**_The Macrotheme Review_**
**_A multidisciplinary journal of global macro trends_**

# Dollarization and Zimbabwean Economy

Nuray Terzi and Tinashe J. Chinoda
*Marmara University, Turkey*

**Abstract**

*Countries with a history of weak inflation control, a lack of domestic commitment ability and a large volume of international trade are more inclined to adopt dollarization. There are two potential benefits to opting for dollarization: Macroeconomic stability and foster international trade. Dollarization motivates macroeconomic stability by solving the credibility problem and international trade also is triggered by increasing stability. However, there are also some cost of dollarization such as loss of an adjustment mechanism or the loss of seigniorage revenue. By the turn of 2008 Zimbabwe was faced with hyperinflation and needs to control inflation. This situation leads to the dollarization of the exchange rate. Therefore, this paper examines the foreign exchange regime implemented by Zimbabwe with a special focus on the dollarization. The cost-benefit analysis of dollarization assess in terms of economic indicators such as GDP, inflation rate, exports, imports etc. The results of the study revealed that dollarization positively influenced the country's economy but the policy is not a panacea for all its economic woes.*

Keywords: Dollarization, Zimbabwean Economy

## 1. Introduction

In 1980, soon after gaining independence from Britain, the newly minted country of Zimbabwe was riding a high wave of national pride, the country adopted the Zimbabwe dollar (ZW$) as an official currency, replacing the Rhodesian dollar at parity. The Zimbabwean dollar was high, it had an exchange rate of 1 ZW$ to 1.47 US$. Astoundingly, by July 2008 the value of the Zimbabwean dollar had dropped to ZW$10 billion to 0.33 US$ and made headlines around the whole world. This was largely powered by the significant increases in the money supply by the RBZ. These actions coupled with an array of misdirected economic policies resulted in an upsurge in inflation (ZimStat, 2008).

The Zimbabwe dollar (ZW$) exchange rate and the country's monetary management policies went through numerous adjustments from 1980 until 2009. Initially, after independence in 1980, the (ZW$) was pegged to a basket of currencies which were subject to periodic devaluations. Secondly, Zimbabwe's Economic Structural Adjustment Programme (ESAP), was launched in 1990, the main objective was to usher Zimbabwe into a new era of modernized, competitive, export-led industrialization. ESAP contained a range of World Bank-inspired reforms on trade, currency deregulation, devaluation of the Zimbabwe dollar, the movement towards high real interest rates, removal of price controls and the reduction of government expenditure. The country had to meet some financial conditions from The World Bank and this drove the exchange regime towards a flexible one. The third change in the exchange market came in early 1994, the market was liberalized, the fixed exchange rate was replaced with an independent float, and this was coupled by regular currency depreciations. This regime took only five years and by 1999 the Zimbabwe dollar was pegged to the US dollar in which the RBZ had the mandate to regularly devalued when it saw fit (Noko, 2011). The fourth period which was official dollarization began in January 2009. The management of the exchange rate was a problem for Zimbabwean authorities in the period (2000 – 2008).

Dollarisation is simply another kind of fixed exchange rate, but, on the extreme end of the spectrum. The new regime of dollarization has a lots of celebrated advantages such as lower administrative costs, a firm basis for a sounder financial sector, and lower interest rates, However, by adopting such a policy the Zimbabwean authorities deprived the country of its sovereignty in the monetary policy. This means that no interventions in the economy and monetization of the domestic deficit.

This paper examines the foreign exchange regime implemented by Zimbabwe with a special focus on the dollarization. In order to achieve this aim, following section gives the literature review on exchange regimes and dollarization. In addition, it outlines the advantages and disadvantages of dollarization. Section three presents the impact of dollarization on the Zimbabwean economy. Section four focuses the impact of dollarization on monetary policy in Zimbabwe. Finally, section five gives the concluding remarks and recommendations.

## 2. Literature Review

### 2.1 Exchange Rate Regimes

The value of a nation's currency in relation to the value of another currency is the exchange rate. An exchange rate comprises of two components; a domestic currency and foreign currency. A nation must make key economic decisions that pertain it exchange regimes; this involves how it will value its currency in comparison to other currencies. This indicates how the nation's currency is managed in the foreign exchange market. The exchange rate regime of any currency largely goes along with the country's monetary policy. According to the International Monetary fund, the Exchange rate regimes are broadly divided into three broad categories (Table 1).

