Capital flows, exchange control regulations and exchange rate policy: The South African experience

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1. Introduction

The relationship between capital flows, exchange control regulations and foreign exchange policies has long occupied policymakers in South Africa. In particular, outflows on the capital account in the late 1950s resulted in tighter and more pervasive exchange controls, initially on residents but extended to non-residents after 1961. These controls on non-residents in turn resulted in a parallel exchange rate system which was abolished only in 1995. The transition to democracy in the 1990s, however, resulted in the nature of the relationship between capital flows, exchange control regulations and foreign exchange policies changing once more. The process of reintegration into world financial markets has provided opportunities for liberalising exchange control, and also new challenges for policymakers.

It is well known that in a competitive model characterised by perfect foresight and complete markets, the welfare benefits of free capital movements are identical to those from free trade. As the comprehensive survey by Dooley (1996) notes, capital mobility in this context allocates capital to its most productive uses across countries, and enables residents of different countries to engage in welfare improving intertemporal consumption smoothing. When these competitive model assumptions do not hold, however, and market failures ensure that “second-best” considerations are important, any number of welfare-enhancing arguments for exchange controls may be developed.¹

The recent empirical evidence is also mixed. An examination of the evidence by the IMF (Prasad et al, 2003), for example, suggests that it is difficult establish a robust link between financial integration into the world economy and output growth. These issues are not focussed on here, however, except insofar as they are relevant to the objective of the paper which is to review of the South African experience with capital flows, capital control regulations and exchange rate arrangements.²

¹ The interested reader is referred to Eichengreen (1999), Dooley (1996), Neely (1999) and de Brouwer (1996)

² Exchange controls were administered throughout the period under review by the Reserve Bank on behalf of the government. To quote the previous Governor of the SARB, Chris Stals (1996)

It should be noted that throughout this period, the responsibility for exchange control
In line with this objective, the discussion tends to focus on capital controls, defined here as restrictions which affect capital account transactions (usually portfolio investments), rather than the broader set of transactions (including current account transactions) affected by exchange controls. The paper begins by discussing the evolution of the system of exchange controls prior to 1983 in Section 2. Section 3 then considers the 1985 debt crisis and the re-imposition of controls, and Section 4 discusses developments in the post-1994 period. Section 5 concludes by looking at the policy challenges currently facing policymakers.

2. The evolution of the system of exchange control: South Africa prior to 1983

Exchange controls have a long history in South Africa, dating back to at least 1939.³ For present purposes, the British influence is of particular interest. As a legacy of the British Empire, in the post-1939 period South Africa had a system of exchange control (a ‘ring fence’) similar to that in Britain and other Sterling Area countries (Miller and Wood, 1979; Stals, 1996), although Gidlow (1995: 180) argues that controls on capital transfers were minor from the immediate post-war period until the late 1950s. At this time controls on residents were tightened somewhat, and then tightened further in 1961 in response to the large-scale capital outflows experienced in the wake of the Sharpeville massacre (Figure 1). Particularly significant was the decision to block the repatriation of the proceeds of sales of South African securities by non-residents at this time. Given the historical links, it is perhaps not surprising that a system with similar characteristics to the British securities sterling mechanism evolved from this decision. This system was for most of the period until 1995 the most visible indication of the exchange control regime in South Africa.

³ Morgenrood (1991: 120-1), however, dates the use of controls back to the late 18th century Cape.
The historical evolution of the system also provides a striking example of the relationship between capital controls and parallel foreign exchange markets, and the perhaps unintended consequences of controls. When the controls were introduced, they were considered to be an emergency short-term measure. To quote De Kock (Lange and van Wyk, 1979:38), later to be governor of the South African Reserve Bank:

We never thought at the time that we were instituting a dual exchange rate system. We thought we were simply applying exchange control, blocking funds of non-residents ... We did talk about it at the time. I mean even in those days there were people in South Africa who had heard of dual exchange rate systems, and there were some suggestions that we should, in fact, institute a formal dual exchange rate system. But we decided against this, partly because the extended exchange control was considered to be a temporary crisis measure (emphasis in the original).
As is now well known, however, these controls duly resulted in a parallel exchange rate system known as the ‘blocked rand’, which evolved via the ‘securities rand’ into the financial rand system. The evolution of the system is traced in this section.

2.1 The Blocked Rand

In terms of the Exchange Control Regulations introduced in 1961, the proceeds of sales of South African securities by non-residents were blocked within the country, and deposited in blocked rand accounts with commercial banks. The balances could only be repatriated under certain circumstances; in general

i non-residents could use blocked rand to purchase shares quoted on the Johannesburg Stock Exchange (JSE), which could be endorsed, exported and sold outside the country (and if the new non-resident owner of the shares sold them in South Africa, blocked rand were again created).

ii the non-resident could use the blocked rand to purchase government, municipal and public utility stocks with a maturity of five years or more. Once these had been held for at least five years, they could be repatriated at the official rate.

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4 Internationally, the use of dual or parallel exchange rate systems (loosely defined) dates back to at least the immediate post-war period, although the best documented formal examples of these systems were implemented in the early 1970s during the breakdown of the Bretton Woods system. With the increased volatility of international capital flows at that time, dual or two-tier exchange rates attracted attention as a means of dealing with disequilibrating flows. Between 1971 and 1974, several European countries employed dual exchange rates systems (most notably Belgium, France and Italy), and much of the early literature focuses on this European experience. Subsequent experience with these systems, albeit of a less formal type, has generally been in developing countries.


6 This was withdrawn in the 1978 budget after the provision had attracted criticism for a number of years as a result of the extremely high yields to redemption on offer. Gidlow (1979: 260), for example, cites the example of the Escom five year stock issued in April 1977. The stock had an annual yield of 12.15 per cent to local investors, which converted to a current yield of 20.5 per cent p.a. (and to over 28 per cent to redemption) to foreigners once the securities rand’s 41 per cent discount to the commercial rand was taken into account. Under the new arrangements, in place from 30 March 1978, the proceeds of such stocks could only be repatriated on redemption through the securities rand or invested in new 6 per cent bonds introduced by the Treasury. The semi-annual interest payments and proceeds on redemption of these bonds could be freely repatriated.
the non-resident could use the blocked rand to take up special non-resident bonds with five year maturities issued by the government. These could again be repatriated at the official exchange rate on maturity.

