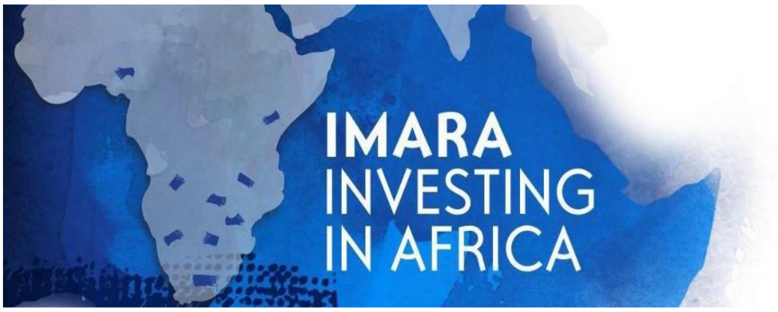

Zimbabwe Investment Notes

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Few Policy Options available post COVID-19

The IMF published its complete Article IV review on Zimbabwe at the end of March. As expected it was a full and comprehensive report that ran to 125 pages. Sadly it confirmed our concerns that we raised at the time of our January Notes that the Staff Monitored Programme (SMP) was at 'risk'. In their words: "*The SMP for Zimbabwe that was approved by IMF management in May 2019 is off track. Performance against quantitative program targets was satisfactory through end-June, but the SMP went off track afterwards, with most end-September 2019 performance criteria missed owing to the large quasi-fiscal operations by the RBZ discussed above. Performance against the SMP's structural benchmarks has been largely satisfactory. The SMP is due to expire at end-March 2020.*" That's a polite way of saying that Zimbabwe is no longer operating under an SMP but as they point out, Zimbabwe will continue to receive Technical Assistance from the IMF going forwards.

As a reminder, the SMP had few concrete economic targets for Government to achieve but the crucial one having adopted the ZWL in February 2019, was to control reserve money by allowing it to grow by no more than 10% per annum. Anything more than that would undermine the new currency. As the IMF stated, all was on track up till June 2019 but started to go 'off-track' from August 2019. During the second half of 2019, quasi-fiscal operations by the RBZ allowed reserve money to nearly triple to ZWL8.8 billion from ZWL3.3 billion at the end December 2018. The IMF report referred to three main culprits behind the monetary expansion. The first was the discounting of an economically sizeable USD Treasury Bill to a domestic firm. *(See our October Notes)*. The second cause was due to the provision of foreign exchange at below market exchange rates to fuel importers in order to contain the increase in the retail price of fuel. This was discontinued in October. The third and more recent cause was the export incentive for gold producers that increased reserve money by ZWL400million per month starting in September 2019. By tripling reserve money – or creating such additional ZWL monies – by definition undermines the currency just as we witnessed in the years 2006-2008.

As the currency fell, the IMF also referred to the distortions in the foreign exchange market that has allowed the premium of the parallel exchange rate to rise above the official interbank rate. "*The higher premium reflects additional restrictions placed by the RBZ, specifically on trading margins for authorized FX dealers, policy uncertainty, and a lack of publically available statistics to guide market expectations.*" At a press conference held on March 11th 2020 prior to the public release of the Article IV, The Minister of Finance flanked by the Governor of the Reserve Bank and certain members of the Monetary Policy Committee announced that with immediate effect, the interbank or official exchange rate would be determined using the new Reuters trading system through the banking system on a willing buyer willing seller basis which he referred to as a "managed floating exchange rate system". This new stated policy was in line with IMF recommendations. Within days, and after a couple of false starts, the interbank rate fell to ZWL24 to USD1 from around ZWL18 to USD1 prior to the announcement. The parallel rate remained at around ZWL40 so the word 'managed' was taking priority over 'floating' it would seem. It soon became clear to the banks that the RBZ was not happy to let the rate fall toward the parallel rate and rejected offers from banks at high rates of exchange. In short, the authorities appeared to back-track on their new foreign exchange policy and as such there remained a large premium between the official and the parallel market rates of exchange. Needless to say, as occurred before the announcement little trade took place at the interbank market whilst most trades continued to take place in the parallel market. This would be an example of the policy uncertainty that the IMF refers to.

