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Abstract

For the past decade, Zimbabwe has been experiencing an economic decline that has resulted in an inflation rate of 231 million percent and an unemployment rate of over 90 percent. Past research has concluded that the economic decline of Zimbabwe has mainly been caused by poor monetary policies and failure of fiscal policies to control the budget deficit. This research aimed to closely examine some of these policies that the Zimbabwean government implemented, the effects of these policies on economic activity, employment and inflation levels in the country. By interviewing many economic analysts in Zimbabwe, I managed to gather the main causes of the country's decline. In an effort to understand the effects of inflation on a country, I looked at other developing countries that have survived similar economic challenges and assessed some of the steps they took to overcome the challenges. From the research, I managed to conclude that although government policies on agriculture, participation in armed conflicts, government spending and investment have been weak, structural reforms can be successfully implemented to get the economy functioning again.

Keywords

Zimbabwe, economic decline, inflation, unemployment rate, budget deficit

THE ECONOMIC DECLINE OF ZIMBABWE

Chido Munangagwa

ABSTRACT

For the past decade, Zimbabwe has been experiencing an economic decline that has resulted in an inflation rate of 231 million percent and an unemployment rate of over 90 percent. Past research has concluded that the economic decline of Zimbabwe has mainly been caused by poor monetary policies and failure of fiscal policies to control the budget deficit. This research aimed to closely examine some of these policies that the Zimbabwean government implemented, the effects of these policies on economic activity, employment and inflation levels in the country. By interviewing many economic analysts in Zimbabwe, I managed to gather the main causes of the country's decline. In an effort to understand the effects of inflation on a country, I looked at other developing countries that have survived similar economic challenges and assessed some of the steps they took to overcome the challenges. From the research, I managed to conclude that although government policies on agriculture, participation in armed conflicts, government spending and investment have been weak, structural reforms can be successfully implemented to get the economy functioning again.

INTRODUCTION

This paper evaluates the economic decline of the Zimbabwean economy by a close examination of the country's macro-economic policies and their subsequent effects on the economy, the country's GDP and output in the different sectors of society. Zimbabwe's economic decline since 1997, has seen the country's macro-economic condition deteriorate progressively into a hyperinflationary environment. This has resulted in a unsustainable socio-economic conditions that have forced 37.8 % of the population to migrate internationally (International Organization for Migration 2008). I will analyze government policies that were the main driving forces in the decline of the Zimbabwean economy while simultaneously assessing the government's argument that sanctions and drought are the main contributors to the current state of the Zimbabwean economy.

The country's economic problems go beyond macroeconomic policies, but are reflective of a political impasse that has challenged the current government of President Robert Mugabe. Since Independence, the Mugabe regime has tried maintaining a one-party state, and has gained significant control of the country's main governing bodies, including the Reserve Bank of Zimbabwe. It is therefore imperative to consider the political economy when looking at Zimbabwe as the entanglement makes the Zimbabwean crisis solution even more complex. The current economic crisis is above all a political problem, that is exacerbated by failed policies. Currently, the Mugabe regime, is facing international condemnation and pressure to relinquish their 30 year reign in power.

Between now and Zimbabwe's political solution, many short term solutions can be put in place to transition into a new political and economic leadership team. In this paper, I analyze the conditions that led Zimbabwe into this state, and various solutions that a stable leadership body can implement.

ECONOMIC HISTORY OF ZIMBABWE

During the pre-independence period, much of the country's wealth was in the hands of the white minority under the rule of Ian Smith who served as Prime Minister of the British colony known as Rhodesia. The colonial period was characterized by the following occurrences:

1. The occupation of land owned by local inhabitants and the relocation of the black people to outlying communal lands. Land was taken from black people without compensation and given to white veterans, many of who were retired World War I soldiers. Blacks were forbidden to own land in these fertile areas.
2. Blacks were excluded from the political process.
3. Black Zimbabweans were forbidden from the best schools and residential areas in Rhodesia.

After 1965, the United Kingdom adopted a different policy towards colonies. A few colonies such as Kenya had now gained independence, and the British government adopted a policy of 'No Independence Before Majority African Rule (NIBMAR).' The Rhodesian Front, the white regime run by Ian Smith, rejected that policy and wanted to maintain governance over Rhodesia.

The Smith regime signed a Unilateral Declaration of Independence in 1965 in opposition to black majority. The British government, the Commonwealth and the United Nations condemned this action and declared it illegal. The United Kingdom went on to impose economic sanctions on Rhodesia, as it viewed their actions as racist. Smith argued that Rhodesia was no longer a British colony and that it had gained independence from Britain, although power was not in the hands of the black majority. South Africa and Portugal were the only two countries that supported Rhodesia and no other country recognized Rhodesia as a state. On the macro-economic level, these sanctions encouraged internal production and a desire to achieve self-sustenance because many countries refused to trade with Rhodesia. In the meantime, two political forces were growing within the black majority – the Mugabe-led ZANU party, consisting of the majority Shona people, and the ZAPU party headed by Joshua Nkomo, consisting of the minority Ndebele people. Africans had always resisted European rulers and in Zimbabwe in 1896-1897, the first Chimurenga war had been fought. The locals had lost the war due to a lack of sophisticated weapons.

