NATIONAL ASSEMBLY

QUESTION FOR WRITTEN REPLY

QUESTION NUMBER 226 [CW288E]

DATE OF PUBLICATION: 10 JUNE 2011

**Mr D B Feldman (COPE-Gauteng) to ask the Minister of Finance:**

Whether, with reference to certain remarks regarding the strength of the South African Rand, the Government is considering interventions to weaken the currency; if not, what is the position in this regard; if so, what are the relevant details?

CW288E

Over the past year, policies have been adjusted in various ways to support a more competitive exchange rate:

1. During the 2010 calendar year, the National Treasury assisted the Reserve Bank to purchase foreign exchange amounting to US$7.4 billion (R54.2 billion) from authorised dealers, while approximately US$3.8 billion (R26.6 billion) was purchased during the first three months of 2011. Purchases were funded from government's cash reserves, increased government borrowing and debenture issuance by the Reserve Bank. The level of gross foreign exchange reserves stood at US$50.1 billion in May 2011.
2. In August 2010, the Reserve Bank also started using foreign exchange swaps to sterilise large one-off inflows related to FDI transactions to minimise the impact of such flows on the rand.
3. Measures to relax exchange control regulations on residents were announced in the 2010 Medium-term Budget Policy Statement. Foreign asset limits for pension funds and institutional investors were also increased by 5 percentage points in December 2010. Over time, an increase in foreign assets will reduce South Africa's external vulnerability, increasing two-way demand for the rand.

4. Fiscal and monetary policies have been adjusted to support the economic recovery. Real interest rates remain low and supportive of growth, while the fiscal deficit will be reduced gradually over the next three years in line with the recovery in the economy.

Since the start of 2011, the rand has weakened by 6.4 per cent against a trade-weighted basket of currencies and by 2.6 per cent versus the dollar. This suggests that policy measures implemented thus far have helped to prevent further nominal appreciation, despite the fact that aggregate capital flows (FDI, portfolio and other investment) have remained positive. In the first quarter of 2011, capital inflows were primarily driven by the repatriation of foreign assets by the banking sector worth R38.2 billion. Portfolio flows, which had previously been the main driver of capital flows,[1] recorded a net decline of R1.3 billion, while net FDI outflows amounted to R6.2 billion.

The decline in net portfolio flows started in the fourth quarter of 2010 and was driven by sales of domestic bonds by foreigners and increases in foreign asset allocations by domestic pension funds and asset managers after the relaxation of exchange controls.[2] We do not have a full picture of the composition of capital flows in the second quarter as the Reserve Bank publishes this data with a lag, but we do know that foreign investor appetite for domestic bonds picked up again in April and remained strong in May and June.[3] Such flows are likely to remain highly volatile and subject to swings in global investor sentiment, particularly given the on-going uncertainty regarding the fiscal situation in Greece and the outlook for the US economy.

**Drivers of capital flows**

The volatility of global capital flows and exchange rates has increased significantly since the global financial crisis and domestic policy interventions in most emerging markets have not prevented upward pressure on exchange rates. This has prompted intense discussion between members of the G-20 on the factors driving capital flows to emerging markets and how they should be managed. This is part of the G-20's work

---

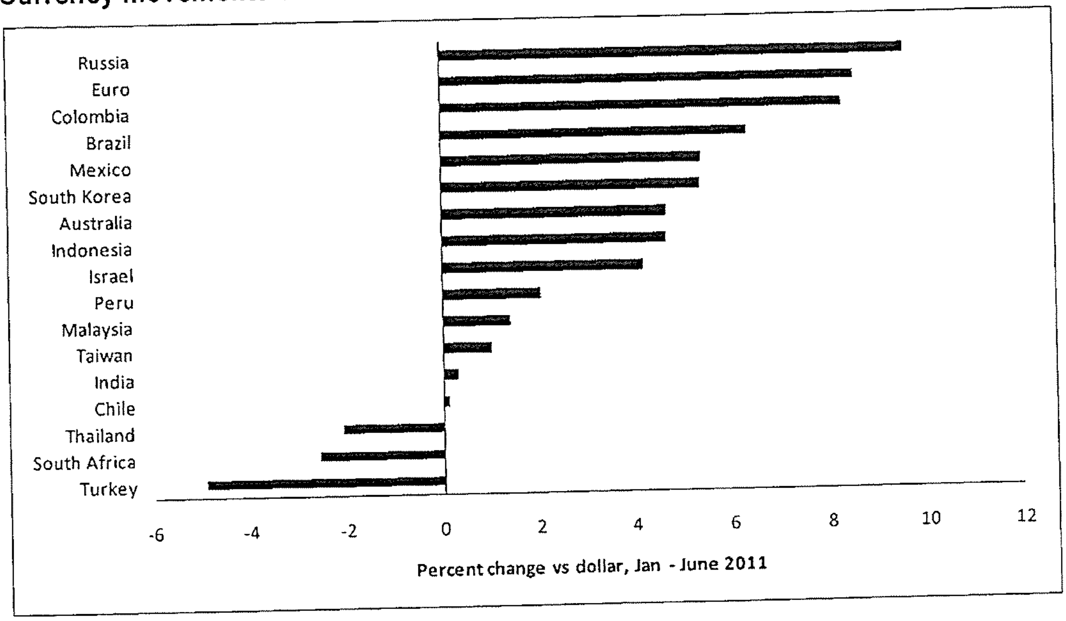
[1] Net portfolio investment turned from an outflow of R134.9 billion in 2008 to net inflows worth R93.8 billion and R79.6 billion in 2009 and 2010 respectively, largely driven by foreign purchases of government bonds.
[2] Foreign portfolio assets (i.e. money invested offshore by domestic pension funds and institutions) increased by R28.2 billion in the whole of 2010 and by R22.1 billion in the first quarter of 2011.
[3] Net foreign purchases of bonds amounted to R29.3 billion between April and June.

