



## *USIPeace Briefing*

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# Depoliticizing Zimbabwe's Economy: *Solutions for Two Million Percent*

By Raymond Gilpin

## **Synopsis**

Although Zimbabwe's deep-seated economic malaise has robbed citizens of their savings, rendered incomes practically worthless and undermined domestic productivity, experts believe that a resolution of the political impasse could trigger much-needed policy reform and economic revitalization. This *USIPeace Briefing* reviews policy options and recommendations proffered at a USIP roundtable discussion on August 12, 2008. The panelists were:

- Keith Campbell, Managing Director at the Executive Research Associates;
- Bernard Harborne, Lead Conflict Specialist at the World Bank;
- Frank Young, Vice President of Abt Associates;
- Callisto Madavo, visiting professor at the African Studies Program at Georgetown University.

USIP's Raymond Gilpin moderated the event.

## **Introduction**

Soaring inflation and currency depreciation have been the most visible manifestations of Zimbabwe's economic woes during the first half of 2008. By mid-July, estimates of annual price increases exceeded a mind-boggling 2,000,000 percent, while the domestic currency lost practically all its value every time it changed hands. According to some estimates, the Zimbabwean dollar (ZIM\$) depreciated three-fold in June 2008.<sup>1</sup>

Three main factors have accounted for this precipitous decline in the country's economic fortunes. The first is bad economic governance perpetrated by President Mugabe and his team. Excessive government spending and a series of wrong policy choices, such as price controls and fixed exchange rates, have crippled the productive sectors. Chronic fiscal indiscipline is the second. Rather than take steps to correct policy failures and institutional weaknesses, the Mugabe regime ran substantial ongoing budget deficits. They deficits were primarily financed by Zimbabwe's central bank, which injected money at extraordinary rates. Third, the failure to uphold the rule of law created chaos and uncertainty, which eroded business confidence, led to

the misallocation of resources and depressed economic output. This has been particularly worrisome in relation to corruption and land ownership.

In addition to creating a litany of economic woes, these factors have also stymied prospects for peace. Bad governance has fostered a culture of impunity and helped reinforce the political and economic muscle of the regime's leadership. This group has become deeply vested in the status quo. They have demonstrated a capacity to do whatever it takes to maintain their privileged positions, which guarantee unfettered access to wealth and power—at the expense of the vast majority of Zimbabweans. At the household level, severe and deepening deprivation contributes to a sense of helplessness and frustration. Failure to resolve Zimbabwe's political and economic problems could exacerbate horizontal tensions (as groups compete for dwindling resources) and vertical tensions (as individuals and groups try to change the system of governance).

### **An Economic Collapse?**

According to Madavo the deliberate mismanagement of Zimbabwe's economy by the Mugabe regime shows that they “care more about themselves than about their people.” The economic policies they adopted deepened poverty and made doing business in the formal sector prohibitively costly. For example, while the mismanaged exchange rate and staggering inflation make the earnings and savings of Zimbabweans worthless, the government insulates itself by conducting transactions at an overvalued “official” exchange rate. The government ignored the implications of this policy (such as foreign currency shortages and an increasing parallel market premium) and sought to mitigate its effects by introducing price controls and imposing limits on daily bank withdrawals.

Another example of the government's apparent disregard of the effects of its policies on economic growth is the high reserve requirements for financial institutions, which has ranged between 40 and 60 percent of deposits since 2004. (In most African countries the figure is below ten percent.) This means that rather than use their deposits to invest and provide loans, the banks turn over most of their capital to the regime for it to be used and taxed (via inflation).

The regime's cash policies are problematic and contradictory. While high inflation requires the impractical movement of many bundles of local currency, individuals and businesses risk fines and/or jail for hoarding if they are suspected of holding large quantities. Madavo opined that the resultant economic catastrophe has “tremendous implications for food security, employment and growth.”

Zimbabwe's faltering economic fortunes meant that government revenue declined while international reserves were decimated. By end 2006, they were equivalent to less than two weeks' worth of imports. (Most developing country governments average at least four months worth of international reserves.) Punitive domestic deficit financing strategies were necessitated by the Mugabe regime's poor relations with the donor community and creditors (both commercial and multilateral).

Domestically, the collapse in investor confidence (spurred by the virtual breakdown in the rule of law—as typified by the mishandling of the land reform process) has also greatly reduced revenue-enhancing options.<sup>2</sup> Rather than address the glaring problems and curtail unproductive spending, the Mugabe administration has continued to expand the public sector and subsidize

avored sectors and projects (like the military and party faithful). This is done as a means of political patronage. A research paper by Gary Milante describes how repressive and autocratic leaders use financial incentives to perpetuate their regimes.<sup>3</sup> This spending has been financed through “quasi-fiscal” activities, where the central bank was required to directly finance subsidies, compensate “exporters” for exchange rate losses, underwrite loss-making government-owned entities and service an ever-growing stock of domestic debt. Quasi-fiscal spending accounted for most of the overall fiscal deficit by the mid-2000s, with interest payments on domestic debt accounting for 80 percent of GDP in 2006.<sup>4</sup> In 2007 the government announced the creation of a new institution, FISCORP Limited, a company owned by the Reserve Bank whose task will be to manage quasi-fiscal activity, particularly the collection and administration of outstanding loans.<sup>5</sup> However, continuing escalation in inflation rates suggests that the new institution has had no positive impact.

