PROCEEDINGS RESUME ON 6 MARCH 2002

CHAIRPERSON: Good morning ladies and gentlemen. Can we commence today's proceedings. The next witness is Dr Stals. Dr Stals, if you could place your full names on the record please?

CHRISTIAAN LODEWYK STALS: d.s.s.

EXAMINATION BY MR POTGIETER: Dr Stals, you have a bundle of documents in front of you. Will you please turn to page 207 of the bundle? Apparently it is 206A. Dr Stals, that is a copy of your CV. Do you confirm the content thereof? --- Yes.

Will you please summarise your CV for the Commissioners? --- I think my CV is relatively short. I studied at the Extramural Division of the University of Pretoria. I obtained my B.Com, Masters and Doctorate degrees. Apart from a short period of time before I joined the Reserve Bank in 1955, I worked at a few different places in Pretoria - the Old Mutual and the City Council. I worked for the Reserve Bank for 44 years and 6 months before I retired in August 1999 and at that time I was Governor of the Reserve Bank. I served as senior deputy governor for five years and Deputy Governor for five years, as Chief Executive Manager of the bank for about two years and then for a short spell for four years as the Director General Finance in the Department of Finance and the last two years since I retired from the bank, I am one of the many unemployeds in the country and work as a director on the board of a few companies. Thank you.

Dr Stals, on page 164 of the expert bundle there is a copy of a statement by you. Is that correct? --- That was prepared by me, yes.

Do you confirm the content of the statement? --- I confirm.

Dr Stals, on page 164 you list the topics that you are going to deal with in your statement and you also have there a list of the annexures. Will you please then turn to page 165 and I suggest that you follow the following procedure: will you please read your statement into the record and feel free to pause wherever you deem it necessary to elaborate or explain? --- Thank you. As I say in the introduction this submission concentrates on macro economic aspects of the South African exchange rate system. In my present position I cannot comment on individual transactions and day to day developments in the markets and in the exchange rate. They are very much an economic macro presentation on the background of the South African exchange rate system and I will elaborate at a later stage on how I perceived developments that took place late last year in the movements of the South African exchange rate. I would welcome any intervention as I go along in reading the statement to you and as you requested, I will add a few explanations and elaborate on what I have said in the written submission to you. I think it is useful to think a little bit back about the developments of the exchange rate system - the system we have today. Where did it come from and why do we have a managed floating exchange rate system in South Africa today. Well, exchange rates all around the world are ruled by the International Monetary Fund of which South is a subscribing member and in terms of the IMF requirements, the government of each participating country, must decide on an appropriate exchange rate system for the country and must inform the fund of its decision. The country must then apply the policies required for the implementation of its decision. Why is this important? The fund can exclude the member from its assistance and its finance facilities if it does not comply with this directive. After the demise of Bretton Woods System of fixed par values in the late 1970's, no uniform exchange rate system was prescribed by the fund. The Bretton Woods System prescribed fixed exchange rates and the whole world were all included in one grid of fixed exchange rates and it was a major effort for a country to change that fixed exchange rate but the Bretton Woods System broke down in the late 1960's and started already on 15 March 1968 with the introduction of the two tier marketing system for gold and so on. But in 1978, April 1978, the IMF issued its view articles of agreement and then they decided that no uniform exchange rate system will be prescribed any more. Each member country have to choose from a number of options alternatives for the determining the value of its currency against other currencies. The main options available for a country such as South Africa at that time were the following: it should determine and maintain a fixed exchange rate for the rand against one major international currency such as the US dollar or a pound sterling. That is incidentally what South Africa did before 1979. We fixed the exchange rate of the rand to the dollar or the pound from time to time. Secondly, a country could determine and maintain a stable value for the rand against the basket of the average weighted value of the currencies of South Africa's major trading partners. I explained in the footnote what this really means - an average weighted value of the currency of South Africa's major trading partners, just for the record it is in the footnote an explanation of what we mean with this. Thirdly, allowed the exchange rate to fluctuate between predetermined margins against any major currency for example between R10,00 and R12,00 to the US dollar. A movement of the exchange rate in the market towards the upper or lower limit will then trigger corrective action by the monetary authorities i.e. the Reserve Bank and the National Treasury. I refer to the monetary authorities. I mean the Reserve Bank and the National Treasury of the Department of Finance, we use to know them. Fourthly, a country could fix the exchange rate either against one other currency or a basket of currencies on a moving peg basis i.e. with periodic adjustments in the fixed rate or it could introduce a managed floating exchange rate where the exchange rate will be determined by market forces of demand and supply in a foreign exchange market with active guidance from the authorities and regular intervention by the Central Bank in the foreign exchange market and in the sixth place the country could accept the fully free floating exchange rate system and let market forces absolutely free to determine a fluctuating exchange rate. At that time i.e. the second of 1978, the .. (intervenes)

Dr Stals, could I interrupt you here. Can you just revert to paragraph 3.5? Is that the system that South Africa preferred? --- Yes, at that time and then on the next page again South Africa preferred this option of the managed floating exchange rate system. So it did not come by coincidence. It was a decision of the South African Government considering various alternative options and we decided for that managed floating exchange rate system.

In so far as in paragraph 3.5 you have used both the words guidance and intervention, active guidance and regular intervention. Is there any difference between the two concepts? --- Yes, certainly. Guidance can be issued by the Central Bank, by the way of statements and kind of talking the market into a certain direction. Intervention is active buying and selling in the foreign exchange market or extending exchange controls or something like that. So I used two words on purpose, guidance is much less than intervention.

And you will deal with intervention later on in your statement? --- Yes, I will come back to that.

Will you also before you continue please deal with footnote 2 on page 166 of the expert bundle? --- If I could read that footnote again:

"It must be noted that in a floating exchange rate system, the rand exchange rate floats against all other currencies and not only against one or a few select currencies. In practice it is convenient to use the US dollar as a reference currency as a means of settlement as intervention currency and as reserve asset only because of the dominant role played by the US dollar in a global financial market."

So what I want to make clear is South Africa does not have a floating exchange rate system against the US dollar. I know the US dollar is used every day in all references, in all quotations and so on, but it is because the US dollar is a convenient currency to use for this purpose. So we can just as well quote a rate against sterling, against the euro, against the Japanese Yen, against any other currency, we are floating against all those currencies at the same time. Now it is more complicated the way markets work throughout the transactions, the floating rate will be consistent. If we change against the US dollar, the US dollar does not change against sterling and we shall change against sterling at the same time and these transactions take place instantaneously and immediately in the market place. So the rand is finding its price against all the currencies all the time changing and moving with currencies, moving against currencies, moving up against some currencies and down against other currencies and that is what the floating exchange rate system is about. Now also this manage floating, it is not in the text. I looked again in the record in 1995 the IMF published a record on what countries did of 180 developing countries in the world and in 1999 adopted this managed floating exchange rate system. So more than 50% of those emerging market developing countries in 1995 took the same decision as we did and that is to introduce this managed floating exchange rate system.

Will you then continue on page 167 with paragraph 4, you referred to in the first few words "At that time, that is the time of the the demise of the Bretton Woods System. --- That is right. That is:

"In the second half of 1978 the De Kock Commission of Inquiry into the Monetary System and Monetary policy in South Africa was busy with a comprehensive review of the financial system and monetary policy in South Africa. The commission was requested by government as a matter of urgency to submit an interim report to the government on the exchange rate system. This interim report was presented to government during November

1978.

The South African Government in January 1979 accepted the main recommendations of the De Kock Commission and communicated its decision to the IMF. The De Kock Commission's recommendation was unequivocal and clear and I quote from paragraph 111 of the interim report of the De Kock Commission .. (intervenes)

Before you quote, Dr Stals, it was the government who accepted the recommendations and not the Reserve Bank? --- No, Gerhard de Kock happen to be Senior Deputy Governor in the Reserve Bank at that time but he chaired this Commission of Inquiry but it was a government appointed commission and the report went back to the government and in terms of the IMF rules and regulations, the government had to decide on the exchange rate system for South Africa. So this was a capital decision of the South African Government taken in January 1979 to accept recommendations of the De Kock Commission.

Dr Stals, would you care to pause a moment and explain the status of the IMF in the context that we are dealing with? --- Well, again the IMF as I have said in 1945 was established. South Africa was one of the founder members, the first 45 members of the IMF. We have always been very important member in the IMF. The IMF's main function in the world is to help countries with balance of payments problems and to provide short term finance, temporary finance to a country and experiences special balance of payments problems. But before you can qualify for the special assistance, you must comply with the conditions and the rules of the IMF and amongst other things those conditions and rules since April 1978 required the country to decide on an exchange rates system that is appropriate for that country that must be approved by the IMF. Now if South Africa wants to make use of any of the IMF facilities, and there are lots of facilities, training facilities, education facilities, consultation facilities, financing facilities, you must be able to prove that you comply with the rules and the regulations of the IMF and then the IMF today there are 200 member countries, just about all countries in the world belong to the IMF. The IMF is highly respected for the guidance it provides to countries on how they should manage their international financial affairs. South Africa as I say is a highly honoured member of the IMF and we do comply with these rules and regulations as far as possible. So it is important for South Africa to be able to tell the world that we are a member of the IMF; that we comply with the rules and regulations of the IMF and any foreign investor who wants to make an investment in South Africa, will certainly ask that question first if nothing else, you are a full member of the IMF, you are a full member of the World Bank, you are a full member of the Washington Group and you do comply with all those rules and regulations. Yes, to attract foreign investment, you must be a member of the IMF and you must comply with the rules of the IMF.

Will you then continue on page 167, paragraph 5? ---

"The De Kock Commission's recommendation was unequivocal clear. The commission recommends a unitary exchange rate system under which an independent and flexible rand finds its own level in well-developed and competitive spot and forward foreign exchange markets in South Africa subject to Reserve Bank intervention or management by means of purchases and sales of foreign exchange mainly US dollars but with no exchange control over non-residents and limited control over residents."

And this was a recommendation made in November 1978 accepted by the South African Government in January 1979.

"In terms of the IMF rules the South African Government has the responsibility to determine the exchange rate system for South Africa. The government, however, appointed the South African Reserve Bank as its agent to prepare the South African financial sector for the managed floating exchange rate system and to manage the exchange rate as envisaged by the De Kock Commission.

In practice the Reserve Bank and the National Treasury works very closely together in determining and executing the exchange rate policy of the country.

It is with monetary policy, with the management of the financial sector system in South Africa with bank regulation and supervision, there is always very very close cooperation between the Reserve Bank and the National Treasury but I must make it clear on the exchange rate system, it is the responsibility of government to decide on the system. They delegated the power, government delegated this power to the Reserve Bank to implement in practice. It did not delegate the power to take the decision but to implement the policy and to manage the exchange rate system on behalf of government.

To the best of my knowledge the South African Government has never taken a formal decision to deviate from the system introduced in January 1979 as communicated to the IMF at that time.

I must point out, however, that the South African exchange rate system and policies are discussed on a regular basis in the annual surveillance meetings between the South African authorities and the IMF staff. So obviously the IMF is very much aware of exactly what South Africa is doing in the management of its foreign exchange markets and foreign exchange rate and this is discussed at least once a year between the IMF and the Reserve Bank, the Department of Finance of the South African Government. So that is the background to our floating exchange rate system. What have been the experience over the past 20 years with the system, it was no easy task in 1979 for the Reserve Bank to transform the South African foreign exchange market from a system of fixed par values to one of managed floating.

Although the Reserve Bank started immediately to switch to the new system, it was only towards the second half of 1979 that floating became a reality. It was indeed only after 1994 when South Africa could afford to start phasing our exchange controls until the South African foreign exchange market reach the full status envisaged by the De Kock Commission. During the period from 1979 to the second half of the 1990's, the following more important changes took place. Firstly, new and modern electronic communication systems were introduced amongst foreign exchange dealers, their international correspondents and the Reserve Bank what we assume today as for granted and dealers walk into offices with communication systems. The modern electronic communication have put you in touch with foreign dealers all around the world on a real time 24 hour basis. Those things did not exist in 1979. So it took a long time for South Africa to introduce these new modern electronic communication systems.

Exchange controls were relaxed in a gradual phasing out programme inter alia to enable banking institutions to participate more actively in the foreign exchange market. Exchange controls were also removed on non-residents completely and substantially relaxed for residents. Thirdly, the deal exchange rates for a financial rand and a commercial rand were merged to provide for a single uniform exchange rate fort he rand. Intervention techniques by the Reserve Bank in the foreign exchange market and in the domestic financial markets had to be refined."

