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USAID STRATEGIC ECONOMIC RESEARCH AND ANALYSIS – ZIMBABWE (SERA) PROGRAM

REVIEW OF ZIMBABWE'S OPTIMUM FUTURE CURRENCY REGIME

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ZIMBABWE ECONOMIC POLICY ANALYSIS AND RESEARCH UNIT

A Review of Zimbabwe's Optimum Future Currency Regime

by

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August 2013

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Abstract

The purpose of this paper is to revisit the issue of Zimbabwe's optimum future currency regime choice in the light of experience in the Zimbabwe economy and developments in Southern African Development Community (SADC) with regard to regional integration, as well as general global experiences with regard to currency regimes. The paper noted that the MCR has endured for four years and has brought much-needed macroeconomic stability, albeit with some unresolved issues - such as the constrained credit environment and banking sector liquidity issues. The Euro-zone crisis has brought about some re-thinking of plans for regional monetary integration, and for this and other reasons the likelihood of a single SADC currency in the foreseeable future has receded. The paper concludes that none of the possible exit routes from the MCR that are discussed in the paper, would be obviously superior in the short term. In this regard the paper recommends that MCR should be retained while its shortcomings are addressed and the pre-requisites for a successful exit in the medium-term are addressed and further economic reforms implemented.

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The views and findings of this study do not necessarily reflect the views of Government of Zimbabwe, ACBF, USAID-SERA or ZEPARU. The authors bear full responsibility for the interpretations, any errors or omissions in this paper.

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Acronyms

AACB	Association of African Central Banks
AUC	African Union Commission
AMCP	African Monetary Co-operation Programme
CMA	Common Monetary Area
EAC	East African Community
ECOWAS	Economic Community of West African States
EMU	European Monetary Union
EZ	Eurozone
FTA	Free Trade Area
IMF	International Monetary Fund
LNS	Lesotho, Namibia and Swaziland
LoLR	Lender of Last Resort
MCR	Multi-Currency Regime
MEC	Macro-Economic Convergence
OCA	Optimal Currency Area
RBZ	Reserve Bank of Zimbabwe
REC	Regional Economic Community
RISDP	Regional Indicative Strategic Development Plan
SA	South Africa
SADC	Southern African Development Community
SARB	South African Reserve Bank
STERP	Short-Term Economic Recovery Programme
USD	United States Dollar
WAEMU	West African Economic and Monetary Union
WAMI	West African Monetary Institute
ZAR	South African Rand
ZWD	Zimbabwe Dollar

1. Introduction

More than three years after the adoption of the Multi-Currency Regime (MCR) in early 2009, the eventual choice of Zimbabwe's exchange rate and monetary policy regime remains a key macroeconomic policy issue for Zimbabwe, as well as of more general topical debate. It is widely acknowledged that the MCR brought hyperinflation to an end; helped to stabilise the economy and establish the conditions for the restoration of positive economic growth. It has also contributed to stabilisation of financial sector. However, the MCR has always been seen as a temporary arrangement. It was initially due to run until at least 2012, and has more recently been extended until at least 2015 (see 2009 National Budget Statement; Medium Term Plan, 2011- 2015).

There was extensive debate on currency regime options in 2009-10 soon after introduction of the MCR, but since then there has been little serious debate or analysis. There was no real consensus in that debate, as opinion seemed to be split. One view was that the reintroduction of a domestic currency – whether called the Zimbabwe dollar or under some other name - at some point in time should be the long-term objective, with the intermediate focus being on establishing the conditions that would minimise the risks associated with the reintroduction of a domestic currency and ensure that it had a positive impact. A second view was that this was unrealistic, largely because of the difficulties involved in establishing the credibility and confidence requirements necessary for successfully reintroducing a domestic currency; the associated discussion focused on the most appropriate choice of foreign currency (or currencies) for use in Zimbabwe. The debate acknowledged that there was no "perfect" solution, and that all available options had both advantages and disadvantages. Taking all of these into consideration, the second view tended towards joining the Common Monetary Area (CMA) as the most favourable option for Zimbabwe. Also, many views held the prospect of joining an eventual SADC Common Currency as Zimbabwe's ideal exit route from the MCR.

The purpose of this paper is to revisit the issue of Zimbabwe's optimum future currency regime choice in the light of experience in the Zimbabwe economy and developments in Southern African Development Community (SADC) with regard to regional integration, as well as general global experiences with regard to currency regimes. The key developments since the previous reviews are that (i) the MCR has endured for four years and has brought much-needed macroeconomic stability, albeit with some unresolved issues - such as the constrained credit environment and banking sector liquidity issues; and (ii) the Euro-zone crisis has brought about some re-thinking of plans for regional monetary integration, and for this and other reasons the likelihood of a single SADC currency in the foreseeable future has receded. In contrast to the early days of the MCR, when it was seen as a short-term option that would need to be replaced sooner rather than later, this review concludes none of the possible exit routes from the MCR would be obviously superior in the short term, and

that the MCR should be retained while its shortcomings are addressed and the pre-requisites for a successful exit in the medium-term are addressed and further economic reforms implemented.

The paper is structured as follows: Section 2 covers the introduction of the multicurrency regime; Section 3 reviews the limited literature on Zimbabwe's currency options; Section 4 considers global currency regime options and choices; Section 5 reviews the experience of monetary integration in Africa and Europe, with a particular focus on SADC; Section 6 presents various options for Zimbabwe with regard to future currency regime options, while Section 7 concludes.

2. Zimbabwe's multicurrency regime

2.1 Origins

In February 2009, the Zimbabwe dollar was demonetised due to hyperinflation, which had led to loss of value and confidence in local currency. The 2009 National Budget announced on 29 January 2009 legalised the use of multiple currencies for transaction purposes. Five foreign currencies were granted official status: the United States dollar, the South African Rand, the Botswana Pula, the British Pound and the Euro. The Rand was initially adopted as the reference currency[2], however the US dollar has gained prominence and is now being used as the principal currency. Stock exchange trading takes place in US dollars, the payments systems, the banking system and the Reserve Bank of Zimbabwe (RBZ) also maintain accounting in US dollars. The Rand is still prevalent in the South of the country, and it also circulates in the rest of the country, in particular coins. Wider circulation of the rand is prevented by South Africa's capital account controls. Other currencies such as the Pula, the Euro and the Pound have limited circulation in Zimbabwe.

Before the official adoption of the multicurrency regime, there were some incidences where the general public were allowed to use foreign currency. The Direct Fuel Imports Scheme which was introduced in August 2005, allowed the purchase of foreign currency fuel coupons as a vehicle to mobilize free funds and increase the availability of fuel for the motoring public. Members of the public used the price of one litre of fuel as a proxy for price of the United States (US) dollar, which raised speculative and parallel market activities. The RBZ Governor banned the procurement of fuel from service stations by motorists using foreign currency fuel coupons in February 2006 (RBZ Monetary Policy Statement, December 2006). He also announced that the redemption of the coupons would be in local currency and the conversion would be done at the interbank rate prevailing as at February 13, 2006. The coupons were redeemed by February 28 and service stations were no longer allowed to sell fuel in foreign currency.

[2] *Short-Term Emergency Recovery Program (STERP), 2009*

The RBZ also selectively legitimized the use of foreign currency when it introduced Foreign Currency Licensed Wholesalers and Retail Shops (FOLIWARS) in October 2008 in order to increase the availability of foreign exchange to productive sectors. However, there were restrictions in the case of some basic commodities since these could only be sold in foreign currency where it was sufficiently demonstrated that such goods would have been imported. This included mealie-meal, milk, bread, cooking oil, sugar, salt, medicines, locally manufactured sanitary pads, locally produced margarine, soap, toothpaste, and school uniforms and exercise books.

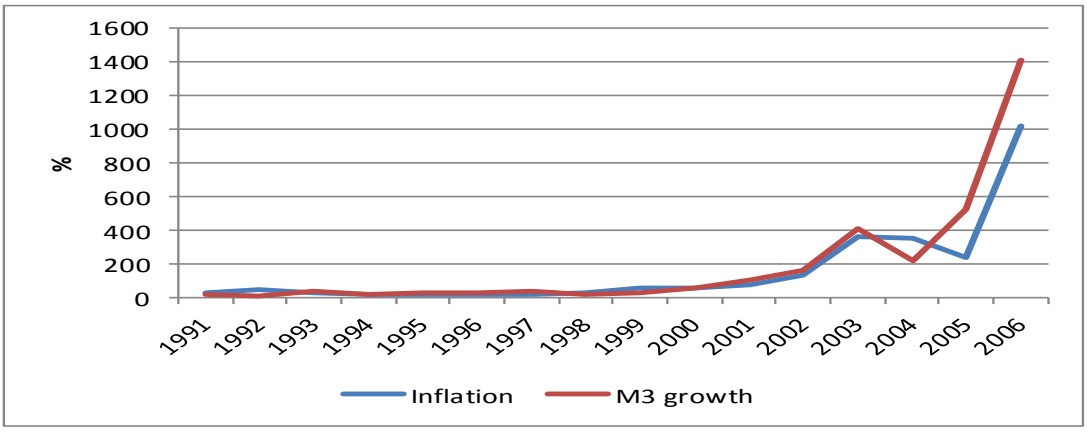
Registered foreign currency denominated shop applicants were required to submit a capability statement and a refundable security deposit to the RBZ. Zimbabwean retailers were required to pay US$20,000 for single storey/floor retail outlets whereas foreigners were supposed to pay US$50,000. For wholesalers owned by Zimbabweans, a security deposit of US$100,000 was required whereas foreigners required US$250,000 for a single floor. Beyond one floor, two licences were required for wholesalers.

When the FOLIWARS were introduced, a total of 1000 retail licences were offered by the RBZ. Emphasis was on the geographical spread of the outlets. However, the licencing of shops to transact in foreign currency led to even unlicensed shops and those in the informal sector illegally trading in foreign currency. The system was overtaken by events when the multiple currency system was adopted given that all shops were now trading in the multiple currencies.

Oil importing companies needed a Foreign Exchange Licence for Oil Companies (FELOC), whilst a Foreign Exchange Licenced Outlet for Petrol and Diesel (FELOPAD) was given to qualifying service stations. Diesel and petrol sales in foreign currency were legalised, with the exception of paraffin and National Oil Company of Zimbabwe (NOCZIM) fuel which would continue to be traded in local currency as per Government Regulations. However, most employees were earning their salaries in local currency. Also small businesses could not afford the exorbitant licence fees, hence only a few companies and individuals benefited from the scheme. By late 2008, hyperinflation had led to the abandonment of the Zimbabwe dollar in virtually all transactions. The resulting de facto dollarization of the economy was the rational response by economic agents to a loss of confidence in the domestic currency.

The suspension of the balance of payments support by the International Monetary Fund (IMF) in 2001, intensified foreign currency shortages. From 1999 onwards, a fixed exchange rate was adopted. The exchange rate that was offered by the Government did not reflect the true value of the foreign currency hence it fuelled the parallel market for foreign exchange. This led to a rise in domestic credit expansion as evidenced by a sharp increase in broad money supply (M3) growth from 1998 onwards (Figure 1).

Figure 1: Money supply (M3) Growth and Inflation (end of period), 1991-2006[3]



Source: Zimbabwe Statistical Agency (ZIMSTAT) and RBZ

At the turn of the millennium the government implemented exchange control measures that resulted in the emergence of foreign exchange parallel market. The parallel market rate reflected the impact of monetary expansion, which fuelled the inflation rate to new levels in the years 2006-2008 as prices were indexed to the parallel market rate. Annual broad money supply was on an upward trend since 1997, rising from 34.9% in December 1997 to 164% in December 2002, largely underpinned by domestic credit expansion. Annual credit to the private sector, public enterprises and government grew by 181%, 135% and 49.5%, respectively in 2002. The growth in broad money supply worsened as the RBZ undertook quasi fiscal operations which were financed through credit creation as from 2003. Broad money supply growth grew from 413.5% in 2003 to 64,113% in December 2007. It also rose sharply from 64,113% in December 2007 to 348.6 quintillion % in December, 2008. The growth had largely been underpinned by money creation related to speculative activities on the parallel foreign exchange and stock market.

