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AN ANALYSIS OF EXCHANGE RATE POLICIES IN THE REPUBLIC OF SOUTH AFRICA 1971 - 1977

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ABSTRACT

The breakdown of the system of fixed exchange rates, which occurred in the western world in the early 1970s, has exerted marked effects upon the exchange rate policies adopted by South Africa. In particular, it has resulted in the local monetary authorities practising a more active policy concerning the exchange rate value of the rand. The purpose of this thesis is to describe and analyze the exchange rate policies of the Republic during the period from 1971 to 1977, and to offer recommendations for change.

The research procedure followed involved extensive gathering of information from published literature, together with confidential information disclosed to the writer by the Deputy Governor of the Reserve Bank.

The thesis is divided into four sections. Section A reviews the traditional exchange rate policy adopted by the South African authorities, and their long-standing support for fixed but adjustable exchange rates in the international monetary system. Section B incorporates an historical review and analysis of changes in the exchange rate for the rand which have materialised since 1971. Section C focuses attention upon the attitudes of the local authorities over the issue of reform of the exchange rate regime in the international monetary system in the past few years. Section D is devoted to an analysis of specific policy issues which have arisen in the conduct of exchange rate policy in South Africa, and highlights areas where improvements could be made. All four chapters in this Section were submitted as evidence to the current Commission of Inquiry into the Monetary System and Monetary Policy in South Africa.

One important conclusion of the study is that the more flexible exchange rate policy adopted in South Africa has had very limited success in affecting positively the current account of the balance of payments. Conversely exchange rate policy appears to have been more successful in improving the position on the capital account.

Another conclusion concerns deficiencies which exist in the provision of foreign exchange facilities, and particularly in regard to forward exchange. In some respects South African policy is characterized by exchange rates and facilities which bear little relation to market conditions. It is recommended that a more competitive market in foreign exchange should be established in both spot and forward transactions.

TABLE OF CONTENTS

page

SECTION A

CHAPTER 1 - EXCHANGE RATE POLICY ISSUES UNDER BRETTON WOODS 1

1.1 Nature of Adjustment Mechanism 1

1.1.1 Problems of More Frequent Adjustments .. 3

1.1.3 Symmetrical Adjustment Mechanism 4

1.1.4 Exchange Rate Adjustment and International Liquidity 8

1.1.5 Scarce Currency Clause 10

1.1.6 Dollar Link to Gold 11

1.1.7 International Nature of Exchange Rates .. 11

1.2 Exchange Rate Flexibility and Inflation .. 12

1.2.1 Influence of Reserve Losses 13

1.2.2 Discipline of Floating Rates 13

1.2.3 Possible Transmission of Inflation Under Floating Rates 16

1.2.4 Inflationary Bias of Bretton Woods System 17

1.3 Exchange Rate System - Implications For Foreign Trade and Investment 18

1.3.1 Extent of Rate Stability 18

1.3.2 Influence on Investment 19

1.3.3 Influence on Foreign Trade of Exchange Rate System 21

1.3.4 Influence of Floating System on South African Foreign Trade 23

1.4 Exchange Rate Flexibility and Role of Gold 25

1.4.1 Influence of Floating Rates on Gold Price .. 26

1.4.2 Exchange Rate System and Reserve Requirements 28

CHAPTER 2 - TRADITIONAL EXCHANGE RATE POLICY IN SOUTH AFRICA

2.1 Factors Encouraging Passive Policy .. 36

2.1.1 Nature of Foreign Exchange Market 36

2.1.2 Import Control Policy 37

2.1.3 *Compatibility with Internationally Accepted* Behaviour 39

TABLE OF CONTENTS (contd.)

		page
2.2	The Influence on Policy of Elasticities of Demand and Supply	40
2.2.1	Factors Affecting Demand Elasticities ..	41
2.2.2	Influence of Supply Elasticities	41
2.3	Internal Policy Instruments - Influece on Policy	43
2.3.1	Influence of External Developments ..	43
2.3.2	Policy Targets and Instruments	47
2.3.3	Absence of Conflict Situation	50

SECTION B

CHAPTER 3 - REVIEW OF EXCHANGE RATE POLICY (AUGUST 1971 - DECEMBER 1973)

3.1	Temporary Link with Dollar	54
3.1.1	Factors Influencing Move	56
3.2	Problem of Realignment of Exchange Rates ..	57
3.3	Rand Devaluation in December 1971	60
3.3.1	Motivation	60
3.3.2	Criticisms	61
3.4	Developments Following Devaluation ..	63
3.4.1	Improvement in Current Account	63
3.5	Link with Sterling Maintained Temporarily ..	64
3.5.1	Motivation	66
3.6	South Africa Links with the Dollar ..	68
3.6.1	Motivation	68
3.6.2	Criticisms	70
3.7	South Africa Revalues	70
3.8	Repercussions of Dollar Float	71
3.8.1	Reaction of the Republic	71
3.9	Revaluation of the Rand in June 1973 ..	73
3.9.1	Method of Revaluing	74
3.10	The Oil Crisis and Repercussions on Rand ..	74
3.10.1	Role of Monetary and Exchange Rate Policy ..	75

TABLE OF CONTENTS (contd.)

		page
CHAPTER 4 - REVIEW OF MANAGED FLOATING OF THE RAND		
4.1	Motivation for Introduction	81
4.2	Principles of Operation of Managed Float ..	83
4.2.1	Rate Changes Effected	83
4.3	Appraisal of Policy	85
4.4	Factors Complicating Operation of Policy ..	90
4.4.1	Forward Exchange Policy	90
4.4.2	Problem of Leads and Lags	91
4.5	Reasons for Abandoning Policy	92
4.6	Lessons to be Learned	93
4.6.1	More Frequent Adjustments	94
4.6.2	Linking to a Currency Basket	96
4.6.3	Rand Float Simulation	96
CHAPTER 5 - EXCHANGE RATE POLICY, JUNE 1975 - SEPTEMBER 1975		
5.1	Devaluation of Rand in June 1975	100
5.1.1	Motivation	100
5.2	September 1975 Devaluation	101
5.2.1	Motivation	101
5.2.2	An Alternative Strategy?	103
5.2.3	Import Controls	106
5.2.4	Monetary Policy	107
5.2.5	Implications of Devaluation	109
CHAPTER 6 - EXCHANGE RATE POLICY AND INTERNAL ECONOMIC STABILITY		
6.1	Influence of Budgetary Position on Policy ..	113
6.2	Exchange Rate Cycle of the Rand	115
6.2.1	Factors Encouraging Policy	117
6.3	Influence of Policy on Growth	118
6.3.1	Reversibility of Policy	119
6.3.2	Export Orientation	119
6.3.3	Statistical Evidence	120

TABLE OF CONTENTS (contd.)

		Page
6.3.4	Importance of the Price Factor	124
6.3.5	Price Elasticities	126
6.4	Implications of the Policy of Revaluation ..	129
6.4.1	Flow of Funds Analysis and Exchange Rate Policy	130
6.4.2	Bank Credit and Foreign Reserves Position	133
6.5	Exchange Rate Policy and Inflation ..	134
6.5.1	Influence of Devaluation on Prices ..	137
6.5.2	Revaluation and Inflation	139
6.5.3	Constraining Factors	140
6.5.4	Pricing Policies of Suppliers	141
CHAPTER 7 - CAPITAL ACCOUNT AND EXCHANGE RATE POLICY ..		148
7.1	Influence of Leads and Lags on Exchange Rate Policy	148
7.1.1	Vulnerability to Leads and Lags	150
7.1.2	Disruptive Potential of Leads and Lags ..	151
7.1.3	Response of Bank	152
7.1.4	Limitations of Strategy	153
7.1.5	Resort to I.M.F.	154
7.1.6	Implications of Differences in Leads and Lags Environment	156
7.2	Implications of Need to Protect Short Term Capital Account	156
7.2.1	Influence of Interest Rates	157
7.2.2	Limitations of Policy	158
7.3	Possible Alternative Policies	158
7.3.1	Floating of Rand	158
7.3.2	Devaluation of Rand	159
7.3.3	Modifications in Forward Cover Charge ..	160
7.3.4	Tax Changes	160

TABLE OF CONTENTS (contd.)

		Page
	SECTION C	
CHAPTER 8 -	INTERNATIONAL MONETARY REFORM AND EXCHANGE RATE FLEXIBILITY - SOUTH AFRICAN VIEWPOINT ..	167
8.1	Background to the Problem	167
8.1.1	I.M.F. Special Report (1970)	169
8.2	Realignment of Exchange Rates (December 1971)	169
8.2.1	Central Rates	170
8.2.2	Widening of Currency Margins	171
8.3	Symmetrical Exchange Rate System	173
8.3.1	SDR Intervention System	173
8.3.2	Viewpoint of the Republic	175
8.3.3	Multi-Currency Intervention System ..	175
8.3.4	Viewpoint of the Republic	178
8.4	Deliberations of the Committee of Twenty ..	179
8.4.1	Objective Indicators - South African Viewpoint	180
CHAPTER 9 -	PROSPECTS FOR A RETURN TO FIXED BUT ADJUSTABLE EXCHANGE RATES	186
9.1	Record of Floating Rates	186
9.1.1	Competitive Devaluations	187
9.1.2	Effects on Foreign Trade	188
9.1.3	Balance of Payments Adjustment and International Liquidity	190
9.2	Viewpoint of the Republic on Floating Rates	193
9.2.1	Floating Rates and Inflation	194
9.3	Opposition to Return to Fixed Rates ..	195
9.3.1	Use of Exchange Rate as Policy Instrument ..	196
9.3.2	Exchange Rate System and Economic Disorders	197
9.3.3	Countervailing Influences	198
9.4	Problems with Reinstatement of Par Value System	199
9.4.1	Need for Prompt Adjustment of Rates ..	199
9.4.2	Responsibility for Rate Changes	202

TABLE OF CONTENTS (contd.)

	Page
9.4.3 De-stabilizing Capital Flows	205
9.4.4 Control Over Eurocurrency Markets	207
9.4.5 Control Over International Liquidity ..	208
9.4.6 Temporary Floating	209

SECTION D

CHAPTER 10 - THE RAND CURRENCY LINK	215
10.1 Linking to the SDR or an Independent Currency Basket	216
10.1.1 Foreign Transactions Composition and Currency Link	216
10.1.2 Currency Basket Peg and Inflation	219
10.1.3 Currency Basket Peg and Speculation ..	220
10.2 Advantages and Disadvantages of Alternative Currency Basket Links	221
10.2.1 Control Over Economic Policy	222
10.2.2 Basket Disclosure	223
10.2.3 Exchange Rate Uncertainty	224
10.3 The Rand-Sterling Link	225
10.3.1 Sterling Link and Transmission of Inflation	226
10.3.2 Sterling Link and Diversification of Foreign Trade	228
10.3.3 Influence on Foreign Portfolio Investment ..	228
10.3.4 Other Implications of Sterling Link ..	229
10.4 The Rand Link to the Dollar	231
10.4.1 Effect of Dollar Link on Inflation ..	232
10.4.2 Implications of Relative Dollar Stability ..	233
10.5 Linking the Rand to a Strong Currency ..	235
CHAPTER 11 - FORWARD EXCHANGE POLICY IN SOUTH AFRICA ..	246
11.1 Case for Provision of Reserve Bank Forward Cover Facilities	246
11.1.1 Disadvantages in Providing Forward Facilities	248

TABLE OF CONTENTS (contd.)

	Page
9.4.3 De-stabilizing Capital Flows	205
9.4.4 Control Over Eurocurrency Markets	207
9.4.5 Control Over International Liquidity ..	208
9.4.6 Temporary Floating	209
SECTION D	
CHAPTER 10 - THE RAND CURRENCY LINK	215
10.1 Linking to the SDR or an Independent Currency Basket	216
10.1.1 Foreign Transactions Composition and Currency Link	216
10.1.2 Currency Basket Peg and Inflation	219
10.1.3 Currency Basket Peg and Speculation ..	220
10.2 Advantages and Disadvantages of Alternative Currency Basket Links	221
10.2.1 Control Over Economic Policy	222
10.2.2 Basket Disclosure	223
10.2.3 Exchange Rate Uncertainty	224
10.3 The Rand-Sterling Link	225
10.3.1 Sterling Link and Transmission of Inflation	226
10.3.2 Sterling Link and Diversification of Foreign Trade	228
10.3.3 Influence on Foreign Portfolio Investment ..	228
10.3.4 Other Implications of Sterling Link ..	229
10.4 The Rand Link to the Dollar	231
10.4.1 Effect of Dollar Link on Inflation ..	232
10.4.2 Implications of Relative Dollar Stability ..	233
10.5 Linking the Rand to a Strong Currency ..	235
CHAPTER 11 - FORWARD EXCHANGE POLICY IN SOUTH AFRICA ..	246
11.1 Case for Provision of Reserve Bank Forward Cover Facilities	246
11.1.1 Disadvantages in Providing Forward Facilities	248

TABLE OF CONTENTS (contd.)

	Page
11.2 Current Forward Exchange Arrangements ..	249
11.2.1 Existing Facilities	250
11.3 Difficulties in Modifying Facilities ..	251
11.3.1 Flexible Forward Cover Rate	251
11.3.2 Forward Exchange Rationing	254
11.3.3 Gold Sales Procedure	255
11.3.4 Implications of Forward Exchange Losses ..	256
11.4 Recent Policy Changes	258
11.4.1 Increase in Forward Cover Charges	258
11.4.2 Reversal of Policy Decisions	261
11.4.3 Extension of Cover Period for Imports ..	262
11.4.4 Question of Forward Cover for Exporters ..	263
11.4.5 The Bank's Broad Objectives	263
11.5 Current Policy Issues	265
11.5.1 Extension of Forward Cover by the Bank to More Than One Currency	266
11.5.2 Provision of Forward Cover on Private Sector Borrowings Overseas	269
11.5.3 Cover for Public Corporations	270
11.5.4 Cost of Cover for Public Corporations ..	271
CHAPTER 12 - THE CASE FOR A FORWARD EXCHANGE MARKET IN SOUTH AFRICA	278
12.1 Institutional Changes Required for an Interbank Market	278
12.1.1 Gold Sales	280
12.1.2 Foreign Loans of Public Corporations ..	281
12.1.3 Exchange Control Relaxations	282
12.1.4 Position of Domestic Banks	283
12.2 Size of Markets	284
12.2.1 Role of Foreign Banks	286
12.2.2 Extent of Forward Dealings	286

TABLE OF CONTENTS (contd.)

	Page
12.3 Intervention Role of the Reserve Bank ..	288
12.3.1 Benefits of Intervention	288
12.3.2 Problems in Intervening	288
12.3.3 Implications for Gold Policy	289
12.3.4 Nature of Intervention	289
12.4 Influence of Exchange Rate Arrangements on Forward Market	292
12.5 Benefits of a Forward Market	293
12.5.1 Market Determined Rates	294
12.5.2 Flexibility of Exchange Rate Policy ..	295
12.5.3 Effects on Capital Flows	295
12.6 Problems With a Forward Market	296
12.6.1 Impact of Speculation	297
12.6.2 Exchange Control Policy	299
CHAPTER 13 - IMPLICATIONS OF FLOATING THE RAND	309
13.1 Floating Rand and Payments Adjustment ..	309
13.1.1 Simplicity and Efficiency	309
13.1.2 Elimination of Structural Deficiencies ..	311
13.2 Exchange Rate Regime and Transmission of External Economic Trends	312
13.2.1 Fluctuations in the Terms of Trade ..	312
13.2.2 Influence of World Business Cycle ..	314
13.2.3 Factors Reducing Insulation Under Floating	316
13.3 Factors Militating Against a Rand Float ..	317
13.3.1 Transmission of Inflation	317
13.3.2 Openness of Economy	318
13.3.3 Volatility of Exchange Rate	319
13.3.4 Domestic Disturbances	320
13.3.5 Business Cycle and Balance of Payments ..	321

TABLE OF CONTENTS (contd.)

	Page
13.4 Intervention Policy with Floating Rand ..	322
13.4.1 Foreign Reserves Stockpile	322
13.4.2 Interest of Exporters	322
13.4.3 Problems in Relying on Monetary Policy ..	323
13.4.4 Influence of Capital Flows	323
13.4.5 Effects on Foreign Reserve Needs	324
13.5 Floating Rand and Exchange Controls ..	325

LIST OF TABLES

		Page
Table 1	- Financing of Gross Domestic Investment ..	19
Table 2	- Rand Changes Against the Dollar (June 1974 - April 1975)	
Table 3	- Distinction Between Official Gross and Net Foreign Reserves	89
Table 4	- Bank Credit Extended to Government	106
Table 5	- Net Gold Output and Government Receipts from Gold Mining	114
Table 6	- Trends in Manufactured Exports (1969 - 75) ..	121
Table 7	- Trends in South African and World Exports ..	122
Table 8	- Annual Percentage Growth Rate in Merchandise Exports and Imports	122
Table 9	- Full Employment Balance of Payments Position ..	123
Table 10	- South African Export Prices in Dollars Relating to Export Prices of Industrial Countries ..	123
Table 11	- Index of South African Domestic Wholesale Prices Compared with Wholesale Prices for Imported Goods	124
Table 12	- Percentage Changes in Inflation Rates and Currency Changes Vis-à-vis the Rand (1970 - 74)	125
Table 13	- Structure of Merchandise Imports (1971 - 75) ..	126
Table 14	- Flow of Funds - South African Economy (1961 - 75)	132
Table 15	- Percentage Changes in Export Prices of South Africa's Main Trading Partners	138
Table 16	- Quarterly Movements in Short Term Capital ..	149
Table 17	- Errors and Unrecorded Transactions	149
Table 18	- Indicator of Leads and Lags Vulnerability ..	151
Table 19	- Official International Reserves (1970 - 76) ..	191
Table 20	- Percentage Increases in Consumer Prices in Selected Countries	194
Table 21	- Foreign Trade Structure (1971 - 75)	217
Table 22	- Net Inflow of Foreign Portfolio Investment ..	229
Table 23	- Average Annual Percentage Consumer Price Rises (1972 - 76)	232

LIST OF TABLES (contd.)

	Page
Table 24 - South African Exports and Imports	
Table 25 - Imports and Exports of Goods and Services in 1976	285
Table 26 - Foreign Liabilities of South Africa 31.12.76 ..	297
Table 27 - Terms of Trade and Gold Price	313
Table 28 - Percentage Change in Consumer Prices	317
Table 29 - Percentage Price Changes in South Africa ..	318

LIST OF FIGURES

		Page
Figure 1	- Relationship Between Business Cycle and Balance of Payments	42
Figure 2	- Relationship Between the Money Supply and Foreign Reserves	44
Figure 3	- Percentage of Merchandise Imports Covered by Gold and Foreign Exchange Reserves ..	49
Figure 4	- Weighted Average Value of the Rand and Percentage Change in Imported Wholesale Price Index	65
Figure 5	- Relationship Between 3 Month N.C.D. Rates, Eurodollar Rates and Foreign Reserves of the Reserve Bank	76
Figure 6	- Effective Value of Rand and Foreign Reserves of Reserve Bank	86
Figure 7	- Excess Liquid Assets of Commercial Banks and Net Official Reserves	108
Figure 8	- Foreign Reserves of Reserve Bank and Trade Weighted Value of Rand	116
Figure 9	- Change in Inventories and Foreign Reserves of Reserve Bank	128
Figure 10	- Relationship Between Bank Credit Expansion and Net Foreign Reserves	135
Figure 11	- Relationship Between Bank Credit Expansion and Merchandise Imports	136
Figure 12	- Terms of Trade and Monthly Gold Price (1968-74)	142
Figure 13	- Foreign Reserves Position and Foreign Loans of Reserve Bank	161
Figure 14	- Size and Structure of Foreign Debt of Government	162

CHAPTER ONE - EXCHANGE RATE POLICY ISSUES UNDER BRETTON WOODS

In the post-war period until 1971 the international monetary system of the non-communist world was based on fixed but adjustable exchange rates, with currency values expressed in terms of gold, or in terms of the gold content of the U.S. dollar which existed in 1944. This so-called Bretton Woods system, however, came under increasing strain and criticism during the 1960s, particularly as regards the exchange rate adjustment process, and the provision of international liquidity. This introductory chapter reviews the standpoint of the South African authorities to the issues which arose during this period concerning this exchange rate adjustment mechanism.

1.1 Nature of the Adjustment Mechanism

South Africa strongly supported the Bretton Woods system of fixed but adjustable exchange rates and rejected freely fluctuating exchange rates, substantially wider margins, and automatic crawling peg arrangements.[1]

In the opinion of most observers a fatal weakness which developed under the Bretton Woods system was that too much emphasis was placed upon 'fixed' exchange rates and too little on 'adjustable' rates. Consequently there evolved overvalued currencies subject to periodic pressures, without any action being taken to change the rate.[2] In the late 1960s this deficiency became glaring and even the introduction of Special Drawing Rights was partly prompted by the desire to provide extra international liquidity to forestall devaluation. This provided one reason why the Republic was cool towards this reserve asset.

Those opposed to change in exchange rate rules pointed out that countries had the right to propose parity changes in cases of fundamental disequilibrium. Thus, even though the Reserve Bank agreed that some countries had clung to unrealistic exchange rates, the question had to be asked whether they would be more willing to do so under a different exchange rate system. One outcome may have been a similar situation where inadequate exchange rate

adjustment materialised, while at the other extreme there might have been a strong temptation to resort to parity changes when other actions would have been appropriate. This danger of exchange rate permissiveness worried the Bank as one of the implications of a move towards greater rate flexibility, or freely floating exchange rates.[3]

The South African monetary authorities therefore took the view that what was needed was not a change in the rules, but a better use of the Bretton Woods system:

> I certainly do not advocate frequent or frivolous resort to devaluation, but we must be careful not to go to the other extreme. There is a tendency sometimes to regard the preservation of an existing exchange rate as an end in itself, or at least as a symbol of national prestige, but in conditions of fundamental disequilibrium it may actually be harmful to the international financial system to prolong the agony by clinging to an unrealistic exchange rate. 4

1.1.1 Role of the I.M.F.

There were suggestions put forward during the latter days of the Bretton Woods system that the I.M.F. should, in cases where fundamental disequilibrium appeared to exist, be given greater power to influence national authorities to change their rates. If such greater powers had been given to the I.M.F. this might have benefited South Africa since both sterling and the French franc may have been devalued earlier in the 1960s. This would have put increased pressure on the U.S. dollar, and, as a result, an increase in the official gold price may have come earlier than it did, payments imbalances may not have developed to the same extent and the Bretton Woods arrangements might have survived. From the viewpoint of those supporting a more flexible exchange rate system such an outcome would have been regarded as unfavourable.

Although the authorities recognized this possibility they were opposed to granting greater powers to the Fund, because they feared that, given the political influence of the U.S.A. in the Fund, such powers could have been used to pressurise surplus countries to

revalue rather than deficit countries to devalue because of U.S. promptings in the Fund.[5] As will be explained later, such an outcome would have been unwelcome to the local authorities. In addition, such a proposal raises the question of formulating meaningful criteria to be employed by the I.M.F. in regard to members' exchange rates. The I.M.F. also had the power to publish reports that, apart from exerting moral suasion, might compel a country to initiate action by evoking 'speculators' to act. This power has never been used presumably because countries would oppose it.

1.1.2 Problems of More Frequent Adjustments

These considerations emphasize one of two major difficulties in bringing about a better adjustment mechanism, which the Bank desired, under Bretton Woods type arrangements. This concerns the fact that no one clear cut definition of fundamental disequilibrium in the payments position of a country is available. The usual criteria of undervaluation or overvaluation are significant payments surpluses or deficits, but these are ambiguous guides subject to cyclical and random forces. Furthermore even structural changes in the balance of payments of a country can be reversed or offset by other countervailing forces. Supplementary guides such as price indices can be used but are not particularly helpful. Relative prices of consumer goods provide an imperfect reflection of the competitiveness of the industries of countries in foreign trade. Even special indices, such as wholesale prices of domestic products, labour costs per unit of output, or unit cost of export articles may give imperfect indicators of relative competitiveness.[6]

Secondly, there is the argument that encouraging more positive attitudes towards exchange rate adjustment, and in particular devaluation, must be constrained. This is because otherwise people will anticipate currency adjustments, significant exchange rate flexibility will develop, the 'money illusion' will be shattered and inflation accelerate markedly.[7] This danger was also perceived by the South African authorities.

However, it is argued that if parity changes are limited to infrequent and large ones the scope for better decision-making will remain very limited, principally because of political difficulties in making parity changes in such circumstances.[8] Also, restricting rate changes could provide problems associated with the need to shift substantial domestic economic resources into the balance of payments sector if an adjustment is made.

1.1.3 Symmetrical Adjustment Mechanism

A widespread desire existed for more prompt adjustment of exchange rates by countries which appeared to face a fundamental disequilibrium in their balance of payments. There was, however, no unanimity on how this less inflexible adjustment process should be brought about. In particular there was the question whether less infrequent devaluations should have materialised, or whether there should have been a more symmetrical adjustment mechanism in which both revaluations and devaluations were reverted to more readily. Since South Africa was not enthusiastic about a more symmetrical adjustment mechanism this issue warrants analysis.

According to Harrod there was no mechanism for prompt adjustment under Bretton Woods since unemployment was considered intolerable, and no other prompt adjustment process was used, partly reflecting the lack of any systematic basis for determining the responsibility for initiating adjustment action between surplus and deficit countries.[9] Flanders similarly argued that the system had a built-in bias towards disequilibrium due to differences in the willingness of countries to tolerate inflation in exchange for full or nearly full employment.[10] The inflation prone countries tended to incur deficits and avoided adjustment so long as their reserves were above minimum acceptable levels. Less inflation-prone countries which enjoyed payments surpluses preferred to accumulate reserves rather than to adjust. There was, therefore, a deflation-devaluation bias in the system. It was argued that this asymmetrical mechanism should be modified in order to encourage or pressurise surplus

countries to revalue more readily so that the principal 'burden' of adjustment did not fall on deficit countries.[11]

There were a number of arguments to support this case. Firstly, the more equally 'costs' of cooperation are distributed among countries, which would be an implication of more equal payments adjustment between deficit and surplus countries, the greater the chance that the system can be maintained intact.[12] However, the South African authorities feared that increased cooperation may be a myth, since deficit countries may escape adjustment if increased emphasis was placed on revaluations by surplus countries. However, even if this occurred it would not necessarily be in the interest of deficit countries. For instance, if there is full employment in both deficit and surplus countries, revaluations could worsen the inflationary situation prevailing in deficit countries, and by raising costs prevent their deficits from being eliminated.

Secondly, it could be globally inconvenient for all countries in disequilibrium to take action on the exchange rate front. Thus, if a surplus was concentrated and its counterpart was widely diffused, so that there were relatively few countries in payments equilibrium, the need for explicit action would be minimised if the rate changes were limited to the surplus countries.[13] However, such a situation did not prevent most of the western countries devaluing against the U.S. dollar in 1949.

Thirdly, if revaluations by surplus countries are not encouraged, the latter will continue to enjoy payments surpluses which are liable to grow, especially if they reflect relatively low inflation rates unaccompanied by sufficiently expansionary internal policies. The larger these surpluses amount to the more difficult revaluations can become, because of the political influence of export and import competing industries that grow as a result of the undervaluation of such currencies.[14] This implies the need for quicker and smaller exchange rate adjustments, the main danger here being that incentives would be given to speculative short-term capital flows.

Fourthly, there is a vague notion that the adjustment following a change in exchange rates is more difficult for deficit than for surplus countries, and therefore the latter should have been more prepared to revalue when appropriate.[15] This assertion is difficult to understand.

At this point it is worth clarifying the concept of adjustment costs. Cohen points out that the adjustment process involves a reallocation of economic resources in both surplus and deficit countries, irrespective of which party changes the exchange rate.[16] However, although the process of adjustment is always shared, the costs in deficit and surplus countries are not. In this respect, Cohen makes a distinction between 'transitional' costs and 'continuing' costs of adjustment. The continuing cost means that for the deficit country its imports would normally be expected to decrease relative to its exports, this cost always being borne by the deficit country and incurred after the process of adjustment is concluded. Thus the deficit country will receive a smaller proportion of the combined output of its own plus that of partners previously in surplus. However, the transition itself from payments imbalance to equilibrium with external balance must also have a cost, *separate* from the continuing cost. This Cohen calls the 'transitional' cost of payments adjustment and refers to the cost of change to the new international equilibrium. It can be identified as the real national income foregone during and on account of the adjustment process, and can be detected by observing the extent to which deficit and surplus countries experience unemployment or inflation while restoring payments balance.

Obviously, a significant part of the transitional adjustment cost may be borne by one country even though the adjustment process is shared. It is this cost which represents the real problem of international distribution of the burden of payments adjustment. According to supporters of more symmetrical exchange rate adjustment a greater share of this burden should have been accepted by surplus countries.

The Republic tends to have a high transitional adjustment vulnerability owing to the substantial fluctuations in its balance of payments. If in deficit, it has to adopt contractionary economic policies, and vice versa for surpluses. From this viewpoint it might be concluded that the Republic would not have found unsatisfactory a more symmetrical exchange rate mechanism among the major currencies.

In reality, however, the monetary authorities strongly favoured placing the emphasis of the burden of adjustment upon deficit rather than surplus countries. They believed that devaluations should be more common than revaluations, since countries pursuing excessively cautious policies leading to undervalued currencies, were likely to be rare. They thought that pressurizing a country to revalue was unjust given the political, economic and social difficulties of such a move. Worse still, pressures to revalue would provide disincentives to pursue anti-inflationary policies, since any country doing this would not only risk domestic political unpopularity, but also risk facing demands to revalue from other countries.[17]

On the other hand the difficulties, political and otherwise, of revaluing also apply to deficit countries if they devalue their currencies. Also, disincentives to pursue anti-inflationary policies could be minimized if the fear of inflation among electorates was sufficiently strong; this, however, seems generally doubtful.

The attitude of South Africa was also influenced by the fact that revaluations mean reducing internal official gold prices in revaluing countries, thus reflecting adversely upon the monetary attractions of gold. The Bank recognized that pressures on surplus countries to revalue were partly motivated by the objective of providing the U.S.A. with a means to resist dollar devaluation in terms of gold. This was one aspect of the asymmetrical adjustment mechanism that the Bank opposed, namely the ability of the U.S. to run payments deficits indefinitely, unlike other countries in deficit.[18]

Given the strong interest of South Africa, as a gold producing country, in global price stability, putting the emphasis for currency

changes upon deficit countries could have had desirable effects on this front owing to the possible balance of payments discipline. On the other hand, pressure on surplus countries meant either that revaluations took place, which would be inflationary for South Africa given an unchanged rand parity, or inflation could be encouraged through more expansionary economic policies pursued in surplus countries. At the same time, a devaluation biased system could increase global inflation if cost-price spirals followed devaluations, but potentially compensated by rising gold prices in terms of rand if not in dollars.

The difficulties in inducing surplus countries to revalue should also not be dismissed. Apart from political obstacles such countries may view their surpluses as temporary, and if rising foreign reserves are regarded as desirable to keep in line with rising volumes of international trade, reaping surpluses can be regarded as more akin to an equilibrium position than a constant level of reserves reaped by a country.[19]

At the same time the Bank was not against revaluations per se. It would possibly have revalued its own currency in the event of an increase in the official gold price. The Bank may not have increased the internal gold price to the same extent as the dollar price increase in an effort to counteract the inflationary effects of such a rise. Also, the authorities might under certain circumstances, have revalued the rand unilaterally by a small amount, despite their support for an official gold price increase. However, this was considered unlikely, given the fixed $35 per ounce gold price and the creeping inflation.[20]

1.1.4 Exchange Rate Adjustment and International Liquidity

Some supporters of a symmetrical exchange rate mechanism argued that revaluations should balance devaluations, any imbalance reflecting either an excess or a shortage of international reserves. Thus, a bias towards devaluations, such as occurred under Bretton Woods, implied a shortage of international liquidity.[21]

Aligned with this was the school of thought which, as part of the objective of making the burden of adjustment shared more equally, advocated an expansion of international liquidity through a new reserve asset.[22] The reasoning was that the more easily deficit countries could supplement their reserves, the less attractive would be accumulation of reserves by surplus countries. Also, the larger the world's reserves the bigger will be the reserves of surplus countries, and this would help emphasize the economic disadvantages of their persistent accumulation. For Scitovsky the inflationary dangers of such a policy were unimportant, because he believed that such a development would induce further adjustment by surplus countries. This may, however, have overestimated the will of governments to curb inflation. By relaxing external constraints on economic policies, emphasis would have shifted on to domestic constraints, which the Bank believed to be relatively weak.[23]

Nevertheless, the authorities believed the problems of exchange rate adjustment and international liquidity were interrelated.[24] One school of thought regarded this interrelationship as unimportant.[25]

Both Salant[26] and Gilbert,[27] on the other hand, argued that the problem of adjustment and the adequacy of growth in world reserves were not easy to distinguish since they were accompanied by the same symptom: persistent deficits in the balance of payments of countries which ran international reserve currency functions. Such deficits did not necessarily mean that these countries had not pursued proper adjustment policies; instead they could reflect inadequate growth of world reserves. They stressed that a substantial portion of the official settlements payments deficits of the U.S.A. in the 1960s reflected the absolute decline, and previous inadequate growth, of monetary gold stocks. This induced, on the part of the Europeans, a demand orientated accumulation of U.S. dollars, leading to payments imbalances and failure to adjust exchange rates. Increased central bank dollar holdings were, therefore, a substitute for unobtainable new gold supplies.

This viewpoint was unacceptable to those who believed that the U.S. deficit was supply determined, that is largely due to internal economic policies. However, the South African authorities believed this demand orientated thesis of the U.S. deficits had some validity.[28] Also, it believed the most suitable response would have been an increase in the official gold price rather than reliance on S.D.R. issues.

As a method of improving adjustment a gold price increase had much to recommend it. For one thing, it could be that some European countries, experiencing payments surpluses would have revalued against the U.S. dollar. Also, insofar as gold reserve increases would have been prized more highly than dollar increases or S.D.R. issues, surplus countries may have been keener to adjust. Finally, an official increase in the price of gold could have improved confidence in the international monetary system, and reduced the need to counteract instability on foreign exchange markets. One reason why adjustment of exchange rates was delayed in the 1960s was the fear that they would intensify the movement into gold. (On the other hand, a gold price increase might have enhanced expectations of further increases, and exacerbated nervousness in the exchange markets.)

The authorities regretted that such a solution was partly debarred by the political obsession of the U.S.A. with the maintenance of a $35 an ounce gold price.[29] However, if the above analysis is correct one can conclude that a revaluation of gold, resulting in a renewed inflow of it into the monetary system, would have had the by-product of encouraging surplus and deficit countries to participate more equally in the adjustment process.[30] Such a result could have been out of line with the preference of the Bank for a devaluation-biased system in an inflationary world.

1.1.5 Scarce Currency Clause

A more symmetrical adjustment mechanism could have been achieved if the Fund had not neglected the 'scarce currency provisions' of its Articles. Birnbaum argued that the 'scarce currency provisions' were intended to impose a sharing of responsibility for balance of

payments adjustment on the creditor countries, and its non utilization allowed payments surpluses to remain and so produce reserve shortages for other countries.[31]

The attitude of the authorities was that the provisions had been constituted in an environment where stability of prices was largely assumed. In the post-war period this assumption was inoperative. However, the Bank would not have opposed its activation on principle, but rather would have judged each case on its merits.[32] This reflected in part the view that in a non-inflationary world a devaluation biased exchange rate system would have largely disappeared. Put differently, the 'scarce currency clause' stemmed from the fear that otherwise all the burden would fall upon deficit states, who would deflate their economies. This fear has been unfounded. Deficit countries instead resorted to devaluations or controls.

1.1.6 Dollar Link to Gold

The authorities also regarded the maintenance of gold-dollar convertibility at a fixed pric as the foundation for the Bretton Woods system; any change in this role of gold would most likely be accompanied by the adoption of greater flexibility of exchange rates including floating rates.[33]

This need not necessarily have occurred. For instance, there would have been no contravention of the I.M.F. articles if the U.S. had decided to sell or purchase gold only at its own discretion while retaining fixed exchange rates by maintaining exchange transactions against other currencies within plus or minus one per cent of their gold parities by intervention in foreign exchange markets.

1.1.7 International Nature of Exchange Rates

One of the alleged advantages of Bretton Woods was its recognition of the need for exchange rate policies to be mutually acceptable.[34] Since an exchange rate vitally affects other countries it cannot be claimed that the rate of each country is its own business entirely. Thus, in the Bretton Woods charter the exchange rate acquired a dual character, being both a market and a negotiated price.

In other words, if exchange rates are to fluctuate to clear the markets, it is equally necessary to adopt procedures for international consultation about rate policies.

Advocates of floating rates may argue that if stable economic conditions prevail greater exchange rate stability will result, thus largely eliminating the need for rules governing floating. This may, however, beg the question if floating rates tend to be associated with instability in the world economy, and in exchange markets.

The authorities recognized this interdependency of currencies, believing it would be necessary under floating rates for agreement on multilateral rules to regulate official interventions. However, they thought that reaching agreement could prove extremely difficult, resulting in probable wrangling between countries concerning charges of exchange rate manipulation by monetary authorities.[35]

1.2 Exchange Rate Flexibility and Inflation

The South African authorities argued that floating rates imposed less discipline on domestic authorities to curb inflation. The argument is that floating, and especially freely floating rates, enable automatic equilibrium in the balance of payments to be attained so that a country could permit domestic inflation to continue more rapidly than abroad.[36] By contrast, under fixed rates the loss of reserves, and the political and economic embarrassment involved in devaluing imposed a stronger discipline upon authorities to restrain inflation.[37] The authorities believed that in the par value system the exchange rate should be looked upon largely as a fixed point of reference in order to provide discipline for the maintenance of sound domestic economic policies.

A fear of the Republic has been that by imparting stronger global inflationary pressures, floating rates would foster greater inflation locally in view of the open nature of the economy. This fear is not unfounded since there was a strong positive correlation between the imported wholesale price index on the one hand, and the local wholesale price index and retail price index on the other hand for the period 1962-73.[38]

Proponents of flexible rates argue that fixed but adjustable rates provide a weaker discipline, because countries can devalue when faced with a 'fundamental disequilibrium', thus providing an escape route.

1.2.1 Influence of Reserve Losses

An important issue is whether reserve losses and the possible need to devalue constitute stronger pressures to oppose inflation than the actual or threatened depreciation of a floating rate. According to Fellner variations of exchange rates will exert more pressure on monetary authorities 'because prompt exchange rate movements are warnings to the public while reserve movements are not'.[39]

However, the loss of exchange reserves may not prompt action so much as the loss of gold reserves. Only the persistent loss of gold by the U.S. seemed to prompt the latter to try and correct its payments deficit. It can be argued that the Bretton Woods system was originally designed to operate predominantly on a gold and I.M.F. credit base with reserve currencies playing a much more limited role than materialised. In such circumstances, with the absence of huge dollar balances, the incentive to take corrective measures would have been stronger due to the potential loss of gold, particularly if central bankers' attachment to the metal was as strong as often suggested. On this basis the advocacy by the Republic of the maintenance of gold convertibility of currencies may have been valid concerning its disciplinary role.

1.2.2 Discipline of Floating Rates

Other arguments have been presented to refute the indictment that with greater exchange rate flexibility the weakening of discipline would exacerbate inflation.

Firstly, it is alleged that under flexible rates volatile capital movements can put greater external pressure on the authorities, at least in cases where there are doubts about the technical ability or political will of the country to reduce pressures of excess demand.[40] Under the par value system a current account deficit, due to excess

demand pressures, could be offset by capital inflows or restrictions on outflows thus reducing external pressures on such a country to rectify the deficit.

Under a system of greater exchange rate flexibility the possibility of larger exchange rate movements would prevail. Forward exchange discount rates could be wider than under the fixed rate system, since larger interest rate differentials could be required to induce capital inflows, which means the latter would not be attracted so easily.

On the other hand for a country facing excessive domestic demand pressures, the expectations in exchange markets could be that the balance of payments will be reversed if corrective measures are taken, and thus will induce speculative capital inflows on this basis.[41] Furthermore, countries might use their greater freedom to induce capital inflows; thus, a country incurring excessive domestic expenditures might permit some currency depreciation so that the resulting speculative inflows reduced the need for more unpopular action. What is more, under floating rates, a particular exchange rate level might be sustained, at least for a while, through official or semi-official borrowings abroad.

Secondly, it has been argued that when the balance of payments is kept continuously in equilibrium a country with a floating rate has to swallow the inflation it generates and cannot unload part of the burden on others.[42] In other words, inflation can be confined to domestic prices, since the exchange rates of countries inflating will decline in foreign exchange markets. However, even under freely floating rates this is not necessarily true; for instance, if two countries are inflating at the same rate the exchange rate relationship between the two could remain unchanged, so allowing inflation to be transmitted. Also, the process can be stifled by capital inflows preventing the currencies of inflating countries falling.[43]

Thirdly, political pressures could create resistance against undue exchange rate depreciation, because of the unpopularity of

intensifying inflation.[44] There are, however, cases presented to support the assertion that floating rates can stifle action to combat inflation. This has been argued with reference to the U.K. since the pound floated in June 1972, the float allegedly being politically preferable enabling pressures to be 'taken on the rate', and crises postponed.[45] Empirical evidence on this issue is not, however, conclusive. Sohmen quotes the examples of Canada and Lebanon, where floating rates during the post-war era did not prevent the pursuit of conservative monetary policies.[46]

Nevertheless, even some supporters of floating rates recognize the dangers of intensified inflation. Thus Grubel claimed that criticism of such a system reflected 'a rather cynical view of democratic processes, namely the idea that central bankers or other economic technicians know better what rate of inflation is in the long run interest of a nation than does the public. Price stability is not a constitutional right. Politicians and the government executive should be sensitive to the public's desired relative quantities of inflation and unemployment. If the public wants to trade some unemployment for a somewhat higher rate of inflation, and makes this preference known by electing candidates who stand for such a policy, it ought to be able to do so without being encumbered by monetary, or any other anchors, thrown out by conservative elements in society'.[47]

This statement illustrates two aspects of this controversy. Firstly, there are differences of opinion as to what priority should be given to price stability vis-a-vis high employment; for South Africa concern over inflation has traditionally been strong partly reflecting the influence of the gold mining industry. Secondly, views differ on how much trust can or should be placed in domestic political institutions. The danger of reduced central bank leverage upon politicians was one reason why the authorities favoured retention of fixed but adjustable exchange rates.[48]

1.2.3 Possible Transmission of Inflation Under Floating Rates

The question needs to be considered how, under floating rates, inflation may be promoted. The allegation is that there is a danger of a continuous fall in the exchange rate producing a deterioration in the terms of trade of a country which in turn promotes a permanent increase in the rate of inflation as workers and salary earners resist falling living standards[49] The higher wages lead to higher prices and smaller exports causing a further depreciation of the currency. If speculators anticipate domestic inflation and move funds into stronger ones such action will further weaken the currency, cause more rapid depreciation and domestic inflation, and thus justify the speculation itself.

It is also argued that floating currencies involve an asymmetrical effect on inflation. When a currency appreciates not all import costs will fall, and those that do will not necessarily be translated into price cuts. Wage rates are sticky downwards, and part of the appreciation benefit will be absorbed in higher real wages. Alternatively, instead of cutting their prices when their import costs fall, many domestic producers may raise their profit margins.[50]

In opposition it could be claimed that for some major industrial countries (but certainly not South Africa), imports do not loom large in the cost of living, so that wage increases just sufficient to offset higher costs of imported goods will never fully nullify the benefits of depreciation. Johnson also argues that 'it is erroneous to assume that increases in the cost of living inevitably produce fully compensatory wage increases'.[51] This claim however, is open to considerable doubt as regards some western countries given the power of certain trade unions. Also, the thesis of a depreciating currency leading to cost push inflation, and thus further depreciation cannot apply to all countries operating floating rates, since it is impossible for all currencies to be depreciating against one another.

1.2.4 Inflationary Bias of Bretton Woods System

The proponents of greater exchange rate flexibility have been on much firmer ground in pointing out the inflationary bias of the Bretton Woods system as it evolved in the 1960s. This allegation is presented by Krieger as follows:

> Looking at monetary developments across the foreign exchanges in the past half-dozen years, one can argue that the common inflationary experiences of the industrial nations arose previously out of the excess creation of international money - mainly dollar reserves - that worked through the fixed exchange rate system to generate over-expansion of national money supplies in almost every industrial country. Thus the Bretton Woods system had a built in inflationary bias that eventually paved the way for its destruction. 52

In order to restore monetary autonomy in countries, advocates of floating rates argued that monetary authorities should stop intervening in foreign exchange markets, thereby ceasing to create supplies of domestic monies from that source. This argument, however, can be interpreted not so much as criticism of fixed but adjustable rates, but as criticism of the way Bretton Woods evolved. The fact that the U.S.A. to some degree controlled the world supply of money through its external deficits, and thus fostered global inflation arose out of the non-functioning of an essential ingredient of the system as initially set up. This was dollar convertibility into gold and the corrective mechanism of U.S. payments deficits leading to internal monetary contraction in the U.S. The lack of dollar convertibility on a proper scale removed an essential discipline of the system, without which the latter faced eventual collapse, unless foreign countries had been prepared indefinitely to accept dollar accruals. The advocacy by South Africa of gold convertibility of the dollar was partly based on this perceived inflationary bias which otherwise prevailed. Simultaneously, its support for an increase in par values in terms of gold was partly based on the view that otherwise the system was not sustainable. Also, floating rates do not eliminate the inflationary forces described since it will

incorporate 'dirty' floating, and the absence of formalized reserve asset settlement arrangements.

1.3 Exchange Rate System Implications for Foreign Trade and Investment

The argument here is that floating rates potentially disrupt foreign trade and investment. Since these allegations stem from the expected instability and uncertainty surrounding rates, it is worthwhile to consider briefly the extent to which exchange rates would tend to fluctuate.

1.3.1 Extent of Rate Stability

The authorities anticipated that floating rates would involve greater fluctuations in rates compared with the Bretton Woods system.[53] It would promote inflation which must be reflected in currency fluctuations, as would the absence of parities since monetary authorities would not intervene to the same extent to smooth out short term fluctuations.

This conclusion is generally accepted, but differences of opinion arose as to the extent of this greater instability of rates, and the influence of speculation in exchange markets under such a regime. (This latter controversy will not be considered here.) Some supporters of flexible rates argue that exchange rate variations needed to achieve external balance may be modest since adjustment is not postponed and therefore wide discrepancies, which under Bretton Woods could eventually entail major rate changes, would be avoided.[54] It should be noted, however, that supporters of floating rates argue that the degree of instability in such exchange rates is determined by the degree of instability in economic conditions in different countries.[55]

Nevertheless, it cannot be concluded that in a stable economic world exchange rate stability would roughly approximate that in a fixed but adjustable peg system. Einzig stressed that with free floating a degree of currency instability must be expected, even if economic conditions are stable, because of leads and lags, capital movements, speculation, arbitrage, and government foreign

receipts and payments.[56] Einzig also feared that interventions designed to smooth out these influences on rates would be de-stabilizing since the authorities' knowledge about day to day influences in markets is limited.

1.3.2 Influences on Investment

In this area it is argued that with floating rates foreign long term investment will be curtailed, because either borrowers or lenders will refuse to conclude long term contracts. The lender might insist upon repayment and servicing in his own currency, but this would shift to the borrower the risks of exchange rate changes.

For short term capital flows the danger is considered less real. Opportunities exist for obtaining forward cover, although such facilities are limited. In the case of the Republic rand/dollar cover is absent for private non-trade capital. Since short term capital flows are often de-stabilizing, any tendency for flexible rates to diminish this item is not serious.[57]

For South Africa the implications of flexibility for long term investment might be particularly harmful, given its dependence on foreign funds. The following table indicates that normally gross domestic investment in the Republic exceeds gross domestic savings.

TABLE 1 - FINANCING OF GROSS DOMESTIC INVESTMENT (Rm)

	1962	1963	1964	1965	1966	1967	1968	1969	1970	1971	1972
Gross Domestic Savings	1456	1570	1705	1902	2095	2541	2466	2770	2790	3184	3869
Net Foreign Capital Inflows	-120	-66	-33	255	141	162	456	180	541	764	411
Change in Gold & Foreign Exchange Reserves*	-188	-87	89	41	-140	19	-534	65	286	239	-404
Gross Domestic Investment	1148	1422	1761	2198	2096	2722	2388	3015	3617	4187	3876

* Note: increase-, decrease+

Source: Reserve Bank Quarterly Bulletin, various issues

Fears regarding the investment implications of flexible exchange rates influenced policy during the post-war era. In particular there was a desire to maintain a stable exchange rate with sterling for much of this period in view of the traditional close links with London as a source of investment funds.[58]

Proponents of flexible rates have several counter arguments. They allege that pegged rates assure borrowers and lenders of only temporary rigidity of exchange rates. With the possibility of periodic adjustments of rates under this system, conversion risks exist over the long run; therefore for long term investments the risk may not be much different under one system compared with the other.[59] Such risks were minimised in the case of the Republic by the currency being kept stable vis-a-vis sterling.

It is also argued by some advocates of rate flexibility that the hedge in long term capital movements between countries comes from the fact that such investments are made in real terms.[60] Thus, if prices in a country rise say tenfold over a period relative to another currency it is likely that the decline in the exchange rate of such a currency will roughly be compensated by the rise in the nominal value of the investment in such a country. This argument may be valid where direct equity investments are concerned, particularly since cash outlays may be small relative to the average rate of return that can be obtained.[61] However, the risks attaching to certain portfolio investments (e.g. government securities) and other short term capital investments under floating rates accompanied by high inflation may be considerable.

Thirdly, it is alleged that the risk of exchange controls is greater under the Bretton Woods type system since adjustments to deficits can take the form of controls rather than exchange rate changes, this threat deterring long term investment as much as variations or potential variations of flexible rates.[62] Others claim that risks of exchange and trade controls are greater under floating rates, particularly if wide rate fluctuations materialise.[63]

Concerning this issue, it is interesting that the authorities in 1961 considered introducing multiple exchange rates to deal with the outflow of capital, but the I.M.F. recommended exchange controls.[64]

Fourthly Caves points out, in defence of flexible rates, that the alternative to exchange rate changes is domestic adjustment of prices or income, or both as a response to disturbances.[65] This increases the solvency risk of long term investments. However, Caves believes that investors may attach greater importance to conversion risks than to solvency risks, although there is no a priori reason for them to do this.

In the local political setting the opposite may well be the case. The outflow of capital in the early 1960s was primarily based on solvency risks, and with greater exchange rate flexibility, the solvency factor may well be more important in influencing inflows. Thus, significant capital began flowing into South Africa after the middle 1960s when greater confidence in the political situation returned (see Table 1).

Lastly, it is argued that over or undervalued exchange rates under the adjustable peg system distort investment patterns, with an over-valued currency reducing capital inflows, and vice versa.[66] However, this can also result under floating rates, because of official manipulation of rates, even if not to the same extent.

1.3.3 Influence on Foreign Trade of Exchange Rate System

The local authorities feared that greater rate flexibility may deter foreign trade, because more volatile rates create risks of lower profits as a result of changes in prices received or paid for foreign currency.

Theoretically, risks under floating rates can be hedged in forward exchange markets, and if these are limited, they can be increased through official action, thus ensuring more competitive conditions.[67] This normally requires a country relaxing exchange control regulations, which it may be reluctant to do. In the case of the Republic the creation of a competitive market would involve

radical changes in institutional arrangements, the desirability of which is discussed in a later chapter.[68]

Under floating rates the demand for forward exchange facilities should increase.[69] However, doubts have persisted whether the supply would correspondingly rise. Foreign exchange markets tend to be short term orientated, since medium and long term currency trends are not amenable to statistical probability calculations belonging to the category of pure uncertainty rather than risk. On this basis forward markets will mainly provide short term facilities, and increased demand, under floating, for long term forward contracts will not be fully accommodated.[70]

According to Einzig the volume of obtainable facilities would decline because of the increased desire on the part of banks, who are authorized foreign exchange dealers, to play safe by reducing their limits for the amounts up to which they are prepared to accept each other's names for forward exchange facilities.[71] In other words, reduced forward facilities under floating rates would arise out of the practice of banks limiting their forward exchange commitments in relation to most other banks. The latter argued that the implications of this would be a reduction in international trade.

As regards local foreign trade this danger does not arise since the Bank provides guaranteed forward cover in dollars at a fixed cost for commercial bank clients. This means that the government and ultimately taxpayers assume exchange risks instead of exchange market dealers. However, where the major overseas foreign exchange markets are concerned, Einzig's warning has been proved correct. Since the breakdown of the Bretton Woods system, banks have reduced the scale of their commitments and foreign exchange dealings have become thinner.

It has also been claimed that during periods of one-sided pressure on a floating currency, the extent to which it is possible to 'marry' customers buying and selling orders will diminish at a time when the demand for forward exchange facilities is very

strong, and when the limits of banks applied to other banks have been reached.[72] (One-sided pressure can, however, emerge under fixed rates providing similar problems of 'marrying' transactions.)

Again this problem does not apply to South Africa, but it can apply in developed foreign exchange markets. However, countervailing forces can operate. Official support of the weak forward currency may be provided; this can discourage capital outflows from the weak currency by making outward interest arbitrage unprofitable.[73] This policy may, however, only be sensible when the run on a currency is expected to reverse itself fairly quickly. An alternative is to raise interest rates to support the currency, which has internal as well as external implications.

1.3.4 Floating Rate System and South African Foreign Trade

The Republic lacks a developed exchange market, and this means that rates for non-dollar currencies are volatile, being dependent upon the dollar if the latter is floating and the rand linked to it. Even so, major problems should not arise in transacting foreign trade.

Firstly, under a flexible rate regime the Bank can provide forward cover at a fixed low rate for either the dollar or sterling, whichever was linked to the rand, thus providing an element of rate stability in contrast to developed forward markets where forward rates fluctuate.

Secondly, experience since collapse of the par value system in 1972 and 1973 suggests that invoicing of foreign trade gravitates towards the currency to which the rand is pegged. Between fifty and sixty per cent of foreign trade, excluding gold, may be invoiced in dollars at the present time.[74] Before 1972 a higher proportion was invoiced in sterling when the rand was linked to it. The ease of changing currency invoicing, however, depends on the extent to which the currency the rand is linked to fulfils a vehicle currency role in international trade.

Thirdly, there should be no problem for traders to obtain forward cover in non-dollar or non-sterling currencies, whichever

was linked to the rand. The Bank might also furnish cover at low rates for more than one currency. This could involve taxpayers in contributions to offset losses incurred by the Bank. Some central banks argue that extensive forward cover, under floating rates, should be officially provided at favourable rates even if losses result, suspecting that otherwise interbank market rates could involve 'exploitation' of traders. The Bank, however, has not subscribed to this view indicating such facilities would not be provided.[75] It is argued that those directly benefitting from trade should bear the cost of insuring in the forward market, and not expect taxpayers to finance losses incurred by central banks.[76] However, to the extent that foreign trade provides economic externalities (e.g. greater competition and variety of goods, etc.), subsidized forward rates may be advocated.[77] An alternative could mean providing forward cover in one or more currencies on a flexible basis, increasing the rate when demand is high and vice versa. The Bank, however, has felt that this might reflect adversely on the official rate and encourage adverse leads and lags if the charge is increased.[78]

Fourthly, irrespective of whether the spread between forward buying and selling rates widens under floating rates, forward cover is either a benefit or drawback to exporters and importers depending on whether a discount or premium on forward rates exists, and the extent of the differential. This point is stressed by Machlup who argues that a floating rate system accompanied by significant spot rate fluctuations, and high forward discount and premium rates can boost foreign trade.[79]

The extent to which this would be relevant for South Africa would depend on the alertness of exporters and importers to changing spot and forward rates, and how quickly they could adapt their operations in the face of fluctuations in the profitability of foreign trade. Where local exports are concerned, short run supply elasticities in many sectors are likely to be small because of the preponderance of agricultural and mineral exports. In 1976 roughly

fifty-one per cent of merchandise exports consisted of non-gold minerals. The mining industry may prefer fixed rates because, in view of its huge capital investments and price quotations for its products in foreign currencies, they may facilitate forward planning. The willingness of marginal export and import firms to operate under highly volatile rate conditions is also questionable, forward cover only obviating risks on specific transactions, but not on foreign trade activities in general.[80]

Since there is a lag between the drawing up of a contract, and the time it is ready to be signed, under floating, forward rates may change from those expected at the time the contract was drawn up, thus inhibiting trade.[81] Locally, this risk is normally minimal in the case of rand/dollar transactions, because of the fixed, although adjustable rate prevailing. In dollar/third currency transactions rates change constantly, and the problem does exist, being particularly relevant for marginally profitable trade. Increased rate flexibility, both spot and forward, also increases the risk that a trader's competitors may get a better rate thus increasing business risks.[82]

1.4 Exchange Rate Flexibility and Role of Gold

Under floating rates the need for official reserves for intervention in foreign exchange markets would be absent provided national authorities allowed exchange rates to be determined freely. Under a completely free regime of floating currencies the perennial need to provide for some growth in international reserves to parallel growth in world trade also disappears. Even if floating rates are accompanied by periodic interventions the need for foreign reserves including gold, is still allegedly reduced, although not eliminated.[83]

Thus, for South Africa greater flexibility of exchange rates has carried threats that central banks would sell at least part of their redundant gold on the free market, causing the price to fall since there would no longer be a fixed monetary gold price

supported by monetary authorities.[84] In addition, it was suggested that the reduced, if not eliminated, monetary role of gold would have a demonstration effect, and weaken faith in holding gold in the private sector.

It might be concluded that these dangers partly explain why South Africa has supported fixed but adjustable exchange rates and currency convertibility into gold. The advantages of a broad gold market for sales purposes preferably requires monetary as well as non-monetary outlets.

1.4.1 Influence of Floating Rates on Gold Price

In reality, these viewpoints regarding the implications of flexible rates were not accepted by the authorities. Instead they anticipated that cutting the link between gold and the dollar would lead to a higher free market price partly because the fixed price of $35 an ounce had become unrealistic because of persistent inflation. This conclusion is, however, critically dependent on the assumption that central bank gold stocks remain largely or entirely in official hands. The authorities believed that central bank sales on the market would probably be insignificant for a number of reasons.[85]

Firstly, events in the 1930s, the early 1970s, and the experience of many South American countries show that a movement towards flexible rates tends to arise when countries face serious financial and economic problems. Irrespective of whether there is any functional relationship between these problems and flexible ates, it must be doubted whether central banks will be keen to sell gold under such conditions. The metal has been traditionally viewed as a strategic independent national asset as well as a store of value.

Secondly, the authorities believed that under such an exchange rate regime inflation would be promoted for reasons explained previously. In addition, the authorities feared that 'competitive devaluations' might materialise, and so provide an environment which could lead to higher gold prices.

Thirdly, the authorities did not completely discount the possibility that a breakdown of the Bretton Woods system would

lead to the emergence of a gold bloc, i.e. a group of countries who tied their currencies to gold while floating against non-bloc currencies.[86]

There are other reasons which suggest that a functional relationship may exist between floating rates and rises in free market gold prices. For one thing, increased currency instability could encourage gold buying by private investors. In addition increased rate flexibility and attempts to reduce the monetary role of gold make partly redundant regulations maintaining official restrictions on private ownership of gold since these were introduced partly to encourage the channelling of gold into central bank reserves.

In addition, if free market prices are boosted this alters the economic case for central banks holding gold. Under fixed exchange rates the acquisition of reserves, unless acquired through SDRs, involves a cost if they are earned through a balance of payments surplus. This means a loss of real resources implying diverting part of the national product to foreign use, and not taking foreign products, and/or through receiving foreign capital and keeping it as a reserve asset.[87] If central banks no longer were to hold reserves under floating rates the financial gain would comprise the difference between the rate of return to be obtained from their alternative use, and the return presently obtained by holding them as reserves, plus or minus capital gains or losses resulting from changes in the value of the latter. Thus, any substantial increase in the value of gold holdings of central banks under floating exchange rates increases the economic benefits of owning gold.

This partly explains why in the early 1970s, when the free market price rose to nearly $200 in 1974, most central banks have shown no desire to sell gold. It also partly explains why the gold sales policy of the Republic incorporates contributing towards a stable market with an upward price trend.

