

*The real reason
for the fall
of the rand*

*by
Richard J Grant*

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Foreword

The *Occasional Paper* series is designed to bring to readers writings of pith and moment which might not otherwise be circulated widely or timeously. This *Paper*, by a Canadian economist who formerly worked in South Africa, is a prime example.

Dr Richard Grant has studied monetary policy as operated by the South African Reserve Bank for some two decades. His understanding of the South African situation is deep but dispassionate. He has consistently had reservations about certain aspects of Reserve Bank policy, whether under Drs de Kock or Stals, and more recently under Mr Mboweni.

The volatility of the rand against the dollar and other currencies is well known. But the rand's downward trend is much less widely discussed and merits far more concern. In 1997 \$1 (US) bought 4.61 rands, in 1998 the rand had fallen against the dollar to R5.55, in 1999 to R6.12 and by 2000 to \$6.96. In 2001 the average exchange rate had fallen to \$8.61, and by mid-2002, after a well-publicised dip in late 2001, it had allegedly 'recovered' to just over R10.

The 'real' picture then, is one of a steady fall. The media hype of late 2001 and mid-2002 suggesting a 'collapse' followed by an equally dramatic 'bounce-back' are more than a little misleading. Yet it was the short-term events which resulted in government appointing an official committee (under the Chairmanship of former Judge Myburgh) to investigate the causes of exchange rate movements in late 2001. There was no sudden fall, only volatility around a steadily declining trend.

Dr Grant goes to the heart of the issue. He dismisses the 'usual suspects' which were discussed so exhaustively during the Myburgh hearings. The Argentina:Zimbabwe contagion effect (p.25) could have done no more, he argues, than confirm the rand in its downward trend. 'Leads and lags' occur as exporters delay repatriating funds out of fear of further rand falls (and vice versa if the rand is expected to rise). As Grant says (p.26) we are all speculators, and speculation is then simply 'self-defence'. Moreover, thoughtful consideration of these defensive activities indicates that speculation smoothes out what would have been even sharper levels of volatility than in fact occur. (Speculators only ever enhance volatility if they err – a possible scenario but on balance an unlikely one or speculation would long since have ceased. Or, if government tries to decelerate or reverse a market trend, then speculative activity will occur in the knowledge that no government – even King Canute's – has ever succeeded in bucking a market. The inevitable adjustment, when it comes, is then discrete rather than gradual.)

So why does the rand fall, and fall, and fall again? Dr Grant makes a persuasive case that the real cause is that more and more rands are being created. When more and more money is printed the price of everything else rises, including the rand price of foreign exchange.

Grant places the blame squarely on the Reserve Bank's unwillingness or inability to control the monetary base (M0 as it is officially known). Although the monetary base represents only the 'small change' of the monetary system and most transactions are paid for via transfers of bank deposits this does not hamper the Reserve Bank's effectiveness to control the money supply in that manner. It does mean that the cash ratios of commercial banks become crucial, and not their broader liquidity ratios. As long as minimum cash ratios are enforced, commercial banks cannot compensate or counter a reduction in the monetary base by the Reserve Bank. The Reserve Bank can do this by selling government securities to the non-bank public to enforce a contraction of its deposits with commercial banks. When that occurs the Reserve Bank receives cheques drawn on commercial banks, the banks debit their clients' accounts, and the Reserve Bank debits the commercial bankers' accounts with itself. Thus the cash holdings and deposits of commercial banks are reduced by an equal amount. In order to restore their cash ratios the commercial banks must then call in other loans from the non-bank public or borrow from the Reserve Bank. The latter is accomplished by repurchase of Treasury bills by the Reserve Bank from the commercial banks.

The provisos here, of course, are that the cash ratios are enforced and meaningful, and that borrowing from the Reserve Bank is indeed at a market-related (and hence variable) rate. As occasion demands, that rate levied on commercial banks will appear to be penal.

The move from a bureaucratically determined Bank Rate to a market-determined Repo (repurchase) Rate was, in fact, the stated intention of the Reserve Bank in May 1998. The Rate could vary daily. The original intent was that the Reserve Bank would signal a tightening or loosening of monetary policy by under- or over-providing the quantity of Treasury bills on offer at its daily auction relative to the cash requirements of the commercial banks. The banks would then bid the tender price of the Bills (and so the Repo rate) in the desired direction. But it took only a few months for this policy to be discarded. In late 1998 the Bank announced that no further market variability in the Rate would be permitted until year-end. That temporary suspension of the new policy has since been ‘forgotten’ and the suspension has essentially become permanent. The Repo Rate is now changed rarely and only by administrative announcement, just as Bank Rate had been managed.¹

The Reserve Bank has apparently chosen interest rate stability as a policy (at least by default). But no central bank can both control the price of its lending and impose a quantity constraint on its loans to, or deposits from, the commercial banks. Hence it cannot both control the monetary base and set Repo Rate.

Grant points out that the Reserve Bank is a monopolist. But even monopolists face demand curves for what they sell (in this case Treasury bills). They can choose an optimal price, or an optimal quantity, but they cannot impose both at levels off their demand schedule. The abandonment of the original intent of Repo indicates the Bank has chosen to set price (and so interest rates) and not quantity.

Grant’s argument may not be agreed with by all. But his view that it is quantity, M0, which should be controlled is persuasive. The Reserve Bank’s own policy of abandoning Bank Rate and moving to a market-determined Repo Rate is consistent with both Grant’s views and economic and monetary theory. It is unfortunate that that policy was abandoned other than in nomenclature. This discussion does not necessarily represent the views of the Directors, members or staff of the Foundation, nor those of the FMF itself (which has no corporate view). Nonetheless the Paper is offered as a potentially valuable contribution to the continuing debate on how best to design monetary policy.

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¹ This policy pattern is identical to that followed by the Bank of England in the 1970s. Bank Rate was abandoned in favour of the Minimum Lending Rate (or MLR). The MLR was analogous to the Repo. When the Bank of England abandoned a variable MLR to return to administered rates, however, the name Bank Rate was reintroduced to avoid confusion.

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For the FMF his publications include two books and a recent monograph: *Nationalisation: How Governments Control You* (1994); *Real Money* (1999); and *Gold, the Euro, the Dollar and the Rand* (2001).

He has degrees from universities in Canada and the United States, including a PhD from George Mason University.

1 The real reason

During the last half of 2001, the South African rand lost a third of its value compared to the US dollar. Although some of this relative loss was retraced in early 2002, it was clear by March 2002 that the inflation targets for 2002 chosen by the South African Reserve Bank would not be achieved. Instead, inflation was once again headed upward.

