POLICY MONITORING AND RESEARCH CENTRE

UNDERSTANDING CURRENCY DYNAMICS

ANALYSIS OF THE STATE OF THE ZAMBIAN KWACHA

Unlocking Zambia's Potential

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ABBREVIATIONS

AD	Aggregate Demand
BOZ	Bank of Zambia
GDP	Gross Domestic Product
IMF	International Monetary Fund
LME	London metal exchange
MOF	Ministry of Finance
SI	Statutory Instrument

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Message
from PMRC

PMRC's vision is "Unlocking Zambia's potential". We recognize that it is only discussion and debate on social and economic policy issues critical to poverty reduction that ultimately leads to policy reform to support a robust and thriving economy.

We achieve our Vision by:

- Producing high quality, relevant and timely policy analysis, policy monitoring, and reform proposals
- Promoting and encouraging an informed public debate on critical social and economic policy issues.

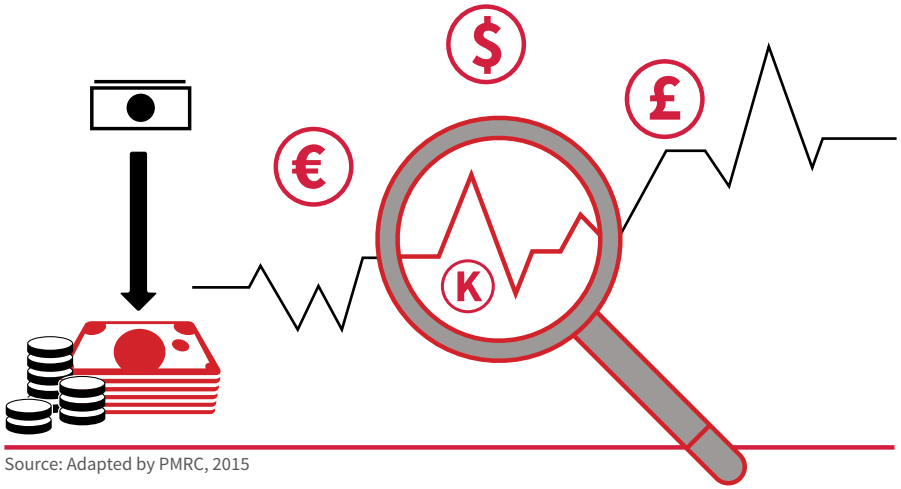
THE CASE OF THE ZAMBIAN KWACHA

INTRODUCTION

The Zambian Kwacha's depreciation that started in early 2013 has continued to be more pronounced since the beginning of March 2015. In the first week of September 2015, the Kwacha hit an all time low of ZMK 1 to 10 US Dollar. Internal and external economic factors have exerted pressure on the Zambian economy in the second half of 2015, thereby affecting the value of the currency. The country has remained vulnerable to developments in the global economy. In particular, the balance of payments position has deteriorated reflecting a widening current account deficit. Both traditional and non-traditional exports have declined significantly while imports have declined at a slower pace. As a result, the Zambian currency (Kwacha) has been on a depreciating trend. Zambia earns most of its foreign income through copper exports. Global commodity prices, including copper, have dropped with the Zambian economy impacted adversely through the decline in the price of copper, which has fallen to around US$4,900 per tonne from above US$6,500 per tonne in 2014.

BACKGROUND

WHAT IS CURRENCY DEPRECIATION?



Source: Adapted by PMRC, 2015

Currency depreciation is defined as a decline in the value of one currency relative to another currency. Depreciation occurs when, because of a change in exchange rates; a unit of one currency buys fewer units of another currency.[1]

While depreciation means a reduction in value, it can be advantageous as it makes exports in the depreciated currency less expensive. A decrease in the level of a currency in a floating exchanges rate system[2] due to market forces. Currency depreciation can occur due to any number of reasons such as economic fundamentals, interest rate differentials, political instability and risk anticipation among investors. Countries with weak economic fundamentals such as prolonged current account deficits and high rates of inflation generally have depreciating currencies. Currency depreciation, if orderly and gradual, improves a nation's export competitiveness and may improve its trade deficit over time. But abrupt and sizeable currency depreciation may alert foreign investors who fear the currency may fall further, and lead to them pulling investments out of the country, putting further downward pressure on the currency. Easy monetary policy[3] and high inflation are two of the main causes of currency depreciation. Inflation[4] can also cause currency depreciation. This is because the higher input costs for export products made in a high-inflation nation will make its exports uncompetitive in global markets, which will widen the trade deficit[5] and cause the currency to depreciate.

