

PROCEEDINGS RESUME ON 24 APRIL 2002:

CHAIRPERSON: Ladies and gentlemen, we start today's session with the evidence of Dr O'Neill.

JAMES O'NEILL d.s.s.

5 EXAMINATION BY MR NAIDU: Mr O'Neill, is your curriculum vitae attached to the bundle of documents at pages 35 and 36? --- Yes.

And for your presentation today you have prepared a series of 32 slides and you have included a conclusion at the end of the bundle of documents? --- That is correct.

Dr O'Neill, you are invited to go through your slides, you may be interrupted from
10 time to time with questions either from the Commissioners or myself, so would you like to commence by providing an introduction indicating how your presentation is defined? ---

Thank you. As you have just heard I have a pack of 32 slides and in essence it is divided into four different parts. The first part, slides 1 to 10, really gives a descriptive picture of how many exchange rates have traded over the past few years and I apologise in advance, in the
15 early stages of it quite a few of you will probably wonder why I am talking about all these currencies seemingly not relevant to South Africa but hopefully their relevance will emerge.

Slides 1 to 10 essentially is setting the scene as the Rand has traded relative to many different currencies in the past. And then I will go on to spend the next section, which is really
20 slides 11 to 26, discussing concepts related to the balance of payments where I will again talk about the balance of payments of quite a few countries culminating in some details about the balance of payment situation in South Africa in the past couple of years. Slides 27 to 30 will focus on the relevance of the Rand in the context of inflation targeting. I will say here, and it will emerge clearer at the time, but I believe inflation targeting to be something which is very important to South Africa and the Rand has great relevance in the context of inflation
25 targeting but it seems to me, as I will make clear at the time, the importance of the Rand separately from inflation targeting is seemingly from a global perspective and from my analytical perspective somewhat and sometimes overstated and I think I will try to show that with the help of those few charts. And then finally on page 32 you will see a survey of 30 of our most important clients. about their thoughts on the Rand and their thoughts about the
30 policy framework in South Africa which I thought separately from my own thoughts would be interesting to show all of you something which we conducted just last week.

Doctor, would you turn to slide 1 and could you just indicate why you have chosen 1999 as the year of commencement? --- I am now on slide 1. What this chart shows you is the three most, arguably the three most important currencies i the world going back since
35 1999 and I have chosen 1999 because that is when the Euro was introduced at the start of European Monetary Union.

What is the significance of that in the context of your presentation? --- As will hopefully become clear in the next few minutes, and as I will state more specifically, the foreign exchange market generally has been very peculiar since European Monetary Union
40 started. Many historical norms have seemingly changed and

lots, lots of developments in the global financial markets have followed a very different path than many people believed to be the case. And I am deliberately starting with the most important currencies because to emphasise the point that certain developments with respect to the Rand over the same period are not particularly peculiar with respect to the Rand. It
45 has been a general phenomenon globally and I will try to show that more specifically now and it should emerge quite clearly, hopefully, over the course of the next few slides.

Right. --- So on this chart you will see three currencies, \$/JPY represents the Dollar against the Yen, GBP/\$ is the Pound sterling against the Dollar and the yellow line on the chart here, EUR/\$ is the Euro/Dollar exchange rate. And I have created an index of all three
50 going back to the start of 1999 and representing the value of 100 to show how they traded together. And the most important points I show in this chart is that you can see the Dollar has strengthened against all three currencies. I will repeat that because I think it is important.

The Dollar has strengthened against the Yen, the Pound and the Euro and as you will see in a few minutes, the Dollar has also strengthened against lots of other currencies and in that
55 context I say and I will show you in a bit more detail, the Rand's weakness generally speaking in the past few years is not really that peculiar from an international perspective.

Two of the points I would like to make, or three of the quick points, not only is the Dollar strengthened of course but it strengthened despite what I think most people are aware of, the existence and deterioration of the US current account balance of payments. Most people,
60 most people would have expected the Dollar to actually weaken, not strengthen. Secondly,

as I make as point 5, you can see for a brief period, from mid 1999 until late 2000, the Japanese Yen actually did strengthen against the Dollar which in some ways is another peculiar global development because as is also very well known Japan's economy has spent many years showing effectively no growth and despite that we have this 12 month plus
5 period where the Yen strengthened. Again I use it as an example as to suggesting perhaps lots of things in the foreign exchange market have happened that have surprised people. And my overall point is that since EMU started there have been some quite peculiar developments, the biggest of which has been the weakness of the Euro itself.

Now proceeding to slide 2? --- Slide 2, I have now specifically chosen five different
10 so-called emerging market currencies, again looking at the Dollar, again in the concept of creating an index for all five back to the start of 1999. And the five I have chosen are really to represent all the four corners of the world in addition to the Rand. BRL represents the Brazilian Real; KRW represents the Korean Won; PLN represents the Polish Zloty and MXN represents the Mexican Peso. And of course the Rand is depicted by ZAR. And as I think
15 you can see pretty clearly in this context certainly until the end of 2001 the Rand's weakness which indeed there was some, was not really that difference than quite a few other currencies and in fact as is very clear here of these five currencies the weakest one until late 2001 was actually the Brazilian Real.

