Zimbabwe Investment Notes

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Zimbabwe at a pivotal moment:

Zimbabwe has had a poor and dysfunctional monetary system for the better part of twenty years with the brief exception of 2009 to 2013 when dollarization was allowed to work. The asset class that does well during such bad times is equity as it acts as a hedge against inflation and devaluation. Money market assets on the other hand will likely perform poorly as returns cannot compensate for a depreciating currency and high inflation. As a result, our high exposure toward equities has served our clients handsomely over the past five years as it did during the hyperinflationary years.

Zimbabwe is now at a crucial turning point. Elections in a matter of weeks have the potential to result in a new Government that is committed to significant economic reform that could change the investment climate for the better for the first time since the 1990s. Crucial to this reform will be the monetary system that the new Government chooses to adopt; without a solid monetary foundation, the economy will forever underperform and will never attract the much needed foreign long term capital.

Fortunately the two major political parties are both committed to economic reform and are encouraging a re-engagement with the international community. This is positive and a dramatic change from the 2013 elections when the policies of the one party were diametrically opposed to those of the other. The proof though will be in the pudding; tough economic decisions will need to be made which newly elected politicians may shy away from as they seek another more palatable path to follow. They have tried this before and have always failed since those paths always arrive at a dead end.

The latest economic statistics that we have to work with are for April issued by the RBZ in their monthly economic bulletin. Interestingly broad money supply, M3, has increased marginally since November last year and as a result the year on year growth has decelerated to 33% having ended 2017 growing by 44%. This of course is still inflationary and reflects the continued borrowing by Government from the RBZ albeit at a slower rate than we saw in 2017. That might explain why the currency premium of RTGS$ over real US dollar ('US$') remained at around $1.40 to $1.50 for the first few months of the year. This changed from April when that rate, the Old Mutual Implied rate and the ZSE all began to increase suggesting that broad money growth may also now be on a rising trend. We will not know for certain until the numbers are released in the weeks and months to come.

The key issue for stock market investors currently is the level of the currency going forwards as this will determine the level of share prices. Whilst officially there is no exchange rate as RTGS$ and Bond Note dollars should trade at par to the US$, this is clearly not the case in practice. There is no doubt a hope in the minds of the politicians and many others that a free, fair and credible election will result in a flood of foreign capital inflows thereby allowing the currency to return to a normalised situation whereby there will be no cash shortages and transfers outside of Zimbabwe will be possible once again. Ironically that would likely see the stock market fall, at least initially, as investors will start to price the market in real US$ and not in RTGS$ as now. Whilst we are optimistic that elections could be seen as reasonably free, fair and credible, we very much doubt there will be an immediate flood of foreign capital that would be sufficient to re-set Zimbabwe's monetary system back to 'normal' as the politicians on both sides might hope; the scale of the problem is simply too great in our view.

In a recent discussion paper issued by ourselves entitled "*Currency Options, Reform and the Implications for Corporates*", we outline the scale of the currency problem, the necessary reforms to rebuild a credible monetary system and a recommendation on a way forward. If we look at the first item concerning the scale of the problem; the total foreign exchange held by the commercial banking system is US$221m (April 2018) which in a trustworthy banking system should support a deposit base of around $1.1billion (i.e. a 20% cash to deposit ratio). Yet reported deposits are RTGS$6.7 billion. We estimate that the RBZ has lent Government over RTGS$4 billion (in the form of an overdraft and bonds) to fund its expenditure. In effect, this is money that has been created electronically and used domestically but it has never been backed by real US$ inflows. For a functioning banking system that all participants trust, to balance foreign exchange of US$214m with deposits implies that deposits in the banking system would require an 80% haircut. Put another way, the exchange rate between RTGS$ and US$ would equate to 5 to 1 against a current black market rate of RTGS$1.65 to US$1. In short, converting existing bank deposits to a new currency given current foreign exchange balances would require a substantial devaluation which politicians and bankers would be anxious to avoid.

