ANALYSIS OF THE ANNUAL BUDGET REVIEW FOR 2016, 2017 OUTLOOK AND 2017 MID-TERM MONETARY POLICY STATEMENT

AUGUST 2017

INTRODUCTION

The Minister of Finance and Economic Development presented the Annual Budget Review for 2016 and the 2017 Outlook to Parliament on 20 July 2017. This is in line with provisions of the Public Finance Management Act (PFMA)[1] which requires the Minister to ensure that full and transparent accounts are from time to time, and not less than annually, are submitted to Parliament indicating the current and projected state of the economy, the public resources of Zimbabwe and the fiscal policy of the Government. This statement was on 2 August followed by the Reserve Bank of Zimbabwe 2017 Mid Term Monetary Policy Statement in fulfilment of section 46 of the Reserve Bank of Zimbabwe Act [Chapter 22:15] which requires the Bank to issue a statement containing an evaluation of the monetary policy of the last preceding six months and a description of the policy measures to be followed by the Bank during the next succeeding six months. This paper unpacks, and critically analyses the two statements with a view to identify issues that Members of Parliament can raise with the responsible authorities when they debate in the House.

REVIEW OF KEY ASPECTS OF THE STATEMENTS

1. Economic Growth Forecasts

Both the Minister and the RBZ Governor are forecasting GDP growth of 3.7 % in 2017, significantly up from 0.7 % in 2016[2]. They expect this huge jump to be driven largely by agriculture, mining and tourism. Agriculture, which benefitted from a good rainfall season and availability of inputs through such initiatives as "Command Agriculture", is expected to register a phenomenal 21.6 % growth in output. The general stability in international commodity prices explains the anticipated 5.1 % growth in mining.

While the nation should certainly celebrate the rebound in agriculture and recovery of mineral prices, people should remember that these are primary commodities which are vulnerable to external shocks such as drought. A poor agricultural season in 2017/18 will easily erode these gains. There is very little of value-addition in the agricultural and mining sectors when this is essential to sustain growth in the economy.

The Governor and the Minister hailed Statutory Instrument 64 of 2016 for reducing the importation of non-essential products thereby enhancing capacity utilisation in the manufacturing sector. The Governor even spoke of some firms in the food processing and packaging sub-sectors now operating at above 70 % capacity. This is positive. There is however need for the fiscal authorities to shed more light on why the policy has been discontinued if it has brought in huge rewards. Furthermore, there is need to assess the impact of the policy on other sectors such as the retail sector and small scale traders. The opportunity cost of a policy instrument should always be articulated.

2. Government Finances

The two statements clearly showed that government finances were not in order. Revenue outturn for 2016 was $3.5 billion, $347.8 million short of the projected inflows of $3.85 billion. The major performers were Value Added Tax, Excise Duty and Personal Income Tax. Corporate Income Tax, at 10 % of total revenues collected, was not a high performer, thereby demonstrating serious viability problems afflicting the business sector.

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[1] Section 7 (2) [a]

[2] 2017 Mid-Term Monetary Policy Statement, page 5

Total expenditure for 2016 amounted to $4.902 billion, against planned expenditure of $4 billion. Huge expenditure overruns of $902.2 million were therefore incurred. Given revenues of $3.5 billion and expenditures of $4.902 billion, the budget deficit for the year ended up at $1.4 billion against a previously projected deficit of $150 million. Wages and salaries to civil servants chewed a huge chunk of the revenues at 91.7 %.

Huge credit to government

What is highly disturbing is that the Government has been increasing its reliance on the domestic market to finance the budget deficit. This is why a large outlay of Treasury Bills (TBs) worth $2.5 billion, are currently on the market. According to the RBZ, the bulk of the TBs were used for expunging the Bank's legacy debt under the Reserve Bank Debt Assumption Act ($826.8 million), capitalisation of institutions where Government has interest ($262.7 million), Government programmes, including drought related expenditures ($531.2 million), ZAMCO ($568.3 million), and Government recurrent expenditure ($312 million).

