



THE EXCHANGE RATE AND THE CURRENT ACCOUNT DEFICIT IMPLICATIONS

Background

The debate on exchange rate movements or volatility is not complete without a discussion of the implications of the Balance of Payments (BOP). The BOP is a summary statement of a country's transactions with the rest of the world through trade in goods, services, and finance. It has two main components: (i) current account; and (ii) capital and financial account. The current account captures transactions of exports and imports of goods and services, factor income receipts and payments, and net current transfers. The capital and financial account records purchases and sales of financial assets. Flows in the capital and financial account finance the current account so that the BOP is in balanced position. In this regard, a current account deficit (deficit) must be financed by an equivalent capital inflow. An external balance is attained when the current account and capital and financial account offset each other, that is, there is neither a surplus nor deficit in the BOP. Any deviation from this balance would reflect an external imbalance that triggers adjustments through exchange rate movements to restore the balance.

The current account can either be in surplus or deficit. A surplus arises when a country's value of exports of goods and services and receipt of factor incomes and current transfers from abroad exceed what it pays for imports of goods and services and payments of factor incomes and current transfers abroad. Conversely, a current account deficit implies that a country's value of imports of goods and services and payments of factor incomes and current transfers to foreigners exceeds its sales of goods and services, factor income receipts and transfers from foreigners. Given this background, this note outlines the implications of a current account deficit on the exchange rate, and, in so doing, advances the debate on the factors driving exchange rate movements in the economy.

What is the relationship between the BOP and the exchange rate?

An understanding of the patterns and composition of international trade is necessary to conceptualise how a current account imbalance affects the exchange rate. The current account balance is determined largely by the level of net exports (value of exports minus value of imports of goods and services) as the other components of the current account (net factor payments and net transfers) are, usually, relatively small. A deficit occurs when payment for imports exceed receipts from exports. However, since imports are financed in foreign currency, a widening deficit results in increased demand for foreign currency. This means that the country is accumulating foreign liabilities locally. These liabilities would have to be paid through other sources of foreign currency such as foreign interest earnings, loans, grants, etc.

In a floating exchange rate regime, such as the one operational in Kenya, the value of exports and imports have a strong impact on the demand and supply of foreign exchange and thus determine the exchange rate. This is why the exchange rate is referred to as a relative price. Depreciation of a currency makes exports cheaper relative to imports. When exports become cheaper, foreigners can afford more of a country's exports, leading to a rise in the quantity of exports. If demand for exports responds positively to changes in the price, then a depreciation will lead to an increase in the quantity exported and, hence, the value of exports. This improves the current account balance. On the contrary, depreciation of a currency makes imports more expensive to the country leading to a reduction in the demand for imports. This reduces the deficit.

In practice, however, this may not happen for various reasons. First, the impact depends on the responsiveness of demand for goods and services to the exchange rate depreciation in the short-term. Exchange rate depreciation does not necessarily lead to an immediate improvement of the trade balance. To illustrate this, if demand for exports is not responsive or if exports have a gestation period, which is the case for most agricultural goods, depreciation will lead to only a marginal increase in the volume of exports. Second, although depreciation would result in exports becoming cheaper, individual exporters may decide to maintain the same foreign price thereby making a bigger profit margin. This often occurs in the short-term when exporters fail to adjust their prices to consumers, but instead preferring to absorb exchange rate movements in their own margins. However, in the long-term, depreciation (weakening) in the exchange rate may have the desired effect of improving the current account balance. So a weakening currency would not be that bad after all for Kenya or any other developing country. Similarly, imports may not be responsive to the exchange rate movements while importers could absorb the depreciation of the exchange rate from their profits.

What is Kenya's experience?

