Weekly Economic Bulletin
Crisis in Zimbabwe Coalition
June 15, 2007

1.0 Summary of economic highlights

a) Zimbabwe dollar collapses on the parallel market
Information reaching the catalyst states that the Zimbabwean dollar crashed from Z$92 000 to US$1 on Thursday, 14 June to Z$100 000 to US$1 in 24 hours on the parallel market. This, analysts say shall induce inflationary pressure on the market.

b) Family bread basket shoots up to Z$5,5 million
The family bread basket for six people for the month of May rose to Z$5,5 million up from Z$3,3 million in April. According to reports by the Consumer Council of Zimbabwe (CCZ), this marked a 65,6 percent increase from the previous month. This comes against the background of very low salaries with the gazetted salary of a farm worker being Z$80 000 per month.

c) Power shortages continue
The country continues to experience power shortages. Households and businesses around the country are being forced to go for long hours without electricity. This has resulted in the continued retarding of business activities.

2.0 Introduction

This week's edition discusses the regime of exchange rates, and specifically how the Zimbabwe dollar relates to the major currencies such as the United States dollar, British pound among others.

Generally, there are three models of exchange rate management. These are;

i. Floating
ii. Fixed
iii. Mixed

The floating method is where the demand and supply of the US$ determines the exchange rate of the Z$.

The second method, the fixed method is where the government, through the Central Bank fixes the exchange rate irrespective of the demand and/or supply of the foreign currency. This is the method being used in Zimbabwe.

The third method of a mixed method is where market forces determine the ratye and government, from time to time moves in to stabilize the exchange rate.

2.1 Fixing or floating the Exchange rate – implications to the national fiscus!

The Zimbabwean exchange rate regime has been classified by various economists as irrational. It is currently pegged at an official rate of USD1: ZW$ 250. On the other hand, the parallel market rate has reached the all time high of USD1: ZW$ 75 000. This implies that for every one dollar exchanged at the official rate, the person will forgo ZWD74 750 in the black market, discouraging the households and firms from channeling their foreign currency to the official market. The Central Bank foreign currency reserves are dry, implying that firms will purchase the scarce commodity from the black market for investment, this will make capital investment expensive. Our exports will become less competitive since the capital on investment will have been acquired at high cost. In this issue we shall focus on the causes of shortages of foreign currency which led to the emergence of the black market. We will also prescribe remedies and models which the government can pursue in order to create a conducive environment for its households, firms and trading partners.

At this point, we need to appretiate the main sources of foreign currency generation in the country which are:

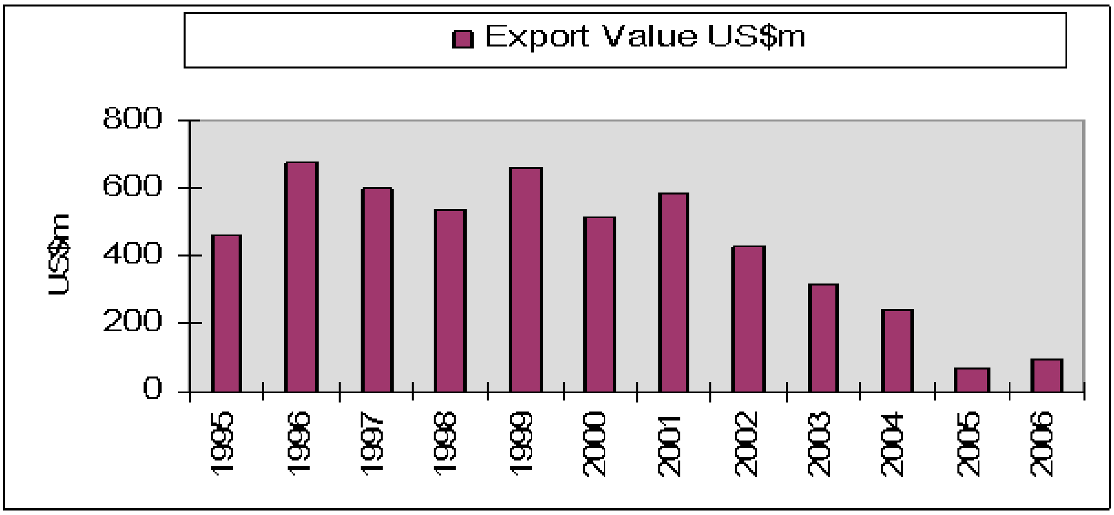
* Exports
* Foreign Direct Investment
* Borrowing

Zimbabwe's exports have been falling mainly due to the fall in manufacturing and the fixed exchange rate which makes our exports expensive in the global market. Case of Zimbabwe and a country like Zambia export foreign currency revenue are mainly from a single dominant sector exports such as agriculture and copper respectively.

