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RBA
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Foreign Exchange Market Dynamics in Rwanda *

February 26, 2023

Highlights

- The steady depreciation of the Rwanda franc (RWF) against major currencies, and instances of exchange rate swings that amply the depreciating streak, has drawn the attention of policy makers, market intermediaries, and businesses and households.
- Underlying the state play in the market as two linked causes. First is the demand–supply imbalance in the foreign exchange market arising from the economy's weak external position. Second is speculative tendencies in the market which, if not checked, will end up being self-fulfilling.
- Market inadequacies have revealed themselves in segmentations that inhibit price discovery, dominancy that engenders speculation, and deposits dollarization that provides an additional layer of pressure on the local currency.
- The National Bank of Rwanda (NBR) finds itself playing the role of a liquidity provider of first resort to the banking system instead of market maker of last resort.
- On the back of limited market depth, the NBR is predisposed to selling foreign currency to banks than purchasing, while commercial banks' customers are predisposed to buying foreign currency from them than selling to them. With that comes latent power that foreign exchange bureaus have to influence the exchange rate market and in instances fuel market speculation.
- With a foreign exchange interbank market whose liquidity is at the very best limited, the NBR is expected to continue making appropriate interventions towards obviating further market volatility.
- The test remains on how NBR's intervention strategy will be deployed alongside initiatives to disincentivize market segmentations that makes price discovery difficult.
- The disincentivizing strategy could extent to measures such as cash reserve ratio differentials for local currency and USD deposits such that a ratio for the latter would be determined at a level that promotes de-dollarization of deposits.

1. Context

The foreign exchange market in Rwanda, like in all other open economies, is critical in linking domestic and international transactions. As a facilitator of currency conversions, the foreign exchange market enables trade between Rwanda and its partners - both regional and global - as well as other financial transactions such as investments.

Based on the centrality of the foreign exchange market in an open economy, the exchange rate – a relative price of one currency versus another – is closely watched. That is for good reasons, among which including:

- Its implications on macroeconomic stability;
- Its influence on the stability of organizations with foreign currency obligations; and
- Its signaling of the broader international competitiveness of the economy.

Rwanda has liberalized its capital account, a consequence of which being that the exchange rate is determined by the market forces of demand and supply of foreign exchange.

Given the nature of the foreign exchange market, the demand and supply dynamics may be underpinned by economic fundamentals as well as sentiments shaping market expectations.

The National Bank of Rwanda (NBR), pursuant to its commitment to a market-based foreign exchange market, allows the exchange rate to adjust in line with the prevailing economic conditions in a broad sense and the market conditions in a specific sense.

In the event that the market dynamics point towards volatility, the NBR deploys varied tools to restore stability regardless of whether the Rwandan franc (RWF) has an appreciation or depreciation stance.

2. State of the market

The state of the foreign exchange market in Rwanda over the past five years is two phased. The RWF was largely stable for the period 2018 – late 2022. Subsequently, the RWF has been subjected to depreciation pressure against major currencies **(Figure 1 – A)** and in instances exhibiting volatility **(Figure 1 - B)**.

