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This Time is Different? - Third Time Lucky

In our last Investment Notes we focused on the Government's decision in February to float the RTGS dollar (ZWL) against the US dollar that for too long had been maintained at one to one despite overwhelming evidence that the two were not the same. The pricing distortions in the economy as a result of that charade were simply too great and untenable. We also argued that for the float to work further economic liberalisation measures would be required urgently for the new policy to be sustainable. Allowing interest rates on ZWL deposits to rise immediately thereby making the ZWL dollar somewhat more attractive as an asset never happened. Indeed the RBZ Savings Bond still yields 7% and bank deposits are at best 5%. After four months in existence, the new interbank market for foreign exchange is still not working efficiently and certainly not in a transparent manner as we had suggested. Under the multi-currency system introduced in 2009, businesses were allowed to offer their products or services in any legal currency and hence goods and services could be bought in US dollars or ZWL. Those US dollars could then be used to import the necessary raw materials that the business required. This system was working rather well and clearly too well as far as Government was concerned. Even in 'controlled' sectors such as fuel it was possible to buy fuel fairly easily from a garage by paying in US dollars whilst a few hundred metres down the road long and winding fuel queues existed for those who were only willing to spend ZWL. Charging for products and services in US dollars as well as ZWL allowed businesses to avoid dealing in the interbank market or even the parallel market.

Of interest to us was the rapid pace of dollarization that was taking place within the economy. From what we could establish, by May much of the country had already dollarized with the exception of Harare where those such as ourselves and the civil servants in the formal economy earn ZWL. The informal economy was already dealing in US dollars. The formal economy was pricing off USD base prices together with the parallel market rate at the time. With little reason to hold ZWL and more reason to own US dollars, the exchange rate between the two became a one way bet. Eventually faced with an angry civil service clamouring to be paid in US dollars, the Government had one major choice to make. Simply dollarize again as in 2009 or ban foreign currencies and go for the ZWL. On 24th June they chose to end the multi-currency system and adopted the Zimbabwe Dollar as Zimbabwe's sole legal tender.

In our previous Notes over recent years we have been consistent in our belief that Zimbabweans and foreign investors have little faith in our monetary authorities who have debased the functional currency of Zimbabwe not once, but twice in just ten years. As such we have suggested that Zimbabwe should delegate that responsibility to a proven monetary authority either by adopting a third party currency, or as we wrote last month, by anchoring our own currency to another one such as the rand through a strict and independently managed Currency Board. Only once confidence in our monetary management had been re-established and restored under either scenario could Zimbabwe even consider adopting its own currency. For us the Government's most recent decision to reintroduce the Zimbabwe dollar is therefore a very bold one to say the least and especially with no international financial support whatsoever to back the new currency. It will now become even more important that the interbank foreign exchange market works successfully and transparently so that businesses in need of imported raw materials can access the funds to do so. If they cannot access the foreign exchange we should expect to see inventories run down and shortages to grow.

As yet Zimbabwe doesn't have a true interbank market. In Nigeria, the naira is traded on NAFEX, an electronic dealing system where commercial banks and the Central Bank input their bids and offers for foreign exchange. Not much different from the ZSE where stock brokers use the ATS System to input their bids and offers for various shares for the market place to see and deal on. This is transparent and leads to one tradeable price at a given time and allows trades to take place freely and transparently throughout the day. At the moment from what we can understand, the banks can deal at whatever exchange rate they like depending upon a willing buyer, willing seller basis that can lead to the same bank dealing in the same currency at different rates depending upon the buyer or the seller whilst those trades are not visible to the rest of the market. We don't believe that the interbank market can work efficiently until it is indeed 'a market'.

As we write these Notes and since the introduction of the ZWL on 24th June, the various foreign exchange rates are converging around 9 to USD$1, including the official interbank rate, the OMIR, the parallel rate and even the Simbisa Implied Rate (SIR). Simbisa just released its new prices and based upon a 'two piecer and chips' as before, the SIR would be around 9.5! Assuming that to be the case and in order to remove pricing distortions we should expect to see a litre of petrol priced around ZWL7.5 against the current price of ZWL5.26 and 'Zesa' (electricity) should be ZWL95 per kwh as opposed to ZWL10.

