

POLICY BRIEF

Zimbabwe's currency 'curse' and the economic malaise

Keith Jefferis

Zimbabwe has been plagued by currency problems. In June 2019 the government banned the multicurrency system and reintroduced the defunct Zimbabwean dollar. The move was intended to address the fast-deteriorating economic crisis and bring sanity to foreign currency supply and demand, in a broader context of economic and political failure. This policy brief discusses Zimbabwe's currency crisis and its implications for macroeconomic stabilisation.

Key findings

- ▶ Zimbabwe experienced full dollarisation from 2009–19, following hyperinflation and the collapse of the Zimbabwean dollar.
- ▶ Countries that have experienced partial dollarisation have, in some instances, managed to recover and re-establish their domestic currencies. The key requirements for such de-dollarisation to succeed are:
 - Ensuring macroeconomic stabilisation, particularly by bringing down inflation, reducing fiscal deficits and ensuring balance of payments stability
 - Using a market-based rather than a compulsory process to exchange dollars for domestic currency
 - Liberalising foreign exchange markets and eliminating (or dramatically reducing) parallel market premiums
- ▶ There is no example in recent history of a country that has abandoned its currency as a result of currency instability (as in Zimbabwe), become dollarised, and then re-introduced a domestic currency.
- ▶ Zimbabwe's de-dollarisation essentially involves introducing a brand new currency, rather than using an existing one.

Recommendations

- ▶ Zimbabwe needs to address the structural dissonance in its economic policy in order to bring about stability. Among the host of issues identified in the country's International Monetary Fund Staff Monitored Programme, the country needs to stop taxing exporters (through compulsory currency surrender requirements) and subsidising imports (notably fuel subsidies) in order to stabilise the balance of payments and hence the exchange rate.
- ▶ Zimbabwe is not in a position to stabilise the new Zimbabwean dollar any time soon, in which case the re-adoption of a foreign currency as legal tender has to be considered.
- ▶ The South African rand is more relevant given the pattern in Zimbabwe's foreign trade, and less likely to lead to the competitiveness problems that plagued the US dollar regime. Adopting the rand is not straightforward, however, and would require the agreement of the South African government.

Introduction

Some of Zimbabwe's biggest headaches over the past two decades have been currency issues, specifically the choice of an appropriate currency regime and periods of extreme currency instability.

This policy brief considers the long-term causes of the crisis, and briefly discusses some of Zimbabwe's policy options and imperatives going forward. It does this in the context of the types of currency and exchange rate regimes in use around the world and the roles of governments and central banks; associated policy frameworks; and the experience of other dollarised economies.

Types of currency and exchange rate regimes

Exchange rate regimes relate to the arrangements put in place by governments to determine the value of national currencies in relation to other, foreign currencies. They are often classified along a spectrum according to their degree of flexibility and the extent to which the exchange rate is determined by market forces.

At one extreme, a freely floating currency has its value determined solely by supply and demand in the foreign exchange market. At the other extreme are 'hard pegs', which include currency boards¹ and situations where a

