumours.

We talked about that a little bit earlier.

You mean that people actually create a rumour. --- If there is nothing going on and you have got a risk position, why not make a story or rehash something? You have got to get in, this is what I came back to the point, there is volatility in the extreme or there is no volatility. There is never a happy medium or very seldom is there a happy medium where the Rand will find a range that it will trade in and everybody is happy. So if you take the right view and you are right you make money and if you lose well you lose. But if nothing is really happening, you have got to generate some sort of interest or talk about something or get the currency moving.

MR GANTSHO: Do you have any evidence to back this up or is this just a perception that is out there in the market, that people do create rumours. --- It is a perception. People phone and we will say: well where did you hear that you know and then I will phone somebody else and say: have you heard that, and now all of a sudden it starts. So it was nothing but somebody started it.

But that has happened in the past for sure? --- It happens, sure.

COMMISSIONER: So when you say it is a rumour, you mean after the event you look back and you find that there was no substance to the rumour? It is not recorded in the media or there is no subsequent following up with that? --- Absolutely or you will get a headline that will come out on, because it has now got to the extent that this rumour has now been blown out of all proportion and somebody will come out and deny and say that this is actually not the case. You have seen those before.

And you will see those denials and then you will know it was a rumour? --- Now again the currency doesn't, it reacts to the rumour and because of the events that now, that rumour has caused, it has triggered deals.

Right. --- And it never comes back.

Good. --- Not never but seldom.

Seldom, ja. --- Traders views. Traders will consider all these factors and sources of information and form a view on the very short, short and medium term direction of the Rand.

Very short can be five minutes.

Trade will then translate this (indistinct) inter-trading strategy designed to generate income and will implement the strategy within the limits available.

The strategy will then be monitored and closed out either if the traders feels that no further profit is to be made or if traders views change or a stop loss limit is reached.

Ethics in a trading room. Point 96, bundle 143. Although traders are usually required to commit to a code of ethics, either an internal code or an international code such as the ACI model code, traders largely ignore these codes, particular in times of high volatility.

Examples of an unethical behaviour that are occurring are the following. Two traders at different banks collude in an attempt to manipulate the Rand in one direction or another. Trades that could be done and then cancelled between two different traders at different banks in order to create the perception of actual trades at a particular rate.

Banks that are known to be very large or active transactors attempting to disguise the activity by asking another bank to execute orders of a trade on their behalf.

MR POTGIETER: If you are, the chief trader comes into the bank on a Monday morning, telling the traders you are going to write within ten minutes an unexpected test on the ACI model code, what would you expect the average (indistinct) to be? --- They would all fail. It is a book that will get dumped in front of you and you will say: yes I know all about this and you will sign the document and you won't read it. So, there are practices and you know, there are supposed to be laws between traders. There are things like my word is my bond and you know, you are supposed to trade in an ethical and professional manner at all times. If people find that, it is the responsibility of the chief dealer to sort out these people that are not trading in an ethical manner and take the appropriate action against them. But very, very difficult to actually prove that somebody is being unethical unless it is blatantly obvious. The toy that we talked about is a good example of how people manipulate, two banks can, I can put a price in and phone you and say: look trade on that price, it looks like the market is going that way or heading that. We will phone each other back afterwards, cancel the trade by doing a counter trade. So there is trades that actually take place but nothing happened. We are trying to create a perception in the market that the market is maybe geared in one direction or another. Some banks that have a reputation of moving the market when they are active in the market, will find other sources to actually front for them in executing trades. Because they don't want to be seen because if they are seen, the market gets nervous and it will move and react and take it away from them, particularly if they are trying to do a reasonable amount. A reasonable amount could mean, \$20 million, \$30 million, \$40 million.

COMMISSIONER: Mr Langley what is the extent of this sort of unethical behaviour amongst the banks. --- It usually happens when it is quiet.

When it is quiet rather than when it is volatile? --- When it is volatile, you don't even have time to get involved in this nonsense.