About when do you identify in 2001 the drop in the Rand? --- Well you can see from
20 this chart quite clearly and it will become more clear on the next charts, mid 2001 the Rand did start to accelerate its decline and so much so that by late in the year the Rand did for a brief period become weaker than the Real. But generally speaking, and again linking to what I said on the first chart, to the international observer for much of this period nothing particularly special about the Rand's weakness. If we may now turn to slide 3.

25 Mr Chairman and Commissioners, before we proceed with slide 3, the computer system yesterday were unable to extract it and make the relevant alterations. Can we amend paragraph 3 in slide 3 to include the words "relative to these four currencies".

CHAIRPERSON: Slide 3, paragraph 3?

MR NAIDU: Yes.

30 CHAIRPERSON: Just give me the words again?

MR NAIDU: "Relative to these four currencies".

CHAIRPERSON: Thank you.

MR NAIDU: Yes, go on? --- On slide 3 I am showing the same five currencies again but on
this occasion I chose to simply create an index just going back to the start of 2001 and here,
35 because it is a shorter date, you can see more clearly what I said a minute ago. That it actually was not until December 2001 that the Rand became weaker than the Real.

Thank you. --- And so I just mention with the amendment, the Rand only really started to weaken notably in the context of these emerging market currencies against the Dollar from December 1 onwards.

40 MS QUNTA: What is the significance of paragraph 3, and I am not sure if I am jumping the gun but why are you saying that relative to these four currencies the Rand was not the weakest? What is the point you are trying to make because surely while it is useful to do a comparative study of the Rand vis-a-vis the other currencies, say for instance the Brazilian currency, surely the conditions within the country must have an impact one way or the other
45 on the currency, even if it is a percentage, so that does not take us very far? Is it just you laying a groundwork? --- As I recall at the outset I apologised for potentially boring people along the way but hopefully it will become apparent as to why I am talking about so many other currencies and again at this stage I would like to emphasise what I said on the first chart. The Dollar has been strong against a lot of currencies, in fact most except the
50 Mexican Peso and so in many cases the Dollar has risen against currencies whose domestic fundamentals are very different from each other. And to spend too much time blaming one specific currency for its decline against the Dollar, generally speaking in my opinion is a mistake because it is a commonality in the past three years that lots of currencies have weakened against the Dollar, some of which have had weak growth, some of which had very
55 strong growth, some have had current account surpluses, some have had current account deficits etc. etc. And so I think I understand the point you are making, that you would rather I talk more about perhaps some of South Africa's fundamentals but I think it is important from my perspective to try to explain to you that generally speaking until late last year there was nothing that interesting from an international perspective about the Rand's weakness and in
60 fact until late last year the Rand was not particularly weak which will become clear in a

minute and in that regard, as I will make clear later, an observation I would make is that the topic of the value of the Rand and its supposed weakness is seemingly given too much relevance in South Africa in my opinion.

Well I suppose all South Africans are affected by the strength or the weakness of the
5 currency either way, so I suppose it is natural that South Africans would be concerned about it. --- I understand but I am trying to show you that in fact given many other important currencies also weakened against the Dollar, there is not a great deal for much of this period that South Africa could do about it because it had nothing to do with South Africa.

Okay, I will let you continue, I might come back to this question. --- Please do.

10 MR NAIDU: If you would deal with slide 4. --- Slide 4.

Here again, Mr Chairman and Commissioners, paragraph 3 should be amended to read "in addition to" at the commence of that sentence and after the comma, "South Africa may be regarded as a major commodity producer". And in paragraph 4, the date should read "late 2000".

15 CHAIRPERSON: Thank you. --- Slide 4, again I am to still provide this descriptive thing. I have shown you the Dollar against the major currencies. I have showed you the Rand in the context of five emerging market currencies. Another way of thinking of the Rand in a global context is relative to three so-called commodity majors which is what you can see on slide 4.

Here you have the Australian Dollar against the Dollar, AUD/\$; The Canadian Dollar,
20 \$/CAD; and the New Zealand Dollar, NZD/\$ and they have all been put in again in an index and on the same scale in order to make a direct comparison and of course once more you see the Rand. And as we have just heard in the amendment, and I repeat all three of those currencies are generally known as commodity currencies and in many ways the South African Rand can also be regarded as a similar sort of currency to those and I think you can
25 see here the sort of same theme again, that until late 2000 - there should be a correction there, it says in point 4, "Rand no weaker than New Zealand Dollar until late 2001", that should be 2000.

CHAIRPERSON: Yes, we made the correction.

MR NAIDU: Now turning to slide 5. --- Now slide 5 is the same three commodity majors, so
30 exactly the same currencies and again because this time of index .. (indistinct), here you can see that it was October of last year something seemed to happen in October which caused the Rand to actually under-perform those commodity majors, so-called commodity majors relative to the Dollar.

