CONFEDERATION OF ZIMBABWE INDUSTRIES
Enterprise Leadership Service

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THE CURRENCY SITUATION AND RECOMMENDATIONS FOR URGENT ACTION

UPDATE TO MEMBERS

We are continuing engagement with the authorities on the situation and this is an update to CZI members on where matters are at. It must be acknowledged that we are pleased with the willingness of the authorities to engage seriously with CZI and other business member organizations in order to find a solution to the rapidly deteriorating exchange rate situation.

INTRODUCTION

The ZWL is now in real peril and urgent and well considered policy measures must be implemented by the authorities aimed at bringing back confidence into the currency markets. In truth we find ourselves in a situation that could and should have been avoided had the appropriate policy prescriptions been in place. We are of course concerned about the response by the authorities so far, which was to blame players in the foreign currency markets as the sole cause of the currency instability.

The economy is clearly in recovery, many businesses are recording growth and initiating expansion projects as noted in our quarterly surveys. We have enjoyed an excellent harvest and significant progress has been made on infrastructure projects.

However the economy is also experiencing “growing pains”. The strong rebound in economic activity is now threatened by the unfolding instability in the currency market. This instability has been primarily driven by:

- *The unrelenting increase in money supply*
- *The arbitrage windows that policy seems to continue to create*
- *Increasing imports on the back of decreasing export competitiveness*
- *Bulk payments for agriculture produce and to contractors*

The pressure on the forex market has been made worse by long delays in settlement at the auction. This instability in the currency has prompted an aggressive administrative response from the authorities that, if continued, will send the economy into a hyperinflationary tailspin destroying all the gains of the previous twelve months.

In our initial engagements with the Reserve Bank we proffered and they indicated that they would implementing an action plan that, will result in the restoration of stability. The key elements of the plan are:

1. *Auction only available foreign exchange and settle bids within two weeks at an absolute maximum.*
2. *Implement the standard rules of a Dutch auction meaning that higher bidders are allocated in full. This will allow supply and demand to play its full role at the auction and make it a true price discovery mechanism*
3. *Further tightening of monetary policy.*

We appeal to the authorities to allow time for this plan to work and to desist from action that will reverse all the gains that we have made over the last twelve months

BACKGROUND

Confidence in the local currency remains low and a strong currency preference for foreign currency persists

The psychological scars of the hyperinflationary period still run deep within the psyche of economic agents in Zimbabwe. We see an almost religious reverence for foreign exchange with economic agents going to extraordinary lengths to procure foreign exchange in order to preserve value.

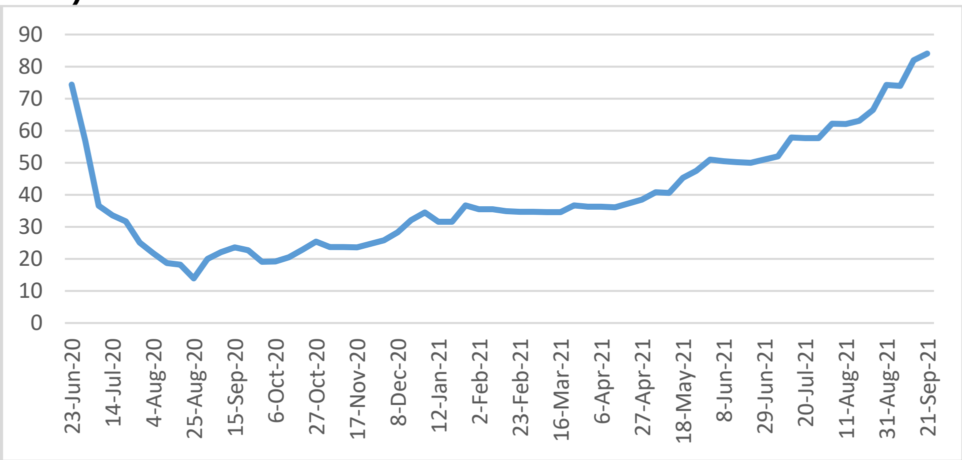
Within such a context running fiscal and monetary policy is nightmarishly difficult. We have had to pay for a massive harvest to farmers in a currency that they do not want. It is little wonder that these payments have led to depreciation of the currency on the open market.

