

# Cause and effect analysis of the Zimbabwean foreign exchange crisis.<sup>1</sup>

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**This paper was presented at  
'Business and Management Conference'  
at the University of KwaZulu Natal, Durbanl, South Africa.**

**5 – 7 November 2009**

## **Abstract**

*The paper explores the main causes and effects as well as possible solutions to the foreign exchange crisis in Zimbabwe. It analyses the currency crisis development from 1997 to 2009. In the process, some of its economic consequences are explored. Since 1997, Zimbabwe experienced various socio-economic and political crises, and there seems to be causal linkages among them. The paper identified the major causes of the foreign currency crisis, among other factors, as the rigidity of the exchange rate, political instability, failure of the financial system, lack of international balance of payments support, lack of manufactured exports and a significant decline in traditional exports due to recurrent droughts and a chaotic land reform process. The crisis led to other socio-economic and political problems like inflation, unemployment, negative economic growth and unprecedented poverty levels. Possible remedies to the crisis include fiscal restraint, ensuring political stability, value addition to exports and re-engagement of the international community.*

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<sup>1</sup> This paper is a follow-up and an improvement of the analysis in a previous paper, published in the *Africana Bulletin* 2009 No. 56. We tried to capture recent developments since the inception of the inclusive government.

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# 1. Introduction

Foreign exchange crises are not rare anymore in the global economy. What differs is the nature, extent and coverage of the currency turmoil. Currency crises have influenced world economic developments since the 1920's. The Zimbabwean currency crisis is only but one of the many crises in the 19<sup>th</sup> and 20<sup>th</sup> centuries. The crisis has caused untold suffering amongst the generality of the populace. Serious foreign currency shortages surfaced in 1999, although its warning signs can be traced as far back as early 1997 when the Reserve Bank of Zimbabwe (RBZ) pulled out of the managed float exchange rate management system and allowed the Zimbabwean dollar to crash. The crisis has changed over the decade from a mere currency instability problem in 1997 to severe foreign currency shortages from 2000. In trying to find solutions to the crisis, the management of foreign currency was transferred from treasury to central bank authorities. Over the years the RBZ has experimented with a number of exchange rate management policies. Most of the exchange rate policies did not yield the desired results, and the currency crisis worsened until the local unit was officially replaced by multi-currency system in January 2009 (RBZ, 2009).

The granting of gratuities to Liberation War Veterans in 1997 set off the foreign currency crisis. It caused inflation through increased budget deficits and rising domestic debt, financed through printing of money and causing the Zimbabwean dollar to depreciate drastically. Makumbe (2000) asserts that the economic crisis in Zimbabwe began when the government awarded war veterans compensation and gratuities. He contends that, by yielding to the demands of the war veterans, the government was forced to print money and this caused the Zimbabwean dollar to collapse against major currencies, with the major crash recorded on the 14<sup>th</sup> of November 1997. On that day, which has come to be known as the "Black Friday", the Zimbabwean dollar lost 71.5% of its value against the United States (US) dollar. This was closely followed by the country's involvement in the Democratic Republic of Congo (DRC) war. Very large sums of foreign exchange were used to finance the war when the foreign currency reserves were at critically low levels. It is believed that about two-fifths of the government budget was being used to finance the war every year. According to the International Institute for Strategic Studies (IISS) (2001), the war in DRC was costing Zimbabwe at least US\$25 million a month between January and June 2000. The DRC war, however, was not solely financed from domestic sources. There were joint business ventures between the two countries and other private illicit deals that financed the war, but these created a bad image for Zimbabwe as an investment destination. Foreign military interventions have drained foreign exchange earnings and worsened the economic crisis (Tambudzai, 2007).

The economic effects of the crisis were the country's inability to meet its import obligations and other international bills, among them the servicing of international debts. The chronic shortage of foreign currency caused a severe shortage of imported raw materials; more remarkable was the shortage of fuel and electricity, which nearly brought the country to a standstill in 2007 and 2008. The government together with the private sector suspended repayment of their international financial obligations after 2004. Many businesses that depend on imported inputs were forced to scale down their operations or close culminating in a severe decade long economic recession.

The foreign exchange crisis worsened some macroeconomic problems that the country was

facing at the time. Annual inflation rates, for instance, ballooned from 58 percent in January 1999 to 1 281.1 percent by December 2006 and further surged to 66 212.3 percent in December 2007 (RBZ, 2008). The highest officially reported rate of inflation was 231 million percent in July 2008 (CSO, 2008). Thereafter, the Central Statistical Office (CSO) stopped releasing inflation figures citing operational problems, but independent researchers and analyst put inflation rates for the year end at over a billion percent (Hanke, 2009). Hyperinflation put more pressure on the Zimbabwean dollar to depreciate as more and more economic agencies demanded foreign currency as a store of value. Economic growth rates over the same period deteriorated immensely, with a combined decline of about 47.26 percent from 1998 to 2007 (IMF, 2008). Figure 1, in the appendix, shows real Gross Domestic Product (RGDP) annual growth rates over the period from 1996 to 2007.

The main aim of the paper is to explore the major causes of the foreign exchange crises (shortages, unstable and unsustainable rates) in Zimbabwe after 1997. The paper will also briefly examine the effects of the crisis on various sectors of the economy. Other sub-objectives include a review of various government policy initiatives and their impact. The paper is part of an ongoing assessment of what led the current economic recession in Zimbabwe, so that similar mistakes can be avoided in the future. The paper will give some policy proposals to improve the foreign currency situation in the country.