Can you proceed with slide 6. --- That is a completely, a simple descriptive picture.

35 I finally chose two other so-called commodity currencies both of which happen to be Scandinavian currencies. NOK is the Norwegian Krone and SEK is the Swedish Krona.

Why have you chosen these two currencies? --- I chose them because they are an alternative class and not directly comparable to the Australian Dollar, New Zealand Dollar and Canadian Dollar but Norway is a major oil producer. Swedish Krona is backed by a
40 currency which also have lots of pulp and paper products and influenced by commodity prices. But also both these countries throughout most of this period have had strong balance of payments current account surpluses and have experienced similar stronger growth in the western world and, as you can see here quite clearly almost exactly the same pattern as the Rand until late 2001.

45 Yes, proceed to slide 7? --- And again the same sort of thing as you saw with the previous currencies, the same three currencies, this time indexed at 01 and once more you can see that it was October, from October of last year onwards that the Rand seemed to notably start to perform weaker than this group of currencies.

Please proceed to slide 8? --- Now before I talk about slide 8 let me just summarise
50 where I have got to. Lots of currencies have weakened against the Dollar since 1999, in particular the Euro which has been a big surprise. If you look at the Rand against different groups of currencies, until October of last year the Rand was no different than any other currency. So quite, you know as I said, in my perspective quite even then why there was so much focus on the Rand per se from a global perspective would seem to me somewhat
55 peculiar. Now let me start on slide 8 quite slowly because I am going to introduce the first of a number of dreaded economic conceptual topics. I apologise to everybody for the shortcomings of economics in advance. It is merely a social science and not a science but what we have here .. (intervenes)

MS QUNTA: That is a remarkable admission, not remarkable, a strange admission. --- Well
60 maybe lots of economists around the world for much of the past few decades should

recognise that. What you have here is two currencies, the Rand and the Euro. And what I am showing is them against the Dollar relative to so-called fair value according to the methodology that we employ at Goldman Sacks to estimate so-called fair value. We define fair value as the inflation adjusted exchange rates which many might know as so-called purchaser power policy, PPP, and we then adjust that for relative productivity. Let me just repeat that, it is the inflation adjusted exchange rate, adjusted again for relative productivity. So countries with stronger productivity conceptually can and should see their real currency appreciate relative to others and countries with weak productivity should see their currencies depreciate. And I am now going to complete the descriptive picture by showing you the Rand against once more a different set of currencies to show you from a global perspective the context of the Rand. And I am starting with this first one in slide 8 to essentially show you that until late last year, according to our fair value models, the Euro was more undervalued than the Rand, as you can see hopefully quite clearly here. And so from my perspective a much bigger mystery, a more intriguing and frankly harder to explain and understand as to why the Euro so weak persistently compared to fair value than the Rand. I would also add because of the fact that Europe is a major trading partner for South Africa, it may well be that the Euro's persistent weakness relative to fair value has held to contribute to the Rand's weakness itself and in that context if the Euro were ever to appreciate back towards some normal notion of fair value, that in itself may be a lot more important to the performance of the Rand against the Dollar than anything to do with anything in South Africa. It may be, probably be the case.

CHAIRPERSON: If the Euro recovers the Rand should recover? --- Probably.

MR NAIDU: Dealing with slide 9? --- Slide 9 shows you the, again in the context of our fair value the Rand against the four other emerging market currencies which I discussed earlier. To refresh your memory MXN is the Mexican Peso, PLN is the Polish Zloty, KRW the Korean Won and BRL the Brazilian Real. And as I have already shown you in a different version but here in terms of fair value, very very little difference between the Rand and the Brazilian Real until late last year and, in fact, the Real was more undervalued. So from that perspective, from a global perspective, the Real let's call it would be more interesting. The other points I want to show you is that some currencies, for example the Mexican Peso, appear to be nearly as overvalued as the Rand is undervalued. I may repeat that because hopefully that would become more interesting and more relevant in the specific surrounding the Rand in the next 10 to 15 minutes. The Mexican Peso has been one of the strongest currencies in the past three years managing to strengthen against this remarkably strong Dollar and according to our methodology it is now quite overvalued. And you will see in the written notes later that I explain importantly why the Mexican Peso has managed to strengthen and stay overvalued whilst some other emerging market currencies, including the Rand, have remained very undervalued. Now before I turn to the balance of payments let me finish with slide 10 which is bringing in some of these other currencies I talked about earlier. Here you can see fair value for the Rand once more but in this context it is relative to the Swedish Krona or in addition to the Swedish Krona, the New Zealand Dollar and the Australian Dollar. And it is the same point again, the mystery really is Dollar strength. For a large part of this period the Rand actually was less undervalued than the New Zealand Dollar, the Australian Dollar or the Swedish Krona. You speak to many people in Australia or many people in the international analytical market place, and they are baffled as to why the Australian Dollar has been so weak, especially as it seems to weak compared to fair value. And again, as you can see quite clearly here, according to our fair value methodology it was only really late last year that the Rand's weakness became such that it was actually notably cheap compared to these currencies.

