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Fronteras Capital Investment Bank

Review and Analysis of Monetary and Fiscal Policy Changes in Zimbabwe

November 2018

Introduction

The purpose of both the latest Monetary Policy Statement (MPS), together with the Minister of Finance's "Transitional Stabilisation Programme" (TSP – a fiscal policy statement by any other name) is to deal decisively with the economic decline, constraints and recession experienced by the Zimbabwean economy over the past two decades.

We present this analysis a month after the announcements to contribute to a broader understanding and discussion on the economic transition underway in the country. We also aim to locate the efforts by the authorities in the global context of such transitions from hyperinflation and deterioration to more conventional economic, monetary and fiscal realities by drawing on the experiences of Latin American, post society and North African countries. The important argument we make is that, the Zimbabwean experience is not totally unique and players in the economy might be well served by studying trends, policy prescriptions and results from countries that have gone through similar changes over the past two decades¹.

Where we are – Q4 2018

Through the end of September 2018, the Zimbabwean economy experienced foreign currency shortages, increased government spending, a weakening current account position, a deterioration of the Real Time Gross Settlement (RTGS) and Bond note parallel rate and an uptick in inflation.

At the time of writing, on post publication and widespread release of both the MPS and TSP policy statements, the prevailing economic environment is dominated by:

¹ Fronteras Capital Investment Bank has research papers giving extensive analysis of the Argentinian, Brazilian, Russia & Eastern European, and Egyptian experiences of economic transition. Each one holds a specific comparative to the Zimbabwe situation and those studies have fed into this document. For access to the fuller papers please email research@fronterasafrika.com.



- Notable distress amongst the general public.
- Widening discrepancy in the value of the United States Dollar (USD) and the value of funds in bank (RTGS) accounts.
- A spike in predominantly (but not exclusively) the non-USD denominated prices of goods in the market.
- Shortages of some (mainly imported) commodities, e.g. fuel, cooking oil, pharmaceuticals.
- Panic buying, hoarding and an appreciation in the value of value retaining assets, including high activity on the Zimbabwe Stock Exchange.
- Temporary and indefinite business closures.
- The Zimbabwe stock-market index surged 60 percent within a week, which was an indication of a stressed financial environment. The skewed market prices forced foreign investors including Franklin Templeton, JPMorgan Chase & Co. and Cape Town-based Allan Gray— who can't repatriate their money because of capital controls — to write down the value of their assets.
- Suspension of medical aid by many private pharmacies and hospitals.
- Mounting uncertainty also drove businesses to temporarily reject the bond note and RTGS payment methods and the economy is effectively dollarizing.

There is a prevailing view that the current situation is in reaction to and is a direct response to the policy pronouncements of the first week of October 2018. We produce below the highlights of both policy statements, the MPS and the fiscal policy matters that emerge in the TSP:

MPS Highlights	TSP Highlights
<ul style="list-style-type: none"> ✓ Separation of FCA accounts into Nostro FCA and RTGS FCA accounts whilst maintaining parity. 	<p>Macroeconomic Imbalances:</p> <ul style="list-style-type: none"> • Fiscal Consolidation • Improved tax(fiscal) revenue collection and administration. • Transparency in debt issuance <p>Fiscal Targets:</p> <ul style="list-style-type: none"> ✓ Public and Publicly Guaranteed Debt as a ratio of GDP should not exceed 70 percent at the end of any fiscal year. ✓ Central Bank lending to the State at any time shall not exceed 20 percent of previous year's Government revenues. ✓ Reduce public service wage bill ratio to revenue from 90% to 62.5% by 2020.
<ul style="list-style-type: none"> ✓ Nostro Stabilization Guarantee Facility. The Bank is finalizing a USD500million 	<p>Government considering a downward revision of lending rates to productive sector from 12%</p>