under the French Presidency to foster global cooperation towards a more stable international monetary system. From these discussions it is clear that the factors driving exchange rates are complex and that there are no simple policy solutions. However, it is clear that the issues are global and need a globally co-ordinated response.

Capital flows are determined by the interplay between economic conditions and policy in both "sending" countries, and "receiving" countries. Recently, push factors such as moderate growth, low interest rates, and easy monetary policies in advanced economies, like the US, and the choice of exchange rate regimes and level of exchange rates in large emerging markets like China, have played an important role in increasing inflows of capital towards emerging markets. Among pull factors, sound macroeconomic fundamentals and high growth in emerging markets have contributed to the recent large capital inflows, also facilitated by financial sector deepening and lower barriers to cross-border transactions. In some countries like South Africa, higher issuance of government bonds to finance the budget deficit has also attracted foreign capital, whilst commodity producers benefiting from high international prices have also experienced stronger inflows.

There has been considerable debate about whether imposing capital controls on short term foreign inflows can help to reduce appreciation pressure. Countries like Brazil have imposed a 6 per cent tax on foreign purchases of bonds to reduce the scale of inflows. However, the Brazilian real has still appreciated by 6.2 per cent against the dollar this year because other inflows, including FDI, have remained strong. Other countries have accumulated foreign exchange reserves to moderate appreciation pressure and used macro prudential measures to prevent the build-up of excessive domestic credit growth and currency mismatches. However, as the chart below shows, most currencies have still appreciated against the dollar this year, except Chile, India, Thailand, South Africa and Turkey.

**Currency movements versus the dollar, 2011**




**G-20 coordination**

At the Seoul Leaders' Summit in November 2010, G-20 members agreed to refrain from competitive devaluations of currencies, which would be detrimental to the overall stability of the global economy. To support this aim, the IMF has proposed a set of guidelines for managing capital flows that aims to prevent harmful policies and so-called "currency wars". The guidelines suggest that countries should only consider imposing controls if the exchange rate is overvalued relative to fundamentals, and other policy options such as reserve accumulation and tighter fiscal policy are not possible. Furthermore, if a country is facing overheating pressures (e.g. upward pressure on inflation, credit growth and asset prices) then controls may be necessary to allow monetary policy to tighten without appreciating the currency. Discussions within the G-20 are focusing on individual country experiences to distil policy lessons. However, the policies of systemically important countries with large external imbalances, like the US and China are also being scrutinised to ensure that the causes of high and volatile capital flows are also addressed.

**Domestic policy considerations**

All of these factors must be considered in designing a policy response that is in South Africa's national interest. If we spend more on reserve purchases we either need to borrow more or spend less on something else; if we impose capital controls we risk raising the cost of domestic capital and not having enough inflows to finance the current account deficit. Similarly, reducing interest rates while inflation is rising will merely erode our competitiveness further. The experience of other countries shows that none of these measures are a substitute for improving the underlying competitiveness of our exporters through improvements in productivity.

Finally, it is important to recognise some of beneficial effects of the strong rand over the past few months, particularly in offsetting the impact of high international oil prices on inflation. The price of Brent crude oil has increased by 20 per cent this year, which has contributed to a 21 per cent increase in the domestic petrol price. The petrol price fluctuates according to monthly changes in the oil price and the rand so it would have increased by much more if the rand had also fallen sharply. For example, if the rand were to weaken to R8/US$ and the oil price rose back to US$125/bbl then the petrol price would rise above R11.00/litre. This would impact negatively on household spending power, increase inflation and ultimately result in higher interest rates, which would reduce economic growth.

The National Treasury will continue to monitor international and domestic factors affecting the rand, trends in capital flows and their impact on the economy and design appropriate policy responses when required.