From July 1964 to 1979, the Second Chimurenga war took place between the white Rhodesians and the ZANU and ZAPU forces. This war, also known as

the Rhodesia Bush War, was a struggle for liberation from the oppressive white minority rule. With China and North Korea backing the ZANU forces, and the Soviet Union and East Germany supporting the ZAPU faction, and with no foreign support, the Rhodesian government was overthrown. Rhodesia gained its independence in 1980 and was renamed Zimbabwe. Robert Mugabe became the first President of Zimbabwe since Independence to date. Zimbabwe achieved majority rule in 1980, and the first decade after independence, the new government focused on programs aimed at building the health and education sectors. The economy continued to be run as in the pre-independence period, as a command economy. The Zimbabwe government made it clear that the state was to play a central role in the country's economic and social development (UNDP Discussion Document 2008). Although not high on a global scale, Zimbabwe's growth rate during the eighties was higher than that of sub-Saharan Africa as a whole. With the end of the liberation war, and good rainfall, farming output strongly boosted Zimbabwe's growth. In the 1980's however, drought had a negative impact on growth. The drought of 1982-3 was followed by another in 1987, when the contribution of agriculture to GDP growth was negative.²² As the drought took place, there was also a world recession that resulted in commodity export prices decreasing. Because of these events, the government decided that it was time to shift economic policies.

Since 1990, policy makers in Zimbabwe worked to liberalize the economic system through the Economic Structural Adjustment Program (ESAP), which allowed for an open market economy driven by a strong export base. The main goals of this program were to:

- achieve GDP growth of 5 percent during 1991 to 1995
- raise savings to 25 percent of GDP
- reduce budget deficit from over 10 percent of GDP to 5 percent by 1995
- reduce inflation from 17.7 percent to 10 percent by 1995 (Kanyenze 2004)

ESAP was implemented to achieve economic recovery and sustained growth through balancing the budget, strengthening the private sector and removing controls on trade. Growth in the 1990s under new macroeconomic policies was a failure. Performance indicators show that the economy grew by a respectable average of 4.3 percent per annum under the 'bad' control policies of the 1980s but only by a miserable 0.8 percent under the so-called 'good' policies.²³ The failure to achieve the expected 5 percent growth rate under ESAP can be attributed to the adverse effect on the manufacturing industry. Although liberalization was viewed by many as positive, it had the effect of exposing the manufacturing industry to foreign competition for which it was unprepared. The agricultural sector needed

22 The Economic Decline of Zimbabwe, Neither Growth Nor Equity. Carolyn Jenkins and John Knight p132

23 Macro-economic and Structural Adjustment Policies in Zimbabwe. Edited by C Mumbengegwi p 3

the boost in exports and so it benefitted from ESAP. Local manufacturers of goods such as clothing, however, faced fierce competition from cheap imports from countries such as China and were also affected by the decline of real wages of consumers. Some economists concluded that the collapse of ESAP was largely due to the government’s failure to control public expenditure and financing of the program through borrowing from domestic banks as opposed to other forms of financing, e.g. taxation. Realizing that the general public was not satisfied with ESAP the government decided to focus on fiscal discipline on the government’s part. The next phase of economic recovery consisted of another set of policies called the Zimbabwe Program for Economic and Social Transformation (ZIMPREST) from 1996 to 2000 that aimed at improving ESAP. Due to poor fiscal policies, however, the budget deficit continued to grow and foreign currency reserves remained low.

THE BEGINNING OF THE ECONOMIC DECLINE

Table 1: Selected Macroeconomic Indicators

Indicator	2000	2001	2002	2003	2004	2005	2006
GDP(current US\$ million)	8,135.8	12,882.6	17,875.6	7,913.1	4,712.1	3,372.5	7,033.7
GNP	7,150.0	12,800.0	30,800.0	7,850.0	4,640.0	3,180.0	n.a.
Population	12,595.0	12,698.0	12,786.0	12,863.0	12,936.0	13,010.0	13,085.0
Current account balance(as % of GDP)	-0.4	-1.0	-2.6	-4.6	-5.6	-7.5	-4.0
Fiscal deficit, including grants (% of GDP)	-18.6	-7.0	-2.7	-0.2	-7.6	-6.1	-3.1
GNS per GDP (%)	11.1	7.0	4.9	-1.4	-3.2	-6.7	4.0
Gross official reserves (months of imports)	1.5	0.6	0.7	n.a.	n.a.	n.a.	n.a.
GDP growth rates	-7.3	-2.7	-4.4	-10.4	-3.8	-6.5	-5.1
CPI inflation	55.6	73.4	133.2	365.0	350.0	237.8	1,216.0

Sources: African Development Bank database; IMF (for balance-of-payments current account balance) – pg 12

Table 1 above looks at the key macroeconomic indicators. The figures appear inconsistent partly because of the numerous currency conversions that took place between 2005 to date. The Reserve Bank has removed zeros from the currency

many times in an effort to manage inflation, so that when such efforts are made, measures of GDP can be ambiguous if they do not account for these changes.

a) *Civil unrest*

In 1997, Zimbabwe's economic decline began to visibly take place. It began with the crash of the stock market on November 14, 1997. Civil society groups began to agitate for their rights as these had been eroded under ESAP. In 1997 alone, 232 strikes were recorded, the largest number in any year since independence (Kanyenze 2004). During the first half of 1997, the war veterans organized themselves and demonstrations that were initially ignored by the government. As the intensity of the strikes grew, the government was forced to pay the war veterans a once-off gratuity of ZWD \$50,000 by December 31, 1997 and a monthly pension of \$2,000USD beginning January 1998 (Kanyenze 2004). To raise money for this unbudgeted expense, the government tried to introduce a 'war veterans' levy,' but they faced much opposition from the labor force and had to effectively borrow money to meet these obligations. Following the massive depreciation of the Zimbabwean dollar in 1997, the cost of agricultural inputs soared, undermining the viability of the producers who in turn demanded that the producer price of maize (corn) be raised. Millers then hiked prices by 24 percent in January 1998 by 24 percent and the consequent increase in the price of maize meal triggered nation-wide riots during the last month. The government intervened by introducing price controls on all basic commodities. (Kanyenze 2004)