Maybe I should elaborate a little bit those intervention techniques and also in terms of the footnote what does it mean when we talk about intervention by the Central Bank in the markets. It is common practice for Central Banks to intervene in financial markets. Intervention can take the form of direct measures such as exchange controls or credit ceilings. That is an intervention by the Central Bank in the operations of the market economy or it can alternatively operate through the market system. The latter procedure is preferable in a market orientated economy such as that of South Africa. The Reserve Bank can for example reduce liquidity in the money market by selling long term government bonds against payment in rands. The rand withdrawn and then destroyed, cancelled, neutralised by the Reserve Bank, will reduce liquidity and exert upward pressure on interests rates. The bank can in a similar way intervene in the market for foreign exchange by selling foreign currency against the rand to authorise dealers in foreign exchange. It is not always understood that the Reserve Bank buys and sells foreign exchange. It just does not deliver foreign exchange or give foreign exchange to the market. You sell it in a commercial transaction where you exchange foreign currencies for rand all the time. By selling foreign currency against rand, the Reserve Bank will increase a supplier of foreign exchange in the market but at the same time it will reduce the amount of rand available in the market. Alternatively the bank can from time to time also be a net buyer of foreign currency against payment in rand with the opposite effects in the market. It is always very difficult to explain that the Central Bank is something completely different from any other institution. The Central Bank creates money. If the Central Bank buys rand from the market, it destroys money. If it sells rand to the market, it creates money. And this is a function of intervention in the market. So the intervention techniques for both .. (intervenes)

Dr Stals, could you explain you say in footnote 3 on page 169:

"The Reserve Bank can for example reduce liquidity in the money market by selling long term government bonds against payment in rands. The rand withdrawn and destroyed by the Reserve Bank, will reduce liquidity and exert upward pressure on interest rates."

The words there withdrawn and destroyed, what actually happens? Is there an actual destruction of the money or does the Reserve Bank keep the money to sell it later? What is the position? --- It is again a technical explanation and the best way I can explain it, is in an accountancy approach. On the Reserve Bank's balance sheet you will never find cash. The Reserve Bank can never hold cash - notes. Notes issued by the Central Bank is a liability of the Central Bank. A piece of paper issued by the Central Bank becomes a liability of the bank. The liabilities I will buy this note back from you. I will give you value one day for that note if you bring it back to me and I will credit your account. In the old days I would give you gold for it. So when the Central Bank buys anything against payment in rand, it issues money which becomes a liability of the Central Bank. That money is now in circulation. The holder of that money whether it is a bank or a private individual has something that it can use to make payments with. When the Reserve Bank buys or brings back the rand into the Central Bank, the liability of the Central Banks is cancelled out and it becomes a piece of worthless paper in the vaults of the Reserve Bank. It is not an asset of the Central Bank. It is not money in circulation any more. So the cancellation is a bookkeeping entry where you reduce the liabilities of the Central Bank. You reduce the amount of money issued by the Central Bank and you reduce the liquidity in the private sector. So money in the vaults of the Central Bank become useless pieces of paper and if you want to put a value on it, it is the cost of printing the money which could be four of five cents per note or ten cents per note nowadays I assume. So the Central Bank issues money by creating liabilities of the Central Bank. It destroys money but reducing the liabilities of the Central Bank.

But it does not become an asset? It may just as well be destroyed, physically destroyed? --- Yes, you can physically destroy if you want. So that is the simple explanation on how the Central Bank issues money; how the Central Bank withdraws money from circulation.

If you could then continue with paragraph 8.5. ---

"Exchange controls are non-residents who are removed and those of residents relaxed. It was indeed only in the second half of the 1990's that the managed floating exchange rate system for the rand as envisaged by the De Kock Commission was fully applied."

And it is obvious why we could only start removing exchange controls in a meaningful way after 1994 after the South African Domestic Political and Social Reforms were introduced; the sanctions and the boycotts and disinvestment campaigns were terminated and then we seriously started removing the exchange controls. I would say today we have removed about 70% of the exchange controls that existed in 1979 certainly. So we have got a long way towards implementing the De Kock Commission recommendations to create an environment in which a managed floating exchange rate system can be applied with effectively.

"Despite this long and slow process of implementation, it is my considered view that the system of a managed floating exchange rate served South Africa well during a difficult and stressful time in its history.

In 1985 when South Africa was forced into a temporary moratorium on the repayment of foreign debt, the floating exchange rate system provided much needed flexibility and allowed the South African authorities sufficient time to switch to a more restrictive domestic economic policy."

I can add in 1996 when there was speculation in the markets about the exchange of the Minister of Finance and possible resignation of the Governor of the Reserve Bank, created all kinds of turmoil in the market.

"Again in 1996 we had a similar adjustment process where the floating exchange rate system made an important contribution. In 1998 when South Africa was severely affected by the East Asian financial crisis, the floating exchange rate system once again enabled the South African authorities to adapt the economy with less pain and disruption than many other countries in the emerging market group. On all three occasions 1985, 1996 and 1998 the exchange rate policy was actively supported by supplementary, monetary and fiscal policies such as a reduction in domestic liquidity for the banking sector and a rise in the interest rate level.

The general experience during the past 20 years with the floating exchange rate system has been as follows: firstly the exchange rate often fluctuated quite a lot over the short term but followed a more rational part over the long term and 1985, 1996 and 1998 provide examples of this violent fluctuation in a short period of time. The average weighted value of the rand against the basket of the currencies of South Africa's major trading partner countries, depreciated over time more or less by the inflation differential between South Africa and these countries. It was a kind of a surprising result but with those periodic volatile changes in the exchange rate, on average over this long period of 20 years, the rand depreciated just a little bit more than the inflation differential. The real effective exchange rate of the rand i.e. after the adjustment for the inflation differential, depreciated over the whole period by a small margin so if anything did depreciate a little bit more than what was necessary. The depreciation process never followed a smooth path. The exchange rate of the rand against the US dollar tended to remain relatively stable for periods up to two years to be followed by rather steep downward adjustment over a short period of time to a new lower level. The process has been described as a staircase adjustment process with a periodic run down of flight of stairs to a new level. The downward adjustments were often triggered by external factors. The East Asian crisis in 1998, the Argentina, Zimbabwe influences in 2001, but were not inconsistent with contemporary domestic economic developments at the time. Mediative external factors were transmitted to the South African economy through a deterioration in the South African balance of payments which in turn affected the demand and the supply in the local foreign exchange market and reduced rand liquidity in the money market. It is very important to realise that a deficit on the balance of payments when South Africa loses foreign exchange and also has an immediate affect on the rand liquidity market on the rand market. You cannot separate the two. You cannot have an outflow of capital without changing the domestic money market and the same factors that influence the exchange rate i.e. the outflow of capital, will also reduce liquidity and push up interest rates. So a consistent monetary policy model, you will also find when a country experiences an outflow of capital, the exchange rate will depreciate, the domestic liquidity will be reduced, interest rates will go up. It is not the Central Bank that pushed up the interest rates. Markets pushed up the interest rates. It is the same market forced that determine the exchange rate, those same market forces can also determine or will also determine the interest rate in the country.

The transmission of negative international developments to the South African economy becomes that much easier in a situation or simultaneous adverse domestic developments. In the circumstances markets at times in the past, over the past 20 years, overreacted. Market interest rates rose extremely high levels and the rand depreciated by more than the inflation differential. Hence the need for a period of consolidation and stabilisation after every sharp depreciation of the rand."

We had that in 1985, we had it in 1996 and we had it in 1998 and I am sure we are experiencing it now in 2002 to get that overreaction in the markets. You run down the staircase to a new level. The markets overreact to get a period of consolidation and you stay on that new level for a two year period or so and that is the experience over the past 20 years and I think we are going through it again.

"A few remarks about the changing environment of foreign exchange markets. As already indicated, South Africa introduced a number of important financial reforms during the past two decades to transform the South African market in foreign exchange from a fixed par value system to a managed floating structure. At the same time major changes also took place in a macro economic environment in which the foreign exchange markets operate.

Firstly, the process of economic globalisation and more particularly of the integration of world financial markets had a major impact on the process of exchange rate determination. The South African exchange rate became a more exposed and subjected not only to economic developments within the country but also to developments in many other countries. Initially in the second half of the 1990's international investors grouped approximately 30 emerging market countries of the world together and developments in one or more of these countries affected others. The East Asian crisis for example started with the financial crisis in the foreign exchange market of Thailand and then very quickly spread to other East Asian countries and to countries as far apart as Russia, Brazil and South Africa.

The experience of 2001 the latest one last year, however, indicated that international investors have now become a more sophisticated and are now differentiating more between different countries within the group of emerging market economies."

Dr Stals, we are dealing here as I understand with the concept of contagion. The last sentence of paragraph 11, which you please explain that? --- Yes, the contagion effect as I said in 1998 when the Thai Baht came under pressure, immediately, almost the next day the South African rand was on the pressure also. But during this past year, Argentina had serious problems. Turkey had many problems and it had very little effect on other countries even their neighbouring countries in South America were not that much affected by the Argentinean experience. Now investors, fund managers, portfolio investors all around the world, I think in 1998 they were less experienced, they saw the group of emerging market countries as a homogenous group in a fund management they had a kind of a percentage say 5% of my total assets should be invested in emerging market countries and they did not make that much of a distinction whether they invested in Indonesia or South Africa or in the Republic of Czech. It was an investment in a homogenous group of emerging market countries and if something went wrong somewhere in one of the emerging market countries, the investors changed their views and their perceptions of each one of the 30 countries in that group and that is why the problems of East Asia through the contagion and through the transfer of decisions of investors, immediately spread and was dispersed to just about all 30 of those emerging market countries. Now in the subsequent discussions through the IMF, through the World Bank, the Bank for International Settlements and so on, a lot of attention was given to this kind of a group effect of the emerging market countries and I think a lot of explanations were given why each one of the emerging market countries should be looked as a separate entity. Nowadays you will find that with most of the international fund managers, they have 0,6% of their total assets for South Africa or have 1% for China or something like that. It is not one homogenous group any more and I think this has been reflected in what happened in 2001 despite the fact that they had serious problems in two or three of the emerging market countries. It did not spread to all the other countries as it did in 1998 which is a very good development to get credit from IMF and the World Bank and the international institutions that did a lot of work in the past two or three years to try and avoid a repetition of the 1998 East Asian crisis and this makes it so much more difficult to explain why was South Africa then affected so much by what happened and make it a little bit doubtful whether Argentina and Turkey and some of those other countries had that had of an effect on South Africa because it did not affect Brazil and it did not affect Mexico and it did not affect many other of the emerging market countries as it did in 1998. The 2001 worldwide experience was very different from the 1998 one despite the globalisation and the integration of the financial markets. "Secondly, explosive increases occurred in private sector international capital flows. These capital movements took the form of direct investment, portfolio investments and short term international capital flows linked to trade transactions, money market operations, transactions in derivatives and for edging purposes and speculation. Volumes in the foreign exchange markets of the world assumed astronomical dimensions and the ability of Central Banks to influence market conditions through intervention diminished."

I believe you have been given a lot of information about these volumes in the international markets and the South African markets and so on but this is an important change that took place over the past ten years because of satellite communication and electronic developments.

"Thirdly, the gradual abolition of exchange controls in South Africa introduced an element of greater volatility in the local foreign exchange market. Foreign currency trading rules were liberalised for resident, corporate, fund managers, foreign exchange dealers and private individuals. All these developments contributed to a more market orientated exchange rate system but also it led to increased volatility in the exchange rate itself."

So we had introduced a managed floating exchange rate system which is a more volatile system. We have seen important changes in the environment, international and local environment which contributed to more volatility. So I think we have to be careful when we get worried about the volatility. This is part of the new world in which we live and the system we have.

Dr Stals, in paragraph 13 on page 172, you referred to fund managers and foreign exchange dealers. Now would it be possible for you to deal with the respective, the effect that fund managers and foreign exchange dealers could have on the exchange rate? Would you put equal weight on the activities of fund managers and foreign exchange dealers when it comes to affecting the exchange rate or not? --- No, I think it is very different. The functions are very different. The fund manager takes the initiative to advise his clients and to move funds around the world depending on his expectations of exchange rates and interest rates and so on. The foreign exchange dealer provides a service. Normally it is not a foreign exchange dealer that takes the initiative or takes the decision to do a transaction. He is commissioned by his client to do the transaction. So I would not .. yes, certainly within the modern set up foreign exchange dealers also do proprietary trading and take positions but that is not the normal function of the foreign exchange dealer. I would say the normal function of the foreign exchange dealer is service to his client but the fund manager itself, yes certainly he can have a very important influence on the outflow of funds from South Africa, the timing of the outflow by advising his clients and by taking decisions within the scope that exchange control will permit him to make investments outside of South Africa at a certain point of time. Sure the timing of the transfer of the funds by the fund manager, the decisions, the advice they give to their clients, can have a very important effect on the outflow of funds from the country and the inflow of funds.

Including offshore fund managers? --- Yes, very much so. Because it is also the .. it is a two-way flow. It is of course South Africa resident funds that can flow out of the country, its foreign owned funds that can flow in and out of the country. So fund manager all around the world yes, sure there were in 1998/1999 also the hedge funds, a long term management fund in New York and so on which had a very important affect on international capital flows at that time I think because of the problems of the LTCM in 1998 in New York and so on. I think the rules have been changed a lot and the hedge funds are not so important any more. This has contributed to some stability in the foreign exchange markets. But fund managers sure in South Africa and international fund managers can have a very important influence on the decisions to bring money into the country or take money out of the country.