Indeed we need to commend the fiscal authorities as they have done the absolute best to manage this process in very difficult circumstances. It will be tragic beyond words to let all this hard work go to waste because of an inappropriate policy response to what was bound to happen in the circumstances that we found ourselves in.

The country still lacks a transparent formal foreign exchange market that responds smoothly to supply and demand for foreign exchange. This has resulted in an increasing parallel market premium that is becoming a growing problem.

After starting well, the Dutch foreign auction in Zimbabwe has now been distorted by a lagging supply stretching over 15 weeks in some instances. This has added to the pressure on foreign exchange that was already very high because of the large payments to farmers and contractors. These factors are the main drivers of the widening parallel market premium. With this widening premium arbitrage, distortions and inflation pressures are entrenching. This has also increased preference for the USD among economic agents making the ZWL$ vulnerable and the inflation environment precarious.

Figure 1: The parallel market premium for Zimbabwe (June 2020-Septemner 2021)



The parallel market premium is a cost of getting foreign currency from the alternative informal market, in the absence of a formal spot market. It is also an indicator of the possible erosion of value of foreign currency by simply trading on the official market. Trading on the parallel market is risky as it is illegal, but given the absence of an alternative formal spot market, it is often seen as worthwhile – and sometimes necessary - to undertake the activity. As long as the parallel market premium is so high, it is not possible to prevent participation on it; only more subtle methods will be adopted in response to aggressive methods of arrests and prosecution.

The CZI Quarterly Business and Economic Intelligence report for the 1st quarter of 2021 reported that business had indicated that the backlog at the auction had become a significant problem. A look at the trends also shows that it was mainly after the end of first quarter, around April-May that the parallel market premium began to increase rapidly, corresponding with the worsening of the settlement periods with some companies waiting on 10 to 15 week auctions. Specifically, it is in May 2021 that the upward trend in the parallel market premium became more pronounced, coinciding with the time when the backlog at the auction became a serious issue.

As at 21 September 2021, the parallel market premium was about 84%. Exporters and any other generators of foreign currency that have to liquidate at the official rate consider this as a heavy tax threatening the viability of exports. This will see more and more exporters seeking a reduction of export surrender thresholds in a bid to contain the situation but even that will not be enough in the absence of corrective measures for the exchange rate situation.

Causes of the parallel market premium

CZI believes that the following key factors are the major causes of the growing parallel market premium in the face of increasing foreign balances in the banking system:

1. A faster increase in local currency money supply relative to the corresponding increase in nostro balances and/or foreign currency inflows. The current reserve money target growth rate of 20% per quarter is too high in compounded terms per annum under conditions of confidence erosion.
2. Large payments to farmers in respect of the excellent maize harvest

3. Payments to Government contractors as investment in infrastructure intensifies
4. Failure of the foreign currency auction system to operate as a proper Dutch Auction system, resulting in failing to produce a price where foreign currency generators are willing to supply the foreign currency auction;
5. High and resurging inflation as a result of the above factors.
6. In light of the above, a desire by all economic agents to store value in the US dollar, thus contributing to increased demand for holding it. This desire further causes the premium to move even further.

Dutch foreign currency auction rules need to be observed
As mentioned above the Reserve Bank has committed to observing the rules of the Dutch auction from now on. By design, a Dutch auction is a price discovery process in which the auctioneer has to start with the highest asking price and lowers it until it reaches a price level where all the bids received will exhaust the entire quantity on offer. Also known as a descending price auction, the Dutch auction gives signals to bidders that your chances of getting an allocation decreases if you offer to pay less. The current rally is a result of the inefficiencies or non-adherence to strict Dutch auction rules:

- Have a known amount to be auctioned beforehand;
- Assign to the bidders from the highest bids down;
- Allow the highest bidders to have their full amounts at the bid rate;
- Only pro rata bids at the lowest accepted rate in relation to the remaining amount available.

