Zimbabwe – Dollarisation and Rabbits. April 2020

"Why, sometimes I've believed as many as six impossible things before breakfast."
— Lewis Carroll, Alice in Wonderland

Conclusion

Events are moving quickly in what is a sign of government disarray and possibly panic. Covid-19 has simply accelerated the demise of the ZWL, a process that has been underway since the end of the multi-currency system in June 2019.

In just two weeks Zimbabwe has moved from a managed floating exchange rate system to a fixed exchange rate system (as at March 26th). This latest arrangement also allows the use of the US dollar in domestic transactions. This fixed rate system is doomed to fail just as it did in the period 2004 - 2008 when the RBZ controlled the fixed rate at the wrong levels. Exporters then were loath to sell foreign exchange at an obviously wrong price.

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.

Introduction

Government economic policy looks to be in a total mess – which is perhaps not surprising. Government expenditure has, for some years, been focussed on maintaining the status quo whilst neglecting important areas like health, infrastructure and food security. Faced with both a severe supply side shock and a severe demand side shock, plus a collapse of remittances and a second year of drought, the government is now faced with a balance of payments crisis and a probable humanitarian crisis as a large swathe of the population have challenged immune systems and are short of food. Against this nightmare economic background which has created a seemingly infinite demand for US dollars but where no US dollars are available, the demise of the ZWL system feels inevitable.

One problem, as we see it, is that many if not most of the current economic policies that are being introduced to hold the system together seem a re-play of the policies adopted during the 2000's (Note 1). The Zimbabwe dollar was pegged to the US dollar at different levels between 1999 until it was taken out of circulation in 2009. Throughout that time, policies were enacted to defend the exchange rate though all failed. The Managed Foreign Exchange Auction System in 2004, for example, failed as the RBZ controlled the rate at the wrong level for exporters. Thereafter, printing, devaluation and re-denomination dominated policy.

All the exchange rate regimes used by Zimbabwe have morphed into a dual exchange rate system where goods and prices for most of the population are based on the floating parallel exchange rate whilst the fixed or crawling official interbank rate was for the political elite, the well-connected and certain essential imports. In all cases a big gap between the official interbank rate and the parallel rate developed as it will right now with the new 1:25 peg.

In effect, with the exception of the previous multi-currency regime, Zimbabwe has had no inflation anchor and no control over monetary policy. The decision by the Ministry of Finance (MoF) to ban the trading of fungible shares with the mistaken expectation of eliminating the Old Mutual Implied Rate, for example, will do nothing to offset the pace of printing money, nor can policies designed to restrict the demand for US dollars. Only policies designed to increase peoples' confidence to hold the ZWL will work, a truism lost on the government.

Back in 2004 the currency began to collapse as quasi-fiscal disbursements by the central bank began to rise (Note 2). These rose slowly at first then accelerated sharply in 2007-2008. With inflation starting to spiral away, the government reacted with the introduction in 2008 of BACOSSI (cheap goods), FOLIWARS, FELOCS and FELOPADS (US dollar wholesale shops and fuel stations). These latter US dollar outlets were licenced (for a US dollar fee) in September 2008, just before the economic collapse and at much higher rates of inflation than now. We suspect that by repeating the same policies as before, Zimbabwe will see the same result but at much lower rates of inflation than in 2007-08.

Dollarisation

It is hard to identify any government policy designed to encourage de-dollarisation - especially since the decision to introduce the RTGS dollar in October 2018 and the decision to drop the multi-currency system in June 2019. Both decisions were, in our view, a disaster.

A study **"Dedollarisation" by *Annamaria Kokenyne, Jeremy Ley, and Romain Veyrune,*** in 2010 for an IMF Working paper, details different types of dollarization.

Financial dollarisation involves the substitution of local currency assets or liabilities for foreign currency assets or liabilities.

Real dollarisation involves the indexation of domestic transactions to the exchange rate.

Transaction dollarisation or *currency substitution* means that the US dollar (or any other foreign currency) is used as a means of payment in domestic transactions.

Financial dollarisation – the decision to separate bank accounts between nostro FCA (foreign currency accounts) and RTGS FCA in October 2018 was the first realisation by the public that deposits held in the banking system were not US dollars. By extension, this meant that banking system assets and liabilities were no longer US dollars but RTGS dollars. The decision to drop the multi-currency system in June 2019 cemented this change.