**Table 1.The Classification of Exchange Rate Arrangements**

| | |
|---|---|
| Hard Pegs | ✓ Exchange arrangement with no separate legal tender<br>✓ Currency board arrangement |
| Soft Pegs | ✓ Conventional peg<br>✓ Pegged exchange rate within horizontal bands<br>✓ Stabilized arrangement<br>✓ Crawling peg<br>✓ Crawl-like arrangement |
| Floating or Flexible Regimes | ✓ Floating/flexible<br>✓ Free floating/flexible |
| Others | ✓ Other arrangements |

Source: IMF

The first category is named the hard exchange rate pegs. Some nations are considering abandoning their domestic currency altogether. This practice is referred to as dollarization. Dollarization is a system in which the currency of another nation circulates as the sole legal tender. Recently, Ecuador, El Salvador and Zimbabwe dollarized economies. A currency board or independent monetary authority, is an independent monetary agency that links the growth of the money stock to the foreign exchange holdings of hte currency board. (Daniels and VanHoose, 2014). For example, Hong Kong SAR uses a currency board. These system usually go hand in hand with sound fiscal and structural policies and low inflation (Mark Stone et al.2008).

Soft exchange rate pegs are the second group. Currencies keep a stable value against an anchor currency. When the parity band allows for a maximum deviation from the parity rate, of plus or minus 1 percent, the exchange rate arrangement is considered a conventional peg arrangement. When the allowed deviation implied by the parity bands is greater than 1 percent, the exchange rate arrangements is considered a pegged-exchange rate within horizantal bands arrangement (Daniels and VanHoose, 2014). If the currency is adjusted periodically in small amounts at a fixed, it is called crawling pegs. Nicaragua's exchange rate arrangement is a good example of a crawling peg. Some countries, such as Colombia and Chile, have combined features of a r-crawling peg with the additional flexibility allowed by an excahnge rate band. This type of arrangement is crawling band. These arrangements lead to for a limited degree of monetary policy flexibility to deal with shocks. On the negative side, they are exposed to financial crises because they can cause to a large devaluation and tend not to be long lasting (Levy-Yeyati and Sturzenegger, 2001).

The last category is floating/flexible exchange rate regimes. The floating or flexible exchange rate system is one in which the forces of supply and demand determine a currency's exchange value in the private market (Daniels and VanHoose, 2014). Some countries that admit the floating/flexible exchange rates let the central banks to interfere mostly to limit short-term exchange rate fluctuations. However, in a few countries, the central banks almost never interfere to manage the exchange rates. Flexible regimes present countries the advantage of maintaining an independent monetary policy. In these economies, foreign exchange and other financial markets so advanced that they absorb shocks without worrying fluctuations in the exchange rate.

Currently, 37 percent of the member nations of the IMF report to have an independent float or managed float exchange rate system. For those countries that peg their currency in some fashion, the US dollar is the most common currency for a peg: a currency basket is the seocnd most common (Figure 1). When the literature is examined, the integration of international capital markets, macroeconomic performance and development of financial sector are the determining factors in the exchange rate system of countries (Terzi, 2017).

