1. BACKGROUND AND INTRODUCTION

1.1 The economic transformation that has evolved in the country over the past 24 months has seen mixed progress towards the cherished objectives of macroeconomic stabilization, inflation reduction, growth in national productivity, as well as foreign exchange generation, among many other aspirations.

1.2 In 2004, marked progress was registered on the inflation front, with the annual rate declining from a peak of 623% in January 2004, to a low of 124% in March 2005.

1.3 On the foreign exchange front, total inflows in the formal market increased from US$301 million in 2003 to US$1,7 billion in 2004.

1.4 In respect of capacity utilization, 2004 saw a remarkable rebound from low levels of around 30% to a range of 65-70% by end of 2004.

1.5 Equally positive, year 2004 saw a considerable return of stakeholder interest and commonality of purpose in the rebuilding of the national economy.

1.6 Year 2004 also saw a notable improvement of business relations between Zimbabwe and a number of key regional and international counterparties in finance, energy and other tradeable sectors, following the country’s resumption of debt service programs, buoyed by improving foreign exchange inflows.

1.7 Across the board, therefore, year 2004 was poised to mark the beginning of a sustained episode of the turnaround of the economy, well into 2005 and beyond.

1.8 The path the country’s economy traversed in 2005 was, however, marked with deep setbacks, some of which threatened to reverse the valuable gains registered in 2004.

1.9 Most notable have been the painful resurgence in inflationary pressures across the board; the relapse of indiscipline, corruption and smuggling of precious minerals; lower than anticipated performance in the export sector; and underperformance in key sectors of the economy.

1.10 Whilst there are apparent adverse shocks that hampered turnaround progress in 2005, such as the drought and increases in international oil prices, the extent of challenges that remain deep-rooted in the economy do impel that, as a country, we enter into a solemn mode of introspection, so as to derive key lessons from our recent experiences.

1.11 This self-appraisal is pertinent in that, collectively, we will be able to **map out the weak links, threats and opportunities** that we need to work on in order to realign the economy back on the rails of recovery, and take-off.

1.12 The purpose of this Supplement is, therefore, to take a surgeon's knife across all sectors of the economy and the fiscal, monetary and structural policy formulation and implementation framework in an open, objective and constructive manner, to flag out **what could have gone wrong in 2005.**

1.13 **Only through this painful process of soul-searching can credible policy options for the future be conceived and implemented.**

1.14 As Monetary Authorities, we strongly believe that it is the right of all stakeholders in industry and commerce, mining, finance, public service, our farmers, the academia, and civil society in general to know what could have possibly gone wrong over the past 12 months as to threaten to wipe out the gains made in 2004.

1.15 It is however, imperative that at the onset, we point out that as Monetary Authorities, we do not claim to have monopoly knowledge of everything. As such, the exposition hereunder is merely an honest and sincere attempt to steer national debate more towards the pursuit of solutions to address the economy's challenges.

2. REVIEW OF THE PERIOD UP TO 2003

2.1 Challenges

2.1.1 The challenges which faced the economy in 2003 are as follows:

(a) Hyperinflation in excess of 590% by December 2003;

(b) Shortage of foreign currency and diminished export competitiveness;

(c) Price and exchange rate distortions;

(d) Under capacity utilization and reduced corporate sector viability;

(e) Contraction in economic activity;

(f) Low savings and investment;

(g) Declining levels of both foreign and local investment;

(h) High and recurring budget deficits;

(i) Domestic debt overhang;

(j) Unstable energy supplies;

(k) Supply side bottlenecks;

(l) Growing incidence of private and public sector corruption;

(m) Financial sector indiscipline;

(n) Strained international relations;

(o) High perceived country risk and reduced international credit rating;

(p) Deteriorating and over burdened infrastructure;

(q) Weak economic empowerment and worsening poverty;

(r) Accumulation of external payment arrears; and

(s) High incidence of brain drain.

2.2 CAUSES OF INFLATION

2.2.1 The following were the major factors underpinning inflation in 2003:

(a) Widening of parallel market activities, particularly for foreign exchange;

(b) Shortages of basic commodities and growing informalisation of the economy;

(c) Asset price bubbles, particularly in the stock exchange and property markets;

(d) Contraction in economic activity resulting in supply side shortages;

(e) Excessive monetary expansion;

(f) Build up in adverse expectations;

(g) Indiscipline and profiteering, particularly in the financial sector;

(h) Ad-hoc price adjustments and discretionary pricing tendencies;

(i) Administered price adjustments; and

(j) Unstable energy supplies.

