

An address given to the Investment Analysts Society, 24 June 1980

The South African forward exchange market

I must say that when I was first approached in connection with this talk this afternoon, my initial reaction was of some apprehension in being asked to address such a distinguished audience on what I perceive to be a rather mundane although, let's face it, very topical subject. I don't really want to go into too much detail this afternoon and will confine myself to the basic principles involved which I think will be more useful to you.

The key aspect of any forward exchange market is the forward premium/discount rate and (so that we all know what we're talking about) I think we should start with a brief definition or explanation of this. I would say that a forward premium or discount is the cost or benefit to an exporter or importer, who has contracted to sell or receive goods quoted in a foreign currency, of covering that currency back to his own from the date of order to the date of payment or receipt. This cost or benefit – we call it a premium or discount – will be expressed in the foreign exchange market as points, which are applied to the spot rate to get to the forward rate. The discount or premium will be expressed as a percentage per annum.

In the case of a South African importer having a foreign currency obligation, he will at the moment enjoy a *discount* in covering forward from the rand to the dollar, although if he has to go beyond the dollar, for instance to the Swiss franc, he may find that the *premium* he pays on the Swiss franc leg will exceed the discount he would receive on the rand/dollar leg. Equally, a South African exporter who has contracted to sell his goods in a foreign currency would pay a *premium* to get from a foreign currency (for instance the US\$) back to the rand and this would be expressed as a cost percentage p.a. based on the period for which the exporter required cover. The reason why an importer and exporter will wish to take cover is obviously to close any foreign currency exposure that they might have and to fix in rand the amount they will have to pay or will receive. At the moment in terms of the South African Reserve Bank regulations, an importer or exporter can cover a maximum of 12 months without special approval, which could be from the date that he places or receives an order at the earliest until the date that he pays or gets paid at the latest.

However, in the case of an *exporter*, there has to be good justification to take the period beyond 6 months (for instance in competing for a new market overseas or in matching international competition or because the type of goods exported warrants the extended period of credit). However, a basic principle of financing is that the period of credit extended should not exceed the useful life of

whatever it is that is being financed – for instance it would be very difficult to justify a credit period of more than 6 months for a shipment of bananas or maize. However, before we get involved with the influence that the forward premium or discount has on credit periods and costs, I think we should go back and briefly trace the recent development of this forward rate in our South African market.

You may all remember that for the last few years an importer and an exporter both paid the Reserve Bank 1% p.a. (in other words a 1% premium) in order to cover their imports and exports from and to the US dollar. Having got the US dollar cover, a foreign exchange dealer could (and still can) take out the third leg of any cover that might be required in the international foreign exchange markets. The old system of covering rand to dollars was at least a mechanism whereby importers and exporters could fix their rand obligations and proceeds, but the amount of the premium was a purely arbitrary figure and had nothing to do with underlying foreign exchange markets and interest rates.

That system had been in operation for several years until about 15 months ago when, as I'm sure you will all recall, the De Kock Commission recommended certain changes to our South African foreign exchange market. One of the changes was the scrapping of the public selling and buying rates which sadly removed the rather comfortable 0,5% turn that a South African authorised dealer made on handling a foreign exchange transaction, but more significantly the De Kock Commission recommended a major change in the principles underlying the rates quoted for forward exchange cover. The Commission proposed that these rates should henceforth reflect interest rate differentials between the South African and the US dollar rates, which was a very correct recommendation and is, after all, the way that forward premiums and discounts operate throughout the rest of the world. Just to prove this point let us suppose that we were all living in Germany and I was your banker and you had imports from the United States which you asked me to cover. I would basically have to sell my holding of DM's spot, converting them into US \$ and put them on deposit in the US until the date when you had to pay your US supplier. The rate that I would quote you for covering your US dollar obligations would obviously be based on the interest rate differential between the two centres for the period concerned.

If we have a look at some current international deposit rates and forward premium/discount rates, you will see what I mean.

Forward rates against the US dollar

Currency	Spot rate	3 month rate	Premium or discount	6 months rate	Premium or discount
£	2,3400	2,2950	7,69D	2,2710	5,89D
DM	1,7650	1,7645	0,11P	1,7590	0,75P
SF	1,6300	1,6140	3,92P	1,5970	4,04P
DFL	1,9350	1,9400	1,03D	1,9340	0,85D
YEN	215,40	216,60	2,22D	216,45	0,97D
BFR	28,26	28,59	4,67D	28,83	4,05D

Euro-deposit rates (%)

Currency	3 month	6 month
£	16 $\frac{7}{8}$	15 $\frac{1}{8}$
DM	9 $\frac{1}{16}$	8 $\frac{1}{2}$
SF	5 $\frac{3}{8}$	5 $\frac{1}{4}$
DFL	10 $\frac{1}{4}$	10 $\frac{1}{16}$
YEN	11 $\frac{1}{2}$	10 $\frac{1}{4}$
BFR	14	14
US\$	9 $\frac{1}{8}$	9 $\frac{1}{8}$

You will notice that by adding the relevant forward premium to or by deducting the forward discount to the dollar from any Euro-deposit rate you will arrive back very close to US dollar deposit rate.

