South Africa: official foreign exchange operations

South African Reserve Bank

Purpose: strengthening foreign exchange reserves

1. Official foreign exchange operations in South Africa are directed towards gradually strengthening the official foreign exchange reserves.

2. In recent years, reserves have been negative on a net basis, with a negative forward position exceeding holdings of spot reserves. With the rand recovering since 2002 from a sharp fall in the second half of 2001, the South African Reserve Bank has since March 2003 been operating in the market to purchase foreign exchange, on a moderate and gradual basis, with the aim of rebuilding the foreign exchange reserves to a reasonable level. The approach, by "creaming off" (purchasing) foreign exchange when the market is active, but explicitly not seeking to set any level for the rand, or to resist market movements, is consistent with the Reserve Bank's overall monetary policy framework, which is based on inflation targeting and a floating exchange rate.

3. This process of rebuilding foreign exchange reserves has yielded good results over the past two years. When the Reserve Bank began "creaming off" (purchasing foreign exchange gradually in the market) in March 2003, the net reserves position was US$ 1.4 billion negative (with the negative forward book standing at US$ 6.8 billion). Purchases in the market were initially applied to reducing the negative forward book. In February 2004, the negative forward book was finally squared off. Thereafter purchases in the market have been applied to building up the gross reserves. Reserves currently (end-December 2004) stand at US$ 14.9 billion gross and US$ 11.4 billion net (see graph).

4. Buying foreign exchange for this purpose on a continuing basis in the market has required careful judgement by the Reserve Bank's management as to the pace and scale of purchases, and clear communication to the market of the policy purpose being pursued; and it has also required considerable professional skills by the Reserve Bank's foreign exchange dealers. It has been important to conduct operations, and communicate with the market, so that the market understands that the exercise does not in any way compromise the Reserve Bank's inflation targeting framework, and in particular does not imply any attempt to manage the exchange rate, but is instead directed at taking opportunities when the market is active gradually to strengthen the foreign exchange reserves.

5. This exercise has clearly been helped by the general tendency of the rand to appreciate over the past three years, partly as a natural recovery from its temporary undue fall in the second half of 2001 and partly also reflecting the general weakening in the US dollar. In the process, the policy of purchasing foreign exchange to rebuild the reserves has helped at times to moderate the pace of the upwards adjustment of the rand. It has also materially reduced volatility in the currency, a process also helped by the steady improvement in international confidence in the economy to which the strengthening in the reserves has materially contributed: hence South Africa's recent rating upgrade from Moody's.

6. As an important element in communicating its policy purpose, the Reserve Bank publishes, within a few days of the end of each month, a full statement of its reserves, the changes over the past month and an explanation of the main changes. This has helped the market to understand the manner in which "creaming off" is conducted and to accept that it is being pursued in a way that in no way conflicts with the Reserve Bank's inflation targeting framework.

7. There is no specific target for the level of the reserves. The aim is gradually to build reserves to a level where the standard ratios of reserves adequacy, as applied by analysts and the rating agencies, puts South Africa broadly in line with normal levels for countries at South Africa's stage of development.

8. Beyond operations designed to strengthen foreign exchange reserves, the Reserve Bank executes normal customer operations on behalf of the government and other customers, and may from time to time smooth the execution of one-off large transactions in the market. But intervention designed to manage the exchange rate is not conducted. The exchange rate is determined by market forces and underlying movements in the exchange rate are taken into account in the decision of the Reserves Bank's Monetary Policy Committee in setting interest rates in order to maintain inflation (CPIX) continuously within the set target range of 3-6%.

Organisation of foreign exchange operations

9. The official foreign exchange reserves are held by the South African Reserve Bank and appear on its balance sheet. Gains/losses in domestic currency terms are, however, booked to the account of the government and the resulting net balance of gains/losses is settled annually between the National Treasury and the Reserve Bank.

10. Operations are undertaken by the Reserve Bank working within the framework of cooperation and communication provided for by working committees of National Treasury and Reserve Bank officials that monitor areas of common interest. Policy on official foreign exchange operations is made fully public, through regular communications, including monthly publication of reserve figures, and through policy announcements where necessary. The move to purchasing foreign currency to strengthen the reserves was announced when it was initiated in March 2003.

11. A proportion of the reserves is financed by medium-term borrowing from banks, on a syndicated or bilateral basis, by the Reserve Bank. Such borrowing currently amounts to US$ 3.5 billion. The remainder of the gross reserves of US$ 14.9 billion, ie the net reserves of US$ 11.4 billion, was financed in rand by purchases in the market. In addition, the National Treasury occasionally issues international bonds in foreign currency, the proceeds of which are typically sold to the Reserve Bank and added to the reserves, with the rand proceeds of the sale contributing to financing the government's budget. Foreign currency borrowing by the government represents only a minor component of its budget borrowing, the bulk of which is financed in the domestic bond market, which is well developed.

Domestic implications

12. All purchases of foreign currency for the reserves are fully sterilised in terms of their impact on domestic liquidity. The instruments the Reserve Bank utilises for this purpose are (reverse) repos of part of its holding of government bonds and the sale of Reserve Bank debentures, both generally at one-month maturities, along with occasional outright sales of government bonds to drain liquidity on a permanent basis.

Official gold and foreign exchange reserves