A further measure to 'control' the parallel exchange rate was to suspend the fungibility of internationally traded shares such as Old Mutual, PPC and Seed Co International on 15th March 2020. There is a strong belief in Government that the Old Mutual Implied Rate ('OMIR') is driving the parallel rate higher. (They had the same belief in 2008 as they suspended fungibility in May of that year too). The reality is that for international investors who need to repatriate their investments quickly and legally, they had no choice but to use the fungibility mechanisms that were in place. The interbank rate could not supply the funds quickly enough whilst dealing in the parallel rate, being a more attractive rate than OMIR, was illegal. Ironically, it was the Ministry of Finance's own directives in June 2019 that pushed the OMIR to a greater premium to the parallel rate by imposing a 90 day delay on internalizing or externalizing fungible shares. The net result was that there were less Old Mutual shares being brought into the country (eg by those few foreign investors who were attracted to ZWL asset values) and onto the ZSE's local share register thereby reducing the supply of shares for the other foreign investors to acquire in order for them to repatriate their investment funds! A shortage will always create a premium. Now that fungibility has been stopped altogether foreign investors will need to wait for the interbank market to function properly or remain locked in for the foreseeable future. Such investors will be very reluctant to invest in Zimbabwe again as a result. Another own goal scored by Government in the process.

The IMF was complimentary about the progress made by the Ministry of Finance to cut the budget deficit and to attempt to stick to budgeted expenditures. The increase in Government revenues was largely due to inflation and the implementation of the 2% tax on money transactions together with a substantial increase in fuel excise duty. Within expenditures the IMF made the point that Government has been successful in reducing the wage costs as a proportion of total expenditure but only because ZWL wages have not kept pace with inflation and the fall in the exchange rate. In real terms Government employees have taken a substantial pay cut. The number of Government employees had not been reduced however. The same of course has occurred in the private sector where wages have declined dramatically in real terms, at a time when disposable incomes have been under pressure due to inflation and due to the increase in taxes referred to above. Consumption has therefore fallen dramatically as we have been hearing from our management meetings since June 2019 when the multi-currency regime was abolished.

Indeed we were surprised by the IMF forecasts for economic growth for 2020 which assumed a growth in the economy of 0.8% after an 8.3% decline in 2019. (These were pre-COVID-19 forecasts). Our discussions with management in industry, banking, mining and agriculture all point to a further decline in GDP in 2020. Agriculture has been badly affected by another devastating drought whilst a decline in funding reduced the amounts initially planted although tobacco should be on a par with 2019. Gold production looks as though it will fall further and platinum at best should be stable. In industry, consumer demand has collapsed pushing volumes down by on average 30% year on year. Finally the financial sector, as we discussed in our January Notes, has declined substantially in real terms to the extent it can no longer finance either the private or the public sectors. In addition, there is still a lingering issue of how the legacy debts/blocked funds will be resolved. Our own predictions pre- COVID, were for another large decline in GDP and hence we disagree with the more upbeat IMF forecasts. Post COVID, we would expect GDP to decline in the double-digits but this remains a moving target and depends on the end to the global, regional and local lockdowns.

In our October Notes, we wrote about Government's efforts to de-dollarise the economy in support of the new ZWL currency. Our conclusion was that if anything, Government policy was encouraging the continued use of the US dollar. In his recent paper (April 2020) "*Zimbabwe – Dollarisation and Rabbits*", Jon Chew, Imara's Chief Investment Officer, detailed the various types of dollarization. Financial Dollarisation involves the substitution of local currency assets or liabilities for foreign currency assets or liabilities; Real dollarization involves the indexation of domestic transactions to the exchange rate and finally, Transaction Dollarisation which means that the dollar or another foreign currency is used as a means of payment in domestic transactions. By introducing the ZWL in February 2019 and converting all RTGS dollar assets and liabilities into ZWL assets and liabilities, Government successfully stopped Financial Dollarisation by making it illegal. Prior to that time, an RTGS dollar was officially at par with the USD although in reality that was not the case. The effect of redenominating assets and liabilities into ZWL was to enable the government to fund itself again by printing money and/or Treasury Bills and to rescue the banking sector. The flip side of such a policy was to break the illusion that Zimbabwe supported property rights, the fundamental backbone of a modern economy. Whilst in 2002, around 4500 commercial farmers lost their property rights with the farm invasions, the entire population together with foreign investors lost their monetary property rights as their US dollars were exchanged for ZWL paper. All at a stroke of a pen.

As we highlighted in our January Notes, the impact of this conversion was to decimate the domestic savings industry and banking sector in real US dollar terms to the extent that neither the pension and insurance funds nor the banking sector can finance very much in real terms in the private or public sectors. Further a number of companies that were owed real US dollars for work done outside of the country on behalf of local companies saw their balance sheets destroyed resulting in bankruptcy. Financial dollarization can only therefore take place if Government allows it through legislation as effectively occurred in 2009. We doubt that Government will do this anytime soon unless it is forced upon them – more on this anon.