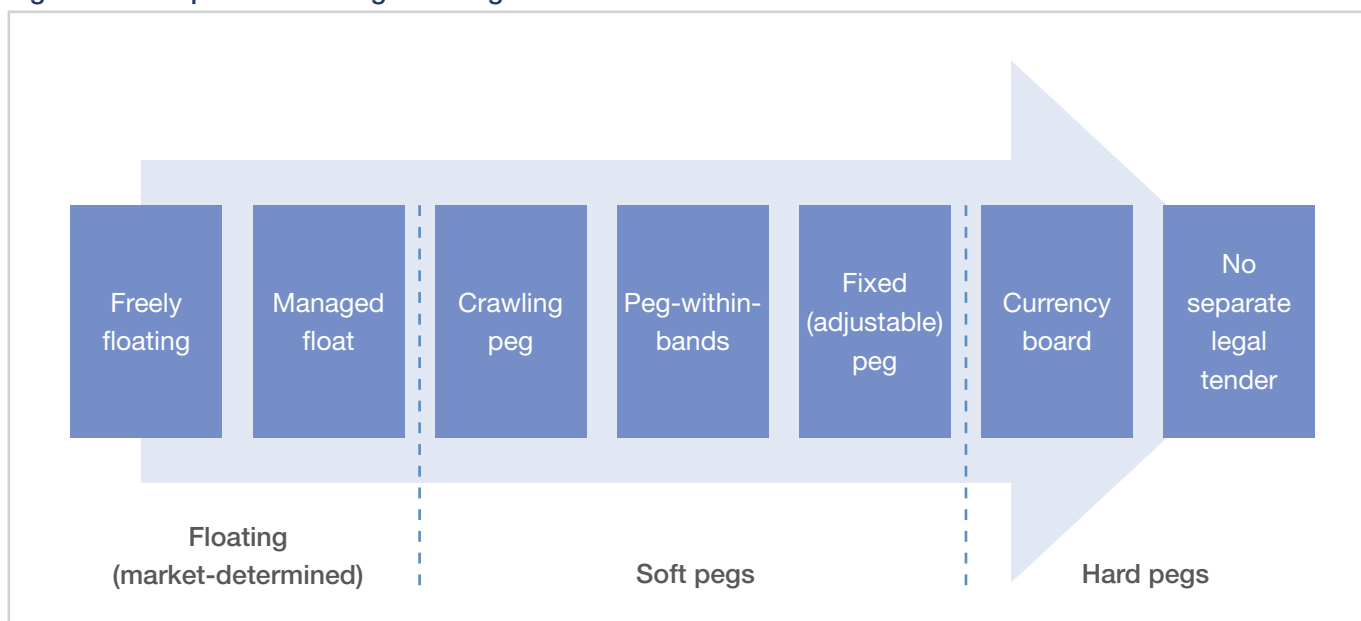
country has no separate currency or legal tender ('full dollarisation'). In between are various types of managed arrangements with different degrees of market forces, rules, laws and interventions by governments and central banks determining a currency's value, including managed pegs and floats.

Monetary unions are a special case, with countries sharing a regional currency rather than using a single national currency. These include the Euro Zone, the Eastern Caribbean Currency Union (ECCU), and the two CFA (*Communauté Financière Africaine*) zones in West and Central Africa.³ There is also the Common Monetary Area (CMA) in Southern Africa, a quasi-monetary union whose members are South Africa, eSwatini, Lesotho and Namibia.

The CMA is not a full monetary union as it does not have a single currency or central bank. However, it has some characteristics of a monetary union in that the South African rand circulates in the three smaller countries, and the national currencies that these countries issue are pegged at 1:1 with the rand.

There is no 'right' exchange rate regime, and there are examples of countries using all of the arrangements shown in Figure 1. However, different regimes will suit different countries at different times, and the optimal choice depends on a wide range of country-specific

Figure 1: Examples of exchange rate regimes



Source: author, drawing from IMF (2018).²

circumstances and priorities. Furthermore, the choice of exchange rate regime has implications for other aspects of macroeconomic policy, such as monetary policy. We will revisit this issue in the context of Zimbabwe below.

Different exchange rate regimes have different regulatory, policy and operational requirements. In almost all cases a country's central bank (reserve bank or monetary authority) plays a crucial role. This can include overseeing foreign exchange markets and licensing participants in those markets; intervening in those markets by buying or selling foreign currency to support or maintain fixed or managed exchange rates; conducting foreign exchange auctions; administering foreign exchange controls (if they exist); and managing a country's official foreign exchange reserves.

The choice of exchange rate regime has implications for other aspects of macro-economic policy, such as monetary policy

This is in addition to other central bank functions that typically (but not always) include control of the issuance of domestic currency; the formulation and implementation of monetary policy; regulation and supervision of financial institutions; lending to government; lender of last resort to banks; and operation/oversight of payments systems.