Yes, you mean because you can make your buck anyway? --- It is the same thing as trying, causing, the principle is the same. There is not too much happening, you have all got a position to try and let the market believe that the currency is maybe swayed in one direction or another. What do people say that it feels heavy or it feels, you know it looks like it ti going to do this and they will trade in that direction so that it will compound the thing, so that it will actually move.

So you mean these practices are used in a way to generate volatility? The circumstances out of which one then makes a buck? --- Yes. Normally this is applicable. When it is extremely volatile, you don't have time for this nonsense.

And do you need it, in times of volatility? --- No. You actually want the phone to stop ringing. You actually want the thing to stop. You actually pray for a quiet day.

MR GANTSHO: What controls are there to prevent this kind of thing. One example for example is that conversations that take place in a dealing environment or in the dealing room, are taped. Wouldn't that discourage this kind of behaviour? --- Ja but we meet in a pub after work and we discuss how we do it.

But what controls are there then and there are controls in other words. --- The guy at the desk must control it, the chief dealer, the guy that is responsible. If your most senior trader is doing it, then you are actually in big trouble.

COMMISSIONER: Now can the chief dealer pick up that his dealers, assuming he is an ethical dealer, the chief dealer, can he pick up that his subordinates are doing this, any one of these examples that you have raised? --- Yes. Dealers are normally sitting this far apart from each other. So you can actually, you can hear a fight with the wife, let alone what is going on in the market. You can hear everything. So it is the responsibility, you should, to start with, you should deal in a professional and ethical manner and there should be no place for that.

Yes. --- But sometimes, people in desperate times and desperate situations do desperate things.

Now when are those desperate situations in a currency market? --- Sometimes, you will get, what we said earlier, you know there is a high price that is paid for rewards. There is a similarly high price that is paid for failure and trader might be fighting for his life on a desk and wants to stay on that desk and will do whatever is necessary to make sure he is profitable.

MS QUNTA: Mr McCauley yesterday mentioned the same practice that you have mentioned, where banks can get involved in deals which in fact are not deals, which you have just described. --- Yes.

And I imagine that he would say that from his experience with the Bank of International (indistinct). To what extent does that happen in this country? --- It is limited. There are banks that do it.

Okay. --- There is a lot of banks that do not tolerate any unprofessional behaviour at all.

But there are banks who do that here? --- But there are banks, there is, the set-up of the bank might mean that there is a responsible person might not be always in the vicinity and the trading activity is left to a young chap that is there and his brief is to make money. And you are so busy that, you know they don't even go near him because it looks like he is there all day, every day and he probably hasn't got time to get involved in these, banks you know, can group together and they will go and try and create an impact in the market because it is better to hunt in a pack. Because your impact is that must stronger.

COMMISSIONER: All right, let's carry on. --- We get to the trading under different market conditions. Point 98.

Set out below is a summary of activities and influences that a trader would encounter under different market conditions. A quiet trading day, the atmosphere, the primary activity in a trading room under quite market conditions will be traders looking for ways to entertain themselves.

They will do, you know on an extremely quiet day, if you had a piece of carpet that was long enough to make a cricket pitch out of, you would be playing cricket, throwing a rugby ball around, getting out on the golf course. The level of concentration will be low.

The early morning activity will probably see some small trading, as all market participants attempt to generate some income from the quiet conditions. If interest fades, the market will grind to a halt, the spread in these markets would be a maximum of 100 points.

There is an example of what 100 points or pips mean. That is the market convention, as we know it, well it is not market convention now but 300 or 400 points now. But those were, it used to be smaller.

Normal or average trading day. The atmosphere. The traders would be very attentive and in conversation with each other to share information on possible trading ideas. The level of activity will be moderate and the market will be trading within a range of exchange rates. These conditions prevailed in the first quarter of 2001 where the Rand traded within a range of 7 65 to 8. There is enough opportunities there for everybody to make money. Some of the circumstances that were explained, would happen.

The spread.. (intervenes)

MR POTGIETER: The difference there would be how many points? --- The spread would be maintained. The market will always try and maintain a standard spread.

But compared to the 100 pips that you referred to .. (intervenes) --- It would still remain on a 100 pips because it is within a range, there is no unnecessary volatility. There might be a day of volatility but the spread would remain the same. It doesn't actually serve anybody for the spread to widen. As soon as the spread starts widening, participants start withdrawing or start reducing their exposures or take longer to make a price. There are a whole set of circumstances that will, we will discuss.