Zimbabwe has real and transaction dollarization underway already. Most retailers will base their pricing on replacement pricing implying that high foreign content product prices will move with the parallel exchange rate and so are indexed. Whilst transaction dollarization was effectively made illegal when the multi-currency system was banned from June 2019, in reality it continued after a short lull during July/August 2019. Indeed Government itself has sanctioned it in a number of cases. In his last Monetary Policy Statement given in February 2020, the governor of the RBZ stated "*Following the gazetting of Statutory Instruments*

33 and 142 of 2019 that provided the de-dollarisation framework for the country to trade exclusively in local currency (mono-currency), the Bank is encouraged by the positive de-dollarisation process that has been taking place in the country." However, just one week later the RBZ allowed for fuel to be sold in both local currency and USD thereby encouraging transactional dollarization in that particular product. Then on 26th March in reaction to the COVID-19 lockdown announcement the RBZ stated: "*the Reserve Bank of Zimbabwe would like to advise the public that it is making it easier for the transacting public to conduct business during this difficult period by making available an option to use free funds to pay for goods and services chargeable in local currency."* In short, transactional dollarization was being authorized.

Jon Chew concluded his paper on his expectations for the future by stating: *"The most likely currency regime to replace the current system will be a multi-currency system that ditches the ZWL. It is too late to rescue confidence in the ZWL in our view. Such a system would function, but, contracts and property rights would remain weak and people would continue to distrust the banks."*

"Other currency options exist e.g. a peg to the rand, US dollar etc. but these too would fail without substantial institutional reform and debt resolution. These options are unlikely for the time being for political reasons so we think the economy is destined to limp along as a function of the available US dollars in the system with high rates of ZWL inflation. At some point full dollarisation will occur when confidence has collapsed completely. COVID-19 may well be the catalyst that brings this about."

In this regard our views differ from those of the IMF in their paper published at the end of the recent Article IV review titled "*Elusive Quest for Macro Stability in Zimbabwe*". (Pages 93-105 of the Article IV paper). They believe that an exchange rate peg to another currency would not work in Zimbabwe due to a lack of foreign exchange reserves. Their view is that monetary targeting would be the most appropriate monetary policy regime for Zimbabwe to adopt. We find this view somewhat at odds with their Article IV conclusions which makes it clear that the SMP failed <u>because</u> the RBZ did not follow the monetary targets agreed between themselves and the IMF in May 2019. (ie a maximum 10% growth in reserve money). Indeed it was the quasi-fiscal operations undertaken by the RBZ itself that tripled reserve money! Had the RBZ been unable, by law, to finance such expenditure in this way the ZWL may have had a chance of surviving. This is where we do agree with the IMF paper and to quote: *"Fiscal sustainability and central bank independence are preconditions for the success of any monetary policy framework. International experience has shown that, more than the choice of the monetary framework, the key for low and stable inflation is having sound and sustainable fiscal policy. By containing debt build-up or the need for monetary financing of the deficit, this minimizes fiscal dominance and facilitates the central bank's job in pursuing price stability and actively engaging public support for this task (Mishkin 2000)."* It is not at all clear whether the Ministry of Finance and the RBZ have been, or are singing from the same hymn sheet which must be a source of frustration for the IMF.

Jon Chew highlights many of the policies being introduced today by the RBZ to support the ZWL were shown to have failed from 2003-2008. We see no reason to expect a different outcome this time around. The latest such move is to peg the exchange rate at an obviously overvalued level of ZWL25 to the USD but without controlling the growth in reserve money. That is in direct conflict to the policy announced just a few weeks before by the Minister of Finance to allow for a 'managed floating exchange rate system' under the guidance of a new Currency Stabilisation Task Force chaired by the Minister of Finance. To be fair the Governor's announcement on 26th March was a reaction to the COVID-19 crisis: *"Government, through the Bank, has suspended the managed floating exchange rate system to provide for greater certainty in the pricing of goods and services in the economy. In its place, the Bank has, with immediate effect, adopted a fixed exchange rate system at the current interbank level of ZW$25 to the US$. This measure will be reviewed when markets stabilise from the effects of COVID-19."*

