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**EVOLUTION OF ZIMBABWE'S ECONOMIC TRAGEDY: A  
CHRONOLOGICAL REVIEW OF MACROECONOMIC POLICIES  
AND TRANSITION TO THE ECONOMIC CRISIS**

The longer the overvaluation lasts, the more controversial subsequent policies will be.  
Dornbusch Rudiger 1991: pp 96

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**ABSTRACT**

This paper chronicles Zimbabwe's macroeconomic policies and economic development trends from the post independence period up to end of 2006. By focussing on monetary and exchange rate policies and their influence on economic developments before and after the reform programme in 1991, the paper attempts to reveal the critical macroeconomic policy underpinnings of Zimbabwe's post-2000 economic tragedy. A key insight from the review is that despite what seemed to be concerted economic management efforts, the authorities actually never succeeded in attaining sustainable economic stabilization goals from the very start of the post-independence era. The constraints imposed by the inward looking policies of the 1980s and the eventual failure of 'free market' exchange rate policies of the early 1990s resulted in chronic real exchange rate overvaluation and depletion of foreign exchange reserves. This eventually culminated in the so-called "Black Friday" currency crash, and a severe foreign exchange crisis that has since been viewed as one of the most important factors that led to the economic tragedy. Hence in retrospect, the review concludes that the post-independence government in Zimbabwe never succeeded in bringing the economy into long term structural equilibrium and, thus failed to create an enabling environment for medium to long term macroeconomic policy sustainability.

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*JEL Classification: E5, F31, F43*

Key words: Zimbabwe, exchange rate misalignment, macroeconomic policy, economic crisis

## **1 Introduction**

Zimbabwe is a low-to-medium income developing country. Her economic performance is strongly influenced by manufacturing, agriculture, and mining sectors. By the early 1990s, manufacturing accounted for 17 percent<sup>1</sup> of real GDP and for more than 56 percent of industrial output. The manufacturing sector has very strong backward and forward linkages with the rest of the economy.

“The strength of the industrial sector is derived from the availability of foreign exchange, depicting the sector’s dependence on foreign inputs. The dearth of foreign currency has in general depressed production to below full capacity levels, a problem amplified by a high debt servicing ratio extracting over 20 percent of foreign exchange earnings. That shortage of foreign currency also reflects the underperformance of exports as a result of depressed demand (Ncube 1991: 6).”

The construction sector is the least dependent on imports, hence its performance reflects, and may cause economic recession. In the 1980s, agriculture employed about 25 percent of workers in formal employment while manufacturing accounted for 22 percent (Ncube 1991). The agricultural sector contributed about 22 percent of real GDP from 1993-2002.<sup>2</sup> It provided 70 percent of total employment<sup>3</sup> and about 60 percent of all principal raw materials for manufacturing. About 40-45 percent of the country’s exports originated from agriculture (Bautista and Thomas 2000). The mining industry contributed about 3 percent of the country’s GDP, having declined from 8 percent in the 1980s. At that time, it accounted for about 6 percent of the labour force. Despite the relatively small composition of the sector in overall GDP, it was the second major foreign exchange earner, contributing 45 percent of the economy’s total foreign currency earnings. This reflects a very disproportionate contribution to foreign exchange earnings, in an economy that was highly dependent on imports.

After the attainment of independence in 1980, Zimbabwe embraced two fundamentally distinct policy regimes. An inward-looking interventionist approach was in place during the 1980s. In 1991, the country shifted to a market-based policy approach – the Economic Structural Adjustment Programme (ESAP). However, despite the extensive policy initiatives under the auspices of ESAP, doubts have lingered concerning the extent to which these policy approaches managed to propel the economy in the intended direction. In particular, the ability of the policy mix to resolve the internal-external imbalance that existed from the 1980s remains debatable. ESAP was formally abandoned in early 2002.

This paper reviews Zimbabwe’s macroeconomic performance during these two policy phases. The key argument of the policy review is that despite concerted economic management efforts, the authorities never succeeded in attaining sustainable post-independence economic goals. The constraints imposed by the inward looking policies of the 1980s and the failure of exchange rate policies resulted in chronic RER overvaluation. This culminated in a currency crisis that has been viewed as the trigger point of the macroeconomic crisis that developed from the late 1990s. While the political economy of

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<sup>1</sup> GDP composition estimates are based on average for 1993-2002, using Central Statistics Office data.

<sup>2</sup> While agriculture plays a predominant role in the growth and development of Zimbabwe’s economy, its share in GDP reflects low incomes received by farmers, particularly those in the semi-arid, low productivity communal and resettlement areas (Bautista and Thomas 2000).

<sup>3</sup> About ¾ of the population reside in rural areas where agriculture is the dominant economic activity.

the crisis is not a subject of investigation in this paper, the study acknowledges the view that failure of economic management will eventually lead to social and political discontent. Such development may inevitably culminate in a fully fledged political crisis that has further negative feedbacks on the real economy.

The rest of the paper is arranged as follows: Section 2 discusses the evolution of the macroeconomic policy framework from the post-independence import substitution strategies, leading up to economic reforms of the 1990s. Section 3 documents the evolution of monetary policies, with emphasis on exchange rate management. This section provides a review of the country's exchange policy leading up to the currency crisis of 1997 and the eventual collapse of the free market currency reforms. Section 4 then discusses some key elements of the crisis that include the external sector, aggregate domestic output as well as the emergence of hyperinflation. In section 5, the main elements of government's policy response are discussed, with the analysis revealing a dramatic turnaround particularly in monetary and exchange rate policy strategies. Section 6 provides concluding remarks.

## **2. Macroeconomic Policy Overview**

### **2.1 The Inward Looking Policy Era: 1980 – 1991**

Zimbabwe's attainment of independence in 1980 came with bright prospects and high optimism for its economic future, both at home and abroad (Green and Khadani, 1986).

The end of sanctions was thought likely to improve both the terms of trade and market access for exports. More external finance - including aid - would further augment import capacity, thus relieving the economy of the capacity utilization, capital stock maintenance, and renewal and new investment constraints of the preceding Rhodesian era. Excess capacity existed to allow more production and past and expected increases in grower prices and wages were likely to provide the markets for the greater output (pp 1059–1060).

The new government tried to consolidate these prospects by adopting a socialist-based economic policy approach. Its prime goal was to use state intervention to redirect development for the equitable benefit of the mass population. This policy framework was underpinned by inward looking strategies that had been motivated by the imposition of sanctions against the country in response to the Unilateral Declaration of Independence (UDI) in 1965. A key facet of this strategy was to expand domestic production and employment through import-substitution industrialization. The import substitution strategy involved a high degree of indirect and direct controls over productive activities.

Among the controls, foreign exchange allocation was the most important policy instrument that guided short- and long-term decisions of enterprises in the private and public sectors. The government administratively allocated foreign exchange to firms for working capital and investment purposes. Allocations were based on the assessed availability of global foreign exchange, historical allocations, specific assessments of the current needs of individual enterprises, and predominantly on the perceived priorities of the economy. The government enforced price controls and financial resource mobilization instruments that included controlled interest rates and credit rationing. In addition to administering wage controls, the state also directly participated in production and service industries.

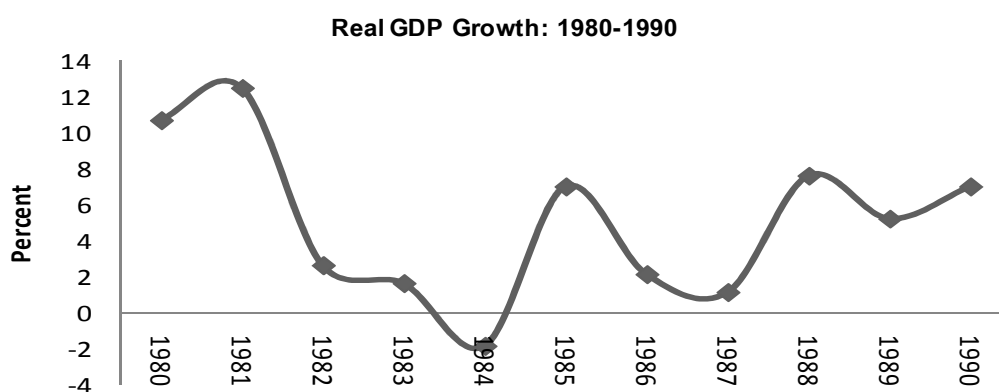
The economy experienced a boom during the first few years of independence under import substitution. Real gross domestic product (GDP) grew by more than 11 percent in 1980 and by about 13 percent in 1981. Capacity utilization increased from 75 to 95 percent while exports increased by 23 percent (Green and Khadani, 1986). Conditions for significant economic growth and strong trade performance were facilitated by favorable weather, increased employment and wages, expansive fiscal policy and improvements in income distribution (Riddell 1984). The removal of sanctions as well as the build-up of optimism and increased consumer confidence at the end of the war of liberation improved the country's terms of trade (Davies and Rattso, 1996). The resultant boom in domestic demand was reflected in an escalating index of retail sales. The index almost doubled from 1979 to 1981. Prior to that period, it had taken eight of the previous years to expand by the same proportion (Riddell, 1994).

