Zimbabwe Investment Notes

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Action at last!

Since we issued our last Investment Notes in early January, much has happened. Indeed as we published, the President dramatically increased the fuel excise tax which more than doubled the price of petrol and diesel. Our view at the time was that this would eliminate the currency arbitrage by removing the discount of Zimbabwe fuel as compared with the region, it would therefore reduce the demand for fuel and hence foreign exchange requirements and finally it would raise substantial revenues for Government in taxes.

Days later, the fuel price rises caused rioting countrywide perhaps not surprisingly. Unfortunately the rioting was crushed using excessive force by the police and sadly the military, coming so soon after the August post-election clamp down that had just been condemned by the Motlanthe Commission's report on the post-election violence. Further the rioting was blamed on the opposition MDC party which then resulted in numerous arrests including MDC MPs. Needless to say, all of these actions resulted in widespread international condemnation and arguably led to the US Government extending economic sanctions on Zimbabwe in early March. For the President who has been attempting to promote the country in a new light and 'open for business' this was yet another major setback for Zimbabwe's international re-engagement efforts.

In those Investment Notes we argued that it was pointless and damaging for Government to continue with the One to One charade. As the black market exchange rate moved out to over RTGS$3 to US$1, the pricing distortions in the economy were becoming untenable, fuel being one such example. It was the same for private sector businesses too such as Delta who maintained low beer prices (on the basis they received US dollars from the Reserve Bank of Zimbabwe (RBZ) at one to one for their inputs) which resulted in record production volumes; ditto Innscor or Baker's Inn with bread. Such high demand for fuel, beer and bread, to name a few, was creating excess demand for imported inputs and hence the need for US dollars. By the end of 2018, the RBZ was unable to supply sufficient foreign exchange hence the growing fuel queues, acute shortages of Coca Cola, medicines and bread.

The one to one illusion was finally broken on 20th February in the Monetary Policy Statement (MPS) when the Governor of the RBZ announced that the RTGS Dollar was officially the functional currency of Zimbabwe (New denomination code is ZWL). Further that this 'new' currency would trade in a new interbank market whose exchange rate should be set by supply and demand. The fact that the MPS was presented in late February and not in early January as is the norm, suggests that the media may have been right in speculating that there was a rift between the RBZ and the Ministry of Finance (MOF) on the direction of economic policy, the latter wishing to embark on a widespread economic liberalisation programme. Whilst the MOF may have won that particular battle it has in our opinion not won the war and as such policy remains a muddle albeit a somewhat better muddle than before. Further liberalisation will be essential if the new currency and interbank market is to work.

The interbank exchange rate was initially set at RTGS$2.5 to USD$1, when the black market rate and the Simbisa Implied Rate (SIR) was 3.5 to the USD, a level that was more or less unchanged since December 2018. After a short period it was apparent that the RBZ was 'controlling' the rate at around 2.5 but after a few weeks it was allowed to move to 3 in fairly short order where the rate stands today. Nigeria introduced an interbank exchange rate in 2017 called the NAFEX which has proved to be very successful largely because the rate is set by the market and importantly it is transparent. In other words, bids and offers can clearly be seen and volumes traded are also disclosed to market participants. This is very much not the case in Zimbabwe and as such there is little market confidence in the system. We hope that a more transparent exchange market will be forthcoming otherwise we fear it will be doomed to failure.

We believe that this is the crux of the matter. An economic liberalisation programme cannot be introduced in half measures as economic distortions will continue. It must also have buy-in from all Government departments for it to work. In this regard the RBZ and the MOF should be working closely together to ensure policy consistency. We don't believe we are there yet.

