UGBS
University of Ghana Business School

POLICY BRIEF No.4

Lending Strength and Stability to Domestic Currencies in Sub-Saharan Africa: A Call to Action

June 2017

www.ugbs.ug.edu.gh

The Policy Issue

In the wake of the globalisation euphoria, the stability and resilience of a national currency has become very important to the growth and development agenda of many countries. Across the globe, national governments have had to actively manage their domestic currencies in relation to major trading currencies in order to attain and sustain steady rates of long-term growth. The need for such an active posture in currency management is fuelled by the potential adverse implications of currency appreciation or depreciation for trade balances and ultimately growth and development.

Over the years, the economies of Sub-Saharan Africa (SSA) have mostly had consistently negative net export positions, mainly due to domestic markets that lack the relevant edge to compete favourably on the international trade scene (see Figure 1).

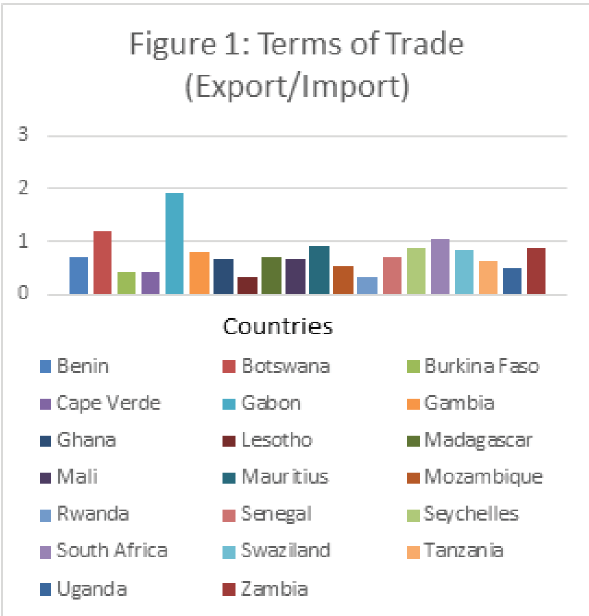

Figure 1: Ratio of export to import values for SSA (1991-2010)
Source: Author's computations based on data from World Bank Development Indicators.

As a consequence of the negative net export positions, most currencies in the SSA region have not fared very well against the major trading currencies of the world. They have experienced a mostly one-sided depreciation relationship with major trading currencies. Whilst conventional economic wisdom presupposes that a weaker currency may provide competitive advantage to increase exports, a continuous depreciation of the currencies can ultimately trigger currency crises, which could have disastrous implications for national economies.

> ***"Whilst conventional economic wisdom presupposes that a weaker currency may provide competitive advantage to increase exports, a continuous depreciation of the currencies can ultimately trigger currency crises, which could have disastrous implications for national economies."***

A typical currency crisis results in loss of trust in the ability of the national currency to act as a store of value and this will direct the flow of investment capital away from the economy. Though SSA has yet to experience massive and widespread currency crises, there is the need to take steps to forestall any such occurrence whilst lending stability and strength through proactive currency management.

Lending strength and stability to the region's currencies is likely to be best achieved by stimulating demand for locally produced goods, on both the foreign and local fronts, and preferably the latter, to counter the constant depreciation that the currencies have experienced against major trading currencies in the last 2-3 decades.

The study covers twenty (20) countries in sub-Saharan Africa and spanned the period, 1991-2010. The sample is the set of emerging and frontier markets in SSA based on criterion variables such as political stability, economic stability, local market access and rise of democracy. In order to understand the dynamics of currency depreciation and appreciation, we take a look at the macroeconomic fundamentals that play out in the foreign exchange market: central bank monetary policy, rate of economic growth of the country, private capital inflows, public debt positions, net export positions and current account balance positions.