This however turned out to be a brief post-independence boom followed by stagnating per capita incomes and worsening income distribution (Davies and Rattso, 1996). It emerged that during 1982-84 the economy had already been suffering from very serious imbalances. The post-independence growth rate turned out to be unsustainable on government and external balance accounts. The cumulative effect of the boom had driven the current account into deeper deficit –with a three-fold deterioration over three years, from Z\$157 million in 1980 to Z\$533 million in 1982 (Green and Khadani 1986). The world recession in 1982 combined with the droughts of 1982, 1983 and 1984 amplified the pressures on the external account. The government responded by occasionally imposing wage restraints, gazetting grower prices that were less than cost increases for large-scale farmers and cutting food subsidies. Sharp increases in electric power rates were instituted, albeit with limited attention to the cost of production of export sectors. Monetary policy was tightened and foreign exchange allocations for visible imports in respect of goods financed out of export earnings were sharply curtailed (Ibid).

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**Figure 1: Real GDP Growth 1980-1990**

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Data Source: World Bank Database

The outcome was that the growth of export volumes averaged 2 percent per annum in 1985-1989 while imports increased by 1.3 percent per annum. Export volumes grew at just about 4 percent per annum throughout the 1980s, unaffected by the

introduction of export-promoting measures in the middle of that decade. The resulting decline in foreign exchange earnings saw government enforcing import compression through severe cuts in foreign exchange allocations for intermediate imports. In so doing, policy intervention secured external “equilibrium” at the high cost of starving the economy of essential imports and, hence, at the expense of local production (Davies and Rattso 1996). This led to a contraction of domestic output and re-idling of capacity, and deterioration of the external balance. Government revenues declined with the unfolding depression, compromising the ability to maintain current and future budgetary stringency.

The strategy of economic controls and import compression failed to generate the employment growth needed to keep pace with population growth. The external account deterioration that had begun in 1982 was followed by a growth slowdown in the mid-1980s. Over the entire decade 1980-89 average real GDP grew by 5 percent compared to a population growth rate of 3.5 percent. Per capita incomes thus increased only marginally, and the ability to sustain the redistributive policies by means of subsidies and social services became increasingly questionable (Ibid.). Overall, although Zimbabwe had emerged from independence with a strong growth thrust, the failure to respond appropriately to the prevalence of adverse domestic and external shocks drove the economy deeper into long-term structural disequilibrium.

## **2.2. Inward Looking Policies and the External Balance**

The foreign exchange allocation system which was at the core of the inward-looking policies had an adverse influence on the overall structure of prices and pattern of production. Competition for access to foreign exchange for imports became a major preoccupation for enterprises in all sectors of the economy. Established enterprises were favoured by the allocation system at the expense of new firms, resulting in high degrees of product concentration. This restricted domestic as well as international competition (Ndlela and Duravall 2000). The volume of exports was limited not only by the exchange rate but also by the system of administrative foreign exchange allocation. Hence, an improvement in the external account balance tended to reflect the effectiveness of the restrictions on imports and domestic contraction rather than an improvement in productive conditions and competitiveness (Davies and Rattso 1996).

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**Table 1: The Savings – Investment Balance: 1980 – 1988 (% of GDP)**

Year	Private Investment	Fixed Public Investment	Fixed Changes in Stocks	in Private savings	Public Savings	Current Deficit	Account
1980	10.6	4.7	3.5	19.7	-5.4	-4.5	
1981	13.4	5.3	4.4	12.7	0.5	-9.9	
1982	10.1	9.9	1.2	12	-1.1	-10.3	
1983	8	11.6	-3.7	5.1	3.6	-7.2	
1984	8.7	9.8	0.4	17.7	-0.4	-1.6	
1985	6.4	9.1	4.3	21.8	-4.2	-2.2	
1986	8.5	7.2	2.7	21.1	-2.5	0.2	
1987	9.9	8.1	-1.4	19.6	-2.1	0.9	
1988	9.8	8.8	4.2	26.7	-2	1.9	

Source: Davies and Rattso (1996)

Foreign exchange rationing contributed to declining investment levels throughout the 1980s. Private sector fixed investment fell from 13.4 percent of GDP in 1981 to 6.4 percent in 1985. The current account deficit worsened from 4.5 percent of GDP in 1980 to 10.3 percent in 1982, before gradually improving during the second half of the decade. The use of import rationing to maintain external balance also caused private savings to reach historically high levels in excess of 15-20 percent of GDP during the second half of the 1980s.

Public sector investment cuts, initiated in 1983 as a response to the public sector deficit, led to a decrease in the demand for imported capital goods. This allowed more foreign exchange to be allocated to intermediate goods and hence raised capacity utilization. The current account balance in turn improved from a deficit of 2.2 percent of GDP in 1985 to a surplus of about 2 percent in 1988. With the current account improvement achieved through import compression and foreign exchange allocation, it was increasingly apparent that the economic goal of achieving an acceptable primary income distribution was failing. The ability to sustain the redistributive policies through subsidies and social services in the presence of foreign exchange constraints became more questionable (Ibid.). Even though the foreign exchange allocation mechanism was meant to save foreign currency, the amount saved was outweighed by the amount lost through bureaucratic delays and inefficiency in the system (Ncube 1991).

### **2.3. The Transition to Structural Adjustment Policies**

As an acknowledgement that the regulatory regime was not sustainable, the government moved to adopt the Economic Structural Adjustment Program (ESAP) in 1991. This shift in policy was meant to pave the way for the liberalization of the economy and to encourage a surge of domestic and foreign investment. The structural reforms had notable effect in the areas of domestic deregulation, liberalization of current account transactions and financial sector reforms. However, progress in public enterprise reform and fiscal rationalization was slow. Trade liberalisation involved, amongst other initiatives, the progressive transfer of imports to the Open General Import Licence, tariff adjustment, increasing the foreign exchange retention thresholds and relaxing exchange controls to allow for the free importation of goods. Domestic deregulation involved the phasing out of price controls, the liberalisation of the marketing of agricultural produce as well as removal of wage controls.

While ESAP ushered in a flexible framework for adjustable and progressive reform of the economy, the first few years of the reform did not live up to expectations. The introduction of the program coincided with the region's most severe drought in living memory in 1991-92. The need for massive drought relief imports led to an unprecedented and unsustainable growth in imports, financed by domestic and external borrowing. At the same time, export values contracted by 14.3 percent, reflecting the impact of the drought on the predominantly agriculturally dependent and agro-based manufacturing exports. As a result, the current account balance worsened to a deficit of 12 percent of GDP. Real exports recovered after the drought. They kept improving, albeit modestly to reach a peak growth rate of 20.9 percent in 1994. The current account deficit steadily improved from US\$842 million in 1992 to US\$180 million in 1996. Gross

international reserves marginally recovered from 1.7 to 3.7 weeks import cover in late 1995 (Table 2).

**Table 2: Selected Balance of Payments Indicators (US\$ Million): 1991-1998**

	1991	1992	1993	1994	1995	1996	1997	1998
Current account balance (excluding official transfers)	-547	-842	-311	-317	-369	-180	-801	-372
Trade balance	58	-251	98	169	88	249	-230	-95
Exports, f.o.b	1758	1530	1610	1947	2216	2496	2424	1925
Imports, f.o.b	-1700	-1781	-1512	-1778	-2128	-2247	-2654	-2020
Capital account (including official transfers)	533	645	535	517	437	109	102	560
Overall Balance	-126	-171	207	268	210	-21	-739	-41
Financing	-126	171	-207	-268	-210	21	740	41
Gross official reserves (- increase)	-83	-22	-216	-232	-254	30	558	64
Arrears (- decrease)								0
Memorandum items:								
Gross official international reserves	371	393	609	584	882	830	272	55
In months of goods and services	1.7	1.7	3.1	2.8	3.7	2.9	0.9	0.3
Current account balance (in percent of GDP)-2	-6.3	-12.5	-4.7	-4.6	-4.8	-2.1	-9.6	-4

Source: *IMF Statistical Appendices*

Despite the mid-1990s recovery, the external balance experienced a negative turnaround in 1997. The current account balance sharply contracted from a deficit of US\$180 million to US\$801 million (9.6 percent of GDP). International reserves also crashed by 67 percent to end the year at US\$272 million, in developments that signalled an imminent economic crisis. These untimely developments coincided with the beginning of the currency crisis in November 1997. Real GDP growth followed a trend similar to exports in the first few years of ESAP. The cyclical growth pattern (Figure 2) clearly illustrates that despite attaining a peak growth rate of 10.4 percent in 1996, the economy never achieved a sustained stable growth path. Much of the fluctuation in growth was related to the performance of the agricultural and manufacturing sectors. The sharp decline in growth in 1997 followed a period of rising domestic inflation and growing instability in the foreign exchange market.

The analysis of economic developments during the two policy eras shows that despite the economy going full circle in terms of both non-market and market based policy approaches, it failed to achieve the primary goals of growth and equitable income distribution. Like the short-lived post independence boom period, post ESAP growth was only sustained for four years in 1992-1998. This experience may, however, not necessarily be a refutation of the appropriateness of the deregulationist policy regime. Rather, it could be the improper sequencing of ESAP policies, the failure to deal with the fundamental structural constraints that had been inherited from the colonial economy, and unfavourable weather conditions, that compromised the progress of reforms.



