IMARA INVESTING IN AFRICA

Zimbabwe Investment Notes

Edition: Quarterly

Date: January 2019

Issued by: Imara Asset Management

Kicking the can down the road is no longer an option!

STOP PRESS: *Since this Note was completed, the President announced on 12th January a more than doubling of the fuel price through a substantial increase in fuel duties, rather than a change in the one to one exchange rate. This will further boost government tax revenues but it should also depress demand for fuel - and hence Government's need for forex – by eliminating the currency arbitrage. It will be essential to ensure there is no increase in the RTGS$ money supply to minimize secondary inflationary effects. That will ensure true austerity if the Government succeeds.*

It was a busy quarter for policy statements of one kind or another. In early October we were presented with the Monetary Policy Statement (MPS) from the Reserve Bank (RBZ) followed by the launch of the Transitional Stabilisation Policy (TSP) by the Minister of Finance, Prof. Mthuli Ncube. At the same time he also announced the 2% tax on the value of the majority of electronic and mobile transfers. We wrote about these in our last Notes published in October. At the end of November, the Minister of Finance then presented his Budget statement for 2019 – entitled "Austerity for Prosperity" which has so far received the approval of the lower House in Parliament (but only after MPs had secured a $60 million increase to their own original budget for personal allowances) but not yet the Senate. The RBZ also released its monthly economic bulletin containing October data. An IMF delegation was in town during November to prepare for their Article IV Review on Zimbabwe which will be released later this month.

Despite a number of policy pronouncements none of them addressed the central issue within the economy, the currency. Indeed the Budget for 2019 reiterated that the US dollar (USD) should continue to be pegged one for one to the RTGS dollar (RTGS$) in an attempt to maintain the currency illusion despite the black market and the Old Mutual Implied Rates (OMIR) suggesting otherwise. As a result and similar to the report and accounts for companies, the budget numbers are also fairly meaningless given the mixture of real USD and RTGS$ within the numbers. This makes the Budget almost impossible to interpret.

The Minister correctly identified the Government's substantial fiscal deficit as a key factor behind Zimbabwe's economic problems. His predecessor Patrick Chinamasa stated as much in his Budget for 2018 but failed in his quest to reduce it. Indeed it ballooned to an estimated $2.8billion for 2018 compared to an original budget of $650m. On the old GDP number of $19billion the estimated deficit amounts to around 15% of GDP, although under the revised GDP numbers this drops to over 11% of GDP, a substantial number for any country attempting to peg itself to the USD. Prof Ncube's aim is to bring that deficit down to $1.6 billion or 5% of GDP in 2019 by way of cutting Government expenditure and boosting Government revenue. In terms of expenditure cuts, he announced a 5% cut to the salaries of all senior civil servants and Ministers from January 1st 2019. In addition 3000 youth officers would be retired immediately, although this measure was also announced in the Budget for 2018. Ghost workers would be eliminated through the introduction of biometric registration for all civil servants. The civil service annual bonus would be based on annual salary only and not including benefits. With the doctors already striking for better pay and conditions and potentially the teachers joining them, one wonders whether he will be able to achieve his employment cost goals in 2019.

On the revenue side, the Minister is hoping to increase government revenues by 17% which we assume will largely be as a result of the new 2% tax on transactions. Preliminary figures that we have seen suggest that Government revenue for October, November and most of December respectively were between 35% and 50% above budget, largely due to the 2% tax. The Minister will be hoping that these revenue gains will not be eaten away by rising civil servants' salaries in 2019 which would imply that the private sector would once again be funding improved conditions for the public sector.

The lack of foreign currency is quickly bringing the country to its knees. Government through the RBZ controls almost all currency allocations within the economy. Most of Zimbabwe's foreign exchange earnings come from tobacco, gold and platinum. During the second half of any year, export earnings from tobacco fall off dramatically. In 2018, local gold production from the majors also fell as they were not receiving sufficient real US dollars from the RBZ for their gold. In the case of Rio Zim, one of the largest producers of gold in the country, they only received on average 12% of their sales in USD forcing them to put their mines on care and maintenance and further took the RBZ to court over the matter. This was resolved through negotiation and now Rio and other large mining companies receive around 50% of their gold sales in USD with the remainder in RTGS$. Small scale miners have been favoured throughout receiving up to 70% of their gold in USD cash which initially resulted in rapidly rising gold deliveries to Fidelity, although there has been speculation that not all of this gold has been mined in Zimbabwe. Data that we have suggests that gold sold to Fidelity halved in the last quarter as compared with the third quarter. Further the amounts sold by small scale producers collapsed by 80% from September levels to below that of the large scale miners.

