ASIA PACIFIC UNIVERSITY OF TECHNOLOGY & INNOVATION

INFLATION ON AN ECONOMY

GROUP ASSIGNMENT

TITLE: REASONING & EFFECTS OF INFLATION ON AN ECONOMY

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1.0 INTRODUCTION:

Zimbabwe has an approximate population of about 13 million people (ZimStat)[2], 2012) with approximately 80% living in villages. The year 1980 was when Zimbabwe got its independence. During its period of hyperinflation in 2000, Zimbabwe adopted the dollar from USA and called it the Zimbabwean Dollar (*ZWD*). Between the years 2000-2008, Zimbabwe faced macroeconomic imbalances experiencing a 79.6 billion per cent monthly inflation (Hanke, Kwok, 2009). This resulted to a budget deficit of ZW$1760 quadrillion (Biti, 2013; CSO, 2005). This resulted to a tremendous fall in the GDP and a high rise in Inflation forcing the government to create trillions of Zimbabwean dollars as a single note due to the fact that their currency was weak almost worthless. (*See figure 1 & 2: Appendix*).

1.1 REASONS OF INFLATION ON ZIMBABWE'S ECONOMY:

The following were some of the reasons that forced Zimbabwe to fall into a hyper-inflation;

In August 1997, almost 60000 soldiers were granted ZWD50000 each, plus a monthly pension of USD125/month outside the budget (Chitiyo, 2000). These expenditures totaled to nearly 3% of GDP which caused an effect of inflating a deficit at the end of 1997.

President Mugabe announced planned to acquire white-owned commercial farms in November 1997 which initiated giving investors a perception of an unsafe financial position and there were severe runs against the currency.

The crushing of ZWD on 14 November 1997 which lost over 75% of its value to the USD in one day on what was known as "Black Friday" is the peak of economic disaster in the Zimbabwean economic history.

Due to Black Friday, the fall of the ZWD in the foreign exchange markets reflected its loss of value to the local markets causing an increase in consumer prices of 25% in January 1998.

The lack of budgeted financing for pension payment packages and land acquisition processes, causing investor panic about the future of financial position of the Zimbabwean government, resulting to a fight of foreign capital caused the crashes in the Zimbabwean money and capital markets and exhausted the foreigners reserves of the RBZ (Kairiza, 2009).

In early 2006, the falling of the interest rates to deeply negative and the parallel exchange rate to the US dollar was sitting at ZW$135,000 to one, causing the ZWD to be even more worthless (Robinson, 2006).

1.2 EFFECTS OF INFLATION ON ZIMBABWE'S ECONOMY:

The following were some of the effects that Zimbabwe faced from the reasons in a hyper-inflation;

Intense loss in currency value. The currency value of ZWD become so worthless to almost nothing. The country was forced to make large denominations of currency to ZWD100000000000 causing people to use large amounts of money to buy small things like a loaf of bread (*See figures 2 and 3: Appendix*)

Great increase in the cost of living and a poor standard of living. As seen in (*figure 3: Appendix*) Zimbabweans had undergone through the worst state in hyperinflation that cost of living shot up to the peak forcing people to spend large sums of money to buy normal daily goods in small quantities causing the standard of living to be weaker.

BOP became a deficit. The NI of the country fell to a deficit of $1 billion in 2005 during hyperinflation. Currently as per the recent recorded deficit value, the budget had reduced the deficit value of $100 million annually.

Excessive fluctuation of the exchange rate. The ZWD was facing an excessive fluctuation in the exchange rate causing the money to be so weak compared to others. In 2004 when the ZWD was compared to USD the rates were ZWD$824 to US$1.

Zimbabwe faced rapid migration. In 1997 when SAMP conducted a survey, Zimbabweans were asked the reasons why they visited South Africa were over 70% were for economic reasons, 29% looking for work while 42% were trading or shopping.

Loss of FDI. During the hyperinflation, Zimbabwe FDI was still below &1 billion annually as the country was unable to attract investors due to inconsistencies. However, after the period of hyperinflation in 2009, it was able to get FDI's starting from $65 million when it adopted a multicurrency system and stood at $400 million in 2013. (*News Day, 2014*).

Decrease in GDP and Increase in the inflation rate. The hyperinflation that Zimbabwe faced was the worst ever as per the Zimbabwean Economy. It caused the GDP to fall tremendously and rise the inflation rate which as a result hyperinflation set in the country. (*See figure 4: Appendix*).