Many interventionist moves were undertaken to try to reverse some of the negative effects of the Structural Adjustment Programs and to try to strengthen the private sector that was suffering from decreasing output and increasing competition from cheap imported products. Some of the most detrimental policies that followed include:

b) *War in the Democratic Republic of Congo*

In a move widely criticized, Zimbabwe entered the war in the Democratic Republic of Congo in 1998. Assessing the involvement of Zimbabwe's troops in the war in the Democratic Republic of Congo, it is evident that this was one of the pivotal starting points of Zimbabwe's economic decline. Zimbabwe aligned itself to the government of Laurent Kabila and fought against the Tutsi rebels of the Rwandan and Burundi forces. Some view the intervention in the war as a move by certain individuals to enrich themselves through the illegal diamond industry that was booming in the Congo.

The costs to Zimbabwe were estimated to have been almost 3 million USD per day, and analysts state that the government spent ZWD 6 billion in unbudgeted expenditure on the war.²⁴ Although different sources quote ambiguous values for government expenditure for that war, the values still reflect a large portion of the budget. Many economists have viewed this as the beginning of the downfall of the Zimbabwean economy due to increased unbudgeted government spending.

c) *The Land Reform Program*

24 <http://www.hrforumzim.com/reports/tort990003/torture990003b.htm>

Commercial farming was one of the largest contributors to national income and export earnings. The question of land ownership has for a long time been in contention in Zimbabwe and it has always been an aim of the Zimbabwean government to ensure equitable land ownership. 'About 5,600 white commercial farmers had access to 15.5 million hectares of land, while over 780,000 smallholder farmers had to subsist on 16.4 million hectares of land. Whereas the average size of a commercial farm was over 1,000 hectares, the average size of a communal farm was less than 10

hectares.²⁵ This inequitable distribution of land was a result of the Lancaster Agreement that was signed during Independence to protect white farmers from losing their land under the new government. The agreement was to last for ten years and assured white farmers that land would not be taken from them for land resettlement programs without compensation. After 1990, the Lancaster Agreement was no longer valid, and the government slowly began to redistribute land while compensating the white farmers. According to many independent views, since the Lancaster Agreement did not hold any longer, the government in 1994 began to distribute the land that was set for resettlement, among the government ministers and ruling party loyalists. By 1997, much of Zimbabwe's very fertile land was still in the hands of the thousands of white farmers that resided in Zimbabwe and also now in the hands of government officials who were benefitting from initial land redistribution efforts. In 2000, President Mugabe initiated the 'Fast Track' land reform program to redistribute land to the black majority. Many independent critics view this as an unruly process that did not redistribute land within the judicial framework. Farms were taken by force and many farmers were given a one day ultimatum to evacuate their farms without prior warning. This project was later relabeled the 'Fast Track Land Reform program' and was aimed at creating 51,000 new farmers. There was a huge disparity between the quality of farming that took place on commercial farms and communal farms; many Zimbabwean economists argue that this was due to property rights. Commercial farmers had title deeds to the land and therefore had access to loans for equipment whereas the black majority on communal farming areas suffered from the tragedy of the commons. The government undertook the first of the white owned farm invasions in a bid to reclaim land that was in the hands of the white minority. Hawkins (2008) states however that the disorderly and hurried way in which the program was carried out contributed greatly to a decrease in production. From then on, agricultural output, which was once Zimbabwe's pride, began to fall drastically. In spite of falling tax revenues, civil servants' salaries were increased. The budget deficit progressively worsened from 5.5 percent of GDP in 1998 to 24.1 percent by the end of 2000. The deficit had been targeted to decline to 3.8 percent of GDP by the end of 2000.²⁶

25 Comprehensive Economic Recovery in Zimbabwe, A Discussion Paper UNDP and independent economists, Zimbabwe 2008

26 Godfrey Kanyenze, The Zimbabwe Situation . www.zimbabwesituation.com

By 2003, Zimbabwe’s economy was the fastest shrinking in the world, at 18 percent per year.²⁷ The most detrimental effects of the land reform program on the economy have been the following:

- Commercial farmers utilized economies of scale to achieve high yields at the lowest possible costs. The Land Reform program redistributed land by partitioning land into smaller farms, thereby eliminating this cost-cutting mechanism.
- A tremendous drop in output has been recorded

To demonstrate this decline in output by looking at Table 2 below, wheat production has declined from about 270, 000 tons in 1998 to 62,000 tons in 2007. There is a wide variation between the production levels, but maize, tobacco and beef have fallen by about a third of 1998 levels. The right hand side of the table shows the proportion of the commodities that are still being produced by commercial farmers. For example, although wheat and dairy production have fallen, the proportion of these goods produced by commercial farmers has increased reflecting that small holder production of these goods has decreased. Although the table states that cotton production dropped to zero on a commercial scale in 2007, small scale farmers had taken over the production of this crop.