1.4.2 Exchange Rate System and Reserve Requirements

Finally, in discussing the price and role of gold under floating rates the size of official foreign reserve requirements must be analyzed closely. Central banks tend to view their exchange rates as a special price, whose influence permeates the entire economy, and therefore should not be left completely to market forces. Also, exchange rate movements by affecting inflation, distribution of national income, etc. have political implications, so pressurizing official intervention to manipulate rates.[88] Moreover, in a floating system, most countries would, as is the practice today, continue to peg their currencies in one way or another. For many less developed countries this is preferred because of operational simplicity.[89] Many also do not possess developed markets which would enable their currencies to be floated. Maintaining relative stability in the value of its foreign reserves may also induce a country to peg its currency.[90]

Thus, the need for foreign reserves, and therefore gold, is present in such a system. The conventional view is that the need will be less, but it has been claimed that because of greater exchange rate oscillations, and the official desire to even out such fluctuations, larger foreign reserves will be required.[91] In similar vein Einzig argued that world liquidity needs would be aggravated by switching of official currency reserves as rates fluctuated.[92]

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CHAPTER TWO - TRADITIONAL EXCHANGE RATE POLICY IN SOUTH AFRICA

Although aspects of this policy have been referred to in the previous chapter adequate analysis makes it necessary to devote more attention to it. During the post-war period until December 1971, South Africa altered its exchange rate only once. This was in September 1949 when the thirty per cent sterling devaluation was followed by a similar devaluation of the South African pound, the move being influenced by memories of the adverse repercussions stemming from the failure to follow sterling immediately in 1931. During this period, therefore, the country adopted a largely passive exchange rate policy, the idea of unilaterally changing the rate virtually never being considered a realistic policy option.[1]

2.1 Factors Encouraging a Passive Exchange Rate Policy

A number of factors help to explain the nature of this exchange rate policy in the post-war era.

2.1.1 Nature of Foreign Exchange Market

Throughout the period since 1945 a foreign exchange market where rates are determined by forces of demand and supply has not existed in the Republic, and cannot do so under current and past institutional arrangements.[2] Thus, a floating exchange rate or a fixed but adjustable rate subject to allowed variations either side of a parity has not been feasible.

There are two main reasons why a developed exchange market is absent in South Africa. Firstly, the rand is not an internationally traded currency, and thus there is no significant market in rands abroad. Almost all foreign business is invoiced in foreign currencies, usually sterling or dollars. Local exporters mostly receive payment in foreign currency which they exchange for rands at the banks, while importers pay in foreign currency bought from the banks. There is therefore limited scope for any foreign bank to buy or sell rand.

Secondly, the Reserve Bank receives all the foreign exchange from the sale of gold bullion, by far the largest export item; in

other words a large proportion of the foreign currency coming into South Africa accrues to one bank. In 1970 gold receipts constituted roughly thirty per cent of total exports. Hence the market is distorted. The Bank is a large net buyer of rand for foreign currency, while the other banks are all net sellers, except in special circumstances when the country is running a substantial payments surplus.

The authorities, therefore, have been forced to peg the rand to an international currency at a fixed but adjustable rate, which during this period was sterling. This arose out of the strong trade ties with the United Kingdom, dependence on United Kingdom capital inflows, and the role of sterling as a reserve currency for countries associated with the sterling area.

Thus, before August 1971, when gold convertibility of the dollar was suspended, the exchange rate between the rand and other currencies was determined daily on the basis of the closing rates between sterling and othe foreign currencies in the London market on the previous day. The rate of exchange between the rand and the pound was fixed, and the Bank provided quotations fixed daily for major currencies such as United States dollars, Swiss francs and French francs.

2.1.2 Import Control Policy

In contrast to the passive exchange rate policy and contributing towards it, import controls have been used extensively in the post-war period.[3] Reliance on this policy had its origin partly in the response to a serious balance of payments crisis in 1948, and partly because South Africa had to a large extent been restricted in its tariff policy on entering the G.A.T.T. negotiations in 1947. In an attempt to reverse the declining foreign reserves, the authorities in November 1948 introduced such controls, and subsequently on occasion similar action was taken to meet payments problems.

The major reasons for recourse to import controls rather than exchange rate adjustments to deal with payments problems have been

threefold.[4] Firstly, the authorities recognized that such controls were politically easier to introduce than either restrictive economic policies or devaluation. Secondly, they provided protection for import substitute sectors, and hopefully industrialization would be promoted. Thirdly, it was thought that the effects on the balance of payments were quicker and more predictable than changes in exchange rates.[5]

As regards the speed of effect, import controls, unlike devaluation, can discriminate between different foreign sources. This is relevant where import reductions from one foreign source reduces the demand for exports less than if imports are cut from other sources.[6] In this respect local import restrictions may have been important in differentiating between the sterling area and the dollar area.

Import controls may have temporary contractionary effects. For instance, they may lead to a temporary rise in savings due to the delay in re-arranging patterns of expenditure or to postponement of expenditures in anticipation of restrictions being removed.[7] Experience, however, contradicts this in the local context since they encouraged 'beat ' import buying because of fears of new import restrict: ularly when imports were rising strongly, and thus tend.. occasion to aggravate fluctuations in them.

Concerning the greater predictability of the effects of controls vis-a-vis currency adjustments, this is partly bound up with elasticities of demand for exports and imports. In some countries the use of import controls has been supported by the arguments of 'elasticity pessimists'.[8] If the demand for exports has a price elasticity below unity, the case for a floating exchange rate or a currency devaluation to cure a deficit is poor. In other words, it is argued that if a fall in the exchange rate, while eliminating the deficit is accompanied by a fall in foreign exchange earnings, then it is better to maintain the existing exchange rate, and reduce imports by other means such as import controls.[9]

Assuming the latter can exert the same or greater influence on imports than a currency adjustment, this has merit, since although there is an economic cost in diverting resources into otherwise uneconomic channels through import controls, a reduction in foreign receipts is avoided. Although not elasticity pessimists, at least as regards the longer term, the authorities have adopted a cautious attitude towards this question in the case of South Africa.[10]

It is generally accepted that industrialization has been helped by this import control policy, although other methods might have been preferable.[11] Over time the authorities, for a number of reasons, have become sceptical of the wisdom of this policy, feeling it was a mistake not to have placed more emphasis on methods such as exchange rate changes to deal with payments problems.[12]

Firstly, it is a negative policy providing no encouragement to exporters, and could partly explain why much of South African industry is lacking in export orientation. Secondly, controls were sometimes imposed when imports had already started to fall. Thirdly, as previously noted, such controls encouraged 'beat the ban' import moves, thus tending to be less quick working than originally anticipated. Fourthly, capital and intermediate products were largely omitted, and thus the scope for controls was limited to consumer goods.

In addition, although at first utilized in order to deal with payments problems, they tended to become more and more a method of protecting import substitute sectors, so conforming to what often happens with this type of instrument. Apart from economic inefficiencies promoted through non-reliance on market forces, this entails well-known administrative deficiencies.[13]

2.1.3 Compatability With Internationally Accepted Behaviour

During the post-war era South Africa had no wish to disregard the spirit or the rules of the Bretton Woods system. Throughout, a cautious policy was practised as shown, for instance, in 1961 when exchange controls were introduced following recommendations

by the I.M.F., instead of introducing a multiple exchange rate system which was considered.[14] This adherence to I.M.F. rules may have partly reflected the importance of the country as a seller of gold to central banks, and in 1970 and 1971 to the Fund itself. The Republic, during this period, also tended to regard a more flexible exchange rate system as involving a 'lurch into the dark'.

2.2 The Influence on Policy of Elasticities of Demand and Supply

Critical to the success of any exchange rate change are the magnitudes of the elasticities. If the elasticities of demand for imports and exports are too low a devaluation can worsen the payments imbalance. For devaluation to reduce or eliminate a deficit, it must reduce domestic currency expenditures on imports relative to domestic currency receipts for exports assuming the absence of capital flows. According to Marshall-Lerner theory, if this is to occur, it is necessary that the sum of the elasticities of demand for imports and exports be greater than one, assuming perfect competition at home and abroad, with infinitely elastic supplies, so that the prices of all goods traded remain the same in their country of origin.[15] Thus, exporters in the devaluing country are assumed to 'pass on' the increased worth of foreign currency in a reduction in their foreign currency price, which is assumed to fall to the full extent of the devaluation. Equally, import prices are assumed to rise in terms of domestic currency to the full extent of devaluation.

The attitude of South Africa towards this factor partly explains why the authorities favoured a stable exchange rate for the rand. The view was that exchange rate policy could not rely heavily on this factor partly because of the difficulties in obtaining accurate measures of such elasticities.[16] However, they tentatively accepted that the elasticity of demand for exports and imports of the country is sufficiently high, at least in the medium to longer term, to generate an improvement in the payments position in the event of

a devaluation, but have not considered such elasticities to be as high as those of Western countries.[17]

Given significant uncertainty about short run elasticities, this factor would rule out enthusiasm for floating the rand, because in this context it is short run elasticities that are of crucial importance.

2.2.1 Factors Affecting Demand Elasticities

The view of the Bank has partly been based on the fact that about eighty per cent of imports are intermediate and capital goods for which local substitution possibilities are limited, and also that a large proportion of exports consist of mineral and agricultural goods where demand elasticities are low.[18] Also, to believe in the 'elasticity pessimism' could imply resorting to a rand revaluation to rectify a payments deficit, which was not considered seriously.[19] In addition, the income elasticity of demand for imports is high.[20] Also, reliance on the price mechanism to boost exports may have been discouraged by the small export manufacturing sector, which in 1970 contributed roughly seventeen per cent of total export receipts. For countries with a large foreign sector, demand elasticities for imports and exports are likely to be relatively small vis-a-vis economies with small sectors where more significant substitution possibilities for imports and exports may exist.[21] Non-price factors such as quality and delivery dates must also be noted as competitive weapons.

2.2.2 Influences of Supply Elasticities

Too much emphasis upon the assumption that demand elasticities are large enough is also constrained by the need to take account of the elasticities of supply of exports of the Republic. The previous theory is based upon the assumption of infinite elasticities of supply of exports and imports. However, assuming elasticity of demand for exports is greater than unity, the supply of foreign exchange from exports will be more elastic the higher the elasticity of supply of exports. Consequently, to assume infinite elasticities

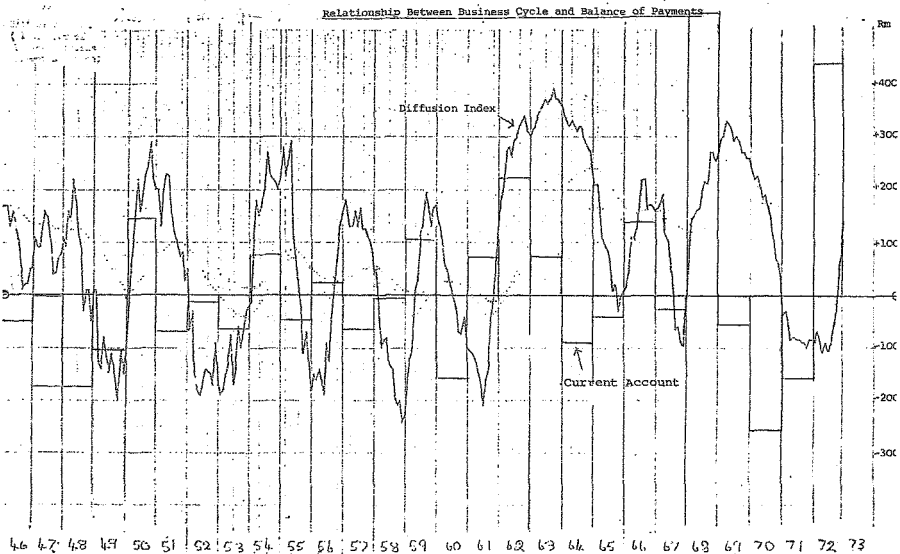

Relationship Between Business Cycle and Balance of Payments
Rm
+40C
+30C
+20C
+10C
-10C
-20C
-30C
Diffusion Index
Current Account
46 47 48 49 50 51 52 53 54 55 56 57 58 59 60 61 62 63 64 65 66 67 68 69 70 71 72 73

Figure 1.

of supply of exports overstates the curative effect of devaluation where demand elasticities are elastic.

Where exports are concerned the supply of primary and agricultural products have a low elasticity of supply in the short run. Also, the proportion of total output of the principal exports such as gold and diamonds which are sold overseas is very large; hence, the possibilities of diversion from the domestic markets to exports are very small. Also, South Africa with its dual economy and restrictions on the mobility of labour together with structural unemployment and under-employment, faces a somewhat rigid economic environment not particularly conducive to the success of exchange rate changes.[22]

2.3 Internal Policy Instruments - Influence On Policy

As already indicated the local economy is characterized by a cyclical trend in the current account of the balance of payments. This is indicated in diagram 1 where the relationship between the business cycle, illustrated by a diffusion index, and the current account is presented. When the diffusion index is above the line 0-0 this indicates an upward phase of the business cycle, and vice versa. Also, evidence shows a high correlation between movements in the foreign reserves and the growth rate of the money supply (see Figure 2). Under the fixed exchange rate system South Africa found that it had limited autonomy over its domestic money supply. Thus, the latter appeared to be largely determined by external factors reflected in the balance of payments. At the same time the ability and willingness of the authorities to neutralize partially or wholly inflows and outflows of money through the external payments channel was restricted. Hence, rates of change in economic activity appeared largely determined by external forces.

2.3.1 Influence of External Developments

A number of reasons can be put forward to explain why the authorities have been largely prepared to let monetary policy be influenced by external factors, a situation which stands out in contrast to that in some other countries in the post-war era.

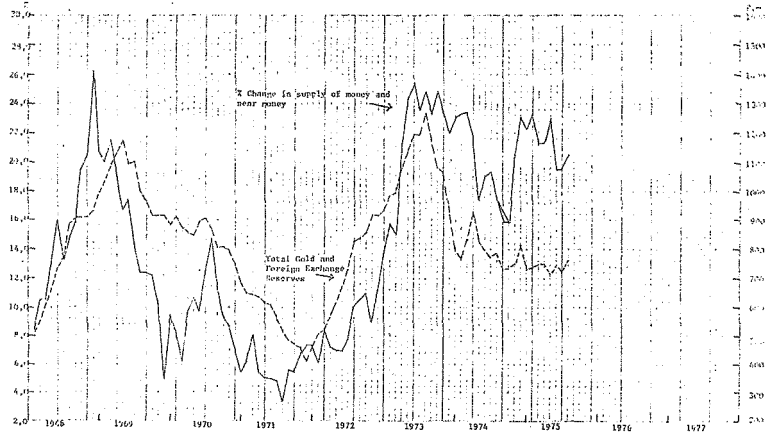


Figure 2. Relationship Between the Money Supply and Foreign Reserves

Firstly, the economy is highly 'open' with around twenty-five per cent national income accounted for by exports of goods and services in 1970. Although a relatively small economy South Africa was the sixteenth largest trading member of the I.M.F. in 1974. Also, the country is heavily dependent on foreign capital inflows.

Secondly, the authorities have taken the view that given that the balance of payments is correlated with the business cycle, maintenance of a stable rand exchange rate was feasible. This was the case provided there was willingness to make adjustments in policy designed to reinforce the stimulatory effects of payments surpluses during the slowdown phase of the business cycle, and contractionary effects of payments deficits during the expansionary phase of the cycle.[23] Hence, by letting the growth rate fall as a payments deficit develops, the decline in the former quickly affected the economy as well as the balance of payments. For instance, in 1960-61 the Bank arranged a stand-by credit facility with the I.M.F. and also arranged for the commercial banks to get foreign deposits to boost the foreign reserves. However, the shock to the economy provided by Sharpeville was so great, alongside the fall in the reserves, that the growth rate declined rapidly, and a balance of payments surplus developed; there was, therefore, no need to draw on the I.M.F. stand-by credit.[24]

This speed of adjustment of the economy to external imbalances partly explains the traditional preference of the authorities for fixed but adjustable exchange rates, and the corresponding lesser attractions of such a system for relatively closed economies relying on income adjustments to external imbalances. In the latter case, under fixed exchange rates, sizeable fluctuations in income may be necessary to correct small imbalances in the foreign payments position. It has thus been argued that small exchange rate changes can efficiently control the balance of trade of a country provided that the size of the foreign trade sector is small relative to gross national product, and conversely a floating rate is likely to be an inefficient device when dependence on foreign trade is high.[25]

Thirdly, the policy of allowing external developments to influence substantially internal monetary conditions partly stemmed from a desire to see the balance of payments act as a discipline on internal policies.[26] Given the 'open' economy the external sector is a particularly sensitive indicator of over or under-expenditure, and thus the desirability of restrictive or expansionary economic measures.

Fourthly, the authorities traditionally have not indulged in significant open market operations to counteract the influence of balance of payments surpluses or deficits on the money supply. This has partly reflected institutional limitations such as the desire to maintain a certain structure of interest rates, and partly operational problems such as the thinness of the market for government and semi-government stock. In particular significant problems have been faced on occasions when attempting to sterilize to some degree payments surpluses such as in 1968 and early 1969. In such circumstances the inflationary implications of rapidly rising foreign reserves has sometimes led to the Bank selling foreign exchange to the commercial banks for investment abroad under forward cover, i.e. with a commitment to repurchase at a specified future date at an assured rate of exchange. Measures of this nature, however, have had only limited influence reflecting the difficulties experienced in the quest to sterilize payments surpluses without altering the exchange rate.[27]

Fifthly, the policy of the Bank concerning its holdings of foreign reserves has influenced monetary policy. Alongside the desire to maintain a stable rand exchange rate, official gold and foreign exchange reserves have not usually been kept at high levels as explained shortly. Thus, the ability of the authorities to utilize foreign reserves, and partially neutralize the effects of the latter on the money supply, as an alternative to quick adjustment to a payments deficit, has been limited. Often, with the reserves falling, the authorities have, unless previously the reserves had

reached very high levels, not been keen to allow them to run down for long. Hence, to restrict reserve losses tight monetary policies have often been favoured. Likewise, once the reserves start to rise the authorities have been happy to see this continue as it usually corresponds with the slowdown phase of the business cycle, and the build up in reserves is desirable, at least up to a certain point, for laying the foundations for new economic expansion which should subsequently be accompanied by rising imports.

A higher level of foreign reserves would have enabled the Bank to be more flexible on the monetary front, but two factors have militated against this. To start with, keeping the reserves at lower levels than would otherwise have been the case, has been facilitated since, as a substantial gold-producing country, the Bank was in a unique position of being assured of a supply of gold from the mines every week at a fixed guaranteed price under the Bretton Woods arrangements. This enabled it to keep a lower level of foreign currencies. Also, although the authorities would have liked to see the reserves built up more significantly this would have involved costs in the form of economic growth sacrificed, which was considered undesirable.[28]

These factors, therefore, help explain the relatively passive monetary policy, and highlight the official policy of relying, apart from the use of import control measures, on aggregate expenditure variations in the pursuit of internal and external balance. The question therefore arises as to what degree of success could be expected in achieving such balance when the emphasis was put upon attempts to change overall expenditures.[29]

2.3.2 Policy Targets and Instruments

In this context it is interesting to relate monetary and exchange rate policies of the Republic applied during the Bretton Woods era to the theory of economic policy put forward by Tinbergen in which there are 'target variables' that policy seeks to influence, such as unemployment and inflation, and 'instrument

variables' that the authorities can directly manipulate to influence the 'target variables'.[30] If exchange rate changes are ruled out as a regular instrument, then fiscal and monetary policy might well be the only tools available to meet objectives. But if monetary policy is largely unavailable because it tends to be determined externally, then fiscal policy alone will be unable to resolve the potential conflict between a balance of payments deficit that requires domestic contraction, and a concurrent recession that requires fiscal expansion. What is more, according to the monetarists such as Friedman, there are no instrument variables available in these circumstances since fiscal policy can have no lasting influence on economic activity unless it is validated by the appropriate monetary policy. Also, there are institutional and political obstacles to the use of fiscal policy that can limit its use, and which have been present in South Africa.[31]

Locally, economic policy has been complicated further since two external policy targets have been supplemented by two internal ones. On the internal front the targets of relative price stability (particularly important for a large gold-producing country), and a satisfactory growth rate prevailed. Simultaneously, on the external front there were targets of a stable exchange rate, and the preservation of a certain structure for the gold and foreign exchange reserves.

Regarding this latter factor Figure 3 suggests that the Bank has had a target structure as measured by the ratio of foreign reserves to annual imports. Disregarding the reserves held in 1946 and 1947, which were a product of the previous war, the average for the whole period to 1971 of the percentage of annual merchandise imports covered by gold and foreign exchange reserves was thirty per cent. Also, the standard deviation of this ratio was 9,7 indicating significant variation in this ratio.

On the three occasions during this period when this figure fell below twenty per cent, the authorities took action to reverse

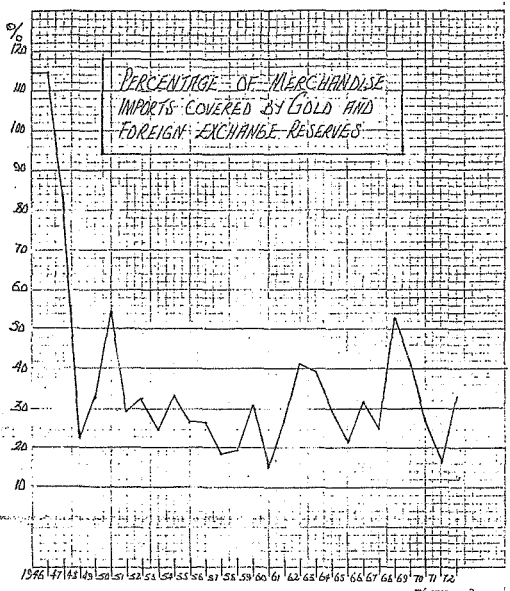


Figure 3.

Source: Adapted from R. Bank Quarterly Bulletins

tne situation. Thus, in 1958, a tightening in credit and exchange controls took place, in 1961 stringent exchange controls were introduced, and in 1971 import controls were tightened and the rand devalued. The authorities appeared to regard a roughly twenty per cent figure for imports covered by foreign reserves as a minimum point below which any further deterioration could not be allowed to proceed. At the other extreme an acceptable ratio has appeared to be around fifty-five per cent: thus, in 1969, when this figure was reached, exchange controls were relaxed on capital outflows.

This policy would appear to have been based on the fact that, given the relatively large external sector, significant changes in the foreign reserves had a marked effect on monetary and economic conditions. Also, fluctuations in the reserves influence the confidence factor in the business community.

2.3.3 Absence of Conflict Situation

This combination of policy targets and limited policy instruments reveals the danger of conflict situations arising between internal and external targets. According to the Tinbergen principle, only by a fortunate coincidence will all policy objectives be attained if the number of instruments is less than the number of goals. During the post-war period, however, the Republic has been spared the problem of a conflict situation, thus enabling, at least until 1971, exchange rate changes to remain largely dormant. Several reasons can be presented to explain this.

Firstly, often inflationary problems and excessive demand pressures tended to become more acute during the expansionary phases of the business cycle when payments deficits were incurred.[32] In these circumstances, contractionary economic policies tended to reduce pressures on economic resources, and improve the foreign reserves position.

Secondly, the attainment of satisfactory real growth did not result in above average inflation vis-a-vis the rest of the world.

Between 1960 and 1970 the average percentage change in G.N.P. deflators for industrial countries was 3,4, and for 'more developing primary producing countries' 4,8.[33] For the same period the average annual change in consumer prices in South Africa was 2,64 per cent.[34] In this respect, it might be argued that concern for relative price stability, especially critical for the gold mining industry in the days of the fixed monetary price, facilitated growth in the economy.

Thirdly, no major structural changes were experienced by the main export industries. If such changes had occurred the maintenance of a fixed exchange rate could have involved either serious inflation or stagnation of the economy in line with external payments deficits. For instance, no major change in the dollar price of gold occurred during this period.

Fourthly, balance of payments fluctuations of the country have largely reflected business cycle trends, and thus not normally required exchange rate changes. Also, movements in the capital account have often complemented current account changes. It has been alleged that developed western countries will not accept, as a normal state of affairs, an overall payments balance due to the simultaneous occurrence of an inflow of capital and a deficit on current account.[35] This is not true in the case of the Republic. Between 1946 and 1970 current surpluses were achieved in only six years. South Africa has also, on occasion, raised interest rates at a time of payments deficits and excess pressures on domestic resources as part of a contractionary policy. Simultaneously, it has boosted capital inflows which helped finance current account deficits during the interim period.[36]

Lastly, the country in the past has been prepared on a number of occasions to impose stricter import controls at times of temporary difficulties.

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2. For a description of South Africa's foreign exchange market and facilities see D.W. Goedhuys, Money And Banking: An South African Perspective. McGraw Hill, 1975, pp.128-36. Also see E.J. Lizamore, 'Foreign Exchange', Standard Bank Review, March 1974, pp.3-10.

3. A brief historical review of these controls is given by D. Lachman, 'Import Restrictions and Exchange Rates', South African Journal of Economics, Vol.42, No.1, March 1974, pp.25-8.

4. In discussing import controls a distinction should be made between import licensing or quotas which has been the principal method used and discussed here, and import controls based, for instance, on an acceptable local content programme in the motor car industry. Through the latter, it was hoped that a viable automobile industry would be stimulated by raising over time the local content programme necessary to qualify the manufacturer for import facilities.

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6. M.F.W. Hemming and W.M. Corden, 'Import Restrictions As An Instrument Of Balance Of Payments Policy', Economic Journal, 1958, p.510.

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9. Randall Hinshaw, 'Elasticity Pessimism, Absorption and Exchange Rates' in International Trade and Finance, Essays in Honour of Jan Tinbergen, edited by W. Sellerkaerts, Macmillan, 1974, pp.59-60.

10. Information received from the Bank.

11. C.F. Scheepers, 'The Effect of Import Substitution On The Volume and Structure of South Africa's Imports 1926/27-1963/64' Finance and Trade Review, December 1969.

12. Information received from the Bank.

13. Jozef Swidrowski, 'Controls and International Settlements', South African Journal of Economics, Vol.40, No.2, June 1972, pp.170-6. Also D. Lachman, op.cit., pp.34-5.

14. Information received from the Bank.

15. This conclusion is also based on the assumption of balanced trade initially. Where an initial payments deficit exists the critical value of the sum of the demand elasticities for imports and exports will be lower, the extent depending directly upon the size of the payments imbalance. For details of this see F. Machlup, International Economics, George Allen and Unwin, 1964, pp.57-8.

For derivations of the Marshall-Lerner condition and related formulas, see C.P. Kindleberger, International Economics (3rd ed.), Richard D. Irwin 1963, appendix D. The technique involves expressing the balance of payments in terms of domestic prices, foreign prices, and the exchange rate, then differentiating with respect to the exchange rate, and expressing the result in terms of elasticities.

16. These difficulties are explained by F. Machlup, op.cit., pp.51-68. The attitude of the Bank on this point is probably illustrated partially by the following assertion:-

'The uncertainty of the degree of elasticities and of their effect on the volume and price of goods exported and imported makes it quite impossible to form even an approximate idea of the extent of the depreciation that would be required to achieve equilibrium. Those responsible for the planning of monetary policy are therefore not in a position to judge whether the game would be worth the candle, among other reasons because they have no means of knowing the size of the candle. They are not in a position to compare the relative advantages and disadvantages of achieving the desired end by means of currency depreciation or by some other alternative means.' P.Einzig, The Case Against Floating Exchange, Macmillan 1970, pp.66-7.

17. Information received from the Bank.

18. In general, it seems likely that demand elasticity for exports of the Republic will be greater than import demand elasticities. This is a proposition which is generally regarded as applicable to different countries, stemming from the assertion that since export products of a single country are usually produced by several other countries as well, export price elasticities can be expected to be well above unity. See Randall Hinshaw, op.cit., pp.60-1.

It is interesting to note in this respect that in an econometric study concerning these variables in the South African context export price elasticity was computed at 2,41 and import price elasticity at 1,04. See H.S. Houthakker and S.P. Magee,

'Income and Price Elasticities in World Trade' Review of Economics and Statistics May 1969, pp.111-23.

By contrast, pessimistic conclusions regarding export and import price elasticities of South Africa have been reached by D.J.J. Botha and P.D.F. Strydom 'Recent Policy Issues In The South African Economy' Three Banks Review, December 1975, p.19.

19. Information received from the Bank.

20. This is generally accepted as true. However according to Houthakker and Magee, op.cit., their conclusions did not indicate this, showing an income elasticity of demand for imports of 1,13.

21. R.I. McKinnon, 'Optimum World Monetary Arrangements and the Dual Currency System', Banca Nazionale Del Lavaro Quarterly Review, Vol.67, December 1963, pp.82-3.

22. A.M.K.M. Spandau, 'Income Policy and Distributive Justice', Inaugural Lecture, Wits University Press, 1974, p.4.

23. It must be noted that the foreign reserves are not perfectly correlated with the business cycle.

24. Information received from the Bank.

25. R.I. McKinnon, op.cit., pp.382-3.

26. Information received from the Bank.

27. For a review of sterilization problems under fixed exchange rates see R.I. McKinnon and W.E. Oates, 'The Implications of International Economic Integration For Monetary, Fiscal and Exchange Rate Policy', Princeton Studies in International Finance, No.16, March 1966, pp.19-21.

28. Information received from the Bank.

29. For an analysis of policy options for a country relying solely upon expenditure variation policies see R.A. Mundell, 'The Appropriate Use of Monetary and Fiscal Policy for Internal and External Stability' I.M.F. Staff Papers, Vol.19, March 1962, pp.70-79.

Mundell shows that two expenditure policies, such as fiscal and monetary policy, can suffice to maintain both internal and external balance, provided only that they do not have identical effects. For any given expenditure reduction one

must improve the balance of payments more than the other. He considers the particular case where, for a given expenditure reduction, monetary and fiscal policy have an identical effect upon the balance of trade, but in addition a rise in the interest rate promotes a capital inflow and thus boosts the capital account. Hence, monetary policy has a greater effect on the external situation than fiscal policy. On this basis, given a situation in a country of external deficit and internal balance, a rise in the interest rate combined with a reduction in the budget surplus is required, so that total expenditure remains the same accompanied by an improvement in the capital account.

30. I. Tinbergen, On The Theory of Economic Policy, Amsterdam, North Holland Co. 1952.

31. J.A. Lombard (ed.) Economic Policy in South Africa, Citadel Press, pp.5-9.

32. Gerhard de Kock, op.cit., p.6.

33. I.M.F. Annual Report, Washington 1974, p.5.

34. Figure derived from Reserve Bank Quarterly Bulletins.

35. A. Lamfalussy, 'Limitations of Monetary and Fiscal Policy' in Maintaining and Restoring Balance in International Payments, Princeton Univ. Press, 1966, pp.157-8.

36. In the face of current account deficits, which suggest a currency is overvalued, the ability to attract capital inflows by raising interest rates is much reduced.

CHAPTER THREE - REVIEW OF EXCHANGE RATE POLICY (AUGUST 1971 - DECEMBER 1973)

This chapter is primarily a historical review and an economic analysis is presented in later chapters.

On August 15th 1971 the U.S. announced that it was no longer prepared to convert official dollars into gold or other reserve assets. In response, most major industrial countries floated their currencies.

From 1967 onwards South Africa had been affected by devalopments in the exchange markets. However, the par value of the rand was not altered, because the payments position, at least until the end of 1970, was sound, the economy was expanding satisfactorily, and skilled labour and capital were scarce. By the start of 1971 the weighted average value of the rand in terms of other currencies was about five per cent higher than its level before the 1967 sterling devaluation.[1]

3.1 Temporary Link with the Dollar

The events of August 1971 forced the authorities to act, because it was clear that the exchange rate between the U.S. dollar and sterling would not remain intact. It was expected that in the new floating regime the dollar would depreciate. Consequently, in an official statement issued on August 23rd it was announced that the rand exchange rate against the dollar would be retained at the existing par value, and would thus depreciate with the dollar against other major currencies.

3.1.1 Factors Influencing the Move

This decision was taken against the background of a large fall in the foreign reserves of the Bank from around R1,175m at the end of April 1969 to around R500m in the middle of August 1971, and a slowdown in the business cycle which had started in December 1970. On the negative side it had inflationary implications, but the major significance of the step was that exchange rate policy was influenced not only by the state of the current account.

Thus, it partly reflected the implications for the gold mining industry and gold sales of staying linked to sterling, and appreciating against the dollar and other currencies.[2] In the latter circumstances, the benefits of rising gold premium receipts on the market would have been reduced. Also, although the free market price rose during the first seven months of 1971 from around $38 to $42 an ounce, despite the fact that South Africa marketed its full production through this channel, the Bank remained uncertain about prospects for the price of gold. The developments on August 15th 1971 were followed by a declaration that the U.S. was working towards gold demonetization.[3] The ability of the country to sell its full gold production would have been complicated if a significant price weakness had developed, its sales policy being influenced by the desire to see a steady rise in the market price. By linking with the dollar and allowing the rand to depreciate, this helped the gold market psychologically by suggesting that the balance of payments could improve and so reduce the need to sell.

3.2 Problem of Realignment of Exchange Rates

The Republic supported the European stand for a number of reasons. Firstly, an official increase in the price of gold had been sought for years. Even a modest increase of around eight to ten per cent would destroy the idea of an immutable $35 price, and could make it politically easier in future for a major official gold price increase to materialise, and dollar convertibility to be restored. The Bank, however, recognized the hostility of the U.S. to such a move.[4] Thus, for those opposing restoration of gold convertibility and the Bretton Woods system any price increase was undesirable.[5] Even a small gold revaluation, relative to the dollar, might also threaten the two-tier gold pricing system, because confidence in the dollar could be shaken and so encourage a move into gold, and a rise in the free market price.[6]

Secondly, South Africa accepted the European thesis that gold, together with SDRs and Fund reserve positions, should retain their

value in terms of the revalued currencies.[7] This partly reflected the desire not to [illegible]redit the SDR as a reserve asset, while many central banks did [illegible]h writing down the domestic currency value of their foreign a[illegible], because capital losses might have raised legal and political difficulties. For South Africa, with its large gold reserves, valued at R34lm at the end of August 1971, a devaluation of the dollar in terms of gold meant an increased dollar purchasing power of such reserves with an unchanged value in terms of other currencies. Alternatively, if the gold parity of the dollar remained unchanged and other currencies were revalued, the dollar purchasing power of its gold holdings would have remained unchanged, but would have fallen in terms of other currencies. The importance of the purchasing power benefits of a dollar devaluation were, however, reduced, given the suspension of official dollar convertibility into gold.

The argument in favour of retaining the value of SDRs was criticized in some quarters. This was based on the grounds that the difference in the value of the asset as between the alternatives of devaluing the dollar in terms of gold or relying exclusively upon revaluation of other currencies was not significant, since the maximum change in the gold price suggested was around eight per cent.[8] Nevertheless, at such an infant stage careful nurturing of the SDR may have been desirable. From the viewpoint of the Republic, however, such nurturing, to the extent that it consolidated the position of the SDR enhanced the danger of it supplanting, and not merely, supplementing, gold in the system.

Thirdly, South Africa regarded a solution involving only revaluations by countries with strong payments positions was equivalent to one in which 'only the innocent are punished', thus reducing monetary discipline and encouraging more expansive future policies by countries running payments surpluses.[9] Also, it could be argued that avoiding a devaluation against gold could have damaged the long term role of the dollar as a reserve asset more than if a devaluation

took place. It could have encouraged even more 'benign neglect' policies in the U.S. and further worsened inflation. The fact that, if the South African argument was correct, prices of other countries would have increased more markedly as well would not necessarily have invalidated this conclusion. This is because relative price stability of a reserve asset is important.

Fourthly, a modest increase in the official price would boost the proportion of world monetary reserves held in gold. This would have reversed, at least temporarily, the declining trend of this ratio (at the end of 1960 gold constituted sixty-three per cent of total reserves, but by the end of 1970 it was only forty per cent). Again this was unimportant while the dollar remained officially inconvertible into gold.

Lastly, South Africa favoured a dollar devaluation because it could help speed up the process of reaching a collective agreement on a new set of exchange rates.[10]

There were three reasons why a speedy solution was desired. Firstly, the linking of the rand to the dollar in August 1971 complicated economic management since it led to serious adverse leads and lags movements in foreign transactions. The decision to link with the dollar encouraged speculation against the rand since it indicated that the authorities were prepared to accept a devaluation. At the same time, to have stayed linked to sterling [illegible] appreciate against the dollar, given the prolonged decline in [illegible]ign reserves, and the overall appreciation of the rand which had [illegible] since 1967, suggests that equal or worse speculation would have materialised. The Bank likewise believed that deflationary measures would have been inappropriate in view of the slowdown in the economy.

Secondly, the authorities feared that if the wrangle persisted world trade would suffer and protectionism emerge, which would be particularly bad for smaller countries heavily dependent on foreign trade.[11] Similar fears were expressed in other quarters about increasing trade restrictions arising out of any festering of the

dispute.[12] The U.S. decision to impose a temporary ten per cent surcharge on manufactured imports was regarded as a bad precedent. It involved violations of G.A.T.T., as well as complicating the negotiation of new exchange rates by distorting the floating of the major currencies.

These two factors, together with the lack of guarantees that an agreed currency realignment would be reached in the short term, prompted the authorities to tighten import controls in November 1971 in an effort to improve the balance of payments.

Thirdly, the authorities wanted a quick return to fixed exchange rates since this would partially reinstate the Bretton Woods system, whereas any prolonged wrangle might lead to the acceptance of floating as a mechanism worthy of retention.[13]

3.3 The Rand Devaluation of December 1971

A major effort was made to reinstate the par value system under the Smithsonian Agreement of December 18th 1971. In terms of this the U.S. dollar was devalued by 7,89 per cent, and the currencies of other countries including Belgium, West Germany, Japan, and the Netherlands were revalued to varying extents. South Africa effected the first readjustment to the par value of the rand since 1949, devaluing the currency by 12,28 per cent, and the official gold price was simultaneously increased to R28,5 from R25 per ounce.

3.3.1 Motivation

The rationale behind the devaluation was provided in a statement issued by the Minister of Finance.[14] The government had particularly borne in mind the substantial balance of payments deficits which had reigned since 1969, and the emergence of unused capacity in certain industries associated with the slowdown in the business cycle. The uncertainty prevailing after August 1971 had also produced adverse leads and lags movements.

The Minister listed the expected advantages as follows. In due course, the balance of payments should improve on both current and capital accounts by eliminating leads and lags, stimulating exports,

curbing imports and encouraging capital inflows. Secondly, it would promote economic growth, and stimulate gold mining. Thirdly, export industries such as agriculture and mining, whose export prices are determined in foreign currencies, would benefit because of the higher price in terms of rands. Fourthly, local industries would be better placed to compete with foreign suppliers both at home and abroad. Finally, investment in industry would be encouraged, leading to the creation of new employment.

Following the link to the dollar in August 1971 many people expected the rand to be devalued by 7,89 per cent in order to maintain the existing rand/dollar exchange rate. The Bank believed that a typical 'conflict' situation had arisen where devaluation was the appropriate policy measure to deal with a fundamental disequilibrium in the balance of payments. Conversely, in view of the downturn in the economy, and the danger of increasing non-white unemployment, further restrictive policies were regarded as inappropriate.[15] The decision to devalue by more than the dollar was undertaken because serious problems on capital account occurred in the last few months of 1971, and the extra devaluation was expected to ensure that the new rate would be viable.[16] The authorities claimed that the main objectives of the devaluation were an improvement in the capital account and stabilisation of the economy; an improvement in the current account of the balance of payments was not a major consideration.

3.3.2 Criticisms

Nevertheless, to devalue at all was not welcomed in all quarters, since doubts were expressed about the 'required' price elasticity of demand for the imports and exports of the Republic being fulfilled.[17] In contrast, the authorities tend to be cautious 'elasticity optomists' in the medium to longer term.[18]

Concerning the build up in leads and lags it was argued that to link with the dollar in August 1971 invited such a development which might have been avoided if the link with sterling had been

retained, and measures instituted to instil confidence in the preservation of the parity of the rand.[19] In view of the economic slowdown, however, and the serious balance of payments deterioration from a surplus of R106m, in the first quarter of 1969 to a deficit of R156m, in the fourth quarter of 1971, it is debatable whether this would have proved successful. The growth in the volume of imports had started to decline during 1971, while the growth in exports had begun rising, a situation alleged to be inpropitious for a devaluation.[20] Yet merchandise exports only rose by six per cent that year after falling in the previous two years, recovering only to the level of 1968.

The claim that economic growth would be stimulated was disputed on the grounds that a sound economy does not need a devaluation to foster growth. Consequently, the unsound local economy, reflecting low labour productivity, would only derive short term benefits from devaluation, unless the labour problem was tackled effectively.[21] Spare labour resources were limited, since unemployment among Whites, Coloureds and Asians only increased from 7 541 in December 1970 to 9 120 a year later.

These criticisms highlight the crucial issue of whether a fundamental payments disequilibrium existed as claimed by the Bank. In retrospect, this did not appear to exist. Not only did the gold price rise strongly following the devaluation, but the world economy picked up with beneficial effects upon merchandise exports, which rose by forty-two per cent in 1972. A new upswing in growth was likely to follow such developments even in the absence of devaluation. Nevertheless, at the time the authorities had to do something, if only because the foreign reserves had reached very low levels taking the reserves/imports ratio as a yardstick. (This is illustrated in Figure 3, chapter 2).

The authorities admit that in view of the subsequent gold price rise and the acceleration in world economic activity in 1972, a more moderate devaluation would have been appropriate. However, since

they were unaware of these coming events, they decided to act decisively and play safe.[22]

The greatest danger was the inflationary repercussions threatened at a time when the inflation rate was already high, with the December 1971 consumer price index seven per cent higher than in December 1970. This danger was exacerbated by the fourteen per cent rise in the seasonally adjusted money supply which eventuated in 1972 compared with a seven per cent rise in 1971. The four per cent price benefit conferred on the gold mines through the devaluation was eroded, consumer prices rising by 7,3 per cent in the year ending December 1972.

An additional factor, however, influenced the devaluation decision. At the time uncertainty reigned concerning the short term sustainability of the gold price, which exceeded $42 an ounce at the end of 1971. The authorities had no definite view on future price trends, but the strengthening of the price was an object of gold sales policy. They hoped this would put pressure on the international community to further adjust the official price, while boosting foreign earnings. This objective, it was anticipated, would be helped by the strengthening of the balance of payments following devaluation; in other words, the latter would enhance flexibility in conducting orderly gold sales.[23]

3.4 Developments Following Devaluation

During the first half of 1972 the balance of payments improved considerably. Devaluation helped to induce a favourable turnaround in leads and lags, and encourage a net inflow of private sector capital. During the last quarter of 1971 an outflow of R3m of the latter type capital occurred, whereas in the first and second quarters of 1972 the respective inflows were R98m. and R171m. These inflows, however, were also promoted by other factors such as the rising price of gold.

3.4.1 Improvement in Current Account

There was a dramatic improvement in the current account, a deficit of R188m in the fourth quarter of 1971 being turned into a surplus of R90m in the third quarter of 1972. It is often argued

that, normally, following a devaluation the current account in the short term should be expected to deteriorate. Given a low short term elasticity of demand for the exports of a country, plus initial bottlenecks in supply, devaluation can cause a short term reduction in foreign currency earnings greater than the reduction in foreign currency expenditures on imports.[24] The fact that the opposite happened in the case of the Republic in 1972 can be ascribed to numerous factors. Most foreign trade is transacted in foreign currencies so that the initial effect of devaluation on foreign currency receipts should be minimal. Gold receipts were rising because of the strength of the bullion market and reached R317m. in the third quarter of 1972 compared with R251m. in the last quarter of 1971. Agricultural exports also expanded following good local crop yields. Most remarkable was the fall in the value of imports compared with 1971. This implied a sizeable drop in volume, since imported wholesale prices rose by 14,6 per cent in the year ending December 1972 (see Figure 4). This fall partly reflected the tightening of import controls in November 1971, which began to be relaxed from July 1972 onwards, and the economic slowdown. Much more uncertain was the contribution of devaluation itself, concerning which scepticism was expressed.[25] Any positive influence must have been very limited in view of the time span, but the authorities believed that during the second half of 1972 devaluation boosted exports and discouraged imports in volume terms.[26] The analysis later on, however, casts doubts on this conclusion.

3.5 Link With Sterling Maintained Temporarily

Following the floating of sterling on June 23rd it was expected that the currency would depreciate in the markets. South Africa had to decide whether to maintain a fixed rate with the pound, and thus depreciate, or whether to maintain its exchange rates with non sterling currencies, and appreciate against sterling. On June 30th it was decided that for the time being, the link with sterling would be kept.

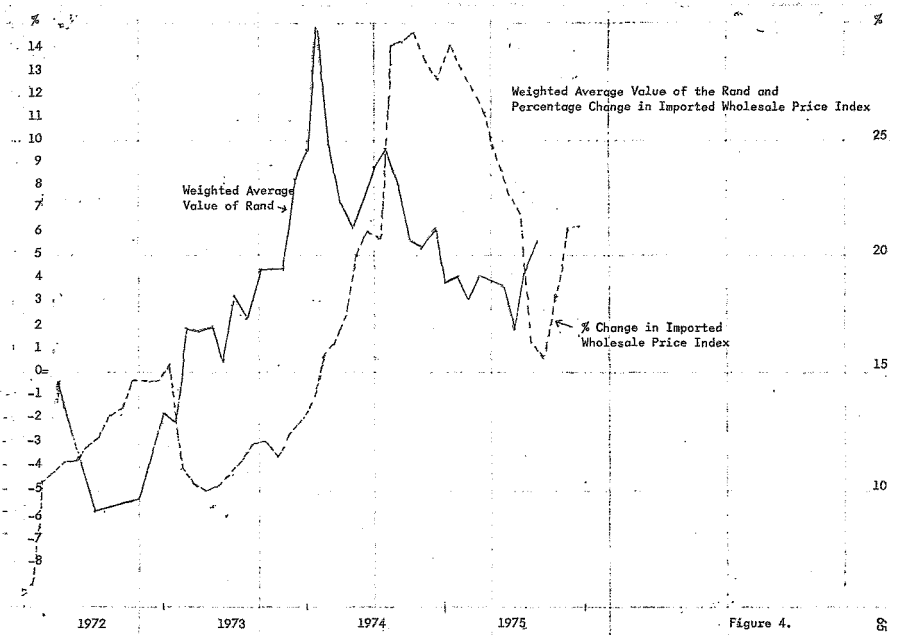

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Weighted Average Value of the Rand and Percentage Change in Imported Wholesale Price Index
Weighted Average Value of Rand
% Change in Imported Wholesale Price Index
1972
1973
1974
1975

Figure 4.

In June 1972 only South Africa, among countries of any significance, chose to link with sterling. At the same time as the pound floated similar exchange control regulations were placed by the U.K. upon overseas sterling area countries including South Africa as upon non-sterling area countries. For practical purposes the sterling area as a formal group ended in June 1972.

3.5.1 Motivation

The reasons for this decision by the authorities were given as follows.[27] Firstly, the improvement in the foreign reserves had not attained a satisfactory level. Obviously, in this respect the authorities wanted to see the reserves rise further since the economy had still not embarked on expansion which would cause imports to rise. Secondly, exports should be promoted particularly in view of the entry of the U.K. into the E.E.C. Thirdly, a stable relationship between the rand and the pound had value for business organisations, as Britain was still the largest single trading partner. This, however, should not be regarded as a particularly important consideration, since the problem can, and has been reduced by changes in trading practices regarding the use of dollars instead of sterling as the unit of account in foreign contracts. Fourthly, if the link with sterling had not been maintained, the danger arose that leads and lags could build up again adversely affecting the foreign reserves. Finally, it was important that nothing should be done which could hinder an upswing in the economy.

Since the authorities, however, expected sterling to depreciate only moderately and fluctuate within relatively narrow limits it can be questioned whether the implications for economic growth of alternatively linking with the dollar would have been significant. Nevertheless, the psychological impact on the business community at a time of still slack economic activity, and the danger of adverse leads and lags developing would have potentially complicated economic management. The authorities were not satisfied with the devaluation result by June 1972, and thought a rand appreciation could not be risked so quickly after the December 1971 devaluation.[28] The short

term nature of the move was indicated by the statement of intent in August 1972 to re-establish an effective par value as soon as possible.[29]

As a result of the move the gold mining industry obtained a marginal windfall. Again this was threatened with partial erosion because of the boost to inflation provided so soon after the previous devaluation. On the other hand since the authorities expected sterling to fall only moderately this disadvantage was potentially not significant.

The move complemented the official desire to maintain flexibility on the gold sales front. This facilitated the maintenance of prices above $60 an ounce prevailing by June 1972, which ideally required continuation of a surplus on the balance of payments. Any sudden deterioration in the balance of payments caused, for instance, by adverse leads and lags would have required greater sales of gold on the market if only because of the stipulations of the I.M.F. gold sales agreement. If the latter had transpired this would have weakened the gold price, particularly since May 1972 the price rise had largely been caused by Bank retentions together with speculative buying of gold. Any such fall would have left the Bank open to accusations of disrupting the market first by withholding gold, and then quickly reverting to fuller sales again.

The pressures on the gold sales front to stay with sterling would not have been so strong, therefore, if the authorities had not started withholding gold from the market in May 1972. Although they were confident enough about balance of payments prospects to moderate gold sales at that time they did not feel sufficiently confident about the payments position to unlink from sterling in June. The authorities were still uncertain about the prospects for the gold price although admitting in retrospect that in view of the subsequent price behaviour, the decision to link with sterling in June 1972 was unnecessary.[30]

By the middle of 1972 the widening gap between the official price of $38 an ounce and the free market price was making countries

reluctant to utilize not only their gold, but also their SDRs and Fund positions, which were all denominated in terms of gold. Also, it was placing strains on the two-tier system under which central banks were not supposed to sell gold on the private market. Uruguay, for instance, was reported as having sold $40m. at the official price from its reserves on the market in 1972.[31] In these circumstances, South Africa was hoping that the widening premium would force a solution favourable to gold.[32]

3.6 South Africa Links With the Dollar

Floating with sterling lasted until October 25th 1972 when a link to the dollar was effected. A new effective par value was established, which amounted to a devaluation of the rand in terms of gold of 4,2 per cent. As exchange rates for the rand against other currencies floating against sterling depreciated by about eight per cent from the end of June to October 25th 1972, the decision represented an appreciation of roughly four per cent in the rand exchange rate against these currencies. In trade weighted terms it meant an appreciation of roughly three per cent.[33]

3.6.1 Motivation

Between December 1971 and October 1972 the external value of the rand depreciated by roughly fifteen per cent. This was viewed as having contributed not only to the improved payments position on both current and capital account, but also as helping to reverse the slowdown in the economy, albeit at the price of fostering inflation.[34] By late 1972, however, it was thought the depreciation should be reversed somewhat partly as an anti-inflationary move. In contrast, by remaining tied to sterling its weakness threatened to boost inflation.[35] Maintaining the status quo, moreover, would have encouraged leads and lags in favour of the rand, and so increased internal liquidity.

The inflationary dangers of remaining anchored to sterling were not inevitable in the fact of further sterling weakness since they could have been counteracted by upward adjustments in the par value of the rand. The authorities, however, were not prepared to adopt

an even more flexible attitude towards exchange rate management. The claim that the depreciation of the rand since December 1971 had *started positively* to affect the current account of the balance of payments was suspect given the short time lag, and the fact that the depreciation had only occurred progressively over time. Moreover, with the decision to revalue, the positive influence of the previous depreciation was bound to be reduced. This, however, again reflected the policy of using the exchange rate for broader purposes than merely trying to influence the current account. Previously, the growth objective had influenced exchange rate policy, but for the next eighteen months or so economic stability became a more important consideration.

There were, in addition, other significant implications. Firstly, by establishing a new par value for the rand, it was intended to reaffirm the commitment of the country to fixed but adjustable exchange rates. Secondly, linking with the dollar reflected the fact that staying with sterling in June 1972 had created a bad impression among certain overseas banking circles, puzzlement prevailing over the rand remaining linked to a weak currency.[36] In this respect, however, the choices facing the authorities were limited either to sterling or to the dollar, both of which were weak currencies. Thirdly, imposition of the investment dollar premium to South African portfolio investments in June 1972 by the U.K. implied a weakening of the traditional investment links with the latter.[37]

The decision to unlink came at a time when the U.K. made a new provisional agreement concerning arrangements to guarantee official working balances held by at least sixteen countries.[38] South Africa was not included in these arrangements, which was a reflection of the dwindling ties with sterling.[39] This meant that holdings of sterling by the Bank were exposed to the danger of depreciation insofar as the weakness of sterling persisted, and could have provided a motive for switching to the dollar. In reality this played no part in

the decision since holdings of sterling consisted largely of working balances only. Most of the reserves were held in dollars because of the weakness of the pound and the importance of dollar transactions.[40]

3.6.2 Criticisms

In some quarters this extra devaluation was considered unnecessary and a dollar parity of around $1,30 would have been preferred, rather than $1,28 chosen by the authorities, so that the weighted average value of the rand in terms of all foreign currencies would have remained unchanged vis-a-vis the position on June 22nd.[41] Others would have preferred to return to the pre-float official rate of $1,33, so incorporating a marginal overall appreciation of the rand relative to the position on June 22nd.

These policy suggestions were influenced by perceived anti-inflationary benefits. This is doubtful. Since the rand had been floating down for four months, price adjustments reflecting this would already have been filtering through to the domestic economy. In view of the 'ratchet effect' in foreign trade any subsequent appreciation of the rand would have been unlikely to reverse the price trend stemming from the previous devaluation. In any case such a policy would have been risky from the viewpoint of adversely affecting the capital account of the balance of payments.

3.7 South Africa Revalues

On February 12th 1973 the U.S. dollar was devalued another ten per cent against gold. Simultaneously, sterling floated down by roughly six per cent, while the Japanese yen began to float, and appreciated in the markets. South Africa decided to maintain the par value of the rand, and as a result of this and other currency changes its trade weighted value rose by approximately six per cent.

Given the importance of securing a significant improvement in the balance of payments since the middle of 1971, and avoiding any marked deterioration so early after an economic upturn, which began in October 1972, the authorities may have devalued the rand against gold so as to roughly leave unchanged its trade weighted value against

other currencies. On the other hand, when in October 1972 the rand was devalued officially by 4,2 per cent, this meant an effective revaluation of roughly three per cent based on market rates ruling at the time. Leaving unchanged the gold parity of the rand was therefore a continuation of the trend which started in October 1972 and was aimed at exerting an anti-inflationary influence. Wholesale prices of imported items rose by an average of twelve per cent in 1972 compared with 4,6 per cent in 1971, while the consumer price index in December 1972 was 7,3 per cent higher than a year ago. Simultaneously, the recovery of the economy and the balance of payments was felt to be sufficient to withstand a small revaluation.

Nevertheless, the decision involved a risk since, with the increase in economic growth, a deterioration in the external position in any case was to be expected at the latest by early 1974. Meanwhile the position of sterling looked precarious, and a further decline would have been harmful for exporting sectors such as the fruit industry in view of the U.K. entry into the E.E.C. Moreover, because of the limited rand revaluation, the anti-inflationary repercussions would be minimal.

Subsequent events, however, vindicated the decision. In particular, the renewed upswing in the gold price to above $80 an ounce more than wiped out the ten per cent cut in rand receipts implied by revaluing against the dollar.

3.8 Repercussions of Dollar Float

Within roughly two weeks of the dollar devaluation, further massive speculation against the currency materialised. The outcome was that the E.E.C. countries, with the exception of the U.K., Ireland and Italy, decided to float jointly against the U.S. dollar. Britain, Italy, Japan, Switzerland and Canada all decided to float independently against all other currencies. The par value system was once again put into suspension, this time indefinitely.

3.8.1 Reaction of the Republic

In the midst of these events, the Republic decided to adhere to its fixed par value in terms of gold and to stay linked to the

dollar at $1,42. In a statement the Minister of Finance argued that neither a revaluation or devaluation was justified, but pointed out that should the E.E.C. currencies appreciate against the U.S. dollar by more than was expected, South Africa would have to reassess its position.[42]

At the time there was talk about the possibility of South Africa abandoning the link with the dollar, and linking to a European currency. Thus, the Minister said that 'should the new E.E.C. monetary arrangements become more permanently entrenched and be extended to all members, it may be desirable at some later stage to associate the rand more closely with the E.E.C. bloc'.[43] Later the Minister claimed that the authorities would have considered this if there had been a European currency to peg to which was a gold-based currency.[44]

The problem was that the rand could only be linked to either the dollar or sterling. The D-mark, which might have been regarded as suitable for linking to was not practicable. The Bank could not buy or sell D-marks in large quantities since a sophisticated capital market in Frankfurt does not exist, and the German authorities have not been keen to see their currency widely used as a reserve currency. Al o, the amount of foreign trade denominated in D-marks is very limited.

What is more, linking to the D-mark in March 1973 would have created problems since by linking to a strong currency - far stronger than the rand - this would have required frequent par value adjustments by the Bank. This would have fuelled speculation against the rand, especially since by the second half of 1973 the foreign reserves were falling steadily.

Following the collapse of the Bretton Woods system in March 1973 the Republic faced adjustment costs in adapting itself to the changed system. For traders the increased fluctuations in exchange rates and their effect on prices had to be contended with. For the Bank there were the increased complications in holding foreign

exchange under floating conditions. Sterling and especially dollars continued to be the dominant holdings and other foreign exchange such as D-marks have been kept small for working balance purposes only. Most exchange holdings of the Bank are short term deposits of less than one year, but with the advent of floating rates gains and losses have been incurred. However, the Bank has not resorted to investing foreign exchange in the Eurodollar market, influenced by the I.M.F.'s disapproval of such practices.[45]

3.9 Revaluation of the Rand in June 1973

In the face of currency uncertainties, a depreciating dollar, and a soaring gold price the authorities revalued the rand by five per cent against the dollar on June 5th 1973. The motivation for the adjustment was provided in an official statement:-

> Should South Africa continue to maintain its existing buying and selling rates for the U.S. dollar, this will mean an average effective depreciation of the rand of between two and three per cent since the middle of March.
>
> Such a depreciation of the rand in present day circumstances is not considered desirable. The balance of payments of the country is still very favourable, and the gold and foreign assets held by the Bank increased from the 16th March by approximately a further R100m. and have now reached the satisfactory level of about R1,200m. The total official reserves approximate today R1,350m. which represents a record level. In this respect it is of particular significance that the price of gold on the private market has risen from about $82 per fine ounce towards the middle of March 1973 to about $120 per fine ounce at present, that is about forty-six per cent.
>
> From the point of view of the balance of payments, a depreciation of the rand is neither necessary nor welcome. From the point of view of containing inflation such a depreciation would also have an undesirable effect. 46

The June revaluation thus carried further the revaluation cycle. Before October 1972 exchange rate policy had been geared to improving the balance of payments and promoting growth. Thereafter it was switched to rand appreciation to try to moderate inflationary pressures.

3.9.1 Method of Revaluing

One interesting aspect was the method used in revaluing the rand. While the rand parity of the dollar was changed from $1,42 to $1,49 to the rand, the gold parity was kept unchanged at R29,75 per ounce. This reflected the fact that at a time when the free market price was roughly three times the official gold price gold parities had lost their significance; in other words, South Africa was displaying that the official gold price was meaningless. It did not signify any alteration in the preference of the country for a fixed exchange rate based on gold par values. Simultaneously, the move made it marginally easier for the Bank to retain gold production rather than sell it all when the market price was substantially higher than the official price. This arose because the mines would get the same price for gold sold to the Reserve Bank, i.e. R29,75 per ounce, instead of a price five per cent lower if the par value of the rand in terms of gold had been correspondingly cut.

Subsequent events again showed the risky environment in which South Africa conducted its exchange rate management. In the latter half of 1973 the dollar appreciated markedly in the face of the oil crisis which prompted the authorities in retrospect to regret having revalued by as much as five per cent in June 1973.[47]

3.10 The Oil Crisis and Repercusions on the Rand

The dollar began recovering in August 1973, but in the wake of the oil crisis in October 1973 the dollar rose markedly, sterling weakened sharply, and the gold price remained relatively stable at slightly below $100 per ounce, having fallen from $127 in June 1973. By December 1973 this combination of circumstances, superimposed on the declining gold and foreign exchange reserves which began in August 1973, had precipitated a substantial build up in leads and lags amid rumours of an impending devaluation. This situation was further complicated by a deterioration of the capital account in the second half of 1973 because of repayments of foreign loans by the central government and the private sector, the increased foreign

exchange risks associated with foreign borrowings in a world of floating rates, and the switching of the financing of foreign trade from overseas to domestic sources owing to the lower level of local interest rates.

The behaviour of the capital account at that stage of the South African business cycle was unusual and disappointing; during the second half of 1973 there was a net outflow on capital account of R226m.

3.10.1 Role of Monetary and Exchange Rate Policy

The role of monetary policy in this situation contrasted with exchange rate policy. Since October 1972, the revaluation of the rand process had been designed to moderate expansion in the economy. Conversely, where monetary policy was concerned while the authorities kept local interest rates higher than overseas rates in general during 1972, thus stimulating capital inflows and strengthening the balance of payments, in 1973 the opposite materialised. An expansionary monetary policy was employed as shown by the falling trend in interest rates as shown in Figure 5, along with fiscal expansion in the March budget. The question arises whether inconsistent policy objectives were being pursued, since some of the benefits of revaluation were counteracted by this monetary expansion. It can be argued that benefits on the inflation front brought about by revaluation were being eroded by monetary trends.

