Note on the foreign exchange market operations of the South African Reserve Bank

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Abstract

Capital inflows to emerging market economies increased substantially following the global financial crisis and subsequent implementation of unconventional accommodative monetary policies in advanced economies. Strong portfolio inflows put significant appreciation pressure on emerging market currencies, raising concerns about export competitiveness and growth prospects. A number of emerging market economies intervened in the foreign exchange markets to limit currency appreciation pressure, including intervening in the spot market and taxing purchases of domestic securities. The South African Reserve Bank did not intervene, instead allowing the rand exchange rate to be determined by forces of demand and supply. The Bank did, however, take the opportunity to increase the level of the country's official foreign exchange reserves. The Bank had intervened in the foreign exchange market during previous episodes of *currency weakness*, but found the success thereof to be limited and the exercise costly. Despite this, the Bank recognizes that there are also costs associated with inaction in the foreign exchange market, which can be much higher than the costs related to intervention. Therefore, the Bank does not rule out the possibility of intervening in the foreign exchange market to dampen excessive exchange rate volatility and ensure both economic and financial stability.

Keywords: South African Reserve Bank, foreign exchange intervention, capital flows, foreign reserve accumulation, oversold forward book, net open foreign currency position

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1. Introduction

The rationale for and extent of the South African Reserve Bank (Bank) involvement in the foreign exchange market have always been a topic of serious debate. This was the case in the 1990s when the Bank provided forward cover to state-owned enterprises (SOEs) and also intervened in the market with the objective of influencing the level of the exchange rate. During 2010 the strength of the rand against other currencies came under the spotlight, with calls for the monetary authorities to “weaken the currency” in order to “achieve a competitive and stable real exchange rate”. However, with the depreciation of the rand seen since the second half of 2011, there was renewed focus on the factors driving the rand.

The purpose of this note is to elaborate on the South African experiences regarding foreign exchange intervention. The note deals with a historic perspective on the Bank’s foreign exchange operations, the objectives of the Bank’s current intervention in the foreign exchange market, and the Bank’s tactics in foreign exchange operations – also during the global financial crisis. The institutional arrangements pertaining to foreign exchange reserves accumulation will also be discussed.

2. Historic perspective on the Bank’s foreign exchange operations

The history of the Bank’s operations in the foreign exchange market can be classified into the following phases: extensive use of the forward market for purposes of providing forward cover; intervention to support the depreciating currency and to support market functioning; and finally, reserve accumulation. When the Bank’s official reserves were extremely low, and this was seen as adversely contributing to the country’s external vulnerability, the Bank also utilised foreign currency loans to prop up its gross reserves. The last outstanding foreign loans were repaid in June 2010.

After the announcement of the foreign debt standstill in September 1985, and the introduction of economic and financial sanctions against South Africa, the country had no access to international capital markets, which included no access to borrowing from the International Monetary Fund (IMF) or other official agencies. Consequently, the forward market was used to encourage and facilitate the use of foreign trade credits by domestic corporates as a mechanism for the Bank, inter alia, to accumulate foreign exchange reserves. During the 1990s, the Bank also provided forward cover at preferential rates, mainly to SOEs. The hedging of the foreign obligations of the SOEs was mainly via outright forward contracts. At this time, the country's foreign debt amounted to US$24 billion and the Bank had a net open foreign currency position (NOFP) of US$12 billion. The NOFP increased to over US$25 billion in 1995.

After the dual exchange rate was abolished in March 1995, the Bank managed to reduce the NOFP significantly from US$25.8 billion to US$8.5 billion in March 1996, mainly by purchasing foreign exchange from the market as well as purchasing the proceeds of government bond issues abroad.

The Bank also has a history of intervention for the purpose of “leaning against the wind”, and in some instances and for short periods, to impact the level of the rand. The exchange rate of the rand depreciated sharply in 1996, owing partly to speculative activity, and the Bank intervened in the foreign exchange market by increasing the forward book to US$22 billion. In 1997, the Bank was again successful in reducing the NOFP, by almost US$10 billion, but the 1998 emerging markets crisis occurred, and again the Bank intervened, with the NOFP returning to the levels recorded ten years before.