The latter decision to abolish the multi-currency system was both an act of desperation and, to a politician, a stroke of genius. There were two immediate problems at the time: the commercial banks were bankrupt because the government could never repay the US dollar denominated T-bills it had issued; and the civil servants were demanding to be paid in US dollars – an impossibility for a bankrupt government. Re-denominating assets and liabilities in the banking system to ZWL from USD meant that the government could now openly print money to pay the civil servants, and the banks now became solvent – all at the stroke of a pen.

It was a major rabbit to pull from the hat but a disaster for the population whose savings were wiped out by this move. Whilst it kept the show on the road for almost a year, cracks are now showing evidenced by the pace of dollarisation. So, the question is, for how long can the current system be sustained?

Financial dollarisation requires legislation to permit it unless there is a systemic meltdown of the system such as in 2008. So, it will be hard for the system to fully re-dollarise if the government refuses to legislate. This is an important point as contracts, along with assets and liabilities in the banking system, have also been re-denominated to ZWL. Contracts and property rights are the foundation stone of a modern economy, so contracts in ZWL that can be changed by political diktat – such as land rights – will be weak just as the land invasions had destroyed property rights a decade before. The current issue of "legacy debt" is a good example whereby the government is having to grapple with contracts between Zimbabwean corporates and foreigners. The legacy debt amounts to roughly US$1bn by some accounts and it is unclear where this shoe will drop. Meanwhile, contracts between Zimbabwean counterparties have been unilaterally re-denominated into ZWL.

With weakened property rights, debt or gearing will be low and the economy will limp along as a function of the amount of US dollars in the system rather than as a function of investment demand.
As the IMF put it in 2017, "the banking sector has not been performing its intermediation role. More recently, banks' main function has been to finance the fiscal deficit, undermining its ability to finance development." On balance, we think *the best* the economy can do is to tread water and to continue in its zombie state – but that was before the lockdown which threatens a very deep recession.
We would think that "Open for Business" is also impossible without f*inancial dollarisation* i.e. without property rights being redenominated into a harder currency*. Financial dollarisation* is therefore the key to a sustainable economic system where there is no confidence in a local currency and any future Government will be judged on policy in this area and the extent to which sound-money policies are introduced.

Left to market forces Zimbabwe will see *Real* and *Transaction dollarisation*, but not *financial dollarisation.* We feel the current multiple exchange rate system is destined to fail because a range of commodities or activities are mis-priced as a result. (Governments in this pickle typically devalue the over-valued official rate in large steps but only after the horse has bolted when dollarisation has set in.) Long before SI 85 of 2020, we had predicted that a return to a new multi-currency system was the next rabbit to be pulled from the hat but one consistent with *financial de-dollarisation, that is, banking assets and liabilities will remain in ZWL.* This too will ultimately fail. It will be more enduring if assets, liabilities and contracts are dollarised, but such a system would then only be sustainable with far-reaching institutional reforms. This system will end with a third default because without extensive institutional reforms and a correctly valued currency, any currency system will ultimately fail. However, a multi-currency system with *financial de-dollarisation* may well be the system to get the government to the next election in 2023.

Real and Transaction dollarisation - whilst there have been no incentives nor positive policies to de-dollarise, there have on the other hand been ample reasons *to* dollarise. The supply of ZWL money was expanded on a massive scale between May and December last year with reserve money rising by 2.7 times. The parallel exchange rate collapsed as a result with one ZWL now worth a mere US 2.5 cents. Inflation is also out of control. Prices rose by 540% yoy in February 2020. The artificially strong interbank rate has led to mispricing, and subsidies have led to smuggling. A hated transaction tax completes the set of policies that have encouraged dollarisation – the exact opposite of what the government set out to do. The main beneficiary has been the informal sector. The latest Statutory Instrument (SI 85) to permit the use of dollars now accelerates the pace of *real and transactional* dollarisation from which it is unlikely there will be any return.