A currency depreciation of this magnitude is a serious event, an event that affects the finances and plans of millions of people. Most of those people have little, if any, understanding of what really happened. But they are affected nevertheless, and will continue to feel the effects for many months, if not years. Their ignorance is not unrelated to the fact that the currency did depreciate and has suffered similar depreciations in the past. During the early months of 2002, many of those with a public voice have hurled accusations in almost all directions. That so many barbs have completely missed the mark gives cause to worry about this sort of history repeating in the future.

Why did the rand fall? The rand fell because most South African citizens do not know what to ask for. It is correct to ask for low inflation. It is correct to ask for an exchange rate that, when it moves, moves slowly against an index of other currencies. These are both correct, but they are not enough. There are two other considerations: citizens must give more thought to how their wishes are carried out, and they must also learn what not to ask for.

What not to ask for

The general recognition of the importance of a low inflation rate, and a non-volatile exchange rate, was a great step forward. Unfortunately these are not universally-held values, mostly owing to ignorance, but partly owing to narrow special interests. Some people still believe that inflationism is good for the economy, that pushing down real interest rates is good for business, and that a depreciating currency makes local businesses more competitive. In the short term, these do indeed appear to be true. But the shortsighted filter of politics screens out consideration of the long-term costs of such inflationism. We are all, today, still feeling effects of policies and decisions enacted months, years, and decades ago. Prices are rising now because business leaders, union leaders, homeowners and other borrowers have, during the past months and years, repeatedly asked for greater “liquidity” – for lower interest rates than were available in the market at the time. Perhaps at that time (and at the present time) people were justified in believing that interest rates were somehow not at the right levels. To the extent that credit markets have been disrupted by previous monetary policy decisions, later economic conditions are not what they should have been.

Those who ask for lower interest rates are also, whether they know it or not, asking for higher inflation. Those who ask for a “competitive” exchange rate are also asking for higher inflation. In order to meet their demands, the Reserve Bank must increase the quantity of money by a significant amount. Such an increase, even for a brief period, sets in motion a series of events that begin immediately, gradually build up to a peak, and then taper out over a number of years. Repeated, or continuous, acts of significant money creation send out a complex chain of these series with effects that are intertwined and cumulative. What is important to remember is that a single increase in the quantity of money will hold down interest rates only temporarily. To keep rates down, another injection of money would be necessary – then another and another. But such increases in money do not increase the real quantity of savings and credit. The interest rates are being held artificially low, to which the market responds by adding on an inflation premium to compensate for the resulting rises in the general price level. In sum, a low-interest-rate policy, if continued, will and does result in higher market interest rates. In the meantime, real credit is being misallocated, and the course of economic growth is disrupted.

The same is true of policies intended to make the exchange rate more “competitive”. The benefits, whether real or merely perceived, are temporary, whereas the burdens accumulate over a longer time period. A so-called “competitive” exchange rate is not a rate that can be set once and for all. Its effectiveness wears out with time. Prices adjust to restore the international terms of trade. A

deliberately “competitive” exchange rate is a deliberate disequilibrium of the goods, currency, and credit markets. Its effects cannot be maintained except through continuous depreciation of the currency. To bring this about would require a continuous increase in the quantity of money at a rate beyond that which could be justified by demands of a normal economy. As with a low-interest-rate policy (which is also brought about through excessive monetary growth), a policy of “competitive” depreciation leads to price inflation and can aggravate industrial fluctuations.

The fact that devaluation is still advocated and used around the world in attempts to bestow competitiveness upon exporters shows that many people still believe in its usefulness. There are many who actively (though not always publicly) support the deliberate weakening of the rand. Some are true believers. Others know better, but recognise that their particular businesses are helped, at least temporarily, by a fall in the exchange rate. These latter interest groups either do not know or do not care that most others are hurt by the fall.

When the rand falls, it temporarily gives an obvious price advantage to South African exporters compared to what they would have had otherwise. For a finite period of time, foreigners will see a relative advantage in buying South African goods. Thus those companies and trade unions that are most desirous to export their products will lobby the government for any kind of “stimulus”, which may include deliberate depreciation of the rand.

There are two main problems with this “competitive depreciation”: it has large (often hidden) costs that are also borne by exporters, and it unambiguously harms all those who hold rand and all those who are not exporters. In other words, most people are harmed for the (possibly short-term) benefit of a few. When policy makers look at the net effect of a policy of deliberate depreciation, it should be recognised that exporters’ gains are smaller than the losses suffered by importers and other citizens. It is nothing more than a negative-sum redistribution of income: wealth is destroyed. And to keep this redistribution going, it is necessary to depreciate at an increasing rate. Once this is recognised, the argument that competitive depreciation is “in the national interest” falls apart.

It is worth repeating that a policy of deliberate currency depreciation is the same as a policy of deliberate price inflation. Both are caused by the inflation of the money supply. The economic “boom” that follows will turn out to be an illusion for most people. Most people will end up worse off. At first, profits and capital values are inflated: they rise. But so will the replacement costs faced by companies. Profits would then be used up in the replacement of materials and capital goods. Further, unexpectedly high profits might very well encourage more consumption instead of more local investment. The inflated profits could be paid out as dividends or used to acquire other (overseas) companies that operate in a less inflationary environment. The most likely outcome of this inflationist policy is a net loss of capital from South Africa – a loss that is further magnified by the fact that taxes are applied to nominal (inflated) profits, not real profits. As one more source of capital loss, this helps explain why South African interest rates remain higher than necessary.

These chronically high interest rates help obscure the cause-and-effect relationship between monetary inflation and price inflation. The high interest rates due to a chronic relative shortage of capital force everyone to be more liquid than they might otherwise wish to be. A business owner who might need capital injections in the future could expect, in a low-interest-rate environment, to meet those possible future capital needs through borrowing. But in the face of high expected borrowing costs, which signal a relative scarcity of capital, it would be prudent to hold larger quantities of more liquid assets, including cash, as a protection against contingencies. This is one way in which high interest rates encourage saving, a way that also happens to contribute to the demand for money. Domestic holding of currency is encouraged, and foreign capital is also attracted to the local currency by the high interest rates. The general price level will be lower, and the exchange value of the currency will be higher, than they would otherwise have been during this time.

Politically, however, such a situation also attracts local calls for an “easier” monetary policy and lower interest rates. When those demands are accommodated, giving the appearance of significantly easier access to credit, the situation can suddenly reverse. At the same time that money supply is increasing, one of the reasons for holding money fades away. Prices begin to rise – the first of which are those of foreign currencies and of sensitive commodities such as gold. The process of rising

prices will gradually touch the whole price structure, and will act toward restoring balance. But the easier monetary policy has not created more savings and credit. It has created only the illusion of these nice things while credit has merely been redistributed from higher-valued uses to lower-valued uses.