The Bank’s intervention to influence the spot exchange rate comprised a combination of spot and forward transactions conducted in the foreign exchange market. These interventions entailed the Bank selling US dollar spot and then entering into a swap transaction with another authorised dealer bank. In the swap transactions, the Bank bought dollars spot and sold dollars forward. In this way the Bank did not lose any spot dollars through its intervention, but instead built up commitments to deliver dollars on a forward basis (the oversold forward book). Such intervention, however, was not that common in other countries, although it was at times used quite extensively by the Bank during the first half of 1996 and during 1998.

Both these interventions (paragraphs 2.2 and 2.4) occurred during extremely challenging circumstances in the financial history of the country, and it took several years to address the economic and financial consequences of these interventions – for example, the NOFP due to the huge oversold forward book, and the losses on the Gold and Foreign Exchange Contingency Reserve Account (GFECRA). The latter account reflects the local currency valuations of the gold and foreign exchange reserves, which is normally settled by the National Treasury (NT).

Subsequent to the 1998 crisis, a decision was taken to reduce the NOFP to zero. The NOFP was reduced from USD22 billion in December 1998 to USD13 billion in December 1999 and to USD9.5 billion at the end of 2000. However, because of regional events at that time, the rand depreciated on a trade-weighted basis by 12.4 per cent during 2000. In 1998 the Bank publicly announced the suspension of the selling of foreign exchange to the market for the purpose of influencing the exchange rate, and confirmed its commitment to a floating exchange rate, with the level of the currency determined by the demand and supply of foreign exchange in the market.

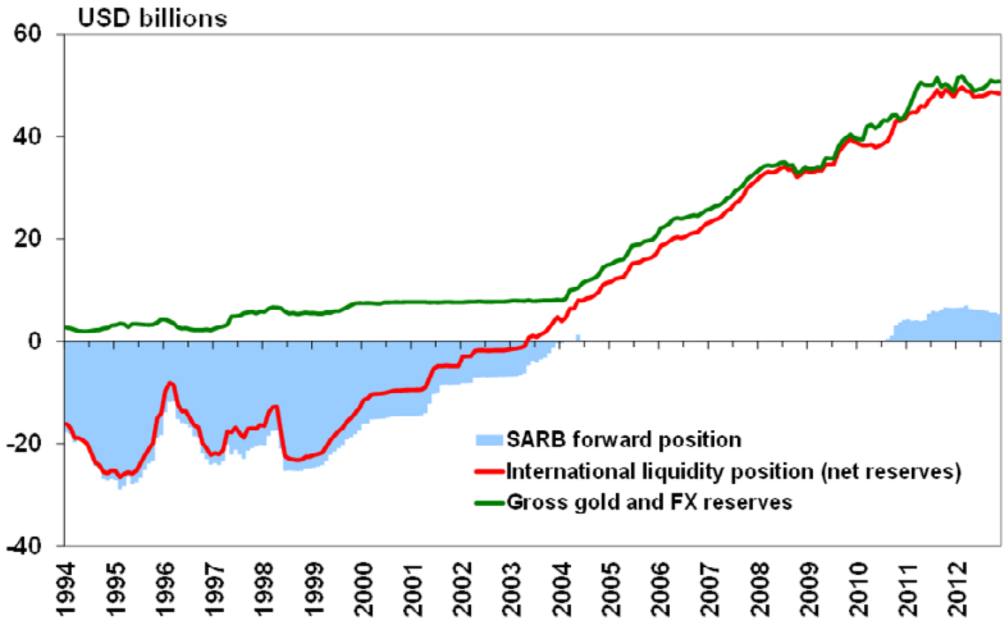
During late 2001, the rand depreciated by almost 40 per cent against the USD despite South Africa’s sound economic fundamentals. The Bank, however, maintained its commitment of non-intervention in the foreign exchange market and the rand reached a level of R13.84 to the USD. Many arguments were put forward to explain the depreciation of the rand, including negative perceptions associated with regional instability, lack of foreign direct investment in the country, low economic growth and high unemployment, exchange controls, and the existence of the oversold forward book.

In 2003, after the NOFP was eliminated, the Bank started accumulating reserves by buying foreign exchange reserves on a spot basis. However, some of the foreign exchange purchased spot was swapped forward to match some of the oversold forward maturities. This led to the gradual reduction of oversold positions and ultimately the squaring-off of the forward book in February 2004. Effectively, spot purchases were swapped to dates of forward sales to match the sale of dollars forward in the books of the Bank.