This is not always the case, however, most obviously in a monetary union (such as the Euro Zone) where the role of national central banks is essentially restricted to that of bank regulation, financial stability and payments, while monetary policy is handled by the regional central bank (e.g. the European Central Bank).

Where countries have currency boards (such as Hong Kong), there is no active role for monetary or exchange rate policy, and indeed wherever there is a pegged exchange rate the implementation of monetary policy becomes passive, with little or no scope for central bank discretion.

Zimbabwe's currency history

Zimbabwe's currency history has been through various phases. For most of the period between independence in 1979 and 2009, Zimbabwe officially operated a fixed (managed) peg regime, with the Zimbabwean dollar pegged to the US dollar. While pegged exchange rates were common historically, since the collapse of the Bretton Woods agreement in 1973 there has been a steady shift internationally towards more flexible exchange rate regimes.⁴

Many African countries adopted fixed or pegged exchange rates on attaining independence. Pegged exchange rates were intended to support macroeconomic stability, but in many cases could not be maintained as the currencies became overvalued relative to economic fundamentals. The same happened in Zimbabwe, and the peg to the US dollar – despite



THERE IS NO 'RIGHT'
EXCHANGE RATE REGIME

periodic adjustments to the exchange rate – became increasingly unsustainable.

As in several other African countries – although to a much more extreme degree in Zimbabwe – the cause of this was large government budget deficits and rapid growth of the money supply. There was an insufficient supply of foreign currency at the official, pegged rate, and a parallel market emerged with a heavily depreciated, market-determined exchange rate.

The inconsistencies of the macroeconomic policy framework and the resulting hyperinflation led to unofficial dollarisation of the economy in the late 2000s, as the Zimbabwean dollar could no longer perform the conventional functions of a currency. Following the 2008 elections and the formation of the Government of National Unity (GNU), a multi-currency regime (with multiple legal tenders) was introduced in February 2009, while the Zimbabwean dollar was to all intents abandoned.

This regime lasted until mid-2019, when the Zimbabwean dollar was formally reintroduced (in the guise of RTGS⁵ dollars) and made the sole legal tender. Since its formal reintroduction the exchange rate has depreciated rapidly, on both the official and parallel markets.

What are the causes of Zimbabwe's monetary instability? The underlying problem in the decades after independence was an attempt to maintain a fixed exchange rate (through the peg to the US dollar) that was inconsistent with Zimbabwe's macroeconomic fundamentals. The exchange rate became increasingly overvalued – relative to Zimbabwe's international competitiveness – leading to balance of payments (BoP) problems, shortages of foreign currency, and the emergence of the parallel market.

In the 2000s this long-term problem was compounded by the rapid expansion of the money supply through fiscal deficits and the Reserve Bank of Zimbabwe's (RBZ) quasi-fiscal activities. The RBZ created money and spent it on behalf of government, for instance on agricultural subsidy schemes, which led to hyperinflation.

The de facto abandonment of the Zimbabwean dollar and the adoption of the multi-currency regime in 2009 led to rapid – albeit temporary – macroeconomic stabilisation, with hyperinflation ending overnight as the RBZ could

no longer print money. In 2009 and for some years afterwards, economic growth turned positive, while inflation was maintained at low levels.

This situation was not sustainable, because subsequent macroeconomic and political reforms were weak and not entrenched. In addition, a number of inconsistent macroeconomic policies were re-introduced or intensified, especially after the end of the GNU in 2013 and the resumption of ZANU PF rule.