Note that blocked rand were not freely transferable from one non-resident to another. It has been argued that the authorities were not willing to allow this since it would have granted official recognition to the blocked rand exchange rate, an action which it deemed undesirable in an era of fixed exchange rates (Gidlow, 1976: 87). Notwithstanding this position, the first option listed above enabled a market for blocked rands to be made by London stockbrokers where blocked balances were freely transferred between non-residents using a method known as ‘gilt-wash’. This parallel market could be characterised as legal, although not officially recognised.

Via the ‘gilt-wash’ method, a de facto second currency emerged. To illustrate the functioning of the method, consider the following example: a non-resident holder of blocked rand uses them to purchase gilt securities from a South African financial institution through a local stockbroker. This stockbroker then ‘sells’ the scrip to his or her London counterpart for pounds (the London stockbroker makes the market by quoting a price for blocked rand in sterling). The London broker duly ‘sells’ the scrip back to the local broker, who in turn ‘sells’ it back to the financial institution. The pounds go to the non-resident, and the London broker has an account in South Africa credited with blocked rand.

Despite the number of transactions listed here, in practice no physical movement of scrip took place (South African financial institutions essentially ‘lent’ gilts in return for a commission). Gilts were generally used in preference to ordinary shares because of their lower brokerage rates, and greater availability (Gidlow, 1976: 89). The blocked rand generally traded at a discount to the official rate, reflecting the relative demands for

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7 The reasoning would seem to have been that recognising the (weaker) blocked rate would have cast doubt on the country’s ability to maintain the official rate, and encouraged speculative capital flows.

8 For amounts in excess of R100 000, these were between 1/8 and 1/16 per cent.
South African shares by residents and non-residents, and the existence of exchange controls on both sets of transactors.⁹

2.2 *The Securities Rand*

Although the possibility of abolishing the blocked rand mechanism was broached at various times (Third Report of the Commission of Enquiry into Fiscal and Monetary Policy in South Africa, 1970: 250-254), changes were announced only in 1975. Amid alterations to exchange control regulations aimed at attracting investment, the ‘securities rand’ was introduced in February 1976.¹⁰ This allowed for direct transfers between non-residents, and for the trading of the currency through brokers on the JSE.

As Gidlow (1979: 255) notes, one of the reasons for the changes was the belief that securities rand transactions would be diverted from London to Johannesburg. This did not materialise, primarily because of the dominance of London as a financial centre. The familiarity of non-resident investors with London, the technical superiority of the market, and the operation of London dealers as principals in the securities rand market were all contributory factors here.

The securities rand operated until 1979, when it was replaced by the financial rand on the recommendations of the interim report of the De Kock Commission (Interim Report of the Commission of Inquiry, 1978). This report was particularly important in determining the structure and evolution of the financial rand system, and is therefore discussed at greater length in the next section.

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⁹ In addition, Gidlow (1991: 48-49) notes that non-resident companies wishing to repatriate the proceeds of, say, asset sales, but refused permission by the exchange control authorities, would be forced to use the gilt-wash method. The resulting increased supply of blocked rand tended to widen the discount.

¹⁰ Note that the term ‘blocked rand’ was retained for emigrants’ accounts, which could not be freely transferred (see also Section 4.4).
2.3 The First Interim Report of the De Kock Commission

From the late 1970s, the policy-making environment in South Africa assumed a more market-oriented profile. Gerhard de Kock, later Governor of the Reserve Bank between 1981 and 1989, was influential in this regard, particularly as a result of his chairing of the Commission of Inquiry into the Monetary System and Monetary Policy in South Africa (the De Kock commission). Asked by the government to initially investigate exchange rate arrangements in South Africa, the commission published its interim report in January 1979. In line with de Kock’s own convictions, the commission’s investigation of exchange rate policies worked from the premise that exchange controls were ‘fair weather’ arrangements which worked best when required least.

In essence, the commission proposed an evolutionary process of reform of the exchange rate system (para 110), which entailed both short-term and longer-term recommendations. In the longer-term, the commission considered a number of alternatives to the existing ‘variable rand-dollar peg combined with the securities rand’ system, including a formal dual exchange rate system (DRS). On the assumption that the pressures on the capital account of the balance of payments would ease over time, the commission opted in the long-term for a unitary rand, subject to a ‘managed float’, with limited exchange controls being applied only to residents.

In the short-term, the commission recommended (para 149) that the securities rand system be gradually expanded into a

more developed and formal system with a managed, market-determined rate for an independent and flexible ‘commercial rand’ and a more freely floating rate for a ‘financial rand’.

The envisaged developments in the securities rand system included extending the uses which non-residents could make of the currency, as well as allowing certain resident transactions to take place via the market.
As far as non-residents were concerned, the widening of the market was intended to remove the imbalance between the sources of and uses for securities rand reflected by the existence of the financial rand discount. Equity investment and disinvestment in all real and financial assets, transfers from deceased estates to non-residents, and immigrants funds were all recommended as financial rand transactions (para 239). Residents’ use of the financial market, on the other hand, was to be expanded gradually and would require exchange control approval (although not necessarily on an individual basis for small applications).

The financial rand system proposed by the commission, in its most ‘developed’ form, did not therefore channel all current transactions through the commercial rand market and all capital account transactions through the financial market. The commission recommended, for example, that resident travel allowances in excess of set amounts be transferred via the financial market (para 239). More importantly, all loan funds were to be transferred via the commercial market (that is, the capital as well as the interest payments which would usually have been included in the current account). Loan funds here included bank loans, syndicated loans, private and public bond issues, debenture issues, mortgages, parent company current accounts and shareholder loans.

The commission cited three reasons for this latter recommendation (para 235). First, with the financial rate likely to be at a discount to the commercial, it was considered “unfair” to expect borrowers to repay at the financial rate existing loans originally contracted at the official rate. The alternative strategy of distinguishing between old and new loans was deemed impracticable from an exchange control viewpoint, and even if it were possible, the potential impact on reserves of repaying old loans with the proceeds of new borrowing at the financial rate was acknowledged.