The end of the SMP will make it very much harder for Zimbabwe to conclude a foreign debt restructuring programme. This was one of the key goals of the new Minister of Finance when he took office in October 2018. As such it will remain very hard for Zimbabwe to access lines of credit from international lenders on concessionary terms. Whilst Government is at pains to blame illegal sanctions on Zimbabwe for its failure to access international lines of credit, in reality it is simply due to the fact that the country has not serviced or repaid – or more importantly – restructured its foreign debt that it has owed now for over twenty years. Adhering to the SMP and undertaking further political reforms, as promoted by the US Government's ZIDERA Act for example, was all Zimbabwe needed to do for it to start the re-negotiation process with the Paris Club of lenders and other international financial institutions. The government has now failed on both counts and as such no new concessionary money will be forthcoming, except humanitarian aid funds such as those from the World Food Programme and the Global Fund. Hence Zimbabwe will only be able to access funds on a commercial basis from the likes of the Afreximbank who undertake collateralised lending backed by our mineral exports. How much more we can draw down on these types of facilities we are uncertain of largely as such loans appear to be a state secret. We are also not sure how much of our exports have already been 'mortgaged' into the future to commercial lenders and whose foreign exchange can no longer be used to fund imports such as fuel and electricity. The Article IV made mention of such loans: "*There is also concern that continued external commercial borrowing at market rates will further complicate the finding of a mutually agreeable resolution to Zimbabwe's debt overhang with its external creditors. A debt reconciliation with creditors, supported by transparency on the terms of all borrowings (including recent collateralized borrowing against future gold and platinum export receipts), is a necessary first step in advancing discussions. Given Zimbabwe's large external arrears, and ineligibility for traditional debt relief mechanisms (e.g. HIPC/MDRI), there is a need to develop, and reach consensus on, affordable solutions to Zimbabwe's debt overhang.*" The prospects of receiving concessionary funding in the near term are slim implying that Zimbabwe will need to find ways of supporting itself until such time as it is ready to undertake the necessary economic and political reforms. In our view a new SMP will not be back on the agenda until Government shows its willingness and <u>ability</u> to undertake the much needed economic reforms.

COVID-19 has served to overtake events in recent weeks now that the virus has gone global and has reached Zimbabwe. The IMF forecasts for Zimbabwe were obviously calculated before the virus was declared a Global Pandemic. Government decisions across the World to close down their economies through lock-down periods will of course have a devastating impact upon the World economy and global trade. An end to the global lock-down won't necessarily result in a sharp bounce back either. So the future is very much uncertain. For Zimbabwe whose foreign exchange reserves are negligible (about one week's import cover according to the IMF), any lock down that restricts export earnings will be very bad news. Such is the case now where South Africa has closed its refineries and its mines and hence Zimbabwe can no longer export gold or platinum. Further the lock down in Zimbabwe has delayed the opening of the tobacco marketing season. Whilst one can hope that such lock-downs will ease in the foreseeable future, longer term export revenues from the likes of tourism could take at least a year to recover. Zimbabwe will therefore have to rely on humanitarian assistance more than ever. Even support such as this may be delayed as Governments around the World concentrate on their own nation's well-being. What is for certain is that Zimbabwe's economy will contract sharply in 2020, as will be the case elsewhere in the World and the region. In our view it will be very much harder for the Zimbabwe economy to recover based on a weak foundation based on the ZWL. More than ever, Zimbabwe needs a strong monetary system to build upon, not one of quicksand.

COVID-19 could be the catalyst to force the widespread political and economic reforms that Zimbabwe so desperately needs. In addition to creating a strong monetary foundation, Zimbabwe will have to focus on a radical rethink with regard to property rights and the rule of law governing them. One of the IMF's recommendations focussed on title for agricultural land as critical for the future success of the sector; *"It is also imperative to improve the regulatory environment and legal clarity of land titles. It is essential to improve the land tenure security of individuals, particularly A1 and A2 farmers. An immediate improvement would be to standardize and de-politicize the leasing of agricultural land. Moreover, to unlock foreign investment, and remove a significant perceived risk to the sector, a formal agreement for compensation of previous farmers who had their land expropriated is indispensable."* Whilst land remains as ever a critical sector with regard to property rights, so too should the financial system where the entire population has been subject to the loss of savings and their earnings as a direct result of the conversion of their USD monetary assets into ZWL. As the IMF points out, the Government and the Monetary Authorities were responsible for creating electronic money that was not backed by real USD which it did as a means to fund its vast budget deficits. "*After 2014, the authorities resumed monetary financing, supported by the creation of domestic quasi-currency instruments. Monetary financing was implemented via an RBZ overdraft and central bank purchasing of government bonds. The substantial increase in RBZ claims on the government, nominally equivalent to the US dollar but not supported by actual US dollar assets, was matched by an equal increase in system liabilities, and in particular bank deposits. Despite formally denominated in US dollars, these deposits began trading domestically at a discount versus the US dollar, and become known popularly as RTGS dollars. Amid strict capital controls and deposit withdrawal restrictions, a parallel market developed to trade RTGS dollars for foreign exchange. Electronic RTGS dollars were also complemented by physical quasi-currencies, first with the introduction of bond coins in 2014, and later of bond notes in November 2016.*" Grand theft on a massive scale that must never be allowed to happen again by law if faith in the banking sector is ever to be achieved once again. "Once Bitten, Twice Shy" as the saying goes, will make all economic participants super cautious going forwards when dealing with and investing in Zimbabwe. This is not a great starting point when trying to rebuild an economy and hence a focus on property rights and the law of contract remains a fundamental requirement going forwards. In our view this will require extensive institutional reform in Zimbabwe and liberalization.