The next section explores trends and exchange rate regimes. Section 3 examines the potential causes of the foreign exchange crisis from an empirical literature comparative (historical) perspective. Section 4 highlights the different government policy measures implemented during the crisis period. This is followed by an appraisal of these policies. The sixth section proffers some policy proposals to policymakers. The seventh gives a summary and conclusion of the general findings.

## **2. Trends and exchange rate regimes**

Between 1997 and 2006, the local unit (Zimbabwean dollar) has depreciated immensely. It depreciated from Z\$0.0109637 (using the revalued Zimbabwe dollar as at 31 July 2006) in January 1997 to Z\$0.018601 by December of the same year against the US dollar. In essence, the Zimbabwean dollar lost about 69.72% of its value. In the following year, depreciation trends continued, with the Zimbabwean dollar losing its value against the greenback to close the year at Z\$0.0373692. These developments prompted monetary authorities to revert to a fixed exchange rate regime and pegged the exchange rate at US\$1: Z\$0.038 in 1999 (CSO, 2000). In 2000, the peg was adjusted to US\$1: Z\$0.055 and remained there until the beginning of January 2004. Exchange controls in the official exchange market for foreign currency fuelled the unofficial trade in foreign currency which offered competitive rates as compared to its counterpart. On the 12<sup>th</sup> of January 2004, the RBZ introduced the Managed Auction System of foreign currency management, which allowed the exchange rate to be responsive to market forces for foreign exchange, though controlled (RBZ, 2004).

By the end of 2005 the Tradable Balances Foreign Currency System had replaced the auction system. This system allowed exchange rates to be determined in the inter-bank market and

adjusted periodically to match market forces. Following its adoption, the exchange rate sharply depreciated from Z\$36.6469 against the US dollar in October 2005 to Z\$99.2016 in January 2006. The rapid depreciation of the local unit prompted monetary authorities to technically fix the exchange rates by introducing a volumes-based adjustment of the exchange rate in the inter-bank market. In May 2006, the exchange rate slightly depreciated to Z\$101.1955 against the US dollar and remained there until July 2006 when it was devalued to US\$1: Z\$250. Thereafter, the exchange rate remained fixed at US\$1: Z\$250 until the end of 2006 (RBZ, 2006a). Table 1, in the appendix, show the US\$/Z\$ exchange rate movements between January 2004 and December 2006.

The exchange rate was eventually revised on the 7<sup>th</sup> of September 2007, more than a year later from the day it was fixed, and then pegged at US\$1:Z\$30 000. This was, however, far below the exchange rate prevailing in the unofficial market which was offering rates above Z\$300 000 per US dollar. The divergence between the official and the 'illegal' parallel foreign exchange rates gave the incentive for the bulk of the otherwise traditional foreign exchange inflows to drown in the underworld market, thus starving the official market of the scarce foreign exchange. The fixing of exchange rates resulted in serious foreign currency shortages in the formal banking systems, as the parallel market became the 'only market of resort' for most economic agents (Nkomazana, 2009: 2). Besides using foreign currency for transactions purposes, most economic agencies used it to hedge against hyperinflation that was bedeviling the country (*ibid*).

Given that the greater proportion of the country's imports consists of critical inputs such as food, machinery, spare parts, electricity and chemicals among many other essentials. With the acute shortage of foreign currency seriously worsened the economic recession. During that period, corporations, embassies, non-governmental organizations and some international organizations experienced delays in accessing their Foreign Currency Accounts (FCAs) balances deposited with the RBZ, as it had used the funds (RBZ, 2008: 53). According to IRIN (2008) most NGOs, including humanitarian organisations were threatened with collapse because of the foreign currency crunch in the country. In April 2008, realizing the far reaching consequences of foreign currency shortages, the RBZ abandoned its fixed exchange rate regime and "introduced a willing-buyer, willing-seller priority-focused twinning arrangement". Under this policy, authorized dealers had to "match sellers and buyers of foreign currency, guided by a predetermined priority list as set from time to time by the RBZ, in consultation with stakeholders across the country's sectors" (RBZ, 2008:36). The inter-bank exchange rate at a given day was determined by forces of demand and supply in the foreign exchange market and each dealer was expected to display the average buying and selling prices that it was offering to willing buyers and willing sellers (*ibid*).

### **3. Causes of the foreign exchange crisis**

Many countries the world over have been hit by currency crises of different magnitudes, the most common ones being the Mexican crisis (1994-1995), the South-East Asian crises (1997-1998) and the Russian crisis (1998). Whilst there is a tendency to speak of currency crises that cover the entire region as a single event and phenomena, background factors and causes are not usually identical among the affected nations (Rodrick, 1997). Rodrick also points out that a new crisis cannot be explained by earlier generation of models, which implies that currency

crises in different regions or countries may have been caused by different factors and have diverse effects. It is therefore crucial to establish the causes of the Zimbabwean foreign currency crisis in order to be more prepared to deal with it, in case it resurfaces in the future. It should be noted that the Zimbabwean currency crisis was caused by a plethora of socio-economic and political factors. It cannot be attributed to a single factor, but a combination of factors have worked together and resulted in this economic malice. Some of the major causes of the foreign currency crisis from the literature are discussed below.