facility with the Afreximbank to back and guarantee Nostro FCA accounts.	to 8%, to promote affordable credit to the private sector.
✓ Forex Retention: All exporters retain 100% of their export proceeds with the exception of gold producers that retain 30% of export proceeds; platinum, diamonds and chrome 35% and; 20% for tobacco and cotton producers.	Privatization of SOEs: ✓ Privatisation of 11 State Owned Enterprises, 6 IDC Subsidiaries, and 17 ZMDC subsidiaries. ✓ Liquidation of 2 State Owned Enterprises and 3 IDC Subsidiaries. ✓ Merging of 11 entities. ✓ Departmentalisation of 7 SOEs into Line Ministries.
✓ Credit Lines for Strategic Requirements: <ul style="list-style-type: none"> • USD500million credit lines from various funding partners (Afrexim Bank, Afrigrain, CDC, Ecobank, IDC SA, CABS, AfDB) • Negotiations for long term credit lines is ongoing. 	Unlocking New Finance ✓ Clearing of multilateral debt
✓ Foreign truckers and traders to purchase goods in foreign currency.	Introduction of bankable 99-year lease, these will be issued to all farmers.
✓ Purchase of Gold by Jewellers in Foreign Currency from Fidelity Printers Previously jewellers would retain 35% and 65% would be deposited in the Bank's Nostro account upon export.	
✓ Cross Border Investment and Offshore Capital Raising Initiatives.	
✓ Settlement of Capital Gains Tax in Foreign Currency when using Offshore Funds.	

Our view is that the policy proposals present a good starting point and departure with past practice and are intended to return the Zimbabwean economy to a rational, near orderly policy (and hopefully, operating) environment. In particular:

- They represent an increase in transparency from fiscal and monetary authorities. For example, the auctioning of TBs which is a departure from the closed system of debt issuance that has been the norm. The gazetting of government debt is also refreshing.
- They represent a roadmap that can enable the beginning of much needed regional and global reintegration. In the TSP, the country outlines its commitment to meeting the SADC integration macro-economic convergence targets, the country has also committed to undertaking initiatives to deepen and strengthen ties with the West and East.



- They deal honestly with central challenges in the economy emanating from policy and government action. In the two policy statements, the MPS and the TSP, government was very frank in pointing out the unsustainability of government debt. What was more refreshing was the diagnosis of the source of money creation. The solutions proffered in the policy documents are well measured.
- They include practical, feasible, yet difficult steps towards reducing deficits and providing fiscal clarity. The review/introduction of electronic transaction tax in order to close fiscal deficits is one example of a difficult but necessary step to balance the books. Rationalization of the civil services and government expenditure as outlined in the TSP is another example of tough steps taken by government to move the country in a sustainable direction. However, there are signs that this measure was introduced hastily without adequate consultations, hence the various revisions and exemptions within a week of the statement and we are likely to see more pullback and adjustments.
- It is important to note, however, that we are of the opinion that there are still some gaps and areas unattended to as highlighted in the next section.

The key to all policy is, of course, implementation and execution. The stated intention from government is to stick to the plan. Can government withstand the pressures from the expected back lash?

Our analysis from countries that have taken this path out of similar positions speaks to a hard road ahead.

In addition, the psychology of the Zimbabwean population that has experienced, chronic shortages, hyperinflation and sustained economic difficulty makes for a high intolerance of economic reform that comes with hardship and memories of past traumas. Other experiences show how hard the road to reform can be. The following experiences are noted below.

ARGENTINA

Argentina experienced tight monetary policies and high interest rates depressed demand and caused real GDP to decline. In Argentina (as may be the case in Zimbabwe) government had to pay a short-term political price to achieve a long-term economic gain. Targeting inflation through price controls etc. failed as it perpetuated an already thriving black market. Formalising the 'informal' monetary system required adjusting the peso to be convertible and backed by treasury gold reserves. This meant incentivising private capital into the mining sector as a priority.



BRAZIL

In **Brazil** it took months for the population and business to adjust to the index system, called URV (Unidade Real de Valor - Real Unit of Value), which was pegged to the dollar. Eventually the URV would also change daily and prices would be fairly consistent in URVs (as much as they would in dollars) and helped contain inflation. The fear of hyperinflation commonly leads to two short-sighted types of behaviour: short-termism (impulsive panic buying) and ultra-conservativeness.