**Figure 2: Real GDP Growth (1991 – 1997)**

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Data Source: World Bank Database

### **3. Exchange Rate Policy Developments**

#### **3.1 Evolution of Exchange Rate Management**

After the collapse of the Bretton Woods exchange rate system in 1973, the then Rhodesian dollar was pegged to the South African Rand (SAR) and to a basket of currencies. In 1980, the government adopted a transaction-weighted basket consisting of five major currencies with a larger weight given to the US dollar. The fixed exchange rate regime was supported by the foreign exchange allocation mechanism and controls on prices and interest rates. Administered exchange rate adjustment was done in response to balance of payments disequilibria and to maintain competitiveness. Foreign currency for both current and capital account transactions was also rationed as a means of achieving a favourable external balance.

With the embrace of market reforms under ESAP the administrative foreign exchange allocation system was terminated (Ndlela, Sikwila and Dliwayo; 2000). A floating exchange rate was adopted and all controls on foreign trade were lifted. Institutions and mechanisms for foreign exchange controls were abolished. Trade liberalization and the elimination of exchange controls under exchange rate policy reforms meant that agents could import goods according to their requirements. The introduction of a market determined exchange rate system was also accompanied by the lifting of controls on investment and the financial sector.

The transition from the pegged exchange arrangements to a managed float proceeded in two phases. The RBZ first adopted a two-tier exchange rate system in January 1994. In the two-tier system, the old official exchange rate was to run concurrently with the new market rate. The system was abandoned within six months in favour of a single market determined rate as it was felt the gap between the official and market rates had reduced sufficiently to warrant a single exchange rate. To facilitate the operation of the market-based exchange rate regime, the role of the RBZ was limited to

indirect intervention to maintain the rate within prescribed band margins and to ensure efficient operation of the market.

Money was used as a nominal anchor for price stabilization while the exchange rate was allowed to adjust in order to meet international reserve targets. Companies and individuals were permitted to open foreign currency accounts (FCAs) and to transact freely in foreign exchange at the market-determined exchange rate. As exchange control regulations were progressively relaxed, allowances for business and holiday travel, education and health care were increased. In line with regional developments, foreign exchange bureaus were authorized to operate. Private sector companies were also allowed to borrow up to US\$5 million offshore without RBZ approval. In July 1994, exporters were authorized to retain 100 percent of their export earnings (Ibid.).

### **3.2. The Currency Crisis of 1997**

Despite embracing a market approach to exchange rate policy in 1992, the “fear of floating” phenomenon was clearly evident in the way the official rate was managed. Heavy intervention ensured minimal variation of the nominal exchange rate, while the RER was characterized by large swings. As illustrated in Figure 3<sup>4</sup>, the REER depreciated by 33 percent between January and October 1991 (36 percent for the bilateral RER). A steep appreciation occurred between October 1991 and December 1992, owing to high drought-induced inflation. Both RER indicators, however, appear to depreciate to reach a peak in February 1994. They then continuously appreciated (by up to about 35 percent on average). In August 1997, the REER was equivalent to its January 1991 level. This persistent appreciation of the RER led many analysts to conclude that the Zimbabwe dollar was highly overvalued, particularly towards the third quarter of 1997. Empirical studies reported rates of overvaluation that ranged between 20 and 40 percent in 1995-1997 (Ndlela et al 2000, IMF 2003, IMF 2005a).

The exchange rate developments during the initial years of ESAP positively illustrate that the government failed to adhere to the fundamental principle that monetary and fiscal policies should be consistent with the chosen nominal exchange rate regime. Violation of this consistency requirement results in severe economic disequilibrium which usually becomes manifest in RER misalignment (Edwards 1989). The experience of Zimbabwe illustrates that the exchange rate remained heavily managed while high government spending created excessive monetary expansion. Progress towards fiscal reform was also compromised by the drought of 1991-92. This led to a much higher deficit than had been projected. Consequently, broad money growth increased to 94 percent as of December 1993.

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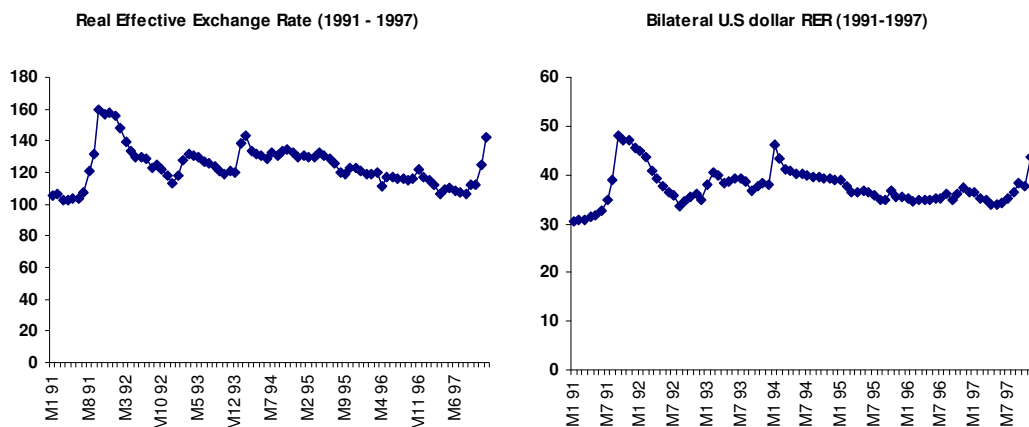
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<sup>4</sup> The RER indices are quoted in domestic currency terms (direct quotation). An increase in the value of the index represents a depreciation while a decrease is an appreciation.

reform was also compromised by the drought of 1991-92. This led to a much higher deficit than had been projected. Consequently, broad money growth increased to 94 percent as of December 1993.

**Figure 3: Real and Bilateral Real Exchange Rates: 1991 – 1997<sup>5</sup>**

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Source: REER indices obtained from the IMF, Bilateral RER computed using IFS data

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Figure 4 illustrates the behaviour of the nominal exchange rate, official reserves, money supply growth, and inflation during ESAP. The inconsistency in fiscal and monetary policy, especially credit expansion through bank financing of the budget deficit, persistently undermined the effort by the RBZ to exercise firm monetary control. Monetary expansion averaged above 30 percent per annum between 1991 and 1997. In 1994 alone, it was 60 percent. Overall, although trade and exchange rate reforms implemented under ESAP had enabled easier and increased access to foreign exchange, the thinness of the market and the lack of appropriate institutional prudence to manage the new system culminated in the currency crisis of 1997 (Ndlela et al 2000).

On November 14, 1997, the Zimbabwe dollar lost almost one fourth of its value in local currency terms. In a day that has come to be known as ‘black Friday’ the currency first collapsed by 47.5 percent, from Z\$12.6 to Z\$24 per US\$. It was restored to around Z\$18 to the US dollar by the end of the day through RBZ intervention.

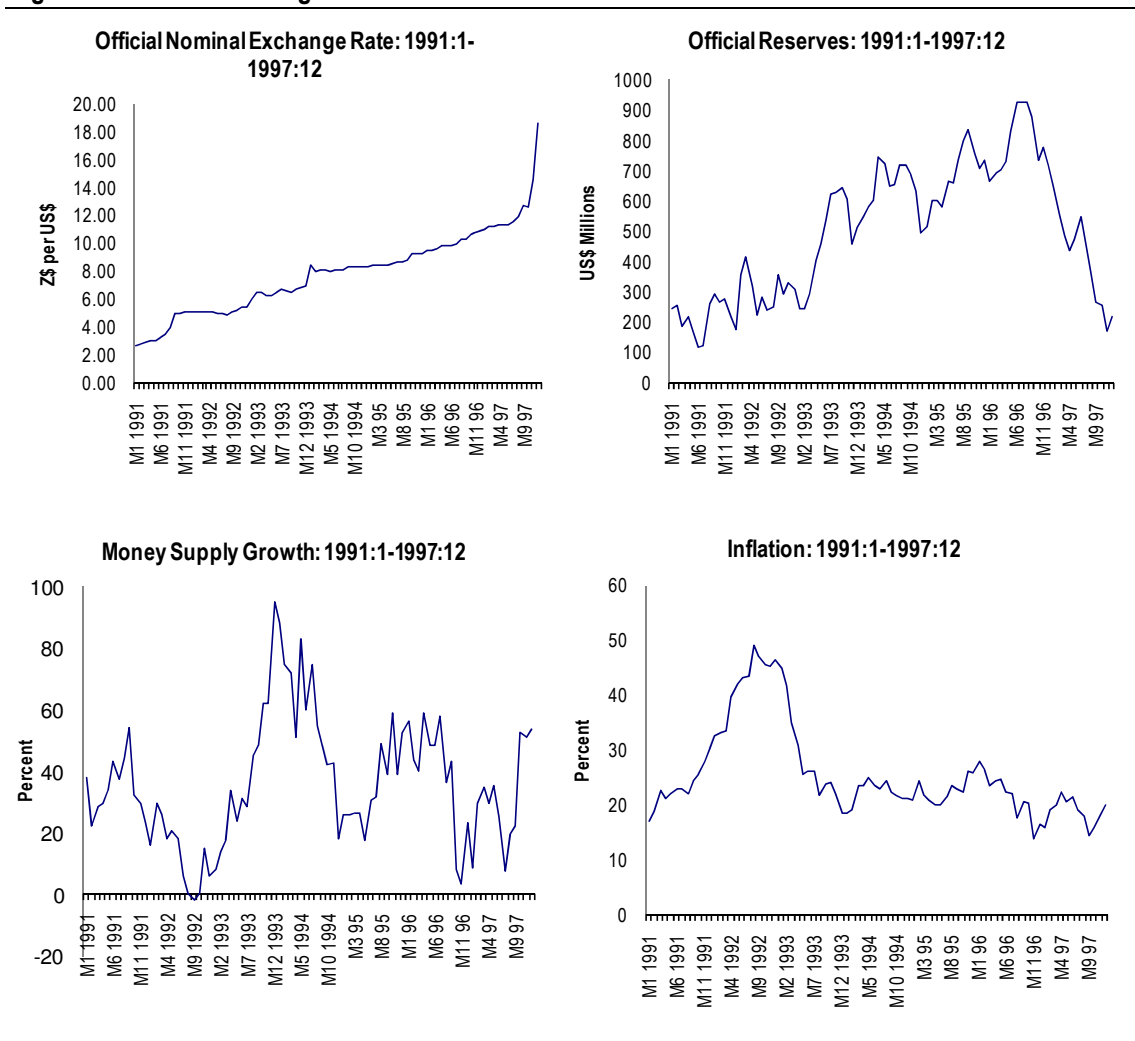
This experience epitomises an inflexible approach to exchange rate management, which results in the persistence over time of an appreciated real exchange rate. During the lead-up to the crisis, there was a tendency to confuse the appreciated exchange rate with exchange rate stability. This perception continued even after the level of gross foreign reserves fell sharply during the six-months to the end of the first quarter of 1997. The appropriate response to this fall in reserves would have been to encourage a more flexible adjustment of the exchange rate while tightening monetary policy. Neither of these two remedies was adopted when reserves began to fall, possibly because the authorities believed that the fall in reserves was temporary. However, monetary policy was progressively tightened since mid-1997, after it became obvious that reserves would not recover (Ndlela et al 2000: 3).

