POLICY ANALYSIS

ZIMCODD

UNPACKING THE 2022 MONETARY POLICY

What is Monetary Policy?

On the 7th of February 2021, the Reserve Bank of Zimbabwe (RBZ) announced its 2022 Monetary Policy. As a refresher, monetary policy details policies by the monetary authority to control either interest rate or money supply to influence macroeconomic variables like inflation, consumption, liquidity, and economic growth, among others. Central banks have various monetary policy tools at their disposal which include among others, open market operations (OMO) that is the buying and selling of government securities like Treasury Bills and Treasury Notes, reserve requirement (cash reserve) ratios which is the proportion of reservable liabilities (deposits) banks should hold onto rather than lending, interest on reserves, and the discount rate. As such, economists mainly measure the performance of a central bank using the level of inflation. Typically, the level of general prices should not exceed 10% which is also a global benchmark for price stability.

2022 Monetary Policy Highlights

Given massive ZWL$ instability particularly in the parallel market and increased inflation pressures persisting in the economy since the advent of austerity and failed currency reforms of 2019, it was obvious that RBZ would adopt a contractionary monetary policy stance, at least on paper. A contractionary monetary policy is driven by increases in the various base interest rates controlled by central banks or other means producing growth in the money supply.[1] The chief goal of this policy stance is to moderate inflation growth by reducing the quantum of money circulating in the economy.

RBZ expects that the measures it announced will pull monthly price increases to hover below 4% in the first quarter of the year (Q1:22) and an average below 3% in the first half of 2022. In January 2021, monthly inflation outturn came in at 5.34% after increasing by 5.76% in both November and

[1] https://www.investopedia.com/terms/c/contractionarypolicy.asp#:~:text=Contractionary%20Policy%20as%20a%20Monetary,money%20circulating%20in%20the%20economy.

December 2021. The Bank projects 2022 annual inflation to hover between 25-35% by December from 60.7% recorded as of December 2021.

Below are some of the key measures in the 2022 Monetary Policy that according to the Bank will help to attain low inflation goal:

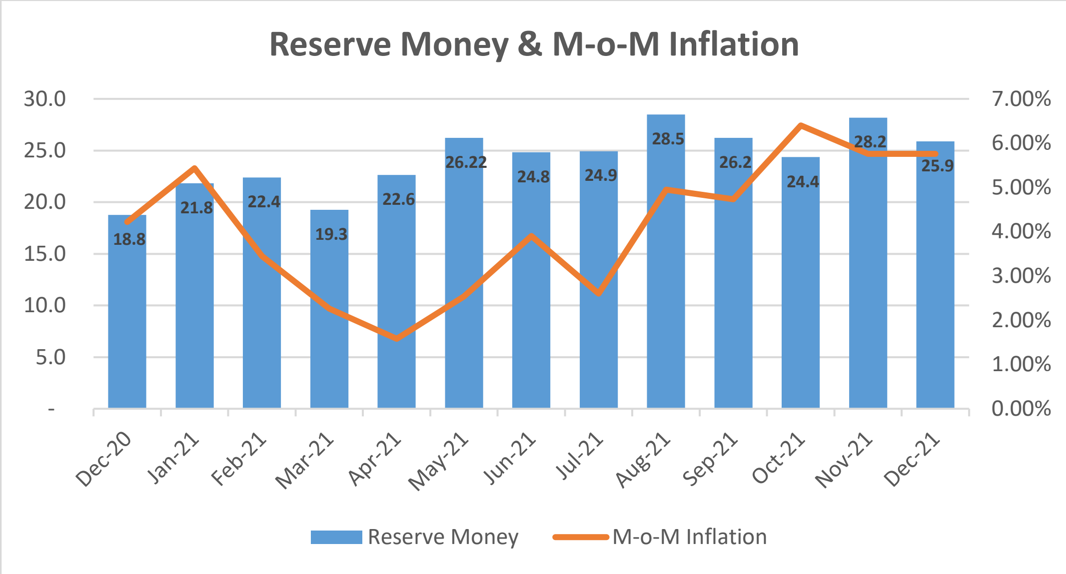
- Continuation of tight monetary targeting framework by reviewing downward quarterly reserve money growth target from 10% to 7.5% through June 2022. The Bank will also continue with aggressive liquidity management through OMO.
- The Bank's policy rate was also maintained at its current level of 60%.
- Statutory reserve requirements for demand (call) deposits and savings and time deposits were maintained at 10% and 2.5% respectively.
- The auction market will be fine-tuned, and the Bank will keep to timeous settlement of auction bid allotments within 2 weeks from the day the auction is conducted.
- Promote the use of local currency through:
    - Increasing forex to fuel dealers designated by ZERA to sell fuel in local currency.
    - Building forex reserves to back local currency by setting aside 5% of forex available for the auction system.
    - Increasing limit on mobile banking transactions as follows:
        - Person to business: ZWL$20,000 to ZW$25,000 per transaction (ZWL$100,000 limit per week).
        - Person to Person: ZWL$5,000 to ZWL$10,000 per transaction (ZWL$20,000 limit per week).
    - Increasing cash withdrawal limit for the banking public from ZWL$2,000 to ZWL$5,000 per week.
- Refinement of US$50 Facility to limit it to vulnerable members of society specifically pensioners, senior citizens, people with disability, and those in need for forex to pay medical bills.
- Export retention threshold for tobacco and cotton growers to be increased to 75%. Also, businesses in tourism and hospitality shall retain 100% of their forex earnings to allow them to recover from the COVID-19 pandemic.