How not to carry out wishes

The nature of interest rates, and their role in human relations, makes them unsuitable as direct instruments of national monetary policy. This does not mean that they cannot be used in this manner; interest rates are the instrument of choice by most central banks, including the South African Reserve Bank. When the Reserve Bank wishes to “tighten” monetary conditions – to reduce liquidity, reduce inflation, and strengthen the currency – it takes actions that will (in the short-term) raise the repo rate, the interest rate on repurchase agreements. These actions would consist of some form of “open market operations”, the net effect of which is the reduction of the monetary base, the quantity of central-bank money available in the economy. (The monetary base, also known as M0, includes all notes and coins in circulation, plus the deposits of banks held at the Reserve Bank.) If the Reserve Bank instead chooses to “loosen” monetary conditions, it will take actions that increase the monetary base. Whatever the direction chosen, it is the change in the monetary base that begins the series of effects associated with monetary policy.

As was noted above, interest rates have a relation to the total demand for money. But they are not central to that demand. When interest rates are used to transmit the will of the central bank to the markets, the message is not unambiguous, or harmless (See Grant 1999). The repo rate could be rising, yet monetary conditions remain loose. Indeed, as was also noted above, a loose monetary policy soon produces higher market interest rates. This describes South Africa’s condition during most of the past twenty years. Only for brief periods has monetary policy been tight, and the official raising of interest rates to achieve this tightening was quick to disrupt credit markets, but slow to remove the cause of inflation. It is a bit like raising the price of sugar in order to reduce tea consumption. It can be made to work, but it is not direct, and not without “collateral damage” in other markets.

Interest rates are the price of credit, not the price of money. Even if there were no money, interest rates could still exist. The relationship between interest rates and the demand for money is arguably too complex and transitory (i.e., potentially too unstable) to justify the use of interest rates as either a guide or key instrument in central bank policy actions. To the extent that such actions are effective, they are so as a result of the effect on the quantity of money that is either issued or withdrawn from circulation by the central bank. In other words, when the Reserve Bank is succeeding in reducing inflation, or slowing the depreciation of the rand, it is not because of the choice of interest rate level. Inflation slows when the growth rate of the monetary base slows.

What gives a currency its value?

A currency has value because people hold it and use it in trade. The more units they hold, and the more they use a particular currency for exchanges, the higher will be the value of that currency. That is how one could describe the “demand for money”. As the economy grows, or in anticipation of increased personal economic participation, individuals will make greater use of money and its substitutes, such as bank accounts and other financial services. Such activity is the reason for the existence of money, and as the activity grows (with goods and services becoming more numerous and of higher quality) the value of each unit of the currency becomes higher than it would have been otherwise.

Why only “higher than it would have been”? The demand for money is only part of the monetary relation. The other side is the supply of money. When the quantity of money increases, then the value of each unit will become lower than it would have been otherwise. This is the same as saying that prices will be higher than they would have been otherwise. The more units of the currency there are in existence, the more of those units will be needed to purchase any particular good.

How do we know that a currency has fallen?

When prices go up for most goods that we can buy, then we can say that our money does not buy as much as it used to. For each unit of the money that we give as payment, we receive less in return. If that is our frame of reference, the standard by which we judge value, then we can say that our currency has fallen in value. When the rate of price inflation is greater than zero, the currency is falling in value. At an inflation rate of 8%, the rand is falling in value faster than it was at 6%.

We do not need to look outside the country to know that the money is falling in value. Everyone can see the prices rising for goods in local shops. But those are not the only goods we buy, and some of them come from abroad. Purchases of goods from other countries entail also the purchase of some amount of the currencies used in those countries. And each of those currencies will have a price; at any point in time, a specific quantity of rand will be needed to purchase one unit of the other currency. That is the exchange rate.

We usually speak of the “value of the currency” in comparison to other currencies rather than to a local standard, though one often hears reference to “internal value” as opposed to “external value” of the rand. The internal value (the local purchasing power) of the rand is usually measured using broad price indices such as the CPI and the CPIX. Being broad-based, these indices will tend to change more slowly than do narrower indices or single prices. An exchange rate is a single price. It is the price of another currency, which, although its value is also dependent on its relation to a multitude of other goods, can change in relative value at least as quickly as a local average of prices. An exchange rate can seem to remain steady for long periods, or trend slowly, or move suddenly and drastically.

Small exchange-rate fluctuations are a daily occurrence, and for the most part not a concern. Even large changes against minor currencies do not necessarily command newspaper headlines. But when the rand price of the US dollar rises at a double-digit rate, it is a matter of serious concern. The dollar is a standard of international comparison, it is the most marketable currency in the world, and is ubiquitously used in transactions well beyond the borders of its home country. This is not to suggest that the dollar is an ideal or absolute standard of value. It is not. But the broad usage of the dollar, and a US price inflation rate of virtually zero, does clearly suggest that the dollar is more stable than the rand in objective value. When the rand-dollar exchange rate changes, it is the dollar that assumes the role of “frame of reference”.

The dollar is not always worthy of its role as a frame of reference. In recent history it has suffered several periods of weakness, particularly in the 1970s after its link to gold was finally severed. In the late 1990s, the dollar was arguably too strong, and particularly so during the year 2000 when the US monetary base declined. This did not bode well for those countries that had linked their currencies to the dollar but had neglected to deregulate their economies and reduce their rates of taxation toward US levels. Argentina, for example, was not wrong to fix the peso to the dollar. But it was wrong to raise tax rates and to fail to deregulate. The United States also is not immune to this consideration, and might have escaped the economic slowdown of 2001 had certain of its tax rates been lower, its regulatory bodies less intrusive, and its constitution better respected.

Dollar strength does not explain more than a tiny amount of the fall of the rand during 2001. The dollar itself did not change drastically relative to gold or other major currencies during that year. Although the dollar environment had been somewhat deflationary, this was not a sudden, late-2001 phenomenon: the dollar had been too strong against gold since 1997, but the rand price of gold has never been higher than it is now (early-2002). When gold is used as the frame of reference the value of the rand has fallen just as worryingly. (The rand price of gold tracks the South African price level (CPI) more closely than does the dollar exchange rate.) It is a signal, an intermediate sign that South Africa has entered another episode of rising inflation. But what was the cause?