We are talking vast volumes of money. --- Yes, very very huge. I do not have figures in my mind any more but I remember in the days when I was more active about this (indistinct) talking to a fund manager in New York and find out what is the amount that a fund manager must invest somewhere in the world every day. It is billions of dollars. It is huge amounts and a very very small percentage of that invested in South Africa can make a big change on the South African balance of payments. So it is very very big amounts that fund managers managed all around the world - pension funds, insurance funds, institutional investment funds and so on. But it is very very big money involved. Let us go a little bit more to the developments in the South African foreign exchange market and the exchange rate of the rand in 2001. Again my perspective on this is more an outsider standing on the side lines and watching it from the side lines with my background and experience of the past.

"The effective exchange rate of the rand remained relatively stable during the two year period from the middle of 1998 up to the middle of 2000. It then started to move slightly downwards until the middle of 2001 after which a sharp depreciation took place. In terms of the staircase theory, the rand was in the middle of 2001 ready for a new run down the next flight of stairs. As in the past, a number of factors contributed to the sharp decline in the exchange rate of the rand in 2001."

The more important of these developments can be summarised as follows, and most of these were explained in much more detail yesterday by somebody else that I read about in the newspapers this morning, but you will find very much confirmation of what you were told yesterday and a repetition of some of those factors.

"Firstly, the various adverse international developments created a negative climate for the rand. The deteriorate in the global economic situation and particularly in the major industrial countries, reduced the flow of capital to emerging market countries. The terrorist attacks in the United States of America on 11 September 2001, created additional nervousness and anxiety amongst international fund managers who immediately withdrew more funds from what they regarded as vulnerable economies. Balance of payment problems in Argentina and banking problems in Turkey contributed to this negative attitude of foreign investors towards weaker currencies in the emerging market world.

Secondly, adverse developments elsewhere, the African continent had particularly in a few neighbouring countries, contributed further to a reduction in the inflow of foreign capital to South Africa and stimulated the outflow of resident funds to the rest of the world. The current account of the South African balance of payments moved into a substantial deficit in the third quarter of 2001 and with the continuing net outflow of resident funds and some withdrawal of non-resident funds from the country, a shortage of foreign exchange developed in the South African market for foreign exchange. Deficit on the current account South African residents now invest outside of the country almost on a continuous basis the flow of the par invest saving. It absorbs about R40 billion per year and that flow is not affected that much by developments in the rest of the world."

So we have that almost constant outflow of resident funds being invested outside of the country. We had a deficit on the current account and because of adverse international conditions, we had a decline in the inflow of particularly portfolio of foreign investments into South Africa, a condonation of three factors that led to a deficit on the overall balance of payments of South Africa and therefore a shortage of foreign exchange.

Dr Stals, was the problem then that fundamentally affected the traders in the trading rooms a shortage of foreign exchange? You referred to the concept of supply and demand earlier. Is that also relevant in this context? --- Yes, it is very difficult if you are a foreign exchange dealer and you are providing a service to your client and you get the instruction from a client in London through his bankers and say yesterday I sold R100 million of my government bonds in South Africa and I wanted to take the money out of the country today. So you had to convert that R100 million into dollars or sterling and you cannot find dollars or sterling to buy in the market. The only way you could find the dollars or sterling in the market is by pushing up the price. Now that is what the market system is about. But it becomes frustrating for dealers I would think if there is a shortage of liquidity they have to run around and South Africa has committed itself to no controls on non-residents. So the non-residents are completely free to bring its money into the country and to take it out. That means that there must be full convertibility. It must be possible for him to sell his dollars against the rand or to convert his rand in South Africa into dollars and take it out of the country. So if there is a shortage of dollars, well it means you have to push up the price for dollars. That is pay more rand to get the dollars and that is where the depreciation comes from. So at a price a dealer will find the dollars but as I say it can be very frustrating. I mean $100 million if you can pay R8,00 for a dollar, it gives you $12½ million and if you have to pay R15,00 it will give you $7 million. So obviously the bank, the dealer wants to do the best possible deal for his client in London and if there is a shortage of liquidity, he may get frustrated about it but that is what his function is to buy the dollars at the price.

And would the same apply in respect of the rand *vis-a-vis* other currencies? --- Yes, I say we always talk about the rand/dollar but exactly the same thing applies to the rand/sterling or the rand/euro and so on through the international foreign exchange market system the rand adjusts automatically and immediate to all the currencies. So I make the point that in the third quarter there certainly developed some shortages of foreign exchange in the market. Well, a very important change in any case from the first half of the year.

"No statistics are as yet available for the balance of payments for the fourth quarter of 2001 but it can be assumed that the shortages in the foreign exchange market continued and may even have increased further."

I am guessing a little bit because we do not have statistics for the current account and for the capital flows yet. It will come in the Reserve Bank's quarterly bulletin later this month. But I think the trends of the third quarter continued in the fourth quarter and the shortage of foreign exchange in the markets continued because of the balance of payments situation.

"As shortages developed in the foreign exchange market, the exchange rate of the rand depreciated. It is understandable that the monetary authorities in South Africa were initially too much concerned about the depreciation. Various statements by the monetary authorities confirmed that there was at that stage no undue concern for the decline in the external value, the exchange rate of the rand, and the authorities would not take any action to alleviate the liquidity shortage in the foreign exchange market. In its statement of 20 September 2001, the Monetary Policy Committee of the Reserve Bank for example said South Africa has been able to withstand the inflation consequences of rising international oil prices and the sharp depreciation in the external value of the rand.

What was even more meaningful to the market, was that the Monetary Policy Committee was at that stage built enough to reduce the Reserve Bank's repo rate or to recommend that it should be reduced by one half percentage point from 10% to 9½%.

In its next statement issued 20 November .. (intervenes)

Dr Stals, the statement that you have just referred to dated 20 September, that one will find in Annexure 3.1 on page 198 of the bundle. Is that correct? --- That is correct.

And the part of it quoted by you, one will find on page 200 in paragraph 6.1? --- That is right, yes.

Just before you continue, I have noted that in so far as you refer in paragraph 15.5 to a statement issued on 27 November 2001, it should be 15 November. That appears from Annexure 3.2 on page 205. Is that correct? --- 205 .. (intervenes)

It is actually not 205, 202. It should be 15 November and 27 November. --- Yes, that is correct.

And again the part quoted by you, one will find on page 205 in paragraph 6.5. Is that correct? --- That is correct.

Dr Stals, will you then continue with paragraph 15.5 please? --- Thank you. I read from this paragraph:

"The next statement issued on 15 November 2001, the Monetary Policy Committee showed more concern about the continuing depreciation of the rand. The risk of high inflation has, however, increased since the previous meeting of the Monetary Policy Committee. The weight of the foreign exchange rate of the rand against the basket of currencies has no declined substantially through a large extent the effect of the depreciation of the rand has been absorbed by reduce labour costs and lower profit margins. Hence a decision still to do nothing. By December 2001 the shortage of liquidity became acute. A joined statement issued by the Governor of the Reserve Bank and the Minister of Finance on 21 December 2001 made it clear that the concern was growing within the ranks of the monetary authorities about the foreign exchange market situation. Research were made about possible action against the offenders of the exchange control regulations but the market was still not convinced because of a lack of real action. Indeed driven by fear of a possible exchange control tightening importers and debtors without standing foreign commitments, continued to rush into the market to buy foreign currency. Exporters and holders of foreign exchange on the other hand were reluctant to sell their assets as they also expected the rand to depreciate further which would increase the rand value of their proceeds. It was only when the Reserve Bank took decisive action to raise its repo rate by one percentage point from 9½ to 10½ per cent with effect from 16 January 2002 that the markets really settled down. The expectation of a continuing depreciation was broken at least for the time being. The rand appreciated slightly and then settled down at a level of between R11,00 and R11,50 to one US dollar. This was still significantly down from a level of 764 that applied at the end of 2000. The combination of a number of adverse factors therefore created a consensus of expectation for a continued depreciation of the rand. In a competitive market system a consensus of expectation amongst many independent participants can easily lead to unplanned market collusion and to an overreaction in the price formation process."

And I think this is explained by the facts and the developments at that time.

Dr Stals, in paragraph 16 you talk about a consensus of expectations or a continued depreciation of the rand. We have also heard the concept to keep the market guessing. Will you please elaborate and explain what you mean here? --- Yes, I think you can have a thousand individual operators in this market but they all read the same balance of payment statistics. They all read about the developments in the world economy. They all hear about 11 September developments in the United States. So it is not difficult for them all to come to the same conclusion and that is in this situation the rand will depreciate. It will come under pressure. There is going to be a shortage of foreign exchange and foreign exchange markets. Now I do not know keep the market guessing, well maybe and I think I will come back to that at a later stage, is maybe the only one that can really keep the market guessing, is the Central Bank or the Reserve Bank. Again everybody knows that the Reserve Bank has a limited amount of foreign exchange and against these big volumes in the markets, the Reserve Bank cannot do that much but the Reserve Bank can keep the market guessing by leaving an uncertainty in the market on what the next step of the Central Bank will be. Is it going to sell dollars tomorrow, yes or no? Is it going to extend the foreign controls, yes or no? So I think particularly with intervention operations and that was the intention of the De Kock Commission, you can keep the market guessing and keep the market uncertain on what the next step will be and that is perhaps a kind of keep the market guessing; keep the market uncertain on what the Central Bank will do because in this background situation that I explained to that developed in this last few months of 2001 in South Africa, the only institution that can keep the market guessing, is the Central Bank and what it is going to do; what its next step will be and for a speculator to be uncertain about what is going to happen tomorrow, well it may exclude him from the market from taking the position.

And Dr Stals I know that you are going to talk about the NOFP later on in your statement. I am not referring to the technical or explanation of NOFP at the moment, but would it not be correct to say that traders that the market out there may have a certain perception in regarding to the NOFP and that they have this perception that whenever dollars will come into the market, it will be taken up by the Reserve Bank, rightly or wrongly. If that is the perception, would that not contribute to a consensus of expectations for a continuing depreciation of the rand? --- Yes.

Whilst you are going to answer, the other point that may be relevant here, is also the policy of the Reserve Bank to target inflation. The emphasis on inflation as opposed to intervening to strengthen the currency. --- Yes, the first one the NOFP yes there is that negative perception I believe sometimes very wrongly and I will try to explain again but I must say I have been trying to explain this for ten years and it seems to me all the world is wrong except me about the NOFP, the Net Open Foreign Position of the Reserve Bank but that perception does exist that if the Reserve Bank uses its forward book or its NOFP, it absorbs dollars from the market and the dollars disappear. Now as I will try and explain again, that is not true. The Reserve Bank buys dollars in the spot market and sells it in the forward market and at the end of the day there is no change in the amount of dollars in the market as long as everybody sticks to the rules and that is that it must be firm ascertained document underlying commitments. But I agree with you that the perception is very strong in the market that the Reserve Bank absorbs the dollars and the dollars disappear and therefore it reduces the amount of dollars available in the market and that perception is so strong particular with foreign investors, that that gives us enough reason why the Reserve Bank is certainly 100% right to reduce and get rid of the NOFP because of lots of misunderstanding and that negative perception that does exist. I think it is true that if that perception does exist that the Reserve Bank will absorb all the dollars at all cost to reduce the NOFP, it will have a negative effect on the expectations on the foreign exchange rate and also creates a little bit of a one-way bet or a one-way option and I think in one of the annexures that I attached here on the 1998 annual report of the Reserve Bank, I think we spelled it out there in some detail to say that the danger of that one-way bet can encourage in speculators to take a position and that is why I do believe that the market should be kept uncertain about what the next step will be.

In the address that you referred to is contained in Annexure 2 on page 190. Is that correct? --- Yes, that is right. Sorry, no it is Annexure 2, page ... ja, 190 it begins and 191. In that statement we referred to the 1998 developments. We explained why the Reserve Bank found it necessary to intervene in the market and made it very clear that it was never the intention to try and fix an exchange rate or to keep the exchange rate at any level but it certainly was necessary to provide liquidity to the market and to make sure that orderly adjustments would take place as far as possible. Oh yes then there is inflation targeting. I certainly support the whole concept of inflation targeting very much of the Reserve Bank. I think that makes one of the policies more transparent and more clear and it certainly contributes to a better understanding and why the Reserve Bank has to do certain things at certain times. I think fixing a target like an inflation target, is very important for the presentation, the marketing, the explanation of monetary policy. I think in any Central Bank, the governor has in his drawer much more than just an inflation target in mind because as I will explain later in economics everything depends on everything else and the inflation target or the inflation result will be affected by a lot of other things that you just cannot ignore because that is the way .. the Reserve Bank does not fix prices every day and therefore it does not control inflation directly. It affects inflation through its operations in the money market, in the exchange rate environment, in the interest rate structure, in the liquidity of the banking system. So these are the operational instruments that you have to use and have to apply and have to take account of every day even if you have a fixation on inflation at the end of the day and as I will explain later whether that target of yours is the money supply or the level of interest rates or the amount of liquidity in the banking system or the bank credit extension or the exchange rate, they are all very much interrelated in a circular process - the one affects the other. So .. .(intervenes)

And would it not be correct to say that the market should not get the impression that the Reserve Bank will target inflation and exclude other factors such as intervention to strengthen the exchange rate? --- Yes.