What are the implications of these measures?

Below is a granular analysis of selected policy measures introduced by RBZ in its quest to save the Zimbabwean dollar from depreciation:

a) 7.5% Reserve Money Target

A quarterly reserve money target of 7.5% down from 10% is commendable considering that it is the most price-sensitive level of the money supply. Reserve money is sometimes defined as the central bank's money because it is injected directly into the economy and at the discretion of the central bank. Its components comprising of currency in circulation and banks deposits at RBZ function more as a medium of exchange than as a store of value hence more immediate impact on price inflation.



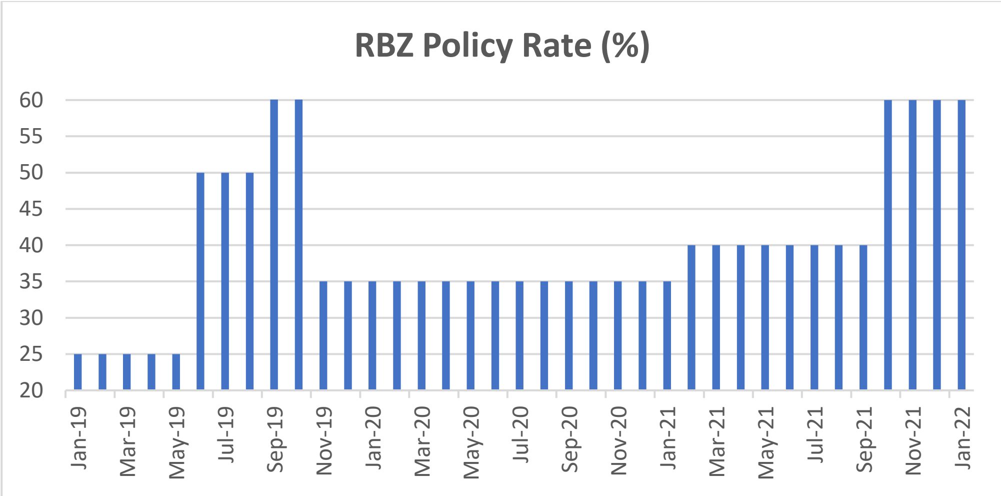
Source: RBZ, ZimStat

In comparative terms, price increases in 2021 were much lower than what was realized in 2020. In 2020, reserve money grew by an average of 7.48% leading to an average monthly price increase of 13.86% and annual price growth averaging 637.4%. For the same period in 2021, reserve money growth averaged 3.35% with an average monthly price increase of 4.11% and an average annual growth of 136.9%. This shows that if the 2022 reserve money growth target is religiously followed coupled with an efficient exchange rate management mechanism and fiscal discipline, inflation growth will subside. Generally, money supply growth should move in tandem with the growth of economic activity (GDP) to dampen inflationary pressure and anchor the exchange rate.

