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South African Rand Manipulation: Economic and Social Implications of Sluggish Regulatory Responsiveness

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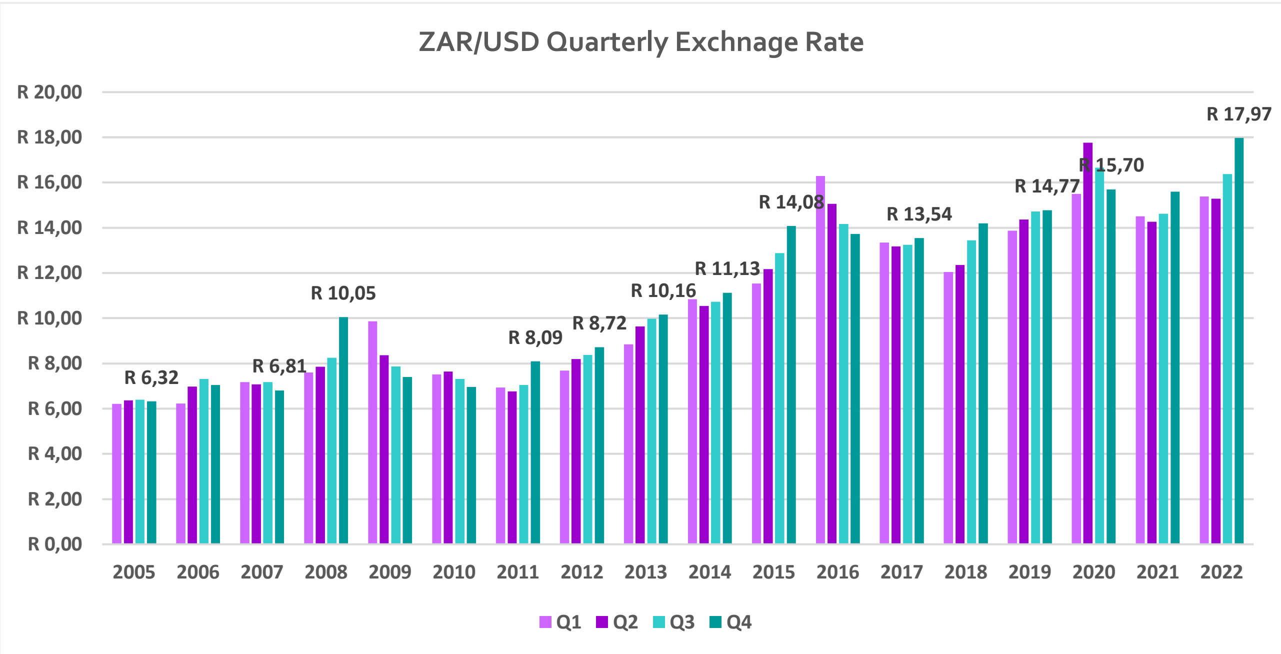
South African Rand Manipulation

The recent revelations of the illegal manipulation of the South African rand by several local and international banks have raised serious concerns about the integrity and efficiency of the foreign exchange market in South Africa. As a licensed rating agency, we note that currency manipulation may come in the form of both legal and illegal currency manipulation considering speculative trades, and central bank instruments for monetary policy purposes which are considered legal. On the other hand, collusion by market players is an illegal practice. We understand the gravity of the alleged manipulation of the rand by major banks and its potential negative consequences on consumers, the economy, and the reputation of these profit-driven entities. We are closely monitoring the developments and the potential implications for the country's macroeconomic stability, financial sector soundness, and sovereign creditworthiness.

The rand manipulation involved traders from different banks colluding to fix the bid-ask spread, the price, and the volume of the rand against other currencies, mainly the US dollar, between 2007 and 2013. According to the Competition Commission, the banks generated about a trillion rand a day from this illegal activity, which distorted the market signals and harmed the interests of other participants, especially the importers and exporters who rely on the foreign exchange market for their transactions. The Commission began looking into claims of rand manipulation and collaboration by a significant group of domestic and international financial firms in 2015. Barclays, Merrill Lynch, HSBC, Standard Chartered, Standard Bank, Absa, Investec, Citibank, and First Rand Bank were among them. Standard Chartered Plc recently acknowledged that it had manipulated currency trading in South Africa and agreed to pay a $2.3 million (R42.7 million) fine. The deal ended the Competition Commission's eight-year investigation into the bank's potential involvement in a cartel to manipulate the rand's value. In 2017, subsequent to acknowledging its participation, Citibank consented to payment of an administrative penalty totalling R69.5m and committed to complete cooperation in the prosecution of the case.