Expansionary monetary policies, particularly in 1973, allegedly thwarted somewhat the aims of devaluation.[48] By 1973, however, the authorities were no longer interested in obtaining devaluation benefits, which meant that the payments position was likely to deteriorate. As Figure 5 shows, the interest rate differential between domestic and overseas rates no longer remained tenable under the pressure of falling foreign reserves. This, together with the high inflation, which reached ten per cent in December 1973, and the strong economic growth prompted a tightening of monetary policy in January 1974, bank rate rising from 5,5 per cent to 6,5 per cent.

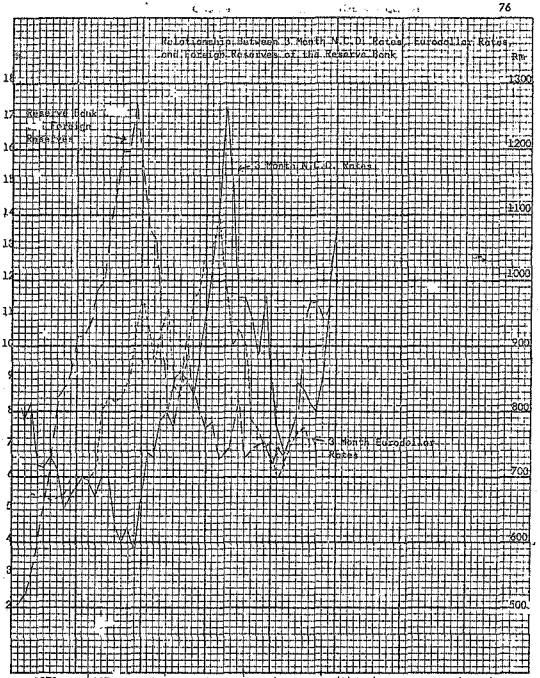

Relationship Between 3 Month N.I.C.O. Rates, Eurodollar Rates and Foreign Reserves of the Reserve Bank
Rm
Reserve Bank Foreign Reserves
3 Month N.I.C.O. Rates
3 Month Eurodollar Rates
1300
1200
1100
1000
900
800
700
600
500
1972
1973
1974
1975

Figure 5.

Together with the renewed upswing in the gold price to above $100 an ounce, this eradicated leads and lags as devaluation fears receded. Given the excess demand pressures reflected in growing tightness in labour and capital markets and an emerging current account deficit, devaluation could have been very inflationary. However, if the bullion price had not risen sharply in 1974, the chances of resisting a downward rand adjustment would have been debatable, given leads and lags superimposed on the declining external reserves, which started in August 1973. Late 1973 was the first time since the second half of 1971 that serious adverse speculation occurred. On both occasions the remedy was elimination of exchange rate fears. In the face of a weak economy and low reserves a devaluation was resorted to in 1971, while on the later occasion, with a strong economy and higher foreign reserves, this was shunned.

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CHAPTER FOUR - MANAGED FLOATING OF THE RAND

Despite the support of the country for fixed but adjustable exchange rates, a radical change took place on June 24th 1974 when a policy of independent managed floating was introduced.

4.1 Motivation for Introduction of Floating

This policy of managed floating was introduced against a background of fundamental changes in the balance of payments structure of economies in the non-communist world following the oil crisis. This, together with serious world inflation, was inducing considerable fluctuations in exchange rates. Particularly, since the latter part of 1973, wide changes in the weighted average value of the rand materialised as the dollar rose strongly, and then fell sharply. Thus, between June 5th 1973 and January 25th 1974, the rand appreciated on average in terms of other currencies by 8,4 per cent during a period when the gold and foreign exchange reserves of the Bank declined by more than R400m. Then, between the latter date and March 29th 1974, when the reserves rose by around R150m, the rand suffered an effective depreciation of roughly 5,4 per cent.[1]

Since these changes bore virtually no relationship to the external position it was felt that in future, considering the expected currency instability, a policy involving making smaller but more frequent adjustments to the rand/dollar rate would be preferable. It would mean that the value of the rand in terms of other currencies could be kept more in line with the payments position, and domestic economic conditions.

This was the main reason for introducing the new policy, but there were a number of subsidiary factors. Firstly, in certain quarters it was argued that a more flexible exchange rate policy would help to de-politicize exchange rate changes by making the latter possible without the cumbersome administrative procedure previously employed which involved Cabinet approval.[2] In reality, in this respect, the move was designed to bluff people into thinking that, by making more frequent rate changes, the currency was independent

of the dollar. Many people, it is claimed, do not understand why the rand is tied to the dollar, and interpret it as signifying lack of independence in the exchange rate field.

Secondly, the move was aimed at deterring leads and lags building up on exchange rate change expectations. Previously, this had complicated economic policy by affecting economic conditions transmitted through foreign reserve changes. To alleviate this it was anticipated that the new policy would attempt to baffle people about rate changes.[3] However, although insignificant rate adjustments could surprise the market, it was difficult to see how changes influenced by fundamental economic forces could do likewise.

Thirdly, the Bank expected, at the time the float was introduced, that the dollar would rise, since the U.S. economy was less badly affected by oil price increases compared with other major western economies. If the rand had stayed tied to the dollar under the previous arrangements, it could have appreciated adding unwelcome pressures on the external front.[4]

During the year ending June 1975 the balance of payments was characterized by a current account deficit of R1 507m, counterbalanced by a large net capital inflow so that the foreign reserves were little changed. From this angle external pressures were not excessive, but any significant appreciation would have been unwelcome. On the other hand, since the upper turning point of the business cycle only occurred in the third quarter of 1974, appreciation of the rand would not have been unsuitable internally, at least during the second half of 1974.

Fourthly, a more flexible policy, by taking fuller account of the external position and hopefully deterring adverse leads and lags, would provide greater gold sales flexibility. For instance, when the policy was introduced the market price was weakening, having fallen to roughly $150 an ounce from $180 in April 1974. The desirability of avoiding unwilling selling of gold was therefore present.

Arguably the change also reflected the low level of the gold and foreign exchange reserves. The minimum acceptable reserves/imports ratio during the postwar period had appeared to be around twenty per cent, but fifteen per cent was approached at times during 1974 if the gold stocks were valued at the official price of $42 an ounce. The Bank, however, denied that this influenced the introduction of managed floating of the rand.[5]

In addition, the move could have indicated a reduced emphasis on import controls as a balance of payments instrument, but this was anticipated for reasons divorced from exchange rate policy.[6]

4.2 Principles of Operation of Managed Float

The question of how the policy would be operated was explained as follows:-

> It is envisaged that the rate will only be adjusted when necessary in the light of foreign or domestic developments and not necessarily every day, every week or at regular intervals of any kind. Under the new policy, the monetary authorities will not necessarily peg the rand to any weighted average of all other currencies. In other words, there will be no firm commitment, even in the short term, to avoid any effective appreciation or depreciation of the rand in terms of all other currencies. Under South African conditions any such commitment might expose the Bank to undue exchange speculation by dealers in foreign exchange and create other practical difficulties. More important it cannot be assumed a priori that in a world of floating currencies a constant average external value of the rand will be in the economic interests of the country.
>
> Nevertheless, in adjusting the rand-dollar rate from time to time the monetary authorities will be guided to some extent by movements in the effective exchange rate of the rand. Other factors to be taken into account are changes in the exchange rates of individual currencies of special importance to the Rand Monetary Area, the Bank's own foreign exchange dealings, actual and prospective balance of payments tendencies and the domestic financial and economic situation. 7

4.2.1 Rate Changes Effected

In bringing the policy into operation in June 1974, the Bank appreciated the rand against the dollar by ,67 per cent based on

a new middle rate of $1,50 to the rand, with the spread between buying and selling rates remaining at 0,5 per cent.

It was widely assumed that movements in the rand would be made to keep its average value more stable than previously, when it was successively dragged up and down along with the dollar. However, during the second half of 1974 this did not materialise (see Figure 6).

The expectation of more frequent and smaller exchange rate adjustments was quickly fulfilled. In mid-August a two per cent devaluation of the rand against the dollar was announced, bringing the middle rate to $1,47, in response to the strengthening of the U.S. currency. On August 19th, prompted by further strength in the dollar the central rate was lowered another 1,4 per cent to $1,45 bringing the overall devaluation against the dollar in the first three weeks of August to 3,4 per cent. On September 5th 1974 a further devaluation of 2,1 per cent was effected in the face of the strength of the dollar. Quickly it became clear therefore that adjustments would be made whenever deemed desirable.

Within a few days on September 10th a 0,7 per cent revaluation was announced with a middle rate of $1,43, which was interpreted in some quarters as a surprise move, in view of the strength of the dollar, designed to confuse speculators.[8] Subsequently, five further upward adjustments were made against the dollar starting in November 1974, the last being a ,68 per cent revaluation on February 25th 1975. All were made in the face of the weakness of the dollar, and had the effect of keeping more stable than previously the effective value of the rand (see Figure 6). These latter changes were designed to avoid speculation in favour of the rand building up significantly, but their sizes were limited ensuring that they had no meaningful anti-inflationary impact. The authorities were probably restrained by the low foreign reserves and, beginning around August 1974, a new downward phase of the business cycle.

Beginning in March 1975 the dollar began to recover, and on April 4th the rand was devalued by 1,4 per cent. Thereafter, the

rate remained unchanged until June 27th when the policy was officially abandoned.

In all, eleven adjustments were made, seven upwards and four down, with the middle rate for the dollar ranging from $1,42 to $1,50, as shown in the table:

TABLE 2 - RAND CHANGES AGAINST THE DOLLAR (June 1974 - April 1975)

June 21st 1974	Revalued by	,67% to $1,50 Equals R1.
August 14th 1974	Devalued by	2,0 % to $1,47 Equals R1.
August 19th 1974	Devalued by	1,4 % to $1,45 Equals R1.
September 5th 1974	Devalued by	2,1 % to $1,42 Equals R1.
September 10th 1974	Revalued by	0,7 % to $1,43 Equals R1.
November 11th 1974	Revalued by	0,7 % to $1,44 Equals R1.
November 18th 1974	Revalued by	0,7 % to $1,45 Equals R1.
January 24th 1975	Revalued by	1,4 % to $1,47 Equals R1.
February 21st 1975	Revalued by	0,68% to $1,48 Equals R1.
February 25th 1975	Revalued by	0,68% to $1,49 Equals R1.
April 4th 1975	Devalued by	1,4 % to $1,47 Equals R1.

Figure 6 shows that movements in the rate against the dollar constituted three cycles. Firstly, a cycle of depreciation against the dollar as the latter strengthened, then one of appreciation as the U.S. unit declined, and finally another depreciation cycle in the face of the strength of the dollar. At the same time, although the trade weighted value of the rand fell marginally during the float, from late 1974 onwards it was not allowed to deviate much. Thus, once the effective rate changed by more than a percentage point or two, an adjustment tended to be made to bring it back into line.

4.3 Appraisal of Policy

This policy had a number of negative results. Firstly, its handling soon allowed market operators to perceive the criteria being used to determine the timing, direction and extent of rand adjustments against the dollar. With the passage of time, the predictability of changes become more obvious, and speculation more serious.

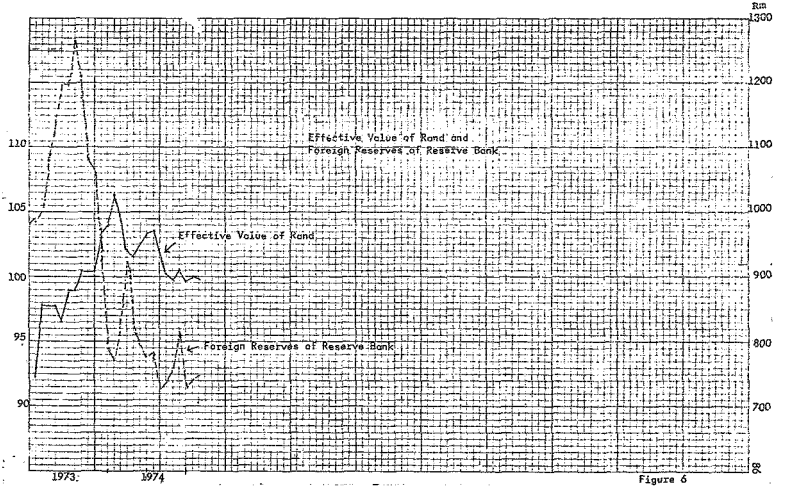

Rm
1300
1200
1100
1000
900
800
700
Effective Value of Rand and
Foreign Reserves of Reserve Bank
110
105
100
95
90
Effective Value of Rand
Foreign Reserves of Reserve Bank
1973
1974

Figure 6

Destabilizing leads and lags, which it was hoped would be discouraged, were encouraged. This stemmed from the increasing predictability of the policy which simultaneously promoted exchange rate consciousness among the business community. Far from reducing public interest in rate changes as they become more frequent awareness of possible adjustments increased.

To what extent foreign exchange dealers were responsible for such speculation is impossible to gauge. Banks are required to provide monthly statements on their investments in foreign currencies, and if necessary the authorities could ask for weekly returns, although as far as can be ascertained this did not occur. Obviously, dealers would have adjusted their short term positions, and particularly the larger banks, given the volume of their foreign exchange business. It is highly unlikely that banks encouraged clients to speculate, but they are responsible for protecting the interests of their clients and they would advise them, for instance, whether to take forward cover depending upon prevailing conditions.

Secondly, leads and lags complicated management of the foreign reserves. In theory, this increased exchange rate flexibility should have reduced the need for such reserves. In practice, the opposite occurred as speculation surrounding the rand intensified foreign exchange traffic in a certain direction and then was unwinded; the resulting pressures had to be borne by the gold and foreign exchange reserves.

Thirdly, the policy which finally materialised of maintaining the trade weighted value of the rand relatively constant was inconsistent with the philosophy behind exchange rate policy since 1971.[9] This incorporated allowing the trade weighted value to be correlated with the gross gold and foreign exchange reserves and the business cycle in an effort to influence internal economic conditions. Under the managed float, policy became dominated by the need to try and counteract leads and lags, and avoid disruptions on the capital account.

Between June 1974 and June 1975 the foreign reserves of the Bank remained stable between R700m. and R800m. Nevertheless, under the float the ability to conduct an effective macroeconomic policy via the exchange rate was undermined. If a sizeable adjustment in the value of the rand had become desirable, achieving it by a series of small changes would have stimulated speculation, and possibly inhibited changing the rate at all. Alternatively, in such circumstances, the managed float could have been abandoned, at least, temporarily.

The question arises why the Bank allowed itself to be 'cornered' as a result of its predictable exchange rate changes, given that when the float was introduced the Bank recognized the dangers of pursuing such a policy.[10] As noted above, the major reason stemmed from the belief that it had to be enacted to prevent build ups in leads and lags: in other words the latter problem would otherwise have been worse.

Another reason may have been that the Bank felt committed to effect changes in the rand rate because otherwise the impression may have gained ground that the policy was lapsing. Thus, if only to avoid inaction, when the dollar moved meaningfully in one direction, the authorities felt obliged to respond. In addition, keeping the weighted value of the rand relatively unchanged, which became discernible towards the end of 1974, occurred at a time when the foreign reserves were stable around R700-R750m.

It would be unwise to assume that a cause and effect relationship existed here. Looking at the net foreign reserve position, instead of the published foreign reserves of the Bank, a different picture emerges (see Table 3). The net foreign reserves incorporate both the holding of the Bank plus those of private sector banking institutions, and are derived by subtracting short term foreign liabilities of the monetary banking sector from total foreign reserve holdings of the sector. As Table 3 shows there was a serious deterioration in the net foreign reserves since around the middle of 1973.

TABLE 3 ~ DISTINCTION BETWEEN OFFICIAL GROSS AND NET FOREIGN RESERVES (Rm)

	(1) Short Term Foreign Liabilities of the Monetary Banking Sector*	(2) Total Official Gold and Foreign Exchange Reserves	(3) Total Net Foreign Reserves (2-1)
1st Quarter 1970	170	1 044	874
2nd Quarter 1970	194	1 033	839
3rd Quarter 1970	190	906	716
4th Quarter 1970	188	807	619
1st Quarter 1971	202	742	540
2nd Quarter 1971	211	691	480
3rd Quarter 1971	194	603	409
4th Quarter 1971	283	651	368
1st Quarter 1972	291	707	416
2nd Quarter 1972	241	863	622
3rd Quarter 1972	229	1 003	774
4th Quarter 1972	256	1 088	832
1st Quarter 1973	240	1 241	1 001
2nd Quarter 1973	235	1 341	1 106
3rd Quarter 1973	273	1 245	972
4th Quarter 1973	247	976	729
1st Quarter 1974	292	1 068	776
2nd Quarter 1974	299	929	630
3rd Quarter 1974	341	872	531
4th Quarter 1974	386	909	523
1st Quarter 1975	370	904	534
2nd Quarter 1975	646	927	281
3rd Quarter 1975	900	1 070	170
4th Quarter 1975	1 039	1 100	61
1st Quarter 1976	1 352	1 346	-6

*Includes Reserve Bank + private sector banking institutions.

Source: Adapted from Reserve Bank Quarterly Bulletin figures.

4.4 Factors Complicating Operation of Policy

Two difficulties in particular complicated matters.

4.4.1 Forward Exchange Policy

Difficultie encountered were compounded by changes in forward exchange cover granted. In August 1974 the Bank increased the cost of forward dollar cover for imports from one per cent to two per cent, the cost of dollar cover for exports remaining at one per cent per annum. Simultaneously, the Bank laid down that traders must take out forward cover within seven days of the contract being signed. This was an awkward measure which discouraged importers from utilizing cover facilities and which together with the cost increase acted as a disincentive for importers to finance their imports overseas. Also, in August 1974 dollar import cover for more than six months was increased from one per cent to six per cent per annum since such facilities were in strong demand owing to harbour congestion in 1974 and early 1975.[11] Thereafter, the cost of forward cover for dollar contracts of six months or less was increased to three per cent per annum in September 1974.

Late in 1974 and early 1975 these measures, plus the weakness of the dollar and the strength of the gold price (late 1974), meant that many importers decided it was cheaper to carry the exchange risks themselves and less use was made of forward facilities. This was the opposite of what the authorities wanted, namely to encourage traders regularly to take out forward cover, and so reduce currency speculation. Not surprisingly, these measures reacted adversely on the Bank from March 1975 onwards. With the dollar strengthening and sterling weakening, the rand looked suspect and this encouraged importers to cover their commitments by borrowing from commercial banks, which resulted in pressure on the foreign reserves.

Against this background, early in 1975, the rate was cut back to one per cent with the aim of encouraging importers to finance abroad, and enter into forward contracts which establish specific payments periods, and thus reduce leads and lags due to speculation by importers.

Official policy during this period involved two unfortunate aspects. Managed floating encouraged leads and lags influences. Fostering the more extensive use of forward facilities would have eased this problem, but the measures adopted only complicated matters in this respect.

4.4.2 Problem of Leads and Lags

The managed floating was superimposed on an environment conducive to leads and lags. The local economy with its open nature, a tendency for current account deficits to be matched by capital inflows, and a fluctuating gold price provides conditions which can lead to serious adverse leads and lags movements which can significantly affect the foreign reserves. Given this situation, maintaining a slightly undervalued exchange rate could have mitigated this problem, as well as complementing economic growth objectives. However, during periods of dollar strength and/or sterling weakness this would have been difficult to engineer. Also, economic conditions would not always be conducive to maintaining a marginally undervalued rate, which in any case could not stimulate the economy much.

Unfortunately, monetary policies exacerbated this capital account problem. During the 1974-75 year ending in June there was an increase of R885m. in the net claims of the banking sector on the government, of which more than R600m. on a seasonally adjusted basis was recorded during the first half of 1975. This aggravated leads and lags in three ways. It contributed directly to an increase in the money and near money supply. Secondly, it provided banking institutions with excess liquid assets, thereby making it easier to expand domestic credit to the private sector in substitution of foreign trade credits. Thirdly, it assisted in depressing interest rates to levels in some cases lower than comparable rates overseas.[12]

Yet, at the same time, one objective of monetary policy was to keep rates up in an effort to stimulate capital inflows and overcome the leads and lags problem.[13] In other words, the latter problem

was encouraging restrictive policies at a time when the economy was slowing down. Moreover, speculation against the rand produced more volatile liquidity conditions in the economy, as well as necessitating the Bank to adjust its foreign exchange investments with a greater emphasis upon liquid assets yielding lower interest rate returns.

Moreover, on the gold front problems emerged. As previously suggested the managed float might have been expected to improve the flexibility of the authorities in conducting gold sales operations. In practice, beneficial effects in this regard were not apparent. For instance, any strengthening of the dollar encouraged the build-up of leads and lags and caused the foreign reserves to suffer (although mitigated by short term foreign loans by the Bank). This increased the pressures to sell gold on the market at a time when the price may already have weakened due to the strengthening of the U.S. unit. There are in fact grounds for suspecting that this sequence of events may have contributed to the weakness of the gold price early in April 1975. What is more, during May and June 1975, the strength of the dollar, particularly vis-a-vis sterling, adversely affected leads and lags, and increased pressures for gold sales at a time when the free market price was weak partly because of a second gold auction by the U.S. and when the need to sell bullion was enhanced by the fall in demand for Krugerrands.[14]

4.5 Reasons for Abandoning Policy

Simultaneously with the 4,7 per cent downward adjustment of the rand against the dollar on June 27th 1975 it was announced that the managed float had been abandoned. Strictly speaking, the policy was only adhered to until the adjustment on April 4th 1975, after which the rand rate was held constant until the more significant adjustment in June.

There were two major reasons why the policy was abandoned. The first reason was the hope that through reducing speculative pressures management of the foreign reserves and gold sales flexibility would be improved. Secondly, it was felt that capital inflows were

deterred, since exchange rate consciousness among the business community increased which discouraged private borrowings overseas on fears of exchange rate changes.

Overall movements in foreign capital inflows do not indicate such deterrents, since the capital account changed from an adverse balance of R150m. in 1973/74 to a surplus of R1 499m. in 1974/75. The source of the leads and lags problem, however, can be gleaned from the private short term capital flows, including errors and unrecorded transactions. In the third quarter of 1974 this item recorded a surplus of R33m, followed by net inflows of R342m. and R201m. in the following two quarters. By contrast, during the second quarter of 1975 expectations of rand adjustments led to an outflow of R66m. In other words, leads and lags seemingly only became a major problem during this latter period as importers speeded up payments, exporters delayed repatriating foreign receipts, and other private inflows were discouraged.

Towards the middle of 1974 the exchange control authorities announced that they would consider favourably private sector applications to borrow abroad for a period of not less than six months, provided the funds financed expansion of production capacity. In August 1974 it was announced that exemption from non-resident tax on interest would be considered in the case of foreign loans for deserving projects. Such incentives were of little benefit at times during the float because of the lack of forward cover on rand/dollar loans, unless the latter financed trade deals. In contrast, this deficiency did not apply to the public sector.

4.6 Lessons to be Learned

From the viewpoint of the Republic, experience showed that where frequent small rate changes were made this would only increase speculation if they became predictable. Paradoxically, linking the rand to a weak currency (i.e. sterling) would in some respects have been more conducive to success of the float. The progressive depreciation of sterling since March 1975 would have necessitated

small upward rand adjustments, which would have deterred adverse leads and lags since exporters would have speeded up transfers of money to South Africa, and importers would have delayed making payments. The maintenance of a slightly undervalued rand would have been possible, thereby potentially providing greater external stability. On the other hand, the political disadvantages of linking to the pound in the sense of the Republic linking its fortunes to that of a country facing serious economic and political difficulties as well as the exclusion of any meaningful stability in the rate for the rand against the dollar and the currencies linked to it, weighed against such a policy.[15] Also, inducing favourable leads and lags can create internal monetary stability problems.

4.6.1 More Frequent Adjustments

The question arises whether other modifications in the float could have made it more successful. In this connection it is worth considering the idea that changes in the rand rate against the dollar should have made the float more akin to a modified crawling peg operation.[16]

Given smaller and more frequent rand adjustments on say a weekly basis or even a daily basis, this could have meant that each rate change was economically insignificant; in addition they could have become less predictable since, on occasions, adjustments could have been made for the sake of making a change even when no economic factors required this, or effected so as to be the reverse of market expectations.

The purpose would have been to tackle more effectively leads and lags. However, whether success could have been achieved is open to question for a number of reasons. Firstly, economic circumstances could arise which require a significant change in the exchange rate of the rand and encourage leads and lags unless the authorities act quickly to adjust the rate. Secondly, a pattern may have emerged which showed that the average value of the rand was being kept roughly constant or correlated with the gold and foreign

exchange reserves. In such circumstances, people taking a view on the dollar and/or the foreign reserves position, would not have been deterred from acting because each change in the rate was insignificant and unpredictable. The incentive may have been encouraged by the likelihood that speculation, if sufficiently strong, would have induced an appropriate adjustment of the rate. In particular, given the position after March 1975 regarding the dollar and sterling, such a system might have aggravated leads and lags. Making smaller and sometimes unpredictable rate changes would not have discouraged traders from taking action in view of the established trends of these currencies.

Moreover, irrespective of its influence in deterring leads and lags, such a system would have meant that stability in the exchange rate of the rand against the dollar bloc currencies would disappear. Making adjustments in the rand/dollar rate on a daily or weekly basis would have arguably constituted a more 'market orientated' exchange rate policy. The validity of this is dubious given the institutional arrangements governing South African exchange rates. Movements in the rand/dollar rate would still have been dependent upon arbitrary, albeit more frequent, changes in the 'peg', while changes in the rand/non-dollar rates would still have been dependent on the rand/dollar rate together with the operation of market forces influencing the floating dollar against other currencies.

It would, however, be unwise to conclude that such a policy would always be unsuitable. The value of undertaking frequent adjustments of the rand/dollar rate may be greater where periodic devaluations or revaluations were persistently being nullified by strength or weakness of the dollar. In other words, suppose the secular trend for the rand was downwards, and periodic devaluations against the dollar materialised say every three or six months. If the dollar simultaneously continued to strengthen, the benefits of the periodic cuts in the value of the rand against non-dollar currencies (assumed to be floating) would be quickly eroded. This would only be corrected

when the next devaluation occurred to be followed by a repeat of the cycle. In such circumstances, exporters may be better served by more frequent but smaller rate changes.

4.6.2 Linking to a Currency Basket

The previous observations suggest the inadvisability of linking the rand to a basket of currencies or the SDR unit which is based on a basket of sixteen major currencies. For South Africa to link the par value of the rand to the SDR at a specified rate, and then alter the rate of the rand on a daily or weekly basis in accordance with changes in the value of the dollar in terms of the SDR unit, would involve automaticity which could at times encourage leads and lags. On the other hand, this problem could be mitigated to the extent that traders expected only gradual movements in the value of the rand against the dollar.

In addition, this procedure would conflict with the desire to see the overall value of the rand rise or fall at certain times, although it would mean that the rand would not automatically float up or down with the dollar.[17] Also, by expressing the par value of the rand in terms of the SDR, it could be interpreted as acceptance of the SDR as numeraire of the international monetary system. The preference of the Republic is for a system with par values expressed in terms of gold.

4.6.3 Rand Float Simulation

Another version of the managed float could have been a simulated rand float under which the rate would have been manipulated to try and reflect developments if the rand was floating.

Technically, it would have been feasible to simulate a rand float only against the pegging currency (the dollar). To simulate other rates would lead to inconsistent cross exchange rates for the rand, and exchange arbitrage would develop at the expense of the Bank, the rates for these currencies quoted by the latter differing from those in the market. The simulation could have been based on weekly movements in the net foreign reserves of the banking sector, although

it would have been an imperfect simulation since the foreign reserves reflect not only dollar but also other currency transactions.

The economic desirability of such arrangements for the rand are contentious, but could have appealed to those favouring a floating rate system.[18] However, it would have offered no solution to speculation, since traders, by monitoring the reserves, would at times have been given a clear indication of potential rand/dollar trends. To alleviate this problem the authorities could have manipulated the foreign reserves, thus discarding a genuine simulated float.

More likely, any simulation would have reflected broader economic and political factors, and not just foreign reserve movements in order to make it less prone to speculation. The system, however, would still have been distinct from the managed float. Rates could have been adjusted in anticipation of dollar rate changes, and not because of actual movements, while being more frequent and surprising, possibly causing some speculators to lose money, and stay out of the market. Also, there would have been no adherence to a specific average external value for the rand.

References

1. 'Statement Regarding Exchange Rate Policy.' South African Reserve Bank Quarterly Bulletin, September 1974, p.15.

2. International Currency Review, July-August 1974, pp.101-2.

3. International Currency Review, September-October 1974, p.110.

4. Information received from the Bank.

5. Ibid.

6. Ibid.

7. 'Statement Regarding Exchange Rate Policy.' op.cit., p.15.

8. International Currency Review, September-October 1974, p.110.

9. This policy is explained in chapter 6.

10. 'Statement Regarding Exchange Rate Policy.' op.cit., p.15.

11. Information received from the Bank.

12. Address by the Governor, South African Reserve Bank Annual General Meeting, 26th September 1975.

13. Information received [illegible] Bank.

14. Overseas sales of K [illegible] fell from 601 000 coins in March 1975 to 180 000 [illegible] 1975. Monthly sales recovered only marginally during the rest of the year.

15. According to the address of the Governor at the Annual General Meeting of the Reserve Bank on August 26th 1975 the U.S. dollar then had a weight of more than twenty-five per cent in the trade and other transactions of the country with the rest of the world.

16. The managed rand float had connections with the crawling peg. Under this the obligation of monetary authorities to keep market exchange rates within a narrow margin of the parity rate is retained, but the latter rate can be adjusted at frequent intervals, after recalculation by reference to a moving average of market rates or foreign exchange reserves over some specified previous period.

    Both systems incorporate the principle of small but frequent changes in parities, but their mechanical operations differ

in two respects. Firstly, no agreed laid down adjustment rules applied to the managed float. For example, there were no limitations on the size of parity changes, whereas under the crawling peg changes in parities are subject to 'gliding speed limits'. Secondly, under the local policy there was no band on either side of the rand/dollar parity whereas, under the crawling peg, obligations are retained on monetary authorities to keep market exchange rates within a narrow margin of the parity rates.

Both aim to deter speculative movements, as well as depoliticize exchange rate changes. Also, both are designed to provide monetary and fiscal policies with greater independence from foreign monetary conditions. In other words, they incorporate more emphasis upon exchange rate adjustment for correcting external imbalances compared with the Bretton Woods system.

However, under the managed float changes in parity were on occasions undertaken to keep the weighted average value of the rand unchanged, whereas under the crawling peg changes would involve small devaluations or revaluations in circumstances where otherwise payments imbalances may develop further. The managed float was designed to cope with an environment incorporating both elements of fixed and floating exchange rates. In contrast, the crawling peg operates where the basic features of the fixed exchange rate system are retained.

17. Assuming the par value of the rand in terms of the SDR remained unchanged.

18. The economic implications of floating the rand are discussed in the introductory chapters, as well as in Chapter 13.

CHAPTER FIVE - EXCHANGE RATE POLICY, JUNE 1975 - SEPTEMBER 1975

Here a historical review of policy is undertaken, which covers the period from June to September 1975. A more extensive economic analysis is provided in the following two chapters.

5.1 Devaluation of Rand in June 1975

In June 1975 the country abandoned the managed float policy, and declared that in future the exchange rate parity with the dollar would be kept constant for longer periods, and only adjusted if considered essential in the event of any basic change in domestic or international circumstances.[1] In other words, the policy in operation since the end of 1971 until June 1974 was reinstated.

5.1.1 Motivation

The 4,7 per cent devaluation against the dollar in June 1975 immediately restored the rand/dollar rate to that which existed before the Smithsonian Agreement in December 1971, and the size of the adjustment indicated that the authorities were keen to see the new rate maintained at least for a few months, barring any dramatic developments on the gold front or on the foreign exchange markets. Judging by the statement issued by the Minister of Finance, the authorities anticipated that the rand would appreciate somewhat in value in the short term.[2] In other words, the rand was deliberately undervalued in the short term because of expectations that this advantage would be eroded, which was subsequently proved correct. In the meantime the move, it was hoped, would ensure that unfavourable leads and lags, which had built up prior to the abandonment of the managed floating, would be reversed. Together with the hoped for improvement in capital inflows, this would have benefited the foreign reserves and internal liquidity. This rate adjustment, although it improved marginally the competitive position of local industry vis-a-vis foreign competition, was dominated by the objective of improving the capital account of the balance of payments.

The move fitted in with the policy pursued since 1972 which incorporated the linking of the average external value of the rand with movements in the gold and foreign exchange reserves. Since then there had been a positive but lagged correlation between movements in the foreign reserves and the weighted average value of the rand. During 1975 the reserves showed signs of possibly bottoming out, but no signs of increasing significantly amidst a business cycle slowdown, and in such circumstances the authorities were probably keen to avoid any significant rand appreciation.

This latter factor partly explains the difficulties experienced immediately after June 1975 in trying to effect a smooth transition from managed floating to a system of less frequent but larger exchange rate adjustments. Given the continued strengthening of the dollar in July many people, noting the basic policy pursued since the breakdown of the Bretton Woods system explained above, suspected that the new policy involved a downgrading of the previous managed float, and that therefore a further downward adjustment of the rand vis-a-vis the dollar was to be expected. The resulting re-appearance of leads and lags was only overcome by raising interest rates, as well as relaxing exchange control regulations.[3] This had a useful 'demonstration effect' in showing that a rise of a percentage point or two in the weighted average value of the rand was not sufficient by itself to induce a rand adjustment.

5.2 September 1975 Devaluation

On September 21st the rand was devalued by 17,9 per cent against the dollar. In view of the strength of the latter, the sharp fall in the gold price, and the danger of a serious re-emergence of adverse leads and lags developing at the time, a downward adjustment was highly likely if not inevitable. What was somewhat surprising was the size of the downward move for which a number of factors could be ascribed as being responsible.

5.2.1 Motivation

The size of the devaluation roughly restored the position of the gold mines to that which existed prior to the gold price decline

at the beginning of September when the price was above $160 an ounce, and thus relieved, in the short term, the problems faced by marginal mines. What is more, the current account deficit had remained sizeable even though the slowdown phase of the business cycle had been in progress since roughly mid 1974.[4] Naturally, an improvement in the external position was anticipated by the move, which alongside the deterring of adverse leads and lags should have strengthened the position of the authorities in conducting gold sales at a time when the bullion markets had been disrupted by the proposed I.M.F. gold sales.

Associated with the latter factor was the probable desire to engineer a marginally undervalued rand. This had in particular useful effects in discouraging speculation against the rand and stimulating capital inflows. In fact, the desire to reverse outflows of funds and thus improve the capital account, and especially to reduce leads and lags problems, was a major motivation behind the devaluation move.[5] According to the devaluation statement issued by the Minister of Finance, the August 1975 measures had already yielded positive results relating to leads and lags influences, and therefore puzzlement existed as to why concern over leads and lags should have played a role in the devaluation decision.[6] The great danger was, however, that in the absence of a decisive devaluation leads and lags influences would have built up again on a scale which the Bank could not have coped with, while simultaneously draining liquidity out of the economy.

Apart from the need to discourage leads and lags the encouragement of capital inflows was important. This arose out of the need to finance substantial capital projects under way such as Sasol 2, and it was argued that the type of foreign capital available at that time was particularly influenced by balance of payments trends. Foreign funds allegedly were not being provided on a significant scale in the form of risk capital, but instead mainly by way of banking funds such as eurodollar finance where security of investment channels was of major importance.[7] In contrast, other parties

claimed that foreign investment is primarily a function of interest rate differentials or yield prospects, and is not encouraged by currency devaluation.[8] In recent years, however, the Republic has become increasingly dependent upon eurodollar and eurobond finance where loans are denominated in foreign currencies.[9] The balance of payments position of a country plays a key role in determining the degree of accessibility of such funds. Also, there is a trend in the Republic for the demand for eurocurrency finance to dry up in the private sector at times of fears of a possible rand devaluation due to the lack of forward cover facilities.

What is certain is that the more pessimistic outlook for a world economic recovery in the short term influenced the authorities in deciding on a big adjustment in the interests of internal growth stimulation.[10] The authorities believed a typical 'conflict' situation had arisen in more pronounced form than in 1971 when the previous sizeable devaluation materialised.[11]

Simultaneously, the move was designed to boost the tax revenue of the government, help reduce its reliance on bank credit to finance government expenditures, and aid monetary and budgetary stability.

In addition, it would appear as though the size of the devaluation was influenced by the view of the authorities that the dollar could strengthen and sterling weaken. In this respect it seemed that in August 1975, at least, not much appreciation of the dollar was expected.[12] A change of mind would appear to have materialised since later the Minister of Finance claimed that the devaluation 'took account of the possibility of a strengthening of the dollar.[13]

5.2.2 An Alternative Strategy

In some quarters this substantial devaluation was criticised on the grounds that such a currency adjustment should be carried out only in circumstances where the economy has undergone fundamental change which requires structural modification, and that the authorities were using the exchange rate as an instrument of economic policy to an undue extent.[14]

A key issue in this argument relates to the fall in the gold price. If this decline was regarded as only temporary, the case for resisting such a devaluation was persuasive, and vice versa if the fall was regarded as more than a short term phenomenon. In the devaluation statement issued by the Minister of Finance he stated that 'in the short term the value of our net gold output is unlikely to come up to earlier expectations'. However, later the Minister said

> the bearish reaction to the I.M.F. Agreement has been largely due to an inadequate appreciation of the true meaning and significance which has given gold a more important and meaningful monetary role than it has held for some time. 15

The latter statement might be interpreted as indicating that in official circles some recovery in the gold price was expected before long. Even if this interpretation was correct, however, one still has to consider, in viewing the merits or otherwise of devaluing, the magnitude of the short term difficulties if no devaluation had occurred. For instance, it was alleged that at $140 an ounce (pre-devaluation), roughly twenty-seven per cent of milled tonnage in the gold mining industry would have been uneconomic involving a labour force of around 200 000, and creating a strong burden on the state assistance scheme for marginal mines.[16] Later, moreover, it became clear that the authorities had anticipated that the prospects for the gold price at the time of devaluation were rather poor.[17]

It has been claimed that except for the cumulative effects during and after a great war, structural changes by themselves are not of major significance as causes of balance of payments difficulties.[18] Since the exports of South Africa are concentrated with heavy reliance on gold the economy can be regarded as particularly vulnerable to structural factors which affect the balance of payments since the gold price can now fluctuate markedly. Certainly, vulnerability of the economy to structural change emanating in the gold sector was less marked in the Bretton Woods era when there was a guaranteed fixed price of gold.

That the economy, at the time of devaluation, had undergone a fundamental change which involved a loss of international competitiveness might, moreover, be argued by reference to monetary and fiscal developments during the 1973-75 period. During the entire post-war period the economy has been characterised by a strong, although somewhat lagged, positive correlation between the rate of growth of the money supply and foreign reserves on the one hand, and the business cycle on the other. Any sustained rise in the foreign reserves has boosted the rate of increase in the money supply, which in turn provided the base for an upward phase of the business cycle. Conversely, any protracted fall in the foreign reserves has been accompanied by a lower rate of increase in the money supply, and less vigorous expansion of the economy. However, recently this consistent pattern was broken. After mid-1973, when the foreign reserves began to fall, followed by the slowdown in the economy initiated around the middle of 1974, this was not accompanied by retardation in the rate of increase of the money supply until 1975.[19] This unusual phenomenon was responsible for the lack of any moderation in the inflation rate of the Republic at a time when inflationary pressures which emanated from rising import prices had started to fall since the beginning of 1975. These developments therefore raised the question whether some sizeable devaluation of the rand was inevitable.

A number of factors can explain this monetary phenomenon. Firstly, the budgets in 1974 and 1975 were characterised by big increases in government expenditure. The latter budget, in particular, was based in part on what in retrospect proved unwarranted, namely the maintenance of historically high free market gold prices.[20] These fiscal developments forced the government to turn more to bank credit to finance its expenditure, as indicated in the following table:-

TABLE 4 - BANK CREDIT EXTENDED TO GOVERNMENT

Net Increase in Bank Claims on Government		Percentage of G.D.P.
1971	R318m.	2,3
1972	R 90m.	0,6
1973	R120m.	0,6
1974	R433m.	1,9
1975	R797m.	3,1

Source: Adapted from Reserve Bank Quarterly Bulletins.

Secondly, the continued high rate of increase of the money supply may have reflected changes in external conditions which confronted the authorities following the breakdown of the Bretton Woods system. Local exchange rate policy had come to incorporate the use of the rate as an instrument of economic policy, whereas before it was a reference point to which internal economic policies had to be disciplined. Official policy may therefore have incorporated a willingness to pursue expansionary policies on the basis that any resulting inflationary pressures and payments difficulties could partially be 'taken on the exchange rate'.

However, if the economic structural change argument was regarded as untenable, and the currency adjustment inadvisable, what alternative strategy could have been pursued? The most likely measures would have been a tightening of import controls and additional restrictive monetary policies. This policy option will now be discussed.

5.2.3 Import Controls

Additional import controls should have improved the balance of payments and would have been more easily reversible at a future stage than devaluation. This is because the authorities in the short term would have been reluctant to revalue the rand unless there had been, for instance, a considerable rise in the gold price. Such a move would have cast doubts on the propriety of devaluation, possibly invited suspicions that a managed rand float was going to be re-introduced, and intensified exchange rate consciousness among the business community.

On the other hand, apart from the economic disadvantages of import controls, it is unclear whether they would have produced significant short term benefits, because the third round of import permits had already been granted. They might also have been criticised overseas as unco-operative in view of the danger of trade controls spreading.

5.2.4 Monetary Policy

As regards the tightening of monetary policy this might have been supported on the grounds that considerable liquidity existed in the economy. For example, since August 1974 there had been a marked change in the excess liquid assets position of commercial banks from a position of -0,3 per cent to +6,9 per cent in July 1975. Since a sizeable proportion of government spending had in previous months been financed via bank credit, a tightening of banking liquidity could have reduced the degree of government spending financed by bank credit. This would have curbed inflation, economic activity and imports, as well as encouraged capital inflows to the extent that local interest rates rose.

It must, however, be remembered that the devaluation was accompanied by some tightening of liquid asset requirements, and in the absence of any significant currency adjustment the severity of deflationary measures required to constitute an effective policy would appear to have been unacceptable to the authorities.[21] Particularly in view of the failure of the gold price to recover meaningfully, it must be questioned whether such measures would have been accepted as sufficient by the foreign exchange market If not, serious pressures on the modest foreign reserves of the Reserve Bank, which stood at R794m. at the end of August 1975, would have built up.

Mention of the leads and lags brings us back to the circumstances surrounding the September devaluation. The excessive expenditure of the government, financed to a large extent via bank credit, meant that the commercial banks built up a considerable excess of liquid assets in the third quarter of 1975 as shown in Figure 7.

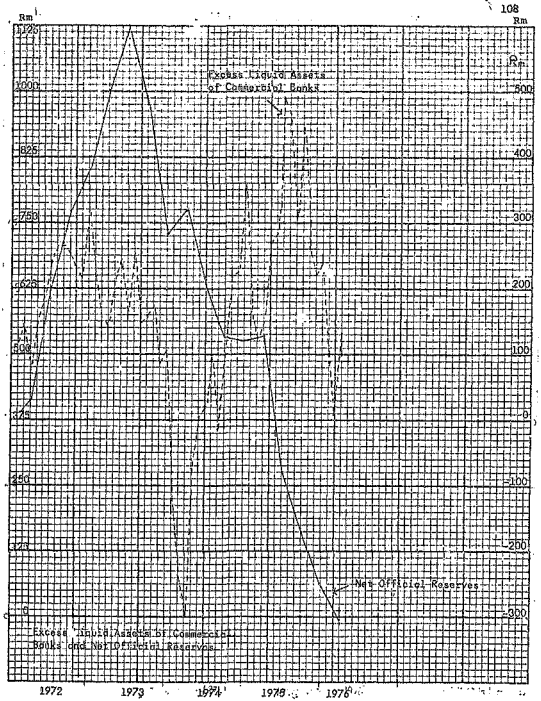

Rm
1125
1000
875
750
625
500
375
250
125
0
Rm
500
400
300
200
100
0
-100
-200
-300
Excess Liquid Assets of Commercial Banks
Net Official Reserves
Excess Liquid Assets of Commercial Banks and Net Official Reserves
1972
1973
1974
1975
1976

Figure 7.

This figure also shows the marked decline in the net reserves of the banking system in the months before September 1975. Hence, once the rand came under suspicion bank credit was available for importers to settle their foreign exchange commitments quickly thus producing a run on the rand. One lesson of the 1975 devaluation was clear. Control over the exchange rate can be seriously undermined in circumstances where excessive government expenditure causes a build up of liquid asset holdings among banks, the rand is under suspicion, and many traders have exposed foreign currency liabilities.

5.2.5 Implications of Devaluation

A major objective of the devaluation was to contribute towards budgetary, financial and economic stability in the economy.[22] In the next chapter this objective is critically analyzed. Compared with the alternative strategies available, increased economic growth in the short term would hopefully materialise. However, in the longer term the growth implications may not have been so favourable. This substantial devaluation was executed when the inflation rate as measured by the consumer price index, was already thirteen per cent. The move therefore considerably complicated efforts to alleviate the problem.

The decision to devalue in September 1975 has also been criticised on the grounds that an improvement in the current account could not be expected since price elasticities of demand for the imports and exports of the Republic are not sufficiently large.[23] Whether accurate estimates of these parameters can be ascertained is open to question. Nevertheless, the repercussions of the devaluation were disappointing. A current account deficit of R1 813m. in 1975 was followed by a deficit of R1 630m. in 1976 but it would still be injudicious to conclude that this reflected failure of the devaluation itself.

A number of factors were detrimental to the success of the devaluation move. Firstly, the trade weighted value of the rand appreciated by 5,1 per cent between the end of September 1975 and the end of May 1976.[24]

Secondly, periodic scares about the danger of another devaluation of the rand and/or import controls, which reflected the payments positions and the strength of the dollar, played a part.[25] Thirdly, during all four quarters of 1976 seasonally adjusted inventory holdings, valued on an annual basis, declined and so helped on the import front.[26] Nevertheless, the deteriorating political situation in the months following the devaluation must have encouraged the stockpiling of imported items. Similar considerations encouraged a flight of capital from the country, one method involving the over-invoicing of imports, which allegedly, reached serious proportions.[27] Fourthly, the terms of trade of the country in 1975/76 moved adversely.[28] Lastly, large capital projects, with a substantial import content, were initiated such as Sasol 2.

References

1. 'Statement Regarding Exchange Rate Policy', South African Reserve Bank Quarterly Bulletin, December 1975, p.17.

2. Ibid., p.17.

3. On August 11th exchange controls were relaxed in order to facilitate foreign borrowing and overseas financing of imports, and forward exchange cover was granted for longer periods. Also, Bank Rate was raised 0,5 per cent to 8,5 per cent and a four per cent increase was announced (to forty-nine per cent) in the minimum liquid asset requirements of commercial banks in respect of short term liabilities, and two per cent (to forty-seven per cent) in that of other banks.

4. During the first half of 1975 the deficit was R803m. compared with R870m. for the whole of 1974.

5. Information received from the Bank.

6. D.J.J. Botha and P.D.F. Strydom, 'Recent Policy Issues in the South African Economy', The Three Banks Review, December 1975, pp.27-8.

7. International Currency Review, May-June 1975, p.103.

8. D.J.J. Botha and P.D.F. Strydom, op.cit., p.28.

9. See statistics in 'South Africa: An Appraisal', Nedbank Group, 1977, pp.229-31.

10. Dr Gerhard de Kock, 'Suid Afrika en die Wereld resessie van 1973-75', South African Banker, February 1976, p.41.

11. Information received from the Bank.

12. International Currency Review, July-August 1975, p.109.

13. Statement concerning rand devaluation rumours issued to the press by Owen Horwood, December 12th 1975.

14. D.J.J. Botha, Financial Mail, Johannesburg 10th September 1975, pp.123-4. Also, D.J.J. Botha and P.D.F. Strydom, op.cit., p.29.

15. Speech in Geneva, Switzerland, 26th September 1975.

16. Information kindly provided by Mr P.G. Ward, investment analyst of a South African stockbroking firm.

17. Statement issued by the Minister of Finance, Owen Horwood to the press which concerned rand devaluation rumours, 12th December 1975.

18. E.M. Bernstein 'Strategic Factors in Balance of Payments Adjustment', I.M.F. Staff Papers, Vol.V, 1956-57, p.157.

19. The money supply increased by twenty-three per cent in both 1973 and 1974; in 1975 it was sixteen per cent. See South African Reserve Bank Quarterly Bulletin, March 1976, p.16.

20. In both the 1974-75 and 1975-6 budget years government spending rose by twenty-four per cent. There were reports, which were not confirmed, that the 1975/76 budget incorporated the assumption of an average gold price of $175 an ounce.

21. Dr Gerhard de Kock, op.cit., p.41.

22. Information received from the Bank.

23. P.D.F. Strydom, 'Inflation in South Africa: Institutional Aspects', South African Journal of Economics, June 1976, p.125.

24. Senbank Currency Review, Johannesburg, June 1976, p.1.

25. South African Reserve Bank Annual Report, 1976, p.5.

26. South African Reserve Bank Quarterly Bulletin, March 1977, pp.5-70.

27. Senator Owen Horwood's Comments, House of Assembly, 15th June 1976.

28. South African Reserve Bank Annual Report, 1976, p.5.

CHAPTER SIX - EXCHANGE RATE POLICY AND INTERNAL ECONOMIC STABILITY

In analyzing the exchange rate policy of the Republic it is important to recognize that capital account factors, together with the objective of maintaining internal budgetary and economic stability, have influenced policy to a greater extent than factors related to the current account of the balance of payments.[1] The purpose of this chapter is to analyze how the pursuit of economic stability has influenced exchange rate policy. The following chapter reviews the relationship between the capital account and exchange rate policy.

6.1 Influence of Budgetary Position on Policy

In recent years devaluations occasionally have been influenced by their fiscal implications. A devaluation results in higher costs for imported military equipment and other imports and in repaying foreign official loans, as well as an increased government liability for losses sustained by the Reserve Bank on forward exchange contracts. Nevertheless at the same time taxation receipts can be boosted significantly by a currency adjustment.

In this respect a particularly important aspect is the relationship between devaluation, tax receipts from gold mining and government revenues. Given a fluctuating gold price the maintenance of reasonable stability of gold mining output in value terms can be important not only for balance of payment but also for budgetary reasons. In 1976 a $10 per ounce fall in the gold price entailed a drop of roughly R190m. per annum in foreign exchange receipts, and a fall in tax receipts of around R113m. on an annual basis.[2] The size of the 'shareholding' of the government in the gold mining industry is further illustrated by the average marginal tax rate of around seventy per cent which prevails. Furthermore, state reliance on gold mining receipts has increased in recent years as shown in the following table:-

TABLE 5 - NET GOLD OUTPUT AND GOVERNMENT RECEIPTS FROM GOLD MINING

	Net Gold Output (Rm)	Estimated Tax and Lease Payments (Rm)	Estimated Tax and Lease Payments as Percentage of Estimated State Revenue
1972	1 161	130	4,30
1973	1 769	154	5,05
1974	2 585	294	8,13
1975	2 540	780	15,09
1976	2 376	837	14,16

1. This refers to the year ending 31st March

Sources: South African Reserve Bank Quarterly Bulletin, various issues and Estimates of Revenue, Government Printer, Pretoria, various issues.

Against this background substantial changes in the price of the metal in both directions have occasionally been compensated for by changes in the exchange rate of the rand against the dollar. This was illustrated by the devaluation in September 1975, which was preceded by a fall of roughly $30 an ounce in the gold price in less than a month.

Faced with such a situation an alternative strategy would have been to increase taxation and/or resort to bank credit, assuming that state expenditures remained unchanged. Relying upon bank credit facilities, in circumstances such as existed in 1975, could not be recommended. Other things remaining equal, it would have boosted the money supply, and thereby worsened the outlook for inflation.[3] In addition, it would have exacerbated problems not only on the current account of the balance of payments, but also on capital account because of, inter alia, the encouragement it would have given to adverse leads and lags influences.

Resort to increased taxation of the magnitude required in September 1975 (more than R300m. on an annual basis) would similarly have been far from easy. Apart from the danger that intolerable balance of payments pressures would remain, raising such amounts

by indirect taxation could be inflationary, even though a sharp fall in the gold price would reduce the money supply. It was only in the March 1976 budget that flexibility in using direct tax measures was improved.[4]

During the period since September 1975 another budgetary factor has exercised a strong influence on exchange rate policy. This concerns the implications of any devaluation upon the liability of the government for forward exchange losses incurred by the Reserve Bank. This subject is covered in detail in chapter 11, dealing with the forward exchange policy of the Republic. As a result of the losses incurred on forward exchange account the incentive to devalue in the face of a significant fall in the gold price has been reduced.

6.2 Exchange Rate Cycle of the Rand

The greater flexibility exercised by the Republic in its exchange rate policy is illustrated by tracing movements in the weighted average value of the rand since the end of 1971. From this date onwards this has fluctuated considerably reflecting alterations made by the Bank in the exchange rate for the rand against the intervention currency, and changes in the value of currencies floating against the intervention currency and therefore the rand. In July 1972, for instance, the weighted average value of the rand was roughly six per cent down compared with the end of 1971, whereas by January 1974 it had appreciated to a level in excess of fourteen per cent above that at the end of 1971.

In addition, the weighted average value, during the post 1971 period, has displayed a strong positive correlation with movements in the gold and foreign exchange reserves of the Bank, although subject to a lag as shown in Figure 8. Since around the third quarter of 1972 (about nine months after the gold and foreign exchange reserves started to rise) until January 1974, the weighted average value of the rand moved upwards. Thereafter, the rand depreciated in line with the fall in the foreign reserves, the latter having peaked out in July 1973.[5]

Foreign Reserves of Reserve Bank and Trade Weighted Value of Rand

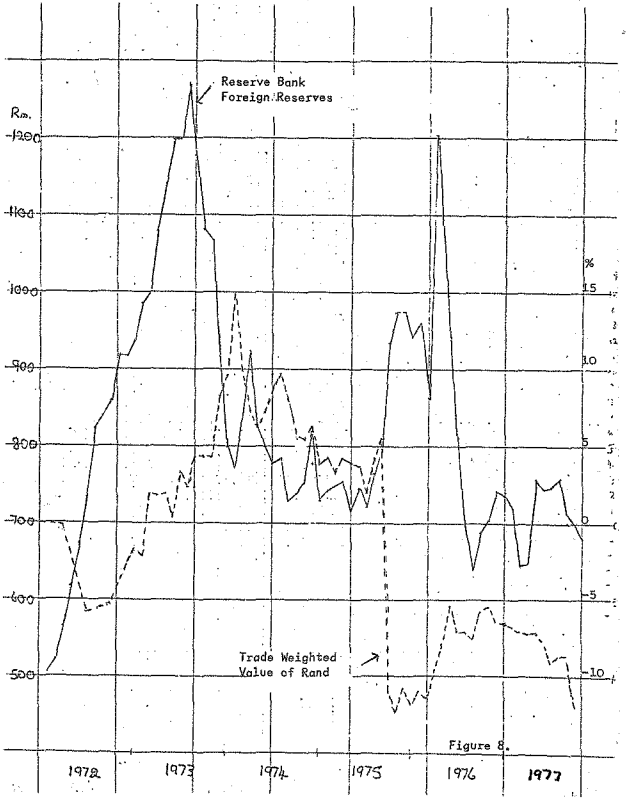


Figure 8.

The relationship between the South African business cycle and the balance of payments follows the pattern of a payments surplus developing during the business cycle downturn and the initial stages of the business cycle upturn, while in the later stages of the upswing and the initial stages of the slowdown a payments deficit tends to prevail. Given this background the authorities have deliberately manipulated the exchange rate to contribute towards external, and more particularly, internal stability. During the business cycle upswing, and also even after the foreign reserves have started to fall, the rand has been appreciated in an effort to restrain the growth in the economy. Conversely, during the downswing and the initial stages of the upswing it has been depreciated to try and stimulate the economy.

6.2.1 Factors Encouraging Policy

A number of factors can be put forward as having encouraged this policy. Firstly, since the breakdown of the Bretton Woods system the Republic has focused attention on the effective exchange rate of the rand against other currencies.[6] Secondly, in conditions where it is no longer feasible to maintain a fixed rate against the intervention currency the attractions of using the exchange rate as an instrument of economic policy is increased. This is especially so when other countries are doing likewise, and when exchange rate changes in the rand are unlikely to invite retaliation due to the insignificance of the rand in the global currency context.

Thirdly, cyclical patterns in the world economy have changed. The latter is now harmonized cyclically to a greater extent than before. Both the 1971-72 and 1976-77 global recoveries involved the major economies moving together with a moderate time lag. This meant that any country which hoped to expand primarily through relying upon other buoyant economies has found it difficult during recessionary periods such as in 1975. The tendency for global recovery to be drawn out has increased the temptation to depreciate the rand during such periods.[7]

This rand cycle policy can be interpreted as reflecting a changed official view about the importance of major economic policy objectives. In particular, it reflected increased emphasis upon economic growth as against emphasis on price stability. This changed order of priorities probably partly stemmed from the accelerating trend of inflation in the western world, which induced a less cautious local inflation policy. Another factor, probably of greater importance, was the sharp increase in the price of gold in the early 1970s. This meant that the gold mining industry was not so adversely affected during this period by cost increases. Further support for this latter contention is provided by the reduced emphasis upon exchange rate changes for the rand since the end of 1975. During 1976 and 1977, at a time when the gold price fell sharply to $103 an ounce in August 1976 before starting a recovery, the parity of the rand remained unchanged. On the other hand, during the latter period, the rand cycle still persisted, since the weighted average value of the rand declined as the foreign reserves remained under pressure and the slowdown in the economy continued (see Figure 8).

6.3 Influence of Policy on Economic Growth

In this section an assessment is made of the influence of this exchange rate policy on economic growth. As already indicated, when the business cycle has turned downwards, then after a lag, the rand has been depreciated in an effort to improve the balance of payments, and stimulate growth. Any depreciation, by boosting export receipts and particularly those of gold mining companies, is likely to strengthen the fiscal position, and therefore the scope for fiscal expansion. This can be unimportant, however, especially in the early stages of the depreciation cycle of the rand, because balance of payments difficulties tend to be a major constraint on expansionary fiscal policies. After the devaluation in September 1975, for instance, an improved fiscal position was followed by more conservative fiscal policies in the March 1976 budget because of inflation and balance of payments problems.

If growth is to be stimulated a more important factor is the influence of exchange rate depreciation on the rates of growth of exports and imports. In this respect a number of factors suggest that the influence has been very limited.

6.3.1 Reversibility of Policy

One aspect of the rand cycle policy has been its short term reversible nature. For instance, the rand was depreciated at the end of 1971 and during a substantial part of 1972, but a reversal policy, which involved appreciation, was initiated as soon as October 1972. In such circumstances, it is difficult to believe that such a policy could have had a material influence on the growth of export and import volumes, and thus economic activity. Moreover, if it is continued in the future its effectiveness could be further reduced. Over time resources may not be so easily transferable in response to a cut in the effective value of the rand because of fears that subsequently the rate will be changed in the opposite direction. Moreover, by depreciating the rand and then subsequently letting it appreciate economic resources are encouraged to move into the balance of payments sector and then to move out, which involves a waste in utilization of economic resources. This argument casts doubts over the influence of depreciation of the rand in improving the external position irrespective of the size of the elasticities of demand for exports and imports.

6.3.2 Export Orientation

In assessing exchange rate policy the export consciousness in the South African manufacturing industry should be noted. Local industrialists, allegedly, suffer from an inferiority complex in exporting, and are oblivious to many opportunities which exist.[8] Local manufacturers need to be educated about export opportunities, since many do not understand the export incentives available, and lack knowledge about exporting formalities.[9] The adequacy of port facilities to deal with expanding exports, particularly of minerals, has similarly been questioned.[10]

Given these deficiencies which relate to manufacturing industry this must blunt the effectiveness of any devaluation. Low export consciousness in this sector also suggests that such a move may only induce a response among certain producers after a considerable time lag when they finally realize the opportunities available. However, such an awareness is unlikely to materialise since policy has been characterized by short term reversibility.

Also, the view has been expressed that manufactured exports are a convenient stop gap for South African companies between local business peaks. In other words, exporting is something to indulge in when local demand falls, and should be dropped when local demand increases to the point where to meet it they must enlarge their plants or work extra shifts. If this is valid this would reduce the attractions of depreciating the rand during the course of the business cycle slowdown. However, Table 6, which shows the trend in manufactured exports, does not support this hypothesis. Although it only covers the main categories of manufactured exports it shows that the most substantial growth occurred in the boom years of 1973 and 1974. In contrast, in 1975 the growth rate fell sharply despite the slowdown in the local economy.

6.3.3 Statistical Evidence

The effectiveness of recent exchange rate policy in improving the current account can also be tested by statistical means. On the basis of data provided in the Reserve Bank Quarterly Bulletins the size of imbalances on the current account in relation to gross domestic product, expressed in percentage form, have increased in recent years. Whereas the figure was 3,2 per cent for the 1965-71 period, it increased to four per cent in the 1972-76 period.