2 *What happened during 2001?*

During the first half of 2001, it was predictable (Grant, 2001) and reasonable to assume that the rand would continue gradually to depreciate against the US dollar until such time as the Reserve Bank had gone beyond its current targets and had brought the South African inflation rate down to a very low, single-digit range. During the early part of the year, the rates of increase of money-supply figures and the various price indices (used to estimate price inflation) all appeared to be slowing. Success in reducing inflation seemed all but assured. After July, however, it became increasingly clear that the Reserve Bank was allowing growth of the money supply to accelerate once again. From July through November, the monetary base (better known as M0), which is the quantity of real money actually produced by the Reserve Bank, increased from R40.3 billion to R45.9 billion. That is an increase of 13.8 percent over four months, which if continued for a year would result in an annual increase of close to 50 percent. Part of the increase in M0, R1.75 billion, was to accommodate an increased need by commercial banks for reserves due to a change in official reserve requirements. Allowing for this, the effective change in M0 from July through November was over 9.5 percent, which is over 31 percent in annualised terms.

But it did not stop there. The figures for December showed a further one-month increase of 6.56 percent. Over the five-month period from July to December 2001, M0 increased by 21.3 percent – adjusted for required reserve changes, the effective rate is 16.5 percent. That corresponds to an annualised nominal growth rate of 59 percent, and an adjusted rate of 44 percent, which is a huge dose of cash for any economy to absorb. It should be no wonder that the rand has fallen in an almost mirror-like fashion.

When M0 increases significantly, the general price level tends to go in the same direction. All prices, including exchange rates, are affected in the same way, and will tend to be higher than they would have been. That is why price indices, such as CPI and CPIX, tend to move in the same direction as the rand prices of foreign currencies. Exchange rates respond to changes in the monetary base, and usually do so more quickly than do other prices. That is why some analysts often mistakenly identify exchange rate changes as a primary cause of price inflation. But the exchange rates, being prices themselves, are not the cause of inflation: exchange rates are caused to change by the same factors that cause other prices to change (see Grant 1999, pp. 36-37). Exchange rates are affected most significantly by the actions of the relevant central banks – more specifically, by how those central banks manage their monetary bases, i.e., by how much money they themselves create or eliminate.

At times when M0 and the general price level have very low rates of increase, then other factors, such as the rate of economic growth, will have a greater relative significance to changes in the price level than would be the case during periods of high inflation. The rate of economic growth is not as susceptible to sudden change as is the growth rate of M0. There is no single person, company, or government agency that can directly and sustainably control the rate of economic growth in any country. There is, however, an agency that can control the quantity of M0: the central bank. In South Africa, that role is played by the Reserve Bank, which has a statutory monopoly on the issue of rand notes and coins. By carrying sole authority (granted to it by the people of South Africa) for the creation of real cash, the Reserve Bank also carries sole responsibility for the creation of price inflation.

No other bank or financial institution can do what the Reserve Bank has the power to do. Commercial banks can extend loans through the creation of bank deposits, which serve to facilitate the holding and transfer of money and come also to be seen as money. But this deposit “money” is of a different character than the real cash upon which its own existence depends. The amount of loans extended by commercial banks is limited by the willingness of people to own deposits rather than hold cash or some other asset. The action of real people going about their daily business (the “market forces” that we hear so much about) is the determining factor that limits credit expansion and the creation of bank deposits. This is what determines the difference between M0 and the broader

measures of “money”, such as M1, M2 and M3. A commercial bank that lends too much (or lends at unfavourable rates of interest), risks loss and possible failure.

No such limitation is placed on the growth of M0. The Reserve Bank is not subject to “market forces” in the same way that commercial banks are. In relation to the central bank, the users of rand do not have the same range of choices available to them that they have in their dealings with commercial banks. By law, South Africans are not supposed to use any money other than rand in their daily domestic business. Even when dealing internationally, they must observe the unsettling formality of seeking the permission of the Reserve Bank to obtain and use foreign currency. The legal monopoly on currency issue enjoyed by the Reserve Bank makes it far less dependent for its continued existence on the consequences of its actions than it would be if citizens were free to choose the type, or “brand”, of money that they use. To the extent that the Reserve Bank and its officers are sensitive to the consequences of their actions, they are so through political pressures rather than direct market influences. That is the nature and necessity of a government agency.

Officially, the Reserve Bank has a policy of targeting inflation and allowing other variables, such as exchange rates, to be determined by the “free market”. Thus it might be concluded that the recent precipitous change in the value of the rand with respect to the dollar (and other currencies) is a consequence of market forces, benign and otherwise. To the extent that people are able to take the quantity of rand that is issued into the market and use it freely in their daily activities, this is correct. But this activity can never be separated from the fact that control of the monetary base, M0, is not a market activity. By the very nature of their institutions, central bankers are at least once removed from the marketplace. They may interact with the market, but are not of the market. Through the authority of the state of which all citizens are a part, South Africa has an established currency. That is both a legal and practical fact.

It is equally pointless for apologists to pretend that the Reserve Bank is “just responding to the market” as it is for free-marketeers to demand that it do so. Under current law, full and true market responsiveness by the central bank is not possible. The Reserve Bank can use various prices, commodities, or other currencies as its standard of value; or it can choose not to do so. Whatever standard, or rule, is chosen for the conduct of monetary policy, that choice is the responsibility of the Reserve Bank or a higher authority. The “market” takes what it is given, and each individual acts accordingly.

What has the market been given?

The short answer to this question is that the market has been given too much money – too many newly created rand – in a given period of time. As noted above, from July through November 2001, the Reserve Bank increased the monetary base, M0, at an annualised rate of over 30 percent – and then increased it more. For whatever reason, the Reserve Bank chose to do that, or at least chose to take the daily actions that led to that result. Such a sudden and rapid increase in any similar primary variable is highly improbable, if not impossible, in the private sector. While M0 was suffering this rapid increase, the broad monetary measure, M3, was increasing at an annualised rate of only 17 percent. Although M3 contains the quantity of rand notes and coins in circulation in the non-bank sector, most of the components that comprise M3 are the liabilities of commercial financial institutions. In other words, the private sector has not obviously “demanded” the increase in the money supply that we have observed. Nevertheless, the Reserve Bank has created that money – and we can expect people to accept and spend the money, and banks to create deposits and extend loans on that basis. That is, M3 will be seen to increase as a result of the M0 increase.

Ghosts from the past

When a central bank wishes to firm up the value of its currency in the foreign exchange markets, it has several related options. The most effective and lasting method is to slow the growth rate of M0. With fewer units of the currency entering into circulation, the supply of the currency will be lower than it would otherwise have been, and the exchange value of the currency will be higher than it would have been. The quickness and strength with which the exchange rate responds to the growth

rate of M0 vary as conditions and expectations change. Direct trading by the central bank in the foreign exchange markets will make the strongest and closest impact. This impact can be strong enough to maintain the exchange rate for short periods of time, even though the central bank continues to inflate the total quantity of money. In the long term, however, the direction of the exchange rate will depend on the overall management of the monetary base.

