

## **De facto dollarization: citizens and businesses' response to Zimbabwe's economic policies<sup>1</sup>**

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### **ABSTRACT**

The research sought to find the response of citizens to government's economic policies by surveying households and businesses especially to currency policies. The researcher therefore conducted interviews with households and business owners to get to know their expenditure and income patterns given an unstable currency characterized by high inflation. The results of the research show that most businesses have adopted income and payment dollarization to cushion themselves against rampant inflation in the economy. While the government continue to be upbeat about the future and prices stabilizing it was noted that business and consumer confidence is low and citizens have begun the process of dollarizing the economy.

### **BACKGROUND**

In 2009 Zimbabwe introduced the multi-currency system or dollarization where foreign currencies became the sole legal tender in place of the local currency. The country had suffered from hyperinflation which devastated the economy. The formation of the unity government brought much needed stability and hope for the poverty stricken citizens. However, the political arrangement was built on shaky grounds as the main political protagonists remained far apart in terms of issues that needed to be dealt with especially concerning political reforms. One of the reasons for the formation of the unity government was to then institute political reforms that would facilitate the holding of free and fair elections that would end the issue of disputed elections that has dogged the country since 2000. During its life from 2009 to 2013 no political reforms took place and in 2013 Zanu PF won elections defeating the Movement for Democratic Change then led by Morgan Tsvangirai amid allegations of vote rigging and vote buying. The use of the US dollar and other currencies had done much to bring stability and tame hyperinflation of 2008.

However, there were challenges of liquidity that continued to affect the economy because government had lost its ability to print its own currency. The citizens and businesses that had suffered losses during the hyperinflation period welcomed the stability and discipline brought about by dollarization. The reckless printing of money to fund political programs and buying of foreign currency on the street by the apex bank was and is still blamed as one of the causes of rampant inflation that reached the peak in 2008 when the majority of businesses and individuals simply rejected the local currency and started pricing goods in foreign currencies.

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In 2016 the Zanu PF led government introduced what it called bond notes which were at par with the US dollar. At the time of their introduction the reasons cited for their introduction was the need for smaller denominations that would cater for issues of change in retail transactions. Eventually the bond notes became the main currency and in 2019 the Mnangagwa led government enacted laws that effectively outlawed the use of foreign currencies in local transactions. This came at a time when the bond notes were losing value in the parallel foreign exchange market and inflation was increasing with both business and citizens questioning the wisdom of the return of the local currency when memories are still fresh about the economic horrors of 2008. During the course of 2019 the Minister of Finance instructed the Zimbabwe Statistics Office not to publish annual inflation statistics arguing they promoted speculative behavior in foreign currency trading.

It was indeed an unprecedented move by the Minister not seen anywhere else. Already there had been an uproar on the official statistics which seemed to understate the true inflation rate as compared to the reality faced by businesses and consumers alike. A prominent American economist estimated the annual inflation rate to be above 500% in August. The government introduced new currency in the market to increase cash in circulation as traders were now a premium on other platforms not using cash for payment. The new currency also marked the official return of the Zimbabwe dollar ten years after its demonetization. Meanwhile the economy continues to be plagued by shortages of electricity, water, fuel, foreign currency and even the democratic space seems to have been shut. Many blame the Mnangagwa government for pursuing ruinous economic policies and lack of consultation.

### **Problem Statement**

Zimbabwe's use of the local currency and its sudden outlawing of the use of foreign currency despite earlier assurances has created mistrust in the economy. More so the way in which the laws are enforced point to selective application of the law. Citizens and businesses have fresh memories of the 2008 economic horrors and seem alert to the dangers of a depreciating currency and high rates of inflation in the economy.

### **Research Objectives**

The research paper seeks to investigate how businesses and citizens have responded to the economic policies of the Zimbabwe government especially concerning the use of foreign currency in local transactions.

### **Research Methodology**

The research undertook a survey of businesses and citizens and sought their views on the current economic policies and their response to those policies. Questionnaires, interviews and emails were sent to get answers on the research question.

