Monthly Macro Economic Developments – July 2016

1. Introduction

Money supply increased by 12.5% on an annual basis and 0.9% on monthly basis from May 2016 to June 2016. Commodity prices have gained over the period due to accommodative polices adopted by the Chinese. The South African Rand has gained from SAR 14.18 on 29 July 2016 to 13.39 on the 17th of August 2016. The country continue operating under a very tight budget due to limited fiscal space and the deflationary environment continues while interest rates both deposits and lending rates declined mainly due legislative pressure.

2. World Economy

2.1 Overview of World Economy and Growth Prospects

Global commodity prices are on a recovery path and this would improve global economic prospects including countries in Sub-Saharan Africa. The recovery is anchored by the Chinese stimulus policy. However, the Chinese accommodative policies are expected to wane by 2017 triggering low price commodity expectations. *These developments provides a glimpse of hope for resource dependent economies like Zimbabwe.*

China is facing sluggish growth with the 6.6% 2016 growth projection under threat. IMF (2016) is citing credit expansion to undeserving firm as a major risk facing the Chinese economy. The Chinese economy is following a Kuznets six characteristics of modern economic growth with sustained high growth rates, with shift from industry to services and shift from investment to consumption. Growth rates are projected to remain around 6% up to 2018. *The sustained growth of the Chinese economy is good news to Zimbabwe which export to China and has recently benefited from Chinese investments.*

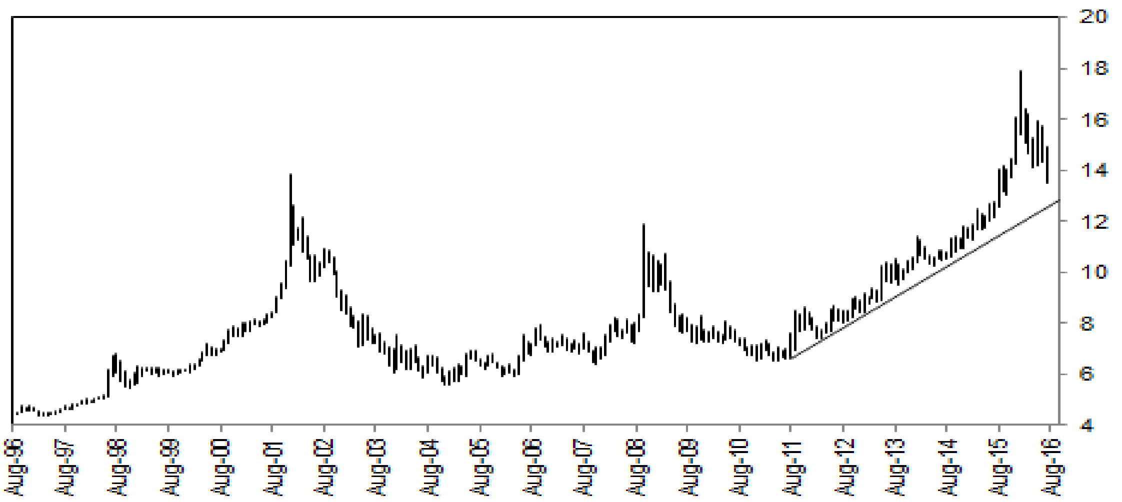
Sluggish mining sector output and weaker agricultural production have dampened Rwanda's economic growth prospects. However, growth remain on path to reach 6.4% in 2016, thanks to increasing investment in energy and transport infrastructure. Rwanda's economy is growing at faster pace compared to sub-Saharan Africa growth. The Government has targeted an improvement in access to energy from 23% as of 2015 to 70% by 2017/18. The targeted transport projects supports regional integration and support international trade and these include:

- Base-Nyagatare road linking Rwanda to Mombasa Port- 51km,
- the construction of a 63km road towards the Ugandan border; and
- A rail link through Burundi to Dar es Salaam in Tanzania.

Infrastructure development is key driver of economic growth in other African countries. Rwanda has also lead in the Country Policy and Institutional Assessment score. This put to the fore that for sustainable economic development a coherent reform of institutions, country policies and infrastructure is needed.

