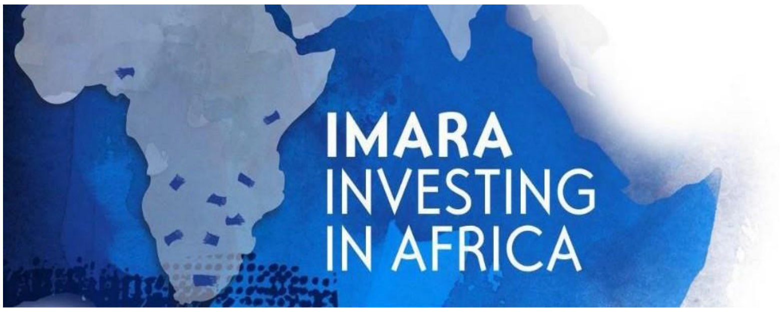

Zimbabwe Investment Notes

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"Inflation is always and everywhere a monetary phenomenon"

This famous quote by Milton Friedman is most often used by monetary economists (such as *Greenwood and Hanke*) to explain inflation. Inflation has to be financed whether it is from demand-pull or cost-push factors and excess money is the financier. An economy needs money growth for nominal GDP to rise and for a little inflation. If that money growth is excessive then inflation will occur for certain. In a country like the US there may be a time lag, perhaps of up to two years, for inflation to show itself once there is excess money in the system. In a country like Zimbabwe, where the general population is well aware of the damaging effects of high or hyperinflation and where money market rates are hugely negative, the impact of excess money creation could be almost instantaneous.

In the US inflation is sitting at around 8.5% at the moment, the highest in forty years and likely to rise further. The politicians and the Federal Reserve for that matter are blaming supply side constraints caused by the COVID pandemic and more recently have been blaming the Ukraine war which has impacted oil and food prices. At the outset of the pandemic, the Fed opened the monetary taps to the extent that M2 (a measure of broad money) has increased by over 40% since 2020 whilst over the past year it has risen by 12% which is allowing the economy to grow but also allowing inflation to rise well above the Fed's target of 2%. In short excess money growth is financing inflation and will continue to do so for the next year or two unless money growth can be reined in. By contrast in Japan, China and Switzerland, there has been no excess money growth to finance inflation which currently stands at 1.2%, 1.4% and 2.4% respectively in each country (*Hanke*). Yet those countries are also experiencing the same supply constraints as well as energy and food price increases as everyone else. Inflation is not being financed in those countries by excess money growth.

Money is created by the central bank and by the banking sector, the latter through bank lending of deposits. After the global financial crisis in 2008, central banks expanded their balance sheets dramatically to avoid a financial implosion. At the time, many feared that this would lead to high inflation but in the event there was no inflation and growth remained below normal in most of the major economies. The reason was simple. Banks were not lending as they were faced with new capital controls that required them to restructure their balance sheets, write off bad loans and rebuild their capital to the new and higher regulatory requirements. By contrast, post the pandemic, banks were encouraged to lend and in a number of instances bank loans were underwritten by Government to further encourage lending. As a result bank credit expanded whilst central bank balance sheets grew.

If we now look at Zimbabwe and in particular the ZWL, the economics explained above works in the same way. Excess money growth over and above the need for nominal GDP growth and some inflation, will lead to inflation and in the case of ZWL, a devaluation in the currency. Looking at 2021 and taking the RBZ Monthly Economic Review, broad money M3 rose by 132% over the year whilst the parallel rate of exchange fell from ZWL115 to ZWL200, a 74% devaluation but as we know GDP also rose sharply in 2021. To date we only have statistics for broad money to the end of February this year which highlights a 6.5% growth in broad money since the end of December 2021. The currency devalued by around 10% over that period so nothing dramatic. The ZSE by contrast rose by 36% over that period but reflecting good corporate numbers and then it gained just 5% in March. The parallel rate fell by around 10% in March so again, nothing exceptional. Then suddenly in April the ZSE gains a whopping 78% and the currency devalues by around 60%.