1 Definition: http://www.investopedia.com
2 A floating exchange rate occurs when governments allow the exchange rate to be determined by market forces and there is no attempt to influence the exchange rate.
3 An easy money policy (or accommodative monetary policy) is a monetary policy that increases the money supply usually by lowering interest rates. It occurs when a country's central bank decides to allow new cash flows into the banking system.

WHAT DETERMINES THE STRENGTH OF A 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. But it is relative.
3. **Stability:** A strong government with a well established rule of law and a history of constructive economic policies are the type of things 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.

Source: (www.marketwatch.com)

UNDERSTANDING CURRENCY DYNAMICS – (WHAT MAKES CURRENCIES STRONG OR WEAK?)

Definition of exchange rate: A currency's exchange rate is its price in terms of another currency. Most major currencies – the pound, dollar, euro and yen for instance – are 'freely floating'[6]. This means their exchange rate is determined by market forces, by the levels of supply and demand on the international markets.

4 Inflation is the rate at which the general level of prices for goods and services is rising and, consequently, the purchasing power of currency is falling.
5 Excess of a nation's imports of goods (tangibles) over its export of goods during a financial year, resulting in a negative balance of trade
6 'Floating Exchange Rate' A country's exchange rate regime where its currency is set by the foreign-exchange market through supply and demand for that particular currency relative to other currencies. Thus, floating exchange rates change freely and are determined by trading in the forex market.

DETERMINING FACTORS

A. Interest rates - A higher interest rate means a better return on bonds, and other Government securities and will, therefore, tend to attract financial capital from overseas.

B. Economic health - Institutions tend to move investments out of weakening economies and into ones perceived to be strengthening. So an economy whose indicators (like growth, inflation and debt burden) are positive tends to see more demand for its currency and see its exchange rate strengthen.

C. Foreign trade - Other countries must buy a countries currency in order to buy goods from that country. So if there is a high demand for the countries exports (relative to demand for foreign imports), the currency will tend to strengthen.

D. Official interventions - Governments or central banks could intervene to sustain up a currency – for political or economic reasons - by buying it on the international markets, or by raising interest rates.

E. Traders Stock exchange - Dealer's choice: Currency movements can be down to speculative trading

F. Shocks and speculation - Markets react like unexpected news and because currency markets are very 'liquid' (shortages of a currency are very rare), exchange rates are prone to move quickly in response to surprises. Currencies are also traded as speculative investments in their own right, and expert brokers trade them according to how they think the market will move. But these trades in themselves will, of course, affect exchange rates.

Source: http://www.forextraders.com

What Determines the Demand of a Currency

- Demand of goods, services and investments priced in that currency
- Speculators
- 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

Source: (www.marketwatch.com)

ZAMBIAN CASE - WHAT HAS CAUSED THIS DETERIORATION

Global Factors

Signs of an economic slowdown in China have led to fears of a global recession, including Africa, given the close ties it has built up with China in recent years. Capital, labour and productivity – the three big drivers of economic growth are all showing significant weaknesses in developed and emerging economies alike. Commodity exporting countries, and emerging markets in particular, are facing increased borrowing costs and the significant deterioration in their credit value.

Source: (Bloomberg finance) bloomberg.com

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. China now accounts for about 15% of global GDP and around half of global growth.

