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**ZIMBABWE'S CURRENCY CRISIS: WHICH CURRENCY TO ADOPT IN THE  
AFTERMATH OF THE MULTI-CURRENCY REGIME?**

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## **Abstract**

The study presented main features of possible currency options which can be potentially adopted by Zimbabwe in the aftermath of multi-currency regime. The currency options analyzed are dollarization, joining the CMA and re-introduction of the Zimbabwe dollar (Z\$). The proposed management systems to underpin the reintroduction of the Zimbabwean dollar are currency board, free banking and Reserve Bank of Zimbabwe (RBZ). For each of the options analyzed, the practicality of Zimbabwe in adopting and/or implementing such currency was also explained. Although any of the three options could be adopted and implemented, the study considered the options in the following descending order of priority: (i) dollarization, (ii) retaining the Z\$ but under the management system of a currency board, (iii) Joining the CMA, (iv) retaining the Z\$ under the management of RBZ, with the institution having new management, and lastly (v) free banking.

# 1 INTRODUCTION

Zimbabwe's severe and chaotic hyperinflation trend in the new millennium and especially from the year 2000 to end of January 2009 led the country to voluntarily abandon one of its sovereign symbols, its monetary currency, the Zimbabwean dollar (Z\$) by adopting the use of other foreign currencies as means of payments, unit of account, store of value and standard of deferred payments. Latest hyperinflation rate figures released by Zimbabwe's Central Statistical Office (CSO)<sup>1</sup> was that of July 2008 in which the country's month-on-month rate was estimated at 231.2 million percent, while the International Monetary Fund (IMF)<sup>2</sup> estimates the hyperinflation rate to be 489 billion as of September 2008. On the other hand, independent analysts, for instance, Steve Hanke (2008)<sup>3</sup> put this inflation rate at 6.5 quindecillion novemdecillion percent (that is 65 followed by 107 zeros) as of December 2008. In comparison with other countries, the second highest inflation rated country in September 2008 was Burma, whose inflation rate was around 39 percent<sup>4</sup>. Relative and in comparison to other African countries in general, and Southern African Development Community (SADC) countries in particular, where the average annual inflation since 2000 has been below 20 percent, Zimbabwe's inflation rate was by far an extreme outlier.

The country has been ravaged by hyperinflation for a considerable period to such an extent that the value of the local currency, the Zimbabwean dollar (Z\$), has been estimated to have lost more than 99.99 percent of its value within a space of less than two years alone, between 2007 and 2008 (Hanke, 2008). On the local scene, the Zimbabwean dollar (Z\$) has been playing second fiddle to other currencies such as US dollar (US\$), the South African rand (ZAR), the Euro and British pound, to mention just a few credible currencies that were widely used in almost all transactions. The use of these currencies gained ascendancy as far back as 2006, although their wide scale use started beginning of 2008 across the board with even rural people selling their livestock in US\$ and ZAR.

A combination of hyperinflation and central bank's monopoly over the production of currency over the past two or so years has forced the Zimbabwean citizens to use the government issued currency *under duress* with no recourse for the populace over their dissatisfaction with the currency's value. During hyperinflation period (2000 – 2009 (January), Zimbabweans felt the bitter brute as they have had to cope with recurrent currency transitions from denomination notes of Z\$5, Z\$10 and Z\$20 maxims (at independence in 1980) to a currency whose denominations has rapidly shifted from thousands, to millions, to billions, to trillions, to quadrillion, to hextrillion, and ended at

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<sup>1</sup> CSO is the collector and custodian of the country's formal statistics on socio-economic issues

<sup>2</sup> International Monetary Fund (IMF) (2009). Preliminary Conclusions of the IMF Article IV Consultation Mission (Facsimile addressed to Zimbabwe's Minister of Finance, 23 March 2009)

<sup>3</sup> Steve H. Hanke is a Professor of Applied Economics at Johns Hopkins University in Baltimore. He has written extensively on monetary issues including dollarization and currency boards in general and has also written a number of briefs and papers in particular on Zimbabwe's hyperinflation scenario

<sup>4</sup> Hanke Steve (2008). Zimbabwe: From hyperinflation to Growth. Cato Institute (Centre for Global Liberty and Prosperity Development Policy Analysis).

octillion<sup>5</sup> by end of January 2009<sup>6</sup>. The presence of both semi and informal dollarization have forced the government to allow use of multiple currencies such as the South African rand, British pound, Botswana pula and the euro<sup>7</sup> and this policy was pronounced during the presentation of the country's 2009 national budget on 30 January 2009<sup>8</sup>. At first, the government insisted that the Z\$ should remain the legal tender alongside other currencies. However, due to worthless and total loss of confidence in the Z\$ by the majority, the government latter suspended the Z\$ from the market, initial for twelve months and then latter for another three years.

Although the country will continue to use the multi-currency regime until end of 2012, questions still remain as to what will be the best option currency to adopt after this regime. This study therefore intends to provide a critique of some of the possible currency options that the country may consider adopting.

## 1.1 Zimbabwe's hyperinflationary trend

Hyperinflation is considered as inflation out of control, a condition in which prices increase rapidly as local currency loss its value. Cagan (1956:25) defines "hyperinflation as beginning in the month the rise in price exceeds 50 percent and as ending in the month before the monthly rise in prices drops below that amount and stays below for at least a year".

The history of hyperinflation in Zimbabwe can be said to date back to early 1999. Although data from CSO shows that the country's monthly inflation rate reached the 50 per cent mark in February 1999, this monthly rate was above 100 per cent by November 2001 before jumping to rates higher than 200 per cent by January 2003. By the December 2003, the rate was squarely at 600 per cent, though it temporarily declined through 2004 and 2005, reaching the trough of 124 per cent in March 2005. Since April 2006, the monthly rate has been above 1000 percent, with the upward trend reaching 2200.2 per cent in March 2007. This inflation rate was estimated at 231.2 million percent by end of July 2008 (CSO) with IMF's (2009) estimates putting the hyperinflation rate to be 489 billion percent as of September 2008. This hyperinflation trend and other economic indicators are depicted in Table 1.

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<sup>5</sup> Zimbabwe's highest money denomination in January 2009 was Z\$100 trillion. Adding back the 13 zeros Zimbabwe's central bank has lopped off since August 2006 (3 zeros were chopped off on August 1<sup>st</sup> 2006 and further 10 zeros were chopped off on August 1<sup>st</sup> 2008) as a means of trying to make the country's currency somewhat more manageable, totally zeros will be 27. Thus in actual fact, the country's highest denomination was 1 octillion by end of January 2010.

<sup>6</sup> One million has six zeros, one trillion has 12 zeros, one hextrillion has 21 zeros; one octillion has 27 zeros, one nonillion has 30 zeros while one decillion has 33 zeros.

<sup>7</sup> It is important to note that the country's use of multiple currencies is not legal or formal dollarization from the government of Zimbabwe's point of view as pointed by RBZ governor. The Herald Newspaper (18 August 2009), "Reintroduce Zim dollar: [RBZ governor]". Available at: <http://www1.herald.co.zw/inside.aspx?sectid=8782&cat=1>

<sup>8</sup> Available at: [http://www.kubatana.net/docs/econ/min\\_fin\\_budget\\_2009\\_090129.pdf](http://www.kubatana.net/docs/econ/min_fin_budget_2009_090129.pdf).

**Table 1: Zimbabwe's economic performance**

Year	GDP		GDP per capita	Annual Inflation
	US\$ billions	% Growth	US\$	%
1980-1998	7.0	3.9	740.4	20.5
1999	6.0	-3.6	508	56.9
2000	5.7	-7.3	489	55.2
2001	5.7	-2.7	490	112.1
2002	5.6	-4.4	478	198.9
2003	5.1	-10.4	433	598.7
2004	5.0	-3.6	430	132.7
2005	5.0	-4.0	427	585.8
2006	4.9	-5.4	417	1,281.1
2007	4.7	-6.1	403	108,844.1
2008	3.2	-14.1	265 <sup>a</sup>	489,000,000,000 <sup>b</sup>

Sources: IMF online database

<sup>a</sup>: Government of Zimbabwe's (16 July 2009). Mid Year Fiscal Policy Statement

<sup>b</sup>: IMF (2009)

Factors which have been among the major causes of hyperinflation in Zimbabwe includes money printing (seigniorage), foreign currency shortages (with its resultant black market premium), demand pull-inflation (due to disrupted production activities, especially in the agricultural sector), and imported/cost-push inflation (Makochekanwa, 2007).

With respect to money printing, the Zimbabwean government has been good at using the money machine print. For instance, the unbudgeted government expenditure of 1997 (to pay the war veterans gratuities); the publicly condemned and unjustifiable Zimbabwe's intervention in the Democratic Republic of Congo's (DRC) war in 1998; the expenses of the controversial land reform (which started in 2000), the parliamentary (2000/2005) and presidential (2002) elections, introduction of senators in 2005 (at least 66 posts) as part of 'widening the think tank base' and the international payments obligations, especially since 2004, all resulted in massive money printing by the government. Above these highlighted and topical expenditure issues, the printing machines has also been the government's solution for such expenses as civil servants' salaries. This printing has thus contributed towards the loss in value of the local currency, the Z\$.

## 1.2 Multi – currency regime

In an attempt to restore credibility in the monetary system and also to arrest the hyperinflationary trend, the government of Zimbabwe introduced the use of multi-currency on 30<sup>th</sup> January 2009. Following introduction of this regime, month-on-month inflation trend sharply declined from the rates of above 49 billion percent to less than 1%

since February 2009 until today, with even negative inflation rates<sup>9</sup> experienced in some monthly rates. The government further suspended the use of the local Z\$ on 13<sup>th</sup> April 2009<sup>10</sup> initially for a year, and further another three years (starting from January 2010). According to the country's three year macroeconomic framework announced on 23<sup>rd</sup> December 2009, "Government will, therefore, maintain the principle of use of multiple currencies over the Framework period 2010 – 2012"<sup>11</sup>. Thus, the use of multiple currencies and the suspension of the Zimbabwean dollar from the monetary system will continue given that they have resulted in the immediate stop of hyperinflation. Although the country has adopted the use of multi-currencies, it is important to note that the regime do not constitute formal dollarization<sup>12</sup>.