To create a situation that may be positive for a one-way bet situation. --- Yes, I think it is important that the market must understand that the Reserve Bank operates through the markets with the inflation target as an objective in mind but you cannot just sit back and wait for the rate of inflation to be published. That is history. The rate of inflation you get today is for the past 12 months. The Reserve Bank must think about what rate of inflation will be next year because what the Reserve Bank does today in the money market, in the foreign exchange market with interest rates, with exchange rates, will be determined, the rate of inflation 18 months downstream that the markets must know that yes to get to that rate of inflation in 18 months from today, the Reserve Bank will do this, in the money market will do this and the capital market will do this with control over bank credit extension will do this. There is no such thing as monetary policy by rules. You cannot design a model and give instructions to the Central Bank and say everything you do must be in line with this instruction. The monetary policy is by discretion. That is what I was paid for and what my good friend successor is now being paid for is discretion to take that decision from time to time and whatever your decision will be on many things, you will be damned. You will be wrong whether you say yes or whether you say no, you will be damned. Somebody will think that what the Central Bank decided was not in his interest and therefore the Central Bank was wrong and that should never be a factor in taking a decision in the Central Bank. You must a clear mind of what is in the interest of the national economy of your objectives and then you must take that decision.

Yes. --- So on inflation targeting it does not take away from the Central Bank the function of managing many other things such as the money market, the interest rate level and the amount of liquidity and the bank credit .. (intervenes)

Dr Stals, you were in that position for many years. Perhaps a few words, I can imagine that decisions must be difficult under those circumstances to act or not to act in a situation where as you say everything depends on everything else. --- Yes, I think it is difficult. The most difficult decision a Central Bank must take every day is a decision to do nothing because you must rely on markets. You must believe in markets. You must have the confidence that the markets will give you the beset results and what you must then decide is whether I should do something to change that decision of the market place. I do not like it, I do not think it is .. not that I do not like it. I do not think it is in the interest of my objectors and therefore I will intervene in that market. So it is a difficult decision surely but I mean if you are a central banker you learn to live in that environment of working through the markets, listening to the markets, taking your guidance from the markets and then decide whether it is necessary for you to do something to change the verdict of the market system and it is quite justifiable that at times you will change the verdict of the market system for example in the exchange rate if you believe that this change in the exchange rate situation is very temporary because of something that you know about, a big transaction that has suddenly come into the market. Surely you justify it to intervene in that market, smooth out that fluctuation, absorb that short term abberation and then let the markets go on again.

And Dr Stals would there be contacts on a daily or a weekly or a monthly basis to keep the Reserve Bank and at least the major banks in South Africa or all the banks for that matter? --- Yes, well again you know it is discretion. Every central banker and every governor brings his own style to the Central Bank. He will manage it in his own way. All I can say is make a general statement that a Central Bank must be in touch with the markets all the time. Central Banks, monetary policy play no role in a completely controlled managed economy like the socially planned economies and so on but in a market economy yes and the only justification for the existence of an independent central bank in the market economy is to operate through market, the existence of markets. When there are no markets, there will be no need for a central bank.

In your time did you contact the major banks? --- Yes, sure certainly especially for example with interest management, repo system and so on, we talked, I myself often talked to the six/seven major banks every day on a daily basis - phoned them every morning at 10:00, I think the bankers will be able to confirm to you that I had almost a standing arrangement that they will expect a call from the governor of the Reserve Bank every morning roundabout 10:00 - between 10:00 and 1 0:30. So yes you have to talk to the markets all the time but there are various different ways in which you get your information from the markets. It is not necessary to do it my way to talk to the banks. I was criticised a lot because I do not talk the 40 other smaller banks. I only talked to the five/six major banks for practical reasons. You cannot phone every banker in the country every day. But sure you have to talk to the banks and you have to find out what is going on, especially with foreign exchange market and the money market operations because the banks are the operators and the dealers and the buyers and the sellers of the assets in those markets. So the central Bank surely must be in contact with the markets just about every day. Not necessary at the level of the governor but certainly I can assure you the foreign exchange department of the Reserve Bank must be talking to the markets not once a day but many times every day.

Mr Chairman, would this be a convenient time to adjourn?

CHAIRPERSON: We adjourn until 11:30.

PROCEEDINGS ADJOURN

ON RESUMPTION

CHRISTIAAN LODEWYK STALS (s.u.o.)

CHAIRMAN: I think we were on page 13. --- Mr Chairman I would like to say a few words about separation in the foreign exchange market. I do not think it is anything new to you but one must take account of the fact that there are many ways in which a position, be it a long position or a short position, overboard, over sold position can be taken in the foreign exchange market. First we have already referred to this that without exchange control both residents and non-residents are free to move investments from within and other countries. Save from changing expectations from what the exchange rate might do, huge amounts of funds can move in and out of the country through such transactions. At this juncture South African residents are still restricted by the remaining exchange controls in what they can do in this regard, although the phasing out of the controls has reached the stage where their actions can no longer be ignored. Secondly importers and exporters can take the positions through a change in the timing of the transfer of their payment, receipts of foreign currency. This is commonly referred to as the leads and lags effect of international trade settlements. Short term speculators can take spot of forward positions not only by transferring funds into and out of a country but also through trading in derivatives, options, forwards and swops. In a market with a turnover of a times more than US$10 billion per day it will be extremely difficult to discover and identify individual transactions with malicious intentions. In the real word it is in any case very difficult to distinguish a speculative transaction from an investment transaction. In a well developed market there is indeed a need for short, medium and long term investors and for buyers and sellers of a variety of spot and forward instruments. Even the speculator has an important part to play in an effective price discovery mechanism based on the principles of demand and supply operating in an amorphous market. On monetary policy at the exchange rate. The monetary policy framework within which a central bank must perform its duties in a market economy includes a number of financial variables that are closely inter related. If a low rate of inflation happens to be the main target of monetary policy the Reserve Bank must in pursuing its objective also take account of changes in the money supply in total bank credit extension, the level of interest rates, the amount of liquidity in the banking system and movements in the exchange rate. Changes in each and every one of these variables will, albeit it with long time lags influence all the other variables in the model. I think if you read the statements issues by the monetary policy committee of the Reserve Bank, the last few you will certainly find references to these other financial aggregates also. The concentration is on the rate of inflation but certainly all these other factors must be taken into account in deciding on the correct policy to achieve the inflation objective. Paragraph 20. Strong arguments are made from time to time for some excessive depreciation to serve as a stimulus for domestic economic development. This argument is based on the premises that the depreciation will make the country's export industries more competitive and provide some protection for local manufacturers against imported good. In certain circumstances and in the short term the argument may be valid. There are however always losers in this game. In the case of South Africa the losers will be the ordinary people who consume imported goods and services and of course local manufacturers that use imported goods and services as inputs in their production processes. Depreciation inevitably leads to the redistribution of wealth income in a way that will most probably in the present South African context be unpopular and the advantages that can be gained in the short term from depreciation are normally eroded in time by riding costs of production. An excessive depreciation of exchange rate in excess of the inflation differential can on the other hand have many disadvantages for an economy, particularly for a country that has extensive international trade and finance relations. These disadvantages will include the rise in the cost of all imported goods and service. Such increases will eventually have to be absorbed by the importers, the local manufacturers and/or the domestic consumers. Price rises will stimulate inflation at both producer and consumer levels. A depreciation is often followed by increased demands for higher wages and salaries, by workers who want to maintain existing standards of living. If successful their efforts can cause further increases in prices and in time lead to the advent of the much feared vicious circle of increasing wages and salaries followed by more inflation and then by a further depreciation of a currency. A depreciation increases the domestic currency value of outstanding foreign currency commitments. This can lead to serious problems for borrowers of foreign currency funds particularly in the case of unhedged positions. This is one of the contributing factors to the complete breakdown of the financial system in East Asian countries in 1998 because of the huge outstanding foreign currency commitments of the banks themselves and of their clients and the depreciation of the currency can certainly have serious adverse effects on the soundness of the financial system. A depreciation reduces the foreign currency value of investments in domestic assets, denominated in the local currency such as government bonds. This will discourage non-residents to invest their funds in a country again in future. In the long term the disadvantages of excessive depreciation in the case of South Africa in the most cases outweigh the advantages. Monetary policy should rather in all circumstances be directed towards the protection of the value of the currency and to the retention of overall financial stability. This is the most important contribution that a monetary policy can make towards sustainable economic development. Although the level of exchange rate in the South African set up is not and should not be an overriding target of monetary policy the effect of changes in the exchange rate on the other variables of the monetary policy model and eventually on the rate of inflation can never be ignored. In proposing a managed float for the rand the De Kock Commissioner therefore recommended whatever other objects it, that is the Reserve Bank might also have from time to time, intervention in the foreign exchange market should ordinarily be a smoothing operation. The intervention policy followed by the Reserve Bank during the 1998 financial market crisis was spelt out in some detail in my chairman's address as governor of the Reserve Bank on the occasion of the annual general meeting of shareholders of the bank on 25 August 1998, see annexure B to this subjection. I do not have the page numbers with me, for the record, is it okay can I go on?

Yes. --- Annexure B. It should be noted that by selling foreign currency to South African banking institutions.

MR POTGIETER: Dr Stals it should be annexure 2 and it is on page 190. Just a small correction there. --- Annexure 2 yes, we changed that from B to 2, 190. Annexure 2. It should be noted that by selling foreign currency to South African banking institutions in a situation of a shortage of liquidity in the forex market the bank at the same time withdraw its rand liquidity from the system. So you may not only sell dollars into the market because you want to supply dollars to the market it is a very convenient, quick, effective way also to take rand liquidity out of the system. A shortage of rank liquidity will lead to upward pressure on domestic interest rates and will automatically reduce opportunities for the financing of speculative transactions against the rand. I want to say a few things again about the net open foreign position of the Reserve Bank. We have already referred to the perception that is very widely held inside and outside of South Africa about this NOFP. I think it is much less harmful than many investors and well informed economists believe but let me just explain a little bit again about this NOFP of the Reserve Bank because it comes up so often in this debate and in this discussion on the exchange rate changes. Reserve Bank intervention in the forward foreign exchange market apart from a spot market where you buy and sell dollars in the spot market, but the intervention in the forward market is more - is a more controversial issue. The practise of providing forward cover through the Reserve Bank introduced by South Africa in 1961 as an integral element of exchange controls transfers the exchange rate risk exposure of institutions and individuals of the South African private sector via the Reserve Bank to the national treasury, that is the tax payer in general. It is a transfer of an exchange rate risk exposure from the individual to the government for the account of the tax payer. That is the most important element objective of the NOFP of the bank to transfer the exchange rate risk from the private individual to government. Why was it introduced in 1961 as part of the exchange controls, the exchange controls made it impossible for the private sector to hedge themselves against possible changes in the exchange rates. Private banks could not hold foreign currencies to serve as a hedge against future commitments. Individuals were not allowed to hold foreign currencies, exporters were required to transfer their export proceeds back to South Africa within seven days, importers were not allowed to pay for imports before the time, all those kinds of restrictions made it almost impossible for the private sector to protect itself against exchange rate changes. The argument was then you the government is introducing these exchange controls that make it impossible for us to cover our exchange rate exposures you must provide a system that will enable us to protect ourselves against possible changes in the exchange rate, and that is where the forward book came from. With every depreciation of the rand losses are incurred by the bank on its forward market operations for the account of the tax payer. This is the major disadvantage of the so-called net open foreign position of the Reserve Bank. It is mainly for this reason that the bank has for some years now made efforts to extricate itself from a net open foreign position. As recommended in the Reserve Bank chairman's address of August 1998 the bank should reduce its intervention operations in the market for forward foreign exchange as exchange controls are gradually removed. The facility was introduced with exchange controls, it should be removed as exchange controls are removed. The footnote is important, I tried to explain what this net open foreign position of the Reserve Bank is. It can be described as a difference between the total amount of foreign currency sold forward by the bank minus the total of its forward purchases and its total holdings of gold and foreign currency reserves. It is in other words a commitment to deliver or to sell foreign exchange that the bank does not have in its possession at that point of time. The NOFP represents the excess demand for forward cover in the private sector that cannot be met by private sector banking institutions partly because of exchange control restrictions of the past. Particularly in times of foreign exchange market distress, many importers buy their foreign currency needs forward whereas most exporters hold onto their foreign currency accruals for as long as possible. This creates an unbalanced situation in the private market. Importers want to cover, exporters do not want to cover, there is a big shortage of forward cover. A net shortage in the market then spills over to the Reserve Bank. The bank will eventually buy the proceeds of the uncovered exports in the spot or cash market. That question is always asked, now how is the Reserve Bank going to meet its commitment on the NOFP. Where will the dollars come from. Well the dollars will come from the balance of payments. Exporters do not cover, importers cover. The importers are not going to buy the dollars in the market when they have to make their payments because they have forward contracts that will mature. Exporters must sell their dollars in the market because they cannot hold it any more, that is the difference that the Reserve Bank buys dollars from the exporters in the market and deliver it or sell it under the maturing contracts to the importers. The imbalance in the foreign exchange market is not created by the NOFP. The imbalance is measured by the overall balance of payment. Are imports more than exports? Yes then you have a problem. It has got nothing to do with the amount or the volume of the NOFP. The overall balance of payments that will determine shortages of foreign exchange in the South African market, not the NOFP of the central bank. During a period of a depreciating rand the Reserve Bank will make a loss on its NOFP and in a situation of an appreciation the bank will make a profit. There is a misconception that the reduction in the net open position of the Reserve Bank absorbs an equivalent amount of foreign exchange and therefore reduces the supply for foreign currency in the market. This is not necessarily correct or true. It must be remembered that by far the major part of the Reserve Bank's forward book is a duplication of foreign commitment of the South African private sector mainly of importers. The total amount of the Reserve Bank's net open foreign position is not an additional foreign liability of South Africa, and that is the misconception. Foreigners interpret this as an addition to the foreign liabilities of South Africa. It is a duplication of foreign liabilities that already exist in the South African private sector. It is not an addition, additional foreign liability of South Africa. It is a foreign liability for the Reserve Bank but the liability to South African residents who carry the foreign liabilities - foreign commitments. The total amount of the Reserve Bank's net open foreign position is not an additional foreign liability of South Africa. It is for this reason not included in the statement of foreign assets and liabilities of South Africa as published by the Reserve Bank in its quarterly bulletin . When the NOFP of the Reserve Bank was $24 billion, that $24 million appeared nowhere in the statement of foreign assets and liabilities of the country because it just represented existing foreign liabilities of the private sector already included in the statement of foreign assets and liabilities. The underlying foreign currency commitments of the NOFP are already covered by the liabilities of the private sector. Importers and borrowers of foreign funds may in terms of the exchange control regulations only make use of the Reserve Bank 's forward cover facilities to cover firm, ascertained and documented outstanding future commitments against possible future changes in the exchange rate. Now I was very glad to confirm this morning again that this is still the requirement. It is what comes into the Reserve Bank's NOFP book must be in respect of firm ascertained, documented commitments of the private sector and this is the widely discussed document of 14, 15 October where this exchange control circular given to me this morning was again confirmed. It is thus incumbent on authorised dealers to ensure by receiving the necessary written confirmation from correspondent banks that the firm and ascertained foreign exchange commitment or accrual exists prior to any transaction being entered into. The underlying transaction must therefore specifically relate to a permissible transaction to which a South African domiciled entity or party is a principle. That is the rule of the NOFP book and this is why I find it so difficult to understand why people think that the NOFP of the

