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The art of creating money

An appraisal of Zimbabwe's economy

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Zimbabwe's economy continues to struggle. The much-anticipated economic growth and stability in the 'new dispensation' remain elusive and ordinary citizens continue to bear the brunt of the economic plunge. This report analyses key economic challenges the country faces; explores the political economy of Zimbabwe's economic reforms; and proposes necessary reforms to turn the economy around.

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Key findings

- Zimbabwe's economic woes have been perpetuated by a conflation of the state and ruling party, ZANU-PF, which has resulted in state capture by the party and created an intricate web of patronage and unbridled corruption.
- Inflationary pressures and currency depreciation through government profligacy have been the defining features of Zimbabwe's post-independence economic decline. A widening budget deficit is a major threat to macroeconomic stability and sustainable economic growth.
- The government adopted an inward-looking import substitution policy that created trade barriers in the form of import bans and tariffs to protect domestic manufacturers and save foreign exchange. However, low levels of productivity in local industries have spurred the demand for hard currency sourced on the parallel market to import products.
- The major driver of inflation is an increase in money supply through the issuance of Treasury Bills to fund budget deficits and state-owned enterprise debt. In August 2018, the value of Treasury Bills issued was US$7.6 billion. In addition, the Reserve Bank of Zimbabwe (RBZ)'s quasi-fiscal activities and debt repayments have increased the government's overdraft with the RBZ to US$2.3 billion, three times higher than its statutory limit. The purchase of hard currency on the parallel (unofficial) market has also fuelled inflation.
- The country's foreign currency reserves are depleting because the RBZ continues to draw down on them to cover government obligations.

Recommendations

- First, the government needs to reorient itself from a closed state-led economy to a modern, market-oriented economy. This model of growth would be driven by an innovative and entrepreneurial private sector that could compete in niche global markets. Light-touch facilitation by the government would guide economic growth along its chosen development path.
- The second strategic imperative is a move from a protectionist import substitution trade strategy to an export-oriented one, where policy is directed towards enabling the private sector to compete successfully on global markets. Supportive policies would include judicious investment in infrastructure, improved education and skills, and cutting red tape to enable companies to operate at lower costs and optimum efficiency. The fundamental aim is to close the current account deficit and find a permanent solution to perennial cash and foreign exchange shortages.
- The third major change is to create an independent central bank that would revert to its traditional role of controlling the money supply to ensure macroeconomic stability. In particular, a target rate of inflation of 3–7% would enable the RBZ to keep interest rates relatively low and stable to buttress private sector investment – especially foreign direct investment to augment local capital investment to drive the economy and create desperately needed jobs.

Introduction

Since the departure of Robert Mugabe as president, Zimbabwe has experienced a distinct change of mood and rhetoric. Gone are the menacing police roadblocks and foreboding First Lady. With an air of calm benevolence, President Emmerson Mnangagwa portrays himself as the face of change – the 'new dispensation'.

Since his election as president in August 2018, Mnangagwa has distanced himself from the Mugabe era by declaring his administration the 'Second Republic'. His mantra is to put the economy before politics, boldly declaring that 'Zimbabwe is open for business', with the aim to transform the country into an upper middle income society by 2030.

According to the narrative of the reformed ruling party, ZANU-PF, Mnangagwa is destined to revive Zimbabwe's ailing economy with massive infusions of new foreign investment. By his own reckoning, he has attracted US$16 billion in foreign investment so far. His former finance minister, Patrick Chinamasa, thought that Zimbabwe would 'easily' achieve an economic growth rate of 6% per annum this year. And the reason for foreign exchange shortages, if one asks Reserve Bank of Zimbabwe (RBZ) Governor John Mangudya, is that the economy is growing so fast. This stream of good news flows effusively from the pages of state media, especially *The Sunday Mail*.

The Zimbabwe Independent, though, sees the economy quite differently.[1] It accuses government officials of propagating a misleading impression of an upbeat economy. The brutal reality, it tells its readers, is that Zimbabwe is on the verge of a catastrophic fiscal collapse and runaway inflation. The government's reckless borrowing from banks through the issuing of treasury bills is crowding out the private sector and financing its ever-widening budget deficit.

On the streets, the mood is equally gloomy. Long queues and interminable delays lie in store for those desperate for the few bond notes sporadically dispensed from ATMs. In supermarkets, the few dollars in shoppers' EcoCash wallets (a mobile phone money transfer system) buy less with each visit. Meanwhile, as bread shortages loom and fuel queues lengthen, frenetic RBZ officials scramble to source foreign exchange for imports of wheat and fuel.

Who to believe? The approach adopted here presumes a standard market economic model as a benchmark against which to assess Zimbabwe's economic policies. That is to say, the aim of economic policy is to achieve high levels of sustainable and inclusive growth and full employment, while maintaining macroeconomic stability. 'Sustainable' means steady growth and resilience against external shocks, such as a strengthening US dollar or oil price hikes. 'Inclusive' means that, as far as possible, everyone, especially the poor, benefits from economic growth. 'Full employment' means that as many people as possible have jobs in the formal sector. But it also means that the country's capital assets are operating near their full productive capacity. 'Macroeconomic stability' means keeping inflation within the Southern African Development Community (SADC)'s target of 3–7% per annum. A solid economy also includes relatively high levels of savings and investment, at around 30% of gross domestic product (GDP), including foreign direct investment (FDI). It is also necessary to keep debts to manageable levels of less than 40% of GDP.

> The economic fortunes of nations are inseparable from politics and governance

As Zimbabweans well know, it is axiomatic that the economic fortunes of nations not only depend on the application of sound economic principles and public financial management; they are also inseparable from matters of politics and governance. In their book *Why Nations Fail* economists Acemoglu and Robinson make a crucial link between state institutions and economic performance.[2] 'Inclusive' economic institutions based on free and competitive markets, they argue, require the state to create an environment conducive for investment through independent and effective state institutions, especially the judicial system, to enforce property rights and uphold the rule of law.

In trying to comprehend Zimbabwe's uniquely opaque and dysfunctional economy, this report briefly lays out Mugabe's legacy of economic governance. Additional policy details explain Zimbabwe's state-led economic development model in section three, including the government's economic

blueprints, the Zimbabwe Agenda for Sustainable Socio-Economic Transformation (ZimAsset: 2013–2018) and its recent replacement, the Transitional Stabilisation Programme (TSP: 2018–2020), presented by the new Minister of Finance Mthuli Ncube. Mnangagwa's foreign investment guidelines presented at the World Economic Forum in Davos, Switzerland, in January 2018 are then outlined. The last part of the report is devoted to analysing the economy, especially the causes of currency shortages and inflation, as well as the veracity of claims that a 'flood' of imminent foreign investment is destined to transform the country's fortunes. Fortunately, the economy's tailspin need not end with another crash. Strong and decisive economic reforms, recommended in the conclusion, would stabilise the economy and lay the foundations for inclusive and sustainable growth.