Figure 1 A: Nominal Exchange Rate

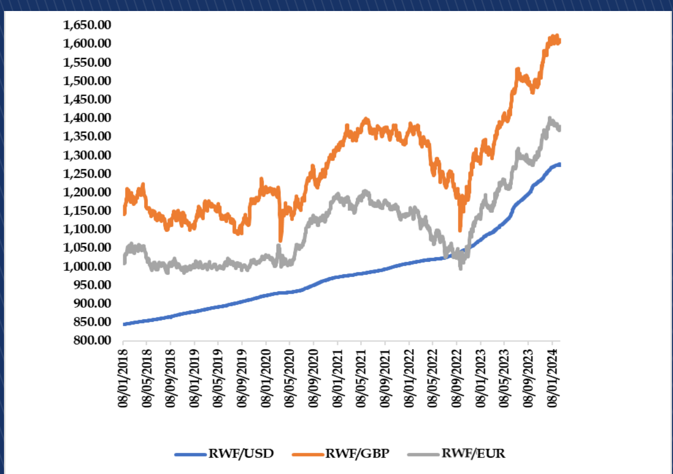
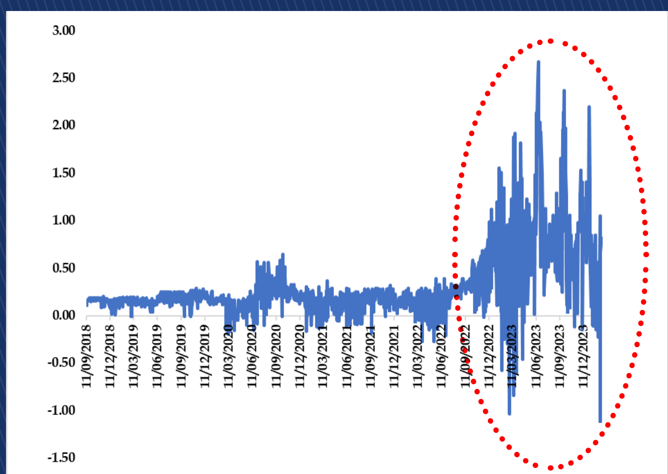


Figure 1 B: RWF/USD Changes



Source: National Bank of Rwanda (NBR)

On account of the steady depreciation and instances of exchange rate swings that amply the depreciating streak, the market has drawn the attention of the stakeholders - policy makers; financial intermediaries, especially banks; the non financial business community on either the demand of supply side of the foreign exchange market; and households.

Underlying the state play in the market as two linked causes.

- ***First is the demand–supply imbalance in the foreign exchange market arising from the economy's weak external position.***

  The steady deterioration of the economy's external balance led to the current account deficit widening to a low of 15 percent equivalent of GDP **(Figure 2 – A)**. The closing of the current account post-COVID19 shock has been slow. Imports continue to outpace exports while net foreign direct investments (FDI), while stable, are still low **(Figure 2- B)**.

  That points to a situation where demand for foreign exchange to meet the import needs – petroleum products, consumer products, as well as plant and equipment – is not sufficiently matched by export earnings as well as other foreign exchange inflows.

Figure 2 A: Current Account Balance(% of GDP)

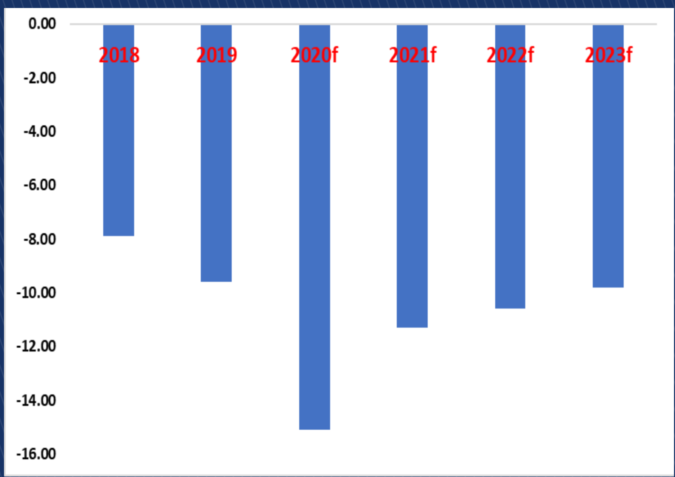
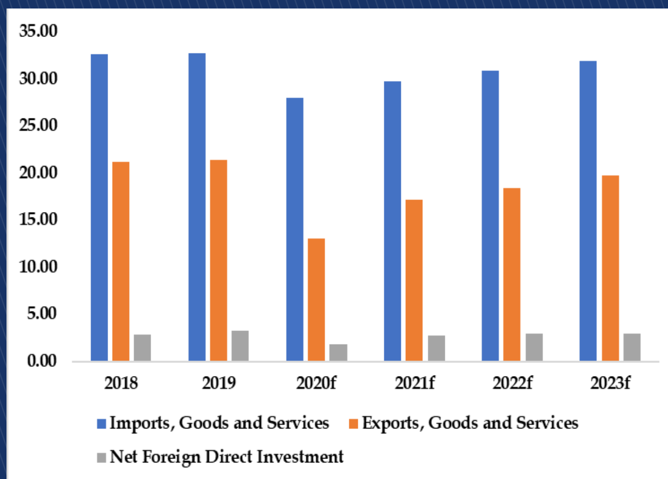


