A Review of the State of the Economy: Showcasing the ugly face of Dollarization

Dr G. Mugano

Director, Africa Economic Development Strategies

First Quarter 2020 Report

13 March 2020

Economic Dashboard

- The current economic environment is characterized by:
  - Chronic inflation, that is, +500% per annum;
  - Price spikes;
  - Acute shortage of foreign exchange
  - Exchange rate volatility;
  - Excessive erosion of wages;
  - Capital erosion;

Economic Dashboard (continued)

- The current economic environment is characterized by:
  - Massive shortage of electricity;
  - Increasing cost of doing business;
  - Budget deficits;
  - Incessant unemployment;
  - Incessant current account deficits;
  - Negative economic growth; and
  - Dollarisation.

ECONOMIC STABILISATION AGENDA: MONETARY FRAMEWORK IN DISARRY

On Exchange rate

- The monetary authorities liberalized exchange rate on 20 February 2019
- Further modification of FX market

Inflation

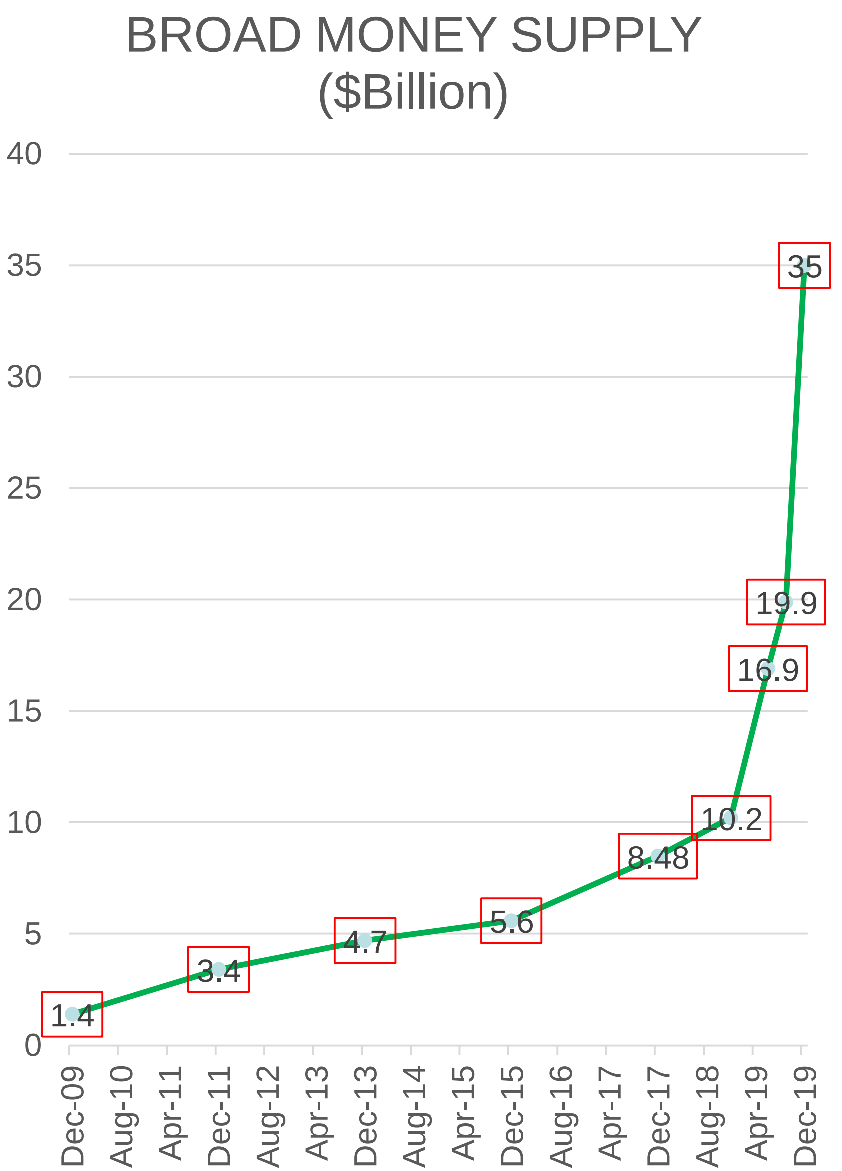
- We have lost the battle -175.5% in June 2019 and is now +500%
- Suspension of inflation reporting following S.I 142 of 2019
  - Manipulate expectations