3. WHAT WAS DONE RIGHT IN 2004

3.1 Introduction of a New Foreign Exchange Management System

i. The introduction of the Foreign Currency Auction System in January 2004 instilled confidence in the economy. The system was transparent and members of the public were invited to observe the auction process in progress.

ii. In the initial stages of the Auction System, the exchange rates on the parallel and formal markets almost converged, resulting in increased inflows on the official market.

3.2 Exchange Rate Adjustments (Diaspora Rate)

i. The introduction of the diaspora exchange rate improved foreign currency inflows into the official system.

ii. The diaspora rate also acted as an indicator for the direction of the weighted average auction rate.

3.3 Interest Rate Adjustments in Line with Inflation Developments

i. Interest rates were adjusted in line with inflation developments along with the maintenance of positive real interest rates.

3.4 Extensive Communication and Stakeholder Consultation of Monetary Policy

i. Since December 2003, the Governor of the Reserve Bank has been announcing quarterly Monetary Policy Statements, which set the tone for Monetary Policy implementation.

ii. The Governor also took time to meet stakeholders during the numerous road shows, breakfast meetings, company visits and strategic planning workshops. This worked well as a confidence building measure.

iii. The Subcommittees of the Advisory Board, which comprise experts from the various sectors of the economy have relayed important information about the respective sectors for policy formulation and evaluation.

3.5 Concessional Economic Support Facilities

i. The Productive Sector Facility (PSF) was established to alleviate the challenges faced by the various productive sectors of the economy, for example, agriculture, mining and manufacturing.

ii. The facility benefited companies in the following ways:
- Companies continued to produce;
- Employment was maintained or increased; and
- Capacity utilization increased from 30% to over 60%.

3.6 Targeted Price Support Subsidies

i. These were introduced to ensure the viability of the agricultural and mining sectors. These mainly covered tobacco, gold and cotton.

3.7 Engaging the International Community

i. The Monetary Authorities and Government continued to engage the international community through consultations with the IMF, the World Bank and the Diplomatic Community in Zimbabwe.

ii. Zimbabwe started honoring its obligations to the IMF, World Bank and AfDB.

3.8 Homelink Initiative

i. In order to enhance foreign currency inflows, RBZ established Homelink, which is an initiative to access foreign currency from the Zimbabweans living and working in the diaspora.

ii. This contributed to the significant increases in foreign exchange inflows in 2004.

3.9 Positive Expectations Through Policy Credibility

i. In December 2003 and during 2004, the Governor announced through the Monetary Policy Statement inflation and money supply targets.

ii. Because of the success of the policies effected in early 2004, these policies were credible and resulted in positive expectations which contributed to the reduction in inflation.

iii. Monetary Authorities put in place a visible money supply reduction program. This saw annual money supply growth trending downwards in line with inflation developments.

3.10 Restoration of Discipline in the Financial Sector

i. The year 2004 saw the Monetary Authorities instill discipline in the financial sector through effective bank supervision and surveillance.

ii. The RBZ placed some institutions under curatorship and closed those which were not viable.

3.11 Stable Energy Supplies

i. RBZ made weekly foreign exchange allocations for ZESA and NOCZIM for the importation of electricity and fuel, respectively. This significantly improved energy supplies.

4. WHAT WENT WRONG IN 2004

4.1 Sluggish Exchange Rate Adjustment

i. Monetary Authorities established the foreign exchange auction system in January 2004. During the first half of 2004, the system was successful and the productive sectors could access foreign currency from the auction.

ii. However, as from the third quarter of 2004, demand for foreign currency was significantly higher than the supply, resulting in pressures on the weighted average auction rate.

iii. The parallel market drifted from the auction rate, signifying an opportunity to vary the exchange rate system to one that was more market determined.

iv. The delay in changing the exchange rate system culminated in the growth of the parallel market and further shortages of foreign exchange.

4.2 Retention of Price Controls

i. Government maintained price controls on some goods, for example bread and grain.

ii. Government has control over tariff adjustments for services rendered by some parastatals such as ZESA, NRZ and Local Authorities.

iii. The delays experienced in tariff adjustments resulted in price distortions, which made these entities, operate under sub-economic conditions.

4.3 Perpetuation of Price Distortions

i. The continuation of the inconsistency between the producer and marketing prices of grain and fuel encouraged arbitrage and led to shortages of the products.

5. WHAT WAS DONE RIGHT IN 2005

5.1 Market Determined Foreign Exchange Management System

5.1.1 The introduction in October 2005 of a market determined interbank foreign exchange market system greatly enhanced expectations for economic recovery through exporter viability.

5.1.2 The new interbank system reinforced positive expectations and anticipations for further liberalization of the foreign exchange market with particular reference to the 30% for which the official exchange rate is applicable.

