International Monetary Fund
African Department

Currency Options for Zimbabwe

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Road Map

1. • Diagnostic of the problem
2. • Zimbabwe and the currency problem
3. • Currency options: Pros and Cons
4. • Supportive macroeconomic policies

Zimbabwe and the currency problem

- A currency should have three attributes;
  - a medium of exchange,
  - a store of value
  - and a unit of account (i.e. for compiling company accounts).
- USD has all the attributes
- RTGS or Ecocash is only a medium of exchange (and cannot be withdrawn easily)
- The 1:1 parity of RTGS and USD has brought rising challenges, and parallel market suggests that this equivalence is not accepted anymore
- As RTGS has increased devalued against the USD in parallel market, it is losing its store of value property, impairing economic development
- The bond notes are facing the same challenge as the RTGS

Zimbabwe Exchange Rate History

Date	Classification: Primary/Secondary/Tertiary	Comments
September 12, 1923-1940	Exchange rate arrangement with no separate legal tender	UK pound
1940-April 1, 1956	Peg (Currency board)	UK pound. Southern Rhodesian pound is introduced replacing Sterling as legal tender.
April 1, 1956-November 16, 1964	Peg	UK pound. Pound of Rhodesia and Nyasaland replaces Sothern Rhodesia pound.
November 16, 1964- February 17, 1970	De facto peg/ Parallel market	UK pound. Rhodesia pound. Capital controls in November 1965, UN sanctions. Officially government announced that they were pegging to gold not the UK pound. Large parallel market premia.
February 17, 1970- March 7, 1980	Peg	De facto to UK pound through August 1971 and SA rand thereafter .The Rhodesian Dollar is introduced 2 to 1.
March 7, 1980–June, 1983	De facto crawling band	US dollar. The Rhodesian dollar's peg to the South African rand was ended. The currency was renamed the Zimbabwe dollar. +/- 2% band. Officially pegged to a basket of currencies.
July 1983–April 1991	Managed floating/Dual Market	
May 1991–July 2, 1994	Freely falling/Managed floating/Dual Market	
July 2, 1994–November 1997	Managed floating/Parallel market	
November 1997—March 2009	Freely falling/Parallel Market	The official rate is pegged to the U.S. dollar with recurring mega devaluations. Hyperinflation
April 12, 2009—October 2016	Exchange rate arrangement with no separate legal tender	US dollar

Zimbabwe exchange rate history (Con't)

- History shows that **a local currency and a dollarized system can both work and can both fail, if the right conditions are (not) in place** (e.g. budget financed by printing money)
- Status quo is not sustainable, and is leading to macroeconomic instability [high inflation (again), lower growth, flight of capital]
- Must tackle
  - **fiscal dominance/monetary financing**
  - **And parallel currencies**

High costs of status quo of 1:1 $/RTGS rate

- Large implicit taxes on exporters and subsidies to importers from surrender requirements
  - ✓ Gross taxes/subsidies amounted to about US$1 billion in 2018 (8% of GDP)

- Rent seeking from allocation of surrendered FX to importers below market rate

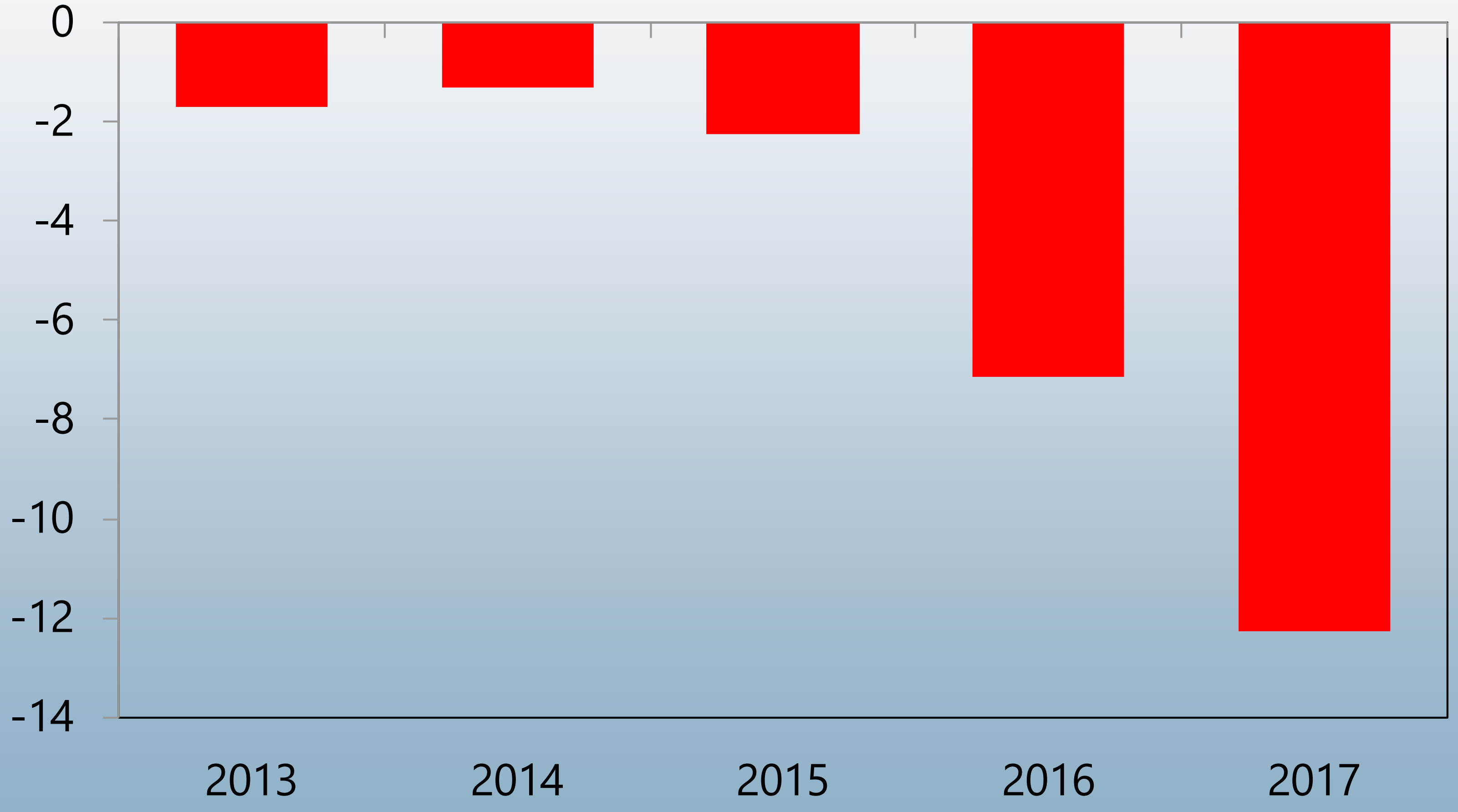
- Loss of FX from arbitrage (e.g., smuggling of fuel)