The MOF does have control of Government expenditure and how it is funded. The fuel excise tax could on our back of the envelope calculations raise between $1billion and $2billion. Taken together with the 2% tax on electronic transactions, the Government should be running a budget surplus or at least could attempt to run a cash budget during 2019. According to the

Consolidated Revenue Fund report released by Government for the first two months of 2019, the 2% tax and the fuel excise duty accounted for over 42% of total revenues which resulted in a budget surplus of $188million. The significance of such a policy is that the Government will no longer need to create RTGS$ to fund its expenditure as has been the case since 2013 and which led to the demise of the USD as our functional currency. With no new money being created, money supply growth will decline. In July 2018, broad money as measured by M3 was growing at 43%. By the end of December growth had fallen to 28% implying a tight monetary policy. We have yet to see the numbers for January and February. As we wrote in our January Notes, a tight monetary policy will be essential to minimize the secondary inflationary effects of a liberalisation in previously controlled prices. Put another way, inflation numbers will rise sharply initially but fall away once the impulses fall away. That is what the MOF is counting on. Official inflation is currently running at 59% as prices adjust for the fuel price rises and the new exchange rate. We have yet to see the price of electricity rise but that is sure to come, providing a further inflationary impulse. Whilst wages are rising in nominal terms, they are falling in real terms.

Such a severe monetary and fiscal squeeze will cause consumer demand to fall and that is already prompting price cuts in certain consumer goods as a means to stimulate demand. We saw Simbisa cut their prices by 25% for example although they maintained the SIR at 3.5. (We feel the SIR is a "purer" estimate of the exchange rate since it is moved at Simbisa's discretion to yield a required amount of US dollars a month to pay their overseas suppliers. There is neither government influence over the rate nor question marks over the size of the trades; it is set purely by retail customers making spur-of-the-moment decisions.) For corporates, falling volumes and rising costs will lead to a squeeze on margins and profitability. We will start to see this when listed companies report their 2019 earnings. Sadly this is all happening after one of the worst droughts in memory that has severely curtailed agricultural production. Further there are few social safety nets for low income earners. It is also coming at a time when Zimbabwe has no IMF balance of payments support, international backing and negligible foreign direct investment. As we wrote in January, Zimbabwe will experience stagflation – a weak economy, high inflation and high unemployment. That implies a tough time for all. In its latest Global growth report the IMF expects the economy to contract by 5.2%. (nb This number may be revised after the recent IMF Staff Mission).

In theory, the tight monetary squeeze that we are experiencing as highlighted by declining corporate cash balances and declining consumer purchasing power should bring stability to the exchange rate. Put simply there should be less RTGS dollars available to chase US dollars. We are not seeing that yet as the black market exchange rate moves over RTGS$4 to USD$1. We doubt that would be the case if the interbank market was functioning properly, unless the RBZ has started to create RTGS$ again. Interestingly, the ZSE is not moving in tandem with the black market exchange rate. In our view domestic institutions are overweight equities, private individuals and corporates have little spare cash whilst foreigners are not bringing new money into Zimbabwe. Hence the stock market has been relatively quiet.

When Government ran a budget deficit of 10-15% per annum from 2015 to 2018 that was funded by creating RTGS$, the 'party' was in full swing especially in the informal sector and to a certain extent in the formal one too as Government stimulated the economy with monetary injections that it created. Superb rains in 2017 added fuel to that fire so life felt alright. But as we had been writing for some time, it was all built on an illusion that Zimbabwe had a USD economy. The money creation which started the party has also brought about a very severe hangover highlighted by the debasement of savings and a sharp reduction in real incomes which we are experiencing today. It was never sustainable. The medicine to cure that hangover would have to be equally painful to enable the economy to stabilise at a lower but more sustainable level. That medicine is economic liberalisation. The length of time to administer the medicine will determine how long the pain will last. Ironically in our view, the quicker the liberalisation measures are adopted, the sooner the pain will ease and the economy can once again begin to grow on a more sustainable basis.

At the moment, the economic reform measures are half-hearted and need to be speeded up. We believe that it is madness for a Government to be responsible for providing foreign exchange for the importation of fuel, medicines or wheat. If foreign exchange was freely allocated by the free market, then it would not be necessary to withhold foreign exchange earnings from our exporters. If our exporters retained 100% of their export proceeds, they would be willing to invest in new production to grow exports still further. This was the case between 2009 and 2013. That also requires a transparent and functioning interbank market that allows importers to acquire foreign currency from an exporter at a market price. Unfortunately for the better part of twenty years – and it could be argued of fifty years – Government through the Central Bank and its ministries has attempted to control the key sectors of the economy. It was only during the dollarisation years of 2009 to 2013 that the free market was allowed to flourish. Not surprisingly the economy grew by 10% per annum during those years.

