PMRC
Policy Monitoring and Research Centre

TAKING THE NON-CONVENTIONAL ROUTE TOWARDS STRENGTHENING AND STABILITY OF THE KWACHA

PRESS STATEMENT

FOR IMMEDIATE RELEASE

Monday 27th April 2020

The onset of the COVID-19 pandemic has negatively affected several economies worldwide. In Africa, the pandemic has caused severe distress to several economies and currencies have weakened in trading and exchange value. The Zambia kwacha has depreciated by more than 20 percent to around K18.4 per US dollar. **The depreciation of the kwacha is attributed to among other factors, the COVID-19 pandemic, the drag in global trade which has slowed down following closure of borders and the lock down in major economies, reduction in commodity prices of coppers which had opened the year at US$6,165 per metric tonne closed at US$4,754 per metric tonne as of March 2020 and the capital flight in the financial markets, in which the international economy has seen investors divesting their funds from traditional assets such as stocks to safe havens that include the US dollar causing its appreciation against other currencies.**

Why is the Kwacha affected year-on? What really needs to be done to strengthen the Kwacha? How is the quoting of USD by some businesses affecting the kwacha? Let us take a moment to reflect on these questions and provide perspectives to the foreign exchange dynamics in Zambia.

We recall that in 2012, Government issued the Bank of Zambia (currency) regulation Statutory Instrument (SI) No. 33 of 2012 to ban all domestic transactions conducted using foreign currency. Further, in 2013, Government introduced SI No.55, which empowered the Bank of Zambia (BoZ) to monitor cash inflows, outflows and international transactions. These two SI's were both instituted then as mechanisms to be used by Government to promote or strengthen the kwacha whilst also protecting the financial market among other measures. Lessons were learnt from both SI 33 and SI 55 with some sectors issuing major concerns. Both SI's had their pros and cons and in 2014 they were revoked to the relief of the Tourism and Mining sectors among others. However, we reflect on the intentions and lessons and ask the question; **is it fair for some businesses in Zambia to continue pricing locally traded goods and services in foreign currency?** Isn't this affecting the kwacha further? Yes it is known that foreign trade investors are concerned with making profits and mitigating losses at all costs thus, would prefer to quote pricing of their goods and services in US dollars in order to avoid the volatility of local currencies. What does this mean for the citizens who then have to bear those costs due to quoting in foreign currency?

As a developing country with minimal hedging mechanisms, **Zambia's currency volatility affects inflation levels, debt denominated foreign currency and trade financing which has implications for competitiveness, trade, and market diversification in the long run**. A study conducted by the Bank of Zambia (2012) that examined 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 (i.e. intervention by the central bank aimed at changing the exchange rate) concluded that volume and value of exports from Zambia are mainly determined by mining. Therefore, mining company policies on foreign exchange transactions influence exchange rate determination significantly, as evidenced in capital account movements. The Mining Sector is Zambia's largest foreign exchange earner and reduced prices of copper entails reduced supply of foreign exchange earnings which will continue to put pressure on the kwacha. PMRC submits that the Bank of Zambia should continue exploring several ways in which to cushion the fall of the kwacha and also ensure monetary stability. Some of the measures and options that we have recommended as PMRC is for BOZ to consider lowering interest rates and increasing liquidity in the country's financial systems through a combination of measures, including lowering capital buffers and reserve requirements, creating temporary lending facilities for banks and businesses, and easing loan terms. In addition, the Government is urged to adopt various fiscal measures to sustain economic activities, which could include; temporarily deferring tax payments and increasing guarantees and loans to businesses. The Bank of Zambia interventions have been reasonably effective regarding short- to medium-term volatility by the purchase and sale of forex and changes in the interest rate on public bonds, thereby sterilising the effects on the money supply. While the efficacy of a policy attempting to manage the long-term exchange rate is difficult it is possible, though costly in the short term. This can be bolstered through the accumulation of foreign reserves and establishment of a Sovereign Wealth Fund to manage mineral wealth revenues.