The second reason for channelling loan funds through the commercial market was the difficulty of distinguishing between loans and trade credit. Since the latter is channelled through the current account, being simply a delayed payment for goods, applying the financial rand rate to loan funds would have created problems for exchange control.
Third, the commission argued (para 235), that in a period of rapid economic growth the commercial exchange rate would “need the support of the net inflow of loan funds, public and private, that may then be expected”. The underlying reasoning here would seem to be that growth in the South African economy sucks in imports, especially of capital goods, which tends to increase the demand for foreign exchange and place pressure on the commercial rand exchange rate. If loan funds increase at such times, diverting them through the commercial market would therefore increase the supply of foreign exchange in this market, offsetting the excess demand for foreign currency.

In addition to the widening of the market, the commission proposed that intervention by the Reserve Bank be allowed “as part of a co-ordinated policy of intervention in the commercial and financial markets” (para 255-6). The rationale here appears to have been to smooth sharp movements in the rate, although the commission anticipated that intervention in the financial rand market would be infrequent and of limited magnitude.

To sum up, then, the De Kock commission’s proposed DRS was an intermediate step on the road to a unified managed float for the rand. Although the proposed system was more developed than its predecessors, the blocked and securities rands, it still did not separate all current and capital account transactions as a standard DRS would have. In particular, the commission recommended that loan funds be channelled through the commercial market, and that resident access to the market be subject to exchange control approval.

2.4 The Financial Rand: 1979-83

The recommendations of the De Kock commission were accepted by the authorities in late January 1979, albeit with some reservations,\(^{11}\) and the securities rand duly became known as the financial rand. The resulting system operated initially until 7 February 1983, when the rand was reunified. Figure 2 shows the level of the (monthly) financial

\(^{11}\) The recommended resident access to the financial rand market to supplement travel and emigration allowances was not implemented, nor was the recommendation that the foreign currency proceeds of Kruger rand and diamond sales be diverted from the SARB to the commercial banks.
and commercial rand exchange rates against the US dollar, and the financial rand
discount, from 1979 onwards. (Summary statistics for the period are compared against
those for the period 1985-95 in Table 1 in Section 3).

Although the precise regulations pertaining to the system were changed from time to
time, the basic mechanics of the financial rand system remained the same. Geographically, as noted earlier, the market was located mainly in Johannesburg and London, and can be viewed as having operated through two channels - the ‘cash’ market and the stock exchanges. In the cash market, a number of local banks quoted two-way rates. Alternatively, non-residents could bypass the cash market by transacting on the London and Johannesburg stock exchanges. Investors would buy South African shares in London with foreign currency, and sell them in Johannesburg (so ‘creating’ financial rand). Disinvestment would proceed in the opposite direction.
Figure 2  The financial rand: 1979-83 and 1985-95
Arbitrage via stockbrokers (especially in London) provided a link between the two channels. To illustrate, the following simple example provided by Shuttleworth (1987: 28) considers the case where the price of de Beers was $9.43 in London, and R41.00 in Johannesburg. The implicit financial rand rate is $9.43/R41.00 = $0.23 per rand. If, however, the financial rand rate was quoted as $0.24 per rand, arbitrageurs (usually in London) would buy de Beers in London ($9.43), sell in Johannesburg (R41.00), thus creating 41 financial rand at a cost of $0.23 each. Selling these in the cash market for $0.24 each, the arbitrageur profited and affected all three markets. The price of de Beers would rise in London and fall in Johannesburg (together increasing the implicit rate above $0.23), and the financial rand rate in the cash market would fall below $0.24. Arbitrage therefore ceased when profits were exhausted (taking transactions costs into account). Note here that the regulations which prohibited local actors in the financial rand market from taking positions, limited their ability to arbitrage severely (they could only perform arbitrage when they could match buyers and sellers at a given cash market rate).

Two aspects of the financial rand system require comment here. The first concerns the implications of the system for the balance of payments. In the case where financial rands were sold to another non-resident via the financial rand market, the ‘destruction’ of (narrowly defined) financial rand did not occur. In this case, the role of the financial rand system as a ‘disinvestment vehicle’ is clear. Each non-resident seller of South African assets had to be matched by a non-resident buyer, with the exchange rate adjusting to clear the market. As a result, non-resident disinvestment from the country via this mechanism had no impact on the country's balance of payments. From a practical perspective, the balance of payments statistics showed net sales by non-residents of securities listed on the JSE as long-term capital outflows, which had to be matched by contra-inflows of either short- or long-term capital.

By the same token, however, there could be no net investment via the financial rand either. The often mentioned ‘incentive’ provided by the financial rand discount could not attract net investment via this mechanism. This disadvantage of the system is clearly recognised in the following quote from Stals (1980),
investments in South Africa by non-residents with financial rand do not benefit the balance of payments. The mechanism only enables non-residents as a group to shift existing investments in South Africa from one application to another ...

While the composition of the stock of assets held by non-residents could be altered, therefore, and individual non-residents could invest or disinvest from the country, the key characteristic of the financial rand system was that non-residents as a group could not.

The second characteristic of the financial rand system at this time was the inherent uncertainty regarding its duration. As has been shown, the system was to a significant extent the creation of the De Kock commission, which had recommended that it be temporary. The possibility that the dual rate would be unified was always present, particularly strongly when the financial rand discount narrowed as in the first half of 1982 (Figure 2).

The conventional wisdom regarding the scrapping of the system was that it would not occur when the financial rand discount was high (Gidlow, 1982: 120). Indeed, this was echoed in the 1994 conditions for reunification set by the SARB (see discussion in Section 4). The reasoning here is that a unified rand exchange rate which settled at a significantly stronger level than the previous financial rand rate would provide a large incentive for non-resident capital outflows.