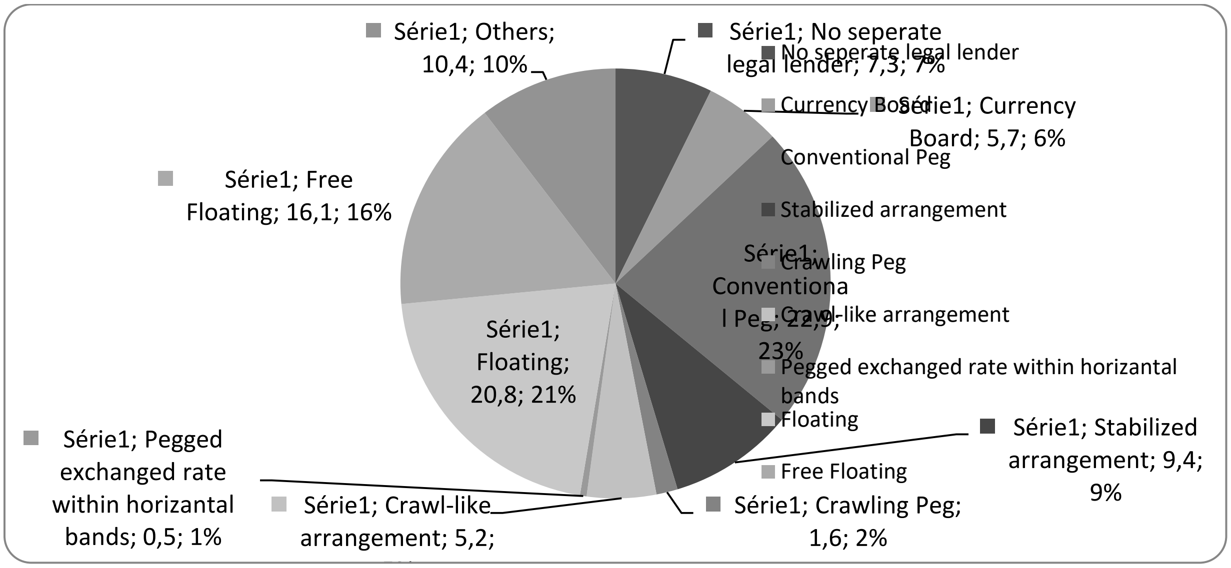


**Figure 1. Current Foreign Exchange Rate System**
Source: IMF

### 2.2 Dollarization

Dollarization is an extreme case of the fixed exchange rate. Countries with a history of weak inflation control, a lack of domestic commitment ability and a large volume of international trade are more inclined to adopt dollarization. (Nor, 2012) There are two potential benefits to opting for dollarization: macroeconomic stability, and to foster trade integration between the dollarized economy and the anchor (Klein, 2005). Many developing countries believe that the domestic currency to the US dollar or using the US dollar as a medium of exchange is better than floating exchange rate regime that might put a country into a severe economic situation (Johari, 2013).

By the turn of 2008, Zimbabwe was faced with astronomical hyperinflation and was in dire need to control it, this leads to the dollarization of the exchange rate. The hyperinflation that led Zimbabwe to dollarize its economy was caused printing money, foreign currency shortages, demand-pull inflation, disrupted production activities, and cost-push inflation (Makochekanwa, 2007). Dollarization was the simplest way for Zimbabwe to escape its economic woes. It is not known whether if the monetary authorities did a thorough analysis of the cost and benefits dollarization, but the policy a was justified and adopted in 2009.

Following table 2 summarizes the advantages and disadvantages of dollarization. One one hand, dollarization motivates macroeconomic stability, make strong the nation's fiscal discipline, improve to access to financial markets, provide lower inflation, develop financial sector, provide stable economic growth and foster economic integration. On the other hand, dollarization leads to loss of an adjustment mechanism, forfeiture of the lender of last resort and loss of seignorage revenues.

**Table 2. Advantages and Disadvantages of Dollarization**

| Advantages | Disadvantages |
|---|---|
| ✓ Motivate macroeconomic stability | ✓ Loss of an adjustment mechanism |
| ✓ Make strong the country's fiscal discipline | ✓ Forfeiture of the lender of last resort function |
| ✓ Improve to access the market | ✓ Loss of seignorage revenues |
| ✓ Provide lower inflation | |
| ✓ Develop financial sector | |
| ✓ Provide stable economic growth | |
| ✓ Foster economic integration | |

Source: Barro and Gordon, 1983; Fischer 1982; Eichengreen, 2000; Berg and Borensztein 2000; Calvo 1999; Dallas and Tavlas, 2001.

## 3. The Impact of Dollarization on Zimbabwe Economy

The Zimbabwean economy came out shining soon after the gaining independence, with the financial authorities and the government pursuing credible policies. This resulted in a good run economically until the 1990s. ESAP (1990- 1996) was a move away from import substitution to an open market driven economy and implementing a monetary policy reform of flexible interest rates and liberalization of the financial sector. ESAP failed dejectedly leading to a decline in job security in the public sector and winding up of some industries. The government reacted with a bad array of policies that led the country's economy to the gutter in the following ten years.

Since 1980's, there is a lot of inconsistency in the growth as seen by positive and negative fluctuations. A serious decline in GDP growth occurred between 1999 and 2008, recording -0.82 and -17 respectively. In this period, the Zimbabwean economy was in crisis and was a worsening year by year. Coming to 2009 when the dollarization regime was introduced the percentage growth of GDP was above 10 from 2010-2012. Economic growth slowed from 3.8 % in 2014 to an estimated 1.5% in 2015 because of weak domestic demand, high public debt, tight liquidity conditions, drought, poor infrastructure, institutional weaknesses and an overvalued exchange rate and negative inflation in 2016. All in all, dollarization revitalized the economy of Zimbabwe but the decline can be attributed to other factors. Therefore, the country 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 (Kavila and Roux, 2016).