## **LITERATURE REVIEW**

### **Definition of Dollarization**

Dollarization can be defined in many ways. Kubo defines dollarization as circumstances where domestic residents hold a significant share of their financial assets in foreign

currency denominated ones. Such foreign currency denominated assets serve different purposes such as payments/settlements and for asset portfolio. Rochon and Seccarecia distinguish between full dollarization and partial dollarization (also called *de facto* dollarization). Full dollarization is thus a situation by which countries fully abandon the local currency and only the US dollar would exist and all assets and liabilities would be denominated in US dollars. Partial dollarization on the other hand, refers to the situation in which the local currency exist and circulate alongside the US dollar. Rochon and Seccarecia point out that in full dollarization the exchange rate is eliminated for good although country risk remain. The policy of dollarization has generally been adopted by countries with a history of economic and financial problems and is considered as a last resort solution (Rochon). Therefore the chief question that need to be answered by literature is what are the costs and benefits of dollarization for a dollarized economy?

### **Benefits of dollarization**

Cohen (2000) points out a number of advantages for the dollarizing economy. First it is argued that administrative expenses are reduced. This is because government does not have to maintain infrastructure whose sole purpose is to produce and manage a separate national money. Secondly dollarization can enable the establishment of a firm basis for a sounder financial sector. The argument goes that dollarization is not merely the adoption of foreign currency but there is also financial integration with the United States which compels domestic financial institutions to improve their efficiency and quality of services.

Furthermore dollarization signals a permanent commitment to low inflation, fiscal responsibility and transparency and is of particular value to countries that previously have not enjoyed much of a reputation for price or fiscal stability. Noko J (2011) cites similar benefits of dollarization as pointed out by Cohen. Noko points out that dollarization allowed Zimbabwe to defeat hyperinflation, restore stability, increase budgetary discipline and reestablish monetary credibility. Fiscal prudence was upon the government resulting in cash budgeting during the unity government. Biti (2009) in his mid-term fiscal review also cited five successes of the inclusive government which are important to the discussion of dollarization in Zimbabwe:

1. Inflation reduction
2. Removal of price distortions in both foreign exchange and goods market
3. Resuscitation of financial service sector
4. Overall business confidence building
5. Policy consistency and predictability on key policy fundamentals.

Another benefit of dollarization cited by Cohen is a reduction of interest rates for local borrowers. This is because dollarization forms a stable relationship with a currency whose reputation is already well established and secure. Evidence show that in 2007 the commercial bank prime lending rate was 578.6% compared to LIBOR + approximately 10% during dollarization in Zimbabwe (Noko).

## Costs of dollarization

In terms of the costs of dollarization a number of issues have been raised. Berg and Borensztein point at the loss of seigniorage as a cost of dollarization. They define seigniorage as the profits accruing to the monetary authorities from its right to issue legal tender currency. In their view loss of seigniorage happens in two forms. First by adopting the US dollar and withdrawing the domestic currency from circulation, the monetary authorities purchase the stock of domestic currency held by the public and banks which effectively returns the accumulated seigniorage accrued over time. The second way to lose seigniorage is that monetary authorities would give up future seigniorage earnings resulting from the flow of currency printed every year to satisfy the increase in money demand.

A dollarizing economy also results in a redundant central bank as it loses its lender of last resort function. The apex bank will no longer be in a position to bail out the financial system in cases of crisis. This, it is argued, exposes domestic banks to potential liquidity challenges.

Cohen also points to the loss of monetary autonomy as the dollarizing economy can no longer exercise unilateral control over its money supply or exchange rate.

