How to kill Zimbabwe's hyperinflation

Poor political policies force the Reserve Bank of Zimbabwe to print money. So, a quick solution to the country's runaway inflation might be simply to get rid of the bank – and replace it with systems that worked well many years ago, writes **Steve H Hanke**

When properly applied, the rule of law guarantees freedoms in the economic, political, intellectual, and moral spheres. In the economic sphere, money constitutes an important element. Ludwig von Mises, one of the most important economists of the 20th century, dealt at length with this issue in his treatise *The Theory of Money and Credit*, published originally in 1912:

'It is impossible to grasp the meaning of the idea of sound money if one does not realise that it was devised as an instrument for the protection of civil liberties against despotic inroads on the part of governments. Ideologically it belongs in the same class with political constitutions and bills of rights. The demand for constitutional guarantees and for bills of rights was a reaction against arbitrary rule and the non-observance of old customs by kings. The postulate of sound money was first brought up as a response to the princely practice of debasing the coinage. It was later carefully elaborated and perfected in the age which – through the experience of the American Continental Currency, the paper money of the French Revolution, and the British Restriction period – had learned what a government can do to a nation's currency system.'

Destroying the economy

Since March 2007, Zimbabwe has had hyperinflation – defined as a rate of inflation per month that exceeds 50%. Hyperinflation is rare: there have only been 29 other cases in history, the most recent in Bulgaria in 1997.

Zimbabwe's hyperinflation is destroying the economy, pushing more of its inhabitants into poverty and forcing millions of Zimbabweans to emigrate. In the 1997-2007 period, cumulative inflation was nearly 3.8 billion percent, while living standards – as measured by real gross domestic product (GDP) per capita – fell by 38% (see Table 1). In addition, hyperinflation has robbed people of their savings and financial institutions of their capital through real (inflation-adjusted) interest rates that are negative (see Table 1). This form of theft occurs, in large part, because the laws and regulations governing financial institutions (pension funds, insurance companies, building societies, and banks) force them to either purchase government treasury bills that yield only a small fraction of the current inflation rate or make deposits at the Reserve Bank of Zimbabwe (RBZ) that pay no interest.

The value of the Zimbabwe dollar has been wiped out. Figure 1 tells the devastating story – one that is ominously following the same plot as that followed by the German mark during the great German hyperinflation of the 1920s.

Worse is yet to come. Most private observers of the Zimbabwean economy believe that data reported by the IMF (see Table 1) are too conservative. Moreover,

Table 1. Zimbabwe Economic Data (Percent)

Year	Real GDP per capita growth	Consumer price inflation	Lending rate[1]	Real interest rate[2]
1990	3.7	15.5	11.7	–5.6
1991	3.8	46.5	15.5	–8.5
1992	–11.2	46.3	19.7	–21.8
1993	–1.4	18.6	36.3	8.1
1994	2.3	21.1	34.8	12.6
1995	–3.1	25.8	34.7	12.2
1996	6.2	16.4	34.2	12.6
1997	2.4	20.1	32.5	13.7
1998	0.4	46.7	42.0	10.7
1999	–3.3	56.9	55.3	–2.6
2000	–7.0	55.2	68.2	12.6
2001	–2.4	112.1	38.0	–35.3
2002	–4.1	198.9	36.4	–96.7
2003	–11.3	598.7	97.2	–267.7
2004	–3.3	132.7	278.9	–71.0
2005	–4.0	585.8	235.6	–2.1
2006	–5.4	1,281.1	496.4	–520.2
2007	–6.1	108,844.1	N/A	N/A

Sources: International Monetary Fund, *World Economic Outlook* database, April 2008, http://www.imf.org/external/pubs/ft/weo/2008/01/weodata/index.aspx; *International Financial Statistics* database, May 2008; and author's calculations.

[1]: Rate charged by commercial banks on loans (*International Financial Statistics* database).