Meanwhile the largest consumers of forex are the fuel companies. The lack of forex in the country has not surprisingly resulted in the resumption of massive fuel queues which will likely get worse rather than better. This has a direct and negative impact on agriculture, the mining sector and industry all of which would fail to operate without fuel. Fuel demand remains very high simply because in USD, fuel is priced at 40UScents a litre (taking a rate of 3.5 to the USD), by far the cheapest in the region, if not Africa. Such a subsidy of course leads to plenty of rent-seeking. For those with USD cash, fuel is available from certain outlets at a more normal level of USD$1.35 but not everybody is lucky enough to have USD available. The RTGS$ price should be closer to $4.7 per litre, a level that would see demand plummet and Government's subsidy fall and with it their need for forex. As we wrote in our last Notes, Egypt was effectively following the same path as Zimbabwe is now but was forced to raise the price of fuel as part of its own reform programme. Zimbabwe will one day have to do the same.

The private sector is also a large consumer of hard currency for imported raw materials. Up until a few months ago, their foreign suppliers were happy to provide credit but with forex supplies waning, amounts owed have reached a level where credit lines have been removed and hence raw materials now have to be paid for in cash. Simbisa, Zimbabwe's largest fast food chain, announced before Christmas that it would give a discount to their customers if they paid in USD cash. That cash could then be used to import critical raw materials for them to stay in business. The "Simbisa Implied Rate" ('SIR') is currently 3.45 to 1USD (based on their *2 Piecer with chips*) which is more in line with the black market rate. Early in the New Year, Delta announced that it would only sell their product in USD (but at the same price) since they had not received an allocation of USD from the RBZ for some time....presumably because their USD quota was now going to the mining and fuel companies! The Government immediately negotiated with Delta to ensure that the company would continue to price in RTGS$ by allocating them with USD again – no doubt from somebody else's allocation – but at the same time allowed them to increase prices by 25%. You can buy locally produced beer at say $1.50 per bottle against imported beer at $5.20 per bottle. No wonder demand for local beer has been so high. That said in certain supermarkets you can now only buy two bottles at a time! If Delta didn't receive USD from the RBZ, then their beer price at the SIR rate should be $5.17 per bottle, more in line with imported products. Demand for their product would fall and hence their need for forex would also slow. Back in 2008, they could not source forex and so they shut their plant thereby allowing the informal sector to take the bulk of their market share with imports. It took dollarization in 2009 to enable them to win back their home market.

At the same time, hospitals, clinics and pharmacies are struggling to source critical medical drugs and supplies putting at risk the livelihoods of many Zimbabweans. It makes no sense for a foreign exchange allocation committee to have to decide whether scarce resources go to fuel, beer, medicines or our exporters. The free market should be the ultimate arbiter but this market is not being allowed to function.

Indeed so desperate is the Government that it too is "dollarizing". The 2019 Budget requires that duty on imported cars and certain other goods (such as wine, cheese, perfumes, tinned fish, tinned fruit, shampoos, handbags, luggage….) be payable in USD and not local RTGS$. This will of course drive inflation as any importer will now be forced to find additional USD to pay Government, the cost of which will be priced into the retail price to the consumer.

Bottom line is we have spontaneous dollarization taking place which the RBZ and Government will find hard to slow. Indeed it is becoming more likely that they will be forced to allow the RTGS$ to "float" although we suspect with stringent conditions in place in the first instance. Critically important for stability will be to cease issuing anymore electronic RTGS$. After all it has been the creation of electronic dollars that has caused the RTGS$ to devalue against the USD to date. In theory, no further issuance of RTGS$ would stop any further devaluation. That would require Government to fund its deficit through other means or to eliminate the deficit altogether. That brings us back to the Budget, to the 2% electronic tax and the current civil service salary negotiations. The Minister of Finance is suggesting that Government is currently running a budget surplus (ie no deficit) but that could disappear if civil service wages are increased too much.