### 1.3 Study justification

Following introduction of multi-currency use, hyperinflation in Zimbabwe is now history. Monthly inflation rates since February 2009 to date have been either negative or when positive, they have been below 1%. However, one major challenge remains in the country's future monetary chapter and this problem involves choice of a single currency that the country should use once the multi-currency dispensation is over. The single currency to be chosen should not only ensure that the country do not return to the chaotic hyperinflation trend, but that its credibility in fulfilling the function of money such as medium of exchange, unit of account, store of value and standard of deferred payments should be credible in the eyes of the majority Zimbabweans and economic agents.

### 1.4 Study objective

The main objective of this study is to critically analyze the various possible currency options that Zimbabwe can consider adopting in the aftermath of the multi-currency regime. This investigation is paramount because of two reasons. Firstly, the use of multi-currency is temporary, and secondly, the country needs a permanent single currency in its monetary system.

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<sup>9</sup> For instance, Zimbabwe's month-on-month inflation rates for 2009 were -2.3% (January), -3.1% (February), -3% (March), -1.1% (April), -1% (May), 0.6% (June), 1% (July), 0.4% (August) and 0.5% (September). (Government of Zimbabwe, 23 December 2009)

<sup>10</sup> The Zimbabwean newspaper (14 April 2009), "Zimbabwe suspends own currency for 12 months", Available at: [www.thezimbabwean.co.uk/index.php?option=com\\_content&task=view&id=20402&Itemid=103](http://www.thezimbabwean.co.uk/index.php?option=com_content&task=view&id=20402&Itemid=103).

<sup>11</sup> Government of Zimbabwe (23 December 2009), "Three Year Macro-Economic Policy & Budget Framework". Available at: <http://www.zimtreasury.org/downloads-sub.cfm?SubID=15>.

<sup>12</sup> According to RBZ authorities, the country had not formally dollarised or randified, because that would involve a number of legal and economic issues. (The Zimbabwe Herald (18 August 2009), "Re-introduce the Zim dollar: RBZ official"). Available at:

<http://www1.herald.co.zw/inside.aspx?sectid=8782&cat=1>

## 2 FUNCTIONS AND CHARACTERISTICS OF A GOOD CURRENCY

Before going into detailed analysis of the possible currency options, it is paramount to reflect on the various functions and characteristics of a good currency. This will help to evaluate the possible best currency option.

### 2.1 Functions of money

Money is generally considered as having four main functions, namely medium of exchange, unit of account, store of value, and standard of deferred payments.

In the *medium of exchange* function, money is used to intermediate exchange of goods and services, thereby facilitating transactions between buyers and sellers. In this function, money avoids the inefficiencies such as the “double coincidence of wants” problem which is normally associated with barter trading system.

A *unit of account* is an acceptable standard numerical unit of measurement of the market value of goods, services and other transactions. This function is a necessary requirement for formulation of commercial agreements which involve debt. To function as a ‘unit of account’, whatever is being used as money must be:

- Divisible into smaller units without loss of value;
- Fungible – that is one unit or piece must be perceived as equivalent to any other; and
- Have a specific weight, or measure or size which can be verifiably countable. For instance, coins are often made with ridges around the edges, so that any removal of material from the coin (lowering its commodity value) will be easy to detect.

The *store of value* function requires the commodity designated as money to be reliably saved, stored, and retrieved and be predictably useful when it is so retrieved.

Money functions as a *standard of deferred payment* when it is accepted in settling debts which might have been accumulated in the past. To successfully discharge this function, the commodity considered as money must not lose its real value rapidly due to inflation, but rather its value should be relatively stable over time.

Mirroring the above functions to the Zimbabwean dollar for the period covering 2000 to end of January 2009, it can be noted without doubt that the country’s currency has failed to effectively perform these functions, especially for the period since 2007. The hyperinflation which characterized the country’s monetary system meant that the majority shunned the use of local currency in any transactions in favour of other stable currencies such as the US\$ and South Africa rand, and also the majority of citizens started pricing their goods and services in foreign currencies, thus stripping the local currency (Z\$) of its medium of exchange and unit of account functions. The same is true



that most Zimbabweans started storing their wealth in assets, jewelry and foreign currency rather than the Zimbabwean dollar, with most transactions either paid in cash or pegged in US dollar in case of credit purchases. As such, the local currency's store of value and standard of deferred payment functions totally withered away.

## **2.2 Characteristics of money**

Good money must have at least six characteristics, and these require the money to be (i) divisible, (ii) hard to counterfeit, (iii) durable, (iv) acceptable, (v) portable and (vi) stable in value. Although the Zimbabwean dollar before it was suspended from the country's monetary system managed to have the first three characteristics, it nevertheless fall short in attaining the last three characteristics. Given that the last characteristics are the most important features required in any money system, the majority citizens were forced to reject it due to its rapid decline in its real value as well as the fact that it was increasingly becoming non-portable to use in transactions, with one having to carry trillions of Zimbabwean dollars to buy just a few groceries.

## **3 POSSIBLE CURRENCY OPTIONS TO ADOPT**

There are three broad possible currency options that Zimbabwe can consider adopting in the aftermath of the multi-currency regime. These three are dollarization, joining the Common Monetary Area (CMA) and retaining the Zimbabwean dollar. Adoption of the last option (that is the Zimbabwean dollar) is further categorized into three possible management regimes which include currency board, free banking and Reserve Bank of Zimbabwe (RBZ).

A general positive view is that Zimbabwe is not new to any of the suggested currency options and management regimes. For instance, between 1892 until 1940, the country's banking system was a combination of free banking, dollarization and monetary area, where the last two systems were due to the fact that South Africa's coins were legal tender in Zimbabwe, with a profit-sharing agreement for revenue seigniorage between the two countries (Hanke, 2008). From 1940 until 1956 the country operated a currency board system before shifting to central bank system under the Central African Federation (CFA), which consisted of the Northern Rhodesia (now Zambia), Nyasaland (now Malawi) and Southern Rhodesia (now Zimbabwe). These systems are monetary arrangements that have proven history or records of success in providing reliable and low inflation currencies wherever they have been instituted. The main motive of instituting any one of these systems or a combination of them on the Zimbabwean economy is that such a system will have the ability of ensuring low inflation rates and a stable currency, and both conditions are necessary for economic growth and development.

### 3.1 Option 1: Dollarization

Generally, dollarization is often used in a number of countries. Specifically, on an informal basis, the US dollar has circulated alongside national currencies in a number of countries, both developing and developed. It is only the formal dollarization, which seems to prop up much interest, especially in previously highly inflated countries such as Zimbabwe. Thus, to have a clear understanding of dollarization, three types of dollarization will be distinguished in this section.

#### 3.1.1 Definitions of dollarization<sup>13</sup>

*Official or full dollarization* occurs when a country makes a foreign currency (currencies) full legal tender and reducing its own currency, if any, to a subsidiary role and being issued only in coins having small value. Generally, under such arrangement, there will be no risk of domestic currency, no currency risk, and therefore, no risk of currency crisis (Bogetic, 2000). With official dollarization, the foreign currency (currencies) adopted will not only be a legal tender for use among private parties, but will also be used by the government. One of the main features of full dollarization according to Borensztein and Berg (2000) is that, once adopted, it will be permanent, or nearly permanent. Compared to currency board, full dollarization will be relatively more difficult to reverse than doing away with or modifying a currency board.

A variation of official or full dollarization is one called *semi-official dollarization or bimonetary system*, which exists when a foreign currency (currencies) is adopted as legal tender dominating bank deposits, but playing second role to the local currency in payment of such costs as wages, taxes, and day to day transaction such as transport, groceries, etc. Under this arrangement, the semi-official dollarizing countries will have their own central banks or monetary authorities with vested authorities to champion their own monetary policies. An example of this arrangement is the Common Monetary Area (CMA) in which Lesotho, Namibia and Swaziland have allowed the South African rand to circulate in their territories as legal tender alongside their respective local currencies at one-to-one exchange rate with the South African rand (ZAR).

*Unofficial dollarization* occurs when residents of a given country hold a large proportion of their financial wealth in foreign currency dominated assets even though foreign currency is not a legal tender according to that country's financial or monetary laws. In this set-up, the dollar (or euro, or rand or any other foreign currency) will be widely used in private transactions as a medium of exchange, unit of account, store of value and standard of deferred payments.

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<sup>13</sup> It is important to note that the term "dollarization" no longer is the preserve of the US dollar only, but now includes use of other foreign currencies, such as euro (where the term 'eurorization' may apply), the South African rand (where the terms 'randization' or 'randify' may apply), and the British pound, among other currencies.

According to Bogetic (2000), unofficial dollarization may constitute holding of foreign currency in a variety of forms such as holding (i) of foreign currency bonds or other non-cash assets; (ii) foreign currency cash, whether possessing it is legal or illegal; (iii) foreign currency deposits in domestic banks; and (iv) foreign currency deposits in foreign banks. In the case of Zimbabwe and during the hyperinflation period, majority citizens have managed to unofficially hold their foreign currency in a variety form of cash. This has been necessitated by a number of factors. Firstly, the fact that most goods and services since 2006 have been priced in foreign currency, so having foreign currency (USD or ZAR) has been a daily prerequisite for any transaction. Secondly, the fact that up to end of January 2009 laws pertaining to opening and operating of foreign currency accounts (FCAs) have been tightened up, making it very difficult even to withdraw foreign currency in any local bank once deposited, made it prudent for people to opt for holding the foreign currency in cash, and not deposit into local banks<sup>14</sup>. Lastly, given the severe and acute shortages of foreign currencies in the country, for one to decide to part away with his or her hard earned foreign currency through deposits into the local bank was inconceivable, as withdrawing it was a fruitless exercise as in 99 percent cases there was no foreign currency cash in the bank.