The process of accumulating foreign exchange reserves has been successful over the past decade. Since March 2003, the official reserves improved from a negative NOFP of US$1.4 billion to an international liquidity position of US$47.9 billion as at the end of December 2012. During the same period, the forward book improved from an oversold position of US$6.8 billion to an overbought position of US$5.2 billion, while the official gross gold and foreign reserves amounted to US$50.7 billion at the end of December 2012 (Graph 1). The current overbought forward position reflects the commitment by the Bank to buy foreign currency against the rand at a future date. The oversold forward position, however, reflected a future commitment which had to be covered by purchasing foreign exchange.

Official gross gold and foreign exchange reserves plus forward position

Graph 1



3. The objective of the Bank's intervention in the foreign exchange market

Many countries react to exchange rate movements through some type of intervention, which is broadly defined as those activities undertaken by monetary authorities designed to influence the level of the exchange rate or to impact on unusual fluctuations in the value of the currency relative to others. Central banks will typically intervene if currencies are under extreme stress, or if they believe that they are misaligned to, or dislocated from, fundamentals, as well as if the spot market is overreacting, causing extreme volatility. However, countries also intervene for purposes of foreign exchange reserve accumulation.

The foreign exchange operations of the Bank are not aimed at managing the rand exchange rate, but directed towards gradually building up the official foreign exchange reserves, managing domestic liquidity and meeting clients' foreign exchange needs. The Bank, therefore, does not target a level for the exchange rate of the rand, or seek to counter forces of demand and supply. This is consistent with the Bank's overall monetary policy framework, which is based on inflation targeting and a flexible exchange rate. The current exchange rate policy of the Bank is alluded to quite often in public speeches by the Executive of the Bank, and as such is well known to the public.

The Bank is not indifferent to challenges posed by volatility of the exchange rate and takes these into consideration in its Monetary Policy Committee (MPC) deliberations. It is generally acceptable for central banks operating within a flexible exchange rate system to maintain orderly market conditions, and thus they may also have to add liquidity in certain circumstances. The Bank, therefore, stands ready to become involved in the foreign exchange market to smooth out abrupt adjustments so as to facilitate an orderly functioning of the foreign exchange market, as well as for financial stability reasons.

Regarding the level of the exchange rate and competitiveness, while it is acknowledged that certain sectors of the South African economy have been affected by what may be perceived to be a relatively strong exchange rate of the rand, it is crucial to highlight the importance of inflation management in this regard. If the nominal exchange rate were to depreciate without inflation being controlled at the same time, there would be no improvement in the level of competitiveness. The real exchange rate is therefore important.

4. Bank's tactics in foreign exchange operations

South Africa has highly developed and liquid foreign exchange markets, including a well-established bond market and a sophisticated equity market. The main foreign exchange derivatives instruments comprise outright forwards, foreign exchange swaps, forward-forwards, currency futures and currency options, as well as currency swaps and basis trading. In its current foreign exchange transactions aimed at reserves accumulation, the Bank mainly conducts spot purchases from the market, funded by both the Bank and the National Treasury (NT). In addition to conducting spot purchases, the Bank utilises foreign exchange swaps with maturities of up to 12 months to fund purchases and for purposes of general domestic money-market liquidity management.

The Bank's participation in the foreign exchange market is informed by volatility conditions, the liquidity situation in the market and cost considerations. However, in certain exceptional circumstances where South Africa experienced considerable foreign direct investment inflows, the Bank directly purchased these flows as off-market transactions to accelerate the process of accumulating foreign exchange reserves, and to ensure the smooth execution of transactions which were exceptionally large relative to the size of the market. As at the end of November 2012, the average daily turnover in the spot rand market amounted to approximately US$4.0 billion, while the total net average daily turnover amounted to approximately US$22.0 billion.

The Bank does not conduct pre-announced foreign exchange interventions, but communicates its foreign exchange operations through a regular monthly publication of reserves figures, which includes a brief explanation of the main changes, and it publishes information about foreign exchange activities in its Annual Reports. This has helped the market to understand and accept that the Bank is consistent in its foreign exchange operations and that the policy being pursued is in line with the Bank's inflation-targeting framework.