Notably, whereas the GNU ran a largely balanced budget (driven by cash budgeting principles, i.e. only spending money that had been collected), since 2014 budget deficits have increased rapidly, financed by government borrowing and money creation. These inconsistencies resulted in increasing US dollar shortages in the financial system, which in turn led to a loss of convertibility between dollars held in banks (RTGS dollars) and US dollars (in the form of cash or for transfers/payments outside of the country). Although the RTGS dollar was initially worth one US dollar, this parity could not be maintained in practice.

Many African countries adopted fixed or pegged exchange rates on attaining independence

Other problems that the governments of 2008–2018 failed to address included a deteriorating business environment, rampant corruption, hostility to foreign investment due to the indigenisation laws, and the failure to start a debt restructuring process. All of these undermined the ability to increase exports and attract capital inflows.

In order to understand the reasons for the shortage of US dollars, despite Zimbabwe's being a de facto dollarised economy, it is necessary to refer to Zimbabwe's BoP. In a country with its own currency the central bank can create and supply money to the banking system, and to the economy as a whole. In a country without its own currency, this option is not available.

In a formal monetary union such as the Euro Zone, the regional central bank may carry out this function, but in the case of unilateral dollarisation (outside of a monetary

union) the central bank cannot play this role.⁶ A dollarised country (and its banking system) can only expand its access to currency through transactions with the rest of the world. We can see how this occurs with reference to the BoP.

Many developing countries have deficits in most components of the current account of the BoP, for instance with higher imports than exports (a balance of trade deficit). This may be offset to some extent by inflows from diaspora remittances and foreign aid.

However, current account deficits are not necessarily a problem, if countries benefit from inflows of foreign direct investment (FDI) and/or have access to international capital markets for borrowing. For them, a surplus on the financial (capital) account can offset a deficit on the current account of the BoP, leading to an increase in foreign exchange reserves and banking system liquidity in line with the growth of the economy.

Zimbabwe's problem is that it runs a substantial current account deficit but does not benefit from inflows of FDI (discouraged by high political and economic risk).⁷ It also does not have access to international capital markets for borrowing (due mainly to outstanding arrears on outstanding debt), while official foreign exchange reserves are largely depleted. Without access to foreign currency from trade or capital inflows, the supply of US dollars in the economy in general and the banking system in particular is highly constrained.

At the same time, government has been running fiscal deficits funded by the creation of RTGS dollars by the RBZ. With a shortage of US dollars, and the creation of RTGS dollars, it was inevitable that the RTGS dollar would depreciate. Essentially, the government did not follow the golden rule of a sustainable dollarised (or currency board) system, which is that money supply (or contraction) must solely be driven by the BoP.

Country experiences with dollarisation and de-dollarisation

While the term 'dollarisation' is widely used, it refers to a range of different circumstances.⁸ Sometimes it refers to a situation where a country has its own currency, but for various reasons that currency enjoys insufficient confidence and a foreign currency is in widespread use.

The three main functions of a currency are store of value; medium of exchange; and unit of account. Especially when inflation is high, the ability of a currency to discharge these functions is inhibited, and individuals and firms may prefer to use a foreign currency (particularly as a store of value and a unit of account).

Partial dollarisation occurs when a foreign currency – often but not always the US dollar – significantly displaces the domestic currency. A key phenomenon is when residents choose to hold their assets in dollar-denominated bank accounts. By contrast, full dollarisation occurs when a country drops its domestic currency (in law or in practice) and completely adopts a foreign currency (or currencies). There are 13 countries (besides Zimbabwe) around the world that are fully dollarised.⁹

Zimbabwe experienced full dollarisation during the decade 2009–19, following hyperinflation and the collapse in value of the Zimbabwean dollar. During 2009–19 only foreign currencies were used, and dollarisation was complete. As noted above, dollarisation is not particularly unusual.