Given this, it is perhaps surprising that when the financial rand system was scrapped in February 1983, the financial rand discount was at a relatively high 17 per cent (Figure 2). Although the balance of payments position had improved as a result of the gold price booms of 1979-80 and 1982-83, the sustainability of this higher price could not be guaranteed, and the political situation was not in any way resolved. In this economic and

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12 Although controls on non-residents were effectively removed at this time, those on capital transfers by residents remained largely in place. The apparatus for registering non-resident ownership of securities was also retained.
political context, the timing of the reunification was questioned at the time; for example, see Bell (1984) and a response by the Financial Mail (3 August 1984: 25). These fears appear to have been warranted; Moll (1993: 2), for example, has labelled the capital account liberalisation of 1983-85 “a disaster”, whilst even Deputy Governor of the Reserve Bank, Jan Lombard has since written (1994: 42)

with the wisdom of hindsight it is clear that in 1982/3 the monetary authorities were too optimistic about the financial strength of the rand and certainly insufficiently sensitive to the international market perceptions of the basic weaknesses of the rand, the high liquidity of the country’s foreign debt, the downside prospects for the country’s foreign terms of trade, the doubts concerning its internal monetary stability as measured by the increase in the domestic money supply, the low level of real interest rates, and the low level of fiscal discipline.

As the preceding discussion suggests, the unified rand was of short duration. The financial rand was reintroduced on 2 September 1985, as part of the response to South Africa’s debt crisis.

3 The 1985 debt crisis and the reimposition of the financial rand system

Given the history of capital controls in South Africa reviewed here, it is not surprising that when the authorities were faced with the crisis of August 1985 they reintroduced the financial rand exchange rate system as a part of their policy response.

The South African crisis of 1985, which resulted in the re-introduction of the financial rand system, may perhaps best be described as a ‘balance sheet crisis’ (to adopt the terminology of Feldstein, 1999) despite the undeniably strong role played by political events. Although the country had a market-determined floating exchange rate, and was running a current account surplus in 1985, it was illiquid in the sense that short-term foreign currency denominated liabilities were high relative to the available foreign exchange reserves.
3.1 The 1985 debt crisis

Between the end of 1980 and the end of 1984, South Africa's total foreign debt increased from R12.6 billion to R48.2 billion (in US dollar terms, from $16.7 billion to $25.5 billion).\(^{13,14}\) As a proportion of this total debt, the country's short-term debt increased from 49.1 per cent to 68.0 per cent. The largest share of this short-term debt, in turn, was private sector debt. In this sort of situation, given the existence of asymmetric information in international capital markets (debtors tend to have better information than creditors), foreign investors tend to be nervous. When adverse shocks are experienced, therefore, these foreign creditors often panic, and if they do some form of liquidity crisis becomes likely.\(^{15}\) In the South African case, political events were the catalyst which sparked the eventual crisis.

In more detail, then, the South African crisis was precipitated by the refusal of US banks to roll over loans to South Africa. In August 1985, Chase Manhattan Bank made the decision to call in all its outstanding loans South Africans, and other banks duly followed suit. This action by the banks, however, was the end result of a number of economic and political factors impacting on the perceived risk they attached to transacting in South Africa.

With regard to the former, the depreciation of the exchange rate of the rand in the period between September 1983 and January 1985 was a particularly significant factor. In this period, from peak to trough, the exchange rate of the rand depreciated by 44 per cent against a basket of currencies, and by 53 per cent against the US dollar (De Kock,

\(^{13}\) Converted using the annual average exchange rate. Debt figures were obtained from Kahn (1987: 25-26), who notes that between 1983 and 1984 the US dollar value of South Africa's debt increased by 6.6 per cent which translated to 65.6 per cent in rand terms as a result of the depreciation of the exchange rate.

\(^{14}\) Total foreign debt represented 20.3 per cent of GDP in 1980, rising to 50.1 per cent in 1985 (Kahn, 1987).

\(^{15}\) A number of countries have experienced similar problems. Mexico's problems with public debt (Tesobonos) in 1994-95, and Korea's experience in 1997 both fall into this category.
The immediate effect of this depreciation was of course to increase the rand value of foreign currency denominated debts. The depreciation of the rand was therefore largely to blame for the 65.6 per cent increase in the rand value of South Africa's debt (from R29.1 billion to R48.2 billion) which is cited above.

The main causes of this depreciation were to be found in the well-documented strength of the US dollar in this period and in the decline in the gold price between February 1983 and February 1985. After the gold price booms experienced in 1979-80 and in 1982-83, this was a period of unrelieved gloom for gold. The London fixing price declined from a peak of over US$500 per fine ounce in February 1983 to an average price of US$299 per fine ounce in February 1985, before stabilising at average price of US$330 per fine ounce in August 1985. Besides these factors, it is also possible, as Bell (1984) and Aron, Elbadawi and Kahn (1997: 3) note, that the depreciation was exacerbated by the absence of the financial rand system.

When this depreciation of the rand is combined with weak world commodity markets, three years of drought in South Africa, and excessive money creation in 1983 and 1984 that permitted inflation rates three or more times higher than those in the country's main trading partners, it is clear that the economic fundamentals of the economy were not strong.

In addition to these disturbing economic fundamentals, the international financial community was also faced with a deteriorating political situation in South Africa in 1985. The government’s declaration of a State of Emergency on 20 July 1985, in an attempt to quell rising unrest, precipitated a financial crisis, with the Johannesburg Stock Exchange and the foreign exchange market affected as investors took funds out of the country. The French government's announcement of restrictions on investment in South Africa also contributed in this regard. Rumours began circulating at this time that international banks would not renew loans to South Africa which were falling due at the end of August (confirmed in the case of Chase Manhattan Bank). In this environment, an expectation arose that political reforms of the apartheid system would be made to appease foreign bankers. In a speech to the Natal Congress of the ruling National Party on 15 August 1985.
1985\textsuperscript{16}, however, then State President P.W. Botha failed to offer any real reforms and destroyed this expectation. Large-scale capital flight out of the country was duly experienced in the remaining weeks of August, until 27 August when the government suspended trading on the JSE and foreign exchanges through to 2 September. On 1 September, an emergency package of measures was announced which included a moratorium on debt repayments, and the reintroduction of the financial rand system in much the same form as had existed in 1979-83.

