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Whilst the private sector has spent the last six years reducing costs, improving efficiencies and boosting their competitiveness, Government has been making little headway in cutting its own costs. In the early years of the Unity Government, budgets were set on a cash receipt basis with no recourse to borrowing. Since 2013 however there has been a growing issuance of treasury bills initially as a means to repay private sector debts, but then to cover the historical debts of the Reserve Bank and latterly ZAMCO. With rapidly declining tax receipts and no simultaneous spending cuts, Government have been issuing treasury bills to the banks in order to fund itself and pay civil service salaries. The net result is that as at April, treasury bills now represent 30% of total bank deposits (source: RBZ) having been below 10% only one year ago.

A good proportion of the treasury bills issued to the private sector by Government in lieu of cash payments have been sold at discounts to par as a means to raise liquidity. There can be no doubt that a part of the proceeds of these sales have been externalized often as a means to import goods and services. In short, locally ‘circulating’ US dollars have been used to purchase real foreign exchange assets overseas. This has led to a decline in banks’ nostro accounts as inward dollar transfers (through exports, diaspora remittances, foreign loans etc) have become lower than outward transfers. In effect, the RTGS system has more US dollars than has been received in the nostro accounts which has caused the imbalance. The imbalance only gets worse as more T-bills are cashed in. At the end of April, Nostro accounts represented a mere 3% of total bank deposits from over 10% back in 2011.

The announcement of the introduction of bond notes caused widespread panic in the economy. Far from easing the cash shortage, it made it worse as individuals and companies hoarded US dollar cash by withdrawing deposits from the banks as best they could. Cash as a percentage of bank deposits fell from 10% in 2013 to just 3% by April this year (before the bond note announcement). This had an immediate negative impact upon consumption with sharp falls in volume demand (e.g 20% in some cases) being witnessed. As a consequence this economic shock will lead to a rapid slowdown in the economy with a consequent decline in tax revenues. Without cuts to Government spending, the fiscal authorities will be forced to issue even more treasury bills to the market place and/or delay further salary payments to the civil service. Many banks have ceased lending much to the private sector as they buy short dated treasury bills from Government. For accounting purposes these might be maturing in December 2016 to tie in with bank’s own year ends so that the bills can be valued at par rather than at a discount. If Government is unable to repay these maturities by issuing more new treasury bills, then bank balance sheets will take a hit. The problem is that banks only have so much free liquidity for them to buy T-bills and it is our belief that the banks may be getting ever closer to that level now. At the end of April, balances with the RBZ amounted to $750 million. With Government spending estimated to be $250m per month for civil servants and say $100m on other expenses (i.e a total of $350 million) and then assume tax revenues per month are down to say $250m per month, there is a shortfall of $100m per month. We feel the banking system had the capacity to fund this for about three months as at end April. Put another way, the money could run out by August. In our minds this explains why Government is struggling to pay June salaries, some of which will be paid in July - over six weeks since the last salary payments. This problem will become even more acute at the end of July we suspect and hence further strike action is a distinct possibility.

Government has often “pulled a rabbit out of the hat” but in this case we fail to see what they can do. Bond notes would only be a temporary fix but they have been delayed until October and they would be financed by external borrowings. That leaves external support as the only lasting option. But external support will require aggressive reform measures which to date Government has shown itself reluctant to undertake especially now with an election in 2018. Should the IMF come to the rescue backed up by an aggressive economic reform programme, then that would be very positive for asset values in Zimbabwe, initially the stock market and then the property market.

Meanwhile the banking sector looks precarious given the public’s lack of trust for the banks and Government’s on-going demands on banks’ excess liquidity. Non-performing loans will be rising given the weak economy and industry’s increasing difficulties in importing raw materials. At the end of April, the loan to deposit ratio of the banking system was down to 61% from 77% at the beginning of 2015 whilst treasury bills rose from 9% of deposits to 28% over the same period. Assuming non-performing loans of say 12% (at best in our view), then NPLs as a percentage of bank equity at the end of April amounted to 36%. If NPLs rise to 15% this would account for 45% of bank equity capital. Again, at the end of April, banks held treasury bills valued at $1.2 billion (which we assume is at par) against bank equity of $900m. If the Government defaults on its Treasury bill capital repayments at the end of December which effectively a roll over would amount to, these bills should be valued at a discount to par value implying a write down of the bank’s equity capital. Again taking RBZ data, a 30% discount on treasury bills would wipe out 40% of bank equity - on top of NPL losses. But that would have been the position at the end of April. At the end of June we can only assume an even worse outcome. Needless to say we have to be more concerned with holding bank deposits in our portfolios than a year ago.