Figure 2 B: Imports, Exports Net FDI (% of GDP)



Source: National Institute of Statistics Rwanda(NISR); World Bank; IMF projections

The demand supply interplay in the foreign exchange market is on the back of an economy showing strong post-shock growth **(Figure 3-A and Figure 3-B)**. Evidently, Rwanda's output growth strongly correlates with that of both the global economy and Sub-Sharan Africa. The economy's growth rate has however has consistently remained higher than that of the both global economy and Sub-Saharan Africa.

Notably, Rwanda has reported stable real quarterly growth rates over the 2021 Q3 – 2023 Q2 period, with indications that the growth stability will likely be sustained. The recorded economic growth is accompanied by increased demand for foreign exchange. The fact that exports are not as responsive to economic growth to the same extent as imports is an indication a structural foreign exchange shortage underlying the demand – supply imbalance.

Figure 3 A: Real GDP Growth (%)

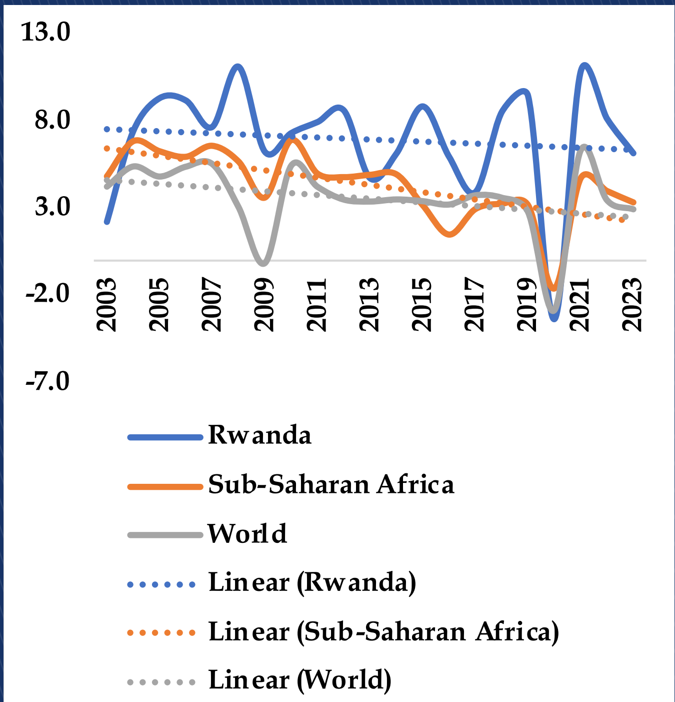
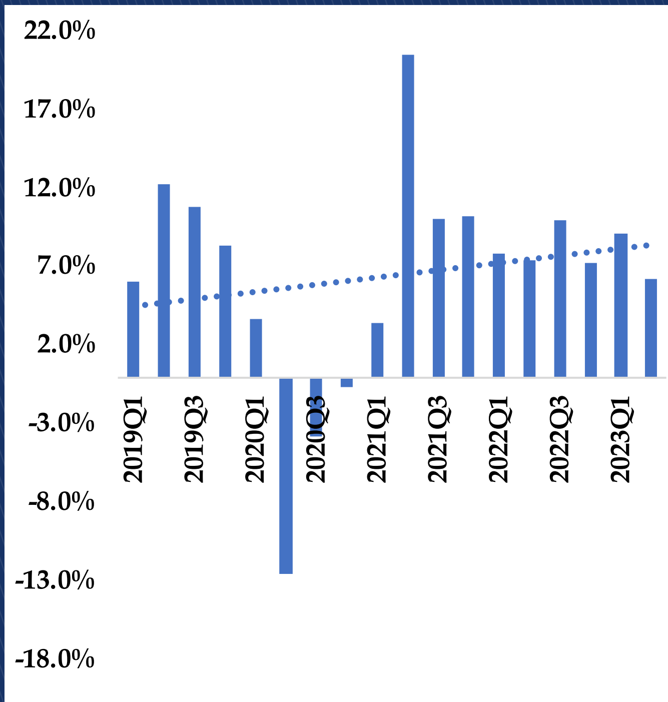