- Recent changes in FX surrender requirements and trading of FX have reduced somewhat the costs, but status quo untenable much longer

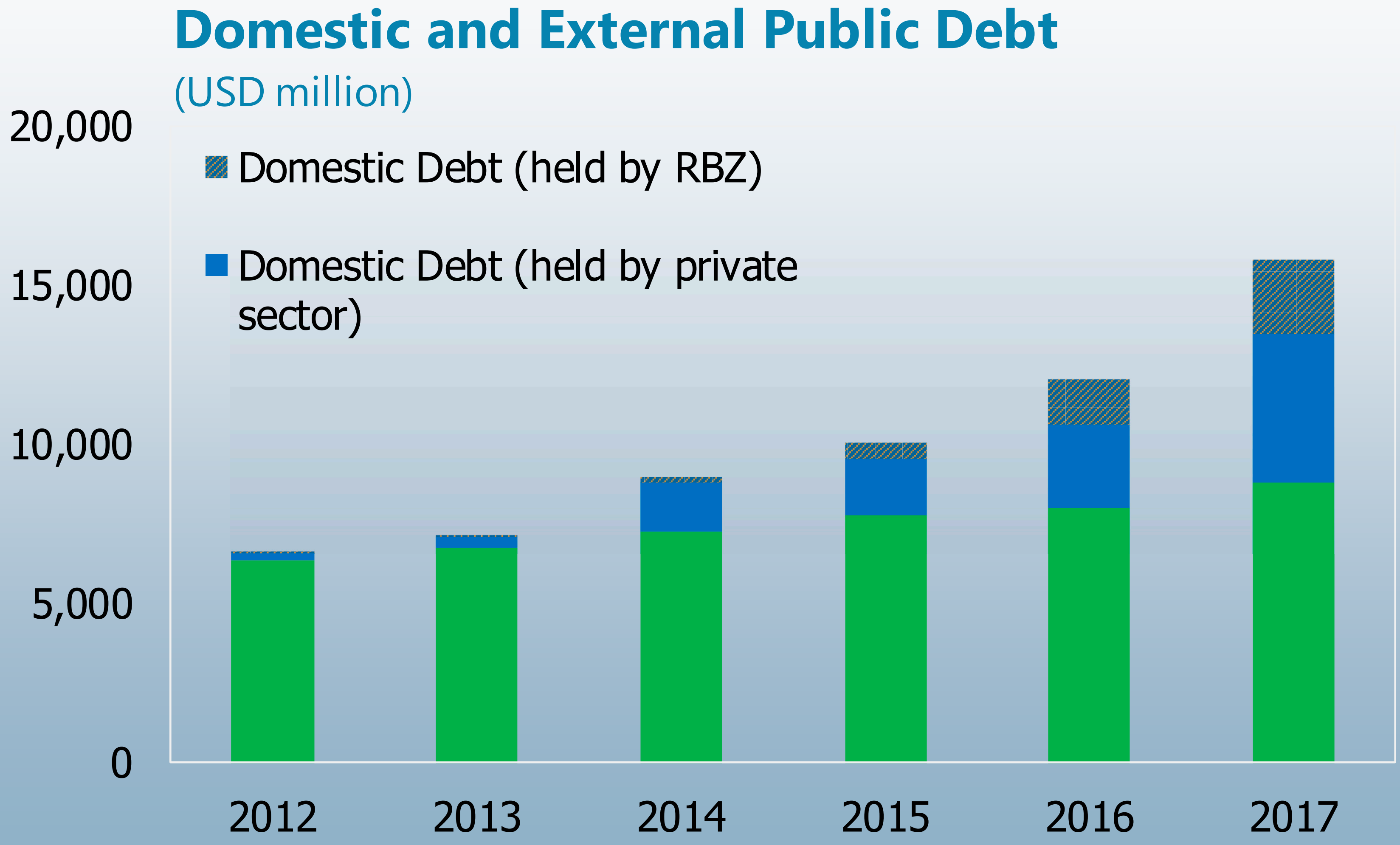
HOW DID WE GET THERE?