Money supply expansion, against an environment of declining real economic activity, fed directly into inflation, as it rose sharply from 18.8% by end of 1997 to 55.9% by end of 2000. It continued spiralling from 133.2% in 2002 to 1,016% by 2006. The Government introduced price controls in 2006 to curb runaway inflation but this resulted in shortages of basic commodities on the official market thereby fuelling inflation as customers were bidding for scarce commodities on the parallel market. Zimbabwe's inflation reached hyperinflationary levels in March 2007, defined as a rate of inflation per month that exceeds 50%. During the hyperinflation era, the highest official inflation figure reported by the ZIMSTAT was estimated to be 231 million % for July 2008. Then the country had by far the highest rate of inflation in the world.

[3] *The statistics for 2007 and 2008 could not be included since they distort the graph*

By 2003, the cost of issuing Zimbabwean dollars was now greater than their face value due to inflationary pressures. This resulted in an acute shortage of banknotes prompting the Central Bank to issue 'bearer cheques' of high denominations on lower quality paper.

Failure to contain inflation by the RBZ made the Zimbabwe dollar denominations larger and larger, making it difficult to transact in the local currency. The RBZ was forced to revalue the Zimbabwean dollar three times within a space of three years. In August 2006, through "Sunrise 1", the Central Bank removed three zeros from the currency. Two years later (August 2008), ten zeroes were removed from the Zimbabwe dollar. In February 2009 through "Sunrise III", a further twelve zeroes were slashed from the local currency. Thus, by the time the Zimbabwean dollar was shelved in February 2009 the highest denomination was a 100 trillion dollar note, which was rejected by the general public.

There were also implications for the exchange rate. Rising inflation led to increased demand for foreign currency to act as both a store of value and a medium of exchange. The pegged exchange rate meant that the official rate was excessively overvalued, leading to foreign currency shortages. Sustaining the fixed peg became impossible, and the authorities were forced to introduce a new exchange policy that linked the exchange rate with trading partners' inflation differentials, leading to devaluations (Table 2).

Table 1: Rates for the Devaluation of the Zimbabwe Dollar (Z$) to US Dollar

	Z$/ US$
1997	18.6
1998	37.4
1999	38.1
2000	55.1
2001	55
2002	55
2003	826.5
2004	5,696
2005	85,158
2006	250,000
2007	30,000,000
2008	3,641,246,000

Source: RBZ website, accessed 15 April 2013

The continued rise in inflation together with a low interest regime (in real terms) put further pressure on the exchange rate. In January 2004, an auction system was introduced for foreign exchange, leading to some adjustment to market pressures. However, the authorities were unwilling to allow a truly market-determined exchange

rate to emerge, and continued restrictions which resulted in many economic agents could only source foreign exchange through the parallel market.

The parallel market had emerged much earlier, around the end of 1997, but grew through the 2000s as the official exchange rate became more detached from reality. Throughout the decade the parallel market became more vibrant and eventually dominated the official market for both transactions and as the basis for price setting.
The authorities attempted to deal with the parallel market and retain control over the exchange rate and the availability and allocation of foreign exchange through a number of exchange controls. These included the Exchange Control (Exchange Rate Management) Order 2000, under which every foreign currency dealer was required to maintain the exchange rate within a specified band, stipulated a maximum commission fee or charge as a percentage of the total nominal value expressed in Zimbabwe dollars of a given currency transaction, increased the level of inspections and compliance monitoring, and specified appropriate penalties on authorized dealers and bureaux de changes to ensure maximum compliance.

The RBZ worked closely with authorized dealers to improve on the administration of the CD I forms as well as their timely discharge. The government gazetted the Exchange Control (Exchange Rate Management) (Amendment) Order, Statutory Instrument 261A of 2001 and the Exchange Control (Foreign Exchange Bureaux de Change) Order of 2001. Further directives were issued to abolish bureaux de change in 2002, and later incentives were offered for non-residents to remit foreign currency through formal channels. While these pieces of legislation were aimed at curbing the activities of the parallel market, the results were dismal and the parallel market remained vibrant. By the time that the Zimbabwe dollar was abandoned in early 2009, there were numerous parallel market rates such as the Old Mutual implied rate; cheque rate, electronic transfer rate etc which varied widely). The IMF estimated the exchange rate at Z$35 quadrillion to the US dollar (IMF, 2010 p.3).

By late 2008 the Zimbabwe dollar had effectively been abandoned in all three of the usual functions of a currency: as a medium of exchange, a store of value and a unit of account, and the economy was de facto dollarised. The multi-currency system was officially adopted in February 2009. After the adoption of the multi-currency system in February 2009, inflation declined sharply to -7% in December 2009. Thereafter, inflation remained at the single digit level.

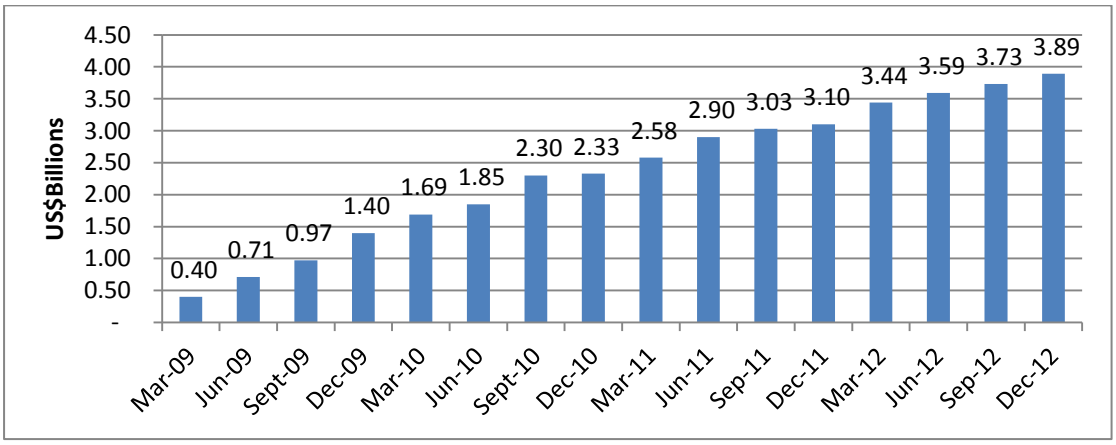
The ultimate source of hyper-inflation was excessive money creation, driven by fiscal deficits. These deficits had been monetised and complemented by the quasi-fiscal operations of the RBZ. It has been estimated that the overall magnitude of the budget deficit, including these quasi-fiscal operations, reached 32% of GDP in 2008. With the abandonment of the Zimbabwe dollar and the introduction of the multicurrency regime, the ability of the RBZ to create money was removed, and with the money supply stabilised, inflation fell dramatically.

2.2 Impact of the multi-currency regime

Advantages

The introduction of the multicurrency system in February 2009 had a dramatic impact, most immediatley by ending hyperinflation almost overnight. Buying power or effective demand by economic agents was compressed as the Z$ accounts were frozen and economic agents started to accumulate US$ balances from zero as there was no conversion of Z$ accounts to US$ accounts (Figure, 3).

Figure 2: Growth in Total Deposits, March 2009 – December 2012



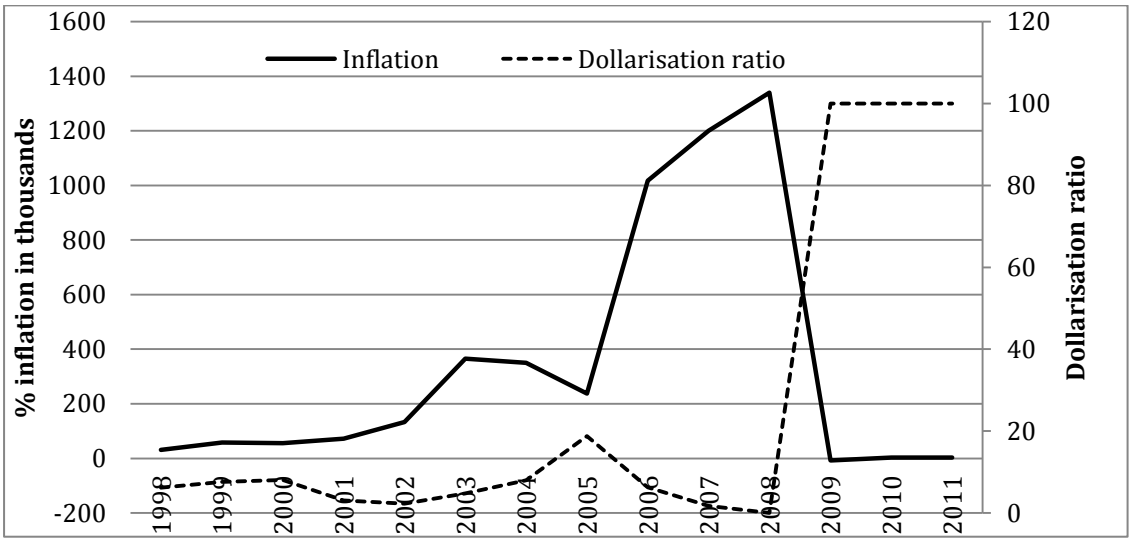
Source: RBZ Monthly Review of Statistics

Total deposits grew by 872.5% from US$400 million in March 2009 to US$3.89 billion in December 2012. However, the greater proportion of the deposits was demand deposits accounting for more than 70% of the total deposits for the entire period, resulting in limited loanable funds.

The capacity of the RBZ to print money and propel broad money supply growth was curtailed by the adoption of the MCR. This in turn helped to stabilise the economy and reverse the process of economic contraction. Subsequently, it fostered the re-monetization of the economy and financial re-intermediation.

The adoption of the MCR coupled with the adoption of a cash budget system under STERP helped enforce fiscal discipline by precluding inflationary financing of the budget, and brought greater transparency in pricing and accounting after a long period of high inflation. By reducing the scope of discretionary monetary policy decisions (with respect to printing money to finance quasi fiscal expenditures) and expansionary fiscal policies (which had in the past resulted in unsustainable fiscal deficits) the policy measures adopted in 2009 helped to improve, policy credibility and lowering inflationary pressures. Consequently, inflation declined to single digit levels in 2009, while the economy started to recover (Figure 4).