The restored legacy

In early November 2017, Zimbabwe's Commander of the Armed Forces Gen. Constantino Chiwenga accused counter-revolutionaries aligned to a faction within ZANU-PF known as 'G40' of infiltrating the party to destroy it from within.[3] The General made it clear that the military would 'protect the revolution' without hesitation by stopping forthwith any further purging of party members with liberation credentials. Within the week, Gen. Chiwenga mounted Operation Restore Legacy, which deposed Mugabe on 17 November 2017, to restore the ruling party's hold on power. Within the month, the general had resigned, cast off his uniform, donned suit and tie and, as the newly appointed first vice-president, stood shoulder-to-shoulder with Zimbabwe's new president, Emmerson Mnangagwa.

It was the plainest confirmation, if one were needed, of the conflation of party and state, and the military's role as guarantor of the revolutionary party's right to rule. The principle that state institutions served the interests of ZANU-PF lay at the core of Mugabe's centralisation of state power. In 1984, he said:

> if the future is to see a greater pace in the unfolding of our socialist revolution, the party must assume its proper historical role by being accorded a place in our society in which 'all economic and social organisations and institutions of the state will', as Nicolae Ceausescu says, come 'under its political control and act in a single manner for building the socialist system'.[4] This situation is only possible when a one-party state democracy has been established.

As Mugabe consolidated his political power, such aspirations would increasingly guide Zimbabwe towards the capture of state institutions and a state-led economic order.

PATRONAGE IS THE HANDMAIDEN OF GRAFT AND CORRUPTION

In September 1987, Mugabe steered Constitutional Amendment 7 through Parliament, establishing himself as Zimbabwe's first executive president. By December of that year he had crushed the main opposition party,

ZAPU, and compelled its leader, Joshua Nkomo, to sign the Unity Accord to establish a de facto one-party state.

As president of the party and state, Mugabe used his sweeping constitutional powers to appoint loyalists to all state institutions – including senior civil servants, judges, military commanders and police commissioners, and directors of all state-owned enterprises (SOEs) and parastatal organisations. Their remit was to maintain presidential and party political power. That meant, first and foremost, a legislative majority to enact laws that could be selectively or punitively applied, as well as commandeering national assets and state finances to serve the interests of the party.

> The livelihoods of farming households depended on deference to party and government authorities

Just as political control was necessary to gain economic control, so control of the state's finances and the means of production would be translated into political control. This was exercised by the simple expedient of rewarding supporters with economic benefits and withholding them from members of the opposition. For example, under Zimbabwe's resettlement and land reform programmes virtually all agricultural land was transferred to the state.

Given that the acquisition, allocation and occupation of agricultural land was the prerogative of the state – and, by extension, the ruling party – the livelihoods of farming households depended upon deference to party and government authorities. If farmers also hoped to benefit from food handouts and farm inputs, their chances were immeasurably improved by holding a ruling party membership card.

The economic problems created by this patronage system are threefold. First, patronage cannot flourish easily within a market economy. It works more effectively in a command economy where the state can acquire, control and allocate benefits and resources to its supporters and favoured constituencies, while denying them to others.

Second, the patronage relationship is premised on a simple equation: economic benefits in exchange for political loyalty. There may be hope, but neither the expectation of repayment for benefits nor the requirement of proper stewardship of SOEs and parastatals. Senior positions, jobs, land and other benefits are not allocated on the basis of beneficiaries' skills, experience or track record of competence. Loyalty is sufficient unto itself.

Third, patronage is the handmaiden of graft and corruption. Officials at every level become gatekeepers who demand a price to allocate land, offer jobs, issue licences, arrange loans or grant favours for one privilege or another. Hence, corruption does not involve a few bad apples who can be exorcised from the system. Corruption, as the former finance minister, Patrick Chinamasa, put it, 'has permeated every fabric of our national life and character, and is now in our blood as it were.'[5]

Zimbabwe's economic model

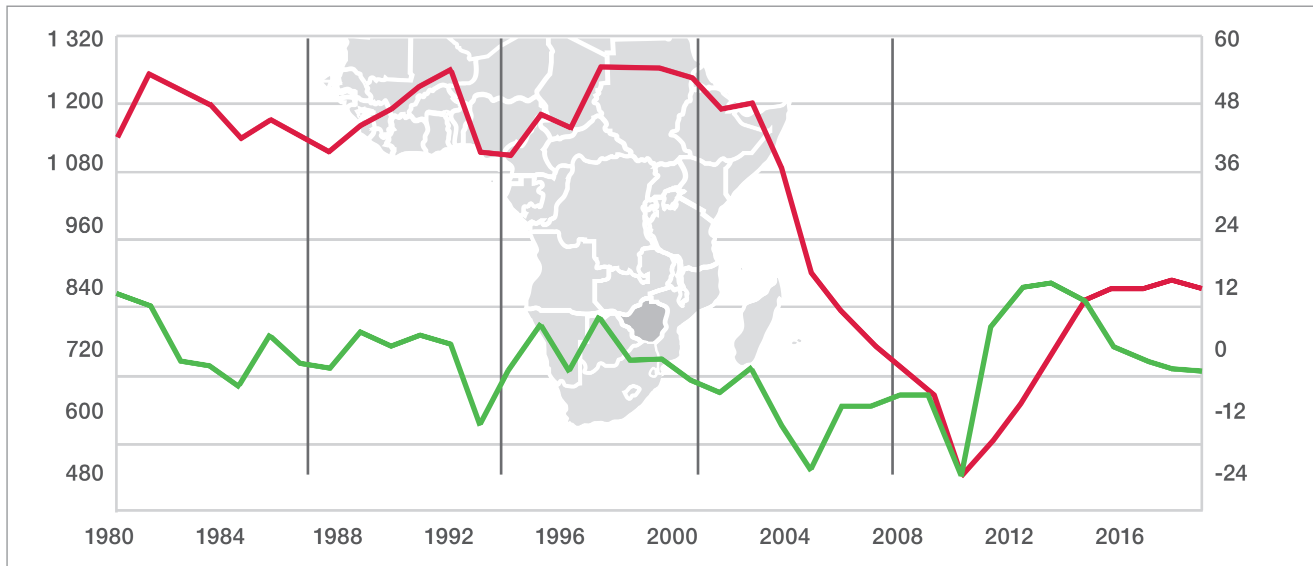
Driven by patronage, the hallmark of the Mugabe government since independence has been unconstrained expenditure. In the 1980s, a burgeoning civil service saw unsustainable budget deficits fuelling inflation and the inevitable slide of the Zimbabwe dollar (Z$). In 1980, 63 Zimbabwe cents bought 1 US dollar (US$). By the end of the decade it took Z$2.64 to buy a US dollar.