### **3.1 Unrelenting government budget deficits**

Huge and continual government budget deficits can lead to currency turmoil. Government debt and the perceived inability of the government to control its budget deficit is a key cause of foreign currency crises under a fixed exchange rate regime and speculative attack on the domestic currency can result from an unexpected monetarisation of the fiscal deficit (Krugman, 1979; Flood and Garber, 1984). This would result in excessive money creation that would “leak out” through overall balance of payment deficits, until shortage of foreign exchange reserves would force the government to devalue or impose controls on capital outflows.

The Zimbabwean government has run massive budget deficits since 1997. Tax revenues were rising slower than the rise in expenditures due to rampant tax evasion and a shrinking tax base because of the broader economic downturn. The period after the year 2000 was characterized by supplementary budgets nearly every year, due to mismanagement of public funds and the ever-rising inflationary pressures. With foreign lines of credit suspended, due to the chaotic land reform process, human right abuses and poor economic policy management, the budget deficit was monetarised, making the local unit ripe for a speculative attack. Increased quasi-fiscal operations implemented by the RBZ, especially from 2006 to the end of 2008, resulted in massive printing of the local unit, thereby rendering it worthless as compared to other currencies. Seigniorage pushed up the rate of inflation, and as predicted by the purchasing power parity theory (PPPT), it eroded the value of the Zimbabwean dollar. The budget deficits played a crucial role in causing the currency crisis, as it triggered an incessant depreciation of the Zimbabwe dollar.

### **3.2 Fragile monetary sector**

Weaknesses in the monetary sector may misallocate investment and leads to excessive real estate investment that does not give higher output. Such fragility in the banking sector reduces the amount of credit available to firms and increases the likelihood of a currency crisis. The failure in financial intermediation results in the moral hazard problem, which arises because of the explicit or implicit guarantee of bank deposits by government (Krugman, 1999; Aghion et al 2001). Banks engage in large-scale extension of credit to finance risky investments as these offer them “Pangloss return” than those obtaining under the best of possible circumstances. The resulting misallocation of resources is manifested in the diversion of funds from projects having high-expected returns to those yielding low or even negative returns on the average.

Developments in Zimbabwe over the period support this notion. High real estate and stock market investments indicated the extent to which loans were used for speculative demand of existing assets that were in fixed supply as opposed to productive investments. Part of the foreign currency inflows were allegedly used for this purpose, thus fueling the asset price

bubble. Some financial institutions even used their vast monetary base (depositors' funds) to participate in the illegal informal market for foreign currency, thus depriving critical sectors in dire need of foreign exchange. These unethical practices, coupled with poor bank supervision by the RBZ contributed to the development and growth of the currency crisis. The inflationary environment and the cash shortages (Zim dollar) exacerbated the speculative behaviour (Tambudzai and Charumbira, 2007)

### **3.3 Rigid exchange rate**

The fixed exchange rate regime pursued by the country over much of the study period fuelled the currency crisis. Krugman (1979) point out that if the equilibrium exchange rate, driven by fundamentals, consistently deviates from the pegged rate, then the central bank will be unable to defend the currency peg, no matter how big their foreign reserves. Economic agents would believe that the government's need to finance the budget deficit becomes its overriding concern and eventually lead to a collapse of the fixed exchange rate regime and to a speculative attack on the domestic currency (*ibid*). It is essentially expansionary domestic policies that lead to deviations and subsequent pressure on the currency to devalue. Proponents of this school of thought present a model in which the fixed exchange rate regime is an inevitable target of the speculative attacks. The government defends the peg with its store of foreign currency reserves. As the economic agents change the composition of their portfolios from domestic to foreign currencies (because rising fiscal deficits increase the likelihood of devaluation), the central bank must continue to deplete its reserves to starve the speculative attack. The crisis is eventually triggered when economic agents expect the government to abandon the peg. This was a characteristic of the Zimbabwean foreign exchange market.

The failure of the Zimbabwean dollar to adjust in line with the prevailing economic conditions resulted in the local currency being overvalued relative to other currencies, thus making it ripe for a speculative attack. Unfortunately, Zimbabwe had run out of foreign currency reserves well before the crisis became fully blown. In most cases, it was living from hand to mouth whilst the unofficial market was flourishing as most citizens were opting to keep foreign currency instead of the local unit. The Zimbabwean dollar had been sluggish in adjusting to fundamentals, for instance, over the period from October 2000 up to the end of 2003, the Zimbabwean dollar was trading at US\$1: Z\$0.055, despite the deteriorating economic conditions that were being experienced over the same period. This meant that the local unit progressively became overvalued. Using a simple transmission mechanism, an overvalued currency discourages exports and promotes imports. This in turn, *ceteris paribus*, would result in deterioration of the current account position, thus putting the country's currency under pressure to devalue.

### **3.4 Current and Capital account deficits and the declining tourism sector**

Reduced exports, recurrent droughts and floods, chaotic land reforms and the general recession over the period negatively affected the current and capital accounts of the Balance of Payment (BOP) accounts. A hyperinflationary environment relative to the country's trading partners, coupled with an overvalued Zimbabwean dollar, was a setback on the country's export competitiveness, as exports became comparatively dearer. Increasing imports in the face of decreasing exports culminated in negative trade balance. Farm invasions and recurrent natural disasters since 2000 reduced Zimbabwe's traditional exports agricultural products. The

agricultural sector accounts on average for 44 percent of total merchandise exports. These developments reduced the country's export base and triggered importation of foodstuffs.