The auction was set up as a price discovery and transitional mechanism and now it has morphed into a source of sub-optimal foreign currency allocation platform.

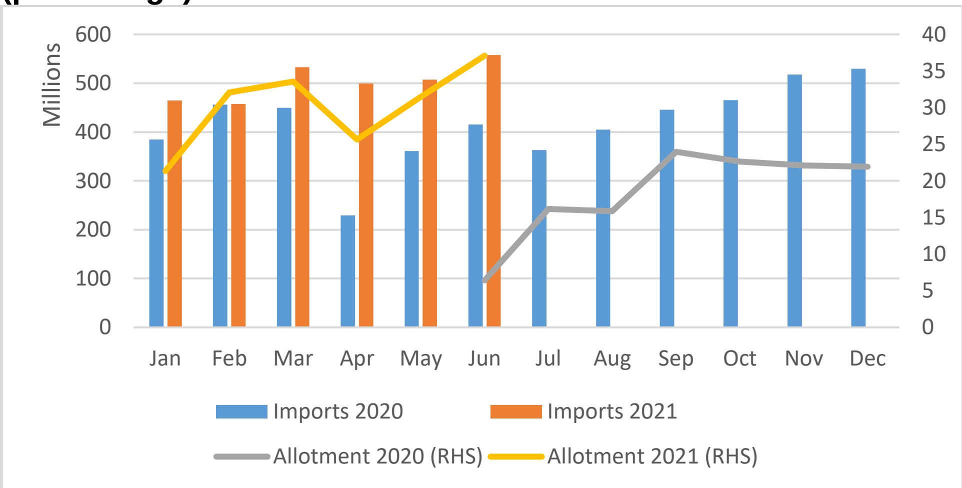
THE RED FLAGS

These are showing up in the delays on settlement, price increases and increasing inflation, which would unsettle the stability that had characterised the year 2021. The predictability of the auction rate has seen participants becoming more cunning, knowing full well that if they bid at the previous minimum acceptable rate, they will still access foreign currency. The risk of losing out, which was the basis for getting the correct price from the auction, has now been minimised by the RBZ preference to auction foreign currency that they do not have.

The extended backlog discourages players that have genuine need for foreign currency and cannot afford to wait for six weeks while those that are importing simply due to the existence of cheap foreign currency do not mind waiting to get their bids honoured, even though they have resources tied down during the waiting period. Thus, the foreign currency auction is now attracting foreign currency demand that would normally not have been there, simply due to the perception that the foreign currency is cheap. It is now profitable to import products rather than producing and sourcing locally due to the exchange rate distortions that have emerged from the auction market. The same phenomenon is being observed at the bureaus de change with artificial demand for foreign currency both for local use (the US$50s) as well as for travel allowances (US$500) now being the norm.

Imports statistics show that the demand for foreign currency to import products, as reflected by the total imports volumes, was being met only by about 35% of resources from the foreign currency auction in June 2021, up from just above 20% in December 2020 (Figure 2). The remaining 65% is met from other sources, including export receipts as well as parallel market. However, the effect of the auction in increasing import appetite is quite apparent from the increase in imports in 2021 compared to 2020 when the auction was not yet in operation.

Figure 2: Relationship between imports (US$) and foreign currency allotments (percentage)



Sources: ZIMSTAT and RBZ Auction results

DIAGNOSIS: WHERE IS THE PROBLEM?

Fundamentally economic agents have a deep seated fear that the Zimbabwe dollar will continue to depreciate. This creates a strong currency preference for foreign exchange. This means that any large payments of local currency have the potential to destabilise the foreign exchange market.

The effect of the strong currency preference for foreign exchange has been made worse by the settlement challenges in the official foreign exchange market.