Direct intervention, to support the value of the rand against the dollar, requires the sale of dollars and the receipt of rand. To sustain such an action requires an adequate supply of dollars (or dollar-related assets), held by the Reserve Bank as reserves, to be sold for rand whenever the exchange rate shows weakness. When South African monetary inflation is high, as it has been for most of the past twenty years, the Reserve Bank's foreign exchange reserves tend to be run down to levels that make further direct support of the exchange rate infeasible. The only way to continue this support, parallel to an inflationary monetary policy, is to borrow dollar reserves. When these reserves are sold, the Reserve Bank has a dollar liability, but no matching asset other than its power to create rand.

In order to repay its dollar debt, the Reserve Bank must eventually reverse the process: it must obtain dollars. To do so, it creates rand with which it pays for the dollars. This can be done gradually, spreading the effect over a long period of time, or it can be done quickly. During periods of relatively low monetary inflation, when the rand is correspondingly "strong", the repayment of the dollars will not be seen to affect the exchange rate adversely. At other times, however, such a repayment will be associated with an observable depreciation of the rand. The magnitude of the depreciation will depend on the size and timing of the transactions involved.

The year 2001 began in South Africa as a time of relatively low monetary inflation, with the annual growth rate of M0 getting down into the upper single-digits. This augmented the credibility of the Reserve Bank's stated goal of bringing the average level of price inflation down below 6% by the end of 2002. It also justified optimism. But the Bank also entered the year still carrying a huge, uncovered dollar liability: the net open foreign-currency position (NOFP), "which is calculated by netting the Bank's net international reserves against its oversold forward book", was \$9.5 billion in January 2001. (At an exchange rate of R7.70 per dollar, that would be about R73 billion.) By mid-year the NOFP had fallen to \$4.8 billion, where it remained for the rest of the year. In January 2002, the NOFP fell to \$3 billion, though most of that occurred only as a result of the Treasury taking the loan liability onto its books.

Since mid-1998, the trend in the NOFP has been downward: it began the year 1999 at \$21.7 billion. During the process of eliminating this liability (not merely shifting it to another department), there has been downward pressure on the value of the rand: during this period the rand would be lower than it would have been otherwise. The purpose of dollar sales, whether in the forward market or from borrowed reserves, is to hold the value of the rand higher than warranted during some period of time. Ostensibly, the purpose had been to make the exchange rate less volatile, but the build-up to a net position of over \$20 billion shows that there was a bias toward treating symptoms of inflation rather than stopping the inflation. Since mid-1998, however, there seems to have been a genuine commitment to reduce these unhelpful liabilities.

Thus, the present is haunted by these ghosts of the past. These short-term props became long-term depressants. But with their gradual elimination, they have become less of a factor. Even during this process, however, the strongest long-term determining factor has been the growth of the monetary base. And before that, to the extent that M0 had grown during the period of the dollar sales, it ensured a continuation of the downward long-term trend for the rand. It was as if the crew were furiously bailing out the boat, but not bothering to plug the leak.

The boat had been leaking quite badly, though at varying rates, for most of the past twenty years. As already noted, a clear determination on the part of the Bank to bring down inflation seemed, by early-2001, to be yielding positive results. But, for whatever reason, by August 2001 a strong upward movement in M0 had begun. That monetary inflation was sufficient to explain at least half of the 30 percent plunge in the rand's value before the correction. It was not the only force present; it never is. But it was the dominant force.

3 *Patriots and traders*

Foreign exchange traders are not the only ones who have watched this happening, and who have predicted the likely consequences. They could not help but conclude that the rand would fall in value relative, not only to most currencies, but to most commodities as well. Anyone holding a rand will find that it buys less and less of most other things. Why would anyone hold rand when to do so assures a loss of wealth? Is there any financial advisor who would recommend such a course? Is there any official of the Reserve Bank who would recommend it? Perhaps one might appeal to patriotism, but how is it patriotic to impoverish oneself? What is the gain to the nation when citizens hold on to a currency that is being inflated? Once the Reserve Bank has expanded the money supply (and unless it quickly reverses the expansion) the value of the rand will become less than it would have been otherwise. That means that prices of goods in South Africa will become higher, as will the prices of foreign currencies. The only question is, “How quickly will prices respond?” Patriots in the private sector have no power to stop the changes, unless everyone holds more cash. But if the cash is merely to be held, why create it in the first place? In any event, once it has been created, those who are most “patriotic” will be the most harmed, and will receive no material benefit for their gesture.

If policy-makers value patriotism, one would expect them to avoid policies that discourage patriotic behaviour. Policy-making must be guided by considerations of how people will be affected and how they are likely to respond. It also presupposes some conception of what constitutes patriotic behaviour, and of how to determine the “national interest”. If it is considered to be in the national interest, with the implication of duty, that citizens continue to hold and use the national currency during a period of inflation, at what level of inflation might they be released from that duty? Is there no difference between an inflation rate of three percent and one of 30 percent? Perhaps the answer might be conditional upon whether the cause of the inflation (and currency depreciation) is internal or inflicted upon the nation by outsiders. We can examine the potential for an external attack on the currency, and of outside forces that might weaken the national currency and cause inflation. But before we look outward, it might be wise to ask, “How is it in the national interest that the Reserve Bank should increase the monetary base at an annualised rate of 44 percent, even if only for five months?”

Historically, the Reserve Bank has tended to increase M0 relatively rapidly toward the end of each year. This is to accommodate a perceived increase in the need for cash during summer vacation and at Christmas time. Then, early in the New Year, some of the cash is gradually removed from circulation. That is why the rate of M0 increase is lower when measured over longer periods: for the year ending in November 2001, the Reserve Bank has published an increase of 17.14 percent (later revised to 15.84 percent). For the year ending in July 2001, the published rate of increase for M0 was “only” 11.8 percent. And for the year ending December 2001, the published increase was 14.73 percent (later revised to 13.64 percent). This shows a big upward change that is not merely seasonal in nature. It suggests that, not only is control of M0 volatile during the year, but there is also a new upward trend in M0 that must necessarily cause alarm. Is the real economy also growing at a rate of 17 percent, or even 11 percent? Is it expected to be? If it were, then a high M0 growth rate would be warranted. But the rate of economic growth appears, in reality, to be much lower – in the low single digits. [The M0 annual growth rate subsequently went higher.]