Large amounts may be traded in the inter-bank market on request. All the market participants are willingly active in the trading activities. When we say there is a market convention, if you call an inter-bank counter party for a price, the price is good in $3 million. There is an exception sometime, you will find smaller banks will phone a bigger bank. The smaller bank doesn't want the risk. He has quoted a customer on a trade of $10 million, he will phone a bigger bank and say: are you prepared to make me a price in the full amount. They trade, it happens. Nobody knows about it and the bigger bank carries on with his business. So, but for an inter-bank quote the price is three million.

Volatile market. A tense environment where emotions run high, where communication is focused on the market events and trading. The level of activity will be high and there will be a wide trading range for the exchange rate.

The trading methods. At the first signs of volatility, when I mention volatility, it is above average volatility. Normal volatility is good for the market but above average volatility. The spreads will start increasing and they will vary in size from 300 to 500 points. The example would be 11 41 to 46.

Smaller banks start withdrawing from the market and traders start reducing the size of their risk positions. Market makers decrease the speed at which they respond to requests for prices because they become more cautious as the market prices are moving faster. This slows down the process of getting market prices.

It might be a good time to put up slide 9 on the bundle 160, just to look at that slide as well and I will explain now in detail, as we hit the panic in the market, the atmosphere will be extreme tension, frayed tempers, zero tolerance, high levels of stress prevail.

The level of activity will be high with sporadic bursts of very heavy trading. Liquidity dries up completely, spreads become as wide as a 1 000 pips, i.e., the price could be 11 40 to 50 and the transaction sizes can reduce to $1 million.

Trading methods market makers are reluctant to quote on any transaction above three million. Most smaller banks will limit their trades to a need to do basis and will be extremely limited in their speculative trading.

There will be heightened frustration from market makers because of their inability to liquidate positions. This frustration is displayed by the reluctance of banks to make prices without a back-up price or a general idea of where the currency, the Rand is trading.

What happens? In periods of extreme volatility like we experienced.. (intervenes)

Mr Langley just before you continue, to put this into perspective, the events of 11 September, how would you describe the market on that day? As normal, volatile, panic and also the second half of last year, towards the end of the year. Did it reach panic stations or not? --- September 11 arrived in South Africa when we were in the midst of already a volatile period. So it will be difficult to quantify what the events of 11 September had on domestic market. It just heightened the level of volatility. Internationally, the level of volatility would have increased tenfold from what it was experiencing prior to 11 September. So there was a massive reaction. A lot is probably unknown as well because of the lot of unknown variables, how different things are going to react to that particular news event, what the repercussions were, the speed of repercussions. Are people just going to go in now. But the Rand was already in a period of, I wouldn't say panic yet but it was in a, the market was in a period of above average volatility and it compounded the problem. I think on the day the Rand appreciated. I think it actually appreciated quite remarkably.

And last year in South Africa?

<u>COMMISSIONER</u>: At the end of the year I think .. (intervenes) --- At the end of the year, that is, it is mayhem. Particularly for the major banks. They have a serious problem because they are market makers. They have large corporate desks that they would be inundated with request as to, they know what is going on, they just want to cover and it is cover at any price.

<u>MR POTGIETER</u>: What do you mean when you say cover? --- Importers, importers are panicking. Exporters will sit back and say: well let's see how far this goes because I mean, it is weakening, the more it goes, the more

money we are making.

Are you talking now about the situation when the currency was at it lowest, 20 December or.. (intervenes) --- The period November December, that period of time.

It was not only a one day period. --- It is not a one day period. It is days and it gets worse every day as people don't want to be drawn into this type of activity on a day in day out basis.