[2]: Lending rate adjusted for inflation.

Note: Consumer price inflation, the lending rate and the real interest rate are reported on an end-of-year basis. The 2007 data fail to accurately reflect inflation pressures because the government mandated sharp reductions in administered prices. In addition, most observers believe that real GDP per capita declined by more than the –6.1% reported by the IMF for 2007.

they believe that in the run-up to the March elections and the June presidential runoff the government forced the RBZ to accelerate the printing presses.

The root cause of the hyperinflation is government policies that have forced the RBZ to print money. From January 2005 to May 2007, the RBZ issued currency at a rate that even exceeded that of Germany's central bank from January 1921 to May 1923, the ramp-up phase of the great German hyperinflation (Figure 2).

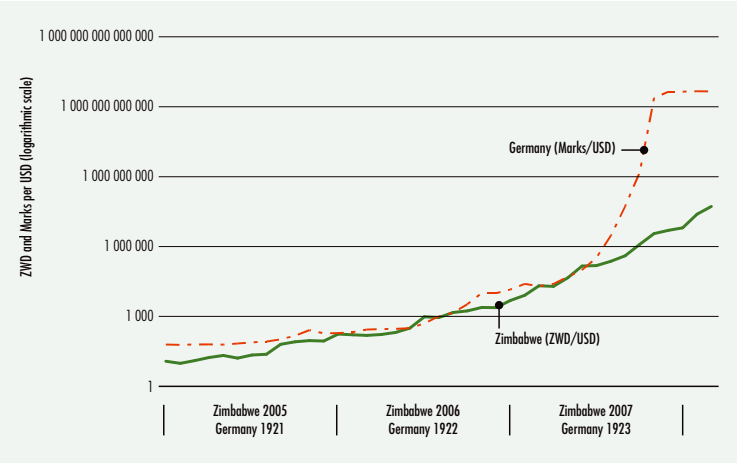
Hyperinflation isn't the only thing produced by the RBZ. It is also a proficient producer of jobs, funded at the expense of every Zimbabwean who uses money. In the 2001–2007 period, the RBZ's staff more than doubled, from 618 to 1 360 employees. The RBZ's staff increase of 120% was the largest of any central bank in the world during this period. Despite the increase, one thing the staff is not producing is accurate and timely data. The RBZ has fallen months, if not years, behind in reporting even the most standard economic and financial statistics.

The most rapid and reliable way to stop hyperinflation in Zimbabwe is to replace central banking with a new monetary regime. That would signal a clean break with the practices that have created hyperinflation and would give Zimbabweans reliable assurance that inflation will henceforth be controlled.

Some may wonder whether it is necessary to replace central banking with another monetary system in Zimbabwe. After all, other countries with inflation in the hundreds or thousands of percent a year – including Angola, Mozambique, the Democratic Republic of the Congo, and Zambia – have checked high inflations without replacing their central banks. Instead, they changed their policies. Why couldn't Zimbabwe do likewise?

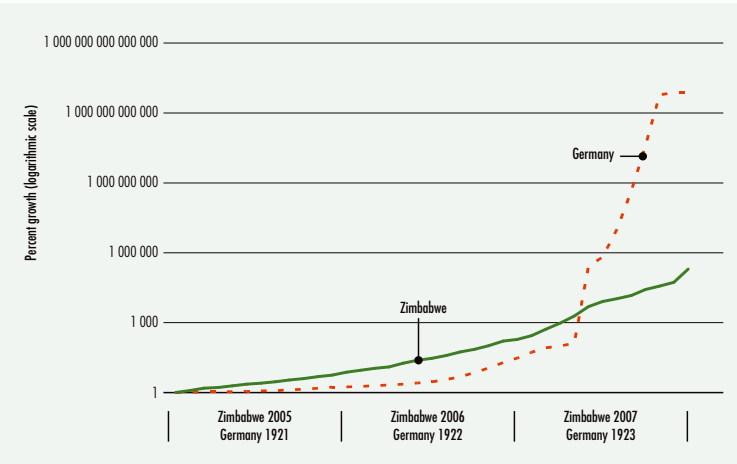
It could, but so far it has not. In Zimbabwe's historical experience with a variety of monetary systems, only central banking has produced hyperinflation. Similarly, throughout the world, hyperinflation has been a phenomenon linked to central banking or its close cousin, the direct issue of currency by a government's treasury.