Increased recourse to the domestic market for financing the budget deficit has worsened the country's public debt position. As of 31st Match this year, Zimbabwe's public debt stood at $11,6 billion or 82% of GDP, of which $7,5 billion or 53% of GDP is external debt, while $4,3 billion (30% of GDP) is domestic debt. The stock of public debt is violating provisions of the Debt Management Act which provides that outstanding Government debt as a ratio of GDP should not exceed 70 % at the end of any fiscal year[3].

We differ with the Governor when he says borrowing through TBs has been largely developmental. The controversial enactment of the RBZ Debt Assumption Act can never be said to be a developmental move. Who says the amounts disbursed to government institutions for capitalisation will go towards the capital budget? The norm has been to use the funds for recurrent expenditure. Assumption of the debts of perennially loss making entities like National Railways of Zimbabwe, Air Zimbabwe and Civil Aviation Authority of Zimbabwe is synonymous with money going down the drain. In addition, drought related expenditure - while extremely important - can never be classified under developmental expenditure. The Governor seems to agree with our observations when he says: "……..it is critical, going forward, that an equilibrium position of a sustainable fiscal deficit is ascertained to ensure that TBs do not crowd out foreign exchange in the market".

Another disturbing trend is the failure by Government to pay suppliers for goods and services received. The Minister announced that Government had accumulated $1.07 billion worth of suppliers and service providers' arrears to a number of domestic creditors who delivered goods and services to various line ministries and departments. These relate to such utilities' obligations as those for water and rates, electricity, telephone and other ICT related services, among others. The issue of concern is that the arrears have not been factored in the current budget, meaning honouring them will worsen budget figures for 2017.

According to the RBZ, domestic credit recorded an annual increase of 21.1 %, from $6 978.7 million in May 2016 to $8 451.4 million in May 2017. The growth was largely due to a 38.67 % annual expansion in net credit to Government. "The surge in net credit to government is consistent with increased recourse by Government to domestic sources of financing, on the back of reduced revenue collections. In addition, the growth in credit to government, reflected banks' holding of Treasury Bills, which are largely purchased at a discount on the secondary market. Credit to the private sector recorded a modest growth of 1.99%, from $3 426.9 million in May 2016 to $3 495.1 million in May 2017".

[3] Section 11 of the Public Debt Management Act

These figures are frightening especially if one looks at the small size of Zimbabwe's GDP, currently estimated at $13 billion. This is exactly the fundamental or underlying problem that has to be addressed to revive the economy.

Measures to reduce expenditure

The Minister of Finance announced a raft of measures to curb excess expenditure. They include:

- Implement the Public Service Wage Policy aimed at rationalising the wage bill.
- Freeze on salary reviews and filling of vacancies.
- Government ministries and departments to institute cost-cutting measures including standardisation of fuel allocation across ministries; review of telephone ad cell phone allowances; review of foreign travel per diem allowances; and use of government vehicles.

The Minister said these measures had been agreed at a Cabinet meeting of 13 June 2017. However, a couple of weeks after making this announcement, President Robert Mugabe ordered a freeze in the civil service rationalisation exercise, and directed that 2 000 youths who had been removed from the payroll, be reinstated. This clearly shows serious policy discord within Government, a development that has frustrated efforts to revive the economy. The bottom line is that it is highly unlikely that measures to cut spending will see the light of day, especially as the country gears up for the harmonised election next year. Governments tend to spend more during an election year. It is now certain that the 2017 Budget targets will be missed. Total expenditure in 2017 is projected at $4.1 billion. Revenue projection is $3.7 billion, giving a budget deficit of $400 million.

Failure to curtail spending also means the country is unlikely to secure funding to clear its arrears with the African Development Bank, World Bank and European Investment Bank. This is a pre-requisite for unlocking new external sources of finance for the country. The IMF Staff Monitored Programme has tied the release of funding to pay for arrears to the public service rationalisation programme. In simple terms, no funding will be forthcoming without the implementation of cost-cutting measures to reduce government expenditure, especially the wage bill.