Continued profligacy saw the Zimbabwe dollar's decline throughout the 1990s and the emergence of a 'parallel' or black currency market. When the government designated 1 471 white-owned commercial farms for acquisition in November 1997, the markets reacted immediately. On 'Black Friday', 17 November, the Zimbabwe dollar collapsed, losing half its value in a single day. By then, it was officially trading at Z$18.61 to US$1 – and Z$25 to US$1 on the parallel market.

The watershed moment came with the electorate's rejection of Mugabe's draft constitution in a referendum in February 2000. To shore up support before elections scheduled for June 2000, Mugabe crushed the opposition Movement for Democracy (MDC)'s rural support base by invading white commercial farms.

Amid the chaos and a plunging Zimbabwe dollar, Gideon Gono, the RBZ governor, announced an economic turnaround plan that would launch Zimbabwe

Figure 1: Zimbabwe GDP and per capita income (Z$, 1980 to 2016)



Source: Knoema, Zimbabwe economic growth and personal welfare from 1980 to 2016

into stratospheric hyperinflation and economic collapse. 'Traditional economics do not fully apply in this country,' he said. 'I am going to print and print and sign the money … because we need money.'[6] In 2007, Finance Minister, Herbert Murerwa, tried to rein in the RBZ's payment of government expenditure, referred to as quasi-fiscal activities. But Mugabe backed the bank's governor, saying:

> They have this word they like using; 'quasi, quasi, quasi'. But I tell them that this is expenditure that we need. We are under sanctions and there is no room for the type of bookish economics we have at the Ministry of Finance.[7]

Gono went on to print million-dollar notes, then billion-dollars notes and finally a Z$100-trillion note before the Zimbabwe dollar collapsed in 2008. Soon afterwards, in 2009, with the establishment of a 'Government of National Unity' (GNU) between ZANU-PF and the MDC, the country adopted a multi-currency regime pegged to the US dollar.

Zimbabwe's political and economic travails are illustrated in Figure 1, which shows the percentage changes in GDP (green line and right axis) and changes in per capita income, expressed in US dollars (red line and left axis). GDP was generally modest but positive up to 2000, except for an unprecedented drought in 1992. After 2000, Zimbabwe's growth dropped precipitously to -12% of GDP in 2003 and 2008.

Growth picked up significantly with the formation of the GNU, but tailed off again after Mugabe resumed power in 2013. Figure 1 also shows that by 2008 per capita incomes had dropped to under US$600, half their level at independence.

Under the restraining hand of finance minister Tendai Biti, who served between 2009 and 2013, the economy bounced back. But the resumption of ZANU-PF power in 2013 spelt a return to Mugabe's spendthrift ways and a slowing of the economy. ZimAsset, the government's five-year economic plan (2013–18), promised Zimbabweans undreamt-of prosperity. It projected a growth rate of 9.9% by 2018 and promised to liquidate US$6.1 billion of debt, build 250,000 low-cost houses and create 2.2 million jobs. Counting on Chinese support, ZimAsset was premised on attracting an implausible US$27 billion in foreign financing.

Although Mugabe met with Chinese leader President Xi Jingping in August 2014 to sign nine so-called 'mega deals' to fund ZimAsset, no figures were mentioned. Others expressed doubts about ZimAsset's credibility. Australia's ambassador to Zimbabwe, Matthew Neuhaus, put it bluntly: 'ZimAsset', he said, 'is not an economic plan. It is just an aspirational document.

It lists the things [the government] wants to achieve, but there is no mechanism to achieve those things.'[8]

When the mega-deals were slow to materialise, Mugabe laid out a 10 Point Plan to reposition Zimbabwe, he said, 'for major economic take-off in keeping with ZimAsset, which requires massive capital injection and rapid implementation.'[9] The plan hinged on building confidence to attract foreign investment through business reforms, creating special economic zones, establishing a one-stop investment centre and fighting corruption.

Other measures included boosting agricultural output for industrial processing to earn foreign exchange; promoting joint ventures to improve the performance of SOEs; and infrastructural development to reduce the cost of production and doing business. There was no commitment, though, to institutional and economic reforms or the government's state-led economic model.

Biti's successor, Chinamasa, gave full expression to the president's plan in his 2016 budget statement. Titled 'Building a Conducive Environment that Attracts Foreign Direct Investment', his budget promised to protect investors through Bilateral Investment Promotion and Protection Agreements (BIPPAs).

Subsequently, billions of dollars in investment deals were announced. A tender had been awarded for the US$2-billion Beitbridge-Harare-Chirundu Highway; the finance minister announced a US$1.4-billion loan for the expansion of Hwange Thermal Power Station; and Nigerian businessman Aliko Dangote was to pour US$1.2 billion dollars into three major projects. And more: along with a Hong Kong investor betting US$1 billion dollars on reviving ZiscoSteel, a US$3-billion Batoka Gorge hydro-electric power scheme was mooted.

Thus, by the time Mnangagwa took over the presidency, the government's foreign investment strategy and state-led economic model were nothing new: they were already well underway.

Open for business

In his inaugural address, Mnangagwa said, 'Today the Republic of Zimbabwe renews itself.' While acknowledging agriculture as the mainstay of the economy, he repeated the call for 'investment-led economic recovery'. However, his was not a ringing endorsement of a market economy. Instead, Zimbabwe would 'incorporate elements of a market economy … interacting with strategic public enterprises … through mutually gainful partnerships with international investors.'[10] It became evident that the president's new dispensation would follow the well-worn path of ZimAsset, Mugabe's 10 Point Plan and foreign investment-led strategy.

At the 2018 World Economic Forum, Mnangagwa unveiled his Investment Guidelines and Opportunities in Zimbabwe and declared that 'Zimbabwe is open for business'. The introductory chapter was alluringly titled Towards

ZIMASSET PROJECTED A GROWTH RATE OF

9.9%

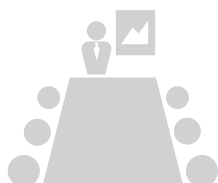
BY 2018

a New Economic Order. He promised investors a properly run economy and a reform agenda founded on sound market-based principles and legal protections in order to build a competitive private sector. His new economic order, however, had a familiar ring.

The legal protection of investments lay at the core of the guidelines. Zimbabwe, it averred, would adhere scrupulously to the principles of legal protection under international law to encourage private enterprise. In particular, Zimbabwe committed itself to protecting foreign investments from expropriation by respecting its international legal obligations under BIPPAs. In the event that an investor's properties were acquired for public purposes, *prompt and adequate* compensation would be paid to the investor in accordance with international law. Should any dispute arise, investors were reassured by Zimbabwe being a signatory to the convention establishing the International Centre for the Settlement of Investment Disputes (ICSID), an international tribunal.