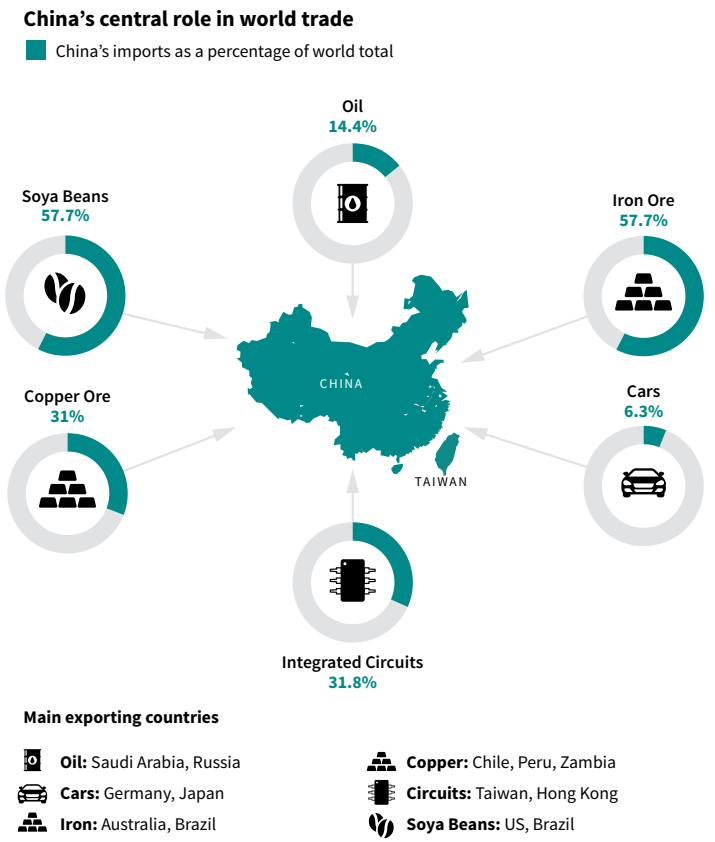
China is also the major trading partner for most African countries. The Chinese currency (yuan) devaluation has been the major driver of the massive volatility[7] in the foreign exchange markets in the second half of 2015.

Therefore, in the medium-term a devaluation of the Chinese currency (yuan) could result in less demand for African goods - as they are priced in dollars that would make them more expensive for the Chinese. Lower demand means Africa will trade less and earn less. If the cycle continues over a much longer period of time (6 months to a year), African countries could see their trade with China decrease. The solution to this however is emphasis on African integration and Trade.

Source: (Bloomberg finance) bloomberg.com

7 Volatility – a situation in which the value of a country's currency changes suddenly and often

Figure 1: China's Role in world trade



Source: The Observatory of Economic Complexity (OEC) 2014

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 slower pace. As a result, the Kwacha has been on a depreciating trend. The financial market is currently experiencing constrained dollar inflows while the demand for foreign exchange currency remains very strong and increasing. The Bank of Zambia (BOZ) reports that growth in the global economy has remained modest and uneven. According to the July 2015 International Monetary Fund (IMF) World Economic Outlook update, growth for 2015 is projected at 3.3%. Growth in emerging markets and developing economies is expected to slow down to 4.2% compared with the out turn of 4.6% in 2014. In Sub-Saharan Africa, growth is projected to slow to 4.4% in 2015 compared with 5.0% in 2014, largely reflecting the drop in commodity prices that has led to deterioration in external sector performance, particularly for commodity exporters.

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, boosting 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 (LME). With this deterioration of the kwacha, it means government debt repayments will become more expensive that estimated.

INTERVENTIONS

Understanding Fiscal Policy and Monetary Policy

A. Fiscal Policy (Custodian- Ministry of Finance- MOF)

Fiscal policy is the means by which a government adjusts its spending levels and tax rates to monitor and influence a nation's economy.[8] Fiscal policy involves the government changing the levels of taxation and government spending in order to influence Aggregate Demand (AD) and the level of economic activity. (Aggregate Demand is the total level of planned expenditure in an economy)

The purpose of Fiscal Policy

- Stimulate economic growth in a period of a recession.
- Keep inflation low (UK government has a target of 2%)
- Basically, fiscal policy aims to stabilise economic growth, avoiding a boom and bust economic cycle.