Figure 1: German & Zimbabwean exchange rates



Sources: Thomas J Sargent, *Rational Expectations and Inflation, 2nd edition* (New York: Harper Collins College Publishers, 1993); 01 May 2008, Imara Asset Management Zimbabwe; and author's calculations.
Note: A logarithmic scale is used so that the chart can fit on one page.

Figure 2: German & Zimbabwean currency in circulation



Sources: Thomas J Sargent, *Rational Expectations and Inflation, 2nd edition* (New York: Harper Collins College Publishers, 1993); Reserve Bank of Zimbabwe, http://www.rbz.co.zw, Statistics, Monthly Review (Feb 2008), page 26; and author's calculations.
Note: A logarithmic scale is used so that the chart can fit on one page.

Replace central bank

Central banks can put a stop to inflation as fast as they can fuel it. All they have to do is stop the printing presses. Unfortunately, they can switch course with ease. So, under central banking, inflation can return as easily as it was snuffed out. Many countries, including the African countries mentioned above, have had prolonged double-digit inflation or multiple bouts of very high inflation under central banking.

Central banks that have made a seemingly permanent transition to low inflation have usually required a long transition period in which to establish their credibility as inflation fighters. During the transition, real interest rates have often been punishingly high and long-term loans in local currency have been difficult to obtain. As a result, economic growth has been relatively slow, general living standards have remained stagnant, and the scourge of poverty has spread.

Given the current state of affairs in

Zimbabwe and the dramatic hyperinflation, the only way for Zimbabwe to make a credible commitment to stop the hyperinflation rapidly and avoid high transition costs is to replace central banking with a different type of monetary regime.

Three options exist for quickly replacing the RBZ, ending hyperinflation, and providing monetary stability:

- official 'dollarisation',
- free banking, and
- a currency board.

These options are not mutually exclusive. For example, a currency board system could be combined with official dollarisation, as in the monetary systems of Lesotho, Namibia, and Swaziland.

A fourth option – formal membership in the South African rand's Common Monetary Area – is not dealt with explicitly here simply because it would probably involve protracted political negotiations and time, which Zimbabwe can ill afford.

A man carries piles of devalued local banknotes while shopping for groceries in the Zimbabwean capital of Harare.
AP Photo/Tsvangirayi Mukwazhi

Dollarisation, free banking or a currency board

Dollarisation occurs when residents of a country extensively use the US dollar or another foreign currency alongside, or instead of, the domestic currency. Unofficial dollarisation occurs when individuals hold foreign-currency bank deposits or notes (paper money) to protect against high inflation in the domestic currency. Zimbabwe is already unofficially dollarised to the extent that Zimbabweans hold SA rand, US dollars, pounds sterling, and other foreign currencies as stores of value. Official dollarisation occurs when a country uses a foreign currency as the main, or only, component of the monetary base. (The monetary base is the medium accepted for final settlement of payments in the local financial system; in other words, it is what banks typically use for clearing.)

For Zimbabwe, official dollarisation could, for example, take the form of using the SA rand, US dollar, or the euro. If Zimbabwe used the rand, it could negotiate a profit-sharing agreement, such as Lesotho and Namibia now have, and which Botswana and Swaziland formerly had. Under the agreement, SA shares the profit (seigniorage) it derives from issuing currency, according to estimates of how many rand notes and coins are in circulation in the partner country. In the late 1920s, when Zimbabwe (then called Southern Rhodesia) used South African coins, it apparently had such a profit-sharing arrangement with SA. The agreement applied to coins in circulation alone, since Zimbabwe had its own notes.