Another central plank of Zimbabwe's commitment to building investor confidence were reforms that would make it easier to do business in the country. Other key reforms included amendments to the country's Indigenisation and Economic Empowerment Act and accelerating the full liberalisation of the current account. These reforms meant that investors need not enter into ventures with local partners and that they could freely externalise their profits and dividends. They could also import spares and materials without having to seek Reserve Bank (Exchange Control) approval. The investment guidelines encouraged investors to take advantage of opportunities in the manufacturing sector, especially in joint partnerships with the government and the privatisation of selected SOEs. Investors were also promised attractive tax incentives, tax breaks and concessions.

Burnishing its credentials as a responsible member of the international community, the investment guidelines committed Zimbabwe to repaying foreign and domestic debts, as well as compensating commercial farmers for the farms they lost during the land reform programme. Finally, Zimbabwe promised the highest standards of governance by ensuring efficient and transparent oversight by state regulatory authorities and by dealing ruthlessly with corruption.



MNANGAGWA PROMISED INVESTORS A PROPERLY RUN ECONOMY AT THE 2018 WORLD ECONOMIC FORUM

Investor confidence

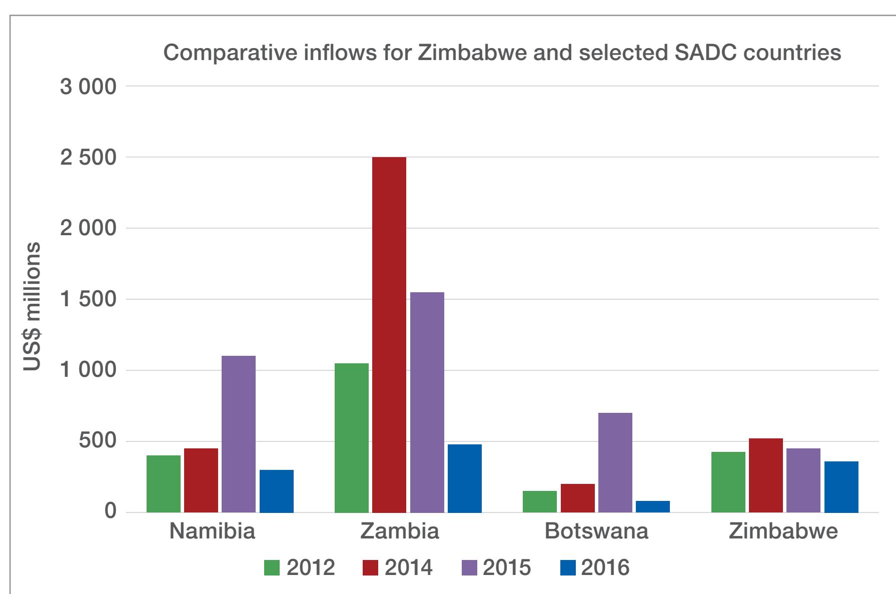
Minister of Foreign Affairs and International Trade Sibusiso Moyo assured investors that Zimbabwe had embarked on far-reaching political and economic reforms. Mnangagwa, he said, had declared the country 'open for business so that the rest of the world can see this awakening giant.'[11] The president boasted that he had signed US$16 billion dollars' worth of investment deals.

Since extraordinary claims require extraordinary evidence, it is necessary to enquire more deeply into the nature, type and probability of these investments materialising. Investors would also be interested in the

transparency of deals, while Zimbabweans would wonder whether the priorities of investments addressed their concerns over unemployment, currency shortages and inflation.

The first question, though, is whether the investment deals actually constitute Foreign Direct Investment (FDI), which is the flow of investment capital by firms and individuals into a country. Figure 2, below, compares FDI flows for Zimbabwe with those for Namibia, Zambia and Botswana from 2012 to 2016. Only Zambia exceeded the US$2 billion mark. Zimbabwe has consistently received less than US$500 million in FDI.

Figure 2: FDI Flows (2012 to 2016)



Source: V Bhoroma, The case for FDI into Zimbabwe, Business Weekly, 26 January 2018

The deals Mnangagwa claims to have notched up include a US$300-million platinum refinery; a US$1-billion injection into ZiscoSteel; the US$4.2-billion Karo Resources platinum project; a US$2.1-billion Lupane coal bed-to-methane project; and smaller lithium and mining investments. Yet, as with a litany of so many celebrated but failed investment initiatives, seeing is believing.

Other investments are not FDI, but concessionary loans from foreign governments to provide capital or to construct facilities and, hence, are repayable in hard currency. Despite moratoriums and concessionary interest rates offered on these projects, the repayment of these loans will only add to Zimbabwe's foreign exchange shortages and its already debilitating debt burden.

ZIMBABWE HAS CONSISTENTLY RECEIVED LESS THAN

US$500 million

IN FDI

A major concern for investors is the transparency of the tendering process. In August 2016, for example, the government awarded the tender for constructing the US$2-billion Beitbridge-Harare-Chirundu Highway to Geiger International of Austria and China Harbour Engineering Company (CHEC). Potential investors might have wondered how CHEC,

which was blacklisted by the World Bank, could participate in – and win – the tender. Nonetheless, in April 2018, Mnangagwa cancelled the agreement, citing lack of progress.

The real reason, though, was to offer China a sweetener. Zimbabwe needed funding from China to complete Hwange Power Station's units 7 and 8. But China had been irked by the government's takeover of Anjin, a diamond-mining company in which China's Anhui Foreign Economic Construction Group (AFECC) had a stake. Zimbabwe therefore agreed to transfer the highway contract to AFECC in return for Chinese funding to complete the Hwange project.[12] Such high-level backdoor dealing could compromise any trust that more principled investors may have had in Zimbabwe's tendering and project procurement system.

Long-suffering Zimbabweans would probably also question the government's investment priorities. The Mnangagwa administration's first major investment pact was a Chinese loan to build a new US$77-million parliament, plus US$153 million to expand Harare's international airport. These loans will swell Zimbabwe's debt.

> The Mnangagwa government has not shown its determination to break with the past

Can the government really justify such big prestige projects given Zimbabwe's other pressing infrastructural needs? To cite but one example: Harare loses about 60% of its treated water through leakages because 5 000 km of its water pipes are obsolete.[13] A new parliament building will be small comfort to the city's water-dependent factories, businesses and families.

Ease-of-doing-business reforms, according to the investment guidelines, are pivotal to building investor confidence. In his 2016 budget statement, Chinamasa tasked the Office of the President and Cabinet with scaling up and driving the process under the Rapid Results Approach. Then vice-president, Mnangagwa headed the Doing Business Inter-Ministerial Committee and was given a target date of March 2016 for the *completion* of all major ease-of-doing-business reforms.