1.3 CRITICAL ANALYSIS:

Looking at the reasons and effects of inflation to the Zimbabwean economy, it's clearly indicated that the reasons were small but were rather very effective negatively to cause such a critical situation of *hyperinflation*. However, if we observe the following facts, for example "President Mugabe planned to acquire white-owned commercial farms which brought fear to the investors of an unsafe financial situation hence resulting to severe runs against the currency" (*See page 1: Reasons of Inflation*), we can deduce that if President Mugabe didn't take over the firms and as an alternative let them remain under the control of the whites but instead imposes good tax rates it would have been a good source of revenue to the government of Zimbabwe hence help in strengthening the currency.

On the other hand, lack of budgeted financing for pension payments and land acquisition processes, were reasons that caused hyperinflation after having given fear and panic to the investors about the future of financial position of Zimbabwe which then resulted to a fight of foreign capital causing the crash in the Zimbabwean money and capital markets and exhausted the foreigners reserves of the RBZ. So, if the government had put much thought in the aspect of preparing/planning a good financial pension budget for Zimbabwe, there may not have been a fight to cause the fall of the ZWD and exhaustion of the foreigner reserves in the RBZ and maybe the government would have a chance from falling into a hyperinflation.

Similarly, this applies to all other reasons. Whereas, if the Government used different approaches to try and solve its economic situation to the better, Zimbabwe would have been able to avoid

Hyperinflation and not have been declared as a poor country casing the currency to be weak to almost "worthless", resulting to the government to create up to "Trillions of ZWD" (*See page 2: Effects of Inflation*), forcing people to use large sums of money to buy small things of cheap prices. (*See figure 5: Appendix*).

1.4 RECOMMENDATIONS AND SOLUTIONS:

During the time that Zimbabwe was under the hyperinflation, President Mugabe had to ask the US if they could the USD for their currency. This process of changing Zimbabwean money to Dollar is known as "*dollarization*". But the overall effectiveness of the *dollarization* didn't bring much change to the ZWD. The following are some suggestions that Zimbabwe could take in order to give the ZWD more strength and help reduce the rate of inflation;

Introduce tax free zones in the country. By doing this, Zimbabwe would be able to attract FDI's to the country for industrial and commercial business. This could benefit Zimbabwe since they could sell the ZWD to the international countries and hence strengthen it as well bring international recognition to the country.

Impose higher dividend rates to banks. This will encourage people to save their money instead of spending it. This is one of the ways governments use to help control the flow of money in the market because if there is too much money in the market, inflation is likely to occur.

Implement a temporary closed door policy. By implementing a temporary closed door policy there will be no export and import practices in the countries, it would give a chance to local industries and markets to sell their local products and services.

Introduce ceiling price and floor price. Here a government will impose high minimum prices for imported goods making them very expensive in the market whereas low maximum prices for local goods making them cheap and affordable. This is a way to discourage consumers to buy imported goods but choose local goods instead.

Anti-hoarding campaigns. These are normally launched by the government to support local goods than imported goods. By doing this, the local consumers will buy the local goods instead of imported goods which will then ensure that the money spent is in the local markets and hence this can prove to be one of the ways the government controls the flow of money in the markets.

1.5 CONCLUSION:

Conclusively, it's clearly shown in the report above that reasons which resulted to a hyperinflation could have easily been avoided if the government of Zimbabwe had made good efforts in properly planning for a good economy for their country. Ideally speaking, the causes/reasons of the hyperinflation in Zimbabwe were entirely the fault of President Mugabe, the government and its ministry of finance because of the ways in which they ruled/controlled the country's economy.

So, if the government had used different approaches/ways to control Zimbabwe's economy, Zimbabwe would have not suffered a hyperinflation and as a result, losing its currency value, having a high cost of living and a bad standard of living and all other effects that occurred during and after the hyperinflation.

1.6 APPENDICES/APPENDIX:

The following appendix includes abbreviations used in the report above, images and diagrams and other relevant information that was not added in the original document;

1.6.1 ABBREVIATIONS:

1. ZWD- Zimbabwean Dollar
2. USD- United States Dollar
3. GDP- Gross Domestic Product
4. RBZ- Reserve Bank of Zimbabwe
5. SAMP- Southern Africa Migration Project
6. NI- National Income
7. BOP- Balance of Payment
8. FDI- Foreign Direct Investors
9. US- United States