Interest Rates

- Interest rate spikes from 15% to 50% to 70% and now down to 35%

Currency

- Mono currency introduced on 24 June 2019 but dollarization remained in force
- Increase in money supply by 250%
- USD pricing exemptions/Dollarisation
  - Fuel; ZESA; Passports; Fast food, etc



Fiscal in a quandary: the trajedy of failing to read the economy

Description	2018	2019	2019 (Sup)	2019 (est)	Budget Strategy Paper (BSP)	2020 budget
Revenue (bn)	5.296	6.598	14.060	21.0	24.8	58.6
Expenditure (bn)	8.161	8.164	18.620	26.2	28.5	63.0

Government Prescriptive Assumptions for 2019 budget

- ✓Dose of austerity which was aimed at reining budget deficit an inflation
- ✓Dec 2019 Inflation 5%
- ✓Growth rate of 3.1%

Fiscal in a quandary: the trajedy of failing to read the economy (cont)

Description	2018	2019	2019 (Sup)	2019 (est)	Budget Strategy Paper (BSP)	2020 budget
Revenue (bn)	5.296	6.598	14.060	21.0	24.8	58.6
Expenditure (bn)	8.161	8.164	18.620	26.2	28.5	63.0

Macroeconomic outcomes (we missed the targets):

- ✓Economic recession (-8.5%);
- ✓+500% inflation;
- ✓Runaway exchange rate and price volatility
- ✓The estimated expenditures rose from $8.164 billion to $18.62 billion (after supplementary budget and closed the year at $26 billion

Economic Outlook: Cue from the National Budget

Budget Strategy Paper Sept 2019	2020 Budget Statement 14 Nov 2019
Growth target of 4.6%	Growth target of 3%
Month on month inflation of 2.3%	Month on month inflation of 2%
Expected Expenditure $28.5 billion	Expected expenditure $63 billion
Expected Revenue $24.8 billion & ($29.663 billion in 2021)	Expected Revenue $58.6 billion
Budget deficit of 1.8% of GDP	Budget deficit of 1.5% of GDP
Nominal GDP $209 billion (from current ($130 billion)	Nominal GDP $340 billion
Agric sector growth est 10.8%	Agric sector growth est 5%

Budget strategy paper is a framework which guides the national budget formulating process and as such its estimates should be very close to the final budget of 2020 as in this case. However, 2019 BSP was in total variance with the 2020 national budget statement in a space of 6 weeks which put doubts to the validity of 2020 budget estimates

Key Points:

1. **Real growth rate is 3% but nominal GDP is growing 162% can only be as a result of inflation;**
2. **Revenue is expected to be $58.6 billion from $21 billion in 2019, i.e., 179%;**
3. **The expected month on month inflation of 2% by year end is put in question;**
4. **The variation in the actual 2020 budget proposals from the prebudget strategy paper put into question the accurateness of the proposed figures – there are high chances that these figures can be changed again.**

Economic Outlook – Cue from 2020 Budget Assumptions

- *Improved rainfall season which should enhance agriculture production* – this is invalid observation since the country witnessed drought. In addition, the agricultural sector is in danger due to the incapacitation of the farmer on the back of the high cost of going back to the farm and capital erosion which happened as soon as the farmer got paid;
- *Electricity generation with trickle-down effects to all other sectors* – electricity generation is a medium to long term goal so we don't expect to see improvement in electricity generation in 2020 hence this assumption will not help the country in meeting its targets. **However, if Government had placed emphasis on electricity imports it will make sense;**
- *Recovery in aggregate demand* – there is no sign that demand will recover especially when one looks at the ugly exchange rate and inflation figures which are eroding income which is the major determinant of demand considering that PDL is now $4000;

Economic Outlook – Cue from 2020 Budget Assumptions (cont)

- *Improved foreign currency availability* – the foreign currency can only improve if we export. The current monetary policy framework which is characterised by interests spikes and manipulation of exchange rate will neither favour production which is the minimum priori requirement to generate exports through import substitution and exports.
- *Improved macro-fiscal stability and business confidence* – macroeconomic stability is not an overnight event. A stable environment requires us to stabilise exchange rate, then inflation and lead to growth – this is a long walk to freedom which requires credible policies. Confidence is build over time by walking the talk which is not happening – reference on policy inconsistency from 1 October 2018 to date.