Chinamasa's aim was to see Zimbabwe's World Bank international ranking for ease of doing business move up from 155 in 2016 to within the top 100 countries by 2017. But rather than moving up 55 places in 2017, Zimbabwe slipped to a dismal ranking of 159 out of 190 countries. It was the worst-placed country in southern Africa.[14] Investors may thus be forgiven for their scepticism about the government's renewed promises on doing business reforms.

Investors are also guaranteed legal protection through BIPPAs. But consider Zimbabwe's record. After 2000, the government failed to protect foreign-owned farms that were covered by BIPPAs from invasion and seizure. It made no attempt to pay prompt and adequate compensation, which international law requires and the guidelines promise. Instead, 11 Dutch farmers and the German von Pezold family were forced to drag the Zimbabwe government to the very international tribunal, ICSID, which Zimbabwe's investment guidelines hold up as proof of the country's commitment to respect international law.

Despite the tribunal ordering Zimbabwe to pay the Dutch and German farmers compensation in 2009 and 2013, respectively, the government has not honoured its international obligations. Given that Zimbabwe is in contempt of an international court, other governments are likely to be wary of entering into new BIPPAs. It gets worse. The Mnangagwa government has not shown its determination to break with the past by upholding property rights and the rule of law. Members of the ruling elite continue to invade farms and mines. The seizure of a flourishing government seed farm by the vice-president's wife Marry Chiwenga undermines the very protections that Zimbabwe has guaranteed in its investment guidelines.[15] Few acts of impunity could have done more to damage to investor confidence.

Fiscal policy

Inflation can be caused by external shocks, such as a price increase in imported oil, or having to pay more for imports if a trading partner's currency strengthens. In Zimbabwe, it is also caused by shortages of foreign exchange (explained in more detail below). But the

most common cause of inflation is the size of the fiscal deficit: that is, when government expenditure exceeds its revenues.

The need to cover this additional expenditure by government borrowing through the issuance of Treasury bills not only increases the government's debt and reduces available financial resources for lending to the private sector, but inflates the money supply. As more money becomes available to buy the same stock of goods and services, prices rise. Like printing money, it dilutes the value of money, which is reflected in inflation.

Finance Minister Chinamasa challenged the 'classical economics' principle that 'if you don't have revenue, don't spend.' He went on to say, 'I don't share that view. For me, we can borrow depending on why and where you apply the money.'[16] Presumably, his reasoning – like that of his counterpart Mangudya, the RBZ governor – is that the level of borrowing is inconsequential if funds are allocated to productive uses. Mangudya believes that ramping up state-led production to grow the economy will increase tax receipts from taxable corporate profits, create jobs whose wages can be taxed, produce goods on which value-added taxes can be levied and, thereby, close the budget deficit.

There are two problems with this approach. The first is that their *expansionary* policy fuels already high levels of inflation. When faced with a budget deficit and inflationary pressure, it is incumbent on a government to dampen inflation by adopting *contractionary* economic measures by cutting expenditure. This will reduce borrowing and decrease the money supply to bring inflation under control. It also reduces the country's debts.

The second problem is that there is no evidence that high levels of expenditure will raise tax revenues to close the budget deficit. In general, government allocations of capital do not face the same strictures as private capital, which must carefully weigh risks to minimise costs and maximise returns in order to repay loans, meet tax obligations and stay afloat. In the case of Zimbabwe, the government allocates scarce capital to the least productive, but politically favoured sectors. These include the Command Agriculture programme, providing finance to the farming sector; the RBZ's quasi-fiscal 'empowerment facilities', such as artisanal gold mining; and resuscitating inefficient, highly indebted SOEs.

These state-sponsored individuals and organisations bear no risk and feel no obligation to repay capital, interest or taxes. Beneficiaries of Command Agriculture, for example, failed to repay US$100 million.[17] And, according to the TSP, a fund to 'empower' the youth, the Youth Fund, collapsed because 84% of beneficiaries failed to repay their loans.

The investment guidelines' suggestion that Zimbabwe is building a competitive economy based on market principles is in stark contrast to the state's control over agricultural commodities, land and capital markets. When the government closed down the commodity exchange in 2001, it set prices of agricultural products itself. Since 2014, it has fixed the producer price of maize at US$390 per tonne, which is more than double the current world price of around US$180 a tonne.[18] Had the government paid this world market price for the 2.1 million tonnes that Zimbabwe produced in 2017, it would have saved taxpayers US$440 million.

> There is no evidence that high levels of expenditure will raise tax revenues to close the budget deficit

The government also poured over a billion dollars into agricultural subsidies, which were the main driver behind Zimbabwe's US$2.6 billion budget deficit.[19] When the government took control of virtually all agricultural land, the land market collapsed, but also immobilised capital markets. Since state-owned farms cannot be transferred to third parties, farmers cannot use their land as collateral to access loans from financial institutions to pay for farm inputs and equipment.

As a result, not only have agricultural investment and production suffered, but it provided the pretext for the government to transfer hundreds of millions of taxpayer dollars into benefits for the ruling party's rural constituencies. As the IMF was quick to point out, such excessive government subsidies on agriculture worsen cash shortages, increase inflation and create 'significant

fiscal risks'. Sustainable growth, it stressed, requires a reduction in fiscal deficits and the implementation of 'reforms to attract investment.'[20]

Yet the government remains unperturbed. Under the Command Agriculture programme, it intends to spend even more: US$1.25 billion.[21] This expenditure is in addition to the government's other major fiscal headache. On top of 90% of tax revenues going towards paying Zimbabwe's bloated civil service, the government has offered public servants pay increases of between 17.5% and 22%, leaving next to nothing to meet recurrent operating costs, spend on investment or pay off its debts.

Without cutbacks in state-led agricultural expenditure and its massive public wage bill, the government needs to either borrow more or raise new taxes. It has chosen to do both. The budget deficit for the first six months of 2018 was US$1.4 billion and is projected to reach US$2.7 billion by the end of the year. As a result, net government borrowing from the banking system has risen from US$6.3 billion to US$7.7 billion (i.e. the US$1.4 billion needed to close the fiscal gap). As an added measure, the finance minister announced a controversial 2% money transfer tax, subsequently amended to include certain exemptions.

Trade policy

Despite reasonably strong mineral and tobacco sales, Zimbabwe's imports have persistently exceeded its exports. Its current account deficit (i.e. negative trade balance), which is expected to more than double from US$316 million in 2017 to US$636 million in 2018, is the prime cause of foreign exchange shortages. Of particular concern is the widening trade gap for goods and services which is expected to reach US$2.15 billion in 2018.

