Policy Note 2

The Foreign Exchange Rate and Poverty Reduction through Economic Growth

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THE FOREIGN EXCHANGE RATE AND POVERTY REDUCTION THROUGH ECONOMIC GROWTH

The foreign exchange rate is simply the price of the Zambian kwacha in terms of other currencies that is supposed to balance the relative supply of and demand for those other currencies with the supply of and demand for the kwacha in international currency markets (including, primarily, those here in Zambia). If left to free market forces it will generally (absent speculative forces) result in a balance of international payments for Zambia, so the country will neither lose nor gain significant foreign reserves.

A free market exchange rate is affected by several factors that can cause it to change over time. Relative changes in supply and/or demand or in world market prices of the country's major imports and exports, like oil and copper, affect its international "terms of trade" and can require adjustments in the exchange rate to maintain the balance of payments. Different rates of price inflation between Zambia and its main trading partners affect the real value relationships between the kwacha and foreign currencies and require nominal exchange rate adjustments to maintain the real exchange rate, or else the balance will be disrupted.

The latter point is not widely understood. The steady nominal "climb," in nominal terms, of the U.S. dollar over most European currencies during the last decade, for example, was simply the market's way of compensating for the fact that European rates of price inflation have been persistently higher than those in the U.S. The "real" exchange rates between the U.S. and most of these countries, with each currency deflated by its own internal rate of price inflation, have changed little over this period.

Price inflation in Zambia is currently around 30% a year, while that of the U.S. dollar is around 4 or 5%. For the real rate of exchange between the Zambian kwacha and the U.S. dollar to remain the same under these circumstances, the kwacha must be allowed to depreciate in nominal terms against the dollar by the difference, or by around 25% a year (2% a month). If it is not allowed to do so it will appreciate in real terms and become overvalued once again, to the great detriment of efforts to stimulate exports and efficient import substitution, to promote sustainable, broadly based economic growth that generates employment, and thereby to reduce poverty.

Despite frequent statements to the contrary, domestic price inflation in Zambia is not caused by kwacha depreciation. The causal effect is the reverse. Domestic price inflation occurs when government fiscal deficits are financed by mechanisms that increase the money supply faster than the growth of real goods and services produced in the economy. A large fiscal deficit thus causes inflation, and a high rate of inflation requires steady kwacha depreciation (in nominal terms, though not in real terms), not the other way around. Any attempt to stop or slow down the exchange rate adjustment is simply a form of price control in the face of relentless inflationary pressures. It will eventually fail and require a more traumatic and costly adjustment later on.

An overvalued kwacha is detrimental to economic development, broadly based and employment-oriented economic growth, and sustained poverty reduction. It should be avoided at all costs. It artificially lowers the kwacha prices of export and import goods and services, reducing the profitability of export production, of "export" services like tourism, and of domestic industries trying to compete efficiently with imports. It increases domestic demand for foreign exchange to buy the less costly imports and simultaneously reduces the country's ability to earn foreign exchange to pay for them. It undervalues the country's main resource endowments of land and labor, reducing returns to their owners (farmers, farm laborers and industrial workers), and encourages investment in more capital-intensive activities that generate fewer jobs per unit of scarce investment resources. An overvalued currency thus inhibits more rapid employment generation, reduces farm and labor income, and thereby perpetuates poverty.

The appropriate government policy is to allow the kwacha to maintain its parity with other currencies in real terms, continuously adjusted for differential rates of inflation as well as for real changes in terms of trade, and not to support a particular nominal rate of exchange that is devoid of economic rationale and can soon become detrimental to economic and social welfare.

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