A worsening fiscal position…

Fiscal Deficit

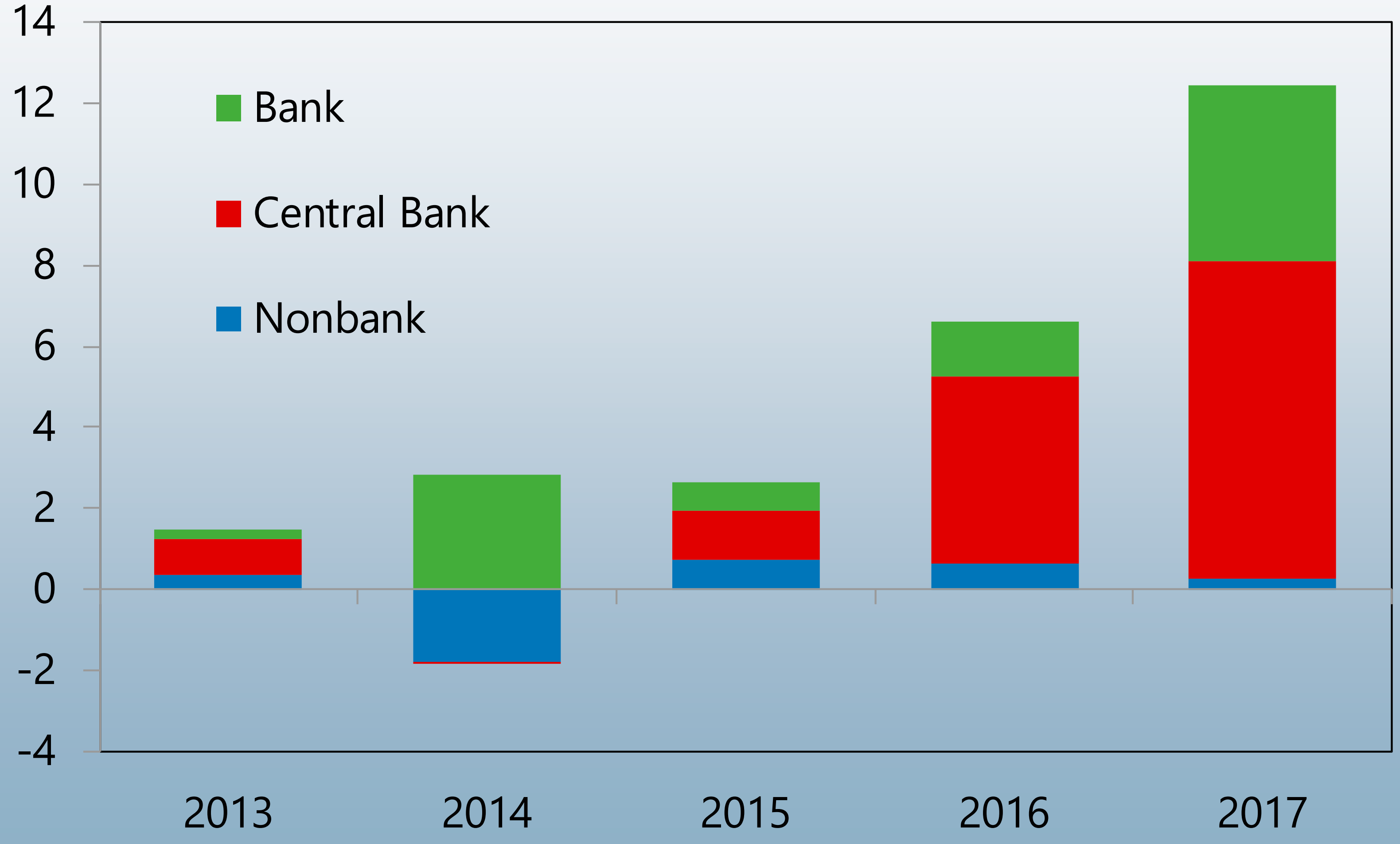


Contributing to higher government financing needs…



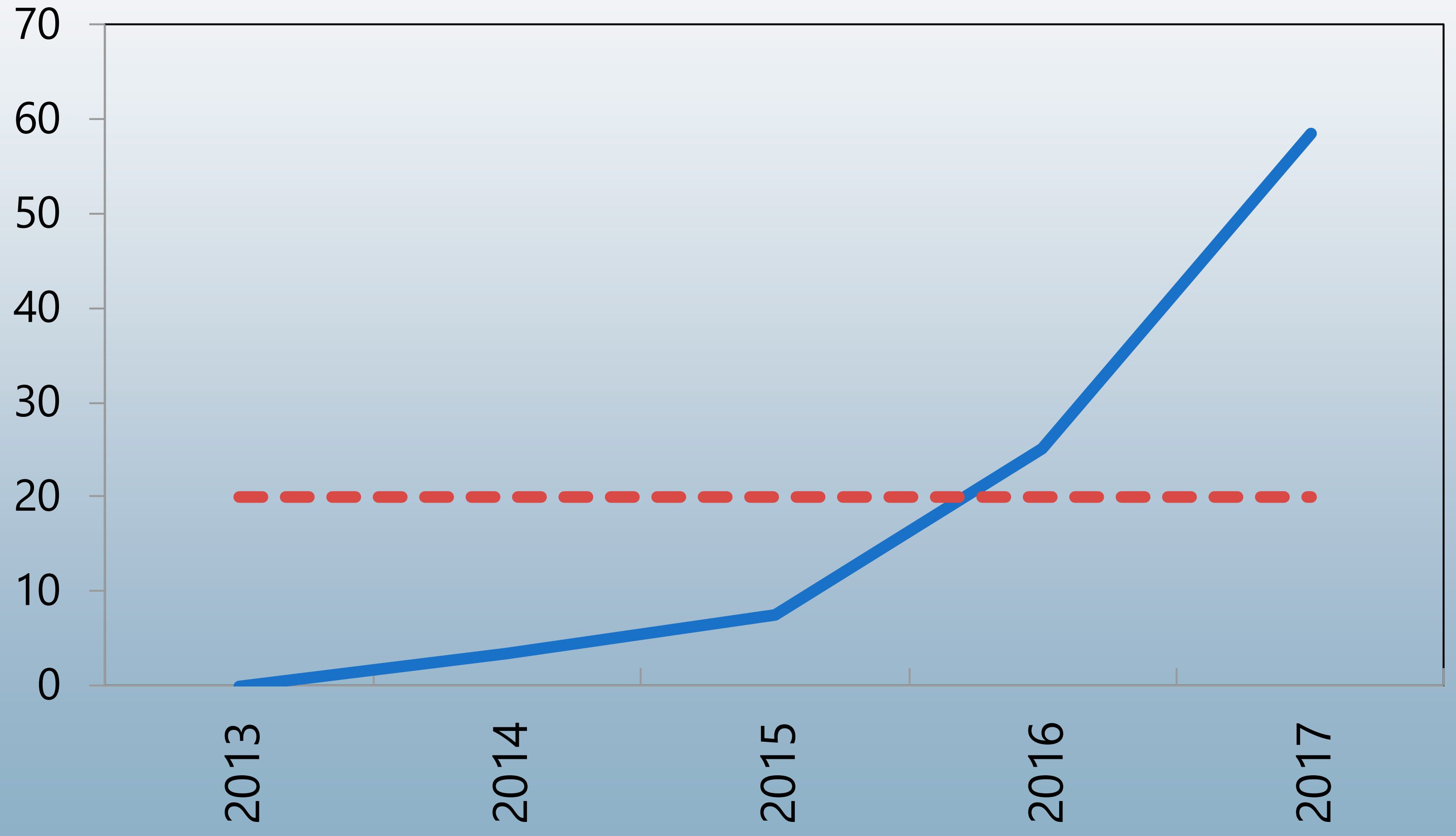
...with a lion share from Central Bank and Banks ...