Another indicator, the share of South African merchandise exports in world exports, similarly suggests that there has been no improvement in recent years as shown in Table 7.

TABLE 6 - TRENDS IN MANUFACTURED EXPORTS (1969-75) Rm.

	1969	1970	1971	1972	1973	1974	1975
Products of Chemical and Allied Industries	47,6	52,5	54,1	63,6	78,0	115,9	130,5
Artificial Resins, Plastic Materials, Rubber Articles, etc.	11,5	11,1	10,8	12,6	14,1	21,4	18,4
Wood, Articles of Wood, Cork, Cork Articles, Straw, Plaiting Materials, Basketware, etc.	1,2	1,6	1,8	2,5	4,0	6,0	4,0
Paper and Paperboard Articles	35,0	31,6	40,1	48,0	60,9	96,0	80,0
Footwear, Umbrellas, Sunshades, Prepared Feathers, Artificial Flowers, etc.	,8	,9	,9	1,0	1,2	1,6	1,5
Machinery, Mechanical Appliances, Electrical Equipment,	47,6	53,6	63,	63,5	73,3	129,2	143,3
Vehicles, Aircraft, Associated Transport Equipment	10,0	9,5	11,2	12,7	13,2	45,2	51,6
Optical, Photographic, Medical, Surgical, Clocks, Watches	1,8	3,1	3,3	3,2	5,0	11,0	13,9
Miscellaneous Manufactured Articles	9,8	9,9	,9	1,8	1,8	2,5	2,6
	165,3	173,8	186,8	208,9	251,5	428,8	445,8
Percentage of Merchandise Exports	11,1	12,1	12,0	9,4	9,9	13,3	12,3
Percentage Increase Over Previous Year for Manufactured Exports		5,1	7,5	11,8	20,4	20,5	4,0

Source: Adapted from Monthly Abstract of Trade Statistics

TABLE 7 - TRENDS IN SOUTH AFRICAN AND WORLD EXPORTS

	World Exports (U.S.$m)	South African Merchandise Exports (U.S.$m)	South African Exports As Percentage of World Exports
1968	212 900	2 261	1,06
1969	245 500	3 134	1,28
1970	282 100	2 917	1,03
1971	316 600	3 502	1,11
1972	376 600	4 114	1,09
1973	524 700	6 210	1,18
1974	727 900	8 520	1,10
1975	795 200	8 851	1,11
1976	903 500	7 939	0,87

Source: Adapted from figures provided by International Financial Statistics, I.M.F., Washington.

This stagnation in the share of South African merchandise exports occurred despite the boom in commodity prices in the 1972-74 period, and despite the faster growth in exports relative to imports which occurred during the 1972-76 period as indicated in the following table.

TABLE 8 - ANNUAL PERCENTAGE GROWTH RATE IN MERCHANDISE EXPORTS AND IMPORTS

	1961-71	1961-74	1972-76
Imports	11,58	15,16	22,4
Exports	5,28	8,52	26,3

Source: Adapted from Reserve Bank Quarterly Bulletins

At the same time the 'full employment' balance of payments position improved considerably during the last cyclical upswing compared with the previous one in 1970.

TABLE 9 - 'FULL EMPLOYMENT' BALANCE OF PAYMENTS POSITION

	4th Quarter 1970	3rd Quarter 1974
1. Unemployment Index Cyclical Low Point	37,5	84,2
2. Seasonally Adjusted Current Account at Annual Rate	-R1 196m.	-R1 342m.
3. Seasonally Adjusted Gross Domestic Product at Annual Rate.	R12 800m.	R22 800m.
4. Full Employment Balance of Payments Position (2/3)	9,3%	5,9%

Source: Reserve Bank Quarterly Bulletins

Again, however, no positive conclusions can be reached concerning the influence of exchange rate policy because of the substantial rise in commodity prices, and particularly that of the gold price. In 1970 gold receipts constituted 29,57 per cent of total export receipts whereas in 1974 they represented 37,37 per cent.

The ineffectiveness of exchange rate policy in this regard is also suggested by analyzing the price competitiveness of South African exports relative to exports of industrial countries. This is done in the following table, which has been constructed from figures for export prices provided in the 'International Financial Statistics' publication of the I.M.F.

TABLE 10 - SOUTH AFRICAN EXPORT PRICES IN DOLLARS RELATIVE TO EXPORT PRICES OF INDUSTRIAL COUNTRIES ($)

	1972	1973	1974	1975	1976
1st Quarter	100	114,2	127,5	121,3	103,6
2nd Quarter	100	113,9	121,4	117,0	110,8
3rd Quarter	96,9	112,8	115,7	109,2	111,8
4th Quarter	108,8	123,3	113,3	99,1	112,0

During the first three quarters of 1972 the rand was depreciated in an effort to stimulate the economy and yet the Table shows that the price index of South African exports vis-a-vis those of industrial countries, expressed in dollars, only improved by roughly three per cent. Likewise, following the devaluation of the rand in September

1975, although price competitiveness immediately improved as shown in the Table, the position deteriorated during 1976.

A not too dissimilar picture emerges if one surveys price trends for domestic goods vis-a-vis imported goods during the same period, as shown in the following table.

TABLE 11 - INDEX OF SOUTH AFRICAN DOMESTIC WHOLESALE PRICES COMPARED WITH WHOLESALE PRICES FOR IMPORTED GOODS (R)
End of 1971 = 100

	1972	1973	1974	1975	1976
1st Quarter	..,2	97,2	96,5	98,1	95,9
2nd Quarter	95,3	98,5	100,1	97,5	96,4
3rd Quarter	95,7	97,6	98,8	97,5	99,6
4th Quarter	95,6	98,0	98,8	97,1	100,1

Source: Adapted from South African Reserve Bank Quarterly Bulletins

The Table indicates that although there was an improvement in the competitiveness of domestically produced goods as against imported goods in the first three quarters of 1972, the same pattern did not emerge after the September 1975 devaluation. During 1976 there was a deterioration in the competitive position of domestic industries.

6.3.4 Importance of the Price Factor

The previous analysis provides no evidence that recent exchange rate policy has stimulated economic growth, and similar conclusions have been reached in other quarters.[11] In particular, the issue has to be faced whether price is an important variable in determining the growth of exports and imports of the Republic.

There is a school of thought which believes that factors such as delivery dates, credit terms, reliability, suitability, after-sales service, etc. are far more important factors.[12] This may be more relevant in the case of a predominantly manufacturing exporting country. However, in the South African context the influence of price competitiveness on exports is blunted by political opposition in the outside world to trade with the Republic.

Statistical evidence, moreover, casts doubts on the importance of price. This is illustrated in the following Table which shows the percentage change in exports and imports, and the differential in inflation rates between the Republic on the one hand and its main trading partners on the other.

TABLE 12 - PERCENTAGE CHANGES IN INFLATION RATES AND CURRENCY CHANGES VIS-A-VIS THE RAND (1970-1974)

	Appreciation+/ Depreciation- of the Rand	Change in Consumer Prices	Export Growth	Import Growth
U.K.	+5,39	48,5	77,7	46,7
U.S.A.	-3,8	27,0	121,4	91,7
Japan	-14,4	52,5	137,2	272,0
Germany	-46,43	27,1	208,9	147,3
Italy	+ 6,96	46,3	110,4	95,5
France	-20,0	36,3	133,1	123,5
South Africa		37,6		

Sources: Adapted from I.M.F. Reports and Reserve Bank Quarterly Bulletins

The Table indicates the lack of any clear-cut relationship between the foreign trade of the Republic with its main trading partners, and corresponding currency and inflation movements. During the period 1970-74 exports to the U.S. rose faster than imports from that country despite an appreciation of the rand vis-a-vis the dollar, and despite the lower rate of inflation in the U.S. compared with the inflation rate in the Republic. On the other hand, Japanese exports to South Africa during this period expanded at double the rate for imports from this country despite a fourteen per cent rand depreciation against the yen and the higher inflation rate in Japan. Moreover, there has been no direct relationship between rand depreciation/appreciation against any one currency and corresponding inflation trends. For instance, during the period 1970-74 the rand appreciated against the dollar despite the higher

inflation rate in the Republic. Where France is concerned a hefty twenty per cent rand depreciation took place even though there was no inflation rate differential.

6.3.5 Price Elasticities

The effectiveness of devaluation is crucially dependent on the magnitude of price elasticities of demand. In the introductory chapters it was explained that the Bank traditionally has taken the view that the demand elasticities for the exports and imports of the Republic are above unity. In recent years research into this subject has yielded different conclusions. No consensus exists on the magnitude of these elasticities in the case of the Republic.[13]

Trying to obtain reliable estimates of demand elasticities is exceedingly difficult. Trying to identify the influence of the price factor while all other things remain equal is the basic problem.[14] In assessing the influence of demand elasticities in the case of the Republic in recent years a number of factors should be noted.

Firstly, elasticity magnitudes, whatever their size, have had very limited scope for exercising an influence. This is because of the short term reversibility of policy, and because on occasions subsequent exchange rate movements have partially eroded the benefits of a parity change.

Secondly, during the 1971-75 period the structure of the import merchandise accounts was modified as shown in the following Table:-

TABLE 13 - STRUCTURE OF MERCHANDISE IMPORTS (1971-5)
(Percentage of total merchandise imports, FOB Prices)

	1971	1972	1973	1974	1975
1. Foodstuffs, Animal Products	4,0	3,9	4,5	4,0	3,7
2. Textile and Textile Articles, Footwear etc.	9,3	9,3	9,7	8,5	5,4
3. Chemicals, Plastics, Rubber Products etc.	9,8	10,4	11,2	12,7	9,7
4. Minerals, Base Metals	15,4	13,5	8,0	10,6	9,6

TABLE 13 (contd.)

	1971	1972	1973	1974	1975
5. Machinery, Mechanical Appliances, Electrical Equipment	26,7	27,1	27,6	23,1	27,3
6. Aircraft Vehicles Articles Transport Equipment	19,7	20,2	17,0	13,8	16,2
7. Oil and Related Products		6,7	-	-	15,1
8. Wood, Paper and Paperboard	3,9	4,1	4,8	4,7	3,2

Sources: Adapted from Monthly Abstract of Trade Statistics, and South African Reserve Bank Quarterly Bulletins, and official statements regarding oil imports.

The repercussions of the oil crisis have modified the structure of the import bill. The relative importance of oil imports more than doubled between 1972 and 1975. Simultaneously, the capital goods items (five and six in the Table) declined in importance. Since the latter are those items whose price elasticity is likely to be particularly low, the structure of the import bill has changed making it, in theory, more responsive to exchange rate changes. Moreover, the Table shows that a significant portion of the import bill relates to intermediate products where demand elasticities may be higher than in the case of capital goods.

Thirdly, events in the 1970s have raised the question whether exchange rate depreciation is futile under certain conditions irrespective of the import elasticities of demand. This arises because of the tendency for importers to speculate on the possibility of import controls being tightened during periods when the business cycle is in a downward phase and the foreign reserves are falling. In other words, inventory holdings have shown a tendency to continue increasing side by side with a fall in the foreign reserves even after a prolonged slowdown in the business cycle, and vice versa.

This trend is illustrated in Figure 9 showing the relationship between changes in inventory holdings, and the foreign reserves. Thus, when the latter reached a low point in December 1971 this marked the turning point for inventory holdings, while when the

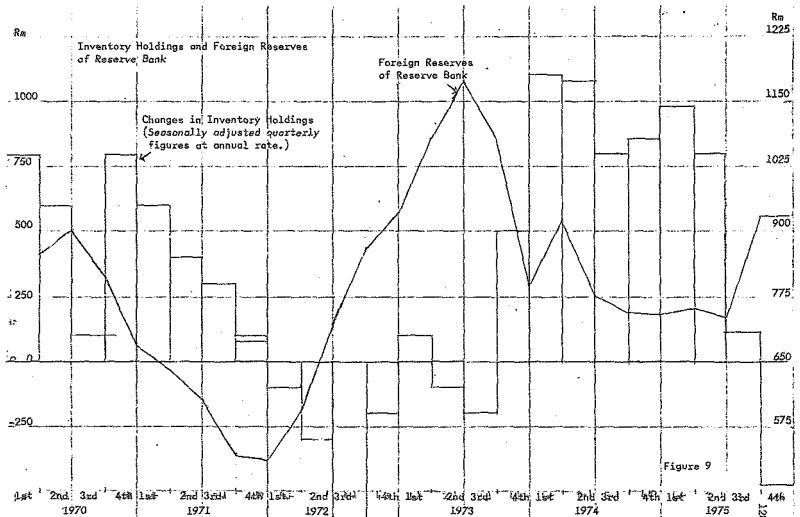

Rm
Inventory Holdings and Foreign Reserves of Reserve Bank
Foreign Reserves of Reserve Bank
Changes in Inventory Holdings (Seasonally adjusted quarterly figures at annual rate.)
1000
750
500
250
0
-250
Rm
1225
1150
1025
900
775
650
575
1st 2nd 3rd 4th 1st 2nd 3rd 4th 1st 2nd 3rd 4th 1st 2nd 3rd 4th 1st 2nd 3rd 4th 1st 2nd 3rd 4th
1970
1971
1972
1973
1974
1975
128

Figure 9

reserves peaked out in 1973 this heralded an upward change in inventory holdings.

During both business cycle downswings in the 1970s (1971 and 1976) import controls have been finally introduced partly reflecting this speculative influence. Thus, one unfortunate aspect of the import deposit scheme introduced in July 1976 is the potential trouble stored up for the future by furnishing an incentive for the operation of this speculative force.

This institutional factor has implications for exchange rate policy. The 1971 devaluation, which was enacted shortly after import controls had been introduced, was followed by a positive short term trend in merchandise imports. The September 1975 devaluation, on the other hand, which did not follow import controls, subsequently had to be reinforced by such a step in July 1976. In other words, can depreciation alone be effective in circumstances where import speculative stockpiling is operative? The eradication of this latter influence would mean that the 'true' import elasticities would emerge, which could be higher than is generally assumed. This institutional factor also casts doubts on the feasibility of making empirical studies to ascertain import price elasticities in the case of the Republic.

6.4 Implications of the Policy of Revaluation

Up to now we have considered whether depreciation of the rand has aided internal growth and the current account of the balance of payments. However, a revaluation cycle has also been employed. Thus when the business cycle upswing became established appreciation of the rand materialised starting in October 1972, and this process continued even after the foreign reserves had started to fall. This policy predominantly reflected the feeling that the depreciation had gone too far, and that revaluation could have useful anti-inflationary repercussions as well as moderate demand pressures in the economy. The appreciation cycle lasted roughly sixteen months ending in January 1974. The effectiveness of this policy was limited for two reasons.

Firstly, it was undermined because the process was reversed early in 1974 even though the economy in that year achieved a real growth rate of more than seven per cent, and the business cycle upswing did not peak out until the third quarter of 1974. It can be argued that the application of the exchange rate as a macro-economic instrument would not have suggested resort to depreciation so early given the internal economic conditions prevailing, and its inflationary implications. Between the end of January 1974 and the end of April 1974, despite the soaring gold price, the trade weighted value of the rand was allowed to fall by roughly 8,5 per cent. The reversal of the revaluation cycle was allowed to develop because of the sharp decline in the foreign reserves which occurred after July 1973.[15] The latter is normal at such a stage of the business cycle in South Africa. This therefore illustrated the limitations of using the exchange rate to curb aggregate demand pressures in the domestic economy in an environment where the rand is linked to a floating currency.

Secondly, the efficacy of the appreciation policy was reduced because an expansionary monetary policy was pursued, with its inflationary implications. In the absence of this expansionary factor the results on the inflation front of the appreciation would have been strengthened. On the other hand, enthusiasm for appreciating the rand could have been reduced since excess demand pressures would have been less pressing.

6.4.1 Flow of Funds Analysis and Exchange Rate Policy

The suitability of using the exchange rate as an instrument of policy in South Africa can be approached by an analysis of fund flows between the various sectors of the economy. This traces the flow of funds through the system and shows the financial balances of the various sectors and whether an overall financial surplus prevails or not. In this analysis the economy is divided into three sectors, namely the public, private and overseas sectors; the private sector in turn can be subdivided between the corporate sector and individuals.[16]

The technique uses the concept of 'financial surpluses' and 'financial deficits' of the different sectors. The total net savings of a sector is considered to finance its own capital formation and stock-building; any surplus saving remaining is the financial surplus of the sector, while any negative saving is its financial deficit. If one sector has a financial deficit it must be financed from the surpluses of other sectors. Given the existence of only three sectors in an economy (public, private and overseas), any net flow of funds out of it (i.e. any resulting current account balance of payments deficit) must equal any financial surpluses of persons plus companies minus any deficit in the public sector. Thus, any domestic financial surplus should reflect itself in a balance of payments current account surplus and vice versa for an overall financial deficit.

Table 14 shows the application of this analysis to the South African economy, from which the following conclusions can be drawn. Firstly, in the Republic during the past 15 years or so current account balance of payments surpluses have consistently accrued when the public and private sectors combined have been in surplus, and vice versa. Secondly, as a general rule, rising public sector deficits tend to become manifest when the balance of payments on current account has turned into a deficit, while reductions in public sector deficits have often been associated with improvements on the current account of the balance of payments. The contrary trends in the early 1960s, however, should be noted which may have reflected the special economic conditions prevailing in the wake of Sharpeville.

The normal relationship explained above consistently occurred from 1969 to 1975, which is of special interest in analyzing exchange rate policy. The economic recovery during 1973 and 1974 was accompanied by expansionary budgetary policies. In both the 1974 and 1975 fiscal years government expenditures increased by more than twenty per cent. However, from October 1972 to January 1974 the exchange rate was deliberately appreciated in an effort to moderate

TABLE 14 - FLOW OF FUNDS - SOUTH AFRICAN ECONOMY (1961 - 75)

	1961	1962	1963	1964	1965	1966	1967	1968	1969	1970	1971	1972	1973	1974	1975	1976
Public Sector	-114	-165	- 82	-160	-389	-470	-348	-366	-419	-729	-1 097	-1 307	-805	-977	-2 234	-3 520
Private Savings	+480	+561	+569	+407	+571	+717	+927	+864	+828	+901	+1 176	+1 505	+1 116	+1 654	+2 003	+1 932
Corporate Sector	-163	-88	-321	-295	-478	-248	-760	-420	-454	-999	-1 082	-369	-217	-1 534	-1 385	-73
Total	+203	+308	+166	- 48	-296	- 1	-181	+ 78	-245	-827	-1 003	+ 11	+ 94	- 860	-1 616	-1 711
Overseas Sector	-203	-308	-166	+ 48	+296	+ 1	+181	-78	+245	+820	+1 003	- 11	- 94	+860	+1 616	+1 711

Source: Adapted from Reserve Bank Quarterly Bulletins

Note: Public sector deficit = consumption expenditure by general government + subsidy payments + transfer to households + transfers to the rest of the world + gross domestic investment by public corporations and public authorities - current income of general government + depreciation provisions of public authorities and public corporations.

Note: Corporate sector = gross domestic private investment - private sector depreciation provisions + corporate savings.

expansionary forces in the economy. Subsequently, with the foreign reserves having been falling since August 1973, exchange rate depreciation was carried out, but simultaneously expansionary budgetary policies continued. Moreover, as the balance of payments turned into deficit tax revenues suffered, particularly in 1975, as a result of the fall in the gold price, and the deterioration in export markets. In the face of the absence of any cutback in state spending in the short term this caused the money supply to increase further as the resort to bank credit intensified. This in turn exacerbated the external payments problem.

Consequently, since around the middle of 1973 budgetary policy was inconsistent with the tighter monetary policy in the form of rising interest rates and exchange rate policy. The latter involved trying to moderate economic expansion by appreciation, and subsequently resorting to depreciation as the payments situation deteriorated.

The relationship explained between the balance of payments on current account and the public sector deficit indicates that an alternative strategy should have been pursued. The excess demand pressures in the economy and payments deficits, which developed after the middle of 1973, could have been tackled more effectively by conservative budgetary policies and more restrictive monetary policies, rather than placing emphasis initially upon exchange rate appreciation, and then depreciation in view of the limited influence of such manipulations upon the current account.

The inconsistency of budgetary and exchange rate policies may be explained by official reasoning that the adverse impact on the balance of payments of such expansion could be, if necessary, counteracted by allowing the exchange rate to fall. If this is the case, its limitations have been exposed. The inflationary implications of such a policy are clear cut, while the 1976 budget had to be very restrictive compared with the three previous budgets.

6.4.2 Bank Credit and Foreign Reserves Position

The limitations in using the exchange rate in this respect is

also suggested by considering the impact of bank credit expansion on the foreign reserves position. The expansionary budgetary policies contributed towards the sharp rise in the money supply in the 1973-75 era. This had important implications for the current account because of the relationship between domestic credit expansion and the external position. Monetarists argue that with a fixed exchange rate the key monetary variable is the rate of domestic credit expansion, and its major role the determination of the balance of payments position, and the split of the increase in the money supply between domestic and overseas money.[17]

Although the rand has not remained fixed there is evidence that these money aggregates have influenced markedly the balance of payments position since 1972. Figure 10 shows a marked, although somewhat lagged, negative correlation between bank credit expansion and the balance of payments position. The initial success of the December 1971 devaluation was associated with a decline in bank credit expansion during parts of 1972. Conversely, a large expansion preceded the September 1975 devaluation, and the subsequent failure of the external position to improve was associated with a further large increase in bank credit. The major factor which explains this relationship is suggested in Figure 11, which shows the strong positive correlation between bank credit expansion and merchandise imports. Thus, the extent of increases in credit facilities granted by banks during expansionary phases have been important in determining the extent of the deterioration of the payments position in the post-1971 era.

6.5 Exchange Rate Policy and Inflation

In the previous sections the influence of exchange rate policy on internal budgetary and economic stability was analyzed. One aspect, however, still needs to be considered more thoroughly, and this concerns the impact of exchange rate policy on local inflationary trends.

During the 1970s the inflation rate in South Africa has

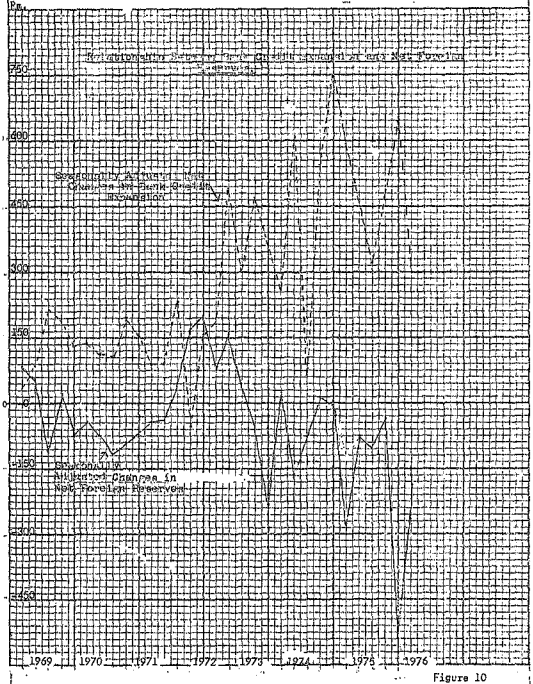

Rs.
Relationship between Seasonally Adjusted Reserve Money and Net Foreign Assets
750
600
450
300
150
0
-150
-300
-450
Seasonally Adjusted Reserve Money
Seasonally Adjusted Net Foreign Assets
1969
1970
1971
1972
1973
1974
1975
1976

Figure 10

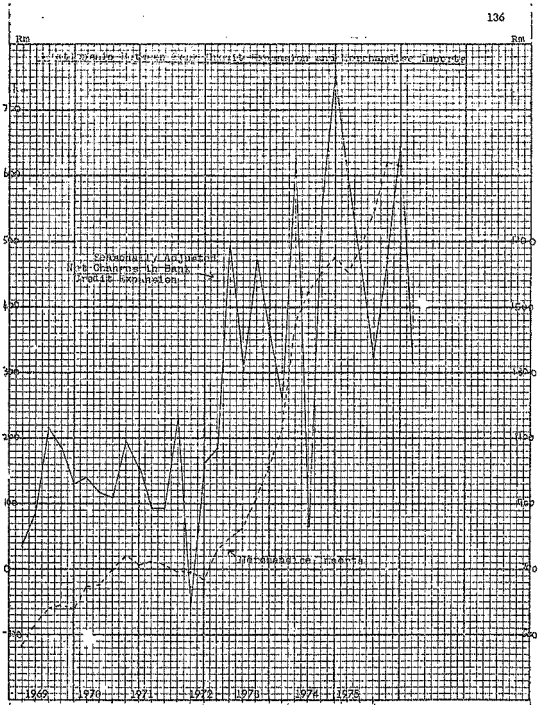

Rm
Rm
Machinery equipment
Net Changes in Bank
Credit Expansion
Unemployment Insurance
1969
1970
1971
1972
1973
1974
1975

Figure 11.

accelerated markedly. Whereas in the 1960-1970 era the average annual rise in the consumer price index was 2,65 per cent, in the 1970-75 period it rose to 8,1 per cent. The question arises as to what extent this acceleration in local inflation could be ascribed to the exchange rate policy pursued.

Rising import prices can exert upward pressure on the domestic price level in a number of ways. They have a strong direct effect because roughly thirty per cent of the gross domestic expenditures at market prices is accounted for by imports of goods and services. On this basis a ten per cent rise in average import prices could be expected to boost the inflation rate in the Republic by roughly three per cent.[18] Secondly, rising import prices indirectly raise local prices by contributing towards an inflationary environment in which it becomes easier for local producers to raise prices. It also may encourage wage and salary earners to demand compensation for increases in the cost of living. Thirdly, accelerating inflation abroad may divert products from local markets to export markets to take advantage of higher profits obtainable as a result of rising prices. Fourthly, a major category of imports is machinery and transport equipment. Rising import prices of such items can permeate the entire economy via the increased cost of investment goods.

Evidence suggests that the deteriorating trends in local inflation in the 1970s can be partly ascribed to the rising prices of imported goods and services. Over the 1964-73 period there was a strong positive correlation between the imported wholesale price index on the one hand, and the local wholesale price index (r^2 = ,78), and the consumer price index (r^2 = ,83).

6.5.1 Influence of Devaluation on Prices

However, in assessing the influence of exchange rate policy on local inflation trends it is necessary to distinguish between inflation trends in other countries on the one hand, and the prices of imported items into South Africa. A marked difference may exist

between the two because of the effects of exchange rate changes on import prices.

The direct effects of devaluation on price trends can be gauged by reference to Table 15. This shows that export prices of the main trading partners of the Republic in terms of their own currencies (representing nearly seventy-five per cent of total South African merchandise imports) rose on average by sixty-three per cent between the end of 1971 and 1975.

TABLE 15 - PERCENTAGE CHANGES IN EXPORT PRICES OF SOUTH AFRICA's MAIN TRADING PARTNERS

	Percentage of South Africa's Merchandise Imports 1972-75	Percentage Change in Export Prices 1972-75
U.K.	19,5	89
U.S.A.	17,0	71
W. Germany	17,9	28
Japan	11,2	50
France	4,0	48
Italy	3,8	94
		Average = 63

Source: Compiled from data given by I.M.F. Financial Statistics and South African Monthly Abstract of Trade Statistics, various issues.

During the same period local wholesale prices of imported items rose by roughly seventy-six per cent. The differential is attributable to the depreciation of the rand vis-a-vis other currencies during the period. On an annual basis the differential amounts to slightly over three per cent. Thus, in regard to the direct effects of imported inflation the major culprit was the sharp rises in prices in overseas countries.

This, however, excludes the indirect effect of devaluation on the price level. The cost-push effects of the devaluation policy have been stressed, and as a result it has been claimed that the benefits of devaluation in recent years have been significantly

reduced.[19] Similar allegations have been made concerning the cost-push effects of devaluation in other countries.[20]

Identifying the magnitude of these cost-push effects on the price level in South Africa is complicated by the imported inflation elements induced through the commodity price boom and the oil crisis in the first half of the 1970s. The presence of such influences, nevertheless, means that the effectiveness of devaluation as a means of stabilizing the economy is impaired. This is because not only is inflation boosted, but also because switches in expenditures from imports to domestically produced goods are reduced, and the expansion in exports blunted. In the extreme case of a one for one effect of devaluation upon the price level benefits on the competitive front would be nil.

6.5.2 Revaluation and Inflation

The revaluation policy carried out between October 1972 and January 1974 was designed not only to check excess demand pressures, but to exert an anti-inflationary influence. The attempt to slow down expansion of the economy, itself anti-inflationary, was therefore accompanied by revaluation directly designed to influence imported inflation. It was recommended that this policy should have been pursued more vigorously.[21] In this section therefore the appropriateness of this revaluation policy is analyzed in the context of the circumstances as existed at the time.

If the demand for imports and exports of a country is elastic a currency revaluation can be sensible when a persistent balance of payments surplus and excess demand pressures prevail in an economy. A currency revaluation would exert an anti-inflationary influence. This is because export incomes would be deflated, along with the expansionary effects of payments surpluses on the money supply. In addition, relief would be provided on the imported prices front.[22] At the same time competitive pressures in the economy should increase as the volume of imports increases and certain exports are diverted on to domestic markets. It may also have favourable long term effects on inflation. A high proportion of imports into South

Africa consist of intermediate and capital goods. Therefore, any fall in prices could stimulate capital investment, and provide a boost to productive capacity, which could mitigate future demand pull inflationary pressures.

However, persistent payments surpluses and pressures of excess demand have not characterized the South African economy in recent years. As the economic recovery gained momentum the balance of payments on current account turned into deficit in the third quarter of 1973. Moreover, any rand revaluation, if it is to produce an improvement in inflation, must lead to an increased volume of imports. In 1973 and 1974, and normally when the local economy is enjoying strong growth, two constraints limit the scope for increased imports, and therefore the benefits of any revaluation.

6.5.3 Constraining Factors

Firstly, a major physical constraint on increased imports in 1973 and 1974 stemmed from the congestion in the harbours. Any disinflationary benefits resulting from a more substantial revaluation could have been eradicated by increased port surcharges levied as a result of greater congestion following increased imports.[23]

Secondly, revaluation was undertaken in 1973 when the foreign reserves started to fall. By around the middle of 1974 the latter had fallen to low levels, since on the basis of the foreign reserves-imports ratio they had dropped below the twenty per cent mark. This obstacle to the revaluation policy would have been less important if the dispute which surrounded the monetary role of gold had been settled in favour of a realistic revaluation, and arrangements which enabled monetary authorities to deal in gold among themselves at market related prices.

The capacity of the Republic to absorb further increases in imports would also be improved if, following a revaluation, the terms of trade improved as export prices in local currency terms fall less than import prices. In these circumstances it would be possible to obtain an increased volume of imports for any given volume of exports. As Figure 12 shows the terms of trade did improve in 1973

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principally because of the increase in the gold price. However, if the Republic revalues by a meaningful margin, a reduction in the rate of growth of exports in rand terms and an increase in the rate of growth of imports is to be expected, but one cannot presume that this will be accompanied by a favourable movement in the terms of trade. In this connection it should be remembered that most external transactions of the Republic are denominated in foreign currencies.

6.5.4 Pricing Policies of Suppliers

The merits of a rand revaluation as an anti-inflationary weapon are also affected by the pricing policies of foreign suppliers. In theory it can be argued that if imported goods are produced under conditions of constant costs, i.e. perfectly elastic supplies, the effect of say a ten per cent revaluation would be to lower import prices in terms of rands by a like amount. If, on the other hand, the supply curve for imported items is perfectly inelastic, a ten per cent rand revaluation would cause the price of imports in terms of rand to remain unchanged. For supply conditions in between perfect elasticity and perfect inelasticity, the domestic price of imports in the revaluing country should ultimately fall by less than ten per cent depending on demand and supply elasticities.

These considerations suggest that economic conditions in other countries, by affecting the foreign elasticity of supply of imports into the Republic, should influence the extent to which revaluation is reflected in lower rand import prices. However, given the importance of oligopolistic market structures which prevail, foreign suppliers in general may not adopt flexible pricing policies.

Where a single competitor raises prices unilaterally other firms (unless passive price followers) may be keen to obtain higher market shares by keeping their prices unchanged, while conversely, when a firm unilaterally cuts its prices, other firms may follow for fear of losing sales. Consequently, price changes, either up or down, may have deleterious repercussions for the firm that

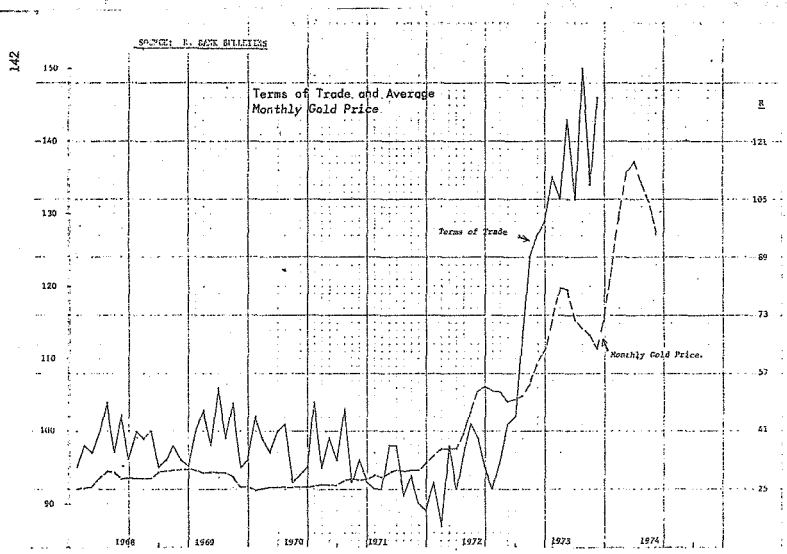

SOURCE: R. BANK BULLETINS
Terms of Trade and Average Monthly Gold Price
Terms of Trade
Monthly Gold Price.
150
140
130
120
110
100
90
R
121
105
89
73
57
41
25
1968
1969
1970
1971
1972
1973
1974

Figure 12.

implements them. Thus, in the context of revaluation, it may be that the main response of foreign suppliers is to raise their own prices proportionally thereby providing no price reductions in terms of rands, while boosting their profit margins. This conclusion seemed to be reached by the Bank for International Settlements:

> Exchange rate changes have contributed to rising world prices. Given an oligopolistic industrial complex and downward inflexibility of prices, the downward adjustment to internal prices (including imports) resulting from currency appreciations seems to be weaker than the upward adjustments following currency depreciations. 24

What is more, assuming that foreign suppliers did cut prices in terms of rand following a revaluation, this still does not necessarily mean that the consumer price level in South Africa would be favourably affected. Reductions in the rate of growth of import prices could be largely nullified if importers and distributors responded by not passing on the price cuts, and instead boosted their own profit margins. In particular this phenomenon might apply where the South African subsidiary firms of foreign controlled supplier firms is concerned. Here, the foreign suppliers could sell to their subsidiaries in the Republic at a fixed price in terms of their own currency, while the latter sell at an unchanged price in rand terms. Thus, the subsidiaries could soak up the effects of exchange rate variations in their own profit margins, which could therefore be boosted following a rand revaluation.

The above arguments particularly apply to cases where exchange rate changes are limited in amount and possibly can be reversed, which was the case during the period when revaluations took place.

In conclusion it should be noted that the efficacy of currency appreciation as an anti-inflationary weapon is not borne out in any statistical correlation between the weighted average value of the rand and the rate of increase of imported wholesale prices in South Africa over the past few years as shown in Figure 4. This does not provide any conclusive evidence, but the analysis of this section indicates that the benefits on the inflation front from the revaluation policy in 1973 are dubious.25

References

1. Information received from the Reserve Bank.

2. Weakness in the gold price also affects state expenditures on marginal gold mines. When the second reading of the Gold Mines Assistance Amendment Bill was introduced in Parliament on 25th March 1976, the Minister of Mines stated that if the gold price did not improve considerably, and costs continued to rise at the existing tempo, about nine assisted mines would have to be paid an estimated R44,5m. during the 1976/77 financial year.

3. At that time bank credit extended to the government was rising strongly. The net claims of the banking sector on the government increased by R120m. in 1973, R405m. in 1974, and R719m. in 1975. See South African Reserve Bank Quarterly Bulletin, December 1977, pp.5-30.

4. In the March 1976 budget it was proposed that the Minister of Finance be empowered to increase or decrease the loan levy by a maximum of ten per cent of the basic tax between budgets.

5. It might be argued that this correlation broke down during the first quarter of 1976 when the foreign reserves of the Reserve Bank rose sharply. This rise, however, reflected a technical factor, namely the gold swap entered into in March 1976, and thus the basic trend remained the same. In any case the need to conclude the gold swap reflected the downward pressure on the foreign reserves.

   If one correlated the net reserves of the monetary banking sector with the weighted average value of the rand the same picture emerges as applies to the correlation of the foreign reserves of the Reserve Bank and the value of the rand.

6. As indicated in chapters 1 and 2 the exchange rate policy of the Republic in the Bretton Woods era largely incorporated the maintenance of a fixed exchange rate for the rand against sterling. Fiscal and monetary policies were strongly influenced by this consideration.

   In contrast, since the end of 1971 the authorities have focused attention on the effective or trade weighted exchange rate value of the rand against other currencies. Medium or long term stability in the rand rate against the currency to which it is linked is no longer regarded as important in conditions in which parity changes or floating exchange rates by other countries feature prominently.

7. In the official statement by the Minister of Finance which explained the decision to devalue in September 1975, *reference* was made to the unsatisfactory state of the world economy.

8. Information received from Mr L Luloffs, *Chairman* of the South African Foreign Trade Organization (SAFTO).

9. Ibid.

10. T.R.N. Main, 'The Reynders Commission and the Mining Industry', South African Journal of Economics, Vol.43, No.1, March 1975, p.98.

11. D.J.J. Botha and P.D.F. Strydom, 'Recent Policy Issues in the South African Economy', Three Banks Review, December 1975, No.108, p.19.

12. C.G. Tether, 'The British Straightjacket', Financial Times, London, 17th March 1976.

13. The most *recent evidence* is provided by P.D.F. Strydom, 'Inflation in South Africa: Institutional Aspects', South African Journal of Economics, Vol.44, June 1976, pp.125-30. Also M.M. Courtney, 'Inflation in South Africa', South African Journal of Economics, Vol.44, No.4, December 1976, pp.457-63.

14. For a thorough review of the problems involved in the *derivation* of elasticity estimates see Fritz Machlup, International Monetary Economics, George Allen and Unwin, London, 1964, pp.59-68.

15. Information received from the Bank. In the second half of 1973 the foreign reserves of the Bank fell by R400m. to R796m.

16. For an illustration of this type of analysis see Walter Ellis, 'Do Budget Deficits Cause Balance of Payments Deficits?', International Currency Review, September-October 1973, pp.24-32.

17. H.G. Johnson, 'The Monetary Approach to Balance of Payments Theory', in International Trade and Money, edited by M. Connelly and A. Swoboda, Toronto Press, 1973. Also, 'Testing the Monetary Approach to Devaluation in Developing Countries', M. Connelly and P. Taylor, Journal of Political Economy, August 1976, pp.849-59. Also, Andrew Crockett, International Money, Nelson, London, 1977, pp.52-55.

The monetary approach looks at the balance of payments as a whole, and not just the current account. Its approach rests

on two basic empirical propositions. Firstly, the demand for money in an economy is assumed to be a stable function of a few variables. Secondly, the price of traded goods is assumed - at least for a small economy - to be largely exogenous, as is the level of output. These assumptions, taken together, imply that in an open economy, the authorities cannot control the quantity of money held by domestic residents. If the quantity of money is below the desired stock, given the level of output and other determining factors, economic units will try to acquire additional money balances. Individually, they will do this by curtailing expenditures relative to their income. The economy as a whole will restore equilibrium by running a balance of payments surplus and attracting money from abroad.

The process of restoring equilibrium between the demand for money and the available supply can be achieved without any sacrifice in the level of output. This is because prices of traded goods are assumed to be given, so that producers can sell as much as they produce at an exogenously given price. All that domestic demand management policy (i.e. credit creation policy) can achieve is to affect the level of domestic demand, and thus the size of the foreign trade balance.

The monetary approach can be formulated (in mathematical terms) as follows. The demand for money - Md - is a stable function of income - Y - and the rate of interest - r -:

$$Md = f(Y,r)$$

The supply of money Ms consists of money created domestically - D - plus money inflows from abroad - R - (i.e. the surplus on the balance of payments):

$$Ms = D + R$$

Since, in equilibrium the demand for money will equal the supply:

$$Ms = Md$$

the balance of payments (or the change in reserves) can be expressed as:-

$$R = Md - D$$

In other words, any discrepancy between the volume of money balances demanded, and the stock of money created by the central bank will be eliminated by a foreign reserve movement generated through a balance of payments surplus or deficit. The implications of this approach is that the only way in which official control over the balance of payments can be exercise is by limiting the rate of growth of domestic credit.

18. This, however, is purely a measure of the import component of domestic spending, and ignores the influence of market forces. There are, also, doubts whether rising import prices will have an independent effect on the absolute price level in an economy. In the case of the Republic, therefore, it can be argued that with an unchanged money supply and velocity of circulation, a trend towards higher import prices must be offset by lower prices of domestically produced goods. With a constant money supply consumers and business will have to outlay more on higher priced imported items where demand is inelastic. This will leave less available to spend elsewhere and cause prices of these other goods to fall. This conclusion stresses that relative prices, but not the absolute price level, changes, but is dependent upon the assumption that prices are flexible downwards.

19. P.D.F. Strydom and H. Wiehahn, 'Cost Push Inflation and Balance of Payments Theory', South African Journal of Economics, Vol.45, No.3, September 1977, pp.257-67. Also, D.J.J. Botha, 'Some Thoughts on Devaluation', South African Journal of Economics, Vol.40, 1972, pp.197-208.

20. P. de Grauwe and C. Holvoet, On Devaluation, Terms of Trade, and Wage Indexing, International Research Paper No.6, Katholike Universiteit te Leuven, 1977. In terms of an input-output analysis for the E.E.C. countries these authors concluded that in all E.E.C. countries, without wage indexing, more than half of the positive effect of the devaluation on the profitability of the competitive sectors was offset by increased costs. In the presence of wage indexing the cost push effects are more pronounced, and the effectiveness of devaluation reduced further.

21. J. Sadie, 'Business Outlook', Management, Johannesburg, Vol.5, No.4, January 1975.

22. This assumes that import prices in foreign currency terms do not rise proportionally with the revaluation.

23. Any reduction in the rate of growth of exports would counteract this disadvantage only to a limited extent. This is because gold, which comprised thirty-three per cent of exports in 1973, is largely air freighted to Zurich. Thus, port facilities play a bigger role in the case of imports than exports.

24. Bank For International Settlements Annual Report, June 1973.

25. A similar conclusion was reached in the case of Canadian experience with flexible rates between 1950 and 1962. See R.B. Dunn, 'Flexible Rates and Oligopoly Pricing: A Study of Canadian Markets', Journal of Political Economy, January - - June 1970, pp.140-51.

CHAPTER SEVEN - CAPITAL ACCOUNT AND EXCHANGE RATE POLICY

In the previous chapter it was stated that factors associated with the capital account of the balance of payments, together with the objectives of maintaining budgetary and economic stability, have influenced exchange rate policy to a greater extent than factors associated with the current account. The previous chapter analyzed the way in which budgetary and economic stability considerations influenced exchange rate policy. In this chapter the relationship between the capital account and exchange rate policy is analyzed.

In recent years there have been two major issues which concern the relationship between the capital account and exchange rate policy. One concerns the problem of leads and lags, and the way this has affected exchange rate policy. The other issue relates to the need to protect the short term position on the capital account of the balance of payments, and the implications of this for exchange rate policy.

7.1 Influence of Leads and Lags on Exchange Rate Policy

During the past six years or so leads and lags influenced the extent of both the December 1971 and September 1975 devaluations, the float with sterling in June 1972, and the linking to the dollar in October 1972. The revaluation in June 1973, the devaluation in June 1975, as well as the decision to introduce a system of managed floating in June 1974 and abandon it in 1975 were all similarly influenced by this factor.

The balance of payments of a country can be structured into three major components, namely the current account, long term capital account, and short term capital account. Of these three the latter is the most subject to changes partly because of leads and lags. In recent years the short term capital account in South Africa has shown greater volatility; for instance whereas in the 1968-71 period the ratio of the short term capital inflows not related to reserves to changes in the net foreign reserves was ,61. in the 1972-76 period it was 1,6.[1] Also, during recent years there has been

no evidence that mitigations in these inflows have been possible because of an inverse correlation between private and central government and banking sector inflows as shown in the following table:-

TABLE 16 - QUARTERLY MOVEMENTS IN SHORT TERM CAPITAL

	1972		1973		1974		1975	
	Private	Official	Private	Official	Private	Official	Private	Official
1st Quarter	-17	19	19	-56	72	45	9	-36
2nd Quarter	37	-48	-44	-52	75	-18	144	137
3rd Quarter	-52	-30	-17	4	34	0	-3	242
4th Quarter	-93	54	-73	-22	252	-21	214	-189

'Official' refers to the Central Government and Banking Sectors.
Source: Reserve Bank Quarterly Bulletins.

Identifying the influence of leads and lags on the capital account can partly be gleaned from the item 'errors and unrecorded transactions'.[2]

TABLE 17 - ERRORS AND UNRECORDED TRANSACTIONS (Rm).

	1971	1972	1973	1974	1975	1976	1977
1st Quarter	34	-3	-91	-234	159	-2	-271
2nd Quarter	9	-23	-41	-155	17	-104	-239
3rd Quarter	49	5	-42	-28	-115	-123	
4th Quarter	17	-33	88	87	-9	28	

Source: Reserve Bank Quarterly Bulletins

Although not totally accurate the table does give some indication of the increasing problem of leads and lags.

7.1.1 Vulnerability to Leads and Lags

For a number of reasons South Africa is particularly vulnerable to this influence. Firstly, the structure of the balance of payments normally incorporates a current account deficit counterbalanced by net capital inflows which reflects the developing nature of the economy. Consequently, the foreign reserves can be markedly reduced by retardation of capital inflows because of devaluation fears, or conversely boosted by greater inflows on expectations of a revaluation.

Secondly, the economy is open partly because a significant segment of it remains foreign controlled.[3] In these circumstances, although strict exchange controls have been operated since 1960, scope for large changes in capital flows through leads and lags exists via such channels as dividend remittances, timing of new investments, repayments of loans from parent companies overseas, and by switches in borrowing as between domestic and foreign capital markets. In addition, there is the potential impact of leads and lags due to the dependence of the country on foreign trade.

Thirdly, the principal export, gold, can fluctuate markedly in price, thus inviting speculation in respect of the rand. Simultaneously, in recent years the official gold stock, a major element of the foreign reserves, has been difficult to mobilize to cope with foreign reserve strains. This arose because only limited amounts could be sold on the market, while the lingering dispute over the monetary role of gold meant that its use in central banking channels was precluded, at least until the middle of 1974. More recently however, this problem has eased because of the use of gold swaps.[4]

Fourthly, in recent years a sizeable number of traders have not taken out forward cover on export receipts or import payments despite wide fluctuations in currency rates, while exchange rate consciousness among the business community has become more marked in the face of greater rate flexibility. Fifthly, at times expansionary monetary policies such as in 1974 and 1975 provided

local banks with additional liquidity which could be used by importers in particular to exacerbate leads and lags problems.[5]

Lastly, the political sensitivity of the Southern African continent can provoke speculation against the rand.

On the other hand, several factors alleviate the problem of leads and lags in the case of the Republic. Non-resident portfolio investment transactions are channelled through the securities rand market. This eliminates pressures on the foreign reserves which emanate from fluctuating investment and political sentiments towards South Africa on the part of non-resident stock exchange investors. Stringent exchange controls also reduce the problem. In particular, such controls provide the Reserve Bank with the opportunity to engage in their own leads and lags operations. At a time of adverse pressures on the foreign reserves the Bank can, if necessary, delay dealing with exchange control applications for permission to transfer capital abroad, while speeding up the processing of applications to bring foreign capital into the country.

7.1.2 Disruptive Potential of Leads and Lags

The potential disruption that these can entail in the administration of the foreign reserves is suggested by the statistical indicators below which relate average quarterly imports and exports to the average monthly foreign exchange holdings of the Bank. Using such indicators the higher the ratio the greater vulnerability of the Bank to the sudden speeding up of import payments, or the withholding of foreign exchange receipts.

TABLE 28 - INDICATOR OF LEADS AND LAGS VULNERABILITY

	(1) Quarterly Average Exports (Rm)	(2) Quarterly Average Imports (Rm)	(3) Average Monthly Reserve Bank Foreign Exchange Holdings (Rm)	Ratio of 1/3	Ratio of 2/3
1972	549	704	307	1,8	2,3
1973	636	874	481	1,3	1,8
1974	804	1 430	241	3,3	6,0
1975	904	1 670	255	3,5	6,5

Source: Adapted from the Reserve Bank Quarterly Bulletins.

This table, while indicating the increasing vulnerability of the Reserve Bank to leads and lags in 1974 and 1974, provides an imperfect view of the problem which adverse speculation can entail. It only highlights the potential for leads and lags which stem from foreign trade and ignores capital account influences. A change in the average leads and lags by a single week is equal to a change of nearly two per cent in the amount of foreign trade.[6] Thus, since the annual total foreign trade of the Republic, excluding gold, in 1975 was R14 266m. a lengthening of leads and lags by one week on the trade front would have tended to reduce the foreign reserves by roughly R285m. other things remaining equal.

7.1.3 Response of Bank

The attitude of the authorities to this problem has been influenced by past experiences in 1931-1932 when the South African pound was initially not floated with sterling thereby causing major capital outflows, and more recently by the troubles in 1971, when the rand was temporarily linked to the dollar. Against this background, when a business cycle slowdown is established and the foreign reserves are under pressure, the temptation to devalue to overcome capital account problems has been strong; hence, for instance, the moves in December 1971 and September 1975.

This strategy to cope with leads and lags pressures has been influenced by other factors too. The authorities have believed that the alternative of deflation can be risky because, when the reserves are low, its ability to ride out speculation is restricted. Deflationary measures take effect after a time lag, but in the meantime the reserves may come under further pressure, particularly because of leads and lags emanating from parties not convinced of the viability of the official strategy.

In these circumstances the problem could be mitigated if sufficiently tough deflationary policies were adopted, but the authorities have been reluctant to deflate too much, because of its potential impact upon growth and non-white employment.

Two other factors have strengthened the preference for devaluation. Firstly, since the beneficial results of deflation take time to materialise, any further fall in the foreign reserves may necessitate increased gold sales. This could depress the market price and cause speculation against the rand to intensify, as well as conflict with the official objective of orderly marketing in the interests of a stable gold market. This factor arguably has become less relevant following the start of I.M.F. gold sales, since control over the market by the Republic has been reduced. Secondly, successful deflation is more difficult to achieve now that the Bretton Woods system has disintegrated. During the period when measures are taking effect the dollar, to which the rand is linked, may appreciate in foreign exchange markets, thus raising the value of the rand. Meanwhile, irrespective of the course of the dollar, several minor currencies are depreciating steadily such as the Israeli pound and South American currencies.[7]

It should also be noted that devaluation, through its effects on leads and lags, may induce a welcome boost to internal liquidity. The relationship between the business cycle and the money supply in South Africa shows that the latter accelerates before the economy expands. Consequently, without the swift reversal in leads and lags which followed the December 1971 devaluation, the upturn in the economy could have been delayed beyond October 1972.

7.1.4 Limitations of Strategy

Nevertheless it is easy to see the inflationary bias of current exchange rate arrangements arising out of this leads and lags factor. It might be argued that in assessing the viability of deflation, rather than devaluation, the authorities should be able to gauge the future course of the dollar. However, in the short term, this is not the case. Various techniques to predict exchange rates are employed, none of which is infallible with different schools of thought existing in regard to the best forecasting methods.[8]

Moreover, in resorting to devaluation to overcome problems on the short term capital account greater difficulties may be created

on the long term capital account. Private long term investment may be deterred if foreign investors become concerned about the extent of exchange rate flexibility practised, although the dangers of deflationary policies exercising a similar influence has to be recognized.

What is more, exchange rate policy cannot be exclusively determined by speculative factors which affect the rand, and thus other measures have been used as supplements. The maintenance of interest rates at higher levels than relevant overseas rates has partly been designed to discourage adverse speculation. Early in 1976 bank credit ceilings were re-introduced so as to curb the availability of banks to finance speculation. In February 1976 exchange controls were tightened such that all South African residents receiving foreign exchange abroad had to sell it within seven days to an authorised foreign exchange dealer in South Africa. Before, foreign exchange had to be transferred to the country within thirty days. This new rule could be circumvented by exporters with the connivance of their foreign customers, but unless the rand was expected to depreciate in the very short term the incentive to break the regulation should be absent.[9] Subsequently, in March 1976 and April 1977, gold swap arrangements with overseas parties were concluded, which strengthened the foreign exchange component of the reserves. In aggregate these latter measures have been useful in reducing the magnitude of leads and lags.

7.1.5 Resort to I.M.F.

The measures already taken are such that any further radical moves would involve extending controls to current account transactions, which is contrary to I.M.F. rules, and would interfere with the operations of traders.

One question concerns the possibility of the Bank resorting to the I.M.F. for credit facilities to try and overcome adverse leads and lags influences. Drawing rights in the Fund can be utilized to deal with current account transactions and for capital transactions connected with the expansion of exports arising out of trade, banking

and other business, or for amortization in moderate amounts. Such facilities are unavailable to meet large sustained capital outflows; instead these are expected to be suppressed. Since substantial leads and lags pressures arise from current transactions, the Bank has been able, if it wished, to utilise its I.M.F. gold and credit tranches. In general however, this has been resisted for a number of reasons.

Firstly, leads and lags have not occurred independently of other pressures on the balance of payments. If, on occasion, speculation alone had caused payments problems, resort to short term borrowings would have been more suitable.[10] Even, in these circumstances the size of the quota of the country in the Fund is small relative to the swings in reserves which can emanate from leads and lags. The gold tranche of the Republic in 1975, for instance, was only R80m. Secondly, the Bank has had inhibitions about using the I.M.F. facilities, because it can incur publicity and stimulate speculation on devaluation fears.[11] For instance, in the first half of 1975, the authorities wished to avoid adverse publicity when leads and lags problems persisted, and preferred to borrow from commercial banks abroad. In other words, while it was busy resisting devaluation the Bank preferred to avoid resort to the I.M.F.

By September 1975, however, devaluation had become inevitable, according to the Bank, and the inhibitions concerning drawing upon Fund resources disappeared.[12] On the other hand, if resort to the I.M.F. had been interpreted as requiring stricter monetary policies, devaluation fears may have receded in the first eight months of 1975.[13] Since the oil crisis in 1973 the number of countries which have utilized I.M.F. facilities has not been as great as might have been expected. Instead, major recourse to the eurocurrency markets has materialized either directly, or indirectly through encouraging nationalized industries to borrow there.[14] This trend may have partly reflected the smaller degree of conditionality vis-a-vis Fund finance in the credit tranches. It is possible that

this factor encouraged the Republic to resort to the private capital markets before September 1975.

7.1.6 Implications of Differences in Leads and Lags Environment

Speculative problems are not unique to a local situation which comprises payments difficulties, low reserves, and a depressed economy. They can materialize when the balance of payments is in deficit, the reserves, although high, are falling, and the economy is booming. The difference is that deterring leads and lags by deflation is much more appropriate under these latter conditions. This is because of its dis-inflationary implications, and because the authorities can resist speculation against the rand more easily when the reserves are higher. Even the internal liquidity effect of such adverse leads and lags will probably not be unwelcome.

Under such circumstances this is what the authorities have tended to do as for instance in January 1974. The same move, however, was carried out in August 1975 when the business cycle slowdown had started, but this was made after a previous rand devaluation, and when the effective exchange rate had only appreciated slightly.

Although of lesser importance favourable leads and lags movements have been prominent in influencing policy on occasion. For instance, the possibility of unwanted speculation in favour of the rand developing in October 1972, in the wake of the weakness of sterling and the improving balance of payments position, partly prompted the unlinking from sterling. Similarly, the June 1973 revaluation was partly influenced by the danger of speculation in the midst of the soaring gold price, and the weak dollar.[15] On this occasion liquidity inflows could have depressed interest rates at a time when the economy was expanding strongly, inflation pressures were mounting, and foreign interest rates rising.

7.2 Implications of Need to Protect Short Term Capital Account

In recent years an active interest rate policy has been practised in order to influence in particular the short term capital

account of the balance of payments. As will be explained, this has, to some extent, been a substitute for a more flexible exchange rate policy.

7.2.1 Influence of Interest Rates

Local short term interest rates traded below overseas short term rates in the latter part of 1972 and the first half of 1973. From the start of 1974, however, local rates have been consistently higher than foreign rates. Figure 5 also indicates that when the foreign reserves peaked out in the middle of 1973 local three months N.C.D. rates were roughly at their maximum negative differential to three months eurodollar rates. Subsequently, as the foreign reserves fell the negative differential was turned into a positive one. When the reserves reached a low point temporarily in the second half of 1974 this positive interest rate differential became more significant. Then, as the foreign reserves rose, this positive differential narrowed.

This reversal in interest rate differentials reflected a number of factors. Firstly, it came to be used as a method of counteracting adverse leads and lags. Secondly, although the economy was in a slowdown since around the middle of 1974, the current account of the balance of payments remained in substantial deficit.[16] Compensatory inflows were therefore crucial. Even when the current account ran into surplus in 1977 this remained the case, since short term capital inflows had to provide a cushion for the fall off in long term capital inflows associated with political uncertainties.[17] Thirdly, despite the presence of forward cover facilities in the case of trade finance, traders have under the influence of floating rates for the major currencies, periodically switched from foreign to domestic sources to finance imports.[18] This has adversely affected short term capital inflows, and one method of discouraging this has been to raise short term domestic interest rates.

Since both short and long term capital inflows are influenced by this interest rate differential, the success of a rand devaluation

could be enhanced by monetary policies designed to stimulate capital inflows. Conversely, a revaluation could be aided by a negative interest rate differential. In 1972, therefore, monetary policy conflicted with the aims of devaluation policy, because local interest rates were allowed to decline.[19] The economy in the first three quarters of 1972, however, was slack, and from October 1972 onwards a rand appreciation policy was pursued until early 1974. In such circumstances it is debatable whether tighter monetary policies would have been suitable, given the short term objective of exchange rate policy, although the inflationary implications cannot be denied. Moreover, keeping interest rates higher in 1972 may have been self-defeating, since it would have stimulated higher capital inflows.

7.2.2 Limitations of Policy

This interest rate policy has nevertheless had two clear disadvantages in recent years. Firstly, by keeping domestic short term interest rates higher than overseas rates this has encouraged the raising of foreign capital to finance imports and exports. On the import side this may have boosted imports as traders were encouraged to buy abroad, rather than in South Africa, because of the cheaper foreign finance facilities. Secondly, and much more important, from 1977 onwards this latter policy has been in conflict with domestic economic objectives. As the current account moved into a surplus and the domestic economic slowdown persisted, the need arose to lower interest rates in order to stimulate the economy. However, this clashed with the need to keep short term interest rates high in order to bolster the capital account, which continued to be weak partly because of political uncertainties.

7.3 Possible Alternative Policies

Several alternative policies can be identified as possibly providing a remedy to this problem of internal and external conflicts of policy, or at least alleviating the problem.

7.3.1 Floating of Rand

One alleged solution would have been to float the rand on the

grounds that this would have made feasible an independent monetary policy. This argument, however, overlooks the domestic repercussions of a sinking rand on the inflation rate. Any acceleration of the latter could have induced the government to initiate more restrictive monetary policies. Moreover, to have floated the rand at a time of balance of payments difficulties could have created suspicions that the authorities were prepared to allow a sizeable fall in the value of the rand. This could have led to speculation and an excessive fall in the rate. In any case this would not have been a practical policy option unless certain institutional aspects of foreign exchange arrangements had been changed.

7.3.2 Devaluation of Rand

The authorities could have devalued the rand, a move which could have yielded a number of benefits. It could have improved the current account position further, and enabled any continued capital outflows to be financed more easily. Moreover, although statistical analysis provides no evidence of any association between a fall in the trade weighted value of the rand and rising capital inflows since the end of 1971, a devaluation could have boosted inflows in three ways. Firstly, following a devaluation, forward cover on imports should have become less essential, and so resulted in a lower cost of foreign trade finance. In this way capital inflows could have been boosted while scope could have existed for a fall in short term domestic interest rates. Secondly, a devaluation might have encouraged long term investment inflows by foreign firms, who were previously exporters to this country, and who decided to set up local operations in order to continue selling their products. This could have materialized if a rand devaluation had rendered unprofitable exports by such firms to the Republic. However, apart from the political factor, the relevance of this latter influence is dubious especially if the benefits of devaluation are quickly eroded, or the currency is subsequently revalued. Thirdly, if devaluation had boosted economic growth and this resulted in a higher return on

capital invested in the Republic, capital inflows could have been boosted.[20] Meanwhile, in another respect, the position on the short term capital account in 1976-77 strongly deterred any devaluation move. The deterioration in the balance of payments position after the middle of 1973 was accompanied by a substantial build up in short term foreign debts of the Reserve Bank (see Figure 13) as well as those of the government. The latter was partly indicated by the declining percentage of marketable foreign stock outstanding to total foreign debt of the government (see Figure 14). These liabilities were a deterrent to devaluation because of increased servicing and repayment costs which would have been incurred.