I interrupted you, you were talking about importers. What did you want to say? --- The only people that are going to be contacting you seriously are import customers because they have got massive import exposures. While the market is relatively stable and calm, they will sometimes take, speculate with what they have to cover, by not covering because every day they stay uncovered, it actually saves them money. But in periods of extreme volatility there is actually no saying where the exchange could start, could end and where it could actually, you know what the events of the day could happen and they will cover everything. You would also have corporate desks in the various banks phoning people and saying: look just, there is no saying where this currency can get to, cover. We cannot advise that you remain uncovered on your commitments that you need to cover. We suggest that you would cover. A bank can never force you to deal, they will give you a recommendation on what they believe is going to happen to the currency and make a recommendation as to what you should be doing with your commitments. This will filter through to the Rand, the spot Rand there because he has got to price these corporate customers that want prices. He has also got to quote the inter-bank market that have corporate customers behind them. They have fund managers behind them and he has got to actually trade his way out of all these various positions and hopefully be in a position to actually service some of these requirements that are needed.

And what fundamentally is the problem under these circumstances. Is this a scarcity of Dollars? --- It is liquidity.

Particularly people wanting Dollar or what is it? --- We are in a desperate situation now. Small banks that don't have to be involved, withdraw from the market. Small banks play a very important role in the normal trading activities of the Rand because they supply liquidity. They are there, they show their interest, there is available liquidity if people need to transact and clear positions, you know, get into a position. The more volatile it becomes, the more reluctant those people are to trade and they withdraw. Then you have people that are call up, what we said you are calling up for aback-up price. If I have got people that are calling me for a Rand price, I would like to know roughly where the exchange rate is. Now if for argument's sake the exchange rate, the last price I made was 11 40 to 11 45, that was the last price I made. I have got a corporate desk shouting at me and they want a price for a customer in $10 million. I have got an inter-bank counter party that is on because he has been asked by the same customer or another customer, he wants a price as well. I have now reached a point where my stop loss limit is at a level where I can't run the position that I have got currently. So I have got to get out of my position first before I can quote the customer and quote the inter-bank counter party. What happens here, you get this gridlock situation. I can't make a price until I get a price, so that I can get out of my position. I am just talking from the perspective if I didn't, I am now, if I have got a position that is fine, I can suggest a rate. But if I am getting a back-up price or need to liquidate a position, then at some point somebody has got to make a price and this slide is a good indication of what happens is that 40 45 might have been a last price that was quoted. Now we all know which the general direction of where the currency is going. I have got ten people asking me and they are all importers, so I know what they are going to do. They are all going to want to buy Dollars. I need to buy Dollars for myself because I need to fund this fund or I need to fund my own position. I have got half an idea of what the inter-bank counter party is going to do. I could make a rate of 11 55 to 11 60. If my customer wants to buy Dollars or my inter-bank counter party wants to buy Dollars as well, he is definitely not going to trade on 11 55 to 11 60. That is the last price he wants to hear. Now nothing has happened, nobody has traded. It has just moved. It was 11 40 45, now it is 11 55 11 60. No business has happened. I have just suggested a rate. If somebody is clever enough and they, you know, they actually deal on the top side, I can look at it in one of two ways. I have actually got out of my position cheaply or I was stupid enough to make the wrong price and lucky to the guy that actually, but 9? times out of ten this is what was happening. The price just ratcheted higher because people didn't want to make a price where they thought they would actually trade on. So you are making a price where you believe that you are pricing it at a sufficient level that you are actually not going to trade. So you are pricing not to deal and you are not pricing to actually deal here. And it just gaps.

MS QUNTA: Sorry, I am just trying to understand you. So in effect, if you are under pressure, you are saying ten different people ring you. --- Yes.

What are you, you are the trader. --- I am the trader.

You are the trader and who is the market maker? --- I am the market maker and the trader.

And the trader okay. --- And I have got ten people shouting at me for a price.

And you have got to make a decision but you don't actually know but you are trying to make a decision on a price that will not cause you a loss. --- Correct.

And it is a risk you are taking either way. If you say 11 55 you may lose and it is actually 11.. (intervenes) --- And it actually hasn't moved.

And it hasn't moved, you will make a loss. --- Yes.

But if you say 11 55 or 11 60 and it has moved, you make a profit. --- No.

Okay, so what is your risk? What is the chance you take because earlier you said that.. (intervenes) --- Massive. Look, let's take for argument sake.. (intervenes)

MR POTGIETER: Do you want use the flip chart? Will it assist or not?