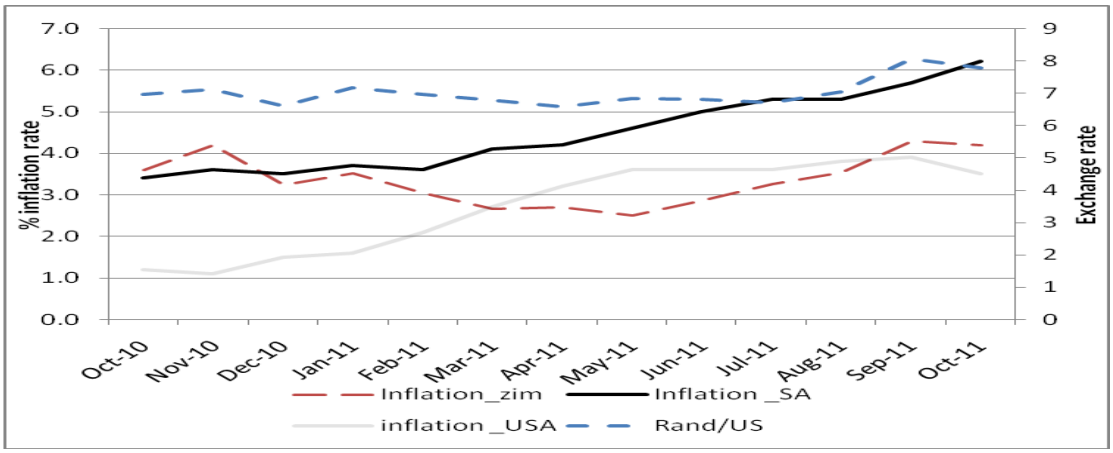
Figure 3: Dollarization ratio VS Inflation, 1995-2011



Source: RBZ

The trend in the inflation levels in Zimbabwe, South Africa and the United States of America since December 2009 shows that year on year inflation for Zimbabwe has converged towards the levels of inflation prevailing in the United States and South Africa (Figure 5). However, from April 2011, developments in the inflation trend mirrored those in the South African economy, although mediated by changes in the Rand-US dollar exchange rate. This can be best explained by the heavy reliance of the Zimbabwean economy on South African imports, so South African inflation is the primary initial determinant of inflation in Zimababwe. Exchange rate changes should, however, have an impact on the transmission of imported inflation. A weakening of the rand against the dollar should tend to offset the transmission of SA inflation to Zimbabwe, and vice versa. But as Figure 4 shows, the relationship is not straightforward; from April 2010 Zimbabwe inflation rose along with South African inflation, with a relatively stable ZAR-USD exchange rate, but as the rand weakened later in the year Zimbabwe inflation accelerated, contrary to expectations. The detailed determinants of inflation in Zimbabwe require further investigation.

Figure 4: Comparison of Zimbabwe's inflation rate and the Anchor Currencies



Source: Reserve Bank of Zimbabwe

Disadvantages

The multicurrency system also poses a number of challenges. Although it was initially intended (for good reason) that the rand would be the reference currency, the US dollar soon became the dominant currency for both accountng records and transactions, with even government accounts being kept in US dollars. This largely refected the difficulties in obtaining ZAR currency, which in turn reflected South Africa's unwillingness to have rands circulating "unofficially" outside of reference currency was largely a practical one. the CMA exchange control zone. With no restrictions on access to US dollars, the choice of Prices and wages are now usually agreed and quoted in United States dollars, while South Africa is Zimbabwe's main trading partner. Movements in the United States dollar/rand exchange rate are therefore likeley to have considerable effects on Zimbabwe's inflation rate, competitiveness and international investment position.

On a practical level, shortages of small change (coins) pose difficulties for retailers, while the quality of notes is generally poor as soiled notes remain in circulation. In both cases, the problem is the high cost of supplying currency when there is no local central bank to do so.

Other concerns emanating from the MCR include:

- The loss of seingorage income that a central bank normally derives from its ability to issue currency; in a dollarised regime, seignorage gains accrue to the central bank of the currency (or currencies) that are in use.
- The loss of monetary and exchange rate policy autonomy, which may affect the country's ability to respond to economic shocks. When a country relinquishes the exchange rate as an instrument, it loses a mechanism for protecting itself from economic shocks. Arguably, national autonomy over monetary policy is supposed to give a country the maximum freedom and flexibility, through the use of various monetary policy instruments, such as interest rates and reserve requirements, to steer the economy in a particular direction. Given that monetary policy is a key instrument of macroeconomic management, the constraints imposed by the MCR on the pursuit of country-specific objectives may therefore be viewed as constituting a hindrance to achieve country-specific economic goals. In this respect, the constraints imposed by the MCR are similar to those imposed on a country in a monetary union or a fixed-peg arrangement such as the Common Monetary Area.
- The lack of lender of last resort (LoLR) facility, whereby the central bank cannot print money to provide liquidity to a bank or banks in distress; hence the ability to respond to financial crises may be restricted. With a national currency, there are in principle no limits to the ability of the central bank to provide liquidity to the banking system, because of its ability to print money;

in a dollarized system, the ability of the central bank to do so is determined by its holdings of foreign currency reserves and its ability to raise credit lines form external sources[4]. Currently there is no Lender of Last Resort facility in Zimbabwe. The government had proposed US$100 million into the facility but failed to secure the funds. The IMF had suggested US$150 million into the facility. Previously, the government had injected US$7 million into the facility.

3. Review of Literature on Zimbabwe's Currency Options

Following the introduction of the multi-currency system in February 2009, a number of papers were produced considering the options available to Zimbabwe. These all considered, in greater or lesser detail, a range of options including the reintroduction of the Zimbabwe dollar, keeping the multicurrency system, formally adopting the US dollar or the SA rand as the currency of a "dollarised" Zimbabwe, joining the Common Monetary Area (CMA) with or without a domestic currency, establishing a currency board, or participating in a possible SADC regional currency. Some of the papers considered the various preconditions for the different options.

Interestingly, no clear consensus emerged across the various papers. The most substantive analysis was carried out by Chigumira. G., Shamu. S and Chipumho. E (2009), Jefferis. K (2009) and Kararach, G., Kadenge, P., & Guvheya, G. (2010). Chigumira et.al (2009) analysed all of the above options, as well as the preconditions for each. The analysis concluded that adopting the US dollar was unlikely to be a preferred option, given the differences between the Zimbabwe and US economies, the different economic cycles, and the fact that US monetary policy and exchange rate developments would reflect shocks impacting on the US economy, which could be quite different to those impacting on the Zimbabwe economy. In considering the use of the SA rand and possible membership of the CMA, the paper concluded that South African monetary and exchange rate policy would be more appropriate for Zimbabwe, however, the institutional structure of the CMA – with all decisions effectively taken by South Africa – would disadvantage Zimbabwe. Nevertheless, it did acknowledge that joining the CMA would be consistent with regional integration and the eventual adoption of a common SADC currency. The main conclusion of the paper by Chigumira et.al (2009), however, was that in the long run, it would be desirable to re-introduce a domestic currency in order to restore autonomy with regard to exchange rate and monetary policy. This would require important preconditions to be in place, most importantly restored credibility of domestic monetary and fiscal institutions. It also emphasises that any de-dollarisation of the Zimbabwean economy should be

[4] *It should be noted that the term "lender of last resort" is used in a different sense in Zimbabwe, where it refers to the ability of the central bank to provide overnight liquidity to the banking system in the normal course of operations (such as through a discount window or Lombard facility).*

market-led (i.e. voluntary), rather than based on a forced or compulsory process. In the meantime, the paper proposed that the multi-currency regime continues.

Kararach et al (2010) examine a similar range of options to Chigumira et.al (2009). The paper considers a range of criteria for assessing the various options, including policy autonomy and instrument availability (exchange rate/monetary policy), seignorage, lender of last resort, inflation, investment risk, as well as practical issues such as availability of coins. It concludes that preferred policies (in order) are: joining the CMA (with a local currency pegged to the rand); full US-dollarisation; "Randisation"; CMA without the local currency option; local currency under a currency board arrangement; and restoring the local currency while maintaining a flexible exchange rate. It is not clear how the criteria are weighed up under the different options, but the CMA option is preferred for reasons of credibility, lender of last resort, seignorage, and regional integration. The option of a local currency with maximum autonomy (i.e. with a floating exchange rate) is ruled out because of credibility issues. As with Chigumira et.al (2009), it also concludes that ZAR is more suitable as the reference currency than the USD.

Jefferis (2009) examines a similar range of possible currency options, on the basis of a two stage process, considering (i) should the Zimbabwe dollar be reintroduced, whether in the short term or further into the future; and (ii) if the Zimbabwe dollar is not reintroduced in the short-term, what currency or currencies should be used in Zimbabwe, and under what arrangements? It noted that contrary to widely-held opinion, having a national currency is not a crucial indication or component of national sovereignty, noting that around the world, 55 countries used currencies other than their own – around one-quarter of the world's total. The paper concluded that, even in the medium-term, it would be unlikely that a reintroduced Zimbabwe dollar would achieve the objective of restoring policy autonomy, either because it would have to be done in such a way as to focus on credibility – such as a currency board – which would provide little autonomy, or because the lack of credibility would mean that effective de-dollarization would be impossible to achieve, on a voluntary basis, as economic agents would continue to hold and transact in foreign currency.

It noted that, internationally, there are no recent examples of a domestic currency being reintroduced after having been completely withdrawn from circulation and replaced by foreign currency. By contrast, the examples of de-dollarisation cited by Chigumira et.al (2009) related to situations where the domestic currency had continued to circulate in parallel with the US dollar. Jefferis (2009) concluded that in considering which foreign currency Zimbabwe should use, the SA rand was preferable to the US dollar, according to the standard Optimal Currency Area (OCA) criteria. Furthermore, joining the CMA would offer certain advantages (sharing of seignorage, possible LoLR facility, access to regional capital markets, availability of coin), which would not necessarily apply in the case of other foreign currencies. Although joining the CMA (initially without a domestic currency) would be the

preferred option, there would nonetheless be costs, including having to implement South African capital (exchange) controls on the rest of the world, and the transition costs of moving away from a system based on the US-dollar.

Kramarenko et al (2010) considered the currency issue in a paper that examined a wide range of issues relating to the post-hyperinflation Zimbabwe economy. This paper goes into some detail in examining trade patterns, and the correlation of terms of trade movements and economic shocks between Zimbabwe and South Africa and Zimbabwe and the USA, in order to determine which might be the most appropriate foreign currency to use. It notes that correlations in both cases are low, especially for terms of trade, but that there is some evidence that Zimbabwe and South Africa are exposed to similar shocks (thereby indicating that the SA rand would be a more appropriate currency to use). The paper also concludes that the reintroduction of an independent domestic currency would not be feasible for the foreseeable future, because of the need for a long history of policy credibility. On balance the paper concludes that CMA membership would bring significant benefits and should be strongly considered.

Beyond these four sets of analysis, several other papers presented more limited commentary or assessment of exchange rate policy options. Hawkins (2009) concludes that "there are compelling arguments against a return to the Zimbabwe dollar"; that "the multi-currency system can be made to work but is flawed and sub-optimal"; and that "there is no overwhelming economic case for preferring the rand …. [but that] … the rand is the pragmatic option". Robertson (nd) also reviews various options and concludes that reintroducing an independent domestic currency is not feasible. However, rather than recommending any one of the alternative options, he focuses on the political, economic and institutional reform pre-requisites for currency stability and the success of different currency regimes. NECF (2009) considers that Zimbabwe "must have" its own currency for reasons of fiscal and monetary autonomy, and as a result does not consider that the use of foreign currencies for a prolonged period is feasible or desirable. However, it took the view that re-establishing the credibility needed for the reintroduction of a domestic currency could be achieved relatively quickly (within 3-4 years).

While there was no consensus from the above publications, there seems to be a predominant view that strong consideration should be given to joining the CMA, or at least to opening discussions with the four CMA members to explore this possibility. To the extent that there are contrasts between the various papers, they focus on:

- the likelihood of and timescale for re-establishing the credibility and conditions needed to reintroduce a domestic currency with some degree of policy autonomy;
- the need for exchange rate and monetary policy autonomy that a domestic currency could potentially provide;

- the likelihood of SADC establishing a regional common currency that could provide an alternative exit route from the multicurrency regime.

Interestingly, since this spate of analyses in the 12 months or so following the introduction of the multi-currency regime, there has subsequently been virtually nothing produced which considers the issue in any detail. The analyses were also done when the country had just introduced the MCR. This analysis is an attempt to re-look at the MCR within the context of the experiences the country has gone through so far and the international experience with currency unions.