**Table 3. GDP in Zimbabwe, 1999-2016, %**

| | | | |
|---|---|---|---|
| 1999 | -0.82 | 2008 | -17.67 |
| 2000 | -3.6 | 2009 | 5.98 |
| 2001 | 1.44 | 2010 | 11.38 |
| 2002 | -8.89 | 2011 | 11.91 |
| 2003 | -17 | 2012 | 10.57 |
| 2004 | -5.81 | 2013 | 4.48 |
| 2005 | -5.71 | 2014 | 3.85 |
| 2006 | -3.46 | 2015 | 1.5 |
| 2007 | -3.65 | 2016 | 1.6 |

Source: http://databank.worldbank.org/data/

As a new born democracy, Zimbabwe had the lowest inflation in 1980 at 5.4%. The period 1980-1990 inflation was generally manageable below 20%. In 1991 inflation started an upward trend reaching the 40s, later, fell to 18%. In 1998 inflation picked up to 31%. This increased can be attributed to cash grants awarded in 1997 to war veterans, and the effects began to be experienced from that year. In 1999 inflation further increased to 58.51% with Zimbabwe's participation in the DR Congo war. In 2001 inflation jumped to three digits as the crisis began to worsen due to the land invasions in 2000. In 2006, the inflation reached four digits. In 2007, it hit five digits and then to eleven digits in 2008. The actual inflation could have been much higher than the official figures. In 2009 inflation was tamed with the adoption of multi-currency and then came an acceptable levels (Table 4).

**Table 4. Inflation in Zimbabwe, 1999-2016,%**

| | | | |
|---|---|---|---|
| 1999 | 58.51 | 2008 | 79.600.000.000 |
| 2000 | 55.86 | 2009 | - |
| 2001 | 76.70 | 2010 | 3.03 |
| 2002 | 140.05 | 2011 | 3.27 |
| 2003 | 431.69 | 2012 | 3.92 |
| 2004 | 282.38 | 2013 | 1.63 |
| 2005 | 302.11 | 2014 | -0.217 |
| 2006 | 1097.67 | 2015 | -2.39 |
| 2007 | 24411.030 | 2016 | -2.06 |

Source: Source: http://databank.worldbank.org/data/

Just the same as the other variables the real interest of Zimbabwe was on the uphill drive to peak at 572 in 2007. The dollarization of the economy cooled the steam with the country contemplating adopting The Feds interest at first in 2009. This wasn't viable for the economy. The standard interest rate after dollarization in Zimbabwe was last documented at 10.68 percent. Interest rate has averaged 13.01 percent from 2011 until 2016, reaching an unprecedented high of 16.04 percent in March of 2012. In the post hyperinflation era, 9.50 percent in February of 2011 has been the lowest (Table 5).

**Table 5. Interest Rate in Zimbabwe, 1999-2016,%**

| | | | |
|---|---|---|---|
| 1999 | 43.87 | 2008 | - |
| 2000 | 67.16 | 2009 | - |
| 2001 | 38.2 | 2010 | - |
| 2002 | 32.87 | 2011 | 9.50 |
| 2003 | 81.33 | 2012 | 16.04 |
| 2004 | 252.12 | 2013 | 11.60 |
| 2005 | 219.28 | 2014 | 11.43 |
| 2006 | 508.74 | 2015 | 12.16 |
| 2007 | 572.94 | 2016 | 10.68 |

Source: http://databank.worldbank.org/data/

While the economy had stabilised, the country's balance of payments position remained under severe pressure, largely due to the adverse effects of the global financial crisis on international trade and global capital flows (Cavila and Roux, 2016). Consequently, the country's current account balance worsened and while exports has declined as apercentage of GDP, imports has continued to stay high as a percentage of GDP in Zimbabwe (Table 6 and 7).