Table 2: Decline in commercial agricultural production for selected commodities between 1998 and 2007

Category	Crop	Commercial Production		Percent of 1998 levels %	Proportion of commercial production in total production %		Percent of 1998 levels %
		1998	2007		1998	2007	
Food crops	Maize	521	160	31	36	23	63
	Wheat	270	62	23	90	96	106
	Soyabeans	113	64	57	99	95	96
Export and plantation	Cotton	77	0	0	28	0	0
	Tobacco	210	65	31	97	88	92
	Coffee	10	1	10	99	98	99
	Tea	18	15	83	99	97	98
	Sugar	553	384	69	97	96	98
Livestock	Dairy	184	86	47	93	98	105
	Beef	350	120	34	67	48	72
TOTAL		2306	957	42			

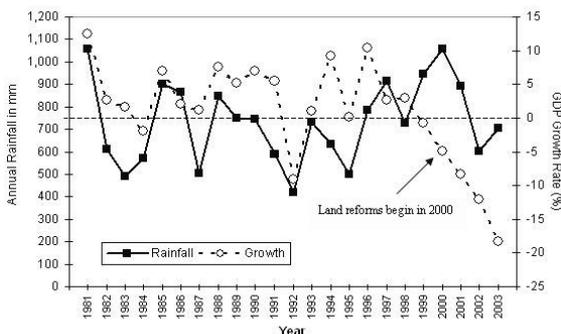
Sources: Commercial Farmers’ Union

²⁷ How the Loss of Property Rights caused Zimbabwe’s Collapse. Craig Richardson. November 14, 2005. http://www.cato.org/pub_display.php?pub_id=9294

- The new farmers do not have access to loans. Due to the tightening of the system, banks started becoming more reluctant to lend money to individual farmers. This is because after the Land Reform Program, banks had no mandate to lend to farmers as the farmers cannot use the land as collateral.
- As a result of the lack of access to loans, the government has had to hand out farming inputs including equipment and fertilizer, increasing unbudgeted expenses

Today, the government argues that the agricultural sector has collapsed due to the continuous effects of drought. In the Monetary Policy presented by the Reserve Bank Governor, Food inflation poses the greatest challenge to efforts to tame inflation. The situation has been exacerbated by projected lower than normal output of grains as a result of incessant rains experienced during the first half of the season and the very hot and dry weather experienced between January and February, 2008 (Gono 2008). During the early 2000s, a drought hit the southern African region, and the Zimbabwean government often refers to this as one of the causes of Zimbabwe’s inflationary economy. The drought led to lower tax revenues from the agricultural sector causing the budget deficit to increase. But according to Figure 2, when the crisis began around 2000 annual rainfall was significantly higher than the calculated average of 754mm. The beginning of the crisis corresponds closely to the implementation of the land reform program. One can therefore conclude that the drought alone was not wholly responsible for the downturn in the Zimbabwean economy. Richardson (2005) estimated that the land reform played a bigger role in creating the crisis than the drought: ‘My econometric estimates indicate that the independent effect of the land reforms, after controlling for rainfall, foreign aid, capital, and labor productivity, led to a 12.5 percent annual decline in GDP growth for each of the four years between 2000 and 2003. ¹³ The drop in rainfall in the 2001–02 growing season contributed to less than one-seventh of the overall downturn. Without above-average rains, Zimbabwe’s economy would have been in even worse shape, hard as that is to believe.’

Figure 1. Annual rainfall and GDP Growth



Sources: Meteorological Services Department, Zimbabwe; and World Bank, World Development Indicators (Washington: World Bank, 2002). 2003 is an OECD estimate.

One of the main challenges associated with land reform in Zimbabwe is the fact that although there was transference of land, there was no transference of skill and knowledge about how to run these farms. The white farmers were forced to leave the farms taking their managerial knowledge and in some cases their tools, leaving the new breed of farmers with a piece of land and no skills to farm it. In retrospect, would it have been more efficient if instead of partitioning these farms, the government had allowed a tenancy situation whereby the white farmers remain and offer their managerial skills and then the black majority would ‘rent’ some of the land? Such a form of private contracting might seem more desirable because the economies of scale would not be lost and there would be no social cost because of a lack of farming skills. Also larger farms are more resilient to handle cyclical turns in the weather making this more efficient at least in the short run until the new farmers acquire more knowledge and skills on large scale farming.

When the economy does recover, how will the new farmers pay back these subsidized loans they are currently receiving especially since many of them are not using the land productively?

a) Quasi-Fiscal Activities (QFAs)

Quasi-fiscal expenditures by the Reserve Bank of Zimbabwe consist of unbudgeted spending on government-led initiatives. These expenditures by the RBZ serve as a substitute for international loans. Mackenzie and Stella (1996) define a QFA as “an operation or measure carried out by a central bank or other public financial institution with an effect that can, in principle, be duplicated by budgetary measures in the form of an explicit tax, subsidy, or direct expenditure and that has or may have an impact on the financial operations of the central bank, other public financial institutions, or government.”²⁸ For the RBZ, seigniorage has fallen from over 5 percent of GDP in 2001 to about 0.1 percent of GDP in 2005 because, given very high rates of inflation, real base money has declined drastically in relation to nominal GDP and the RBZ has invested in assets, including QFAs, with large negative real interest rates.²⁹ Here seigniorage can be considered to be the net revenue earned from issuing currency, i.e. the difference between the production cost and circulation cost of issuing currency and the interest earned on securities when the securities are traded for notes. These QFAs consist of the following:

- **subsidies** to farmers and banks. These are accounted for as no-interest receivables from the government on the ‘other assets’ part of the RBZ balance sheet. The major subsidy programs have been to the agricultural and public enterprise sectors through programs such as Agricultural

28 Sónia Muñoz, Central Bank Quasi-fiscal Losses and High Inflation in Zimbabwe: A Note

29 Sónia Muñoz, Central Bank Quasi-fiscal Losses and High Inflation in Zimbabwe: A Note

Sector Enhancement Facility (ASPEF), the Productive Sector Facility (PSF) and more recently Basic Commodity Supply Side Intervention (BACOSSI) – which consisted of imported food hampers that were sold at a highly subsidized rate.

