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Escaping Deflation In Zimbabwe: The Role Of Fiscal And Monetary Policies

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Abstract: *Zimbabwe is struggling to escape from a monetary deflation. The paper traces the causes and effects of deflation in Zimbabwe and considers policy options available to government to escape from deflation. The paper concludes that monetary authorities in Zimbabwe are constrained to use monetary policy to fight deflation given the absence of a domestic currency. Although fiscal authorities are also constrained by lack of budgetary support, the paper recommends fiscal policy as the stabilisation tool of choice to tackle deflation in Zimbabwe. The government should work towards improving transparency and accountability in revenue collection particularly from mineral sales. The government should foster a conducive environment for investment and facilitate the formalisation of the informal sector.*

Keywords*: monetary deflation, fiscal policy, monetary policy, quantitative easing, money supply, inflation expectations*

I. Introduction

The Zimbabwean economy is currently experiencing a deflation which begun in February 2014 when a month-on-month inflation rate of -0.49% was recorded. Figure 1 shows that the deflation is persistant and worsening. Deflation is defined as a sustained decline in the average level of prices. Horwitz (2014), classified deflation into two categories, that is, price deflation which is due to improvements in productivity and monetary deflation which result from a deficient supply of money. Price deflation is termed good because it is associated with increases in output. In contrast, monetary deflation is associated with declines in output and thus it is deemed harmful.

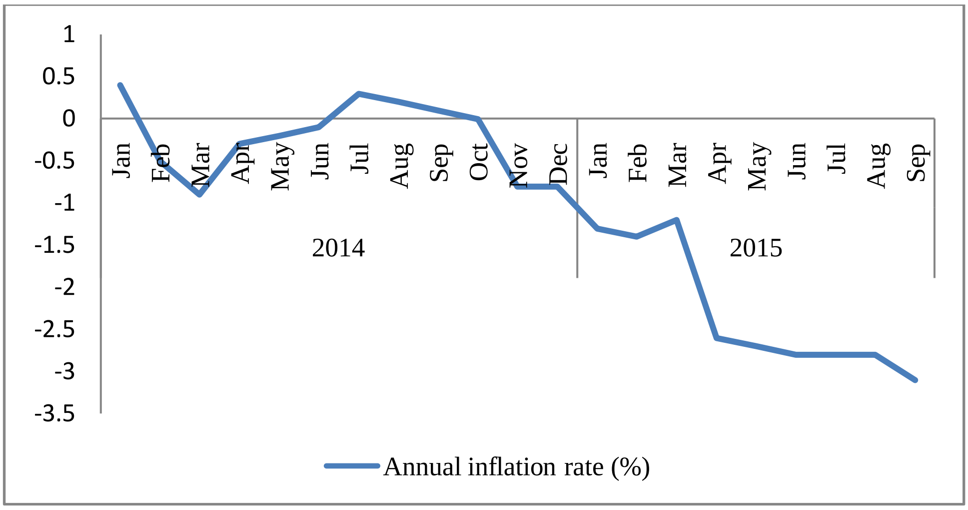

Figure 1: Year on year inflation rate

Source: Reserve Bank of Zimbabwe

The form of deflation saddling the Zimbabwean economy is monetary deflation because the country is faced with a crunching liquidity crisis. This paper traces the cause of deflation in Zimbabwe and also considers policy options available to government to rescue the economy from the scourge of deflation.

II. Causes Of Deflation

The major cause of monetary deflation is an insufficient supply of money in an economy which leads to reduced aggregate demand of goods and services. A deficient supply of money forces households to reduce their consumption expenditures in order to increase their money balances. The reduced expenditure results in a decline in demand for goods and services which in turn leads to an excess supply of goods. Now, too much supply versus low demand forces prices to go down.

Local economists do not quite agree on the causes of Zimbabwe's deflation. Some economists, notably the Reserve Bank of Zimbabwe governor Dr John Magunja, attribute the deflation to a self-correction of commodity prices arguing that upon adoption of the multicurrency system in 2009, the price of most goods and services in Zimbabwe were relatively high compared to regional averages due to high production costs. According to this school of thought, local producers are forced to reduce prices in order to compete with cheap imports from mainly China and South Africa.

A divergent view on Zimbabwe's deflation attributes the decline in the general price level to the depreciation of the rand against the US dollar. The US dollar is the commonly used currency in Zimbabwe. Given Zimbabwe relies heavily on imports from South Africa, an appreciation of the dollar against the rand means goods can be imported cheaply from that country hence the resultant decline in prices.

However, there is emerging consensus that the deflation in Zimbabwe is due to a fall in government, personal and investment spending due to the liquidity crisis currently bedevilling the economy. Government cannot spend as much given the ever shrinking revenue base and lack of access to lines of credit. Workers have low disposable incomes to buy goods and services due to meagre salaries and wages and high taxation. Unemployment is rising given the prevalent company closures and downsizing. Investment is depressed given the unfriendly investment climate in Zimbabwe.

III. Effects Of Deflation

Delong (1999) contends that deflation does more macroeconomic damage than an equal and opposite amount of inflation. He argues that deflation generates high real interest rates due to the fact that the nominal interest rate has a lower bound at zero. This means that nominal interest rates can not fall below zero. The high real interest rates that follow from deflation depress investment by increasing the cost of capital. Investors shun the capital markets when long-term real interests are high because they are unwilling to borrow at high cost. High borrowing costs make the end commodity expensive and therefore not affordable to most consumers.