Now proceeding to slide 11, you are now going to deal with the balance of payments. --- So I completed the first part of what I wanted to say, giving you a descriptive picture of how the foreign exchange market globally has traded the past three years on the context of how the Rand has traded against them and hopefully showed you that it was only really the fourth quarter, October onwards, that the Rand did become notably weak. I am now going to turn for the next section to a detailed look at the balance of payments. Again for a number of other countries first and then specifically South Africa and hopefully it will become apparent as to perhaps why the Rand did fall sharply towards the end of last year.

Dealing with slide 11? --- And in order to do that let me just refresh your memory because I have read some of the previous testimony, I know the balance of payment has been discussed quite a while but let me make it clear that the balance of payments is in

essence a country's accounting identity. The balance of payments has to equal zero. I am not accountant but I gather from those that I can understand the surplus in one side has to be exactly the same as the deficit in the other. And in economics terminology the current account balance of payments is always mathematically the same as the capital account. So if you have a surplus in the current account, you are going to have a deficit in the capital accounts. If you have a surplus in the capital accounts you have got to have a deficit in the current accounts. And as you can see here, the capital accounts includes those different categories. Net foreign direct investments (FDO), something that I will come back to talk about quite a bit, net portfolio flows, both bonds and equities, short-term money flows, often referred to as hot money in the international media and then central bank foreign exchange reserve changes. All those four items together are the main items of the capital accounts and put together by definition they must be equal to with the opposite side of the current accounts. Now I turn to slide 12 where I am going to introduce an additional conceptual idea which relates to the balance of payments and I will perhaps do this quite slowly because it is very important to explain in the concept as to why some currencies have weakened more than others compared to fair value and why some have strengthened. We have a concept that we refer to as the broad basic balance of payments. You might want to note here after the first point on slide 12 where I say we define the broad basic balance, you might want to put in brackets BBoP. We abbreviate the broad basic balance to the BBoP and we define the broad basic balance as the current account plus net FDI plus net Portfolio flows. Let me repeat that, the Bbop is the current accounts, net FDI and net Portfolio flows. I.e. the broad basic balance, the Bbop is the current account plus long term capital flows and we do it because we think that the broad basic balance, the Bbop, is probably the best guy to commercial flows in foreign exchange. So countries with a Bbop deficit, as I have now tried to show you, are generally likely to have weak currencies and currencies with a Bbop surplus are generally likely to have strong currencies. And here I will talk very specifically about the Rand in South Africa but first again I would like to talk about some other very important cases starting on slide 13 with the US Dollar. What you can see here on this chart is the current accounts balance as a percentage of GDP and as you can see and is well known and a major topic of global finance, is the US current account balance of payments has deteriorated such that its deficit is now above 4% of GDP and probably heading towards 5%. And as I said right at the start, it has surprised many people since 1999 that despite that the Dollar has strengthened. And as I say in point 3 here, this is actually the highest current account deficit the United States has ever shown since floating exchange rates started.

CHAIRPERSON: When would that have been more or less? --- Since the start of the 1970's. Higher than the deficit in the mid 1980's which prompted a meeting of the G7 and led to a deliberate policy co-ordination to get the value of the Dollar down. The current account deficit has risen, in those days the current account deficit was just under 3% of GDP and it led to a significant decline of the Dollar. Here you can see the current account deficit has got much bigger and as I have already showed you, despite that the Dollar has strengthened against many many currencies and I think the answer as to why, hopefully you can see here, is the broad balance of payments, the BBoP has actually remained in surplus and the reason why that is the case is because the United States as a transit(?) large amounts of foreign capital both in terms of portfolio flows and foreign direct investments, something I would suggest is relevant to South Africa. Both those forms of capital flows have been very powerful and more than offset the US current account deficits and that is almost definitely why the Dollar was strengthened so much against many currencies around the world, which is what you can see on slide 14. The right-hand scale shows you the broad balance of payments once more as a percentage of GDP and against it on the left-hand scale we show the trade weighted value of the Dollar as calculated by Goldman Sacks and because of the BBoP balance, the trade weighed value of the Dollar has risen. Perhaps now I can go on to talk about some more examples. Let me now turn on slide 15 to the Euro.

MR NAIDU: Before you go on, doctor, can you just perhaps explain the right-hand scale and the left-hand scale in the context .. (intervenes) --- From slide 14?

Yes. --- On slide 14 the right-hand scale shows the broad balance of payments, the BBoP as a percentage of GDP on a fourth quarter moving average. And the left-hand scale shows in index form the trade weighed value of the Dollar according to Goldman Sacks, its own calculation, since 1998. The trade weighted Dollar means the Dollar against the basket of all the major trading partners for the United States.