By some estimates Zimbabwe’s economy (once a regional anchor) contracted by 30 percent between 2004 and 2006; unemployment is rife and poverty deepens by the minute. Young explained how households and businesses have developed “imaginative and extremely agile strategies” to survive because “the Zimbabwean currency has lost value as a medium of exchange.” The failure of financial institutions to attract deposits and provide credit has forced Zimbabweans to adopt mechanisms to avoid the costs and perils of doing business via official channels. The practically worthless currency has been replaced with innovative means of exchange, like petrol coupons and non-perishable groceries.<sup>6</sup> Savings are widely held in US dollars and South African rand. The “official” economy is irrelevant and a number of informal, barter systems have developed, based on strong community networks. They allow groups to purchase and barter essential commodities (like food and fuel) while hedging against inflation and currency depreciation. It is this informal economy that has forestalled full-scale economic collapse in Zimbabwe. Young described the social infrastructure upon which the informal economy is built as “very strong” because it is based on a level of social trust and a keen determination of real market conditions. With the right incentive structure and institutional framework, these economic relationships could transition to a reformed formal economy with relative ease.

## **Considering Solutions**

Politics and economics are very closely intertwined in Zimbabwe. The Mugabe regime views both the finance ministry and the central bank as its money machines. Continued government intervention in credit allocation, resource distribution and trade has progressively weakened the economy and its institutions. This is why Campbell believes that “Zimbabwe’s economy won’t get fixed until politics gets fixed.” He noted that recent cracks in the “wall of silence” (as African leaders begin to speak out against Mugabe’s excesses) bode well for fundamental political reform in Zimbabwe. This is particularly true in South Africa, where a change of guard in the ruling African National Congress has led to pressures on domestically weakened President Mbeki to be more proactive in brokering change in Zimbabwe. Campbell believes that “Zimbabwe’s economy must be central to ongoing discussions.” There is broad-based consensus that depoliticizing Zimbabwe’s economy is a necessary and non-negotiable first step.

Harborne reiterated the importance of “a political breakthrough” and outlined steps that could be taken to encourage meaningful economic reform in Zimbabwe. These include designing a clearance mechanism to address the massive debt amassed by the Mugabe regime, developing a

comprehensive strategy and mobilizing external resources to help finance reform and provide social safety nets. Zimbabwe's external debt was estimated at \$4.8 billion in 2007 (some 300 percent of exports), while domestic debt rose from ZIM\$346 billion in December 2002 to ZIM\$1.4 trillion in June 2005.<sup>7</sup> International strategies and domestic commitment to reduce this burden are critical for adequate investment flows and buoyant private sector-led growth to resume. A comprehensive strategy should guide efforts to mobilize and utilize external financial support. Harborne talked about the importance of coordinating international assistance in order to ensure aid effectiveness and maximize development impact.

Remedial measures must reflect Zimbabwe's circumstances. The policy response must be focused on the root causes of the economic malaise and designed to be conflict-sensitive. The approach to the country's escalating inflation is a case in point. Some observers correctly identify the cause of recent high inflation (relentless money creation), but confuse the channel (the central bank) with the root cause (the Mugabe regime).<sup>8</sup> Consequently, their reform agenda has focused on abolishing the central bank and replacing it with a currency board. Furthermore, money creation is not the only factor at play. The speed with which money changes hands — "the velocity of money" described by economists — is also a factor. More attention should be devoted to understanding and addressing the reasons for high money velocity rates in Zimbabwe. Domestic and external stakeholders must be careful to relate policy recommendations to the domestic situation.

Zimbabwe's economy urgently needs to be stabilized (to contain inflation), while steps are taken to bring about policy and institutional reform (to provide the framework for broad-based growth). Both initiatives should run concurrently. As mentioned earlier, institutional failure (i.e. a malfunctioning central bank) is not the primary cause of inflation; the main culprit is the Mugabe regime. Thus, replacing the central bank with a currency board is not the answer. A depoliticized and independent central bank could stem the relentless injection of money into the economy and restore confidence.<sup>9</sup> Quasi-fiscal activity should be curtailed and eventually eliminated.

The country's exchange rate policies should also be revised. The effects of the failed fixed system have been felt across the economy and it will take some time to restore confidence. During this period, the Zimbabwean currency could be pegged to a convertible currency (or basket of currencies). The ultimate goal would be to effectively unify the official and parallel market exchange rates and ensure some predictability in the foreign exchange market. At the same time, steps should be taken to reestablish the rule of law, remove punitive trade controls, encourage private sector development and institute public expenditure management reform.