The other option would be to boost existing foreign exchange balances to a level that would support the current RTGS$6.7 billion deposit base. This would require an injection of over US$1 billion of real US$ capital into the banking system which sounds a much simpler option. It would only work though if there was trust in the monetary and banking system as without trust, that US$1 billion would be externalised within minutes. At the moment there is very little trust in the banking system following the comingling of US$ and RTGS$ which has effectively destroyed people's savings in US$; a foreigner would also be less than keen to send real US$ to the banking system today only to have it turn into something else (i.e. an RTGS$) on arrival. Banks could in theory allow new FCA accounts into which foreign currency could sit but that would imply that there is something different from an FCA account and a local RTGS$ account breaking the illusion that they are one and the same. In addition, only ten years ago, FCA accounts were stolen by Government and converted to Zimbabwe dollars that were eventually hyper-inflated away. The bottom line is that we don't believe that the existing monetary and banking system is sustainable for very much longer and a new currency – the second in ten years – will need to be introduced but this time one that cannot be interfered with by our monetary authorities until such time as trust has been re-established.

This is a pity as the multi-currency system – or in practice, the US$, worked well between 2009 and 2013. There are two reasons why it worked well. The first is that the Government ran a cash budget; they spent what they earned in tax receipts and, since the economy was booming as foreign capital entered, so too did tax receipts thereby allowing Government to increase its expenditure. The second and equally important reason is that the US$ was at that time devaluing against most major currencies globally, including that of the South African rand. A weak dollar usually results in strong commodity prices which also occurred during that time. So Zimbabwe enjoyed a devaluing currency against its major trading partner and rising commodity prices as an added bonus. This double whammy lasted until 2012 when the US$ started to recover albeit gradually.

The re-election of President Mugabe in 2013 on an Economic Empowerment ticket put paid to a continuation of the economic reform that had begun in 2009 and further scared away all-important foreign capital. Rather than take any economic pain as the private sector had been doing by cutting costs, labour and salaries (referred to at the time as "internal devaluation" by the RBZ Governor), Government made no real effort to cut back the civil service and expenditure. Indeed the Minister of Finance's efforts in this regard were shot down and ignored. With no more capital entering the economy – it was actually leaving by then – and with no cuts to expenditure, the Government started to run a growing fiscal deficit. This was originally funded by issuing treasury bills to the banking sector until the banks could take no more given the size of their capital base. At this point they also stopped lending to the private sector. Meanwhile the US$ strengthened sharply in 2014/2015 whilst commodity prices started to fall; the rand became very competitive making it hard for the private sector to operate against their South African peers.

A strong US$ is never good for emerging economies and for commodity producers - in economic terms it amounts to a tightening of global liquidity. It made Zimbabwe's US$ look all the more attractive for those who could access them. Making matters worse, in its July 2014 Monetary Policy Statement the RBZ reduced the maximum nostro account compliance threshold from 30% to 5% in a desperate attempt to maintain domestic liquidity to fund the recently announced ZimAsset investment programme. This effectively allowed retail depositors to access cash that had been held offshore by the commercial banks; capital flight then did the rest. This forced the RBZ to end the free funds regime and to re-impose exchange controls to stem the outflow of US dollars.

[NB: The US$ has been very strong in recent weeks and the effect has seen the exchange rates of emerging economies weaken, in some cases sharply as global US dollar liquidity has tightened. During the second quarter of 2018 the rand, the Brazilian real and the Turkish lira have all fallen by around 18% against the dollar whilst the Chinese yuan has weakened by 6%.]

Since Government's fiscal deficit continued to balloon and since treasury bills could no longer fund that deficit, the RBZ simply created electronic dollars and lent those to Government instead. In reality this signalled the end of the US$ system and the re-introduction of a local currency in its place, the RTGS$. As a further illustration of this, the Government then issued Bond Notes as physical cash in November 2016 although the Bond Note announcement had been made back in May 2016. Trust in the banking system plummeted further and so, to avoid a run on the banks, cash withdrawals were limited both in US$ and the new bond notes. Government had no option but to introduce a cashless society by supporting and encouraging electronic payment methods such as swipe machines, ZIPIT and mobile money transactions.

This situation could have been avoided had foreign capital not been scared away by strict empowerment laws, had trust remained in the banking system and critically had Government joined the private sector initiative by cutting costs and devaluing internally as a means to curb the fiscal deficit. There would have been pain though as the strong dollar weakened commodity prices and made South Africa that much more competitive relative to Zimbabwe worsening Zimbabwe's balance of payments position. The cost cutting would necessarily have been severe. Critically had Zimbabwe pursued the October 2015 Lima Agreement and received IMF backing for a reform programme, Zimbabwe may have qualified for IMF balance of payments support that would have eased the pain somewhat. The Zimbabwe Government opted against that option and the rest is history.