Reserve Bank is an additional foreign liability for South Africa. South Africa has big problem if the NOFP book is growing because where will the dollars come from. You must make a forecast prediction of what the overall balance of payments looks like if you are worried about where the dollars will come from. You might not look at the NOFP book. The NOFP book can go up or down without any change in the overall balance of payment position. It is just a transfer of firm ascertained documented commitments of the South African private sector for the exchange rate risk exposure to the Reserve Bank. When the Reserve Bank decides to reduce its NOFP it buys foreign currency with rand in the spot market from exporters, via authorised dealers in foreign exchange and then sells the currency for rand to holders of the forward contracts to redeem the bank's outstanding commitments. At the end of the day the Reserve Bank's transactions leave both the money market and the foreign exchange market in a neutral position. The gross foreign reserves held by the Reserve Bank will also show no change. The NOFP will however decline. So it is still my argument that change in the NOFP of the Reserve Bank transfers the risk exposure but does not change the overall demand and supply for foreign exchange in the South African foreign exchange market. The forward market, the spot market is an integrated market and it is ... (intervenes).

CHAIRMAN: Sorry Dr Stals there is a question.

MR GANTSHO: I thought the issue is not whether or not whether the NOFP is an additional liability to the country or not, I thought the issue is the form of the liability itself. The fact that it is of a short term nature and creates that kind of nervousness in the market that the dollars that come into the economy would be mopped out by the Reserve Bank whenever those dollars flow into the economy. I thought that was a nervousness, and not whether or not there is an additional liability. --- Yes, no if I am right the Reserve Bank does not provide forward cover for a period in excess of 12 months any more, we used to in the past, it is only for 12 months but it is linked to the payment for imports over that 12 month period in any case. So the underlying liability must be met by South Africa, whether there is a cover with the Reserve Bank or not. So if we are worried about the short term nature we must be worried about our import account for the next 12 months because we have to pay for those imports in any case. And the fact that we intermediate the Reserve Bank with the NOFP in this payment for instance makes no changes to the commitment of South Africa to pay for the imports. It is not an addition to what we have to pay for the imports in any case. It is the same imports that I have now covered with the Reserve Bank or not covered.

CHAIRMAN: You see Dr Stals I understood the evidence of the last few days to be this, it might be dealing more with the perception than the reality as you have explained it, which is that the perception is that while it exists the NOFP that the Reserve Bank becomes a buyer of dollars and in a way drains the market of dollars and therefore when dealers take a view on what to do one of the factors they take into account is that while the Reserve Bank is a buyer of dollars that will drive the currency down. That is in a simplistic way what I understood two of the witnesses to have said so far. I mean is that correct that that may have an impact on a perception of the value of the rand? --- Yes, no as you quite rightly state that is the perception and as I have been fighting for years to change that perception because I do not think it is right, there is a flaw in that perception. It only takes the forward cover transaction halfway and that is the Reserve Bank buys the dollars in the market to reduce the forward book, but how do you reduce the forward book, you pay the dollars back into the market. So if you take the two transactions together to reduce the forward book the Reserve Bank takes dollars out of the market in a spot transaction buys the dollars quite right, reduces the amount of dollars in the market, but what happens to the dollars then. Well the Reserve Bank pays it back in the forward book. There are two transactions, one is buying the dollars spot and taking it out of the market, the second one is selling the dollars in the forward book and putting it back into the market, so through a reduction of the NOFP we do not reduce the amount of dollars in the market.

So you are saying it is all based on a misconception? --- Yes as I say I have been trying to explain this for years but without success and I even see around here people shake their heads. I do not know, somebody must explain to me then why is it different why doesn't it work like that. I come to some leakages that can be different but ... (intervenes).

MS QUNTA: Before you go on Dr Stals ... (intervenes). --- May I ask the Reserve Bank whether they do these forward transactions different from what I explained to you but as I say you buy dollars spot and then you sell them forward they go back into the market.

Before you go on you say you have been trying to correct this misconception, how have you done that, have you issued statements, is it known - would the market know that if the dollars come out, if you buy it on spot you put it back, would the market know that? --- Yes well this explanation I am giving you here today I have repeated many many times in international conferences, in papers, in statements and I think if you read the chairman's statement of 1998 I think it is even mentioned in that statement also, but no we have - I have tried to explain it many many times but as I say either I do not understand it or somebody might explain to me how you - the dollars will disappear because if the bank buys it spot and sells it back in the forward book to reduce the forward book the dollars go back into the market. And I come to what is happening now to the dollars after the Reserve Bank has paid it out and there may be some leakages then but the Reserve Bank transaction of increasing the forward book or reducing the forward book through simultaneous spot and forward transactions cannot really change the amount of dollars in the market. CHAIRMAN: Can you continue please. --- To determine what effect the reduction of the Reserve Bank's NOFP will have on the exchange rate of the rand one will have to find out what the reactions were of the previous holders of the forward contracts that have now been excluded from the Reserve Bank facility. That importer who now cannot get forward cover from the Reserve Bank any more, what is he going to do now. In most cases private banks will be able to accommodate the clients with new forward contracts now carried by the banks themselves, but most probably at a higher premium, it may cost him more but he can get that forward cover from his bank. It must also be noted that the total forward book carried by the private bank now has for some years been far in excess of the Reserve Bank's book, this market has developed quite well outside of the Reserve Bank and carried by the Reserve Bank allowed by the Reserve Bank so gradually the private banks can take over this whole function of forward cover, especially if we remove the exchange controls and it is happening. To the extent that the private banks can cover forward sales to the importers with forward purchases from exporters the forward market business is very lucrative for them. Unlike the Reserve Bank however because it is a national treasury, because the Reserve Bank does it for account of the national treasury private banks cannot carry any substantial amount in the form of an uncovered overboard or over sold position in the forward book. At the end of the day it is the unbalanced or the unbalancable part of the private sector forward book that is carried by the Reserve Bank. The reduction of the Reserve Bank's NOFP can lead to come leakages of foreign exchange out of the country, e.g. when borrowers of foreign funds decide not to pay the higher premium charged by the private banks but rather to repay their foreign liabilities. That is the important decision. If an importer cannot get the cover any more he will say well I am not going to use the foreign credit facilities any more, I would rather repay it. Yes sure the the dollars will go out of the country. Or a borrower of short term funds overseas well I cannot get this cover any more I rather repay my foreign loan. And that is possible, and then it will go out of the country, but that is a secondary transaction, that is a decision of the private sector. It is also true that the transfer of forward contracts from the Reserve Bank to the private banks may lock up more foreign exchange for spot against forward cover purposes if banks cannot find enough exporters to sell to the banks on a forward basis their future earnings from the exports. One way for a bank to cover his future commitment is to say I hold more dollars in my accounts overseas and I can use these dollars then to sell forward in South Africa and that is why as the Reserve Bank reduced its forward book the country's foreign reserves did not decline but there was a transfer of foreign reserves from the Reserve Bank to the private banks, or the private banks increased their foreign holdings. Yes if they had to do more forward business that is one way to cover their forward position, if they cannot get exporters to sell to them dollars forward they can say I hold more dollars in my accounts overseas and I can use that and that can be seen as a leakage out of the market, it is still owned by South Africa, it is still in the foreign reserves of South Africa but it does not again does not disappear. We do not lose those dollars at all. And in terms of banking regulations, private banks may only hold a limited amount of an uncovered position in the foreign exchange market. The perception that - yes I may add here that there can also be a leakage if that forward book of the Reserve Bank does not comply any more of this requirement that it must in all cases be in respect of a firm and ascertained foreign exchange commitment or accrual and that it must be a transaction to which a South African domiciled entity or party is a principal and that is why this circular that the Reserve Bank issued on 14 October was very important because if we comply with those requirements what the NOFP of the Reserve Bank will do is not change total amount of dollars available in the market. It could have secondary effects yes. The perception that a reduction in the NOFP of the Reserve Bank reduces the overall supply of foreign exchange in the South African foreign exchange market by an amount equal to the decline in the NOFP is therefore not always right. It is my contention that the reduction in the NOFP of the Reserve Bank last year contributed to the greater volatility in the exchange rate but its role as a contributing factor to the depreciation of the rand has been exaggerated. Contrary to the general belief in the market place the ultimate full withdrawal of the Reserve Bank from the forward foreign exchange market to my mind lead to greater volatility in the rand exchange rate and not to a more stable rate. Without this shock absorber an external disturbance will have a greater impact on the spot exchange rate in a limited market where it will be more difficult to buy foreign currency forward, particularly in a situation of negative expectations about possible future movements in the exchange rate. Again because of those negative perceptions the misunderstanding there is in the world about the forward book I still think it is right that it should be removed, I think it should be removed in any case as exchange controls are being removed. I think it is difficult to say but it may lead to a stronger rand, but it will certainly lead to greater volatility. You will have more volatility if you cannot take forward cover, if there is a limited amount of forward cover available any external shock will have a bigger effect of the exchange rate than when you have this facility. So again I do not understand this perception that if the forward book disappears there will be less volatility in the market. My analysis brings me to the conclusion that there will be more volatility in the market. May I add that perhaps this misunderstanding is because central banks did mismanage and abuse the forward cover facility in the past, the Bank of Brazil for example went into the international markets and said sell me dollars today I will sell them back to you six months from today and that to give their dollars to meet shortages on the balance of payments for that day. That certainly created an additional liability for that country because six months later the Bank of Brazil had to pay the dollars back to the international markets. This is not as far as I know what the policy is in South Africa. It must firm, ascertained commitments of South African residents to take out cover with the Reserve Bank. Big disadvantage of the forward book still remains that you expose the general tax payer to the exchange rate changes instead of the users of foreign exchange, and that is the main reason why we supported for many years and tried to get the forward book out of the Reserve Bank.

The final few words, a kind of a summary, conclusion. Any search for an explanation of the rapid depreciation of the rand last year the commission must take the following facts into account. In the present system the South African exchange rate is determined by forces of demand and supply operating in a market environment subject to some direct and some market based intervention by the monetary authorities. The system of a managed float is by its nature unstable. Volatile movements in the exchange rate can be expected from time to time. From the experience of the past twenty years the deduction can be made that the nominal exchange rate of the rand against other currencies will over time depreciate more or less by the inflation differential between South Africa and its major trading partners. This depreciation does not follow a straight line path but rather a staircase adjustment process. The periodic adjustments to a new level in the past often led to an over reaction in the market with a subsequent consolidation period. During the past two decades globalisation led to an integration of financial markets on a world wide basis. There has been a big increase in international capital flows emanating from the private sector. Turnovers in foreign currency markets assumed astronomical dimensions. South Africa participated in these developments and removed all or relaxed exchange controls to an important extent. All these developments contributed to a more volatile exchange rate for the rand. In the second half of 2001 various adverse external and domestic developments led to a deterioration in the South African balance of payments and therefore to a decline in the supply of foreign exchange. Without any official support shortages developed in the markets of foreign exchange with a strong concurrent pressure on the rand to depreciate. South African authorities certainly at the right time indicated in their statements as I tried to indicate in my quotes from the monetary policy statements as the situation deteriorated progressively the authorities came in and said more and more that we are worried about what is happening in the foreign exchange markets, the monetary policy statement of 15 November certainly emphasised it, the joint statement issued by the minister of finance and the governor of the Reserve Bank in December certainly also conveyed to the market the concern of the authorities about the depreciating currency. If I created the impression earlier that it did not help in any way, certainly it helped by changing attitude which progressively became clear from the statements made by the Reserve Bank and the minister of finance certainly contributed to the final stabilisation of the rand and to the appreciation of the rand at a later stage. To my mind the final strong indication from the private sector came to the private sector came when the bank - the repo rate was increased in January. So yes gradually the authorities made it clear to the market that this depreciation of the rand is a problem and we shall have to do something about it.