### **3.1.2 Advantages of dollarization**

#### ***i. Low inflation***

Dollarization especially constituted at the right conversion rate has the ability to ensure low inflation to the dollarizing country and this has been evidenced in Zimbabwe since beginning of February 2009 after the adoption of the multi-currency regime. This comes from the fact that the dollarizing country's inflation will be closely related to the anchor country's inflation rate since these two countries will be using the same currency and applying relatively similar monetary policies (devised by the anchor country). For Zimbabwe this will be one of the most important advantage should the country officially dollarize given that hyperinflation has had unbearable social ramifications as majority of citizens have been pushed below the poverty datum line.

#### ***ii. Reduced administrative expenses***

With dollarization there will be reduced administrative expenses. The reasoning here is that, the government of the dollarizing country will not incur the cost of maintaining an infrastructure dedicated solely to production and management of a separate national currency. For a country like Zimbabwe, these savings especially at such a time as this (where the country is coming out of severe hyperinflation) will be significant given that the country has been using a lot of resources over the years (e.g., money printed to

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<sup>14</sup> Since introduction of multiple currencies in the beginning of February 2009, FCAs have been liberalized, that is, anyone can open an FCA

purchase foreign currency on the parallel market) in chasing the little foreign currency in the hands of exporters, banks, and individuals.

**iii. *Establishment of a sound financial sector***

Dollarization can also provide the firm basis for the recreation of a sounder financial sector. In this case dollarization will go beyond the mere adoption of a foreign currency, but will also mean financial integration with the anchor country and this will force domestic financial institutions to improve their efficiency and the quality of their services. Also dollarization implicitly implies a supposedly irreversible institutional change, which can act as a signal for permanent commitment to low inflation, fiscal responsibility, and transparency. Such a scenario would be an asset to a country such as Zimbabwe given that it has not enjoyed a consistent good reputation for price or fiscal stability.

**iv. *Lower interest rates***

With dollarization there could be substantial reduction of interest rates for local borrowers. Dollarization establishes a stable relationship with a currency whose reputation is already well established and secure, thus lowering the level and volatility of domestic interest rates (real and nominal interest rates) by eliminating the risk of devaluation, thereby eliminating the devaluation-risk premium in local currency interest rates. Through dollarization, instead of investing heavily in efforts to build market confidence in its own monetary policy, a government can achieve instant credibility by “hiring” the respected anchor country’s central bank policy (Meyer, 2000). Given that Zimbabwe’s interest rates<sup>15</sup> have been by far higher than the average rates applied in other neighbouring Southern African countries, any policy that reduces them is likely to be viewed as positive for the future prosperity of the country.

**v. *Stimulate domestic long-term capital markets***

Dollarization spurs the development of domestic long-term capital markets by eliminating the risk of high inflation and currency devaluation. This comes from that fact that in a dollarization system, the dollarizing country cannot devalue the anchor currency it has adopted<sup>16</sup>. The confidence brought about by a stable adopted currency (among other factors) will motivate investors, both domestic and foreign, to participate in the country’s long-term capital market. Zimbabwe’s long-term capital markets have not been

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<sup>15</sup> By end of 2008 Zimbabwe’s interests were above 400 percent compared to SADC’s rates of below 20 percent

<sup>16</sup> Devaluing any currency is the privilege of only one country, the owner of the currency. Thus, if Zimbabwe adopts the US dollar or South African rand, it will be only the US government which can devalue the US dollar or the South African government which can devalue the rand.

attractive to most investor for a long time (2000 – 2008), and thus any confidence restoration in this market through dollarization will be a benefit to the country.

*vi. Lower transaction costs*

Since the country will be using an anchor currency, which in most cases will be highly traded, and convertible, for instance the US dollar or the South African rand, when compared to the local currency, transaction costs in international trade and investments will be lowered, as there will be reduced need for currency conversions. During the country's hyperinflation period, because of the non-convertibility of the Zimbabwean dollar, transaction costs of doing international business were very high when using the Zimbabwean dollar. For instance, if a buyer from Zimbabwe wanted to import from Japan, the buyer had to first convert the Zimbabwean dollars to US dollars, and then convert US dollars into Japanese yen. Because of hyperinflation and shortage of US dollar in Zimbabwe's banks, the buyer had to purchase the US dollars from the expensive foreign currency black market and this meant exorbitant transactions costs. On the other hand, in the case of dollarization with US dollar as the anchor currency, the Zimbabwean buyer will simply do one conversion from US dollar to yen, thus reducing transaction costs (of importing in this example).

### **3.1.3 Possible Disadvantages of dollarization**

The disadvantages of dollarization are demarcated into two categories, namely, economic and political drawbacks. Cohen (2000) argues that, in reality the more critical disadvantages of dollarization are *political*, not economic, and claims that the former drawbacks "are in fact the costs that are likely to matter most in practice".

#### **3.1.3.1 Economic costs**

*i. Forfeiture of autonomous monetary authority*

Adoption of dollarization implies the forfeiture of independent and autonomous monetary policy, since the dollarizing country will no longer exercise unilateral control over its own money supply or exchange rate. There will be an inherent hierarchical relationship as such authority is ceded to the US Federal Reserve (if US dollar is the adopted currency) or South African Reserve Bank (if South African rand is the adopted currency), with little promise that the dollarizing country's specific circumstances would be taken into account when monetary decisions are made in the anchor country.

Nevertheless, in most cases when a country considers instituting dollarization, it is likely that much of the country's monetary autonomy will already have been greatly eroded, as the case with Zimbabwe, which was more than 95 percent dollarized (informally, and semi-officially) by the end of December 2008. Generally, the greater the degree of currency substitution that has already occurred due to informal dollarization reflecting

market pressures and preferences, the greater is the degree of constraint imposed even now on a government's ability to manage macroeconomic conditions and hence the smaller will be the actual loss of monetary autonomy if the local money is formally replaced by dollarization. For Zimbabwe, informal dollarization has rendered monetary pronouncements useless; hence formal adoption of dollarization may not bear much difference as the country has already implicitly/seemingly forfeited its monetary authority independence.

***ii. Loss of seigniorage revenue***

The major cost of dollarization especially to a country like Zimbabwe that has been generating revenue through money printing for economic survival over the years, is forfeiture of a potential tool for underwriting public expenditures, that is, the forgoing of the capacity to create money, otherwise known as seigniorage. Seigniorage is the interest income a central bank earns by issuing non-interest bearing money to buy interest-bearing assets (Burdekin, 2008). A country's central bank is part of its government; hence that income is part of the government's revenues. When a country officially dollarizes, its central bank has to withdraw the local currency from circulation and replace it with US dollars or the anchor currency. To get those US dollars, the central bank will have to sell some of its assets, normally interest-bearing, US dollar-denominated assets. The result is that the central bank's interest income declines.

In other words, seigniorage can thus be considered as an alternative source of revenue for the state beyond what can be raised via taxation or by borrowing from financial markets at home or abroad. What cannot be paid for with tax receipts or borrowed funds can be paid for, in effect, by money-printing. Dollarization automatically terminates that revenue unless explicitly offset by some kind of agreed formula for seigniorage sharing with the anchor country. But once again, in reality, the potential loss of seigniorage will be smaller; the greater is the degree of prior informal dollarization. In the case of Zimbabwe with wide spread informal dollarization, this loss will thus be very small.

***iii. Loss of the ability to use inflation tax***

Although somewhat close to the above drawback, with dollarization, a country will lose its ability of using the inflation tax ("revenue of last resort") by printing money in a national emergency. Normally, a government levies an implicit inflation tax when it issues too much new money that it generates inflation. With inflation, the real value of money will diminish over time; thus inflation behaves like a tax levied on those who hold the local money. When a country officially dollarizes, its government can no longer issue new money, so it can no longer use the inflation tax (Meyer, 2000). Zimbabwe has heavily been using this inflation tax for the past few years (2004 – 2008) and adoption of dollarization will surely be a cost.

*iv. Loss of lender of last resort*

Dollarization relinquishes the formal lender of last resort function of the dollarizing country (through its central bank) since in adopting a foreign currency, the latter country also gives up a central bank capable of discounting freely in times of financial crisis. Theoretically, it follows that domestic banks may become more exposed to potential liquidity risks. In practical terms, however, this alleged cost could be rather easily offset by a number of channels. First, dollarization normally eliminates or minimizes the overall need for international reserves, given that a share of external transactions that previously used to involve foreign currency can now be treated as the equivalent of domestic transactions. Thus, a percentage of the central bank's dollar assets could then be devoted to a public stabilization fund that will bail out domestic financial institutions under stress. Another channel is that a contingency fund could be built up over time from tax revenues, or flexible credit lines with foreign banks or monetary authorities could be negotiated, using future tax revenues or seigniorage sharing as collateral. Thus in reality, this disadvantage is not a serious drawback for Zimbabwe if it considers adopting dollarization<sup>17</sup>.

*v. Unable to adjust exchange rate in critical circumstances*

The country will be unable to adjust its exchange rate in peculiar circumstances when that might be helpful to its economic activities. In effect, the fact that the economies of the anchor and dollarizing countries generally differ, requires that, appropriate policies, including exchange rate adjustment be tailor-made to suit the dollarizing country scenario. This loss of control over exchange rate policy may expose the country's economy to external shocks such as primary commodity prices and food price, especially given that the world trading system is likely to open up further due to globalization.

### **3.1.3.2 Political costs**

*i. Loss of nation symbol*

Among the most tangible national symbols which differentiate one country from the rest includes flags, national anthems, postage stamps, public architecture and money being one of the most potent one. According to Cohen (2000), the ability of money to symbolize the uniqueness of national identity stems from two ways. Firstly, since the government or its central bank issues its preserved currency notes, money plays the role of reminding citizens on daily basis of their loyalty, connectedness and oneness with the country. Secondly, the fact that it is pervasively used on daily transactions, a currency highlights the fact that everyone is part of the same social entity. Thus adoption of

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<sup>17</sup> The situation of the loss of lender of last resort in a set up like a monetary union is slightly different with the one when a country dollarize. In the former, regional monetary policy to be implemented in signatory members is normally crafted by all participating regional members and there will be clearly laid out rules regarding the function of lender of last resort.

foreign currency through dollarization entails loss of these prerogatives. Specifically, given Zimbabwe government's foreign policy thrust of sovereignty, this will be a major blow not only to its national symbol but also to its sovereignty.