RUSSIA AND EASTERN EUROPE

In **Russia and Eastern Europe**, following the collapse of the Soviet Union, it was noted that once inflationary expectations have become ingrained in a society, people become very sceptical of government and central-bank promises to keep inflation under control. This scepticism leads them to maintain "*defence mechanisms*" against the effects of inflation and the inflation tax such as hoarding of hard currency and capital externalisation. This was especially acute under Russia's drive to privatise state assets. An incredible transfer of wealth ensued that saw the creation of an oligarchic class which was often antagonistic to the state and its policies. Additionally, the culmination in many Eastern European states of these reforms found expression through the formation and fostering of strong opposition parties that sought to change incumbent regimes.

EGYPT

The recent **Egyptian** case is a study into the extent to which competition between political unrest and state formation brings about economic uncertainty. In Egypt, after the departure of long-time strong man Hosni Mubarak we saw an interim military government, which was punctuated by abuses and military trials. Thereafter, Islamist President Mohamed Morsi became the country's first democratically elected leader. But he granted himself unlimited powers, and his government cracked down on dissent, triggering nationwide protests. With no clear pronounced plan on economic direction and uncertainty, inflation increased. In July 2013, Egypt's powerful military overthrew the unpopular Morsi and outlawed his Muslim Brotherhood, branding the decades-old Islamist movement a terrorist organization. The following year, the chief of the armed forces, Abdel Fatah al-Sissi, was elected president and has overseen the harshest crackdown on dissent in the country.



Can Zimbabwe buck the trend?

FCIB Outlook/Expectations

Essentially, one of the major outcomes that we expect to see as a result of this policy – and hopefully governance – shift is a return to real banking. The MPS is pushing commercial and retail banks back to their true roles in the economy. We are concerned, however, by a weakness in the statements in highlighting and dealing with the exchange control gap.

Secondly, we are disappointed in the seeming silence on Reserve Bank of Zimbabwe (RBZ) reforms. Can the current structure of the central bank, given its historical role and operation, deliver these desired radical results? On the institutional outlooks, we have noted the following key reform areas and expectations from the RBZ:

1. The Bank has re-introduced **liquidity reserve ratio**, at a rate of 5% of banks deposits, monitored on a weekly basis - this will reduce money in circulation. This policy had been dropped eight years ago. Although the RBZ has waited this long to fight money supply growth, it seems to be a step in the right direction. Liquidity reserves are instruments used by most central banks the world over, including all in the SADC and even the US fed.
2. Re-introduction of strict use of **Letters of Credit (L/Cs)** for substantial forex payments - an established method of ensuring that parties to an import/export contract do deliver. We hope that enforcement and implementation of these will be a move away from the lax approach to this standard policy as experienced in previous years.
3. We welcome the recommitment of **Lender of Last Resort** mandate to facilitate efficient and reliable market operation if implemented accordingly.
4. **Re-Introduction of FCAs** and separating them from other forms of currency (RTGS dollars) is effectively now accepting the existence of a local currency, a good move, but confidence will remain an issue and this can only be earned over time. Corporates will have no choice but to use these, but individuals will be slow in using this new facility due to confidence issues.
5. **Retention schemes for forex earners** a welcome move, however most industries feel the retention levels are short of their requirements.
6. The **1:1 exchange rate** remains the ONE thing that will stall everything in the short to medium term as arbitrage operations by all economic players is inevitable. The parallel market will not truly die or go away.
7. Return to the **"weekly" auction of TBs** again was a policy that the RBZ used to adhere to but somewhere along the road it abandoned it, showing that transparency issues were put aside.

In effect there were really not many 'new' initiatives by the Bank, just a return to normal practices. These measures are welcome, and they should restore normalcy to the market.



What was not specified in the documents, however, is what institutional reforms are required at the Central Bank itself given its history of engaging in quasi-fiscal activities.