Floating the RTGS$ would of course be an admission that the 'one to one' has been an illusion all along but by now surely most people in Zimbabwe realise this. The creation of USD nostro accounts alongside RTGS$ nostro accounts was the first stage in that process (See our October Notes). It would also be an admission that Zimbabwe has been using its own currency (RTGS$) for a number of years. For that currency to be sustainable though, we believe that Zimbabwe would need to have an independent Central Bank with a Board that includes respected international representatives so as to ensure that Government cannot interfere with monetary policy and also to provide guidance and supervision to the RBZ management team. An independent central bank could be enacted quickly by the President if he so chooses but he would likely face political headwinds in doing so.

The latest monthly economic report from the RBZ is for October. Positively it points to a rapid slowdown in monetary growth in the past few months. At the end of July, Broad Money (M3) grew by 48% but by the end of October this number had fallen to 31%. If the Minister has indeed run a budget surplus over the last quarter of 2018 as he suggests, then Broad Money could slow still further. We will be watching the final numbers for 2018 closely although we are unlikely to see the December numbers until early March. Official inflation meanwhile reached 31% at the end of November following the sharp price increases experienced in October and November of 16% and 9% month on month respectively. September's inflation rate was 5%. In reality actual inflation was higher than that since many prices within the inflation basket such as fuel and electricity are controlled. In short, Zimbabwe has been experiencing 'Stagflation' during the second half of 2018, ie rising prices, slow to no growth and high unemployment. With the fuel and currency crisis worsening by the day, there can only be contraction not the growth Government hopes for.

If the Minister can continue to run a budget surplus or at least a balanced one, we should expect to see monetary growth continue to fall and that in itself will bring month on month inflation down and support the black market exchange rate. Indeed that rate could even strengthen against the dollar as the market currently does not expect such a scenario. Combine slowing monetary growth with an independent Central Bank governed by a respected supervisory Board, and the Minister would have a better chance of floating the RTGS$, in affect formalising a new Zimbabwe dollar. Floating the currency would require a 'normalisation' or liberalisation of RTGS$ prices where they are controlled (eg fuel, beer, bread etc) but it would also require interest rates on RTGS$ loans to rise, including Government debt and of course bank deposits. This would certainly result in *austerity* but at least the economy would function again albeit at a lower level. It might not be *prosperity* but it would be an important step in that direction. Such an outcome is not impossible and hence we cannot discount it in our thinking.

Our own view though has not changed as we do not believe that Zimbabweans would have long term confidence in a new currency following hyperinflation and the latest debasement of the RTGS$. We continue to believe that the solution lies not in our own currency but in the adoption of the Rand, joining the Rand Monetary Area (MMA) and the Southern African Customs Union (see our July 2018 Notes). The RBZ would become purely the regulator and supervisor of the banking system. That to us will finally allow for a lasting solution to Zimbabwe's monetary stability. "Stability is not everything, but without stability, everything is nothing." (Dr Karl Schiller). Zimbabwe had monetary stability between 2009 and 2013 and as a result the economy recovered rapidly, incomes rose, employment increased and foreign direct investment started to flow for the first time in decades. That stability ended when the RBZ broke the rules by creating electronic RTGS$ to fund Government's ever increasing expenditure. Taking the SIR rate of 3.45 to 1USD, RTGS$ wages, deposits, debts and prices would be multiplied by 4 to redenominate to rands. At a stroke, Zimbabwe would once again become competitive with its major trading partner.
Meanwhile the international community is watching from the side lines. As we mentioned in our last Notes, the Government will need to prove that it is "walking the talk" both politically and economically before any material support will be forthcoming. The IMF will soon be releasing its Article IV Review which we eagerly await. Following the TSP and more importantly the Budget for 2019, Zimbabwe now has a programme that the IMF can monitor under a "Staff Monitored Programme". This comes with no financial obligations as far as the IMF is concerned or put another way, it will not result in any new money being released for Zimbabwe. Under an SMP, the IMF will continue to provide technical assistance and advice and will monitor Government's progress.

Further, before any further funds can be released by the IMF and other multi and bilateral institutions, Zimbabwe must first pay off its debt arrears. The Minister of Finance is well aware of this and has said that this would be done as soon as he is able to. Essentially though, it will require a loan from a third party to repay that debt in order to be able to access credit lines from the multilateral agencies. There will be no point in doing this until the multilaterals are ready however which ultimately will require them having confidence that they are indeed working with a new dispensation that does what it says it will do. We would not expect to see IMF financial support until 2020 at the earliest.

