

Zimbabwe: Economic Outlook January 2019

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In the Fiscal and Monetary policy statements issued on October 1, 2018, Zimbabweans were invited to believe that government was accurately focusing its attentions on the more serious problems and would soon be announcing decisive measures to overcome them.

These claims were repeated in the Transitional Stabilisation Programme, which emphasised that the adoption and implementation of imaginative fiscal and complementary monetary policies would rebuild investor confidence and open up the economy to more business. The Programme was therefore intent on increasing Public Sector Capital Expenditures to more than 25% of total spending in 2019 and expressed the hopes of private sector involvement.

As these policy documents were unusually critical in their assessments of government's past performance and as they acknowledged that the prevailing imbalances were fuelled by public deficits, which caused the unsustainably large fiscal borrowing requirements, they gave us confidence that these problems would receive attention. The admission that rapid money supply growth rates led to government consuming scarce foreign reserves, which undermined currency stability, also suggested that important policy changes were on the way.

Also, in envisaging that economic growth during the Programme period would be driven by the private sector, and that government's role would be to facilitate a supportive macro-economic and business environment, government was recognising the need for a fundamentally important policy change. Strengthening government expenditure management as well as fiscal responsibility to "crowd in" the private sector were described as "first and foremost" priorities.

Following on the same transformation lines, the Reserve Bank Governor claimed that the country was witnessing paradigm shifts on both the economic policy and political fronts, which he claimed were critical in breathing impetus for new growth into the economy. On the very disturbing currency issues, he made the surprising claim that, "The packages of reforms that have been put in place by Government since November last year provide a strong springboard upon which the economy is showing great signs of sustained recovery". However, he assured us that the proposed Monetary Policies would "cement these reforms by putting in place measures to strengthen the multi-currency system in order to safeguard financial and price stability".

In a separate Pre-Budget Strategy Paper, the 2019 Budget was to take further measures to prioritise Ease of Doing Business reforms by bringing a new investment authority into operation in order to attract larger inflows of direct foreign investment. This will be the Zimbabwe Investment Development Agency.

However, when it was presented on November 22, 2018, the National Budget carried no indications of commitment to any of the promised reforms. As a starting point, total spending is to rise by 47%, even though revenue is expected to increase by only 17%. Borrowings to fund the budget deficit will have to increase by 44,6% to \$4,1 billion. Government expenditure proposals, therefore, do not support the assurances offered at the beginning of October.

On the Public Sector Investment Programme figures, the Budget shows that the capital spending will come to only 18,4% of total expenditure, instead of the Transitional Stabilisation Programme target of "more than 25%".

Although proposals are being made to ensure that future Treasury Bill sales will be regulated by reverting to the former tender procedures, and although government accepts the need to comply with limitations imposed on the size of its overdraft with the Reserve Bank, the borrowing requirement will continue to place government into direct competition with the business sector for limited foreign reserves. It will also continue to crowd out the private sector's access to bank finance.

Any hopes that the measures would overcome distortions caused by the scarcity of cash were swept aside by government's recognition that RTGS balances¹ and US dollar balances needed to be banked in separate accounts. Market pressures began to generate exchange rate options, but this process was disrupted by government attempts to impose a 1:1 exchange rate. Differing rates on the various informal markets now accommodate the public's assumption that cost variations are inevitable, but poor guidance has given rise to disturbing wage demands. Price-setting trends being endured by shoppers have created serious instability that already shows signs of causing social unrest.

So far, government has failed to resolve the difficulties, but it is not clear whether they want to. It suits them to sustain the 1:1 exchange rate for privileged individuals, who have priority rights because of who they are, or what they import. Current conditions certainly contradict the RBZ Governor's claims that "signs of sustained recovery" are evident. On the contrary, the viability of many businesses is in doubt and the formal economy is a fragile state.

If it does want to overcome the problems, government's attempts to deal with them have missed their targets. One of the main challenges has been the budget deficit. The needed funds were raised mainly through sales of Treasury Bills and government bonds, all of which, as negotiable instruments, now appear as assets in the accounts of banks, building societies and pension funds. Their value matches the finance released by the buyers of government securities, so they duplicate the quantity of money involved and increase the Money Supply.

Other Treasury Bills of undisclosed value were used to settle government debts. When these were discounted in the money market, they also added to the growth of the money supply. Unfortunately, this additional money had the backing of neither local productive capacity, nor US dollar balances.