- losses from exchange rates as banks bought foreign currency from exporters at higher price than they sold it to importers
- **losses** due to the fact that foreign liabilities exceed foreign assets. Total external debt increased from US 3,1 billion in 1991 to almost US 5 billion by 1997, before falling to US 3,5 billion by 2000. This decline represents the drying up of traditional sources of external financing following the fall-out with the IMF and subsequent withdrawal of development partners. (Kanyeze 2004)

Although the full extent of quasi fiscal activities is unknown, estimates by the International Monetary Fund (IMF) put the overall financial borrowing requirement at 64 percent of GDP in 2005, when the central budget deficit was 3 percent of GDP, implying a quasi-fiscal deficit of 61 percent of GDP and of 82 percent in 2006, when the central government deficit was 7.5 percent, indicating a quasi-fiscal deficit in the region of three-quarters of GDP.³⁰

Table 3: Zimbabwe Budget Balance 2007/2008

\$ Trillions	Budget (Dec 2006)	Estimated out-turn (November 2007)	Actual out-turn
Revenue	29.4	46.6	99.8
Expenditure	43.3	43.6	86.5
Deficit	13.9	+3.0(surplus)	+13.3(surplus)
Domestic Debt, year end	0.176 (2006)	21,176 (2007)	+21.0 (increase)

Sources: Government of Zimbabwe: Financial Statements 2008 Budget; Reserve Bank of Zimbabwe

IMPACT ON CONSUMERS

An inverse relationship exists between real income and inflation. As inflation steadily rises in Zimbabwe, the average consumer's real income is drastically falling because wages are not keeping pace. A series of government led initiatives to aid consumers proved to be counter-productive. In July 2007, the government engaged in the implementation of price controls to ease the burden on consumers. Because producers were not able to meet demand pressures, shortages quickly arose. Consumers hoarded the cheaper goods that were now available; producers incurred significant losses on selling goods at a price lower than the

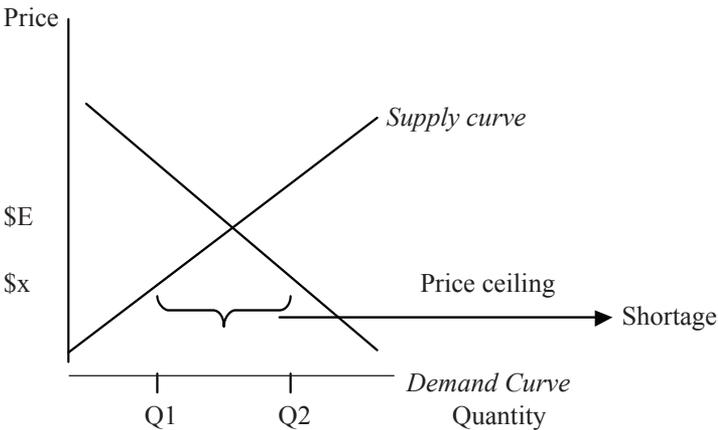
³⁰ Comprehensive Economic Recovery in Zimbabwe, A Discussion Paper UNDP and independent economists, Zimbabwe 2008

market price \$E, and queues for basic goods became the order of the day (as shown in Figure 4 below). As a result, economic activity shifted to the informal sector. According to independent estimates, 80 percent of economic activity is in the informal sector, however, no formal studies have been made as it is difficult to measure.

As a result of the inflationary pressures and price ceilings, the main effects were:

- a thriving parallel market
- shortages of basic goods
- informalization of the economy as Zimbabweans began to cross borders to buy basic goods and sell them in foreign currency at a much higher price.

Figure 2: Effects of a Price Ceiling

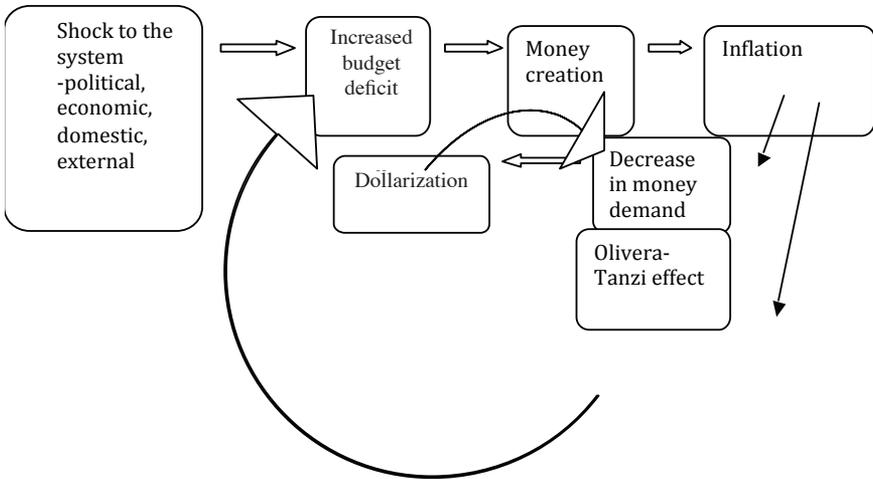


HYPERINFLATION

In the last decade Zimbabwe experienced chronic high inflation which exploded into hyperinflation in 2006-2007.

HOW HYPERINFLATION OCCURS

Figure 3: The process of hyperinflation



As shown in Fig. 3 above, the phenomenon of hyperinflation is always triggered when an economic system faces a shock, be it external, political, or domestic. In many cases, such an unprecedented shock leads governments to spend more money than they receive from revenues, thereby increasing the budget deficit. In the case of Zimbabwe, the shock consisted of the war veterans' gratuities in 1997 and subsequently, the participation of Zimbabwean armed forces in the DRC war.