b) RBZ Policy Rate

The maintenance of the RBZ policy rate at 60% is a step in the right direction in the fight against ravaging inflation. In 2019, when annual prices were increasing by an average of 237.3% to close the year at 521% from 42.1% in December 2018, the Bank began to adjust its policy rate upwards. Broadly, the RBZ policy rate is the lending rate a central bank uses to regulate availability, cost, and use of money and credit.[2] A high policy rate reduces excessive liquidity problems and ensures financial market stability. In the Zimbabwean case, a high policy rate is needed to discourage borrowing large volumes by banks for speculative purposes. Therefore, by maintaining a 60% rate RBZ has admitted that the Zimbabwe dollar is under pressure and in need of full support.

[2] http://www.arthapedia.in/index.php?title=Policy_Rate



Source: RBZ

While a high policy rate is the right prescription to the current rampant ZWL$ deterioration and price spiral, it has negative spill-over effects on the entire economy which can subdue national output (GDP) growth. It increases the cost of borrowing hence increasing the cost of doing business. The corporates always find a way to shift their cost to the consumers (citizens). To give the desired impact, this policy stance should be aided by sustainable money supply growth.

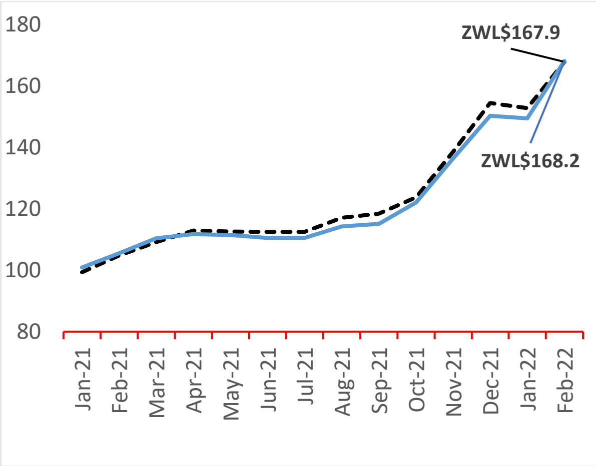
c) Statutory Reserve Requirement Ratio

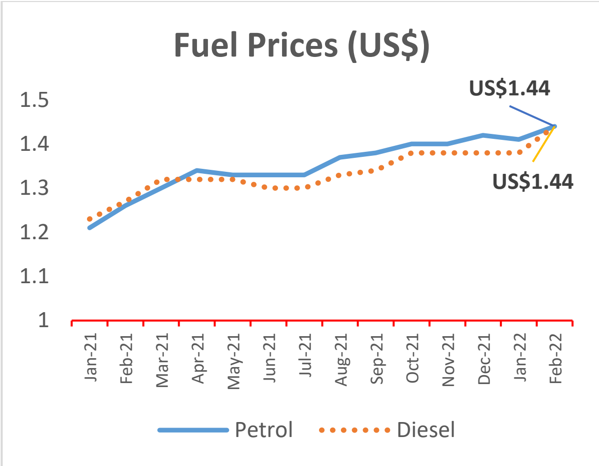
RBZ also maintained a statutory (required) reserves requirement ratio at 10% for demand (call) deposits and 2.5% for saving and time deposits. For starters, statutory reserve requirements are money balances banking institutions are required to maintain in their Statutory Reserve Accounts (SRA) equivalent to a certain proportion of their eligible liabilities (EL), this proportion being the SRR rate.[3] Keeping a high reserve ratio of 10% on-demand/call deposits reduces free funds available to banks for speculative lending which can destabilize the local currency. However, if these reserves are not earning interest rates, they become a cost to banks thus crippling money creation in the economy. Just as a high central bank policy rate, high statutory reserves may trigger a liquidity crunch.