We see portfolio risk as the permanent loss of capital. It is a mistake to see risk as a short term loss in capital. A decline in the stock market is a short term loss in capital but it is NOT a permanent loss of capital. Holding money market assets in hyperinflationary times amounted to a permanent loss of capital. Holding equities and property in those times ultimately resulted in investors owning a US dollar asset when hyperinflation ended. We are concerned that holding money market assets in the current environment might result in a permanent loss in capital once again UNLESS a third party can assume Government debt. This is by no means a certainty in today's Zimbabwe. We therefore have to be especially cautious in our asset allocation decisions for our clients.

Positively, the IMF continues to work with Government to resolve Zimbabwe's economic issues. It is unfortunate that we are 'between' IMF programmes having successfully concluded the Staff Monitored Programme (SMP) at the end of 2015. We have yet to embark on a Structural Adjustment Programme (SAP) including an Extended Credit Facility (ECF). Before we can move to an ECF, Government first has to repay its arrears but second embark on a credible reform programme which it has to implement, not pay lip service to. Whichever way we look at it, we are not sure that Government has too many options left and indeed this may be the only credible one left in the 'hat'.

If we can achieve an ECF programme before the end of the year – which itself will likely require a political change of mind in some form – then the future looks exciting as we have always believed. That would be great for the stock market and latterly the property market.

Ultimately, as a means to avoid the money laundering and 'cash exporting' issues - we believe that Zimbabwe could end up adopting a currency board as Hong Kong and more recently Bulgaria have successfully achieved. To do so and to add credibility this needs to be administered by an external party for it to stand a chance (i.e. not by the Zimbabwean authorities for the time being). We further believe that the most appropriate peg would be to the dollar. The bulk of our exports are priced in dollars (platinum, gold, tobacco and one day power?) whilst the key imports being energy and for now agricultural commodities are also dollar based. Why adopt a weak currency subject to political discounts and with exchange controls (i.e. the Rand) that Zimbabweans escaped from in 2008? Since adopting the US dollar, Zimbabwe has been subject to tough economic disciplines that has made the private sector more efficient. Whilst old outdated businesses have closed, new more modern services have replaced them.

To make Zimbabwe attractive, the Government will need to radically improve its efficiency and improve on the ease of doing business. The focus though needs to be on Zimbabwe's comparative advantages rather than attempt to keep unproductive businesses alive. In this regard the agricultural sector as a potentially substantial employer, an exporter and an import substitution industry with a formerly developed infrastructure (e.g. dams) should be a prime target. This in itself will help revitalize businesses that supply the sector. Mining is another of the country's key comparative advantages especially gold, platinum and diamonds, all of which are relatively close to the surface and hence more profitable than their counterparts in South Africa. All of these are also significant employers but which require foreign capital to grow them. Tourism too is a comparative advantage, employs many people whilst it takes advantage of Zimbabwe's educated and friendly people. Unfortunately, Government's desire for funds has resulted in policies to date that hinder rather than encourage these sectors to develop.

In a fully globalized world, Zimbabwe's consumption base is too small to achieve the necessary economies of scale to produce many products efficiently. Other countries can produce more cheaply and effectively. As such even if we were to operate in a rand environment we would not necessarily be able to compete with South African producers. There should be products – such as irrigation pipes for example – which can supply Zimbabwe and the surrounding region and still be competitive with South Africa. This is another reason why we believe that adopting the rand would not live up to industrialists' expectations. More important is to make the Government sector more productive, efficient and cheaper. Hence privatization should be a key policy going forward together with a leaner and enabling civil service.

John Legat, Chief Executive