Domestic Financing



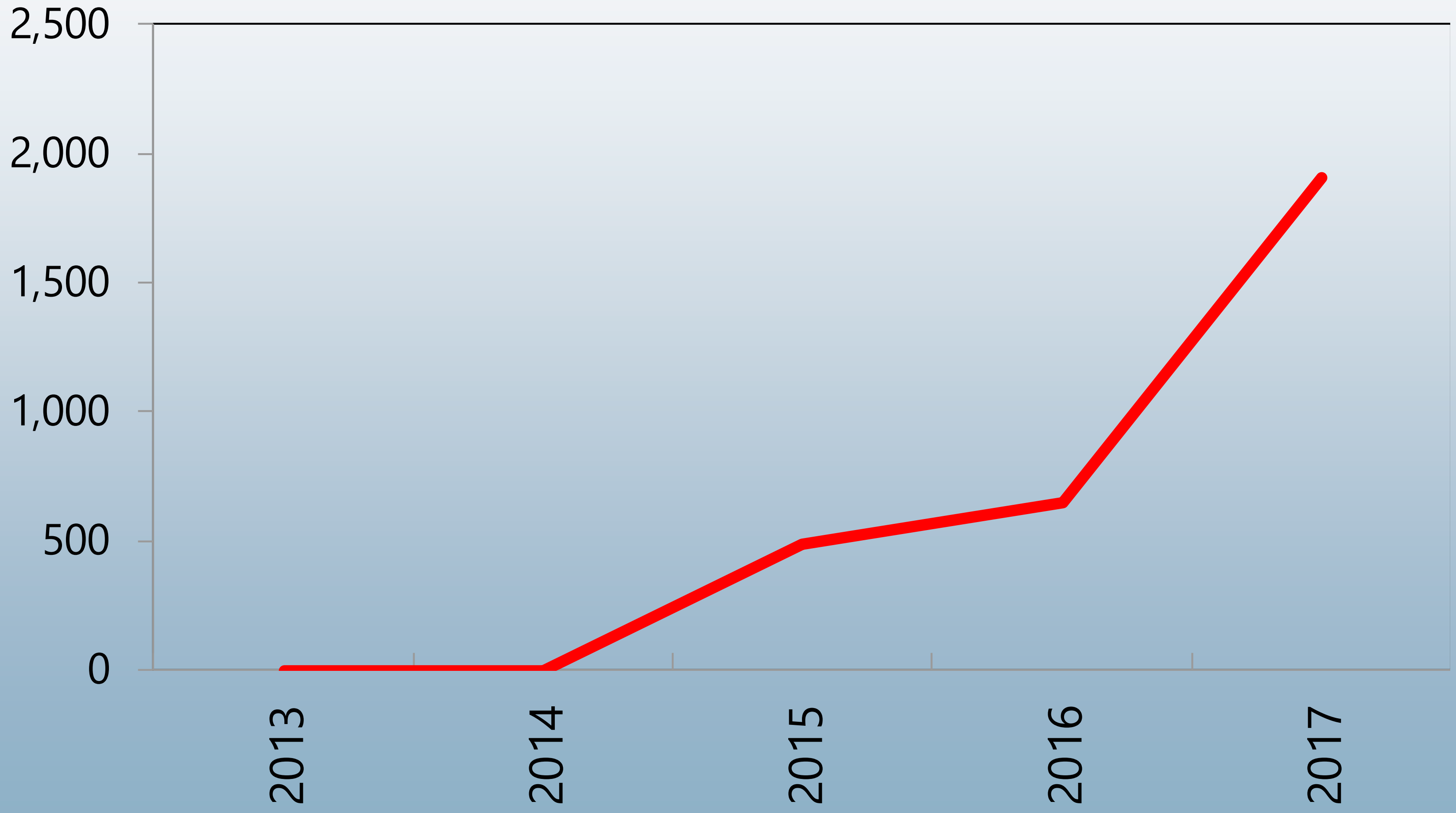
… met by an overdraft from RBZ…

RBZ Overdraft and Loans



… and Treasury Bills.