The new 'dispensation' or Government that came into being in November 2017 is taking a very different approach. The new strap line is "Zimbabwe is open for business" and one of the first initiatives they undertook was to kill the indigenisation policy for all sectors except platinum and diamonds (which will probably go at a later stage). Part of the wider initiative has been to re-engage with the international community to promote Zimbabwe as a new investment destination. This is certainly working as it has generated much interest. Imara alone has met with delegations from the IMF, World Bank, IFC, EIB, DFID, AFC, CDC, AfDB together with a number of foreign investors looking at specific projects over the past six months, something that we haven't seen for decades. That is a positive start but all of them insist that elections must be free, fair and credible before they will take Zimbabwe seriously again. The second major issue for them and especially for the investors is that the currency issue must first be resolved.

In our discussion paper, we concluded that Zimbabwe's best option – and there are few of them – would be to join the Rand Monetary Area (MMA) as well as the South African Customs Union (SACU). The existing multi-currency system which in reality became a US$ one, has morphed into a mess now that US$ have been co-mingled with RTGS$ as discussed above; it is not sustainable. Further we believe it is hard to fix given that domestic debt is estimated at US$6.7 billion (or higher) whilst we also know that total foreign debt is US$11 billion, an enormous burden (around 100% of GDP) if we were to start again with a US$ monetary system even if a part of that foreign debt could be written off. Introducing another new Zimbabwe currency is also not an option in our view as the public (and foreign investors) have zero trust in our monetary authorities or the banking system for that to even work. Even a currency board, where a new Zim currency would be pegged to someone else's currency would not work unless the currency board was managed outside of the country, by an independent authority. After all, Zimbabwe has been one of the few, if not the only country that has adopted the US$, then allowed it to fail by creating electronic dollars. That leads us to conclude that one of the very few options open to us would be to join the MMA but using the rand as currency rather than our own should the desire be to have a long term sustainable monetary base from which to rebuild the economy. That also assumes the South Africans would be happy to allow us in!

This is the crux of the matter. Adopting the US dollar as our functional currency was Zimbabwe's choice but it did not require supervision from the US Federal Reserve. Had that been the case, Zimbabwe would not have been allowed to create electronic dollars. Joining the MMA will require Zimbabwe to be effectively supervised by the South African Reserve Bank to ensure that we manage our monetary and banking affairs correctly and in line with South Africa's monetary policy. Whilst this might be popular with the general population and within business circles, this may not be so popular amongst the politicians. That said it was interesting that the MDC in their election manifesto said that they were committed to the removal of bond notes, the introduction of a new currency but then joining the MMA with that new currency. This was somewhat confused given that bond notes are a new currency but the end game is sensible in our view. ZANU-PF recognises that a new currency will not work until the economic conditions are 'right' which pre-supposes that they will be happy to use another country's currency for now.

One legacy of past government prolificacy has been an enormous debt burden which, sadly, is denominated in US$. Zimbabwe is deemed to be in debt distress by the IMF, and, even if "domestic" debt is somehow transformed into a "soft" currency, the remaining dollar-denominated debt due to the World Bank and foreign creditors is around 50% of GDP. GDP growth needs to be higher than half the interest rate on this debt for this debt to fall as a proportion of the economy, so introducing a "soft" currency such as the rand will make this US$ debt dangerous each time the US$ strengthens. For this reason, debt forgiveness rather debt restructuring looks essential ahead of introducing any new currency or ahead of joining the MMA; it will be an important indicator to watch out for in any IMF negotiation.

Should the 'new' Government post July's elections seek and be allowed to join the MMA, there will be little choice but to significantly reign in Government spending to reduce the fiscal deficit to low and manageable levels and one consistent with the adoption of the rand. In our view this would put an end to the "Command" policies (eg Command Agriculture, Command Livestock etc) that have so inflated Government spending and resulted in artificial agricultural prices, subsidies and other economic distortions. It would require a streamlining of the civil service which should follow on from a vastly reduced Government in terms of Ministers and Ministries to a size more compatible with the Zimbabwe economy. Instead, and with the support of international and regional investors and lenders, Government should focus on creating an enabling environment for the private sector to operate in and one which encourages long term investment. Critical to this would be an adherence to property rights whether in the form of agricultural leases, mining licences, title deeds and a judiciary that is there to uphold those rights. A system that is built on political patronage does not work as Zimbabwe has learned the hard way over many decades.