High inflation in Zimbabwe has been fueled by a rapidly growing money supply reflecting growing fiscal and quasi-fiscal deficits. Quasi-fiscal losses have increased greatly since 2004, due to huge foreign exchange subsidies to public enterprises and government, price supports to exporters (to compensate them partially for the highly overvalued exchange rate), and interest payments on open market operations.³¹ In August 2006 Zimbabwe's annual inflation rose above 1,000 percent, dramatizing the severity of its economic crisis. Redenominated notes were issued in August so that 1,000 old Zimbabwean dollars become one new dollar. The annual inflation rate, already the highest in the world, raced to 1,729.9 per cent in February 2007 from 1,593.6 per cent the previous month. On a monthly basis, however, inflation slowed to 37.8 percent from January's 45.4 percent. The inflation rate dropped momentarily due to the artificial effect of price controls to alleviate the suffering of many Zimbabweans. The controls led to hoarding of goods, however, and even longer lines for basic goods. Manufacturers were forced to close businesses as they were incurring huge losses.

In 2007 government spending increased once again in real terms. In the budget announcement, there was no mention of ways to lower the Quasi-Fiscal Activities

31 IMF Working Paper. Lessons from High Inflation Episodes for Stabilizing the Economy in Zimbabwe WP0799

and the budget made very little accommodations for QFAs. In June of the same year, the government adopted price freezes, followed by a wage freeze 2 months later. According to the government, inflation dropped to 6,592.8 percent in August from 7,634.8 percent in July. Queues for basic goods became a common characteristic, as consumers hoarded products after price reductions leading to shortages of basic goods. This in turn, causes the parallel market to thrive, as individuals choose to engage in 'cross-border trading' – buying goods in neighboring South Africa, Botswana or Zambia and selling them on the parallel market at much higher prices. In 2007, the hyperinflation was really biting the pockets of the ordinary man on the streets. In an effort to cushion the general consumer from the deteriorating value of his money, the government implemented price controls on all basic goods. However, these controls backfired as the general public rushed to hoard the incredibly cheap goods and any profits that the manufacturers were making were inevitably eroded resulting in many of them being forced to stop production.

Expectations of inflation also fuel the crisis. Because people see the prices rising, they expect them to continue to do so in the future. The more chronic people's expectations are of an increase in inflation, the more they adapt their behavior to fit those expectations. People begin to get rid of their money more quickly, causing prices to rise faster.

It is also common knowledge to all Zimbabweans, that for many years, the Zimbabwean dollar has been overvalued. For example, in 2007, the official rate was still 250 ZWD to one USD, yet the USD was trading at hundreds of thousands of Zimbabwean dollars on the parallel market. This posed a huge problem, in that only those in influential positions who had access to this rate were able to acquire foreign currency from the banks for such a cheap rate and were therefore able to finance lavish lifestyles and trips abroad. Consequently, one would find that some members of the population were not eager to see the crisis being resolved as they were benefitting from it greatly. Also, producers of goods are required to sell some of their foreign currency to the Reserve Bank at a much lower rate than they would be able to acquire on the parallel market.

One of the main hindrances to reducing hyperinflation in Zimbabwe is the recurring wave of political instability that have resulted in a loss of investor confidence and caused many foreign investors to pull out of the country, citing that the environment is unstable, unpredictable and risky. The Indigenization Bill that was passed in Parliament that aims at shifting 51% of ownership of companies into the hands of Zimbabweans has been criticized by some as adversely affecting investor relations within the global economy. Analysts argue that foreign-owned companies will not be willing to invest in a country where their companies have the potential to be nationalized. This results in a reduction of foreign currency in the economy. Fig. 3 demonstrates the above as events in 1997 shocked the system, driving the government to achieving a much higher budget deficit. The Reserve Bank of Zimbabwe has over the years been engaged

in rapid money supply, for example, increasing M3 supply from **1 638.4%** in January 2007 to **51 768.8** in November 2007 (Gono 2008), further fuelling inflation.

EMERGENCE OF A PARALLEL MARKET AND MULTIPLE EXCHANGE RATES

As can be expected of a hyperinflationary environment, black market for foreign currency and basic goods that are either not available in stores or too expensive to buy, is now the most reliable source of goods. Having returned home this summer to conduct informational interviews, I discovered that individuals and businesses alike could not access foreign currency from any banks and had to resort to securing this money from the parallel market, which consists of many skilled laborers who have had to move from formal employment to become informal traders as their formal wages were being eroded by hyperinflation. The main currencies that are traded are the South African rand, the Botswana Pula and the United States dollar.

Every day as I travelled through the streets of the capital city, I encountered many traders who typically stood by the side of the road and solicited deals by whispering to passers-by, “I can help you change your money to Rands, US dollars or pulas.” Having just come from the States and in desperate need of the local currency, I ‘shopped around’ for the best Zimbabwean dollar rate that I could get for my US dollars. After some screening, I found one trader who I thought seemed slightly trustworthy, and decided to trade with him. In a bid to be as discreet as possible, he took me up many flights of stairs of a nearby building, to a room that was filled with other traders, and where massive amounts of different currencies were trading hands. He quickly handed me the equivalent Zimbabwean dollar amount that I required, took my US dollars and immediately began trading with the person next to him who was looking for US dollars. And that was it, I had my foreign currency and he had made a huge profit by selling me trillions of Zimbabwean dollars that would be worthless by the next morning and obtaining the stable US dollar. Daily, the ordinary Zimbabwean is forced to engage in such illegal acts because foreign currency and goods are readily available on the parallel market. The parallel market is the most desirable choice because it is the most efficient market in Zimbabwe currently. It avoids the hassles of applying for bank drafts for foreign currency that are never approved; it is very responsive to changes in demand for foreign currency and very responsive to what is happening in the media. For example, when the Reserve Bank requires foreign currency for a project, usually a QFA, they have no alternative but to get the money from the parallel market. Since the bank buys the foreign currency in bulk, supply of foreign currency in the market decreases, pushing up the trading rate for that day. Other drivers of the market included the recent talks between the political parties that sent the rates shooting downwards as optimism filled the market. At the first signs of collapse between the two parties, however the ZWD to USD exchange rates shot up tremendously.