The RBZ Governor in his monetary policy statement did not mince his words on what needs to be done to bring sanity in government finances:

> "*The lower supply of U.S. dollars (foreign dollars) is attributable mainly to limited access to foreign finance, declining foreign investor confidence which has reduced capital flows and the indiscipline-induced leakages of forex through illicit transactions and other nefarious activities that include rent seeking behaviour. The root cause of excess demand for forex, on the other hand, is emanating mainly from increases in money supply as a result of greater spending by Government, money creation – loans and overdrafts – by banks. It is these external and domestic imperatives or fundamentals that need to be addressed to bring equilibrium and resolve the challenges besetting the economy.*
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> *"Bringing equilibrium or rebalancing the economy therefore requires action to increase the export of goods and services whilst simultaneously reducing fiscal deficit to sustainable levels and executing structural reforms that increase investor confidence and transform the state owned enterprises. These measures are critical to deal with the confidence deficit which is also a major source of gross market indiscipline – rent seeking behaviour, corruption, illicit flows, side marketing – within the national economy. Whilst the Bank is using a number of initiatives including non-traditional home-grown monetary policy tools and the export incentive scheme*

to address export competitiveness to stabilise the economy, the other two imperatives are outside the purview of Monetary Policy".

The Minister of Finance in his statement also alluded to the same when he said: "It is however important to note that for any future consideration of new financing from the IMF, Zimbabwe would be required to comply with other applicable IMF policies, which includes resolving arrears to other multilateral creditors under the *pari-passu* rule (African Development Bank, the World Bank, European Investment Bank) as well as bilateral official creditors; and implementing strong fiscal adjustment and structural reforms to restore fiscal and debt sustainability and foster private sector development".

3. Cash Crisis and Parallel Market

The Governor admitted to the existence of a flourishing parallel market for US dollars. He said the market viewed the intrinsic value of the dollar in Zimbabwe being lower than the foreign dollar, hence the high premiums of between 5 and 25 % on the parallel market.

Apart from reigning in government expenditure, our analysis is that other issues that have contributed to the liquidity crisis are as follows:

- *Financial sector angle*: The banking sector has allowed the quality of their loan book to deteriorate overtime, hence diverting a substantial proportion of liquidity from the financial sector. The RBZ Governor in his statement states that there has been an improvement in non-performing loans ratios since 2011. However, this improvement is explained by the fact that the bulk of the non-performing loans (at $898.57 as of June 2017) have been disposed to the Zimbabwe Asset Management Company. There is no doubt that the deterioration in the quality of the banking sector loan portfolio has had a negative knock-on effect on the volume of available liquidity in the market. Thus, the deterioration in the loan portfolio of banks worsened the financial crisis, limiting the availability of funds for on-lending to corporates.
- *Illicit financial flows:* Illicit financial flows also worsened the crisis with Zimbabwe losing an estimated US$2.83 billion (Afrodad, 2014) between 2009 and 2013, translating into an annual average cash leakage equivalent to US$570.75 million. The mining sector accounted for the bulk of the leakages, that is $2.793 billion, constituting 97.9% of the illicit outflows from the country. The RBZ has estimated a leakage of US$1.8 billion through this valve in 2015, with US$1.2 billion of this accounted for by corporates, whilst outward bound remittances accounted for the balance.
- *International Trade linkages:* Zimbabwe has been running a current account deficit since dollarisation, with most of the import bill being dominated by consumer goods at the expense of capital. A negative trade balance has persisted since 2009, recording US$2.4 billion in 2016. The country's current account deficit averaged about 8.5% between 2000 and 2008, and 14.1% during the multiple currency era. These deficits, alongside weak capital inflows have led to a steady drain of dollars out of the economy (Sibanda, 2016). The worsening trade imbalances and inclination towards holding or externalizing physical cash have continued to drain cash balances from circulation in the economy, and the adverse effects are being transmitted to the banking sector manifesting in cash shortages at banking institutions, (RBZ, 2016).
- *Banking sector confidence at all-time low*: The Zimbabwean public has lost trust and confidence in the banking institutions to the extent that the major dealings with them involve withdrawals of funds to safety, and if it were not for controls on withdrawals like those imposed during the hyperinflation of 2008, the banking sector would have collapsed, (Makina, 2016). This scenario is highly unsustainable, and has the potential to trigger a run on the financial sector in the short- to- medium-term.