The best time to administer tough medicine is at the beginning of an electoral cycle in the hopes that the economic recovery will occur toward the end of that cycle. This Government is doing just that. The key question for us all will be whether the reformers will win over the hard-liners who have become used to controlling the economic levers. Much has happened in this regard in just eight weeks with the introduction of a new currency. We hope the coming months will see further liberalisation taking place that would help to cure the hangover. The Government's goal must surely be to have a growing economy, low inflation, increased foreign direct investment, debt clearance and an IMF funded reform programme by the time of the next election in 2023. That is an achievable goal if they stay the course.

Of great importance in this regard will be to win the support of the IMF and the international community. An IMF Staff Mission was in Zimbabwe last week and it has since reached an agreement with the Zimbabwean authorities on macroeconomic policies and structural reforms that can underpin a Staff Monitored Programme (SMP). An SMP now needs to be agreed by the IMF Executive Board for it to be implemented but it is at least a major step in the right direction. In an IMF press release Gene Leon, Mission Head, stated:

"The SMP, which will be monitored on a quarterly basis, aims to implement a coherent set of policies that can facilitate a return to macroeconomic stability. Successful implementation will assist in building a track record and facilitate Zimbabwe's reengagement with the international community. The policy agenda to be monitored under the SMP is anchored on the authorities' Transitional Stabilization Program and emphasizes fiscal consolidation, the elimination of central bank financing of the fiscal deficit, and adoption of reforms that allow market forces to drive the effective functioning of foreign exchange and other financial markets. In addition, the agreed policies—both macroeconomic and structural—can be expected to remove critical distortions that have held back private sector growth and to improve governance. The SMP also includes important safeguards to protect the country's most vulnerable people."

Whilst this will bring no financial support to the country it brings essential moral support and is a positive indicator that economic policy is heading in the right direction, however harsh it might feel. Zimbabwe had an SMP as recently as 2013 but it never had the buy-in from President Mugabe and some members of his cabinet. It therefore ultimately failed. We hope that this time will be different.

Indeed financial support from the multi-lateral agencies will only come if the economic liberalisation measures are fully implemented but also when Zimbabwe receives the necessary political support from the United States as we wrote in our last Notes. The earliest that could be would be 2020 but more likely after that. The events of August and January were a major setback in this regard implying that much work needs to be done to achieve that goal. The decision to repeal POSA and AIPPA are positive statements but now action to implement is required. The recent retirement of a number of senior military personnel may be related to the excessive force used by the military to supress civilians and the opposition parties but of that we are not sure. Time will tell. Implementation of the recommendations made by the Motlanthe Commission would be a further step in the right direction.

Whilst the Government is making moves to liberalise the foreign exchange market, there have as yet been no changes made to the money markets. Indeed interest rate structures are still low judging by supply and demand criteria as evidenced by banks that are reluctant to lend and pension funds that are reluctant to buy so called 'risk free' Government securities. As such bank deposits still yield around 4% and the RBZ Savings Bond is yielding 7%. These are clearly way below inflation and take no account of the economic risks of Zimbabwe. Consequently it is very hard to justify increasing exposure to money market assets as an investment. Our own views suggest that interest rates should be in the twenty to thirty percent range based upon international comparisons of countries in default and especially now that the functional currency is the ZWL. With Government as the main borrower, this is clearly not to their advantage and has not been budgeted. The reality is that interest rates have to rise. In Zambia, which is not yet in default, ten year treasury bills yield 26% in Kwacha terms. Those levels of interest rates, against a devalued RTGS dollar and against a backdrop of cash budgeting, would be attractive for local pension funds and indeed foreign investors, so long as the foreign exchange market was functioning and liquid. The MOF has stated that interest rates will be adjusted shortly and with over RTGS$ 2 billion of treasury bills soon to mature, we suspect that these will be rolled over into longer dated bonds at higher interest rates. We will be watching with interest as this could impact upon our asset allocation strategy.