Zimbabwe has had a current account deficit since 1989 though small surpluses were once recorded in 1999 and 2000. The deficit has been fluctuating in magnitude and averaged 10 percent of GDP from 1997 to 2002 against an international benchmark of 3 percent of GDP (CSO, 2002). In the first half of 2006 the total agricultural exports declined by 23 percent (excluding tobacco). Tobacco exports alone fell by a whopping 16.3 percent for the same period (RBZ, 2006b). Economic contraction as reflected by company closures reduced export earnings and exacerbated the depletion of the country's foreign currency reserves. The current account balances of Zimbabwe from 1996 to 2007 are shown in Table 3 in the appendix.

Appleyard et al (2006) argued that that the Asian crisis unlike previous ones was caused by a capital account deficit. The uncertainties caused by falling rates of return on assets due to overinvestment caused capital outflows. The souring relations between Zimbabwe and western countries can also be blamed for the country's currency ordeal. Unlike in Asia where there was overinvestment, in Zimbabwe it was bad politics that affected the capital account. The imposition of '*targeted or smart*' sanctions has brought about a significant decrease in the country's capital inflows. Zimbabwe experienced excessive foreign capital reversals, with the International Monetary Fund (IMF) and the World Bank (WB) withdrawing their BOP support and other development oriented loans to the country citing failure to meet budgetary. Some foreign companies suspended their operations and relocated to neighboring countries, with some donor organizations abandoning their operations in Zimbabwe. These activities were reinforced by the negative real interest rates that prevailed over the period. This led to capital flight as short-term foreign investors shifted their funds to other markets with positive real interest rates, further putting more pressure on the already exhausted peg. This was a serious factor in instigating the foreign currency shortages.

The waning tourism sector had far reaching negative effects on foreign currency generation. The tourism sector continued to contract as some countries (US, UK, Australia and Canada) discouraged their residents from visiting Zimbabwe by publishing travel warnings. The sector, which used to contribute at least 8 percent of Zimbabwe's annual GDP was affected mainly by the political crisis in the country, withdrawal of transport services by most direct overseas airlines especially those from Europe and the negative image of the country that has been portrayed externally.

In trying to summarise all these causes, RBZ (2006b:78) asserts that,

*... the foreign exchange market setbacks are a supply and demand issue, linked to sanctions against the country, linked to lack of balance of payment support, linked to smuggling and indiscipline in the economy, linked to shortage of funds to support whatever devaluation ..., and above all, linked to poor performance of the export sectors.*

### **3.5 Political instability and corruption**

The period of the crisis coincided with serious political instability since the country's independence in 1980. This is the period that saw the formation of a formidable opposition party,

the Movement for Democratic Change. The political atmosphere was generally volatile from the year 2000 to 2008 because of hotly contested elections. In the year 2000, violence characterized the constitution referendum and the parliamentary elections that followed after. Violence continued towards the 2002 presidential elections, which were won by the ZANU PF candidate Mugabe. The political violence was very detrimental to the economic well being of the country. Zimbabwe received bad publicity, thus thwarting prospects for potential foreign direct investments (FDI), thus negatively impacting the country's foreign exchange inflows. This period also coincides with the invasions of farms orchestrated by the veterans of the liberation war, a move that was internationally condemned and has resulted in low output in the agricultural sector. This further reduced the country's export earnings and also strained the meager earnings as they had to be used to import maize. Episodes of violence that erupted following the delay in the announcement of the 29 March 2008 presidential election results and period leading to the 27 June presidential run-off also brought unwarranted pressure on the Zimbabwean dollar. Uncertainty that grabbed the business community over the period was very retrogressive as far as currency generation is concerned.

Wei and Wu (2001) attribute currency crises, among other factors, to corruption and cronyism. They argued that increasing public corruption in emerging market countries has contributed to the currency crises in the developing world. Corruption acts to repel more stable forms of foreign direct investments and leaves countries dependent on volatile foreign loans to finance growth. Crony capitalism, through its effects on the composition of the country's capital inflows makes the country more vulnerable to currency crises brought about by self-fulfilling expectations. They also argued that corruption might weaken domestic supervisions, with a subsequent deterioration in the quality of bank and firm's balance sheets.

In Zimbabwe, corruption is so rampant, both in the private and public sectors. The government had to set up the Anti-Corruption Ministry and Commission, to fight the scourge. The absence of transparency and problems related to political corruption are very detrimental to the country's capacity to generate foreign exchange inflows. Transparency International (2007) ranked Zimbabwe 150<sup>th</sup> on the Corruption Perception Index (CPI) for 2007 out of 172 countries polled. This marks a significant increase in corruption levels in the country given that the country was ranked 65<sup>th</sup> in 2001. In the African continent, out of 52 polled countries, Zimbabwe is seated on the 40<sup>th</sup> spot. Given the increased attention being paid to the CPI by foreign investors, the worsening of the country's ranking is undoubtedly a threat to the country's ability to generate foreign currency. Table 4, in the appendix, shows the growth of corruption in Zimbabwe over the past seven years.