As far as export performance was concerned, the Governor announced that total foreign currency receipts was $2. 96 billion between Jan and June this year of which foreign investment was only $33 million. Fuel and loan repayments were the biggest consumers of the foreign currency receipts. This flies in the face of claims by other commentators that vehicle imports are chewing a huge chunk of foreign currency receipts.

Bond Notes

The printing of another batch of bond notes under the US$300 million standby liquidity support from Afreximbank is still another fire-fighting measure. Although the Governor insists that the bond notes are an export incentive, reality on the ground is that they are being used to try and ease the cash crisis. However, the bond notes continue to disappear onto the parallel market, and there are no signs that this latest batch will not suffer the same fate. The Governor should clarify to the members of parliament his pronouncement that the bond notes will be released into the market on a “drip-feed” basis. The point here is that without addressing fundamental issues related to high government recurrent expenditure, and consequent increased borrowing from the domestic market to finance the expenditure, the release of bond notes onto the market in small batches will not cure the economic ills.

Zimbabwe Portfolio Investment Fund

The establishment by the RBZ of a Zimbabwe Portfolio Investment Fund (‘the Fund”) to facilitate the efficient repatriation of portfolio related funds to foreign investors investing specifically on the Zimbabwe Stock Exchange (ZSE), is welcome. Foreign investors had faced serious challenges in repatriating proceeds of their investment back home, thereby militating against the quest to attract more foreign capital inflows. The Governor said the Bank would place an initial seed capital of $5 million into the Fund to kick-start the repatriation mechanism and improve investor confidence. The Fund will be administered by two banks that he did not specify. We are not sure if the seed capital is adequate to revive investor confidence on the equity market. It is our hope that the banks will not abuse the facility as has happened to other funds that end up financing non-productive expenditures of the institutions administering them.

The Governor must be applauded for increasing the amount of foreign currency cash a person can carry outside Zimbabwe per trip $2000. This will assist mainly the small scale traders, who need the cash to import goods for resale back home.

4. Financing Facilities for Productive Sector and Marginalised Groups

The announcement of a number of facilities to promote exports, tourism, production and the empowerment of students, youth, women and people living with disabilities is a step in the right direction.

The facilities are as follows:

- $70 million export finance facility
- $15 million tourism support facility
- $10 million youth empowerment fund
- $5 million people with disabilities fund
- $15 million cross border facility
- $40 million gold support facility
- $10 million business linkage facility
- $10 million horticulture facility

- $15 million women empowerment fund

The central bank is therefore trying under very difficult circumstances to play its part in promoting access to finance by the productive sector and marginalised groups such as women and youth. The main problem with these facilities is that information has not been widely disseminated on how beneficiaries can access the funds. The other problem is that some of the beneficiaries view the facilities as government handouts. This explains why there has been a high default rate. For example, a report from the Ministry of Women Affairs, Gender and Community Development for the period January to April 2017 showed that outstanding debts from the Women Development Fund stood at US$1,4 million.

The Governor in his statement was upbeat about the performance of the microfinance sector. He said a number of microfinance institutions had increased support to the SME sector, through agricultural value chain financing and provision of working capital requirements. As part of efforts to support the microfinance sector and facilitate lower lending rates, the RBZ had established a $10 million Microfinance Revolving Fund, which would be administered by the Zimbabwe Microfinance Fund.

The Governor further announced that microfinance institutions had been directed to align their lending rates so as to ensure that the effective lending rate, inclusive of all administrative costs, do not exceed 10 % per month. He however admitted that some of the microfinance institutions had not complied with this directive and were charging rates above 10 %. In terms of measures to be undertaken to enforce compliance, the RBZ Governor could only say "appropriate supervisory action will be instituted". There is need to specify the actions to be undertaken. Since the central bank can only rely on moral suasion for financing institutions to reduce lending rates, it is difficult to see what action the bank can take when it does not have statutory powers to put a cap on lending rates.

The Governor also announced the introduction of Savings Bonds which will encourage individuals, families, households, small and medium enterprises, schools, universities, public and private institutions, corporates, churches and investors in general, to save money. The minimum investment amount is $100, interest rate is 7 % and are tax-free. The Governor described the 7 % as high yielding returns. We are not sure if the bonds qualify as a high yielding investment instrument given that lending rates by banks are pegged at an average 15 %.