It is not easy to embark upon an economic liberalisation programme that will necessarily bring short term economic hardship and time will tell whether the Government will stay the course. As ever there will be many vested interests that could derail or hinder the new policies. Half measures will not work so much more needs to be done, especially with regard to making the interbank foreign exchange market effective. In our previous Notes we have written about Zimbabwe adopting the Rand as its national currency but having had discussions with officials in South Africa, we recognise that such a move would take many years and would not be easy to implement. We sadly continue to believe that our own currency will not be trusted for many years to come and hence it will not be seen as a store of value. Debasing a currency twice in just ten years does not give much confidence for the future of the RTGS dollar. Our own view would be for Zimbabwe to adopt a currency board against the Rand using the RTGS dollar now that it has been legalised. This would require the abolition of the RBZ in its current form so that the rules of a currency board could not be broken. There is a precedent in the form of Argentina. Argentina adopted a loose currency board in 1991 under what was referred to as the Convertibility Plan. This ultimately failed as the Government did not close its Central Bank which ultimately broke the rules of the currency board by increasing the Peso money supply by more than the US dollar reserves. Much like Zimbabwe did from 2013. Argentina today has a reformist Government under President Macri yet despite an emergency bailout from the IMF of over $50billion it is still faced with a devaluing currency. Pushing interest rates to over 60% has not helped defend the Peso as foreign and local investors have no trust in the Argentinian Central Bank and hence the Peso.

Adopting the RTGS dollar as the functional currency of Zimbabwe will certainly keep the chartered accountants busy. We have written before that the numbers being reported by listed companies are relatively meaningless as they are a mixture of US dollars and RTGS dollars. Indeed we understand that 2018 accounts will be qualified due to the currency issues which will imply that 2019 accounts will also suffer that fate. This could have implications for companies with loan covenants. In our own analysis we have therefore tried to focus more on volumes and replacement values. We will also focus closely on cash reserves and availability. With inputs no longer at one to one but likely around four to one implies that corporate RTGS dollar cash balances will decline faster than previously, not to mention higher wage demands and utility price increases that will have a similar effect on bank balances. Going forwards financial reports should be more meaningful but again it would help if the interbank market was functioning based upon a market based exchange rate. As we wrote back in January, the reported numbers for 2018 look very good but we surmised that the real picture was likely much worse than that. There is no doubt that most companies are faced with a sharp slowdown and still struggle with finding the foreign exchange required to run their businesses. We have undertaken many company visits this past quarter that has helped us better understand the trends in the economy. We will continue to do the same over the coming months.

We took the decision in early February to take some profits in our equity holdings where liquidity allowed. A tighter monetary policy provides a headwind for equities which could prohibit them from rising by much if at all. Further there will be a sharp slowdown in the economy at a time when costs are rising to reflect the new currency and exchange rate that will largely impact previously controlled prices. Profit margins for many domestic companies will likely fall. Further corporate cash flow will also come under pressure putting at risk cash dividend payments for shareholders. That's not a great background for equity investments in general and hence the ZSE is likely to remain subdued. For the time being monetary assets can only offer a safe haven over the short term when equities and property are falling in nominal terms but as an asset class they are a highly risky investment when interest rates are far below inflation and whilst there is so much economic uncertainty. Whilst the Government has taken the decision to introduce a new currency for Zimbabwe that finally breaks the illusion that we had a USD economy, it will take years for public perception to have any confidence in the new currency going forwards, unless Zimbabwe adopts a currency board. As such, monetary assets will remain risky as will "alternative" assets which have an element of debt within them. Property will continue to be a tough sector as the economy weakens and sellers withdraw.

Overall then, given the uncertainty that still exists with regard current economic liberalization measures, we prefer to act cautiously. As we have written in our previous Investment Notes, we will only feel confident to reduce equities significantly in favour of monetary assets as we did back in 2009 when we are confident in the Government's monetary and financial policies. Sadly we are not there yet. To do otherwise would be to take on too great a risk for our clients' portfolios.

In our January Notes we encouraged Government to make key economic decisions urgently rather than 'to kick the can down the road'. They certainly did that beginning with the MPS. There is still much to do as we have written in this Quarter's Notes. We hope that Government will continue to make bold decisions to further liberalise the economy over the coming months thereby taking the pain now, rather than later.

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

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