# Zimbabwe Investment Notes

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## Dedollarisation………….A Road to Nowhere?

We have been proved correct in our belief that there would be no confidence in a new Zimbabwe currency (ZWL). Since it was launched last February, the ZWL has fallen from its initial level of ZWL2.5 to the US dollar (USD) to around ZWL15.5 to USD1 as we write with the black market rate hitting around ZWL22 on Thursday 19th September. Put another way, USD100 a year ago would now be worth the equivalent of USD6 more or less wiping out the value of savings in less than twelve months! The most recent collapse - from what we can establish- could actually be due to Government's own actions.

At the time of our last Notes published in early July, the interbank and the parallel rates were starting to converge at around ZWL9.5 to USD1. Indeed by mid-August both rates were within 10% of each other at ZWL10.5 to 1 after the interbank rate was allowed to move toward the parallel rate. All seemed to be well as the rate of change was falling sharply and relative stability seemed possible. As such prices, which largely keyed off the parallel exchange rate, were levelling off too giving some credence to the Minister of Finance's forecasts that the monthly inflation rate would start to fall sharply over the second half of 2019. Indeed the parallel rate barely moved between the end of June and the end of August.

Then all of a sudden and out of the blue, the parallel rate started to devalue sharply falling to ZWL15 to USD1 in early September. Initial explanations focused upon the close of the tobacco season or the need to import food or simply that the exchange rate always weakens in the latter few months of the year. Needless to say, a weakening parallel rate immediately impacted prices which rose as a consequence breaking the relative stability that had been enjoyed since June.

Our own investigations suggest a much simpler explanation. The RBZ broke its and the Government's goal to maintain control of monetary growth; in short they printed money. This may have occurred in August or early September. Unfortunately the RBZ monthly economic bulletins that are usually issued around six weeks after month end are not available for July or August as yet despite the fact that we are now in October. There have been numerous rumours, fake news and semi-truths as to what is behind all of this but most credible reasons stem back to the funding of Command Agriculture and the 'technical' partner for the programme, Sakunda, hence the bank accounts of Sakunda were recently frozen. Our own sources have revealed that there is some truth in these stories.

We read in a Financial Times (FT) article (26th September) that in early February and before the introduction of the ZWL on 22nd February, Sakunda received US$366m of Treasury Bills from the RBZ for Command Agriculture. We assume for both the 2018/19 and maybe the 2019/20 farming seasons. The Ministry of Finance would have been aware of this as it would form a part of the IMF's Staff Monitored Programme (SMP). When the ZWL was created all domestic debts in USD were converted to ZWL including Treasury Bills held by the banks. The FT alleges that the Bills owned by Sakunda remained in USD. When Sakunda wished to liquidate those Bills to raise funds for the forthcoming agricultural season, the RBZ, on behalf of Government, would have settled in ZWL and not USD at a rate that the FT suggests may have been around ZWL8 to USD1. If correct this would have amounted to ZWL 3 billion (not the ZWL6 billion as per social media rumours at the time), just short of the ZWL3.5 billion of reserve money in the banking system at the end of June. Sakunda may have then attempted to convert part of these funds into USD which drove the rate rapidly. The parallel rate jumped from around ZWL11 on 27th August to ZWL15 ten days later. By 20th September the rate had gone through ZWL20.

In effect the RBZ has been forced to print money to fund the agricultural sector. Put another way, the RBZ has become the lender of 'first resort' since the commercial banks' balance sheets already hold large amounts of Treasury Bills making it hard for them to lend directly to the private sector. In economic terms a simple case of crowding out. This implies that every time the Government, through the RBZ, is forced to fund these and other programmes, money supply and therefore inflation will rise.

Worryingly, the Governor of the RBZ during his Monetary Policy Statement presented on September 13th 2019 spoke consistently about stability and in particular the need to control the growth of reserve money to no more than 10% by the end of 2019 (Paragraph 25 of the MPS). If indeed reserve money has been allowed to grow well beyond this target, we fail to see how the Government will be able to meet the targets set by the SMP.