**Table 6. Exports of Goods and Services in Zimbabwe (% of GDP)**

| | | | |
|---|---|---|---|
| 1990 | 22.9 | 2011 | 42.8 |
| 2000 | 38.2 | 2012 | 32.9 |
| 2007 | 37.8 | 2013 | 29.4 |
| 2008 | 41.5 | 2014 | 27.1 |
| 2009 | 22.0 | 2015 | 25.9 |
| 2010 | 36.8 | 2016 | - |

Source: http://databank.worldbank.org/data/reports.aspx?source=2&country=ZWE

**Table 7. Imports of Goods and Services in Zimbabwe (% of GDP)**

| | | | |
|---|---|---|---|
| 1990 | 22.8 | 2011 | 79.5 |
| 2000 | 35.9 | 2012 | 63.2 |
| 2007 | 46.4 | 2013 | 59.3 |
| 2008 | 68.1 | 2014 | 52.5 |
| 2009 | 46.5 | 2015 | 49.7 |
| 2010 | 63.6 | 2016 | - |

Source: http://databank.worldbank.org/data/reports.aspx?source=2&country=ZWE

Movements in US dollar have considerable effects on Zimbabwe's competitiveness and foreign direct investment (Table 8). FDI net inflows to Zimbabwe in 2015 were at US$399 million from US$105 million in 2009. In 2014 the country attracted US$472 million in FDI. The investments are across a number of sectors including, agriculture, energy, transport and telecommunications.

**Table 8. Foreign Direct Investment, Net Inflows, (BoP, million US$)**

| | | | |
|---|---|---|---|
| 1990 | -12,2 | 2011 | 344,3 |
| 2000 | 23,2 | 2012 | 349,8 |
| 2007 | 68,9 | 2013 | 373,0 |
| 2008 | 51,6 | 2014 | 472,8 |
| 2009 | 105 | 2015 | 399,2 |
| 2010 | 122,5 | 2016 | - |

Source: http://databank.worldbank.org/data/reports.aspx?source=2&country=ZWE

## 4. The Impact of Dollarization on Monetary Policy in Zimbabwe

Despite a preceding economic, social and political unrest, the dollarization achieved to stabilize Zimbabwean economy (Sikwila 2013). After the introduction of the United States dollar as an official currency in Zimbabwe, the consumer price index was substantially brought down leading to an inflation rate that remained within single digits between 2010 and 2017, with 2016 and 2017 recording deflationary figures. The immediate outcome of dollarization was price stability and the elimination of hyperinflation. In the financials and the business arenas, faith and optimism started going up. Businesses and analysts were better able to plan because there was more predictability of key indicators. The out of control inflation was stabilized and then, this stabilized the overall economy, sustained the buying power of the Zimbabwean people, and allowed the nation as whole to experience significant economic growth.

The long-term economic planning is easier to do under the stable currency, and the hope was that the dollar would attract foreign direct investment that was elusive during the hyperinflationary era. After dollarization, generally, all manufacturing industries in Zimbabwe started showing positive changes (Mutengezanwa et al. 2012).

The strength of the dollar, however, proved to be a negative factor as it reduced the attractiveness of local products in the international market, thus foreign companies selling their products in Zimbabwe profited because of higher prices charged in Zimbabwe.

The major cost though of dollarization, especially to a country like Zimbabwe, is forfeiture of seigniorage. Seigniorage is the interest income a central bank earns by issuing non-interest bearing money to buy interest-bearing assets (Makochekanwa 2007).

Like most central banks in the world, the primary mandate of the Reserve Bank of Zimbabwe is to regulate the money supply and ensure stability and smooth functioning of the banking system. Consequently, this dollarization regime has limited the ability of the Zimbabwe Central Bank to effect changes in the monetary base primarily controlling inflation as well as perform the role of lender of last resort.

The Zimbabwean central bank can no longer make its own monetary decisions. Zimbabwe's monetary policy is now essentially made thousands of miles away in Washington, D.C. by the American Federal Reserve Board. The decisions which the American Federal Reserve Board makes, furthermore, might not necessarily be in Zimbabwe's best interests. That is, the Zimbabwean economy will always be at the mercy of the decision outcomes.

The new multi-currency regime implies that the Zimbabwe Reserve Bank can no longer exercise an independent monetary stance, and that, effectively, the monetary policy of the main-currency country, the United States, has become the monetary policy of Zimbabwe, with the monetary policies of the other currency countries acting to iron out any negative outcomes from U.S. monetary policy.