The imperative for economic growth, and to ease foreign exchange and cash shortages in the medium term, is to boost exports. As Paul Krugman, who won the Nobel Prize for Economics for his work on trade, observed:

> What a country really gains from trade is the ability to import things it wants. Exports are not an objective in and of themselves. The need to export is a burden a country must bear because its import suppliers demand payment.[22]

International trade in goods and services on competitive global markets is primarily based on the economic principle of comparative advantage. Countries trade in those goods they produce most efficiently and cost-effectively to earn foreign exchange. History has shown that market-based, export-oriented economies – from the Asian tigers to China and Vietnam – register the highest growth rates and fastest reductions in poverty.

THE BUDGET DEFICIT IS PROJECTED TO REACH
US$2.7 billion
BY THE END OF 2018

At the heart of Zimbabwe's trade deficit is a policy conflict between an export-oriented trade policy based on comparative advantage and global competitiveness to *earn* foreign exchange, on the one hand; and a protectionist import substitution policy based on self-sufficiency and local competitiveness to *save* foreign exchange, on the other. The former relies

primarily on creating conditions that enable the private sector to operate efficiently to facilitate exports on *global* markets; while the latter relies on constraints to trade to enable SOEs and local businesses to become self-sufficient to provide goods and services for the *domestic* market.

Zimbabwe champions its import substitution and self-sufficiency policy. For example, until recently, Command Agriculture was formally known as the Specialised Maize Production and Import Substitution Programme. State media readily celebrate any production as foreign exchange saved, regardless of the costs and budgetary implications.

But the most telling expression of the government's trade policy – in breach of Zimbabwe's international trade obligations under the SADC Free Trade Area Agreement – was to raise tariffs and impose import bans by gazetting Statutory Instrument (SI) 64 of 2016. The then finance minister, Chinamasa, reasoned that domestic production would become more competitive – it would 'level the playing field', he said – by making imported goods more expensive on the *local* market. The meaning of competitiveness in trade theory, though, is quite different. Trade agreements aim to remove trade barriers, especially tariffs, to level the playing field for all countries to compete fairly on *international* markets.

Protectionism will only make Zimbabwean companies *less* competitive on global markets. As many protected local firms will inevitably need to import goods, materials and spares – while lacking the competitive edge to export and earn foreign exchange – an import substitution policy will worsen currency shortages. Moreover, tariffs will increase the cost of local and imported goods paid by hard-pressed Zimbabwean consumers.

Import substitution policies based on self-sufficiency also come at a high economic cost because they run counter to the economic principles of opportunity cost and comparative advantage. For example, the government allocated US$140 million to its Command Wheat programme and Zimbabwe's Grain Marketing Board buys wheat for US$466 per tonne from local growers.[23] The world price of wheat, however, is just US$210 per tonne and the total cost of importing wheat into Zimbabwe is around US$375 per tonne.

Because Zimbabwean farmers must bear the additional cost of irrigating their wheat, they are at both an absolute and comparative disadvantage when growing and trading in wheat. Trade theory holds that Zimbabwe would benefit significantly if it used its scarce water supplies to grow and export suitably identified high-value crops that have lower opportunity costs than its trading partners and, hence, enjoy a comparative export advantage. It would also earn more foreign exchange to help end its currency shortages.

Protectionism will only make Zimbabwean companies less competitive on global markets

Foreign exchange

When the government began suffering persistent and widening current account deficits and cash shortages, it took control of the country's foreign exchange reserves and allocations. In May 2016, the RBZ announced measures to deal with cash shortages while simultaneously stabilising and stimulating the economy. But rather than setting out a programme of fiscal, monetary and trade reforms, the governor, Mangudya, deflected responsibility for cash shortages using a number of specious economic arguments.

First, he suggested that Zimbabwe had become overly dependent on the US dollar. Then he blamed the public for making insufficient use of debit cards and electronic transfers. Low levels of local production, he continued, were responsible for driving the demand for imports. Businesses were accused of 'externalising' US dollars.

These arguments were the prelude to his justification for instructing commercial banks to channel half of their clients' foreign exchange earnings into the RBZ's coffers. The private sector and banks' laissez-faire approach, he maintained, were responsible for the 'inefficient distribution and utilisation of foreign exchange resources.' The RBZ, he claimed, could do better. Its 'priority list' would henceforth guide the bank's control and distribution of foreign exchange.

Since bond notes and real-time gross settlement (RTGS) balances (i.e. funds received by electronic transfer and unsupported by actual dollars) could not be used for

imports, their value gradually depreciated against the US dollar. When Zimbabweans and their businesses responded perfectly rationally by holding or buying US dollars, either to import goods or to exchange them for depreciating bond notes and RTGS balances, they were accused of sabotaging the economy.

Mnangagwa was persuaded to use his presidential powers on 1 December, issuing SI 145, which declared a three-month moratorium for 'looters' to repatriate funds they had allegedly externalised to foreign banks using spurious transactions. But, given the iron laws of economics, it was unsurprising that his threats made little impact on the parallel currency markets or the inevitable depreciation of RTGS balances.

> Remittances into Zimbabwe reached US$935 million in 2015

The investment guidelines had also promised investors that they could freely remit investment income such as profits and dividends offshore without having to seek Reserve Bank (Exchange Control) approval. To facilitate the repatriation of dividends, the RBZ had established a Portfolio Investment Fund. But as foreign shortages began to bite, the backlog in dividends awaiting remittance to international shareholders had reached US$75 million by October 2017.

British American Tobacco was refused permission to remit US$10 million to shareholders and US$5.5 million payable to international suppliers. Underlining the seriousness of these defaults, a representative of Export-Import Bank of India said: 'In all discussions … we should be talking of ease of remittance out of Zimbabwe. This has been a major stumbling block for investors wishing to invest in Zimbabwe.'[24]

Without the necessary reforms to resolve the currency crisis, the RBZ resorted to stop-gap measures: a Nostro Stabilisation Facility to ring-fence borrowings from Afreximbank.[25] The RBZ borrowed US$545 million in 2016, a further US$600 million in 2017, and it is currently negotiating an infusion of an additional US$500 million in foreign exchange.

To guarantee repayments to Afreximbank, the RBZ simply raised platinum and chrome exporters' mandatory foreign exchange transfers to the RBZ from 50% to 80%. Its predictable justification was to 'ensure effective administration of foreign exchange' and 'guarantee equity in the foreign exchange market.'[26] More recently, the RBZ has adjusted the amounts surrendered to 80% for tobacco and cotton, 70% for gold, and 65% for platinum, diamonds and chrome. Exporters of all other products retain 100% of their earnings.