The major problem with foreign currency in Zimbabwe is the fact that there are multiple exchange rates (six in August 2008 – the cash rate, the transfer rate, the UN rate, the Old Mutual rate, the Inter-bank rate, the government rate). The reason behind multiple exchange rates lies in the fact that the government holds the government exchange rate at an extremely artificially low rate that no one can access except government officials, giving them no incentive to eliminate this overvaluation and inequity. Those who can access foreign currency at very reduced rates buy it and then sell it at mark-up prices of up to four thousand percent. This arbitrage, backed by the population's inflation expectations, results in rapidly increasing prices. Because there are very limited exports, much of Zimbabwe's foreign currency comes in from remittances sent to families by the workers in the Diaspora.

It will be interesting to see what becomes of the many illegal foreign currency dealers who have amassed a large amount of foreign currency when the economy recovers.

EFFECTS OF THE CRISIS

Currently the Zimbabwean economy is being run by the informal sector. At least eighty percent of the economy uses foreign currency, but there is still a huge demand for Zimbabwean dollars because until recently, most stores were not allowed to legally sell their goods in foreign currency. As a result, most official transactions occur in Zimbabwean dollars leading to a great demand of the local currency. Many companies have been forced to close shops and service providers such as schools are being forced to charge their fees either in US dollars or in fuel coupons, especially when world oil prices are going up. This is very rational behavior especially now that the US faces the threat of going into a recession; the next best way for companies to store value is to charge in foreign currency. If the government was keen, they could possibly initiate a very sophisticated form of dollarization, where they used these fuel coupons as currency to restore the public's confidence in some form of storage. The government is reluctant to dollarize using the South African rand because of the politics in the region. Because of these various factors, people in Zimbabwe generally like to keep their money in non-monetary assets or in foreign currency, mainly the British pound, the US dollar and the South African rand (ZAR). Because of the economic crisis, millions of Zimbabweans are now in the Diaspora, hoping that the remittances they send through agents such as Western Union will alleviate the families suffering from the hyperinflation.

The policies that have been adopted so far in Zimbabwe have proven to be ineffective as these target the effects and not the causes. These measures, which include price controls and price freezes, only provide very temporary alleviation from the suffering but are ineffective in the long term. Price controls, imposed in Zimbabwe in 2007, faced two major obstacles: the first was to set prices for all prices of consumer goods, intermediate goods and raw materials in the economy;

the second was to adjust them to scarcities and surpluses. Since the first problem made the goal of controlling 'all' prices impossible, government usually set prices for a basket of consumer goods. But that created another set of problems since producers of these products had their prices controlled but not their inputs. Profit margins disappeared and, sooner or later, the products themselves.³² Price freezes, which were adopted in August 2006 in Zimbabwe, aim at keeping the prices of all goods stagnant. This measure is usually difficult to adopt as it requires shops to be monitored or for shop owners to submit a list of their prices every so often, but this is not feasible as it is time consuming and gives way to corruption.

As the economic crisis deepens, and the general discontent grows, the Zimbabwean power making forces are becoming highly centralized due to the mistrust and elitism that characterizes the current regime. Many major political and economic decisions are controlled by a few in power, which is similar to the economic conditions of Russia under Brezhnev.

POSSIBLE MACRO-ECONOMIC SOLUTIONS

Different solutions have been presented, including recommendations by US economist Steve Hanke. In his paper, titled Zimbabwe, From Hyperinflation to Growth, Hanke argues that if Zimbabwe adopts certain principles, it could well be on the road to recovery. His suggestions include dollarization of the economy, which would effectively result in Zimbabwe adopting the US dollar or the South African rand as the official currency. As of September 2008, the Zimbabwean economy moved to partial dollarization with the Reserve bank approving a few licensed producers to sell their goods in foreign currency. Local economists have criticized suggestions to dollarize because in the cases where dollarization has taken place, the economies have been very small and undiversified such as Lesotho that now uses the South African rand. Although it might not be that apparent, Zimbabwe's economy is very diversified. Zimbabwe was ranked among many middle income countries such as Turkey, Singapore, Malaysia and Nigeria in the 1970's and used to engage in trade with the US and Europe. Zimbabwe had the fourth strongest economy in the world. With this in mind, many feel that eradicating the multiple exchange rates would be more desirable.

Steve Hanke also suggests that Zimbabwe adopts a currency board and a free banking system where banks freely issue notes with minimum government regulation as opposed to the Reserve Bank handling that responsibility. This is because when the state intervenes in note issues, it crowds out competition and forces everyone to accept the quality of service set by the state, and this limits flexibility if choice. Also in the case where by too many notes are issued, the public will have a difficult time getting rid of an over issue of notes.