A fall in the supply or demand of such goods in the international markets will lead to foregn currency deficits in the country. This forced the Zambian government to adopt a fixed exchange rate, where the government intervenes in the foreign currency market to determine the value of the domestic currency in relationship to that of trading partners. This is done through devaluation or revaluation. Devaluation, if the exporting arm is functioning will stimulate more exports as the value of the domestic currency would be weak globally hence a single USD will be buying more. At the same time, it will make imports expensive, in the long run the prices of exports will become expensive again as the imports will be relatively expensive, forcing the central bank to devalue again.

The Zimbabwean situation is different from the Zambian situation. The Zambian government fixed the exchange rate till 1991, to regulate and influence the price of copper since it was the backbone of its economy. It was going to be irrational for the government to float the exchange since it was enjoying relative monopoly powers in the supply of the commodity. In such a situation its justifiable to fix the exchange rate rather than floating it.

On the other hand, the Zimbabwean agriculture sector, who demised is man made has been declining in its exports value after the marauding war veterans invaded the farms in the year 2000 as shown by the diagram below:



Andy Hodges (2006)

When the agricultural industry is not performing as in the current situation, there is no justification by the government in fixing the exchange rate as this will create demand deficits. As USD1:ZWD 250 the demand will outstrip the supply. This has lead to the development of a parallel market which is serving the deficit at USD1: ZWD 75 000.

In order to sustain the disparity for ZWD74 750, in functional economies, the government is supposed to provide the firms with the deficit from it foreign currency reserves, through the

Reserve Bank of Zimbabwe. In our case the central bank has been reported to be insolvent[1]. Our national coffers are dry.

Confronted with such a catch 22 situation the government has to borrow, that is to say if the deficit is short term in order to finance such short falls. This is when the deficits can be repaid in the short run by favorable balance of payments, where export value will outstrip imports. However the situation of Zimbabwe can be defined outside such a model. The recent reports on economic growth ranged the country's economy as the worst and fast crumpling one, worse than Iraq. This will low our borrowing ratings, as the country is deemed a high risk. On the other hand the country does not have the capacity to repay its debts due to the shortages in foreign in the country, which has led to the government printing money to outsource foreign currency in the 'illegal' black markets to met its obligations. Hence the effect is we cant borrow we cant repay if we borrow. The situation has been made worse by the rapid shrinkage in Foreign Direct Investment (FDI).

In 1998, foreign direct investment (FDI) in Zimbabwe totaled over $444 million; by 2001, FDI in-flow had fallen to $5.4 million. There has been a comparable decline in foreign portfolio investment, reflected in the transformation of Zimbabwe's capital account balance, from a surplus in 1995 equal to 7.1% of GDP to a deficit in 2002 equal to 6.5% of GDP. The lack of foreign currency in the country has made investment even less attractive because of the near-impossibility of converting earnings out of the rapidly depreciating local currency, which the government in any cases restricts. The suspension of IMF funding, with its negative implications about the credit-worthiness of the country, has limited most business transactions to a cash basis. The situation was worsened in June 2003, when the IMF suspended Zimbabwe's voting rights in the organization for failure to make effective efforts to repay arrears of about US$305 million to the fund. Zimbabwe's total arrears increased from US$700 million at the end of 2001 to US$1.5 billion at the end of 2002[2].

It doesn't therefore make sense for the government to maintain its interventionist approach to the foreign current market, since doing so will be sustaining the black market. It must also be pointed out that the sum of the crisis summed above has led the emergence of a new profession of people selling foreign currency. In normal economics, foreign currency demand is derived since people will not demand it for the sake of it, they do so when investing abroad, purchasing goods from abroad and settling national obligations. However in the Zimbabwean situation, firms and households are demanding the currencies for the sake of it, leading to speculation.

The Reserve Bank must move away from fixing the exchange rate and pave way for floating exchange regime where by the value of the currency will be determined by the law of demand and supply so that the foreign currency will return to the official channels. The government must stop channeling the scarce currency and effectively allocate it to the exporters and firms who will invest the money in productive activities. It does not make economic sense for the government to blow 60 000 pounds, in 2002 and US$ 1 million recently in paying the New Africa Magazine to batter its tainted image[3]. This is at a time when ZESA has left the country in the dark as it fails to pay its debt with the Democratic Republic of Congo Supplier of US$ 5 million[4].

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[1] Zimbabwe Independent June 8 – 14, 2007
[2] www.SaxoBank.com
[3] Zimbabwe Independent June 8 – 14, 2007
[4] The Business Herald 12 June 2007