MR POTGIETER: Dr Stals in this context if you refer to page 127 of the expert bundle in front of you. The top graph there diagram 19, this is a diagram that was handed in by Mr Rudolf Gouws yesterday when he testified on the basis of this document *inter alia*, do you see there that from 1 December there was the Manuel/Mboweni statement and it appears from this diagram that that actually, that joint statement actually stabilised and strengthened the rand, would you go along with that? --- Yes I will accept that, I think as I say I do not follow the developments on a day to day basis any more, it was my perception that the rand stabilised yes towards the end of December, early January. I will accept this that the joint statement already made an important contribution and the follow up with the repo announcement made a further contribution sure, so as I say progressively even already from the monetary policy committee statement in November the indications were made clear that - the indications were there that the authorities were getting more worried about the exchange rate changes, and that I think must be useful for the market and it helped to change expectations. The 15 November statement, the 21 December statement, the announcement of the increase in repo rate, that all helped to stabilise the market.

Yes will you continue.

MS QUNTA: So in effect Dr Stals if I can just follow up on that question, your comment in paragraph 15.6 and 15.7 which indicates that it is only with effect from 16 January 2002 that the market settled down, would you revise those comments in the light of what you have just said? --- Yes I should say it was only on 6 December that the market actually reached a new situation of stability but it was progressive, it was a process that already started I think early in December throughout December and especially from 31 December. If that conveys the wrong impression perhaps the words were a little bit too strong in here, so I should say that 21 December it made a contribution I will accept that. Good and the last part of paragraph 31.4. There was a growing perception in the market that the rand will continue to depreciate. Protective action by importers and expedient conduct by exporters squeezed the market even further, early December there were signs of panic in the market because of the shortage of liquidity. In the monetary policy framework as part of the summary, of a country such as South Africa there are a number of inter related financial aggregates that function in a circular process of action and reaction. These include the domestic price levels, the rand liquidity available in a banking system, the bank credit extension to the private sector, the money supply, the level of interest rate and the exchange rate or external value of the rand. Out of step changes in any one or more of these aggregates will also affect all the others. Without the natural market adjustment process or pro-active policy actions a process of disruption initiated by a breakdown in any one of the elements of the chain can easily lead to a vicious circle of continuous further depreciation. Increases in bank credit extension, higher rates of gross in the money supply, more inflation in the domestic economy and once again more depreciation. To break this vicious circle may ultimately require very painful and disruptive monetary and fiscal policy actions. Finally then the reduction in the net open foreign position of the Reserve Bank last year may have contributed to the woes of the rand. The contribution of the reduction of the NOFP to the depreciation of the rand has however been exaggerated in the media and in the market. As long as the Reserve Bank enters into forward foreign exchange cover transactions for South Africa residents in respect of firm ascertained and documented commitments increases or declines in the banks NOFP will be neutral as far as supply and demand conditions are concerned in both the markets for foreign exchange and for domestic rand liquidity. It is my view that the volatile movements and depreciation in the exchange rate of the rand last year can be explained satisfactorily in terms of the macro economic environment and market developments during that period. Thank you.

MR GANTSHO: Dr Stals one of the recommendations of the De Kock Commission as you referred to on page 167 of the bundle was to keep limited controls over residents. Do you have any view as to whether this is the right thing to do, given some comments that are made that this actually restricts, constrains the ability of residents to take positions that will be beneficial to a rand when it is attacked by non-residents. --- I think when I read through that De Kock Commission report again I think one has to present it to this commission with some reservations and the one is that the situation has changed a lot since 1978 and 1979 when that report was written. For example in those day the Reserve Bank was still responsible selling all the gold of South Africa, therefore was a very big operator in the foreign exchange market by the nature of its business. That has changed for example and I think the De Kock Commission would have made a slightly different recommendation if they took account of that and I think the same applies to the retention of some control on residents. That was appropriate for that time because we had very extensive exchange controls on both residents and non-residents and what the commission recommended was that it should be gradually removed starting with the non-residents, the financial rand and the commercial rand dual exchange rate system and then extend it to residents but the commission at that time had no problem if some controls on residents should be maintained. I do not think today, I think we have removed something like 70% of all the exchange controls that existed at one stage. Apart from one aspect of the exchange controls and that is the block rand system of the former resident funds blocked in South Africa I think the remaining exchange controls on residents in South Africa are not very effective and not very important any more. And my own personal view is I have little problem if they are all removed, I do not think it will make that much of a difference to the system in South Africa and I think we should gradually work out - ourselves out of the block rand system also and get to a stage where we get rid of all the exchange controls. So no my answer to your question is that I will, in the context of the environment in which we live and operate today I will not accept that recommendation of the De Kock Commission I would go all the way and take the exchange controls away. Again for that perception of the foreign investor in South Africa he says well there is a dog with teeth, whether it will bite or not I do not know, so as long as you have exchange controls I am worried about investing in your country. So take them away and I do not think it will have that much of an effect today.

MS QUNTA: Dr Stals I am sure you are aware of the terms of reference of the commission, I do not know if you have it in front of you. --- I do not have it but I ... (intervenes).

But you are aware. What the commission is tasked to do or was tasked to do by the President was to look at any transactions which contributed or gave rise to the rapid depreciation of the value of the rand during the relevant period which is 1 January and 31 December 2001 and if those transactions were either illegal or unethical and whether they arose as a result of collusion or resulted in improper gain are you able in any way to assist the commission in terms of your experience in the past with regard to its terms of reference. I am aware that what you have given us is background and macro economical situations but are you able to assist the commission in any way in terms of reference? --- I am sorry to be negative about it, it is extremely difficult and I think this has been pointed out to the commission already, to identify, to find individual transactions in this huge volume of operations and business in the foreign exchange market that would be suspicious even. Now whether there are illegal, illegal in terms of what the exchange controls and regulations, I will be very reluctant to test the exchange rules and regulations in any court today because by phasing out exchange controls, by removing certain controls, by abolishing 70% of your controls that existed you make the rest very ineffective and very difficult to apply. That is why I say one can just as well take away the rest. Even when we had exchange controls in full force the system was never 100% effective. So it is very difficult to say today what is illegal and to test this in a court on whether it is illegal or not, so that definition of illegal, apart from the problem of finding the transaction whether it is illegal or not is going to be difficult. And unethical, now unethical in terms of whose definition of unethical or ethical. I mean in the market place the only objective is to make a profit. If the market provides you with the opportunity to make a profit for yourself or for your institution or for your shareholders well that is ethical, that is the ethics of the market economy so again the word unethical is extremely difficult to apply to transactions in a relatively free, open, managed floating exchange rate market system. So I have great sympathy with your commission and with its mandate and with its instruction, I just think it is going to be extremely difficult. Yes sure you will find things that are suspicious that would not be - that would be against the spirit of what we may think is in the national interest and so on but to prove the very legal or unethical may be extremely difficult even if you could find those transactions. And yes sure in that environment and in that situation that we experienced in late last year sure there will be people who will or dealers or operators or investors or speculators who will make the most out of the situation and make profits and try and increase their income in the operation. Most of us will regard as unethical if not illegal but to test that in a court I think will be extremely difficult so I think you are going to find it very very difficult to give an answer to this part of your instruction, your mandate.

So your view is that there may have been some transactions like that but that the commission would find difficulty in establishing those transactions? --- And what is more you know most of those transactions I will guess, if you can find some of them, would be relatively small transactions. I do not think big corporate institutions and so on will expose themselves to this kind of illegal or unethical transactions and so on. And with the turnover of make is $6 or $7 billion per day it must be quite a big transaction a substantial transaction before you can really affect the exchange rate in the market. So that is another big problem you have. I mean this small opportunist who comes into the market with R1 million to do a transaction he is not going to move the exchange rate in any direction.

Thank you. Dr Stals a last question, in your - in the 20 years that you say the rand has had a managed floating exchange rate has been enforced has it ever happened that the rand depreciates by 40% in 20 years as it did in December. Are you aware of any instance that that happened? --- No I do not think so, even in 1998 the East Asian crisis the total depreciation of the rand during that period was at its worst was 20%, just over 20%, 21%. Then also like now it appreciated and we ended up the year I think with less than 10% depreciation, so no, but then again you know progressively the environmental circumstances make for greater volatility as we remove more exchange controls, as we get more integrated in the world financial markets. As a volume of international transactions increase, well possibly we can have more volatility. Again it is very difficult to measure what happened last year against what happened in 1998, 1996 and 1985, so and this is what my fear is also that in future we will see even more volatility, greater volatility than we have seen in the past.

I do not have further questions.

<u>CHAIRMAN</u>: Any further questions around the room? Thank you Dr Stals you may be excused and thank you for your contribution. Mr Ginsburg I wonder if you could just come forward in regard to the Reserve Bank's evidence next week. I wonder if I can ask you to ask the Reserve Bank to apply its mind to Dr Stals's views on the NOFP because if this is an opportunity that the commission can use to disabuse people of their views of how the NOFP can have a negative impact on the currency I think we should take that.

<u>MR GINSBURG</u>: Yes.

<u>CHAIRMAN</u>: And it may not have been part of your preparation but I know that you are continuing to prepare this week. I wonder if you can ask your client to deal with this particular aspect.

<u>MR GINSBURG</u>: We will certainly do so Mr Chairman.

<u>CHAIRMAN</u>: And lead some evidence next week.

<u>MR GINSBURG</u>: We will certain do so. We take your comments to heart.

<u>CHAIRMAN</u>: Thank you Mr Ginsburg. Now Mr Brooks in regard to yesterday's evidence from Mr Gouws. There were outstanding slides of his which we do not have, and I would like them before we start reading the record that is about to be handed to us.

<u>MR BROOKS</u>: Mr Commissioner I did speak to Mr Gouws this morning, he is going to send them over to me. I do not know whether they are on their way, I will phone him.

<u>CHAIRMAN</u>: But you are following it up. And then our next witness is at 14:00 is that correct?

<u>MR BROOKS</u>: That is correct.

<u>CHAIRMAN</u>: I will adjourn until 14:00.

<u>COMMISSION ADJOURNS</u>

PROCEEDINGS RESUME

CHAIRPERSON: Mr Brooks the next witness, Mr Luüs.

MR BROOKS: Commissioner, I think before we call Mr Luüs, for all those parties who have forgotten to switch off their cell phones, will you please ask them to switch them off now.

CHAIRPERSON: Very good idea.

MR BROOKS: I call Mr Christo Luüs, Mr Commissioner.

MR LUüS: My name is Christo Luüs, I am an economist at ABSA Bank.

CHRISTO LUüS d.s.s.

CHAIRPERSON: You may sit Mr Luüs.

MR BROOKS: Commissioner, Mr Luüs's statement you will find on page 207 of the bundle and he will refer to the diagrams which you will find as from page 217 of the bundle.

CHAIRPERSON: Fine proceed.

EXAMINATION BY MR BROOKS: Mr Luüs you have a copy of your statement and the diagrams before you. Mr Luüs? --- I have yes.

Could you just very briefly summarise for us your CV? --- I am an economist at ABSA Group Limited. I have started in 1985 at the United Building Society as econometrist and I have had various positions since then which later became ABSA Bank. I have got a B.Comm Honours from RAU, a MBL from UNISA and I have completed the FIFN exam. I have been involved in the writing of books on the options, futures ... (indistinct) equity market, as well as matters pertaining to personal wealth, and that is about it.

Thank you very much. Then on page 208, paragraph 5, could you please take us through your statement please. --- With regard to the rapid depreciation the value of the rand during the last few months of 2001, I am of the opinion that the factors that at any time influenced the rand's value can be divided into three broad categories. First there are the factors that relate to the demand and supply of rands, based on goods and services flows, that is the current account on the balance of payments. These are addressed in paragraph 6. Secondly there are the factors that have a bearing on the confidence and/or risk perception of market participants with respect to the South African economy and which primarily affect capital flows or the financial account on the balance of payments. These factors are elaborated upon in paragraph 7. Thirdly there are factors, mainly technical in nature, relating to currency trades which may be performed in both the spot and forward and other ... (indistinct) markets and which can influence transactions on both the current and the financial account of the balance of payments. These factors are addressed in paragraph 8. Paragraph 9 briefly addresses the role of speculators in the rand slide and paragraph 10 provides some pointers as to possible options that in my view could prevent further rapid rand depreciation. Paragraph 11 concludes with some choices that in my view would constitute bad policy decisions.

