Zimbabwe Investment Notes

Edition Quarterly

Region Zimbabwe

Date July 2017

Issued by: Imara Asset Management (Zimbabwe)

The Great Illusion:

We have been blessed with more data releases over recent weeks that have helped us substantiate the views that we articulated in our last Investment Notes. In short that rising Government spending can only now be financed largely through loans from the Reserve Bank of Zimbabwe (RBZ) which is ultimately inflationary and of course unsustainable. The RBZ now issues their monthly bulletins using the IMF's format. We have also received the first quarter report from the Ministry of Finance and finally the recently launched Economic Update from the World Bank.

Taking the monthly statistics from the RBZ first, these provide us with data up to the end of April. Under the new format, we can now see that RBZ loans to Government are much greater than we had understood them to be from the old data. At the end of April these totaled $2.4billion of which we know $1billion is a straight overdraft implying that the difference must be 'other' loans. Also of interest are the value of treasury bills (T bills) held by the financial sector which at the end of April amounted to $1.95bn up from $1.55bn at the end of December. This is a $400m increase which surprised us as we felt that the financial sector couldn't justify holding more T bills given their limited capital base, hence the value of bills had been stable during the second half of 2016. At current levels, T bills held by the commercial banks are now 1.7x the level of bank equity capital, up from 1.3x at the end of 2016. In our view this ratio should be setting off alarm bells in the banks' board rooms but clearly it is not. Looking at various bank balance sheets at end May, CBZ would be most exposed with a ratio of over 4x equity followed by ZB at 2x.

Looking at it from the commercial banking sectors' perspective though, their total deposits have risen by $330m to $5.2bn during the first quarter. Loans to the private sector are lower than a year ago, reflecting managements' lack of interest in lending to the private sector where non-performing loans have been a problem for them. The private sector has been largely crowded out by Government. So banks have channeled their rising deposits back into T bills. They have all but curtailed the ability of depositors to withdraw their money in the form of cash hence the long queues that now exist outside the banks. (In most other countries this would have resulted in bank branches being set alight as depositors vent their anger!). Banks are happy with "swipe" as the money never leaves the RTGS system as electronic money from a consumer moves to the service provider's account within that system. Allowing large cash withdrawals would imply a run on the banks which would collapse the financial system. As such we should expect to see the lack of cash and bank queues to continue for the foreseeable future.

In the RBZ data, rising deposits are a consequence of the increased Government borrowing to pay civil service salaries In to bank accounts. At the end of April, total Government borrowing totaled $4.4bn up from $3.9bn at the end of December and $3bn twelve months before, meaning a 46% increase year on year. Those additional funds have been channeled toward civil servants, public enterprises, Command Agriculture and many other entities. That has directly boosted the money supply. M3 rose by $480m or 8.5% from the end December to end April and by 24% year-on-year. There is now a high correlation between the growth in the money supply and Government borrowing.

Ordinarily such a sharp rise in the money supply should lead to an acceleration in inflation. Inflation as measured by the CPI is to a large extent controlled. Food is an important component and a good agricultural season should keep prices from rising (they should have fallen after a bumper crop but for an extremely high price of maize set by Government). Energy is also an important component. Petrol prices will remain based on external oil prices so long as Government can provide the fuel companies with the US dollars they need in return for their electronic dollars at par. Electricity prices are determined by Government who have been reluctant to allow an increase. Inflation is showing itself in imported goods' prices and of course the ZSE which to some extent is also a forward indicator of prices. The CPI meanwhile has risen from -3% deflation to around 1% now. The World Bank predicts 3.2% inflation for 2017 rising to 9.6% in 2018.

The Ministry of Finance's quarterly review highlighted that the public sector deficit for the first quarter amounted to $230m. Tax revenues fell short of even recurrent expenditure during the quarter which are largely employment costs for the civil service. Given that it is an election year, it seems highly unlikely that Government will meet a budget deficit for the full year of just $400m. Indeed we would expect to see a similar or higher number to 2016 which ended up at $1.4billion. Such a deficit can only really be funded by further issuances of T bills to the public, to the commercial banks, or by increasing loans from the Reserve Bank. As previously mentioned, the commercial banks already hold large amounts of T bills and these T bill holdings can continue to rise so long as private lending falls to accommodate the rise in T bills - and so long as the government doesn't default on paying interest or principal on the T bills issued. The fact that bank holdings of T bills plateaued in 2016 suggests a limited appetite by the commercial banks for more, hence the increase in borrowing by Government from the Reserve Bank. What the Government owes the Reserve Bank could end the year at nearly $3.6billlion but borrowing from the Reserve Bank directly boosts the money base which is ultimately inflationary. Generating inflation to reduce Government debt in real terms is a trick that didn't end so well the last time (2008), but it would of course break the illusion that a US dollar deposit in the banking system equals a US dollar. The reality is that commercial banks have already been forced to default on their depositors by refusing cash withdrawals, and bank transfers are inflating away at anything up to 18-20% a year in real terms. Put another way, the banking system should be seen as no longer being denominated in US dollars. It is actually denominated in something that is devaluing quite quickly. In 2009 all monetary assets and liabilities eventually lost all their value; commercial bank balances with the Reserve Bank plus T bill holdings (two monetary assets of the commercial banks) are 3.0x bank capital and reserves and 20% of GDP. These are large numbers.