Distortions Nexus Economic Instability

- The following presents distortions which have become real impediments to economic revival:
  - Distortions in the pricing of maize nexus free funds imports and shortage of mealie meal;
  - Distortions in the fuel pricing, that is, ZWL garages versus DFIs and the angels of corruption;

Distortions Nexus Economic Instability (cont)

- Distortions in the foreign exchange market and how it brings in rent seeking behavior across various economic agents (whether in the money markets, pricing, FX);
- Distortions in the pricing of electricity (USD pricing versus ZWL);

Review of New Exchange Rate Framework: Challenges Ahead

- The recently announced exchange rate management measures (**by Minister of Finance**) whilst good on paper faces the following risks which will undermine their effectiveness:
  - Because the system does not include everyone who want foreign currency to trade through the interbank, the black market will continue to thrive;
  - RBZ doesn't have enough liquidity (foreign currency) to seed into the market with a view of stabilizing it;
  - There is misplaced understanding of what constitute demand for foreign currency…. Large component of demand of foreign currency is coming from the informal sector, economic households and even firms which are not importing all in the name of trying to preserve value of their money in the face of chronic inflation – **it is therefore very difficult for the taskforce to manage the rate even if they bring 1 million professors of economics from Harvard University;**

Review of New Exchange Rate Framework: Challenges Ahead (cont)

- The announced penalties will not work because Government has no capacity to police the 5.7 million in the informal sector who are fully dollarized;
- distortions which are in the economy will be used as vehicles to corruptly drain foreign exchange from the system and will dry the market leading to escalation of the rate;
- In view of social pressures and humanitarian crisis, the budget has and will continue to force growth of money supply which will push the rate upwards

Socio-Economic Headwinds

- Erosion of capital/shrinking of companies
- Serious incapacitation of workers – both in private and public sector;
- Surge in money supply growth as the current stock of $20 billion broad money catches up with $63 billion budget. Broad money is anticipated to reach $100 billion with the following consequences:
  - Surge in exchange rates and inflation;
  - Supplementary budgets;

Socio-Economic Headwinds (cont)

- Economic decline and weakening demand;
- Continuous decay of the social infrastructures and services:
  - Health (Corona virus);
  - Education (primary, secondary & tertiary);
  - Water and sanitation

Socio-Economic Headwinds (cont)

- Ugly price spikes and price plateaus and ultimate dollarization with Government involved. Examples:
  – Electricity bills;
  – Passports;
  – Duties and finance bill;
  – Fast food industry pricing regime;
  – Fuel sector – how the commuters omnibus will deliver us to the dollarization destination
- Social and political tension

Dealing with Economic Challenges: Policy Perspective

- The country requires structural policies, that is, industrial, agricultural and national trade policies more and less emphasis on fiscal and monetary policies;
- Structural policies will deal with root causes affecting Zimbabwean economy, that is:
  - Low production;
  - Drought of confidence

Dealing with Economic Challenges: Policy Perspective (cont)

- On production, the budget didn’t exhaust trouble shooting areas which we are importing US$2.2 billion made up of cereals (US$519 billion), vegetables (US$200 million), soya beans (US$250 million), fertilisers (US$150 million), pharmaceuticals (US$250 million), iron & steel (US$300 million),tissues and paper (US$105 million), chewing gums, toothpicks, pampers, etc;

Dealing with Economic Challenges: Policy Perspective (cont)

- On confidence, the following are evident and must be addressed:
  - Lack of policy clarity, predictability, policy inconsistency, etc
  - the budget as noticed is a moving target and as such it will worsen the confidence situation and it becomes very difficult if not impossible to de-dollarize as we have noticed.