The interbank market will require support from the exporters. Whilst there is no doubt that Zimbabwe is super competitive in the region following the devaluation that has occurred, in practice exports may be tougher than expected. Exporters who require energy and power must surely be suffering from the 18 hours of official load shedding that would require generators to fill the gap at a huge expense - that is if sufficient diesel can be accessed to run them. Tobacco prices are down this year due to lack of demand and a poor quality crop. Gold production is down whilst smuggling of gold outside of formal channels is a growing risk. Zimbabwe is also about to enter the traditionally lean months of foreign exchange (August until December). A further unknown is how much of our export earnings have already been accounted for by the likes of Afreximbank who have provided offshore loans based upon our future export revenues. We believe that our export earnings will be down in 2019 as compared with 2018. Further, if the exporters require the US dollars that they have generated to run or even expand their business there may not be sufficient spare export earnings to channel to the interbank market for importers to buy. This may be especially the case given the imported diesel required by exporters to run their generators. The risk at that stage would be for Government to force exporters to sell all of their foreign exchange as occurred in 2007 which resulted in most exporters ceasing production altogether.

On the demand side, the drought will require Zimbabwe to import food and of course electricity. On the latter Zimbabwe still owes USD$60million for power provided but not yet paid for but to avoid power cuts we will need to import if our neighbours are willing to supply us. Then again electricity prices are controlled at a mere US cents 1.1 per kwh (a tenth of world prices) so it is not surprising there is no power and no local funds available to pay for it! If prices were ten times higher, ZESA (the utility) might just have the ZWL funds available to enter the interbank market to buy the foreign exchange necessary. As it stands ZESA will make a huge loss which will eat into Government's current budget surplus. Looking forwards, the region will need above average rains next season to help replenish Lake Kariba whilst Hwange needs US dollars to repair its old equipment. We do not expect the power situation to improve anytime soon.

In 2008 when the formal sector could not access foreign currency for imported raw materials, production slowed dramatically. In its place the informal sector grew rapidly. In the end almost anything was available on the black market either for rand or US dollars. Diaspora payments at the time came in the form of goods rather than through money transfers as has been the case up to now. It took dollarization in 2009 for the formal economy to win back market share and to reequip.

Government will therefore be hoping that 'this time will be different'. In 2008 the Zimbabwe Dollar was brought down by excessive Government expenditure financed by printing ever larger amounts of cash. In 2019, Government spending in real terms has collapsed at a time when tax revenues have risen dramatically driven by the 2% tax on electronic payments and the heavy fuel duties. Hence we have an apparent budget surplus for the first six months of 2019. Demands on Government will increase however with July salary increases for the civil service about to be granted. Further, the GMB has had its role as monopoly buyer of maize reinstated as a means to control the price of mealie meal. In short expect huge losses as GMB (i.e. Government) subsidise prices once again. This has to be funded by Government thereby reducing the budget surplus. As the economy weakens and production slows, in part due to the long power cuts, then tax revenue may also come under pressure as compared to the first half. We should learn more about Government's current forecasts from the mid-year Budget Review due to be presented later this month. We need to be cautious though. The numbers being bandied about are fairly meaningless now. What is a budget surplus of $600 million so far in 2019? At the interbank rate it would be a mere US$70 million or what ZESA alone owes its neighbours. With official inflation of around 100%, most numbers do not reflect reality given the time lags. It is the same with numbers released by the corporates.

On a positive note, the Government and the IMF both agreed and signed a Staff Monitored Programme to run for twelve months to end March 2020. The programme will be monitored on a quarterly basis with the first review based on the quarter to the end June which of course will include the recent policy announcements. The introduction of the Zimbabwe Dollar was a sovereign decision made by the Government and was not an IMF inspired policy measure. The IMF team will be looking to ensure that Government does not increase its foreign debt and further, that domestic spending is not funded through the creation of new ZWL monies by the Central Bank. With this in mind we assume that the $400million in new bond note cash that was recently announced will be issued against electronic bond note monies that will be cancelled so as to ensure that no new funds are created. In addition the IMF will be looking to ensure that the foreign exchange interbank market is operating effectively and transparently which to date has not been the case.