Smuggling of the country's precious minerals and scrap metal cannot be ruled out as one of the causes of the currency crisis. With increased illegal diamond and gold panning in Manicaland and along the Great Dyke regions, respectively, large quantities of diamond and gold were side marketed during the period of study. RBZ (2007) asserts that diamonds worth about US\$800 million, gold valued at about US\$400 million and other minerals valued at US\$200 million were smuggled out of the country every year. Undoubtedly, if these resources were channeled into the formal system, foreign currency problems would have been minimized. The intensified fight against smuggling has seen a great improvement in the flow of these minerals to proper marketing channels, a clear sign that the country lost billions of dollars through smugglers' clandestine activities.



### **3.6 Contagion effect and self-fulfilling expectations.**

Given that the Zimbabwean currency crisis began in 1997, a period coinciding with the South-East Asian currency crisis (1997-1998) and the Russian crisis of 1998, contagion cannot be wholly ruled out as one of the causes of the currency crisis, though with limited effect. Eichengreen, Rose and Wyploz (1997) argued that devaluation in one country affects the price level or the current account by a reduction in exports in a neighboring country. In either case, devaluation in a neighboring country becomes increasingly likely. The spillover from one country into neighboring countries can be attributed to a number of different scenarios. An individual shock can be transmitted from one country to the other through trade and world financial market such as the stock exchange (*ibid*). A combination of these scenarios can serve as an explanation of the apparent financial linkages that are responsible for the spread of speculative attacks from one currency to another. Zimbabwe as a global player might have been prone to such attacks. When domestic borrowers saw what was happening in the Asian markets, where the exchange rate had been pegged to the US dollar, they might have tried to cover themselves to avoid the same fate, by pulling out of the local unit or currencies believed to be risky. Usually, when the market perceptions shift, they tend to do so for a bunch of currencies in the region or across countries with similar fundamentals (*ibid*).

Rakshit (1999) assessed the role of liquidity, informational problems, fragility of short-term expectations and self-fulfilling expectations. He identified a combination of factors such as the downturn in export demand, disproportionately large external liabilities in relation to foreign exchange assets, the weakening of bank's balance sheet that may force a country to renege on its foreign dues and suffer a crisis. In the Zimbabwean context, the expected devaluation of the Zimbabwean dollar made the currency crisis inevitable. The unsustainable macroeconomic imbalances and rampant buying of foreign currency to hedge against high inflation levels and constantly depreciating currency made the currency crisis self-fulfilling.

## **4. Previous government efforts alleviate the currency crisis.**

The Mugabe regime took a number of measures to mitigate the crisis, although with limited successes, from both the fiscal and the monetary fronts. Some of the policy initiatives are discussed below.

### **4.1 Mobilisation of foreign currency from expatriates**

Mobilisation was led by the Homelink project. Homelink was a brand name for the network of privately owned registered money transfer agencies in Zimbabwe and their foreign money transfer agency partners through which Zimbabweans abroad can send money to persons or organizations in Zimbabwe. This initiative was aimed at ensuring that Zimbabweans in the diaspora send their money home through formal channels as opposed to the parallel market, thus ensuring that they contribute to the country's economic recovery. The initiative dubbed "the great trek into the Diaspora" saw monetary authorities traveling to a number of countries, which include the United States, the United Kingdom and South Africa, to appeal to Zimbabweans in

those countries to contribute to the economic turnaround through investment and other contributions. The Homelink initiative was initially very successful though its success was short-lived. In the year of its introduction in 2004, the programme saw increased foreign exchange inflows, realizing US\$54.8 million. Although the Homelink initiative continued to play a crucial role in mobilization of the scarce foreign reserves into the country, its significance dwindled due to the flourishing black market for foreign currency and loss of faith in the Mugabe regime. Holders of free funds were exchanging their foreign currency in the illegal market due to the more attractive rates being offered by that market. On the backdrop of exchange rate divergence between the official and the parallel market for foreign exchange, the RBZ notes that “Zimbabweans in the Diaspora, who had contributed significantly in 2004, virtually stopped transferring their money through legitimate official channels, preferring, instead the risky underground routes” (RBZ, 2006b:69). As such, the RBZ in a bid to promote the free flow of foreign exchange in the economy relaxed some of its regulations, allowing recipients of transfers from the diaspora to be paid their free funds in foreign currency without limitation (RBZ, 2006b:80). Late 2008 the RBZ in a bid to assist the businesses faced with a chronic shortage of foreign currency introduced the Foreign Exchange Licensed Wholesalers and Retail Shops (FOLIWARS), Foreign Exchange License for Oil Companies, Foreign Licensed Outlets for Petrol and Diesel.

#### **4.2 Initiatives to promote exports**

A series of incentives were extended to exporters by the previous government. These initiatives include the Concessionary Loan Scheme, Export Delivery Bonus, Incremental Export Initiatives, Enhanced Carrot and Stick Export Retention scheme, indefinitely extending the Foreign Currency Accounts (FCAs) retention period for the benefit of exporting companies, Targeted Fuel Sales in Foreign Exchange, Exporters’ Special borrowing facility, liberalisation of Free Funds Administration, Export Supportive interest rates, Export Market Development Fund, reduction of foreign currency surrender to the RBZ to 30 percent, Textile Exports to America promotions, Tax Concessions on exporters (especially companies in the Export Processing Zones), the setting of the Value Addition and Import Substitution Fund, just to name a few. These measures were meant to promote exports, a move imperative to the generation of the much-needed foreign exchange. A significant number of exporters benefited from these measures, though the benefits to the overall economy in the form of improved foreign currency inflows were not realized.

