Exchange rates and exchange control

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What is an exchange rate?

An exchange rate is the rate at which the currency of one country is exchanged for the currency of another country. For instance, if one goes to a bank (an authorised dealer in foreign exchange) and purchases one United States dollar by paying R4,50 to the bank, the exchange rate of the rand against the dollar is R4,50 for one dollar.

How are exchange rates determined?

The exchange rate of the rand is basically determined by market forces. For instance, buying and selling rates for dollars quoted by authorised foreign exchange dealers are based on the supply of and demand for dollars in the market at any given time. The South African Reserve Bank may, in line with prevailing monetary and exchange rate policy, intervene in the market from time to time by purchasing or selling dollars. When intervening in the market, the Bank does not attempt to bring about any structural change in the economy or to affect longer-term movements in balance of payments transactions; it merely intervenes to smooth out unduly large short-term fluctuations in the money-market liquidity or in the exchange rate. During 1996, for example, the Reserve Bank intervened quite heavily in the foreign exchange market by supplying the market with a substantial amount of dollars when the large demand for foreign exchange threatened to disrupt the market and cause an unwarranted depreciation of the rand.

Factors influencing exchange rates

The balance-of-payments position of a country or expected changes in transactions with the rest of the world is the most direct determinant of a country's exchange rate. Demand for foreign currency arises from the importation of merchandise goods and the payment for services or from the redemption of capital obligations. The supply of foreign currency, on the other hand, emanates from the exportation of goods and services or from an inflow of foreign capital. If, as a result of South Africa's transactions with the rest of the world in a given period, the total inflow of foreign exchange is greater than the outflow, the supply of foreign currency exceeds the demand. Under these circumstances, the rand will appreciate on average against other currencies.

In addition to the underlying balance-of-payments position, the level of the exchange rate of the rand could over the longer term also be influenced by the inflation differential between South Africa and its main trading partners or international competitors. If the inflation rate in South Africa is consistently higher than that of its major trading partners or competitors, South African producers will lose their competitive edge and South African consumers might be tempted to import goods instead of buying locally produced goods. This will reduce South Africa's exports while the demand for imports will rise, the demand for foreign currency will increase, foreign currency will become relatively scarce and more expensive and the rand will depreciate against other currencies.

Furthermore, non-economic factors such as political developments, unfounded rumours, speculative transactions and unfavourable perceptions about South Africa may change the exchange value of the rand to a level which does not reflect the balance-of-payments position, nor its comparative purchasing power.

What is meant by exchange control?

Exchange control regulations restrict the free movement of foreign exchange in order to protect an economy from large disruptive fluctuations in capital movements and other international economic shocks, and to preserve scarce foreign exchange reserves for essential purposes. Exchange control was introduced in South Africa in 1939 as part of the emergency measures adopted by the Sterling Area because of the outbreak of the Second World War. From 1961, however, South Africa's exchange control received its own identity when capital account transactions of non-residents were also restricted.

Why is exchange control necessary?

Although exchange control in South Africa has had some success in regulating capital flows, it has been unable to prevent volatile movements in the foreign exchange holdings of the country. In addition to its limited effectiveness, there are also other important disadvantages in applying such measures, such as:

- exchange control hampers the effective application of monetary policy because it often prevents the most desirable combination of money supply growth, interest rates and exchange rates;
- exchange control inhibits the development of domestic organisations by restricting their expansion in other countries;
- exchange control has at times discouraged inward foreign investment in South Africa; and
- the maintenance of exchange control is expensive and time consuming to the Reserve Bank, authorised dealers in foreign exchange and the private sector.

When will exchange control be abolished?

In view of these disadvantages, the South African authorities have decided, in principle, to abolish exchange control. In implementing this decision, the authorities have opted for a phased approach, which allows the consequences of certain relaxations to be absorbed before further measures are introduced. A "big bang" approach, or the abolition of all existing exchange control rulings in one step, could very easily give rise to a massive demand for foreign exchange which could upset and destabilise the South African foreign exchange market. Considerable progress has already been made in dismantling exchange control. Further relaxations will take into account the circumstances prevailing at the time and, in particular, the foreign liquidity position of the country.

This is the fourth in a series of fact sheets on the South African Reserve Bank, compiled by the Research Department: Information Division and distributed by the Executive Management Department: Communications Unit.

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