The value of money becomes unstable if it has no substantive backing. In this case, with the additional money quickly became purchasing power in the hands of government. As typical purchasing patterns inevitably call for access to imported goods, they increased the competition for scarce foreign exchange.

The budget deficit was already responsible for part of the trade deficit, but the exchange rate uncertainties introduced by the Monetary Policy Statement on October 1 2018 increased the cost of converting the ballooning RTGS balances into US dollars. Importers' RTGS balances were less valuable than the money they needed to pay for imports. Government's attempts to regulate the allocation of US dollars then led to further imbalances and pressures on money values.

The budget was expected to describe extensive plans to reduce future budget deficits by shrinking the size of government. Instead, it has chosen to close the gap by increasing taxes. Information on revenue inflows will be needed for some months before the impact of the new

¹ **Real Time Gross Settlement** systems are specialist funds transfer systems where the transfer of money or securities takes place from one bank to any other bank on a "real time" and on a "gross" basis. ... RTGS systems are typically used for high-value transactions that require and receive immediate clearing.

2% tax on almost all electronic transfers can be assessed, but its impact can be expected to cause a reduction in the taxes collected from other sources.

More seriously, this new tax on every link in the manufacturers' supply chain will be increasing production costs. These effects will make Zimbabwean producers less competitive.

The budget was also expected to reveal many new measures that would support the claim that "Zimbabwe is Open for Business" and that the country intended to become a serious competitor for direct foreign investment inflows. With costs being further increased by the new taxes, potential investors will see fewer chances of profiting from investments and will take their capital elsewhere.

In the Budget Speech, reference is made to the Ease of Doing Business, but in this, the Minister of Finance [Mthuli Ncube] chose to place the responsibilities for bringing about promised changes with line ministries, Parliamentary Portfolio Committees and local authorities. He could have taken a much more direct approach by listing and targeting for removal all the recently imposed permits, licenses, registration procedures and approval requirements. These are expensive and seriously discouraging for new investors, and are considered a serious burden by those already in business. The former Minister of Finance [Patrick Chinamasa] agreed that they served only to keep totally unnecessary jobs open in the civil service. Unfortunately, that is the argument that seems to be keeping them in place.

The Minister could also have listed the labour laws. These have become powerful rights for employees, but expensive obligations for employers. They impose barriers to all changes that involve labour-force restructuring, so they add to production costs, reduce productivity and slow all attempts to modernise.

These labour laws are also discouraging the arrival of new foreign investors, because they do nothing for the Ease of Doing Business. Provisions have to be made to fund retrenchment packages and these add further to costs that have to be recovered from customers. Almost any consumer goods that can be produced in Zimbabwe today can be imported at lower prices, so cost cutting is essential.

The Minister had another good reason to speak about changes to labour laws, because these laws are the most important of the reasons why he cannot downsize the Public Sector. Retrenchment packages amounting to several years' pay would have to be paid to almost all retrenched public sector employees, so it seems certain they will remain on the government payroll until this extravagant entitlement is removed. A start could be made right now.

Retrenchment packages had to be paid to private sector workers, even though it was politically-inspired policies that caused the loss of hundreds of thousands jobs. Employers had to face up to the financial challenges involved, but the retrenchment costs so badly depleted reserves that they affected investment levels. For some disgraceful facts, today, formal sector employment is well below its level at independence 39 years ago, but government employment is more than three times the 1980 figure. In the interim period, Zimbabwe's population has more than doubled.

The challenges imposed by the currency issues featured extensively in the Minister's Budget Speech, but most of the references were either to describe the existing problems, or were to impose requirements that companies earning hard currencies should pay their taxes in hard currencies. The adoption of policies that will instil confidence by improving the prospects of increasing economic stability are referred to more obliquely. Claims about the country's extensive mineral resources and growth potential did nothing to inspire confidence.

More deeply seated issues affecting confidence and discouraging investment inflows were not discussed. Many foreign organisations had been eagerly awaiting the outcome of the elections and had been looking for evidence of the frequently promised change of direction. They saw that the thinking was repeated in the October 1 2018 statements from the Ministry of Finance and the Reserve Bank, but also saw that these were not carried through into subsequent policy directives. Fears are now being expressed that government has slipped back into a control mode that replicates the measures in place under Mugabe.

