Life Offices Association of Zimbabwe

Demystifying Insurance Part 16

Welcome to part sixteen of Demystifying Insurance, a continuation of the Life Offices Association (LOA)'s ongoing National drive to make insurance easily understood by all. This week, we focus on currency value and how its depreciation led to hyperinflation in Zimbabwe.

A country's currency value really comes down to supply and demand. If a particular country's currency is in high demand by purchasers — such as travellers, governments and investors — it will increase the currency's value.

Direct and indirect accelerants for inflation
A lower currency value leads directly to an increase in inflation. Local citizens and foreign visitors find it cheaper to buy local products, which increases demand for local goods and exerts an inflationary upward pressure on prices. Indirect inflationary accelerants include governments that are forced to print more money to purchase hard currency, pay foreign debt or import critical capital goods.

A continual fall in the local currency value reduces public confidence, leading to hoarding of foreign currency. There are many factors that can apply a positive or negative effect on the demand and value of a particular currency, as the following reveals.

Level of foreign currency & mineral reserves
Nations with huge amounts of foreign currency or minerals such as gold, have strong currencies. A currency backed by gold increases investor confidence. Such nations can settle foreign debt by using reserves without printing money or raising taxes.

Interest rates
For foreign investors, high interest rates are like nectar to bees. Decreased demand for a currency by foreign investors decreases its value. Low interest rates also have a direct effect on inflation by reducing deposits into banks or increasing withdrawals. As more money circulates, the more inflation there is.

Printing of money
When a country prints an excessive amount of currency, it leads to inflation due to an increase in demand. This can also decrease its currency value as foreign buyers would require more local currency to purchase the same goods. Also, whenever you have more of anything, it can result in decreased value, such as the current low price of oranges.

Current state of the economy
The potential for economic growth in a country is a major consideration. If the potential is strong, then its currency value can be expected to increase. Foreign investors inevitably seek out stable countries with strong economic performance in which to invest their capital. A country with positive attributes will draw investment funds away from other countries perceived to have more economic risk.

If a country is experiencing a poor economic environment, it can decrease the demand for that country's currency. More specifically, increasing unemployment reduces consumer spending, leading to a decrease in business expansion and a falling economic growth rate. The result? A fall in foreign investor confidence and activity.

Prices of foreign goods
Related to the economy is the price of foreign goods. If foreign companies for some reason (such as increased production efficiency or economies of scale) sell goods at a cheaper price than comparable locally produced products, it can really hurt the economy of that country.

National debt and fiscal deficit
In a democratic society, national debt and the fiscal budget must be paid by the taxpayer. If taxes increase, the purchasing capability of society is reduced. This also reduces consumer spending and leads to a decrease in business expansion and a falling economic growth rate.

War and terrorist attacks
War, terrorist attacks, or the strong potential for war, can decrease investor confidence due to the potential total loss of property or defaults on money owed. As a result, the demand for (and subsequent value of) the local currency would fall.

A war can also increase a country's fiscal deficit thereby necessitating an increase in taxation, while investors would not want to indirectly sponsor war through such taxes.

Increase in government size and projects
Government departments, civil servants and national projects all cost money. Again the tax payer will need to pay for the new growth, which in the long run has a negative effect on the economy. Excess government recruitment and projects can therefore lower the currency value.

Political problems, negative publicity and sanctions
If a nation is perceived to be politically unstable and negative publicity about that country is spread, then it is likely to have less tourists, foreign investors and export opportunities. This would reduce its foreign currency reserves and hence its currency strength.

Positive or negative perceptions
The above factors determine the degree of demand for a currency. Whether or not the perception is accurate, it is what makes the difference between a currency purchaser buying or selling a currency. Also, if local individuals lose confidence in the local currency, they will tend to hoard more stable currencies.

Natural and other factors
Other factors leading to a decline in the demand of a currency include governments who fix the exchange rate, natural disasters such as earthquakes and even droughts or very cold winters, which have an effect on agriculture and energy consumption.

Level of infrastructure, skilled manpower and basic facilities such as healthcare also affect investment and currency demand, making them the key pillars of a strong and stable currency.

In next week's article we explore local events that demolished these key pillars. . . and left Zimbabwe exposed to a devastating economic hurricane — hyperinflation.

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