3.2 The Financial Rand: 1985-95

As Figure 2 showed, the financial rand exchange rate was markedly weaker against the US dollar in this period than in 1979-83, partly as a result of the intervening debt crisis. The financial rand discount, however, soon settled into a comparable range. From Table 1, it can be seen that the mean monthly commercial and financial rand exchange rates in the 1979-83 episode were 89.95 and 120.76 SA cents per US dollar, respectively, while in 1985-95 the corresponding figures were 270.42 and 384.87 cents per US dollar. The mean financial rand discount (FRD) increased from 25.31 per cent to 29.08 per cent. Possibly the most important statistic here, however, is the standard deviation of the returns.\textsuperscript{17} For foreign investors, this measure gives some indication of the exchange rate risk involved in investing in South Africa; the higher the standard deviation, for example, the greater the chance of a large increase (depreciation here). As Table 1 shows, the standard deviation of the financial rand exchange rate is greater than that of the commercial rand in both periods, while that for the unified rand lies between those of the dual rates in both periods. This crude measure therefore suggests that the financial rand system might have reduced the volatility of the commercial rand exchange rate (Farrell, 2000 confirms this finding using more sophisticated techniques).

\textsuperscript{16}This is often referred to as the ‘Rubicon’ speech.

\textsuperscript{17}The return is calculated here as $\ln x_t - \ln x_{t-1}$. 

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### Table 1: Summary statistics for the financial rand system

<table>
<thead>
<tr>
<th>Financial rand system 1979-83</th>
<th>Unified rand 1983-85</th>
<th>Financial rand system 1985-95</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Comrand (cents/$)</td>
<td>Finrand (cents/$)</td>
</tr>
<tr>
<td>Mean</td>
<td>89.95</td>
<td>120.25</td>
</tr>
<tr>
<td>Median</td>
<td>84.48</td>
<td>121.58</td>
</tr>
<tr>
<td>Minimum</td>
<td>74.84</td>
<td>94.79</td>
</tr>
<tr>
<td>Maximum</td>
<td>115.93</td>
<td>150.38</td>
</tr>
<tr>
<td>Std Dev (returns)</td>
<td>0.02</td>
<td>0.061</td>
</tr>
<tr>
<td>Observations</td>
<td>49</td>
<td>49</td>
</tr>
</tbody>
</table>

Note: The commercial rand exchange rate here is the monthly average rate against the US dollar. The financial rand rate and the financial rand discount (FRD) relate to end of month rates against the US dollar. This difference in measurement and the fact that, in general, mean(x)/mean(y) ≠ mean(x/y), ensure that the mean FRD is not exactly equal to \( \frac{\text{mean(finrand)} - \text{mean(comrand)}}{\text{mean(finrand)}} \times 100 \). The minimum and maximum monthly values for the commercial and financial rand rates in each period need not fall in the same months, therefore the formula for the FRD need not apply in the case of these exchange rates and the FRD reported here. Source: SARB Quarterly Bulletin, various issues.

A further summary statistic which has received attention is the 'size' of the financial rand pool. This is difficult to estimate, however, since the usual definition of the financial rand is not suitable for this purpose. Narrowly defined, financial rand were 'created' when non-residents sold South African assets - quoted or unquoted shares, gilts, semi-gilts, or property. Conversely, when financial rand balances were used to purchase these assets, financial rand were 'destroyed' (in the sense that they became ordinary commercial rands in the hands of the South African seller). Of course, this situation was complicated by the fact that financial rand were also created when the authorities redesignated commercial rand as financial rand in order to allow residents access to the market.

More fundamentally, however, defining financial rand in this narrow way may be misleading. Since the underlying (that is, non-resident held) assets were easily
convertible, it might be wiser to view both financial rand balances and the relevant assets as ‘financial rand’. This wider definition has been suggested by a number of commentators (for example Hamblin, 1987 and Garner, 1994), and is of some importance when attempting to estimate the ‘size’ of the financial rand market. In addition, the concept of a ‘closed pool’ arrangement is clearly illustrated using this broader definition. Non-resident sales of assets are simply the conversion of one form of financial rand (for example, non-resident held quoted shares) to another (a financial rand deposit).

Estimates of the size of the pool of financial rand in this sense are reported as at the end of 1992 in Lombard (1994: 46)\(^\text{18}\), and as at the end of 1993 in Garner (1994: 15). As Table 2 shows, these studies suggest that holdings of unquoted and quoted shares and of stocks far outweighed the contribution of financial rand balances to the wider pool.

**Table 2: Estimates of the size of the financial rand pool**

<table>
<thead>
<tr>
<th></th>
<th>As at end 1992 (Lombard, 1994)</th>
<th>As at end 1993 (Garner, 1994)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Amount (R billion)</td>
<td>% of total</td>
</tr>
<tr>
<td>Financial rand balances on deposit with banks</td>
<td>7</td>
<td>4</td>
</tr>
<tr>
<td>Govt and public enterprise debt stocks</td>
<td>58</td>
<td>32</td>
</tr>
<tr>
<td>Quoted equity investments</td>
<td>23</td>
<td>13</td>
</tr>
<tr>
<td>Unquoted direct equity investments</td>
<td>74</td>
<td>41</td>
</tr>
<tr>
<td>Loans trapped under the Standstill</td>
<td>17</td>
<td>10</td>
</tr>
<tr>
<td>Total</td>
<td>179</td>
<td>100</td>
</tr>
</tbody>
</table>

\(^{18}\) These estimates are based on work by IMF staff members and researchers from the London School of Economics’ Centre for the Study of the South African Economy (CREFSA).
The financial rand system remained in place until March 1995, when it was abolished once more (Section 4). Despite its relative longevity, there have been few attempts to ascertain empirically the effectiveness or otherwise of the system. Part of the reason for this is that answers to such broad questions are difficult to come by in this context. Farrell (2001) considers the less ambitious question of whether the imposition of capital controls in South Africa affected the volatility of foreign exchange rates, providing insulation to the commercial exchange rate of the rand in this way, and finds in the affirmative.

