Zimbabwe Investment Notes

Edition: Quarterly

Date: October 2018

Issued by: Imara Asset Management

Time to "Walk the Talk" and now!

We chose to delay these Notes until we had heard the Monetary Policy Statement (MPS). We were not expecting a Fiscal statement to follow a few days later in the form of the "Transitional Stabilisation Programme" (TSP) which ran to over 360 pages! The timing of it was a surprise as the new Minister of Finance, Professor Mthuli Ncube, has only been in his job for a few weeks and the week previous to the release of the TSP he was in New York at the UN meetings providing little time to put such a document together. Indeed it would appear that there was little if any time available to consult with the private sector or even such bodies as the IMF before its release.

The key issue in the MPS was the introduction of USD nostro FCA accounts that would run parallel to an RTGS FCA. This is significant as it effectively admits officially that the two accounts – and therefore the two currencies - are different. Up until then, bank deposits were a mix of RTGS dollars and US dollars (mainly the former) and were a muddle as we described at length in our last Investment Notes (July 2018). In attempting to maintain the illusion that an RTGS dollar (RTGS$) is equivalent to a US dollar (USD) and despite the black market rate at the time being 2:1, the Governor insisted that the two accounts should be valued at one to one.

Prior to the MPS, both the Governor of the RBZ and the new Minister of Finance reiterated that it was too early to introduce a new Zimbabwe currency and that the authorities would retain the multi-currency system that we have had since 2009 whether it would be the USD or the rand should Zimbabwe join the rand monetary area (MMA). These were the options given. Only once Zimbabwe's economy was on a sound financial footing with strong foreign exchange reserves, would they consider a new local Zimbabwe dollar. This of course completely missed the point since Zimbabwe introduced its own currency (RTGS$) in 2013 when it issued treasury bills and created electronic dollars that were not backed by real USD. The very fact that the MPS has differentiated the two accounts could be the first and crucial step toward a realistic monetary policy overhaul.

The free market's immediate reaction to the MPS was to debase the RTGS$ even more to the extent that in just one week the RTGS$ fell from 2 to the USD to over 5. The Old Mutual Implied Rate fell from 2.5 to the USD to an incredible 8.75 to the USD at its worst over the same period. That effectively implies that an RTGS$ is worth 11cents of a real USD. Panic then erupted in the streets and shops, fuel queues re-emerged and supermarket shelves began to empty. Unfortunately in certain instances prices were hiked beyond any rational levels whilst the stock exchange (ZSE) went limit up, rising by 80% in just ten days. Such gains are hard to justify assuming monetary growth is around 40%-50% per annum and indeed a correction has since taken place on the ZSE. The message though is clear. The hyperinflation years are fresh in the minds of most Zimbabweans which has rightly resulted in a lack of trust in Zimbabwe's economic and monetary authorities, hence our consistent argument that a local Zimbabwe currency will never be sustainable for very long for years if not decades to come.

If this new Government of the Second Republic is to be taken seriously, then it is pointless to maintain this 1:1 illusion. Looking at the monthly economic bulletins published by the RBZ, actual USD held by the banking system in nostros and cash should amount to around 20% of all deposits. As such a rate of 5RTGS$ to 1USD would be about right on a worst case scenario in part because those numbers exclude any foreign currency that might be held outside of the banks and under mattresses or in the informal sector. In short the rate has certainly overshot this past week as panic set in. The authorities should now allow the banks and the private sector to trade between the two FCA accounts and thereby formalise an exchange rate between RTGS$ and USD that is set by the free market. Interest rates on the two accounts also need to be liberalised with higher rates being offered for RTGS$ vs USD rates. This could result in the RTGS$ strengthening against the USD thereby halting the slide. Critical to RTGS$ stability though will be the immediate cessation of RTGS$ creation in order to fund Government expenditure.

Over time, as confidence grows in the Government and the monetary authorities, then that rate could converge further with the USD. Some semblance of confidence will only come when Government implements its stated economic reforms, the core of which is to run a balanced budget and cease creating RTGS$. It also requires Zimbabwe to repay its arrears with the World Bank, the AfDB and the EIB a commitment first mooted in Lima in 2015 and confirmed again last week in Bali. This would then allow for Zimbabwe to once again receive vital and necessary financial and technical support from the international lenders such as the IMF and other multilateral agencies.

Conflicting signals from the Minister of Finance during the week he was in Bali however and post the MPS/TSP have unfortunately further undermined his and the authorities' credibility. At Chatham House in London the Minister appeared to agree that the value of an RTGS$ was different from the USD. When the black market exchange rate collapsed whilst in Bali he then suggested that the Afrieximbank would underwrite RTGS$ balances at one to one which we believe would not only be impossible but highly unlikely.