The growth rate of M0 is volatile because the Reserve Bank does not focus its attention directly on it. Instead, it focuses on managing the rate of increase of a general price index, the CPIX. The rate of change of the CPIX is an estimate of “the” rate of price inflation. When the CPIX is rising, or is expected to rise, a policy of inflation targeting would require the Bank to reduce the growth rate of M0 sufficiently to bring the rate of price inflation down to an acceptable rate. At the best of times, coordinating this is difficult: the effect of changes in the monetary base on consumer prices occurs gradually over time, affecting different prices at different rates (see Grant 2001, pp.21-23). These difficulties are compounded when central banks attempt to alter the size of the money supply by manipulating interest rates, and the “demand for money”, rather than controlling the level of M0

directly (see Grant 1999, pp.103-113). This may explain the seemingly out-of-control behaviour that the Reserve Bank's monetary operations periodically exhibit.

It is not necessary for the Reserve Bank to scrap its inflation targets; they are quite reasonable. But in order to achieve them, and to bring down interest rates as well, it will be necessary to change the Bank's method of managing the money supply. This can be done immediately without any organisational disruption, but must involve some method to guide the direct and steady control of M0.

Do we need to “fight” inflation?

It is very common to hear economists and central bankers speak about “fighting” inflation or currency weakness. The implication of this sort of language is that the cause of currency weakness is seen as being “out there” rather than “in here”. But the only countries that have been successful in controlling inflation (and thus maintaining the value of their currency) have been those that recognised the sole responsibility of their own central banks. As mentioned above, the central bank has a monopoly on the creation of cash. But it is extremely important to notice also that it is only through the control of cash creation that the value of the currency can be controlled. Cash, which includes notes and coins in circulation plus reserves held by financial institutions, is formally known as M0. It is the foundation upon which all deposit creation depends.

When M0 is increased, prices will later be higher than they would have been otherwise. An increase in M0 is the essential element in the process that we call inflation. Without it, there is no price inflation. Further, it is not caused by some malicious or impersonal outside force. It is caused at home, by the domestic central bank. In South Africa, it is the responsibility of the Reserve Bank. No other group has that power. There is no outside force to “attack” or “fight” against. Any such fight is necessarily an internal struggle. The Reserve Bank causes inflation; only it can stop the inflation.

There are still those who believe that South African inflation is a “cost push” phenomenon. Others are more specific in identifying administrative prices (controlled by government agencies) as being strong determinants of the rate of price inflation. But these observers have failed to consider the full context in which inflation occurs. By failing to recognise the difference between cause and effect, and between what is discretionary and what is necessary, they end up saying nothing more than “prices went up because prices went up”. (See Grant 1999, pp.36-37, 50-54.)

Asymmetric accommodation

Prices are simply ratios of how much of one good people are willing to give up to receive another good. As these ratios change over time with some prices going up and some going down – and changing direction at other times – the general price level will also fluctuate. (Single prices and narrower indices obviously fluctuate more than do broader indices.) These price changes are a natural part of daily trade and will occur regardless of monetary policy. But when monetary policy decisions attempt to accommodate (follow) these kinds of price movements, the result is not natural. It is not a matter of responding to market needs. As mentioned above, the central bank is a political institution with monopoly power over money supply. This does not make it omnipotent, but neither does it make it omniscient.

Central banks often have a tendency to accommodate upward movements in prices but are reluctant to do the opposite for downward movements. Upward accommodation of non-monetary general price fluctuations gives the illusion of continuous non-monetary inflation, and is a source of the “cost-push” mythology mentioned in the previous section. This accommodation is sometimes referred to as “validation” of the inflation. It is a poorly chosen word: it suggests that the non-monetary events that brought about the upward fluctuation are also the cause of the continuous experience of price inflation. Many observers lose the trail of causation in the overlapping statistics. Previous monetary inflation can affect prices gradually over long periods of time, and the lags between action and result are neither uniform nor narrow.

How to stabilise the rand

The bottom line is that inflation will be stopped when the Reserve Bank stops increasing the quantity of M0 at high rates. This can be put into effect immediately by placing limits on by how much M0 is allowed to change (either up or down) on a weekly basis. By reducing both the growth rate and the volatility of M0, the rate of price inflation will be brought under sustainable control, and monetary policy will cease to be the disruptive force on the South African economy that it has been for the past several decades.

As a direct consequence of properly controlling M0, the exchange rate of the rand will stabilise relative to the major currencies – and cease to be a matter of concern. This does not mean that there will be no fluctuations in exchange rates, only that the fluctuations will be much smaller and slower. The recent problems with the rand are not derived from the change in exchange rates alone. It is possible, as has been argued (Grant 2001, p.24), that recently the US dollar has been too strong a standard by which to judge another currency. But this strength does not explain the drastic falls in the value of the rand. Even compared to gold, which is a superior standard of measurement (especially for South Africa), the rand has fallen. Similarly, when the dollar falls against gold – as it has in early 2002 – that will not be sufficient to free South Africa from inflation, even though the rand will appear stronger against the dollar.

Another advantage of directly controlling M0 is that the Reserve Bank would no longer have a reason to manipulate interest rates. The current practice of raising or lowering interest rates to “head off inflation” or to “stimulate the economy” is itself disruptive to the economy; it is more often a source of trouble than a cure. Raising interest rates does not even have an unambiguous impact on inflation expectations. In the medium to long term, inflation and interest rates rise and fall together. No central bank has, or can have, enough information to decide what the level of interest rates should be at any given time (see Grant 1999, pp.101-129).

4 *What did not cause the rand's weakness?*

Although the evidence linking the rand's weakness to excessive growth of M0 is impossible to ignore, there are still many accusations being hurled in several other directions. Some of these accusations have already been addressed above; it is important also to examine the possible effects of speculation and international contagion.

Contagion?

Some observers have pointed out that the rapid drop in the value of the rand during late 2001 coincided with the social and economic crises in Zimbabwe and Argentina. It was then suggested that the maladies of those countries were communicable, and that South Africa was unlucky enough to have caught the ailment. If this can happen, then we need to examine how it can happen. It might be best to begin by asking, Why is it that some countries are affected by "contagion" from bad events elsewhere, but other countries seem not to be?