The last time that Zimbabwe's economy was on the rocks was back in 2008. Ultimately this led to the Government of National Unity that brought all Zimbabweans together to resolve the economic issues at hand. COVID-19 may well be the catalyst that brings such an outcome to the fore once again and which leaves the current political bickering behind for the sake of the entire Nation.

From an investment perspective, our strategy in this very uncertain environment has not changed. In this regard, our underlying assumption is that the ZWL will continue to lose value as Government, through the RBZ, undertakes further quasi-fiscal expenditures financed by boosting reserve money. Indeed COVID-19 simply makes this more likely. The recent announcement that Government is embarking on yet another Command Agriculture project to grow winter wheat will ultimately be funded in this way. Although the programme is due to be financed by loans from CBZ Bank, the lack of sufficient funds in both the insurance/pension funds as well as the banking sector implies to us that it will ultimately be the Government that steps in as the guarantor of those CBZ loans. Inflation is therefore likely to rise further from the current 676% (March 2020), whilst transactional and real dollarization will continue. In line with Jon Chew's paper, we ultimately expect a return to the multi-currency system but without the ZWL. We therefore have to be very aware of the risks of holding any ZWL asset that could lose all of its value as occurred in 2009. The ZSE rose strongly during the first quarter by nearly doubling in value in ZWL terms. Hard assets such as property and equities listed on the ZSE therefore make up a larger proportion of pension and insurance fund assets as monetary assets, including prescribed assets, lose real value. This puts the regulator, IPEC, in a difficult position. On the one hand they are attempting to force pension and insurance funds to meet the prescribed asset levels (20% of market value for pension funds) but on the other, they are guiding pension fund trustees not to sell down strongly performing assets such as equity and property under poor market conditions. In their recent paper (13th March 2020) "*Guideline for the Insurance and Pensions Industry on adjusting Insurance and Pension Values in response to Currency Reforms*" it clearly states: *"Insurers and pension funds shall use all means necessary to avoid selling assets under poor market conditions. Insurance companies and pension funds shall prepare analysis of expected asset, liability, income and expenditure cash flows in order to properly manage their liquidity position and avoid forced sales of assets when market prices are depressed. Sufficient assets in cash and cash-equivalents shall be maintained to meet expected cash flow needs." (Para 12.4).* This would imply that only new cash inflows into pension and insurance funds could be directed toward prescribed assets which will not be enough to raise prescribed asset levels to 20%. On the other hand, pension fund trustees will be unwilling from a fiduciary perspective to allow their investment managers to invest in assets that will lose real value relative to the likes of property and equities.

We fear that the very large gains in ZWL property values pushed through by various pension funds during 2019 (*see our January 2020 Notes*) and an aggressive move into long term alternative investments (including land banks) has made a number of pension funds illiquid. Any liquidity requirements of the pension funds will therefore need to come from their equity investments implying that a greater proportion of such portfolios will be invested in highly illiquid assets as equities are sold down. This does not bode well for the future of those particular funds.

Asset values based in US dollars remain very low by historical standards and arguably are lower now than they were when the economy crashed in 2008. As stated above, the outlook for the economy going forwards is now further complicated by COVID-19. Back in 2009, the Government of National Unity became an 'enabler' for the economy through liberalization, as opposed to legislation and regulation, and hence allowed the private sector to rebuild the economy with the assistance of foreign investors. As the economy started to grow rapidly, so too did asset valuations in USD terms. From our perspective, the same medicine is now required in 2020 and beyond. We are not aware of any other option.

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