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<sup>5</sup> An increase in the RER represents a depreciation while a decrease in a real appreciation

A combination of events together with the perception that the currency was highly overvalued eventually precipitated the ultimate breakdown of confidence in the market. These included the awarding of huge unbudgeted war veterans' gratuities and pensions that the government could not afford, the controversial military engagement in the Democratic Republic of Congo (DRC), and the perception that reserves had declined to unsustainably low levels.

**Figure 4: Nominal Exchange Rate and Selected Macroeconomic Fundamentals**



Source: Reserve Bank of Zimbabwe, International Financial Statistics (IFS) Database

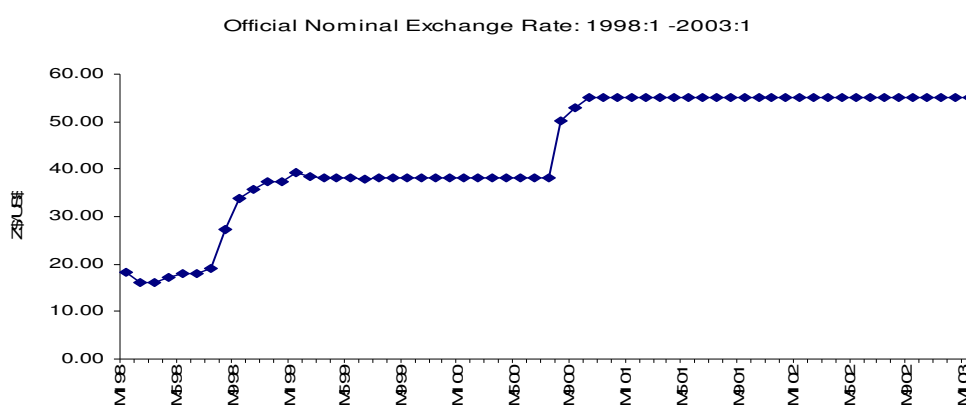
The response of the authorities to 'black Friday' also worsened the crisis (Robinson 2001). In addition to restoring the nominal exchange rate to a level which was still overvalued, exporters were deprived of the right to maintain foreign currency denominated accounts. The export proceeds repatriation period was reduced from 180 to 90 days. "Emergency" tariffs were imposed on various commodities, distorting the protection structure without measurable benefit to exporters (Ibid.). Additional measures included the raising of the rediscount rate and tightening of restrictions on foreign exchange holdings of authorized dealers.

Figure 5 illustrates the nominal exchange rate after the currency crash. The rate was still appreciating within the first 2 months of 1998 as the RBZ continued its frantic intervention efforts. By end of the first quarter of 1998, speculative pressures on the currency were clearly overwhelming. Despite an artificially steady trend that lasted for 4 months, a series of crashes was imminent. With the seemingly counter-effective measures, the exchange rate crashed again by about 49 percent between July and November 1998. At that time the RBZ had run out of reserves and was unable to defend the currency. The floating regime was abandoned and replaced by a super-fixed regime in which the exchange rate was fixed at Z\$38/US\$. After a brief crawling peg, the rate was eventually fixed rate at Z\$55/US\$ in November 2000. It remained at that level for 28 months until a 98 percent devaluation lifted it to Z\$824 against in February 2003.

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**Figure 5: Official Nominal Exchange Rate: 1998 – 2003**

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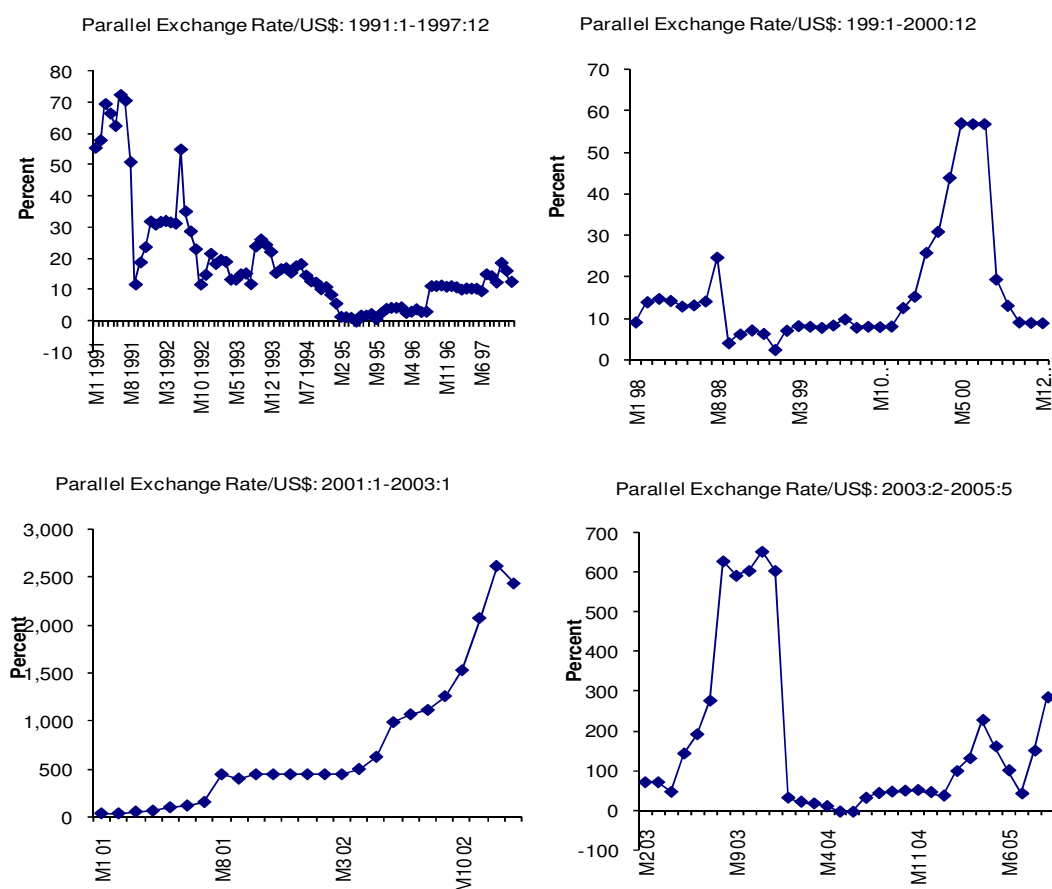
Data Source: Reserve Bank of Zimbabwe

### **3.3. The Parallel Market for Foreign Exchange**

Foreign exchange shortages and the balance of payment crisis deepened after the currency crash. The RBZ responded by further tightening exchange control measures. As a result, the parallel market premium started gradually to increase. Before the currency crash, the premium had steadily declined from about 70 percent in 1991 to about 12 percent in December 1997. Despite increasing to about 24 percent in August 1998, the premium had subsequently subsided. It ranged between 4-10 percent from September 1998 to end of 1999, before increasing to a peak of 57 percent between May and July in the run up to the parliamentary elections of June 2000.

The parallel market grew rapidly in size and dominance. From about 9 percent in December 2000, the premium sharply increased to 120 percent in June 2001. At that stage, the nominal official exchange rate had only become relevant for official transactions, such as debt service and the importation of liquid fuels and electricity. Almost all other transactions were conducted at the parallel market rate (Robinson 2001). Even though it was illegal, the parallel market was tolerated by the authorities and operated in a quasi-official way by the banks.