Remittances into the country, another key source of foreign exchange, reached US$935 million in 2015, but had tumbled to US$699 by 2017 because hard currency was 'comingled' with RTGS balances. This meant that deposits in foreign exchange could not be withdrawn and their value immediately depreciated to the parallel market rate for RTGS balances – that is, by nearly half. Realising this, the RBZ created Diaspora Investments Accounts where deposits with local banks are ring-fenced against co-mingling. Alternatively, those in the diaspora can buy diaspora investment bonds or invest in Diaspora Tobacco and Gold Production Financing, which are bonds to fund the RBZ's quasi-fiscal activities. Diaspora remittances have, however, remained subdued.

Monetary policy and debt

Rising imports continue to exceed export revenues. Between February and June 2018, the trade deficit rose by 34% to US$1.26 billion. As less currency trickled into Zimbabwe, the government's expansionary fiscal programme demanded ever more funds. It was this simultaneous widening of both the current account and budget deficit that created the currency shortages.

Trouble started when the RBZ began drawing down its foreign currency reserves to pay civil servants. When these reserves started drying up, the RBZ instructed commercial banks to reduce their own nostro reserves (US$ accounts) and surrender a designated portion of exporters' earnings to the RBZ. In recompense, the RBZ credited exporters' bank accounts with an equal amount denominated in US dollars, but which could only be used for internal RTGS electronic money transfers.[27] US dollars were thus miraculously created and the balance in RTGS accounts became a localised and surrogate form of currency. But since it was not

actual money, only a book entry, it did not have an underlying reserve that could be withdrawn as cash.

The RBZ also printed its own version of US dollars – bond notes – under the pretext of creating an export incentive. It claimed they were backed by US$200 million in Afreximbank reserves. Sceptics demurred, especially when the RBZ decided to increase its bond note programme to US$500 million in August 2017. Bond notes in circulation had risen to US$379 by June 2018.

The third method of creating money was to use the government's overdraft facility with the RBZ to pay government creditors and fund quasi-fiscal activities through the RTGS payment system. Details are hazy, but are understood to have included payments to agricultural suppliers, payment of government debts to parastatals, as well as subsidies towards the RBZ's US$470-million quasi-fiscal 'production and empowerment facilities'. Beneficiary, SOE and parastatal accounts were simply credited with funds or had their debts written off against the government's overdraft with the RBZ. By the end of August 2018, the government's overdraft stood at US$2.3 billion, three times higher than the legal limit imposed by section 11(a) of the Reserve Bank Act.

But even as the government printed bond notes and created ever more virtual money, the dearth of real export earnings and inflows of hard currency meant that the RBZ's foreign reserves continued to dwindle. By September 2017, the backlog of requests for foreign exchange had reached US$600 million, of which international airlines were owed US$50 million.

Businesses not considered a priority were forced to tap into the parallel market, paying higher and higher premiums in RTGS funds for hard currency to stay in business. Such was the desperation that even the Zimbabwe National Road Authority was forced to buy foreign exchange on the parallel market to pay its debts to the Development Bank of Southern Africa.[28] By October 2018, traders were paying 3 RTGS units for each genuine US dollar.

The ballooning RTGS balances sitting in banks proved all too tempting for the government. On discovering it could access these balances by issuing Treasury Bills, the former deputy finance minister, Terence Mukupe, asked tongue-in-cheek, 'Why are we printing the [Treasury Bills]?' To which he replied: 'We do not have the IMF, so we have to create our own IMF.'[29]

By April 2017, the government had issued over US$4.4 billion in Treasury bills at an average interest rate of 8%. The unintended consequence, though, was to crowd-out lending to the private sector, where capital is most efficiently allocated through the market and earns the highest returns to generate economic growth and jobs. By August 2018, bank loans to the government – through the issuing Treasury bills – had increased by 70% to US$7.7 billion; yet loans to the private sector had edged up by only 7%.[30]

Continued government borrowing from banks is now putting the stability of the banking sector at risk. From a mere 4% a few years ago, one-third of bank assets now consist of government debt, or 1.7 times the level of

BY THE END OF AUGUST 2018, THE GOVERNMENT'S OVERDRAFT STOOD AT

US$2.3 billion

the banks' capital base. Treasury bills are already heavily discounted in the market by 20–30%, and up to 45%. Should the government default and panic ensue, with banks trying to liquidate their assets simultaneously, discounts would rise and values plunge, putting banks' solvency at risk.

In tandem with the issuing of Treasury bills, the money supply increased by 44% in 2017 and a further 40.8% by June 2018 to US$9.14 billion, compounding the dangers of inflationary pressure and adding to the government's unsustainable domestic debt burden. Domestic debt, which stood at just US$442 million in 2013, had surged to US$10.5 billion by February 2018.

But even this pales into insignificance when compared to the debt the government owes in compensation payable for the commercial farms it seized after 2000. The government behaved as though its constitutional obligation to pay compensation simply did not exist. When this liability is brought into account and reflected on the government's balance sheet – as must happen – Zimbabwe's debt position could conceivably skyrocket to an eye-watering 200% of GDP, and more.

In addition to its domestic debt, Zimbabwe's foreign debt stands at over US$8 billion, of which two-thirds (US$5.6 billion) is in arrears. Of these arrears, US$1.4 billion is owed to the World Bank and US$680 million to the African Development Bank. The TSP reiterates Zimbabwe's commitment to clear these Bretton Woods debts in the hope of borrowing fresh capital and entering into negotiations with its other external creditors for debt relief or rescheduling.

Economic recovery and growth

Without a change of strategy and the implementation of fundamental economic policy reforms to close the budget and current account deficits, no end is in sight for a stagnating economy beset by currency shortages and an inflationary spiral. While the government maintains the fiction that inflation rose to 5.4% in September 2018, US economist Steve Hanke calculated that inflation had hit 156% by October 2018.

The path to macroeconomic stability and national prosperity demands at least three broad changes to Zimbabwe's economic strategy:

- The first is a reorientation from a closed state-led economy to a modern, market-oriented economy. This model of growth would be driven by an innovative and entrepreneurial private sector that could compete on niche global markets. Light-touch facilitation by the government would guide economic growth along its chosen development path.
- The second strategic imperative is a move from a protectionist import substitution trade strategy to an export-oriented one, where policy is directed towards enabling the private sector to compete successfully on global markets. Supportive policies would include judicious investment in infrastructure, improved education and skills, and cutting red tape to

ZIMBABWE'S DEBT POSITION COULD CONCEIVABLY SKYROCKET TO AN EYE-WATERING

200%

OF GDP

enable companies to operate at lower costs and optimum efficiency. The fundamental aim would be to close the current account deficit and find a permanent solution to perennial cash and foreign exchange shortages.