The notes were issued under 'free banking', a system of competitive issuance by private commercial banks of notes and other liabilities with minimal regulation. A completely free banking system has no central bank, no lender of last resort, no reserve requirements, and no legal restrictions on bank portfolios, interest rates, or branch banking. Free banking systems existed in nearly 60 countries during the 1800s and early 1900s. In general, these systems were relatively stable, issued currencies convertible into gold or silver at fixed exchange rates, and were not purveyors of inflation.

Zimbabwe had free banking from the time its first bank was established in 1892 until the government replaced free banking with a currency board in 1940. That free banking system was among the least restricted that ever existed. Reflecting the limited use of modern money and credit among the population at the time, the country had only two commercial banks, the Standard Bank of South Africa and the Bank of Africa (later part of Barclays Bank). They issued notes denominated in pounds, and kept their privately issued pounds equal to the pound sterling – except during the First World War and for a few years afterwards, when the local pound floated along with the South African pound (the predecessor to the rand) against the pound sterling. Free banking ended in Southern Rhodesia not because it performed poorly, but because the government desired the profits from issuing notes.

Currency boards or central banks replaced free banking systems because intellectual and political fashions favoured monopolising the issuance of notes and coins by a government body. Today, no free banking systems exist. In the last 30 years, economists' interest in free banking has revived because of dissatisfaction with the performance of central banks. More recently, the possibility that

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countries, that peg their currencies to the dollar.

The global credit crunch and weaker trade will take its toll on global economic growth. The overall impact will be falls in demand, less trade, lower investment rates, and lower economic growth rates. Therefore, even the growing Asian economies, such as China, Vietnam, and Singapore, face declines in economic growth.

SA is likely to be severely affected by a global recession because of the country's high level of integration into global trade and financial markets, the high trade deficit and the recent unsustainable consumption growth. The Southern African region will in turn be affected, with countries dependent on remittances and aid being hardest hit. Those exporting mining commodities might have some growth to offset the impact of the likely global recession. ■

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Rocky courtship to an African marriage – *continued from page 20*

in AU circles. This reflects a tendency of African leaders and other stakeholders to give prominence to new processes at the expense of older ones, which creates inter-institutional rivalry – thereby dissipating energies and resources required for the continent's development.

Integrating NEPAD into the AU has been painfully slow, if not static. Moreover, while the APRM process is an integral part of NEPAD and should constitute a component of the NEPAD-AU integration agenda, it cannot be treated entirely the same as NEPAD. While NEPAD might be readily amenable to integration into AU processes because, like the union, it is all-inclusive, the APRM may not be so amenable because of its selective and discretionary character. Caution is needed. ■

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'Xenophobia' and the neighbourhood watch – *continued from page 22*

that have an impact on people's lives, especially those of the poor.

Regional integration in its present form, which favours economic and political co-operation at the leadership and business levels, does not address the needs of the majority of the region's citizens. What is needed is development that takes place throughout the region in rural and urban areas and that reduces the imperative for people to move from their home country to neighbouring countries for work over long periods of time.

The meeting agreed that pressure should be exerted on governments in the region to review their migration policies. Migration between countries is natural as people's needs change and they search for new spaces where their needs are best met. Hence it should be facilitated, monitored and de-pathologised, especially in regions that wish to share economies and trans-national policies, and view themselves as trans-border communities. SADC's Free Trade Area will facilitate the movement of goods and services across borders in the region. Hopefully it will also highlight the need to support the legal movement of people across borders.

Governments were also requested to learn from each other, especially in relation to disaster management practices. In addition to the political and economic integration that SADC hopes to achieve, it should also ensure that the region's people are involved in decision-making processes that affect their lives, more especially the lives of people who live in poverty. ■

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electronic money will make notes and coins obsolete, enabling banks to offer full-fledged rivals to government-issued currencies, has generated considerable interest.