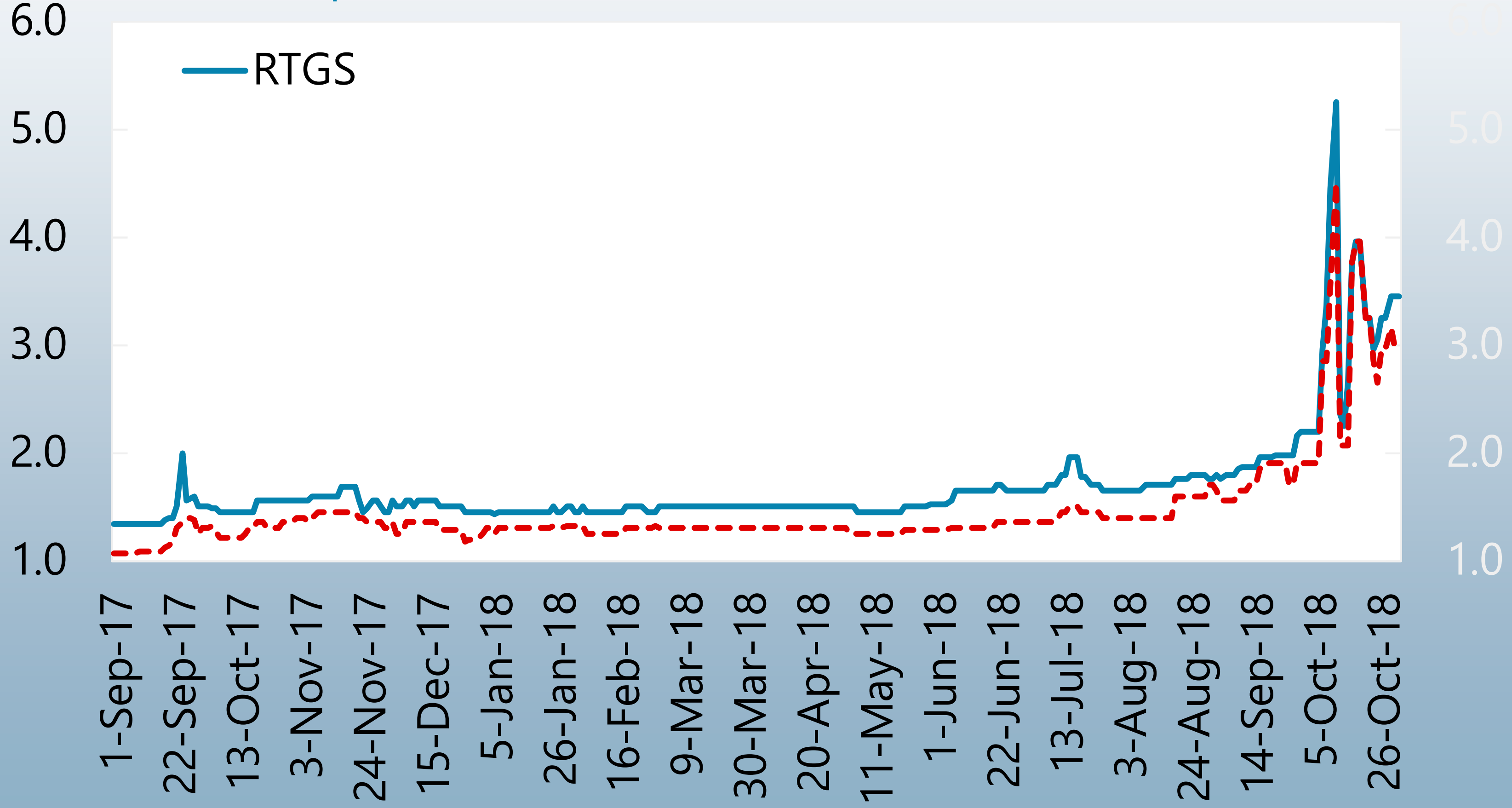
T-Bills Issued



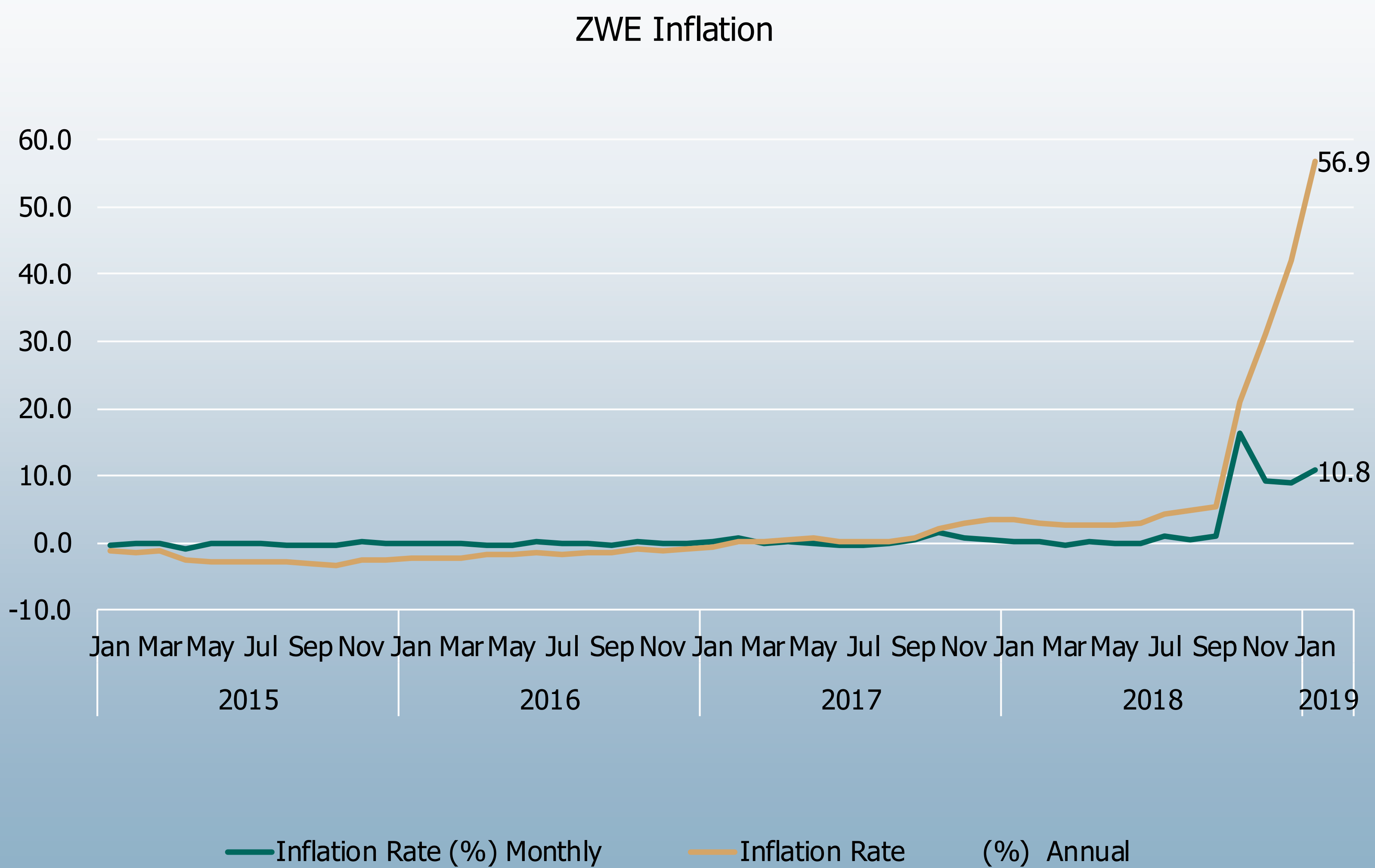
The parallel market exchange has been very volatile recently…