Thirdly, we further expect certain aspects of the economy to respond strongly – for better or worse – to the proposed policy regime, should implementation be as close to true as technically and politically possible. We hold the view that the following sectors will perform in the following ways in the short to medium term:

Sector	FCIB Outlook
Mining	<ul style="list-style-type: none"> - Production output improvements driven by Gold, Chrome and Platinum in the Medium to Long Term. - Increased output anticipated from Small Scale mining sector as supported by the U\$60 million facility from RBZ. - The key will be in a change in the ability of miners to retain majority earnings in foreign currency in order to (i) enable procurement of imported inputs and (ii) to incentivize formal sales of gold to the government via Fidelity Printers.
Agriculture	<ul style="list-style-type: none"> - Positive outlook particularly in Tobacco, Maize, Cotton and Horticulture and Livestock. This is also due to the successes of the Command Agriculture initiatives from the previous and ongoing agricultural seasons. - We expect further investments in this area from both the government and increasingly, from the private sector.
Construction	<ul style="list-style-type: none"> - Large construction will lead the way, particularly the rehabilitation of the road network (Chirundu-Beitbridge Highway particularly.) In the medium term, and other infrastructure projects.
Manufacturing	<ul style="list-style-type: none"> - Will remain uncompetitive as long as our import bill continues to rise and against currency uncertainty.



Banking and Financial Services	<ul style="list-style-type: none"> - The impact of the separation of FCAs for USD and RTGS will be subject to consumer confidence in the sector. - Given currency uncertainty in the short to medium term, it is likely that banks will pull back on lending both as a result of increased prudence from lenders, and as consumers wait to understand the full impact of borrowing given the recent announced changes.
Tourism	<ul style="list-style-type: none"> - Upward trajectory dependent on competitive pricing and ease of immigration laws. - This sector holds great promise to be a forex earner. - Most must be done to enable ease of bookings to be done in country – especially with regards to airline tickets and accommodation.

Finally, we hold the view that as a result of the policy statements we can expect shifts in money supply and currency performance. We hold this view both from our reading of the statements, and by drawing from historical experience in countries emerging from similar economic difficulty.

Zimbabwe, Brazil and Argentina have all been through bouts of economic uncertainty and hyperinflationary policies. The methods of creating disinflation from an economic perspective are contingent on a number of key government positions.

1. A monetary policy that notes **indexation** (that economic players will always factor the real price of goods and services regardless of price controls, the parallel market etc.) will always be present. It is therefore imperative for the value of the bond note to officially tally with the USD. In Brazil an index, called URV (Unidade Real de Valor - Real Unit of Value), with daily variations, was pegged to the dollar but as the URV would also change daily and prices would be fairly consistent in URVs (as much as they would in dollars); all economic agents were encouraged to quote their prices both in local currency (which would be effected by the high inflation rates) and in URVs (which, pegged to the dollar, would remain pretty stable).
2. Policies conducive of the influx of **FDI and balance of payments support**. In the Brazilian case investors saw advantages in pouring massive amounts of capital and



therefore, the Real gained value against the dollar (US\$ 100 = R\$87), which helped importers but harmed exporters. In the Argentinian case, what the government offered the public was freedom to choose the currency to be used in its transactions and for its savings. In practice, the choice was given between the American dollar, that the public had already transformed into its currency during hyperinflation, and the convertible peso that began to be offered by the central bank. In accordance with the Convertibility Law, this currency should be at least as stable as the dollar.

3. **Economic diversification.** The commodity super-cycle taught us that a raw material export-led strategy is fragile and governed by external pricing factors. Investments in *Special Economic Zones* that enable exports in beneficiated products or services mitigate the risks of external pricing regimes.
4. **Infrastructure investment:** In the Brazilian case, prioritising market driven programs of private sector concessions such as building and operating ports, airports and toll roads on a BOOT (build own operate transfer) basis enabled investor confidence. Corruption, regulatory and pricing issues and labour capacity are the key risk factors in this area.
5. A major difficulty that plagues anti-inflation reforms is **credibility**. Once inflationary expectations have become ingrained in a society, people become very sceptical of government and central-bank promises to keep inflation under control. A reduction in the civil service although politically inexpedient, is economically prudent and the privatisation of SOEs would also increase efficiencies and attract FDI.