8 Definition: http://www.investopedia.com

Fiscal policy is often used in conjunction with monetary policy. In fact governments often prefer monetary policy for stabilizing the economy.[9]

B. Monetary Policy (Custodian – Bank of Zambia – BOZ)

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. It is the actions of a central bank that determine the size and rate of growth of the money supply, which in turn affects interest rates. Monetary policy is maintained through actions such as modifying the interest rate, buying or selling government bonds, and changing the amount of money banks are required to keep in the vault (bank reserves).[10]

Broadly, there are two types of monetary policy, expansionary and contractionary. Expansionary monetary policy increases the money supply in order to lower unemployment, boost private-sector borrowing and consumer spending, and stimulate economic growth. Often referred to as "easy monetary policy," this description applies to many central banks since the 2008 financial crisis, as interest rates have been low and in many cases near zero.

Contractionary monetary policy slows the rate of growth in the money supply or outright decreases the money supply in order to control inflation; while sometimes necessary, contractionary monetary policy can slow economic growth, increase unemployment and depress borrowing and spending by consumers and businesses.

Source:http://www.bloomberg.com/news/articles/2015-09-07/zambia-trying-to-avoid-imf-runs-out-of-options-as-kwacha-slumps

9 http://www.economicshelp.org/macroeconomics/fiscal-policy/fiscal_policy/
10 http://www.investopedia.com

Understanding the Exchange Rates

An exchange rate is the rate at which one country's currency can be traded for another country's currency. When a currency appreciates it means it increased in value relative to another currency; depreciates means it weakened or fell in value relative to another currency. When a currency buys more than its equivalent in another currency, it's often labeled strong.

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:*** When a currency appreciates or strengthens in relation to other currencies, imports get cheaper. This means 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:*** When the exchange rate for a currency strengthens it makes imports cheaper. 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. All of this leads to lower prices and ultimately more money in circulation whilst promoting a higher standard of living.
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.

A country can't unilaterally declare that their currency is now stronger. Importers, exporters, investors and speculators ultimately decide that on the global stage.

Source: http://www.forextraders.com

SOLUTIONS AND INTERVENTIONS TO THE KWACHA

PMRC Position and Recommendations

SHORT TERM

1. 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.
2. Government must halt all none priority development projects e.g. (selected township roads) as this will reduce imports to stabilize the economy.
3. 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.
4. Introduce policy interventions that will boost the demand for the Kwacha e.g. through a Statutory Instrument (SI).
5. Central bank must tighten monitoring of balance of payments to reduce illicit flows of funds.

LONG TERM

1. 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
2. Addressing the energy challenges for increased manufacturing with value addition for export purposes.
3. 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.
4. Effective fiscal adjustments: The government needs to expedite the establishment of an effective protective mechanisms such as sovereign wealth funds.

Economies like Chile's and Norway's, that have well prepared and prudent macroeconomic management systems, fiscal rules and fiscal stabilization mechanisms (like sovereign wealth funds) demonstrate house these mechanisms can be critical tools for avoiding painful adjustments when commodity prices drop unexpectedly.

Zambia's neighbours have established sovereign wealth fund. In 2012, Angola started a $5 billion sovereign wealth fund to invest in agriculture, mining, infrastructure and real estate, plus cash, bonds and equities. The Luanda-based fund, headed by the eldest son of President Jose Eduardo Dos Santos, is aimed at diversifying the economy away from oil.

Zimbabwe, plans to establish a fund, which will be financed by mining royalties and special dividends on state mineral and metal sales, according to a draft of the Sovereign Wealth Fund of Zimbabwe Act.

CONCLUSION

In reality however, the way to make a currency stronger is to work on the core fundamentals underlying the currency - to improve the scale and scope of reach, and to create a forward expectation of relative strength compared to the things a currency is being traded against.

In particular, currencies are simply alternatives for value, and the relative strength or weakness of currency is very much tied to the forward expectations of the economy it represents. If monetary supply is constant, and the forward economy is strengthening in relative terms, the currency will strengthen.

Of course the inverse is true, which is why quantitative easing[11], over time, is expected to produce inflationary effects, which in real terms, equal a weakened currency.

11 Quantitative easing (QE) is an unconventional form of monetary policy where a Central Bank creates new money electronically to buy financial assets, like government bonds. This process aims to directly increase private sector spending in the economy and return inflation to target.

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