4 The liberalisation of exchange control in the post-1994 period

The improvement in the political situation in South Africa culminated in the democratic election of a Government of National Unity in April 1994, which duly inherited an economy which was not highly indebted but where residents had little opportunity to diversify their portfolios. The political transition resulted in renewed interest in the issue of exchange control (see, for example, Garner, 1994 and Lombard, 1994). While there appeared to be a consensus that the controls, which affected some current account transactions as well as resident and non-resident capital account transactions at this stage, should be liberalised, a debate arose regarding the nature of this liberalisation. The main issues here concerned the timing and speed of the liberalisation, the necessary preconditions for liberalisation and the treatment of residents and non-residents in the liberalisation process.

The outcome of this debate on exchange control has had important implications for the subsequent direction of policy in South Africa. The various positions adopted and the decisions taken are set out in Section 4.1. The rest of Section 4 then presents a chronological discussion of the reforms in the post 1994-period. The abolition of the financial rand system is dealt with in Section 4.2, and subsequent reforms are set out in Section 4.3. Section 4.4 discusses the foreign exchange and tax amnesty introduced in 2003, and its implications for exchange control.
4.1 The debate on the abolition of exchange controls

The main issue of contention regarding the future policy direction on exchange control concerned the speed with which the controls should be removed. In 1994, for example, the South African Chamber of Business (SACOB) published a discussion document prepared by former Deputy Governor of the South African Reserve Bank Jan Lombard which outlined various options for abolishing exchange control, including a ‘big bang’ approach (Lombard, 1994). This option involved the immediate removal of all exchange controls on residents and non-residents, and attracted support mostly from elements of the private financial sector. Supporters of this approach argued that exchange control provides a disincentive for foreign investment. Besides an ideological aversion to state intervention, the case for a ‘big bang’ approach is supported by a number of economic arguments. The main argument, based on Dooley and Isard (1980), is that controls, by making it difficult to repatriate funds, introduce a form of investment irreversibility which deters investors. Other arguments cited at the time (CREFSA, 1994: 18) include the related view that the inconvenience and uncertainty associated with continued exchange control deterred foreign investors, and that abolishing all exchange controls would signal a strong and credible commitment by the new government to fiscal and monetary stability.

While these arguments were acknowledged to provide a strong case for abolition in the medium term, the case for an immediate removal of all controls was more contentious. The large literature on the sequencing of financial liberalisation (McKinnon 1973, 1993 and Edwards 1984) suggested that the capital account should not be liberalised until the end of the economic reform process. Supporters of a more gradualist approach to the dismantling of exchange controls in South Africa, including the Reserve Bank, had reservations about the risks involved in a ‘big bang’ approach. The SACOB report mentioned earlier did not find in favour of this option. Chris Stals, the then Reserve Bank Governor, was clearly opposed to the approach. He argued (Stals, 1994 and 1998) that after the years of exchange control there was a huge pent-up demand for moving

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19 In a presentation to the parliamentary Joint Standing Committee on Finance, he compared the total
capital out of the country, that the country’s foreign reserves were depleted, and that
distortions present in the economy would mean an unduly painful short-term adjustment
were a ‘big bang’ approach to be followed. He argued specifically against what he
termed the “naïve” view that immediate abolition would attract sufficient capital inflows to
offset the expected increase in outflows. He believed that exchange control was just one
obstacle to investing in South Africa (along with social and political stability, economic
viability, sound monetary and fiscal policies, and improvements in productivity), while
exchange controls were the only obstacle to moving funds out of the country.

In the light of these considerations, the authorities have preferred to follow a gradual or
phased approach to exchange control liberalisation, with some concern for sequencing
considerations (Ramos, 2003). The discussion above and in Section 5 suggests that this
decision is consistent with current thinking on capital account liberalisation. This
approach has distinguished between controls on non-residents and on residents, with
the former being liberalised first. These reforms are discussed in the following two
sections.

4.2 The abolition of the financial rand system in 1995

An early step in the liberalisation process was therefore the (re)abolition of the financial
rand system, effective from 13 March 1995. Since the debt standstill arrangements had
been rescheduled late in 1993, non-residents were now able to introduce and repatriate
funds, and transfer current and capital gains, without restriction.

As had been the case in 1983, the timing of the abolition of the financial rand system
was again an issue in 1995. As one commentator noted, “influenced by the uncertain
impact of abolition, the Reserve Bank is determined to abolish the financial rand from a
position of strength” (CREFSA, 1994: 19). The Governor of the Bank consistently argued
that three preconditions should be met:

abolition of controls to jumping off a cliff (CREFSA, 1994: 18).
(i) a substantial reduction in the discount of the financial rand to the commercial rand
(ii) a significant increase in the country's net foreign exchange reserves
(iii) a substantial reduction in the stock of financial rand-denominated deposits in the banking system

The last of these conditions was perhaps operationally problematic, given the difficulties in measuring this stock which were discussed earlier. The remaining conditions were generally held to be sensible, in that the financial rand discount captured the perceptions of foreign investors and therefore their willingness to leave assets in the country, and that increased reserves would allow the authorities to adjust to the net outflow of capital and downward pressure on the exchange rate which were likely to follow the abolition. In the event, as Figure 2 shows, the financial rand discount stood at around 8 per cent per cent on 10 March 1995.

4.3 Further relaxation of exchange controls: 1995-

Following the abolition of the financial rand, the gradual liberalisation of exchange control has proceeded smoothly until the present time. The more significant relaxations for residential institutional investors, residential corporates and private individuals are discussed here.

4.3.1 Resident institutional investors

Significant progress has been made in allowing resident institutional investors (insurers, pension funds and unit trusts) to diversify a portion of their assets abroad. Initially this was via the asset swap mechanism introduced in July 1995 (Table 3 provides a summary of the exchange control circulars regarding the mechanism). Asset swaps have been proposed as a means of diversifying portfolios internationally without impacting severely on reserves (Merton 1990, Bodie and Merton 2002). The South African experience is discussed in an interesting recent paper by Vittas (2003).
The mechanism for the South African asset swaps involved qualifying institutions putting forward proposals to swap part of their existing portfolios for the foreign assets of foreign investors, with the proposals required to incorporate measures to “lock-in” the reciprocal foreign investment for a period of 2 years (ie the requirement was that the local institution ensured that the foreign counterparty or its replacement/s remained invested in South African securities).
Table 3  Summary of exchange control circulars on asset swaps