5.2 Interest Rate Adjustments

5.2.1 Monetary Authorities adjusted interest rates in line with inflation developments. The overnight rate as the key policy rate was frequently adjusted upwards from 95% to 105% in February 2005 to the current level of 540% - 550%, in response to resurging inflationary pressures.

5.2.2 Treasury bill rates were also increased to 340%-360% in order to encourage investor participation.

5.2.3 The upward review of interest rates indicates that the Reserve Bank is keen to curtail inflation, and this helps to build confidence in the economy.

5.3 Communication of Monetary Policy which Improved Confidence Building

5.3.1 As in 2004, Monetary Authorities have continued to disseminate information on Monetary Policy. However, the level of communication slackened in 2005 as evidenced by delays in the announcement of first quarter Monetary Policy and reduced outreach missions such as breakfast meetings.

5.3.2 The third quarter Monetary Policy Statement was translated into local languages so as to enhance communication of policies to the public.

5.4 Extensive Stakeholder Consultation on Policy Formulation and Implementation

5.4.1 Monetary Authorities undertook extensive stakeholder consultations through regular Advisory Board meetings, sector specific meetings, subcommittees of the Advisory Board, workshops, seminars and strategic planning retreats.

5.5 PLARP Initiative

5.5.1 The Monetary Policy Statement of January correctly recognized the Local Authorities and Public Enterprises as the missing link towards macroeconomic recovery and initiated a programme for re-orientation.

5.5.2 Under this programme, the Bank released about $3 trillion to assist the Local Authorities in their turn around programme.

5.5.3 The Bank also created 2 fully fledged Divisions dedicated to the turn around of parastatals and Local Authorities so that they become efficient in their service delivery. In addition, the 2 Divisions have spread their geographical presence to all regions of the country.

5.5.4 Under this initiative, positive returns in respect of Hwange Colliery, ZUPCO, ZISCO and Bulawayo City Council have already been realized.

5.6 Removal of Price Distortions

5.6.1 In 2005, support prices for cotton, gold and tobacco were removed.

5.6.2 The Bank also announced a macroeconomic convergence target of December 2006 for exchange rate convergence and March 2007, for interest rate convergence.

5.7 Accelerated Payments to the IMF

5.7.1 Payments to the IMF were accelerated in 2005. Cumulative payments now amount to US$155 million.

5.7.2 Settlement of obligations has the potential to unlock balance of payments and budgetary support and international creditors and donor communities which take a cue from the IMF.

5.8 Partial Liberalization of the Fuel Sector

5.8.1 The introduction of foreign currency denominated coupons for fuel in 2005 improved fuel supplies.

5.8.2 In addition, the partial liberalization allowing the private sector to import has also materially enhanced fuel availability.

5.9 A Targeted Money Supply Reduction Program

5.9.1 Following the third quarter 2005 Monetary Policy Statement, Monetary Authorities introduced a reserve money targeting Monetary Policy framework with explicit reserve money, and money supply targets.

5.10 Provincial Interventions.

5.10.1 To better understand economic development at the shop floor, Monetary Authorities introduced a provincial intervention programme. This allows for timely on the spot decision making process as well as enhancing RBZ geographical presence across the country.

6. WHAT WENT WRONG IN 2005

6.1 Monetary Authorities

6.1.1 Delayed Realignment of the Exchange Rate

i. The controlled auction system introduced in January 2004 was initially characterized by periodic exchange rate movement in line with inflation differentials.

ii. However, by the end of 2004 exchange rate adjustments were no longer consistent with inflation developments resulting in perceived over valued auction rate.

iii. As a result, the parallel market resurfaced undermining confidence in the exchange rate management system as well as the credibility of the Central Bank.

iv. Although the new exchange rate management system introduced in October 2005 greatly enhanced confidence in the foreign exchange market, continued existence of the official exchange rate albeit applicable on 30% of export proceeds still represents a tax to exporters and a distortion to the price of foreign exchange.

6.1.2 Misuse of Concessional Facilities

i. The introduction of concessional facilities was meant to provide a temporary respite to companies which were facing cash flow difficulties. It was also envisaged that the disbursements of the facilities would be funded from the banks' pool of statutory reserves so as to avoid direct printing of money.

ii. The amount disbursed to date is however, in excess of the level of statutory reserves, which has occasioned direct printing of money.

iii. Another challenge relates to the diversion, abuse and non productive application of funds by some beneficiaries, which undermines monitoring efforts, and impact on the effectiveness of policy interventions.

iv. This diversion of concessional funds has been partly encouraged by the widening gap between the concessional rates and the market determined rates, which creates arbitrage opportunities.

v. Disbursements under the concessional facilities also resulted in an increase in stabilization costs as Monetary Authorities continue to mop excess liquidity at a high cost, particularly when compared to the subsidized nature of the special facility loans.