Kenya's current account balance has generally been in deficit since 2004 when the deficit stood at 0.82 percent of GDP. The deficit widened to stand at about 10 percent of GDP in 2012 largely reflecting a faster growth in imports of goods into the country relative to exports. The imports have been largely in machinery and transport equipment, manufactured goods and oil products for industrial purposes. These are essential goods whose demand is not responsive to price changes. Growth in exports has been sluggish with little diversification away from the traditional exports of coffee, tea and horticulture. International trade in services which form part of the current account balance has been in a surplus over the years, mainly due to improved earnings in export of transportation services, tourism services, communication services among others. Net current transfers also increased, supported largely by rising emigrant remittances. However, the growth in the services account and net current transfers was not sufficient to offset the deficit in the merchandise or goods account. The huge import bill in the current account increases demand for foreign currency, while slowdown in exports of goods reduces the inflow of foreign currency. The combined effect exerts pressure on the exchange rate to depreciate (weaken).

Despite these developments, the deficit in the last decade reflects increased public investment which required imports of heavy machinery and equipment. The government ambitiously started building roads and airports, geothermal drilling and other public investments. This

debate then takes us to the mismatch between the foreign exchange that has been spent on imports of machinery and equipment to rollout public investments – especially in infrastructure – and the capacity created by these investments for the future earnings of foreign exchange that may only be realised in the long-term. Consequently, the Kenya Shilling could weaken in the short-run but the economy will benefit from these investments and will have a stronger capacity for growth in the long-run. Growth and increased productive investments will strengthen the currency in the long-term.

How do we assess the current deficit?

We now focus on whether or not a deficit is desirable. This depends on the nature and source of the deficit. If the deficit arises from financing productive domestic investments such as infrastructural projects and human capital development that generate revenues and employment in the future, such a deficit is desirable. This was the case in South Korea in 1970s and 1980s when the country invested heavily in productive capital for future wealth creation. Similarly, if the deficit is caused by foreign firms relocating their machinery, building materials and capital equipment (all these are captured as imports and may therefore widen deficit), this will not translate into payment for imports. In fact, this is a sign of good domestic policies and investor confidence in the domestic economy. In both cases, the deficit is desirable for the economy. However, a deficit is not desirable in situations where increased imports are due to final consumption and other unproductive or even luxury spending.

Kenya has a floating exchange rate regime and a liberalised capital account. Under this arrangement the exchange rate acts as an automatic stabilizer such that any short term net capital inflows (outflows) would cause the exchange rate to appreciate (depreciate) to restore external balance. The Central Bank of Kenya has in the recent past argued that when a country is operating under a floating exchange rate regime and a liberalised capital account, it is impossible to simultaneously control exchange rate movements while running an independent monetary policy and having free international capital mobility. This is the macroeconomic tri-lemma or ‘impossible trinity’. It amounts to trying to stabilise the exchange rate, having free capital mobility and running an independent monetary policy. The Central Bank must surrender one and focus on the remaining two objectives. It is important to appreciate that with heightened investment promotion to actualise the *Vision 2030* development plan; there will be increased capital inflows especially for investment and also for speculation which in turn could strengthen the exchange rate. In such a situation, the ultimate solution lies in the ability of the economy to expand its productive capacity so as to absorb the ensuing exchange rate dynamics.

How is the deficit financed?

The question now is how the deficit can be financed? It is financed through net private and/or official capital flows. Private financing of the current account is in form of net private flows, net direct investment and net portfolio investment. Capital inflows in Kenya are predominantly portfolio flows. Data on portfolio flows are scanty with Diaspora remittances being the only officially reported component. Portfolio flows tend to be volatile and are incentive-driven in the sense that they are motivated by either interest or exchange rate differentials between the domestic economy and the rest of the world. Similarly, portfolio flows react to the changing risk profile of the country. The deficit can also be financed through official flows using official reserves or official external borrowing. Official flows can be incentive-driven but also policy-driven in the sense that the government can use

official reserves to intervene and support the exchange rate or guarantee state corporations to borrow externally. Foreign Direct Investment (FDI) is a source of long-term financing of the deficit but data is scanty. Although Kenya is the main source of Foreign Direct Investment in the East African Community region, FDI flows into Kenya is quite low.

In Summary

The current policy challenges revolve around the fact that whenever there are external shocks hitting the economy and driving prices from the supply side, and there are also imbalances in the economy, these are reflected in exchange rate movements. Consequently, policies and programmes that support the growth of exports as well as the economy's productive capacity remain the main sustainable solution to narrowing the current account deficit and dampening its effects on the exchange rate movements, and hence domestic price stability.