The general population is currently experiencing r*eal* and *transaction dollarisation* in their everyday lives; the consequent fall in living standards as wages fail to keep up with retail inflation affects everyone. We suspect *real dollarisation* will force events and drive a move by government employees to dump the ZWL as living standards fall to unbearable levels. The government is therefore in a pickle; it must print money to keep civil servants happy, but this will be inflationary. *Real dollarisation* will therefore increase and living standards will continue to fall while wages are paid in ZWL. It was government employees, by all accounts, that refused to accept the Zimbabwe dollar in 2008/2009.

The Economy

Zimbabwe has two underlying economic problems; the first is that it is a so-called "fragile state" and the second is that the financial system is bankrupt once again as US denominated liabilities and legacy debt are growing as the ZWL devalues. Both problems tend to go hand-in-hand; overlaying a new currency system on a fragile economy is unlikely to work if there are institutional weaknesses.

The World Bank classifies Zimbabwe as having "High Institutional and Social Fragility". In its 2017 Article IV, the IMF wrote that studies suggest that on average it takes around a decade for fragile countries to overcome fragility (Note 3). Zimbabwe's current position differs from those states that overcame fragility in two key ways.

a) An extremely high public-sector wage bill which at 20 percent of GDP, 100 percent of tax revenues, and two-thirds of government spending, is several times higher than the average for the formerly fragile countries. Relative to Zimbabwe's income level, its public administration is both large and well compensated.

b) A difficult international context as aid and debt relief were essential elements to restoring stability for all the formerly fragile countries. Zimbabwe's prospects for assistance on a similar scale appear bleak at present.

The IMF goes on to add that international comparisons would suggest that measures to reduce the public sector wage bill would be more productive in terms of generating fiscal space. Given the social and economic costs involved, successful reform of the public sector will require strong support at the highest level of Government. Other countries have found that challenging.

The IMF also recommended in 2017 that *"fiscal consolidation is the most urgent and critical element for stabilising the economy"* as part of a programme to stabilise what was then the dollarised regime. So, bringing public finances into balance is the first step in escaping from fragility and de-dollarising the economy. Relatively few countries have emerged from fragility (examples include Cameroon, Ethiopia, Mozambique, Niger, Nigeria, Rwanda and Uganda), and fewer still seem to have de-dollarised successfully (examples include Chile, Israel, Mexico and Poland). The second step is to then resolve external debt issues via reforms to parastatals etc as required by an IMF reform programme to make a local currency more attractive as a store of value than the US dollar.

Based on the 2020 Article IV press summary, the public sector wage bill has now fallen to 4.9% of GDP or to around one third of government spending. The projection is for this to fall to 4.3% of GDP or one-quarter of spending in 2020. Quite whether the government is achieving its key objective of cutting the civil service wage bill as a percentage of GDP remains to be seen given the huge uncertainty over the measurement of real GDP. With the government steadfast in its refusal to reform key institutions - SOE's, property rights etc – in return for debt relief, any real fall in wages will only be temporary as inflation can only rise if the ZWL remains in existence. If the system fully dollarises soon, as seems likely, inflation will turn to deflation and the government will have to cut headcount as the projections suggest a still large overall fiscal deficit of 5% of GDP. One significant caveat though is that the latest IMF numbers must use official government figures for the exchange rate in calculating GDP. The GDP figure used works out at US$1,255 per capita which seems too high to us.

Overall, it seems clear looking at newspaper headlines and recent policies that there is a low probability of either a balanced budget or reform. As a result, we expect more policies to ration scarce foreign exchange (manipulating the exchange rate and retention ratios of exporters) rather than policies to increase the amount of foreign exchange (economic reform and growth).

Stress Points

There is no limit to how far the parallel exchange rate can fall, and inflation rise with an expanding fiscal deficit funded by printing. US dollar denominated debt compounds the problem.

A major export boom would help but is unlikely with the world grinding to a halt. Outside support would entail an IMF reform programme which is now off the table. The sale or mortgage of assets to China/Russia or the Afreximbank for cash or collateralising future platinum or gold sales would keep the show on the road temporarily but would complicate any future Paris Club debt restructuring. Balancing the budget would help, but this would mean laying off increasingly militant workers or raising tax on an already narrow and literally hungry tax base. The outlook is undeniably grim with the easy looking political option being the printing press and inflation.