7.3.3 Modifications in Forward Cover Charge

In order to alleviate the problem on capital account a cut or abolition of the one per cent forward cover charge on imports could have been undertaken.[21] Other things remaining equal, this would have reduced the cost of foreign trade finance.[22]

A number of factors, however, rendered such a move unlikely. It would have increased the exposure of the Reserve Bank on forward exchange account against a background of large losses, which have been incurred in recent years. Secondly, any significant deterioration in interest rate differentials, which favour using domestic finance, could not be counterbalanced by tinkering with the forward cover charge. It is inconceivable that the authorities would provide forward dollars at a discount. Thirdly, alterations have been rendered unlikely since the middle of 1977 because the issue of forward cover provision is being investigated by the De Kock Commission.

7.3.4 Tax Changes

Another option would have been to allow a fall in domestic short term interest rates, and simultaneously protect the capital account by the subsidization of interest rate costs on say short term foreign trade finance. For instance, tax relief of 150 per

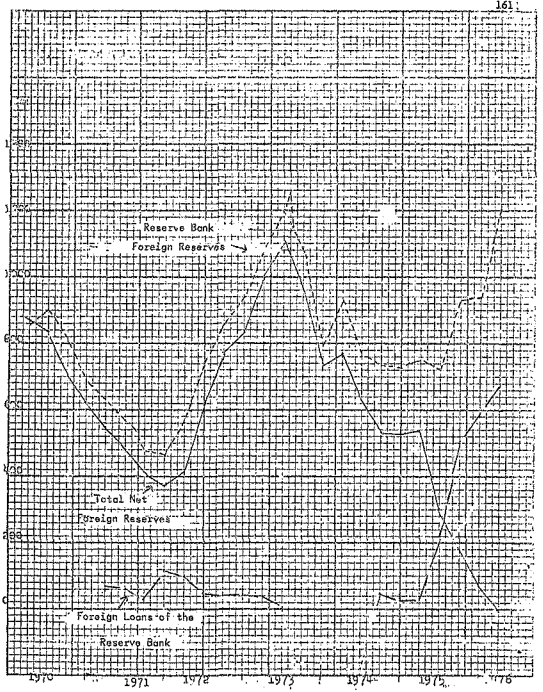


Figure 13. Foreign Reserves Position and Foreign Loans of Reserve Bank

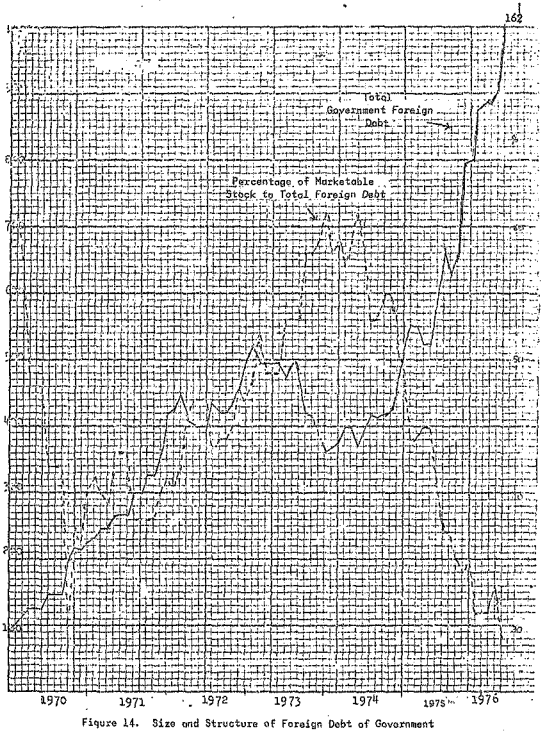


Figure 14. Size and Structure of Foreign Debt of Government

Monetary authorities may be predisposed towards the latter practice because it creates an appearance of active management on the exchange rate front, while simultaneously, adjustments in the overall value of the currency vis-a-vis the basket become confused in certain quarters with daily changes in the relative value of the relevant currencies. Moreover, the authorities of the country, although keen to maintain the effective value for its currency over certain periods, may be conscious that any pegging policy introduces distortions in the sense that the peg does not fully reflect exchange rate movements which would occur if the currency was floating. At certain times it may be keen to allow the latter's value to be more market orientated. Alternatively, a country effecting periodic devaluations may desire to prevent its currency from appreciating in the intervals between such adjustments, which can happen if it were linked to a national currency. This consideration could be relevant for a country experiencing a very high inflation rate (but less so for the Republic) if it adopted an independent currency basket link.

10.2.2 Basket Disclosure

If the latter kind of basket is adopted, an important issue is whether the contents should be disclosed. Some countries do provide such information, but there is a case for not doing so.

Firstly, non-disclosure may facilitate the de-politicization of exchange rate policy, as the currency composition or the weights can be changed in secret. If such manipulation was suspected, however, it may discourage foreign investment, as investors felt less able to predict the trend of the exchange rate.[26] For the Republic this would be an important consideration. Although non-disclosure avoids possible embarrassing investigations into whether the basket is appropriate, it can also be criticized on grounds of unwarranted secrecy.[27]

Secondly, to the extent that the predictability of rand currency changes was reduced, this could moderate speculation,

particularly if, at the same time, automaticity in exchange rate policy is lessened by not adhering to a specific average value for the rand in terms of the basket. Nevertheless, the capacity of market operators to discover the composition of the basket should not be underestimated, and therefore it would be advisable that the basket contain an unidentifiable variable.

10.2.3 Exchange Rate Uncertainty

From the viewpoint of generating greater certainty and confidence in the exchange rate system, an SDR peg has been alleged to be superior.[28] It is also claimed to be preferable for ensuring constancy between the cross rates of pegging countries.[29] For developing countries linking to different baskets, varying cross rates would exist between their respective currencies. This would be unimportant for South Africa since its trade with Third World states is small owing to balance of payments structures and political obstacles.[30] However, exports of manufactured goods to these countries might be restrained by such exchange rate arrangements. Around twenty per cent of merchandise exports of the country consist of these products, while a substantial part of the remainder is sold under conditions allowing no control over prices obtained. Thus an SDR link might be preferable to the Republic, if adoption of this peg spreads, in the sense that uncertainty faced in exporting would be reduced compared with an alternative basket peg.

Since July 1974 the SDR has been defined independently of gold, but the Republic supports in principle a restored par value system based on gold. Linking to this asset may therefore impair the credibility of this policy, even though par values could not be expressed in terms of a fluctuating gold price. Whether the greater use of the unit as a reference point will promote its monetary role is doubtful. For instance Saudi Arabia refused to participate in SDR allocations in 1969, but pegged its currency to the latter in March 1975 when it severed its link with the dollar.

10.3 The Rand-Sterling Link

Virtually throughout the inter-war and post-war periods the Republic maintained an unchanged rate against sterling, and the decision to link to the dollar only came in October 1972 at a time when the Bretton Woods system was crumbling. Even subsequently, the course of the rand/sterling exchange rate could be interpreted as showing that the authorities had a target range for the rate. Until late 1976 the rate fluctuated between an upper limit of around 1,85 rand to the pound sterling, at which level the rand was revalued in February and June 1973, and a lower limit of around 1,50 to the pound, which in September 1975 was accompanied by a devaluation.

This pattern probably did not reflect any conscious attempt to manipulate the sterling rate, since changing the rand/dollar rate solely to influence the sterling rate could not normally be justified given the extent of trade links with the U.K. and the sterling denomination in foreign trade. Instead, the movement of the rand/sterling rate from around the end of 1972 until late 1976 partly reflected the stability of the sterling/dollar rate from August 1973 to March 1975.[31]

Unlinking from sterling in 1972 has been justified on both political and economic grounds. Politically, there has been the desire to avoid being tied to a weak currency, probably because of the bad impression it might create in overseas banking circles, and domestically, because it could be presented as showing independence of such a currency in conducting exchange rate policy. Although the economic image of the country may have been enhanced by a dollar connection, it has not provided any greater degree of independence, nor at times avoided an undesired weakening of the rand. From another viewpoint this connection may be less desirable for if United States political hostility towards the Republic mounts, it probably can more easily apply an economic boycott than Britain.[32]

10.3.1 Sterling Link and Transmission of Inflation

On economic grounds the inflation record of the country has been better than that of Britain. Over the 1966-76 period the average annual rise in consumer prices was 9,6 per cent in Britain compared with 6,7 per cent in South Africa. More recently the differential has widened. During 1972-76 the British average annual inflation rate was 14,6 per cent, while the local rate was 10,6 per cent. If a sterling link means that the Republic faces a higher inflation rate than would otherwise be the case, and this is considered undesirable, such a policy entails 'costs' which have to be set against possible benefits. However, a number of factors suggest that the inflationary dangers of a sterling link need not be significant.

Firstly, the rand technically could be periodically revalued against sterling to compensate for any inflationary differential. One difficulty here is that in view of the danger of asymmetrical price effects of exchange rate changes, and in particular the possible 'ratchet' effect, the influence on the local price structure of revaluing against sterling may be very limited, especially in the case of small adjustments.[33] Also, pressures to revalue would probably differ depending on whether inflation rates in the two countries were accelerating, declining or stable. If rates were declining, and especially if the differential was narrowing the incentive to keep the rand/sterling rate unchanged could be stronger, and vice versa if inflation rates were accelerating.

Secondly, although the external value of the pound has fallen markedly in recent years, its internal weakness does not automatically mean that it will be persistently weak externally while floating thus weakening the rand if linked to it.[34] This is partly because the British balance of payments structure is being modified by North Sea oil production, and also because the capital account plays a major role in influencing the sterling exchange rate. In the next few years, oil output could exert upward pressure on the rate despite high inflation, and its adverse implications for manufacturing industry.[35]

Likewise, a lower inflation rate in South Africa does not, except possibly in the long term, mean that the rand must appreciate against the pound if pegged to it. This pegged rate, and thus the overall value of the rand, would be determined by factors such as internal economic conditions, terms of trade movements, capital inflows, sterling rates against other currencies, as well as local and overseas inflation trends.

Thirdly, by linking to sterling, monetary and fiscal policies may be less expansionary. If a greater depreciation of the external value of the rand results, the incentive to pursue expansionary policies may be blunted, especially at times of balance of payments deficits, because of their inflationary implications, and because such a depreciation might foster faster economic growth by stimulating exports and discouraging imports.

Supporting this viewpoint is the consideration that when a country's currency is pegged to that of a major nation, it expresses an intention to align its policies largely with those of the partner country.[36] Thus a sterling link could affect capital inflows harmfully as confidence in the quality of economic management in the country withers, and given the importance of foreign funds to the Republic, a strong incentive to pursue more cautious monetary policies could arise. In contrast, by pegging to the dollar, which has experienced an inflation rate lower than the world average in recent years, policy may become more stimulatory.

In retrospect, it was also apparent that the fiscal policies of the country in 1975-76 were based on the maintenance of unsustainable gold prices, which led to increased reliance upon bank credit.[37] With a sterling link, excessive dependence on gold would be even more risky, the metal being denominated in dollars, thus possibly inducing a more conservative fiscal stand.

On the other hand, even if a peg to the British unit did constrain domestic actions the influence could be marginal, because of difficulties in pursuing divergent monetary policies due to the

danger of destabilizing capital inflows. Moreover, these arguments concentrate on the effect of alternative currency pegs on the domestic policies of a country, when the causality may be the reverse. As regards the influence of gold, from a payments stability viewpoint a dollar link is beneficial, given a fluctuating bullion price, the dollar float, and the approximate thirty per cent contribution of the metal to total exports.

10.3.2 Sterling Link and Diversification of Foreign Trade

Against the background of the relatively poor post-war economic growth of the United Kingdom, and its entry into the Common Market in 1973, this past link to a floating pound may have been interpreted as negative in view of the desire of the Republic to diversify its export trade.[38]

Whether severing the association has contributed in this respect is difficult to say, but the share of Britain in the merchandise exports of the Republic fell from around twenty-two per cent in 1972 to less than twenty per cent in 1975. The dollar link may have encouraged traders to concentrate their efforts on the dollar area, because exchange risks are limited to the rand/dollar leg where cheap forward cover is obtainable, whereas British trade involves two-leg transactions, and a higher risk. Such a trend, however, may have been curtailed as a result of greater dollar trade opportunities being partially sacrificed for higher profit margins and prices. Also, sterling transactions can still be attractive for local importers when the forward dollar rate stands at a sizeable discount. Moreover, low British economic growth implies small growth of exports to Britain from the Republic, but the marginal propensity to import is far higher than that of the United States.[39]

10.3.3 Influence on Foreign Portfolio Investment

From another angle it can be alleged that the desirability of a sterling link was diminished following the imposition of the investment dollar premium and surrender rule to South African shares in June 1972, and March 1974 respectively. This has been a

contributory cause of the reduction in the intake of foreign portfolio capital of the Republic in recent years, which is indicated in Table 22.

TABLE 22 - NET INFLOW OF FOREIGN PORTFOLIO INVESTMENT (Rm)

1968	1969	1970	1971	1972	1973	1974	1975	1976
113	16	44	83	112	-30	-26	-36	-87

Source: South African Reserve Bank, Quarterly Bulletin (various issues)

The importance of foreign exchange considerations in influencing overseas portfolio investment has been put forward in the case of Japan.[40] However, whether a relatively stable rand/sterling rate would have been important for South Africa in recent years seems doubtful. Apart from the restrictions on portfolio investments in local shares, the impact of political events is suggested by the fact that direct British foreign investment remained strong until 1974.[41]

It would be wrong to conclude, however, that exchange rate factors have been playing no role recently. As the previous table shows, since 1973 a net outflow of portfolio investment has materialized. This partly reflects the substantial securities rand discount which has encouraged foreigners to invest in quoted securities via the securities rand market. As a result no new funds enter the country while, when the investments are redeemed, the funds may, depending on circumstances, be repatriated through normal banking channels.[42]

Exchange rate policy may be facilitating this future exchange outflow, since the reduced enthusiasm for flexibility, following the abandonment of managed floating in June 1975, may have made foreign investors less concerned about rand devaluation possibilities. A sterling link could have reduced investors' willingness to invest using securities rand unless the currency was revalued to counteract depreciation resulting from the pound peg.

10.3.4 Other Implications of Sterling Link

In the light of past events the question arises whether such

an association could have provided other benefits. The periodic candidature of the rand for revaluation, due to weakness of the British currency, could have been strengthened by speculative capital inflows. This was the case in October 1972 when, apart from unlinking from the pound, the rand was revalued by roughly four per cent. In contrast, under the dollar peg the American unit occasionally has firmed markedly, producing adverse capital movements, and providing partly the rationale for devaluation, allegedly to an unjustified extent, such as in September 1975.

This danger would have existed under a sterling link if weakness of the pound had encouraged the authorities to let the rand float down. What seems more certain is that a sterling peg, by providing at times an undervalued rand, would have restrained adverse leads and lags movements. This should have enabled the managed rand float to be conducted more successfully in 1974-75, may have lessened the resort to tighter exchange controls to dampen leads and lags influences, and facilitated orderly gold sales.[44] On the negative side, stimulation of speculation in favour of the rand could have entailed internal liquidity problems.

On the forward exchange front the ease and costs of access to forward markets can influence selection of a currency peg by a country.[45] Here the dollar has the advantage over sterling since it is the most widely used vehicle currency.

In another respect a sterling link may have been preferable. The one per cent per annum charge for forward dollar facilities enables traders to cover exchange risks at rates which do not adequately reflect the risk faced by the Reserve Bank. This, together with the normal net forward commitments of the latter to sell dollars, can involve substantial losses in the event of a rand devaluation.

If anchored to sterling, rand revaluations would have been desirable occasionally, thus encouraging exporters to sell sterling forward, and discouraging importers from buying forward. This could have resulted in the Bank facing net forward commitments to

buy, and thereby losses in the event of a revaluation. However, during the 1970-75 period the ratio of merchandise exports to imports varied between 0,53 and 0,78, a considerable reduction in the covering of imports and increase in export covering thus being necessary for the above result to apply. If it did not, revaluations would not have entailed losses.

10.4 The Rand Link to the Dollar

It may be argued that support for gold by the Republic and its indictment of the international monetary system as being too dollar orientated was not inconsistent with its decision in 1972 to peg to the American unit. Although it constituted adherence to a dollar standard this most probably did not reflect enthusiasm, but restricted ability to manoeuvre, in adapting to global monetary developments over which the country was largely an observer. In any case a de facto dollar standard had existed prior to August 1971 due to the unofficial virtual suspension of dollar convertibility into gold after March 1968, while the system has been diluted by adoption of floating exchange rates by the major Western countries. Thus, the primary significance of the move may be confined to the use of the dollar by the Reserve Bank as the intervention unit.

On the other hand, the roles of the latter as an intervention currency and official reserve asset are interdependent. More important, other countries have similarly severed their ties with sterling and anchored their currencies to the dollar, the cumulative result arguably being a strengthening of its near monopoly status as an international asset. The pound traditionally has been the only major reserve currency alternative to the dollar, but alongside the decline of sterling as an intervention currency the British authorities have favoured reducing its official reserve currency role. Thus, in January 1977 they negotiated a $3 billion 'safety net' with major Western financial nations to finance withdrawals of official sterling balances.

10.4.1 Effect of Dollar Link on Inflation

Empirical evidence suggests there has been a stronger correlation between South African and British inflation than between American and local price trends, which might have stemmed partly from the rand-sterling ties.[46] It is alleged that inflation in countries which peg their monetary units to the dollar can be profoundly, if not completely, influenced by price trends in the United States.[47] On this basis local inflation should have been modified by the change in 1972. There are, however, reasons for doubting the validity of the above claim in the case of the Republic, the dependence of the economy on America not being crucial, while the dollar peg is flexible. Recent trends in this regard are shown in Table 23.

TABLE 23 - AVERAGE ANNUAL PERCENTAGE CONSUMER PRICE RISES (1972-76)

	South Africa	United States	United Kingdom
1972	7,0	3,3	7,1
1973	10,0	6,2	9,1
1974	11,6	11,1	16,0
1975	13,5	9,1	24,3
1976	11,1	5,8	16,6

Sources: I.M.F. Financial Statistics and South African Reserve Bank, Quarterly Bulletin (various issues).

The patterns are inconclusive, the time span being short, but the association with inflation in the United States lagged one year has been strong, whereas on a year by year basis the correlation with British inflation has remained prominent.

However, important changes have recently occurred in the balance of payments structure of the Republic which, if they persist, could influence local inflation trends. In particular, since roughly the end of 1975 a marked deterioration has materialized in the long term capital account position, and consequently dependence

on short term capital inflows has increased.[48] Given the fixed rand/dollar rate existing since September 1975 and the importance of short term dollar finance, this means that monetary policies of the Republic are becoming more dependent on short term interest rate trends in the United States, which could imply a closer relationship between price trends in the two countries.

10.4.2 Implications of Relative Dollar Stability

The general superiority of the dollar in its link role is partly based on the claim that among major currencies it is the least likely to have its value deliberately manipulated by the American authorities because of their largely passive exchange rate policy.[49] Traditionally, they have only intervened in exchange markets on requests from, and for the account of, other countries.[50] Also, a number of difficulties would arise if the United States were to intervene extensively because of the danger of inconsistent dealings vis-a-vis other monetary agencies, and trading problems in currencies with thin markets.[51]

Irrespective of which currency is used for intervention purposes its fortunes bear no close relevance to those of the rand. Nevertheless, the American passivity can be advantageous if it is associated with greater stability of its currency. In this respect the trade weighted value of sterling declined by 38,8 per cent between the end of 1971 and 1976, whereas the United States unit appreciated by 4,7 per cent.[52]

A more active United Kingdom exchange rate policy should be anticipated partly because of the greater openness of the economy, and the desire to avoid sudden massive withdrawals of short term foreign capital which could depress the exchange rate unduly. The adverse implications which this can bestow locally were illustrated in March 1976 when Bank of England intervention was interpreted bearishly, contributing to the fall of the pound from $2,02 to around $1,56 by October 1976. This caused the rand to rise at a time when the net foreign reserves were falling, and the economy

experiencing a prolonged slowdown which had started around the middle of 1974. Even so, a sterling peg would have been less appropriate, since further depreciation of the rand, following the September 1975 devaluation, would have materialized.

The relative stability of the dollar and the extent of foreign transactions denominated in that unit have constituted important arguments in favour of the rand being linked to the dollar. However, this stability can be exaggerated, since in the past few years its effective value has gone through a series of sizeable downswings and upswings. On occasion, moreover, South Africa could have benefited from a more active intervention policy by the American authorities.[53] Also, the next few years may witness a reversal in the fortunes of the dollar and sterling.[54]

Another question is whether the greater past stability of the dollar has reduced foreign reserve needs relative to a sterling link. As previously noted there is evidence that requirements increased in the 1973-75 period. Tying the rand to the British unit could have reduced adverse speculative pressures, although its 'demonstration effect' might have retarded other capital inflows. A more important factor is the nature of the relationship between the equilibrium rates for the pegged currency against the intervention unit.[55] If the rand/dollar relationship is more positively correlated, changes in the value of the rand induced by fluctuations in the value of the dollar will tend to be less inappropriate, and the need for reserves smaller than with a link to the pound.

Whether this is the case is difficult to say, partly because the relationship is complicated by the business cycle lag between the two countries.[56] Also, the value of the dollar is markedly affected by market actions of other countries, which indirectly influences the value of the rand. The fear has been expressed that such intervention by central banks holding substantial dollar reserves will distort its value.[57] The appropriateness of dollar movements, moreover, will in future be affected by American gold

sales policy. If sales are undertaken primarily when it is desired to manipulate the value of the dollar upwards, South Africa could face the unfortunate combination of a falling gold price and an appreciating rand.

10.5 Linking the Rand to a Strong Currency

A number of difficulties would arise if ties were established with a currency like the German mark or Swiss franc, which in the 1971-76 period appreciated overall by thirty-seven per cent and fifty-five per cent respectively.[58] Firstly, linking to a strong currency would be accompanied by adverse speculative flows, and require periodic downward adjustments of the rand. This leads and lags problem could be exacerbated because a link to the mark or franc would not provide an association with a currency area of the size of the dollar area, and thus fluctuations in the external value of the rand would be greater. Secondly, pegging to either of these units would be difficult because the Reserve Bank could not deal in them easily, while the respective monetary authorities have shown no enthusiasm over the prospect of becoming reserve currency centres. Thirdly, linking to any currency, other than the dollar or sterling, would involve additional costs in conducting foreign transactions. Currencies such as the mark and franc are relatively thinly traded, and thus an extra leg in transactions would arise, which could raise import costs and reduce export incomes marginally.[59]

When the dollar started floating in 1973 there was speculation that the Republic might abandon it and link to a European currency. At the time the Minister of Finance commented that 'should the new E.E.C. monetary arrangements become more permanently entrenched and be extended to all members, it may be desirable at some later stage to associate the rand more closely with the E.E.C. bloc'.[60] Later, the Minister claimed that the authorities would have considered this if there had been a European currency to peg to which was a gold-based one.[61]

The resort to fixed exchange rates, and even a unified currency, within the E.E.C. including Britain and new member countries, is a long term possibility, and tying the rand to such a bloc would warrant serious consideration. In 1976 the E.E.C. countries as a whole bought around 47,5 per cent of the merchandise exports of the Republic, and were the source of roughly forty-eight per cent of merchandise imports.[62] However, the prospect of any country returning to gold appears unlikely, an essential pre-condition possibly being a bout of hyper-inflation.[63] The only European states which could conceivably link to the metal are West Germany and Switzerland. This is so in view of their strong currencies, payments positions, and large gold holdings. As previously noted, a number of technical and economic difficulties could militate against linking to such currencies, even if the monetary policies of the Republic were geared to maintaining a fixed exchange rate.

In conclusion, it could be said that both advantages and disadvantages would follow the tying of the rand to a currency basket. However, at this stage, given the experimental nature of such action and the advisability of further study of it, there appears to be no pressing case for its adoption. There were strong grounds for severing the sterling peg, but the superiority of the association with the dollar over sterling may not last. Even in the past few years anchoring to the pound would probably have conferred some benefits.

References

1. Today, although major currencies are floating, the majority of I.M. ers peg their currencies in one form or another. end of 1976 the number was ninety-seven o: a total Fund membership of 129.

2. Botswana left the Area in the second half of 1976.

3. U. Tan Wai, 'Some Economic Concepts and Policy Issues in Developing Countries', Finance and Development (Washington: I.M.F., 1975), Vol.12(2), p.30.

4. It has been pointed out that switching the currency peg can involve the banking sector of a country holding balances in a different currency, building new working relationships and obtaining new credit lines with a different financial centre. See Stanley W. Black, 'Exchange Policies for Less Developed Countries in a World of Floating Rates', Essays in International Finance (Princeton University Press, No. 119, December 1976), pp.24-25.

   South African banks traditionally had dealing networks in London, but today a currency peg switch should create no problems, the banks having spread their banking connections with the growth of the Eurocurrency market, and the resort of the Republic to various segments of it.

5. The SDR unit comprises a basket of sixteen currencies, namely the U.S. dollar, German mark, sterling, French franc, Japanese yen, Canadian dollar, Italian lira, Dutch guilder, Belgian franc, Swedish krona, Australian dollar, Danish krone, Spanish pesata, Austrian schilling, and South African rand.

6. The rand/sterling rate could be quoted similarly if sterling was the intervention currency used by the Reserve Bank.

7. For example, one rand could be valued as equal to forty U.S. cents plus twenty U.K. pence plus eighty German pfennige. If at the close of trading on a particular day, the sterling rate was £1,60, and the mark £2,40 then twenty pence is worth thirty-two U.S. cents and the eighty pfennige thirty-three cents. Thus the rand rate quoted by the Reserve Bank the next day would be £1,05. If, at the close of that day, the sterling rate had risen to £1,80 the rand rate would appreciate to £1,09.

8. E.M. Bernstein et al. 'Reflections on Jamaica', Essays in International Finance (Princeton University Press, No.115, April 1976), p.2.

9. South African Reserve Bank Quarterly Bulletin, March 19.5, p.S-63. The respective weights were German mark 8,8 per cent, French franc 4,4, Italian lira 2,2, Japanese yen 6,0, Dutch guilder 1,8, Portuguese escudo 3,3, Swiss franc 1,6, pound sterling 22.1 and U.S. dollar 34,3.

10. Before the foreign trade of the Republic utilizing sterling finance (but not involving trade with the U.K.) had increased markedly because of the significant discount on forward sterling.

11. The raising of foreign capital by the Republic in traditional national capital markets has declined, only $32,6m and $87,7m. being obtained by straight bond issues in 1973 and 1975 respectively, and nothing in 1974. See O.E.C.D., Financial Statistics Supplement, (Paris: Bureau of Publications, No.10A, 1976), p.158.

12. O.E.C.D., Financial Statistics (Paris: Bureau of Publications), No.10 pp.578-610, and No. 108, 1977, pp.232-40.

13. Eurodollars account for roughly seventy-five per cent of total Eurocurrency deposits. See Rita M. Rodriguez and E. Eugene Carter, International Financial Management (Inglewood Cliffs, New Jersey: Prentice Hall, 1976), p.464.

    It should also be noted that loans can incorporate multi-currency options providing the borrower with the facility to switch denomination of the loan at certain times.

14. As far as the writer can ascertain even where this strategy is both profitable and feasible, public corporations do not arrange such covering operations.

15. Moreover, although a considerable amount of foreign borrowings are denominated in one currency, this is not necessarily undesirable, a prominent factor being its sta If the authorities become concerned about the exten gn liabilities in a particular currency then, in s of public corporations, pressure could be exerted . the nature of forward cover.

16. Victor Barrett, 'The Rush to Peg to SDRs' Euromoney, May 1975 p.37. Also, I.M.F. Survey, Washington, Vol.5., 1 March 1976, pp.69-71.

17. For instance, the Scandinavian currencies have a combined weight of 5,5 per cent whereas foreign trade of South Africa with this group is very small.

18. Stanley Black, op.cit., p.25.

19. The evidence arises by comparing the 1969 to mid-1972 period with the 1973-75 period in which exchange rate flexibility increased.

The analysis involved taking the percentage change in the quarterly net foreign reserves of the Republic, and deducting the percentage quarterly change in world reserves, since the trend in the latter can be used as a proxy for the share of South Africa in world liquidity growth and represents 'use' of reserves. Given this information two techniques were employed to measure the use of reserves in the respective periods. Using the first method, the average of the absolute values of the quarterly percentage changes in reserves in the two periods were computed giving a figure of 9,2 per cent for 1969 to mid-1972, and 21,9 per cent for the later period. With the second method the standard deviation of percentage changes in quarterly net reserves about the mean value was computed for the two periods, giving results of 10,0 and 19,4 respectively.

For a full explanation of the rationale behind this approach see Esther C. Suss, 'A Note on Reserve Use under Alternative Exchange Rate Regimes', I.M.F. Staff Papers, Vol.XXIII No.2, July 1976, pp.387-94.

20. Such a basket would have to be based on the foreign trade and payments structure of the country, and if it reflected only trade transactions it could be based on three different indices. An export weighted index could be used representing the arithmetic average of its exchange rate against other relevant currencies, relative to a base period, weighted by each trading partner's share in the exports of the country. Secondly, it could be an import weighted index constructed on similar lines, except that it would be based on the weighted share of each trading partner in the imports of the country. Thirdly, a bilateral trade index could be constructed, which is the arithmetic average of the export weighted index, and the imported weighted index, weighted by the share of exports and imports, respectively, in the total foreign trade figures.

21. R.R. Troeller, 'Currency Baskets and How to Find Stability in Motion', Journal of Institute of Developing Countries, Vol.XIV, No.3, September 1976, p.219.

22. Although the parity of the rand remained unchanged between the pre-November 1967 sterling devaluation and the beginning of 1971 the weighted average value of the rand in terms of all other currencies rose by about five per cent. See South African Reserve Bank Annual Report, 1973, p.19.

23. Andrew D. Crockett and Saleh M. Nsouli, "Exchange Rate Polices for Developing Countries', Journal of Development Studies, Vol.13, No.2, January 1977, p.133.

24. In the 1966-76 period the Republic suffered from instability in export growth, the annual average growth rate in money terms being 11,9 per cent with a standard deviation of 16,4, the corresponding figures for world exports being 17,4 per cent and 13,2. These figures are based on information provided in I.M.F. Financial Statistics, May 1977, pp.56-57.

25. The Israeli pound was devalued in this manner in March, May and July 1977, while in May 1977 the value of the Sri Lanka rupee was appreciated by roughly twenty per cent against its basket. In November 1976 the Australian government abandoned the policy whereby its currency was pegged in a fixed relationship to the average of a trade weighted basket of currencies. See Michael Gleeson-White, 'A Basket of Three Civil Servants', Euromoney, February 1977, p.122.

26. Andrew D. Crockett and Saleh M. Nsouli, op.cit., p.132.

27. The New Zealand central bank has been subject to this charge while linking to a non-disclosed basket. See International Currency Review, Vol.9, No.2, 1977, p.19.

28. Andrea S. Gerakis, 'Pegging to the SDR', Finance and Development, I.M.F., Washington, Vol.13, March 1976, p.35.

29. Ibid., See also Andrew D. Crockett and Saleh M. Nsouli, op.cit., p.132.

30. As regards Africa, Asia (excluding Japan) and South America, around eighteen per cent of the merchandise exports of the Republic went to these areas in 1976, and around ten per cent of merchandise imports came from them. See SAFTO, Fourteenth Annual Report, 1976-77, Penrose Press, pp.9-10.

31. Taking end of the month dollar/sterling quotations the rate varied between $2,26 and $2.46 to the pound. For most of the period the rate was locked in an even narrower range of $2,30 to $2.40 to the pound.

32. Although traditionally merchandise imports from Britain have been higher than those from the United States, in 1976 merchandise imports from North America (including Canada) were greater. However, the British economy is far more 'open', and its investment stake in South Africa more substantial than that of America. See SAFTO, Fourteenth Annual Report, 1976-77, op.cit., p.10.

33. The 'ratchet' effect implies that frequent exchange rate changes produce an inflationary bias for a country over time because domestic prices will be raised more by depreciations than they will be decreased by appreciations of the same magnitude. This is associated with the proposition that domestic prices are flexible upwards, but not downwards. See P. Einzig, The Case Against Floating Exchanges Macmillan, 1970 , pp.92-101. Also, Gerald M. Meier, Problems of a World Monetary Order O.U.P., 1974, p.244.

34. Between the end of 1971 and 1976 the trade weighted value of sterling fell by 38,8 per cent whereas that of the rand fell by 6,5 per cent. See 'Trade Weighted Exchanges From Smithsonian', Euromoney, February 1977, p.145.

35. In the year ending April 1977 consumer prices in Britain rose by 17,5 per cent compared with an average of 9,1 per cent for O.E.C.D. countries in the same period.

The problems faced by the British authorities in exchange rate management in the wake of the growing contribution of oil to the balance of payments has led to a division of opinion concerning whether sterling should be allowed to reflect market forces and appreciate in exchange markets, or whether a depreciation should be engineered. See Terry Burns, 'Why a Falling Pound Solves no Problems', The Times, London, 11. July 1977, p.17. Also Michael Surrey, 'The Case for Holding Down Sterling', The Times, London, 13 July 1977, p.21. Also, Wynne Godley, 'Large Scale Devaluation is not the Answer', The Times, London, 18 July 1977, p.17.

36. Andrew D. Crockett and Saleh M. Nsouli, op.cit., p.129.

37. After reaching £197,50 an ounce in December 1974 the gold price fell to £103,50 an ounce in August 1976.

38. During the period 1959-69 the average increase in real gross domestic product in the United Kingdom was three per cent per annum. This compared with 4,3 per cent in the United States, 5,8 per cent in France, 5,1 per cent in West Germany, 5,7 per cent in Italy, and 11,4 per cent in Japan. See G. Douglas Vaughan, An Introduction to Applied Economics, Heinemann, 1974, p.150.

39. The marginal propensity to import is around 0,30 for Britain and 0,10 for the United States.

40. H. Fournier and J.E. Wadsworth (eds), Floating Exchange Rates - The Lessons of Recent Experience (Sijthoff,Leyden, Netherlands, 1976), p.83.

41. A British Department of Industry inquiry concluded that United Kingdom net direct investment in the Republic rose from £290m. in 1962 to £1 997m. in 1974. Between 1962 and 1965 investment rose by thirty-five per cent, by 49,5 per cent between 1965 and 1968, by eleven per cent from 1968 to 1971, and by fifty-three per cent from 1971 to 1974. Since then a substantial decrease has occurred. See Sunday Times Business News, Johannesburg, 10 April 1977, p.12.

42. Under exchange control regulations a non-resident can buy an existing quoted gilt or semi-gilt security with securities rand, and if held for five years he can repatriate the proceeds based on the prevailing rand/dollar rate. For new issues of semi-gilt securities, however, permission to buy using securities rand, although normally given, has not been automatic. Permission was withdrawn completely in March 1978.

43. See comments by D.J.J. Botha, Financial Mail, Johannesburg, 10 September 1975, pp.123-4.

44. This latter factor probably partly explains the decision to stay linked with sterling in June 1972.

45. G.K. Helleiner, 'The Less Developed Countries and the International Monetary System', Journal of Development Studies, April/July 1974, Vol.10, p.357.

46. In the 1962-72 period the correlation between inflation in South Africa and Britain was $r^2 = 0,46$, and on a one year lagged basis $r^2 = 0,69$. During the same period the figures for the United States and the Republic were $r^2 = 0,18$, and on a one year lagged basis 0,36.

47. G. Haberler, 'The International Monetary System After Jamaica and Manila', Review of World Economics, Tubingen: J.C.B. Mohr, 1977, No.1, p.26.

48. In 1975 net long term capital inflows were R1 746m. whereas in 1976 they fell to R921m. By the second quarter of 1977 there was a net outflow of R76m.

49. R.F. Mikesell and H.N. Goldstein, 'Is Europe becoming a Deutschmark Zone?' Euromoney, December 1976, p.36.

50. A.P. Thirlwall (ed.), Keynes and International Monetary Relations, Macmillan, 1976, p.45.

51. J. Marcus Fleming, 'Floating Exchange Rates, Asymmetrical Intervention and the Management of International Liquidity', I.M.F. Staff Papers, July 1975, p.270.

52. 'Trade Weighted Exchanges from Smithsonian', Euromoney, February 1977, p.145.

53. For instance between March and July 1973 the trade weighted value of the dollar fell by nearly eleven per cent and the Republic may have benefited from stronger support for the dollar at this stage since the five per cent revaluation of the rand in June 1973 was partly stimulated by this development. By the end of 1973 this revaluation arguably looked inappropriate partly because of a sharp recovery in the value of the dollar.

54. During 1977 the value of the pound against the dollar rose from around $1,70 to $1,90.

55. Andrew D. Crockett and Saleh M. Nsouli, op.cit., p.130.

56. Normally the South African business cycle lags behind that of the United States by around 9-12 months at a maximum. See I.M.F. Survey, Vol.15, No.6, 15 March 1976, p.86.

57. Because dollars constitute a major portion of countries' foreign exchange reserves, monetary authorities intervening in foreign exchange markets to stop their currencies depreciating are likely to sell dollars. Countries acting to prevent their units from rising may buy currencies other than the dollar. The end result could be downward pressure on the dollar at times when this is not welcome to the United States or the world at large. See Robert Solomon, The International Monetary System, 1945-76. Harper and Row, 1977, p.329.

    There is, however, a constraint on this activity, namely the difficulty faced by central banks in dealing in non-dollar currencies.

58. 'Trade Weighted Exchange Rates From Smithsonian', op.cit., p.145.

59. Even sterling is not totally immune from this disadvantage today, since the decline in its reserve currency role has been paralleled in the past few years by a similar trend in its vehicle currency role.

60. 'Statement Regarding the Par Value of the Rand', South African Reserve Bank, Quarterly Bulletin, March 1973, pp. 18-19.

61. N. Diederichs, International Currency Review, London, July-August 1973, p.12.

62. SAFTO, Fourteenth Annual Report, 1976-77, op.cit., pp.9-10.

63. E. Victor Morgan and Ann D. Morgan, 'Gold or Paper?' Institute of Economic Affairs, Hobart Papers, No.69, 1976, p.54.

CHAPTER ELEVEN - FORWARD EXCHANGE POLICY IN SOUTH AFRICA

The question of the provision of forward exchange facilities in South Africa has long been neglected, owing to a number of circumstances. For long periods the system of fixed but adjustable exchange rates prevailed, while the main export item of the country, gold, was sold through the Reserve Bank itself at a fixed guaranteed price of £35 per ounce. The concentration of foreign trade with the U.K. and the even larger denomination of sterling in foreign trade in aggregate meant that a forward market in currencies other than in sterling was of relatively little importance. Also, until 1967 the demand for forward facilities in sterling must have been limited, since as a member of the ling Area South Africa had a long record of an unchanged rand/ster:ling exchange rate, while in the absence of a proper foreign exchange market the rand/sterling rate was not subject to fluctuations within exchange rate margins which could have induced forward covering for foreign trade involving relatively small profit margins.

This environment has progressively changed. Currently, international monetary arrangements comprise a hybrid system of fixed but adjustable exchange rates and floating rates, with South Africa adopting a much more flexible exchange rate policy than during the Bretton Woods era. Adverse leads and lags which have confronted the authorities in recent years have involved both pressure on the spot and the forward foreign exchange rates. Since these pressures and the associated problems on the capital account of the balance of payments have been sufficiently powerful to influence exchange rate policy, interest in and the importance of, forward exchange dealings has correspondingly increased. Apart from these considerations the continued expansion of the foreign trade of the Republic affects positively the volume of forward exchange business undertaken.

11.1 Case for Provision of Reserve Bank Forward Cover Facilities

Given the absence of a fully developed local foreign exchange market and the associated absence of forward cover facilities available on a private basis in the market, there are strong arguments in favour of forward cover facilities by the authorities. Such justification is based on the argument that traders should be safeguarded as far as possible from the risks stemming from exchange rate fluctuations, especially since most of the foreign transactions of the country are denominated in foreign currencies.

In fact it has been argued that the authorities in countries such as South Africa are under a strong moral obligation to provide forward facilities, at least for current account transactions, irrespective of the risk involved.[1] This is also of practical interest in that the export trade is encouraged as well as the importation of essential capital goods. The latter can be costly, and long delays in delivery frequent, in which circumstances the existence of forward facilities can be of considerable benefit to importers. Likewise, exporters may feel that, in the absence of such facilities, they are at a competitive disadvantage to exporters in other countries who are obtaining forward cover to deal with their exchange risks.[2] These risks have to be faced by someone, and it has been argued that in this respect monetary authorities are better equipped to evaluate and respond appropriately to currency trends than are businessmen.[3]

However, the services provided in the Republic are such that the scope for currency flexibility enjoyed by the central bank is limited. Furthermore, if the arguments above are regarded as valid this still leaves unanswered the vital question of the extent to which these official facilities should be rendered.

It has been claimed that the justification for official support of forward rates can be that it reduces spot sales of foreign exchange relative to forward sales, and thus can relieve short term pressure on the foreign reserves position of a country.[4] By contrast, in the case of the Republic, the basic idea behind the provision of

forward facilities by the Bank is that the evaluation of its future foreign currency requirements can thereby be facilitated. More particularly, because of its advance knowledge of part of the market's purchases and sales of foreign currency, it is in a position to improve the management of the gold and foreign exchange reserves, its currency working balances and investment portfolio, and future gold sales on the private market. In addition, by providing in particular forward cover for imports, the Bank is better able to gauge the trend regarding import finance practices, and whether changes in monetary policy, cover facilities, etc., are desirable.[5]

The gold function appears especially important. This stems from the responsibility of the authorities for marketing the gold output of the country which constitutes around thirty-three per cent of total exports, and roughly seventy-five per cent of production in the western world. Other relevant considerations are the speculative elements in the private market, and the desirability of relative price stability as a means of potentially enhancing the monetary role of the metal. Looking ahead, as the exports of the Republic hopefully become more diversified, and Russian gold production rises, the yellow metal may exert less influence on local forward exchange policy.

It is pertinent to enquire whether the basic objective behind this policy should have been modified in recent years by the breakdown of the par value exchange rate system. It can be argued that with the adoption of a more flexible regime the relative need for foreign reserves has been reduced. If this is true for South Africa then, by implication, it might be concluded that the priority of anticipating future foreign currency flows should have been lessened somewhat.

There are grounds for suspecting that this conclusion may well be unwarranted. On occasions in recent years sudden and powerful adverse speculative pressures have aggravated the function of management of the foreign reserves. This latter task has been further complicated by the floating of the major currencies, which

has meant that the value of foreign currency working balances is more uncertain than in the Bretton Woods era. Evidence of the problems which have emerged can be gleaned from the trend in the external short term liabilities of the monetary banking sector, which have risen from R256m. at the end of 1972 to R1 552m. at the end of September 1976.[6]

11.1.1 Disadvantages in Providing Forward Facilities

In particular here the danger may arise that in view of the position of the Reserve Bank as a net seller of foreign exchange to the commercial banks under normal circumstances, the authorities may become reluctant to devalue. This is because losses on net forward commitments to sell could arise in proportion to the size of any devaluation. Yet, although the Bank may be absolved from indictment for the act of devaluing, any losses incurred are the direct result of the type of forward facilities it provides. Of greater importance a benign attitude towards losses cannot be counted upon in government circles.

It is possible, moreover, that profit/loss considerations could affect exchange rate policy in other directions. For instance maintaining the link with sterling, although advantageous from the viewpoint of reducing adverse leads and lags, would have had potentially adverse implications in respect of forward operations. By linking to the U.K. currency, which has been and still is fundamentally weak, periodic revaluations of the rand against sterling would have been required. This would have encouraged exporters to sell sterling receipts forward, while discouraging importers from buying forward. In turn this would possibly have resulted in the Bank incurring net forward commitments to buy, and thus facing losses in the event of a rand revaluation against sterling.

The potential losses incurred by the Bank in providing forward facilities, which have to be financed by the taxpayers, provide support for the view that those who directly benefit from foreign trade should bear the cost of insuring in the forward market. Thus,

insofar as assistance from the authorities is necessary it should be provided on commercial terms so that taxpayers do not have to finance any losses recorded by the Bank. However, if such cover is granted on a subsidized basis it may encourage the business sector to expect official concessions in other fields. Yet, to the extent that foreign trade provides economic externalities (e.g. greater local competition, a greater variety of goods, etc.) then an argument in favour of subsidized forward rates can be made out.[7] Unfortunately, this still does not clarify the issue of the scale of subsidization which is warranted.

11.2 Current Forward Exchange Arrangements

Since the major export, gold, is sold by the Reserve Bank and the latter is consistently a net seller of foreign exchange to the banks, Bank transactions on a forward basis are unlikely to be in balance as suggested in the following table.

TABLE 24 - SOUTH AFRICAN EXPORTS AND IMPORTS Rm.

Year	Net Gold Output	Merchandise Exports	Merchandise Imports	Ratio of Merchandise Exports to Imports
1970	837	1 441	2 584	,56
1971	922	1 556	2 937	,53
1972	1 161	2 218	2 852	,78
1973	1 770	2 510	3 545	,71
1974	2 565	3 137	5 734	,55
1975	2 540	3 563	6 736	,53

Source: Reserve Bank Quarterly Bulletins

This feature is enhanced by the lack of a forward market where a forward discount offered by a forward seller of dollars would imply a gain to a forward buyer and vice versa. Instead positive charges are levied on both forward buyers and sellers of dollars. This imbalance means that the central bank normally has an exposed forward position, sales commitments being larger than purchase commitments of foreign exchange.

The size of this imbalance tends to be increased due to the negative correlation existing between the latter and the ratio of merchandise exports to imports. Over the course of the business cycle this can fluctuate markedly tending to rise during the later stages of the downswing and initial stages of an upswing thereby reducing the imbalance on forward cover account. The reduction is further enhanced by the fact that with the ratio rising associated with an improved trade position the incentive of importers to take out cover and for exporters to desist from doing likewise is reduced. Conversely, the ratio tends to fall during the latter stages of the business cycle upswing and initial stages of the downswing, thus increasing the imbalance, the latter further enhanced as confidence in the rand's position tends to deteriorate.

At the same time, in the absence of the forward cover facilities of the Reserve Bank, local commercial banks would not be able to cover their own forward positions in external foreign exchange markets. This is because the rand is not quoted on the major external foreign exchange markets. Forward quotations between the rand and foreign currencies would require comparable investment facilities in South Africa and the main overseas centres, and interest yields on comparable investments, so that covered interest arbitrage could exert its normal influence on forward rates. Such conditions are precluded by the current exchange control regulations operated by the Republic.

11.2.1 Existing Facilities

Given the existing environment it is, therefore, necessary for the Bank to provide a form of administered forward cover which presently takes the form of cover in dollars against the rand at a fixed cost of one per cent per annum for either purchase or sales contracts. For non-U.S. dollar currencies forward exchange rates for the rand are derived from the relevant forward rates of these currencies against the U.S. dollar. Any forward premium or discount is then modified by the fixed cost of one per cent per annum if the purchaser or seller wishes to extend the forward exchange cover down to the rand.

The cost of forward cover in non-dollar currencies depends therefore basically on the U.S.A balance of payments position, which affects confidence in the dollar, and interest rate differentials between New York and foreign financial centres. Consequently, forward rates for the rand are different from what they would be if direct quotations were possible between the rand and these other non-dollar currencies. An actual forward premium for the rand against a foreign currency might be replaced by a discount if a direct forward rate were quoted.[8]

Forward cover is provided by the Reserve Bank to local traders for future merchandise import payments up to a twelve month maximum period, with the possibility of a longer period in the case of capital goods, following special application to the Bank through authorised dealers in foreign exchange. As regards future merchandise export receipts, forward cover for a maximum period of six months is granted, although exporters can also apply for permission to extend contracts. In addition, cover is available to public corporations for future repayments of foreign capital and interest on foreign borrowings. Likewise, authorised dealers in foreign exchange can obtain cover for the repayment of foreign loans raised in their own names, provided approval is given by the Bank. All such contracts are optional ones, which is an additional advantage to traders.[9]

11.3 Difficulties in Modifying Facilities

The cheapness and stability of the official charge of one per cent for forward dollar facilities enables traders to cover the exchange risk at rates which do not reflect the full magnitude of the risk faced by the Bank. This, together with the normal net forward commitments of the latter to sell dollars may entail substantial losses in the wake of a rand devaluation such as that which occurred in September 1975.[10]

11.3.1 Flexible Forward Cover Rate

This risk could be reduced if the Bank quoted forward rates for the dollar at a more flexible cost figure, at least for imports,

adjusting the charge, for instance, at times of greater exchange rate risk associated with greater demand to cover forward import payments.

Such a policy could however, have disadvantages in other respects. Raising the cost of forward cover can deter traders from using such facilities, with adverse repercussions on the future ability of the Bank to meet its forward commitments, which may conflict with the aim of flexibility in conducting orderly gold sales on the free market. From the viewpoint of encouraging traders to use forward facilities regularly it is desirable to make the cover charge as low as possible for both importers and exporters.

The extent to which rises in the cost of forward cover for imports would deter the taking out of cover is difficult to gauge, such decisions, seemingly, being influenced by a motley of factors. Einzig has claimed that traders who are operating on small profit margins cannot afford to run exchange rate risks and therefore must cover.[11] Many South African importers are probably not faced with such competitive conditions, given the structure of imports and the well developed import distribution sector. Yet in those cases where they are, rises in the forward charge could make importing unattractive. Nevertheless, in the case of the Republic the existing rate is very cheap, especially since the cost of forward cover is tax deductible, and with almost all foreign trade denominated in foreign currencies this, it can be argued, should provide an incentive to cover even if the cost is raised on occasions.

Also, raising the charge for forward covering of imports can encourage traders to switch from overseas sources of finance to domestic sources if local banks are sufficiently liquid to provide the finance.[12] Such a development harms the balance of payments. Any step which encourages the taking out of forward cover tends to boost the use of overseas finance, and vice versa, other things remaining equal. Making such an upward adjustment may, in addition, be interpreted as a sign of reluctance on the part of the Bank to

continue selling large amounts of forward dollars. It may thus invite suspicions about a possible devaluation and stimulate adverse leads and lags, and/or lead to fears of tighter import controls, or both.

On the other hand, the Australian Reserve Bank, operating in an environment of similar foreign exchange arrangements, quotes a flexible forward rate in both U.S. dollars and sterling, and rations from time to time the amount of forward cover business it handles on a specific day.[13] In the case of the latter, however, a more balanced forward exchange position normally prevails, and therefore changes in the cover charge may not be so easily interpreted as a sign of future trends in the balance of payments position of the country. In the case of South Africa, where a large unbalanced position normally prevails, changes in the rate may be interpreted more easily. Also, forward cover is not necessary on a sizeable portion of Australian foreign trade since much of its business with Asia and the Middle East is denominated in Australian dollars.[14]

Even so, the question may still be posed whether relatively small changes in the forward cover rate would necessarily invite large scale currency speculation against the rand. After all it amounts to saying that speculation will be encouraged by increases in the cost. At times the market will have already discounted some form of action, in which case a change in the rate may not exacerbate the problem. Moreover, leads and lags operations can be curbed partially by tighter exchange control regulations, which is what the authorities have done in recent years.[15] Following the deterioration of the political situation since 1975, over-invoicing of imports has been one method of exporting capital. This speculation against the rand has been aided by the low cover charge faced by importers.

Any tendency to change the cost of forward cover for imports would be stronger at times of balance of payments deficits, when a rise in the charge could be considered, than at times of payments surpluses, when a rate cut might be deemed suitable. The authorities

can much more easily accommodate greater selling and reduced buying of forward dollars by traders than they can in the case of greater buying and reduced selling of forward dollars. In the latter case the short position in forward dollars may become embarrassing, prove costly in the event of a devaluation, and possibly complicate orderly gold sales.

Regarding exports, an inclination to raise the cost of forward cover is probably constrained by its possible adverse effects on export receipts. However, the degree of utilization of forward facilities by exporters is probably much less than in the case of importers, because the principal export, gold, is sold by the Bank itself, while the cover facilities offered exporters are less generous than for importers. In recent years this situation may well have been entrenched by the fact that the rand on a trade weighted basis has depreciated by around one per cent per annum during the period 1972-76.[16] This may, therefore, nullify somewhat the potential drawbacks surrounding an increase in forward charges.

On the other hand, these considerations might be construed as suggesting that exporters should be granted a rebate on forward dealings, rather than incur a charge. This should, other things remaining equal, encourage exporters to cover forward, repatriate funds more quickly, and potentially boost export receipts. Assuming spot exchange rates for the rand remained unchanged it would represent a partial disguised devaluation, but without compensatory modifications in cover charges for imports would adversely affect the cash flow position on forward exchange account.

11.3.2 Forward Exchange Rationing

An alternative approach to the problem of the distorted forward position faced by the Bank would be to directly reduce the imbalance by administrative means. Over the period 1971-75 the average ratio of merchandise exports to imports was ,62, thus suggesting that the objective of achieving approximate potential balance in forward exchange where merchandise trade transactions

are concerned would require in the region of a one third reduction on the import side. This would not be easily achieved. Restricting the normal cover to imported capital goods would create an imbalance in the opposite direction, since during the current decade capital items have averaged round forty-four per cent of merchandise imports.[17] There would also be the problem of deciding whether it would be appropriate to provide cover to all categories of such goods. Refusing to grant cover facilities on imported consumer goods would not entirely solve the problem either, the latter constituting around twenty per cent of merchandise imports.

The Philippine central bank, for example, rations forward exchange to certain categories of imported items.[18] Nevertheless, it could be alleged that this kind of policy is inappropriate for an increasingly open economy like that of the Republic. Whereas in 1970 exports and imports of goods and services as a percentage of gross domestic product were 22,5 per cent and 29,5 per cent respectively, by 1975 the respective figures had reached 28,5 per cent and 35,9 per cent. It would, moreover, create business uncertainty as to whether the categories of imports exempted from forward cover might change and possibly invite speculation. Similarly, it could provoke prolonged debate and dispute regarding the merits of providing or disallowing cover to different categories of goods. In sectors where import cover is disallowed, upward price pressures could emerge, depending on competitive conditions, as businesses try to compensate for the increased risks faced on the exchange rate front by raising prices.

11.3.3 Gold Sales Procedure

In theory, the most efficient method of overcoming this distorted position would be to leave the import side unchanged, but arrange for gold sales to be conducted by the Chamber of Mines so that they sold the dollar receipts through the banking network. This is based on the fact that during the 1970-75 period the average ratio of merchandise exports plus net gold output to merchandise imports

was unity. A precedent in this direction has been set by the Chamber handling Krugerrand sales which constituted 21,1 per cent and 13,2 per cent of total gold output in 1975 and 1976 respectively.

In practice it is not at all certain that this would solve the problem, since gold is sold on a 'spot' basis in the bullion markets, and therefore the incentive to take out forward cover would normally be absent. Apart from this, by buying the local gold output the Reserve Bank is not only able to control the quantity of gold exported, but thereby control the main source of foreign exchange of the country. Being allowed to handle the gold sales might also be construed as emphasizing the continued monetary role of gold. Moreover, in recent years the authorities have gained expertise in selling the metal in the private market, and are in a position to derive information about potential future market prospects through such channels as the I.M.F.

11.3.4 Implications of Forward Exchange Losses

It can be alleged that the losses incurred as a result of the September 1975 devaluation have precluded subsequent flexibility in the conduct of exchange rate policy. The prospect of further substantial losses on forward cover account plus the heavy foreign borrowings by the Bank and Government help explain the decision to impose import restrictions rather than devalue in July 1976.[19]

It may be argued that in these circumstances, a policy decision to devalue is not necessarily ruled out, but rather the timing will be modified. Instead of such action materialising at a time of intense pressure on the rand, an attempt will be made to stave it off by other temporary measures until the balance of payments position improves, and net forward sales commitments decline as greater confidence is restored. The potential weakness here is that there can be no guarantee that temporary measures will achieve the short run objectives, while the existing losses remain a fait accompli.

Under current forward exchange arrangements the losses problem could become magnified. The imbalance between net forward purchases

and sales will tend to grow as foreign trade expands. Moreover, as noted previously, the external value of the rand has tended to depreciate overall in recent years. Although it can be argued that enthusiasm for flexibility in exchange rate policy has been waning, the consensus view may well be that the rand will remain a devaluation-prone currency because of political factors, and also the emphasis upon growth to absorb a population rising at 2,9 per cent per annum.

The risks faced by the Bank are further enhanced by the fact that the gold price is now subject to volatile movements unlike in the Bretton Woods era. The price fall, which suddenly occurred in September 1975, could occur again at some stage, conceivably forcing the authorities to devalue despite its loss implications. Meanwhile, in the absence of a major further deterioration in the external position, the existing losses which have accrued could encourage traders to stop taking out cover on the reasoning that a devaluation in terms of the dollar would be senseless. These considerations suggest the desirability of taking steps to ensure more balanced forward exchange business, and/or increasing the cover charge.

Given the losses which have been recently incurred the latter method would require a significant increase in the rate if the forward account position was to be materially improved. For instance, taking trade transactions involving dollar cover and assuming that twenty-five per cent of merchandise exports in 1975 were covered, a one per cent increase in the charge would have yielded roughly R8,9m. extra other things remaining equal. Assuming fifty per cent of merchandise imports were covered in the same year, a similar increase in the rate would have brought in approximately R33,7m. extra. Even though the assumptions made here cannot be totally accurate, the orders of magnitude involved are illustrated. Nothing but a very substantial increase in the cover charge will provide adequate protection against any future major devaluation.

Yet such a change would have repercussions on the attitudes of traders towards taking out forward cover. On the other hand, the implications for the general price level should not be serious. Given that merchandise imports now constitute around twenty-five per cent of gross domestic expenditure, each one per cent rise in the forward cover rate should increase prices by a maximum of roughly 0,25 per cent.

A more radical approach would be for the authorities to disengage from forward exchange business, and hive off the function to the private market; in other words, promote the establishment of a market mechanism for forward exchange such as prevails in respect of currencies like the pound sterling, U.S. dollar and Swiss franc, etc. Forward rates would move in accordance with supply and demand, and thus speculation based on actual or anticipated policy changes by the authorities would not be at the expense of the latter, assuming official intervention was absent, as can occur under the present system.

This, however, is not a short term solution, as will be explained in the next chapter. Unless substantial rate fluctuations in the market were to be tolerated, the Bank would be compelled to intervene on forward account. Moreover, it is highly likely that the authorities would have to continue providing forward facilities for contracts in excess of one year.[20]

11.4 Recent Policy Changes

In October 1972, when the link with sterling was broken, the Bank ceased to quote a forward rate in sterling, and switched to quoting a forward rate for the dollar. At that stage the demand for forward sterling must have been relatively low, given the weakness of that currency. Thereafter, commencing in 1974, the Bank made a number of changes in its forward exchange policy.

11.4.1 Increase in Forward Cover Charges

In August 1974 the authorities increased the cost of forward cover for imports in dollar contracts from one per cent to two per cent

per annum. This move was prompted by the fact that during the previous fiscal year the taxpayers had to finance losses on forward exchange deals by the Bank totalling R98m., and also because it might discourage imports marginally.[21] At the same time, the cost of cover in dollars on exports was maintained at one per cent per annum.

Employment of the cover charge as an instrument to deter imports involved a number of drawbacks. With the rand linked to the dollar, and the latter floating, the benefits of any increase in the charge for import cover could quickly be eradicated. Meanwhile, in 1974, the economy was experiencing a boom, the real gross domestic product rising by 7,1 per cent, hardly an environment in which a marginal increase in the cover charge could exert much, if any, effect on imports.

Concurrently, the Bank specified that traders must take out forward cover within seven days of the contract being signed.[22] This measure was introduced in order to encourage traders to cover forward on a more regular basis. Previously, traders often did not take out immediate cover but then if, after say three months, the rand looked suspect, they would, in a short space of time, rush to take out cover, thus burdening the Bank with substantial dollar forward commitments with roughly the same maturity. Such a rush probably created administrative problems as well.

The expectation that this measure would lead to more regular covering was problematical. Apart from the cost having been increased, the traders at whom it was aimed were those prepared to take a view on the prospects for the currency, and desist from covering at the time that deals were consummated. Why should such people materially alter their tactics in the face of a seven days ruling? Naturally under the new arrangements, if their behavioural patterns remained unchanged, they sacrificed the option of covering at a later stage. However, this does not mean that all options are closed, since, for instance, they can pay prematurely either using their own cash resources or bank finance. If the latter option is closed then

flexibility is reduced, but during the second half of 1974 and all of 1975 the average monthly excess of actual over required liquid assets of the commercial banks were 2,8 per cent and 4,2 per cent respectively.

