



Why Floatation?

20 May 2008

In an unprecedented move in early May 2008, the central bank eased foreign exchange rules by allowing banks to buy and set the currency rate. This is an effort to put a stop to the parallel market thereby creating a willing buyer and willing seller scenario. Floatation has buoyed the market and will bring bigger players into the country – banks with the financial muscle to attract foreign currency in big enough quantities to build a threshold needed for the economy's sustenance.

What does the floatation of the Zim dollar mean?

Floatation is an acknowledgement that things are changing politically and that the previous system was economically unsustainable. It indicates that the country has finally been squeezed of foreign currency thus moving to this system in order to fill its coffers again. It signals a return to formal markets in the forex trade.

In addition, ZANU PF, through the Reserve Bank of Zimbabwe, is wooing voters especially as they still need to pay for the largesse they parceled out to rural electorate in the run up to the March 29 elections.

The central bank (cum ZANU PF), wants the electorate to presume that they can bring change in the face of an impending new government. The hope is that this move will be seen as progressive and people will forget that they have been stifling economic change all along.

Floatation might be a clear signal that the RBZ is moving away from quasi-economic activities and returning to its monetary responsibilities. Zimbabwe has had a deficit for nearly eight years yet on an annual basis it needs US\$3.2bn to cover its balance of payments requirements.

However, the recent floatation will not see the immediate recession of the black market. In essence, it is less to do with mopping up street traders or the black market than it is about preying on exporters – the remaining formal foreign currency earners. Such policy U-turn means the chickens are coming home to roost. ZANU PF had no floatation in their election manifesto – they are just preying on MDC and Makoni's election manifesto which explicitly stated they would float the currency.

Potential Pitfalls

The floatation could be too little too late in that receipts coming through the new channels are highly likely to be channeled towards food imports as Zimbabwe is now a net importer. In addition, the worldwide rise in food and fuel prices will mop up the reserves the central bank is hoping to build. Therefore – the best intentions are not going to be felt anytime soon without a substantial external injection of funds.

Cash shortages are likely to be a permanent feature for some weeks if not months as banks withhold their cash from the public in order to purchase currency. In addition, if the banks buying foreign currency officially offload it on the black market, then the vicious cycle will continue. Banks may offer below market prices for foreign currency thus discouraging sellers to use the "willing buyer-willing seller" platform and go back to bargain on the streets. The recovery plan is ill conceived unless the RBZ requests that banks surrender all the money they get to the central bank rather than leaving banks open to selling on the black market.

The floatation will only work to stabilize the currency if there are adequate inflows to support demand – given the current tumultuous political environment supply may remain depressed. Inflation might still soar under this system given that two key constituencies banks and the black market are now competing for the same commodity. This could push the price of that very commodity up, fueling further inflation.

Floatation, implemented in isolation, will not work. Previous interventions are illustrative – specifically the 2004 foreign currency auction system. Under this system, businesses had to first obtain RBZ approval for their foreign currency allocations and then queue at

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the auction. But floatation has done away with this system and allows retail banks to sell foreign currency. This is a positive recovery effort.