<table>
<thead>
<tr>
<th>Date</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>14.7.1995</td>
<td>New facility was introduced permitting institutional investors to obtain foreign investments by way of swap arrangements. Decision noted negligible country risk diversification of institutional investor assets of R500 billion as well as low level of foreign exchange reserves of R12.5 billion, hence the attractiveness of the asset swap mechanism. Authorization of individual transactions was required, based on application and approval, up to 5 per cent of total assets. Mention was made of possible future allocation for outright foreign investments and reference to gradual easing of exchange control.</td>
</tr>
<tr>
<td>21.6.1996</td>
<td>Limit on investment in foreign assets by way of asset swaps was raised from 5 to 10% of total assets. Limit for outright foreign investments was introduced. This was set at 3 per cent of net inflow during calendar 1995, but subject to overall limit of 10 per cent of total assets.</td>
</tr>
<tr>
<td>13.3.1997</td>
<td>Limits of 10% of total assets for asset swaps and 3% of the net inflow during calendar 1996 for outright investments were renewed. Additional limit of 2% of net 1996 inflow was introduced for outright investments on registered stock exchanges in SADC member countries. The total overall limit was kept unchanged at 10% of total assets. Clear definition of net inflow was provided for each type of institutional investor. Also, for unit trusts, the relevant entity was changed to the unit trust management company and its total assets under management in South Africa.</td>
</tr>
<tr>
<td>1.7.1997</td>
<td>Definition of qualifying institutions for the asset swaps mechanism was broadened to include all registered fund managers offering private client asset management services.</td>
</tr>
<tr>
<td>22.7.1997</td>
<td>It was clarified that only asset swap transactions that did not involve a flow of funds would be permitted. Future transactions should be structured on the basis of an exchange of cash and/or a portfolio of assets.</td>
</tr>
<tr>
<td>11.3.1998</td>
<td>The overall limit of foreign assets by way of swaps was raised to 15 per cent of total assets. The limit of outright foreign investments for long-term insurers, pension funds and unit trust management companies was raised to 5 per cent of the net inflow during calendar 1997 while the limit of outright investments on registered stock exchanges in SADC countries was raised to 10 per cent of net calendar 1997 inflow. Both flow limits were subject to the overall 15 per cent asset limit.</td>
</tr>
<tr>
<td>23.2.1999</td>
<td>Dispensation and limits were renewed without change. Reference was made to applications for foreign asset swaps of R130 billion approved and R60 billion transacted up to the end of 1998.</td>
</tr>
<tr>
<td>23.2.2000</td>
<td>Limit of 15 per cent of total assets was renewed for long-term insurance companies, pension funds and fund managers. It was raised to 20 per cent for unit trust management companies. The definition of assets was broadened from total assets employed in South Africa to total assets. The limit of outright investments for long-term insurers, pension funds and unit trust management companies was raised to 10 per cent of net calendar 1999 inflow, with no separate limit for investments in SADC countries, but subject to the respective asset limits.</td>
</tr>
<tr>
<td>21.2.2001</td>
<td>Reference was made to total foreign assets acquired under the asset swap mechanism amounting to R100 billion. However, the asset swap mechanism for new transactions was terminated. Total foreign assets were retained at 15 per cent of total assets for long-term insurers, pension funds and fund managers and 20 per cent for unit trust management companies. New foreign investments by log-term insurers, pension funds and unit trust management companies were, however, limited to 10 per cent of the net calendar 2000 inflow, subject to the overall asset limits.</td>
</tr>
<tr>
<td>13.11.2001</td>
<td>The cash flow dispensation was extended to registered fund managers, who were authorized to make new foreign investments up to 10 per cent of their net calendar 2000 inflow, subject to the 15 per cent asset limit.</td>
</tr>
</tbody>
</table>

Source: (Vittas, 2003: 11)
Although this relaxation addressed a significant problem associated with exchange control, namely the inability of South African institutions to diversify their portfolios (negligible diversification of assets of around R500 billion was mentioned at the time), and was designed to protect reserves, it created a number of problems. A key issue in this regard was the compensation required by non-residents for being locked-in and enduring the administrative burden of the asset swap mechanism (recall that there were no restrictions on non-residents after the abolition of the financial rand system, and they were therefore free to invest in South Africa without these complications). A danger was therefore that the asset swaps, if popular, would undermine the role of the JSE, with a large parallel market emerging, and volumes and prices on the exchange not reflecting the true situation (CREFSA, 1995). A further difficulty was the enforcement of the lock-in measures.

Despite these issues, however, the asset swap mechanism achieved some success. By the time the mechanism was scrapped on 21 February 2001, R100 billion in asset swaps had been transacted, suggesting fairly significant diversification was achieved. As Vittas (2003: 19) argues, the swaps “deviated considerably from the optimal features of swap contracts that have been underscored by Bodie and Merton” and “… turned out to be rather cumbersome and difficult to enforce, but even so they achieved their basic objective of greater diversification without capital flight”.

More recently, in 2003, as an interim step towards prudential regulation, institutional investors have been allowed to invest on approval up to the foreign asset limits noted in Table 3 (i.e. 15 per cent of total retail assets for long term insurers, pension funds and fund managers, and 20 per cent of total retail assets for unit trust companies). The restriction limiting institutions to 10 per cent of the prior year’s net inflow of funds therefore no longer applies.
4.3.2 Resident companies

Some progress has been made in allowing resident companies to make direct investments abroad and raise foreign funding against their domestic balance sheets. Between 1994 and 1998, these amounted to about US$ 10.7 billion (Stals, 1998). Current limits on approved investments are R2 billion for investment into Africa (including SADC), and R1 billion for the rest of the world. Also, from 2003 dividends repatriated from foreign subsidiaries are eligible for an exchange control credit, which may be retransferred for approved foreign direct investments.

4.3.3 Private individuals

Private individuals over 18 years of age and in good standing with the tax authorities were permitted to make limited investments abroad from 1 July 1994. Initially, the limit for offshore holdings was R200 000 per individual. This limit has since been increased on various occasions and from 23 February 2000 it has stood at R750 000 per individual.