6.1.3 Frequent Policy Variations

i. In 2005, some policy measures were not given ample time to address the intended objective. For instance, the 5% export support window was abolished before it became fully operational, which sends mixed signals on the credibility of policies to be implemented.

ii. In line with the policy of compounded effective rates, the reduction in nominal interest rates appeared to be inconsistent with the fight against inflation. Interest rates were subsequently adjusted upwards in the second quarter of the year.

6.1.4 Inadvertent Negation of Policy Interventions

i. Significant liquidity injections through economic support facilities have engendered higher demand for currency, thus compromising the effectiveness of Open Market Operations (OMO).

ii. Currency in circulation now accounts for over 90 percent of reserve money.

iii. The increase in the overnight rate is ordinarily intended to tighten credit conditions so as to fight inflation. In our situation,\ however, the existence of concessional facilities significantly weakens the effectiveness of the overnight rate adjustments. Consequently, the overnight rate has not been effective in influencing other interest rates.

6.1.5 Expansionary Effects of Quasi-Fiscal Operations

i. Against the background of increased demand for agriculture financing, as well as the need to reorient Parastatals and Local Authorities, at a time when Government is under funded, the Central Bank has increasingly assumed responsibility over quasi-fiscal activities with the objective of enhancing agriculture and economy-wide recovery.

ii. These quasi-fiscal related interventions have, however, led to significant growth in reserve money and money supply as they cannot be offset by OMO.

6.1.6 Continuation of distortions... Multiple Interest and Exchange Rates

i. Although it was generally understood that distortions would persist in the interim, the policy thrust was to progressively remove these in the medium term.

ii. Interest and exchange rate distortions, however, persist and this undermines confidence, as the market tends to discount policy effectiveness in an environment characterized by arbitrage opportunities.

iii. Principally, these distortions relate to a disparity between concessional rates at 50% and market rates in excess of 300%. Also, disparities continue in respect of the official exchange rate at Z$26 000 and the interbank rate at Z$96 000 to the US dollar. It is apparent that some line ministries in Government continue to expect funding at the exchange rate of Z$824 to the US dollar.

iv. Equally distortionary, on countless occasions, some parastatals and Government ministries have queued up and received significant amounts of foreign currency from the Reserve Bank without paying a penny in local currency. This effectively tantamounts to indirect printing of money, as in real terms, the Reserve Bank would have funded the respective entities.

6.2 Fiscal Authorities

6.2.2 Repeated Fiscal Budget Overruns

i. The Government has had recurring slippages over the past several years, occasionally giving rise to supplementary budgets, as well as predominance of bank financing of the fiscal deficits, accentuated by the drying up of external funding and incapacity of the non bank sector in a shrinking economy.

ii. Parliamentary elections, Senatorial elections, and drought induced expenditures occasioned a supplementary budget in 2005. Fiscal slippages have greatly weakened complementarity between fiscal and monetary policy.

iii. Further, a range of quasi-fiscal activities are presently accounted in the RBZ balance sheet. These should ordinarily be part of the fiscal budget. In reality, therefore, the fiscal budget is much wider than what is reported.

iv. The revenue collection framework has also not fully netted in a significant constituency currently evading taxes, particularly in the medium to small scale enterprises sectors.

v. Fiscal budgets have also not built in comprehensive measures meant to promote investment, rein in under performance in ministries, as well as instill good corporate governance and accountability in public enterprises, the majority of which continue to be a national liability.

vi. Fiscal budgets have also tended to lack credibility due to unrealistic assumptions and failure, in some instances, to anticipate known commitments, such as the inevitable obligations relating to debt service payments. Whereas Monetary Authorities have been making frantic efforts to repay, among others, the IMF, the World Bank, the AfDB, NOCZIM and ZESA suppliers' credits, no provisions have been made in the fiscal budget for Government to meet these costs, once again frustrating monetary programs meant to rein in inflationary pressures.

vii. The structure and composition of the country's national budget also continues to fall short of being an effective instrument to steer greater complementarity with the private sector. In particular, the continued predominance of the wage bill and debt service obligations in the fiscal budget poses a serious threat to meaningful national gross fixed capital formation, which is an important ingredient to economic growth and development.

viii. Whereas on paper Government has adopted a cash budgeting system, by and large, expenditure overruns remain a sore experience.