MS QUNTA: No, no I think it is the process from the 11 40 to 11 55 that I am trying to understand and, because you say and then you suggest a rate and you take a risk. You can either, if you are right you win. If you are wrong the other guy wins. --- Let's assume that me as the market maker and the trade, I don't have a position and I have just cleared my position and when I last traded, it was between 11 40 and 11 45.

Okay. --- Now I have ten people asking me for a price at the same time. Something has happened or I believe something has happened. I must use my judgment to rationale why ten people are calling at the same time and why three or four inter-bank counter parties are calling, something has happened. So it is either 11 30 35 or it is 11 55 60. The market invariably or if it has got to guess rate, will go up rather than down.

Okay. --- I must make a judgment call. If my judgment is to make that price of 11 55 to 11 60 and I get traded at 11 60, I am in big trouble.

Why? --- Because I have just dealt somewhere between 11 40 and 11 45. I have now made a rate where I believe there is no hope in hell that I am actually going to do a trade between 11 55 and 11 60 and I get traded at 11 60, I know where the next price is going to be. Now I am short of Dollars, now I don't want to be, because if I have just traded nearly 20 cents away from where I last traded, I want to get those back as quickly as possible. And if I call a different bank and he makes me 11 75 11 80, I have got a serious problem.

So what do you .. (intervenes) --- Do I immediately that at a loss at

11 80 which is 20 cents on say $3 million which is R600 000,00 or do I hope like hell that is comes back because the next price could be 12 and this is what compounds the problem sometimes, is that people, they hear a price, they don't think, they just think: it has moved again and let me just get these things in and they buy them.

The Dollars. --- The Dollars. Now they have bought these Dollars, now the guy that has just made the price thought: why is he hitting that price? What is going on and now all of sudden, you know, panic just takes over, now you have just got to get out at any price. But this gridlock situation where there is no prices in the market and I will come back to what could happen, you need somebody that is going to supply a price, dealers need comfort. They want a little blanket that they know that there, there is prices and there, there is prices. This is where the voice brokers play a role. There is a price you can hear it, there is a toy you can see it. When there is nothing, something has happened, something is going on and you have got to make a decision. Okay but now all this has happened, we haven't got because I have get ten people shouting at me that they want a price and they want it now. They are not interested in my problems, they are interested in servicing their customer. And the bank is getting irritated now because he needs to do something and he is: where is my price. And there is nothing to allow me to sort of gauge where I should pitch this thing. So I am going to pitch it one way.

COMMISSIONER: So how long have you got to make that decision? --- Usually, if a bank calls you and you know where the price is, you call me, you go Rand and I will go 40 45 as you call or within 30 seconds you have got your price, you have dealt, you have said no and you have gone away.

But your example where ten banks are phoning you and there is an inter-bank relationship.. (intervenes) --- Now you have got a gridlock situation, you need somebody to, that could take a couple of minutes before somebody offers something that people can sort of say: well okay, that is where it is. Maybe nothing has happened. Maybe it is still 40 45 but you must remember the market is now in a state of panic and they just want to make sure where it is. But by somebody making a stupid rate like 55 60, it could just move and ratchet up very, very quickly .. (intervenes)

MS QUNTA: So it actually moves? --- It could move.

Okay. --- If somebody suggested that is where the price is because you don't, if there is no price, any price is a rate and if a rate is there, you can actually trade on the rate.. (intervenes)

MR POTGIETER: And you won't know what the reason is why he made that price? --- You don't know what the reason is.

It could be a good reason, there may be no reason. --- It might be somebody just panicking saying: well that is a bloody (indistinct) let me get out of it. Out. Now you have made a price that you thought nobody would deal on and they have dealt on it.

MS QUNTA: Would anyone gain from that? Who would gain from that movement, say .. (intervenes) --- There is only one person that gains in a situation like this and it is certainly not a market maker. This is a market maker's nightmare because he has got no liquidity. The only person that is actually sitting back in times of trouble, is a person that has preempted a move like this, he has got lots of Dollars at ten and he will just watch the ride and he will then make a call on when he actually enters the market or when he doesn't. And they are usually fund managers because they started this chaos.