In addition this was an awkward measure. It led to dissatisfaction on the part of importers who complained of being pressurized into taking out forward cover immediately on ordering goods, even though shipment might be months later. This was probably particularly the case in industries with a long lag between ordering and shipment. In other words, although the feasibility of importers always being in a position to effect cover within a week of a contract was probably not in doubt, it certainly was irritating. It discouraged traders, therefore, from taking advantage of forward cover facilities, while the increase in the cost of the latter also acted as a disincentive to importers to finance their imports through bank finance. Such traders instead settled their import payment liabilities more quickly. Others, while continuing to use bank finance, were encouraged to switch from overseas sources to domestic bank sources.

At the time that the cost of forward cover for six months or less was increased from one per cent to two per cent per annum that of import cover for more than six months, if granted, was raised to six per cent per annum, since at that time such facilities were in strong demand owing to harbour congestion. Hardly had importers recovered from this series of shocks when the cost of forward cover for dollar contracts relating to imports of six months or less was increased to three per cent per annum in September 1974.

Later that year and early in 1975 the combination of all these measures plus the relative weakness of the dollar, and the strength of the gold price (late 1974) meant that many importers decided it was cheaper to carry the exchange risks themselves, and less use was made of forward facilities. This was the opposite of what the authorities had desired to achieve, namely to encourage traders to take out forward cover regularly, thereby reducing trader speculation

on currency changes, and so moderating the influence of leads and lags. This set of measures backfired on the authorities from March 1975 onwards, when with the dollar then strengthening and sterling weakening, the rand began to look somewhat vulnerable. This prompted importers to rush to settle by borrowing from the commercial banks, thereby putting extra downward pressure on the gold and foreign exchange reserves.

It could in fact be argued that official policy at this juncture involved two unfortunate aspects. The adoption of the managed float encouraged speculation and leads and lags. Encouraging the more extensive use of forward facilities would have eased this problem. In reality, however, the measures adopted in the latter respect only complicated matters further.

The extent to which the forward cover charge rises alone contributed towards this state of affairs is difficult to assess, since an important factor may have been currency and gold price movements. However, once less forward covering had materialised, the subsequent foreign exchange pressures should not have been a complete surprise, since the external position was deteriorating. Following a current account surplus of R58m. in 1973 a deficit of R948m. was incurred in 1974, and only substantial capital inflows were moderating the fall in the reserves. The underlying vulnerability of the rand, not helped by a twenty-three per cent expansion in the money supply in 1974, became even more obvious following the currency developments in March 1975.

11.4.2 Reversal of Policy Decisions

Against this background the Bank, early in April 1975, cut the rate back to one per cent per annum with the aim of encouraging importers to raise finance abroad, and enter into forward contracts for specific payments periods. Such a trend, other things remaining equal, would reduce unfavourable leads and lags influences arising out of rand speculation on the part of importers, and help the balance of payments position.

Subsequently, the difficulties faced by traders in taking out forward cover associated with the seven days stipulation, resulted in August 1975 in the termination of this provision. Again the aim was to encourage greater use of the Bank's forward cover facilities.

4.4.3 Extension of Cover Period for Imports

Simultaneously, forward cover granted by the Bank to importers was extended from six to twelve months, while the charge remained at one per cent. The authorities also announced that they were prepared to consider granting forward cover on application for periods longer than twelve months if required for the importation of capital goods with long delivery periods and/or under extended credit arrangements.[23]

The extension of the period for normal import cover was a move which had been advocated for a long time.[24] It was encouraged by a number of factors. Under the previous arrangements where forward cover for imports was limited to six months from date of order, import finance was only available for four months if there was a two month delay before shipment.[25] A shipment might arrive, say, eight months after ordering, but the importer had to fulfil his forward commitment to purchase dollars after only six months.

In these circumstances, the change to a maximum period of twelve months for covering of imports allowed importers to obtain finance for longer periods. It therefore encouraged the greater utilization of forward cover facilities and overseas finance, as well as stimulating those importers who had obtained six months import finance under the old arrangements, to extend the period of credit where possible. The result has been a moderation of pressures on the foreign reserves from this source; in other words, a bigger lag has been built into import payments, which is helpful to the balance of payments.

Secondly, given the complaints that the forward cover period for imports was too short, the Bank received large numbers of applications for cover in excess of six months, which had to be screened on an individual basis. Making the modification,

therefore, also reduced the administrative burden on the authorities.

11.4.4 Question of Forward Cover for Exporters

For many years exporters, likewise, have pressed for an extension of the cover period beyond six months, a move which would facilitate the offering of credit terms for exports beyond 180 days.[26] Where raw material exporters are concerned the 180 day limit on forward cover is probably not particularly important since much exporting of such items is based on relatively short credit.[27] As regards manufactured exports the problem is probably more relevant, heightened by the development of serious balance of payments problems for most non-oil exporting nations in recent years following the oil crisis. Today a significant amount of exporting may be influenced materially by the credit terms which can be offered. From the viewpoint of the Bank, moreover, a longer cover period for exports would contribute under normal circumstances towards a reduced net forward commitment to sell dollars.

The authorities have, however, resisted this concession no doubt because they do not want to see a bigger lag built into foreign exchange receipts. If an exporter obtains six months' credit from a local bank, then it takes six months before the foreign exchange receipts arrive. An extension to twelve months following a similar lengthening in forward cover facilities provided by the authorities means a similar delay before the foreign exchange comes in if the exporter is granted finance by a local bank.[28] Under present conditions, particularly, extending the cover period and thus the lag in export receipts will be resisted due to the deficit on the current account of the balance of payments.[29] However, in more propitious circumstances such a move will warrant consideration.

11.4.5 The Bank's Broad Objectives

The above comments do indicate that by changing the period in respect of forward cover facilities the authorities have a weapon at their disposal for influencing the short-term balance of payments position. The willineness to use such a weapon is, however, likely

to be constrained by the objective of trying to avoid a situation in which traders are discouraged from taking out cover. For this reason there is likely to be considerable reluctance to shorten the cover period for either imports or exports.

This review of recent policy measures is an indication of the authorities' desire to encourage the more regular use of forward cover facilities, and there is evidence that this is materialising to some extent. Progress in this direction is, however, limited by the nature of the forward cover in operation. If it is suspected that a rand devluation is imminent, importers tend to take advantage of the cheap cover facilities, while exporters tend to refrain from selling foreign currency proceeds, and vice versa.

It is also limited by the practice of floating exchange rates. Traditionally, South African importers tended to finance their imports from overseas sources. The advent of floating rates on a large scale has, in the past couple of years or so, encouraged importers to seek domestic finance whenever possible in order to reduce the exchange rate risk faced. Particularly at times when domestic liquidity has improved, and domestic interest rates have fallen somewhat, some importers, taking advantage of increased banking liquidity, have tended to finance imports locally or settle early, so putting pressure on the balance of payments.[30]

In other words, although it is at times cheaper to finance imports abroad and take out cover, some traders have resisted such a financing avenue. This to some extent undoubtedly reflects inertia as well as lack of experience about forward exchange facilities. It probably also reflects relatively high profit margins associated with some classes of imported items, so that relatively small differences in costs between overseas and domestic sources of finance are inconsequential. In addition, some traders may feel that they should use the available local bank credit facilities lest they may in future lose them. Finally, irrespective of costs, small traders can find it difficult to obtain finance

abroad, because overseas banks are not keen to handle relatively small amounts of business of which the relative credit instruments may not be easily marketable.

The official response has been to bring about higher short-term interest rates in an effort to encourage traders to finance abroad, but seemingly with only limited success. It was partly against this background that bank credit ceilings were re-imposed in January 1976. This measure at least forced more importers to obtain foreign finance and use forward cover facilities. This trend was further strengthened by the decision in July 1976 to introduce a temporary twenty per cent import deposit scheme on a wide range of imported goods.[31]

The question arises whether the authorities are placing too much emphasis on trying to encourage traders to cover as a matter of policy rather than a matter of opportunity. It is resulting in facilities being furnished which do not fully reflect the inherent risks involved. To the extent that it is successful, it means that the Bank potentially faces greater net forward dollar sales commitments which can inhibit flexibility in exchange rate management. If the latter policy aims at maintaining a fixed exchange rate for the rand against the dollar then this problem disappears. However, with the dollar floating this is not a realistic strategy in the long term. Moreover, insofar as such a policy is successful, it becomes more necessary to take account of the implications of changes in the foreign trade performance. Finally, the degree of success attainable through this policy is limited because some traders cannot resist taking a view on the currency.

11.5 Current Policy Issues

There are a number of deficiencies in the existing forward facilities. Technically, there would be no major problems in providing cover for selective invisible exports and imports, such a scheme possibly reflecting the increasing net deficits on services account which have materialised over the years.[32] In view, also,

of the dependence of the country on imported capital goods the demand for forward cover for such imports in excess of one year must be high. This requires special application to the Bank, but there is no automatic approval, although a sympathetic attitude prevails and the nominal one per cent per annum charge is still levied. Moreover, if the imports are denominated in another currency, obtaining cover for the second leg of the transaction could be very difficult, particularly for as long as five years.

The high foreign exchange risk on forward account to which the authorities are exposed here is obvious. It could be lessened by charging a more flexible market-related rate subject to negotiation, although this may create an additional exchange control burden. This very cheap rate levied on capital goods importers may also reflect the feeling that it is conducive to attracting foreign capital inflows.

11.5.1 Extension of Forward Cover by the Bank to More Than One Currency

Traditionally, forward cover by the authorities has only been provided for a single currency, but proposals for extending cheap cover to other currencies have been put forward on a number of occasions.[33]

It can be argued that extensive forward cover under floating exchange rates should be provided by central banks such as those in South Africa where no developed market exists, even if losses are incurred, in order to avoid possible exploitation of traders as to the forward rates quoted by commercial banks. This is based on the assumption that forward rates display relatively larger premiums and discounts under floating conditions compared with the par value system. Yet, even in the Bretton Woods era, large forward rate differentials emerged.[34] In any case forward cover is either a benefit or a drawback to exporters or importers depending on whether the forward rate is at a premium or a discount.[35]

Moreover, the spread between forward buying and selling rates quoted by commercial banks can be misleading as an indicator of

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Moreover, the spread between forward buying and selling rates quoted by commercial banks can be misleading as an indicator of

exchange profits being reaped. Deals cannot always be 'married' at rates quoted, thus exposing banks to currency risks. Local banks also suffer from the disadvantage of geographical position, being far away from major overseas centres which can lead to dealing opportunities being missed, while banks claim that an increasing number of customers are sophisticated concerning currency matters.

In favour of an extension it may also be argued that importers buying from the foreign countries whose currencies are included in the extended forward cover facilities may get more favourable terms if the contract is denominated in the exporter's currency, and the importer takes cover from the authorities. Where sterling is concerned, which is the most important currency after the dollar, this is, of course, already the case. Similar considerations apply in regard to South African exports. In addition, it is worth considering whether quoting a forward rate in more than one currency would make it easier to effect forward cover in the additional currency or currencies since, under present circumstances, obtaining cover in non-dollar currencies involves two legs in the transaction. In assessing the possibility of dealings problems arising the key factor is the link of the rand to the U.S. dollar. The latter is the most important vehicle currency in foreign exchange markets, and thus local residents wishing to deal in third currencies via the dollar should face no problems. By contrast, if the rand was linked to a less important transactions currency, forward dealings in third currencies would involve difficulties. Moreover, it is not always appropriate for local traders to cover both legs of transactions involving third currencies.

Opponents of such proposals can argue that the authorities have no right to expose taxpayers' money to such exchange rate risks when already dollar cover, the most important currency, is provided cheaply. Even if one assumes that forward rates for selected non-dollar currencies were to incorporate a fixed charge (or rebate) based on the floating spot rates, containment of risk exposure

would suggest that differential rates should apply depending on the strength of the relevant currencies.

In practice, any possible justification for extending official forward facilities would currently probably apply to sterling alone. To extend official cover to currencies other than sterling may create technical problems. For instance, forward trading in German marks may not be easy for the authorities in view of the limited money market facilities in West Germany. Some countries, such as West Germany and Switzerland are not enthusiastic about carrying an increasingly important reserve currency role.[36] In any case, the trade of the Republic in currencies other than sterling and the dollar is small.[37]

A precedent for extending forward facilities exists in the provision of sterling cover to exporters of sugar and canned fruit at a three per cent charge on a monthly basis. Subsidized forward sterling facilities may improve the export orientation, particularly of the manufacturing sector, in view of the large discounts which can prevail on forward sterling-dollar rates.[38]

On the other hand, recent exchange control regulations introduced by the United Kingdom authorities will reduce the sterling denominated foreign trade of the Republic.[39] Apart from this the major problem associated with granting sterling cover at a non-market rate is the danger that, in view of the fundamental weakness of the currency, the authorities would incur a long sterling position. Even if, overall, the pound in future years maintains its weighted value against other currencies, it may still weaken against the dollar, to which the rand is tied.

Compounding this problem would be the danger that providing sterling cover would encourage exchange arbitrage by local banks. Where forward rand-dollar transactions are concerned the only dealing source at a one per cent per annum charge is the Reserve Bank. There is no market abroad where such attractive rates are quoted. If the authorities were to give forward sterling-rand quotations,

the situation would be different. Here, the Bank would have to deal via the dollar, and thus pay the market price on sterling-dollar transactions. If the authorities established market related quotations for forward sterling they would have to take the forward sterling-dollar rate and then divide by the forward dollar-rand rate.

Local authorised dealers in foreign exchange would be able to operate on the same basis. If the latter asked the Bank to quote forward pound rates, they could also ask correspondent European banks to quote forward sterling-dollar rates, and thereby determine forward sterling-rand rates using the same procedure as above.

Therefore, because local banks could obtain two such quotations, they would be tempted to engage in profitable arbitrage at the expense of the Bank, if the latter quoted non-market related rates for forward sterling-rand even though strictly not permissible.

11.5.2 Provision of Forward Cover on Private Sector Borrowing Overseas

Presently, the public corporations are allowed to take out cover on their overseas loans and interest payment liabilities.[40] If forward cover were extended to private sector foreign borrowing in addition to export finance requirements, the open forward position of the Bank would increase. It is this prospect which basically explains the reluctance to provide such assistance, as well as possibly the increased administration involved. Central banks which do provide cover facilities have traditionally been reluctant to extend them to cover private capital flows.

The extension of forward cover to the private sector would stimulate such inflows, especially of dollar denominated loans, as much overseas borrowing is in the Eurodollar and Eurobond markets. It may also contribute towards a smoother inflow over time of foreign private capital, because under current arrangements there is a tendency, at times of revaluation or devaluation rumours, for such capital inflows to be speeded up or held back, respectively, because of lack of forward cover facilities.

There is, however, the wider question whether further international indebtedness is desirable. Using various criteria

the country does not appear to be overborrowed as regards foreign debt.[41] It could cause the country to become even more dependent on capital inflows to finance current account deficits, and stimulate economic growth. In view of the volatility of these inflows, due partly to political influences, the danger arises that future management of the economy may be complicated.

Given this and the increased exposure to which the authorities would be committed, some limitation of forward cover facilities to the private sector would probably be desirable. A more market related charge would also seem likely.

One possibility would be to provide forward cover on private sector foreign loans used for the purchase of locally produced capital goods. In this way, import replacement in capital goods industries could be encouraged. The present situation arguably is anomalous since forward cover is available on trade finance for the importation of capital goods, but not on foreign capital used for the acquisition of locally produced goods in this area. Also supporting such a concession is the argument that the public sector taps a substantial segment of domestic capital funds through the prescribed investment requirements, thus forcing the private sector to look abroad for funds.

On the other hand, it is uncertain whether this would encourage much switching of demand for capital goods from foreign to domestic sources while attracting the tapping of foreign funds, especially if the charge for rand-dollar cover was market related. Moreover, the desirability of such a move is debatable given the large unemployment problem, and the need to encourage labour intensive production methods.

11.5.2 Cover for Public Corporations

The justification for restricting cover facilities on foreign loans to public corporations is that since the latter are subject to price controls and official inducements on occasions to raise capital overseas, they are entitled to special consideration.[42] This is

especially the case where substantial capital sums are concerned. For instance, the Koeberg power station project of Escom involved foreign loans amounting to around R800m. and the ability of Escom to cover such sums in the foreign exchange markets is very doubtful. Also, much investment by these bodies has been aimed at strengthening the strategic position of the country in the face of hostile external elements. Allowing the public corporations to operate purely on commercial lines could mean that insofar as greater resort was made to the local capital market they could exert a disruptive influence in view of their size. Moreover, in view of the probable low interest rate elasticity of supply of local funds no large scale extra local funding would seem feasible.

Nevertheless, concern has been expressed recently in some overseas quarters that certain corporations have been over-extending themselves in foreign markets irrespective of political factors. There is evidence to suggest that bodies like Iscor and Escom agree with this assessment, both being keen to augment their reliance upon internal cash flows.

The net domestic investment expenditures of public corporations have risen sharply in the past few years relative to those of the private sector.[43] If the Bank had stopped granting cover or charged a higher rate this expansion might have been curtailed. This is, however, a dubious conclusion since in view of the dominant market position of these corporations, there would have been scope for them to raise prices to compensate for higher charges or the withdrawal of such facilities.

11.5.4 Cost of Cover for Public Corporations

A controversial issue has been the policy of the Reserve Bank to grant forward cover at one per cent per annum to the public corporations irrespective of the currency denomination of the loan. This has been done in order to encourage these organizations to raise foreign capital. It has, however, had the predictable result of inducing these corporations to raise foreign loans in hard

currencies where the interest rates have been lower. Given the sharp depreciation of the rand against currencies such as the German mark and Swiss franc in recent years huge, but undisclosed, losses have been incurred by the Reserve Bank in providing cheap cover.[44] What has been cheap capital from the viewpoint of the public corporations has been expensive capital from the viewpoint of the country as a whole.

The vulnerable position of the Reserve Bank would be reduced if a differential charge was imposed. Alternatively, it could provide the cover on the rand-dollar leg, but leave the corporations to take out cover on the second leg where this is applicable in the major foreign exchange markets. Under such an arrangement the overall cost of forward cover for these organizations would not necessarily be more costly. If finance was raised in a weak currency, which may be sterling, the forward exchange rate of such a currency would probably stand at a discount against the dollar. Thus, the higher interest rate attaching to such loans could be counter-balanced by the savings in taking out cover on the dollar-sterling leg.

The absence of this procedure may reflect several factors. Obtaining forward cover for non-dollar currencies in excess of a year or two could be difficult. Moreover, the authorities may disapprove of it because they fear it may be interpreted as speculative behaviour on the part of the public corporations.

On the other hand, it is difficult to see how the covering of dollar-third currency liabilities on a private basis can be viewed as speculative activity. Private firms are allowed to cover such liabilities in the foreign exchange markets. The granting by the Bank of cheap forward cover on hard currency loans can equally be alleged to be official speculation in view of the risk to which it is exposed.

References

1. P. Einzig, A Dynamic Theory of Forward Exchange, Macmillan, 1967, p.503.

2. Richard H Miller, Forward Exchange Facilities in Developing Countries, Finance and Development, March 1975, p.12.

3. P. Einzig, op.cit., p.504.

4. Eric B. Chalmers (Editor), Forward Exchange Intervention, Hutchinson, 1971, p.30.

5. Commercial banks are obliged to submit to the Bank monthly details of all forward purchases and sales of foreign currency made by them. Insofar as greater use of forward cover facilities is made by importers this may mean that the latter are making additional use of overseas finance vis-a-vis domestic finance. Also, changes in the utilization of forward cover for imports may presage a change in the t. end of imports and the current account of the balance of payments.

6. Reserve Bank Quarterly Bulletin, December 1976, p.S-25.

7. A. Lanyi, 'The Case for Floating Exchange Rates Reconsidered', Essays in International Finance, No.72, February 1969, Princeton University Press, p.8.

8. I.J. van Kan, 'South Africa's Role in Financing International Trade', South African Banker, August 1969, pp.333-40.

Under existing arrangements, given the one per cent forward cost of dollars against rand, the determination of the forward rate for a given period vis-a-vis the spot rate is:-

Spot selling rate for dollars = 1,1471

Thus for a 3-month period the forward dollar selling rate

$$= \frac{1,1471 \times 1 \times 3}{100 \times 12}$$

$$= ,0029$$

Thus, the three months selling rate = 1,471 - ,0029 = $1,1442.

The three months buying rate for dollars = spot buying rate + ,0029

= 1,1529 + ,0029 = $1,1558

As regards forward rates for the rand against third currencies, once the dollar/third currency rate has been determined it is a matter of multiplying the rand/dollar rate by the determined rate.

9. This means that the forward cover taken out by a trader can be wound up at any time during the period of the cover.

10. On 9 April 1976 the debit balance on the Forward Exchange Contracts Contingency Reserve Account in the books of the Reserve Bank stood at R333,8m. compared with R59,7m. on 19 September 1975, the last working day before the devaluation. This information was released by the Minister of Finance, Senator Horwood. He pointed out that the losses cannot be wholly ascribed to the rand devaluation against the dollar, but must be attributed in part to the floating of currencies against the U.S. dollar and therefore the rand. See House of Assembly Debates, Hansard No.12, p.818, 20 April 1976.

11. P. Einzig, op.cit., p.65.

12. If an importer can obtain domestic finance rather than overseas finance, then from the day the local bank discounts the bill of exchange for the overseas supplier, the importer only has a rand commitment. This means that forward cover can be disregarded. However, it should be noted that the importer still faces a currency risk from the day that the order is accepted until the day the bank provides local finance. During this period the importer may decide to cover, and then use the bank finance to pay off his foreign exchange commitment.

13. H.W. Arndt, 'Foreign Exchange Aspects of Australian-Japan Economic Relations', Australian Economic Papers, June 1974, p.33.

14. Information provided by Australian Trade Commission, Johannesburg.

15. For instance, the maximum period for the repatriation of export receipts acquired was reduced from thirty days to seven days in January 1976.

16. Based on National Westminster Bank trade weighted indices published monthly in Euromoney.

17. Based on figures in Monthly Abstract of Trade Statistics.

18. I.M.F. Survey, I.M.F. Vol.15,No.5, 1 March 1976, p.71.

19. At the end of October 1976 the foreign loan liabilities of the Reserve Bank stood at R657m. compared with nil in the middle of 1973. At the end of September 1976 the foreign debt outstanding of the government stood at R1 079m. compared with R106m. at the end of 1969. Reserve Bank Quarterly Bulletin, December 1976.

20. It is interesting to consider the implications of a forward market for the rand's rate against the dollar. Given the current uncertain political environment in the Republic together with the wide inflation rate differentials, it would appear inevitable that the rand would trade at a discount against the dollar on a forward basis.

21. The Bank does not disclose details of its forward commitments, because it feels that such a move could encourage speculation. A minimum of statistical information concerning the forward exchange transactions of the Bank arguably should be published. To reduce the speculative danger it could be published with a time lag of a few months.

22. This was a widespread interpretation of the ruling that the forward exchange contract must be established within seven days of the trader entering into a foreign exchange contract.

23. Statement by the Reserve Bank Governor, T.W. de Jongh, Report of The Reserve Bank's Fifty-fifth Ordinary General Meeting, 26 August 1975, p.11.

24. Third Report of the Commission of Enquiry into Fiscal and Monetary Policy in South Africa, Pretoria Government Printer, No.PR.87, November 1970, p.118.

25. South African traders cannot obtain import finance from a bank before the date of shipment of order overseas.

26. Third Report of Commission of Enquiry into Fiscal and Monetary Policy in South Africa, loc.cit. Also, Commission of Enquiry into the Export Trade of the Republic of South Africa, (Chairman H.J.J. Reynders), Vol.2, Pretoria Government Printer, p.486.

27. P. Einzig, Foreign Exchange Crises, Macmillan, 1971, p.78.

28. An exporter who obtains local bank finance still incurs a currency risk until such time as the overseas customer finally pays. In other words, the local bank finances the exporter, but when the foreign customer discharges his commitment in foreign currency, a shortfall in local money will arise if the rand has been revalued in the intervening period. This will be to the account of the exporter, since the bank will not expose itself to currency risk of this kind.

    On the other hand, if the exporter obtains overseas finance then there is no need for forward cover. He repatriates the money while the overseas bank gets repaid when the credit period of the importer expires.

29. In 1975 the deficit was R1 616m.

30. Statement by the Reserve Bank Governor, T.W. de Jongh, Report of the Reserve Bank's Fifty-sixth Ordinary General Meeting, 24 August 1976, pp.8-9.

31. This scheme was later terminated at the beginning of February 1977.

32. In 1962 the net deficit was R231m. increasing thereafter in every year to reach R1 224m. in 1975.

33. Commission of Enquiry into the Export Trade of the Republic of South Africa, op.cit., pp.486-7. Also, Third Report of Commission of Enquiry into Fiscal and Monetary Policy in South Africa, loc.cit.

34. C.J. Oort, P. Ungphakorn, S. Okita and W.M. Martin, Steps to International Monetary Order, Per Jacobsson Foundation, 1974, p.35.

35. F. Machlup, 'Less Rigidity is Not Enough', Euromoney, March 1973, pp.40-41.

36. Hans Mast, 'Reserve Currency Role for Deutschemark', Euromoney, December 1976, p.40.

37. Well over fifty per cent of the Republic's foreign trade is denominated in these two currencies.

38. In November 19[illegible] 3 months forward sterling/dollar rate was at a [illegible], more than fifteen per cent on an annual basis.

39. In November 1976 it was announced that U.K. banks will in future be barred from lending sterling to foreigners to finance third country trade. Prior to this the amount of foreign trade by the Republic utilizing sterling finance, but not involving importing or exporting to the U.K. had increased markedly arising out of the significant discount on forward sterling which prevailed. This practice will now cease.

40. Not all such loans are covered. There appears, for instance, to be no cover granted on loans denominated in European units of account. Here, of course, the lenders have a choice of currencies of which to demand repayment of principal.

41. Taking the ratio of capital inflows to gross domestic product at market prices it is true that in 1975 the figure was higher at 6,5 per cent compared with 3,3 per cent in 1965. Simultaneously, however, taking the value of foreign dividend and interest payments to gross domestic product at market prices, the ratio was 2,7 per cent in 1974 compared with 2,6 per cent in 1965. As regards the ratio of foreign dividend and interest payments to export receipts the figures were 8,8 per cent and 9,5 per cent respectively.

42. Aggregate figures concerning the corporations' foreign borrowings on a gross or net basis have traditionally not been revealed. However, an analysis of the accounts of these bodies suggests that in the last couple of years or so gross capital inflows may well have been well in excess of R500m. on an annualized basis at times.

43. By 264 per cent in the 1972-75 period as compared with eighty-eight per cent for the private sector.

44. Between the end of 1970 and the end of 1977 the Swiss franc appreciated by 162,5 per cent against the rand, while the German mark rose by 111,6 per cent.

CHAPTER TWELVE - THE CASE FOR A FORWARD EXCHANGE MARKET IN SOUTH AFRICA

Given the absence of a developed foreign exchange market in South Africa, and the absence of forward cover facilities on a private market basis, there have been strong arguments in favour of such facilities being provided by the authorities. In particular, it can be argued that the latter should enable traders to safeguard themselves as far as possible from exchange rate fluctuations, especially since most of the foreign transactions of the country are denominated in foreign currencies.

In recent years, however, the local foreign exchange environment has changed in two important respects. The Bretton Woods system of fixed but adjustable exchange rates has collapsed compelling South Africa to adopt a more flexible exchange rate management policy. Secondly, the Reserve Bank has accumulated huge losses on forward exchange account.[1]

The purpose of this chapter is to consider the institutional requirements for a local interbank market in both spot and forward transactions. The feasibility and benefits of such a market are examined with special attention being paid to aspects of forward exchange.

12.1 Institutional Changes Required for an Interbank Market

Until now a fully developed interbank market for rand-dollar transactions has not existed.[2] As a result, it is impossible to let the rand float or be given an adjustable parity subject to permitted variations either side of it. This is because both mechanisms involve, to differing degrees, allowing market forces to determine the exchange rate.

Even so, a limited local interbank market already exists for spot dollars, since the banks prefer to deal among themselves, and approach the Reserve Bank only when net dollar positions cannot be covered in it.[3] Activity in this market varies, but it is facilitated when the balance of payments improves, and the gap between merchandise

imports and exports narrows. For forward transactions a less active dollar market exists, because of difficulties which can arise if forward contracts need to be extended, and problems in finding counterparts for varying maturities.[4]

An impediment which can confront countries keen to develop a proper interbank market is the lukewarm attitude or opposition of authorised dealers.[5] This may be relevant in the case of the Republic since the banks act as agents of the Reserve Bank in dealings, and foreign exchange is provided at a fixed mark-up, the main requirement involving adherence to exchange control rulings. Dealers tend to be passive, and normally do not compete aggressively for exchange business. In contrast, with a fully developed interbank market banks would be competing on a price basis, and profits would depend vitally on the actions of dealers.[6]

Resistance among local banks to such changes in market arrangements do not reflect simply this question of competition. Better communications with the major foreign exchange markets would be necessary in an extended interbank market, since up to the minute exchange rates from oversees are presently not available to certain dealers. Small banks, moreover, may find it more difficult to gauge market trends because of their smaller foreign exchange business vis-a-vis larger banks.

Any opposition, however, could be lessened if exchange margins adequately compensated for the risks involved. If the rand was assigned a par value, and limited margins, the environment would, arguably, not differ greatly from present arrangements, and even if it was floated banks may still quote fixed daily rates for small transactions. The latter could also gain from relaxations in exchange controls, the administration of which is a burden for banks. Meanwhile, the profits of the banking sector should benefit from the expanding foreign exchange business it would handle.

Both spot and forward markets could develop together with transactions confined to rand-dollar deals, since markets in other

currencies would be unlikely to materialise because of insufficient trading volumes.[7] Nevertheless, introducing such rand-dollar markets would require modifications in foreign exchange procedures for certain payments items.

12.1.1 Gold Sales

Apart from local banks handling diamond and sugar export receipts instead of the Reserve Bank, the establishment of private rand-dollar markets would necessitate the Chamber of Mines selling gold bullion in addition to Krugerrands, and channelling the foreign receipts through the banking network.[8]

By selling most of the gold output, the Reserve Bank has been able not only to control the volume exported, but also the main source of foreign exchange of the country. In this way the authorities influence the money supply. In recent years this has been important because of the substantial discrepancy between the free market price and the official price of gold.[9] Now it is irrelevant since gold is purchased from the mines at a market related price.[10] Irrespective of this, if the proportion of export receipts derived from gold falls significantly below the present level of around thirty-three per cent, this official function will become less important.

The I.M.F. traditionally encouraged gold producers to sell the metal to monetary authorities at the official price. By handling sales of the Republic the Reserve Bank could accomplish this, while promoting the monetary role of gold. The policy of the Fund now is to reduce the role of the metal, one third of its stocks being scheduled for disposal, partly on the market, by 1980. It is doubtful, moreover, whether the Reserve Bank, in conducting gold sales, is keen on transactions with monetary authorities, but instead prefers buying to be channelled through the private market.[11]

From the viewpoint of marketing expertise, the Bank has acquired new skills and experience, since the changes in market environment initiated by the two-tier pricing system in March 1968.[12]

It has close contact with the volatile bullion markets, and derives information about prospects for the metal through channels like the I.M.F. at a time when its international monetary role is still in dispute. Gold sales of the Republic also have their secretive aspects.

On the other hand, the Chamber of Mines, through Intergold, has developed marketing expertise as well as an expanding organization to promote Krugerrand sales. This brings it into contact with both coin and industrial buyers. If it handled all sales it could exert greater control over the sources of demand for gold, since it already undertakes advertising campaigns with jewellery manufacturers and retailers. By contrast, the Reserve Bank sells only to the primary markets in Zurich and London. The Chamber, in addition, has its contacts with the I.M.F. and a private organization may well sell its own product more efficiently than a government controlled institution.

The authorities may well be reluctant to relinquish this function of selling gold, but it has already partially materialised. As much as one third of current production is sold in the form of Krugerrands by the Chamber when demand warrants it. Insofar as this market expands coin production capacity could be enlarged, although larger Krugerrand sales may increase volatility in the gold markets by reducing output available to meet the more stable industrial demand for gold.[13] The authorities could still manage possible gold sales to official agencies, while close liaison between the Bank and the Chamber would be necessary. Otherwise the selling policy of the latter could be in conflict with the policy of the former regarding sales of its own stocks.

12.1.2 Foreign Loans of Public Corporations

Currently, the public corporations sell their foreign loan receipts, and repay them, through the Reserve Bank. The provision of such facilities by the authorities may reflect partly the view that they are in competition with the rest of the banking sector in providing foreign exchange, but whether a better rate is granted to these organizations, than would be obtained from local banks is unclear.

cent of the cost, instead of 100 per cent, could have been provided. The cost to the Exchequer would at least partly have been offset by the lower interest rates paid by the government on its new borrowings. On the other hand, such a scheme would have been inequitable from a tax viewpoint, and it could have encouraged a switch to imports from domestic sources.

References

1. 'Short term capital inflows not related to foreign reserves' means loans raised which are not designed directly to boost the official foreign reserves.

   For the same two respective periods the ratio of short term capital inflows to changes in money and near money has remained at ,55.

2. This component comprises essentially the residual in balance of payments accounting. Apart from leads and lags, circumventions of exchange controls show up in this account, while it is also used to disguise the magnitudes of other accounts. For instance, oil and arms imports are not fully reflected in the merchandise import figures given in the Reserve Bank Bulletin, and the discrepancy shows up in the errors and unrecorded transactions figures.

3. At the end of 1973 foreign liabilities of South Africa, including both the public and private sector, totalled R10 380m. as regards both direct and indirect investments. See Supplement to South African Reserve Bank Bulletin, March 1976.

4. The March 1976 gold swap enabled South Africa to raise between R450m. and R500m. in foreign currency by using R142m. of gold originally valued at R29,55 per ounce. The April 1977 swap, by using R88m. of gold, probably raised between R300m. and R350m. in foreign exchange.

5. The supply of money and near money rose by 22,3 per cent in 1974, and 17,4 per cent in 1975.

6. P. Einzig, Foreign Exchange Crises, Macmillan, London, 1970, p.71.

7. Information received from the Bank.

8. One school claims that the best available indicator of future rates is the forward market. The argument is that short term interest rate differentials in different countries continue to reflect expectations of currency appreciations or depreciations. Thus, the weaker a currency the higher short term interest rates will be in such a country, and vice versa. If rates on six month deposits in London are ten per cent, while they are eight per cent in New York, then sterling is expected to decline against the dollar at an annual rate of two per cent in the next six months. Similarly, the forward premium or discount on currency will indicate the expected

rate of appreciation or depreciation, since forward exchange rates normally reflect differences between eurocurrency deposit rates for two countries. See G. Dufey and I.H. Giddy, 'Forecasting Exchange Rates in a Floating World', Euromoney, London, November 1975, pp.28-35.

On this basis the Bank could derive an estimate of future movements of the weighted value of the rand for the next six months by noting the six months forward discounts or premia prevailing for the dollar against other relevant currencies. These figures could be weighted accordingly to obtain an estimate of the future value of the rand.

The forward rate hypothesis is unacceptable in other quarters. One view claims that the most efficient forecasting approach uses econometric models in which heavy emphasis is accorded to the trade balance of a country. On this basis the U.S. trade balance is the key variable in assessing the outlook for the rand. See J.F. Norris and M.K. Evans, 'Beating the Futures Market in Foreign Exchange Rates', Euromoney, London, February 1976, pp.62-71.

Others argue that in the long run the trend of inflation in a country relative to that in its major trading partners is the predominant factor. In the short run, however, disturbances such as the external payments position and interest rate differentials are important. See D. Kern, 'Inflation Implications in Foreign Exchange Rate Forecasting', Euromoney, London, April 1976, pp.62-9. Also, G.E.J. Dennis, 'Price and Quantity Adjustments in Exchange Rate Forecasting', Euromoney, London, August, 1976, pp.52-6.

9. Exporters could arrange for customers overseas to deposit money in a bank earlier than indicated by trade documents.

10. Information received from the Bank.

11. Ibid.

12. Ibid.

13. The collapse of the gold price in September 1975 would certainly still have revived devaluation fears.

14. By the end of 1976 the combined external debt of the non-O.P.E.C. developing countries is estimated at $180b. Of this around $75b was owed to banks in the eurocurrency markets as well as other private banks. These banks were estimated to account for some forty per cent of these countries' outstanding debts compared with less than ten per cent in 1970. See Melvyn Westlake, 'Taking the Strain of the Third Worlds' Mounting Debts', The Times, London, 18th March 1977, p.27.

15. Information received from the Bank.

16. The deficit on current account was R998m. in 1974, R1 813m. in 1975, and R1 71lm. in 1976.

17. There was an outflow of short term capital not related to reserves of R1 086MM in 1977, while net long term capital inflows fell from R989MM in 1976 to R211MM in 1977.

18. Information received from the Bank.

19. P.D.F. Strydom, 'Inflation in South Africa: Institutional Aspects'. South African Journal of Economics, June 1976, Vol.44, No.2, p.128.

20. For a theoretical discussion of the effects of a devaluation upon the capital account of the balance of payments in the absence of speculation, see John Borcich, 'Capital Flows, Devaluation, and the Balance of Payments', Canadian Journal of Economics, Vol.5, 1972, pp.227-36.

21. Changes in the cover charge imposed on exporters have been unnecessary, because the lower interest rates overseas have induced many exporters to use foreign trade finance, and so obviate the need to take out forward cover since exports are denominated in foreign currencies.

22. Total short term foreign trade finance arranged by South African banks abroad varies, but at times it is probably well in excess of R1 000m. Many factors preclude any massive switching of these foreign facilities to local sources, the most important relating to the limited scope of the local bankers' acceptance market. Nevertheless, any sudden switching to local sources to the extent of say R100m., could significantly affect the foreign reserves position.

CHAPTER EIGHT - INTERNATIONAL MONETARY REFORM AND EXCHANGE RATE FLEXIBILITY

Following the dollar devaluation in 1971 efforts were made to work out details of a reformed monetary system through multilateral consultation and agreement. By 1974 this attempt had to be abandoned in the wake of the oil crisis. The purpose of this chapter is to review the viewpoint of South Africa concerning this exercise with special reference to the question of exchange rate arrangements.

Reform of the system stemmed from the reluctance to salvage the Bretton Woods arrangements, which the Republic favoured, but which would have required a substantial increase in the official dollar price of gold.[1] This, the monetary authorities were not prepared to undertake. Moreover, it is not clear whether this would have provided more than a temporary reprieve for the Bretton Woods system. The collapse of the latter was regarded by some as inevitable sooner or later owing to its lack of a clear assignment of responsibility for initiating adjustment, and a crisis-proof method of effecting adjustment.[2]

Two important issues of reform concerned the method of regulating exchange rates and, secondly, the market intervention system, that is, the manner in which these regulations were to be brought into effect by foreign exchange market intervention by central banks.

8.1 Background to the Problem

The first major reform came at the end of the 1960s with the creation of a new reserve asset. At that time it was generally accepted that international liquidity was not increasing fast enough to keep abreast of the need for reserve expansion which resulted from the growth of international trade. South Africa accepted this conclusion and recognized, like most others, that the existing reliance upon U.S. dollar deficits to provide global liquidity expansion was inherently unsound, since it fostered currency instability, and maladjustments in the structure of the world payments system.[3]

The Republic advocated an increase in the official gold price, but instead the monetary authorities created a new international fiduciary reserve asset called the Special Drawing Right (SDR), issued by the I.M.F. and distributed among countries on the basis of Fund quotas. South Africa did not believe that SDRs could be a substitute for gold, and expressed doubts whether sufficient international control over their issue would be forthcoming.[4]

In addition, the feeling grew during the 1960s that the Bretton Woods arrangements might require modification in the exchange rate field. The increasing importance of cost-push elements on top of demand pull inflationary pressures created more marked differential inflation rates between countries, and created structural payments problems difficult to correct given exchange rate policies stressing their inflexibility. Although the rapid growth in the international mobility of capital occasionally helped finance payments imbalances, usually it accentuated them, especially when parities were under suspicion.

In 1969 the annual report of the I.M.F. recognized that if exchange rates that are no longer appropriate are nevertheless maintained, they contribute to the persistence of balance of payments disequilibria, the encouragement of speculation and crises in the foreign exchange markets. South Africa accepted this view as indicated by the Minister of Finance:-

> What is needed is that better use be made of the Bretton Woods system. This is the real lesson of recent events. The latest annual report of the Fund is surely right when it states that 'support of the Bretton Woods system on the part of member countries calls for them to pursue internal policies to keep aggregate demand within the bounds of available resources, inasmuch as inflationary pressures have been the most frequent source of exchange rate difficulties. It is also important that countries in future should not wait too long before adjusting their par values to correct fundamental disequilibrium in their balance of payments as they have unfortunately often done in the past. 5

8.1.1 I.M.F. Special Report (1970)

In 1970 the I.M.F. issued a special report on 'The Role of Exchange Rates in the Adjustment of International Payments'. This considered various methods of achieving a limited increase in exchange rate flexibility through modifications in institutional arrangements or in policy attitudes consistent with the underlying philosophy of the Bretton Woods system. The report reiterated I.M.F. support of the par value system, but acknowledged that, in certain specific forms, greater rate flexibility would be consistent with the articles of agreement of the Fund. At the same time floating exchange rates as a permanent régime, substantially wider margins around parities and automatic crawling pegs were all rejected. Par values should be retained but should be changed more promptly after the emergence of a fundamental disequilibrium. The report advocated study of two possible innovations. One was a slight widening in the margins around parity to check short term capital flows, and help smooth the transition from one parity to another. The other was the authorization of strictly temporary periods of floating, but only in exceptional circumstances and under safeguards adequate to protect the interests of the international community.

The attitude of the Republic was summed up by the Minister of Finance when he said

> I am in general agreement with the broad conclusions of the report, namely, the rejection of freely fluctuating exchange rates, substantially wider margins, and automatic crawling pegs, and the reaffirmation of the basic principle of the Bretton Woods system. 6

At the time the report only satisfied the firm believers in the latter system, and soon after its proposals were forced into the background by events that, in the eyes of many, revealed the necessity for more fundamental changes.

8.2 Realignment of Exchange Rates (December 1971)

A major currency realignment was reached in the Smithsonian Agreement of December 1971, which involved a devaluation by the U.S.

and revaluation by others. Two interesting steps were taken in conjunction with the realignment.

8.2.1 Central Rates

Firstly the I.M.F. decided that for the time being, countries could declare 'central rates' rather than parities for their respective currencies. One difference between par values and central rates is that the latter can be expressed in terms of gold, S.D.Rs, or other currencies, while par values can be expressed only in terms of gold (or dollars of the weight and fineness existing on July 1st 1944). This development was probably regarded in some circles as a step towards a declining numéraire role for gold. A more important difference is that changes in central rates do not require prior approval by the I.M.F., though it must be notified and can challenge them.

Immediately after the realignment thirty countries declared central rates as distinct from thirty-one, including South Africa, that declared or reaffirmed par values. The majority of the industrialized countries opted for the former, and although members of the E.E.C. were expected to return to par values, they have retained central rates.[7] This shows the inaccuracy of the claim that the distinction between 'central rates' and 'par values' had no practical difference, and that it was made by the I.M.F. only for legal reasons to enable countries to repeg to the dollar at new 'central rates' before the dollar price of gold was changed by the U.S. Congress.[8]

It has been argued that the institution of central rates was not the answer to the problem of prompt parity changes. Owing to the exemption from prior approval by the Fund, the system could lead to disorderly exchange rate changes more easily than the par value system, despite the right of the I.M.F. to challenge central rates.[9] Also, there may be no reason why prompt parity changes should be less practical than changes in central rates since the Fund was perfectly able to give timely prior approval to requests for changes

in par values.[10] On the other hand, the reluctance to change central rates may have been lessened since they were not expressed in terms of gold.

The local authorities regretted this move away from a formal par value system, but regarded it as partly the result of a compromise. The U.S.A. strongly resisted a return to a par value system unlike the I.M.F. and many other countries. Resort to central rates was, therefore, a face-saving device to break the deadlock.[11]

8.2.2 Widening of Currency Margins

The second interesting step was to permit a widening of the margins of fluctuation around parities or central rates from plus or minus one per cent to plus or minus 2,25 per cent in relation to the respective intervention currency used. Thus, as against an intervention currency two non-intervention currencies pegging to it could experience a maximum swing of nine per cent as against four per cent previously. Subsequently, the new margins lost some of their significance because of the narrower currency fluctuations agreed upon by members of the European joint float and the floating of certain major currencies.

South Africa opposed substantially wider margins on the grounds recorded in the 1970 report by the Executive Directors of the I.M.F. However, as regards the question of slightly wider margins around parities the attitude of the Republic was expressed as follows:-

> We are prepared to support a slight widening if this will help in any way to reach agreement on the more basic issues, although it will be evident that I do not believe this will, in itself, contribute much to the solution of our problems. 12

The authorities regarded this move also as a political compromise necessary to facilitate agreement on realignment of rates between those who wanted larger margins and those who wanted smaller margins. The authorities were not enthusiastic about it partly because it could have created problems if the rand was linked to a major currency which could fluctuate more widely against other currencies.[13] What is more, traditionally the authorities had not

used the margins permitted under the Bretton Woods system, and the wider margins were not regarded as big enough to have a meaningful influence upon current account balance of payments trends.

This widening of the currency margins could have involved technical problems if the gold convertibility of the dollar had been restored and the official fixed gold price retained. The dollar could then depreciate and appreciate in terms of other currencies by as much as 4,5 per cent, but in terms of gold by only one per cent if the traditional margin between buying and selling rates had been retained. Thus, central banks might have preferred gold to a greater extent than the dollar as the more stable reserve asset. Alternatively, in the case of an expected dollar depreciation within the margins, they might have switched into gold and, in the case of a dollar appreciation, into dollars.

One motivation behind the decision to widen the margins concerned the argument that the moderate increase in scope for exchange rates to change in the face of market pressures would slightly reduce the prospective profitability of speculation on possible parity changes. By widening the margins, and thus marginally reducing pressures for parity changes the move could have discouraged capital flows based on speculation.[14] This was based on the argument that if parity changes are more frequent, even if of small amount, speculators are more likely to move funds.

On the other hand, the move was interpreted as deleterious to the proper functioning of a par value system by those who believed in more frequent but smaller parity changes. The latter believed that such a system would deter speculation compared with that which prevailed under the Bretton Woods exchange rate mechanism.[15] The local monetary authorities, in contrast, placed emphasis upon prompter, rather than more frequent, exchange rate changes. Moreover, the experience of South Africa since 1972 has provided some justification for the argument supporting wider margins rather than more frequent parity changes. Locally, more flexible exchange

rate policies have been associated with periodic bouts of foreign exchange speculation.

8.3 Symmetrical Exchange Rate System

A reform considered in the 1972 report of the I.M.F. concerned shifting from an intervention system in which most currencies were pegged to the U.S.A. dollar to one where intervention was made more symmetrical. The Bank was not so interested in this as many other countries because it does not intervene within set margins in the local foreign exchange market. Nevertheless, in principle the Bank favoured getting away from a dollar standard system such as evolved after August 1971.[16]

This could be achieved by two different exchange rate mechanisms: an SDR intervention or a multi-currency intervention system.

8.3.1 SDR Intervention System

Under this arrangement each monetary authority would support the par value of its currency by buying and selling it on the foreign exchange markets against SDRs. In other words, the currency of each country would have a par value expressed in SDRs. This would require allowing private financial institutions to hold SDR balances, since monetary authorities, when intervening in the markets, would have to deal with private parties. It would be left to private arbitrage operations by such institutions to guarantee that currency rates within the margins set by the official buying and selling prices for SDRs were maintained. Profits to be made by exchange arbitrage might be sufficient to induce private institutions to use SDRs even if no interest was paid on private holdings.[17]

Such a system would resemble the gold points mechanism of the gold standard. Under that system gold was used when people, having payments to make abroad, bought it from the central bank when the market rate for the domestic currency threatened to exceed the gold export point, and vice versa. Under the SDR intervention system the gold points would be replaced by SDR points at which the authorities would buy and sell their own currency against SDRs.

Such a system has been recommended as enabling the role of reserve currencies to be eliminated, and their replacement by an SDR based reserve system.[18] One of the alleged implications is that it would reduce the flexibility of national monetary authorities in regard to their monetary and fiscal policies.[19] These conclusions, however, presuppose U.S. willingness to relinquish its reserve currency role and accept a reserve asset settlement system. The local authorities did not believe this was the case. The major inducement to the U.S. to agree to an SDR system would have been its greater freedom to alter the exchange rate value of the dollar. If the latter were no longer an international numéraire or a reserve asset other countries might be less likely to follow a devaluation of the dollar in terms of SDRs with devaluation of their own currencies. Also, the U.S. would no longer be responsible for initiating a change in the official price of gold.[20] It is however, doubtful whether such benefits outweigh the losses involved in relinquishing its reserve currency role such as the ability to use the dollar internationally to finance U.S. capital outflows, and to run payments deficits when convenient.

Among other implications, by extending SDR holdings from a claim held by central banks to one held in the private sector this would tend to integrate national money market conditions in different countries, since private funds could be moved into SDRs as a hedge against a weak currency. This could lead to switching problems which could be destabilizing for weaker currencies.[21] Simultaneously, this new money instrument may ultimately lead to a world currency.[22]

During the reform negotiations in 1972 and 1973 support built up among a few European central bankers and many developing countries in favour of this system. It was favourably received by some central bank technicians because of its resemblance to the gold standard. It attracted the less developed countries because they could participate, if they wished, on an equal footing with the main industrial countries, unlike with the alternative system of multi-currency intervention.[23]

8.3.2 Viewpoint of the Republic

Despite the fact that it incorporated a par value system, the authorities were not enthusiastic. It displaced gold as numéraire, and would have placed the SDR at the centre of the system, and by conceivably dismantling multiple reserve asset arrangements, jeopardize the monetary role of gold. Since the authorities regarded the SDR as unsuitable for purposes of serving as more than a supplement to existing reserve assets, the system would have placed too much reliance on the unit. Moreover, the authorities regarded the SDR as a cumbersome instrument to use in foreign exchange markets.[24] This problem may have been made more manageable by allowing commercial banks to arbitrage SDRs without their being allowed to hold them. If a group of central banks agreed to buy and sell SDRs at par plus/minus 2,25 per cent, any deviation greater than 4,5 per cent from parity between the market exchange rates of the participating central banks would create opportunities for profitable arbitrage by buying SDRs from one monetary authority and selling to the other.[25]

8.3.3 Multi-Currency Intervention System

Under this system, instead of employing the dollar for intervention, central banks would effect the latter by a mechanism using the major currencies.

This could function alongside a reserve asset settlement system and a par value regime. Each participating central bank would establish a dealing price against other currencies. This would be the price at which it would supply its own currency against foreign currencies when it was pressed against its upper limit of the margins in the exchange market, and/or the price at which it would supply foreign currencies when its own currency was pressed against its lower limits of the margins. Central banks could agree either to intervene at the lower limit, or at the upper limit, or they could intervene in both directions, and harmonize their dealing prices through operational coordination. This is practised

currently by certain European central banks which intervene in the currencies of one another. A central bank could obtain currencies it needed, if intervening on the selling side, from the issuing central bank, and if intervening on the buying side by selling its own currency. Credits or debits built up with foreign central banks could be settled in reserve assets at say monthly intervals.

This allegedly would eliminate some of the asymmetries which the single currency intervention arrangements involve for the U.S. because of the role of the dollar as the principal intervention currency.[26] It would allow the U.S.A. the same margin for fluctuations of its currency in terms of others as was available between currencies of third countries under the par value system, rather than one half of that margin, as prevailed while the margins were fixed in terms of dollars.

It would become easier for the U.S.A. to change its parity, since it would be reflected in U.S. dealing rates for all currencies (and in rates set by other countries for the U.S. dollar). Previously, a U.S. parity change had to be reflected operationally by changes in the dollar dealing rates of other countries. The validity of this, however, is open to question since even under a multi-currency system changes in dealing rates between countries still require mutual acquiescence. Particularly if countries made frequent parity adjustments the position of the U.S.A. may not hange materially. In addition, it has been claimed that unilateral action by the U.S.A. to float its currency would be possible, rather than being dependent as in the past on other countries deciding to float their currencies. This would arise because a withdrawal by the U.S. from the system would allow other countries to suspend their intervention in dollars, while maintaining interventions and parity relationships vis-a-vis other currencies.

It could provide an incentive to avoid accumulating foreign exchange reserves by dispensing with the need for working balances. This, however, is not guaranteed since in the absence of a strict

reserve asset settlement system it could lead to the adoption of multi-currency reser... This would be potentially inflationary since diversificatio... ...es would lead to international liquidity growth.[27] ...addition, such a system is not essential to reduce or eliminate official foreign exchange holdings. This could be achieved by stipulating tight control over dollar working balances held by countries other than the U.S.A. It could be arranged that currencies needed for exchange market operations be supplied by the issuing central bank, and cancelled by periodic settlement in reserve assets.[28]

It has been suggested that something akin to a multi-currency intervention system may be needed if the spread of controls over private capital movements reached a stage where they interfered with private arbitrage in foreign exchange markets. In this event consistent cross rates would have to be maintained by central banks themselves.[29]

On the other hand, it has been stressed that the multi-currency intervention system is subject to technical disadvantages.[30] It involves much more intervention in the exchange markets than was required under the Bretton Woods system. Under the latter, assuming 'n' currencies were traded on the exchange markets, only n-1 relationships among central banks overall was required, since intervention was largely confined to the use of the dollar. Intervention could proceed without much, if any, consultation. A multi-currency system is more complicated and costly to operate. It would require specific rules to prevent inconsistent intervention between currency margins.

At the same time, such a system need not necessarily be associated with a par value regime, since it has been suggested that under floating rates such intervention might operate.[31] Under such arrangements monetary authorities which engage in multiple currency intervention could use the weighted average value of their rates, rather than the dollar exchange rate, to guide intervention

to influence the value of their currencies. However, the danger of inconsistent intervention arises if one country buys or sells the currency of another country when the latter is trying to stabilize its effective exchange rate value. Various procedures have been suggested to try and overcome this problem.[32] Others regard multi-currency intervention as impractical under managed floating, because avoiding conflicts demands rules governing which currency should be used in intervention. This would require a criterion as to whether a currency was weak or strong which, it is alleged, is impossible.[33]

8.3.4 Viewpoint of the Republic

The authorities accepted in principle a multi-currency system, since it could incorporate a par value regime with gold as the numéraire. However, although regarded as less impractical than the alternative SDR system, enthusiasm for it was modified by the practical difficulties mentioned previously, and doubts that a return to a reserve asset settlement system could be effected, which ideally should eventuate.[34]

Any multi-currency intervention system could not be universally applied. World trade is dominated by invoicing in a small number of currencies, while some countries might refuse to intervene in certain other currencies or might deny them the swap facilities necessary to enable them to intervene effectively in their own exchange markets. This might be particularly relevant for less developed countries.[35]

Under the SDR system any country could participate if so desired. Under the multi-currency system the Republic would not be a member, since it has no properly developed foreign exchange market. Even if it had, problems would arise if countries like Japan and Australia were members. If the Bank intended intervening in these currencies but first wished to check with the relevant authorities to ensure that they had no contrary intentions the authorities would need to introduce night shifts in order to telephone. Moreover, since the rand market would be thin this would pose extra intervention responsibilities.

Given the absence of a proper market and the simplicity and low cost of intervening by using the dollar, the Bank, as a non-member, could pursue its normal intervention policy. In order to gain a close informal association with a multi-currency group the authorities could deal in a number of multi-currency units. However, its rates would have to be consistent with the rand/dollar rate in order to avoid private arbitrage operations. It would also involve competing with commercial banks for foreign exchange business, and thereby hinder the development of an exchange market, which is essential if the rand was ever to join a multi-currency group.

Moreover, not being a member of such a group could appear particularly disadvantageous for the Republic if the group did not practise strict reserve asset settlement procedures. This would mean that deficit members of the group could enjoy credit facilities, denied to non-members, as their currencies are accumulated by surplus members of it.

8.4 Deliberations of the Committee of Twenty.

In July 1972 the Governors of the I.M.F. appointed a Committee at ministerial level which contained one member and two associates for each of the twenty constituencies that choose an Executive Director of the Fund, and assigned this Committee of Twenty to advise and report on all aspects of reform of the international monetary system. South Africa was represented on this Committee by the Deputy Governor of the Reserve Bank.

As regards the adjustment process, the main innovations of the Outline of Reform published by the Committee were as follows. Surveillance of the adjustment process, at least for balances of international importance, should be carried out at special meetings in the Fund. In that process, considerable importance would be attached to automatic reserve indicators. They would play a role in triggering consultations about a country's imbalance. They could operate presumptively, or even automatically, in triggering financial pressures on surplus countries in the form of negative interest rates

on their excess currency balances. The type of indicator favoured for these purposes appeared to relate to the reserve levels of countries.

8.4.1 Objective Indicators - South African Viewpoint

These were viewed by their advocates principally as a means of introducing an element of exchange rate flexibility into the par value system without attempting to undermine it. Supporters of such indicators wanted prompter and more frequent exchange rate adjustments, motivated in part by the desire to avoid currency crises and speculative capital flows. The Committee never formalized entirely its thinking on this issue. For instance, there was never complete clarity whether *mandatory or automatic adjustment* measures were expected, as contrasted with presumptive rules that merely request a country to consult with the I.M.F. on possible policy adjustments. Nevertheless, the political feasibility of both approaches was in question, and particularly so where automatic rules were concerned.

Regarding the use of a reserve indicator structure which might be employed presumptively to activate pressures on a country, the *viewpoint* of South Africa was expressed as follows:-

> Apart from the great practical difficulty of reaching agreement on such a structure, I doubt whether, in the light of the experience of the past few years, it would really serve a useful purpose. A reserve indicator, after all, is not necessarily a good index of the basic balance of payments or a reliable signal for action on exchange rates or other measures.
>
> I also have serious doubts about the desirability and usefulness of pressures in general. Even over the past few years, can we really believe that pressures would, for example, have induced surplus countries to appreciate their currencies to a greater degree than has actually taken place? I am quite certain that pressures of a type which would produce an open confrontation between the Fund and the country concerned would not help to achieve the results we desire. The whole experience of the Fund over the years has been that a great deal can be achieved by consultation and suasion. 36

The authorities were fearful that such a system would be exploited by the U.S. through I.M.F. channels to pressurize surplus countries into revaluing their currencies.[37] This policy it disapproved of as explained elsewhere. In addition the authorities believed that the employment of statistical indicators and formal international assessments would be likely to intensify the speculative capital flow problem.[38] Insofar as this materialised the maintenance of a par value system of any kind would be seriously threatened, and most probably prove impossible to function. This conclusion may be valid even if efforts were made to mitigate the influence of increased predictability of parity changes on speculative capital flows. This could be attempted by greater controls on such flows, wider exchange rate margins, and/or encouraging adjustments by countries by alternative means besides par value changes.[39]

The idea of employing the foreign reserves of a country as an objective indicator generated serious reservations on the part of the authorities.[40] Apart from the comments explained above, the authorities believed it would invite misrepresentation of reserve figures by central banks. The latter could falsify their reserve holdings, and engage in secret reserve swap agreements with other banks, practices which could seriously undermine such a system. Even if detection fears or reluctance to erode the authority of the I.M.F. acted as a deterrent, countries could lengthen the maturity of foreign deposits beyond one year, the latter not being counted as part of the reserves of a country by the I.M.F.

Moreover, the problem of defining what a maximum and minimum level of reserves should be is daunting. A system that pinned countries down to avoiding marked changes in their reserves would limit the use of the latter for stabilizing such variables as output and exchange rates. Moreover, as regards the minimum level of the reserves of a country, once defined the danger would arise that the level necessary to maintain confidence in the markets would rise thus requiring quicker adjustment measures and reducing further the role of reserves as a stabilizing influence.[41]

Introducing an element of automaticity into the adjustment process through objective indicators was regarded by the authorities as under-rating the complexities of economic life.[42] It adhered to the view that in seeking to achieve simultaneously economic objectives of differing degrees of compatibility, countries must have flexibility to apply that combination of policies which is best calculated to overcome their specific problems, and takes account of the range of instruments at their disposal. A mechanistic formula, even if operationally feasible or politically acceptable, which the Bank doubted, would inhibit such response flexibility.

Summary

This chapter has attempted to throw light on the policy attitudes of the authorities during the years of deliberations on exchange rate reform in the 1970s. International efforts at restoring a par value system, however, ended following the oil crisis. It then became clear that floating rates would become more widespread, and would persist indefinitely.