4. Global Currency and Exchange Rate Choices

This section considers the general choices available with regard to exchange rate and monetary policy options. It takes an international perspective and reviews the choices that have been made by countries around the world. This experience shows that there is no single "right" answer with regard to exchange rate and monetary policy options, and also that there are a large number of countries around the world that do not have their own currencies – and in certain circumstances this is an optimal choice. Other key conclusions are that (i) the choices of exchange rate and monetary policy are not independent; (ii) options and choices for smaller countries may be different to those for larger economies; and (iii) one of the key factors affecting the range of available options is the degree of credibility that policymakers and institutions have. The review of international experience will help to frame the available options for Zimbabwe.

4.1 Does a country need its own currency?

Which factors that should influence the choice of currency and monetary policy regime? We can deal first with the "nationalistic" argument. It is clearly not necessary for a country to have its own currency to be a "country". Fully 55 countries around the world have no currency of their own, and hence are *de facto* members of monetary unions[5]. Of the 186 countries reported in the IMF's Annual Report on Exchange Arrangements and Exchange Restrictions in 2010, therefore, 30% had no currency of their own. A further ten countries have similar quasi-monetary union arrangements whereby they have given up all monetary policy autonomy (for instance through a currency board).

The group of countries without their own currency or with quasi-monetary union or dual currency arrangements includes a wide range of countries, ranging from very small countries (Andorra, Micronesia), to very large economies (France, Germany). Such a practice is widespread in Africa, where 20 countries (including Zimbabwe) fall

[5] *The majority of the 55 are members of one of the four formal monetary unions in existence (CEMAC, WAEMU, ECCU and EMU), which together have 39 members. The remaining 16 (including Zimbabwe) have unilaterally "dollarized".*

into one of these categories. The number of countries that has been increasing over time.

Adopting another country's currency or a regional currency nevertheless has implications for economic policy, and may or may not be beneficial for individual countries. The merits of doing so need to be assessed on a case by case basis. However, the argument that a country *must* have its own currency is primarily political and will not be considered any further here. It may be beneficial to have a national currency, but in other circumstances it may not be beneficial or even possible. Below, we consider the economic reasons for and against different possible currency regime choices.

4.2 Types of regime

Monetary and exchange rate arrangements cover a spectrum ranging from "freely floating" at one extreme to "hard pegs" at the other. Typical classification categories are shown in Table 2 below.

Table 2: Classification of Exchange Rate Regimes of IMF member states[6]

Category	Description	No of countries (2010)
1	Exchange arrangement with no separate legal tender:	49
1a	*Use of another country's currency as sole legal tender*	*12*
1b	*Currency union (such as the euro zone)*	*37*
2	Currency Board arrangement	7
3	Conventional pegged exchange rate (pegged to another currency or basket of currencies at a fixed rate)	30
4	Stabilised arrangement	24
5	Crawling peg/horizontal band	7
6	Managed float	38
7	Independently floating	13

Source: Author, based on IMF (2010)

The above relates to exchange rate policy; clearly there is an associated and closely related decision regarding the choice of monetary policy framework. The IMF classifies members broadly by whether they have an exchange rate target or a

[6] *Note that while the categories are based on the IMF's classification, the approach used here is different. The IMF classifies monetary union members according to the type of exchange rate regime of the union currency (e.g. all euro zone members are classified as having a freely floating currency, and all ECCY members as having a currency board). Here, monetary union members are classified under the "no separate legal tender" category.*

monetary target, and within the latter category, whether the monetary target is a monetary aggregate, an inflation target, or some other target.

The two key issues governing the choice of exchange rate and monetary policy framework are:

(i) facilitating macroeconomic adjustment in response to exogenous shocks;
(ii) providing a nominal anchor for prices.

The first objective relates to the need for adjustment when the economy is subject to an exogenous shock, such as a decline in the price of its exports leading to a change in the country's terms of trade and real income. This is particularly important when such shocks are asymmetric, i.e. different to those affecting the country's main trading partners or competitors. The ability to adjust in response to asymmetric shocks is an important component of retaining international competitiveness.

Such adjustment can be achieved through a floating or flexible exchange rate, or perhaps through a managed or stabilised arrangement. However, the harder the peg becomes the less likely it is that the exchange rate can play an active adjustment role. Where the nominal exchange rate is not flexible, adjustment of the real exchange rate has to take place through changes in relative prices (domestic / foreign and tradeables / non-tradeables).

The second objective relates to the need for a macroeconomic variable that anchors the overall price level (as opposed to real or relative prices), and hence plays a major role in determining inflation. In a floating rate country, this generally has to come from a target such as a monetary aggregate (money supply) or an inflation target, although some very large countries do not have a formal target. In a fixed exchange rate country, the exchange rate provides the nominal anchor. Furthermore with a fixed exchange rate there is little scope for active monetary policy. Attempts to manage interest rates (either directly, or indirectly through the money supply) will lead to capital inflows or outflows that will put pressure on the exchange rate and tend to move it away from the fixed rate. To prevent this, such capital flows have to be accommodated or sterilised, and this in turn will either lead to depletion of the foreign exchange reserves or unsustainable sterilisation costs for the central bank, which will in turn force the monetary policy stance back to it starting point. The constraints on monetary policy autonomy under a fixed or pegged exchange rate regime can only be softened, to a limited extent, by the possession of very large foreign exchange reserves or the imposition of restrictions on capital flows (which would in turn be likely to restrict inflows of foreign direct investment, which most developing countries are in need of).

For countries with independent currencies, the choice on where to locate on the spectrum from floating rates to hard pegs, involves weighing up how best to achieve these two objectives through an exchange rate / monetary policy combination. Typically the "ideal" choice, giving the highest degree of policy autonomy, is seen as

a combination of a floating exchange rate (to give flexibility in adjusting to shocks) and an active monetary policy (enabling the control of inflation).

This is certainly the choice of many larger economies. However it is not a clear-cut choice – the second largest economy in the world, China, has followed a different policy combination. The floating exchange rate / active monetary policy choice also has steep pre-requisites to be successful – notably a high degree of credibility for the monetary authorities, developed financial markets, good quality statistics and a well-understood transmission mechanism. It also tends to work better in larger economies, with a lower pass-through from exchange rate changes to inflation. But it also has disadvantages, in that the exchange rate can be volatile, and adjustment can often "overshoot", leading to large changes in competitiveness, rather than stabilisation.

While floating exchange rate / active monetary policy regimes may appear to provide maximum policy autonomy, they can also be mismanaged in a way that ends up providing little or no policy autonomy. This is particularly the case when the ability to create money is not responsibly exercised. The experience of Zimbabwe in this regard is well known, and although an extreme case has parallels elsewhere, where excessive expansion of the money supply has led to weakening of floating rate currencies.

International experience shows that smaller countries are more likely to choose a harder peg with the exchange rate acting as the nominal monetary anchor, allowing monetary policy to adjust passively. A harder peg, depending on how exactly it is structured, may provide credibility and reduce risk – useful if the former is in short supply and the latter is elevated. But only certain types of peg, in certain situations, can provide credibility. Obviously, an unsustainable peg will make things worse rather than better. Typically, a peg requires either very high foreign exchange reserves, or legal backing through a currency board, and a supportive fiscal policy framework, along with effective institutions, to be sustainable.

When the policy choice is extended to accommodate the choice between an independent national currency and the use of another currency or joining a monetary union, other policy issues also become relevant, although they will generally be subsidiary from a policy perspective to the two key issues above. Amongst these subsidiary issues are the distribution of seignorage and the provision of lender of last resort facilities to banks.

The issue of credibility is particularly important in the choice of monetary and exchange rate policy frameworks. Credibility is necessary for any policy framework to work effectively, and a high degree of credibility opens up policy options. For instance, a large and well-established monetary authority such as the Federal Reserve has such a high degree of credibility that it can operate a credible monetary policy framework without an explicit policy target. Other monetary authorities need a more

formal target (such as an inflation target or a monetary aggregate target) against which they can be held transparently accountable, in order to build credibility.

Alternatively, an exchange rate peg can derive credibility from various sources, such as a very high level of foreign exchange reserves (Botswana, or Gulf oil exporters), an external guarantee (such as the CFA franc zones), a currency board arrangement with sufficient legal backing and a credible supportive policy framework (Hong Kong). The relationship between credibility and the choice of policy framework is two way: a high degree of prior credibility opens up policy options, and conversely a low degree of policy credibility reduces policy options; and where credibility is low, an appropriate policy framework can help to build credibility.

If the policy choice is to be a fixed / pegged exchange rate or the adoption of a foreign currency, a further issue arises in respect of the choice of currency peg. Various dimensions arise here, including the choice of monetary policy anchor, commonality of shocks, trade patterns, exchange rate stability and competitiveness concerns.

The dilemma that Zimbabwe faces is that monetary authorities have lost the policy option of using exchange rate and monetary policy frameworks to facilitate macroeconomic adjustment in response to exogenous shocks, while at the same time have lost the institutional and policy credibility needed to underpin such autonomy.

5. Monetary Integration in Africa

Consideration of Zimbabwe's exchange rate and monetary policy options in the context of the multicurrency system raises issues around the broader process of monetary integration in Africa. This is because any system that involves adopting another country's currency by definition involves monetary integration with that country. Given that Zimbabwe's current regime involves a form of monetary integration with the USA, it is important to consider whether there are other monetary integration options available. In particular, there has been discussion of formal monetary integration in Africa with the adoption of regional currencies, and even an eventual continental single currency. If this does take place, it could offer Zimbabwe an exit route from the multi-currency system.

5.1 Proposals for Monetary Union in Africa

In 1991 the Abuja Treaty was agreed, and proposed establishing an African Economic Union, including a monetary union, involving all members of the African Union, by 2028. Prior stages included the establishment of regional and continental free trade areas and customs unions, which would then be combined at a continental level and before progressing to a continental common market and monetary union. The building blocks for this process were to be regional economic communities (RECs), such as the Southern African Development Community (SADC), the Common Market for

Eastern and Central Africa (COMESA), and the Economic Community of West African States (ECOWAS), among others.

With the proposal for a monetary union including a single currency and African Central Bank agreed by Heads of State, a parallel initiative was then pursued by the Association of African Central Banks (AACB), which developed the African Monetary Co-operation Programme (AMCP) in 2002. This had similarities with the process envisaged in the Abuja Treaty, but envisaged the prior establishment of common regional currencies and central banks prior to the eventual amalgamation of those regional currencies into a single continental currency. The AMCP has a more accelerated timeline than the Abuja Treaty, and envisaged the introduction of a single African currency by 2021.

An initiative is under way to consolidate the AUC and AACB initiatives, through the formation of a joint committee of the two institutions together with a working group that is intended to propose a revised programme for monetary integration in Africa. This is due to be completed during 2013. A weakness of the joint AUC/AACB initiative, however, is that the Terms of Reference focused on *how* monetary union in Africa should be implemented, rather than *whether* monetary in union in Africa would be a good idea. Proposals for African monetary union have largely been driven by political processes (at the level of Heads of State of the African Union), and the costs and benefits have never been examined in depth to reach a final balanced decision.

5.2 Proposals for Monetary Union in SADC and other RECs

The process envisaged in the Abuja Treaty and the AMCP has been widely adopted, at least on paper, by RECs in Africa. SADC's Regional Indicative Strategic Development Plan (RISDP), adopted by the SADC Summit (Heads of State) in 2003, proposes the establishment of a SADC Monetary Union including a SADC central bank to be up and running by 2016 and the introduction of a common currency by 2018. This is preceded by a process of macroeconomic convergence (MEC) with targets for a range of primary and secondary macroeconomic indicators to be achieved in 2008, 2012 and 2015. It is also the culmination of a process of ever-deeper integration including the establishment of the SADC Free Trade Area (by 2008), SADC Customs Union (2010) and Common Market (2015).

