Theories

Balance of Payments Policies

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In the case of an overall balance of payments deficit i.e. where the current and capital accounts are in deficit, LDCs such as Zambia have a number of policy options open to them.

1. Improve the current account balance by promoting export expansion or limiting imports or both.
   These objectives can be brought about by a number of measures:
   - Expand the export of copper and other primary commodities
   - Expand the export of secondary goods through adopting policies of import substitution
   - Introduce protectionist measures such as quotas, tariffs and other non-tariff barriers
   - Changing the value of the exchange rate through a devaluation or allow the currency to float and depreciate
   - Follow restrictive deflationary monetary and fiscal policy that reduces domestic demand and hence imports and reduces inflationary pressures in the economy
2. Improve the capital account balance by encouraging capital inflows.
   Again a number of possible measures are open to the government:
   - private foreign direct or portfolio investment
   - borrowing from foreign commercial banks
   - borrowing from foreign governments
   - borrowing from multilateral agencies such as the IMF

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Theories

Interpreting the Balance of Payments

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The Balance of Payments is part of the national accounts which records payments to, and receipts from the rest of the world. The account is made up of three sections. These record details of inflows and outflows of foreign exchange.

- the current account : inflows and outflows generated by international trade
- the capital account :inflows and outflows resulting from the movement of capital and money
- financing: inflows and outflows that enable the balance of payments to balance

Balance of Payments on Current Account

This includes all the payments made and receipts earned that result from trade. Hence this part of the accounts allows us to judge the international competitiveness of a country. When Zambia exports copper to another country it generates a flow of foreign exchange into Zambia and out of the other country.

If exports are greater than imports i.e. inflows of funds are greater than outflows of funds then there is a Balance of Payments surplus on current account. If imports are greater than exports i.e. outflows of funds are greater than inflows of funds then there is a Balance of Payments deficit on current account. In the accounts, outflows of foreign currency are denoted with a minus sign.

The Balance of Payments on Current Account are broken down into:

- the Balance of Trade or the Visible Balance which measures the net flow of funds resulting from trade in goods. If the value is positive then there is an overall inflow of foreign exchange. If negative there is an overall outflow of foreign exchange.
- The balance of invisible trade measures the net flow of funds resulting from the trade of services. This balance of invisible trade will include all of the following inflows or outflows of funds:
  - flows resulting from financial services e.g. banking , insurance , brokerage firms
  - flows from shipping and aviation services
  - expenditure by foreign government on embassies and military bases
  - flows from tourist services
  - gifts of money from overseas residents to domestic residents
  - net property income from or paid abroad
  - payments of interest on official debt.

By looking to see if the value of the account item is positive or negative indicates whether there is an inward or outward flow. However, there are many other flows of foreign exchange taking place unrelated directly to trade. These are recorded in the capital account.

The Capital Account

The capital account records inflows and outflows of foreign exchange that result from capital flows. In the case of Zambia the capital account will include flows resulting from:

- repaying of debt to foreign commercial banks, foreign governments and multinational agencies such as the IMF. This is referred to as amortization
- borrowing from foreign governments and foreign commercial banks
- flows of aid into the country from overseas agencies
- flows of foreign direct investment such as investment by multinational corporations
- resident capital outflow or capital flight as a country's citizens send money out of the country into foreign banks, or to purchase foreign property or financial assets.

In addition an outflow of funds occurs where a Zambian resident or firm acquires capital or financial assets in another country. An inflow occurs where a foreign resident from another country acquires capital or financial assets in Zambia.

The Overall Balance and the Need for Financing

The current account and the capital account are added to obtain the overall balance of payments. Once again the sign will determine whether there is an overall inflow or outflow.

As the name suggests the balance of payments must, by definition, balance. As it is the inflows of foreign exchange that ultimately enable subsequent outflows to occur there must be some way of ensuring that the inflows of funds always equals the outflow of funds. Indeed, if it looks as though there is going to be an imbalance and inflows are less that the outflows, the government or its agent the Central Bank may resort to a number of ways of generating additional inflows of funds. This is referred to Financing. These can be referred to accommodating flows.

In the case of Zambia the data shows that the country regularly experiences a balance of payments deficits and needs to generate an inflow to finance it. Normally there are a number of financing options open to countries in this situation.

- Use up reserves of foreign currencies held at the Central Bank.
- Borrow from foreign central or commercial banks
- Borrow from organisations such as the International Monetary Fund
- Reschedule its debt or having its debt reduced

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Theories

Foreign Exchange Markets

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Each country in the world has its own currency. When individuals or firms import a good or service they need to purchase the currency of the exporting country. Equally exporting firms generally expect to be paid in their own currency. In some cases, often in LDCs, the exporting firms would prefer to be paid in a hard currency i.e. one that is generally acceptable world-wide. However, in most cases importing and exporting can only operate effectively if there is a system whereby countries can exchange currencies. The foreign exchange market enables this to happen. The foreign exchange market is made up of all the institutions that buy and sell foreign currencies. Indeed when you buy foreign currency prior to going on holiday at the bank you are involved in transactions on the foreign exchange market. Your bank must buy the currency of the country you are intending to visit at the relevant exchange rate. A currency's exchange rate represents the value of a country's currency expressed in terms of another country's currency.