*ii. Loss of insurance against risk*

Zimbabwean government whose budget has over the past years depended heavily on money printing, preservation of a national currency acts as a kind of insurance policy against risk, where seigniorage is a marginal source of revenue for the state. Although money printing has wrecked havoc in accelerating hyperinflation in Zimbabwe, it can however serve as an emergency source of revenue in the face of genuine problems, thus providing an option of finding needed purchasing power quickly when confronted with unexpected contingencies. With seigniorage, needed resources can be gathered together instantaneously without being forced to wait for tax returns to be filed or loans to be negotiated. Referring to seigniorage, Keynes (1920) noted that, “A government can live by this means when it can live by no other.” Thus, adoption of another currency means this privilege will be completely eroded away.

*iii. Foreign policy and diplomacy*

From a foreign policy and diplomatic perspective, the ability of any sovereign state to have its own national currency reduces the risks of external dependence or threat. Autonomous national monetary authority ensures that a country will not rely on external sources for its most vital economic resources. With full dollarization, this insulation is lost. At the same time, the anchor country whose money is used to dollarize in the dollarizing country gains an authoritative device, which it can employ to influence the dependent dollarized economy. For instance, in the CMA, South Africa's monetary policy and changes in exchange rate influence monetary policy and exchange rate changes in Namibia and Lesotho. Given that these countries use South African Reserve Bank (SARB) as their lender of last resort, when interest rates are changed in South Africa, CMA member countries automatically and instantly change their rates to reflect the changes done by South Africa.

**3.1.3.3 Factors to be considered in assessing Zimbabwe's readiness for dollarization**

Given that Zimbabwe is coming out of severe hyperinflation, and that dollarization provides a possible panacea to restore credibility and confidence in the monetary system, it is important to digest the various criteria to assess the extent to which the country is ready to dollarize. To this end, this section provides some factors that need to be considered.



### 3.1.3.3.1 Monetary related factors

#### *i. Policy credibility*

Countries where historical evidence especially in the monetary area shows that policy makers have suffered from a lack of policy credibility, are potential beneficiaries of rule-based monetary regime such as a currency board or dollarization given these systems' imposed discipline. Lack of policy credibility is normally measured by looking at some of the following variables: the country's experience with inflation (with Zimbabwe having been through hyperinflation); a past history of exchange rate instability and crises (with Zimbabwe having to deal with over seven exchange rates ranging from the official, bank, parallel market, gold, tobacco, import/export rate among others)<sup>18</sup>; the existence of previous financial and banking crises (with Zimbabwe having placed at least five banks<sup>19</sup> under curatorship since 2004); the degree of unofficial dollarization (where between 2006 and 2008 use and application of foreign currency in any transaction was a street choice free for any scenario); the country's inability to borrow long-term in domestic currency (with borrowing being a major liability in Zimbabwe from any bank or micro finance institution); and a defunct fiscal record characterized by high budget deficits (with Zimbabwe's deficits have been averaging more than six percent of the country's GDP since 1999 according to figures from RBZ). In a nutshell, all these variables perfectly suit the situation of Zimbabwe for the past five or so years. Hence, judging by this criterion, Zimbabwe is ripe for either formal dollarization or currency board.

#### *ii. History of monetary instability*

Generally, countries that need the most imposed rules, for instance through adoption of dollarization are those that have had a history of monetary instability. Specifically, dollarization is considered as the most appropriate for countries that have had high monetary instability but now have a competent and stable governments or are in the process of instituting such government with deep popular support that are determined to commit to rigid monetary rules to maintain long-run policy stability. Zimbabwe situation portrays this description, and as such, is a suitable candidate for dollarization.

#### *iii. Current exchange rate regime*

Although a country can adopt dollarization starting from any exchange rate regime, a successful past experience with credibly fixed exchange rates is a step forward. Past experience with fixed exchange rates, according to Roubini (2001) indicates three things. Firstly, it signals that the country has already shown its commitment to a stable currency. Secondly, it indicates the country's willingness to pay any costs associated with fixed exchange rates, and lastly, it is a sign to indicate that the country will unlikely experience

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<sup>18</sup> These rates have been applied especially between 2004 and end of January 2009 at different time periods

<sup>19</sup> According to RBZ, the following banks have been once (or are currently) under curatorship: Barbican Bank, CFX Bank, Royal Bank, Time Bank, Trust Bank

further large costs from giving up altogether a national currency. Another advantage of previous implementation of fixed exchange rates is that the additional transitional costs associated with moving to dollarization from fixed rates are lower than when starting from more flexible exchange rate regimes. Zimbabwe, although its previous and current fixed exchange rates regimes have not been successful, it nonetheless has implemented these policies with the intention of stabilizing its currency. Thus, to a greater extent, the country, by inferring from this requisite factor is a potential candidate for dollarization.

***iv. Reserve coverage of monetary base***

Theoretically, literature points that another criterion for dollarization is that the foreign exchange reserves of the country to implement dollarization should at least cover the monetary base (or the currency in circulation)<sup>20</sup> (Roubini, 2001). Nevertheless, one branch of literature suggests that potential countries for dollarization which do not satisfy this requirement may consider borrowing the necessary reserves from official or private creditors (Meyer, 2000). These reserves are needed to convert the money base into US dollars (after dollarization). Currently, Zimbabwe's foreign currency reserves have been exempt for a number of years to such an extent that the country struggle to buy (or import) essential products such as medicine and electricity, among other imports. IMF (2009) statistical figures shows Zimbabwe gross official reserves at US\$58 million and US\$5.8 million for the end of year periods 2007 and 2008, respectively. At the same time, no rational official or private creditors are currently willing to lend to the current Zimbabwean government. However, international creditors<sup>21</sup> have indicated willingness to provide credit lines only to business entities were they are assured of getting profitable returns at mutually agreed rates. Thus by considering this criterion, dollarization in Zimbabwe may be successful.

***v. Soundness of the banking system***

Existence of a sound, competitive, well supervised and well regulated banking system is an important ingredient for the successful implementation of dollarization. A weak banking system may lead to financial panic and serious economic distress in the case where the banking sector experiences systemic crises that are fiscally costly especially given the absence of a strong lender of last resort facility under dollarization. However, this weak banking system maybe helped by the presence of foreign banks<sup>22</sup> in a dollarizing economy and in the case of Zimbabwe, presence of foreign banks will also go a long way in stabilizing the country's financial sector whose banking sector has been generally weak. For foreign banks play the important roles of reducing the risk of banking crises and providing implicit lender of last resort support through home country

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<sup>20</sup> Whether this will be sufficient or not will depend of the country's import basket

<sup>21</sup> These includes creditors from South Africa and China

<sup>22</sup> It is important to note that although these foreign banks, other than having good capital, may bring into the country bank risk management best practices; the assumption is that their positive contribution will outweigh their negative contribution to the overall economy and financial sector.

head offices. Currently, foreign banks operating in the country includes Barclays, Standard Chartered, Stanbic, among others, and these may act as stabilizers. Thus, presence of these foreign banks makes Zimbabwe a potential candidate for dollarization.

***vi. Extent of informal dollarization***

The greater is the magnitude of unofficial dollarization, the smaller will be the benefits of exchange rate devaluation and the greater are will be the potential benefits of formal dollarization. In a situation where the US dollar (or other currencies) is already used as a unit of account, means of payment and store of value, the costs of a transition to formal dollarization will be minimized. Zimbabwe is currently 100 percent (unofficially) dollarized, and thus any formalization will just cement the current situation. Thus, according to this requisite fact, Zimbabwe is currently the most ideal candidate for dollarization.

***vii. Ability to provide lender of last resort functions after dollarization***

Although dollarization limits a country's central bank's ability to provide lender of last resort services to its banking system, such a function can be performed even in a dollarized economy through a variety of channels. First, in the case where foreign reserves are in excess of what is normally needed to cover the monetary base, such excess reserves can be used to cover some components of monetary aggregates including demand deposits and other longer-term liquid liabilities of the banking system. For Zimbabwe, this option is not available given that its foreign currency reserves have long dried up. Second, the country instituting dollarization can build liquid reserves through borrowing either from the private sector (private contingent credit lines) or from the international financial institutions. Such international institutions in the case of Zimbabwe include International Monetary Fund (IMF), African development Bank (AfDB), among other potential institutions. Again, this option may not be available for Zimbabwe given that no rational lender is currently willing to lend money to Zimbabwe because of the previous government's mismanagement<sup>23</sup>. Third, changes in reserve requirement ratios<sup>24</sup> may provide further liquidity to a banking system under pressure. This may be a possible available option for Zimbabwe if it dollarize. Fourth, in the situation where there is provision of seigniorage revenue-sharing arrangement with the anchor currency's country, the discounted value of the stream of future seigniorage payments could be used as collateral for lines of credit with private and/or official creditors. This option is to be debated between Zimbabwe and the country with the

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<sup>23</sup> Some countries such as China have however indicated willingness of lending to Zimbabwe despite the latter country's mis-management. China's willingness may be strategic, given its interest in Zimbabwe's mining and infrastructure projects.

<sup>24</sup> Reserve requirement ratio (RRR) is the percentage of deposited money that a bank is required (by monetary authorities, e.g., RBZ in case of Zimbabwe) to keep and not to lend in the form of loans. For instance, is the RRR is 10 percent, it means that for a \$10 deposited, a bank will be allowed only to lend a maximum of \$0.90 and keep \$0.10 in its coffers (or lodge it with central bank). This RRR is required to ensure than depositors will get their cash at any time they visit the bank for withdrawal.

currency to be adopted in case Zimbabwe decides to formally dollarize, and as such we consider it not available as of now.