Zimbabwe: Parallel Market Exchange Rate

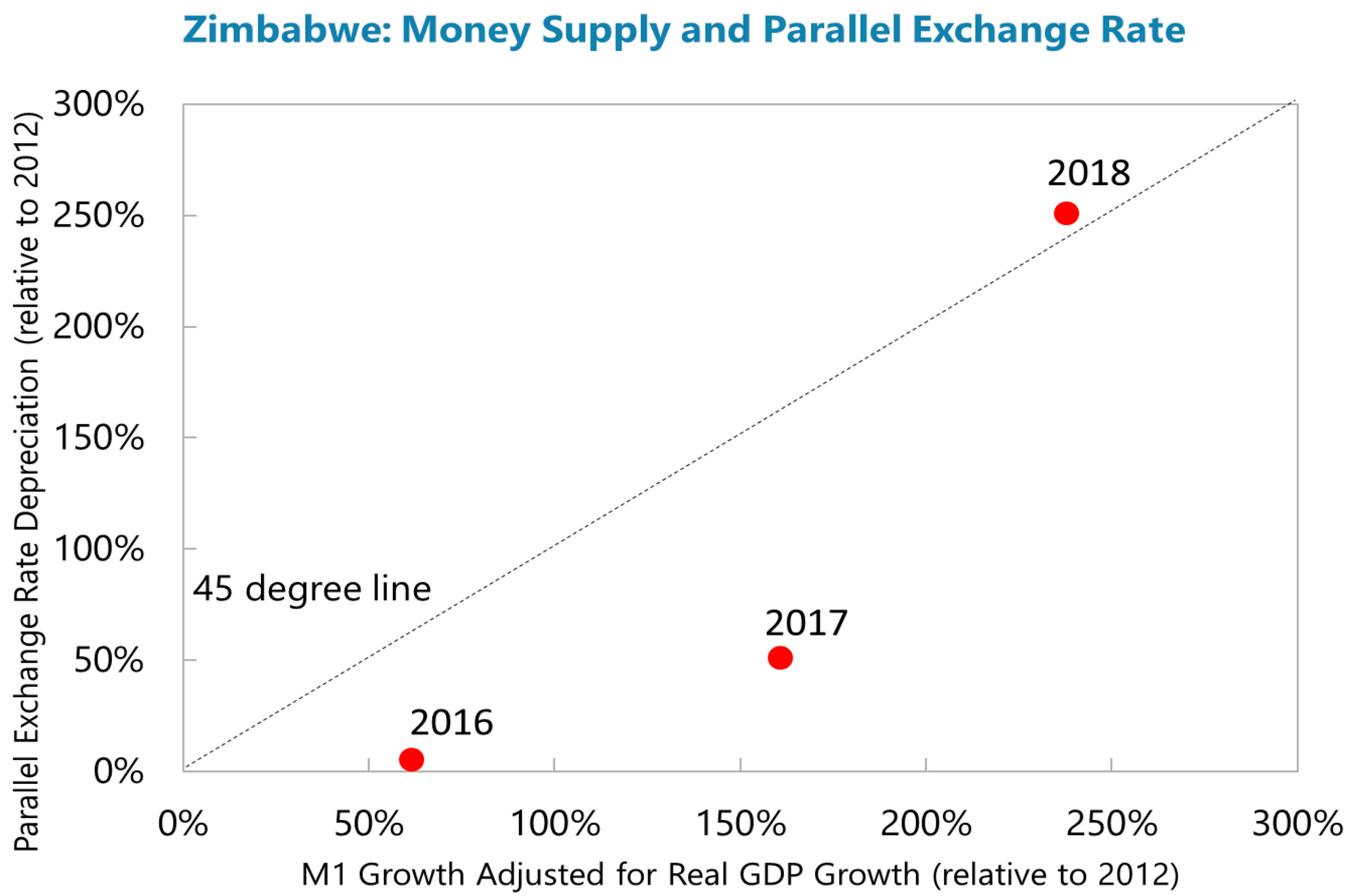
(ZIM dollar per 1 US$)



Contributing to rising inflation …

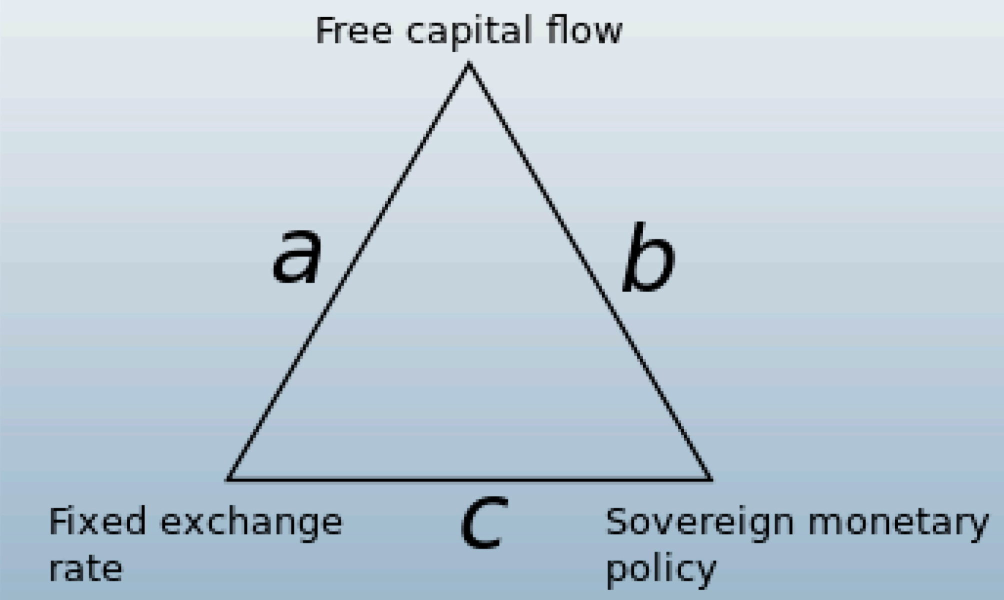


The Exchange Rate and Money Growth: *'the evidence'*



Sources: Reserve Bank of Zimbabwe and IMF staff calculations.