Oh. Which chaos? --- The chaos that actually precipitated to the events that we found ourselves in, in November and December last year. Because they had that ability to buy a billion Dollars. Now if they buy a billion Dollars, somebody must actually supply them with that liquidity. Or if a corporate customer needs to buy $200 million, he has got to buy those from the inter-bank market. He must go to a bank and actually source those Dollars. The bank then goes to the inter-bank market to try and source the Dollars.

MR POTGIETER: Are you referring to domestic or foreign.. (intervenes) --- Domestic. The foreign bank, when foreign banks will, they are participants in our market and they will come and if they need to $200 million or $300 million, they will source from offshore and onshore.

Okay Mr Langley if you want to finish by close to 16:00 you had better move on. --- I think that gives us a good idea of the panic. The corporate trouble making which is point 1-2-3 bundle 1-4-5:

There are certain corporate customers that regardless of market conditions, apply the same principles when obtaining a competitive quote from different banking groups. They will call up three different banks for a competitive quote. This practice, in normal market conditions, is acceptable but when the Rand is in chaos, this practice only compounds the problem. The reason is that if the size of the transaction is more than $10 million, traders will have difficulties clearing positions because of the liquidity problems and because more than one bank will already have knowledge of the transactions.

An example of it, if a corporate customer is phoning me and I know he is phoning two other people, I know somebody is going to get the deal. So I am actually going to go in and try and what you call, front run the deal because if I get it, well then I want to have some, get Dollars in to actually fund the position that the customer is going to do or I know that you are going to get it, so I am going to, you are going to have to go and buy them, if you don't have them. So that is what happens and that compounds the problem in the experience that we had in November and December last year. I am going to use an example now of the De Beers transaction and the impact that it has on the Rand market.

That is page 146. --- Page 146.

In order to illustrate the concepts discussed so far in this statement, I will now discuss the events and actions surrounding the De Beers transaction in 2001. I do not suggest that De Beers or Anglo American acted in appropriately but use this transaction as an example of the market's reaction to this type of transaction.

You are now referring to slide 10? --- I will refer to slide 10.

Page 161. --- Factors surrounding the De Beers Anglo American transaction concluded in June 2001 caused a great deal of underlying problems for the Rand. When the deal was rumoured to be happening and was then confirmed by preliminary announcements, the Rand was trading at a level or approximately 8 10 to 8 15 to the Dollar.

You say when the deal was rumoured to be happening? Was there no certainty at the time? --- There was speculation out in the newspapers that this deal could actually be happening or there is the likelihood that this transaction could actually take place.

And the traders would be aware of the .. (intervenes) --- Or there was an offer on the transaction.

The traders would obviously be aware.. (intervenes) --- Again it is that news headline that you see on your Reuters or on your newspaper, you react to the headline.

At this time the expected magnitude of the deal and the expected flow of Dollars into the forex market caused the following strong reaction in the Rand. Speculators sold Dollars against the Rand in the hope of buying these Dollars back later at a lower exchange rate, thus making a profit. Local exporters.. (intervenes)

Just pause there. You say speculators sold Dollars against the Rand? --- I know that that transaction, if that transaction was actually to go ahead, the expected flow of Dollars from that transaction, was close to $3 billion.

It would strengthen the Rand. Make Dollars more available, that was the expectation. --- The expectation was .. (intervenes)

Strengthen the Rand. --- It would have significant impact on what the spot rate was. Because again, as the Dollars leave the market, if they are going to come into the market, they have got to be, come into the market by natural means and if there is more sellers than buyers, the price will go down.

So they now sell Dollars.. (intervenes) --- They now sell Dollars.

In the hope of buying them back later with (indistinct) Rands. --- If that, now what they do is, they sell the Dollars at say 8 10. If that flow of Dollars was to hit the foreign exchange market, it would happen after a certain period of time, the magnitude of the deal would have a significant impact on the exchange rate. A huge, it would have taken it substantially stronger.