A related effect of deflation is that it lowers demand and raise unemployment. A deficient money supply induced deflation causes reduced expenditures. The reduced expenditures in turn results in a decline in demand for goods and services such that goods go unsold and inventories pile up. The providers of goods and services respond by reducing production, cutting down on working hours and lowering wages. The can even go to the extent of retrenching workers and in the end closing shop.

The resultant high real interest rates from deflation also cause large transfers of wealth from debtors to creditors by increasing their real indebtedness. Thus deflation results in bankruptcy for highly leveraged operating companies which in turn feed into high unemployment.

Deflation can also disrupt the financial system. Delong (1999) rightly observes that deflation's transfer of wealth from debtors to creditors diminishes the economy's ability to keep the web of credit and financial intermediation functioning. A great deal of harm is done to bank's balance sheets from reduced value of collateral and from debtor's diminished ability to service loans. This leads to financial sector bankruptcies and banking crises. The disruption of the financial system puts additional downward pressure on investment, demand and unemployment.

IV. Policy Options To Escape A Deflation

Traditional stabilisation tools to fight deflation are monetary policy, fiscal policy, or a mixture of the two. Fiscal policy refers to those decisions that the government makes concerning taxes and spending while monetary policy refers to decisions made by the central bank about money supply and interest rates. The suitability of each tool in fighting deflation in Zimbabwe is analysed in the sections that follow.

4.1 Monetary Policy

Monetary policy can be used to increase nominal aggregate demand of domestic goods and services. This can be achieved through lowering interest rates by increasing money supply. With increased money supply economic agents increase their expenditures of domestic goods and services thereby inducing an increase in output and prices.

Japan is one country that also experienced serious deflation. In an attempt to escape the deflation, the Bank of Japan increased money supply through quantitative easing. However, the problem of deflation persisted. Leightner (2005) attributed the unfavourable result to the problem of dealing with people's expectations. He explains that when consumers and businesses already expects deflation, the fact that nominal interest rates cannot fall below zero significantly limits the stimulative effect on output that monetary policy can have. Svensson (2003) suggests that monetary authorities could manipulate the private sector to believe in future inflation. At zero nominal interest rates, higher inflation expectations reduce the real rate of return, and thereby raise aggregate demand and the price level.

Another avenue that monetary authorities can fight deflation is to devalue the domestic currency via large open market sales of the domestic currency in order to generate sufficient import price inflation and raising foreign demand for domestic goods and services. However, in Zimbabwe monetary authorities are constrained to use monetary policy to fight deflation given the absence of a domestic currency. Zimbabwe does not have a currency of its own that it can devalue in order to induce import price inflation. It cannot also increase money supply through quantitative easing. Monetary authorities cannot also rush to reintroduce the Zimbabwe dollar since memories of hyperinflation are still fresh in people's minds.

4.2 Fiscal Policy

Fiscal authorities can fight deflation through deficit spending (Eggertsson, 2006). This is achieved through cutting taxes and issuing nominal debt. The rational of reducing taxation is to increase disposable income of economic agents who in turn are expected to boost their expenditures of domestic goods and services thereby inducing an increase in output and prices. Tax cuts increase output. Fiscal authorities can provide money-financed tax cuts in collaboration with monetary authorities. Eggerston contends that government would simply cut taxes until the private sector expects inflation instead of deflation. At zero nominal interest rates, higher inflation expectations reduce the real rate of return thereby raising aggregate demand and the price level.

An alternative is for fiscal authorities to increase debt through seeking external lines of credit. Eggertsson (2006) argues that a higher nominal debt gives the government an incentive to inflate to reduce the real value of debt. However, Tcherneva (2011) cautions against raising debts and deficits arguing that an unsustainably high budget deficit translates into an onerous tax burden on future generations. Besides, raising debts and deficits will discourage private creditors from lending to the government and it will also put an upward pressure on interest rates, inhibiting capital formation and growth. Moreover, deficit spending crowds out private spending in investment because the government will be competing for funds with the private sector in order to finance its expenditures.

Fiscal authorities in Zimbabwe are constrained to use fiscal policy to fight deflation. Government cannot provide money-financed tax cuts due to the absence of a national currency. In fact the government do not simply afford tax cuts given it is struggling to raise enough revenue to pay its workers. The government is finding it difficult to access external lines of credit given it is highly indebted and has a notorious history of defaulting on loan repayments. The country is mired in a debt crisis with external debt alone estimated at over US$10 billion, which means the government finds it difficult to issue new debt.

Be that as it may, fiscal policy is still a stabilisation tool of choice to fight deflation in Zimbabwe. But for fiscal policy to be effective, the government needs to first address structural challenges in the economy. The government should do away with vague policy objectives, for instance, the indigenisation and empowerment laws which are arguably inhibiting foreign direct investment. Instead the government should cultivate an investment climate favourable to foreign investment by creating strong institutions capable of enforcing the rule of law and property rights. The government should work towards improving transparency and accountability in revenue collection especially from mineral sales. It should plug mineral leakages which result from under-declared exports, transfer pricing and rampant smuggling of minerals. If the government can fully harness revenue streams available to it, it would be in a better position to finance its national budget without incurring further debt. It would then be able to increase disposable incomes of households either by cutting income taxes or increasing salaries of its workers. This has the effect of increasing consumption expenditures and output. The government should also create a conducive environment for investment and facilitate the formalisation of the informal sector.

V. Conclusion And Recommendations

There is no full proof way of getting out from a deflation. Both fiscal and monetary policies have their limitations, in particular, the problem of dealing with people's expectations. Good monetary authorities should be able to forecast deflation and proactively craft policies to tackle it before the public gets to expect it.

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