Labels reflecting quarter-four averages.

The rand manipulation also had adverse effects on the monetary policy transmission, the inflation outlook, and the balance of payments. By artificially weakening the rand, the banks increased the cost of imports and the inflationary pressures in the economy, which forced the South African Reserve Bank (SARB) to raise the interest rates more than it would have otherwise. This, in turn, reduced the economic growth and fiscal revenues and increased the public debt burden. Moreover, by creating volatility and uncertainty in the exchange rate, the banks discouraged foreign investment inflows and exacerbated the current account deficit, which made the country more vulnerable to external shocks and capital flight. This is reflected in the country's debt burden (even with a smaller share being foreign currency-denominated debt) and debt servicing costs considering the severely weakened currency strength of the rand against the U.S. dollar.

From a credit rating perspective, these factors collectively weigh heavily on the overall financial stability and economic outlook of South Africa. Sovereign Africa Ratings considers the manipulation of the rand to be a significant risk to the country's creditworthiness. This has resulted in several downgrades of South Africa's credit ratings, making it more expensive for the government and entities to borrow funds and limiting their access to international markets. This has prompted the need for alternative finance, as evidenced by the National Treasury reentering the Sukuk market after almost a decade.

It is worth noting the implications of the loss in currency strength both on the micro and macro levels. Firstly, the manipulation of the rand creates an unlevel playing field for consumers, leading to potential financial losses, increased costs via cost-push inflation from increased import prices, and reduced purchasing power. Increasing interest rates in an attempt to curb imported inflation will negatively impact local citizens' standard of living and further exacerbate economic inequality within South Africa without effectively controlling inflation. Such negative effects on consumers can subsequently lead to a decline in consumer confidence and reduced economic activity. Sovereign Africa Ratings views this as a credit negative in terms of the social and institutional effectiveness factors under consideration in its sovereign methodology.

Secondly, the manipulation of the rand has broader implications for the economy as a whole. It undermines the stability of the financial market and erodes trust in the banking sector. This directly affects investor sentiment, potentially leading to capital flight and reduced foreign direct investment (FDI) into South Africa. With reduced FDI, the country's ability to attract much-needed investment for infrastructure development, job creation, and economic growth becomes compromised.

The rand manipulation scandal has also exposed the weaknesses in the regulatory and supervisory framework of the foreign exchange market in South Africa. The SARB, as the custodian of the market, has admitted that it was unaware of the collusion and the market abuse and that it lacked the legal powers and the resources to effectively monitor and enforce the market conduct rules. The Financial Sector Conduct Authority (FSCA), as the regulator of financial institutions, has also been slow and ineffective in investigating and prosecuting the banks involved in the scandal and in imposing adequate sanctions and remedies.

As a licensed credit rating agency, we believe that the rand manipulation scandal poses significant risks and challenges for the South African economy and the financial system and that it requires urgent and decisive actions from the authorities and the stakeholders. SAR will view as a credit positive the following measures to restore the confidence and credibility of the foreign exchange market and to mitigate the negative impact of the scandal on the country:

i. If the SARB strengthens its oversight and surveillance of the foreign exchange market and enhances its coordination and cooperation with the FSCA and other relevant agencies. This includes amending the Exchange Control Act and the Currency and Exchanges Manual to grant it more legal powers and tools to regulate and supervise market conduct and to impose sanctions for market abuse.
ii. If the FSCA expedites its investigation and prosecution of the banks involved in the rand manipulation and imposes appropriate penalties and remedies, in line with the international best practices and standards. It would also be prudent to utilise cooperation agreements and memoranda of understanding with international regulators to effect regulatory action in their respective jurisdictions to deter future occurrences.

iii. The banks involved in rand manipulation are expected to cooperate fully with the authorities and the regulators and accept their responsibility and liability for their actions. The banks should also implement effective internal controls and governance mechanisms to prevent and detect any future market abuse and to foster a culture of ethical and responsible behaviour among their employees and management.

iv. If the government supports the efforts of the SARB and the FSCA to restore the integrity and efficiency of the foreign exchange market and to protect the interests of the consumers and the investors. The government should also pursue prudent and consistent macroeconomic policies to maintain fiscal and external sustainability and to enhance economic growth and resilience.

We hope that this opinion will contribute to the public debate and the policy dialogue on the rand manipulation scandal and that it will help to improve the understanding and awareness of the issues and the implications involved. We will continue to monitor the situation and update our rating assessment accordingly.

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