**Figure 6: The Parallel Market Premium: 1999 – 2006**



Data Source: Reinhart and Rogoff (2003) database for 1991-1998, Author's compilation (1999-2005)

Attempts to curb the parallel market by tightening exchange controls had a devastating impact on export receipts and only exacerbated the increase in the premium. In particular, the highly restrictive exchange control requirements squeezed the limited foreign exchange available, and the premium increased to 450 percent by end 2001. It reached an astounding 2625 percent by December 2002 (Figure 6). While private companies and individuals also relied on the parallel market to meet their foreign currency needs, it was the participation of major state entities that precipitated sharp increases in the premium (IMF 2003).

A maxi-devaluation of 93.3 percent led to a temporary appreciation of parallel market rates in February 2003. The premium declined from about 2400 percent to about 60 percent in March 2003 as the majority of exports moved to informal channels (Ibid.). The effect was, however, short-lived. By the end of 2003, the premium had recovered to about 650 percent. This prompted the authorities to take urgent measures that culminated in the introduction of a managed foreign exchange auction in January 2004.

The launch of the auction sharply reduced the premium to about 30 percent. In May – June 2004, it was a negative, -4.5 percent. Although such periods of negative premium may be difficult to justify theoretically, in practice they may be rationalised by

the fact that the emergence of a significant negative premium can be associated with expectations of revaluation of the official exchange rate (Agenor 1992).

A negative premium may also emerge during periods when exchange controls restrict commercial banks from buying foreign currency from exporters without proper identification of the seller. In such circumstances, a negative premium represents a “laundering charge” paid by agents who have no legal rights to the foreign currency they are offering for sale (Ibid.). The fluctuations in the premium in 2004 reflect the response to stringent exchange controls and rigid exchange rate management. After an initial increase of about 30 percent, the premium had sharply increased to about 230 percent in mid 2005. A brief slowdown to about 40 percent was initiated by an official devaluation. However, by end of 2005, it had again reached levels of up to 300 percent

## 4. Towards Full-Scale Economic Crisis

### 4.1 The External Balance Collapse

After the currency crash, trade contraction and a foreign aid freeze induced by political instability led to a rapid deterioration of the country's external position and intensified the foreign currency crisis. Balance of payments support by multilateral agencies was also suspended owing to failure to meet performance targets and mounting political instability. Private capital flows, largely consisting of foreign investment and long- and short-term capital inflows, declined substantially as investor confidence collapsed. As a result, the capital account deteriorated sharply between 1998 and 2000 (Table 3). Gross international reserves also collapsed from US\$55 million in 1998 to US\$16 million 2001, equivalent to only three days import cover.

**Table 3: Selected External Indicators**

	1998	1999	2000	2001	2002	2003	2004 <sup>1</sup>
Current account balance (excluding official transfers)	-372	47	-38	-82	-213	-346	-421
Trade balance	-95	249	293	323	-19	-151	-309
Exports, f.o.b	1925	1924	2200	2114	1802	1670	1680
Imports, f.o.b	-2020	-1675	-1907	-1791	-1821	-1821	-1989
Capital account (including official transfers)	560	143	-227	-386	-317	-210	-170
Overall Balance	-41	-37	-135	-177	-456	-476	247
Financing	41	37	135	177	456	476	247
Gross official reserves (- increase)	64	8	25	6	1	1	9
Arrears (- decrease)	0	114	281	292	570	443	240
Gross official international reserves	55	47	22	16	15	16	16
Import cover (months)	0.3	0.2	0.1	0.1	0.1	0.1	01
CAB (in percent of GDP) <sup>2</sup>	-4	0.5	-0.4	-1.0	-2.6	-4.6	-5.7
Total Arrears	9	123	404	803	1520	2141	2584
Total Debt	4466	4321	4014	3845	4370	4843	4960

Source: IMF Statistical Appendices (2005)

1/ IMF Estimates, 2/ Year End Usable Reserves

Sustained exchange rate overvaluation and structural distortions in major export sectors, particularly in the agricultural sector, resulted in exports declining from 30.3 per cent of GDP in 2000 to 9.6 per cent in 2001. The cumulative decline in export receipts from 1996 to 2001 was 37 percent. This critically impaired the ability of the economy to acquire essential imports. Total imports fell from 31.4 per cent of GDP in 2000 to 16 per cent in 2002 (AFDB/OECD, 2004). Real export earnings declined by 18 percent during the same period. The current account deficit increased from about 0.4 percent of GDP in 2000 to about 6 percent in 2004. Without any foreign financing or usable reserves, this deficit was financed by an accumulation of arrears. Hence, by mid-1999 the government had defaulted on most of its external debts. Arrears (on both public and private sector debt) amounted to 2.8 percent of total external debt, or US\$123 million, at end of 2002. They escalated to US\$2.58 billion or 52 percent of external debt by end of 2004. Total external debt in 2004 was equivalent to 3 years of exports at current levels.

#### **4.2 The Growth Slowdown**

Real GDP growth sharply declined from a peak of 10.4 percent in 1996 to 0.5 percent in 1998 in the aftermath of the 1997 currency crisis (Table 4). The economy contracted by an average 5 percent per annum during 1999-2002, and by 10 percent in 2003. Of the key sectors, manufacturing contracted by about 13 per cent in 2002 and a further 14 per cent in 2003. The fall in capacity utilisation to an all-time low of 55 per cent in 2003 (from about 60 per cent in 2002) was attributed to shrinking domestic demand and low export competitiveness (AFDB 2004).

Industrial production, which relies heavily on imports, was badly hit by acute foreign currency shortages. As a result, output of non-metallic minerals fell 40 percent, food 30 percent, textiles 26 percent, wood and furniture 20 percent and transport equipment 12 per cent (Ibid.) Agriculture, on the other hand, declined by 22 percent in 2002, reflecting the repercussions of the government's fast-track land reforms. The cumulative decline in real GDP from 1999 to 2004 was about 32.6 percent in real terms. In total, manufacturing and agricultural sectors contracted by 57.9 and 24.6 percent over the same period. However, it was the construction sector that suffered the most severe impact, recording negative growth of 35 and 42 percent in 2001-2002 and a cumulative contraction of 122.3 percent in 1999-2004.

Lack of foreign currency meant exporting and even non-exporting companies that wanted to import new capital, raw materials, and spare parts were forced to seek foreign exchange on the parallel market. This resulted in cash flows being strained by the substantial parallel market exchange premium. The transport sector, which had been crippled by fuel shortages, was also unable to refurbish and replace obsolete capital let alone to expand to meet demand. This forced companies that relied heavily on transportation of raw materials to close down or sharply scale down operations.

According to the Confederation of Zimbabwe Industries (2004) survey, 840 manufacturing companies closed down in 2000 - 2004, with heavy loss of employment. In addition, 60 percent of companies had no planned investment in 2002-03. This turn of events with respect to economic growth was a clear illustration that the economy was in a severe recession. The economic base of the country was disintegrating and so were the underlying standards of living and the socio-political environment.



**Table 4: Gross Domestic Product, Percentage (Constant 1990 Prices)**

	1998	1999	2000	2001	2002	2003	2004
<b>Percentage Change at Constant 1990 Prices</b>							
Agriculture, hunting and forestry	2.3	3.6	3.2	-3.9	-22.7	-1.0	-2.9
Mining and quarrying	8.4	-7	-6.9	-13.5	2.2	-28.7	24.9
Manufacturing	-3.4	-4.5	-11.5	-5.4	-13.2	-13.8	-9.5
Electricity and Water	-4.3	7.6	-1.0	10.3	6.2	1.5	-1.5
Construction	6	-11.1	-15.0	-35.2	-41.0	-15.5	-4.5
Finance and Insurance	6.2	-4.5	0.8	-1.2	-21.2	-23.7	-3.0
Real Estate	5.4	5.1	4.9	4.2	3.9	2.2	-5.0
Distribution, hotels and restaurants	0.8	0.4	-8.8	-5.2	-4.5	-30.8	-4.3
transport and communications	-11	-3.7	-6.3	-5.5	-1.0	-8.1	-5.5
Public administration	-3	-4.8	-6.2	4.7	2.0	2.1	-4.5
Education	6.8	-8	3.7	5.9	1.0	-0.7	-4.0
Health	6.6	14.5	-7.6	17.8	-13.0	1.4	-5.5
Domestic services	-1.1	-6.3	-5.0	5.7	2.5	0.4	-2.5
other services	2.2	7.4	-2.1	-2.7	1.8	1.8	-5.5
Less: imputed bank service charges	37.4	13.9	13.9	0.0	-24.8	-25.6	-15.5
GDP at Factor cost	-0.8	-2.1	-5.4	-3.4	-4.8	-10.8	-3.4
Net other taxes on production	39.4	-16.2	-17.1	-23.7	-43.6	-71.6	-25.0
GDP at basic prices	-0.7	-2.2	-6.1	-3.5	-4.9	-10.9	-3.5
Net taxes on products	10.8	-14.7	-24	6.7	0.6	-5.4	-10.5
GDP at market prices	0.5	-3.6	-7.3	-2.7	-4.4	-10.4	-4.2
<b>In Percent of GDP</b>							
Private Fixed Investment	18.9	12.1	10	5.7	4	1.2	--
Public Fixed Investment	1.7	1.4	0.6	1.6	1.5	2.0	--
Changes in Stocks	0.1	1.8	2.5	-1.7	-14.3	-16.2	--
Private savings	14.6	18.2	28.2	6.0	-11.9	-17.0	--
Public Savings	-1.2	-5.7	-18.1	-6.6	-1.2	2.1	--

Source: IMF Statistical Appendices (2005).