The three main functions of a currency are store of value, medium of exchange and unit of account

Countries that have experienced partial dollarisation have, in some instances, managed to recover from that position and re-establish their domestic currencies. The key requirements for such de-dollarisation to succeed are:

- Ensuring macroeconomic stabilisation, particularly bringing inflation down, reducing fiscal deficits and achieving BoP stability
- Using a market-based rather than a compulsory process to exchange dollars for domestic currency
- Liberalising foreign exchange markets and eliminating (or dramatically reducing) parallel market premiums

Examples of successful recovery from (partial) dollarisation include Israel, Poland, Angola, Bolivia and Peru.¹⁰ Zimbabwe is different, however, as de-dollarisation essentially involves introducing a brand new currency, rather than increasing the use of an existing one.

There are examples of countries introducing a new currency in place of a pre-existing foreign or regional currency, including Botswana (which dropped the South African rand in 1976), the Czech and Slovak republics on the break-up of Czechoslovakia in 1993, and South Sudan on achieving independence in 2011.¹¹ The first three of these were successful, but South Sudan's was not.

The crucial factors in the successful cases were the credibility of these countries' (new) central banks and macroeconomic policies. These factors are not yet present in Zimbabwe, which is attempting to introduce a new currency with a two-decade history of economic and currency crisis, and a central bank (the RBZ) that is still trying to re-establish its credibility.

There is no example in recent history of a country that has abandoned its currency as a result of currency instability

There is no example in recent history of a country that has abandoned its currency as a result of currency instability (as in Zimbabwe), become dollarised, and then subsequently re-introduced a domestic currency. Ecuador dollarised in 2000 following a period of macroeconomic instability and high inflation, but has retained the US dollar as its sole legal tender.

It has been claimed that Zimbabwe must reintroduce a domestic currency because of the need to have its own independent monetary policy. This is not a valid argument. There are 57 countries that have no separate legal tender, are members of monetary unions or operate a currency board,¹² and hence do not have an independent monetary policy.

In addition, most of the additional 43 countries that operate conventional fixed exchange rate pegs also lack an independent monetary policy, because in these circumstances monetary policy is driven by the need to support the exchange rate rather than influencing aggregate demand or inflation.¹³

Way forward for Zimbabwe

What is the way forward for Zimbabwe in terms of its currency?

Macroeconomic stabilisation is essential, and the government that has been in place since 2018 has taken some steps in this regard with the adoption of an International Monetary Fund (IMF) Staff Monitored Programme (SMP) in May 2019 and some reduction of fiscal deficits. In addition, the destructive indigenisation law has largely been scrapped.

However, by February 2020 the SMP was already off-track, and money creation to finance the fiscal deficit contributed to currency instability.¹⁴ There has also been some misfortune from natural disasters, notably Cyclone Idai and a drought in 2018–19. These shocks complicate the normal process of macroeconomic adjustment, especially in the absence of foreign aid inflows.

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COUNTRIES DO NOT
HAVE AN INDEPENDENT
MONETARY POLICY

Much more still needs to be done. Ending the taxation of exporters (through compulsory currency surrender requirements) and gradually reducing the subsidisation of imports (notably fuel subsidies) are essential in stabilising the BoP and hence the exchange rate. Improving transparency in the allocation of foreign exchange and unifying the foreign exchange market are also critical. The latter would end the distinction between the official market and the parallel market and would so end the profits that rent-seekers with privileged access to foreign exchange can earn through ‘round tripping’.

Regaining access to international capital markets through agreed debt rescheduling as part of a latter-day HIPC¹⁵ programme is also essential.

The RBZ must be strengthened by giving it policy independence, ending ‘fiscal dominance’ (forcing it to lend money to the government to finance fiscal deficits), improving the quality of data required for the implementation of monetary policy, and dramatically enhancing transparency relating to fiscal, monetary and foreign exchange transactions.

It is by no means clear that Zimbabwe will be in a position to stabilise the new Zimbabwean dollar any time soon, in which case the re-adoption of a foreign currency as legal tender has to be reconsidered. The US dollar is probably not the most appropriate foreign currency for Zimbabwe – essentially, it is likely to be too strong and will worsen the competitiveness problems that the economy already faces – and serious consideration should be given to adopting the South African rand. The rand is more relevant given the pattern of Zimbabwe’s foreign trade, as South Africa is Zimbabwe’s largest trading partner.