**viii. *Revenue cost of seigniorage loss***

Dollarization that occurs without seigniorage-sharing with the anchor currency would imply a revenue cost in the form of seigniorage revenue loss. For countries in which seigniorage accounts for a significant fraction of government revenues, such loss has serious fiscal consequences and needs to be compensated by an increase in non-seigniorage revenues. If seigniorage revenues are significant, this switch in sources of revenue may require tax reforms to reduce a structural reliance on seigniorage. In the absence of revenue-sharing, the seigniorage loss is partly reduced if the dollarized country imposes non-remunerated reserve requirements on its banking system (essentially another form of taxation of banks) and thus the central bank can earn the interest rate on the non-currency component of the monetary base. To mitigate this potential revenue loss, the Zimbabwe government can impose the non-remunerated reserve requirements.

**ix. *Central bank solvency in the absence of seigniorage sharing***

Another version of seigniorage loss to be well thought-out is how such a loss affects the solvency of the central bank of a dollarizing economy. Under normal circumstance, the discounted value of future seigniorage is considered as an asset for the central banks, which does not appear in the current balance sheets of central banks. This generally means that central banks officially have often negative net worth and this will not be a worry in a case where a country has its own currency since the discounted value of the stream of seigniorage revenues is a substantial asset that is not shown in such balance sheets. In the case of Zimbabwe, its central bank's balance sheet shows negative net worth, a situation that indicates insolvency of the RBZ. This apparent insolvency of RBZ becomes a hurdle if Zimbabwe decides to dollarize, especially in the case where seigniorage will not be shared with the anchor country and in such a case a negative net worth of RBZ will become a real form of insolvency. Thus, the ability of RBZ to provide credible lender of last resort services (if authorized to do so by dollarization imposed rules) may thus be further undermined. Using this criterion, implementation of dollarization by Zimbabwe may not be a successful adventure.

**x. *State of public finances***

The greater is the budget deficit and the stock of public debt, the greater will be the risk that dollarization might fail. This comes from the fact that unsustainable fiscal conditions may eventually tempt policy makers to reverse dollarization, return to a domestic currency so as to be able to run again the printing process and regain access to the inflation tax. At the same time acute fiscal problems may also weaken the confidence of

the public in the fiscal authorities and lead to a foreign debt-related financial crisis where the country may end up stopping honouring financial creditors<sup>25</sup>. Zimbabwe is currently one of the countries with very high budget deficit and stock of public debt<sup>26</sup> as well as severe fiscal problems caused among other things by persistence hyperinflation in the past few years. Thus using this criterion, implementing dollarization may not achieve the desired end.

### 3.1.3.3.2 Supply side and trade related factors

#### *i. Ability to successfully pursue counter-cyclical monetary policy<sup>27</sup>*

Literature on the subject matter has suggested that some small open economies with a history of high inflation and high exchange rate volatility are normally unable to use monetary policy for countercyclical purposes. Generally, presence of a combination of unofficial dollarization, lack of policy credibility and wage indexation<sup>28</sup> are some of the complex issues which may render monetary policy ineffective to counter cyclical shocks. The ability of Zimbabwe on this factor is difficult to access, especially given that ever since the high inflationary period there have been a number of factors bedeviling the country to such an extent that its monetary policy has been reduced to printing money and instituting some caveat policies to chase the few US dollars earned by exporters. By and large, the country has not shown any ability to pursue counter-cyclical monetary policy to date, although there is a higher possibility of such policies in the near future especially with the new government of national unity (GNU)<sup>29</sup>.

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<sup>25</sup> A good example is Mexico's 1982 foreign-debt crisis. The Mexican government borrowed heavily from foreign sources to such an extent that its foreign debt was around US\$70 billion in January 1982 and increased to US\$80 billion by October same year. Because the country could not repay the foreign debt accord to time lines, on 6<sup>th</sup> September 1982, it suspended all payments that we done to recoup foreign debt (Mabry, 1982)

<sup>26</sup> Zimbabwe's total external debt was US\$5.3 billion (or 149% of GDP) by end of 2007, US\$6 billion (or 185% of GDP) and is estimated to be US\$6.5 billion (or 185% of GDP) by end of 2009, IMF (2009).

<sup>27</sup> Counter-cyclical policies are aimed to go in opposite direction with trends in economic activities. A good example is the ball-out packages that have been rolled out by European countries and USA over the past few months. As a result of downward trends (recession) in these countries, such things as low product demand and rise in unemployment, these governments has instituted counter-cyclical policies in the form of ball-outs to come out of these problems, For UK, the 'scrap car' scheme were citizens are given advanced 2000 pound sterling by a government scheme for purchase of a new car is aimed at stimulating the low car sales. This increased demand will encourage more production, which in turn will mean more people employed. USA and Germany are some of the countries which have these 'scrap car' schemes (though in various names).

<sup>28</sup> Wage indexation refers to a situation were the percentage increase in wages reflect percentage increase in inflation. A one-on-one indexation means that if inflation increase by 20%, wages will also increase by 20%.

<sup>29</sup> On 13<sup>th</sup> February 2009, Zimbabwe's major political parties formed a coalition government, popularly called government of national unity (GNU)

**ii. Correlation of the business cycle with the anchor currency's country**

In a situation where the dollarized country's business cycle is highly correlated with the one of the anchor country there will be no need for exchange rate adjustment. With such synchronization, any shock hitting a common currency area will be common to all the economies in the area. As such there will be reduced need (if any) for currency adjustment and in such a situation the monetary policy of the anchor country will likely be appropriate for the dollarized economy. The extent of business cycle synchronization between the dollarizing and anchor countries in turn depends on real and structural factors such as the degree of trade integration and the similarity in production structure between the two countries. As alluded to in the immediate previous paragraph, due to chaotic structural changes which happened in Zimbabwe since 2000 to date, there has not been any serious business cycle to talk about since production has been dwindling year after year. Thus, under this criterion, one can safely say the country's business cycle is not synchronized to any of the potential two anchor countries (United States and South Africa).

**iii. Trade integration with the anchor currency's country**

Existence of a potential dollarizing country's greater share of its exports and imports that is accounted for by trade with the potential anchor country, the better it will be for the former country to dollarize. This is important as it will ensure that the dollarizing country economically linked to the anchor country, hence in such as case adopting the latter country's currency will likely work for the former part. Financial and capital integration also correlate with trade integration. Although there is not much in terms of volumes from Zimbabwe's side in these variables, the country is however highly integrated with South Africa, and not USA, in its trade interactions<sup>30</sup>. Considering this criterion, one can conclude that Zimbabwe is a potential candidate for dollarization using South Africa as the anchor country and the latter country's rand as the chosen currency to dollarize with (that is, randization).

**iv. Vulnerability to terms of trade shocks**

Vulnerability to terms of trade shocks is normally greater for countries whose exports are concentrated in a narrow range of often-primary commodity exports. A small country and a price taker<sup>31</sup> in the market for exports and imports imply that the country may not be able to modify its terms of trade. Under such circumstances, the benefits of dollarization

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<sup>30</sup> For the five year period, 2000 to 2004, Zimbabwe exported an annual average of US\$576 million worth of products to South Africa and US\$73.4 million to USA. For the same period, the country's annual average imports were US\$917 million from South Africa and US\$57.4 million from USA (TIPS database. Available at: [www.tips.org.za](http://www.tips.org.za).)

<sup>31</sup> Price taker in this case means that prices for export products from Zimbabwe are determined at world market through demand and supply, and Zimbabwe will only either take the price or leave it (it can not set the price say for its tobacco, cotton, gold etc)

will be potentially larger for such a small open economy<sup>32</sup>. Zimbabwe's main exports (though they are currently at minimum levels) are primary commodities including tobacco, sugar and cotton. Thus, inferring from this criteria, the country is a suitable candidate for dollarization.

### **3.1.3.3.3 Other factors**

#### ***i. Flexibility of labour markets***

Enough flexibility in labor markets implies that any external shocks which require a change in real wages and/or mobility of labor across sectors will not have lasting effects on the rate of unemployment. This flexibility may include the following types: (i) downward flexibility of nominal wages (to induce a reduction in real wage if that is required), (ii) labor mobility across sectors and regions if changes in relative prices require a reallocation of factors of production, and (iii) low hiring and firing costs to ensure labor market flexibility (Roubini, 2001). Although there may be some rigidities in Zimbabwe's labour market, generally, the country has relatively enough labour market flexibility and thus judging by this factor, the country is ready for dollarization.

#### ***ii. Degree of labour migration***

Although free labour mobility between the country considering dollarization and the anchor country is an important, such free mobility is generally ruled out as there are restrictions on cross-national labor migration. Nevertheless, in practice the degree of labor mobility may be significant as there will also be a significant number of legal (and illegal) temporary and permanent migrant workers who can move between the anchor country and their country of origin. This is the present situation between Zimbabwe (the potential country to dollarize) and South Africa (the potential anchor country). It is believed that there are currently more than three million Zimbabweans (a quarter of the population) living and working in South Africa, both on legal and illegal basis, with the latter migrants being the majority. Thus, one can safely say, there is relatively less restrained labour mobility from Zimbabwe into South Africa and more so with South Africa having suspended visa requirements for Zimbabwe seeking to enter or work for shorter period of 90 days or less.

#### ***iii. Degree of capital mobility***

Successfulness of dollarization is also enhanced by a higher degree of capital mobility into the dollarizing economy, with capital mobility measured by flows of inward foreign direct investment (FDI). For the past decade, there has been no meaningful inward FDI

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<sup>32</sup> One measure of openness used in literature is percentage ratio of total trade (exports plus imports) to GDP. For the time analyzed in this study (i.e., 2000 to end of January 2009), Zimbabwe's annual openness ratio was averaging above 67% using IMF database.

into Zimbabwe due to a number of factors including political, hyperinflation and general mismanagement of the economy. Thus, according to this criterion and as of now, implementation of dollarization may not be successful<sup>33</sup>.