When a Zambia farmer wants to purchase a British tractor they must purchase UK pounds on the foreign exchange market. This they must do at the going exchange rate. The problem that Zambia and many LDCs face is that their currencies are weak and not universally acceptable on the foreign exchange market. UK banks will not sell pounds in exchange for Zambian Kwacha as they are not worth a great deal in term of global purchasing power. For Zambia to import tractors it needs to gain access to a hard currency - either pounds or something that can be exchanged for pounds. The importance therefore of its export industries such as copper and agriculture for earning foreign currency is obvious.

The rate at which a country's currency can be exchanged for that of a hard currency is a very important factor when considering the trading position of a country. There are two systems that can determine the value of a country's currency:

- A fixed exchange rate system where a country's government determines the value. This was the system adopted by Zambia until 1991.
- A floating exchange rate regime where the value of the currency is determined by supply and demand for the foreign currency. This system replaced Zambia's fixed exchange rate in 1991.

In addition there are a number of intermediate systems. For example, that operated by the IMF prior to 1971 where the exchange rate of member countries were allowed to float or be market determined between a ceiling and a floor. A similar system existed with the Exchange Rate Mechanism of the European Monetary System.

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Fixed Exchange Rates

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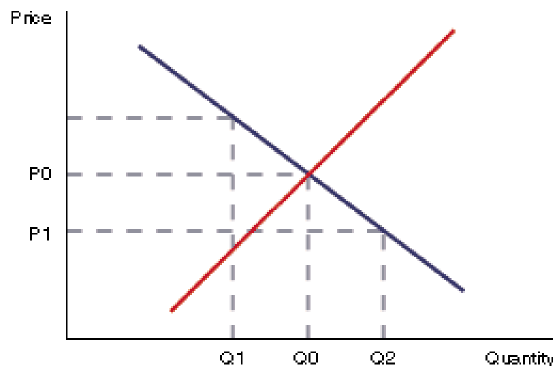
Prior to 1991 Zambia operated a fixed exchange rate system. With a fixed exchange rate system the government, often acting through its agent the Central Bank, fixes or pegs the value of the currency to another currency such as the US dollar. Official exchange rates are then usually quoted in terms of US dollars. It shows the value of US dollars in terms of Zambian Kwacha and vice versa.

If the pegged value coincides with the equilibrium price for foreign exchange and consequently the balance of payments equilibrium then there is no need for the government to act. The problem arises when the balance of payments and foreign exchange market go into disequilibrium. Consider the effect of a fall in the value of exports of copper. The balance of payments of Zambia will go into deficit. The earnings of foreign currency and thus the available supply to Zambia will be less than the demand for foreign currency. The official exchange rate is consequently overvalued.

Where excess demand for foreign currency exists the central banks of LDCs have three options open to them if the official exchange rate is to be maintained:

- They can accommodate the shortage by using up reserves of foreign currency or borrowing foreign currency from overseas incurring foreign debt.

- They can deal with the balance of payments deficit through reducing the demand for imports such as operating protectionist measures such as tariffs, quotas and licences.
- They can attempt to ration the amount of foreign exchange made available to those people they consider should have it through exchange controls.



The diagram above illustrates how a system of exchange controls operates. Under free market conditions the equilibrium price of foreign currency in Zambia would be P0 with Q0 units of foreign currency supplied and demanded. If the government maintains an artificially low valued foreign currency P1 (i.e. an overvalued domestic currency) Q2 will be demanded and Q1 will be supplied. There will be an excess demand equal to Q2-Q1. As with many attempts to implement a maximum price, the government often steps in to ration the item in short supply. This is the essence of exchange controls.

Why was an overvalued fixed exchange rate maintained?

The government of President Kaunda was following a policy of import substitution and industrialisation. An overvalued kwacha would keep the price of imported goods such as oil and capital items for the copper industry artificially low.

However the impact of an overvalued exchange rate on the balance of payments should be considered.

The foreign currency price of Zambian exports is raised hence making them less attractive abroad and the local price for imported foreign goods is lowered making them more attractive in Zambia. Both of these, in the absence of any form of effective protection such as export subsidies or barriers to imports, would lead to a worsening of the balance of payments and debt situation.

In such a situation a parallel, dual or black market for foreign exchange usually develops. Foreign currency will be bought illegally at an exchange rate far in excess of the official exchange rate.

The IMF usually requires those countries seeking assistance to either allow their currency to depreciate if it is floating exchange rate or to devalued it if it is a fixed exchange rate. In either case the value of foreign currency increases and reduces export prices and raises import prices.

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