Right? --- Moving to slide 15, and I hopefully again emphasise if you do not recall

what I said earlier, the performance of the Euro itself indirectly is very important for the Rand because of the closeness in terms of trade and here you can see in my opinion just why the Euro has been weak. Small current account surplus actually for the early part of the Euro's existence and that was why many people expected the Euro to perform well. But actually in

5 the modern world of international finance, when you look at a broad balance of payments, throughout that period and in particular through 1999 and 2000, the Euro ran a large broad balance of payments deficit. At times close to 4% of GDP, again on a 12 month moving average basis. As foreign capital failed to be attracted to the Euro zone, and in fact not only

10 did it fail to be attracted in the form of both FDI and portfolio flows, a lot of foreign capital left the Euro zone to all the parts of the world including the United States. Slide 16 shows you on the right-hand axis the broad balance of payments for the Euro zone again as a percentage of GDP and against it on the left-hand scale you can see the trade weighted value of the Euro which I have already described fell showing the same picture I have just described. To

15 complete the big picture before I talk about two specific emerging market countries which I think are relevant for you to think about in South Africa, let me just complete the big picture by talking about Japan, the Yen and Japan's balance of payments. Slide 17 shows you the current accounts and the BBoP for Japan. As you can see here and in contrast to the US and the Euro zone Japan has had a large current account surplus for much of that period and if you recall the charts I showed you right at the start, I said that the Yen did strengthen

20 against the Dollar for a brief period in 1999 through to 2000. It is because the size of the current account surplus helped Japan to have a large broad balance of payment surplus. Despite all of Japan's problems they have had a BBoP surplus for much of the last four years. Now as you can see here in the past 12 months or so, the current account surplus has declined slightly but the broad balance of payments balance has shifted from surplus into

25 deficit. And if I go from that straight into slide 18 you can see a reasonably similar pattern with the trade weighted value of the Yen to the .. (indistinct) exhibited by the broad balance of payments. When the broad balance of payments which is shown on the right-hand axis was very strong, the trade weighed value of the Yen rose. When the broad in Japan started to weaken, so did the value of the Yen. So there seems to be reasonable evidence looking at

30 the three major currencies that the way they trade relative to each other and relative to fair value seemingly depends on this BBoP. Now let me talk about two what I think are very interesting emerging market countries. On slide 19 I show you the BBoP for Mexico as well as its current account balance. Remember I said some time ago that the Mexican Peso was one of the few currencies that has actually managed to strengthen against the US Dollar in

35 recent years. Hopefully this chart makes it pretty clear as to why that probably happened. What you can see here is that even though Mexico had a current account deficit for most of this period close to 3% of GDP, because of very large FDI inflows into Mexico primarily as well as occasional portfolio flows, in particular because of very large FDI inflows, Mexico has had a BBoP surplus and it is almost definitely the case that is why the Mexican Peso has

40 been so strong because Mexico has succeeded in attracting lots of foreign direct investments. To complete the picture I do not think I need to perhaps dwell on slide 20 but this shows you on the right-hand axis the BBoP for Mexico again against the trade weighted value of the Peso. Let me show you one last example before I talk specifically about the balance of payments in South Africa because again I think it has conceptual relevance to

45 events in this country and policy for a future policy. Now in order to do that I am going risk slightly confusing people, so perhaps I will explain it carefully. Here you can see something that we call the NBoP which is, the N stands for narrow and we call this a narrow balance of payments because China does not have liberalised financial markets. It is not possible generally for residents of China to buy foreign bonds or foreign equities and it is not possible

50 for foreign residents to buy and sell Chinese equities or bonds. So here we are looking at a narrow balance of payments because as it says in point 2, they do not have a completely open capital account. To refresh your memory, the BBoP is current accounts, FDI and portfolio flows, the NBoP is simply the current accounts and FDI. But as you can see here, China has got and has had for a while very strong BBoP surpluses and again the reason why

55 that is the case is because China has attracted massive foreign direct investments. On current indications this year China may attract foreign direct investments in excess of 5% of GDP and on some indications from the United Nations, in the next few years that could rise as much as 10% of GDP. Not surprisingly, therefore, the Vemnimb(?) which is the currency of China, has shown a tendency to appreciate in recent years on a trade weighted basis.

60 CHAIRPERSON: Just give us the name of that currency? --- Vemnimb.

Just spell it for me please? --- What a difficult challenge that is. It might be easier for you to call it the Chinese Yuan or Oemnimbi, I think it is.

If we call it the Chinese Yuan it would be .. (intervenes) --- The Chinese Yuan would .. (intervenes)

5 Would strike a cord in some way. --- Yes.

Okay. --- But I am sure if I made that spelling incorrectly it will get me in trouble on my next visit to Beijing, so please treat me delicately.