This proves one vital principle and if you forget everything else I say this afternoon, please remember just this one point. That forward premiums and discounts reflect interest rate differentials. They have at best *very little* and usually *nothing* to do with expectations of currency movements.

Now, around April last year, arising out of the Reserve Bank's acceptance of some of the De Kock Commission's recommendations, the Reserve Bank immediately moved from the old 1% premium for both importers and exporters to a 2% discount for importers and a 2% premium for exporters. This more or less reflected the interest differentials between South African and US dollar rates at that time. Shortly after implementing this change, South African rates moved down and US interest rates started to rise. This would have been around May last year, and as you all know, that rate remained unchanged right up until the 17th April this year. This was even though South African interest rates had continued to move down, and US interest rates had moved up and continued to move up more rapidly through the last quarter of last year and the first quarter of this year.

So, why didn't the Reserve Bank change the 2,5% rate, when this was obviously the wrong rate in the market? Well to answer that, we have to look at the South African Reserve Bank's overall forward currency book. As you will remember at the time (May last year, and this continued throughout the period to September), importers were tending to cover because they felt that there was a cap on the rand, as to how high the rand would be allowed to go against the US dollar, and that the rand would not move up by more than 2,5% p.a. It therefore made good commercial sense for them to take advantage of the 2,5% discount.

Exporters, on the other hand, a large proportion of whom sell for cash and who might not be interested in cover in any event, also felt that the rand would not move up by more than 2,5% p.a. and therefore they tended not to cover. On the capital side as well, private sector companies and public sector corporations, who had borrowed overseas, would have taken out cover with the South African Reserve Bank through to the dollar (some of them getting a special rate through to the Swiss franc and DM) whereas there was no converse entry in the South African Reserve Bank's books because South Africans, as you know, are not allowed to make loans abroad without specific approval.

All this contributed to a total unbalanced book at the Reserve Bank during the period – I guess at up to 3 billion rand. Now a central bank, using the same principles as we discussed earlier on, would normally lay off this imbalance

by placing funds on deposit overseas to earn the interest rate differential. However, in South Africa's case, our foreign currency cash reserves were at a very low level throughout this period and the amount that was available for placing on deposit overseas was nowhere near the amount of the total imbalance of the Reserve Bank's book. The result was that the Reserve Bank had in effect to lay off this exposure with the South African Treasury (which flows through to all of us) and one of the effects of implementing the De Kock Commission's recommendation was that the South African taxpayer was subsidising South African importers to the extent of 2,5% p.a. To have increased the rand/dollar forward exchange rate at a time when there were no basic changes in the rand/dollar exchange rate expectations, would have had no effect on the fundamental imbalance, but it would have meant, if the rate went to 5 or 7,5%, that we continued to subsidise the South African importer but at a much higher level.

That position pertained through until around about September last year, when, because the gold price had started to climb, South Africa's current account surplus had started to widen and expectations changed to the view that the rand would tend to move up against the dollar by *more* than 2,5% p.a. This was reinforced by the belief that the US dollar would continue to be weak against our major trading partners (and you must remember that the Reserve Bank uses a basket of currencies in setting the rand/dollar exchange rate). So around last September a change started to appear in the forward exchange market whereby importers tended no longer to cover, and exporters (using the converse of the argument) tended to cover. By November, as a result of this change, the feeling was that the fundamental imbalance of the Reserve Bank had reduced to below 2 billion dollars. At that stage, it would have been possible for the Reserve Bank to have increased the forward premium/discount rate, perhaps even to have doubled it, and yet to have taken the same amount out of Minister Horwood's pocket – up to 100 million rand p.a. (2,5% x R3bn or 5% x R2bn).