> ***"Lending strength and stability to the region's currencies is likely to be best achieved by stimulating demand for locally produced goods, on both the foreign and local fronts, and preferably the latter, to counter the constant depreciation that the currencies have experienced against major trading currencies in the last 2-3 decades".***

Summary of Findings

From the study, we find that depreciation pressure on national currencies can be curbed by increasing Central bank rates. The high interest rate environment attracts foreign capital that is in search of high earning assets for investment purposes. Such inflows of foreign capital ultimately dampen the depreciation pressure on the local currencies and lend strength to the currencies. This is not to say there is infinite space to increase the policy rate, hikes could very well increase cost of capital, shrink investment or trigger panic of default and thus cause capital flight. Such occurrences have negative implications for economic growth.

The findings also show that increasing exports relative to import will provide a significant boost to local currencies. Overall, we find that improvements in all forms of trade and investment income flows play important roles in stimulating currency appreciation. In essence, every policy move that directs capital inward into the economy is beneficial for the region's currency positions. Public borrowing also appears to improve currency positions, seemingly suggestive of productive use of borrowed funds by governments.

Interestingly however, our evidence suggests that increasing the rate of growth within national space economies is accompanied by currency depreciation. This unusual phenomenon seems to be caused by an excessive demand for foreign goods in the domestic economy together with a decline in the productive capacity of local economies. This ultimately triggers or fuels inflation and causes currency depreciation.

Conclusion and Policy Implications

Strengthening the local currency can be worked out using some of the following suggestions. Our analysis suggests the local currency will enjoy strength and stability if we can do the following:

- Actively pursue value addition to exports of African economies and thus increase the income flows from export activities. The increase in export revenue flow will improve currency positions.

- Target, support and improve local industries that have the potential to compete favourably on the global market. This will ultimately improve the currency's stance by increasing export earnings and increasing demand for local currencies.

- Protect budding local industries from the heavy competition from large foreign trade counterparts through quotas or tariffs. This might very well require re-looking into certain trade agreements.

- Advocate for the patronage of locally produced goods and services and minimise the excessive demand for foreign goods.

- Actively promote entrepreneurship and stimulate domestic productivity to meet demand and thus curb demand-fuelled inflation that flow from supply deficiencies which negatively affect the national currencies.

These recommendations, if effectively implemented, can contribute significantly to addressing the currency management challenges that have plagued many countries in Sub-Saharan Africa during the last 3 decades.

Further Readings

- Combes, Jean-Louis, Kinda, T. and Plane, P. (2010) Capital Flows, Exchange Rate Flexibility, and the Real Exchange Rate. IMF Working Paper, WP 11/9.

- Gochoco-Bautista, M.S. and Bautista, C. C. (2005). Monetary policy and exchange market pressure: The case of the Philippines." Journal of Macroeconomics, Vol. 27.

- Gunsel N. R., Tursoy, T. and Rjoub, H. (2010) An empirical analysis of currency crises, fundamentals and speculative pressure. African Journal of Business Management Vol. 4(6), pp. 972- 978,

- Fiador, V. and Biekpe, N. (2015) Monetary policy and exchange market pressure–evidence from sub-Saharan Africa, Applied Economics, vol. 47, issue 37, 3921-3937.

About this Brief

The UGBS policy brief series are generated from published research papers on topical issues by faculty members of the school. The series are part of the School's efforts in contributing to policy issues that are critical to national and international development. This Policy brief was produced from a paper published by Applied Economics, vol. 47, Issue 37, in 2015 under the title "Monetary policy and exchange market pressure–evidence from sub-Saharan Africa".

About the Author

Vera Ogeh L. Fiador is a Senior lecturer and researcher in the Department of Finance of the University of Ghana Business School, Legon, Ghana. Vera holds a PhD from the University of Cape Town. Her research interests and expertise span a broad array of issues in corporate finance, investment, development finance and economic growth.

Correspondence

Dr. Abdul-Gafaru Abdulai
Coordinator, UGBS Seminar Series and Policy Briefs
P. O. Box LG78, Legon, Accra-Ghana
Email: agabdulai@ug.edu.gh
Tel: +233(0)546 695 432
Mobile: +233(0) 203 403 401