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CHAPTER NINE - PROSPECTS FOR A RETURN TO FIXED BUT ADJUSTABLE EXCHANGE RATES

Reform of the international monetary system proceeded a stage further in Jamaica (January 1976) where arrangements agreed upon by the I.M.F. Interim Committee represented far-reaching changes. In particular, the floating of currencies was legalized. As a result, the new Article IV of the I.M.F. statutes represents a marked departure from the Bretton Woods principle of fixed but adjustable exchange rates.[1]

In other words, the international community has been sufficiently satisfied with contemporary international monetary procedures to turn its back on Bretton Woods. The purpose of this chapter is to assess the rectitude of this, and the prospects of a return to fixed but adjustable exchange rates, which the Republic in principle favours. To begin with a brief review of the recent exchange rate regime is therefore necessary.

9.1 Record of Floating Rates

The extension of floating rates since 1972 has occurred during a period characterized by turbulent economic and political conditions. Any appraisal of this mechanism is constrained partly by the short time span, and partly because, during this period many currencies, particularly those of developing countries, have been tied to a major currency such as the U.S. dollar or the SDR.

Flexible rates have eliminated the kind of exchange rate crisis which plagued the Bretton Woods system in its dying years.[2] Changing the exchange rate no longer requires a formal initiative with its implications for national prestige as it did under the par value system. Even so, floating rates have not eliminated foreign exchange crises. Developments have shown that the assumption that the floating system would prevent extensive foreign exchange losses by central banks is a fallacy. In March 1976 alone the Bank of England lost more than one billion dollars unsuccessfully trying to shore up the pound, while in the same month the Bank of France

lost over three billion dollars in its unsuccessful attempt to prevent the franc leaving the joint European float arrangements.[3]

Simultaneously, currency crises have allegedly been defused because countries can more easily follow independent monetary policies than before.[4] This is debatable. U.S. interest rates still appear to exert a major influence on interest rate policies of other countries, a conclusion supported by statistical evidence.[5] Also, despite the increased scope which exists for allowing inflows and outflows of funds to influence the exchange rate of a country rather than the domestic money supply, countries have displayed concern over the movements of their exchange rates. This casts doubts over the discretion available in operating independent monetary policies. Moreover, to the extent that greater orientation towards domestic policy objectives does occur this could raise inflationary expectations and unrest in foreign exchange markets.

9.1.1 Competitive Devaluations

This concerns the danger that excessive depreciation of a major currency can induce a similar weakening of other currencies. Many commentators have detected little or no evidence of such practices, in contrast to what happened during the period of floating in the 1930s.[6] Yet in other quarters it has been claimed that signs of such practices have emerged where the major currencies are concerned.[7]

Certainly, there has been evidence of countries, including South Africa, deliberately using the exchange rate as an instrument of economic expansion. Since 1972 the effective exchange rate of the rand has been correlated with the gold and foreign exchange reserves and the business cycle.[8] By contrast, the par value system aimed to prevent depreciations or appreciations for purposes of cyclical economic management. Par value changes were prohibited where these were not needed for payments equilibrium over a country's business cycle.

Two other conclusions can be made. Firstly, any prolonged recession in the world economy will increase the danger of competitive

devaluation practices emerging, particularly if agreed rules for currency intervention are absent. It has, however, been argued that during a global recession any attempt by the rest of the world to export its unemployment by buying dollars and thus causing the latter to appreciate, would, assuming high capital mobility, induce capital outflows from the U.S. and expectations of a weakening in the rate for the dollar.[9] Any rebound in the latter would, however, only occur if other countries were unwilling to go on buying dollars in the foreign exchange markets.

Secondly, aggressive depreciation policies require governments to be sufficiently insensitive to their inflationary implications. So far, evidence suggests that governments can be conscious of the adverse domestic implications of such action.[10]

9.1.2 Effects on Foreign Trade

In the opinion of some writers, foreign trade and investment do not appear to have been affected much, if at all, by the floating rate system. The business community has adjusted without noticeable discomfort, and spot and forward markets have adapted favourably.[11] It has been claimed that the statistical evidence relating trade to output suggests that, if anything, the former has grown relative to the latter.[12] World trade in real terms increased by thirteen per cent in 1973 compared with an average annual growth of 8,5 per cent in 1960-70. The growth rate fell to five per cent in 1974, but world output, which grew by five per cent at an annual rate in the 1960-70 period and by 6,4 per cent in 1973, increased by only one per cent in 1974.[13] In other quarters the slowdown in the growth of world trade in 1974 and its fall in 1975 were regarded suspiciously as evidence of the harmful effects of floating rates upon world trade, notwithstanding the severe recession which materialised.[14]

Reaching a conclusion on this issue is difficult in view of the many factors which influence foreign trade at different points in time. The floating rate era has been accompanied initially

by a world boom and high inflation, and later the oil crisis and recession.

Nevertheless, the floating of currencies would appear to have complicated foreign trade business as well as increased the risk. The volatility of floating rates cannot be eradicated in the forward market, since forward rates can be just as volatile as spot rates, the benefit of forward cover being to provide certainty about cash flows only for a particular transaction.[15] Fluctuations in spot and forward rates have been substantial compared with the Bretton Woods era. In forward markets there has been increased demand for cover facilities, but the volume obtainable has declined, while the margin between buying and selling prices of banks has widened. (This applies to spot rates as well.) This has been attributed to the increased desire of banks to play safe by reducing limits for the amounts up to which they are prepared to accept the names of each other for forward exchange, as well as the desire to reduce their unmatched positions.

The reduction in foreign exchange facilities which has occurred in the post Bretton Woods era should not be attributed solely to floating rates. It has been suggested that the decline of the dollar in 1973 took both banks and companies by surprise, and induced them to curtail their unmatched positions.[16] Also, the collapse of the Herstatt bank in 1974 made the bigger banks reluctant to deal with smaller banks, thus reducing exchange facilities available.[17] Moreover, any increased spreads between bid and ask prices in foreign exchange markets might discourage foreign trade. One study shows that in May 1975 the spread for three major currencies, in terms of dollars, was four to eight times what it was in 1970. Even so, the spread did not exceed one sixth of one per cent of the cost of foreign exchange in May 1975.[18] Another study, which goes only through mid-1974, shows similar results for the spread on forward as well as spot transactions.[19] The added cost of trade from this source appeared very small.

It has been objected that the exchange rates of major currencies vis-a-vis the dollar have fluctuated excessively and not reflected underlying economic conditions. As a result it has been impossible to conduct international trade based on comparative costs, and a flow of international capital based on comparative profit and interest rate levels.[20] The implication of this viewpoint is the desirability of international co-operation to smooth exchange rate movements.

Others question the possibility of employing criteria to test the proposition that exchange markets over-react.[21] Moreover, if trade weighted indices, rather than movements of individual rates vis-a-vis the dollar, are used exchange rate fluctuations are less marked.[22]

9.1.3 Balance of Payments Adjustment and International Liquidity

Floating rates have not eradicated payments disequilibria. Floating has not been 'clean', since monetary authorities have, on occasions, intervened heavily in exchange markets.

In these circumstances, it is not clear whether the need for foreign reserves in general has fallen. Certainly statistical analysis using the criterion of 'reserve use' provides no evidence of this.[23] To the extent that such needs have not fallen, to attribute it to floating rates alone requires that all other things have remained equal. In fact, changes in global economic conditions in recent years may have been more important than the change in exchange rate arrangements in affecting the demand for international reserves.

Some have argued that floating rates, far from reducing payments disequilibrium, have perpetuated imbalances. The cases of the U.K. and Italy are quoted where due to the perverse short term effects of depreciation, and the ensuing rise in the cost structure aggravated by trade union pressure on wages, floating has made matters worse, and has been accompanied by resort to import controls of various kinds. These examples suggest that insofar

as the payments troubles of a country reflect underlying disequilibrium within the economy or structural divergencies vis-a-vis the outside world, exchange rate manipulation is no answer. Conversely, a country such as West Germany has seemingly gained on the payments front from appreciations of the mark, aided additionally by speculative capital inflows on anticipation that the low inflation rate in the country will lead to further appreciation of the mark.

Possibly, most important of all, the question arises whether floating rates have left unresolved the problem of the rapid growth of world liquidity fuelled by rises in official foreign exchange reserves, primarily dollars, and the growth of the Eurocurrency markets. In 1968 the gross size of the latter stood at around $25 billion, while today it is roughly $500 billion.[24] Since the beginning of 1970, as Table 19 illustrates, official world liquidity has risen by more than 200 per cent. This development precipitated the collapse of fixed exchange rates as countries tried to contain the flood of dollars into strong currencies.

TABLE 19 - OFFICIAL INTERNATIONAL RESERVES (1970-76)*$m.
(Figures refer to the end of the first quarter of each year)

	Total	Foreign Exchange
1970	81 250	31 700
1971	99 400	49 430
1972	137 895	82 835
1973	179 069	117 847
1974	187 939	126 690
1975	229 823	162 058
1976	234 206	165 302

*i.e. Gold($42 per ounce), SDRs, Fund Reserve Positions and Foreign Exchange.

Source: I.M.F. Financial Statistics

The importance of this phenomenon stems from the allegation that a systematic relationship exists between changes in world

reserves and the rate of worldwide inflation with changes in world money supply serving as the crucial link.[25]

One argument in favour of floating rates was that this growth in official international reserves could be modified markedly, but although the growth rate has slowed down, the problem allegedly remains.[26] This growth would probably have slowed down in any case since, if the Bretton Woods system had survived, it could only have done so if this problem had been tackled. This would probably have involved a massive gold revaluation and the absorption by the U.S. of the surplus dollar holdings held by foreign central banks, or alternatively, some form of international funding of these dollars, together with strict rules concerning future reserve asset settlement. Also, the dollar float in 1973 created a potential boost to world liquidity since it facilitated the liberalisation of U.S. capital export restrictions such as the abolition of the interest equalisation tax.

On the other hand, unrestricted growth in official currency reserves may be viewed as not partly attributable to central bank intervention in the markets, but to the lack of an asset settlement system. However, establishing the latter is more difficult under floating rates, because of the problem of agreeing upon rates at which foreign currencies accumulated by central banks should be converted into primary assets. Moreover, in regard to gold revaluation proposals, opponents can ask what discipline on reserve growth would be present if the U.S. could write up the value of its gold reserves whenever growth of official dollar liabilities threatened convertibility of dollars into gold.[27]

A contrary view asserts that the recent growth in official foreign reserves is not a cause for concern.[28] In the three years to March 1976 world reserves increased by SDR54 billion or about thirty-six per cent. Almost seventy-five per cent of this accrued to OPEC countries. Since the reserves of most OPEC countries are qualitatively different from those held by other countries, it is

argued that they should be viewed as long term investments rather than short term liquid assets.

This is based on the belief that the distribution ofreserves is more important than the absolute amount. In a situation like the present the quantity of international reserves is therefore viewed as not excessive, while it could be if the distribution was different. Nevertheless, omitting such reserves from calculations of world reserves, overlooks the possibility that such 'long term' investments, through changed payments circumstances, can become short term assets. Already, a number of OPEC countries, e.g. Iraq, Nigeria and Iran, have launched ambitious industrialization programmes. On present evidence only three members - Abu Dhabi, Kuwait and Saudi Arabia - seem likely to continue enjoying sizeable payments surpluses. Moreover, there have been claims that the reserves of Saudi Arabia, and possibly other OPEC countries' reserves, are being seriously understated.[29]

These observations emphasize the problems of valuing objectively official reserves under contemporary conditions. This has been exacerbated by the difficulties in valuing gold reserves in the presence of a fluctuating price. It may be argued, along similar lines, that since official gold holdings are largely long term investments, they should be omitted from the valuation of international reserves. Unfortunately, this is too simplistic; already, several countries have mobilised their gold reserves either by marginal free market sales or by collateralising part of their stocks.

9.2 Viewpoint of the Republic on Floating Rates

Much comment on floating rates has been in the context of the major currencies which float in fully fledged foreign exchange markets. When this regime is looked at from the viewpoint of developing countries, the picture is different, the attitude of the local monetary authorities being summed up as follows:-

> South Africa's experience with different types of exchange rate arrangements during recent years has strengthened our belief that, whereas floating exchange rates may under certain circumstances be desirable for major industrial countries with developed foreign exchange markets, it has serious disadvantages for most other countries and for the international monetary system as a whole.[30]

By linking to the dollar the effective exchange rate of the rand has fluctuated markedly, on occasion inappropriately considering internal economic conditions. Given the policy of periodically adjusting the peg with the dollar, speculation has been invited both in favour of and against the rand. The latter has, on occasion, complicated the task of selling gold by putting pressure on the foreign reserves, and thus the need to sell more of it. Simultaneously, adverse leads and lags have increased the size of desirable reserve required to support a given volume of imports in contrast to the claim that more flexible exchange rates reduce the size of reserves required, other things remaining equal. This has induced a tightening of exchange control regulations. Moreover, it has been found that floating rates can discourage importers from utilizing overseas trade finance.[31]

9.2.1 Floating Rates and Inflation

The country has consistently opposed a more flexible exchange rate regime because of its alleged inflationary bias. However, recent experience has furnished no conclusive evidence on this issue.

TABLE 20 - PERCENTAGE INCREASES IN CONSUMER PRICES IN SELECTED COUNTRIES

	Annual Average 1961-71	1972	1973	1974	12 Months to December 1975
Canada	2,9	4,8	7,6	10,9	9,5
Japan	5,9	4,5	11,7	24,4	7,6
France	4,3	5,9	7,3	13,7	9,5
West Germany	3,0	5,5	6,9	7,0	5,4
Italy	4,2	5,7	10,8	19,1	11,2
U.K.	4,6	7,1	9,2	16,0	24,9
U.S.A.	3,1	3,3	6,2	11,0	7,0
Total O.E.C.D.	3,7	4,7	7,7	13,2	9,3

Source:- R. Solomon, The International Monetary System, 1945-76, Harper and Row, p.269.

What has eventuated is a 'vicious circle' thesis which claims that unmanaged exchange rates have provided an independent source of inflationary pressures in countries such as the U.K. and Italy where they are already above average levels compared with other major countries. Thus, the exchange rate declines in anticipation of further inflation causing import prices to rise, and so expectations regarding inflationary trends are self-fulfilling.

Conversely, the defenders of floating rates argue that if and when the market becomes confident that inflation in a country will be brought under better control, confidence in the currency will improve. In the absence of effective anti-inflation policies intervention in the foreign exchange market by monetary authorities can only hold a rate for a limited time. Also, it can be counter productive because it may lead merely to the postponement of effective monetary and fiscal policies, and increase the ultimate cost of restoring monetary stability. This argument was put forward in connection with the funding of U.K. official sterling balances at the end of 1976.

The feared breakdown of monetary discipline under floating rates has not been visibly borne out. There has been evidence that monetary authorities become concerned when exchange rates fall because of their inflationary implications, this acting as a form of discipline. However, all countries now suffer from inflation. The expansion of money supplies makes inflation possible without causing exchange rates to depreciate, and 'politicians in each country can blame inflation on the world economy where it is nobody's responsibility'.[32]

9.3 Opposition to Return to Fixed Rates

It is generally agreed that the Bretton Woods system served the world well, even though it was only truly operational from the late 1950s when the major European currencies became convertible.[33] The I.M.F. articles proclaimed the conviction that international economic conduct must be governed by an explicit code, incorporating

the maxim that adherence of members to the rules was advantageous on balance, even if it appeared disagreeable at times to an individual government.[34] Arising out of this mutual co-operation, the system was claimed to be capable of modifications in the fact of pressures which built up in the 1960s, and which resulted, for instance, in the introduction of SDRs.[35]

In recent years some ambitious proposals have been made, which have remained no more than proposals. As pointed out by Einzig, it is easy to fault reform suggestions, but much more difficult to make a counter-proposal for thorough-going reform which would be economically satisfactory, politically acceptable and technically feasible.[36] There has been a simple alternative to more ambitious reform plans which would involve the reinstatement of the Bretton Woods system in a modified form. This has been the policy recommendation of South Africa.

9.3.1 Use of Exchange Rate as Policy Instrument

To some extent opposition to restoration of fixed rates may reflect modern social trends where discipline has tended to be undermined. Thus, partly arising from this is the reluctance of governments to discard the exchange rate as an instrument of economic policy in contrast to attitudes under Bretton Woods when it was much more regarded as a target. Governments now regard the exchange rate as a tool similar to interest rates, etc.[37] Enthusiasm for floating rates is partly built upon the belief that countries should be able to adopt monetary and fiscal policies for the purpose of fulfilling domestic economic objectives, with limited constraint exerted by external institutional features. Also, the exchange rate may be the most efficient instrument available to deal with the balance of payments, given the priority of policy makers on high levels of employment, and the power of trade unions intent on at least maintaining their relative wage positions.[38]

As previously indicated, the efficacy of balance of payments adjustment under floating rates can be exaggerated, as well as the

freedom from external constraints. Also, it remains to be seen whether these policies are conducive to long term price stability and stable growth.

9.3.2 Exchange Rate System and Economic Disorders

The Bretton Woods system was based upon exchange rates being maintained over long periods. Nowadays, it is questioned whether rates of economic change, the diversity and reversibility of capital flows, differing economic growth rates of countries, and the unpredictability of economic changes are not so great that such exchange rate stability is an illusory target.[39]

It has been widely assumed that no return to fixed rates could be contemplated under the conditions prevailing in the wake of the oil crisis. Yet the latter disturbance was one where no exchange rate mechanism could eradicate the current payments imbalances. Since real consumption and investment expenditures of the OPEC countries in aggregate could not rise sufficiently, even with appreciation of their currencies, the surpluses on current account needed to be bridged by capital transfers.

Where exchange rate adjustments could have been helpful, following the oil price hikes, related to the main industrial countries whose competitive positions were affected to varying extents, and who did not benefit equally from long term investment by oil exporting countries.[40] In view of the difficulty of knowing the extent of adjustment required by individual countries, a period of exchange rate flexibility had its attractions. On the other hand, substantial devaluations may have been preferable to an adjustment process drawn out over time which meant only limited payments adjustment supplemented by foreign borrowing and mildly deflationary policies. The incentive to deflate under fixed rates may have been greater in order to make devalued exchange rates appear viable, and minimize speculative capital flows. However, if more deflationary policies had worsened the global recession in 1974-75 the danger of trade controls spreading would have arisen.

The latter danger could have arisen for other reasons too. It has been argued that what enabled the world to weather the initial results of the oil crisis was not floating rates, but the Eurocurrency markets.[41] During 1974 alone OPEC amassed liquid assets of $60 000m. of which more than one third was placed in the Eurocurrency markets, and then recycled to deficit countries. If recycling through the I.M.F. had proved less easy and more protracted, without the Eurocurrency markets, deficit countries would have been driven to drastic import curbs, which would have fostered a deepening of recessionary conditions.

Meanwhile, preservation of the status quo is justified on grounds that international traders have become accustomed to floating, and any return to fixed rates would be harmful, creating new uncertainties for international trade.[42] In view of what has been said regarding foreign exchange dealings since the advent of floating rates this is not easy to justify. It may reflect a rationalisation for inertia which develops under any type of monetary arrangements, ensuring that only crises tend to initiate major changes.

9.3.3 Countervailing Influences

This analysis highlights the poor prospects for a return to a par value system in the foreseeable future. Yet not all factors suggest that this will persist. There has been a historical pattern for an eventual return to fixed rates such as after the Napoleonic War, the First World War and the Great Depression.[43] The possibility of further economic integration with Communist countries, and the entry of them into the I.M.F. would alter the outlook. Communist countries favour controlled exchange rates. The tendency for the U.S. economy to have a larger proportion of gross domestic product originating in the external sector, may modify the enthusiasm of that country for floating rates. If the dollar floats upwards and becomes markedly overvalued, American support for floating will, it is claimed, diminish rapidly.[44] Moreover, greater global economic stability could prompt international efforts to restore fixed rates.[45]

Even existing arrangements have been alleged as not constituting a basic departure from the par value system.[46] Managed floating is being practised, and if it operates on the basis of international consensus as to what should be the loose structure of exchange rates, can be aligned to a regime of par values. Several developing countries are dissatisfied with the system of floating.[47] Finally, pressures have emanated from within the E.E.C. for a return to a par value system by those who favour greater monetary and economic integration.[48]

9.4 Problems with Reinstatement of Par Value System

The U.S. has the power within the I.M.F. to veto any return to a par value system. The Reserve Bank regards the current system as akin to an 'inconvertible dollar standard' with no foreseeable prospect of a return to a Bretton Woods type system which, in principle, it favours.[49] Apart from this, various technical and economic problems would arise if such a return was contemplated.

9.4.1 Need for Prompt Adjustment of Rates

The authorities believe that under any reinstated system countries must be prepared to change their exchange rates more readily, but still with changes only permissible in cases of fundamental disequilibrium. It adheres to the view that the undue rigidity of Bretton Woods was not due to the system itself, but was the consequence of inappropriate application of it. The U.K. and the U.S.A., for instance unduly delayed making exchange rate changes, the latter obsessed by the desire to maintain an unchanged official gold price.[50] In contrast, others have alleged that the inadequate exchange rate mechanism was partly a result of the Fund which failed to take any initiative on exchange rate structures, and helped solidify the feeling that these matters were the prerogative of governments.[51]

Whether it is realistic to anticipate that governments will accept limitations on their sovereignty in this field is doubtful. In any case, the Bank believes that if a return to a par value system was made countries would be more prepared than in the past to make

rate changes in view of past experiences.[52] Such a belief has, however, been described as misplaced:-

> The delays in the past were undue only in hindsight; they were the result of supposed prudence and caution when governments were thinking that the time for adjustment of the parity had not come. Governments resisting revaluation or devaluation were hopeful that balance could be restored at unchanged exchange rates - i.e. that the disequilibrium was not fundamental. 53

The criteria which reflect a 'fundamental disequilibrium' under the Bretton Woods system were never spelt out, partly reflecting the difficulties in establishing them. Also, national authorities may well be subject to bureaucratic delays in making adjustments. Nevertheless, the above statement disregards whether adjustment in the 1960s was not partly due to attempts to shore up the system without altering the dollar gold price. Since that proved illusory *it may be that under a restored par value system, resistance would* be less, especially if par values were not expressed in terms of gold.

Insisting that changes be allowed only in circumstances of fundamental disequilibrium is important in order to prevent the system being transformed from one extreme to the other. Under Bretton Woods the maintenance of parities came to be looked upon as a major objective by leading Western countries. In one respect this was to be recommended, since resistance to dealing with payments problems by internal economic instruments would have meant that the system would have disintegrated much earlier. As Einzig noted:

> From the viewpoint of maintaining the Bretton Woods system, *it is equally important to avoid getting into a mentality* that changes in parities don't matter, and to avoid getting into a mentality that such changes must be prevented at all costs regardless of the extent of any prevailing fundamental disequilibrium. 54

Even assuming that a 'halfway' position can be achieved it is still questionable whether stable but adjustable exchange rates can be attained. Under a par value system the degree of exchange rate stability can be viewed as depending upon the time span. A small

number of large changes which occur periodically does not necessarily provide greater stability than a series of smaller, but more frequent exchange rate adjustments.[55]

Where the degree of harmonization of economic policies of countries is close, parity changes should be limited in both size and frequency. Under present global conditions, with high and divergent inflation rates, stability under a par value system would be non-existent. It would therefore hardly be sustainable. Flexibility in changing rates under any restored fixed rate system could also be enhanced since the U.S. resorted to devaluations in the early 1970s. It has been argued that this has reduced the credibility of fixed rates, and only slight disequilibrium will induce massive speculation and further rate changes.[56] With the passage of time and changed circumstances this danger could recede. The dollar for instance was devalued in 1934 but after 1945 was regarded as 'better than gold'. However, the scope for, and profits from, speculation is now much greater.

Currency stability might be influenced in another way if changes in rates were made more readily than in the Bretton Woods era, since this could imply that parity adjustments would be undertaken at an earlier stage of disequilibrium. This may make it more difficult to establish the correct size of exchange rate changes, and open up the possibility that events will develop differently from what was expected. This could require a subsequent reversal of the exchange rate.[57]

This need not necessarily eventuate since making more prompt exchange rate changes does not automatically imply more frequent ones. This possibility would be enhanced if deflation, as a mechanism for payments adjustment, was not emphatically excluded such as occurred under Bretton Woods. In any case, this danger of premature currency adjustments could be minimized if they were guided by the concept of fundamental disequilibrium, although this might preclude prompt changes.

9.4.2 Responsibility for Rate Changes

Another problem concerns assigning responsibility for exchange rate changes when deemed necessary, and in particular where reserve currencies are involved. Under Bretton Woods, lack of clarity on this led to argument about where responsibility lay, and encouraged political moralizing and acrimony. This problem emerged in 1971 over the question of realignment of currencies between the U.S.A. and Europe and Japan. This episode demonstrated that no clear cut basis was available for assigning responsibility for initiating exchange rate adjustment among the various countries concerned.[58]

On this issue the standpoint of South Africa is to put the emphasis upon deficit countries given an environment of inflation and economic growth. Under current economic conditions the 'scarce currency' concept may be irrelevant in view of international financial co-operation provided through the I.M.F., mutual currency arrangements, SDRs, etc. The ability of deficit countries to avoid deflation has increased, aided by the success of Third World countries in exacting enlarged credit facilities.[59]

On the other hand, there has been widespread support for a more symmetrical adjustment process partly on the grounds that this reduces payments imbalances. The danger is that this would encourage deficit countries to avoid adjusting adequately themselves. However, it has been argued that, psychologically, deficit countries need reassurance that their adjustment efforts will be reinforced rather than thwarted by surplus countries.[60]

Initiating exchange rate changes has another aspect. It is argued that a Bretton Woods system is now redundant because of the changed status of the U.S.A. whose political and economic strength has declined. As a result it is no longer prepared to accommodate the payments wishes of the rest of the world, and allow exchange rate initiatives to be made solely by others. On this basis, reform must take into account the implications of a positive exchange rate policy by the U.S.A. in contrast to the Bretton Woods

system in which the Americans could not unilaterally change their own exchange rate.[61]

This conclusion is of uncertain validity. There was nothing inconsistent with the I.M.F. Articles for the U.S. to pursue an active exchange rate policy provided it was prepared to change the price of gold. The willingness to do this was absent partly because of uncertainty about its ramifications for the monetary system, and partly because of the perceived threat of gold to the supremacy of the dollar in international monetary affairs. Possible damage to the reserve currency role of the dollar could be a major obstacle to willingness to devalue the dollar in any restored par value system. However, the need for devaluation could be minimized, if not eliminated, by appropriate U.S. monetary and fiscal policies, and co-ordination of these with those of other leading countries. The support for gold by the Republic has not meant that it is antogonistic towards the dollar:-

> South Africa believes that the dollar can and should play a key role in international finance as a transaction and intervention currency and as a reserve asset, not only in the immediate future but probably for many years to come; there is as yet nothing to take its place. But to do its job properly the dollar must be strong and readily acceptable. This implies, I believe, that the U.S. economy and balance of payments must be sound and that some form of convertaibility for the dollar should be restored. 62

Thus, the Republic wishes to see a strong gold base in the monetary system alongside a healthy dollar believing that the U.S. economy is a key factor in promoting world economic stability and stable exchange rates. Under such conditions prospects for a return to fixed parities become more feasible. Conversely, the U.S.A. wants a healthy dollar but a weak gold base in the monetary system. The South African authorities doubt whether this is a compatible arrangement.

There has, moreover, been illogicality on the so-called U.S. handicap on exchange rate matters. On the one hand it has been

argued that devaluation would be followed by virtually every other country thus nullifying the exercise.[63] On the other there has been support for the idea that other countries should revalue against the dollar. But if any dollar devaluation against gold would be self-defeating what grounds are there for supposing that other countries would revalue unilaterally against the dollar? In undertaking the latter a country is revaluing also against all other countries who do not follow suit, unlike with a dollar devaluation providing others do not follow the dollar down.

It is not clear whether the U.S. wishes to pursue an active exchange rate policy. Since the advent of floating rates, the U.S. has maintained a largely passive intervention policy. Apologists point out that sizeable intervention in exchange markets, even if desired, is complicated by the long-standing use of the dollar by other countries for intervention purposes, and precluded by lack of currency reserves held by the U.S. The latter, however, could acquire such holdings by selling gold to foreign central banks.

This asymmetry in the position of the dollar has been aggravated under floating rates. Under a par value system, other countries would have to convince the international community that they should follow changes in the value of the dollar, while under managed floating they could simply intervene to prevent the effective value of the dollar from changing.[64]

Assuming that the U.S. takes an active interest in its exchange rate, any restored par value system might involve other difficulties. Countries, it is asserted, wish to engineer undervalued exchange rates, and thus par values were agreed upon, and maintained for so long under Bretton Woods because of American indifference to its exchange rate, and its overvaluation. The question, however, arises as to what extent, if any, the overvaluation of the dollar resulted from European demands for an increase in their foreign reserves by means of dollar accruals, given the impossibility of adding to their gold reserves due to its low price in the 1960s. Aiming for an undervalued rate, moreover, brings problems, and the need eventually

to adjust by inflationary policies or by revaluation.

9.4.3 De-Stabilizing Capital Flows

One of the most difficult problems in operating a Bretton Woods type system concerns the vast shifts of capital which can be encouraged whenever suspicion of a currency change arises. Hence, sooner or later, capital flows can cause the system to be undermined, and finally break down under the weight of ever increasing de-stabilizing speculation.[65] Moreover, in efforts to minimize speculative capital flows, countries frequently issued firm pronouncements on the fixity of exchange rates.[66] This made it more difficult to undertake exchange rate adjustment if this was eventually deemed desirable.

Problems could be intensified under a modified Bretton Woods system since if, more frequent but still sizeable, changes in exchange rates materialised, this could further undermine stability. If a currency is changed more readily the concept of 'stability illusion' will be shattered, and destabilizing speculation will become larger rather than smaller.[67] As previously noted more prompt adjustments do not necessarily mean more frequent ones, but even if this is the case and exchange rate stability was not impaired the problem remains.

Speculative flows of capital have become much more pressing with the convertibility of the major currencies for current account purposes, the growth of international trade, and increased information about overseas countries associated with the growth of communications. Likewise, multinational corporations have emerged with facilities to switch funds from one operating area to another, alongside the growth of the Eurocurrency markets. The latter, it is alleged, was encouraged by the fixity of exchange rates which invite speculative attacks, and therefore encourage the supply of speculative funds provided through this market.[68] Since the breakdown of the latter system there has been no apparent fall off in capital movements. Instead, it is claimed that current account transactions in exchange markets are declining in relative importance.[69]

What would be needed is a mechanism that would prevent massive speculation, and/or increase the risks attaching to such capital flows.

The dollar overhang provides a major obstacle in the way of a return to a par value system, even though the real burden of the overhang has been reduced by dollar devaluation and inflation.[70] Following the oil crisis a dollar glut has built up among oil exporting countries whose interest in monetary stability may not match that of the European countries. The oil crisis, also, has resulted in a new build up of sterling reserves by OPEC countries, while the Eurocurrency markets have received another boost from petrodollar deposits.

It would be desirable that any return to fixed rates should be accompanied by a plan to immobilise this 'foot loose' hot money held by central banks and even private individuals.[71] Reaching agreement, however, would present major difficulties. Dollar balances are growing larger by the day; as this continues the more difficult it is likely to be to consolidate them. Moreover, which dollars should be affected? Should consolidation involve funding only the obligations of U.S. banks and the U.S. money market, or should all dollar holdings including Eurodollars be affected? If the latter was contemplated, it would have a severe effect upon the Eurocurrency system, and commercial banks operating in this market would oppose consolidation of central bank Eurodollar holdings. In addition, the Americans appear to be opposed to the restoration of a reserve asset settlement system.

Even if agreement was reached on the desirability of funding partially official dollar balances, the problem of the funding method would remain. A widely discussed approach has been the setting up of an I.M.F. Substitution Account into which dollars could be swopped for SDR issues.[72] A minority school has favoured a substantial gold revaluation, and the restoration of dollar convertibility into gold.[73] This recommendation has been consistently supported by the Republic.

If the magnitude of international volatile capital, such as the dollar overhang, could be reduced, it may prove possible to contain speculation sufficiently to make a Bretton Woods type system viable. Most probably, however, this would be insufficient, and a

tightening of capital controls may well be necessary.[74] The original I.M.F. articles embodied the principle that capital flows were to be suppressed rather than financed, and the Bretton Woods system collapsed principally because of the massive capital outflows from the U.S.A. On the other hand, the effectiveness of such controls is dubious. It has been claimed that to be effective they would have to cover virtually all foreign exchange transactions, and would therefore be unacceptable to all.[75]

9.4.4 Control Over Eurocurrency Markets

Side by side with any tightening of capital controls the question of introducing controls over the Eurocurrency markets, which by the end of 1977 totalled around $500 billion, would have to be considered. The velocity of movements in foreign exchange have increased markedly, because of these markets and maintaining fixed rates was made much more difficult.[76]

Supporting controls has been the claim that these markets are capable of creating to an almost unlimited extent deposits (largely dollars), and thus means of payments which augments world liquidity and intensifies currency unrest.[77] Others have rebutted the charge of a large potential multiple credit creation in the Eurocurrency markets.[78] Some commentators have concentrated attention on the scope for money creation in these markets brought about by central banks depositing currency reserves in them. If stopped, the scope for deposit expansion would be very limited.[79] Unfortunately central banks in less developed countries are opposed to this. They wish to invest their currency reserves at the highest possible interest rate given their large net international debt position, and are keen to see the perpetuation of free access to the Eurocurrency markets.

If controls over the markets were introduced they would presumably include rules governing the recourse of central banks to them, the imposition of reserve requirements on currency balances held by all eurobanks, and the effective practice of international open market operations. Clearly, the collaboration of all countries, including

the U.S. would be necessary, but there must be dounts whether it would be forthcoming.

Even if capital flow problems can be managed more effectively it would remain crucial that the necessary degree of harmonization of economic policies among countries was present. Presently, countries are pursuing largely independent economic policies indicated by wide differentials in inflation rates. Many doubt the feasibility of returning to fixed parities because they believe this problem would remain.[80] Even the closely knit countries of the European Common Market have been unable to achieve the required degree of coordination of their policies.[81]

9.4.5 Control Over International Liquidity

A key aspect of the Bretton Woods system concerned the role of reserve currencies, and in particular the dollar. The gold convertibility provisions were designed to provide discipline over U.S. policies, but there was no legal obligation on other countries to exercise the convertibility privilege. In practice, this 'convertibility on demand' provision meant that the U.S. could persuade holders of its currency not to request conversion. It thus imposed little adjustment pressure on the reserve centre, and encouraged vast accumulations of official dollars. This suggests the need for a 'mandatory' reserve asset settlement system under any revised Bretton Woods arrangements. However, the willingness of the U.S. to agree to this is doubtful. If it did agree it may only be on condition that countries commit themselves to prompt and frequent exchange rate changes so that it was never seriously embarrassed by settlement demands. In addition, the stability of such a system would be questionable owing to possible capital flows.

Any restoration of a fixed but adjustable rate system could be based on the SDR as numeraire and principal growth element in world liquidity, but the record of the SDR places doubt over its capacity in this role. Alternatively, the system could be based on a gold/exchange standard, which South Africa favours, but this

would require the setting of a new official gold price at a level high enough to ensure that newly mined gold enters the monetary system. The poor chances of this happening have been confirmed by the I.M.F. amendments to its Articles, which preclude countries from linking their currencies to gold, and pegging the gold price. Yet, for years retention of a fixed gold price as well as fixed exchange rates were regarded as non-negotiable, but both have disappeared in recent years.

9.4.6 Temporary Floating

Another problem concerns the execution of exchange rate adjustments. One procedure is to announce a new fixed rate based, inter alia, on calculations of purchasing power parity differentials, a method which suffers from the imperfections of purchasing power parity calculations. Also, this procedure can encourage an excessive devaluation in the hope of making sure the new rate will be sustainable. Correspondingly, a country in payments surplus will be reluctant to revalue too much for fear of turning its surplus into deficit. There is a danger that the latter will revalue too little and deficit countries devalue too much under the adjustable peg system.

To overcome these problems countries could float their currencies for a temporary period long enough to establish the probable long run equilibrium level, and then re-peg it at a new rate. The local authorities are not opposed to such temporary floating.[82] Its value, however, can be reduced if, during the float, significant intervention in exchange markets is undertaken, which monetary authorities may feel is imperative to avoid excessive rate volatility. Also, the float may need to be prolonged so as to be free of distortion from purely seasonal or cyclical influences. Moreover, once temporary floating is given official recognition confidence in the fixity of rates may well be impaired, and destabilizing capital movements encouraged.[83]

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CHAPTER TEN - THE RAND CURRENCY LINK

In conducting exchange rate management the South African authorities have traditionally linked the rand to either sterling or the dollar, but in recent years this currency pegging decision has been complicated by a number of factors.[1]

Firstly, there has been the large and growing importance of foreign transactions together with inexperience in coping with the volatile exchange rate position in the world, circumstances which have been reflected in numerous policy modifications.

Secondly, in applying policy the authorities have needed to take account of the interests of other members of the Rand Monetary Area, namely Botswana, Swaziland and Lesotho.[2] In the case of Kenya, Tanzania and Uganda, which belonged to a common customs area, the choice of pegging was complicated by differences of opinion as to what key currency they should peg to.[3]

Lastly, the pegging policy options for the rand entail both advantages and disadvantages, and circumstances can alter the desirability of a specific currency link. The purpose of this chapter is to elaborate upon these aspects.[4]

Under present institutional foreign exchange arrangements in the Republic there are two main alternatives to the policy of linking the rand to the dollar. These comprise relinking to sterling or pegging to the Special Drawing Right (SDR) or an alternative currency basket.

If the country linked its currency to the SDR its exchange rate would be expressed in terms of the SDR, i.e. the latter would be worth a certain amount in terms of the rand.[5] Hence the rand/dollar rate could change daily in line with alterations in the SDR/dollar value, and appreciation or depreciation of the U.S. unit in foreign exchange markets would cause the value of the SDR in terms of the dollar to fall or rise respectively.[6] Dollar depreciation, by causing the dollar price of the SDR to rise, would cause the

rand to appreciate against the U.S. currency, and vice versa if the latter appreciated in the markets. Alternatively, if a fixed rand/dollar rate for longer periods was desired, limited fluctuations around the SDR peg value could be permitted.

On the other hand, the rand could be assigned a specific value against a trade-weighted basket of currencies of significance in external transactions, and its value against the intervention currency adjusted daily to the variations of the basket currencies in exchange markets so as to maintain the average value of the rand.[7] If necessary, on occasion, the latter could be revalued or devalued against the basket.

10.1. Linking to the SDR or an Independent Currency Basket

In certain quarters adoption of this exchange rate mechanism by the Republic has been favourably regarded, but the view taken here is that on balance no material advantages appear to justify such a move.

10.1.1 Foreign Transactions Composition and Currency Link

It has been suggested that linking to the SDR or another currency basket might be particularly suitable for a country whose foreign transactions are not conducted mainly in one currency, on the grounds that the additional uncertainties regarding debt repayments, servicing liabilities and foreign trade receipts and payments should be minimized.[8]

In order to assess the validity of this argument in the case of the Republic it is necessary to consider the pattern of foreign transactions, and the influence upon them of the existing currency pegging policy. Table 21 shows the average percentage over the period 1971-75 of South African imports from and exports to the countries listed.

TABLE 21 – FOREIGN TRADE STRUCTURE (1973–75)

Country	Imports	Exports
United Kingdom	18,4	25,8
United States	15,3	8,1
West Germany	15,4	7,8
Japan	9,9	12,1
France	3,5	2,6
Italy	3,4	2,9

Sources: S.A. Reserve Bank, Quarterly Bulletin (various issues) and Commerce and Industry Journals, Government Printer, Pretoria

The diversified nature of foreign trade is shown in the table, but it omits the important dollar contribution provided by gold. *Using the criterion of currency denomination* of foreign transactions, in 1973 the Reserve Bank incorporated nine currencies in its trade weighted index for the rand, the dollar and sterling, having combined weights of roughly fifty-four per cent of the total assigned.[9] The importance of the dollar to S[illegible]ca has increased in recent years primarily because of t[illegible]nce of denominating trade in the currency to which the ra[illegible] pegged, and the availability at a cost of one per cent per annum of *forward dollar cover* from the Reserve Bank. Meanwhile, the role of sterling will decline following the British decision in November 1976 to stop U.K. bank lending of sterling to foreigners to finance third country trade.[10] This will lead to greater reliance on dollar trade finance, thus further encouraging dollar denomination in the Republic's foreign trade. Overall, however, the pattern of foreign trade transactions is not unsuitable for linking the rand to *a currency basket*.

Regarding capital account transactions, autonomous private short-term capital flows incorporate substantial trade credit facilities where dollar finance predominates, while in the case of

private and public long-term foreign borrowing, Eurocurrency and Eurobond finance constitute a major element.[11] Here, although currency denomination tends to be restricted, variations between the public and private sectors prevail. In the latter case nearly all long-term credits raised in the Eurocurrency market are dollar denominated. For instance, where publicized medium and long-term international bank loans raised by the private sector are concerned, only dollar denominated issues were resorted to in 1974 ($131m), 1975 ($141m), and 1976 ($30m), whereas the public sector (including the public corporations), although mostly using dollar finance, raised the equivalent of $54m. and $29m in German marks in 1974 and 1976 respectively.[12]

The question arises to what extent pegging policy has influenced the denomination of private and public sector debt. The dominance of the Eurodollar segment of the Eurocurrency market provides strong encouragement for the private sector to tap dollar funds.[13] This factor of accessibility suggests that if the rand was linked to a non-dollar unit, incentives to raise loans in the currency concerned would be blunted. At present the existing rand/dollar peg may stimulate the use of Eurodollar finance, since the risk is less than if funds are raised in another currency, when another and possibly volatile link may be present. Effecting forward cover on this second leg could eliminate the cost advantage of employing non-dollar finance, since interest rate differentials between two currencies are normally reflected in the corresponding forward rates.

The smaller reliance of the public sector upon dollar finance may partly reflect unsophisticated foreign fund raising operations in which the major criterion has been interest rate differentials. Also, the public corporations are given forward cover by the Reserve Bank at one per cent per annum on non-dollar loans, which makes hard currency finance at relatively low interest rates attractive. Utilizing foreign capital in a weak currency and

covering only the rand/dollar link locally may still be advantageous for such corporations because of the forward discount against the dollar on such a unit, but this could be precluded by the difficulty in obtaining forward cover in excess of one year.[14]

It is argued that an SDR or other currency basket link would be unsatisfactory for a country which has large foreign borrowings narrowly denominated, because of the greater uncertainty in regard to debt repayments and servicing liabilities. This would not apply, however, to public corporations in the Republic. The heavy reliance of the private sector on dollar funds should not be a significant drawback, since a basket peg would not necessitate a change in the use of the dollar as the intervention currency, and because its resort to such finance principally stems from the institutional nature of international capital markets. Consequently, for these reasons, linking to a currency basket would be unlikely to promote financial diversification in raising overseas loans.[15]

Likewise, tying to a currency basket should not diminish the incentive of importers and exporters to denominate in dollars. If the latter remained relatively stable in foreign exchange markets the value of the rand in terms of the dollar, quoted by the Reserve Bank, would not change much and the situation would not be materially different from a pegged dollar rate.

10.1.2 Currency Basket Peg and Inflation

From a monetarist viewpoint any moderation of the rate of inflation arising from pegging in this manner would probably be regarded as inconsequential. Pegging involves some loss of control over the domestic money supply and thereby over domestic inflation, the extent depending on the flexibility of the link. If stability of the effective exchange rate of a country is desired, monetary policy must be geared to match the average inflation rate of its trading partners. If the target is price stability, exchange rate appreciation will be necessary in today's inflationary world, and monetary policies will have to be tightened accordingly.

On the other hand, given the stability of an appropriate currency basket, anchoring to it could reduce both the fluctuations of the rand vis-a-vis other currencies and, therefore, the imported inflationary forces at times of dollar depreciation in exchange markets. This has, on occasion, been a prime factor inducing countries to abandon pegging to the dollar or sterling, and instead to link to a currency basket.[16] Remaining tied to a weak unit can be a drawback for a country with an open economy, keen to resist inflationary pressures, but unwilling to revalue against the intervention unit periodically.

If there were no reluctance to revalue, however, the case for staying linked to the weak currency would be stronger, particularly if that currency were affected by relatively high inflation, but not depreciating in exchange markets. In the latter circumstance a link to a currency basket would, in the absence of revaluation against it, entail imported inflation. There could, in any case, be little desire to revalue, if the monetary instability were perceived as temporary.

Moreover, linking to any currency bundle can be an ineffective bulwark against inflation for other reasons. If the countries whose currencies comprise it are experiencing inflation, the import prices of the Republic would be affected. When the dollar was strengthening markedly in exchange markets and if the authorities wanted the currency to appreciate as part of an anti-inflationary programme, this objective would be hindered, especially if the peg did not allow for margins. Meanwhile, a specific link to the SDR unit would not stabilize the trade weighted value of the rand, since the unit's currencies, and their respective weights, bear limited resemblance to the trade pattern of the country.[17]

10.1.3 Currency Basket Peg and Speculation

On the negative side, of more importance are the problems which would be likely to arise at times when the dollar was unstable, since frequent adjustments of the rand/dollar rate would occur.

Although the business community should adapt to this, there is a danger that speculation would be encouraged. This arises from the automatic change in the dollar rate of the rand on a daily basis in line with changes in the value of the dollar against the basket, even though such pegging is designed to reduce the exchange rate risk faced by traders, and is made more pertinent by normal dependence upon capital inflows to finance current account deficits.

Before concluding that speculation would be worse, three factors should be noted. Firstly, on occasions when gradual changes are expected in the rand/dollar rate, leads and lags will be only moderate. Secondly, margins around the basket peg could be used to reduce the frequency of changes in the rate for the rand, although strictly speaking, this means abandoning the tie to the basket. Thirdly, it may be possible to switch to a more stable intervention currency during the period when frequent changes in the rand/dollar rate are expected.

Whether these would be positive influences is difficult to say. If not, this kind of exchange rate policy would alter required foreign reserve holdings. It has been suggested that the need for foreign reserves might be reduced by an SDR peg if it resulted in approximate stability of a country's effective exchange rate.[18] In the case of the Republic, given the institutional foreign exchange arrangements and foreign currency invoicing of external transactions, the opposite conclusion could be justified, imposing a cost in foregone opportunities of using the investment in foreign reserves instead for economic development. Already there is evidence that associated with the move to floating exchange rates in recent years, South Africa's external reserve needs have increased rather than diminished.[19]

10.2 Advantages and Disadvantages of Alternative Currency Basket Links

The case for adopting such an exchange rate mechanism is further elucidated by analysing the merits of the alternative currency basket links which are available.

Some of the problems of an SDR peg could be mitigated by linking the rand to a weighted currency basket of significance in the foreign transactions of the country.[20] It would contribute towards greater stability of the external value of the rand, and thus check more effectively imported inflation which may emanate from depreciation of the U.S. unit in exchange markets. It would also permit tailoring the basket to reflect changing import and export patterns in the foreign trade of the country.[21] Such flexibility may possibly be directed towards stimulating greater diversity of foreign trade patterns. On the other hand, this may make it more difficult to decide which currency to peg to if a direct link with a national unit was later restored.

Also, administering an SDR association would appear to be easier, the value of the latter being published daily by the I.M.F. This problem could be resolved by employing a simplified basket, comprising a small number of currencies. An extreme version would be one including only the dollar and sterling, but this would be unsuitable if both units depreciate or appreciate while remaining unchanged against each other, since control over the average external value of the rand would be lost.

10.2.1 Control over Economic Policy

Linking to an independent currency basket, if it maintained a stable weighted exchange rate, would mean relinquishing the rate as an instrument of economic policy and a return to exchange rate management as pursued in the Bretton Woods era. In the latter period, of course, the external value of the rand could still alter owing to exchange rate adjustments by other countries.[22] It is argued that a country pursuing this policy could benefit from the discipline imposed by an effective fixed rate, as well as enjoy greater trade and capital flows.[23] However this policy - or lack of policy - would not necessarily be desirable in the case of South Africa given the large size, and volatility, of the external sector, and the floating gold price.[24] Several countries pegging in this manner have devalued or revalued against their currency baskets from time to time.[25]

In the interests of broadening an interbank market, channelling at least the less sizeable loans through it would be desirable.

12.1.3 Exchange Control Relaxations

Modifications in exchange controls necessary, in particular, to set up a forward rand market can be gleaned by reference to the major foreign exchange markets. In a developed forward market, rates are theoretically quoted on an interest rate differential basis; in particular, major western currencies are quoted on the basis of differences in eurocurrency interest rates.

Free markets for the latter currencies require that both residents and non-residents have access to a deposit market in the relevant currencies. For example, if a bank sells a customer $1m. three months forward against sterling, the position of the bank will be short $1m. and long in sterling to the amount to be received in return for the dollars, assuming the original position of the bank was square. To balance its position, the Bank could buy spot dollars against borrowed sterling. Because dollars normally earn less in interest than sterling in interest, the bank would be compensated for the loss in interest resulting from holding dollars rather than pounds for the three months, by having to provide less dollars to his customer when the forward contract matures.[14]

If banks could not undertake these swap transactions by borrowing and investing in dollars and sterling they would be forced to find counterparts in the exchange markets in order to avoid open positions. This in turn would mean that forward rates for the two currencies could diverge from their respective interest rate differentials. In the absence of euromarket facilities this would occur, since British banks cannot lend sterling to non-residents.[15] Similar regulations exist for most currencies including the rand where, in addition, there is no market in eurorand.[16] As a result, in order to promote a competitive forward rand market, it would be desirable to facilitate swap transactions. This would entail making exchange control relaxations which enable foreign banks to borrow rand.

This could create problems when the rand is weak, since foreign banks would take out short positions in the currency by borrowing from local sources. Two factors suggest that this problem would be manageable. Firstly, local banks would not have unlimited funds, particularly if bank credit demand is strong, and interest rates on foreign borrowing could rise markedly in such circumstances. Secondly, the authorities could change reserve requirements on such lending to foreign institutions by local banks. Thus, when downward pressures on the rand emerged the amount which local banks had to deposit free of interest at the Reserve Bank, to compensate for loans granted to foreign banks, could be raised. This would induce a rise in the cost of such loans, and so discourage speculation.

12.1.4 Position of Domestic Banks

Relaxing restrictions on position-taking by local foreign exchange dealers would be desirable so that they could accumulate stocks of foreign currencies. This would aid the role of the banks as a stabilizing influence, as arbitrageurs. Too strict rules on open positions could exacerbate exchange rate fluctuations by forcing banks to find counterparts in the market, which implies significant movements in rates as well as greater intervention by the Reserve Bank. Simultaneously, scope for arbitrage operations by local banks would help broaden the market.[17] Any restrictions which in effect confine this facility to overseas banks would be inequitable, as well as possibly encourage exploitation of loopholes such as opening up bank branches overseas.

On the other hand, the absence of, or only negligible, limits on open positions could encourage currency speculation by banks.[18] There are, however, factors which suggest that such activity by local banks would be very restrained. Firstly, the banks would be keen to avoid publicity in regard to open positions kept. Secondly, the substantial distance between the Republic and European centres means that in the event of a communications breakdown, local banks

loss contact of currency trends. This would, particularly, discourage banks from holding large open positions in non-dollar currencies, because of the difficulties in squaring off such positions in a local interbank market. Thirdly, during periods of currency disorder banks could be required to supply additional details on their foreign exchange positions in addition to, say, monthly returns.

12.2 Size of Markets

The previous section analyzed the main institutional changes required to set up an interbank market, with particular reference to forward exchange. In this section the extent to which an efficient market could develop is considered from the viewpoint of trading volumes to be expected. The development and maintenance of a good exchange market presupposes a high and balanced turnover, the absence of stringent exchange control regulations or fears of such measures, and a high degree of confidence in the banks of the centres concerned.[19] The size of a rand market, therefore, would partly depend on how large the Republic looms in world trade, an indication of which is provided in Table 25.

Compared with the currencies of the leading western countries, the supply and demand for foreign exchange locally is small in the case of visible and invisible trade. If the trade of the Republic, however, is compared with developing countries the position is far more favourable as the table shows. The importance of this is magnified when it is noted that countries such as Israel, Mexico, and Malaysia operate developed interbank markets in foreign exchange. The inclusion of the rand from July 1974 until April 1978 as one of the sixteen currencies comprising the basket backing of the SDR is further evidence of the status of South Africa in world trade. In short, even if one excludes capital transactions, foreign trade volumes should not preclude the establishment of a genuine local market in foreign exchange, provided that major items such as gold receipts are channelled through it. The breadth of the market, moreover, would improve as foreign trade and investment transactions

TABLE 25 - IMPORTS AND EXPORTS OF GOODS AND SERVICES IN 1976 ($m.)

Developed Countries			Developing Countries		
	Exports	Imports		Exports	Imports
United States	172 739	162 314	Australia	15,261	16 268
West Germany	123 309	113 262	Spain	14 446	20 024
Japan	80 542	76 495	South Africa	9 872	11 764
United Kingdom	68 708	69 711	Mexico	7 077	10 635
Italy	45 940	48 372	Israel	4 421	7 691
Switzerland	21 975	18 215	Argentina	4 622	4 031
Sweden	21 674	23 380	Malaysia +	4 191	4 325

+Refers to 1975.

Source: I.M.F. Financial Statistics, Washington, August 1977

grew.[20] In addition, if the rand was floated and import controls relaxed or dismantled, the size of the market could increase.

At the same time, the exchange control position would be important in determining market volumes, and therefore the degree of official intervention required to maintain stable trading conditions. The integration of the securities rand market into normal foreign exchange dealings would provide a significant addition to market volumes, but is not essential, particularly if the downward pressure on the rand it could induce was not wanted by the authorities.[21] Small countries such as Argentine have adopted multiple currency practices while interbank markets have existed. The value of trade transactions is of critical importance. Britain has employed two-tier exchange market arrangements for decades as well as comprehensive exchange controls, and yet the market for sterling is still the second most important after the dollar.

12.2.1 Role of Foreign Banks

Some argue that an impediment would be the unwillingness of foreign banks to play an active part in a rand exchange market. A reluctance to hold and deal in rands would presumably exist because of the political factor in Southern Africa. However, assuming the local political situation does not deteriorate markedly this could be unfounded, since overseas banks are probably comparatively well informed about the local political situation. Although rand balances would only be of interest to banks with regular South African business, such investments would be short term, and foreign exchange transactions which involve the rand should be profitable business.

12.2.2 Extent of Forward Dealings

History provides encouragement about the likelihood that adequate forward markets can develop if given a chance.[22] In assessing the viability of a rand forward exchange market a number of factors would restrict its size. In general, conditions for forward rand dealings would be more difficult than for spot transactions. Only a handful of broad forward markets exist, and they are thinner

than spot markets. All spot transactions are for the same date while forward deals are for a variety, so that turnover for a specific date is smaller. For forward contracts beyond six months conditions would be particularly thin, and deals between banks and customers probably subject to negotiation. Moreover, the ability of banks to handle large transactions would be limited because of difficulties in finding a counterpart in the forward market, or undertaking swap transactions due to the restricted money and capital market facilities in the Republic.[23]

A further complication would be provided by gold receipts, which were worth about R2,8b. in 1977. These are sold on a spot basis, and thus the need for forward cover would be absent. Without sufficient interest rate arbitrage operations this would lead to one-sided covering, causing the rand forward rate to be out of line with interest rate differentials, and possibly falling to a substantial discount. In these circumstances, commercial traders would be unable to find cover at reasonable premiums or discounts. With an unlimited volume of funds available for arbitrage operations, and an unlimited willingness to use such funds, no one-sided pressure could produce more than a temporary discrepancy in the rand/dollar forward rate. Local banks, however, would probably be reluctant to employ more than a small proportion of their funds in this way, especially when domestic credit demand was strong.[24] Moreover, even if exchange controls did not preclude non-residents borrowing in the Republic limited funds would be available for arbitrage, and such borrowings would not be profitable unless comparatively large discrepancies existed between the forward rand rate and interest parities.[25]

A one-sided market could be strengthened by two other factors. If the rand was persistently weak exporters would be discouraged from covering. Secondly, if a large degree of political unease prevailed in regard to South Africa, arbitrage operations by foreign banks could be inhibited.

12.3 Intervention Role of the Reserve Bank

The analysis of the previous section indicates that in order to contribute towards a sound forward market the authorities would have to buy and sell forward exchange in dollars at market rates for different dates in dealings with authorized banks.

12.3.1 Benefits of Intervention

Official forward intervention has a number of advantages over spot intervention. More selective incentives for movements of short term capital can be provided, and the impact on forward rates can be greater because of thinness of the markets. Deals need not be disclosed in published statements issued by the central bank, thus preserving an element of secrecy about official forward operations.[26] There can be occasions, however, when secrecy may not be desirable, since encouragement may be given to the inappropriate use of the instrument.[27] Failure to publish forward commitments may also stimulate misguided rumours.

12.3.2 Problems in Intervening

Forward dealings by the Reserve Bank would raise a number of problems. As with spot intervention the authorities would be initially operating without any trading experience. They would have to acquire dealing experience while being aware of the implications which action taken may have on the balance of payments and the internal economy.

Intervention policies, meanwhile, could affect participation in the market by private parties. The main ingredients of an efficient forward market are commercial deals, interest arbitrage, and speculation. If the authorities relaxed exchange controls significantly, and curtailed intervention, wider rate fluctuations could occur, particularly if the rand floated, possibly encouraging speculators and arbitrageurs to enter the market. Large scale official intervention in a rand forward market, however, would seem inevitable. If this reduced arbitrage opportunities of banks, because of reduced rate fluctuations, and constrained their foreign

exchange earnings, it may tempt them to take greater risks in open positions in order to profit from speculation. Alternatively, and more likely, it could discourage banks from expanding their foreign exchange business due to a greater reluctance to take risks.

12.3.3 Implications for Gold Policy

Intervention, both spot and forward, could have implications for gold policy. The country, traditionally, has held a large proportion of its foreign reserves in gold. Yet ample foreign exchange reserves facilitate intervention, and could have a psychological impact on the market. This problem, however, could ease if the process of gold remonetisation continues which enables gold to be mobilized more easily.[28] In addition, the authorities could, if necessary, raise foreign credits.[29]

If the rand was floated this would ameliorate problems in intervening if the need for foreign reserves was reduced compared with present arrangements. This is uncertain since intervention problems could be complicated under a rand float by the influence of gold price movements on short term capital inflows. If a falling gold price induced adverse speculative pressures on the rand, intervention by the authorities could become more difficult in the face of falling reserves, which in turn might encourage further speculation against the rand. The importance of this factor would partly depend upon the degree of instability of the gold price. Even in the securities rand market the correlation between price movements of the metal, and the discount rate prevailing is not always close.[30] Volatile changes in the securities rand rate could also influence conditions in the interbank market, and possibly induce official intervention in the former market occasionally to stabilize the rate.

12.3.4 Nature of Intervention

Forward dealings by the authorities could include both swaps (i.e. buying spot and selling forward and vice versa), and outright operations, but the latter would predominate.[31] In the face of any one-sided pressure on the rand, and where large transactions are

concerned, it would be inexpedient for the authorities to engage in large swap operations because of difficulties in dealing in large rand transactions. The problems in carrying out swaps could be exacerbated if the spot rand-dollar rate was fixed within margins.[32] On the other hand, swap operations have advantages since the Reserve Bank would avoid the risk of losses through a change in the spot rate, while maintaining its net foreign reserves after allowing for forward commitments.

The nature of intervention could be both passive and active. Passive intervention would usually aim at maintaining the forward rate at a given level at which the authorities would be prepared to buy and sell forward dollars. They need not initiate dealings, but stand ready to deal at specific rates if approached by the banks, catering for large transactions which the interbank market could not handle.[33] Apart from certain foreign trade items large loans raised by the public and private sectors would require such a facility. Certain non-dollar currency loans raised by public corporations could be unsuitable for cover in either the overseas or local markets. For other loans, although cover could be obtained on the dollar-third currency leg this would probably not apply in the rand-dollar market.

Apart from the question of the ability of the market to handle large transactions, there arises the problem of the extent to which longer term forward facilities would become available. Foreign exchange markets do tend to be short term orientated. This is because medium and long term currency trends are not amenable to statistical probability calculations, and instead belong to the category of pure uncertainty, which allegedly will mean that long term facilities will be limited.[34] Possible difficulties in obtaining commercial import cover in excess of twelve months, in particular, suggests that passive intervention in this area would be desirable.

If greater bank competition existed, however, with an interbank market this could encourage the offering of facilities in this area, provided the necessary exchange control modifications were made.[35]

Banks could take out swap transactions for, say, twelve months at a time, and on maturity renew the forward contracts hoping that this could be done at rates within the margins allowed for when originally quoting terms to customers.[36] Meanwhile, if exchange controls were relaxed, banks would be able to find counterparts in the market, on occasions, for requirements in excess of one year. They would at times even be able to marry long term forward requirements of importers and exporters within their own banks.