Zimbabwe's military and its leaders have been major beneficiaries of the government's quasi-fiscal excesses. Substantial transfers and subsidies are made provided to keep them loyal and in check. This fiscal drain has reinforced the regime-focused nature of the military and cultivated a culture of entitlement. Thus, fiscal reform in Zimbabwe will have profound ramifications for the country's armed forces. Observers believe that security sector reform would help redefine the role of the military within the economy (particularly its ability to leverage civilian power structures for personal gain), while also reforming civil-military relationships.

Rebuilding Zimbabwe's economy will require concerted effort from a wide range of stakeholders, especially Zimbabweans. True country ownership and broad-based participation

are critical. Appropriate Zimbabweans individuals and institutions must assume leadership of this process because any strategy must fully reflect the country's changing economic relationships and address current and emerging challenges. The effectiveness of these efforts will be critically dependent on the ability and willingness of Zimbabweans and their government to implement and sustain reforms. In 2000 the United Nations Development Program initiated dialogue on a country-owned approach to economic recovery.<sup>10</sup> The modalities and recommendations highlighted during those consultations could constitute the starting point for a comprehensive approach.

## **Towards Economic Revitalization and Peace**

The economic policies of the Mugabe regime have increased conflict and contributed to instability in Zimbabwe. Mismanagement of the currency and misappropriation of public funds have unleashed tremendous inflationary pressures that have punished citizens and stifled the productive sector. The chaotic land reform policy led to a wave of violence that debilitated domestic output and undermined confidence. Furthermore, stark inequities in income distribution and the allocation of public funds have heightened tensions within the economy and created a burgeoning and disaffected underclass. Both businesses and households have been forced to engage in conflict-inducing competition for increasingly scarce resources. Vast numbers of politically and ethnically marginalized groups have borne the brunt of these misguided policies.

A political solution that wrests control of Zimbabwe's economy from Mugabe and his regime is a precondition for sustainable economic reform. In addition to correcting the failed policies of the past, this would also dismantle Mugabe's collectively reinforcing network that has monopolized access to government subsidies, contracts, public institutions and finance in recent decades. Stabilizing the economy would reduce tensions by improving livelihoods, minimizing uncertainty and fostering confidence. Policy and institutional reforms would help revive Zimbabwe's enterprising class and attract much-needed investment. Reinstating the rule of law will eliminate impunity, address violence and provide a viable framework for broad-based growth and development. A vibrant economy would underpin lasting peace in Zimbabwe.

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- <sup>1</sup> See “A Worthless Currency,” *The Economist*, 17 July 2008
- <sup>2</sup> See “Zimbabwe’s Domestic Debt Soars”, VOA News, 12 May 2005
- <sup>3</sup> Milante, Gary. “A Kleptocrat’s Survival Guide: Autocratic Longevity in the Face of Civil Conflict,” World Bank Policy Research Working Paper 4186, (April 2007).
- <sup>4</sup> Coorey, Sharmini, Jens R. Clausen, Norbet Funke, Sònia Muñoz, and Bakar Ould-Abdallah. “Lessons from High Inflation Episodes for Stabilizing the Economy in Zimbabwe,” International Monetary Fund Working Paper WP/07/99, (April 2007).
- <sup>5</sup> Zimbabwe Reserve Bank, Supplement 1, pg 87-92, [http://www.rbz.co.zw/pdfs/2007%20MPS/ch17\\_20.pdf](http://www.rbz.co.zw/pdfs/2007%20MPS/ch17_20.pdf); and Mhaka, Levi. “Gono Busy Securing Own Financial Interests.” *The Zimbabwe Times*, August 14 2008.
- <sup>6</sup> Shaw, Angus, “Petrol Coupons the New Currency.” Mail and Guardian Online, August 7, 2008, <http://www.mg.co.za>.
- <sup>7</sup> “Zimbabwe Country Brief” The World Bank, September 2007, <http://web.worldbank.org>, (External Debt); and “Zimbabwe Debt Soars to Z\$1,4 trillion”, VOA News, 12 May 2005, (Domestic Debt).
- <sup>8</sup> Hanke, Steve H. “Zimbabwe: From Hyperinflation to Growth,” *The CATO Institute Development Policy Analysis* No. 6, 25 June 2008.
- <sup>9</sup> Muñoz, Sònia. “Central Bank Quasi-fiscal Losses and High Inflation in Zimbabwe: A Note,” International Monetary Fund Working Paper WP/07/98, (April 2007).
- <sup>10</sup> UNDP Country Cooperation Framework for Zimbabwe (2000-2003), 22 February 2000, DP/CCF/ZIM/2, United Nations, New York; and “Zimbabwe: UN Hopes New Plan Can Help, 10<sup>th</sup> November 2000, [www.globalsecurity.org/military/library/news/2000/11/war-001110-afzwe2.htm](http://www.globalsecurity.org/military/library/news/2000/11/war-001110-afzwe2.htm)