Responding to the Socio-Economic Challenges: Policy Perspective

1. Stabilisation of exchange rate - requires the following measures:
   - Closing the lid on money supply taking into account that already there is an injection of into agricultural sector through PIPs and also the risks coming with legacy debts;
   - Radical elimination of corruption especially in the foreign exchange market;
   - Improvement of supply of foreign currency through securing new lines of credit and stopping corruption which is causing serious wastage especially in the fuel sector (coming on the back of price distortions – US$0.50/litre at Z$ garage vs US$1.43.litre at DFIs);
   - Avoid manipulation of the interbank market
   - Mopping excess money
2. Provision of key utilities such as electricity, fuel and electricity;

Responding to the Socio-Economic Challenges: Policy Perspective (cont)

3. Production, Production, Production and Production through:
   - Creation of an enabling environment for business – this requires well thought policies not the knee jack reactionary policies we saw in recent months;
   - Reforms, that is, tax reforms, doing business reforms, SOE reforms and various legislative reforms (addressed but no timeline on ZIDA);
   - Stopping corruption will free money for productive use;
   - Commodity exchange – like previous budgets mentioned but no timelines
4. Social contract to deal with macroeconomic instability – the budget referred to COLA in dealing with wage erosion which will push inflation spiral.

Navigating the Socio-Economic Challenges: Microeconomic Perspective/At a Company Level

- In view of the ravaging inflation, what are the key performance indicators for the company? Is the company going to maintain the traditional indicators such as financial ratios or will place more emphasis of things like assets acquired as a store of value, stock, investments into key infrastructures? All of which will be used as capital when the currency finally collapse.

- What is the company strategy in 2020? Is the company going to spend great deal of time fighting a storm which is passing?
  - or the company will strike a balance in fighting the storm and become more strategic about the future – for example working along the value chain story presented by the opportunities coming with imports;

Responding to the Socio-Economic Challenges: Microeconomic Perspective/At a Company Level (cont)

- Moral suasion should also take centre stage in dealing with salary negotiations especially in the context of wage erosion nexus inflation and price spikes - there is no company which can compensate for the erosion of wages;
- Cost containment is key in keeping with erosion of cashflows
- Investment in research and development;
- Companies have to work on export as an alternative way of raising foreign exchange

Responding to the Socio-Economic Challenges: Microeconomic Perspective/At a Company Level

The main concern for companies is value preservation and this can be tackled using IAS 29.

The International Accounting Standard (IAS) 29 define the following as characteristics of a country in a hyperinflation (as is) and strategies employed:

a) The general population prefers to keep its wealth in non – monetary assets or in a relatively stable currency. Amounts of local currency held are immediately invested to maintain purchasing power;

b) The general population regards monetary amounts not in terms of the local currency but in terms of a relatively stable foreign currency. Prices may be quoted in that currency;

c) Sales and purchases on credit take place at prices that compensate for the expected loss of purchasing power during the credit period even if the period is short; and

d) Interest rates, wages and prices are linked to price index

It is a fact that this is already happening in Zimbabwe because the currency has lost its key function of store of value and ultimately medium of exchange!

Government fears on Dollarisation & Mitigation

- Government fears on dollarization are centred on:
  - Salary demands by civil servants;
  - Competitiveness challenges for export companies;
  - Ineffectiveness of the monetary policy and tight fiscal space;
  - Loss of sovereignty;
  - Loss of seignorage

Government fears on Dollarisation & Mitigation (cont)

- Can Government hold on the use of ZWL?
  - Already Government, under pressure, has given concession to fuel, fast food, passports and ZESA and is also demanding tax in forex. More demands for exemptions are coming from:
    - Companies in the distribution sector who will be accessing fuel priced in USD;
    - Exporting companies, just like companies with free funds, will demand to charge in foreign currency;
    - Food sector, especially mealie meal producers who have free funds will demand to price in foreign currency

Government fears on Dollarisation & Mitigation (cont)

- We are back to foliwars period in some sense and eventually Government will see final dollarization
- From a mitigatory perspective, Government will stand to raise salaries from taxes and build forex reserves from deposits something they cant do now.
- In addition, competitiveness will be fostered through the reform agenda

Way forward

In view of the observations made in this presentation the following recommendations are proffered:

Government must adopt dollarization

or

At the very least we should go for a dual currency – where ZWL and USD are used as the main currency

Thank you

AFRICA ECONOMIC DEVELOPMENT
STRATEGIES

www.dailynews.co.zw