That aside, having announced the TSP, the Minister and his team now need to put their words into a credible action plan or "walk the talk". Whilst he made it clear that Government needed to slash its own spending to reduce the budget deficit, the first and only policy announcement he gave was to increase taxes. The imposition of a 2% tax on all non-cash money transfers came as a surprise to all and we suspect followed little if any consultation. The announcement was followed by widespread panic and heavy criticism from all sectors of the economy to the extent that the Minister was forced to announce a number of exceptions to the tax which in practice may also be unworkable or administratively burdensome. Had the tax been 0.2% with a maximum limit he might have got away with it but sadly the damage has now been done. His credibility has once again been called into question. A tax on transfers is not unusual and has been introduced elsewhere in Africa as a means to capture tax revenues from the largely informal sector. It is however a regressive tax as it hurts the poor more than the rich. The new tax has been gazetted but could be subject to legal challenges as the correct legal procedure for such a tax have not been followed.

What the general public want to see however are policy announcements with regard to the cutting of Government spending to reduce the deficit. How much do they intend to cut the civil service, whether they will stop funding the Command Agriculture programme preferring private sector involvement instead, liberalising the fuel market (i.e fuel prices are priced in RTGS$ and not USD). Whilst the TSP was long on ideas and proposals – more like the usual wish-list – it was short on action plans. This needs to come soonest and we hope it will be outlined in November's budget statement for 2019.

Whilst the new Government's interaction with the international community has been commendable with recent meetings in New York, London and Bali, follow up action needs to be taken as evidence that important change is afoot in the country. Of vital importance will be to meet the demands of the United States which recently renewed the Zidera Act that imposes sanctions on Zimbabwe. These demands are not onerous in themselves as it simply requires bringing existing laws into line with the new Constitution as well as removing or repealing laws that impinge upon human rights in the country. It will be important in this regard for senior members of the Government to travel to Washington to meet with the Senators who are behind the Zidera Act as well as the State Department to inform them of the changes to be made and the timescale for action. If the US drops Zidera and hence its sanctions, it will make it far easier for other multi-lateral agencies to provide the necessary financial support that Zimbabwe so desperately needs. Time is of the essence in this regard not least because of the un-necessary post - election shootings on the streets of Harare which were, at the very least, a major PR disaster.

Fixing the economy and introducing a sound monetary system on which to grow the economy will be painful as both the Minister of Finance and the President have warned. A budget deficit for the first six months estimated at $1.4billion and potentially $2.7 billion for the full year imply a massive fiscal injection into the economy. Before the Minister revised the GDP numbers, this amounts to 16% of GDP and follows 10% of GDP in 2016 and 2017. These are big numbers and the fact that the deficit has primarily been financed by creating RTGS$ which itself has given rise to money growth of over 40% explains why corporate volume and revenue growth in a wide variety of sectors have been so strong. Further adding fuel to the fire have been artificial RTGS$ prices that have in essence been linked to the USD. Examples would be fuel, bread and beer where prices have barely changed as the RBZ has been able to supply inputs based on USD prices. Volume growth (or traffic on the streets) in such products has naturally been very large putting further pressure on Zimbabwe's limited foreign exchange receipts. When and if the fiscal deficit is finally reduced, the money supply declines and prices are based on the RTGS$ exchange rate, then we should expect to see a sharp slowdown in demand as prices and the economy adjust. In short, expect deflation.

Zimbabwe has a precedent in the form of Egypt which undertook radical economic reforms following the coup that took place in July 2013. At that time Egypt was suffering from a rising budget deficit (11.5% of GDP at its peak), a growing current account deficit and falling exchange reserves. The new military Government took its time to implement its reform programme which it finally started in October 2016 with a plan drawn up by the Egyptian authorities in conjunction with an IMF team. For many years the Government had pegged the currency at around EGP8 to the USD despite a black market exchange rate of EGP11.5, a rate that in itself constrained the availability of foreign currency. At the end of 2016 the exchange rate was liberalised and immediately moved to EGP18 making Egypt competitive once again. Fuel and electricity subsidies were slashed, and VAT was introduced for the first time at 13%. Prior to 2016 the Government artificially subsidized petrol at below the world market price, the cost of the subsidy of course increasing as global oil prices rose. They hiked the fuel price by 50% in 2016 and a further 55% in 2017. Bread prices and water prices were also liberalised. A part of the savings on such subsidies were used to assist the poor who were the hardest hit as the reform programme took hold in effect providing a social safety net. Inflation rose immediately from 10% to over 30% in 2017 but the authorities increased interest rates to 20% to tighten policy. Treasury bills yielded over 25% post the devaluation which in the first 6 months of 2017 attracted USD15 billion of private foreign portfolio investment! The IMF programme itself was valued at $12 billion over the three year plan (2016-2019). Inflation today has fallen back to 16% and treasury bills now yield 18%. The economy is growing at 5.5% this year.