A monetarist would suggest that in March or April, the money taps must have opened to finance such inflation. We wont know for sure until the numbers can be scrutinised, if indeed that will be possible. If we look back at events in March and April, there were bi-elections to finance, the 2022 Census was underway whilst the end of the rains prompted road rehabilitation works. All three of these were expensive projects. Add to this the preparations for the purchase of the maize harvest and winter wheat planting. It could well be that Government did not have the funds available to fund such expenditure bearing in mind the TB issue at the end of March was heavily undersubscribed at a rate of just 24%. As a result it is possible that the RBZ lent those funds to Government through a short term overdraft in March and April. This is money creation. These funds were then banked by the private sector and with deposit rates of 25% at best with inflation of 96%, it would have made sense to buy an asset instead of leaving the money in the bank, the most liquid being the ZSE hence its rise. The currency more than likely devalued by a similar factor to the increase in the money supply, although panic may have driven that higher. Put another way there were more ZWL relative to the USD than before hence its price fell. There is also talk, as yet unsubstantiated, that exporters were receiving more ZWL for their export retentions as the rate used in that calculation had moved from the auction rate to the "Tolerance" rate, now the new interbank rate. That would have required more ZWL which the exporters would have needed to find a home for.

Had interest rates on ZWL monetary assets been attractive enough, recipients of those extra ZWL could have deposited the money in the banks or bought government Treasury bills. This could have mopped up surplus ZWL liquidity which instead immediately went into equities or other hard assets. If deposit rates or yields on Treasury bills were nearer 125% as compared with the current 25% - a premium over the current 96% inflation rate – then at least there would be another liquid ZWL asset class available to consider.

The government reacted to the currency and ZSE gains by introducing a "super-tanker" of measures to try to stop what they deemed speculation. The ZSE was partly blamed but as we have written before (July 2020), the ZSE is a cash settlement market, there is no credit. So a buyer has to have had the ZWL available to purchase shares in the first place. That ZWL was surplus to the buyer's needs and hence financed the rise in share prices. The seller meanwhile was left with that cash which he could have used to buy other goods if they were able to or it simply remained in cash. Increasing capital gains tax to discourage short term investors will therefore make little difference to the buyer with excess ZWL liquidity. As we wrote in our last Investment Notes, equities are one of the few asset classes to own when you have an unstable monetary policy, wherever you are in the world.

Businesses have been accused of driving the parallel rate by chasing USD. Again they would need surplus ZWL liquidity to do so but thanks to the dual currency system that Zimbabwe has, there is far less need to do this since businesses can charge for their goods and services in US dollars; indeed a number of the businesses we speak to generate more USD than they need and hence invest the surplus into new plant and equipment.

Banks are being blamed for creating money and hence bank lending was stopped altogether. Banks however operate primarily in the ZWL sector which, as we have written before, is declining as a percentage of the economy to the extent that they no longer have the capacity to make meaningful loans to their clients given their own credit limits and lending criteria. Only if loans are guaranteed by Government would this argument fall away and as far as we know, Government only guarantees CBZ Agro loans. That in itself would add to money supply as the loans would not have been backed by deposits. To suspend bank lending in an economy will simply cause it to grind to a halt and start declining, not what Government would want before the 2023 elections. Maintaining the dual currency system was a smart move by Government as to have done otherwise would have resulted in a collapse in the economy as we saw back in June 2019 when they did just that.

Indeed back in the winter of 2019, investors may recall that the newly introduced ZWL had finally found some stability until suddenly in August it collapsed for no apparent reason. We wrote about this episode in our October 2019 Notes where we highlighted that the RBZ had redeemed USD366m of Treasury bills for ZWL on behalf of Sakunda, money it had to create. The ZWL moved from ZWL11 to USD1 at the end of August to ZWL 20 a month later. Government panicked and introduced restrictions on Bureau de Change, Ecocash and introduced SI212/213 which imposed heavy fines on businesses that linked their prices to a foreign currency unit but all along it was the creation of ZWL that was the culprit. Then in June 2020, Government closed the ZSE for a month and suspended dual listed shares indefinitely as it was felt that these were driving speculation and the devaluation in the ZWL.

To resolve the problem of a devaluing currency, rising prices and a booming stock market would simply be to cease creating excess money in the first place since that is the financier behind these symptoms. As it is the US Federal Reserve is yet to blame itself for their high inflation preferring to accuse external factors such as the Ukraine War; the Swiss National Bank on the other hand may take a different view.

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