### 4.3. The Emergence of Hyperinflation

The emergence of hyperinflation has been linked to excessive monetary expansion and rapid depreciation of the currency, particularly on the parallel market. From 1998, the government's increased reliance on bank credit led to high levels of credit expansion that were unrelated to productive economic activity. Significant increases in civil service allocations and other expenditures in the run-up to the elections in June 2000, together with the strain of defence spending due to military involvement in the DRC conflict<sup>6</sup> and a surge in interest payments, pushed the budget deficit to 18 percent of GDP by 2000. As a result, monetary growth averaged 61 percent in 1999 and reached 60 percent in December 2000. Inflation increased from 70 percent in October 1999 to 100 percent in November 2001, before reaching 200 percent by December 2002.

In attempts to stabilize prices, the government announced a temporary price freeze in November 2002. Under the measures: (i) prices of commodities would remain fixed for a period of six months subject to a previously announced order of October 2001; (ii) the freeze was extended to cover a broader spectrum of goods, including some beverages, all household utensils and equipment, new cars, and entertainment services;

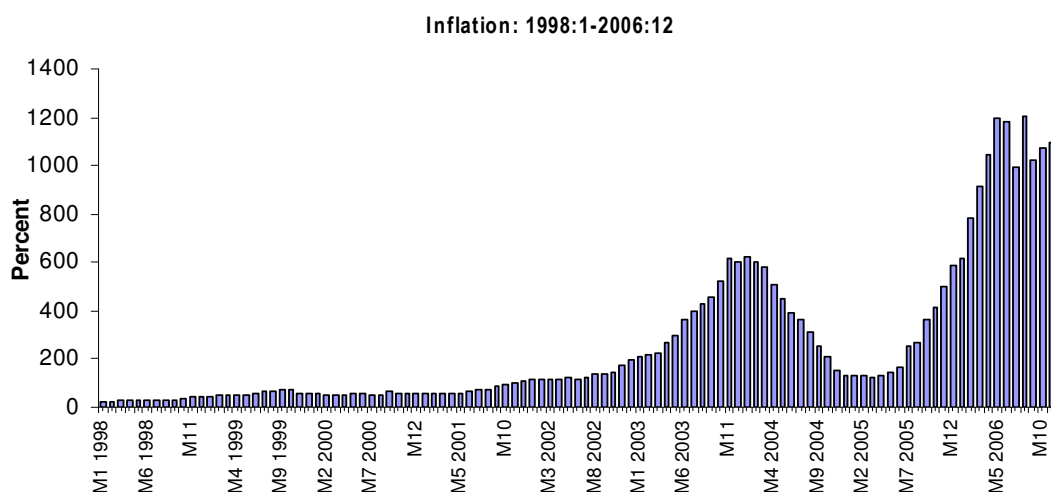
<sup>6</sup> According to the Economic Intelligence Unit (2004), Zimbabwe spent an estimated US\$250 million in the DRC involvement.

and (iii) the rebranding and repackaging of items to avoid price controls was prohibited. The new control measures resulted in 70 percent of items in the consumer price index (CPI) being subject to administered pricing (IMF 2004). This administered pricing system, however, did little to halt the hyperinflation. In fact, most basic commodities disappeared from shelves and black market trading of goods thrived.

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**Figure 7: Annual Inflation: 1999-2006**

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Data Source: Reserve Bank of Zimbabwe

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Inflationary pressures further increased with the growing impact of currency depreciation, foreign exchange shortages, acute shortages of goods spurred by administered pricing, and the sharp contraction in domestic production. At the same time, the growth in money supply, driven by quasi-fiscal operations of the RBZ and government borrowing, increased to some 455 percent in 2004.

This was followed by a drastic increase in inflation of more than 400 percentage points within one year to reach 622.2 percent in January 2004. Inflation subsequently decelerated to 130 percent at end of 2004 in response to a tighter regulatory environment and administered foreign exchange allocation. However, in mid 2005, the upward spiral resumed and continued without restraint. It reached 1000 percent in June 2006, ending the year at 1280 percent. In all, the government tried to institute a number of frantic policy measures in attempts to control the unfolding crisis. Of particular interest and relevance to the understanding of the impact of RER misalignment is the monetary policy response.

## **5. Monetary and Exchange rate Policy Response to the Crisis**

### **5.2. Interest Rate Policy Response**

The RBZ tried to use interest rates as one of the main market instruments for foreign exchange market stabilization. The market rates were largely influenced by the RBZ rediscount rate (later replaced by the bank rate in 2000) and the short-term Treasury Bill

(TB) rate. Use of interest rates to ease demand pressures on the overvalued exchange rate and to control rising inflation caused rates to triple over two years, rising from about 25 percent at the end of 1997 to exceed 70 percent by the end of 1999. However, without any reserves to back the currency in the presence of a growing parallel market, the rise in interest rates fuelled money market speculation and crowded out productive investment.

The use of interest rates to stabilize exchange rates during a currency crisis has been justified in terms of its potential to curb acute capital flight. The conventional 'flow' view of cross-border capital movements holds that higher interest rates raise the yields on domestic assets and attract capital inflows or discourage capital outflows. Increasing interest rates also makes it very costly for speculators to take short positions in the currency under attack, thereby discouraging speculation in the foreign exchange market. Tight monetary policy is further perceived as a signal of the commitment of the monetary authorities towards defending the currency. This may restore confidence and avert further speculation (Backus and Driffil 1985).

On the other hand, some economists oppose this view (Stiglitz and Furman, 1998, Radelet and Sachs 1998, Goderis and Ioannidou, 2006). Instead, they argue that raising interest rates during a crisis may further weaken the currency. This is because increasing interest rates can worsen the financial position of debtors, inducing bankruptcies and increasing the probability of default. This may in turn affect the firms' creditors and the health of the banking sector. The outcome could be a credit crunch that worsens the financial situation, resulting in capital outflows and exchange rate depreciation.

Furthermore, higher default probabilities and riskiness may offset the enhanced attractiveness of investment in local currency-denominated assets and discourage foreign investors. Reactions to the enhanced riskiness of particular classes of assets may well increase the probability that a speculative attack develops into a currency crisis. Moreover, interest rates have to be increased to very high levels in order to make domestic investment attractive (Goderis and Ioannidou 2006).

Failure of the interest defence led the RBZ to loosen monetary policy in September 2000. To provide a low interest environment to stimulate productive sector borrowing, banks were authorised to use statutory reserves to issue loans at preferential rates (15 and 30 percent) to exporters and the productive sectors, respectively. Monetary policy was further loosened in January 2001 when the RBZ redeemed all maturing short-term TBs. This led to a sharp increase in liquidity and a precipitous decline in interest rates. The reference 91 day TB rate crashed from around 55 percent to 12 percent. An increase in inflation from 57 percent in January 2001 to 112 percent by mid-year led to real interest rates becoming highly negative (up to -80 percent).

While the RBZ maintained a rule of keeping the bank rate at 2-2.5 percent above the inflation rate, it did not serve any purpose, as banks do not need to borrow from the Central Bank in a liquid market. The rule was implicitly abandoned towards mid 2001. While interest rates had closely followed the bank rate for a long time, in 2001 the situation changed drastically. The bank rate was rendered an ineffective monetary policy tool. The excess liquidity, together with the low interest rates, perfected the conditions under which foreign exchange arbitrage began to thrive at an unprecedented scale.

The experience demonstrates that if economic activity is severely constrained by an overvalued exchange rate and foreign currency shortages, then provision of domestic currency funding, even at the lowest rates, cannot stimulate productive investment.

Companies instead compete for the limited foreign exchange on the parallel market using any funds they can secure. Hence the premium in the parallel market rose to levels that, by July 2001, were estimated to exceed the level required for export competitiveness by some 60 percent (on an inflation differential basis) (Robinson 2001). Faced with large negative real interest rates, individuals and companies had no incentive to save, and every incentive to spend on consumption and to speculate in shares and property. The dramatic surge in the stock market and recovery of property prices generated wealth effects (of asset inflation) that amplified spending and inflationary pressures. Anecdotal evidence suggests that excessive purchases of some imported goods including luxuries were made and stockpiled while severe shortages of vital imports ensued (Ibid.).<sup>7</sup>

In November 2002, the RBZ formally abandoned the Bank rate as a monetary policy tool and replaced it with the Repurchase Agreement (Repo) Rate. Preferential borrowing rates of 15 and 30 per cent were prescribed for exporters and productive entities, while all other rates were left to the market. Unlike the September 2000 policy which allowed productive lending to be made from statutory reserves, this time the preferential rates applied to market for loanable funds. Statutory reserve requirements were increased from 10 to 20 percent for time and savings deposits, and set at 50 percent for demand deposits. The growing need for government borrowing from the private sector to finance failing state enterprises and to procure foreign exchange for critical imports however kept the upward pressure on interest rates. As a result short-term money market rates started increasing sharply from about 30 percent in December 2002, to about 600 – 900 percent by December 2003.

