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Inflation dynamics in a dollarised economy: the case for Zimbabwe

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Introduction

The rapid and sustained loss in value of the Zimbabwean dollar, which began in the last quarter of 1997, led to its rejection as a medium of exchange during the second half of 2008, as inflation soared. Zimbabwe slid into hyperinflation in March 2007, with the annual inflation rate reaching a record 200 million per cent in July 2008.

Hyperinflation ended abruptly when the country abandoned the use of the local currency and adopted a multi-currency system in February 2009.The abandonment of the local currency and adoption of the multi-currency system weakened parallel market activities and arbitrage opportunities and dissipated inflationary pressures.

This paper is an empirical analysis of the major factors that influenced price formation in the dollarised Zimbabwean economy; a completely new macro-economic environment. A significant development in this new macro-economic environment was the loss of monetary policy autonomy of the central bank, which contributed to the relevance of the study.

Key results

The study found that the the US dollar/South African rand exchange rate, South African inflation, international oil prices and inflation expectations are significant determinants of inflation in the dollarised Zimbabwean economy in the long run. In the short run, inflation is determined by international oil prices, the US dollar/South African rand and South African inflation.
Given that South Africa is Zimbabwe's major trading partner, accounting for about 60 percent of the country's imports, the price formation mechanism in Zimbabwe is directly related to exchange rate and inflation developments in South Africa. An appreciation of the South African rand against the US dollar implies that Zimbabwe will require more US dollars to purchase one unit of the rand. Other things being equal, the appreciation of the South African rand against the US dollar directly translates into increased costs of business for Zimbabwean companies, which are then passed onto domestic consumers to maintain profit margins.

Policy Implications

The key findings of the study indicate that Zimbabwean policy makers do not have any control over price formation in the dollarised economy, as this is largely dependent on external factors. The loss of the country's monetary policy autonomy, typified by the lack of the exchange rate as a tool at the authorities' disposal constrains the available policy options on the exchange rate front. This notwithstanding, the country can cushion itself from the vulnerabilities associated with the fluctuations of the US dollar/South African rand exchange rate through an internal devaluation mechanism, in the absence of a nominal exchange rate devaluation.

A reduction in the cost of production will result in domestic consumers substituting foreign goods for cheaper domestically produced goods. In this regard, inflationary pressures emanating from imports of finished consumer goods such as cooking oil, soap, beverages and other food items can be significantly reduced.

The country also needs more investment to increase output across all sectors of the economy. In this regard, it is imperative that the Government of Zimbabwe creates an environment conducive for business to enable the private sector to increase production. These policy measures will reduce reliance on imported finished goods from neighbouring countries.

Furthermore, the need to improve efficiency remains critical if the country's goods are to maintain their competitiveness in both the domestic and international markets. Improvement in efficiency, however, entails the adoption of modern production technologies as well as accessing external lines of credit at internationally competitive interest rates. The expeditious resolution of the country's debt overhang remains critical in efforts geared towards unlocking affordable lines of credit from international capital markets. Improving the country's productive efficiency can significantly reduce production costs and offset the negative repercussions of the appreciation of the US dollar against the South African rand. The meaningful attraction of both debt and non-debt creating capital flows, notably foreign direct investment, requires that supportive measures be adopted pro-actively in Zimbabwe. In this regard, there is need for the country to align its investment laws and procedures to international best practices.

The attraction of foreign direct investment entails the review of the country's indigenisation and economic empowerment laws in such a manner that achieves the twin objectives of attracting the much-needed capital and advanced technology as well as integrating the indigenous people in mainstream economic activity. The attraction of foreign direct investment remains the cog that underpins the attainment of efficiency and export competitiveness; effective plugging of attendant supply gaps; permanent shedding of import dependency and diversification of the country's export basket away from over- reliance on primary products to finished products. It is also imperative that the country creates a land market to resuscitate the agricultural sector, which is the backbone of the economy, through its forward and backward linkages with the manufacturing sector.