The transformation of the Industrial Development Corporation (IDC) into a development finance institution is a progressive measure that should enhance the availability of finance to the industrial sector. How the transformed institution is going to be capitalised remains to be seen.

CONCLUSION AND RECOMMENDATIONS

Measures by the Minister of Finance and the RBZ aimed at boosting supply from the productive sector so as to generate the much needed foreign exchange are commendable. However, the challenges have not abated and seem to be worsening. For instance, we are witnessing more bank queues as desperate clients try to access cash from the banks. Fuel procurement has recently become erratic. Industry continues to struggle as witnessed by declining profitability. The RBZ foreign exchange rationing system is failing to fully address market needs, hence threatening economic revival. Introduction of bond notes has been accompanied by the resurgence of a flourishing parallel market that is now anchoring economic transactions. A multiple pricing regime has emerged in the goods market threatening consumer welfare and poverty. Inflation picture for the 1st half of 2017 is upward, confirming that Zimbabwe is fast creeping out of the deflation mode since 2014.

The bond notes are now spilling into neighbouring economies triggering a biting shortage of liquidity in the domestic market. As the economy is slipping deeper into the informal sector, government revenues will be affected, threatening public sector delivery capacity. The crisis is hurting the ordinary man, and hence the need for government to tackle the crisis head-on.

The multi-currency policy was supposed to be short-term thus affording policy makers some breathing space whilst proffering more durable solutions to the country's problems, yet we allowed it to continue unchecked. The policy orientation of our leadership is reactionary and not futuristic, hence continued use of the US$ as a medium of exchange when it has become a problem to our fiscal and monetary policy. The US$ as a reference currency is not sustainable unless we are having similar circumstances (financially) as those enjoyed by Panama, Ecuador etc. Government has continued to focus on short-term policy interventions yet the challenges require a broad and holistic approach that casts a medium- to- long-term outlook.

To date most of the underlying problems that have eroded business confidence remain unresolved and will continue to haunt the fragile economy going forward. The current interventions have tended to be more of a short-term reactive nature rather than being proactive, and holistic.

Whilst the choice of the US$ as the anchor currency was involuntary given the market position during 2009, this should have been backed up by complimentary exchange policies to safeguard that policy decision. Also of note was the entire choice of a multi-currency regime ahead of formally prescribing one currency denominator, e.g. the Rand given our financial, trade, social and economic links with mainland South Africa.

We therefore make the following policy proposals in the short-to-medium term:

a) Under the current circumstances adopting the Rand will reduce the cost structure across the entire economy by a minimum 60 % and restore the competitiveness and viability of local industry. It will also reduce the fiscal pressures that government currently must bear with. This would also improve the liquidity position in the economy given that 65 % of Zimbabwe's trade is with South Africa, and a significant proportion of Diaspora remittances is accounted for by Zimbabweans leaving in that economy. In addition, there are South African banks operating in Zimbabwe which could be called upon to provide rand liquidity, and act as a de facto lender of last resort, (Makina, 2016).

b) The country needs to open the debate on the appropriate currency regime to all stakeholders, for an inclusive and durable resolve on this controversial subject. A starting point would be for government to appoint an independent technical Currency Commission to explore the possible options on the currency issue.

c) The central bank must restore the Nostro Account thresholds back to their 2009 levels of 30% to improve the country's international credit-worthiness, as well as ability to discharge foreign settlements. This is already straining the productive sector which is failing to import raw materials timely, as Banks are failing to discharge foreign obligations. This could immediately trigger a surge in banking sector confidence.

d) Zimbabwe urgently needs to realign its public finance management to available revenue generation capacity. Fiscal policy rationalisation should focus on changing the structure of the budget from consumption to development orientation. Fiscal adjustment would reduce government's reliance on the banking sector to fund its expenses, and thus ease the current mounting pressure on domestic banking sector liquidity. Currently, 90 % of the budget is taken up by public sector wages, with little scope for capital or developmental expenditure. To rationalise public expenditure government should immediately implement the following fiscal measures:

- ✓ Introduce Fiscal Rules through amendments to the Public Finance Management Act (PFMA) that provide a cap for public wages and salaries and development expenditure to entrench fiscal responsibility.
- ✓ The Fiscal Rules should set expenditure thresholds, such as allocate a minimum of 30 per cent of the Budget to development expenditure, whilst recurrent expenditure (including the wage bill) should not exceed 70 per cent of the Budget. Ensure that expenditure on wages and benefits do not exceed 35 per cent of taxes and not more than 10 per cent of GDP.
- ✓ Government should immediately introduce a biometric payroll administration system in the public service to improve transparency and accountability. The system which has also been used in Ghana, Nigeria and Kenya as part of their payroll audits is effective in weeding out ghost workers, and hence a significant cut-back on revenue leakages.
- ✓ Government should divest from public enterprises to reduce the budget deficit given that most of these are a drain on the fiscus. In 1980 Zimbabwe had 20 parastatals, and this figure has since risen to current levels of 107, (World Bank, 2017). Government should therefore, implement a major programme to privatise public utilities to improve efficiency and viability.

e) Macroeconomic and sectoral policy review to improve the efficiency and transparency of economic governance.

f) Government should shift its approach to political economics and accommodate a broad-based approach to policy making. Parliamentary oversight also needs to be strengthened for effective executive oversight and accountability in public finance management.

g) Addressing investment climate related policies (Indigenisation Act review) and deepen the current work on World Bank supported doing business reforms to entrench a business-friendly environment in the Zimbabwean economy so as to attract the much-needed capital.

h) The introduction of Bond notes has been the greatest threat to financial sector confidence and stability, and as such there is need for an immediate review of the policy which has only addressed the symptoms and not the root cause of the liquidity crisis. The Bond notes should have been phased out within six months as initially proposed, whilst affording the government an opportunity to explore other durable medium- to- long-term measures to stabilise the economy and the currency regime.

i) The root causes more structural in nature, warranting a broader approach that fosters to restore production in the economy, as well as a major adjustment in the size and expenditure framework for government.

In the medium-to-long term, the government should undertake the following:

a) Deepen agrarian reforms to finalize tenure related challenges so as to unlock financial sector investment and hence boost production.

b) Broaden the export capacity by promoting high value manufactures as well as explore the export capacity of the services sector which now accounts for a huge global premium.

c) Restore infrastructure capacity by opening space for private sector investment to strengthen road, rail, capacity as well as energy generation in Zimbabwe.

d) Government should curb illicit financial flows by strengthening existing institutional capacity such as the Financial Intelligence Unit (FIU), under the RBZ, as well as tightening Anti-Money Laundering legislation.

e) To engender transparency and accountability, most high net worth investment contracts with multi-nationals are negotiated privately yet these imply a huge fiscal burden through forgone revenues. These mega-mining contracts for instance should be brought before Parliament for scrutiny, to ensure executive accountability in their implementation.

f) Resuscitate the Zimbabwe Mining Revenue Transparency Initiative (ZIMRTI) a noble initiative mooted during the Government of National Unity era as a way of improving accountability and transparency by players in the mining industry.

g) Tighten legal and institutional lapses in the domestic fiscal and financial systems to limit opportunities for corruption and other forms of trade mal-practices (e.g. transfer pricing, tax avoidance, and mis-invoicing). Corruption requires political will, and whilst the Zimbabwe Anti-Corruption Commission (ZACC) is in place, it is still to bring to book high profile personalities. The institution therefore, requires strengthening and independence to effectively deliver its mandate in a non-partisan way.

We therefore need an immediate reform agenda that focuses on the challenging structural problems afflicting the nation from production, investment, savings, and consumption to restore economic stability and position the country for sustainable economic recovery and growth in the medium to long term.

Other Recommendations

a) The Minister of Finance announced that Government was reviewing the Public Finance Management Act to align it with the Constitution and further improve on effectiveness of public resource use and accountability arrangements. Parliament, through the Public Accounts Committee and the Portfolio Committee on Finance and Economic Development, must be proactive in this alignment process through submitting proposed amendments. These proposals have already been drafted with the assistance of the Southern African Parliamentary Support Trust.

b) Parliament must thoroughly scrutinise the Public Entities Corporate Governance Bill once introduced in Parliament to ensure that a good piece of legislation is enacted that will reign in wastage and abuse of resources by public entities.

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