Investors do not know everything, and they are well aware of that. They use various methods to find and digest information. In many cases they economise on their use of information by looking for similarities in different countries and economic sectors and then treat groups of similar countries and sectors the same way. Perhaps many investors place South Africa in the same general category as Zimbabwe or Argentina. It is understandable then that when something goes wrong in either of those two countries, investors will either subject their South African investments to closer scrutiny or cautiously sell them. Closer scrutiny will reveal more good and bad attributes of an investment. If the better-informed investors are satisfied that their assets are safe and worthwhile, they will maintain their investments and, perhaps, buy more assets from the less-well-informed investors who wish to sell. The effect on asset and currency prices would tend to be small and temporary. If, however, the investigation reveals that investment conditions have deteriorated, or are not as good as previously thought, then asset prices can be expected to fall accordingly. If a significant portion of the investors moves the proceeds of their sales out of the country, then this will have a downward effect, at least temporarily, on the exchange value of the local currency.

Did South Africa catch an illness from Zimbabwe or Argentina? No, it did not. The most that happened was that investors took a closer look at the political, economic, and social conditions of the country and saw something that caused them to revise their expectations. Of all the factors that might have given them a fright sufficient to reduce (so rapidly) the dollar value of the rand by one third, the one that stands out is the rapid increase in M0. A sudden, apparently unnecessary, inflation of the money supply leads investors to worry about further surprise inflations in the future. These expectations of future inflation are then "capitalised" in current prices, with one symptom being an even larger drop in the exchange value of the local currency. As long as the Reserve Bank executes its policies in a manner that seems inconsistent or erratic, the rand will always appear, in the eyes of those who do not recognise this, to be "undervalued". The bad news is that it is not undervalued. The good news is that the discrepancy can be removed by an internal change of policy.

The worst thing that could happen is that the government reacts inappropriately and makes matters worse. There are many historical examples of this. When governments react by tightening exchange controls, they frighten away potential investors and give citizens an increased incentive to move more of their wealth out of the control area. At best, the result of the tightened controls is a false sense of stability – the stability of stagnation.

Another example of inappropriate policy response has given rise to the urban legend that "increases in oil prices cause inflation". This belief was given great impetus during the 1970s when the OPEC countries quadrupled oil prices in 1973 and increased them again later in the decade. It was during this time that inflation rates rose significantly in the major oil-importing countries. Observing this coincidence, it was not difficult to jump to the conclusion that the inflation was caused by the oil price increases. This conclusion was (and is) wrong. What most people failed to notice, because they did not understand the relationship, was that central banks had reacted to the

fear of recession (that might be triggered by the oil price increases) by significantly increasing the quantity of M0. The central banks had recently been set free to inflate when the link between gold and the dollar was severed with the final demise of the Bretton Woods system. The inflation of the 1970s was caused by deliberate increases in money supply; the oil price was “framed”. But the larger story is worse than that. The inflationary policies of the central banks magnified the potential for recession, and gave the world the decade of “stagflation”: both stagnation and inflation.

The pathway of apparent “contagion” is usually paved in advance by the respective governments. Policy actions that are detrimental to the economy, such as rapid increases (or decreases) in M0, are often not detected immediately by those who might be affected adversely. Often, these people never know the real causes of their difficulties. But they do feel the effects. And the effects will come sooner or later, whether or not there is trouble elsewhere in the world. The policy actions of the South African Reserve Bank during 2001 cleared the pathway to the R10 dollar and beyond. The most that Argentina and Zimbabwe could have contributed to this was a slightly quicker journey to where the rand was going anyway.

Speculators?

Have “speculators” attacked the currency of South Africa? Probably. They were invited to do so. And it does not matter that those issuing the invitations did not have that intention. As emphasised above, when the Reserve Bank increases the monetary base (M0), there will be consequences. The speculators do not create those consequences, they merely predict them. When they act upon their own predictions (in order to profit from them), and when their predictions are correct, they accelerate the appearance of the predicted outcomes.

Simply stated, “speculators” do not really cause the outcomes for which they are often blamed. The total array of outcomes is, of course, affected by the timing of the speculators’ actions. But to describe the overall effect of their actions as negative is to ignore the possible benefits of the revelation of fundamental reality sooner rather than later. Speculators react to what they see, to what has already happened, and to what they expect will happen next. If their beliefs are groundless, they are likely to lose money. They gain a profit only when they are correct in their evaluations of what they have seen.

When contemplating a policy response to speculation, it is necessary to separate the context and capabilities of speculators from their intent. What they can do, and what they intend to do, are not necessarily the same. Those who attempt to do the impossible will invariably suffer loss. They will lose resources to those who are acting in closer concert with the realities of the marketplace. Some traders may try to set up a profit by taking advantage of quirks in the institutional structures of stock and commodity exchanges. Others may wittingly or unwittingly break the law in pursuit of profit. In either case, there are natural remedies: the already-existing institutions will react to reduce the quirks, and to enforce the law. To the extent that people feel able, or compelled, to break the law – or to the extent that people unwittingly break the law – it may be advisable either to improve the publicity and enforcement of the law, or to change the law itself.

It is far easier to react to a profitable situation that presents itself than to set it up from scratch. In its roots, the word “speculate” does not imply any sort of “attack”. It is derived from the same roots as the Latin words that meant “to observe”, “to explore” and “to spy”. The Latin word *speculum* meant “mirror”. We find here not only “observation” but also the implication of “reflection”. In English we often use the word “reflect” to mean “to think”. Similarly, the English word “speculate” has taken on a similar meaning. This serves to show us something of the application of the word before it picked up its somewhat sinister connotations in more recent times. The sinister connotations come more from the targeting of speculators as convenient scapegoats, implicated by their uncovering of a problem rather than by their creating it. Speculators, in the modern (commercial) sense, observe what is happening, think about the consequences, and become relevant to our discussion by acting upon their predictions. Speculators are regularly attacked by politicians who need to cover up their own mistakes, and by other investors who lost out by not being as observant or as quick as the other speculators.

Do speculators act morally? Do they act lawfully? The answers to both questions might be delivered in a more useful form by answering the practical question, “Should we stop them from acting?” As policy makers, we could identify whatever it is that they do, and then make it illegal. But would the consequences of such law-making be desirable or, as is more likely, make the situation worse? All too often, regulatory laws have effects that are not only unintended, but opposite to those that are intended. Exchange controls are an obvious example of this.

A real attack

Exchange controls are touted as being a means of protecting the external value of the local currency and of keeping capital within the country. On the surface, this seems to make sense: if people are limited as to how much foreign currency they are allowed to purchase each year, then it follows that they will spend and invest less in foreign locations, and more in the domestic economy, than they might have otherwise. Similarly, the value of the currency should be held higher by the reduced effective demand for foreign currencies. The trouble is that it does not really work that way. The honest supporters of exchange controls have forgotten that the world is in motion: it is a place for living. Without the continuing work and care of people, capital wastes away. Exchange controls do nothing to help this. By restricting the ability of South African residents to function freely in the foreign exchange markets and in international trade and investment, these controls put South Africans at a disadvantage. Exchange controls reduce the rights of South Africans relative to the residents of other countries, and give no benefit in return. They are an example of a policy that punishes patriotism.