While conducting my research, I discovered that many Zimbabwean economists were of the opinion that although credible, Steve Hanke's proposals would not function in Zimbabwe, because they do not take into account the political

32 www.kubatana.net/docs/econ/zimcodd_breakfree_0708.pdf. Zimbabwe Coalition on Debt and Development

economy. They preferred a more comprehensive macro-economic reform strategy that corrects that corrects the pricing side, that tackles government expenditure, liberalizes the one-sided judicial system, and reduces inflation expectations by restoring confidence in the general public. How that will be done is yet to be seen, but in the case of Zimbabwe, one cannot separate the politics and the economics as the two go hand in hand.

After careful analysis, I propose that although the ultimate solution in Zimbabwe must begin with a political settlement. However, in between now and a political settlement much can be done in the short-term to remedy the current crisis.

- **Short term solutions**

One problem in Zimbabwe is that the accurate measure of the value of goods is distorted by people's inflation expectations; therefore each retailer sells goods at above the real value of the good, so as to evade losses incurred from hyperinflationary pressures.

To tackle this problem in the short term, the government could adopt a store of value that is appreciating in value as the official medium of exchange. A good example of this could be fuel coupons. However, given the current financial crisis, and the lack of access to credit, demand for gas has decreased sharply, causing oil prices per barrel to drop significantly since July 2008. Regardless of this fact, once the global economy recovers from the worst of the recession period, oil prices will begin to stabilize.

Another way to curb the unprecedented increase in prices and to restore consumer confidence is to re-introduce price controls on goods charged in foreign currency. Since the government has recently moved to allowing partial dollarization of the economy by letting licensed retailers sell their goods in foreign currency, they should impose price caps on the prices of basic goods because retailers are still inflating prices even though their revenue is in the form of stable foreign currencies.

It is worth noting that these minor remedies will not be able to effect much change in the production sector of Zimbabwe. The intractable problem of output can only be solved by restoration of investor confidence, and a monetary boost from bodies such as the IMF. Policy recommendations that examine the economic decline and hyperinflation as solely an economic problem under represent the severity of the crisis. Short term solutions exist, but are ultimately inadequate.

- **Long term solutions**

In the long term, once the political impasse has been resolved, the government can put in place a comprehensive macro-economic stabilization policy that encompasses all sectors of the economy. According to the IMF, there are 5 key elements necessary in ensuring that Zimbabwe achieves reasonable stabilization:

1. *Transparent transfer of quasi-fiscal activities to the government budget, as announced by the 2007 budget.* ³³No entity outside the budget should undertake any activity of a fiscal nature (including interest payments, subsidized credits etc) without offsetting transfers transparently provided for in the budget. Although this would not reduce inflation, it would allow for increased transparency and accountability and the rigor with which fiscal actions are reviewed would also be applied to these measures.
2. *Substantial fiscal tightening, including the newly absorbed QFAs of the RBZ or any other entity.* ³⁴For example, to lower inflation by about 800 percentage points, it was found that a minor adjustment of at least 10 percentage points of GDP would be necessary, based on 2006 figures. This must be complemented by government reduction of the government wage bill, and reduction of capital expenditure which more than doubled in 2006.
3. *Liberalizing the exchange regime by unifying the exchange rate and removing restrictions on current international payments and transfers.* ³⁵ This would involve the devaluation of the interbank exchange rate, pegging it closer and closer to the parallel market rate. Only one exchange rate must be in operation.
4. *Deregulating prices and imposing a hard budget constraint on public enterprises.* ³⁶ (Enterprises need a hard budget constraint that requires them to cut costs and operate at present levels of budget subsidies and agreed pricing formulas. Deregulating prices and allowing public enterprises to introduce cost-recovery pricing would be an essential element of a plan to move the operation of these enterprises to a commercial footing. Price deregulation would likely lead to a one-off spike in prices, but strong fiscal adjustment would ultimately reduce inflation pressures.)
5. *Establishing a strong money anchor to reduce inflation and inflation expectations.* ³⁷

From many cases of inflation that have been studied, it has been concluded that output levels can be restored fairly quickly, within the first two years of stabilization. In the case of Zimbabwe, maintaining the growth in output will depend on addressing a few factors including public enterprise and civil service reform, central bank reform, public expenditure and tax reform to sustain the fiscal adjustment and stimulate output growth.³⁸

33 IMF Working Paper. Lessons from High Inflation Episodes for Stabilizing the Economy in Zimbabwe WP0799

34 IMF Working Paper. Lessons from High Inflation Episodes for Stabilizing the Economy in Zimbabwe WP0799

35 IMF Working Paper. Lessons from High Inflation Episodes for Stabilizing the Economy in Zimbabwe WP0799

36 IMF Working Paper. Lessons from High Inflation Episodes for Stabilizing the Economy in Zimbabwe WP0799

37 IMF Working Paper. Lessons from High Inflation Episodes for Stabilizing the Economy in Zimbabwe WP0799

38 IMF Working Paper. Lessons from High Inflation Episodes for Stabilizing the Economy in Zimbabwe WP0799

Although there is lack of external support, Zimbabwe could begin an effective stabilization program with assistance in the form of policy measures from external bodies.

In conclusion, it is clear that most of the government policies although intended for the public good ignored the social costs associated and were not carried out in the most efficient, transparent manner. The agricultural sector in Zimbabwe would probably be the quickest to revive as it requires basic knowledge and minimum skills and it is not dependent on other factors of production besides inputs, good rain and knowledge. Manufacturing on the other hand will be slower to recover because it is partly dependent on the agricultural sector and requires a greater number of skilled labor, most of whom have left the country. Mining and tourism are also strong areas with the fastest growth potential as soon as investor confidence is restored in Zimbabwe. However, Zimbabwe first needs to re-examine its political condition, before any long-term stabilization effort can be put in place.

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