Pricing all locally traded goods and services in Kwacha

One of the suggested ways that we may need to interrogate in order to stabilise the kwacha exchange rate is for the Central Bank to put in place measures to prevent business houses that are pricing locally traded goods and services in foreign currencies, especially the US dollar. The Bank of Zambia has guided on several occasions before, and in line with the Bank of Zambia Act, that the kwacha is the legal tender in Zambia. Therefore, all domestic transactions are required to be priced and settled in Kwacha. Unauthorised entities that engage in some form of foreign currency trading need to stop such practices as they are contravening the Banking and Financial Services Act (BFSA). If left unchecked, the practice has the potential to increase the demand for foreign exchange and intensify pressure on the exchange rate. **Pricing in foreign currency implies that businesses are adjusting their prices to reflect the extent of the movements in the exchange rate and yet most of their operating costs are not in foreign currency**. The adverse effects of pricing and paying in foreign currencies are mainly felt by the general public rather than business houses as the former has no ready means of hedging against currency depreciation. Measures to prevent business houses from quoting locally traded goods and services in foreign currencies and thus, encourage pricing in kwacha could be achieved through some legal provisions similar to the SI 33 but with some dollar equivalency. The absence of the legislation which explicitly prohibited the use of the dollar has left traders free to determine their prices in the foreign currency. But for such measures to be effectual, the Bank of Zambia through its monetary policy conduct needs to minimise the current exchange rate volatility, and ensure that inflation is contained with the targeted bands of 8-10 % in an effort to protect businesses from exchange rate losses. It must be noted that the use of the dollar and VISA transactions have to be cleared internationally and this is expensive. This further builds the case for the collecting strengthening of our regional currencies.

It is important to note that incomes of the overwhelming majority of Zambians are not in foreign currencies. Therefore, these are bound to bear the full impact of quoting prices in foreign currencies more so if compelled to pay in foreign currency for domestically traded goods and services, such as, rentals and school fees. Furthermore, quoting and demanding payment in a foreign currency amounts to dealing in foreign currencies, which is a practice that is for authorized foreign currency dealers only. It is also likely to lead to a multiplicity of exchange rates, which may differ significantly from competitive market rates and thereby destabilize the orderly functioning of the foreign exchange market.

What opportunities exist?

The SADC multi-currency regional payment system

Perhaps eliminating the trading barriers that exist among African countries and enhancing regional integration could ease the pressure on trade within Africa through the Africa Free Trade Area and easing customs and excise duties could help local manufacturers import necessary additives needed in value chains while also exporting their produce to markets within the region, bringing in the much-needed forex. One such opportunity is The Southern African Development Community (SADC) Integrated Regional Electronic Settlement System (SIRESS). SIRESS is a regional payment and settlement system that was developed to facilitate funds transfer for cross-border payment in the SADC region. At a regional level, efforts aimed at encouraging trade facilitation and stability of local currencies against convertible currencies should be encouraged. Southern Africa has made progress towards creation of a multi-currency regional payment system, which is currently using United States dollar and the rand as settlement currencies. The expectation is that Southern African Development Community (SADC) Integrated Regional Electronic Settlement System (SIRESS) is expected to move into a multi-currency settlement system and Zambia should be at the fore of ensuring that this objective is achieved. The addition of the other regional currencies including the kwacha will not only promote intra-SADC cross-border transactions but also expected to facilitate greater cross-border trade and investment in the region. The adoption of a multi-currency settlement system is an important milestone that builds on other progressive developments in consolidating progress and catalysing milestones already attained by SADC Free Trade Area. Without SIRESS, all US dollar transactions are settled through correspondent banking arrangements using US correspondent banks. It must be noted that visibility of the platform is low in Zambia. If it were highly utilized, then to some extent, it would have minimized the pressure on the foreign exchange regime currently obtaining. The main benefits of the SIRESS system are its efficiency and reduction in costs because previously the transactions would go through a correspondent bank. Where as transactions previously took two to three days to clear, now they are cleared within 24 hours with SIRESS and fees paid to non-SADC clearing banks are removed. The elimination of an intermediary – often a United States or European correspondent bank – means foreign exchange money stays in the region and payments are processed faster.

Productive Capacity in Manufacturing

Another measure that can help boost the performance of the kwacha is the need to put in place deliberate initiatives to promote investments in productive capacity of local firms, especially those engaged in export-oriented “manufacturing value addition” as well as import substitution. This will ensure that there is reduced demand and outflows of foreign exchange in the economy. As PMRC, we state that the establishment of a Taskforce by Government, as announced by the Minister of Finance to bring more Zambian products on the floors of major chain stores in order to support domestic production which has previously been hindered by the lack of a reliable market is welcome and should be encouraged and actualised as soon as possible. The Taskforce comprises of representatives of South African owners of chain stores, Zambia Association of Manufactures (ZAM), Zambia Farmers Union (ZNFU) and the Zambia Chamber of Commerce.

In view of the prevailing global, regional and national challenges obtaining due o the negative effects of the COVID-19, PMRC continues to explore ways through which we can support the Government to institute measures that will set the economy on a path of recovery. We shall continue playing our part to ensure that our post –COVID economic recovery is effective. Our call for Government therefore is to consider exploring ways through which some of the evidence we have presented can be considered so as to strengthen our currency and contribute towards economic recovery.

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