#### **4.3 Creative foreign exchange management**

Since 2004, the central bank changed from one foreign exchange management system to the other, in search of a regime that best suited the volatile macroeconomic and political environment. The fixed exchange rate regime dominated the period from 1999 to end of 2003, before the RBZ adopted a Managed Auction System of foreign currency management in January 2004. This system was abandoned at the end of 2005 for the Tradable Balances Foreign Currency System, but it was not long before the monetary authorities reverted back to the Fixed Exchange Rate System in August of the same year. In May 2008 the RBZ adopted a flexible exchange rate system, but the public remained skeptic about dealing with the RBZ since it only purchased foreign currency from the public but could not sell it back when the public wanted foreign currency. Realizing the complete collapse of the Zimbabwean dollar, the RBZ hatched a plan to allow selected businesses to transact in foreign currency. In September 2008, 600 shops and services were licensed to trade using the South African rand and the United

States dollar. In January 2009, the acting Minister of Finance, Patrick Chinamasa officially legalized the use of foreign currency by presenting a US dollar denominated budget. Although most transactions were already being conducted in foreign currency, the 2009 budget ushered in a new era of legal transactions using foreign currency by everyone in the country without discrimination. In the multi-currency system, the Zimbabwe remained the country's legal tender, though the South Africa rand, Botswana Pula and the United States dollar were allowed as mediums of exchange.

#### **4.4 Actions to limit illegal activities and foreign exchange externalization**

In 2003 the then Finance Minister Dr Hebert Murerwa cancelled licenses of bureaux de changes on allegations of being “conduits for parallel market dealings”. This was an attempt to bring sanity in the foreign exchange market since these institutions were accused of conducting illicit deals in the illegal market (black market). The government arrested and fined illegal foreign currency dealers on several occasions. These dealers range from street dealers to organizations breaching the Exchange Control Regulations. A number of individuals and institutions, including banks, contravening the Exchange Control Act have appeared in court and fined large some of money, with some having their licenses cancelled. The RBZ introduced the Whistle Blower Fund to reward those who alert monetary authorities of clandestine activities perpetrated by both individuals and institutions, especially on the foreign currency front. Whistle blowers are rewarded for their tip offs.

Following an observation that the financial sector was involved in corrupt activities, fuelling the currency crisis, the RBZ reformed its supervision of financial institutions by establishing a specialized bank supervision division. This gesture was meant to see to it that they do not engage in such activities again. On this front, the monetary authorities made tremendous strides, though loopholes were exploited by these institutions throughout the period.

#### **4.5 Actions to be taken by the inclusive government in 2009**

Under the new administration Statutory Instrument 5 of 2009 remains in force as pronounced by the previous government. Although the Zimbabwe dollar remains legal tender, in reality it has become extinct and the new Finance Minister Biti declared it dead. In the 2009 budget review statement the government proposes a number of possible measures to alleviate serious foreign shortages. These include increased exports and fewer imports, attraction of foreign loans and grants, ensuring that tax evasions are minimised and the payment of tax by informal business, and the employment of a cash budget system. However, the Finance Minister seems to forget that the country has virtually little left to export at the moment and has perpetually relied on importing food and other essential commodities for the past decade.

### **5. Why these policy measures failed?**

The failure of foreign exchange related policies of the previous Mugabe regime can be attributed to policy inconsistencies and reversals. It is imperative for policy makers to shun such policy approaches in order to build confidence among foreign investor and the business community. Consistent policies are a prerequisite to lure foreign investors. These are so important to enhance the country's foreign exchange inflows in the form of FDIs. Consistency in policies

enhances policy credibility, a vital characteristic of any successful economic policy. Inconsistent fiscal and monetary policies have combined to constrain investment and economic growth. Over the past eight years the country's exchange rate policy has changed more than four times, sending a wrong signal to would be investors.

Both the monetary and fiscal authorities formulated and implemented short-term policies. Policies such as the prosecution of illegal currency dealers, the banning of the Bureau de changes and the setting of the Whistle Blower Fund were meant to address the symptoms of the crisis, not the cause. They lack the long-term perspective and as such were bound to fail. There is, therefore, a need for complete overhaul of the policies formulated by the government. In other words, there should be a paradigm shift towards policies that tackle the causes of the crisis, not its symptoms alone.

Despite crafting some good policies, but the government's implementation record remains a cause for concern. For instance, the Value Addition and Import Substitution policy initiatives have not yet gathered reasonable momentum despite being long advocated for as means of increasing foreign currency and saving the little that accrues from our export proceeds. Unless we walk the talk, our problems on the foreign currency front will remain.

## **6. Potential policies to alleviate the crisis**

Since currency crises are often symptoms of ailing domestic economies, it is therefore inappropriate to prescribe policies that focus only on foreign currency generation as the cure for a crisis. With the stakeholders of the economy in agreement that most of the economy's problems can be traced back to the foreign currency problems, a number of policy measures can be implemented to redress the currency shortages.