## De facto dollarization

What is often ignored in the dollarization debate is the extent to which countries are already unofficially dollarized. This is important because the degree to which citizens and businesses alike have chosen to voluntarily use foreign currency either as a transaction substitute or a store of value for monetary services of the domestic currency has implications for the economy. Feige et al argue that the greater the extent and variability of unofficial dollarization, the weaker is the central bank's knowledge and control over the effective money supply. In addition unofficial dollarization reduces the central bank's ability to earn seigniorage from its currency issue. Unofficial dollarization is also a reflection of the mistrust that citizens have over the stability of the domestic monetary regime, the credibility of monetary policies and perceived stability of the banking system.

Feige (1997) also argues that unofficial dollarization has fiscal consequences in that foreign cash transactions reduce the cost of tax evasion and participation in the unofficial economy. The consequence is the weakening of government's fiscal ability to mobilise resources from the private sector and this results in worsening fiscal deficits. It is further argued that the resultant underground economy distorts macroeconomic information systems. Thus given such effects an informed policy decision making needs better knowledge of the extent, causes and consequences of unofficial dollarization.

## RESULTS

The survey on both business and households was done in August 2019 for Masvingo urban only. 50 households and 50 businesses in various sectors were randomly chosen. The questionnaire covered aspects related to income (revenue), expenditure and savings (assets).

## Income for households

The survey was able to collect information on characteristics of households. Income sources were grouped according to source such as salary/wage income, income from business ownership, income from agriculture and mining activities. The observation of the researcher were that foreign currency denominated income was highest among those with business ownership at 40% while salary/wage income consisted of only 9% and income from agriculture, mining and constituted 33% and other activities constituted 18%. The salary/ wage income dollarization is mainly driven by workers but the sector is still small compared to the population in Masvingo. Income from agriculture and mining dollarization is on the rise in Masvingo as people venture into small businesses such as chicken rearing, fish farming and artisanal mining in which they earn foreign currency.

The research observed that most agriculture products prices are now pegged to the US/Bond exchange rate in the informal market with most vendors demanding to be paid in cash. In the informal sector the indexing of prices to foreign currency is rampant. Real dollarization is has become the norm in the town of Masvingo where prices and wages are indexed to foreign currency. This includes the situation where prices are quoted in US dollars but payments can be made in local currency by converting the prices using prevalent market exchange rates.

## Expenditure Dollarization

Here the research sought to establish on what goods and services households spend using foreign currency. The local currency was mainly used to pay for public goods and services such as water electricity. Food items are still bought using the local currency as the major retailers still sell using local currency. Significantly health sector is another sector where households spent significant amounts of foreign currency. The country is highly informalized and Masvingo urban reflects that structure. Therefore most health institutions and pharmacies can be accessed easily with medical aid but without that citizens have to fork out foreign currency as the local prices are discouraging as they are set at prices that make the use of foreign currency look better. Rentals are also being paid in foreign currency mostly in United States dollars or South African rands. Private schools are also demanding huge amounts in the local currency making the payment in foreign currency lucrative.

## Business Surveys

The survey on businesses focused mainly on business practices and pricing decisions under the current environment. The research noted that businesses in Masvingo urban have multiple pricing system. First there is a pricing system based on cash which is the lowest followed by point of sale system where bank cards are used and then the mobile system which tends to be the most expensive in most cases. Most businesses no longer have price tags in the local currency and neither do they have in foreign currency as the practice of selling in foreign currency is illegal. The research observed that most business in the spare car parts price their products using foreign currency but are not keen to inform the customers and would rather sell at high prices in local currency which at times could be 25% above the interbank rate if converted to foreign currency. The business sector in Masvingo, urban if not the whole of Zimbabwe, have little confidence in the local

currency and have adopted various measures to protect their businesses when dealing in the local currency

## CONCLUSION

Real dollarization and payment dollarization is on the rise in Masvingo urban as households and businesses seek to protect their earnings from inflation. While government has banned the general use of foreign currency it has also allowed certain player within the economy to continue pricing their products in foreign currency, a move which highlights the inconsistency of the government in policy making. The response by citizens and businesses alike has been de facto dollarization. This has enabled them to continue surviving in a difficult operating economic environment where policy inconsistency is the order of the day.

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