*iv. Implicit or explicit fiscal federalism and income insurance schemes*

In a domestic currency union, for instance USA's federal system, misfortunes experienced in one region are squarely (or partly) compensated by a federal (or central) system of tax and transfers. With dollarization, such an automatic insurance scheme disappears, as monetary integration will not be associated with fiscal integration since the dollarizing and anchor countries will be having different fiscal policies. However, there may be some implicit forms of income insurance that may still be at work. For instance, if a dollarizing country has a large number of migrant workers in the anchor country, worker remittances may be an important source of income for the dollarizing economy. Zimbabwe is fortunate to have a sizeable proportion of its working population (nearly 50 percent of its labour force) working in diaspora, including such countries as South Africa, UK, Botswana, to mention just a few countries. Although Zimbabweans in diaspora have been sending remittances, they have not been sending them through formal banks or money transfer channels due to the perennial central bank (RBZ) fixed exchange rate which individuals have rationally evaded for their unfairness (Bracking and Sachikonye, 2008). Most Zimbabweans have been sending money through bus drivers (especially those in South Africa), relatives and other money transfer agencies whose exchange rates were closer to the daily black market foreign exchange rates that were prevailing in Harare at the time of sending the money. Nevertheless, if the country formally dollarize, they will not be any problem with exchange rate and there is 100 percent probability that these remittances may come into Zimbabwe through formal bank channels.

*v. Political factors*

The success of dollarization requires a high level of majority support. Normally, countries entangled in deep political divisions, with significant political minorities opposed to dollarization, countries that lack stable democratic institutions; with a history of political turmoil may not be good candidates for dollarization. In such a situation, there will not be any political support for dollarization and there would be a greater probability that groups opposed to dollarization may at some point reverse the dollarization when they come to power. Zimbabwe at present is caught up in a dilemma where confidence in the use of the local currency has been eroded. Business and industry are pressuring for dollarization. Opposition to adoption of dollarisation might come from politicians who have been direct beneficiaries of the skewed predicament of hyperinflation obtaining the foreign currency at close to ridiculous, subsidized exchange rates.

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<sup>33</sup> This may however change particularly if property rights issues via the empowerment legislation are addressed. This was the case with post conflict countries such as Angola, Mozambique have seen a surge in their natural resource sectors such as oil; gas etc. Zimbabwe relatively good financial and physical infrastructure could support this trend well.



Given the above analysis, Table 2 therefore provides a summarized version of the country's readiness for dollarization from the arguments presented above.

**Table 2: Zimbabwe's readiness for dollarization**

<b>Criterion Factor</b>		<b>Ready</b>
<b>Monetary, financial and fiscal factors</b>		
<b>1</b>	Policy credibility	Yes
<b>2</b>	Inflation experience	Yes
<b>3</b>	Current exchange rate regime	Yes
<b>4</b>	Reserve coverage of monetary base	No
<b>5</b>	Soundness of the banking system	Yes
<b>6</b>	Extent of informal dollarization	Yes
<b>7</b>	Ability to provide lender of last resort functions after dollarization	No
<b>8</b>	Revenue cost of seigniorage loss	Yes
<b>9</b>	Central bank solvency in the absence of seigniorage	No
<b>10</b>	State of public finance	No
<b>Supply side and trade related factors</b>		
<b>11</b>	Ability to successfully pursue counter-cyclical monetary policy	No
<b>12</b>	Correlation of the business cycle with the South Africa (or USA)	No
<b>13</b>	Trade integration with South Africa (or USA)	Yes
<b>14</b>	Vulnerability to terms of trade shocks	Yes
<b>15</b>	Openness to trade	Yes
<b>Other factors</b>		
<b>16</b>	Flexibility of labour markets	Yes
<b>17</b>	Degree of labour migration	Yes
<b>18</b>	Degree of capital mobility	No
<b>19</b>	Implicit or explicit fiscal federalism and income insurance schemes	Yes
<b>20</b>	Political factors	No
	<b>Overall Readiness</b>	<b>YES</b>

**Source:** author summary from analysis presented above

### **3.2 Option 2: Joining Common Monetary Area (CMA)**

Another possible option that Zimbabwe can consider is to join the Common Monetary Area (CMA) currently consisting of South Africa, Lesotho, Namibia and Swaziland. In such a system, Zimbabwe will adopt the South African rand as the legal tender, operating alongside the local currency, the Zimbabwean dollar on a one-to-one exchange rate with the South African rand.

### **3.2.1 Pros and Cons of joining CMA**

#### ***3.2.1.1 Advantages of joining CMA***

The advantages of joining CMA are almost the same as those explained under dollarization and are just listed to include the following:

- i. Lower inflation rates
- ii. Reduced administrative expenses
- iii. Low interest rates
- iv. Stimulation of domestic long-term capital markets
- v. Reduced financial fragility
- vi. Lower transaction costs

#### **3.2.1.2 Disadvantages of joining CMA**

##### ***i. Possibility of not accepted***

One big problem with this option is that CMA countries may not accept to admit Zimbabwe as one of its potential CMA member. Whether the reasons will be political or otherwise, there is a strong possibility of this happening. The truth of the matter is that the CMA is already a “moving ship”, with its evolved and long established goals, rules, preferences and oneness that may not be altered without vigorous and protracted negotiations.

##### ***ii. Loss of monetary policy autonomy***

Given the historic evolvement of CMA, currently the monetary policy formulated by the South African government, specifically for its economic is by default applied in the other CMA member countries. Thus joining CMA will imply that Zimbabwe will forfeiture its monetary policy autonomy to South Africa, without any guarantee that its specific needs will be taken into account.

##### ***iii. Seigniorage loss and revenue sharing formula***

Another potential problem will be on how to deal with the issue of revenue sharing. Currently, the formula has been agreed upon as reflected in the CMA agreement, and this formula has taken the interests of all CMA members into account. Now when Zimbabwe decides to join, this issue will have to be amicably negotiated and that might result in some problems and reduction of seigniorage revenue to Zimbabwe.

### 3.3 Option 3: Reintroducing the Zimbabwean dollar

The other option will be to reintroduce the Zimbabwean dollar (Z\$) instead of opting for another currency (e.g., US\$ or rand) or currency system (e.g., joining the CMA). Nevertheless, given the loss of credibility of the local currency in sight of the majority citizens, its come back can only be viable when a management system has been put in place to ensure that the currency will not return to the same problems which forced the country to abandon it in the first place. This section therefore details three possible management systems that the country can consider to institute for the sake of managing the reintroduced Zimbabwean dollar. These systems are the currency board, free banking and central bank (RBZ).

#### 3.3.1 System 1: Currency board

*In the beginning God created sterling and the franc. On the second day He created the currency board and, Lo, money was well managed. On the third day God decided that man should have free will and so created the budget deficit. On the fourth day, however, God looked upon His work and was dissatisfied. It was not enough. So, on the fifth day God created a central bank to validate the sins of man. On the sixth day God completed His work by creating man and giving him dominion over all God's creatures. Then, while God rested on the seventh day, man created inflation and the balance-of-payments problem (Peter B. Kenen, 1978: 13))*

An orthodox currency board arrangement is a monetary system where the board issues domestic notes and coins that are fully backed by sufficient holdings of a foreign reserve currency, thus making the domestic currency convertible on demand into a foreign anchor currency at a fixed exchange rate. The foreign currency reserve levels are normally set by law and are equal to 100 percent, or slightly higher, of the country's monetary liabilities (notes, coins, and if permitted deposits) (Hanke, 2002a). Thus, under this system, the currency board does not actively determine the monetary base, but rather the referred fixed exchange rate and the required 100 percent holdings of foreign currency to back domestic currency convertibility preclude the board from changing (increasing or decreasing) the monetary base at its own discretion. The main responsibility of the currency board therefore is to convert the domestic currency it issues into the anchor foreign currency at a fixed exchange rate. As such, the amount of domestic currency circulating in the market is a function of the invisible hand that is the forces of demand and supply for the domestic currency.

Although this system outlaws independent monetary policy, it however permits earned seigniorage revenue gained through investing the foreign reserve holding in interest-bearing paper, like U.S.A treasury bills. Burdekin (2008) argues that this system permits small economies reap the benefits of seigniorage without necessarily compromising the discipline afforded by being linked to the opted foreign currency anchor.

### 3.3.1.1 Salient features of currency board

The salient features of a currency board are summarized in Table 3. To put these self-explanatory important characteristics into comparative scenario, parallel features of a typical central bank are also presented in the same table.

As the table shows, a currency board presents features that are normally propagators of economic stability, especially in the case where the central bank has totally failed to discharge its mandate of being a pillar of economic viability and prosperity through its monetary policies. For Zimbabwe, to help contextualize the extent to which the central bank has failed to be a pillar of the country's economic success, but rather has acted as an agent to the country's economic demise, information on each feature of the country's central bank has been bracketed as shown in column three (3) of the table. Thus, given this extremely poor performance of Zimbabwe's Central Bank and at the same time, the fact that, "All currency boards have performed well, when compared to central banks" (Hanke, 2002), it becomes paramount for the country to consider adoption of such a system.