The first year of the reform programme was tough and most listed companies reported a sharp slowdown in demand and profits but a big improvement as far as the ease of doing business was concerned. Being able to source foreign currency was a key improvement. Foreign investors returned to the stock market early in 2017 now that they could invest at a correctly valued exchange rate. By the end of 2017 companies were reporting rising demand once again and a sharp improvement in profitability. Capital investment increased as a result and the stock exchange enjoyed many new IPOs in 2017 and 2018.

Returning to Zimbabwe, since we do not believe that an RTGS$ or another local currency would be sustainable for the reasons previously given, it remains our view as outlined in our July 2018 Notes, that the easiest solution, should Zimbabwe be allowed to do so, would be to join the Rand Monetary Union (MMA) by converting all domestic debts, treasury bills and deposits, prices and wages into rand at or near to a market determined RTGS$ exchange rate. For example a 2RTGS$ to 1USD would crystalise a 50% haircut and would make Zimbabwe broadly competitive again with South Africa and our neighbours. That would imply a rate of 1RTGS$ to ZAR7. Put another way, all wages, prices, share prices, deposits as well as all local debt would be multiplied by 7 to bring about a redenomination in rand. A $100 wage would become ZAR700.

Our preference for the Rand against the US dollar is three-fold. Under the Rand our monetary authorities - whom few trust any longer - would fall under the supervision of the South African Reserve Bank. (nb. this may be politically unacceptable here). Second the rand is a commodity based currency and moves up and down against the US dollar which cushions the South African economy from terms of trade shocks when the dollar is strong (as is the case now) and commodity prices are weakening. Finally South Africa is by far Zimbabwe's largest trading partner. This process would then be followed by Zimbabwe joining the Southern African Customs Union (SACU) opening up a huge new economic market on our doorstep. This is again crucial as import tariffs would be slashed thereby significantly reducing prices for goods in Zimbabwean shops.

Whether Zimbabwe adopts the rand, or the US dollar (again) or for that matter somebody else's currency, will require the Government to run a cash budget as was the case when we dollarized in 2009. In short Government could only spend what it receives in tax revenue and hence its budget deficit would be zero. The Minister spoke in New York about the need for a "fiscal shock" and we suspect that this is what he meant. As stated previously the deflationary pain that this would entail (moving from a deficit of 16% of GDP toward zero) may be too much for the politicians to bear although now would be the best time to implement such measures being the start of the political cycle.

Simultaneous to the measures introduced locally, will be the need to resolve our external debt obligations with the World Bank, AfDB and the Paris Club. We should hear fairly soon as to how the World Bank meetings in Bali went for Zimbabwe. Ultimately we hope that Zimbabwe will be able to engineer a haircut on its external debt as well but to do this we will need the full support of the international community, something that Zimbabwe has not yet achieved especially after the post-election military intervention in the streets of Harare. First the Government will need to show that it can indeed walk the talk and do as it says. That message has been made clear by the international community in London, Washington, Paris and now Bali.

We have recently had two meetings with the local IMF mission here in Harare. The IMF recently had a technical team on the ground working with the authorities and based on that work, the IMF will start work on Zimbabwe's article IV review from mid-November. This report should be signed off by the IMF Executive Board in mid-January 2019. With that timeline, it would be highly unlikely that a new economic reform programme would receive any IMF financial backing before the second half of 2019 at best. Indeed as the US Government has clearly stated, Zimbabwe needs to provide clear evidence that it is reforming both economically and politically before any funds can be released. The new Government has a busy year ahead of it as a result. The first IMF programme that we could hope for would be an IMF Staff Monitored Programme (SMP) but for that the IMF would need a programme to monitor, something that Zimbabwe does not yet have. An SMP does not come with financial backing however.

If the Minister's own agenda can be met, we should have a better idea of where we are going by the time we write our next planned Investment Notes early in January. At the moment however the signals from the authorities remain inconsistent and lacking credibility and hence we feel reluctant to make forecasts until we have more certainty as to Government's political and economic policies. As far as our portfolio strategy is concerned future economic policy will guide our investment strategy. If we end up with a sound monetary system that replaces the muddle that we have now, we would expect to experience higher interest rates and rates above inflation. That would encourage us to rebuild our money market assets within our portfolios as we did back in 2009 after the dark days of hyperinflation when we had close to 100% invested in equities. We would fund those investments by reducing our weightings toward equities. If on the other hand the new Government does not radically alter economic policy from what we have now, we will maintain our current equity exposure as a hedge against future devaluation.

John Legat, Chief Executive
Imara Asset Management (Zimbabwe) Ltd
October 2018