So what does chart 22 show, we have interrupted you? --- Chart 22 shows you that in the early part of this period the Oemnimbi actually fell sharply but that is when they had a BBoP deficit. In the recent past, if you look since 1995, there has been a slow steady appreciation of the Oemnimbi as the NBoP as risen. As you can see in my notes, I have mentioned as my final point here that the Oemnimbi actually would have strengthened probably a lot more if it would not have been for large accumulation of foreign exchange reserves by the Chinese authorities. To offset some of the commercial pressures resulting from the NBoP the Chinese authorities have bought large amounts of foreign currency to offset the .. (drops voice). Now I am going to home in a look in the balance of payment situation of South Africa but before I do that, again let me just summarise the clarity of what I have said. Countries with BBoP surpluses tend to be countries whose currencies appreciate, countries with BBoP deficits tend to be countries with currencies that depreciate. Now talking about South Africa, because of the peculiarity of the net open foreign currency position, it is very hard to talk about the balance of payments in exactly a similar manner to other countries. So what you see on slide 23 is simply what I have called an adjusted broad basic balance. And let me just walk through with what you could read here, it should be self-explanatory but let me make sure you understand what I am showing you. The adjusted broad basic balance that we calculated for South Africa shows the current accounts plus FDI plus portfolio flows which is the BBoP which I described for other countries. And in South Africa's case we have added the change in the net open foreign currency position.

CHAIRPERSON: Just let us pause there, when the NBoP is reduced to nil then your comparison would stand? --- Correct.

30 Then we are back to BBoP? --- Correct.

So it is just that one element that changes your analysis? --- Yes.

Right. --- Because in effect the reduction of the forward bulk has been effectively the same as a large commercial ongoing outflow. It would to the foreign exchange market .. (indistinct) but also I would guess that many people participating in the market, reduction of the forward bulk is effectively the same as a company in South Africa undertaking a foreign direct investment overseas. So in terms of thinking about the BBoP in South Africa, I think you have had to have included what has been happening with the forward bulk. But you are right to point out that the forward bulk goes to zero, effectively it becomes the same as elsewhere.

40 Right. --- Hopefully now you can see why the Rand has been weak. Chart 24 or slide 24 shows you the current account balance of payments on the left-hand side and the adjusted BBoP below it. By and large South Africa's current account balance the past few years has been very respectable, give or take minus half a percent of GDP or plus half percent of GDP. Nothing to be concerned about, pretty balanced. However, when you calculate a BBoP an incorporate the forward bulk, as you can see here the adjusted broad balance has been significantly in deficit for most of this period and I am going to show you some numbers specifically by quarter in a minute so that we can look in detail at specific quarters. Before I do that, slide 25 shows you the performance of the Rand on a trade weighted basis which is the left-hand side against the adjusted BBoP and to the casual observer or I guess particularly the keen analytical mind, it might become a conclusion from observing this slide that it may be a surprise that the Rand did not fall more sooner because over that period South Africa has run a large adjusted BBoP on a moving average basis and yet it was later on that the Rand fell. And I suggest that as being relevant because it could well have been the case, particularly in the context of South Africa introducing inflation targeting which I am going to talk about. The other investors including speculative investors might actually have been offsetting these commercial outflows for a period of time by being optimistic about the outlook for South Africa particularly South African bonds for example with the introduction of inflation targeting and it may have been the case that late last year something happened to result in those people having less confidence combined with the underlying commercial deficit prompted the significant drop of the Rand.

Just while we are on that slide, between 1998 and 1999 you see that tremendous spike. is that at least partly due to the increase in the NOFP in 1998 that you went up to about .. (intervenes) --- Yes.

Thank you, the next one? --- Slide 26 which you will probably, unless your eyesight is better than mine, you will probably find difficult reading from where you are sitting but you have the table in front of you. What we have done here is show all the components of the balance of payments or most of the components by quarter looking at the year 2000 and the year 2001. You see the current accounts, net FDI inflows, net portfolio flows and the BBoP, both in Rand and then again in Dollars and then you will see on the first yellow line, or in the middle, you will see the BBoP again as a percentage of GDP by quarter and then the bottom half of the table adds on the quarterly change in the forward bulk. So we end up with this adjusted BBoP. And what you can see there I think is quite interesting, is that last year the weakest period for the adjusted BBoP were indeed Q3 and Q4. Now again I warn you of the dangers of economics. Economics is a social science, not a science but with that caveat one could say that the Rand's weakness late last year is absolutely no surprise whatsoever in the context of this sort of analysis.

Can I just check the statement that you make in paragraph 3 where you say only sizeable BBoP imbalances in quarter two 2000, quarter two 2001 and quarter 4 2001 but if you look at your figures, the quarter four BBoP was minus 11 284. That seems to me to be .. (intervenes) --- Let me come to my notes.

Just look at your note 3 and then see whether that is not inaccurate. --- I said only sizeable BBoP imbalances in Q2 2000, where it is minus 5.5%; Q2 2001, that is a mistake and Q4, it should be Q3 2002. Those three quarters. That is a typo.

So in 2001 it is the last two quarters? --- Yes.

That you say were only sizeable? --- Sizeable. If you look at last year, we say the adjusted BBoP, you see there in Q1 it was .7; in Q2 it was close to balance but in Q3 it was minus 3.4 and Q4 it was minus 4.3.

Okay, I think my problem is a grammatical problem. What you are saying is that there were sizeable imbalances in quarter 3 .. (indistinct) --- Yes.

The word only I think confused me. --- I am sorry.