The RBZ reaction to the runaway parallel rate was to freeze the bank accounts of Sakunda and Croco Motors on Thursday afternoon 19th September. Then on the 20th September increased regulations were imposed upon the Bureau de Change forcing them to trade close to the interbank exchange rates. Over that weekend, the parallel rate fell from ZWL22 to USD1 back down to around ZWL17. The interbank rate was ZWL15 to USD1 (a devaluation of 50% since the end August). Then on Friday 27th September, the Government imposed heavy fines for anyone pricing goods or services based on a foreign currency or indeed "a unit" (SI212/SI213). Finally on 30th September they attempted to prevent Ecocash from taking or receiving cash, an attempt that failed soon after. In short, there has been a huge increase in regulation in an attempt to support the currency that itself has been undermined by the Government's own monetary policy. You couldn't make this up!

Disconcertingly for the Government, the IMF began their quarterly review of Zimbabwe's SMP and the Article IV consultations on 5th September and which ended two weeks later on 19th. Although the review was for the quarter ended June, when all the figures still looked good, the currency crisis must have alerted them to the fact that all was not well and something must have happened since the end June. Indeed their recent report speaks of 'a recent expansionary monetary stance' and calls for 'transparency on monetary statistics' - we assume as a means to build market confidence. The IMF is clearly worried by the likelihood that the fiscal deficit could become 'unsustainable' with 'pressures to finance agriculture'. Interestingly the IMF has yet to release its final report on the review with further talks with the Zimbabwe authorities due to take place at the IMF/World Bank meetings from October 14th to 20th. Reading between the lines we fear that the SMP may be stalled already.

Speaking with members of the diplomatic community, the Minister of Finance's hopes of agreeing a deal on foreign debt with the Paris Club early next year are very unlikely to occur. This is based on the slow pace of political reform by the Government despite much talk. The recent ban on peaceful demonstrations and violent aggression by the police toward any marches only serves to antagonise the international community. Should the SMP fail, there will be little hope of financial assistance until at least 2023, or after the next elections. It is therefore imperative that Government moves very fast on both the political and economic agendas over the coming months.

In our last Notes, we wrote about the need to create a proper functioning interbank market so as to produce one price for the ZWL that everyone, including Government, could deal with. Sadly there has been little improvement in this regard. The interbank rate is merely a number with little foreign exchange actually dealt at that rate. The banks themselves will trade far more of their clients' foreign exchange at higher rates with no transparency, in effect bringing the black market from the streets to the bank trading floors. The fuel prices set by ZERA are currently based on an exchange rate of ZWL13 to 1 but up until a few days ago it had been set at ZWL9.5 to 1. This makes no sense and we would expect to see fuel prices rise by at least another 20% to bring them in line with the current interbank rate. By contrast, ZESA prices have been increased at long last. Tariffs look to have been increased from 2UScents per kWh to 12UScents per kWh, more in line with the cost of imports. At an interbank of ZWL15 to USD1, that implies the new electricity tariff has risen to ZWL1.81 per kWh. It will be reviewed monthly, we assume based upon the USD price and the interbank rate of the day even though this would be 'illegal' under SI212 and SI213. Almost all the companies we have spoken to would be happy to pay an import parity price if they could guarantee power since the cost of running generators is so much higher.

We also wrote in July about the need to establish a proper market determined bond market which would help to give some attraction to holding a ZWL. High interest rates could do that. But again Government is interfering in order to keep interest rates far below inflation thereby reducing its funding costs. Whilst they might have increased their overdraft rate to 70% from 50%, no bank actually will take an overdraft. Government has been issuing Treasury Bills as a means to establish a yield curve but again the auctions are a charade. A recent auction for ZWL300 million only raised $80 million with the lowest bid at 12% and the highest at 19% with the average allocated at 15%. We doubt the highest bid was 19% as published, more likely 40% or higher. By comparison Zambia's Eurobonds currently yield 20% (in USD) as the international markets price in the possibility of a default by Zambia. Zimbabwe is already in default!