The final option for quickly replacing the RBZ is a currency board. Currency boards have existed in more than 70 countries and a number are in operation today. A currency board is a monetary institution that issues notes and coins. Even though some currency boards have accepted deposits, the board proposed for Zimbabwe would be prohibited from doing so. A currency board's monetary liabilities are fully backed by a foreign reserve currency, also called the anchor currency, and are freely convertible into the reserve currency at a fixed rate on demand. The reserve currency is a convertible foreign currency or a commodity chosen for its expected stability. As reserves, a currency board holds low-risk, interest-earning securities and other assets payable in the reserve currency. A currency board holds reserves equal to 100% or slightly more of its notes and coins in circulation, as set by law.

The Southern Rhodesia Currency Board was established in 1940. The board replaced free banking, a system that had experienced no severe problems and had served the country well. In establishing the currency board, the colonial government was acting in accord with the prevailing belief of the time

that issuing notes and coins should be a government monopoly. Officials were also aware that a currency board would generate profits and, therefore, revenue for the government.

The notes and coins of the Southern Rhodesia Currency Board were also legal tender in Zambia (then called Northern Rhodesia) and Malawi (then called Nyasaland). The board existed until 1954, when it was replaced by the Central Africa Currency Board. The main feature distinguishing the Central Africa board from its predecessor was that it allowed representation on its governing body by Zambians and Malawians as well as Zimbabweans.

The three governments of the Federation of Rhodesia and Nyasaland then transformed the Central Africa Currency Board into the Bank of Rhodesia and Nyasaland, a central bank, in 1956. The central bank was one of several institutions intended to bind Zimbabwe, Zambia and Malawi into a single economic unit and ultimately perhaps a single political unit. As with the transition from free banking to a currency board, the transition from a currency board to a central bank did not occur because the currency board had experienced any severe problems. Rather, central banking had become the intellectual fashion of the time for countries that were independent or wanted to become independent soon. There was as yet little recognition of the dangers that inept central banking could bring: high inflation, exchange controls, and financial underdevelopment.

When the federation dissolved in 1964, its central bank was divided into three separate central banks for each country that had been a member of the federation. Thus the Reserve Bank of Rhodesia came into being.

Official dollarisation, free banking, and a currency board are all proven systems with records of success in providing reliable, low-inflation currencies in Zimbabwe and elsewhere. Any one of these systems, or a combination of them, could be successfully implemented immediately, without preconditions, and would therefore quickly put an end to hyperinflation and produce stable money. While the differences among the three options are worth pondering, it must be stressed that any one would represent an enormous improvement over the monetary policy that the government has forced the RBZ to produce or that the RBZ is likely to produce in the near future.

Financial liberalisation

Financial liberalisation is a vital companion policy to dollarisation, free banking, or a currency board system. With the elimination of hyperinflation, the rationale for price controls and foreign exchange controls no longer exists. Both should be prohibited. Other forms of 'financial repression', including interest rate ceilings, the forced purchase of government bonds, minimum reserve requirements for financial institutions, and the compulsory allocation of credit to favoured borrowers should also be prohibited. This liberalisation would allow for the free flow of capital in and out of Zimbabwe. It would also increase the return on savings and reduce the cost of capital in Zimbabwe, removing major impediments to economic growth and improved living standards. Such has been the experience of other countries that have ended financial repression.

Financial liberalisation is of critical importance for Zimbabwe's economic recovery. Depreciation of assets has exceeded investment for some time, resulting in capital consumption and the atrophy of the nation's plants and equipment. In addition, the combination of hyperinflation and price controls has wiped out much of the country's stock of working capital. The quickest way to replenish Zimbabwe's capital stock is to import capital. To accomplish this, stable money and a liberal financial regime are important prerequisites. ■

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