**Table 3: A typical currency board versus a typical central bank**

	<b>Typical Currency Board</b>	<b>Typical Central Bank</b>
<b>1</b>	Usually supplies notes and coins	Supplies notes, coins, and deposits ( <i>Until end of January 2009 rue for Zimbabwe, though RBZ had voluntarily stopped supplying coins since they have been rendered void</i> )
<b>2</b>	Fixed exchange rate with reserve currency	Pegged or floating exchange rate ( <i>Zimbabwe used to have pegged exchange rate before multi-currency regime</i> )
<b>3</b>	No conflicts between exchange rate policies and monetary policies	Frequent conflicts between exchange rate policies and monetary policies ( <i>currently true for Zimbabwe</i> )
<b>4</b>	No balance of payments crisis	Frequent balance of payment crisis ( <i>replicates the Zimbabwean scenario</i> )
<b>5</b>	Foreign reserves of 100 percent	Variable foreign reserves ( <i>currently zero reserves for Zimbabwe</i> )
<b>6</b>	Cannot become insolvent	Can become insolvent ( <i>reflective of Zimbabwe</i> )
<b>7</b>	Does not hold domestic assets	Does hold domestic assets ( <i>looking at RBZ's Balance sheet, its currently true for Zimbabwe</i> )
<b>8</b>	Full convertibility	Limited convertibility ( <i>Zimbabwe's currency was non-convertible</i> )
<b>9</b>	Rule-bound monetary system	Discretionary monetary system ( <i>This was true in the case for Zimbabwe</i> )
<b>10</b>	Not a lender of last resort	Lender of last resort ( <i>The Central Bank holds that function in Zimbabwe</i> )
<b>11</b>	Does not regulate commercial banks	Often regulates commercial banks ( <i>the RBZ has recurrently regulated the operations of Commercial Banks</i> )
<b>12</b>	Transparent	Opaque ( <i>in the Zimbabwe case, currently no openness exists,</i>

		<i>rather the institution appears to be run by instinct)</i>
13	Immune from corruption scandals	Prone to corruption scandals ( <i>a number of corruption scandals involving RBZ officials have been reported</i> )
14	Protected from political pressure	Politicized ( <i>In Zimbabwe, RBZ is highly politicized and currently controlled by one political party</i> )
15	High credibility	Low credibility ( <i>No credibility in the case of Zimbabwe</i> )
16	Earns seigniorage only from interest	Earns seigniorage from interest and inflation ( <i>True for Zimbabwe as it used to earn from inflation and inflation tax</i> )
17	Cannot create inflation	Can create inflation ( <i>in Zimbabwe the Central Bank has largely been viewed as the main agent fueling hyperinflation</i> )
18	Cannot finance spending by domestic government	Can finance spending by domestic government ( <i>over the past few years, RBZ has saliently financed the domestic government</i> )
19	Requires no preconditions for monetary reform	Requires preconditions for monetary reform ( <i>each monetary presentation has been coupled with monetary reform thus reactive to the existence of certain preconditions</i> )
20	Rapid monetary reform	Slow monetary reform
21	Small staff	Large staff ( <i>Zimbabwe's RBZ staff is not only large, but the bank has had a massive staff increase of 120 percent between 2001 to 2007, from 618 to 1 360 employees</i> )

Source: Hanke (2002, p. 90) and author compilation

As alluded before, all countries to date which have implemented currency boards have witnessed positives changes in their economic performances following adoption of such monetary systems. A snapshot of some of the countries that instituted currency boards, as shown in Table 4 indicates that their economic variables changed for the good after implementation of such an arrangement. In all countries tabulated, their respective inflation trends declined from as high as four digits (or triple or double) to single digits. At the same time, their respective GDP growth rates shifted from negative rates to positive growth rates. Thus, these experiences are a true testimony that currency boards can help a country out of hyperinflationary trend and also from declining economic growth.

**Table 4: Before and after implementation of a currency board**

Year	Argentina (1 <sup>st</sup> April 1991)		Estonia (20-24 June 1992)		Lithuania (1 <sup>st</sup> April 1994)		Bulgaria (1 <sup>st</sup> July 1997)	
	Inflation (%)	GDP growth (%)	Inflation (%)	GDP growth (%)	Inflation (%)	GDP growth (%)	Inflation (%)	GDP growth (%)
1989	4,923.6	-7.0	n/a	n/a	n/a	n/a	69.6	-0.5
1990	1,343.9	-1.3	23.1	n/a	n/a	n/a	64.3	-9.1
1991	<b>84.0<sup>a</sup></b>	<b>10.5</b>	210.5	n/a	n/a	n/a	4,027.8	-10.8
1992	17.5	10.3	<b>1 076</b>	<b>n/a</b>	1 175	n/a	79.4	-8.4
1993	12.6	6.3	89.0	n/a	188.4	-16.2	63.8	-11.6
1994	3.9	5.8	47.7	-1.6	<b>44.9</b>	<b>-9.8</b>	121.9	-3.7
1995	1.6	-2.8	29.0	5.0	35.7	1.2	32.9	-1.6

1996	0.1	5.5	23.1	5.0	14.9	5.1	310.8	-8.0
1997	0.3	8.1	11.2	10.8	8.5	8.5	<b>549.2</b>	<b>-5.8</b>
1998	0.7	3.9	8.2	5.4	3.1	7.5	1.6	4.1
1999	-1.8	-3.4	3.3	-0.1	0.4	-1.5	7.0	2.3
2000	-0.7	-0.8	4.0	9.6	1.6	4.1	11.3	5.4
2001	-1.5	-4.4	5.8	7.7	2.1	6.6	4.8	4.1
2002	41.0	-10.9	3.6	7.8	-0.9	6.9	3.8	4.5
2003	3.7	8.8	1.3	7.1	-1.3	10.3	5.6	5.0
2004	6.1	9.0	3.0	7.5	2.8	7.3	4.0	6.6
2005	12.3	9.2	4.1	9.2	3.0	7.9	7.4	6.2
2006	9.8	8.5	4.4	10.4	4.5	7.9	6.1	6.3
2007	8.5	8.7	6.6	6.3	8.2	8.9	11.6	6.2
2008	9.0	6.5	10.2	-1.5	9.2	3.9	9.6	6.3

**Source:** International Monetary Fund, World Economic Outlook database

**Note:** “a” a bold figure marks the year in which a currency board was implemented

### 3.3.1.2 Benefits and drawbacks of a currency board

#### 3.3.1.2.1 Advantages of a currency board

##### *i. Disciplined monetary policy rule*

The most important advantage of currency boards is that they replace a disciplined monetary policy rule (a gold standard without gold) for an undisciplined discretionary monetary policy, thus extinguishing the inflationary tendencies of the latter. To a country like Zimbabwe which is coming out of man-made hyperinflation environment, this possible advantage will be a great achievement for the country.

##### *ii. Fiscal discipline*

Another benefit of currency boards is that they ensure fiscal discipline since the currency board law prohibits any money printing to directly finance government expenditures. This benefit emanates from a combination of the fact that the monetary policy rule of the currency board restricts the scope for credit expansion, and also that the monetary authorities will be sensitive to external visibility and the fact that it will be costly to devalue in a fixed exchange rate regime. Due to the indiscipline characteristic of the RBZ through money-printing and lethargic policy implementation fiscal discipline has since been wanting. Thus, any system which tries to restore fiscal discipline is needed as a matter of urgency in the Zimbabwean economy.

***iii. Possibility of stringer political will underpinned by amended law***

With a currency board system in place, there is a possibility of a stronger political will given that there will be a new central bank law or constitutional amendment which will be enacted to provide legal basis of the implementation of this new monetary system. This ‘law’ will make it harder for any political party to “undo” at will, thereby removing any possibility of speculative attacks on the local currency and also reducing the costs of borrowing. Given that in the case of Zimbabwe, there has been absence of political will to fight inflation over the past years, this advantage will apparently nail down policy makers in making overtures which will ensure the successful implementation of a currency board, which will in turn (prospectively) help the country in having price stability and a stable currency.

**3.3.1.2.2 Possible disadvantages of a currency board**

***i. Difficult to correct overvalued exchange rate***

In the case where the real exchange rate fixed under the currency board system become substantially overvalued to the detriment of the country (for instance, resulting in the country’s exports becoming uncompetitive at the international market), it is very difficult to correct this exchange rate. This stems from the fact that the exchange rate adjustment will be absorbed solemnly by domestic costs and prices, with no help from the nominal exchange rate. Nevertheless, this drawback is watered down by proponents of currency boards on the basis that practical experiences of countries which have instituted such monetary arrangements, for instance Hong Kong which adopted a currency board in 1983 have continued to be one of the most competitive economy in the world (Gwartney and Lawson, 2001). Thus this argument is therefore neither here nor there if Zimbabwe really wants to adopt this system.

***ii. Loss of ability to fine tune monetary policy to deal with shocks***

Another cited criticism of a currency board is that such a system inputs rigid rules to such an extent that the country will forfeiture its ability to fine-tune its monetary policy to respond to unanticipated and asymmetric external shocks. Thus, according to this drawback, a country with a currency board in place will be more prone to external shocks than are countries with central banks. This criticism however contradicts practical experiences. For instance, the recent financial and banking crisis which started in the USA in mid 2008 have affected most countries, developed and developing alike, and most of the countries affected have central bank systems, and not currency boards. Also, Hanke (2002b) pointed out that the variability in growth rates between countries with currency boards, on one hand, and countries with central bank systems, on the other hand, was almost the same. This prompted Hanke (2002a) to conclude that whether a country has a currency board or a central bank, the most important thing to note is that the

country with a currency board is prone to external shocks, while a country with a central bank system is subject to internal shocks, with both shocks producing effects of similar magnitude. To this end, this disadvantage becomes just a mere criticism.

**iii. *Constrained lender of last resort (LORR)***

The loss of lender of last resort (LORR) function by the central bank has been put forward as one of the disadvantages of a currency board monetary system, by both economists and some institutions. For instance, United Nations Conference on Trade and Development (UNCTAD) (2001:117) clearly states “a currency board regime makes payments crises less likely only by making bank crises more likely”. Although this sounds economically well thought, practical experiences however refute such thinking. For instance, the current financial and banking crises which started in mid 2008 in USA and currently bedeviling many major developed countries are all occurring in countries with central bank systems in which the lender of last resort functions are fully practiced. Zimbabwe is also a very good example to refute the line of thinking presented by UNCTAD above in that the country has had serious banking crises in 2004 under the central banking system. In sharp contrast to the possible loss of LORR criticism, practical experiences show that countries which have implemented currency boards (for instance, Bulgaria), have not only prevented banking crises, but rather their banking systems have tended to become firm over time, since the presence of currency board system provided a strong emphasis on the banking system that they would not be bailed out by the LORR. Hence, this criticism of loss of LORR cannot prevent a country like Zimbabwe to implement a currency board if the country seriously wants such a monetary arrangement.

**iv. *Optimum currency area***

Some argue that if the country opting for currency board is not in optimum currency area with the anchor country, then implementing a currency board will be fruitless and a waste of resources and effort. Optimum currency area is considered as “... an artificial construct within which exchange rates should be fixed and between which exchange rates should be flexible” (Hanke, 2002: 101). Again practical experiences have proved this argument to be vain given that some countries which have adopted currency board system, for instance Argentina, have succeeded in achieving their currency board objectives (among others, lowering inflation and increasing GDP growth rates) by using the USA as the anchor country, though the former country was not in an optimum currency area with the latter anchor country. Thus, Zimbabwe can choose any country as the anchor, whether the country is in the same optimum currency area with Zimbabwe or not.