Since the Minister of Finance chose to "dedollarise" the Zimbabwe economy by introducing SI 142 essentially making it illegal to use other currencies as legal tender, we have been researching the whole concept of dedollarisation. Fortunately there is an IMF Working Paper authored by *Kokenye, Ley and Veyrune* dated August 2010 on the subject. For dedollarisation to work they argue that a number of economic ingredients are essential and most are market-based as legislation on its own tends to fail. There should be a credible macroeconomic stabilisation policy that leads to low inflation, two-way exchange rate flexibility and a functioning foreign exchange market (Zimbabwe does not have these). Second there should be Efficient Liquidity Management which leads to market based interest rates (Zimbabwe does not allow this). Third there should be fiscal consolidation to stabilise inflation (Zimbabwe fails again). Fourth there should be Biased Taxation that allows the ZWL to be treated favourably vs foreign currencies (Zimbabwe fails this test too). Fifth the market needs instruments to hedge foreign exchange risk and inflation risk such as inflation linked bonds (Zimbabwe has none). Six, there should be Financial Liberalisation whereby banks can set their own interest rates to achieve real returns (Fail again). Seven, all Government operations should be in local currency such as tax collection (Zimbabwe taxes in USD in certain sectors so fail). Eight the local payments system must be biased to the local currency but in Zimbabwe the lack of cash makes it easier to use USD cash. Nine, foreign exchange regulations should favour domestic users of foreign exchange but in Zimbabwe foreign medical expenses and foreign school fees are allowable for example. Bottom line, Zimbabwe fails on most requirements to dedollarise and if anything continues to bias policy that favours dollarisation. Even then, we can find few cases in economic history where dedollarisation has worked. In the few cases where it has, it has done so thanks to an internationally backed economic reform programme that prompted large capital inflows. Zimbabwe has no capital inflows and is unlikely to get them anytime soon. Our base case scenario, that determines our strategy going forwards, therefore remains the same; dedollarisation will fail and dollarisation in some form is inevitable. Formally adopting the USD this time around in a world of increased anti-money laundering compliance, may be hard to do. Adopting the Rand via a currency board or even directly remains the most sensible alternative in our view as we have stated previously in our Notes.

Over the past two months we have met with a large number of listed companies, as well as private entities, members of the donor community and we have spoken to various international investors. In our view and in this environment, we feel that this is the best way for us to understand what is really happening on the ground - we will learn far more outside of our offices than sitting at our desks. It also helps us to define how we should be positioning our clients' portfolios.

With regard the listed companies, we have written before about how meaningless the vast majority of published reports and accounts now are, all of which are qualified anyway. Looking at the volumes traded by the vast majority of these businesses to give us a better understanding, all was progressing reasonably well until the multi-currency system was abolished in June, following which volumes are down in some cases by up to 50%. Prior to that, companies were largely taking a combination of USD and ZWL.

Given the hyperinflationary environment that we now find ourselves in, we believe that finance directors now need to produce inflation or hyperinflation accounts. As yet there has been no directive from the Public Accountants and Auditors Board who we assume are deliberating over what inflation index to use now that Government is no longer releasing annual numbers.

In terms of corporate balance sheets, it is essential that companies revalue their property, plant and equipment to ensure that the amounts they are depreciating allow for the replacement of those assets at a future date. This will obviously expand corporate balance sheets in ZWL terms that will, as in 2007, have implications for the banks. In short, since banks' balance sheets are largely invested in ZWL Treasury Bills and ZWL loans which cannot be revalued to any great extent, their own balance sheets will shrink sharply relative to their clients making it close to impossible for them to lend any meaningful amounts. This is already becoming apparent in the agricultural sector; in previous years corporates would borrow monies from the banks to on-lend to contract farmers to produce the agricultural inputs that they need. In real or USD terms in 2019, the amounts that banks can lend in this way have become too small to make a difference forcing those corporates or the farmers themselves to seek funds elsewhere. Bottom line is that we expect a contraction in agricultural production in the forthcoming season whether it rains or not. Zimbabwe looks set to remain an importer of maize, soya and wheat for another year or two at least.