6.2.3 Contradictory Statements by Politicians.

i. In 2005, there were numerous contradictory statements by Government officials on matters relating to macroeconomic policy and management.

ii. These statements relate to the conclusion of the land reform program, stopping of farm invasions and other disruptions to farming, 99 year leases, agricultural prices and provision of inputs, as well as repayments of loans granted to farmers.

iii. Non implementation of promises made in respect of land tenor has also been a negative factor.

iv. Alienation with the international community, particularly in respect of the provision of food aid, Operation Restore Order and Garikai, as well as differences on Bilateral Investment Protection Agreement (BIPA) compensation.

v. Some high profile politicians and senior Government officials have been, on numerous occasions, implicated in corruption and smuggling of precious metals as well as basic commodities, felonies against which none of them have been prosecuted.

vi. The cumulative impact of these statements has further eroded confidence and undermined stabilization efforts.

vii. The recent wave of fresh farm invasions, which in some cases are known to have been tacitly sponsored by high ranking politicians are deplorable acts of sabotage to the country's economy and its people.

Judicial Inadequacies

viii. Equally damaging has been the visible capacity constraints in the country's judicial system, which also seems to have fallen victim to the generally observed deterioration in the public sector service levels.

ix. It also remains a colossal tragedy to the nation that not a single soul has been known to have been made to pay for the trauma and billions of dollars fraudulently stolen from the banking public by known culprits, with most of them vanishing unscathed.

x. Operationalisation of expeditious economic crimes has largely remained a phantom, notwithstanding the apparent evidence that this policy direction has been long overdue.

6.2.4 Perennial Lack of Preparedness for Agricultural Seasons

i. Year in year out, slippages on tillage and input provision have been and continue to be observable phenomena, notwithstanding Zimbabwe's long history in Agriculture, and the known devastating repercussions of such laxity.

ii. In comparison to the 2004/05 agricultural season, the state of preparedness for the 2006 agricultural season has been markedly lower.

iii. The increase in foreign exchange inflows in 2004 occasioned timely provision of inputs including diesel for tillage, seed and chemicals.

iv. Presently, the country has experienced above normal rainfall, but farming activities have been comparatively lower. This poses challenges on both food security and foreign exchange generation.

v. Whereas by and large the land redistribution process has been completed, it remains a national tragedy that vast tracts of land continue to lie idle.

vi. Also, the non-effective usage of what should otherwise be beacons of farmlands and equipment by such entities as ARDA, AREX and DDF continues to be a devastating blow to agriculture.

6.2.5 Continuation of Distortions

i. Multiple fuel pricing persists in the economy with lower prices, supposedly for farmers and Government, and higher prices for the private sector. This has spawned feverish rent seeking behavior with subsidized fuel subsequently resold on the black market.

ii. Distortions in the pricing of grain where producer prices are higher than selling prices are further avenues for gross rent seeking behavior.

6.2.6 Partial Liberalization

i. The fuel sector was partially liberalized in 2005, paving way for private participation in the fuel imports.

ii. Although it is a step in the right direction, partial liberalization inherently promotes rent seeking behavior.

6.3 Local Authorities

6.3.2 Corporate Governance challenges

i. Weak corporate governance structures characterized by lack of audited financial statements and in most cases, no substantive personnel in positions of authority. This was prevalent in all Local Authorities.

ii. Further, Local Authorities are characterized by multiple reporting structures impeding effectiveness of service delivery.

iii. These structures include reporting to various Government departments.

iv. Political interference in Local Authorities, especially in Chitungwiza and Harare Municipalities.

v. Councillors who are pursuing political self interests at the expense of focusing on developing the Local Authorities they serve.

vi. Lack of commitment by Executive Management of Local Authorities, especially in Mazowe Rural District, Chinhoyi Municipality, Murewa Rural District Council and Harare City Council.

vii. Lack of unity of purpose from Councillors brought about by differing political opinions.

viii. Lack of transparency. A case in point is Bindura Municipality where Productive Sector Funds were used to purchase a portion of a farm before seeking council resolution. The issue was only brought to Council after the sale had been concluded.

6.3.3 Operational Inefficiencies

i. Information management systems in most Local Authorities are still inefficient, as evidenced by poor database maintenance and debt recovery systems. A case in point is Harare City Council whose computer system constantly breaks down.

ii. Weak tendering process which results in awarding of tenders to briefcase companies, for example, in the Chegutu Municipality case.

iii. Lack of expertise in formulating turnaround strategies and project proposals resulting in Local Authorities hiring expensive consultants, some of whom end up assuming executive powers as in the case of Chegutu Municipality.

6.4 PARASTATALS

6.4.2 Corporate Governance Challenges

i. Like their Local Authority counterparts, parastatals are also characterized by multiple reporting structures impeding efficiency of their operations.

ii. These structures include reporting to various Government departments, Parastatal boards and other entities.

iii. Political interference, particularly in the appointment of Chief Executive Officers and other key staff, results in incompetent management teams.