Excessive government expenditures, under a fixed exchange rate regime, are presumed to lead to currency crises, we therefore urge the government to stick to its budget plans and leave within its means. Extravagance by office bearers should be a punishable offence. In this regard, supplementary budgets and the government's support window from the RBZ should only be restricted to extreme emergencies, and unsanctioned quasi-fiscal operations by the RBZ should be stopped.

Within a global village our country cannot survive in autarchy, without support from the international community and bilateral relations. The international community has a role to play in the revival of the economy severely battered by the economic and political crises. It is true that Zimbabwe cannot solely and forever depend on external BOP support, debt relief and other forms of aid, but the current situation demands such assistance. Although the Look-East policy is a good start, the re-engagement of the IMF and the World Bank (WB) remains paramount for Zimbabwe to gain international credibility. In addition, extensive campaign against negative publicity should be conducted, complemented by democratic reforms. This will help redefine the country as a safe destination for investment and tourists, thereby improving the country's FDIs and tourist arrivals, especially with the 2010 World Cup finals scheduled for South Africa. These measures, if implemented, undoubtedly will enhance the country's inflows of foreign exchange.

Zimbabwe's exports are dominated by a narrow range of primary commodities, which have a low value addition and are prone to fluctuations in international commodity prices. This is against its imports, which are finished goods and machinery, with high and stable prices. The resultant terms of trade are negative, making the country's current account to be in deficit. Volatility in commodity terms of trade and the low income-elasticity of demand for primary commodities, suggest that reliance on commodity exports alone is not sustainable. This has resulted in an uneven flow of foreign exchange. Countries that have taken advantage of higher incomes and price elasticities of value added exports underscore the importance of manufactured exports as an important guarantor of a sustainable flow of foreign exchange. In these economies, earnings from manufactured exports account for a relatively large proportion and have provided more foreign exchange inflows than bilateral and multilateral grants and loans. Vulnerability of commodity exports to international price shocks clearly suggests the need to adopt export strategies, which have a long-term bias towards value addition. On this front, industry should concentrate increasingly on value addition as well as developing new and competitive product ranges. A sustainable BOP position and exchange rate stability largely depends on the performance of the export sector.

To improve beneficiation and value addition for exports (and supplementary to the efforts by Export Processing Zones), the researchers recommend that a special fund be set aside to promote those participating in value addition. These should be provided with starter up funds if their proposals qualify to be described as value addition on primary products for exports. In the same spectrum, firms involved in import substitution should be given more incentives for doing so. Import substitution is meant to reduce the demand for the foreign currency to fund imports while at the same time promoting growth of the local industry. By substituting demand for externally produced ones, we can retain foreign currency within the economy. Some imports are not necessary to say the least, but still attract substantial local interest because little has been done to promote local manufacture of these goods. Those who come up with new technologies should be rewarded to encourage a culture of research in the country. The Ministry of Industry and International Trade, in collaboration with the Ministry of Science and Technology should take a lead and give positive incentives for innovation. Import substitution approach replaces externally produced goods and services, especially basic necessities such as energy, food and water, with locally produced ones. "Buy Zimbabwe Campaign" commissioned by the RBZ in 2005 can be revived to save the country's foreign exchange.

Political stability is essential for economic growth and development. The political instability in Zimbabwe is not conducive to private investment and FDI. The best proposal is the creation of a government of national unity that brings together both political foes. Without a stable and legitimate government in place, there will be no end the exchange rate instability, and foreign currency shortages. Foreign exchange availability in the formal market will remain a pipe dream.

Given the ravages of inflation and other poor macroeconomic fundamentals, the shelving of the use of the Zimbabwe dollar is a priority. This will build investor confidence and boost production. To avoid confusion through the use of multiple currencies, the Zimbabwean government can negotiate with South Africa to formally adopt the rand as a legal tender. Joining the Southern African Customs Union (SACU) would also bring more benefits as far as the generation of foreign currency is concerned.

## 6. Conclusion

The paper intended to highlight the major causes of the foreign currency crisis in Zimbabwe. In the process the paper also wanted to examine the effects and policy dilemmas faced by the Zimbabwean government. The article managed to clearly show that the Zimbabwe currency crisis is both “fundamental and financial panic” driven. It is unique from other currency crises in that it has persisted over a decade. The crisis uncovers serious structural problems in the economy, including weaknesses in the financial sector, delays in the vital transformation in the industrial structure and defects in corporate governance. These structural flaws are regarded as major factors that caused instability of the Zimbabwean dollar. Unlike in other crises where the IMF and other international financiers were swift to help the affected nations, it is disturbing to note that Zimbabwe has been left to battle over the turmoil on its own. No notable successes have been registered in this endeavour. It is therefore imperative that the international community comes on board and rescue the country.

The long-term stability of the country can only be guaranteed by large inflows of foreign exchange from both exports and international financiers. This coupled with political reforms that will usher in a new era of political stability, rule of law and respect for property and human rights will make foreign currency availability an achievable goal. There is need for restoration of investor confidence and a good image of the country, if significant foreign exchange inflows are to be generated. The policy change to a multi-currency system was a welcome development. However, a quick move back to the Zimbabwe dollar will be suicidal since the manufacturing and agricultural sectors of the economy have not recovered yet.

