CLOSING REMARKS BY TREVOR A MANUEL, MP

MINISTER OF FINANCE

TO THE COMMISSION OF INQUIRY INTO THE RAPID DEPRECIATION OF THE EXCHANGE RATE OF THE RAND AND RELATED MATTERS

24 May 2002

Mr Chairman:

1. I am grateful for the opportunity to make some closing remarks upon the completion of the hearings of this Commission.

2. The National Treasury has carefully reviewed the evidence presented to the Commission by a wide cross-section of experts, both local and international.

3. These experts have presented a broad spectrum of views on the causes of the Rand's rapid depreciation towards the end of last year.

4. It seems true to say that there was a complex set of factors at play. The Commission has heard evidence of both external and internal factors which impacted on South Africa's balance of payments and confidence levels.

5. Certainly, global financial conditions following the events of September 11 last year were not conducive to capital flows to emerging markets, including South Africa. This has the effect of creating an underlying weakness in a currency.

6. In terms of internal factors, many of the statements made before the Commission have tended to focus on Government policy, including exchange controls, the net open forward position (NOFP) and a lack of intervention in the foreign exchange market.

7. All the arguments presented have been carefully considered. In the light of the Commission proceedings, it may be useful to summarise our position at this time.

8. Some commentators have called for a “big bang” approach to exchange control relaxation. At the same time, however, most of these same commentators have recognised the complexities and pitfalls inherent in capital account liberalisation.

9. Mindful of these complexities, Government’s stated commitment has always been clear and unequivocal – we are committed to a gradual process of exchange control liberalisation that takes into account critical sequencing considerations. A sustainable development path requires that certain conditions be in place before proceeding to full

capital account convertibility.

10. We have touched on these before in our testimony to the Commission, but they include ensuring that appropriate macroeconomic fundamentals are in place, that a sound and well-regulated financial system exists to promote financial stability, including prudential regulation, and that social safety nets are in place to protect the poor against the potential social costs of globalisation.

11. It is perhaps appropriate to pause at this point and take stock. Governments have to make policy choices in a complex and often unforgiving world. At the centre of the range of policy choices that our Government faces lies the principle that South Africa is an open economy. In that environment, it is inevitable that from time to time there will be turbulence. The events of late last year were clearly one of those times.

12. It is tempting at such times to look for quick fixes or hasty policy responses. But this, invariably, leads to unintended consequences and policy uncertainty. Rather, as our own experience and that of other countries internationally has borne out, the best response in such circumstances is to be confident that the policy choices we have made - and the good performance of the economy that we

have achieved – over the past five or six years will support the ongoing growth and sustainable development that the South African economy needs.

13. As we sit here in the Commission five months, practically to the day, after the peak of the Rand's volatility, this faith in the soundness of our macroeconomic fundamentals would appear to have been justified. The Rand has appreciated by 38% against the dollar in the last five months from its record low of R13.85/$, and by approximately 19% since the beginning of the year. The recent strengthening of the Rand suggests a recognition amongst investors of the soundness of the South African economy and that the depreciation of the Rand last year was clearly overdone.

14. It is also heartening to note, from the testimony provided to the Commission, a general recognition by international experts that Government's macroeconomic policy has been well-directed and put on a sound, sustainable footing.

15. Far-reaching fiscal reforms have been undertaken. Monetary policy has been consistent in tackling the distortionary impact of high inflation. Trade reform and financial market development have increased the flow of foreign currency into South Africa. Government spending has been reprioritised to increase spending

on social services, which promotes redistribution and provides a safety net against the potential social costs of globalisation. On-going financial market reform has kept South African financial market standards consistent with international best practice and has prevented exchange rate volatility translating into financial instability.

16. The process of economic reform is ongoing. Macroeconomic stability has been achieved. The focus has now shifted to microeconomic reforms aimed at promoting the competitiveness and job-creating potential of South African industries, as well as the strengthening of the balance of payments through the promotion of exports and attracting longer-term capital flows such as equity investment and FDI. This, in turn, will provide the foreign currency flows necessary to support further capital account liberalisation.

17. To reiterate, timing and sequencing are critical. It has been broadly recognised internationally that a gradual approach to liberalisation is advisable and should occur late in the process of economic reform. The IMF has stated that it considers the present pace of exchange control liberalisation in South Africa to be appropriate[1]. Prudent liberalisation must consider factors such as the sequencing of economic reform and the strengthening of the balance of payments. As such, it is not possible to set a timetable for the gradual

1 IMF Article IV Consultation report, March, 2001. Page 17.

relaxation of exchange controls, but rather such policy will be monitored and reviewed continuously.

18. There is another benefit to a gradual approach to liberalisation that perhaps does not receive sufficient attention. Gradualism may produce internal and external criticism about the slow pace of reform, but it has also avoided policy reversals in the face of currency crises. The Commission is probably aware of another country's experience, whereby exchange controls had to be reintroduced in the face of economic crisis. A gradual approach to exchange control liberalisation has enabled the South African Government to deliver a policy message which is consistent and certain.

19. The testimony before the Commission may have indicated that, from time to time, irregularities may have occurred in the application of exchange controls. This evidence will have to be carefully considered by the Commission in terms of recommending ways to improve the application and enforcement of these controls. However, the testimony does not seem to point to any systematic gaps in exchange control regulation.

20. The effectiveness of exchange controls in protecting South Africa's foreign reserves has been borne out by the fact that,

notwithstanding the gradual relaxation of exchange controls, there has been substantial growth in the country's reserves from approximately two weeks of import cover in 1994 to the prevailing levels of approximately 24 weeks of import cover.

21. Turning to the NOFP, the policy of extinguishing the net open forward position has been positively viewed by investors, rating agencies and the IMF. The exposure inherent in the NOFP was perceived by the market to be a risk. As such, it is our belief that the reduction in the NOFP has lowered the Rand's vulnerability to speculative attack and, in turn, has reduced South Africa's sovereign risk premium. The NOFP stood at $2,9 billion at the end of March 2002 and has ceased to be of major concern to the international investment community.

22. Lastly, issues of our policy on exchange rate management should be viewed in light of the transition to an inflation targeting regime. Policies of intervention have, in the past, shown limited success. To reiterate our position, Government has chosen to follow a flexible exchange rate to act as a shock absorber against global developments. Exchange rate adjustments help cushion the economy from external trade and capital flow shocks, and mitigate the impact of economic contraction, especially in respect of the poor. Government policy is to target inflation rather than the level of

the exchange rate. The shift to an inflation-targeting framework has enabled us to avoid the skyrocketing interest rate increases that accompanied the exchange rate volatility of 1998.

23. In closing, I would like to congratulate the Commission on the professional and thorough manner in which this enquiry has been conducted. It is clear that the Commission has had to deal with issues close to the hearts of all South Africans who are concerned about building an economy that is as strong and resilient as it can be, but also one that is equitable, in which the wrongdoings of the few should not be at the expense of the many. The Commission has pursued these concerns with vigour. I can assure you that the National Treasury has listened carefully to all the evidence presented before the Commission. We look forward to receiving the Commission's final report, and considering its insights in the pursuit of our commitment to managing economic reform in a manner that is, above all, consistent, considered and directed at sustained growth, employment and development.

Thank you.