Mr Luüs could you just stop there please. There are certain expressions used by the witness that are not common expressions, but they have been dealt with and explained at this commission repeatedly. So I am not going to ask the witness to deal with those and explain those again, it will be a matter of reinventing the boom again, I think.

CHAIRPERSON: If we are ignorant we will ask.

MR BROOKS: Yes, I was going to suggest that if there are any remarks or expressions that are not explained and where you require explanation please do interrupt.

CHAIRPERSON: Yes, we will ask.

MR BROOKS: Thank you.

CHAIRPERSON: Yes, we will ask.

MR BROOKS: Mr Luüs please continue. --- On page 209, paragraph 6,

"Demand and supply factors.

Various demand and supply factors can be said to relate mainly to foreign exchange payments made and foreign exchange proceeds received for goods and services. Various factors can also be identified that will have a negative impact on the value of the rand, that is each of these could, all things remaining equal, cause the demand for rands and/or the supply of foreign currency to decline. Alternatively the demand for foreign currency and/or the supply of rands on the foreign exchange market could rise. These developments will ultimately lead to either a larger deficit or a smaller surplus on the current account of the balance of payments and a depreciation of the rand exchange rate."

And then the few factors are numbered there.

"1. An increase in imports. That is the demand for foreign currency will increase to pay for more imports."

Could you just explain that briefly, what do you mean by that? --- Well, if there is a need to import for instance capital goods in order to produce more goods within the borders of the country, of course there will be a need to import these from abroad and in order for that to be paid in dollars there will of course be a demand for dollars in the foreign exchange markets. So all other things equal, if imports rise without a concomitant increase in exports for instance, that will lead to a smaller deficit - rather a smaller surplus or the larger deficit on the current account which will have a negative effect on the rand exchange rate.

Right thank you. --- We already touched then on the decrease in exports which could have the same effect.

"3. An increase in South African services and income payments abroad."

Could you explain what do you mean by South African services and income payments abroad, what is that? --- Well, services relate mainly to non-factor goods, in other words the invisible account on the current account. That mainly pertains to insurance costs, transport costs, the tourists going abroad, or tourists coming to South Africa and the proceeds or payments that are related to those flows, mainly of services. Income payments also include then the dividend payments and the interest on any loans that are being financed, either by the private sector or the Government.

Yes now, we have often heard and read in the newspapers about the De Beers or the Anglo dividends that have flowed overseas, is that what you mean by the income payments that have gone abroad? --- That is exactly what it relates to yes.

Is that an example of income payments going abroad? --- That is right yes.

Right, do you have any figures in regard to what these dividend payments are that went abroad last year? --- Well, those are figures that are being published by the Reserve Bank in the quarterly bulletin and we have a graph that will show the - just later on the ... (intervenes)

So we will deal with that later? --- Yes, we will just mention how the flows have actually progressed over time.

Thank you. --- And then fourthly:

"A decline in foreign services and income payments received for South African services."

such as we have already mentioned the port service charges and tourism proceeds.

Right. --- Paragraph 7:

"Confidence and/or risk perceptions.

The second group of factors, in my opinion, impact on the willingness of investors to commit new capital or to retain existing capital holdings in South Africa. This aspect has become extremely important since of the past number of years financial account balances have outstripped the balances recorded on current account of the balance of payments."

and that is then depicted in graph 1 on the screen as well. And as you can see there since 1995 we had quite significant ... (intervenes)

So that is page 219 of the record? --- That is right yes.

Can you just take us there? --- The financial account since 1995, as you can see was in positive territory over the entire period and in the fact it does outstrip the current account deficits that we have experienced since 1995. The situation the was changed in 2000 when we actually had a capital outflow or on the financial account and I must just add that these figures do not include the unrecorded transactions on the balance of payments that pertain to both the financial and the current account. I have not depicted them on the graph, because they, as I say, relate to either one of those groupings and it is not exactly then sure where the allocation should be made, but these are purely then the financial and the current account transactions and once again in 2000 we have had quite a negative situation. The figures that you there pertain to the first three-quarters of the year and indications are that in the fourth quarter we have also had a nett outflow of capital or a nett outflow on the financial account, together with a small deficit then that emerged on the current account, which probably then placed the whole year in deficit as well. So since 2000 I would say that, to a great extent, exerted pressure on the rand because both of those accounts were then in deficit.

Thank you. ---

"If foreigners perceive ...

sorry, I just go back one sentence:

"This aspect has become extremely important since over the past number of years financial account balances have outstripped the balance recorded on current account of the balance of payment. If foreign investors perceive the expected returns achievable on the investments over a specific term to be sufficiently high and/or the risks to be sufficiently low, capital inflows will create an additional supply of foreign currency and a demand for rands, which will normally support the value of the rand. The converse will be true if they are of the opinion that the risks are too high and/or the expected returns are too low. They will then cease to commit new capital to the country and may even sell the existing South African assets, thereby creating downward pressure on the value of the rand. South African residents may likewise be influences by more or less the same set of factors on which they will base any decision to move capital abroad, rather than investing it in South African assets. Many analysts, politicians and Government officials have repeatedly pointed to the host of positive economic factors that should have prevented the rapid depreciation of the rand. These include stable and disciplined fiscal and monetary policies, low inflation, low foreign debt ratios, a sound and advanced financial system and the reliable and well functioning judicial system. Because many macro economic factors have indeed improved since the new democratic order has been established in 1994 some decision-makers have expressed the sense of betrayal by the investor community because our currency is being punished despite having achieved the lot in a relatively short period of time."

I then refer to graph 2 which just shows the changes and that ... (intervenes)

That is on page 220. --- 220 yes. That just shows the change and the real effect of exchange rate of the rand. Now, a few things are quite clear from this graph. First of all the extent of depreciation that we have had in 2001 was basically matched by a similar depreciation in the real effective exchange rate of the rand during the mid 1980's. Of course we all know that that went hand in hand with a lot of political upheaval in the country, as well as a dead standstill being announced and also exchange controls being tightened at the time. In the run up to the elections in the early nineties there was actually a strengthening of the real effective exchange rate, but in 1996 and again in 1998 in the wake of the Asian crisis we had very sharp depreciations in the real effective exchange rate of the rand. Now if one goes a bit further and you just take the averages over the periods then for the period 1985 to round 1995 the average rate of depreciation and the real effective exchange rate was around 7,9%. Sorry, sorry, it was 0,4% increase. The nominal effective exchange rate decreased by around 7,9%, but in this value there was a slight increase over that period on average and then in the period since 1996, the rate of depreciation, the real effective exchange had averaged around 4% per year. So it does indicate that since the mid nineties on a real effective basis measured against a basket of currencies, the rand did slip.

Faster than the others in the basket? --- Well, of course you measure it again just a major trading partner nations currencies, yes so against those currencies it has then depreciated at a more rapid pace.

"However one should remain mindful of the fact that investors are foreward looking. Therefore improvements relative to what other countries are doing is important, together with confidence that problems in our economy that are still existing or that have recently developed will in future be addressed effectively. In this regard various observers have pointed out to numerous negative factors and perceptions that may have contributed towards the formation of negative sentiment in the recent past at various times and to varying degrees. These factors, in my opinion, have been nibbling away at confidence which eventually culminated into a large scale sell off of rands. Some of these negative factors included the following:"

and that is in no particular order.

"1. High-end rising rates or levels of unemployment threatening socio-economic stability.

2. The perceived lack of labour market flexibility, compounding the unemployment problem and being detrimental to higher productivity growth.

3. Low savings and fixed capital formation levels constraining the economy's long-term growth potential.

4. Dissatisfaction amongst poverty stricken people is mounting because of growing economic inequality and this creates fertile ground for unrest and crime.

5. Government's attempt to combat crime are considered ineffective.

6. The Civil Service is considered to be bloated and inefficient.

7. Essential public services notably health and educational services are believed to be deteriorating. The quality of education specifically is seen as being inadequate to fulfil the skills required for a modern growing economy.

8. The country's infra-structure notably railways and roads is not maintained

properly.

9. A high nett tax burden which is taxes paid, less services received in this productive effort. The new capital gains tax introduced in October 2001 is seen as detrimental to saving an investment.

10. Political leadership is seen as weak and directionless, particularly in view of its irrational handling of the HIV Aids pandemic.

11. Ambiguous policy approaches with regards to Government's desire to attack foreign investment in the economy. Examples include calls for a debate on foreign land ownership and the moves to restrict foreign ownership in private security firms followed by an about turn on the issue.

12. South Africa's foreign relations are at times seen to be counter-productive with the country often choosing to side with rogue states such as Libya and Cuba.

13. Zimbabwe has had a severe impact on the confidence because of the disregard for the rule of law in that country and the potential destabilising effect of that country's problems on the entire region. The South African Government's failed policy of quiet diplomacy has created uncertainty as to its resolve to prevent similar conditions from developing in South Africa. Some evidence of the negative effect that Zimbabwe has had on South African capital markets can be found in the nett foreign purchaser of South African bonds."

And there is a graph on ... (intervenes)

Is that graph 3 on page 221? --- That is correct yes.

Right, will you just take us through that? --- The nett purchases of South African bonds by foreigners amounted to a cumulative figure of 6,1 billion for the period 1994 to 1999, which includes a 3,9 billion dollars outflow during the Asian economic crisis of 1998. Our graph only shows the picture since the beginning of 1997 of course.

"Since the beginning of 2000 when the instability in Zimbabwe started to take shape, foreigners have sold R48 billion or $6 billion in South African bonds."

And this has happened despite the significant rise in South-African bond prices implying a decline in bond yields which you see there depicted by the orange line, over the period 2000 and 2001.

"14. Privatisation has lost momentum and this has created less scope for foreign capital inflows and therefore reduce support for the value of the rand.

15. Many of the aforementioned factors have influenced people's perceptions of the longer term future of the country. This, combined with the potential for much larger remuneration packages abroad have exacerbated the so-called brain-drain. High levelled skilled persons have at the same time not been allowed to augment the dwindling skills base because of restrictive immigration policies.

16. Lack of moral support for the rand on the part of the authorities which actually took effect through pronouncements that authorities remained largely unconcerned by the rand's decline because of the boost that the lower rand [provides to exports, arguably contributed to the rand's slide. After a statement on 21 December 2001 by the Minister of finance and the Governor of the South African Reserve Bank that the rate of depreciation of the rand in recent weeks is of increasing concern the rand recovered from the all time low it reached on that date."

And here I just want to point your attention to two graphs on respectively page 222 and 223 where we have just tried to at days when there was either a large movement in the value of the rand or associated volatility in the value of the rand and just to link that to certain events that has happened since the beginning of last year. Graph 4(b) on page 223 actually here depicts the statement by the South African Reserve Bank and the treasury after the peak where Argentina Circavello resigns and here I just want to point out two changes of the graph. It was not the Argentinean President that resigned, but actually the minister of finance there at the very peak of the graph and then the next block the statement of the reserve bank did not say that they will defend the currency as is wrongly stated in the graph, but it was just a statement to say that they were increasingly concerned by the movement of the rand.

"8. The technical and other factors.

The following factors can be regarded as being of a technical nature which would have contributed ... (intervenes)

Sorry, you have forgotten paragraph 7 number 17. --- I am sorry. Yes, the last point then:

"17. Contagion from adverse developments in other emerging market economies because South Africa is lumped together with these countries, developments that may lead to a world-wide demand for dollars because of that currency's safe haven status evidently also adversely affect the rand.

8. Technical and other factors.

8.1 The fact that exporters tend to postpone the repatriation of the export earnings in anticipation of further rand depreciation the so-called lags that may develop from time to time.

8.2 Secondly, importers may increase the hedging operations and/or accelerate payments for imports, the so-called leads that may take place in the foreign exchange market.

8.3 Technical factors and market interventions that may affect liquidity in the foreign exchange market may also influence the value of the rand. Since 1994 the average daily turnover in the South African foreign exchange market has increased considerably, from $2,7 billion in 1994 to $8,3 billion dollars in June 2001. It is interesting to note that transactions by foreigners already averaged around 60% of this figure by early 2001."

and that is depicted in graph 5, the source the Reserve Bank and it is on page 224.

"8.4 On 14 October 2001 the South African Reserve Bank grained liquidity from the foreign exchange market by stricter application of foreign exchange regulations. This measure worsened the rand's slide. The SAABS figures indicate that total nett turn-over on the South African foreign exchange marked declined by 27,2% and 17,7% respectively in November and December last year, compared with the average monthly figures up to October of that year. The factor that may have lead to a one-way debt situation with regard to the future value of the rand is the so-called nett open foreign currency position with NOFP. The NOFP places a major constraint on any strengthening of the rand against other currencies because the SAAB has openly stated its intention to eliminate the NOFP. SAAB is therefore keen to buy dollars when any surplus emerges in the foreign exchange market. It can then use these dollars to reduce its commitments on the forward foreign exchange account which forms the major part of the NOFP. This means that as long as the NOFP remains in place with the authorities clearly eager to eliminate it as quickly as possible, the rand tends to be perceived as a vulnerable currency and this can at times invite one-way speculation against the rand.

