UNDERSTANDING CURRENCY DYNAMICS

KWACHA ANALYSIS INFOGRAPHIC

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What is a currency? A system of money in general use in a particular country: *(Oxford Dictionary)*

WHAT IS CURRENCY DEPRECIATION?

Currency depreciation is defined as a decline in the value of one currency relative to another currency. Depreciation occurs when a unit of one currency buys fewer units of another currency.

While depreciation means a reduction in value, it can be advantageous as it makes exports in the depreciated currency less expensive.

WHAT DETERMINES THE STRENGTH OF A CURRENCY?

A currency's exchange rate is its price in terms of another currency

1. **Interest Rates:** High interest rates can help promote a strong currency, because foreign investors can get a higher return by investing in that country.
2. **Economic Policies:** Tight fiscal discipline and anti-inflammatory monetary policies help promote a strong currency.
3. **Stability:** A strong government with a well established rule of law and a history of constructive economic policies are conditions that attract investments and promote a strong currency.
4. **Positive Trade Balance:** A positive balance is known as a trade surplus if it consists of exporting more than is imported; a negative balance is referred to as a trade deficit or, informally, a trade gap.

WHAT DETERMINES THE DEMAND OF A CURRENCY

- Demand of goods, services and investments priced in that currency
- Speculators: perception of market behaviour
- Central Banks - occasionally central banks will buy up a foreign currency to affect the exchange rate
- Demands for goods and services and investments priced in a different currency
- The demand of a currency are also influenced by factors such as interest rates, economic growth and inflation

UNDERSTANDING THE EXCHANGE RATES

An exchange rate is the rate at which one country's currency can be traded for another country's currency.

STRONG EXCHANGE RATE EFFECTS

When a currency appreciates or strengthens (a higher exchange rate) there are many effects for citizens and the economy.

a. Cheaper Imports: The currency will buy more of another foreign currency so that you can purchase foreign goods. It is also an advantage for importers of raw materials.

b. Lower inflation: This means the citizens of that country will spend less money on foreign goods. This in turn puts pressure on the manufacturing industries in the particular country to keep their prices low, so they can remain competitive.

c. Balance of trade deficit: One of the biggest disadvantages of higher exchange rates or a strong currency may be that it leads to trade deficits. Because strong currencies lead to cheaper imports, a country tends to import more and export less.

CURRENCY DYNAMICS - EFFECTS OF THE WEAK KWACHA

A very strong currency makes a country's exports more expensive, affecting the nations trade competitiveness, while a weak currency makes imports more expensive, increasing domestic inflation.

The ideal course is to aim for middle ground and avoid destabilizing fluctuations.

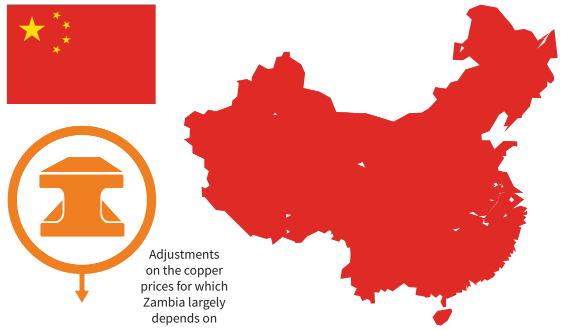
In the Zambian context, the strength or weakness of the kwacha is mostly determined by the price of copper as predicted by the London metal exchange. With this deterioration of the kwacha, it means government debt repayments may become more expensive than estimated.

UNDERSTANDING FISCAL POLICY AND MONETARY POLICY

Fiscal policy is the means by which a government adjusts its spending levels and tax rates to monitor and influence a nation's economy.

Monetary policy is the process by which the monetary authority of a country controls the supply of money, often targeting an inflation rate or interest rate to ensure price stability and general trust in the currency.

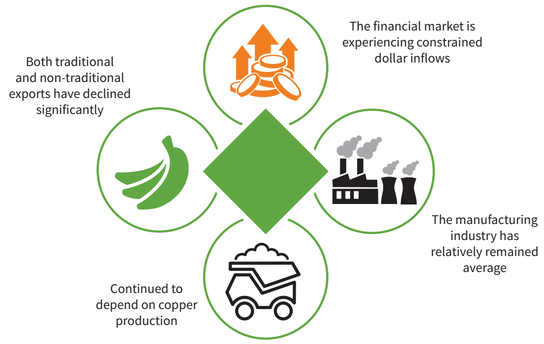
ZAMBIAN CASE - WHAT HAS CAUSED THIS DETERIORATION



GLOBAL FACTORS - THE CHINA EFFECT

The financial landscape movements in the Chinese economy have impacted the global economy and have caused a lot of adjustments on the copper prices for which Zambia largely depends on for its foreign exchange.

The Chinese currency (yuan) devaluation has been the major driver of the massive volatility in the foreign exchange markets in the second half of 2015.



LOCAL FACTORS

- Since independence, Zambia has continued to depend on copper production and export for its foreign income.
- The manufacturing industry has relatively remained average amidst calls for diversification into Agriculture.
- Both traditional and non-traditional exports have declined significantly.
- Imports have declined at a slower pace.
- The financial market is currently experiencing constrained dollar inflows while the demand for foreign exchange currency remains very strong and increasing.
- As a result, the Kwacha has been on a depreciating trend.

PMRC RECOMMENDATIONS

SHORT TERM

- The Government (Ministry of Finance and the Bank of Zambia) should take ownership of the situation and solidify will by calling for a consultation Indaba (energy and currency). This will yield holistic responsive medium to long-term interventions.
- Government must halt all none priority development projects e.g. (selected township roads) as this will reduce imports to stabilize the economy.
- Waver tariffs on essential imports for consumables so as to cushion the cost of living currently being influenced by the power shortages and depreciation of the Kwacha.
- Introduce policy interventions that will boost the demand for the Kwacha e.g. through a Statutory Instrument (SI).
- Central bank must tighten monitoring of balance of payments to reduce illicit flows of funds.

LONG TERM

- Diversification of the economy from copper in order to exploit high potential sectors such as agriculture, tourism, manufacturing and energy. Boost local manufacturing industry by revising taxes
- Addressing the energy challenges for increased manufacturing with value addition for export purposes.
- The government should look to lower capital investments as part of economic diversification for the country. Many developing countries are placing high hopes on new natural resource-based investments: growth corridors in Guinea and Mozambique, an oil refinery in Uganda, natural gas in Tanzania. Natural gas is one of the optional energy alternatives that has been identified as a viable investment option that could yield long term benefits for Zambia.
- Effective fiscal adjustments: The government needs to expedite the establishment of an effective protective mechanisms such as sovereign wealth funds.