6.4.3 Other Challenges

i. Lack of meaningful investment in the entities by the principal shareholder. In many cases cumulative losses have eroded shareholder equity resulting in negative shareholder equity.

ii. Huge local and foreign debt overhangs.

iii. Antiquated plant and machinery.

iv. Severe capacity underutilization due to lack of maintenance and rehabilitation, capacity mismatches, and working capital constraints.

v. Reliance on inappropriate funding mostly of a short term nature to fund capital investments.

vi. Dependence on old antiquated operating systems leading to operational inefficiencies.

vii. Entrenched lethargic business culture, lack of accountability and sense of urgency.

viii. Poor financial management and control systems.

ix. Poor pricing structures due to price controls, political interference in price setting, weak financial management systems that prevent the entities from setting objectives, economic prices, skills drain, outdated or non existent management information systems, and entrenched corruption

6.4.4 Selected Public Enterprises

6.4.4.1 Air Zimbabwe

i. Air Zimbabwe owes local creditors excluding the Reserve Bank Z$125 billion and foreign creditors US$19.65 million as at 31 December 2005.

ii. To date the Bank's exposure to Air Zimbabwe is Z$1 378.2 billion of which US$18.066 million has been paid to foreign creditors.

iii. Foreign currency payments amounting to US$3.3 million have also been met by the Bank for which no local currency cover has been provided.

iv. The net loss position of the airline for the year 2004 was $47 billion and it rose to $317 billion for the first 10 months of 2005 despite the assistance rendered to the institution by the Central Bank.

v. Managerial incompetence as exhibited by the decision to enter into a costly lease agreement with PB Airlines and the continued operation of loss making routes, such as Dubai and China generating combined flight loses of US$980 000 per month before taking into account other costs like handling, landing, navigation and office administration costs.

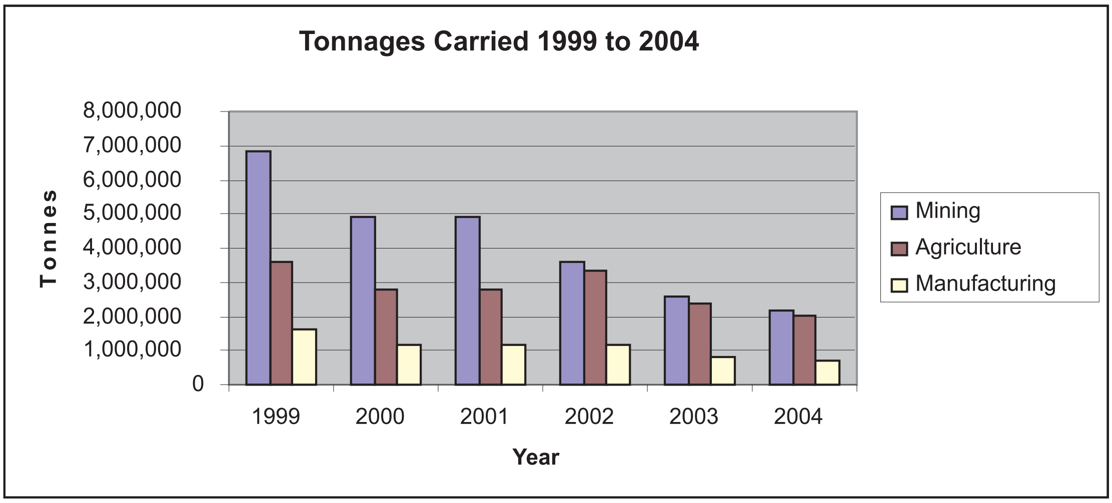
vi. The airline continues to fail to restructure its revenue stream where it earns 70% of its revenue in local currency despite having 70% of its costs being in foreign currency leading to the airline failing to pay for fuel, IATA, aircraft insurance and other direct operating expenses.

vii. Inability of the IT system to produce accurate management information to aid decision making.

6.4.4.2 NATIONAL RAILWAYS OF ZIMBABWE

i. Despite receiving Z$132.2 billion from the Central Bank, NRZ continues to reel under challenges which include: Outdated IT infrastructure and support software, weak financial reporting and control systems.

ii. Tonnages carried declined drastically from around 12 million tonnes in 1999 to less than 5 million tonnes in 2004.



iii. The parastatal only managed 3,9 million tonnes in 2005 and this falls short of at least 6 million tonnes required for the parastatal to break even.

iv. As of November 2005 the company had cumulative losses of $462 billion compared to losses of $45 billion in 2004.