Joining SACU would entail the removal of trade barriers and trade tariffs with the other members of SACU, and in practice South Africa. This would open Zimbabwe up to a consumer market of 66 million people but also to increased competition. It would do away with the need for middlemen, runners and other informal sector participants but it would importantly result in prices of imported goods falling dramatically thereby improving the spending power of Zimbabweans. It would require Zimbabwe corporates to restructure to focus on their comparative advantages, which may simply be their local/regional brand names and distribution rather than manufacturing. For South African producers, Zimbabwe could become the manufacturer and exporter of goods to countries to our north such as Zambia, DRC, Tanzania and Malawi. The ease of doing business would improve considerably especially as the hunt for foreign exchange for inputs would come to an end and dealing with middlemen would cease. More than likely it would also encourage skills and capital to move back to Zimbabwe from South Africa initially as the diaspora seek opportunities back home. With the agricultural landscape so uncertain in South Africa at the moment, Zimbabwe could stand out as an attractive option for new investment – but only so long as property rights are back in place.

Critically for Zimbabwe as a commodity producer, the rand would make more sense than the US$. As we discussed earlier, a strong dollar puts enormous strain on a commodity based economy such as ours - or South Africa's - at times when the dollar is strong as it is now and as we experienced in 2013-2016 when commodity prices were under pressure. To avoid the pain of a terms-of-trade shock when commodity prices fall, it makes sense to be part of a floating currency regime such as the MMA that eases the pressure on domestic liquidity and on industry itself.

The key question remains as to how to get from our current muddled RTGS$ system to the rand within the MMA. First Zimbabwe will need the support and assistance from the SA Government and Central Bank to adopt the rand. Second it will require a major economic reform programme that has the blessing of the South Africans as well as the multi-lateral lenders led by the IMF. Third the banking system will require a capital injection together with credit lines of at least the equivalent of a US$1 billion to support a functioning banking system. Fourth the size of the domestic debt at the time (US$7 billion or higher) may require depositors and lenders to take a haircut in order to convert to rand which could be engineered through a non-market exchange rate.

Zimbabwe's foreign debt would be subject to an agreement with the international lenders which may or may not be based on the Lima Agreement. Preferably for Zimbabwe that foreign debt would be restructured with part of it converted to rand to ease any repayment pressure when the rand weakens against the US$. Joining SACU simultaneously would ease some pain since imported prices would fall sharply (by at least 30%) that would likely result in deflation for a while helping to compensate for any haircut on depositors' savings. None of the above will be easy and it will take time to negotiate but it is possible with international and regional assistance. It should be the main priority of the new Government that should be formed in August; without a sound monetary system foreign investment and long term capital will remain scarce.

As investment managers, we have to make decisions on asset allocation whether to be invested in local equities, the money market or property. Our strategy to date has proved correct with a heavy weighting toward equities at the expense of the money market. Equities have once again been the perfect hedge as our US$ assets have been debased by the heavy dilution from RTGS$ that has caused the money supply to expand rapidly as the Government has created RTGS$. Should a new Government attempt to carry on with such a monetary policy, then this strategy will continue to work well in an inflationary environment. If on the other hand, Zimbabwe joins the MMA, then we believe that there could be attractive debt instruments as interest rates normalise at higher levels. These could be both publicly or privately issued bonds. Property should also start to recover on the back of increased foreign investment into the economy that leads to greater demand for office space and residential property. Equities will also be in demand by foreign investors who have been absent from Zimbabwe for political or economic issues for many years. The key will be to ensure that we own the right companies in our portfolios that would perform well under a more competitive environment but would equally benefit from an easier operating landscape and one that is growing rapidly. It is our job to pick those winners for the long term.

Zimbabwe has muddled through for too long now but has the potential to do so much better under a strong reform minded leadership that has the opportunity to improve everyone's lot. All eyes are now focused on the elections!

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