However, the process of regional economic integration in SADC has moved slowly. The FTA has been implemented, and observed by most (but not all) SADC members; however, the proposed Customs Union has been deferred. Instead, attention is being focused on the grand "Tripartite FTA" comprising SADC, COMESA and the East African Community (EAC). Rather than a progressive deepening of regional economic integration *within* a REC, the process now seems to be following the path of broader integration *across* RECs. There has also been slow progress with achieving

capital and labour market integration (removal of exchange controls and allowing labour market mobility).

Various interpretations for this course of events are possible. The decision to pursue broader rather then deeper integration, at least for the time being, is accompanied by a reluctance to address issues of overlapping REC memberships (where one country belongs to more than one REC). At the FTA stage, overlapping memberships can be accommodated, but they are not compatible with a customs union, common market or monetary union (where a country can belong to one grouping only). Deepening integration beyond the FTA stage therefore requires countries to decide which REC they are committed to, which has so far proved to be problematic[7]. It also requires a willingness to forgo sovereignty at the national level and delegate sovereignty upwards to relevant regional bodies with supranational legal authority, a willingness that has so far been almost entirely absent from regional integration initiatives in Africa, not just in SADC.

With regard to monetary union within SADC, there has been little or no public support for the RISDP proposal from either Heads of State or Central Bank Governors, and no pubic debate of the issue.

Although the RISDP has been accepted by Heads of State, it is not a legally binding document. The Finance and Investment Protocol (FIP) formalises some of the commitments embodied in the RISDP, but does not go nearly as far. For instance, the FIP contains commitments to pursue macroeconomic convergence (MEC) and limited harmonisation of capital markets and bank regulation, but nothing beyond that. The FTA Agreement is also legally binding (on states that have accepted it), but there is no legal basis for moving beyond this, for instance to a customs union.

The RISDP is in the process of being revised (during 2012-13), and it is possible that the monetary integration objective will be removed or downgraded during the revision.

Outside of SADC, there has been greater progress towards monetary integration in some other RECs. Of course there are two existing monetary unions (WAEMU and CEMAC), which together involve a total of 14 countries. The remaining members of ECOWAS (outside of the WAEMU) have agreed to move towards a monetary union, and have established the West African Monetary Institute (WAMI), based in Accra, Ghana, to support the process. The EAC has also agreed in principle to establish a monetary union, and have commissioned a roadmap to guide the process. The EAC has also agreed on some of the prior steps towards regional economic integration: a FTA is in place, a Customs Union has been agreed and is in the process of being

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[7] *For instance, of the 15 members of SADC, seven are also members of COMESA, while one is also a member of the EAC.*

established, and there is some labour mobility between EAC member states. The five member states have established a Monetary Affairs Committee (MAC) which meets regularly and is charged with driving the process of monetary integration. However, the somewhat ambitious deadlines for achieving monetary union, such as that for agreeing a monetary integration protocol, have been frequently missed or postponed. Zimbabwe in considering the option of joining the SADC Monetary Union as an exit route from MCR is premised on the realisation this objective expeditiously. This priority and urgency is not shared by other members and this objective cannot be achieved unilateral decision by one country.

5.3 The Common Monetary Area (CMA)

Within SADC there is already a quasi-monetary union in the form of the Common Monetary Area (CMA), whose members are South Africa, Lesotho, Namibia and Swaziland (LNS). The CMA stems from a Multilateral Monetary Agreement, which dates back to 1974 when the Governments of South Africa, Lesotho and Swaziland formalised arrangements for the Common Monetary Area (CMA). Namibia joined the CMA on achieving independence in 1991. Prior to 1974, an informal arrangement had existed between South Africa, Botswana, Lesotho and Swaziland under which the South African rand circulated as legal tender throughout the four countries. Botswana declined to join the CMA in 1974 and introduced its own currency, the Pula, in 1976[8]. The 1974 Agreement introduced several new features that were not in the previous informal arrangement regarding the circulation of the rand in Lesotho and Swaziland.

The key features of the CMA are as follows:

Role of SA rand: the SA rand is the central currency of the CMA, and circulates throughout the four countries. It is legal tender in all four member states.

Other National Currencies: Lesotho, Namibia and Swaziland also have the right to issue their own national currency, and the arrangements regarding the issuance of currency by these countries are subject to a separate bilateral agreement between the issuing country and South Africa (Article 2.2);

Capital Mobility: the CMA constitutes a single monetary area with no restrictions on the movement of funds between member states, whether for current or capital account purposes capital (Article 3);

Access to Financial Markets: Governments, banks and firms in Lesotho, Namibia and Swaziland have the right to issue securities in the South African money and capital markets (Article 4.1);

[8] *As an emerging mineral (diamond) producer subject to different shocks to the other CMA members, the Government of Botswana felt that it required the policy autonomy to respond to shocks that the introduction of an independent currency would bring. It also took the view that rapidly rising mineral exports, balance of payments surpluses and foreign exchange reserves would provide backing and credibility for an independent currency. There was also a political objective in distancing Botswana from apartheid South Africa.*

Lender of Last Resort: Lesotho, Namibia and Swaziland have the right to enter into separate bilateral agreements with South Africa, under which the SA Reserve Bank may provide temporary liquidity facilities in exceptional circumstances (Article 4.3);

Exchange Controls: while each member of the CMA shall administer its own exchange controls, the exchange controls implemented by Lesotho, Namibia and Swaziland have to be substantially the same as those of South Africa (Article 5);
Seignorage: the South African government undertakes to make annual payments to Lesotho, Namibia and Swaziland as compensation for rand currency circulating in those countries, according to an agreed formula, unless those countries choose to issue their own currencies under Article 2.2 (Article 6).

Consultations: the CMA Commission, comprising one representative from each member state, holds regular consultations in order to reconcile their respective interests in the formulation, modification and implementation of monetary and foreign exchange policies for the CMA, and reaches decisions by consensus (Article 8);

Accession: any other state may join the CMA with the agreement of all other members;

Bilateral Agreements: the Multilateral Agreement may be supplemented by bilateral agreements between South Africa and Lesotho, Namibia or Swaziland. These bilateral agreements must be consistent with the main multilateral agreement and may cover additional monetary matters. In particular, bilateral agreements cover:

- the issuance of currency by Lesotho, Namibia and Swaziland;
- the geographical areas in which the respective currencies are legal tender;
- the formula for calculating seignorage compensation payments for rand in circulation when new national currencies are issued; and
- reserve backing for currencies issued by Lesotho, Namibia and Swaziland.

Subsequent to the 1974 agreement, Lesotho, Namibia and Swaziland (LNS) have all introduced their own currencies – Lesotho maloti, Namibian dollars and Swazi emalangeni, and have their own central banks. The terms of the issuance of these currencies and their status *vis a vis* the rand have changed over the years, Generally, however, in terms of the bilateral agreements governing the issuance of those currencies, the issuance of domestic currency must be fully backed by rand assets – either rand on deposit at the South Africa Reserve Bank (SARB) or South African government securities (which are counted as part of the foreign exchange reserves of those countries). These currencies are all pegged 1: 1 to the rand.

The holding of rand reserve backing (in the cases of Lesotho and Namibia, but not Swaziland) means that the peg can be maintained because these currencies can always be exchanged for rand. It also means that the governments of Lesotho and Namibia cannot issue unrestricted amounts of domestic currency – the issuance is essentially restricted by their holdings of foreign exchange reserves, and so has some similarities

with a currency board arrangement. This prevents unlimited or destabilising currency issuance by the Lesotho and Namibia governments.

Monetary Policy: although it is not a formal requirement of CMA membership, the structure of the agreement means that there is *de facto* a single monetary policy in the CMA, which is set by the SARB. While there may be small differentials between benchmark interest rates in LNS and South Africa, generally LNS interest rates move in tandem with those in South Africa. Deviations between LNS interest rates and SA rates would lead to unsustainable capital inflows or outflows which would destabilise the LNS financial sectors and potentially undermine the peg to the rand.

The CMA is a unique arrangement and has no direct parallels anywhere in the world. It is not quite a monetary union (as in the CFA zone, Euro zone or ECCU), as it does not have a single currency or central bank. However, it does have some monetary union features, including shared seignorage, effectively a single exchange rate *vis a vis* the rest of the world, internal capital mobility, and a shared monetary policy.

5.4 Implications of the Euro-zone crisis for monetary integration in Africa and SADC.

The experience of European Monetary Union (EMU) has in many ways provided the inspiration for proposed monetary integration in Africa, whether on a regional level (as in SADC) or in the continent as a whole (as in the AMCP). The linear integration process followed by the EU, through a free trade area, customs union, common market (with capital and labour mobility) and finally a single currency and monetary union, has been laid out as the process for monetary integration in Africa to follow.
However, the past two years have seen a range of (largely) unanticipated problems emerge in the Euro-zone (EZ) that have threatened the continued existence of the EZ and raised the prospects of the exit of one or more members or the complete collapse of the EMU project. These problems have revolved around sovereign debt, capital markets and banks, but reflect deeper issues relating to the fundamental structure of the EMU, the management of fiscal policy, the functioning of capital markets, the role of national and regional institutions, and the relationship between political and economic factors. They also draw attention to the fundamental questions of how economies adjust to shocks and maintain competitiveness while in a monetary union.
As a result, the Eurozone is no longer a “shining” role model – instead it is now experiencing an existential crisis, and needs major restructuring if it is to survive. With hindsight, the design of the Eurozone was flawed, and it may or may not be possible to address those flaws at this stage. The lessons of this must be taken on board in consideration of monetary integration in Africa.

One of the key lessons is that monetary unions may or may not be good for member states. It is no longer self-evidently the case, if it ever was, that monetary unions are always beneficial, or that the benefits always outweigh the costs. For some Eurozone

members, it is likely that the costs have outweighed the benefits. In particular, monetary union may not be beneficial for a member state that is not prepared to make difficult political decisions to undertake the structural reforms and adjustments necessary to ensure regional and international competitiveness in the context of a monetary union.

It is also evident from the experience of the EZ and other monetary integration experiments that monetary unions are neither necessarily stable nor durable, and certain design features are essential in determining durability and stability. In fact, the number of surviving monetary unions in the world is less than the number of failed/fragmented monetary unions over the past 50 years. One important lesson from the Eurozone crisis is that even a small member state can cause instability in a large monetary union. This experience is contrary to earlier expectations that it would primarily be the larger member states that determined the economic fortunes of the union. This particularly applies if there is a sufficiently high degree of economic and capital market integration – which is of course the objective of a monetary union.

All stable monetary unions (i.e. all existing monetary unions excluding the Eurozone) have involved the smaller members delegating responsibility for monetary policy to a large, dominant economy either within or outside of the monetary union; and have required either all members or the smaller members to adhere to a fixed exchange rate vis a vis that dominant country.

While macroeconomic convergence (MEC) is an important pre-condition for monetary union, but it is not a sufficient condition (most EMU members met the Maastricht MEC criteria, but EMU still has problems[9]). The convergence process prior to monetary union needs to be carefully designed and must go beyond convergence of macroeconomic outcomes in the form that has typically been specified to date. With regard to macroeconomic variables, it must ensure also that interest rates converge and that exchange rates stabilise. For SADC, MEC criteria need to be extended to include these variables. Furthermore, it may not be sufficient to specify MEC criteria in terms of absolute levels (e.g., inflation below 5%) but to focus on the dispersion of performance, e.g. member states must have inflation no more than X% above the mean inflation rate of the three best performing countries.