Exchange controls are an attack on more than just the rand. The punishment of patriotism devalues citizenship and gives impetus to what is called the “brain drain” or “skills drain”. The loss of skills has the same effect as a loss of capital. But that is not the only capital loss. Foreign investors are more wary of a country that feels it needs such controls. Experience shows that the presence of exchange controls signals the existence of other pernicious policies and regulations – and gives reason to fear future policy misjudgements. As a result, higher returns are required, and interest rates are likely to be higher. This is an effect that is opposite to what was supposedly intended. (See Grant 1992; 1999 pp.84-87)

A further loss is created through the long-term effect that bad law has of reducing respect for all law, and for governmental authority. Exchange controls have undoubtedly made such a negative contribution. They are not alone in this: there is a complex array of harmful regulations, as well as some useful ones, and many that are relatively benign. Common are those regulations that seem to have no effect other than to impose compliance costs on private businesses, their customers, and other residents in the form of cash drains, increased bureaucracy (both public and private), and business uncertainty. None of these regulations can stop what is called “speculation”; they can only change its appearance.

We are all speculators now

The harder one looks at “speculation” as an activity, the less mysterious it becomes. Currency speculation is not limited to professional currency traders. It is a natural part of any business that makes or receives payment in other currencies. When the rand is expected to fall, any South African who receives a payment in US dollars will have an incentive to delay selling them for rand as long as possible, and as long as allowed by exchange control regulations. If the rand were to strengthen relative to the dollar during this period, then this “speculator” would lose wealth. To speculate is not necessarily to be correct in one’s predictions. Most business managers try to limit the risks that they take to levels that they can justify. They may deliberately “hedge” their investments by buying or selling in the forward (or futures) market that corresponds to their inputs or product. Speculators play an important role in taking on the risks of those who might not otherwise be able to engage in a particular type of business – whether mining, farming, or manufacturing.

Risk is never completely removed from business or any other human activity. We speculate when we delay buying an appliance, such as a computer, in the hope that its price might be lower in the

future. We speculate when we buy it now in the belief that its price will be higher in the future. Even governments speculate. When a government increases the size of its budget, it is speculating that it will be able to raise the funds necessary to cover that budget. When the Reserve Bank acts to raise or lower interest rates, it is speculating that this will have the desired effect on monetary demand, and on economic activity. When the Bank deliberately weakens the rand, in a short-sighted attempt to subsidise exporters, it is speculating that the economic and political gains will not be wiped out by the “side effects”.

None of us can avoid speculating to some extent. Indeed, the aspect of speculation that entails observation and reflection should more likely be encouraged rather than punished. What we should discourage is the taking on of unreasonable or uninformed risk. We should especially discourage actions that put others at risk without their consent or possibility of compensation. That is the purpose, and usually the effect, of our basic laws. For centuries we have had laws against theft, fraud, and the initiation of force. To the extent that they are recognised as having desirable net effects, such laws survive the test of time. Others do not survive, and others still should not survive.

If there are speculators who gain (or lose) from the use of theft, fraud, or the initiation of force, they could and should be dealt with by the currently existing laws of any country with a fair judicial system. But investigations that are seen as witch hunts against individuals who may be guilty of none of the above will serve only to stifle commerce, confidence, and social harmony. An honest and clear-headed search for the causes of the recent steep fall of the rand will recognise that acts of “speculation” were made possible and encouraged by the loose and erratic monetary policies of a government agency, the Reserve Bank. For residents of South Africa, what is called “speculation” is, in fact, self-defence.

5 *Conclusion*

Sometimes it takes a great deal of thought to recognise the obvious. Significant events that unfold before a complex background can often pass undetected by observers who are overwhelmed by the complexity and do not know where to look. This seems to describe the present scenario (following the latest fall of the rand), in which those with the loudest voices are directing our attention in exactly the wrong direction. It is not contagion, speculation, treason, or even racism that has caused the rand to depreciate against most other currencies during the year 2001. The cause of the rand's fall is much closer to home, and much simpler, than many people wish to recognise. The fall of the rand was caused by the actions of the government agency that produces it: the South African Reserve Bank. The Reserve Bank increased the base supply of rand and, as happens to any commodity for which supply is increased, the value of the rand became lower than it would have been otherwise. Whatever the motives of the Bank, this is what happened. The sudden rapidity of M0 increase, though temporary, brought a quick reaction (and, perhaps, over-reaction) from those who had good reason to fear a return to the old inflationist ways.

Those who search for a more "complex" explanation are missing the point. A craving for complex solutions is often the product of an insufficiently complex worldview. When details blind us to the big picture, we have a problem. When we fiddle with the vagaries of prices and monetary demand, and then let the money supply go wild, we have a big problem. That problem is much larger than the changing exchange rate: the whole economy and the price structure have been, and will be, disrupted by the huge increase in the monetary base (M0). No credible demand-for-money argument can justify the degree of instability in the past management of M0. Any other possible contributor to the fall in the rand is trifling in comparison. The whole history of inflation in South Africa leads us repeatedly back to the same source. Until that source is recognised for what it is, we will continue to see monetary disruption, an under-performing economy, and a weak currency.

Certainly, South Africans would benefit from less regulation, less-intrusive social policies, and a far less ambitious fiscal policy. [Note that this is not a call for zero regulation, no social policy, or the abolition of government spending.] Whatever the level of inflation, improvements in these policies would bring an improvement in the overall standard of living. A cut in marginal tax rates would be (and has been) very positive for long-term growth and for the demand for the rand. But these types of policies are not the cause of inflation or of the long-term downtrend of the rand. Even if such policies were inflationary, they did not change as suddenly as did M0 during 2001.

Whatever method is chosen to restore stability to the value of the rand, it must contain one crucial element: a limit on the growth of M0. This limit has two dimensions: growth rate and volatility. The growth rate of M0 should be close to the expected (reasonable) growth rate of the economy, perhaps three to four percent – but not more than ten percent. This increase in M0 should be reasonably uniform throughout the year. The growth rate should not be volatile; the injection of money should occur smoothly over time (see Grant 1999, pp.156-162). Perhaps this could best be achieved by stabilising the spot rand price of gold. There is more than one method of controlling M0 and determining its growth rate (see Grant 2001), but there is no escape from the need to control M0. The Reserve Bank has the monopoly necessary to do this, and this is the only way that it will achieve its inflation targets.