Fuel shortages, the doctors' strike, threatened strike action by teachers, the spread of cholera, water rationing, pressure on US dollar allocations from mining companies, Delta Corporation and many others, have all affected confidence.

Perhaps the most disappointing event was the groundbreaking ceremony for a new parliament building, which is entirely irrelevant to the country's needs. All of these have called into question the government's frequently repeated claim that the New Dispensation is going to drive the country in a new direction.

To support their claim that a new era has definitely started, ruling party supporters usually refer to the number of senior posts that have changed hands, the suspension of board members, the list of parastatals being offered for privatisation and the investigations into the conduct of officials, but these have done nothing to place the country onto a more certain development path.

Key indicators that reflect government's determination to stay in control are in proposals for regulations that will govern the procedures for transferring foreign exchange from one bank client's nostro account to another's. This proposal involves nostro as well as RTGS accounts that will be set up by the Reserve Bank and it is intended to enable a settlement arrangement that will work through an independent Settlement bank. The Reserve Bank will be linked into the system so that mirror accounts will permit transfers to be monitored.

Each of the banks will open an account with the yet-to-be-identified Settlement bank by depositing an initial amount into their own nostro account with that bank. Subsequent movements to and from these accounts will reflect in the Reserve Bank's mirror accounts. The commercial banks will be free to change the balances on deposit in these accounts, according to their clients' requirements.

When local US dollar payments or Telegraphic Transfers have to be made from one local client to another, the necessary procedures will be followed through the Settlement bank. Such transactions will affect the commercial banks' Nostro accounts, not the Reserve Bank's mirror account at the Settlement bank. Similarly, foreign cash withdrawals will be from each commercial bank's nostro account and, despite its function as Lender of Last Resort, the Reserve Bank will not offer foreign currency loans to any commercial bank client.

Commercial bank clients would be required obtain and deposit the needed foreign exchange so that their bank can establish the required nostro account with the Settlement bank. In terms of the proposed arrangement, the Reserve Bank will not be permitted to have access to funds held in nostro account balances entrusted to the Settlement bank. A complication that could affect the proposals is that certain transfers have to be monitored by the US Federal Reserve Bank. International linkages between banks, their branches and subsidiaries, can put banks in danger of being accused of money laundering, funding terrorist movements or breaking American sanctions. Heavy fines have to be paid by banks found guilty of such transgressions. Zimbabwe is considered a threat. This needs urgent attention.

Separate proposals are being presented on the best options that could formalise and regulate conversions between RTGS dollars and US dollars. The current uncertainty and market

indiscipline is generating widely differing retail prices and it is threatening the survival of many suppliers. Part of the problem is that government insists that a 1:1 relationship still applies between the bond notes and US dollars. The value of the bond notes was originally said to have been secured, or underwritten, by Afreximbank. For some reason, nobody now claims that this relationship is actually functional.

As at the end of October 2018, the bond currency totalled \$521 million, compared to Transferable Deposits, mainly in the form of electronic money, totalling \$8 095 million. Foreign currency in the banks totalled only \$70 million. Adding the non-liquid government securities of \$3,1 billion, and various other longer-term loans, takes the financial asset total to \$13,8 billion. The backing behind the US dollar balances plus the backing offered by exports worth about \$4 billion a year, together with, if it does exist, the backing behind \$521 million in bond notes & coins, suggests that actual tangible support backs only about one third of the country's broad financial base.

As most of the dollars were created, rather than earned, by the money-duplication effect of selling Treasury Bills and bonds, it is difficult to argue that all these units should have a 1:1 relationship with the US dollar. Accordingly, those wishing to convert portions of their RTGS or electronic balances into foreign exchange should expect to have to pay extra. However, as the current process is not only haphazard, it is also technically illegal, the country is in need of ideas that will put the conversion process onto a formal and legal basis.

In all such debates, all manner of difficulties can be avoided by accepting that market forces, rather than authoritarian demands, are more likely to yield a workable answer. To facilitate this, proposals should be considered that the commercial banks could be authorised to establish a platform on which entirely market-driven supply and demand relationships could be used to establish daily or weekly exchange rates. If these rates were applied to all transactions without exception, discipline would be restored and the corruption sustained by privileges would be eliminated.

Policy decisions on these lines could bring back the stability on which the confidence of local investors could be rebuilt. From there, a real recovery could start to emerge.

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