In addition, a plan must be drawn up for the convergence of macroeconomic policies and not just performance. In particular, monetary and exchange rate policies must be harmonised. The nature of this convergence and harmonisation will vary depending on the countries involved and the ultimate monetary and exchange rate policy to be adopted by the monetary union. For instance in SADC, for most member states it means ultimately moving from a floating exchange rate/active monetary policy (e.g.

[9] *In some cases countries appeared to meet the Maastricht criteria and as a result secured entry to the Euro-zone, but it is now clear that this was on the basis of highly creative accounting that led to misrepresentation of public sector finances (Italy) or outright distortion of official statistics (Greece).*

inflation targeting) combination to a managed/pegged exchange rate/passive monetary policy combination, prior to monetary union taking place. The nature of the harmonisation and transition process, its stages and duration, have to be defined. Furthermore, the nature of the final monetary/fiscal policy framework for a monetary union should be considered and agreed prior to the union being established.

The EZ experience also shows that it is difficult for monetary union to work when there are so many differences between economies of member states, in particular when there are vastly diverging levels of regional and international competitiveness. The major differences between economies in Regional Economic Communities (RECs) in Africa – in terms of the level of economic concentration/diversification, per capita income, trade patterns and exposure to external shocks – raise questions as to how they can survive without national level macroeconomic policies. The adoption of a single monetary and exchange rate policy across all countries in a REC (or across all countries in Africa) may be damaging. Given that many African countries depend on primary products for exports, they are likely to be affected by shocks. When a country relinquishes the exchange rate as an instrument, it loses a mechanism for protecting itself from economic shocks that are different to those affecting the economy (or economies) of the anchor currency. Given that monetary policy is a key instrument of macroeconomic management, the constraints imposed by a single currency area on the pursuit of country-specific objectives may therefore be viewed as constituting a hindrance to achieve country-specific economic goals. Such diversity would make it difficult to sustain a monetary union, given that countries may have different shocks that may require different policy responses.

The Eurozone experience also suggests that monetary union is not very effective at promoting convergence – clearly the continuing divergences in levels of competitiveness and structural characteristics in the Eurozone have been part of the problem. This contradicts the arguments of some that the process of monetary union will itself be sufficient to bring about convergence, and hence that convergence prior to monetary union is not necessary.

A particular problem that is evident from the Eurozone experience is that adjustment to asymmetric shocks is very difficult once a country no longer has access to monetary and exchange rate policy, and where fiscal policy is constrained. More generally, it is difficult to restore competitiveness at the national level once this is lost. The usual response to a lack of international competitiveness would involve exchange rate adjustment (devaluation), but this is not possible in a monetary union. The process of "internal devaluation", through an adjustment in prices and real wages, which is necessary in a monetary union, has proved extremely difficult to achieve in the Eurozone. Indeed, it is the lack of competitiveness of some member states, combined with excessive fiscal deficits and debt, which has proved so damaging in the Eurozone.

It is also clear that the process for establishing an effective monetary union is lengthy and should not be rushed, and should not be driven by timetable that does not take account of economic realities. The criteria for entry to a monetary union are crucial, and should be strict, and not driven by political desires; variable geometry is therefore essential, in that not all potential candidate members (of a REC) will be eligible to join the monetary union as soon as it is established. To minimise the potential for misrepresentation, performance against entry criteria should be independently audited.

Consideration needs to be given to whether membership of a regional or African monetary union is compulsory or voluntary. In Europe, a commitment to join the Eurozone is required once a country joins the EU, although the UK, Denmark and Sweden negotiated an opt-out from this requirement. In other monetary unions and arrangements (WAEMU, CEMAC, the ECCU and the CMA) membership is voluntary. Some countries may decide that it is not in their interests to join the monetary union. In addition, provision should be made for a member state to exit the monetary union, voluntarily or perhaps even compulsorily, in the event of severe breaches of membership criteria.

One of the major lessons of the EZ experience is that the tension between common (regional) monetary / exchange rate policy and national fiscal policy needs to be effectively addressed. This can be done in various ways, but all involve constraining national autonomy over fiscal deficits and sovereign borrowing. Effective mechanisms need to be in place to ensure that national fiscal and debt outcomes do not destabilise the monetary union, including sanctions that can be imposed on transgressors. Essentially what is required is some kind of fiscal union, in addition to monetary union. However, adding a fiscal union to a monetary union is close to full economic union and raises important questions. Does this require a federal constitutional structure? Is fiscal union likely to be acceptable to member states? Fiscal union/constraints need to be balanced by mechanisms for fiscal transfers between member states (notably from larger/richer member states to smaller/poorer member states). It is not clear if this would be politically acceptable.

Structural reforms are essential for successful and beneficial membership of a monetary union – but are often resisted. Important questions relate to how members or prospective members can be forced to reform; should structural reform be an entry criterion; and if so, how should it be defined?

Crisis management mechanisms need to be established (in terms of institutions, processes and resources). This could involve the establishment of a stabilisation fund that supports countries in difficulties, conditional on the implementation of structural reforms.

A banking union needs to be considered (with common licensing, regulation, supervision and deposit insurance across all members, based on a regional regulatory institution). Existing regulators (central banks) would therefore need to delegate some of their regulatory / supervisory powers upwards to a supra-national institution.

Having explored the experience of the CMA, the Eurozone and other monetary integration experiments the key question that remains is how does this experience inform the choices that Zimbabwe has with regards to future currency, monetary and exchange policy regimes?

6. Zimbabwe's Future Currency and Exchange Rate Policy Choices

6.1 Options for Zimbabwe

The choice of a preferred option for Zimbabwe is not an easy one – as many previous reviews have pointed out, all options have advantages and disadvantages which need to be evaluated and weighed up. There is also the problem of timescale – the medium to long-term options are different to the short term ones. The following options will be considered:

Exchange rate / monetary policy framework
Domestic currency – floating exchange rate and active monetary policy
Domestic currency – fixed peg, passive monetary policy
Currency board
Multi-currency (status quo)
US-Dollarisation
Randisation
CMA (Rand monetary area)
SADC monetary union

A New Zimbabwe dollar?

The first issue to be addressed is whether the Zimbabwe dollar can or should be reintroduced as an independent currency. The "nationalistic" argument – that it is *necessary* to have a currency to be properly a "country" has been dealt with earlier; it is primarily a political argument and will not be considered further here. However, there are economic arguments that need to be considered, as well as the institutional pre-requisites.

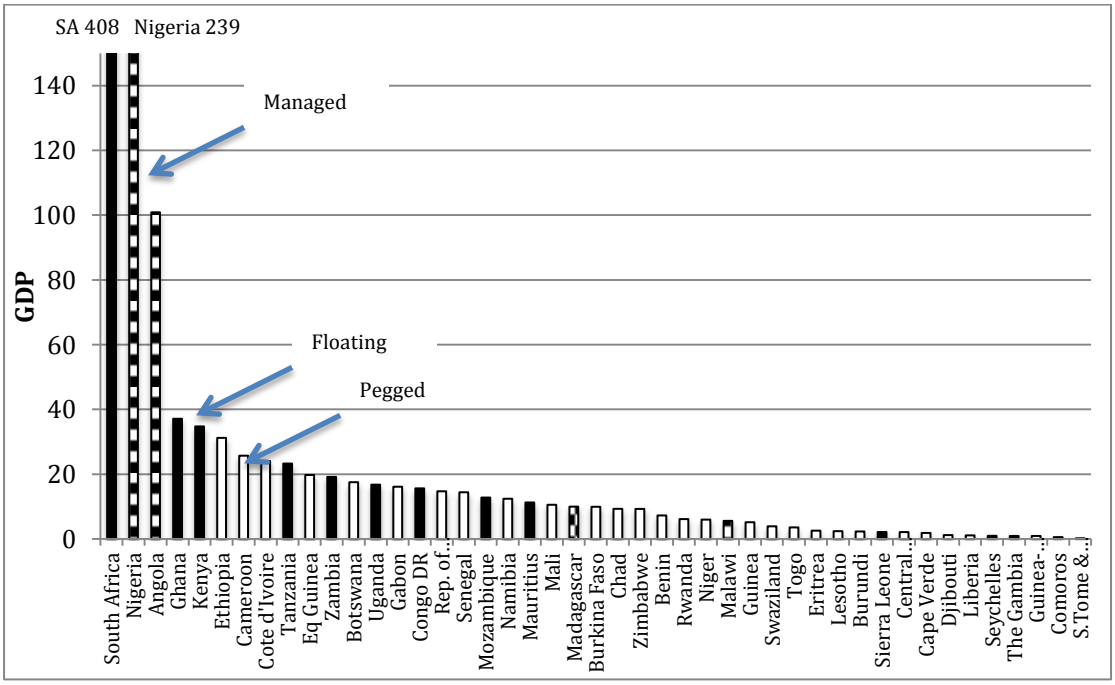
The economic arguments around having a national currency (and hence national autonomy over monetary and exchange rate policy) are focused on the need for policy

instruments that will enable a country to adjust to changing economic circumstances, and particularly economic shocks. Without this adjustment tool, there are concerns that a country may become uncompetitive, resulting in lower growth and incomes than would otherwise be the case. In the absence of this tool, a country requires other adjustment tools, such as fiscal policy and flexible markets for commodities, capital and labour.

Although this may sound like a strong argument in favour of an independent currency, the reality is more complex. The level of flexibility is highest with a flexible or floating exchange rate and discretionary monetary policy, but this may not be a realistic option for many smaller countries. For smaller economies, the role of the exchange rate in providing a nominal anchor for prices – through a pegged or fixed rate mechanism - tends to be more important than its role as an adjustment mechanism. With a pegged rate, de facto policy autonomy is highly constrained.

As Figure 5 shows, in Africa very few small economies have floating exchange rate regimes – in such economies (GDP of $10bn or less), exchange rates are generally either fixed or "stabilised". Many of those with fixed rates are participants in a monetary union, taking the view that it is worthwhile giving up some policy autonomy in return for the benefits it can bring in terms of economic credibility and stability.

Figure 5: Exchange rate regimes and economic size in Africa



Source: IMF (2010); WEO database

Zimbabwe is likely to be experiencing considerable economic change in the medium term, driven by a number of – possibly conflicting - factors, including the impact of

political reform (new constitution and elections); continued recovery from hyperinflation; the indigenisation drive; structural reforms; and the implementation of the Zimbabwe Accelerated Arrears and Debt Strategy (ZAADS) with components of HIPC-style debt restructuring processes. All of these suggest that the flexibility that would be offered by an independent currency might be helpful to support the necessary adjustment and maintain competitiveness. However, even if this were *desirable*, it is necessary to consider whether it is *feasible*.

In considering the question of whether Zimbabwe should reintroduce a domestic currency for economic reasons, we note that:

(i) There is no recent example of a country that has reintroduced a domestic currency following *complete* dollarisation. While some countries have introduced new currencies after leaving monetary unions or integration arrangements (sometimes associated with political fragmentation)[10]. However, these have been in stable situations with strong political and popular support for the new currency, and no historical "baggage" to deal with;

(ii) Zimbabwe's hyperinflation was the second highest ever in recorded history, and the highest anywhere in the world during the last fifty years, and hence the destruction of the credibility of the monetary authorities was correspondingly severe;

(iii) Any reintroduction of the Zimbabwe dollar would have to be on a voluntary basis, with foreign currencies circulating alongside the domestic currency (certainly as a store of value, and perhaps also as a medium of exchange). The closest example of this being attempted is in Liberia, where both the Liberian and US dollars are legal tender, but the latter accounts for the majority of financial assets and currency in circulation (around 70% of M2) despite extensive government efforts to encourage de-dollarisation.