MS QUNTA: And are you suggesting that those imbalances account for the dramatic fall in the Rand in the last quarter of the year 2001, is that your view? --- I am suggesting that it is no surprise to me that when I now look at these, remember some of these dates have only become available recently, since the Commission first started but when I calculate the broad balance of payments which is something we have done for many countries around the world, it is the only way of explaining this peculiar world of foreign exchange since 1999 adequately.

When I look at this and adjust it for the forward bulk and see that in Q3 and Q4 last year you had deficits of 3,4 and 4,3, it is not, I am not saying this accounts for it but what I am saying is it is absolutely no surprise that the Rand fell sharply and I am also observing the fact that if you put it together with the accumulating underlying BBoP deficits earlier on it is actually a little bit surprising that the Rand had not weakened further. If you go back to the charts I showed you earlier, a large part of 2000 and 2001 the Rand was actually trading very similarly to the Australian Dollar, the Swedish Krona against this very strong US Dollar despite the fact there were these small BBoP deficits emerging and then we get into later last year, assuming the data is accurate, it looks like there was large commercial outflows.

If we were to accept your views, we could close down this Commission after today and it would be very useful for us to do that but perhaps I do not understand economics sufficiently. If you say that .. (intervenes) --- It is a dangerous thing to want to do.

I have a little bit of economics but it may be dangerous but let me find out from you, if you say that you are not surprised that the Rand depreciated in the last quarter, we have had evidence here before the Commission that in fact the normal economic practice that people use to explain the depreciation of currencies cannot quite explain what happened in the last quarter and for a lay person if a currency, because I recall that in the space of 20 days it fell by 40% which is quite dramatic. --- Mm.

If you now say that you are not surprised, do you then links the imbalances, the deficits, directly to the depreciation of the Rand? --- Yes.

And are you suggesting that there could be no other explanation for that dramatic fall in the last few months because you must also remember the terms of reference of the Commission covers the whole year. --- The whole?

It covers 2001. --- Yes.

And it also focuses us, and I mean your evidence is extremely valuable but we are looking at transactions specifically that could have impacted on the depreciation of the Rand but my question specifically to you is, are you discounting that there may have been other factors besides the deficits that impacted, particularly in the last three months, I am not even talking about the rest of the year? --- I am going to talk about that in a few minutes partly in the concept of inflation targeting. But let me also say some other points to answer you now. What I am trying to suggest to you is that on an underlying basis South Africa has had a BBoP deficit as you saw for the past few years when you incorporate the reduction in the forward bulk which is effectively the same thing as a commercial foreign exchange outflow. It is a fact. The second point is that it a bit surprising observing that that the Rand actually managed to hold as well as many other currencies against the Dollar until late last year and my suspicion is, which is point number 3, that actually for some investors, including foreign investors, might have been quite positive about the Rand, speculatively, a speculator might have been quite positive about the Rand and it would not be surprise if that had been the case because in my opinion the introduction of inflation targeting for South Africa was an extremely positive thing to have done in 2000 and put South Africa on the radar of many investors around the world, including those that you would normally describe as opportunistic. And point number 4, I am saying when I look at this and see the size of the deficits in Q4, if there was something that happened to upset the confidence of some people given the underlying balances that got worse, it is not at all surprising that the Rand fell sharply.

So that it would be .. (intervenes) --- I could not say that can account mathematically for the exact move but it is no surprise to me that that led to a sharp change in the performance of the Rand when I look at these numbers.

So you have also mentioned that it would be the confidence of people, the players in our economy or foreign investors. Are you then suggesting that the levels of investment in the country by the foreign investors, going to their perceptions about the country and what we are doing, that that would have impacted on the exchange rate of the Rand? --- Yes, one of the reasons why I showed you the broad balance of payments for Mexico and China is that their underlying balance of payments position has been fundamentally sounder and one of the reasons, particularly in the case of Mexico because of its large current account deficit, the main reason is because they had attracted large foreign direct investments which is not subject to the vagaries of sentiment. With what has happened here, remember I said the balance of payments is an accounting identity, has to equal zero. If there is a BBoP deficit of 3,4% in Q3, by definition that means there has to be a speculative surplus of 3,4% of GDP in order that it equals zero. If those people are suddenly concerned about something and stop holding the investments or positions or whatever it is they had, it is absolutely no surprise to see the currency coming under a lot of pressure very quickly.

And the other economists called as experts also mentioned issues like the crisis in Zimbabwe and those sort of things to explain the fall of the Rand. What is your comment on that? --- I will show you a client survey. My opinion, there are various specific events, the underlying reason for the Rand's weakness is the BBoP position. You know, in some ways some people might take from this, therefore, that the forward bulk itself or its reduction directly contributed but it certainly made it more complicated and what I would say is of course related to the questions Judge Myburgh asked me earlier, once the forward bulk is gone, that will help for the underlying balance of payments to be somewhat stronger.