The existence of dollarization in Zimbabwe has made the credit balance sheet and interest rate channels less effective, while the exchange rate channel is more effective. Openness, remittance, and availability of external funds for loans give individuals a wider opportunity to finance their consumption as well as investment. As a result, even if there is a change in domestic monetary policy, the response might be slow which makes the interest rate and lending channels less effective (Mengesha 2014).

## 5. Conclusion

For the long and short of it all, dollarization is a positive stance for equilibrium in the short run, and other numerous countries have implemented such regime to attain stability. From the analysis, it can be noted that the production levels are going down from 2013 onwards. Dollarization invigorated economic stability in the short term, but structural and institutional complications still strain the country down. These must be addressed if Zimbabwe is to realize long-term economic growth and progress or late alone work towards the sustainable development goals. Zimbabwe needs to restructure public finances, introducing and sustaining credible policies to control government expenditure. These will resultantly reduce poverty and promote economic growth. With the alteration of powers in global economics, de-dollarization can be a key forthcoming policy for Zimbabwe. This paper strongly recommends that thoughtful reforms be commenced before the national currency is to be returned. The current multi-currency system should be wellmaintained until confidence has been built and trustworthiness of the central bank reinstated. Reengagement with the World Bank, the IMF, and other potential sources of outside backing is of critical importance. Finally, the government should take grave steps to establish a partnership with the private sector to address the most serious economic and social issues facing the country.

**References**

Barro, R.J and Gordon, D. (1983). Rules, Discretion and Reputation in a Model of Monetary Policy, Journal of Monetary Economics, Vol. 12, pp 101-21.

Berg, A. and Borensztein, E. (2000): “The Pros and Cons of Full Dollarization,” IMF Working Paper WP/00/50, Washington, DC.

Calvo, G.A(1999). On Dollarization, University of Maryland, April 10.

Dallas, H. and Tavlas, G. S. (2001): “Lessons of the Euro for Dollarization: Analytic and Political Economy Perspectives,” Journal of Policy Modelling, Vol. 23, pp. 333-45.

Daniels, J.P and D.D. VanHoose (2014), Global Economic Issues and Policies, Third Edition, London and New York, Routledge.

Eichengreen, B. (2000). When to Dollarize. Paper presented at a conference on dollarization hosted by the Federal Reserve Bank of Dallas, 6-7 March.

Fischer, S (1982). Seignorage and the Case for a National Money. Journal of Political Economy, Vol.90(2), pp, 295-313.

Johari, R. (2013). Growing Dollarization in Business Banking: Congruous or Ironic? Macrotheme Review 2(4), pp.193-198.

Levy-Yeyati, E. And F. Sturzenegger, (2001). Exchange Rate Regimes and Economic Performance, IMF Staff Paper 47, pp.62-98.

Stone, M., H. Anderson and R. Veyrune (2008). Exchange Rate Regimes: Back to Basics IMF’s Monetary and Capital Markets Department, March.

Kavia, W. and Roux P.L (2016). Inflation Dynamics in a Dolalrised Economy: The Case of Zimbabwe, ERSA Working Paper 606, pp.1-19.

Klein, M.W. (2005). Dollarization and Trade. Journal of International Money and Finance.

Makochekanwa, A. (2007). A Dynamic Enquiry into the causes of hyperinflation in Zimbabwe, Working Paper Series No. 9 South Africa.

Mengesha, Lula G.(2014). The How, Why and What questions of Dollarization, Th e Emprical Economic Letters 13 (7)Department of Economics, , New Zealand, pp.1-15.

Mutengezanwa, M., Mauchi, F. N., Njanike, K., Matanga, J., & Gopo, R. N. (2012). The possibility of reintroducing the Zimbabwean Dollar. Australian Journal of Business and Management Research, 2(6), 01-08.

Noko, J. (2011). Dollarization: The Case of Zimbabwe, Cato Journal 31(2), 339-65.

Nor, M.I (2012). The Effect of Dollarization on Developing Economies: Lessons from Somali's Informal Market, Academic Research International, pp.591-597.

Sikwila, M.N. (2013). Dollarization and Zimbabwe Economy, Journal of Economics and Behavioral Studies, Vol. 5. No.6, pp.398-405.

Terzi, N. (2017). Current Issues in Global Finance (in Turkish), Beta, İstanbul.

Zimbabwe National Statistical Agency) (various reports, 2000–08).

http://databank.worldbank.org/data/reports.aspx?source=2&country=ZWE