8.5 A second factor that has arguably contributed to the rand weakness is the remaining exchange control regulations which the Government has indicated will be abolished over time. However, the remaining exchange control regulations potentially deter foreign investment because foreigners believe that the gradual or sudden removal of such controls will lead to a gradual or sudden further depreciation of the rand. In addition South Africans who have illegally remitted capital abroad in previous years are highly unlikely to repatriate such funds, even under very favourable exchange rate conditions."

Well, what do you mean there by illegally remitted funds? --- Well, they have taken money abroad without getting approval from the Reserve Bank and those are now being held in foreign assets or in foreign bank accounts.

Yes. Are there any figures substantiating what has been taken out? --- No, there are no figures, since it is illegal they are also not ... (intervenes)

No, but this is just a perception, it is not recorded or there is no proof of what has been taken out, that is what I am trying to establish. --- No, except for the annedotal evidence emerging from certain foreign fund managers in off-shore tax havens for instance.

Where would we find that? --- I am afraid you will not be able to.

The point I am trying to make is you say it is illegally remitted abroad, but there are not hard facts that can tell us yes, this is what has been taken out, or anything of that nature? --- No.

Carry on. ---

" Furthermore the partial lifting of exchange controls over the years has probably made the enforcement of the remaining measures much more difficult.

8.6. Remaining exchange controls are rendering the rand weak currency because of the fear that comprehensive exchange controls may again be implemented at any time. Once such fears have been allayed by the dismantling of the Exchange Control Department at the South African Reserve Bank, this should provide a major confidence boost to the rand.

Although not strictly speaking a technical factor, one may also assume that some panic buying of foreign currency by investors may have played a role, especially during December 2001. Such reaction could have aggravated the fallen rand considering the thin market conditions at the time.

9. The role of speculators.

Speculators are blamed by some analysts wholly or partly, for the depreciation of the rand which occurred during the final months of 2001. In South Africa speculators are regularly blamed in part for any weakness of the rand during times of turmoil. Speculation is a word with many nuances. It can include the operation of leads and lags which we discussed earlier, but when the authorities refer to speculation against the rand they are mostly referring to speculators with an open foreign exchange position and more particularly a short position in rands. In my view speculators would find it difficult to continue making profits from taking short positions in the rand if no underlying negative or sentiment factors were present. Put differently speculators may reinforce a trend but are unlikely to initiate and maintain a strong trend on their own. Speculators are usually required for the efficient functioning of markets. As *Mark Levenson* puts it in his book entitled *Guide to the Financial Markets*: although speculation is often derided as an unproductive activity it is essential to the smooth functioning of the market. Buy buying and selling contracts with great frequency speculators vastly increase liquidity, the supply of money in the markets. Without the liquidity that speculators provide the futures market would be less attractive to hedgers, because it would be more difficult to buy and sell contracts at favourable prices.

10. The solutions or recommendations that I would put forward as a way of aiding the rand and preventing further rapid depreciations:

In my view tightening or expanding exchange control or inhibiting in any way market operations with regards to the exchange rate will be counter-productive. Instead economic policy should concentrate on the following issues:

On a higher more ... (indistinct) economic level I would argue that the ultimate long-term solution to ongoing rand weakness would be to enhance long-term economic growth potential of South Africa, which in turn should strengthen the country's balance of payments position. This can primarily be achieved by addressing the so-called sentiment factors referred to in paragraph 7.

The abolition of exchange controls should remain an important objective for Government, together with more efficient management of the remaining NOFP, meaning that at times foreign exchange inflows should be allowed into the forex market thereby supporting the rand.

Macro economic policy options that should receive special attention includes measures that will significantly reduce the tax burden including the abolition of the newly introduced capital gains taxes and the elimination of bureaucratic measures that inhibit the free flow of resources and that restrain the ability of South African based firms to be internationally competitive.

Reducing the economy's dependence on volatile portfolio capital flows in favour of greater proportion of foreign direct investment, FDI, especially relating to the creating of new productive capacity should become an important objective. In view of the lack of domestic sources of capital a certain level of foreign investment is required. FDI is the least volatile, owing to its long-term nature. However, the longer term nature of FDI means that it takes more to convince this type of investor to invest than the portfolio investor. The direct investor is concerned with issues such as being able to acquire the necessary skills within the domestic labour force or the HIV Aids infection rate of its potential labour force. Crime and violence are a concern because of the additional cost they impose on business. These costs can be significant from insurance cost to security cost, as well as the costs incurred in luring staff to high crime regions.

The ultimate solution to the rand's woes therefore is a holistic macro economic strategy that addresses the wide range of issues that prevent FDI from flowing into the country in significantly larger amounts. This strategy will have to include more than sound monetary and fiscal policies. It will have to address all of the factors listed as having a negative impact on sentiment and retarding economic growth. In addition such a strategy will have to be effectively implemented."

And then point 11 which I regard as undesirable policy options on the part of Government:

" Some analysts may subscribe to the idea of more regulation as far as the currency and exchange controls are concerned. Such measures could include the following:

1. The re-introduction of comprehensive exchange controls. This would probably be the worst option, since foreign investors would be completely unwilling to direct their capital to South Africa under such conditions. It should be borne in mind that most modern economies with open and free societies have no exchange control regulations, so that the criminal offence in terms of existing regulations in the Republic of South Africa is not regarded as an offence in many other countries.

2. More stringent application of the existing exchange controls may be considered."

This has already been done by the monetary authorities in October last year with adverse consequences, in my view. And then I just want to make a change, that the word "most" rather read "much".

" Much of the dealing in rands is in any case taking place off shore, making the enforcement of exchange control regulations rather difficult.

3. A fixed exchange rate regime may be considered. Many countries with severe inflation problems have implemented fixed exchange rate regimes with limited success. In fact open economies, that is that have significant trade flows with the rest of the world, with low levels of reserves and inflation rates in excess of that of their trading partners, and these basically all pertain to South Africa, will find it extremely difficult, if not impossible to maintain a fixed exchange rate regime for any length of time. The most recent example was Argentina which had to abolish the system of the economy experience severe distortions and structural problems."

Thank you Commissioner.

And Mr Luüs, for the record, you confirm the contents of this statement? --- I do yes.

Thank you Mr Commissioner.

EXAMINATION BY MR GANTSHO: Sir, you have made on your last paragraph, page 216, a statement to the effect that most of the dealing in rands is in any case taking place off shore. Can you give us a basis for this statement, because we heard evidence to the contrary yesterday. --- Yes, I think ... (intervenes)

Oh sorry, you have changed it? --- I have changed it to "much".

Okay, sorry.

CHAIRPERSON: Just picking up my co-commissioner's question, do you accept the figures that Mr McCauley gave us, because in the preparation for the Commission we have been given different figures. He gave a figure of 8 out of 11,3 billion. Do you accept that that is correct? --- Yes, he said that the South African market was around $8 billion I think in April last year.

Yes. --- Which more or less ties up with the figures that the Reserve Bank produced in the region of $7,5 billion, but the Reserve Bank figures only break it down into - well apart from the various categories and types of instruments they just list the monetary sector, the non-monetary residentials and then non-residents.

Yes. --- That presumably does not include the off shore trading taking place in the rand. Those are the figures that then are collated by the VIS.

Yes, my understanding is that in the last few years they have now been able to accumulate statistics in regard to the off shore trading in the rand and that came to just over 3 billion. --- I believe so yes.

I mean is your sense - or from your knowledge that that is correct. Can we accept that proportionality between the two? --- I would really have no idea.

You have got no idea? --- So I just accept the figures.

You accept it? --- Ja.

MR GANTSHO: The last question from me is based on the statements that you have made under paragraph 7 of your statement on page 210, where you have listed a number of factors that contribute to negative sentiments. Who holds these negative views and perceptions? You said that investors are forward looking and not backward looking and these factors may have been there and they may still be there, but they are statements that have been made by the President, by the Minister of Finance for example, which are forward looking. Are those kinds of statements that are positive taken into account in forming these sentiments? --- Well yes, I think it is a balance and at any one time if an investor has to decide to commit capital to South Africa he will of course try to balance either on a subjective way or maybe - or rather in an objective way, but most probably in a more subjective way, the factors that will actually limit his growth potential on that investment in years to come, and if you have a structural imbalance such as high employment or a lack of savings and investment in the domestic economy then evidently that will also have an effect on his perceptions of the nature of growth or return that he can expect in the future on his investment here. And if the balance of those factors are more negative than positive, evidently he will either postpone his investment or all together abandon that idea.

CHAIRPERSON: So when you list these factors at the bottom of page 210 onwards, are you saying those are factors potential investors would take into account? --- That is right yes.

You are not dealing here with a trader sitting behind his desk as we heard yesterday from Mark Langley, or would they - would it also apply to them? --- I think, ja essentially they will more react on specific events rather than taking the long-term view yes.

So this is really investors that you say, who take these views? --- That is right yes.

MR BROOKS: Thank you. You are talking more about the long-term investor as opposed to the short-term investor, the market investor? --- Well ... (intervenes)

Portfolio investor. --- Well, they will also be influenced by these, but evidently they may be in on a very short period of time and well there the perceptions on the rand are of course quite important. If they perceive the rand to be under pressure and to be not performing well and potentially will be lower at any future moment in time that it is now, they will also refrain from investing ja.

CHAIRPERSON: A question in regard to the role of speculators which you have dealt with specifically, to what extent in your experience does a speculator drive a currency one way or the other? --- Well, as ... (intervenes)

As defined by you. --- It is of course not possible to isolate the role or their role in any currency movement, because one simply does not know, but since they can make money either way they can go long in the currency and make money or they can go short in the currency and make money. One would assume that they also operate in the rand market in both directions, but if there is an underlying negative force one can call or perceptions that actually influence more the structural capital flows on the balance of payments, of course that presumably would be more - to go more short than long on the rand and that will in effect probably augment the trend already in place, but it is not - it is not really, I think really possible to isolate their role or to put a figure to it.

Yes, you cannot make an assessment to the extent to which they would have an impact. --- No, not in rand terms no.

And then you have given us a graph similar to other graphs we have seen at page 222 and 223, if you can just put it up onto the board to discuss that. When an economist such as yourself puts this on the board and then identifies events such as on the left-hand side Zimbabwe and Argentina and so on, is this something that is being done after the event? In other words one - do you as an economist see what happens to the currency and then say let me assume, let me try and find out on the probabilities what drove the currency on that day, or do you say in my dealer room on that day this was a headline which pushed the currency or which impacted on the currency? --- The way we have constructed the graph actually used that method, namely that we went back in history and we just isolated the days where there was a lot of volatility or depreciation or in some instance appreciation in the currency of the rand and then the main headlines as they appeared on Bloomberg I think, was then used to attach to those points. But of course press and also people with an interest in either buying or selling rands at any one particular point in time often want to know what is driving the currency and then, yes, you have to give comments and that is then based on the headlines as you call it at any particular point in time.

Thank you. Any questions arising?

MR GANTSHO: One of the factors that you listed or one of the recommendations that you have made is the elimination of bureaucratic measures on page 215. Can you be more specific just to help the Commission understand what are you recommending there? --- Can you just repeat the ... (intervenes)

On page 215 the first paragraph it is about the second sentence, you are saying there that the elimination of bureaucratic measures that inhibit the free flow of resources, what exactly do you mean? --- Well, the most important I think which we elaborated upon later on in my view would be exchange control still, and - but one can also put measures such as the immigration laws that are still very restrictive in terms of employing people with skills, also the elaborate extent of taxation which is highly developed and very complicated in South Africa and that is being made more so with the introduction of new taxes in the previous budget. Also taking cognisance of all the labour legislation that have changed dramatically in the recent past and also the measures associated with opening a business in various sectors and the restrictions that apply in terms of certain businesses, for instance in the IT or the telecommunications sector.

Thank you.

CHAIRPERSON: Any further questions? Any further questions from the floor? Mr Le Roux?

MR LE ROUX: Can the reduction of the nett open forward position negatively influence liquidity of the market? --- Well, I think if one looks what has happened during the course of 2001 then the stated intention of the authorities was to actually wind down the NOFP and basically that consist of three parts or the way it is calculated. First of all you start with your gross reserve position, then you deduct from that the nett liability or the liabilities of the monetary authorities, the Reserve Bank essentially and then from that is also deducted the foreign open - the forward book, to arrive at the nett open foreign position. Essentially what the Reserve Bank was doing then was not to prop up the reserves, but to build down that nett open - or rather the forward book, essentially paying off the commitments in terms of forward exposures more quickly than was required, because these are actually consisting of a lot of contracts that are supposed to mature at various stages during the immediate future. If the Reserve Bank then utilises currency inflows such as those associated with the De Beers deal, proceeds from privatisation which are known by the market to be forthcoming at any particular point in time, all - then foreign loan proceeds that the government enters into and there is in the process also a large demand for dollars by other players such as the - those related to foreign trade that will, in my view yes, have a negative impact on the market and also on the perceptions that basically a one-way bet is created for the rand.

Thank you Mr Chairman.

CHAIRPERSON: Thank you that concludes today's proceedings. We will start tomorrow at 10:00. Thank you.

PROCEEDINGS ADJOURN

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