CHAIRPERSON: Okay, let us move on. --- Now I want to come back to some of the things that we have just discussed there. So now I want to spend a bit of time about the context of the Rand's weakness, on the context of the Rand, in the context of overall economic policy in South Africa. I am going to start by showing you on chart 27 how CPIX inflation, which is the targeted instruments which the Reserve Bank introduced last year or in 2000, has performed compared to its target as you can see here. And again I want to say in my opinion this was an extremely important and positive thing for South Africa to introduce and what happened in the operation of policy in respect to this target, I think, is a lot more important than the topic of the Rand. And it seems to me that in the event that led up to the weakness in Q4, already there was so much discussion about the Rand's weakness which to me seems, I would describe it as unhealthy plentiful because this is what policy should be focused on and I think more support and encouragement should be given and more knowledge of the inflation targeting process for all residents of the country. And in so far as the Rand's value is relevant for the success or not of inflation targeting, fine, but the Rand per se and what happens to it

in the context of inflation targeting is not really relevant. The first country to successfully introduce defined inflation targeting in the modern era is New Zealand. It introduced inflation targeting towards the start of the last decade. And you will see, if you go through the history books, New Zealand has had a lot of volatility with its currency also but you will read that New Zealand policy makers have made it very clear that because they have chosen inflation targeting, what happens to the New Zealand Dollar is only of relevance in so far as their inflation objective and they know that they cannot use the only instrument they have available to meet two different objectives and if you have an inflation targeting process your instruments have to be geared towards achieving that target.

10 CHAIRPERSON: As a matter of interest, what has happened to the New Zealand Dollar, is that their currency, the New Zealand Dollar?
 --- The New Zealand Dollar is their currency.

So what happened in the period that they have been so focused on inflation targeting in the last decade? --- Initially in the first period the New Zealand Dollar appreciated significantly against the Dollar and this was also because the Dollar itself in the mid 90's of course was extremely weak, so it was not difficult for many currencies to strengthen against the Dollar. But the New Zealand Dollar did also strengthen on a trade weighted basis and I think this is important because in the context of that inflation targeting New Zealand also introduced other economic reforms including a complete dismantling of exchange controls and policies to attract foreign investments. And it allowed effectively - New Zealand, in those days, had broad balance of payment surpluses and the New Zealand Dollar did very well. Now in the past five, six years the New Zealand Dollar, as I think I showed earlier, has shared in the strength of the Dollar against many currencies by weakening.

25 But that is against the Dollar? --- Yes.

How has it done against the trade weighted index? --- On a trade weight it had a very bad experience in 1998/99 because of the Asian crisis. New Zealand has similar characteristics in some ways, it is a different source of commodities but it is a small open economy and the Asian crisis caused lots of trouble for New Zealand in terms of the price of many of their commodities fell sharply. In terms of diverse terms of trade the New Zealand Dollar fell sharply. It subsequently recovered on a trade weighted basis. New Zealand and many other countries effectively copied what New Zealand had done, including the UK. You will read in the UK press frequent complaints about the strength of the pound. The Bank of England has set an inflation target by the policy makers and they say quite honestly, I would say in an economic context, they cannot do anything about it because their target that have been mandated to them by law is to achieve the inflation target. Now the other point I want to establish here which you will see more clearly in a minute, South Africa chose to include oil prices in its target inflation levels, CPIX includes oil prices. Now before I go to the next one, you can see here as I have written, that as a result of the banks around the world in the past couple of years it seems to us, and my team, which is actually, one of which is sitting in the room here today, it seems to us that inflation will remain a book target over the next 12 to 18 months based on some of the policies that have been introduced recently and some of our views of subsequent world events, it should come back into target later next year, as you can see according to the profile we have here. But let me show you something from this chart, slide 28 shows you what we have called the CPIX Inflation Matrix. And what you can see here, if I explain it slowly, is along the top axis 12 different alternative levels of the Dollar against the Rand and on the top axis 12 different potential levels of the Rand ranging from 9 to 11.20. On the left-hand axis or going downwards, you can see 12 different prices of crude oil using West, WTI stands for West Texas Intermediary which is a bench mark for crude oil prices or one of the bench marks for crude oil prices globally. So 12 different levels of the Rand, 12 different levels of WTI. And so you have got 144 different combinations of CPIX depending on the level of the Rand and depending on the level of crude oil prices. And the more you go to left and the more you go upwards, you end up with a combination of the Rand and oil prices that results inflation moving significantly below the Reserve Bank's targets. And the more you go to the right and the more you go to the bottom, you end up with a combination of oil prices and the Rand that result in inflation going significantly above target. And the whole reason why I am trying to show you this, is you can see on the very different oil price scenarios you could get very different outcomes for CPIX. And as I say in my notes, crude oil prices is something that hardly anybody has got control over, including policy makers certainly in South Africa. And so, as I say in my notes, in so far as you have

no control over oil prices, they do affect the CPIX. It adds to this notion of what I have said earlier that why should people be so bothered analytically about what happens to the Rand in the context of inflation targeting.

CHAIRMAN: Let us take the tea adjournment for 15 minutes.