Given the continued political and economic uncertainty in Zimbabwe, and elevated perceptions of country risk, it therefore seems unlikely that the conditions will exist for the meaningful reintroduction of the Zimbabwe dollar as an independent currency at any time in the foreseeable future. Certainly, the political and economic environment may change following the adoption of a new constitution and elections that are expected to be held in 2013, leading to meaningful re-engagement with the international community, including a debt-reduction programme, all of which could contribute to reduced risk.

New legal frameworks (for the RBZ, and fiscal policy) and a restructuring and recapitalisation of the RBZ may help. But confidence and credibility cannot be legislated – they have to be earned, and given the destruction of political and

[10] *E.g. Ethiopia/Eritrea; Czech Republic/Slovakia; Sudan/South Sudan*

institutional credibility that has taken place in Zimbabwe, this may take many years. Many asset holders – particularly savers and pensioners – were effectively expropriated under hyperinflation. It seems unlikely that there would be widespread voluntary acceptance of a new Zimbabwe dollar, given the experience of wealth destruction that previous holders of ZWD financial assets suffered, even if higher nominal returns could be earned on ZWD assets than on, say, USD assets. The relevant question is, what would be the incentive for wealth holders to convert their assets to ZWD, given the risks of doing so? And if the majority of the money supply remains in the form of foreign currency, as seems likely, then policy autonomy would be limited.

Would a fixed peg help to stabilise a new domestic currency and provide credibility? This very much depends on the basis of the peg. Countries with successful fixed (or managed) pegs generally either have very high levels of foreign exchange reserves (Botswana, China) or a currency board type of arrangement, whereby all domestic currency has to be backed by foreign exchange reserves. Currency boards or related arrangements are used by Hong Kong, Djibouti, the Eastern Caribbean Currency Union, Namibia and Lesotho to underpin their currencies.

A fixed peg or currency board is unlikely to be feasible for Zimbabwe in the foreseeable future, for a variety of reasons. At present, the foreign exchange reserves of the RBZ are virtually non-existent[11]. With Zimbabwe's very high level of foreign debt (well over 100% of GDP) and situation of "debt distress", combined with large current account deficits and limited access to foreign capital inflows, the prospect of any significant accumulation of foreign reserves lies far into the future. Without sufficient reserves, a fixed peg is not sustainable and is highly vulnerable to balance of payments deficits and speculative attacks. And it would not be possible to establish a currency board without sufficient reserves to "buy out" the monetary base (currency in circulation and bank deposits at the RBZ). The magnitude of this is unknown, given the uncertainty over the amount of cash in circulation in Zimbabwe. Besides accumulating sufficient reserves, a currency board would require a restructuring and recapitalisation of the RBZ (with a potentially significant fiscal cost) as well as a robust legal framework. But even with this in place, a currency board (like a fixed peg) is vulnerable to speculative attacks, given that the reserve backing in a currency board only applies to the monetary base and not the broader money supply. And again, institutional and legal credibility is necessary.

It is also important to realise that fixed pegs in general, and currency boards in particular, provide little monetary policy autonomy. The main function of a central bank under a currency board is to implement the currency board rules, and protect the peg, and it would not, for instance, have any significant discretion over money supply or interest rates. There is also very limited seignorage income in a currency board

[11] *Import cover was reported as 0.3 months in September 2012 (IMF, 2012)*

arrangement (because the central bank cannot create money without holding foreign reserves as backing). Similarly, there is only limited capacity to act as lender of last resort for the monetary authority in a currency board arrangement[12]. So the "policy autonomy" objective of reintroducing a domestic currency would not be achieved under a currency board arrangement.

The lack of institutional credibility and capacity therefore provide major obstacles to the reintroduction of a Zimbabwe currency, especially in a policy framework that provides policy autonomy. Credibility cannot be legislated – it has to be earned, and this will take many years. The use of foreign currencies – and the constraints that this imposes on policy implementation – is an important component of rebuilding this credibility. And without this credibility, there can be no meaningful policy autonomy.
A further question is whether the reintroduction of a domestic currency is needed to provide additional fiscal space, and help to resolve the fiscal constraints currently facing Zimbabwe. Although in principle a domestic currency would provide some fiscal autonomy, in practice it is unlikely. Given Zimbabwe's history, it is unlikely that economic agents would voluntarily finance government debt denominated in a domestic currency in the forseeable future. Zimbabwe's current lack of fiscal space is not due to the MCR but because of a narrow tax base, weak revenue collection, over-spending on salaries, and perhaps most importantly due to the massive debt burden. The MCR provides a tool for preventing fiscal profligacy, which was the root cause of hyperinflation. Effective implementation of the ZAADS programme and public finance management (PFM) reform can open up fiscal space, even within the MCR.
This does not mean that a domestic currency can never be reintroduced. However, it does mean that it should not be part of current macroeconomic planning and strategy.

Foreign currency options: USD vs ZAR

If reintroducing a domestic currency is not likely to be a realistic option in the short- to medium-term, the question becomes what is an appropriate foreign currency, and currency arrangement, to use?

The main potential reference currencies that have been considered are the US dollar (USD) and SA rand (ZAR). An important point to note is that the currency structure of Zimbabwe's foreign trade – with USD the most important currency of exports and the ZAR for imports - will always expose Zimbabwe to fluctuations in the USD/ZAR rate, regardless of the currency policy adopted; the question is how to distribute this exposure across economic agents. A peg to the ZAR would stabilise inflation around the SA inflation rate, but leave exporters exposed to ZAR-denominated earnings volatility. A peg to the USD would stabilise export earnings, but lead to more inflation volatility. There is a danger that exchange rate changes could lead to

[12] *With a domestic currency, the LoLR capacity of the central bank is unlimited as it can, in theory at least, create as much money as necessary to provide liquidity to banks. In a currency board arrangement, the monetary authority can provide (limited) LoLR facilities from excess foreign exchange reserves, external lines of credit, or being permitted to have less than 100% reserve backing for the monetary base.*

appreciation of the real exchange rate (RER), especially if the USD is retained in Zimbabwe. With the SA rand as the reference currency, however, the expected long term depreciation of the ZAR against the USD should help both regional and international competitiveness of both exporters and firms competing with imports. A peg to the ZAR is probably more consistent with longer-term plans for regional economic integration within SADC. As earlier analyses concluded, use of the ZAR is probably more appropriate than the USD in terms of conventional Optimal Currency Area criteria, even though in many respects Zimbabwe and South Africa do not form an OCA.

Unilateral Adoption

However, if the choice of foreign currency is posed in terms of unilateral adoption, then arguments in favour of the USD are stronger. The US government poses no restrictions on the use of the USD by other countries, and US dollar banknotes are readily available through banking channels. Coins are less readily available, not due to restrictions on availability but because of the high costs of transportation relative to value. There are also high costs associated with taking soiled banknotes out of circulation. Needless, to say, unilateral adoption of the USD would not entitle Zimbabwe to any share of seignorage revenue accruing to the US monetary authorities or to any influence over monetary policy decisions. The coin problem could potentially be solved by producing coins locally (as is done, for instance, in Panama), preferably on a currency board basis (i.e. all coin issuance backed by foreign exchange reserves held by the RBZ). However this would require a restructuring of the RBZ and an adequate legal framework to ensure that any limited money creation ability is not abused[13].

In the case of the ZAR, notes and coins are not readily available, due to SA exchange controls, which make it impossible for banks to export significant currency volumes outside of the CMA. It would therefore be difficult to adopt the ZAR unilaterally, as it would at least require a bilateral agreement between the governments of South Africa and Zimbabwe; even then, there does not appear to be any interest in such an agreement on the part of South Africa.

Common Monetary Area (CMA)

An alternative to adopting the ZAR unilaterally is to do so through the CMA. As discussed earlier, the CMA is a monetary integration arrangement involving South Africa, Lesotho, Namibia and Swaziland, and not a full monetary union (which would have a single currency and central bank). It is based on a common agreement between all members plus a set of bilateral agreements between SA and the other members. It provides for the SA rand to be legal tender throughout the CMA member states, and permits LNS to issue their own currencies that are legal tender only in those countries.

[13] *Various innovative solutions to resolve the coin/change problem have been introduced, including providing change through mobile (cellphone) money transfers, plastic money tokens, supermarket credit notes or coupons etc.*

These currencies have always been at par (1:1) with the ZAR. In the case of Lesotho and Namibia, all domestic currency issue has to be backed by ZAR deposits at SARB or other approved assets (hence the arrangements represents a quasi currency board). This does not apply in the case of Swaziland, which has opted for a different arrangement, and it is notable that Swaziland is the only member of the CMA where the sustainability of the peg has been called into question.

The CMA provides for shared seignorage (payment from SARB to reflect SA rand in circulation in other member states). It also provides for the free flow of capital to and from SA, and access to SA capital markets for LNS (hence access to larger savings pool and FDI). There is also the potential for access to liquidity facility at SARB (LoLR), although this would have to be negotiated. The CMA is a common exchange control area (hence LNS broadly apply SA exchange controls).

Joining the CMA is a potential option for Zimbabwe, although such a move would have to be agreed by all four existing CMA members. There is no indication as to what the attitude of current members would be towards an application to join from Zimbabwe.

One key issue that will certainly be considered by CMA members is whether Zimbabwe could potentially contribute to economic instability in the CMA. On the face of it, this seems unlikely. The Zimbabwean economy is very small in the CMA context, and would contribute an estimated 2% of GDP to an expanded CMA. The conventional wisdom has been that in a monetary union or integration arrangement, any systemic instability would come from the larger members. However, the Euro-zone experience has demonstrated that this is not true – Greece accounts for around 2% of Euro-zone GDP, and has been the source of huge instability in the wider grouping. Although the causes of this instability are complex, the main reasons are a combination of excessive fiscal deficits and the deep integration of capital markets, which means that the risks of Greek default are spread throughout the Euro-zone banking system. In addition, sovereign risks in the capital markets were mispriced.

Table 3: GDP of CMA Member States and Zimbabwe

	GDP (USD bn, 2011)	% incl. Zim
South Africa	422.04	93.6%
Namibia	13.02	2.9%
Swaziland	3.92	0.9%
Lesotho	2.69	0.6%
Total	**441.66**	
Zimbabwe	9.24	2.0%

Source: IMF WEO database

In theory, a similar situation could arise in the CMA, if a small member state ran large fiscal deficits, financed by borrowing in the CMA capital market, and then proved unable to service those debts. The CMA makes no provision for centralised control or

restrictions on fiscal deficits, and decisions to finance those deficits would lie with individual institutions (which would purchase government debt in the bond market).

However, in practice this situation is unlikely to arise, or at least if it did it would not cause the same problems in the CMA as in the Euro-zone. De facto, there is a high degree of centralisation in the CMA, given the dominance of South Africa. It would soon become apparent if the South African financial system was building up a high degree of exposure to the debt of Zimbabwe (or any of the other small member states), through the normal supervisory process for banks and non-bank financial institutions such as pension funds. This is in contrast to the Euro-zone, where one of the problems has been the decentralisation of bank supervision and hence the lack of a centralised supervisory picture of the exposure of European banks to Greek debt[14].

Nevertheless, it is important to realise that the CMA makes no provision for the bailout of member states, and it should not be assumed that any assistance would be forthcoming (or at least not without strict conditions, as in the case of Swaziland) in the event of a fiscal crisis.

A further contrast between the Euro-zone and the CMA is that although the origin of the sovereign debt problem was in Greece, in many ways concerns about Greek debt and default reflect broader concerns about larger economies – notably Portugal, Ireland, Spain and Italy. In all of them there are concerns about debt sustainability and hence risk to lenders and capital markets, so although Greece may represent only 2% of Euro-zone GDP, its problems are reflective of potentially much larger problems. This would not apply in respect of Zimbabwe in the CMA.