6.4.4.3 ZIMBABWE ELECTRICITY SUPPLY AUTHORITY

i. The country and the region are faced with a pending shortfall of peak electricity supplies from 2007. This notwithstanding, none of the investment that is required to meet the pending shortfalls is taking place.

ii. Although all the players in the sector know about what needs to be done, none of the decisions that need to be taken have been taken regardless of the long lead time needed to implement the required action plans.

iii. On average ZESA generates around 50% of the nation's electricity requirements. The balance is met through imports. Most of the countries supplying the country are likely to be unable to do so from 2007 leading to a deepening energy crisis in the country.

iv. Policy inconsistencies, when it comes to electricity pricing, are the major risk factor. Despite the electricity regulator ZERC having the mandate to set the tariff, Cabinet continues to dictate tariffs.

v. This significantly increases the risk as prospective investors are wary to invest in a sector where the prices are not determined by economic fundamentals.

vi. ZESA sells electricity at ZW$218.08/KW hour after producing it at an average of ZW$1 386.20/KW hour.

vii. Currently ZESA's escalating import bill exceeds its total revenue leading to severe cash flow constraints.

6.4.4.4 ZIMBABWE IRON AND STEEL COMPANY

i. The company, like Air Zimbabwe, is another classic case of mismanagement and lack of policy direction.

ii. Despite accessing over Z$666 billion the company continues to experience severe financial hemorrhaging with a cumulative loss of $2.87 trillion for the 9 months to September 2005 compared to a loss of $1.298 trillion in 2004.

iii. The company's cost of sales, operating costs, and finance charges greatly exceed the revenue generated hence the perennial losses, and the gap is widening every continued month of operation.

iv. The challenges at ZISCO have manifested themselves through low plant capacity utilisation with an October 2005 output of 6 736 tonnes compared to a breakeven output in the region of 25 000 tonnes.

v. The company's insolvency is increasing with each continued month of operation at the current level, while the equipment is actually being damaged by the intermittent start-stop mode of operation.

vi. Given the current state of operating and management capacity at ZISCO it would actually be cheaper to close down operations at the company as the challenges at the company are having severe adverse effect on other companies like NRZ and Hwange to whom the company owes over $250 billion.

6.5 Private Sector

i. The private sector has also contributed to the relapse in indiscipline and deflation of business confidence in the economy through an observable sense of indifference and aloofness to some of Monetary Authorities and Government's turn around programmes.

ii. Such aloofness and indifference has manifested itself through:

- Ad hoc discretionary and, in some cases, unscrupulous pricing practices, bearing no relation at all to production costs. This anomaly has become prevalent in property markets, schools, municipalities, retail shops and the wholesale sector, among other producers and service providers;

- Illegal retention of export proceeds beyond statutory requirements; under-pricing of exports; smuggling of precious metals and minerals, exporters taking too long to respond to incentives;

- The deceleration in gold deliveries to the Reserve Bank from 22 tonnes in 2004 to 13 tonnes in 2005 is largely attributable to the wide spread leakages that were taking place, engineered and driven by some players in the sector, and in some cases sponsored by very prominent members of society;

- Understatement of operating profits to evade taxes;

- Pursuit of political agendas through diversionary economic means;

- Misuse of funds allocated under the special facilities programmes for speculative purposes, rather than production and employment creation;

- Misrepresentations to the Exchange Control Authorities on usage of foreign exchange resources, culminating in the importation of trinkets, solely for the pursuit of selfish super profits, at the expense of needy priority sectors.

5.5 Economy Wide Corruption and Indiscipline

i. The economy's performance has also been undermined by the growing cancer of corruption and indiscipline across all sectors of the economy.

6. WAY FORWARD

6.1 Against the background of surging inflation pressures in the economy and the attendant reversal of gains achieved in 2004, it is imperative that substantive comprehensive disinflation measures are pursued vigorously.

6.2 It is important to note that addressing the current macroeconomic imbalances requires complementarity of both fiscal and monetary policy, as neither in isolation will achieve desired objectives.

6.3 Introspectively, there were quite a number of positive initiatives undertaken in 2005. These need to be continued and buttressed by supportive measures.

6.4 The following positive measures instituted in 2004 and 2005 need to be sustained and reinforced:

6.4.1 The Interbank Foreign Exchange Market

6.4.1.1 The interbank foreign exchange market represents a step in the right direction and has assisted in further building confidence in macro economic management.

6.4.1.2 The envisaged positive response is expected to gain momentum in 2006, particularly reflecting the time lags needed for companies to increase capacity utilization and production, expand exports and hence generation of more foreign exchange.

6.4.1.3 For the period that concessional funding is in place, the total facility levels should not surpass the level of statutory reserves to avoid money printing.