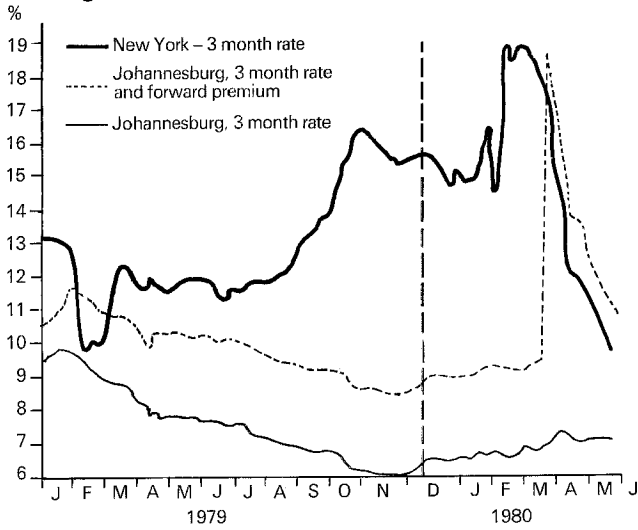
Anyway, this was not done at the time because I guess it would have achieved nothing positive and in any event, at that particular stage, another important situation was developing – this of course was the liquidity inflow, which arose from the continually rising gold price through November and December last year, causing a build-up of surplus liquidity in the South African money market at a time when the Reserve Bank felt that short-term interest rates were already too low. The Reserve Bank found the 2,5% forward exchange rate level was a useful tool in controlling this liquidity as importers and exporters set about changing their terms of trade to take advantage of what became increasingly attractive means of financing South African trade.

You will see that a South African exporter quoting in dollars was in a position to offer his foreign buyer finance at all-in rates of around about 9,5% p.a.

You can also see, supposing this importer was an American concern, that the US domestic interest rates were rising throughout this period and this gap was becoming wider and wider and consequently exporters found that they had a new and very useful marketing tool which they used on a broad basis. Importers, on the other hand, suddenly found it attractive both from their own and their foreign suppliers' point of view to pay for their imported goods as soon as possible, even though they

may previously have been having 2 or 3 months free credit, and to obtain a discount. Let's look at some figures:

Foreign vs local trade finance costs



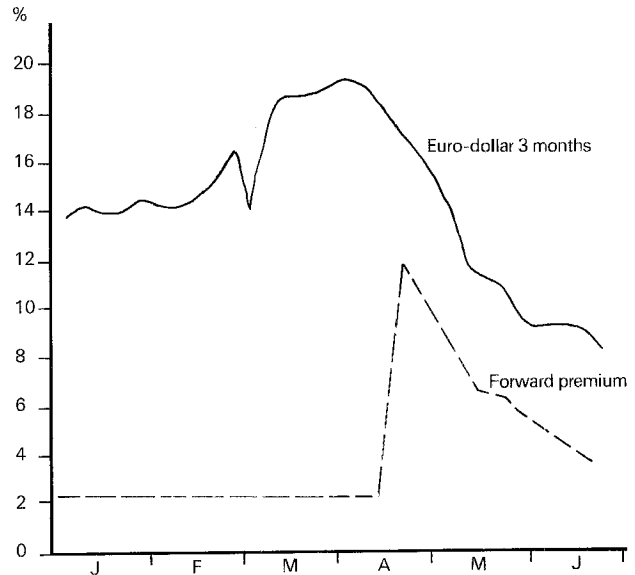
The discount would be pitched at a level which took into account the cost to the importer of financing himself in South Africa for this additional period, but nonetheless made it attractive for the foreign exporter to receive cash at an earlier stage and thereby to reduce his (very expensive) foreign overdraft. We have been assuming that the trading partner had been quoting in US dollars, but you will see from what I said earlier that whether he was British or German or Swiss or French really doesn't matter because having got into the dollar at a very cheap rate, he could then, using the forward markets, get into these other currencies at equally cheap rates. And so this whole saga of rand financing, as we call it, developed and the figures involved became enormous. I would say that during the period November until early April, the amounts were running at around about 4 - 500 million rand per month.

Now, whilst these figures were equalled by the current account surplus inflow, there was no major drain on the net reserves as far as the Reserve Bank was concerned and, by keeping the forward rate down at an unrealistically low level, the Reserve Bank was able to control what would have been an embarrassing inflow of liquidity. I believe that this was entirely the right strategy at the time. However, it was a rather dangerous game, simply because the figures involved were so large and when finally the gold price started to weaken and the country wanted to have a flexible gold sales policy, the low level of the Reserve Bank's foreign cash reserves simply did not permit this. Also at that time it came to the Reserve Bank's notice that at least one bank in South Africa was using the South African money market to finance international trade, and of course that is simply not on. The concept of South Africa becoming lender to the world on an ongoing basis (although satisfying and good for our morale) is plainly ridiculous. (Funnily enough, this is exactly what happened in Britain some 5 years ago, when the Bank of England was eventually forced to close the window on the use of the London Acceptance Market for financing international trade.) And so we came to the major move on 17th April this year when the Reserve Bank increased the forward cover rate from 2,5% to 12% p.a. which, at that stage, was the interest differential between South African and US interest rates.