### **5.1. Exchange Controls and Multiple Currency Practices**

One of the major responses of the RBZ to the currency crisis was abandonment of the managed float and resort to an administratively fixed exchange rate. Under the new regime, the currency was arbitrarily pegged against the U.S. dollar at a rate determined by the RBZ in consultation with the Minister of Finance. Although the Minister of Finance had the final authority of approval in the announcement of any exchange rate adjustment, experience dictates that this process had to go through the highest political office. Moreover, the government's attitude towards exchange rate management was noticeably driven by fears that nominal devaluations would trigger an unacceptable and potentially permanent surge in inflation. Hence, exchange rate adjustments were very infrequent, while being subject to intense political scrutiny. With virtually no usable reserves, the exchange rate was not supported by any form of market-based intervention. The RBZ relied almost entirely on exchange controls to enforce compliance and direct foreign exchange inflows and transactions to the official market. The meagre reserves that were mainly obtained from export proceeds were subject to very tight rationing. Table 5 illustrates the series of measures that were introduced between 1998 and 2002.

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<sup>7</sup> Where the foreign exchange is rationed, the relatively wealthy and powerful may stand a better chance of obtaining it. This rationed foreign currency, often obtained at a high premium in the parallel market, is more likely to be used for the importation of luxury items than of basic necessities (Huizinga, 1995).

**Table 5: Exchange Control Policy Measures: 1998 – 2002**

	<b>Policy</b>	<b>Policy Directives</b>
February 1998	Surrender Requirements	<ul style="list-style-type: none"> <li>Reintroduction of compulsory export surrender requirements with all exporters required to surrender 25% of their foreign exchange (forex) proceeds to the Reserve Bank for critical import payments such as electricity, fuel and official government financing</li> </ul>
August 1998	Capital restrictions on authorized dealers	<ul style="list-style-type: none"> <li>Increase in capital requirements for foreign exchange bureaux from \$US10,000 to \$US100,000 and the suspension of the licencing of new ones.</li> <li>Bureaux were allowed to purchase currency from an authorized dealer up to a maximum of 50% of capital in cash per month, without prior Exchange Control Approval.</li> <li>All forward contracts were suspended and Authorized Dealers foreign exchange limits were reduced from a limit of US\$5 million to US\$2 million or 10% of capital.</li> </ul>
January 1999	Restrictions on foreign currency account balances and transactions	<ul style="list-style-type: none"> <li>Authorized dealers required to offload 50% of the FCA balances into the market</li> <li>FCA balances to be retained for a maximum of 60 days after which they are offloaded onto the market</li> <li>Export proceeds to be sold only to Authorized Dealers.</li> <li>FCA funds restricted to financing own requirements.</li> </ul>
January 2000	Compulsory allocation of foreign currency balances to state entities	<ul style="list-style-type: none"> <li>Authorized Dealers to ensure that 50% of all payments made from export proceeds on any single day are allocated towards NOCZIM<sup>8</sup>, ZESA and debt service payments and preferential allocation to horticulture and gold exporters.</li> <li>On any drawdown by an FCA holder, the equivalent should be set-aside for NOCZIM and ZESA.</li> <li>Authorised Dealers allowed to accumulate foreign currency balances to a minimum amount of US\$50 000, after which the funds should be transferred to FMB, MBCA and Stanchart on account of NOCZIM, ZESA, and PTC.</li> </ul>
March 2000	25% Surrender Requirements	<ul style="list-style-type: none"> <li>Authorized dealers were required to set aside 25% of their currency payments towards priority areas set by RBZ. This was to cover fuel and electricity imports.</li> </ul>
June 2001	40% surrender requirements	<ul style="list-style-type: none"> <li>The 25% export surrender requirement was increased to 40 % due to persistent shortages of forex to cover ZESA and NOCZIM imports.</li> </ul>
December 2002	100% surrender requirements	<ul style="list-style-type: none"> <li>In attempt to control parallel market and boost official inflows, all forex bureaux de change closed with immediate effect.</li> <li>Surrender requirements increased from 45% to 50%.</li> <li>All foreign currency receipts from exports to be deposited with the RBZ, including exporters 50% entitlement.</li> <li>Introducing priority list for approval of foreign exchange payments</li> <li>Cancellation of exemptions on 40% retention for export processing zone companies and other special entitlements</li> <li>All loan applications regardless of their level to be submitted to external loans coordinating committee.</li> </ul>

Compiled from Reserve Bank of Zimbabwe Exchange Control Orders

<sup>8</sup> The National Oil Company of Zimbabwe (NOCZIM), the Zimbabwe Electricity Supply Authority (ZESA) and the then Post and Telecommunications Corporation (PTC), now TelOne, are responsible for the procurement and supply of petroleum , electricity and telecommunication services respectively.

Furthermore, in an attempt to support the producers of strategic exports such as gold, tobacco, and cotton, the RBZ introduced an array of “support prices” through multiple currency practices. Special subsidised domestic currency prices were set up for goods, which were traded under the direct marketing and supervision of the RBZ. This arrangement granted producers an exchange rate heavily depreciated relative to the official rate, albeit much lower than the parallel market rate. The effective exchange rates were often computed on a minimum cost recovery basis and entailed huge subsidies. In the process, the RBZ incurred heavy exchange rate losses as it had to sell the foreign the currency it received to the government at the overvalued official rate.

In February 2003, the official exchange rate for most transactions was devalued by 93 percent, from Z\$55 to Z\$824 per US dollar. To avoid certain political fallout with government, the RBZ introduced a two-tier exchange rate system. Under the arrangement, the new rate would apply to all market transactions, while government and state entities continued to access foreign exchange at the old rate of Z\$55 per U.S dollar. The two-tier arrangement of February 2003 was underpinned by the Exchange Control Order of December 2002. All foreign exchange transactions regardless of amount were to be subject to RBZ approval (RBZ 2003).

### **5.3. The Foreign Exchange Auction System**

At the height of the foreign exchange crisis in December 2003, the RBZ introduced a Dutch foreign exchange auction system. The managed auction was intended to be a strategic measure to stabilize the foreign exchange market and control the parallel market. All foreign currency accounts held with commercial banks were migrated to the RBZ, and all foreign exchange transactions remained subject to RBZ approval. The launch of the foreign currency auction effected a 74 percent devaluation of the official exchange rate, from Z\$824 to Z\$3218 per US dollar at the first auction in January 2004. The dual official exchange rate system was retained. A fixed rate of Z\$824 per US dollar was applicable to government transactions and official payments while all other transactions were subjected to the going auction rate. The following measures were introduced to support the auction system (RBZ 2003):

- i. Exporters were required to surrender 50 percent of their foreign currency earnings to the Reserve Bank to finance critical imports and government payments.
- ii. Of the 50 percent export proceeds they surrendered, half was to be immediately converted at the fixed official exchange rate of Z\$824 per US dollar and the other half at the going auction rate. The funds would then be credited to the exporter's account in local currency.
- iii. The remaining 50 percent of proceeds was to be deposited into the Exporter's foreign currency account held with the RBZ for own use, subject to Exchange Control approval. This portion could only be retained in foreign currency for a maximum period of 60 days, after which the funds would be converted at the going rate and auctioned (Ibid).

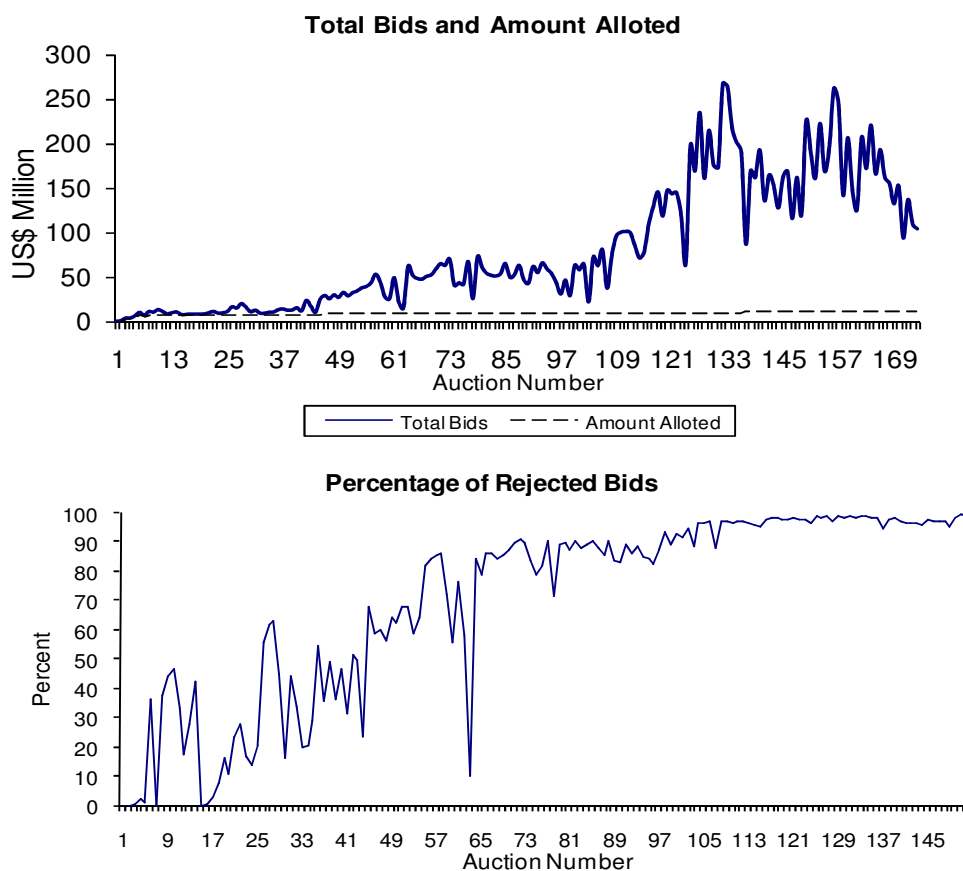
A notable short-term impact of the auction system was the immediate reduction in the parallel market premium. The parallel market rate appreciated by 40 percent from Z\$6500 to Z\$3000 per US dollar. In addition, the transfer of foreign currency accounts to

the RBZ largely curtailed the quasi-official participation of financial institution in the parallel market. Nonetheless, the market remained very active but operated now underground. In terms of exchange rate determination, the auction system turned out to be heavily controlled. The auction rate was predetermined. Bids that were considered high and, therefore, potential stimulants for inflation were rejected. Approval of bids and allocation of foreign exchange at the auction was subject to the RBZ priority list and Exchange Control approval. Bids for currency that would be used for purposes not considered of high priority were also rejected. Figure 8 shows total bids versus amount allotted and the percentage of bids that were rejected for the duration of the system.