- The third major change is to create an independent reserve bank that reverts to its traditional role of controlling the money supply to ensure macroeconomic stability. In particular, a target rate of inflation of 3–7% would enable the RBZ to keep interest rates relatively low and stable to buttress private sector investment – especially FDI to augment local capital investment to drive the economy and create desperately needed jobs.

In the meantime, the economy demands immediate policy reforms. The most critical is to balance the budget by reining in government expenditure on subsidies to agriculture, SOEs and the RBZ's quasi-fiscal empowerment facilities. As the government should not 'create' US dollars, the Treasury must run a cash budget by following Biti's inimitable remark: 'We eat what we kill.'

Producer price subsidies on commodities, especially maize, could be significantly reduced by re-establishing an agricultural commodity exchange and allowing the market rather than the state to determine prices. Input markets for seed, fertiliser and farm equipment, as well as import commodity markets – from wheat and soya to electricity and fuel – could be efficiently handled by the private sector, rather than the leaden, bureaucratic hand of the state.

While creating a land market involves a long-term programme of providing secure and transferable rights over agricultural land, the process could be initiated by providing secure property rights over farms that still have registered title. Repealing Section 72 of the Constitution – along with the Gazetted Land (Consequential Provisions) Act – would align Zimbabwe's laws with the SADC Tribunal ruling under international law, facilitate bank lending, and send a strong and unmistakable signal regarding property rights to foreign investors. Currently, bankers have been reluctant to lend to farmers with title deeds because even productive farms can be acquired and reallocated by nothing more than a gazetted notice and an offer letter.

Given the RBZ's return to its orthodox monetary role, all spending on quasi-fiscal activities should cease. Spending less would not only enable the government to significantly cut its level of borrowing – by reducing its overdraft and ceasing to issue Treasury bills – but reduce the money supply to mitigate the threat of runaway inflation. It would have the added benefit of reducing government debt and stabilising the banking sector as it resumes lending to the private sector. Given the private sector's ability to allocate capital more efficiently to investments that yield higher returns, Zimbabwe's economy would show clear and early signs of recovery.

> Spending less would enable the government to significantly cut its level of borrowing

Another immediate policy requirement would be to hand back foreign exchange to the firms that earned and owned it, without the need for Reserve Bank (Exchange Control) approval. The RBZ cannot match the market's allocative efficiency and, after all, if this privilege can be offered to foreign investors, why not to local ones?

Given the devaluation of RTGS balances and their current co-mingling with US dollars, it is necessary to ring-fence any future deposits into new foreign currency accounts and then create a currency market where foreign currency can be openly traded against RTGS balances. There would be no need for the RBZ to determine priorities. If state-owned electricity supplier ZESA, for example, required foreign exchange to import power, it could exchange its RTGS balances (received from consumers) for South African rand to meet its obligation to pay South African electricity supplier Eskom.

In his October 2018 Monetary Policy Statement, the RBZ governor directed banks to separate nostro foreign currency accounts from RTGS balances. Yet, the government insists on trying to put the currency genie back in the bottle by maintaining the illusion of a 1:1 ratio between the value of the two accounts.

Threats by the president and the vice-president against illicit dealers accused of economic sabotage by

manipulating the currency to create artificial shortages and unjustified price hikes, serve only to undermine the government's credibility to grasp market fundamentals. Allowing banks greater freedom to set market-based interest rates would gradually lead the exchange rate between RTGS and US dollar balances to stabilise and perhaps converge.

A further short-term measure to reduce government expenditure and cut its losses would be to overhaul the SOE and parastatal sector. As opposed to the tepid privatisation programme proposed in the investment guidelines, the dire state of the economy demands much bolder measures. The government should shelve appeals for investors to resuscitate already dead and doomed SOEs that have proved such a burden on the fiscus and taxpayers.

> The government needs to develop a clear and coherent long-term economic reform strategy

Instead, all SOEs providing *commercial* goods and services should be privatised. The reason is simple: the government is already weighed down by the hugely demanding task of efficiently delivering a wide range of *public* goods and services, from defence and policing to education and health. Moreover, the lesson of history is that governments inevitably make a mess of meddling in business.

The government needs to develop a clear and coherent long-term economic reform strategy to build a modern market-based economic system:

- The first long-term reform is to create a smaller, more efficient and affordable civil service geared towards the effective delivery of public services. By establishing a reformed and more flexible labour market, civil servants would gradually be attracted from the public service to job opportunities created by a vibrant private sector. As the public sector wage bill shrinks and tax revenues rise (from taxes earned from a more profitable private sector), the Treasury could increase allocations for government operational expenditure and infrastructural investments to significantly improve efficiency.
- The second is an agrarian reform programme based on secure and transferrable rights to all agricultural land, including communal land, to stimulate well-functioning land and capital markets. Over time, more farmers would have access to capital markets for seasonal and long-term investments that would make their farms more productive, provide outputs for industrial processing and earn foreign exchange to mitigate currency shortages. The corollary is that the government's declining expenditure on farm input subsidies would enable it to channel investment spending into productivity-enhancing infrastructure projects – especially roads, water and power – to undergird agricultural growth and industrial processing.
- The third strategic reform is to create an open market economy by removing tariffs and barriers to investment and trade. The government's investment guidelines recognise that the crucial accompaniments of FDI are innovations, technologies and skills that drive competitiveness and economic growth.[31] In addition to earning foreign exchange and resolving the crisis of cash shortages, opening up the economy would create a wealth of job opportunities, especially for Zimbabwe's legions of unemployed graduates.

Giving substance to these reforms requires a painstaking process of building a realistic and well-integrated institutional, policy and legal framework that articulates exactly *how* macro-economic stability and sustainable economic growth will be achieved.

Concluding remarks

History shows us that no country is interminably locked into an irreversible downward spiral. For all the economic solutions, including those presented here, there is a need, above all, to think and do things differently. In particular, a post-liberation vision or narrative should create an inclusive political culture where democracy and tolerance become a natural way of thinking and behaving.

The core values of governance that constitute a pluralistic society – human rights, secure rights to property and the rule of law – undergird the building of an open, market-based economic system. Freedom

to engage in political activity goes hand-in-hand with freedom to engage in economic life.

The most pressing need for Zimbabwe is the restoration of public trust in its state institutions. At the top of the governance reform agenda is the need to clearly separate the ruling party from the institutions of state: not just the military, judiciary and media, but also SOEs, parastatal organisations and regulatory authorities. It is also the essential first step towards systematically dismantling the patronage system and eradicating the endemic corruption that afflicts the economy.

While markets and the private sector are the engines that drive economic growth, an essential ingredient of the modern state is an impartial and efficient merit-based state bureaucracy that serves all citizens equally and fairly, irrespective of their gender, race, ethnicity or political affiliation.

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