The South African monetary authorities do not have a target level for foreign exchange reserves, but use generally accepted measures such as import cover, an augmented Guidotti Ratio, and the Jeanne-Rancière model as guidelines for reserves adequacy.

5. Foreign exchange operations during the global financial crisis

Strong capital inflows into emerging-market economies, including South Africa in the past few years have presented policy-makers with the challenge of appreciating exchange rates, which raised concerns about the competitiveness of the export industries. Some emerging-market countries have implemented measures such as taxes on the purchase of domestic fixed-income securities and equities, and pre-announced currency market intervention programmes, in order to limit currency appreciation and build foreign exchange reserve balances.

South Africa studied all these measures and found that they would not be appropriate for its economy, given that South Africa's savings and investment imbalances make the country dependent on portfolio flows to finance the current-account deficit. In addition, the efficacy of some of these measures has been doubtful in terms of achieving the desired results. Therefore, South Africa has not deemed it necessary to adjust its approach to official involvement in the foreign exchange markets in any material way.

6. Institutional arrangement pertaining to foreign reserve accumulation

Although the Bank also carries the cost of foreign reserves accumulation in various ways, the National Treasury (NT) has funded the major portion of foreign exchange purchases since 2005. This funding is reflected on the Bank's balance sheet as a rand- as well as foreign-currency-denominated deposit.

The accumulation of foreign exchange reserves by the Bank has resulted in an increase in official reserves on its balance sheet. However, because of the Bank's policy of sterilised interventions, the Bank's domestic liabilities increased with the issuance of the securities (SARB debentures) that it had to issue for sterilisation purposes. Some of the Bank's foreign exchange purchases were sterilised through government deposits and by using foreign exchange swaps. The utilisation of foreign exchange swaps has the advantage of temporarily postponing the domestic money-market liquidity impact, but costs are still incurred in the process. The rand costs are transferred to the government's account via the GFECRA, while the US dollar cost is reflected in a decline in the foreign exchange reserves. The other instruments that the Bank uses for sterilisation purposes are reverse repos of part of its holding of government bonds, and government deposits with the Bank.

The costs of sterilisation increased substantially as the Bank accelerated its accumulation of foreign exchange reserves. Given the interest rate differentials between South Africa and the major advanced economies, the Bank incurred losses, since it pays high interest rates on its domestic liabilities but earns low returns on the foreign exchange assets held on the balance sheet. In addition, the Bank is exposed to significant valuation effects stemming from both currency and interest-rate risk on its foreign assets.

Valuation gains/losses on gold and foreign exchange holdings in domestic currency terms are, however, for the account of the government and the resulting net balance of gains/losses is settled from time to time as and when agreed between the Bank and Government. However, the portion of the net balance with a cash flow or money-market liquidity impact is settled annually. Because the Bank's interventions are sterilised, there is no impact on the commercial banks' credit extension stemming from the Bank's foreign reserves accumulation.

The Bank has not experienced problems with monetary policy implementation due to its foreign exchange operations. However, from time to time the Bank does encounter challenges, specifically with its open-market operations. But these are addressed by continuous evaluation and relevant adjustments to its operational procedures.

7. Concluding remarks

The Bank's involvement in the foreign exchange market is mainly for the purpose of accumulating foreign exchange reserves. The Bank does not intervene to try and manage the level of the exchange rate, and it adheres to a policy of a flexible or floating exchange rate. However, this does not mean that the Bank is indifferent to challenges posed by volatility of the exchange rate. The Bank therefore stands ready to become involved in the foreign exchange market to smooth out abrupt adjustments, to facilitate an orderly functioning of the foreign exchange market, and for financial stability reasons.

Given the micro-structure of the domestic foreign exchange markets and the complex dynamics associated with it, it will be a challenge for the Bank to have an impact on the level of the exchange rate. The high volatility could be ascribed to the fact that the market is deep and liquid for an emerging market economy, and should not be confused with inefficiencies and structural deficiencies in the foreign exchange market.

At the macro level, a flexible exchange rate regime allows the central bank to follow an independent monetary policy framework of flexible inflation targeting, which is deemed suitable and appropriate for the economic conditions of the country. As a result, monetary policy in South Africa aims to achieve price stability, while the nominal exchange rate adjusts to balance the external accounts.