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**Figure 8: Total Bids and Amount Allotted on the Auction (US\$ millions)**

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Data Source: Reserve Bank of Zimbabwe

A fundamental weakness of the auction system was that the demand for foreign exchange exceeded the available supply by far. With the major source of auction funds being export proceeds, exporters were also heavily penalized by the two-tier exchange rate system, and this further crippled official inflows. During the course of the auction system, exporters who needed to import inputs had to purchase the foreign exchange from the auction at a more depreciated rate (20 – 25 percent premium) than they had sold it to the RBZ. In addition, although the gradual relaxation of surrender requirements on

exporters resulted in a de facto depreciation of the official rate by mid-May 2004, it did not ease the critical foreign exchange shortages.

An evaluation of the auction system shows that from the Auction 1, the amount of bids sharply increased from US\$0.47 million to a peak of US\$267 million on auction number 133. On the other hand, the amount allotted only increased from US\$0.47 million to 12.5 million by auction number 171. By auction number 108, the percentage of rejected bids averaged over 97 percent, implying the acceptance of a paltry 3 percent of bids. After failing to cope with excessive demand, the auction system was abandoned in October 2005. It was replaced by the interbank rate which was to be determined freely in the market but subject to RBZ approval. The move resulted in the official exchange rate depreciating from an auction rate of Z\$26,000 to \$60,284/US dollar on the interbank market. However, a further 29 percent depreciation during the first month prompted the abandonment of the market based system. It was replaced by a transactions-weighted exchange rate wherein the rate was capped to adjust only by a 1 - 2 percent margin if transactions exceeded certain thresholds. Otherwise, it was to be periodically adjusted during occasional monetary policy announcements.

#### **5.4 Currency Reforms and Prospects for Stabilization in Retrospect**

In a monetary policy statement (MPS) issued by the RBZ on 31 July 2006, the Zimbabwe dollar was revalued by removing three zeros from the nominal exchange rate. The loss of value of the local currency, which eventually forced the currency reform, was mirrored in the extent of depreciation of the Zimbabwe dollar. In 1996, the exchange rate had been Z\$10/US\$. Since then, it was officially devalued by 99.996 percent to reach Z\$250,000/US dollar in July 2006.

The depreciation on the parallel market was even more dramatic with the rate reaching Z\$650,000 within days of the announcement of currency reforms (Robinson 2006). Interest rates were extremely high and volatile. Before the MPS, overnight rates at the central bank were set at 850-900 percent per annum. The 91-day TB rates had been of the order of 350 percent in the first half of 2006, but they were subsequently changed with unprecedented frequency. Banks were called upon to reduce their lending rates, and statutory reserve requirements were eased.

As the overvaluation progressed, the authorities tried to alleviate the burden on exporters by providing producer subsidies and credit to the private sector that was funded by the Reserve Bank at highly concessional rates. The first of these, the Productive Sector Facility (PSF), was launched in February 2004 as an alternative to devaluing the currency. Under the PSF, companies borrowed at interest rates of 30 percent, later adjusted to 50 percent in July 2004. However, it was the expansion of these quasi-fiscal activities that mainly fuelled sharp increases in reserve money as well as broad money in 2004–2005, feeding into the acute inflationary spiral (IMF 2005b).<sup>9</sup>

Evidence also indicates that these facilities were not put to their intended use. Indications were that most of the cheap funds were diverted to speculative purposes in the foreign exchange market while some were invested in gilt-edged securities and short-

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<sup>9</sup> The RBZ in its defence of the quasi fiscal activities maintained that the provision of concessionary resources to the productive and export sectors of the economy arrested economic decline, stimulated productive activities and restored business confidence (RBZ 2005)



term money market instruments offering very high interest rates. In an environment where money market interest rates are multiples of the interest rates available to participants, it is more lucrative to deploy those funds to obtain the certain returns from money market investments rather than using them for the uncertain and more demanding purposes for which they were intended. The PSF was discontinued in July 2005 without any noticeable macroeconomic benefits but huge quasi-fiscal losses to the RBZ. However, those concessionary facilities that provided support for the government's land reform program and state-owned enterprises were retained. A new concessionary facility was introduced for small-scale enterprises. Banks were also urged to match the amount which the RBZ had pledged to provide for this purpose (Robinson 2006).

Overnight RBZ accommodation rates were reduced from 850 to 300 percent for secured, and from 900 to 350 percent for unsecured lending, which is equivalent to 1884-3157 percent per annum when compounded. Although the move ensured positive real interest rates on overnight loans, such a sharp drop in interest rates was likely to be perceived by the markets as a signal that inflation would continue to increase without restraint. Furthermore, the announced devaluation of the currency from Z\$101,000/US\$ to Z\$250,000/US\$ was largely perceived as inadequate relative to the prevailing parallel market rate of Z\$650,000 per US dollar. Although some positive changes in the MPS allowed indefinite retention of 75 percent of export proceeds, the prospects were that, without the exchange rate adequately rewarding exporters, the shortages of foreign currency would persist and continue to spur imported inflation into the economy.

Speculation, hoarding and parallel market activity are inevitable responses to distorted economic incentives. No amount of policing will eliminate such activities as long as the underlying policy framework is inadequate. Unfortunately, the cumulative result of ill-conceived, half-hearted stabilisation measures has resulted in an economic situation which is much more difficult to address than it was even a few years ago, when the crisis was already deemed to be all but intractable (Ibid.5).

In retrospect, the developments in Zimbabwe show that as early as 1982, 2 years after independence, the economy was already developing critical structural disequilibrium problems, particularly with respect to the internal-external balance. But the authorities failed to address the problems that faced the economy then. Instead, the economy appears to have been sustained by running huge current account deficits that were mainly financed by donor funds, heavy external borrowing and strong recourse to the domestic financial system.

The eventual abandonment of reform initiatives in the midst of a currency crisis and impending recession at the end of the 1990s further reveals the extremes to which a crisis that is driven by prolonged RER misalignment can degenerate. With extensively delayed macroeconomic adjustment, the authorities were left to contend with increasingly complicated and highly controversial options. The experience of Zimbabwe could justify the presumption that any stabilization approach which in the face of an exchange rate crisis fails to acknowledge the need to realign the exchange rate, and therefore restore the internal-external balance, faces bleak prospects under any circumstances.

## **6. Summary and Concluding Remarks**

This paper has reviewed Zimbabwe's exchange rate and monetary policies in relation to macroeconomic performance during the post independence period, 1980 up to 2006. The review provides a case study of the extent to which failure to implement credible policies can lead to severe exchange rate misalignment, currency crisis and full scale macroeconomic instability. The analysis further demonstrates that despite the initial economic boom and optimistic redistribution objectives that underlined post-independence government policies, the economy had always remained stuck in long-term structural disequilibrium from as early as 1982 from which it never recovered.

The inward looking policy regime that was supported by extensive controls on the economy failed to achieve its intended objectives of growth with equity. An initial short-lived post independence boom was followed by serious foreign exchange shortages, declining investment, high budget deficits, unsustainable current account deficits, high levels of unemployment and lacklustre economic growth. On the other hand, the structural adjustment programme adopted in 1991 was stymied by drought and other inherent structural and institutional rigidities in the economy. This led to sustained exchange rate misalignment and a currency crisis at the end of 1997. By the end of the 1990s, a macroeconomic crisis was unfolding that was characterized by a severe balance of payments crisis, a sharp recession and hyperinflation. The Government eventually backtracked on its policies – abandoning ESAP as it struggled to cope with the crisis.

In a series of ad hoc monetary policy responses to the crisis, the government engaged in a vicious cycle of policy reversal. In particular, a sharp increase in interest rates was meant to stabilize the currency after the crash of 1997. However, very high interest rates in an import dependent economy with acute foreign exchange shortages did not stimulate investor confidence, but led to widespread financial market speculation and crowding out of productive investment.

Follow-up efforts to reduce interest rates for the benefit of the productive sectors created highly negative real interest rates. Again, with the foreign exchange crisis and hyperinflation firmly entrenched, this shifted activity to the parallel market for foreign exchange. Rampant goods and property market speculation also occurred. Moreover, attempts to rely on the most extreme exchange control measures along with heavy financial repression elements created more distortions in the foreign exchange and financial markets.

## 7. References

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