Adopting the rand would likely require a loan from South Africa to recapitalise the Zimbabwean monetary base

Adopting the rand is not straightforward, however, and would require the agreement of the South African government, as that country’s exchange controls on capital movements restrict access to South African currency and the payments system.¹⁶

Beyond that, adopting the rand would probably require Zimbabwe to join the CMA, with the agreement of the other member states (Lesotho, Namibia and eSwatini). If this could be achieved it would have several advantages. The CMA agreement¹⁷ has provisions for the sharing of seignorage revenue that would accrue to the South African Reserve Bank (SARB) from the circulation of the rand in Zimbabwe.

It is also possible that the Zimbabwean dollar could be reintroduced on a similar basis as the domestic currencies in the smaller CMA member states, which is akin to a currency board arrangement and hence has elements of stability built in. Joining the CMA would also provide access to the South



A KEY LESSON FROM ZIMBABWE IS THAT THERE IS NO ESCAPING THE LAWS OF ECONOMICS

African capital market, and would support greater regional trade integration, for instance through the SADC Free Trade Area.

Adopting the rand would likely require a loan from South Africa to recapitalise the Zimbabwean monetary base on conversion from RTGS dollars to rand. None of these requirements is straightforward, especially given South Africa's economic weaknesses and rising government debt, and would take some time to achieve. But taking an in-principle decision as to what is desirable and opening discussions with the government of South Africa would be a good start.

Conclusion

What are the lessons learned from Zimbabwe's currency experiences? The first is that there is no escape from the laws of economics. Large budget deficits are always unsustainable, and, if financed by printing money, will result in inflation and currency depreciation. Second, if the economic fundamentals are wrong, then the choice of currency regime is irrelevant – both dollarisation and a local currency will fail, regardless.

Third, most developing countries are dependent on capital inflows, which in turn need a positive business

environment (for inflows of FDI) and debt restructuring (if debt is unsustainably high). Both need positive engagement with the international community.

If the economic fundamentals are wrong, then the choice of currency regime is irrelevant

Without capital inflows or substantial export growth, the BoP will be unsustainable. This will cause either currency weakness or economic contraction.

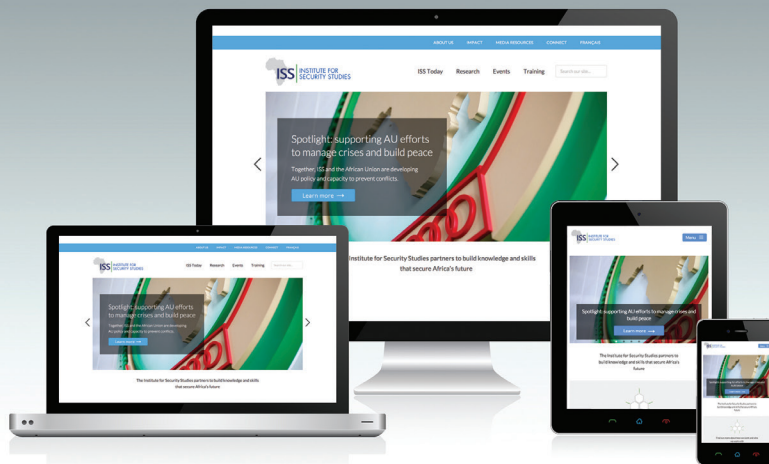
What is the likelihood of sustainable reform, comprising an improved macroeconomic policy environment and business climate, proper accountability, improved data and greatly increased transparency? From a political economy perspective, the absence of these conditions hinders long-term economic growth, but in the short term creates incentives and opportunities for rent-seeking and corruption. Only with a shift from a short-term to a long-term perspective will the policy environment improve.