To have moved the rate by any lesser amount would have

been ineffective because the interest rate gap was still there for traders to take advantage of, although at a lower level of profitability. I prefer to think of the Reserve Bank's action as simply a reflection of the fact that it had run out of room to manoeuvre, rather like a sailing boat on the one tack getting too close to the shore and being forced to tack the other way. It did not mean that the policy had changed, but merely that the Reserve Bank was pursuing another tack to get there.

Euro-dollar rate vs forward rand premium



Well, as you know the 12% (the second best bargain of the year) didn't last very long and for two good reasons. The first was that following the increase from 2,5% to 12%, the 12% applied for the full period, this is anything from 2 weeks up to 12 months. However, as I explained before, this forward cover rate should reflect interest differentials and it didn't take the market and the Reserve Bank very long to realise that whilst 12% might have been the correct differential at the 1, 2 and 3 month maturities, it certainly was not the correct differential for any longer period. This was because the Euro-dollar interest rates were expected to decline and the 6, 9 and 12 month rates were considerably less. Therefore, early the following week the Reserve Bank split the forward exchange rate into the three maturity bands which we still have today, namely:

- (i) 1-121 days, which spans the 3 month maturity period;
- (ii) 122-243 days, which spans the 6 month maturity period; and
- (iii) 244-365 days, covering the longer end.

Further, as the US recession started to bite deeper, the US interest rate structure started to decline at a rapid pace so that we find today that the 3 month Euro-dollar rate, which had been as high as 20% when the Reserve Bank pushed the premium to 12%, has now declined to around the 9% level and of course the premium, now accurately reflecting deposit rate differentials, has come down by a similar amount. At the moment the Reserve Bank is setting this forward exchange rate in neutral territory. In other words, it is neither favouring use of domestic nor overseas finance. But of course, it is a useful tool with which to influence trade finance and I am sure we will continue to see it used again in the future.

The South African forward exchange market

We keep another chart on a daily basis showing which way we think the premium should move according to relative interest rates

Months	1	2	3	6	9	12
1. Euro-deposit rates	9,00	9,06	9,25	9,25	9,06	9,13
2. SA deposit rates	4,50	4,75	5,00	5,50	5,75	6,00
3. Difference between 1 and 2	4,50	4,31	4,25	3,75	3,31	3,13
4. Forward discount/premium	4,00	4,00	4,00	3,50	3,00	3,00
5. Margin between 3 and 4 (possible future movements in forward rate)	0,50↑	0,31↑	0,25↑	0,25↑	0,31↑	0,13↑

From today's chart you will see that the Reserve Bank can be expected to increase the 3 and 6 month rates by 0,25% and don't pay too much attention to the 1 and 2 month rates because very little financing takes place over this short period.

If the differential moves out beyond 0,5% in any period, we will naturally assume that the Reserve Bank is once more trying to influence traders to finance here or overseas and this will be one useful pointer to see which way the Reserve Bank is currently seeking to influence domestic liquidity and local interest rates, the foreign reserves and the exchange rate. But we are still left with the Reserve Bank's fundamental problem of its imbalanced forward exchange book. However, as expectations abound that the rand will rise by more than the forward cover discount for importers and premium for exporters, importers will increasingly tend not to cover and exporters to cover, thereby reducing the imbalance. But more importantly the cash portion of South Africa's foreign reserves should now be building up rapidly and enable the Reserve Bank to have a larger quantum of money to place on deposit overseas to earn interest differential, which can then be placed against the losses sustained on its forward currency book.

Ladies and gentlemen, in conclusion, I would have thought that the implications of this new flexibility of

management of the forward exchange rate between the rand and the dollar will lead inevitably to greater liquidity. After all, at a gold price of even \$500 an ounce, we have a current account surplus at the rate of some 3,5 billion rand p.a. (at \$600 this rises to R5 billion) and of course, as traders return to their more normal terms of trade, the short-term capital outflow which took place earlier this year is starting to reverse. It is impossible to put a precise figure on this, but if we assume that the amount of capital which went out of the country during the period from October to April was in the range of 2-3 billion rand, it would not be unrealistic to expect a short-term capital inflow of at least R200 million a month over the next few months. Add this figure to the current account surplus and you will see that the net capital inflow will be running at some R600 million per month for the next few months. This is an extremely healthy situation and will obviously enable the government to maintain its expansionary policies. This is in marked contrast to previous economic recoveries. After all, every time the government has gone on an expansionary tack in recent years and the import bill mounts up, we have almost immediately run into balance of payments difficulties. Somehow, I don't think that that is going to happen too quickly this time around, and the government will have a free rein to deal, hopefully, with other, more pressing problems.