Once again, Government is shooting itself in the foot by controlling the agricultural markets and in particular maize having made the GMB the sole buyer and at fixed prices. It would appear that it is almost impossible now to acquire feed stock for chickens, pigs and cattle putting the country's livestock at risk. The government has recently allowed companies to import maize using 'free funds' (i.e USD) but whilst local prices up the food chain are controlled in ZWL this would be a risky option.

In real terms the Zimbabwe Stock Exchange (ZSE) has not kept pace with the rise in the USD at least to date. In the latter years of the last decade, the ZSE proved to be the best hedge against inflation (and then hyperinflation) of any asset that could be acquired with the former Zimbabwe dollar. In those times it was almost impossible to buy property with local currency and private equity was USD linked. But importantly both of those asset markets took too long to buy into and time is of the essence in hyperinflationary times. The ZSE by contrast traded every day and hence private individuals and companies could buy any listed company using surplus funds of that day. Indeed if Zimbabwe had not had a functioning stock market in those days, long term savings such as pension funds would have been wiped out to nothing by 2009. As it turned out, when Zimbabwe dollarized in February 2009, the ZSE reopened in USD and any pension fund that had invested in listed companies had a liquid USD asset which rerated sharply up until mid-2013.

We see no reason why that phenomenon should not occur again this time around. Indeed the fact that the ZSE has not kept pace with inflation to date makes it incredibly cheap in USD terms even as compared with valuations back in 2008. Take Delta whose market valuation was USD359 million in September 2008. Today at the interbank rate it is USD319 million or as low as USD182 million using OMIR at ZWL26 to USD1. Yet Delta has invested USD450 million to modernise and upgrade its plant and equipment and has acquired new businesses within the region over the past five years. By mid-2013, Delta's valuation had risen to USD1.75 billion, a fivefold increase over five years! We visited Proplastics last month which at the time of our visit was valued at $5million yet it has invested USD7.5 million in a brand new plant over the past five years which will make it one of the lowest cost producers in the region. It ends that period with no debt. Dairibord has spent over USD34 million upgrading its plants and installing a whole new operation since dollarization and yet today its market valuation at the interbank rate is USD9 million. It was valued at USD46 million in September 2008 and by 2013 the valuation had doubled to USD90 million. OK Zimbabwe has spent the last ten years expanding its floor space and upgrading all of its existing outlets that has cost USD25 million over the past three years. At the interbank it is valued at USD40million or USD25 million using OMIR. In 2013 it was valued at USD350 million. All of these are just a few examples where USD assets can be bought at a large discount to their replacement value using ZWL and which offer potentially huge upside in USD terms.

That is simply not possible with property at the moment or for that matter private equity. Both these assets need USD linked inputs to bring them to completion. Two years ago Imara completed an office development on behalf of its clients. We bought the majority of the materials upfront thereby enabling us to complete the project on budget by July 2018. We would simply not be able to do that today using ZWL. If a client allocated us ZWL to develop another office block, or for that matter to build student accommodation or residential housing, it would be highly likely that the project could not be completed at all without allocating more funds; in short it could become an unlimited liability to complete. The same could be said for all those listed companies who have invested over the past ten years using their own USD. It would be extremely hard for them to do so today using ZWL and to borrow USD would be extremely risky unless they could export their products to earn USD to repay those debts. Yet we can buy those same businesses today that have recently been upgraded and modernised at a large discount in USD terms and for ZWL! What a bargain and an opportunity. We have no idea whether we saw the bottom of the ZSE in August or not but what we do know is that the USD valuations of the counters we own offer enormous USD upside at some point in the future. The same cannot be said for any monetary assets available on the money market today.

With inflation anywhere between 300% per annum and 400%pa (Steve Hanke's estimate), time is of the essence. Wages have to be spent immediately before prices for goods and services rise further. Similarly pension fund contributions need to be invested as quickly as possible for otherwise real value will be lost very quickly. There are very few liquid 'hard' assets available for pension funds that can be bought for ZWL speedily. Listed equities remain the safest and proven investment in such an inflationary environment. Importantly they can be purchased today, tomorrow and we hope the next day. One day, we hope in the not too distant future, these assets will revalue in USD terms as happened between 2009 and 2013.

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