6.4.2 Money Supply Targeting Framework

6.4.2.1 The current framework of money supply targeting needs to be sustained and implemented vigorously. The effectiveness of the money supply targeting framework in curtailing money supply growth and reducing inflation is conditional on the scaling down of concessional disbursements and financing of the fiscal budget.

6.4.3 A Tight Interest Rate Environment

6.4.3.1 A tight interest rate environment is critical for disinflation and should be continued. The effectiveness of this instrument is compromised in an environment of recurring liquidity injections.

6.4.3.2 However, very high interest rates have down side effects on the economy, affecting borrowing, production and economic activity. Interest rate policy has to be based on reasonable real rates of interest.

6.4.4 Wide Stakeholder Consultations

6.4.4.1 This has been an important pillar in monetary policy formulation and should be further sustained. Stake holders have made important contributions to Monetary Policy and its implications on the economy.

6.4.5 Proactive Engagement of the International Community

6.4.5.1 The Bank has aggressively undertaken to proactively engage the international community. This is critical for ensuring that the country is not isolated, and is preparing to reclaim its position among the community of nations.

6.4.6 Removal of Some Price Controls and Distortions

6.4.6.1 The partial liberalization of the economy has removed some distortions, but a lot more distortions remain. The economy is characterized by dual interest and exchange rates. Progressive unification of these rates within a given time frame will ensure uniformity in the economy and remove rent seeking opportunities.

6.4.7 Communication with the Public

6.4.7.1 Effective communication of Monetary Policy to the public is critical and must be sustained.

6.5 The following measures need to be implemented vigorously:

6.5.1 Supportive Fiscal Policy

6.5.1.1 Fiscal Policy has not been sufficiently complementary to Monetary Policy. Fiscal slippages persist, with recurring expenditure over-runs and supplementary budgets.

6.5.1.2 Concrete expenditure control measures must be put in place and budget deficits contained within sustainable levels consistent with non-debt financing of the budget.

6.5.1.3 Resources should be deployed towards capital development.

6.5.1.4 The civil service must be adequately resourced to achieve efficiency in service delivery.

6.5.1.5 Strategies are urgently required to deal with quasi-fiscal obligations, domestic debt over hang and accumulation of arrears.

6.5.2 A social Contract

6.5.2.1 A social contract binding key stakeholders, Government, labour and business is urgently required. This must be premised on genuine interface and win – win strategies with mutual benefits for all stakeholders and the economy.

6.5.3 Structural Reforms

6.5.3.1 Structural reforms must be instituted to complete the liberalization of the fuel sector and expanded to include agriculture production and marketing of grain.

6.5.4 A Cap on Disbursements

6.5.4.1 Sustainable reduction in money supply requires a cap on concessional disbursements and the subsequent scaling down of such disbursements. A revolving fund which progressively self finances could be established for targeted intervention.

6.5.5 Enforcement of Discipline

6.5.5.1 It is imperative that authorities adopt a zero tolerance for indiscipline and corruption in both public and private sectors.

6.5.5.2 Of particular significance is the need to curb all farm invasions and disruption of productive farming activities.

6.5.6 Parastatal and Local Authorities

6.5.7 Achieving Parastatal and Local Authorities efficiency is critical for macro economic stability and economic recovery. These institutions are a missing link in the recovery programme. The PLARP initiative was instituted to realize this goal.

6.5.8 Conceivably, Parastatal and Local Authorities turn around is markedly much more complex and could require more than Central Bank intervention. There are interwoven complexities, vested interests and entrenched cultures that militate against substantive recovery.

6.5.9 Importantly, the PLARP initiatives must be pursued, perhaps with some innovations to current policy.

6.5.10 Policy Consistency and Credibility

6.5.10.1 Macroeconomic Policies must be implemented consistently and persistently. Policy variations and frequent changes often undermine the credibility of Monetary Authorities. Flexible, but clinical policy execution is also critical.

6.5.11 Productive Land Utilisation

6.5.11.1 Against the background of surging food inflation which stood at 742% in December, 2005, it is imperative to ensure maximum land utilization. Authorities should ensure that there is no dereliction of land typically characteristic of multiple land ownership.

6.5.11.2 Authorities should also ensure that the one- man-one farm principle is religiously observed.

6.5.11.3 Sub-optimal land utilization is the clearest way to perpetuate food insecurity and accentuate food inflation. It is, therefore, imperative that every inch of arable land be put to productive use as an effective weapon against inflation, the country's enemy number one.

Thank you.

DR G. GONO
GOVERNOR
RESERVE BANK OF ZIMBABWE

24 JANUARY 2006

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