Our company visits suggest that the main pressure point on the system will come from the parallel market premium as many activities in both the formal and informal market, and including government activities, are on the same side of the trade in what is an illiquid parallel market. As the parallel rate falls, inflation rises. As inflation rises, the civil servants demand more money. More money means more printing. Real incomes fall. One interesting study [all hyperinflations tend to attract extensive academic research] **"On the tracks of Zimbabwe's Hyperinflation: a Quantitative Study"** by Yavuz Topal for the Federal Financial Supervisory Authority in Germany in 2013, concluded what most people now know, that Zimbabwe's hyperinflation was caused by the movement of the parallel market premium and the change in the money supply. So the focus on the parallel rate is key to understanding the stress in the system.

Our meetings suggest many corporates now source foreign exchange (FX) at the parallel rate as the official interbank market is too small and mis-priced. This means a constant weakening pressure on the parallel rate. Compounding the US dollar shortage, individuals, corporates and pension funds have tried to hedge against inflation and devaluation by property development. A visit to one real estate company suggested that the import content of a house or office building is typically about 60% - a number that seems to recur across other industries including farming; one government contractor mentioned having to source their FX at the parallel rate as government contracts were only paid in ZWL. This means that attempts by government to stimulate the economy also tends to weaken the parallel exchange rate.

More recently, a Ministry of Finance plan to introduce a market based interbank market failed – which was hardly surprising. By all accounts some members of The Monetary Policy Committee (MPC) were advocating a free-floating exchange rate to balance the supply of FX thereby allowing the whole economy to function normally. However, the government – or more accurately, the RBZ - reversed course when it saw that the interbank rate was likely to fall directly to the parallel rate and what that would mean for inflation. In anticipation of the experiment with the market based interbank rate the RBZ helpfully published the FX inflow into the country (US$6.9bn for 2019), but whilst this inflow might balance FX demand to generate exports, it falls well short of the demand needed for a swathe of domestic requirements like construction, agriculture, importing solar panels, healthcare, infrastructure etc, activities which also source FX on the parallel market. Adding a layer of uncertainty to FX demand is the response to the virus lockdown. Most measures needed to alleviate the symptoms of the illness require US dollars, especially for water, respiratory machines and PPE. An effective response looks to be beyond the resources available (as it does in many African countries).

A further stress point is legacy debt – such as supplier credits, dividends etc. These are to be assumed by the RBZ at 1:1 – according to the soundbite. It seems, on closer inspection, that corporates must raise the US dollars in the market - at the parallel rate - to pay their offshore suppliers. They then receive ZWL back from the RBZ at the interbank rate. This sounds simple but different corporates clearly understand the scheme in different ways and few seem to suggest the scheme is working. This scheme places pressure on the parallel rate but in theory should slightly tighten ZWL money supply as the ZWL issued as the difference between the parallel rate and the interbank rate should be destroyed. However, with the ZWL being electronic money, it is unclear if the ZWL really is cancelled as there is no published audit of currency destroyed nor does the central bank publish a balance sheet with any regularity. With numbers of at least US$1bn banded around for legacy debt, the total money supply could rise by ZWL12bn if the ZWL isn't cancelled. As at December 2019, the broad money supply was growing by 249% yoy, much of it explained by the well-publicised redemption of T-bills at 1:1, but the assumption of legacy debt would raise this by a further third. Overall, the legacy debt mechanism seems more like a back-door way of allowing corporates legal access to the parallel market.

It is not obviously clear where legacy debt liabilities lie, but it seems the commercial banks themselves have been issued with deferred IOU's by the central bank repayable in 5 years for any loans they have guaranteed to their correspondent banks on behalf of the ultimate borrower in Zimbabwe.

We understand that the Ministry of Finance (MoF) believes that foreign creditors and investors (airlines, dividends etc) should take a haircut on legacy debt whereas the central bank would prefer to assume the debt onto the RBZ balance sheet. In effect, if the MoF has its way, the commercial banking sector may experience a sharp rise in non-performing loans if their domestic clients struggle to raise US dollars to pay external suppliers. If the RBZ dominates, then the parallel rate will take the hit. The commercial banks had share capital and reserves as at November 2019 equivalent to a mere US$160m. This rose to US$255m in December due almost entirely to property revaluations of foreclosed property as well as their own on-balance sheet properties.