Notes

- 1 In a currency board arrangement, the central bank or monetary authority can only issue domestic base money (cash or bank reserves) to the extent that it holds foreign exchange reserves. Hence the quantity of money in circulation is fixed and cannot be increased unless foreign exchange reserves are accumulated. Such a currency has a fixed exchange rate or peg to a reference currency.
- 2 International Monetary Fund (IMF), *Annual report on exchange arrangements and exchange restrictions 2018*, <https://www.imf.org/en/Publications/Annual-Report-on-Exchange-Arrangements-and-Exchange-Restrictions/Issues/2019/04/24/Annual-Report-on-Exchange-Arrangements-and-Exchange-Restrictions-2018-46162>
- 3 The West African Economic and Monetary Union (WAEMU) and the Central African Monetary and Economic Community (CEMAC).
- 4 In 1980 over 90% of emerging market economies had pegged or fixed exchange rates. By the mid-2000s this had fallen to 40% (AR Ghosh, JD Ostry and MS Qureshi, Exchange rate management and crisis susceptibility, IMF, Working Paper WP/14/11, 2014, <https://www.imf.org/external/pubs/ft/wp/2014/wp1411.pdf>)
- 5 Although originally denominated in US dollars, most of the currency held in the banking system could not be converted to actual US dollars, due to shortages of US dollar reserves. However, it could be transferred between domestic bank accounts. Such transfers were made through the Real-Time Gross Settlement (RTGS) interbank settlement system, which appears to be the origin of the name RTGS dollars.
- 6 The monetary policy implemented by the US central bank (the Federal Reserve) pays attention only to economic conditions in the US, and not to any other countries where the US dollar may be in use.
- 7 As at January 2020, Zimbabwe had been given a Country Risk Score of 0 (on a scale of 0 to 15) by GCR Ratings – the lowest of any country that GCR rates.
- 8 'Dollarisation' does not necessarily require the use of the US dollar, but can refer to any foreign currency.
- 9 Of which seven have adopted the US dollar, four the euro, and three the Australian dollar.
- 10 M Mecagni et al., *Dollarization in sub-Saharan Africa: experience and lessons*, Washington DC: IMF, April 2015.
- 11 Another country to gain independence in recent decades was Timor-Leste in 2002. It decided to adopt the US dollar as its currency.
- 12 This includes members of monetary unions (Euro Zone [19], ECCU [6], WAEMU [8] and CEMAC [6]), currency boards (5), and no separate legal tender (13).
- 13 It is a well-known principle of international macroeconomics (the 'Impossible Trinity') that a country can choose to have an active monetary policy (for instance through managing interest rates) or an active exchange rate policy (fixing or managing the exchange rate), but not both, if it has an open capital account.
- 14 IMF, IMF Executive Board concludes Article IV Consultation with Zimbabwe, 26 February 2020, <https://www.imf.org/en/News/Articles/2020/02/26/pr2072-zimbabwe-imf-executive-board-concludes-2020-article-iv-consultation>
- 15 The Highly-Indebted Poor Countries (HIPC) initiative provided a mechanism for qualifying countries to benefit from a substantial reduction in their international debt in exchange for policy reforms.
- 16 The circulation of the US dollar outside of the US or the adoption of the US dollar as national currency does not require the agreement of the US government, so it can be done unilaterally. This is because the US has no exchange control restrictions on capital movements. Indeed, the US benefits from other countries' use of US dollars because of the seignorage income it earns. The downside for those using US dollars is that there is no mechanism for sharing this seignorage income, as well as the need to follow US monetary policy.
- 17 Along with the accompanying bilateral agreements between South Africa and each of the other members.

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About the author

Keith Jefferis is a consultant in the Peace Operations and Peacebuilding programme of the Institute for Security Studies. He is a former deputy governor of the Bank of Botswana and an expert on monetary policy.

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