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Determinants of the Exchange Rate and Policy Implications

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Policy Brief

Determinants of the Exchange Rate and Policy Implications

Exchange rate policy in Zambia – as in most countries – excites a certain amount of controversy. On one side, politicians often want to see a "strong" currency (i.e. where a unit of the local currency buys more rather than less foreign currency), since imports, especially those of consumption goods, would then be cheaper. On the other side, many economists want to see a "competitive" currency (i.e. where a unit of the local currency buys less foreign currency), since that makes exports and import-substitutes cheaper, enabling local businesses, especially outside of the traditional mining products, to compete more effectively and expand their markets under certain circumstances.

Low short-term exchange rate volatility is particularly important for developing countries where people transacting internationally have little or no access to hedging mechanisms. An importer of food and intermediate input products, Zambia is not an exception. In the short-term, volatility affects inflation levels, trade financing and aid denominated in foreign currency. In the long-run, it has implications for competitiveness, trade, and market diversification.

When and why does a currency (the Kwacha) appreciate or depreciate; and how has its behaviour over the past years been determined? What is the impact on the economy and how should the Bank of Zambia (BoZ) respond?

These questions were examined in a paper commissioned by the International Growth Centre in Zambia (www.theigc.org) and prepared by Professor John Weeks of the School of African and Oriental Studies at the University of London. Covering the period 2004-2013, the study tested the statistical relationship between the nominal Kwacha/US dollar exchange rate, and the trade balance, relative interest rates (i.e. Kwacha vs. US dollar interest rates), and foreign exchange transactions conducted by the Bank of Zambia, (i.e. intervention by the central bank aimed at changing the exchange rate).

The volume and value of exports from Zambia are overwhelmingly determined by mining. Hence mining company policies regarding foreign exchange transactions play a major role in exchange rate determination, the effect of which becomes evident in capital account movements. Other factors influencing the value of the Kwacha are other exports, imports, international reserves, aid, debt service, capital flows and the interest rate spread between the Kwacha and the benchmark US federal fund rates.

The study found that the variability of the nominal exchange rate against major currencies has declined over recent years, and that the variability – or instability of the currency-- is quite low compared to other countries. However, in recent months the nominal Kwacha has mildly depreciated, consistent with external indicators. The same conclusion holds for the purchasing power parity (PPP) (i.e. the nominal exchange rate adjusted for relative price levels in Zambia compared with trading partners). This exchange rate has been slightly more unstable than the nominal rate. The PPP exchange rate in recent years has changed little, and has shown no consistent tendency to appreciate.

By contrast, the "real" exchange rate, measured as the ratio of tradable goods prices (exports and importable goods excluding mining) to non-tradables has moved against the former since the late 1990s, based on the available data (which could be revised when the CSO re-bases the national accounts data). Tradables have therefore become relatively less profitable.

With relative prices highly influenced by policies of the mining companies regarding their export earnings and international prices, the BoZ has limited room to influence the Kwacha. Moreover, there is a trade-off between nominal depreciation and domestic inflation; while measurement bias of real exchange rates and equilibrium prices also plays a role.

Nevertheless, BoZ intervention to date can be considered reasonably effective regarding short-to-medium term volatility. The BoZ reduces short-run volatility of the exchange rate through the purchase and sale of foreign exchange and changes in the interest rate on public bonds, sterilising the effects on the money supply. If the objective is to moderate currency appreciation, it sells Kwacha per foreign currency at a cheaper price than the equilibrium price at the expense of losing international reserves. To moderate depreciation it must offer more foreign currency per Kwacha inducing traders to sell Kwacha. During 2005-2007 appreciation was partially mitigated, and since 2008, depreciation has been slowed by the BoZ with a slightly greater effect. It is estimated that during 2006-2013 Bank of Zambia operations reduced variation in the Kwacha from 9.2 percent of its quarterly value to 5.5 percent.

The study concludes that exchange rate policy is well managed. While it is not likely that a policy attempting to manage the long term exchange rate would be effective, it is possible, though costly in the short-term, to reinforce the current effectiveness of exchange rate policy to further reduce short-to-medium term volatility. However, limits set by reserve holdings and inherent instability of mineral prices hinders the Bank's ability to achieve a bigger reduction in the volatility of the currency.

The establishment of a sovereign-wealth fund to manage copper revenues should be considered. It could be used as a counter-cyclical mechanism to stabilise the fiscal balance, and to accumulate reserves to fund public investment. If well managed, it could become an important source of output growth, reinforce macroeconomic stability, and provide space for monetary policy.

While shifting incentives towards non-mining tradables is desirable for long-term growth, it would require more than better exchange rate management. In Zambia, the exchange rate is not an effective instrument to foster competitiveness of non-copper exports. Although it could be part of a diversification strategy, effective developmental policies at the sectoral level would also be needed.

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