Any remaining facilities provided by the authorities should be at market rates. Similar facilities would be non-existent in the interbank market if the Reserve Bank continued levying nominal charges for import cover facilities in excess of twelve months.[37] This practice could induct local importers to take advantage of favourable official rates, and lengthen credit terms for imports, if the forward rand discount in the market for less than twelve months was more than the official charge. This would reduce volume in the interbank market, and increase the burden faced by the Bank. It would be inequitable, also, if traders which require longer term import cover could obtain it at favourable rates vis-a-vis importers requiring short term cover.

Active intervention would involve the authorities taking the initiative in the interests generally of m[illegible]ilization. Dealing skills would be required concerning intervention timing, and deciding whether to deal in small or large amounts, while disguising any operations would encounter serious difficulties, particularly in the forward market. Concealment would be easier if foreign exchange brokers were presen[illegible] but the local market would be too small to support them.[38] On the other hand, if the authorities dealt through a large bank, the size of transaction would probably enable other dealers to detect official presence. Moreover, switching banks would have limited scope since there are only twenty-two authorized dealers, and a handful of large ba[illegible] The authorities might divert intervention to overseas centres, but this would

adversely affect local market [illegible], and may still be detected locally if the overseas bank, acting on behalf of the authorities, entered the South African market.

12.4 Exchange Rate Arrangements and the Forward Market

Recent advocates of a genuine interbank market have stressed the scope for letting the rand float. Yet as far as facilitating the development of a forward market is concerned, it is uncertain whether such an exchange rate regime would be preferable. Under stable conditions with pegged rates, traders can be disinterested in taking out cover until a scare occurs, when the market may become one-sided. By contrast, with a floating rate use of the forward market could become more widespread and routine, leaving less scope for a one-way market to exist. If capital is mobile, interest arbitrage could facilitate forward rates remaining near to their interest rate parities, aided by speculators who recognize the transitory nature of discrepancies.[39] In addition, with a floating rand, banks may be quick to cover positions in the market, instead of waiting in the expectation of offsetting commitments, as could happen if rates were relatively stable.

On the other hand, several factors suggest the benefits of floating the rand in this respect could be exaggerated. Local policy has incorporated the furnishing of forward cover at low cost to encourage traders to take out cover regularly. This practice could persist under a pegged rand-dollar rate, which had permitted margins of fluctuation. If the rand became a weak currency, a one-sided market would tend to develop under a floating regime. Moreover, adapting to an interbank market might be helped by official pegging within limits in view of the long-standing practice of pegging the rand to a major currency. If greater flexibility was the ultimate objective, intervention margins could be gradually widened, and intervention operations scaled down progressively, both in the spot and forward markets.

Some opponents of floating rates have stressed that although the demand for forward cover would increase, the supply of such

facilities could contract. This stems from the desire of banks to be cautious, and thus reduce limits for their total open positions in foreign currencies and even covered commitments, as well as for the names of individual banks.[40] In a rand interbank market tendencies towards restricted facilities due to caution regarding the credit standing of customers could be mitigated by banks asking for deposits from clients when arranging forward contracts. As regards the phenomenon of limits for names which are accepted by banks practices vary widely. Only small local banks might face this constraint, and the negative impact on the volume of facilities in the market could be small. Banks whose names have reached limits may, to some extent, cover positions by operating in spot exchange through swap transactions.

12.5 Benefits of a Forward Market

An argument in support of any private exchange market, in spot and forward transactions, is the potential gain to be derived by customers of banks in the provision of foreign exchange services, which arises out of the more competitive environment prevailing.

A substantial increase in foreign exchange business would be handled by the banks, and the spread on rand-dollar spot transactions would shrink from the current one-half per cent fixed figure, provided the market was reasonably balanced. A spread of less than ,125 per cent between spot buying and selling rates is not unusual even for secondary currencies in overseas foreign exchange markets. On the other hand, local banks may try to compensate for the narrowing of spreads by charging directly for foreign exchange services, which are at present exempted. For instance, levies may be imposed for the processing of exchange control applications. At the same time competition may diminish in respect of entry of new banks into foreign exchange. Under the current system with its protected margins small banks can enter without incurring major difficulties, and make profits. With a proper interbank market the squeeze on margins plus the need for skilled dealing staff may discourage entry.

Greater bank competition could create two problems. Firstly, if local traders search for quotations to a greater extent this could be counter-productive in the case of non-dollar currencies. *A trader who simultaneously asks several local banks for third* currency quotes may find the rate driven up in a thin market, since overseas correspondent banks often can guess correctly that the South African banks are buyers.[41]

Secondly, the effectiveness of certain exchange controls may be diminished. At present, banks quote fixed daily rates for specified currencies for amounts up to an equivalent of R2 000.[42] With an interbank market customers could seek several quotations as well as transact business with more than one bank, whereas under current regulations a customer is supposed to conduct a specific foreign exchange requirement through one bank only. If banks disregarded this rule in their quest for business money could be transferred abroad illegally.

Dismantling the relevant exchange controls would overcome this problem, but in any case its importance can be questioned. Banks are unlikely to contravene exchange regulations since they *would risk the loss of their licence to deal in foreign exchange,* while even if the rand was floated banks may still quote fixed daily rates for small transactions. The practice of customers bargaining with several banks, meanwhile, may be constrained if they appreciate the services of these institutions in providing foreign exchange.[43]

Apart from this general advantage a number of benefits on the forward exchange side could be derived from development of an interbank market.

12.5.1 Market Determined Rates

Under present arrangements there is no attempt to relate the charges for risk avoidance to the risks involved in providing rand-dollar forward cover.[44] With a forward market any rand discount against the dollar faced by importers would be a benefit

to exporters, which could marginally assist the balance of payments on current account. Such help, however, would partly depend upon the extent to which exports and imports are normally covered, with the change in arrangements certain to affect the policies of traders concerning forward cover.

12.5.2 Flexibility of Exchange Rate Policy

To the extent that the authorities could disengage from forward exchange business flexibility in conducting exchange rate policy would improve in two ways. Firstly, the option of allowing the rand to float, albeit on a managed basis, would emerge. Secondly, recent official losses on forward exchange account, and further losses which devaluation could entail, are strong disincentives to such a policy irrespective of its other merits.[45] A number of difficulties at present inhibit the raising of cover charges, such as the danger of stimulating speculation, and therefore an interbank market, which provides cover facilities at reasonable cost, has its attractions.

As previously indicated, the Reserve Bank would still have to intervene, and probably extensively, in the forward market. Even so, this should not unduly affect its flexibility in operating exchange rate policy even if the rand did not float. This is because, unlike at the current time, it would be providing facilities at market related rates.

12.5.3 Effects on Capital Flows

Any rand forward market would broaden the scope of facilities available since, for instance, rand-dollar cover for invisible trade transactions is currently absent. Similarly, a forward market could stimulate capital inflows by presenting the private sector with the opportunity, which up to now has been denied, of taking out rand-dollar cover on short term foreign loans.[46]

On the other hand, by encouraging inflows the potential for withdrawals is increased, even though forward facilities can obviate the desirability of disinvesting.[47] If the rand traded at a higher

forward discount to the dollar than the current one per cent cover charge, t ·ld reduce the attractions of financing foreign trade thro eas trade credits. In particular, if the forward r discount fell markedly below the rate indicated by interest rate differentials, the negative effects on capital inflows could be significant, complicated by outflows due to interest rate arbitrage.[48]

Any deterioration in the capital account position would be a negative influence, since normally the gross domestic savings of the country do not cover gross domestic investment.[49] Deterring the raising of trade finance from foreign banking sources could be particularly disadvantageous under present circumstances in which long term foreign capital is difficult to obtain.[50]

This problem would be influenced by the nature of the exchange rate regime in operation. It would be less important if the rand was floated. This is because any reductions in capital inflows could be compensated for by depreciation of the rand-dollar exchange rate, although this could have unwelcome implications for prices. If the rate was pegged appropriate changes in short term domestic interest rates could be made, but this could conflict with domestic economic policy objectives. Alternatively, the authorities could intervene in the spot and forward markets to try and establish more suitable spot-forward differentials. This, however, would be a difficult operation. It would involve an exchange rate risk, because the authorities would be trying to narrow the forward rand discount below its market level. In addition, the scale of intervention required may be unacceptable, and raising the forward rate by intervention over a protracted period may not be feasible.[51] If knowledge of large official forward commitments spread, fears may arise that they could not be all met leading to speculation against the rand.

12.6 Problems with a Forward Market

Although certain problems in operating a rand forward market were discussed in the previous section, there are two issues which deserve further elaboration.

12.6.1 Impact of Speculation

It is generally agreed that forward markets, by substantially reducing the costs of holding positions, encourage speculation.[52] Even if such activity normally arises only when a country pursues inappropriate economic policies, the vulnerability of the Republic would be enhanced by the political factor. Given the prospective imbalance in a rand forward market, in the absence of official support, speculators could fulfil a useful role in helping to fill the gap reflected in excess supplies of the rand. At times of adverse pressure on the currency, however, interest arbitrage operations could be overwhelmed by speculators using the forward market to take positions. In these circumstances forward rand rates could diverge widely from interest parities, and the market could become an expensive facility for covering by commercial traders. In addition, pressures on the forward rate could emanate from hedging activities by non-residents, an indication of which is provided by the size of external liabilities outlined in the following table.

TABLE 26 - FOREIGN LIABILITIES OF SOUTH AFRICA (Rm) 31.12.76

Central Government and Banking Sector		4 243
Long Term	2 008	
Short Term	2 235	
Private Sector		15 686
Long Term	26	
Short Term	± 660	
Total		19 929

Source: Reserve Bank Quarterly Bulletin, March 1978 pp.S-64 and 65.

If the forward discount widened and outward interest arbitrage operations were restricted or prohibited in order to limit capital outflows, the forward and spot markets would be separated, and even bigger discounts on the rand could develop.[53] Such a rand discount, moreover, far from encouraging cheap forward

rand buying, may induce more selling if confidence in the rand deteriorated further.

These difficulties presented by speculation and hedging can be exaggerated in the local context. Speculative activities would largely be confined to domestic and foreign banks, both of whom would face limits in this respect as previously explained, plus leads and lags operations by traders. Where hedging is concerned, the retention of the securities rand market would prevent non-residents from using the forward market to hedge against their portfolio investments in the Republic.[54] More important, hedging would be rendered very difficult if the exchange control regulations continued to stipulate that banks provide forward cover to clients only if documentary evidence is produced showing that it is required to meet fixed commitments or accruals either of a trade or financial nature.

Nevertheless, in circumstances where adverse pressures on the currency do occur, the question arises whether official intervention, through forward sales of dollars, would be justified. By reducing any discount on the rand it may prevent confidence from being eroded further, and increase the attractions of financing imports abroad. Intervention in support of the currency in the forward market may also help to stabilize the spot rate if speculators alter their spot market positions on the basis of what is happening to the forward rate.[55] The success of such operations could depend partly upon the degree of pressure which prevails. If the authorities emerged as a powerful buyer of forward rand backed by substantial resources, the market may expect the intervention to be effective and act accordingly. On the other hand, if the foreign reserves were low, its dealings would have to be limited, which may fail to inspire confidence. Moderating any rand discount, moreover, may encourage forward selling by reducing the cost of speculation and forward covering by importers.

12.6.2 Exchange Control Policy

The danger of sudden massive capital outflows is the rationale behind much of exchange control policy in the Republic, but it is impossible to gauge accurately, since it is so dependent upon unpredictable political developments. Relaxing exchange controls, which affect non-residents, may encourage capital outflows on fears that having seen controls in force for so long, investors would shift funds out on anticipations of eventual re-introduction. On the other hand, non-residents who wish to disinvest, because of perceived political risks, could do so and if the currency was floated it would probably fall initially. Once these disinvestments have occurred, however, any future political disturbances may exert only moderate pressure on the exchange rate.[56] Moreover, any fall in the rand could encourage capital inflows as well as discourage outflows. Depending on circumstances, it is possible that relaxations would be interpreted as a sign of strength, and lead to a net inflow of funds. For instance, if exchange control regulations were relaxed as part of a programme for developing an interbank market at a time when the gold price was rising significantly, capital inflows could increase markedly as foreign investors reappraise prospects for the economy.

Most important of all, in the context of this chapter, the necessity for relaxations in exchange controls does not appear to provide sufficient grounds for not developing an interbank market in spot and forward exchange. Difficulties would arise, but creating such a market would not necessitate dismantling the bulk of existing controls. In relation to exchange control policy two extremes exist. Tight regulations could be retained which would lead to a narrower market, and require significant official intervention, or a broader market could be promoted, probably requiring less intervention, by introducing more extensive relaxations.

To conclude, the purpose of this chapter has been to show that the development of an interbank market in the Republic is

feasible, provided that certain institutional changes were made. The question, in particular, of promoting a forward exchange market has been considered, and on balance the advantages to be derived suggest that it would be a desirable evolution.

References

1. At the end of March 1978 the Government owed the Reserve Bank R1 132m. in respect of losses on foreign exchange holdings, gold transactions, and forward exchange contracts. Warning has been given of potential further losses on forward contracts, which could be substantial at the then current exchange rates, and will also be a charge on the Government. See comments by Senator Horwood, Minister of Finance, House of Assembly Debates, Hansard No. 10, April 1978, pp.4270-71.

2. One imperfect measure of the breadth of a foreign exchange market is the ratio of commercial bank holdings of foreign currency assets to central bank holdings of currency assets. At the end of 1976 this ratio was ,19 compared with ,16 and ,14 at the end of 1975 and 74 respectively, an inverse correlation existing between this ratio and the total reserves held by the Reserve Bank.

   The calculated ratios for recent years, however, exaggerate the importance of the holdings of the banking sector, since the gold reserves of the Reserve Bank have been valued at the old official price of R29,75 per ounce. The stability in the foreign currency holdings of local authorized dealers is possibly a better indicator of the restricted nature of foreign exchange dealings undertaken by them, and their reliance upon the Reserve Bank for exchange facilities.

3. It is more profitable to use the interbank market. Public selling and buying rates for dollars set by the Reserve Bank are $1,1471 and $1,1529 to the rand respectively. By contrast, selling and buying rates quoted by the Reserve Bank in dealings with authorized dealers are $1,1486 and $1,1515 to the rand. In the interbank market the spot rate is fixed by gentlemen's agreement among the banks at $1,15 for both buying and selling. In these circumstances, it is more lucrative for banks to deal in the interbank market, when possible, rather than with the Reserve Bank and even more profitable to marry transactions within their own banks.

   There is, also, an interbank market between local banks and overseas banks. Here fixed rates are laid down by the Reserve Bank such that the rate for a local bank to buy dollars from a foreign bank is $1,1522, while for selling dollars to a foreign bank it is $1,1478. This is a very limited market primarily because of the small amount of invoicing of foreign transactions in rands. Exporters are reluctant to denominate in rands partly because if export finance in dollars is utilized they incur an exchange risk. The latter cannot be covered because it is not permissible for a local exporter to buy dollars with rand on forward account.

4. Extensions of contracts by traders are a regular occurrence due, for instance, to delayed shipment of goods ordered, extended suppliers' credits, and extended import trade finance. Dealing with the Reserve Bank when an extension is required, is preferable since it is a guaranteed source, whereas finding a counterpart in the interbank market can be very difficult.

5. Robert Z. Aliber, editor, The International Market for Foreign Exchange, Praeger, New York, 1969, p.187.

6. Price competition under the present trading arrangements is not entirely absent. For instance, although foreign exchange dealers of commercial banks charge a one-eighth per cent commission on transfers of rand balances from a resident South African account to a non-resident account, dealers of merchant banks do not impose such a charge.

7. Overseas banks provide facilities between the dollar and other trading currencies, and therefore with an interbank market spot and forward requirements for rand-non-dollar transactions could continue to be provided in this indirect way.

8. It would be technically feasible for spot and forward markets to be set up with the Reserve Bank continuing to use them to dispose of the dollars accruing from its sales of newly mined gold. This arrangement, however, would be subject to major weaknesses. The authorities would face a conflict between maximising the gold sales receipts for the Chamber of Mines on the one hand, and intervening for purposes of stabilizing the markets and for broad economic reasons on the other. Moreover, with gold contributing around one third of total export receipts the presence of such a large official seller could easily restrain the role that authorized dealers are prepared to play in the market.

9. For example, at the end of 1974 the free market price was nearly R150 per ounce compared with the official price of R29,55 per ounce. At that time the Reserve Bank purchased gold from the mines at the official price, and if it was sold on the market at a higher price the premium was paid out accordingly.

10. This procedure started in April 1978.

11. R.M. Gidlow, 'Down the Mine', Euromoney, London, December 1975, pp.97-8.

12. At that juncture the Group of Ten central banks, excluding France, decided neither to buy nor sell gold on the market, and therefore allowed the free market price to fluctuate. Simultaneously, they retained the fixed official price in dealings between themselves.

13. There are indications that the demand for Krugerrands is increasing. In 1976 and 1977 3m. and 3,3m. coins respectively were sold, while in the first four months of 1978 alone sales exceeded 2m. See Chamber of Mines Report Johannesburg, April 1978, p.8.

14. For an exposition of how private arbitrage can ensure that forward rates between two currencies exactly mirror differences in interest rates prevailing for the two currencies, see International Currency Review, London, Vol.9, No.5, 1977, pp.48-9.

15. There is one exception to this position. A British bank can still provide trade finance to a non-resident if the transaction involves imports to or exports from Britain.

16. For a market in eurorand to develop South Africa would have to export capital, but normally it is a capital importer. It would also be desirable that certain exports be denominated in rand to encourage foreigners to hold the currency. At the same time, such a market could be hindered by political inhibitions on holding rand by foreigners.

17. Arbitrage transactions refer in particular to interest arbitrage. If banks were permitted to engage in the latter, then once the premium or discount on the rand in the forward market departed from the interest rate differential profitable arbitrage could be undertaken. For instance, if the three months interest rate in South Africa was six per cent per annum and four per cent in the eurodollar market, the rand should sell at a forward discount equivalent to two per cent per annum. Thus, if forward rand sold at a higher discount it would be profitable for local banks to sell rands spot and buy dollars for investment in the eurodollar market, and sell forward for rands. In this way they could earn more than six per cent without incurring an exchange risk. This process should raise the forward rand back to a two per cent discount rate per annum

18. Limits imposed could be of two kinds. Firstly, limits could apply to the total open positions of authorized dealers in all currencies, both spot and forward together. This could preclude banks from taking up excessive positions against the rand. Secondly, limits on the total amount of exchange in all currencies that may be held by banks against forward sales. This could ensure a degree of concentration of foreign reserves with the Reserve Bank, and preclude excessive amounts being arbitraged out of rand for short term investment abroad.

19. P. Einzig, A Dynamic Theory of Forward Exchange, Macmillan, London, 1961, p.30.

20. Any generalized economic sanctions imposed on this country would modify this prospect.

21. The size of the s· ·ities rand market is unknown with a great proportion of the ·.iness handled in London. One firm of securities rand dea·.·s in Johannesburg informed the writer that they alone can handle as much as R2m. a day on occasion.

One implication of an interbank market could be the desirability of not extending the scope of transactions carried out through the securities rand market, since this would reduce volume in the former market.

22. Leland B. Yeager, International Monetary Relations: Theory, History and Policy, Harper and Row, New York, 1976, p.270.

23. For instance, suppose a customer wished to sell forward six months R20m. against dollars. If the bank could not find a counterpart in the interbank market it would be unlikely to be able to undertake a swap transaction, since borrowing R20m. and selling spot against dollars would be difficult. Even the weekly Treasury bill issue can often be only around R60m.

24. In theory, the speed with which discrepancies are eliminated, and the amount of arbitrage funds that will flow would depend upon the elasticities of demand and supply for both rand and dollars. The more inelastic are supplies of spot rand and forward dollars, and the more inelastic the aggregate demand schedules for spot rand and forward dollars, the less arbitrage funds will be required to eliminate discrepancies between forward rand rates and interest rate differentials.

25. In normal conditions interest arbitrage is undertaken only by banks possessing liquid funds. The latter are better able to take advantage of prevailing discrepancies than those which have to pay interest on borrowed funds for arbitrage operations. However, when a persistent sizeable discrepancy exists between the forward rate and interest parities, it can be profitable to employ borrowed funds provided the discrepancy covers borrowing costs.

26. Francis A Lees and Maximo Eng, International Financial Markets, Praeger Publishers, New York, 1975, pp.480-1.

27. Eric B. Chalmers, (Editor), Forward Exchange Intervention, Hutchinson Educational, London, 1971, pp.61-66.

28. In March 1976 the Reserve Bank arranged a gold swap enabling it to raise between R450m. and R500m. in foreign exchange by using R142m. of gold originally valued at R29,55 per ounce. A subsequent gold swap in April 1977, using gold worth R88m. probably raised between R300m. and R350m. in foreign exchange.

29. Foreign loans of the Reserve Bank were zero at the end of 1973, but reached R689m. at the end of 1976.

30. During May 1978 the securities rand rate fell from around seventy-three cents to the rand at the beginning to around 71,5 cents by the end of the month. During the same period the gold price rose from roughly $170 an ounce to $184.

31. Outright operations mean that the central bank incurs a net long or short forward position in a particular currency.

32. Suppose the Reserve Bank bought R50m. three months forward for dollars. If it was to undertake a swap transaction it would borrow R50m. and then sell for dollars which it would invest for three months, after which it would fulfil its commitment. In buying the dollars, however, downward pressures would be exerted on the spot rand rate, which could force the authorities to intervene to support it. This would entail a loss of foreign reserves, and may conflict with monetary policy objectives, because the money supply in South Africa would fall, other things remaining equal.

33. This role by the authorities could reduce the importance of swap transactions undertaken by dealers. These are often resorted to in overseas markets when there are hectic trading conditions, and banks cannot quickly cover all their commitments in the interbank markets. If the latter conditions existed locally, and the Reserve Bank was acting as a passive intervener, recourse to it by dealers would probably eventuate.

34. Fred Hirsch and David Higham, 'Floating Rates - Expectations and Experience', Three Banks Review, June 1974, No.102, pp.11-12.

35. Currently, an exporter can only enter into a forward contract for a maximum period of six months, and an importer for a maximum period of twelve months. For longer periods official permission is required.

36. For example, if a customer wanted to buy dollars three years forward, a bank could quote a forward rate to the customer, and take out swap transactions by borrowing rand and investing in dollars. These swaps would be renewed at the end of the first and second years. With this arrangement the bank would face the risk that changes in interest rates would render the deal unprofitable. For instance, suppose the bank offered dollar cover for three years at a premium of three per cent, which reflected three per cent lower interest rates on one year dollar deposits compared with rand deposits. If, at the end of the second year when the swap was renewed, the interest rate differential in favour of the rand was five per cent, the bank would incur a loss on the forward contract.

    In order to obviate this risk the bank would have a number of possible options. It could include a clause in the forward contract, which stipulated that any additional cost incurred in renewing swaps would be passed on to the customer. Alternatively, it could offer one year forward contracts, which are renewable on flexible terms. Or, it may undertake a swap transaction for the full three years, and therefore quote a forward rate to the customer, which reflects interest rate differentials on three year deposits as between rands and dollars.

37. At the present time the official charge is one per cent per annum for import cover in excess of twelve months.

38. In certain foreign markets where brokers operate they often specialize in specific currencies. In the local setting this would be impossible, since only a rand-dollar interbank market is likely to emerge.

39. Leland B. Yeager, op.cit., p.266.

40. P. Einzig, The Case Against Floating Exchanges, Macmillan, London, 1970, pp.123-37.

41. This arises from the substantial proportion of exports of the Republic which are denominated in dollars. This figure must be well in excess of fifty per cent.

42. E.J. Lizamore, 'Foreign Exchange', Standard Bank Review, March 1974, p.7.

43. P. Einzig, A Textbook on Foreign Exchange, Macmillan, London, 1969, p.45.

44. Charges for dollar-third leg transactions are market related, but it is a dollar-foreign currency and not a rand-foreign currency market.

45. Given these losses revaluation of the rand could be resisted if the authorities had a long forward position in dollars.

46. If loans in excess of one year were to enjoy such facilities official intervention would again seem necessary.

47. If an investor anticipates that the foreign exchange value of his investment in the Republic is liable to decline, forward selling of the rand could be undertaken provided this was not contrary to exchange control regulations. When the contract matured the investor could buy the necessary currency in the spot market to fulfil the contract, and make a profit if the rand had depreciated. This is known as hedging.

48. As explained in footnote 20 such outflows of funds via interest arbitrage should have the benefit of reducing the forward rand discount.

49. In 1977 gross domestic savings exceeded gross domestic investment for the first time since 1968.

50. According to information received from local banking sources foreign acceptance credits were in excess of R1 000m. at the end of 1977.

51. At the end of May 1978 the foreign reserves of the Reserve Bank totalled R1,76b. with currency holdings only roughly R350m.

52. For a contrary view see Charles P. Kindleberger, International Economics, Richard D. Irwin, Illinois, 1973, p.292.

Kindleberger argues that the development of a forward exchange market produces no fundamental change in the character of international capital movements. He maintains that while a forward market simplifies hedging and speculation, it does not induce many people to hedge or speculate who would not already do so with the aid of loan funds in the countries concerned, despite the greater ease and the reduced cost of such operations. On the basis of this contention all that a forward market is supposed to do is shift part of the buying or selling pressure temporarily from the spot to forward exchanges, while the total of both is supposed to be substantially unchanged.

53. Even in the absence of exchange control changes the elasticity of supply of interest arbitrage funds should be relatively low due to the absence of a market in eurorand, and the limited local money and capital market facilities. On the other hand, if the elasticity was high, forward rates should not depart much from interest rate differentials, changes in speculative activity in the forward market being quickly transmitted to the spot market through arbitrage. In other words, if speculators sold forward heavily and widened the discount, arbitrageurs would sell rand spot and buy forward, thus reducing the forward rand discount.

54. All purchases and sales of portfolio investments in the Republic by non-residents are channelled through the securities rand market.

55. Richard E. Caves and Ronald W. Jones, World Trade and Payments, Little Brown, Boston, 1977, pp.347-8.

56. The case of Israel is interesting in this context. At the end of October 1977 the Israeli pound was floated, and within a few days the currency depreciated by roughly forty per cent against the American dollar. Thereafter, until the end of February 1978 the rate fluctuated in the range of fifteen to sixteen pounds to the dollar. By the beginning of June 1978 the rate stood at around seventeen pounds.

CHAPTER THIRTEEN - IMPLICATIONS OF FLOATING THE RAND

The purpose of this chapter is to analyze the implications of floating the rand, assuming the necessary institutional changes in foreign exchange practices are effected, which permit a fully developed market to materialise in spot and forward exchange.

The strength of the case for flexible exchange rates differs between countries for two basic reasons. Firstly, the typical form and source of disturbances to balance of payments positions differs significantly from country to country, and floating rates do not help equally to restore internal and external equilibrium in all cases. Secondly, the adequacy and flexibility of internal policy instruments, and the restrictions on their use imposed by various factors, can vary among countries influencing the attractions of alternative exchange rate policies.

13.1 Floating Rand and Payments Adjustment

As a mechanism for facilitating balance of payments adjustment a floating rand could furnish several benefits.

13.1.1 Simplicity and Efficiency

Of all the variables available for balance of payments adjustment, the exchange rate is the easiest to alter because of the existence of the market mechanism. To allow the rate to appreciate or depreciate in terms of another currency is much easier than to change the domestic level of prices and incomes relative to other countries, and preferable to instituting exchange and trade controls.[1] Apart from exchange controls, measures like the import surcharge and restrictions on petrol sales currently operating in the Republic may constitute evidence of an overvalued exchange rate. Floating the rand may eliminate the current costs of resource misallocation by allowing such controls to be scrapped.

These arguments, however, are subject to qualifications. Firstly, short run price elasticities of demand for imports and exports of the Republic could be too low, producing a spiral of

depreciation or appreciation in the absence of official intervention.[2] This question was discussed in previous chapters. Alternatively, although elasticities may be high enough, the responsiveness of trade to exchange rate changes may be less in the case of South Africa compared with major industrial countries, because of the lesser importance of manufacturing exports, which constitute only around twenty per cent of merchandise exports. As a result, greater movements in the rand could be necessary to adjust to external shocks. Even this is uncertain, however, it being alleged that the reaction of trade to currency changes will be delayed the most if the country specializes in the export of finished goods rather than primary products.[3]

Secondly, greater exchange rate flexibility adopted by the Republic in recent years has not reduced the size of deficits and surpluses on the current account of the balance of payments as measured by the ratio of current account payments imbalances to gross domestic product at market prices. In the period 1965-71 the ratio was 3.2, whereas in the 1972-76 period it was 4,02. Nor has the era of flexibility altered the long-standing feature for the current account position to be closely correlated with the public sector deficit before borrowing.[4]

Thirdly, resort to a floating rand rate will not produce effective payments adjustment if it leads to a vicious circle of exchange rate depreciation, because of the unwillingness to adopt policies that promote price stability. South Africa traditionally has favoured fixed rates, because of the focal point it can provide for pursuing policies conducive to their maintenance. On the other hand, floating the rand could carry its own kind of discipline. A depreciating rate quickly increases inflation, and its unpopularity may induce responsible economic policies. This could be strengthened if foreign investors, fearing imprudent policies with a floating rate, brought about a fall in net capital inflows.[5] In contrast, with a fixed rate, adjustment may be postponed by borrowing and drawing down reserves.

Fourthly, domestic price and income adjustments may not be so difficult politically to undertake in the Republic as in many western countries. The economy is relatively small, and it may be able to obtain a better social consensus on important issues such as the need to restrain wage demands, trade union militancy not being such an important problem.

13.1.2 Elimination of Structural Deficiencies

For many years official policy has aimed at diversifying foreign trade relationships of the country so that reliance upon Western Europe for exports is reduced, and the trade risk spread.[6] In recent years the most rapid growth in import has been in the non-industrialized world, and particularly the oil exporting countries, which has been increasing its relative importance in world trade. In this area South Africa has been making inadequate progress.[7] As a means of encouraging export diversification a floating rand may be desirable, since the current fixed, albeit adjustable, rand/dollar link, together with the cheap fixed forward dollar cover available, may have contributed to the strengthening of trade relationships with the dollar bloc.[8]

Moreover, if reliance on import controls, as a short term balance of payments measure, could be reduced, a floating rand could eliminate a long standing structural deficiency on the external front. This concerns the import stockpiling which can materialise at times of falling foreign reserves on anticipation of a tightening of controls, and so accentuating the external difficulties as happened, for instance, in 1971 and 1976. If reliance was made upon the exchange rate on a continuous basis to deal with payments imbalances the incentive to stockpile could be blunted. This is not guaranteed, however, because any sharp fall in the rand, at times of payments deficits alongside buoyant domestic economic conditions, would probably be resisted by intervention. Importers may still suspect, therefore, that the traditional import control techniques will be resorted to.

13.2 Exchange Rate Regime and Transmission of External Economic Trends

Where external economic trends affecting South Africa are concerned, these can be categorized into two main areas, namely changes largely reflected in terms of trade movements, and those largely reflecting cyclical output movements in the rest of the world.

13.2.1 Fluctuations in the Terms of Trade

A country may have a strong case for employing a floating exchange rate when alterations to its external accounts originate externally through, say, changing demand for certain of its exports. Thus, with an initial export expansion due to rising commodity prices abroad, the internal adjustment and expansion of the national income and price level necessary to restore equilibrium under fixed exchange rates only follow the improvement in the foreign reserves. Under these circumstances, the long term change in the output of the export industries may well be less than the initial change before adjustment forces take hold throughout the economy.

By contrast, a fluctuating exchange rate tends to promote adjustment without an expenditure lag, cushioning the impact on the output of exports through exchange rate appreciation or depreciation, and furnishing an immediate incentive for output adjustments elsewhere in the economy. Hence, the impact of export expansion is not initially felt in export industries alone. Thus, since reallocation of resources is costly, and transitional changes for a specific industry, which overshoots the mark, may cause long term misallocation of fixed capital, adjustment to external price shifts through flexible rates may be beneficial.[9]

In the case of South Africa exports are heavily concentrated in the field of minerals and agricultural products, which constitute around eighty per cent of merchandise exports and whose prices can be volatile. In addition, gold constitutes around thirty per cent of total export receipts, and in recent years improvements in the

terms of trade have been associated with a rising gold price as shown in the following table:-

TABLE 27 - TERMS OF TRADE AND GOLD PRICE

	Export Prices	Import Prices	Terms of Trade	Average Gold Price (R)
1970	100	100	100	
1971	97	104	93	29,2
1972	105	119	88	45,1
1973	127	130	98	67,0
1974	157	154	102	101,1
1975	175	192	91	118,0
1976	207	236	88	108,5

Sources: Adapted from IMF Financial Statistics and Reserve Bank Quarterly Bulletins, various issues.

Thus, a floating rand and a rising gold price could lead periodically to an appreciation of the currency, cushioning the impact on the gold mining industry, and providing for immediate adjustments elsewhere in the economy. Conversely, on occasions, such as in September 1975, when the price of gold fell sharply from around £160 to £130 an ounce, this could induce a fall in the value of the rand, alleviating problems faced by the industry, as well as helping to stabilize the economy.

On the other hand, several factors militate against floating the rand to mitigate the internal repercussions of changes in the terms of trade associated with significant movements in the price of gold. The potential influence of the latter upon a floating rand can be exaggerated. From around the middle of 1973 to the end of 1974, when the gold price advanced strongly and the terms of trade moved in favour of South Africa, the current account was in deficit and the gold and foreign exchange reserves of the Bank fell.[10] Thus, during this period a floating rand would have depreciated in the absence of significant intervention in the foreign

exchange market by the authorities. Also, at times such as in 1975, a devaluation of the rand can compensate for a sharp fall in the price of gold under present exchange rate arrangements. An appreciation of the rand in the face of a significant price rise of the metal, and, in particular, a depreciation in the case of a price fall, moreover, may reduce discipline over cost increases in the gold mining industry.

13.2.2 *Influence of World Business Cycle*

Changes in the balance of payments and economic conditions in the Republic are also considerably influenced by cyclical movements in world trade, with a tendency for the business cycle of the Republic to lag behind that of western countries.[11] In these circumstances, it is likewise argued that a country can generally insulate itself from such income fluctuations abroad more effectively through floating its currency.[12] Ruling out induced changes in capital movements, a flexible exchange rate averts changes in the trade balance, and blocks transmission of the business cycle by that route.[13]

In the context of the Republic, however, this argument in favour of a floating rand is subject to two qualifications. Firstly, it has been argued that fluctuations in the terms of trade of countries will be greater under a system of exchange rate flexibility.[14] Fluctuations in the balance of payments of a country can be eliminated under flexible rates, but only at the expense of allowing greater movements in the terms of trade, brought about through currency appreciation or depreciation. This will lead to greater fluctuations in the internal price level.[15] On the other hand, currency movements are constrained in practice by official intervention in foreign exchange markets.[16]

Secondly, recent events pose the question whether resort to floating rates has not altered the business cycle relationship of the local economy with the outside world. Historically, the South African business cycle has been closely synchronized with the

United States economic cycle with a lag of around nine to twelve months at a maximum.[17] Thus, for instance, the United States enjoyed a cyclical recovery starting in the second quarter of 1967, and the local economy followed at the beginning of 1968, while an American upswing in the first quarter of 1972 was followed by the South African cycle in October 1972. By contrast, although the United States economy revived in the second quarter of 1975, the local economy remained in a downturn during 1977.

In one respect greater synchronization could have been expected. Whereas in 1970 exports and imports of goods and services, as a percentage of gross domestic product, were 22,5 per cent and 29,5 per cent respectively, by 1976 the respective figures reached 29,6 per cent and 35,9 per cent. Also, the proportion of merchandise exports going to the United States rose from 8,4 per cent in 1970 to 11,0 per cent in 1975.

Other factors, however, suggest a lower degree of synchronization. Firstly, the more flexible local exchange rate arrangements may tempt the authorities to delay implementing restrictive policies in boom phases, which could lengthen the corrective phase required before a new upswing could develop. Secondly, an economic upswing might be delayed or accelerated because of the link of the rand to the floating dollar. If the latter appreciates, when the local economy is slack, this would impair the competitive position of the economy, and conversely improve it with a dollar depreciation. For instance, between October 1975 and December 1976 the trade weighted value of the rand rose by roughly six per cent in the midst of a prolonged economic slowdown.[18] Thirdly, during 1974 when the western world experienced a recession, the South African real gross domestic product grew by 7,2 per cent, helped by a doubling of the gold price to nearly $200 an ounce by December 1974. The possibility that the gold price will move in an anti-cyclical manner means that the economy may continue to move in a non-traditional direction.[19] If so, insulating the economy through floating the rand becomes

less important, although there is no guarantee that this influence of the metal will be substantial.[20]

13.2.3 Factors Reducing Insulation Under Floating

Even in theory floating rates may not prevent the transmission of economic influences from one part of the world to another. A business cycle upswing abroad it is argued can produce an appreciation of the currency of a country in foreign exchange markets associated with an improvement in its terms of trade. Composition of expenditures will be changed as cheaper imports are substituted for domestic products, and in addition total domestic expenditures will change. Assuming given domestic prices, a decline in import prices increases the real income corresponding to any given money income. As import prices fall, therefore, the amount spent on goods and services will fall if savings are a function of real income. In other words, a boom abroad allegedly causes a contraction in the economy as domestic aggregate demand falls.[21]

The validity of this savings hypothesis has been criticized, in the case of the Republic the personal savings ratio being volatile, fluctuating markedly as agricultural incomes change.[22] Also, the unchanged foreign trade balance assumption of the theory is unrealistic, since freely floating rates do not materialise.

The proposition that under floating rates disturbances could be contained within each country is, also, questionable because of the possible influence of capital flows. It has been argued that the smaller impact of external disturbances under floating rates reflects the assumption that investors expect the exchange rate tomorrow to be the same as it is today.[23] Capital flows, however, could be a function of the expected change in the exchange rate rather than that of any interest rate differential, and thus, if investors expect the exchange rate to remain unchanged in the longer term, elasticity of capital flows should be fairly high, and stabilize the exchange rate. Hence, if the American economy weakens markedly, initially this could cause the exchange rate of

other countries to decline, but expectations of long run stability in exchange rates will induce capital inflows into such countries, causing them to appreciate quickly. In these circumstances, the transmission through the trade account would be roughly the same under floating as under pegged rates.

13.3 Factors Militating Against a Rand Float

For the Republic several factors militate against such an exchange rate policy, apart from the question of institutional modifications required in foreign exchange arrangements.

13.3.1 Transmission of Inflation

For a country heavily dependent upon international trade like South Africa, a floating currency could be attractive if the rate of inflation in the outside world is higher than its own. By adopting a floating rand imported inflation could be reduced as a result of an appreciation of the currency vis-a-vis foreign currencies. Such an inflation differential, however, has not existed recently as is shown in the following table:-

TABLE 28 - PERCENTAGE CHANGE IN CONSUMER PRICES

	Industrial Countries	United States	United Kingdom	South Africa
1972	4,5	3,3	7,1	7,0
1973	7,5	6,2	9,2	10,0
1974	12,6	11,0	15,9	11,6
1975	10,7	9,2	24,2	13,5
1976	7,7	5,7	16,8	11,1

Sources:- IMF Financial Statistics and South African Reserve Bank Quarterly Bulletins, various issues

A floating rand could enable the country to remain competitive in international markets through exchange rate depreciation to counteract any relatively high local inflation. On the other hand, floating rates, far from reducing payments disequilibrium, may perpetuate imbalances.[24] Moreover, price differentials are probably not so crucial in influencing the current account position of the

Republic, given the emphasis on primary commodity exports, as in a predominantly manufacturing orientated exporting country. In addition, with a floating rate a major determinant could be capital flows.

Simultaneously, adoption of a floating rand could conflict with official policy to curb inflation. In recent years imported inflation has provided a strong impetus to local price trends as shows in Table 29.

TABLE 29 - PERCENTAGE PRICE CHANGES IN SOUTH AFRICA

	Consumer Price	Wholesale Prices	Imported Wholesale Prices
1972	7,0	6,9	12,1
1973	10,0	13,7	11,6
1974	11,6	16,6	22,6
1975	13,5	15,5	22,4
1976	11,1	14,4	17,3

Source: Reserve Bank Quarterly Bulletings.

This imported inflation has been partly the result of the rand devaluations of 1971 and 1975.[25] Apart from its direct impact, this devaluation policy allegedly has promoted pervasive cost-push pressures in the domestic economy.[26] Given the necessity of relaxing certain exchange controls and, particularly if introduced at a time of payments difficulties, a floating rand would probably depreciate. This could worsen inflation, since a rand float could be interpreted as official willingness to see a downward float, creating the danger of a substantial fall.[27] Tight monetary policies and active intervention in the foreign exchange market could be necessary to confine the inflationary implications.

13.3.2 Openness of Economy

Not only is the local economy highly open, but in addition official policy traditionally has been adjusted to reinforce the stimulatory effects of payments surpluses during slowdown phases of the business cycle, and contractionary effects of payments deficits

during expansionary phases of the cycle. The resulting speed of adjustment of the economy to external surpluses and deficits suggests one advantage of a fixed rand exchange rate, and the corresponding greater attractions of floating for more closed economies, instead of relying on income adjustments to rectify external imbalances. Small exchange rate changes can, allegedly, efficiently control the balance of trade of a country provided its foreign trade sector is small relative to gross domestic product. Conversely, a floating rate is likely to be an inefficient device when dependence on foreign trade is high.[28]

The validity of this argument, however, is crucially dependent upon the willingness of a country largely to subjugate monetary policy to external needs. The willingness of South Africa to do this may be modified if the problems on long term capital account continue. As a result of this, protection of the short term capital account has become imperative, meaning that no independent monetary policy can be pursued.[29] Floating the rand, however, is not the only way of reasserting monetary independence, since, alternatively, the latter could be restored by extending the securities rand market to include all capital account transactions. Unfortunately, this would make more difficult the creation of a fully developed spot and forward interbank market in rand/dollar transactions.

13.3.3 Volatility of Exchange Rate

Given the open economy plus the potential impact of capital flows, the rand exchange rate could be subject to sizeable fluctuations.[30] Apart from having possibly inhibiting effects upon trade and capital flows, inflationary pressures could arise out of the 'ratchet effect', which tends to raise the price level more rapidly over time than would be the case under pegged rates. Every time the rate depreciates the resulting rise in the cost of living will prompt increases in domestic wages, and thus prices. Conversely, because wages and prices are inflexible downwards, no

symmetrical fall in the price level will materialise when the exchange rate appreciates.

Empirical evidence of the existence of 'ratchet effects' is far from convincing.[31] With a developed interbank market, moreover, forward exchange facilities would be available for traders and investors, which currently do not exist.[32] Thus, it is difficult to see why trade and investment flows should be harmed under such a system.

Simultaneously, however, the average level of frictional unemployment could be higher. Under a floating rate, if it produced significantly greater monthly, seasonal or annual fluctuations in the exchange rate than under a fixed rate, the result will be over frequent market attempts to reallocate resources among the export, import competing and domestic sectors leading to an increase in the average rate of frictional unemployment.[33] With a floating rand foreign trade based on transitory price/cost relationships not reflecting comparative advantage may eventuate. Given the size of the balance of payments sector, and the high level of unemployment prevailing in the Republic, this could be troublesome.[34] On the other hand, the employment situation might improve if the rand depreciated, since this would raise the cost of imported capital goods, inducing possible substitution of labour for capital.

13.3.4 Domestic Disturbances

Maintaining a fixed rand exchange rate might be beneficial where certain types of domestic disturbances influence the balance of payments. South Africa, a large exporter of primary products, is characterized by large random variations in exportable surpluses of agricultural crops due to climatic factors. Under a floating regime the rand might appreciate in good crop years (and vice versa in poor years), lowering import prices or at least the rate of increase, and imparting output fluctuations in the import competing and export industries, which could be temporarily disruptive. By maintaining a fixed exchange rate, and possibly taking fiscal and

monetary action to offset income variations, the country may cope better with fluctuations in export earnings, and avoid disruptive output redistributions in the balance of payments sector.[35]

As regards a floating rand this would be unimportant. In 1976 agriculture constituted only 7,5 per cent of gross domestic product, its contribution being in secular decline. The principal export crop is maize, which is subject to erratic production, and therefore in export surpluses. In 1975 and 1976 maize exports were roughly four per cent and 2,7 per cent of total exports respectively.

13.3.5 Business Cycle and Balance of Payments

A special relationship exists between the local business cycle and the balance of payments position. During the later stages of the business cycle downswing and the initial stages of a cyclical upswing, a payments surplus develops, while during the later stages of the upswing and the initial downswing in the business cycle, a deficit tends to materialise.[36] Given these circumstances, a floating rand could have a destablizing effect on the economy. Conditions could deteriorate during the downswing as the rate appreciates in the face of a developing payments surplus, while during the business cycle expansion overheating could be magnified as the rand depreciates in line with an external deficit.[37] Hence, the traditional fixed exchange rate policy of the Republic has assisted the economy with an income leakage through the balance of payments at the top of the business cycle, and an income injection at the bottom.

Given the potential destabilizing influence of a floating rand, this might be counteracted by appropriate monetary policies.[38] Thus, during the downswing, when the exchange rate appreciates because of a balance of payments surplus, expansionary monetary policies should be pursued. This will not only have useful domestic effects, but will, through inducing a capital outflow due to falling interest rates, weaken the exchange rate. Conversely, during the upswing contractionary monetary policies should be pursued, which will dampen

the economy, a result supplemented by capital inflows, which will tend to restrain downward pressures on the exchange rate, and possibly induce an appreciation.

13.4 Intervention Policy with Floating Rand

Despite this, it is likely that if the rand was allowed to float, the authorities would prefer to adopt an active exchange rate policy, rather than rely heavily upon monetary policy to influence the exchange rate and economic conditions. For a number of reasons it is likely that a rand float would develop into a highly managed operation with considerable de-emphasis upon rate flexibility normally associated with floating.

13.4.1 Foreign Reserves Stockpile

For one thing an active intervention policy could allow the authorities to maintain or build up the foreign reserves in case a return to a fixed but adjustable exchange rate is decided upon.[39] Such a policy, moreover, could enable the gold reserves to be mobilised more extensively, dovetailing with the official preference for an important monetary role for the metal in the international monetary system. Meanwhile, active intervention would provide rationale for reverting to a fixed rate, if this was favoured.

13.4.2 Interest of Exporters

Given the importance of the export sector, the temptation would be strong to influence the environment, in which this sector operates, by exchange rate manipulation. This could be strengthened by pressure group influences from exporters who may dislike large swings in the exchange rate. The mining industry traditionally has been unenthusiastic about floating rates, and yet, in the short term, any rand float would benefit the industry if the rate fell. On the other hand, volatility of the rand rate could discourage long term mining investment by making production planning more difficult. Although in the longer term differences in rates between a fixed and floating rate system should not be of major importance, the increased uncertainty created by floating rates may induce

greater caution than if the rate was fixed. For similar reasons manufacturing exporters may press for intervention with a floating rand.

13.4.3 Problems in Relying on Monetary Policy

Given the importance of capital flows to the balance of payments of the Republic, and in particular the sensitivity of short term foreign capital to interest rate differentials, changes in monetary policy could have a marked impact upon the exchange rate. This would be aided by the fact that interest rate changes in the Republic would not induce other countries to take similar action.

Using this instrument, however, would be difficult. It would be impossible to know exactly how the exchange rate would respond to given monetary policy actions, and in particular how the foreign exchange market would react. Monetary policy would have to be used carefully and flexibly, some claiming that the danger of its inappropriate employment constitutes a persuasive argument against flexible rates.[40] This is relevant in the local context, since institutional constraints exist which make more difficult the execution of monetary policy, such as thin trading conditions in the secondary capital market.[41] Also, capital flows would be influenced by the extent to which an efficient forward exchange market developed, and exchange controls were relaxed. Meanwhile, under a freely floating rand the inflationary impact of any exchange rate depreciation during the expansionary economic phase can be modified by contractionary monetary policies, but the latter are slow working.

13.4.4 Influence of Capital Flows

Foreign capital inflows into the Republic can be affected not only by interest rate changes, but also by political and speculative factors. If the rand faced such adverse pressures it would depreciate, but the new exchange rate could involve undervaluation on trading grounds, and promote inflation. In other words, the rate could settle in a range inconsistent with

longer term balance of payments adjustment, and adjustment costs incurred as the disequilibrium on current account is eliminated. Such events could easily have materialised in 1960-61 and 1975-77, if the rand had been floating, sizeable current account surpluses compensating for capital outflows. Under these circumstances, the effectiveness of monetary policy, by means of higher interest rates, in stemming capital outflows would probably have been very limited. Thus, the fear that a large difference might develop between the short run market clearing rate and the longer run equilibrium rate provides another reason for suggesting that a floating rand would be highly managed. This could be encouraged further by official profits from intervention if the rand subsequently recovers from a bout of selling.

On the other hand, the extent of self-fulfilling speculation under floating can be exaggerated. Resources available are not unlimited, and speculations who misjudge the market will tend to drop out, leaving active those normally capable of correct forecasting.[42] Moreover, under current exchange rate arrangements large scale capital outflows have necessitated running current account surpluses in the past year or so, albeit probably on a smaller scale than with a floating rand.[43] Simultaneously, recent methods of alleviating foreign capital shortages have been expensive, such as inflows obtained via the securities rand market.[44]

13.4.5 Effects on Foreign Reserve Needs

Economizing on foreign reserves is claimed to be possible with a floating currency because of more limited intervention. However, given the policy described as likely to be followed by the Republic under floating, foreign reserve needs of the Reserve Bank may not fall. The outcome could be complicated by two factors. Firstly, the extent of intervention could be influenced by the extent to which exchange controls were relaxed. By enhancing the breadth of the foreign exchange market it could reduce intervention requirements, but insofar as it contributed to downward

pressure on the currency it could increase intervention undertaken. Secondly, gold price movements could influence capital inflows. For instance, if a falling gold price induced adverse speculative pressures on the rand, intervention could be made more difficult in the face of falling foreign reserves, which in turn might encourage further speculation against the rand.

Even if official foreign reserve needs did fall foreign reserve requirements of the banking sector at large may not, since a floating rand would require foreign exchange dealers holding larger foreign currency positions to help stabilize the foreign exchange market, and undertake arbitrage transactions. Moreover, any Reserve Bank savings on this front could be counter-balanced by higher costs, or greater difficulties, in raising foreign capital, if the level of the net foreign reserves affects the international credit status of the country.[45]

13.5 Floating Rand and Exchange Controls

As already indicated, floating the rand would require setting up an interbank market in foreign exchange, which in turn would necessitate relaxing exchange controls. The latter requirements do not furnish grounds for not developing an interbank market, and floating the rand, since the bulk of existing exchange controls would not have to be dismantled. Concerning exchange control policy two extremes would exist; retaining fairly stringent regulations leading to a narrower market requiring significant official intervention, or promoting a broader market, possibly requiring less intervention, by making more extensive relaxations as far as non-residents are concerned.

The danger of sudden massive capital outflows is the rationale behind much of exchange control policy in the Republic, but it is impossible to gauge accurately being so dependent on unpredictable political developments. Relaxing exchange controls affecting non-residents may encourage capital outflows on fears that having seen controls in force for so long, investors would shift capital

out in anticipation of eventual re-introduction. On the other hand, non-residents wishing to disinvest, because of perceived political risks, could do so causing the rand to fall initially. Once these disinvestments have occurred, however, any future political disturbances may exert only moderate pressure on the exchange rate.[46] Moreover, any fall in the rand could encourage capital inflows as well as discourage outflows. Depending on circumstances, it is possible that relaxations would be interpreted as a sign of strength, and lead to a net inflow of funds. For instance, if the rand floated downwards at the same time as the dollar price of gold was rising, the profitability of gold mining could increase dramatically. This could encourage capital inflows generally as foreign investors reappraise prospects for the economy.

Exchange controls, moreover, infringe on economic freedom, are partially ineffective, and currently costly to administer. As regards this latter problem a floating rand could reduce the burden. Not only could significant controls be scrapped, but the responsibility for administering the remaining exchange controls might be shifted more onto the local banks.[47]

References

1. W.M. Scammell, International Monetary Policy: Bretton Woods and After, Macmillan, London, 1975, p.90.

2. No consensus exists on the magnitude of these elasticities in the case of the Republic. The most recent evidence is provided by P.D.F. Strydom, 'Inflation in South Africa: Institutional Aspects', South African Journal of Economics, Vol.44, No.4, December 1976, pp.457-63.

3. Brian Tew, The Evolution of the International Monetary System 1945-77, Hutchinson, London, 1977, pp.72-3.

4. More specifically since around 1960 there has been the tendency for rising public sector deficits before borrowing to be associated with current account deficits, and vice versa.

5. Andrew D. Crockett and Saleh M. Nsouli, 'Exchange Rate Policies for Developing Countries', Journal of Development Studies, Vol.13, No.2, January 1977, pp.139-40.

6. In 1976, forty-seven per cent of merchandise exports went to the EEC countries.

7. South African Foreign Trade Organization Fourteenth Annual Report, 1976-77, pp.7-8.

8. In 1976 the United States became the major supplier to the Republic for the first time, and was the fourth largest export market of the country.

9. R.E. Caves, 'Flexible Exchange Rates', American Economic Review, May 1963, p.126.

10. At the end of July 1973 the holdings of the Bank amounted to R1 268m. whereas at the end of December 1974 they had fallen to R729m.

11. Gerhard de Kock, 'The Business Cycle in South Africa - Recent Tendencies', The South African Journal of Economics, Vol.43, No.1, pp.1-15.

12. R.E. Caves, op.cit., p.126.

13. In other words, with a freely floating exchange rate, disregarding capital flows, the balance of payments items of a country overall cancel out, the national income of such a country being equal to its own expenditures on goods and services, and therefore such national income is a circular flow involving a closed or autonomous circuit.

14. S. Laursen and L.A. Metzler, 'Flexible Exchange Rates and the Theory of Employment', Review of Economic Statistics, November 1950, pp.281-99.

15. Irrespective of the influence of terms of trade movements induced by currency fluctuations, it has been argued, also, that such movements brought about by changes in foreign prices, can lead to greater variance of the price level under floating rates, assuming the demand for imports is inelastic. Under these conditions any rise in import prices, caused by overseas prices rising, will precipitate a fall in the exchange rate, both traded and non-traded goods therefore rising in price. On the other hand, pegging the exchange rate will prevent prices of traded goods rising domestically, which have not changed in foreign currency terms, and will therefore lead to a smaller movement in the prices of non-traded goods. See Stanley W. Black, 'Exchange Policies for Less Developed Countries in a World of Floating Rates', Essays in International Finance, Princeton University Press, No.119, December 1976, p.10.

16. During the period from March 1973 to January 1977 gross foreign exchange market intervention by the major central banks is estimated at $172 billion. See IMF Survey, Washington, Vol.6, No.6, 21 March 1977, p.81.

17. IMF Survey, Washington, Vol.5, No.6, 15 March 1976, p.86.

18. This problem would disappear if the rand floated, since its value would no longer change solely in accordance with movements in the dollar rate.

19. During 1978 the local economy, aided by a gold price increase, may improve side by side with a slowdown in western economies.

20. Even in 1974 the increased gold receipts of R790m. represented only an increase of four per cent in gross domestic product at market prices.

21. S, Laursen and L.A. Metzler, op.cit., pp.281-99.

22. Over the period 1967-76 the average ratio of personal savings to gross domestic product was 7,5 per cent, but in the good agricultural years of 1967, 1972 and 1975 it was above the average.

23. Robert Z. Aliber, editor, National Monetary Policies and the International Financial System, Chicago Press, 1974, p.305.

24. The cases of the United Kingdom and Italy in the 1973-76 period have been referred to on the grounds that because of the perverse short term effects of depreciation, and the ensuing rise in the cost structure aggravated by wage increases, floating rates made matters worse. The failure of depreciation to rectify the deficits also raised fears of import controls being introduced, further encouraging imports.

25. Export prices of the main trading partners of the Republic (United Kingdom, United States, West Germany, Japan, France, and Italy) rose on average by sixty-three per cent in the 1972-75 period. Simultaneously, South African import prices rose by seventy-six per cent.

26. P.D.F. Strydom and H. Wiehahn, 'Cost Push Inflation and Balance of ... ments Theory', South African Journal of Economics, Vol.45, No.3, September 1977, pp.257-67.

27. This could be a major problem in introducing a float, particularly if it was accompanied by the dismantling of the securities ran' ... ket, and a unified foreign exchange market established. ...he end of February 1978 the securities rand rate stood at a discount of roughly thirty per cent to the official rate, and abolishing this market, under these circumstances, would provoke a capital outflow, which could cause the rate to drop sharply. At the same time ...owever, the securities rand rate is not a highly accurate measure of the international value of the rand in a free market since, inter alia, it is affected by both technical factors and by significant individual transactions.

28. R.I. McKinnon, 'Optimum World Monetary Arrangements and the Dual Currency System', ...anca Nazionale Del Lavoro Quarterly Review, December 1963, Vol.67, pp.382-3. Also H.R. Heller, 'Choosing An Exchange Rate Regime', Finance and Development, I.M.F., Washington, June 1977, Vol.14 No.2,p.24.

29. During 1978 the authorities may be forced, by rising American short term interest rates, to push up comparable local rates in order to prevent more capital outflows. This will, if it occurs, coincide with continued economic sluggishness, the economy having been in a downswing since the third quarter of 1974.

30. During the last few years of floating exchange rates among major western countries, short run exchange rate movements have been far greater than corresponding trends in domestic price levels. See Jacques R. Artus and Andrew D. Crockett, 'Floating Exchange Rates - Some Policy Issues', Finance and Development, I.M.F. Washington, December 1977, Vol.14, No.4, p.27.

31. Andrew D. Crockett and Morris Goldstein, 'Inflation Under Fixed and Flexible Exchange Rates', I.M.F. Staff Papers, Washington, November 1976, Vol.XXIII, No.2, p.530.

32. At present, for instance, no rand/dollar cover is available to the private sector on foreign loans raised excepting foreign trade finance.

33. A. Lanyi, 'The Case for Floating Exchange Rates Reconsidered', Essays in International Finance, Princeton University Press, February 1969, No.72, p.29.

34. Unemployment among Europeans, Coloureds and Asians increased by 288 per cent from the end of 1964 to October 1977 reaching 33,628.

35. R.E. Caves, op.cit., p.127.

36. Gerhard de Kock, op.cit., pp.3-7.

37. It can, therefore, be argued that a flexible exchange rate would be helpful if the country tended to be in external deficit during a business contraction period, and in surplus during one of expansion, a state of affairs not applying in the Republic. In such circumstances, the payments deficit would cause the floating currency to drop, and exert an economic stimulus in the contractionary business phase. In the period of expansion and external surplus, the exchange rate would rise, thus dampening the economy.

    For an analysis of the compatibility of exchange rate systems and types of economy, see J.L. Stein, 'The Optimum Foreign Exchange Market', American Economic Review, Vol.55, 1963.

38. With a floating exchange rate, if expansionary fiscal policies entail higher interest rates, this will attract foreign capital into the country causing the exchange rate to appreciate. This would harm the foreign trade sector, so negating the initial boost given to the economy by expansionary fiscal policies. Hence, under floating rates a de-emphasis on such policy as a macro-economic instrument is normally recommended. See J. Marcus Fleming, Essays in International Economics, George Allen and Unwin, London, 1971, pp.237-48. Also E. Sohmen, Flexible Exchange Rates, Theory and Controversy, Chicago Press, 1961, pp.83-90 and pp.123-4.

39. The attractions of floating the rand could diminish markedly if there is any move back towards fixed but adjustable rates. During the first few months of 1978 there was evidence of waning enthusiasm for floating rates as the persistent weakness of the American dollar threatened to induce countries to tighten exchange controls and erect trade barriers.

40. E. Sohmen, op.cit., p.326.

41. In recent years there have been improvements in trading conditions, which have facilitated Reserve Bank open market operations. See A.P. Faure, 'The South African Money Market', Finance and Trade Review, Vol.XII, No.4, December 1977, pp.303-8.

42. Milton Friedman, 'The Case for Flexible Rates' in Essays in Positive Economics, Chicago Press, 1953, pp.157-203.

43. A current account surplus of around R750m. materialised in 1977 counterbalanced by a net outflow of short term capital not related to the foreign reserves of R1 086m.

44. By buying government and semi-government stocks with securities rand at a sizeable discount to the official exchange rate, holding them for five years, and then repatriating the proceeds through normal banking channels, non-residents have been receiving redemption yields as high as twenty-five per cent per annum. Exchange control modifications in the March 1978 budget ended this facility.

45. Andrew D. Crockett and Saleh M. Nsouli, op.cit., p.140.

46. The case of Israel is interesting in this context. At the end of October 1977 the Israeli pound was floated, the initial reaction within a few days being roughly a forty per cent depreciation of the rate. Thereafter until the end of February 1978 the rate has fluctuated in the range of fifteen to sixteen pounds to the dollar.

47. This could arise because a major reason for refusing to give banks more discretion under current arrangements is the official fear that banks may deliberately misinterpret the rules to try and gain more business from clients. If the controls were less pervasive the opportunities to do this would be reduced.

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