Country	Price controls	Monetary Reform taken	New currency introduced	Export oriented policies
Brazil	✓	✓	✓ (URV)	✓
Argentina				
Zimbabwe	✓	✓	✓ (Bond Note)	✓

Impact of reduced government spending and a decline in government driven high money supply.

The fiscal reform outlook is mixed as we expect some progress to be made on public the wage bill and on government driven industry support programs like Command Agriculture. However, this progress will likely be hamstrung by slow delivery of the reforms and political sensitivities around retrenchments and wage rationalisation. Despite consolidation efforts, we anticipate that the government deficit will remain above USD1 billion over the coming three years to 2021.

1. Whilst the idea of cutting government spending is sound, the reality is that the scope to cut expenditure is limited and government is not in a strong position to borrow



from the foreign lenders like the IMF and World Bank. This means that the only debt market government has access to is the domestic market which means government national budget financing will for the foreseeable future put pressure on money supply growth.

2. Further, given government's limited access to other sources of debt financing, public sector borrowing will continue to grow at a quicker pace than other sections of the Bank balance sheet. While this will boost asset growth, it will crowd out the private sector and leave the sector highly exposed to public finances.
3. Adding on to that most of the ministries are underfunded and a cut in government spending might have a bearing on service delivery and undermine the functioning of government.
4. On a positive side, a decline in money creation/supply will curtail the runaway RTGS price inflation. However, the preliminary projections indicate that government deficits will remain a feature up to 2020, which means that government borrowing will remain a key factor in the money supply equation.
5. Cutting expenditure will also have a bearing on economic growth especially in a country like Zimbabwe where government is one of the largest sectors contributing to growth.
6. A decline in government borrowing will likely create space for private sector borrowing opportunities, which had previously been crowded out the domestic debt market. This will boost private sector productivity.
7. However, the decline in government activity in the debt sector will likely negatively impact commercial bank profits, which had been largely driven by TB market. Further, the lack of a sovereign currency and low US dollar liquidity will see private sector credit demand remain weak and weigh on firm profitability, meaning banks will likely remain reticent to lend.

Outlook for USD, bond, RTGS relationship

1. A major challenge is the budget deficit, which even on preliminary projections (we shall get more details later this month when the national budget is announced), show a deficit up to 2020.
2. The Balance of Payments situation remains fragile and export growth will face challenges, as it will still be driven by commodities, which currently contribute 85% to our export proceeds. It is significant to highlight that the risk in this area is the volatility of international commodity markets.
3. More importantly Zimbabwe's import appetite remains voracious, gobbling over USD\$2billion more than exports bring in every year. This will continue to put a strain on the availability of foreign currency in the market and if unchecked will continue to fuel the parallel market.
4. A key challenge is budget deficit-led domestic borrowing which has built up inflation, implying that the currency should fall in value. We argue that it should have been allowed to fall in value over the past five years gradually.



5. With an artificially strong currency, imports continue to get even cheaper and export competitiveness will continue to suffer. It is important for government to ensure measures that can bring realistic parity to the economy.
6. The 1:1 RTGS (FCA) and real USD exchange rate is currently not a reality that no amount of controls can enforce. Simply stated, we see the parallel market continuing to exist and as corporates earn currency, they too will find themselves engulfed by this activity to realize maximum value.
7. Will Zimbabwe weaken its currency regime? Holding the Bond or RTGS at par with the USD is not sustainable, especially given the US Government's strategic objective of a strong dollar in line with American sovereign interests, which are most certainly not aligned with Zimbabwe's. So in near the future the Government may be forced to devalue the RTGS balances gradually to enable realistic market forces to come into full effect. The example of Brazil is instructive. This will need strong political will.

We will be publishing our analysis of the upcoming budget with commentary on its implications on the broader economy over the coming year with insights that may lend themselves towards business strategy.

Contact us at: research@fronterasafrika.com

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