1.6.2 IMAGES AND DIAGRAMS:

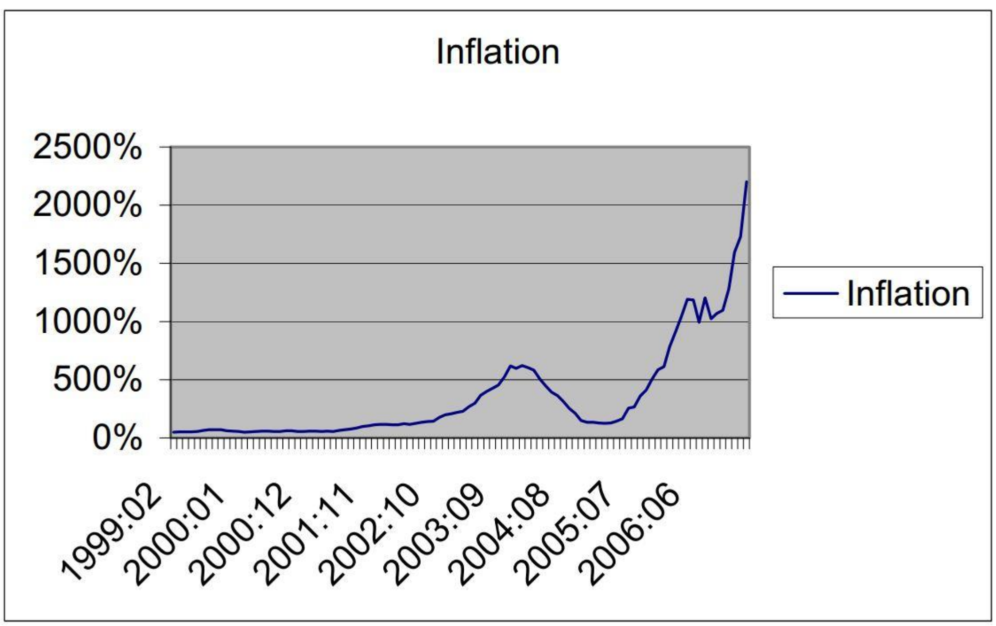

FIGURE 1: GRAPH OF INFLATION FROM 1999-2007

(*Source: Makochekanwa, 2007*)

FIGURE 2: 1TRILLION ZIMBABWEAN DOLLAR NOTE

(*Source: Federal Reserve Bank, 2011*)

In 2008, the Zimbabwe dollar was so devalued by extreme inflation that this much currency was needed to pay for a single loaf of bread.

FIGURE 3: TOO MUCH MONEY TO BUY A SINGLE LOAF OF BREAD

(*Source: Coomer, 2009*)

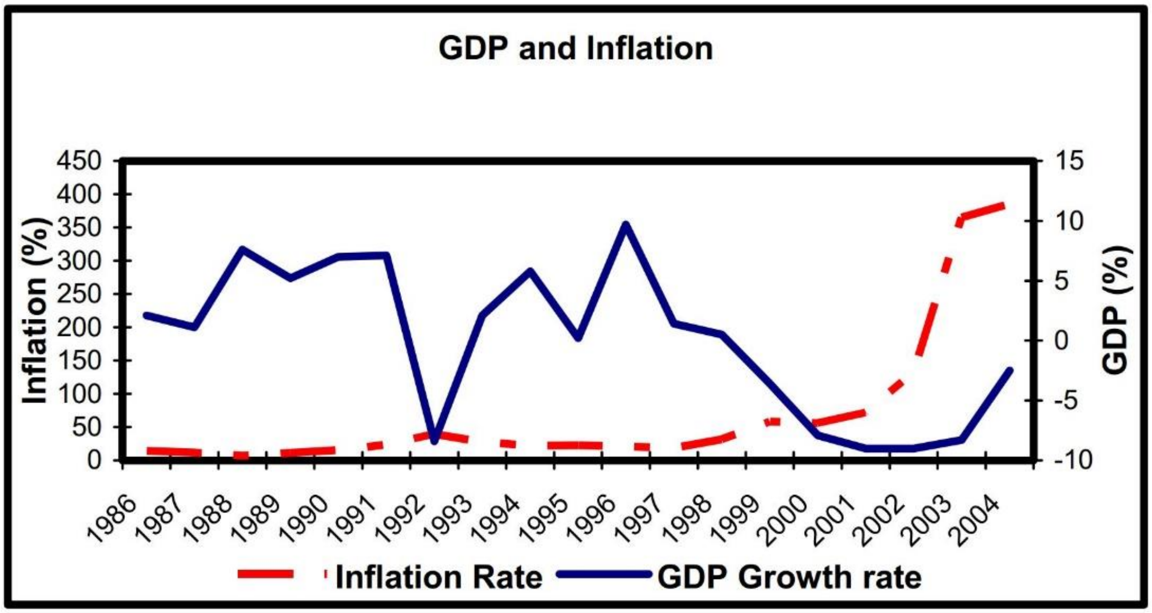

FIGURE 4: GDP AND INFLATION RATES IN ZIMBABWE

(*Source: Gono, 2005*)

FIGURE 5: TWO HUNDRED AND FIFTY MILLION DOLLARS TO BUY JUST A COUPLE OF SWEETS

(*Source: Economist.com, 2013*)

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