The current challenges with the auction have been discussed for a long time, without any apparent movement in addressing the concerns. The lack of movement to address the issues can be explained as due to fear of market forces by government and a sub-optimal foreign currency management framework.

Fear of market forces and implications

Business generally believes in the power of the market, where market forces are the arbiter of trading conditions. However, there is fear from government that overreliance on market forces would see powerful firms tilting market outcomes in their favour, resulting in inflationary pressure. There are strong feelings that if the exchange rate is allowed to float, it will end up chasing the parallel market rather than converging with it.

However, business is of the view that it is such attempts to control the auction rate that have actually enabled the parallel market to thrive. At introduction, the auction had managed to stabilise the parallel market rates as the rate was seen to be converging towards a situation where interests of foreign currency generators and those demanding foreign currency were protected.

However, the foreign currency auction rate started defying all market principles by failing to show any significant fluctuations like all the other currencies in the region in response to the emerging global and regional market dynamics as well as developments in local money supply. Confidence on the rate began to evaporate. The erosion of confidence is manifested in the increased demand for foreign currency at the parallel market and preference to hold on to the USD rather than releasing it into circulation. Thus, the fear of market forces has actually worsened rather than abated inflationary pressures.

Sub-optimal foreign currency management framework
The current foreign currency system is currently too dependent on the central bank. However, the central bank also has other interests, or can end up tolerating other interests, conflicting with the desire to have a proper Dutch Auction influenced exchange rate. The RBZ has been giving assurances and promises that:

- the backlog will be cleared;
- only foreign currency that is available would be auctioned; and
- it will not interfere with the demand preferences thus allowing true price discovery.

It is imperative that these measures are implemented without further delay and strong signals are sent into the market that the auction will indeed become a true auction. This will significantly undermined the parallel market.

SUPPORTIVE MEASURERS NEEDED
To support the measures mentioned above we recommend the following additional measures:

- **Temporary reduction** of the total amount to be allocated at the auction market to about $25 million or less over the next three weeks while clearing the Auction backlog;
- Adopt a **first in first out** (FIFO) method in clearing the backlog. In the interest of fairness, those bids that have been waiting in the queue for longer should be settled first before new bids as a way of enhancing confidence among all the players in the market;
- **Communicating** the amount available for Auction beforehand (say 24 hours before)
- Settling winning bids **within 48-72 hours** (T+3). This will not be difficult once the auction is based on the declared available amounts.
- Further tightening of monetary policy – the RBZ has already indicated that monetary policy will be further tightened and this is a vital additional measure to support the other measures that the RBZ has committed to taking. In particular we recommend the broadening of the monetary targeting framework

to incorporate the domestic portion of M3 as well as the current Reserve Money targeting framework.

LIKELY IMPACT OF THESE MEASURES

Given the moral hazard and adverse selection issues that have already taken effect, it is expected that there will be **some short-term adjustment challenges** as the exchange rate from the foreign currency auction rises. This would have an impact **on prices of products that were being sold based on the official rate**. However, the current reality is that **most of the products are being sold in local currency at prices that are based on the parallel market**. Thus, the majority of prices in Zimbabwe reflect a blended rate, which is between the official and the parallel market, hence the impact on prices will be manageable as the parallel market rate has to slow down or decline once the official auction operate effectively. The expected results of the above intervention are that the auction will once again become a reliable source of supply of foreign exchange for the productive sector and thus make the parallel market increasingly irrelevant.

CONCLUSION

Zimbabwe has come a long way to the stage where inflation is down and the economy is accelerating. Unfortunately, macroeconomic risk remains elevated.

The greatest risk facing the economy right now is an inappropriate policy response to the rising parallel market premium. Clamping down on informal foreign exchange trading in the absence of a viable formal market will have catastrophic consequences for the economy.

What has facilitated the economic rebound is access to foreign exchange for the productive sector via official channels. The recommendations in this paper will put this back on track and combined with tighter control of money supply will result in convergence between official and parallel markets. This would allow policies to be concerned more about competitiveness and productivity rather than currency trading.

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