Figure 3 B: Quarterly Real GDP Growth



Source: National Institute of Statistics Rwanda(NISR); IMF

- ***Second is speculative tendencies in the market which, if not checked, will end up being self-fulfilling.***

The NBR fully acknowledges that under a liberalized foreign exchange regime the dynamic nature of the market could result in volatility and risky behavior. That is the basis upon which the Central Bank has issued detailed regulations to govern foreign exchange operations[1].

Even on the back of the regulations, there is implicit market tension between intermediaries – banks and deposit taking microfinance banks on the one hand and foreign exchange bureaus and other institutions – that are authorised by the Central Bank to deal in foreign exchange.

On the back of the foreign exchange demand – supply imbalance the market power leans more towards the supply side. Amidst the foreign exchange shortage, those in export business – therefore foreign exchange earners – are incentivized to seek the best deal in the market.

While banks and deposit taking microfinance institutions dominate the financial system, they are overtly price takers in the foreign exchange market. The current state of market points to a possible negative Cumulative Delta whereby aggressive foreign exchange sellers dominate the market.

Such sellers are continuously in search of attractive rates. Foreign exchange bureaus keen on business growth amenable to offering competitive rates, in the process inviting a response from banks and deposit-taking microfinance institutions to obviate losing market share.

An additional layer of pressure on the FRW comes from the speculative switching of deposits from local currency deposits to USD deposits. On the back of foreign currency outflows outpacing inflows, the local currency – foreign currency deposit switching augments other speculative practices and ends up entrenching the depreciation bias of the RWF.

[1] *See Regulation N° 42/2022 of 13/04/2022 [Governing Foreign Exchange Operations (regulation_governing_foreign_exchange_operations.pdf)]*

3. Levers of Support Amidst Inadequacies

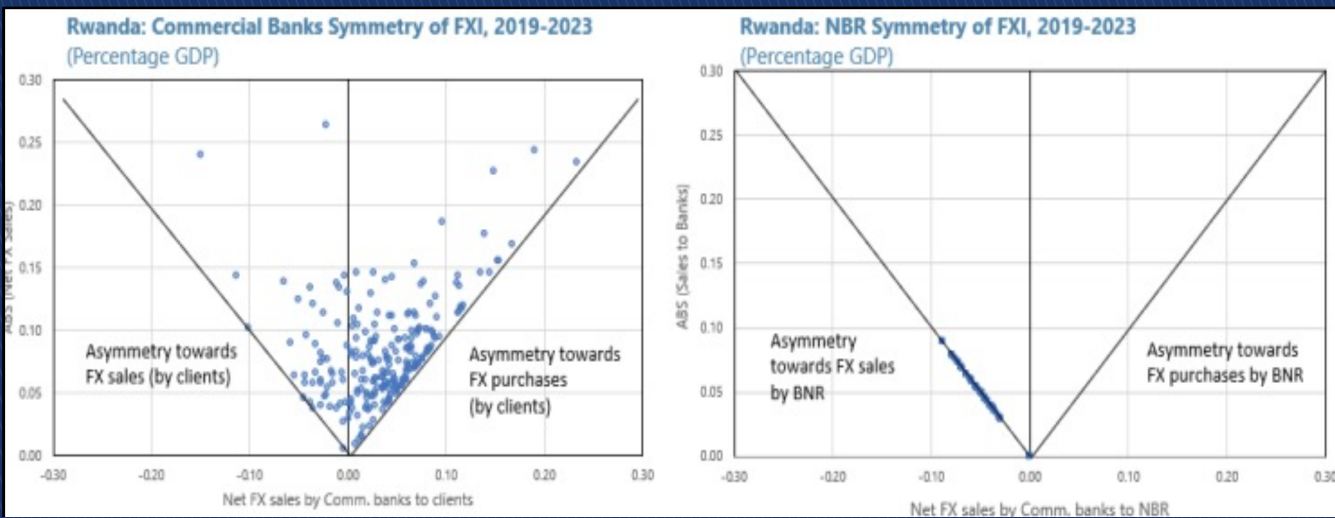
A gradual adjustment of the nominal exchange rate of the RWF vis-à-vis major currencies that is devoid of volatility has been seen as necessary in correcting the economy's external position given the slow pace of fiscal consolidation and limitations in monetary policy transmission[2].