The IMF's Staff Monitored Programme was holed below the water line almost before the ink had dried on the agreement in May 2019. Current reserve money growth of 2.7x compares to a target of +10%. A realisation that there is now no potential IMF help, no reform, no Paris Club re-scheduling and no "Open for Business" is bearish; Zimbabwe must now pull itself up by its own shoe straps.

Rabbits in the hat

There are several strategies that the government could play to delay the day of reckoning - some better than others:

a) A prices and incomes policy
b) A unified exchange rate
c) A more highly dollarised multiple exchange rate system with ZWL as part of the system
d) A return to a multi-currency system without the ZWL in the basket
e) A hard currency regime e.g. the US dollar or the rand
f) a Government of National Unity (GNU) and hard currency
g) A GNU, hard currency and institutional reform

a) A prices and incomes policy was tried before and ended in disaster. Shelves in the shops emptied almost immediately and a similar outcome would happen again. Such a policy would reveal that the government really has run out of ideas.
b) A unified ZWL exchange rate is now probably too late because of the implications for inflation and has already failed with the market based interbank experiment being discarded. It may have been possible when the multi-currency system was first abolished, but people have now lost total confidence in the ZWL and the demand for US dollars is now sky high for hedging, healthcare etc.

c) A two-tier exchange rate as now with a wide range of commodities being priced in US dollars would allow prices for major inputs to adjust to a global level and could keep the show on the road for some time. The pressure to change such a system will come from people whose pay in ZWL doesn't keep up with retail inflation i.e. civil servants (and those in the formal ZWL economy) so this system will always tend to be inflationary as the civil servants would have to receive regular cost of living allowances. This doesn't, of course, address the issue of weak property rights either, or the fact that multiple exchange rates are normally associated with corruption and rent-seeking. Ultimately, we think the two-tier nature of this system with an overvalued interbank rate will be its downfall as corporates and farmers will avoid selling dollars at the wrong rate at any cost.

d) A return to a multi-currency system is most likely as government employees ditch the ZWL. This would allow contracts in hard currency, but no one would have any confidence in them unless they were subject to SA or Mauritian law (for example). The same would apply to the banking system; people would try to bank with foreign banks only if they were allowed to

e) A hard currency regime will fail without extensive institutional reforms. But it is also a possible currency regime to get the government over the finish line in 2023. Wages would be re-set in a harder currency much like in 2009, and balance sheets would have to be re-built. All of this takes time. A default is normally considered to happen when a country fails to repay external debt. Less well documented, or appreciated, is that high inflation is a default by government on domestic debt (Note 4). Defaulting countries also tend to be serial defaulters so a second default by Zimbabwe in a decade is not actually that unusual. This system would end with a third default because without extensive institutional reforms and a correctly valued currency, any currency system will ultimately fail as domestic and foreign players would not trust it

f) A GNU and hard currency regime would also fail as above.

g) A GNU, hard currency regime and extensive institutional reform is the only sustainable currency regime which would give confidence in property rights and the law of contract. Such reforms would include the overhaul of SOE's, a balanced budget etc. Importantly this would require the abolition of the Central Bank from the monetary system (it becomes redundant when adopting someone else's currency), a measure that should have been implemented back in 2009 and which would have arguably allowed dollarization to work to this day. For political reasons, this is unlikely for the time being despite it being the only long term solution for Zimbabwe's economy.

The current multiple exchange rate system will keep the show on the road for a while, and the last area to dollarise will be government wages. So, appeasing the civil servants will keep pressure on the fiscal deficit which will mean:

a) continued high rates of inflation
b) continued fall in real wages.

Thereafter, we would expect a return to a multi-currency system without the ZWL. Covid-19 is simply likely to accelerate this process.

Jonathan Chew April 2020
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Notes:

1. Remember November: A timeline of how a country lost its currency. NewZWire November 14, 2018
2. Dollarisation: The Case of Zimbabwe – Joseph
3. "Exiting from Fragility in sub-Saharan Africa: The Role of Fiscal Policies and Fiscal Institutions", Delechat, Fuli, Mulaj, Ramirez, Xu, IMF WP/15/268, and "Building Resilience in sub-Saharan Africa's Fragile States", IMF 2015.
4. This Time Is Different: Eight Centuries of Financial Folly [Carmen M. Reinhart, Kenneth S. Rogoff]