Joining the CMA could potentially be highly beneficial for Zimbabwe. Assuming that the terms of membership were similar to those of Namibia and Lesotho, Zimbabwe would receive seignorage income, which it would not do so in the case of unilateral adoption of another currency (and which it does not receive now). It would also have access to a broad and deep capital market. The constraints imposed on monetary and fiscal policy would help to build credibility. Essentially, monetary policy would be delegated to South Africa (rather than to the USA as at present), and benchmark interest rates would be set by the South African Reserve Bank[15]. With regard to fiscal policy, the level of possible budget deficits would be set by the capital market and the price that the Government of Zimbabwe would have to pay for debt financing[16].

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[14] *Hence one of the policy responses to the Euro-zone debt crisis has been the proposal to establish a "banking union" with centralised regulation and supervision.*

[15] *In practice Zimbabwean interest rates bear little resemblance to USA rates. This presumably reflects the dominance of the country risk premium in determining actual interest rates in Zimbabwe.*

[16] *However, until there is a comprehensive debt restructuring and forgiveness arrangement for Zimbabwe (along the lines of the HIPC initiative) it is unlikely that any sovereign borrowing will be possible. Hence the present situation of cash budgeting would continue to prevail.*

The CMA would also offer the advantages outlined earlier with regard to the discussion of the suitability of the ZAR or USD as anchor currency, in terms of OCA criteria and export competitiveness.

The CMA would also permit Zimbabwe to introduce its own currency in due course, with a peg to the ZAR, as has been done by the other CMA member states. This is unlikely to be possible in the short-term, however, because such currency issue would have to be compensated by the deposit of rands at the SARB, under the CMA's quasi currency board arrangement. As with the discussion of currency boards earlier, this would require the accumulation of foreign exchange reserves by the RBZ[17]. A Zimbabwe currency introduced under the CMA arrangement would have little independence, as it would be tied 1:1 with the rand. However, the same applies to the currencies of Namibia, Lesotho and Swaziland, and those countries have all found that the disadvantages of constrained monetary independence have been outweighed by the benefits of the peg to the rand, including stability, credibility and the anchor to the monetary policy of a well-respected central bank. In the very long term, having introduced a currency within the CMA, it would of course be possible for Zimbabwe to leave (as Botswana did), and have a more independent currency. But if joining the CMA achieves the anticipated benefits, leaving it would be likely to reintroduce credibility problems and undermine those benefits, and hence it would not be appropriate to think of the CMA as only a short- or medium-term solution.

The CMA does, however, have disadvantages. The counterpart to participation in the CMA capital market is the requirement to impose South African exchange controls on transactions with the rest of the world. In principle, this would require residents (firms and individuals) to convert their USD holdings to ZAR. However, there are generous limits on holdings of non-ZAR assets by individuals in particular (current limits are the equivalent of approximately USD 0.5 million), and so in practice this might not be of major concern. Also, companies engaged in foreign trade are permitted to hold USD accounts at domestic or foreign financial institutions under CMA exchange controls.

SADC Monetary Union

As noted above, the RISDP envisages a SADC Monetary Union including a single central bank and common currency to be introduced by 2018. Realistically, however, this will not happen. Although there has been some progress with macroeconomic convergence, none of the other preparatory steps for the introduction of a common currency within five years have been taken – there is no roadmap, no monetary institute or other institutional preparation, and no plan for policy convergence. Perhaps most importantly, no SADC member state is publicly backing the proposal. The revision of the RISDP taking place during 2012-13 will almost certainly defer the

[17] *It would also require the restructuring of the RBZ and the cleaning up of its balance sheet, but this is required regardless of the currency option chosen, and is not specific to the CMA.*

idea of a common currency to a later date, or perhaps indefinitely. Hence participation in a SADC common currency should not be perceived as an exit route from the MCR at any time over the next decade.

Continuation of the MCR

The multi-currency regime has brought considerable benefits to Zimbabwe, largely because of the discipline imposed by de facto dollarisation. In particular, the MCR brought about stronger fiscal discipline than before 2009 and prevented the RBZ from engaging in the excessive monetary expansion that led to hyper-inflation. Although it was forseen as a temporary solution, it may be appropriate for the MCR to remain as a medium-term solution. As Kramarenko (2012) notes, there is no pressing need for a significant modification of the existing currency regime; instead, attention should be paid to improving its functioning by addressing the factors causing weaknesses. These include improving fiscal discipline, undertaking structural reforms to improve competitiveness and the investment climate, and more disciplined supervision of the banking system by the RBZ.

A potential threat that arises under the MCR or indeed any system based around a foreign currency or currencies where there are no foreign exchange reserves is the impact of continuous trade deficits on the banking system. Trade deficits mean that outflows of currency to pay for imports exceed inflows from export earnings. This could potentially lead to a draining of liquidity from the banking system, potentially destabilizing banks or at least further inhibiting the supply of credit. This will not necessarily happen, as compensating flows from currency held outside of banks, remittances from overseas, or capital inflows could offset the trade deficit outflows. Nevertheless, it remains a concern, and reinforces the need to reduce country risk and resolve the issue of outstanding debt. This would help to restore Zimbabwe's access to regional and international capital markets, enable external borrowing and encourage inward foreign direct investment. This would facilitate the generation of a surplus on the capital account that would help to offset any current account deficit and, in very positive circumstances, contribute towards building foreign exchange reserves.

6.2 Assessment of Options

The various currency regime options can be assessed in terms of a variety of criteria, including:

- enabling a domestic currency
- providing a nominal anchor for prices
- facilitating adjustment to exogenous shocks
- building institutional and policy credibility
- allowing seignorage
- providing a Lender of Last Resort facility
- whether feasible or realistic

The assessment of the various options in terms of these criteria is summarized in Table 4 below. Amongst the key results of the assessment are that while there are various ways of reintroducing a domestic currency, none of them are advisable in the short-to-medium term. Neither fixed nor floating exchange rates would be sustainable, given the lack of institutional credibility and foreign exchange reserves. It is also the case that one of the hoped-for exit routes from the MCR, that of joining a single SADC currency, is unlikely to materialise in the foreseeable future, if at all. Various options provide the essential ingredient of a nominal anchor for prices, but they all involve delegating monetary policy to a foreign monetary authority and importing credibility and basic price stability from that source. On balance, pegging to South African monetary policy is probably more advisable, at least in the medium term, than pegging to US monetary policy.

A second consequence is that the nominal exchange rate will not be available as a means of adjusting to shocks, and other forms of economic flexibility will therefore be required in order to keep the real exchange rate at an appropriate level. Of the advisable options, only the CMA provides some access to seignorage income. With regard to a LoLR facility, other options – besides the ability to print money in the form of domestic currency – will need to be pursued.

Table 4: Assessment of Currency & Exchange Rate Options

Framework	Own currency	Nominal anchor	Adj. to shocks	Builds Credibility	Seignorage	LoLR	Other Comments
Floating exchange rate	Yes	No	Yes	No	Yes	Yes	Open to abuse; requires monetary policy authorities with high degree of credibility and limited discretionary powers; which monetary anchor would be used? Long term.
Adjustable peg/crawl	Yes	Partial	Partial	No	Yes	Yes	Open to abuse and speculative attacks; which currency would be chosen for the peg? Uncertain basis of crawl or adjustment. Long term.
Fixed peg	Yes	Partial	No	No	Yes	Yes	Open to abuse and speculative attacks; which currency would be chosen for the peg? No credible basis for peg; unlikely to be sustainable. Long term.
Currency board	Yes	Yes	No	Yes	Limited	Limited	Vulnerable to speculative attacks; needs strong legal framework and supportive policies to be credible. Medium term.
Multi-currency (status quo)	(No)	Yes	No	Yes	No	No	Interim solution only, but could be refined and kept for some time (de facto US dollarisation). Could have local coins. Status quo.
US-Dollarisation	(No)	Yes	No	Yes	No	No	Coin problem; not evident that US monetary policy peg is optimal for Zimbabwe. Could have local currency circulating in parallel, but willingness of households/firms to hold this is questionable. Short term.
Randisation	No	Yes	No	Yes	No	No	Needs support of SARB, which is unlikely
CMA	(Yes)	Yes	Partial	Yes	Yes	Partial	Needs support of other CMA members, would take time; solves coin problem; would have to adopt SA excons; provides access to SA capital markets; SACU question. Medium term.
SADC MU	No	Yes	Partial	???	???	???	Highly uncertain timescale; no implementation plan; unlikely to happen for many years, if at all. Long term

7. Conclusions

There is no single option that meets all criteria – as in all countries, it is a question of balancing the pros and cons of different options before deciding on the one that is optimal in a given situation. Zimbabwe's choices are, however, more constrained than those of most countries because of its recent history. Given the recent hyperinflation and loss of monetary control, a credible nominal anchor for prices is an essential pre-requisite of a sustainable monetary and exchange rate policy arrangement. This cannot at present be achieved through a discretionary policy under the control of the domestic monetary authorities, which in turn rules out, for the foreseeable future, the re-introduction of a domestic currency on the basis of a floating exchange rate or a conventional adjustable or fixed peg. A new Zimbabwe currency under the current circumstances would only be workable in the context of a currency board arrangement or membership of the CMA (which is a quasi-currency board) – i.e. an arrangement that does not permit any discretion for domestic policymakers.

In the short- to medium-term, the available feasible options all require the choice of an external currency (or currencies) to provide the basis for Zimbabwe's currency whether directly as legal tender or indirectly as the basis for a currency board peg. Of the two main choices, the South African rand is a more suitable option than the US dollar. Unfortunately, however, unilateral adoption of the SA rand is not feasible, and utilisation of the rand would have to be done through membership of the CMA. This would take some time to achieve, and would not be Zimbabwe's decision alone as it would require the agreement of the existing CMA members.

Joining the CMA offers several advantages for Zimbabwe, as well as some drawbacks. One of these is the SACU issue, as ideally joining the CMA would be accompanied by membership of SACU in order that trade within the currency bloc is not restricted. However, this would depend on changes to the SACU revenue distribution formula that would facilitate new entry, which will in turn take some time to be agreed by existing SACU members. The SACU revenue distribution formula is currently being reviewed prior to possible revision; one of the objectives of the review is understood to make the formula more accommodating for new members. However, no new proposal has yet been agreed by existing SACU members, so the introduction of a new revenue formula is likely to be some way off. In the shorter-term, full implementation of the SADC FTA would be an interim solution for Zimbabwe.

The feasibility of various options also depends on the time-scale being considered. In the short-term, Zimbabwe has little choice but to continue with the MCR. Any other options require a considerable period of time to deal with the pre-requisites. A move from the MCR to full official dollarisation could be achieved fairly quickly and without much disruption, but it is not clear that this makes sense as a long-term option

for Zimbabwe.[18] Joining the CMA is a more attractive option, but membership would take time to be negotiated (especially if accompanied by SACU membership), as would the adjustment from a USD-based to a ZAR-based system. Of the other possibilities, it does not appear that randisation (unilateral adoption of the rand as an anchor currency) outside of the CMA is an available option, nor is a SADC common currency except in anything very long term. Reintroducing the Zimbabwe dollar on a currency board basis could be achieved in the medium term but would require extensive institutional, legal and policy reforms, and would in any case confer no greater policy autonomy than using a foreign currency or currencies. Reintroducing a domestic currency could in theory be done at any time, but doing so in a form that would confer policy autonomy is only likely to be feasible in the long or very long term. In these circumstances, continuing with the MCR while undertaking reforms and holding discussions within the region that would support successfully exercising other choices in the medium to long term may be the best approach. Rushing into a change of currency regime before the necessary prerequisites are in place is likely to do more harm than good.

[18] The recent experience of Greece in the Euro Zone has shown that this could equally create severe binding constraints with no easy exit pathways.

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