The NBR is no doubt keenly watching developments in the foreign exchange market in line with its mission of ensuring price stability and sound financial system, cognizant of the limitations confronting it. Foreign exchange market dynamics have both macro stability and financial stability dimensions that the NBR is navigating.

Foremost, on the back of persistent demand-supply imbalances and the structural foreign exchange shortage discussed in **Section 2** above, the Central Bank finds itself playing the role of a liquidity provider of first resort to the banking system instead of market maker of last resort.

Given the limited maturity of the market, the NBR is expected to continue playing that role as it addresses two entrenched attributes of market asymmetry. The NBR is predisposed to selling foreign currency to banks than purchasing, while commercial banks' customers are predisposed to buying foreign currency from them than selling to them **(Figure 4).** Arising from the latter attribute is the latent power that foreign exchange bureaus have to influence the exchange rate market and in instances fuel market speculation.

Figure 4: Foreign Currency Market Asymmetries



Source: IMF (2023)

Given that the foreign exchange adjustment is a lever that the NBR strategically deploys to the economy's external imbalances, attention is drawn on the policy response under the current market conditions. Should the view be that the NBR foreign reserves targets will come under pressure, expectations will be that it should be ready to accommodate deeper exchange rate adjustment.

But a deeper adjustment – meaning allowing for further depreciation of the RWF vis à-vis international currencies – is a double-edged sword. The exchange rate passthrough effect to inflation is strong in Rwanda[3], thus further depreciation could necessitate additional monetary policy tightening.