The South African Rand has significantly gained since the start of July 2016 by about 7.5%, and 14 .9% year to date as shown in Figure 1. The trend could extend on the condition that SA authorities adopt prudent, business friendly policies and a tight monetary policy. On the downside, South Africa is trapped in stagflation and the ruling party's grip on power is fast loosening leading to a difficult policy environment. *The strengthening of the Rand is a welcome development to Zimbabwean manufacturers who were finding it difficult to compete with lowly priced South African products.*

Figure 1: The South African Exchange Rate; 1US$ to South African Rand,



Source: BMI Research, August, 12, 2016.

3. Marco-economic Developments

The country is facing tight liquidity conditions manifesting in cash shortages. The slowing growth of the economy has affected the government's ability to raise revenue. The reengagement process might be concluded by year end 2016 or in the first half of 2017. However, as we get into 2017, the country will be in an election mode and this might hinder much progress on meeting the condition of reengagement. Government revenue is expected to contract by 2.5% in 2016 and it will have serious repercussions on ability by government to meet its salary obligations let alone funds dedicated for infrastructure development. Government has missed its revenue targets by 6.0% in the first half of 2016. The tight liquidity in the market is mirrored by approximately US$ 2.5 billion trade deficit. The current political fluid situation has increased the country sovereign risk and has been compounded by the announcement of the introduction of bond coins. *The government continues operating on a very tight budget implying priorities towards long term projects will suffer.*

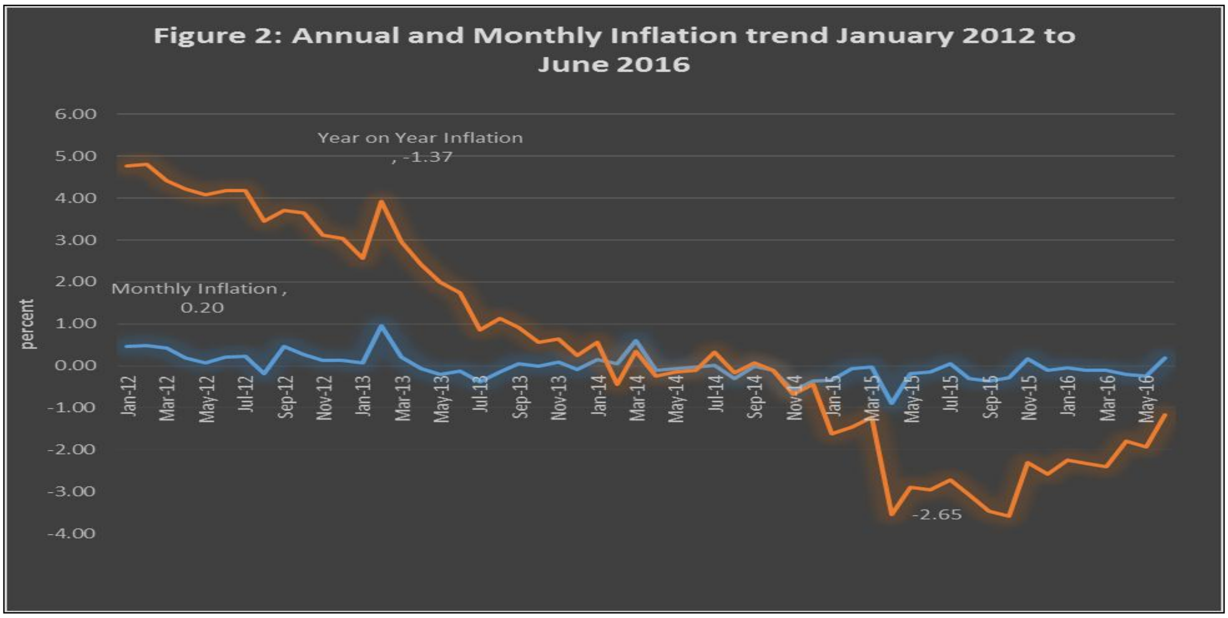
3.2 Inflation and Interest Rates

Year on year inflation gained by 0.32 percentage points to reach negative 1.37% in June 2016. The month on month inflation broke the trend that started in December 2015 to register growth of 0.20% as shown in Figure 1. The strengthening Rand might influence short term inflation outlook but the country remain in deflation until the end of the year if the multicurrency environment is maintained. However, if a local currency is introduced inflation pressures would kick in and the possibility of returning to hyperinflation cannot be meekly dismissed. *A lower inflation environment should encourage savings and be a boon to infrastructure development, however, higher sovereign risk remains the single major inhibiting factor mobilisation of long term funds.*