Impossible trilemma



Choose a monetary regime that can be credible

- Countries without history of policy credibility should choose monetary regimes that are transparent, easily monitored, and costly to change.
- This in turn ensures that they follow macro policies that are consistent with that monetary regime (e.g., fiscal discipline).
- Policy credibility in Zimbabwe is low (e.g., in Zimbabwe, the 2009 dollarization was a grassroots phenomenon, it was not imposed top down by the government).
- Therefore, a monetary regime is more likely to be accepted/successful if it involves little discretion.

OPTIONS, PROS AND CONS

Options that a country can pursue

- Dollarization
- Joining a monetary union
- A currency board
- National currency – pegged, hard peg or floating exchange rate

Dollarization

Pros

- Credible: returning to a monetary regime accepted (chosen) by the public;
- Multiple exchange rates eliminated;
- No financial stability issues (i.e. no bail-in of depositors needed)
- Its difficult to reverse making it a credible exchange rate regime

Cons

- Can lead to overvaluation (Zimbabwe/region uncorrelated with US economy);
- Large fiscal cost / debt crisis (domestic debt must be repaid in full);
- Large fiscal adjustment required (must run fiscal surpluses, or small deficits + high growth to repay domestic debt)

Joining the Rand Monetary Union – Currency Union

Pros

- Credible (hard to reverse, elimination of currency risk);
- Correlated shocks with SA, other countries in CMA

Cons

- Process to join is long - numerous preconditions (harmonizing financial system and adopting SA capital account controls; accepting and enforcing fiscal rules; harmonize customs rules and probably join SACU; promoting wider circulation of the Rand, …);
- No monetary policy

A currency board

Pros

- Credible (predictable, rules-based, elimination of currency risk);
- Monetary financing ruled out (fiscal discipline is required)

Cons

- Requires large reserves, with coverage close to stock of domestic currency (Zimbabwe has 1 week of imports worth);
- No LOLR;

Pegged national currency

- There is no advantage in introducing a national currency to peg 1:1 to the USD – the same benefits can be achieved at lower cost by returning to dollarized regime. The advantage therefore lies in being able to peg at another rate (e.g., close to parallel rate) or to other currencies
- National currencies are important as they help to determine a nation's economic health
- Seigniorage benefits

Hard peg

Pros

- Requires fewer reserves to implement,
- Provides a nominal anchor that lowers inflation expectations
- It avoids the time-consistency problem

Cons

- Subject to speculative attacks
- Limited gains from exchange rate flexibility
- Limited independent monetary policies

Floating national currency

Pros

- Manage ToT shocks – shocks can be absorbed via the exchange rate
- Independent monetary policy (policy flexibility)

Cons

Unclear nominal anchor (no history of inflation targeting, official CPI only partly accurate);

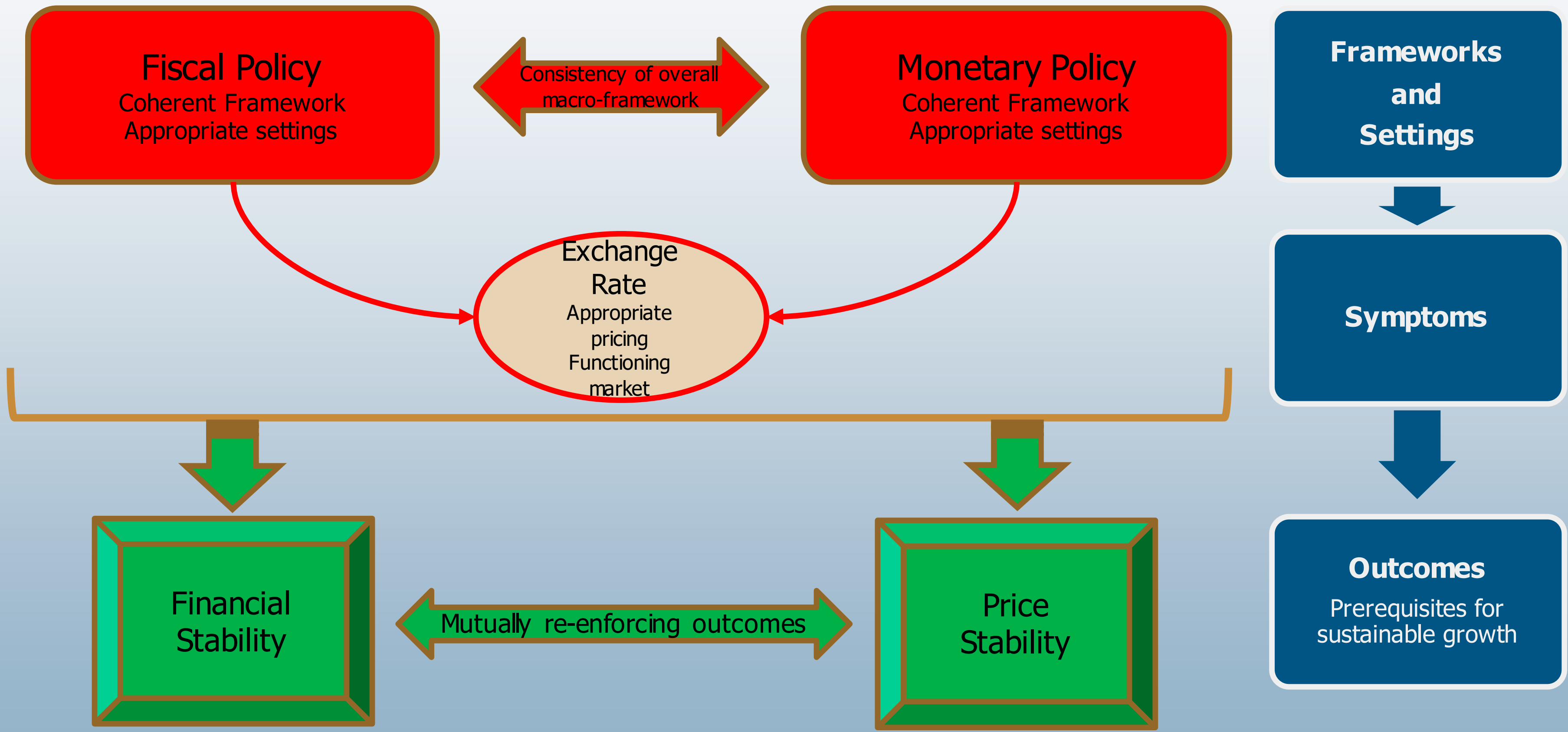
- Lack of policy credibility will create volatility, overshooting, all while having no initial reserves;
- If successful reengagement, then large capital inflows may create Dutch disease
- Floats require institutional capacity-building at the central bank/statistics offices/… which takes time and resources

Monetary Frameworks – Which Anchor?