This prospect helps to explain to a certain extent why the ZSE is rising sharply and why the Old Mutual Implied Rate (OMIR) is trading at a 50% premium to the price in the UK. The OMIR is effectively suggesting that $100 in your electronic deposit account today is only really worth $50 as it discounts a domestic default. As we learned in 2009, shares in the stock market became US dollar assets having started as Zimbabwe dollar assets and hence they provided the ultimate liquid hedge against a depreciating asset. Should Zimbabwe default domestically and is therefore forced to "dollarize" for a second time, or "randise" or adopt a currency board, then equities and property – or cases of whiskey – will be the assets to hold.

This is not to say that we believe that Zimbabwe will experience hyperinflation again. Far from it. We may not even see the CPI at 50% per annum let alone 50% per month (which is hyperinflation). This time around however, Zimbabweans will *behave* as though there will be hyperinflation; they have experienced the effects of rapid inflation before on their monetary assets and hence will react sooner to protect them than they did in 2000-2005. In this regard we would not be surprised to see commercial banks using surplus liquidity to buy property or hoard foreign exchange rather than treasury bills going forwards.

Meanwhile the World Bank, supported by the Ministry of Finance, issued a report entitled "Zimbabwe Economic Update, the State in the Economy". This essentially puts into words the monetary statistics that the RBZ and Ministry of Finance publish, but with substantially more information that puts into perspective the size of Government or the State within the Economy. The World Bank estimates that the public sector represents roughly 50% of GDP which is a level more attune to a developed economy such as those in the Nordic countries. But of that number, half of that is represented by government revenues of which all is paid as civil service salaries. They estimate that the wage bill as a share of government revenues are more than double the average in the SADC area and other low income countries. The other half of the public sector is accounted for by such entities as the local authorities, state owned enterprises (SEPs), ZINARA, and donor funded projects. Many of the latter such as the local authorities and the SEPs have not produced audited accounts in years. Further with 27 line ministries, 107 SEPs and 95 local government units, the World Bank believes that costs and manpower are likely duplicated and service delivery to be poor given the lack of overall coordination.

Positively, these weaknesses are well known by both the Ministry of Finance and the RBZ. The very fact that the World Bank's Economic Update was launched by the Minister of Finance himself suggests that it has his Ministry's backing. What is necessary is to have the political backing to adopt the proposals that the World Bank outlines in their report. At least the information and data is now being collected and could at some point be acted upon. As an example, the Auditor General under the 2010 Audit Act, has been publicizing major holes in SEPs accounts and identifying serious gaps in corporate governance in local authorities and SEPs. Despite all those efforts it is rare that any misdeeds are acted upon, at least publically, which only encourages more misdemeanors in the future. Then again, at least they are a "known known."

At the end of April, the Finance Minister announced that the conditions precedent to the repayment of Zimbabwe's debt arrears proposed in the Lima Agreement in 2015 had been met. Put simply, the Government had identified new lenders who would assist with the debt clearance thereby triggering new concessionary lending by the international financial institutions (IFIs). He was quick to state however that these loans would not be drawn down until such time as they were sure that the IFIs would resume lending. We took that to mean that this was unlikely to be until after the 2018 elections after which an economic reform programme to tackle the issues outlined above can be implemented. As we see it, the authorities in the RBZ and MOF know what the key issues are, they now have the data, they have the international support, they know those in Government abusing the system and they know largely how to fix it. This is very positive news but equally frustrating that politics once again inhibits progress as they cannot implement the necessary change without the necessary political support.

The Government is clearly hoping that the economy can continue to limp along until the elections take place. Fuel is still available, the lights remain on whilst the supermarket shelves remain full. The fact that gold and minerals plus tobacco have performed well and brought in the necessary US dollars has been a major help. In addition a good maize crop will obviate the need for food imports in theory and hence will save foreign exchange. From what we can gather from the companies that we speak to, those who need dollars for imports can usually find them but at a premium of 15-20% as opposed to 12-15% a few months back. As alluded to above, this premium will expand as more electronic money is created. In addition, as inflows from tobacco sales eases, we would expect to see further controls imposed on foreign exchange usage.

For the past twelve months, the ZSE has been one of the World's best performers rising by 94%. This has been great for local investors in an uncertain environment. For foreign investors it will remain an illusion until such time as their capital can be repatriated freely. This may not occur until the IMF and other IFIs re-engage and start lending based upon a credible economic reform programme that is likely being drafted as we write.

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