**v. *Currency boards mainly desirable in small countries***

Some theorists argue that currency boards works perfectly in small tiny economies. Such argument is not supported by empirical evidence given that practical experiences indicate



that even large countries have successfully implemented currency boards. For instance, Argentina and Hong Kong which implemented this system are not tiny and to date ranked the 31<sup>st</sup> and 40<sup>th</sup>, respectively (out of 182 countries reported) in terms of GDP in 2008 (IMF's World Economic Outlook database). To the contrary, Zimbabwe has been drifting over the recent year from being a small country into a very small country as measured by its GDP figures. Thus, Zimbabwe is a supper candidate of a currency board.

### **3.3.2 System 2: Free banking**

Free banking entails a monetary system in which commercial banks and market forces control the provision of banking services in a country. According to Smith (1936), unlike central banking system, under free banking system private banks have ability to raise sufficient capital, garner public confidence and gain acceptance of their privately issued notes and ensure profitability of their undertaking, in the absence of special conditional authorization from a government authority.

The principle replicates financial sector liberalization, as it is open to undertaking by would-be investors, and in the Zimbabwean scenario: locals, foreign nationals or even as an investment offer to the Zimbabwean Diaspora to which most credible bankers have sought favourable pastures. The basic requirement desired for forming their banks is that they meet requirements common to other business operations such as shareholders and profile disclosures, periodic publishing of financial statements and portfolios disclosures to their clientele to enhance their credit worthiness. They would then enjoy liberties ranging from; printing and issuance of bank notes, acceptance of deposits to current accounts, payment and collection of cheques for customers, borrow money on term-deposits and other forms of secured and unsecured borrowing, lend money and further provide guarantees and documentary letters of credit.

Thus, under free banking system banks would have the liberty to issue deposits and circulate notes in any currency they so consider as being favoured by economic agents. The most important assumption is that the system is liberal and provides liberty for banks and customers to discover what works best for their business and day-to-day transactions. Historical evidence nevertheless shows that in most instances, instead of having multiple currencies in circulation for a long time, there would be convergence of the issued notes into a single unit of account, typically gold or a foreign currency.

#### **3.3.2.1 Main features of Free Banking**

The following are some of the most important characteristics of a free banking system:

- i. *Competition in issuing of notes*: The central bank's note issuing monopoly will be replaced by competitive issuing of redeemable bearer currency. In light of technology and communication advancement in this globalized world, not only

will the issued notes be limited to issued in hard copies but can also extend to include any form of electronic tokens, too.

- ii. *Uninsured banks*: The government will not bail out or insure banks that cannot pay their depositors. Thus, under the system, any bank, which becomes insolvent, will be subjected to the country's general laws of bankruptcy, with a possibility that depositors may lose their money upon liquidation.
- iii. *Mutual acceptance*: Whilst under central banking, the law underpins any printed currency to be accepted as legal tender, in this system, there will be mutual acceptance by banks of each other's notes at par as well as indirect redemption of notes by banks through note exchange.
- iv. *No legal tender*: No currency will be a legally enforced currency under this system. Thus, any economic agent will be free to accept or deny trading in the currency they choose. Nevertheless, in the case where the central bank issues currency, that currency will only be mandatory for government-related transactions and payments such as taxes and fines.
- v. *No enforced fractional reserve ratio*. There will be no mandatory fractional reserves, but rather banks will be at liberty to float their reserve ratio, or in some instances selling their financial products with differing fractional reserves, and differing restrictions on withdrawals rules.
- vi. *Development of short-term credit markets*: The system is premised on the development of short-term credit markets to ensure automatic currency smoothing, whereby banks with excess reserves lend to banks in need of reserves on short-term basis at an agreed interest rate.
- vii. *Automatic clearing houses*: Although there will be competition among banks in provision of such services as current accounts, there will however be clearing of inter-bank payments between participating banks through clearing houses and settlement banks.
- viii. *Investment opportunities*: As a means of trying to harness the benefits of the system, there will be development of investment opportunities in such activities as marketable debt securities as well as provision of investment opportunities that can be liquidated at short notice.

### **3.3.2.2 Advantages of Free banking**

#### ***i. Competition in the banking sector***

Free banking not only involves competition among banks on the deposit side, but it also extends competition to issuing of notes. Hanke (2008) points out that use of multiple brands of currency notes have not resulted in any problems for free banking systems when compared to multiple brands of deposits which have resulted in some problems in central banking or other systems.

#### ***ii. System is safer from money printing abusive dispositions***

Under free banking the banks produce their own currency, which would compete for the business of money users. Competition in currency would give producers the incentive to neither overproduce or under produce currency and therefore maintain its value. For banks to have their liabilities (currencies) accepted, they would have to make them redeemable in some commodity (e.g. gold) or some other asset. Clients would not accept more paper liabilities without some link or connection to an item, which has value outside of the banking system.

### **3.3.2.3 Disadvantages of Free banking**

#### ***i. Possible loopholes***

In the Zimbabwean context, unless things change, free banking would obviously be suspect and flawed with loopholes prone to manipulation given the country's experience with high profile white-collar crime or manipulative tendencies tailored for self-aggrandizement by way of enormous profiteering. The existence of the liberty to issue deposits and circulate notes in any currency as favored by the participating economic agents will naturally create this scenario.

#### ***ii. Potential for bank runs***

With a combination of no lender of last resort and Zimbabwe's experience with bank runs, there will be a possibility that bank runs may also happen, in which case depositors may end up losing their money. The situation will be even more severe for local banks with no any possible external sources to bail them out, unlike international banks that can get the 'lender of last resort' facility from the headquarters or branches from other countries.

*iii. Possible confusion in the banking sector*

Whilst free banking may look sound on the blueprint, its application may lead to possible confusion in the banking sector, especially when involving issuing of multiple currencies by participating banks. Because of the complexity of banking business, by virtue of it involving money, lack of authority from government through central bank may end up creating more harm to the economy than good.

*iv. Free banking system irrelevant*

Although Zimbabwe once had an experience with free banking between 1892 –1940 holding features of a “least restricted system” with only two commercial banks (Standard Bank of South Africa and Bank of Africa) issuing notes denominated in pounds kept equal to the pound sterling, one would be quick to remind such postulations of the time, era and country specifics compatibility of the system. The era reflects the pioneer era, with a colonial regime; holding a small banking population thus limited clientele. Thus any form of banking business would obviously be a function of good faith among elite. The population has grown, and the economy has been exposed to varying white-collar crimes and corruptive tendencies, which renders the system idealistic.

As rightly noted by Schuler (2001) free banking remains a forgotten banking system, such that regardless of wide spread interest in it, it exists nowhere today as a living system. Experimenting with such a vulnerable economy would not be worth the risk.

*v. Government’s loss of Control over Monetary Policy*

The Central Bank is generally government instituted. The fact that the RBZ issues notes to the market provides it with an indirect control over the rest of the money supply function. Under free banking, for the fact that private banks will be issuing notes, it implies loss of authoritative control over money supply.

**3.3.3 System 3: Retaining the RBZ**

The local currency can be re-introduced under the supervision and management of the central bank, the Reserve Bank of Zimbabwe (RBZ). However, given the clear proof of the inability of the RBZ since 2004 to manage money in such a way that the currency retains its main functions of medium of exchange, unit of account, store of value and standard of deferred payments, RBZ can only manage the re-introduced local dollar if there is a change of management and its functions are limited to that of ensuring price stability. Unless RBZ gains some credibility in the eyes of the economic agents, the re-introduction of the country’s local currency may prove to be disastrous as it may arouse previous memories of hyperinflation and rapid loss of value of the currency.

Thus, the best way to build confidence in the currency would be to ensure that even the management at the country's central bank is overhauled by bring in new team and experienced managers with track record of professional conduct in financial sector. In the initial stages, the contract duration of the new management can be for short periods of say two years, renewable upon meeting of mutual set monetary and performance targets. Such conditional office tenure will ensure that the management will conduct their duties in uttermost good faith and for the betterment of the country, and not manipulating the functions of RBZ to serve certain groups of people and political parties at the expense of national develop, as has been the case since 2004.

Besides changing the management of RBZ, the country should also amend the Reserve Bank Act to limit the bank's activities to those related to price stability, with fiscal activities left to relevant ministries. Restricting RBZ's functions to only inflation fighting will mean that the bank will not be involved in money printing for the sake of financing fiscal activities as has been the case since 2004, and in that way, chances of reviving hyperinflationary trends through money printing will be limited, if ever it will happen. The end result will be enhanced credibility of the RBZ, and eventually economic agents' confidence in the local currency will be boosted.

#### **4. WHICH OPTION SHOULD THE COUNTRY ADOPT?**

The monetary systems presented and detailed in the preceding pages are all potential options that the country can consider adopting after the multi-currency regime comes to an end. Nevertheless, given country's current situation, the study considers the options in the following descending order of priority (i) dollarization, (ii) retaining the Z\$ but under the management system of a currency board, (iii) Joining the CMA, (iv) retaining the Z\$ under the management of RBZ, with the institution having new management, and lastly (v) free banking.

#### **5 CONCLUSION**

The study presented main features of possible currency options which can be potentially adopted by Zimbabwe in the aftermath of multi-currency regime. The currency options analyzed are dollarization, joining the CMA and re-introduction of the Zimbabwe dollar (Z\$). The proposed management systems to underpin the reintroduction of the Zimbabwean dollar are currency board, free banking and Reserve Bank of Zimbabwe (RBZ). For each of the options analyzed, the practicality of Zimbabwe in adopting and/or implementing such currency was also explained. Although any of the three options could be adopted and implemented, the study considered the options in the following descending order of priority: (i) dollarization, (ii) retaining the Z\$ but under the management system of a currency board, (iii) Joining the CMA, (iv) retaining the Z\$ under the management of RBZ, with the institution having new management, and lastly (v) free banking.

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