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## APPENDIX

**Table 1: Official Exchange rate movements: January 2004 to December 2006.**

DATE	EXCHANGE RATE ADJUSTMENTS	COMMENT
12 January 2004	From: Z\$0.824/1US\$ To: Z\$4.198/1US\$	Introduction of the foreign exchange auction.
21 April 2004	From: Z\$4.619/1US\$ To: Z\$5.200/1US\$	Introduction of Diaspora/ export floor to enhance export viability.
28 October 2004	From: Z\$5.200/1US\$ To: Z\$6.200/1US\$	Revision of Diaspora/ export floor to enhance export viability.
19 May 2005	From: Z\$6.200/1US\$ To: Z\$9.000/1US\$	Revision of Diaspora/ export floor to enhance export viability.
25 July 2005	From: Z\$9.000/1US\$ To: Z\$17.600/1US\$	Adjustment in line with inflation developments.
20 October 2005	From: Z\$26.000/1US\$ To: Z\$76.000/1US\$	Adjustment to reflect market forces on the introduction of the Tradable Foreign Currency Balances System (TFCBS).
20 January 2006	From: Z\$85.000/1US\$ To: Z\$99.200/1US\$	Introduction of the volume-based TFCBS.
31 July 2006	From: Z\$101.196/1US\$ To: Z\$250.00/1US\$	Adjustment to restore exporter viability.

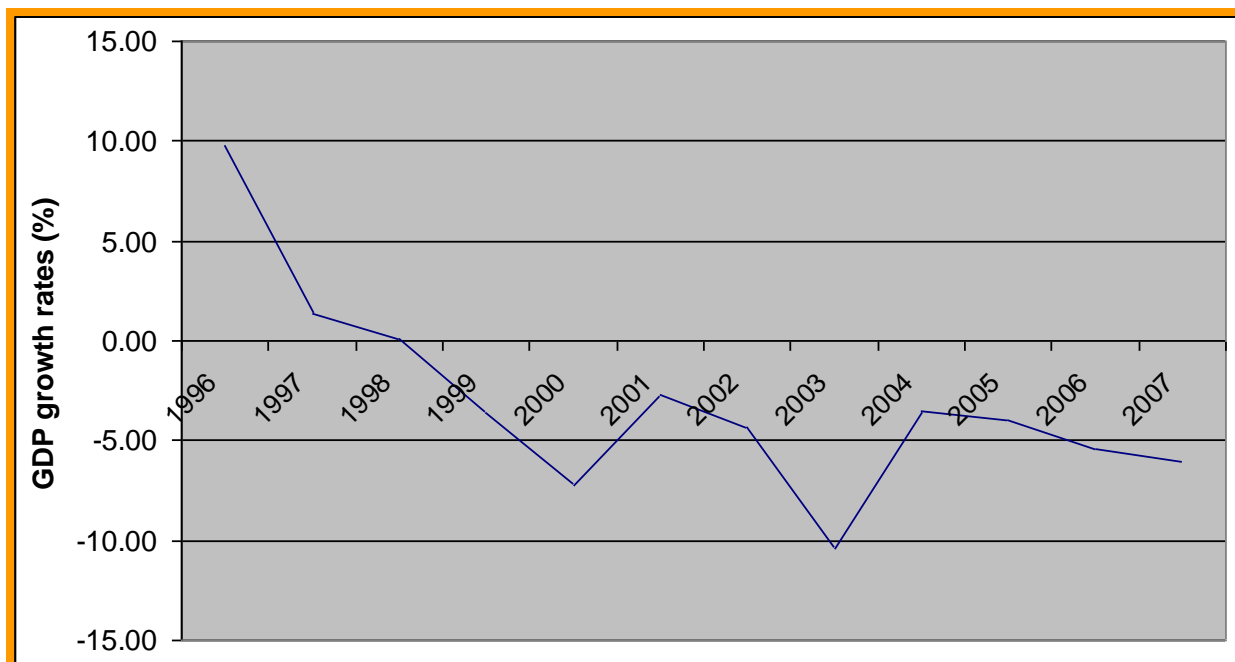
**Source:** RBZ (2006:78)

**Table 2: Year on year inflation rates for Zimbabwe from 2001 to 2007**

Year	Consumer Price Index (2000=100)	Annual Inflation Rates (%)
2001	212.1	112.10
2002	634.03	198.93
2003	4,430.25	598.74
2004	10,311.27	132.75
2005	70,719.04	585.84
2006	976,709.84	1281.11
2007	1064068073.53	108844.13

**Source:** IMF (2008)

**Figure 1: Annual GDP growth rates for Zimbabwe from 1996 to 2007**



Source:

IMF (2008)

**Table 3: The current account balances for Zimbabwe from 1996 to 2007**

Year	Current account balance (US\$Billions)
1996	-0.094
1997	-0.716
1998	-0.296
1999	0.168
2000	0.033
2001	-0.042
2002	-0.175
2003	-0.308
2004	-0.392
2005	-0.511
2006	-0.344
2007	-0.165
2008	-0.494.8 *

**Source:** IMF (2008) \* CIA estimate(2009)

**Table 4: Corruption Perception Index for Zimbabwe: 2001 – 2007.**

Year	2001	2002	2003	2004	2005	2006	2007
Corruption Perception Index	65	71	106	114	107	130	150

**Source:** Transparency International (2007)