In addition to this, change needs to take place politically too. In our last Notes we wrote about the need for Zimbabwe to engage with the US senators responsible for the Zidera Act which was recently revised. This Act prevents the US from agreeing to any debt relief or financial assistance for Zimbabwe until reforms take place. The retiring Chairman of the Senate's foreign affairs sub-committee on Africa, Senator Jeff Flake managed to squeeze in a meeting specifically on Zimbabwe before he stood down as Senator after last year's US mid-term elections. This took place in early December before the recess. Flake spent his early years in Southern Africa and time in Zimbabwe so he knows the country and its people well. His colleague on the same committee Chris Coons also has good African experience. Both met with President Mnangagwa in April before the elections and reiterated their requests. Significantly they chose to invite respected businessman Joe Mutizwa to the Senate hearing to put Zimbabwe's case forward. This is unusual as this has not occurred in recent memory. Listening to the hearings, it is apparent that both Flake and Coon wish to see Zimbabwe succeed economically and politically and both recognise the important changes that have already taken place. However there are four issues that need to happen for Zimbabwe to send a clear and positive signal to the World. The first is that AIPPA and POSA must be repealed and reformed. Second is that the political harassment of the Opposition must cease and that charges against Tendai Biti must be dropped. Third, the recommendations of the Commission of Inquiry into the August shootings must be adhered to and those responsible to be brought to account. Fourth Zimbabwe's legislation must be brought into line with the 2013 Constitution. They reiterated that none of these demands requires international assistance and support, and hence lies squarely on the shoulders of the Zimbabwe Government. The message is therefore clear. Once again the ball is in Zimbabwe's court.

Soon after the Senate hearings, the President released the findings of the Commission of Inquiry. Most sides were to blame it seems. The MDC Alliance for inciting violence both before and after the elections, the police and army for their heavy handedness and using excessive force to deal with the protests and the ZEC for taking so long to announce the results to name a few key points. The recommendations centred on compensation for the victims and their families, electoral reforms to speed up transmission of the election results, aligning POSA to the Constitution, equipping the Police to handle demonstrations without the need for military assistance, the need for nation building and reconciliation and finally that the members of the police and military personnel in breach of their duties should be held accountable. So similar to the demands of the US Senate, the Zimbabwe Government must now implement these recommendations to provide the international and local communities with another clear signal that Zimbabwe is making positive changes from its tainted past. The coming months will be critical in assessing any changes in this regard.

From an investment perspective, nothing much has changed over the past quarter to change investor perception, both domestic and foreign. Investors need a sound monetary system as a foundation to make long term decisions. Whilst the Budget provided a number of economic reform measures – if indeed they are implemented – the key issue of the currency has not been addressed. A decision on this substantive issue has to be made sooner rather than later and we hope that it is imminent; kicking the can down the road in the hopes that some kind of economic miracle can bail them out is no longer an option for Government.

Until such time as we do have a stable monetary system, we have little choice as domestic investors than to stick with hard assets such as equities and property rather than risk money market assets which can rapidly lose real value especially when interest rates are well below current inflation as they are today.

There is no doubt that the operating environment for businesses continues to deteriorate. As fund managers and analysts we are further faced with fairly meaningless reports and accounts given the mix between USD and RTGS$ and the accounting exchange rate of one to one. The numbers being reported on the face of it look very good but we have to be alert to the fact that the real picture on the ground may tell a different story. That is why we continue to engage the management of our holdings on a regular basis, a role that takes much of our daily routine, fuel queues excluded!
Whilst the Budget for 2019 was a positive step in the right direction in its goal to reduce the Government's budget deficit, it remains to be seen whether the Minister's aim is achievable and the current civil service wage negotiations are critical in this regard. Until such time as the Government changes course on its current monetary policy and breaks the one to one illusion, we cannot justify changing our investment strategy that favours hard assets over monetary assets.

As we write, the situation on the ground is worsening dramatically with regard fuel queues and the ability of the private sector to function, whether in agriculture, mining or industry. The economy is grinding to a halt as the fuel runs dry. It is possible that such a crisis will result in a change in monetary policy sooner rather than later. At that point we can make a better assessment of where financial markets may head and plan accordingly with regard our strategy.

Key economic decisions need to be made urgently rather than focus on international roadshows to entice foreign Governments and investors who also await a change in monetary policy before making their move. Kicking the can down the road is no longer an option.

We wish all of our clients and investors a successful and prosperous 2019 despite the difficult circumstances facing us all at the start of this New Year.

John Legat, Chief Executive
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January 2019