d) More forex to fuel dealers

Increasing forex to designated fuel dealers to import more fuel to sell in local currency is another commendable policy move given that the fuel market has largely dollarized, and prices continue to increase. Between February 2021 and February 2022, maximum diesel pump prices in US$ mounted 13.4% from US$1.23 to US$1.44 per liter. As for petrol, the maximum pump price per liter mounted 14.3% to US$1.44 from US$1.26.

[3] https://www.bnm.gov.my/statutory-reserve-requirement-srr-





Source: ZERA Monthly Fuel Updates

Therefore, increasing fuel sold in local currency will provide relief to average citizens who are earning in fragile Zim dollar. The revival of the local currency fuel market will also create demand for local currency, hence supporting its value. However, this policy stance may have little impact on currency stability as it will likely create an avenue for corruption and arbitrage in the fuel market. The top fuel importers who also play a bigger role in the fuel retail market will find incentives to hoard fuel and channel it to the parallel market to earn riskless profits since the Zimbabwe dollar is overvalued on the auction market. Parallel market premiums, which are the percentage difference between parallel and official rates, are currently hovering above 100%.

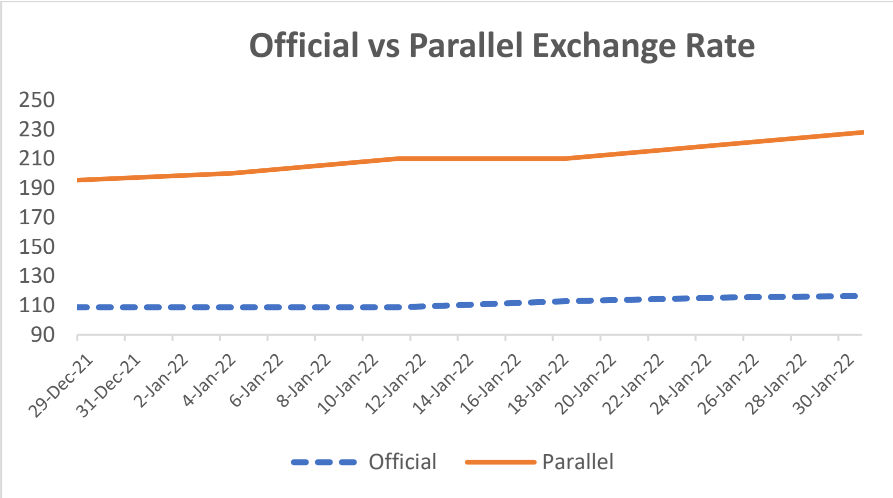
e) Withdrawal Limits

The increase of cash withdrawal limits from ZWL$2,000 per week to ZWL$5,000 will bring transaction convenience to the public as price levels have increased from the last limit that was set last year. A ZWL$2,000 withdrawal limit was one of the contributing factors to widening black market physical cash premiums. In as much the Bank is targeting a cashless society to deepen financial inclusion, there are transactions that still require cash. Although ZWL$5,000 per week is still insufficient to address the problem, the increment will save the public some amount of time that was being wasted in bank queues as well as travel costs to and from banking halls.