So does this now mean that you then have to take a position, based on rumours. Either you do nothing and you lose big time or you do something.. (intervenes) --- Somebody might argue, somebody might sit in a trading room and argue that: look they are only talking about the deal, nothing is happening yet, I will buy Dollars and he is going to lose money because nine out of ten people are betting that there is going to be an initial, there is always an initial reaction to any news item. You will see now as, what people, their initial perception of the deal is that speculators sell, exporters get involved in the market because they want to now lock in because they are scared that the Rand is going to have a prolonged period of strength. So they take advantage of the higher spot rate plus the forward premium. Exporters now, as importers have to pay a premium, the exporters get a discount and they have the added benefit of getting the forward points.

What about the importers? --- The importers withdraw because they are all saying well why buy now, if this rate is going lower. Every day we stay out of the market, we are saving money.

And what you have now described, did this actually happen? --- This is what happens over, it happened. If you look at.. (intervenes)

But in the case of De Beers did this actually happen. --- No.

What you have just described? --- No.

Not. --- I will get into that detail. If you look at that green line on the graph, that will show the move that actually happened in the Rand as a result of that, the rumoured news of the pending deal. It moved very, very close to, it got to about 7 70.

It strengthened in other words. --- The Rand strengthened, it strengthened from above 8 to close to 7 70. The new, then the new items start coming through, the Rand had a very strong, when we talked about technical analysis earlier, the Rand had a very strong support area which is technically based at 7 65 and it really didn't break that level. And it was unable to break that level.

There was a perception that the Reserve Bank who buy Dollars to fund interest payments, repay loans and reduced the size of his net open forward position, could be buying Dollars and these events triggered the following: speculators that had previously been drawn into the market, now believed that the level was appropriate for locking in profits on Dollars that they had sold.

Rumours about the possible proceeds of the deal going directly to the Reserve Bank also started circulating and this accentuated the market reaction. Then importers re-entered the market to cover their forward commitments. Up until now the only news in the market regarding the De Beers Anglo transaction was the following. The deal was being negotiated, a final price was not yet determined, discussions with minority shareholders were ongoing and without a majority vote, the deal would not be concluded.

The movements in the Rand described above, have happened prior to a single Dollar being sold from this transaction and in fact before this deal had been finalised.

So that was just an example of what happens, how the market reacts to news, what their perception is and how that perception might change because of sequence of other events that might start happening and we moved all the way, we got very close to a level where we had actually started the whole move. The Rand settled around 8. I think the deal was actually concluded around 8. The deal was then executed.. (intervenes)

Well the Rand strengthened and lost ground again. --- Yes but the market perception changed.

Without Dollars having entered the market yet from this deal? --- This all happened prior to whole deal being finalised.

On expectations? --- It was all expectations. The initial expectation of the positive sentiment that this deal would have for the Rand market and then as those perceptions changed and it looked like the Dollars would flow directly to the Reserve Bank and not into the inter-bank market, that perception changed. So now there was going to be, now you had to cover the short Dollar positions that you had, to fund the positions that you had that were open. Importers that were holding back now had to cover and the whole sequence of events that had initiated the move to 770, was undone.

Okay. Now the next heading is the deal is executed on 147. --- When the De Beers component of the transaction was executed, the expected flow of Dollars to the market, flows directly into the Reserve Bank, as the market had now anticipated. The flow into the market of Dollars due to the Anglo American was not clear but these Dollars did not flow into the forex market immediately.

You are talking about two components, Dollars that would flow to De Beers and Dollars that would flow to Anglo American. --- When the deal was originally, when it started looking very likely that the deal would actually be concluded, obviously it would be the bank's responsibility to market De Beers and Anglo to suggest possible ways of hedging a deal of this magnitude. And it wasn't initially clear whether De Beers would get the full proceeds or Anglo American would get the, they have both got dealing rooms and both were obviously traders and dealers, would like to execute a deal of that magnitude. It was unclear who would get what from the actual deal to execute the conversion of the Dollars to Rand. The way it panned out is that I think the deal was split in half, half went to De Beers, half went to Anglo American. The half that De Beers got went directly to the Reserve Bank.

Why? --- To reduce the nett open forward position.