All regimes can have low and stable inflation as the ultimate policy objective

Regime (intermediate target)	Requirements / Issues	Zimbabwe context
Inflation Targeting (inflation forecasts)	• CB independence / credibility • Medium-term inflation objective • Functioning markets for transmission • Credible inflation forecasts • Clear communication strategy	• Impaired markets • Fiscal dominance • Low capacity to forecast inflation • No track record ***Not feasible at this point, however feasible / desirable over the long-term***
Exchange Rate Targeting (the exchange rate)	• Similar inflation rate to the anchor currency • Adequate reserves • Loss of monetary independence • Macro-implications – dealing with ToT shocks ➢ Large fiscal adjustments needed	• Little capacity to contain exchange rate pressures • Economy faces ToT shocks ***Not sustainable given lack of reserves and exposure to ToT shocks***
Money Targeting (money aggregate)	• Credible monetary statistics • Capacity to analyze monetary developments • Basic operational instruments • Interest rate volatility high if M^d is unstable • Useful regime to re-anchor expectations following high inflation • Challenges with communicating quantities	• Monetary statistics are credible • Analytical capacity has been retained • Necessary instruments are available • Requires some operational changes and a strong focus on monetary analysis ***The only credible option at this point.***

The Road to Price and Financial Stability



Foreign Exchange Operations

- To support:
  - ✓ Monetary operations
  - ✓ Market development
- Intermediation to support price -discovery
  - ✓ Surrender requirements to the RBZ can initially be retained to support regular, transparent auctions (surrender should progressively move to banks, and ultimately be eliminated)
    - Small volumes, twice daily
    - Announce intended monthly volumes in advance, recognizing seasonality of demand
- Countering disorderly markets
  - ✓ Rule-based – recognizes the realities while facilitating smooth adjustment
  - ✓ Establishes intervention thresholds (i.e. a frontier) based on intervention budget over each time period

Meeting Reserve Money Targets

- Objectives
  - ✓ To achieve money targets, while
  - ✓ Containing interest rate volatility
- Reactivate liquidity monitoring and forecasting activities
  - ✓ Requires coordination with the MoF on cash management
- Review monetary instruments: move to price -based operations
  - ✓ Reserve requirements – modalities and levels
  - ✓ RBZ securities – requires coordination with MoF on debt issuance
- Tradeoffs during transition: Transmission vs Stability
  - ✓ Specify the target as an average over a period (e.g. a month)
  - ✓ Initially, seek to temper excessive movements in wholesale interest rates
  - ✓ Consider adjusting lending caps slowly – eventual elimination

Financial stability risks

- Depositors' reaction
  - ✓ Deposit withdrawal risks for weaker banks
- Asset quality
  - ✓ Rise in NPLs from weaker GDP growth
  - ✓ Squeeze in interest margins from high share of government debt at fixed rates
- Foreign exchange gaps
  - ✓ Supervisory data suggest large negative foreign asset positions
- Interest rate risk gaps
  - ✓ Speed of adjustment for deposit vs lending rates

Preserving financial stability after introducing new FCU

Prior Actions

- Appoint high-level team(s) to prepare implementation strategy
- Design strategies and measures to:
  - Address valuation and cashflow risks related to banks' government exposures
  - Offset new FX-imbalances
  - Deal with liquidity issues, including calibrating restrictions
  - [Recapitalize banks]
- Order banks to submit (i) opening balance sheets; and (ii) forecasted balance sheet at COB of the first day at market FX-rates

Other Priority Actions

- Banks to offset FX-imbalances
- Banks to submit new business plans, with credible time-bound measures to correct potential regulatory breaches, including for capital requirements
- Professional valuation of banks´ assets and business plans
- Create proper incentives for banks to allow soft landing of borrowers while protecting depositors against inflation

Supporting FX market efficiency

- FX controls regime should be simplified and its scope expanded. The controls should be at their tightest initially and be gradually relaxed as conditions allow
- The market should move freely and without a band
- The market could work with/without surrender requirement but repatriation requirement would need to remain and enforced
- Banks should be subject to tight Net Open Position limits to force them to sell the FX purchased from exporters
- Only banks should be allowed to trade in FX and residents/nonresidents can sell/buy FX only with/from commercial banks.
- The current sanctioning regime needs to be made more effective, allowing the RBZ to impose sanctions (e.g., for violations of data provisioning requirements)

MPS February 2019

- Liberalized the exchange rate
- RTGS, Ecocash, bond notes are now known as the ‘RTGS dollar
- Retailers to maintain prices at current levels.
- Retentions will continue
- All forex holdings to be liquidated within 30 days at the market rate for the day
- ‘Interbank Foreign Currency Exchange Market’ which enables the electronic movement of USD locally.

Implication of the MPS

- Legalizing FX trade – black market premiums could be lowered
- 30 days to use retained FX – this could impact negatively on USD savings and ultimately FX holdings
- Banks can now earn FX income and this will impact positively on their balance sheets
- Improved valuation of assets and liabilities – Bank's balance sheets can now reflect USD and RTGS assets and liabilities

Developments

- $5 million was traded on the first day
- Black market rates moved from 1:3.8 to 1:4 to 1:3.5 in 3 days and have stabilized at 3.5
- Some banks took some time to configure their systems
- Some banks have used up the seed capital that they got from the RBZ
- We will see how the rate moves when exporters and other FX holders start off loading their FX on the market (There is reportedly no new flows besides the seed capital)
- If rates continue to drop, we are likely to see prices of goods and services declining

THANK YOU