However, the Bank was silent on the introduction of higher denomination banknotes like ZWL$100 notes. The existing ZWL$50 note, which is the biggest note in Zimbabwe cannot buy a loaf of bread or cover a one-way local trip. Introducing higher denomination banknotes does not impact prices since it is the quantum of money stock circulating in the economy that has a huge impact on prices. As long as banks will exchange their RTGS balances for higher denomination banknotes, this will not create new money in the system. With prices continuing to rise, the public will have to carry numerous notes thus causing transacting inconvenience. Monetarists posit that money should be portable, that is easy to carry around.

f) Refinement of the auction market

The Bank also announced that it will continue to refine the auction market to discover the true price of the local currency. However, this has been the government talk since the introduction of the auction system on 23 June 2020. The maintenance of the auction system in its current form is contributing largely to the massive depreciation of the local currency. Although the parallel market rates have a speculative component, parallel premiums of over 100% alone highlight the inefficiencies of the official exchange rate management system. It is profitable for one to buy forex on the auction (low market) and sell it in the parallel market (high market) at a lucrative rate thus defying the purpose of the auction.



Source: RBZ, ZIMCODD

The RBZ has become the sole source of forex traded on the auction system, a position that makes the system prone to manipulation and insider trading shenanigans. An ideal and efficient market should have many buyers and sellers. As a sole seller, the Bank might be overwhelmed by demand, a trend that was experienced in 2021 when forex allocation backlog increased to more than US$200 million yet forex deposits held by commercial banks were way above US$1.5 billion. Lack of access to the auction market is forcing the public to rely on the expensive parallel market. Therefore, there is a need for bold actions to ensure transparency and inclusivity in the auction market.

The risks to 2022 Outlook

The measures put forward by the Bank are informed by existing economic trends, and on paper can deliver currency and price stability. However, the market is re-dollarizing fast as evidenced by the scramble for US dollars by formal businesses to catch up with the informal economy. Most supermarkets are offering huge discounts for forex transactions while maintaining ZWL$ prices benchmarked at the parallel market rate. The government is also dumping its currency as shown by increased taxes on forex. RBZ statistics show that nearly 60% of banking sector deposits are local currency hence disputing the fact that the economy is near dollarization. The bank however ignores the fact that the general public, informal traders, as well as other formal companies, are banking their forex earnings in their homes in fear of the repetition of 2019. In 2019, citizens were shocked that their US$ deposits were no longer forex but local currency. This should remind authorities that de-dollarization is a process, not an event.

The economy is still battling the COVID-19 pandemic, massive structural rigidities, high corruption, high energy prices, acute electricity shortages, illicit financial flows, externalization, unsustainable public debt, poor service delivery, and rapid change in climatic conditions; the challenges that are greatly subduing economic activity. Further, the global economy is experiencing a wave of inflation driven by supply chain disruptions, high energy prices, and accommodative policies that were implemented in the fight against the pandemic. This development if prolonged might lead to imported inflation since Zimbabwe is an import-dependent nation. Zimbabwe is also approaching watershed 2023 harmonized elections which may fuel political instability and unsustainable fiscal spending as government implements populist policies to appease the electorate especially those in the rural areas – the stronghold of the ruling party. This poses a great danger to RBZ's tight monetary targeting framework hence further destabilizing the exchange rate.

Conclusion

If RBZ religiously follows the tight monetary targeting framework as per the 2022 policy, it will be able to reduce excessive liquidity (money supply) in the economy. The exchange rate system should be revamped to discover the true value of the local currency thus dampening depreciation pressures. Also, larger banknotes are now long overdue to increase public transaction convenience. The fiscal side should also support the monetary front by ensuring that they spend within budgets and promote the use of the local currency by collecting most domestic taxes in the domestic currency. However, the balance of risks to currency and price stability is to the downside. With premiums now at 110% and authorities reluctant to address auction inefficiencies and increased money supply growth, it will take time to address exchange rate issues. The local currency is suffering from public and business confidence deficits as authorities have lost public trust. As such, it is the public's position that the government should take the re-dollarization route for a short to medium term (3-5 years) to stabilize the macroeconomic fundamentals that are currently in disarray. While a monetary policy leg is crucial in economic management, the nation should return to the Zimbabwe dollar if and only if all prerequisites such as industrial production and prudent market-driven policies are fully instituted.

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