As stated in previous Notes, whilst the SMP does not bring with it any financial backing, it is critically important with regards to proving to external creditors that Zimbabwe's Government has a credible reform programme that it is prepared to stick to. A positive track record after just twelve months of the SMP would be the first trigger for external creditors to embark on any debt negotiations with the key objective of re-opening international lines of credit for Zimbabwe in the future. A successful SMP with the IMF should therefore be seen by all arms of Government as critically important and especially if the intended goal is to ensure a middle-income economy by 2030 with international backing. As we have written previously political reform must also go hand in hand with economic reform; new credit lines will not be forthcoming until both have been achieved so a successful SMP will not necessarily imply international backing until the political reforms have also taken place.

During such uncertain times as we are in now we have stepped up our engagements with corporate management in both the private and listed space, with international financiers, with the agricultural community and with foreign investors. As mentioned above, we have to be careful with the numbers which are now heavily distorted by inflation and the various changes of currency. The accounting profession has had a tough time since the ZWL was floated in February forcing almost all companies to receive qualified accounts from their auditors. The removal of the multi-currency system and now with inflation at 100% will further complicate their lives. Indeed the re-introduction of inflation accounting is a distinct possibility as occurred in the 2000s. The reports from the listed companies all look highly positive on the surface but drill down and strip out inflationary gains and the picture will look very different. Focusing on cash flow and the ability to replenish working capital will be key areas to focus upon. Foreign debt and foreign creditors on the balance sheet will also be critical areas to analyse. Business models that have worked well over the past ten years may not work under the new economic conditions we find ourselves in. This is especially the case in 2019 where we are experiencing monumental economic reforms that can make or break business models.

As asset managers we are always on the look-out for new types of investments to offer our clients. Due to exchange controls, we are generally restricted to the traditional asset classes of listed equity, property and the money markets. Following on from the trend internationally over the past thirty years, “alternative investments” are the new buzz words amongst the Zimbabwe investment community today. When Zimbabwe dollarized in 2009, Imara were leaders in introducing corporate debentures/bonds as alternative investments. We continue to seek new ‘alternatives’ for our clients but our principal concern with such investments remains preservation of client capital. Corporate bonds worked well in a dollarized environment with a stable monetary system where bank capital was scarce. Lending became much less attractive from 2014 when the monetary system became unstable. Likewise property investments in a US dollar environment are attractive when rental yields in US dollars can easily cover maintenance and building costs which are typically linked to US dollar costs. When yields become denominated in a weak currency overnight the initial investment attraction may fall away. The same may be true for export businesses where the business case may be first class under one operating environment but could be a disaster under another; a change in export retention levels could for example change everything. The environment that we currently are experiencing in Zimbabwe where changes to macroeconomic policy can be dramatic, is not conducive to taking excessive risk in such illiquid alternative investments as private equity, lending or even property development all of which make more sense in a stable monetary environment. Extra caution is required for now.

Money market assets are clearly unattractive at the moment with yields so far below inflation and likely to remain so for the foreseeable future. Such assets, similar to alternatives, only really become viable under stable monetary conditions where long term investment decisions can be made with more confidence. That leaves a diversified portfolio of investments in liquid equities and completed properties as the better opportunities in such an uncertain and inflationary landscape.

It is by no means certain that Government will be successful with their new currency policy given the appalling track record of the monetary authorities over the past twenty years. Our default scenario remains dollarization should Government fail. Holding hard assets such as property and listed equities would become imperative under such a scenario as was the case in 2008. For now dollarization has been postponed but the risks remain high.

There is still much work for Government to do in further liberalising the economy and the monetary system. For there to be long term confidence rebuilt, the mandate of the Central Bank will need to be changed so that it is no longer seen as a tool of the Government of the day but as a guardian of a stable monetary system. In the short term, it will be critical to ensure there is an efficient, functioning and liquid interbank market in place very soon so that shortages do not occur in the formal economy thereby encouraging the informal economy to take its place. We look forward to the imminent mid–year Budget Review for further guidance and hopefully reform measures.

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