4.4 The Foreign Exchange and Tax Amnesty

The introduction of the foreign exchange and tax amnesty in 2003 provides an interesting addendum to the review of exchange control liberalisation presented here. It is well known that amnesties tend to set poor precedents and erode government credibility. As Dornbusch (1987: 149) has noted, amnesties are “deeply destructive of sound public finance”. The reasons for introducing the amnesty therefore require some comment here. Furthermore, there are some implications for exchange control which are worth noting.

Two broad motivations for amnesties emerge from the international experience. The first case is where the intention is to use an amnesty to repatriate flight capital for the purpose of fostering national development, a view which will be shown to be problematic, and the second is where the intention is to ‘regularise’ assets held abroad
and include them in the tax base. The South African amnesty is of the second type.

Underlying the first motivation is the perception that flight capital is an unutilised reserve of funds that can be retrieved to promote national development. Capital flight results in the exportation of domestic savings and foreign exchange from countries where they are generally in short supply, with negative consequences for investment and growth (and for debt levels if financed externally). Proponents of amnesties in this context see the repatriation of flight capital as necessary to reverse this process. Proposals for amnesties to repatriate capital in certain Latin American countries and more recently in Russia have emphasised this view.

The foundations of this argument require closer scrutiny, however. If the concern is the enhancement of investment and growth then, as Buiter and Szegvari (2002: 7) argue in the Russian context, it does not matter in principle whether the necessary capital inflows are repatriated flight capital rather than foreign direct or portfolio investment by non-residents. Unless economic arguments for specifically targeting past flight capital can be made, then encouraging residents to repatriate offshore funds by means of an amnesty seems in general to be a second best option to encouraging flows from all potential sources by improving the investment climate. Evidence suggests that improved macroeconomic stability and governance encourage the return of flight capital (for example Ajayi, 1997 cited in World Bank, 2002: 71).

The second and perhaps less controversial motivation for an amnesty, upon which the South African version is based, is what might be termed the regularisation of undisclosed offshore investments. In this case, even if the funds for these investments were acquired legitimately, the manner in which they were transferred abroad criminalized them. This provides a barrier to repatriation, even when the circumstances

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20 They do however cite two economic reasons why attracting past flight capital may be more desirable than encouraging increased capital flows from all potential investors. The first is a fiscal reason based on the relative tax treatment of these flows (ie past flight capital will now fall within the tax net), and the second is based on the argument that owners of offshore capital possess local knowledge that makes them particularly valuable investors. The grounds for the latter argument, however, seem tenuous. The benefits of local knowledge seem difficult to pin down, and as Buiter and Szegvari note the important technology transfer aspect of FDI may not be involved in investment sourced from repatriated flight capital.
that encouraged capital flight have changed. Furthermore, since the investments are not reported, they remain outside the tax net in residence-based tax systems. The intention of the amnesty in this context is to regularize these investments by decriminalising them and bringing them into the tax net. The recent Italian ‘tax shield’ is an example of this type of mechanism.

Although the South African amnesty appears to be designed in line with the preferred motivation, the key to the success of the amnesty is the requirement that it be credible, both in the sense that taxpayers believe that the investment climate will remain favourable and in the sense that government is able to make the commitment that no future amnesties will be allowed.

Finally, at the same time as the amnesty was introduced, it was announced that the “blocked” funds of former residents of the country, funds in excess of the emigration allowance that were placed in “emigrants’ blocked accounts”, would be unwound. The distinction between the emigrants’ settling-in allowance and the private individual foreign investment allowance for residents was removed, replaced by a common foreign allowance of R750 000 per individual (or R1,5 million per family unit). Holders of blocked funds and new emigrants may take out amounts of up to R750 000 (including amounts already transferred) without charge, and amounts exceeding this on approval of the Exchange Control Department. Approval is subject to an exiting schedule and an exit charge of 10 per cent of the amount.

5 Some issues for the future

The debate regarding the use of capital controls has a long history, and tends to be revived with each new round of crises. This has indeed been the case in recent years. Events in East Asia in 1997-98 appear to have softened attitudes towards the use of controls on capital flows, which had turned negative since the 1980s. Prominent economists such as Kenneth Rogoff, formerly of the IMF, have recognised that earlier positions may have overstated the benefits of free capital movements and not emphasised enough the dangers involved in liberalisation.
Proposals for Tobin taxes, Chilean-type controls on capital inflows and, more controversially, for what have been termed ‘curfews on capital flight’ have been voiced. The case for controls on inflows has been made by Eichengreen (1999), for example, and Krugman (1998) has set out the case for controls on capital outflows in the aftermath of a financial crisis.²¹ Ul Haq et al (1996) review the arguments for a Tobin tax. By contrast, several recent studies interpret the Chilean and East Asian experiences less enthusiastically. Edwards (1999) and Gregorio et al (2000) on Chile and Edison and Reinhardt (2001) on Malaysia and Thailand would be examples in this regard.

These ambiguities suggest that policymakers tasked with liberalising South Africa’s exchange controls still have important decisions to make. Although developments would seem to indicate that the current gradualist approach was the correct option to choose in 1994, or at least not the incorrect option, and that significant inroads have been made into liberalising exchange control, the current goal of removing exchange control is perhaps not the end of the story. While it stands to reason that further liberalisation should attempt to maximise the benefits and minimise the costs of reforms (Eichengreen, 1999), it should be remembered that the economy will still have to cope with volatile capital flows in future and that policymakers need to have systems in place to do this. The shift away from attempting to manage capital flows directly and toward limiting the vulnerability of the economy to volatile capital flows via prudential regulation is an important development in this regard.

²¹ Krugman’s argument may be summarised as follows: capital controls allow policymakers to delink domestic interest rates from exchange rates, and therefore to lower domestic interest rates in the wake of a crisis without precipitating a recessionary depreciation of the currency. While acknowledging the costs entailed in imposing controls - the distortions and abuse which tend to accompany them, and the negative signals sent to foreign investors - he nevertheless argues that when the recession following a crisis is severe these costs may be worth paying. Interestingly, Krugman also argues that controls are necessary in addition to the imposition of a debt standstill. In a crisis, anyone who is able to will convert domestic currency into foreign, while the debt standstill will only close the one particular channel for capital flight (related to the repayment of debt).
References