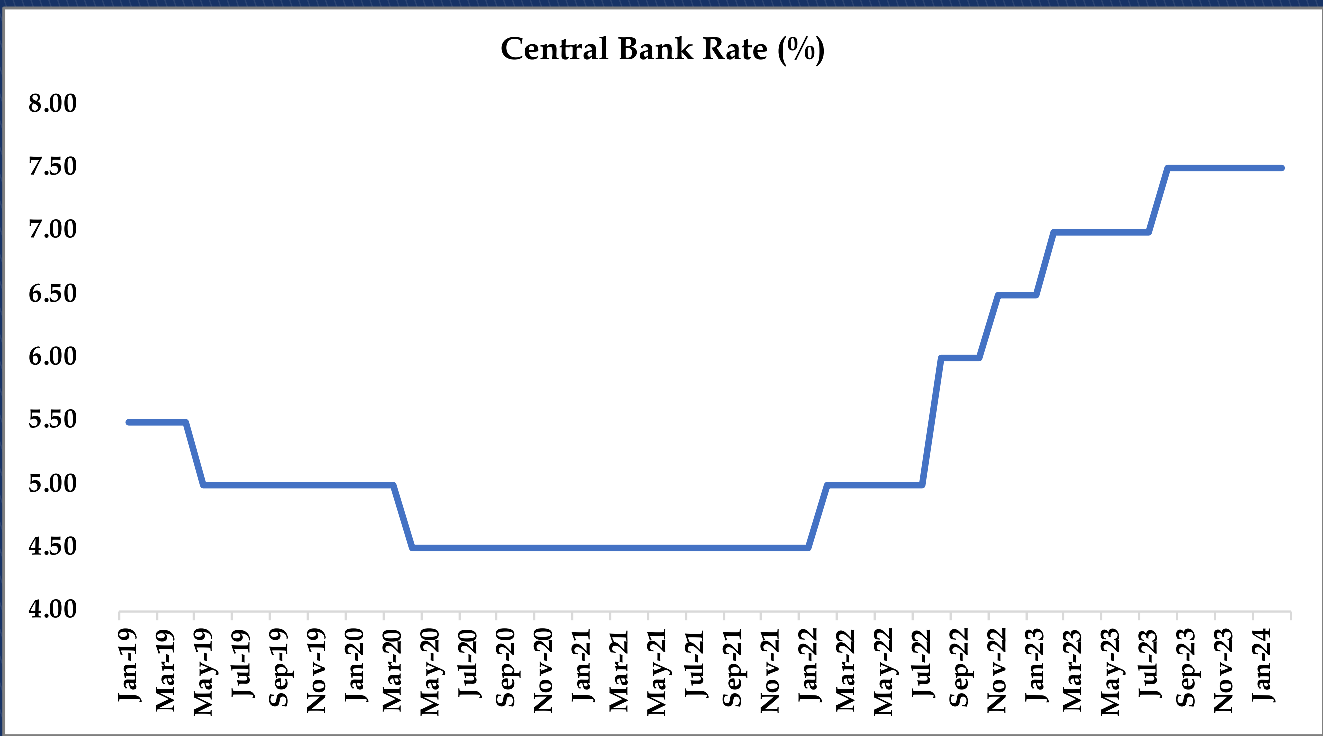
2 See IMF (2023). The 2023 Article IV Review and Second Review under the Policy Coordination Instrument and Resilience and Sustainability Facility Arrangement. (1RWAEA2023003 (1).pdf).
3 Ibid

The NBR's monetary policy decision of February 2024 considers the current stance as appropriate therefore not needing further tightening **(Figure 5)**. Even as recent studies argue that monetary policy tightening reduces the rate of currency depreciation[4], the current monetary policy stance implies that the Central Bank will be relying on other tools to stabilize the market.

On the back of a foreign exchange interbank market whose liquidity is at the very best limited, the NBR is expected to continue making appropriate interventions towards obviating further market volatility.

The test remains on how NBR's intervention strategy will be deployed alongside initiatives to disincentivize market segmentations that makes price discovery difficult. The disincentivizing strategy could extent to measures such as cash reserve ratio differentials for local currency and USD deposits such that a ratio for the latter would be determined at a level that promotes de-dollarization of deposits.