Table 1: Inflation by sector, Zimbabwe,Zimstats, June, 2016

	Index			Inflation %	
Sector	**June 2015**	**May 2016**	**June 2016**	**Year on year**	**Month on Month**
Food and non alcoholic beverages	94.18	90.70	90.38	-4.03	-0.35
Alcoholic beverages and tobacco	105.54	103.60	103.64	-1.80	0.04
Clothing and Footwear	98.24	97.11	96.90	-1.36	-0.22
Housing water, electricity, gas and other fuels	100.00	97.90	98.42	-1.58	0.53
Furniture household equipment and maintenace	96.22	92.70	92.68	-3.68	-0.02
Health	102.92	103.00	103.14	0.21	0.14
Transport	101.07	98.40	98.33	-2.71	-0.07
Communications	74.05	72.50	72.50	-2.09	0.00
Recreation and Culture	98.05	97.40	97.15	-0.92	-0.26
Education	116.83	133.40	136.98	17.25	2.68
Restaurants and Hotels	100.07	100.00	100.27	0.20	0.27
Miscellaneous goods and services	97.08	95.00	95.05	-2.09	0.05
Non Food Inflation	**99.77**	**99.23**	**99.67**	-0.10	0.44
All Itmes	97.9	96.37	96.56	-1.37	0.20

Food and non-alcoholic beverages declined by 4.03% in June 2016 on a year on year basis and also registered a 0.35% decline on a month on month basis. Non-food items declined by 0.10% year on year and gained by 0.44% month on month as shown in Table 1. Bread and cereals, meat, milk, cheese and eggs, fruits and vegetables registered price declines on year on year basis and month on month.



The development in inflation ignites the debate on the effectiveness of adopting a fixed exchange rate policy for the country as economists contend that tight liquidity situation ensures that leads to contractionary effects on the economy and is worsened by price deflation due to debt effects. The moral hazard created by dollarization may lead to over-borrowing by economic agents plunging them into debt trap. If investors lose faith in the sustainability of the system a sudden money supply contraction results leading to spike in interest rates. Dollarization therefore, inhibits, decline in interest rates even in deflationary environment.

As the US$ continues to strengthen the country could only gain competitiveness through a very painful slow process of price and wage deflation. As a rule of thumb, dollarization's *effectiveness is improved if the country whose currency adopted share similar productivity growth rates and business cycles and with which it is a significant trading partner. This provides the theoretical argument for adoption of the rand than the US$.*

Money supply increased by 0.9% between April 2016 and May 2016 to reach US$ 5050.9 million representing a 12.50% annual increase. Money supply reached US$ 5 billion of which, 53.7% consist of demand deposits and base money, 13.8% savings deposits, 15.7% U-30-day deposits and 16.9% O-30 day and Time deposits. S*hort term deposits are dominant but are not suitable for long term infrastructure projects.* Nominal lending rates to individuals decreased from 11.38% as at 01 July 2016 to 10.69% as at 29 July 2016, while for corporate clients interest moved from 7.36% to 6.79% over the same period. While. *This is a positive trend for the economy, it might not be sustainable in light of hovering country risk issues and capital flight that might result.*

Savings deposit rates slightly declined between 01 July 2016 to 29 July 2016, as savings deposits slightly increased from 3.10% to 3.03%, 1 month deposits decreased from 5.67 to 5.49%, and 3 months deposits decreased from 6.14% to 6.03% respectively. *The decline in deposit rates has not been enough to compensate for the fall in lending rates threatening the interest margins. However, as sovereign risk heightens, the liquidity situation would tend to worsen pushing even the deposit rates higher threatening the Bank's interest margin.*

4. Conclusion

The country's inflation situation ignites the debate on the optimal currency environment for the country and increases the call for the adoption of the South African Rand as business are averse to the introduction of the local currency. The dominance of short term deposit make the country capital markets shallow will remain under-developed for some time.