Figure 5: Monetary Policy Stance



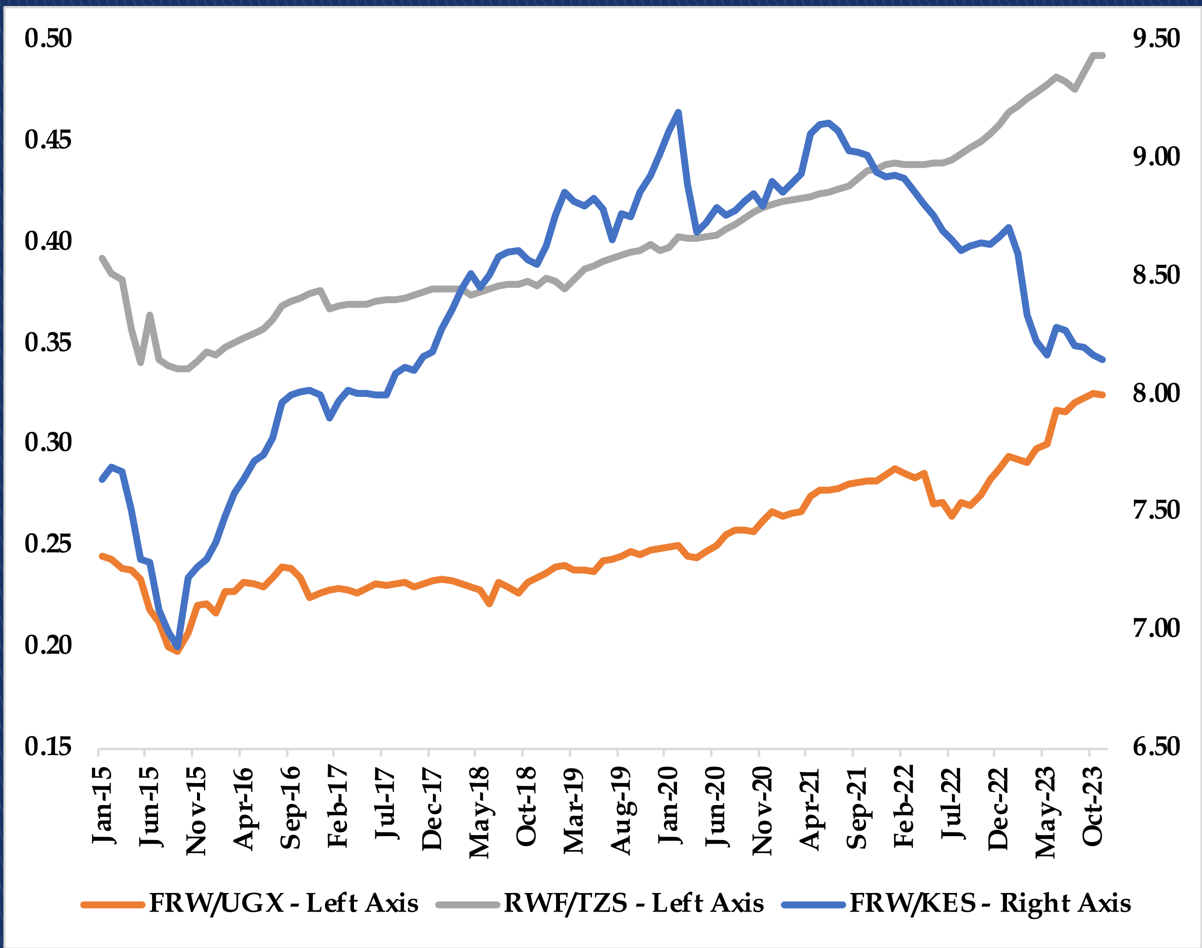
Source: NBR

4 Nyalihama, C., Manishimwe, C., and Maniraguha, F. (2023). "Exchange Rate Channel of Monetary Policy Transmission Mechanism in Rwanda", NBR Economic Review Vol 20, pp. 35 – 59. (BNR_Economic_Review_Vol_20_V3.pdf)

4. Regional Perspectives

The experience of foreign currency depreciation against major currencies experienced in Rwanda is observable in other markets in East Africa, more so in Kenya. Instructively, the RWF has been fairly stable against the Uganda Shilling (UGX) and Tanzania Shilling (TZS), and over the past three years appreciating against the Kenya Shilling (KES) **(Figure 6)**.

Figure 6: Nominal Exchange Rate – Regional Currencies



Source: IMF (2023)

The common dimension to the regional currencies' performance has been the interplay between the external and internal imbalances, with the capacity to support stability varied depending on the relative depth of each market. The key driver of the Kenyan currency depreciation for instance has been pressure to meet external public debt obligations as the economy emergences from the shocks associated with the COVID19 pandemic and the global geopolitics.

The financial flow linkages amongst the East African economies, whether through trade or investments, have a bearing on the exchange rate of each economy vis à vis major currencies. The bilateral rates amongst these economies are subject to arbitrage as conversions are often done via the USD. Thus, the local circumstances unique to each of the economies are important than the relativity of the extent of currency movements.

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* This *Research Note* benefitted from discussions with Treasurers of seven (7) Commercial Banks. The Research Note represents the authors' understanding of the discussions and how the inferences arising therefrom fall within the broader context of the foreign exchange market dynamics. Therefore, the views and interpretations of the discussions are solely those of the authors.

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