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Working Paper 5

Recovery of the Financial Sector and Building Financial Inclusiveness

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Foreword

This paper is part of a series of working papers prepared under the UNDP,s Comprehensive Economic Recovery (CER) initiative in Zimbabwe. Its main focus is to build on the analysis contained in UNDPs *Comprehensive Economic Recovery in Zimbabwe – A Discussion Document* which was launched in 2008. Given the fundamental transformation wrought by the decision to abandon the local currency and dollarize the economy, it was felt that there was an imperative need to revisit many of the issues raised in the 2008 document and to update the analytical framework as well as the policy options available in light of this development.

In addition, it was also felt that in the context of macroeconomic stability, the longstanding challenge of building an inclusive financial system in Zimbabwe could now be addressed in greater depth. Throughout the paper the importance of ensuring financial inclusiveness is highlighted, both in terms of the health of the financial system itself, as well as its positive potential impact on national poverty reduction efforts.

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Executive Summary

This working paper evaluates the prospects for recovery of the financial sector and achievement of financial inclusion. It starts by giving a historical perspective of the financial sector while tracking performance over critical periods. The paper concludes that the sector's performance has not been responsive to the needs of the wider economy. Another key feature of the development of the sector is that it lacked inclusiveness as it did not adequately cater for the needs of the poor and the marginalized small-scale business sector. A disturbing 70 percent of the population remained unbanked at the end of 2006.

The financial sector faced many challenges arising mainly from disorderly macroeconomic conditions characterized by hyperinflation and policy inconsistencies. In particular, the Reserve Bank presided over quasi-fiscal activities that fuelled hyperinflation. This undermined financial intermediation, resulting in the public losing confidence in the banking sector with a further deterioration in terms of financial inclusiveness.

The paper further observes that from 2002 onwards price distortions emanating from controls became so severe that the analysis of official statistical data produced perverse outcomes. By the end of 2008 the distortions had become so severe that authorities formalized dollarization that had de facto become widespread over the years. Dollarization has, however, presented its own challenges. While it stabilized inflation, it has had a profound effect on the banking sector whose capital levels had been eroded by hyperinflation. Drawing from international experience and best practices, the paper discusses policy options for both recovery of the financial sector and for building financial inclusiveness as the country goes forward.

Acronyms

AFC	Agricultural Finance Corporation
AfDB	African Development Bank
ASPEF	Agricultural Sector Productivity Enhancement Facility
BACOSSI	Basic Commodities Supply Side Intervention
CBZ	Commercial Bank of Zimbabwe
CGAP	Consultative Group to Assist the Poor
CIDA	Canadian International Development Agency
CMA	Common Monetary Area
CSO	Central Statistics Office
DFID	Department for International Development
DFIs	Development Financial Institutions
ESAP	Economic Structural Adjustment Programme
HIVOS	Dutch Humanistic Institute for Development Cooperation
IOM	International Organization for Migration
KAF	Konrad Adenauer Foundation
MFI	Microfinance Institution
MSE	Micro and Small Enterprise
MTA	Money Transfer Agency
ODA	Official Development Assistance
OECD	Organization for Economic Co-operation and Development
POSB	Post or People's Own Savings Bank
PTC	Posts and Telecommunication Corporation
RTGS	Real Time Gross Settlement
SACCOS	Savings and Credit Cooperative Societies
SARB	South African Reserve Bank
SDF	Social Dimension Fund
SEDCO	Small Enterprise Development Corporation
SME	Small and Medium-Scale Enterprises
SSA	Sub-Saharan Africa
TB	Treasury Bill
UNCDF	United Nations Capital Development Fund
UNDESA	United Nations Department of Economic and Social Affairs
UNDP	United Nations Development Programme
USAID	United States Agency for International Development
ZABG	Zimbabwe Allied Banking Group
ZSE	Zimbabwe Stock Exchange

Section 1

Introduction and Conceptual Framework

1.1 THE ROLE OF THE FINANCIAL SECTOR IN THE ECONOMY

There is now an overwhelming body of empirical evidence that financial-sector development matters for economic growth, and that through the mobilization of savings the financial sector plays a critical role of providing resources required for investment (World Bank, 2007). The causal relationship between financial development and economic growth is seen to operate through three linkages: (1) financial deepening promotes economic growth; (2) economic growth stimulates financial development; and (3) financial development and economic growth influence each other. Recent empirical work by Fung (2009) observes that the mutually reinforcing relationship between financial development and economic growth is stronger in the early stage of economic development, and this relationship diminishes as sustained economic growth gets under way. What this means is that low-income countries with a relatively well-developed financial sector are more likely to catch up with their middle- and high-income counterparts while those with a relatively under-developed financial sector are more likely to be trapped in poverty. In South Africa, the empirical results of a study conducted by Odhiambo (2009) show that both financial development and economic growth has contributed to poverty reduction.

1.2 FINANCIAL INCLUSIVENESS

While healthy and competitive financial markets are viewed as an effective tool in spreading opportunity and fighting poverty, the so-called '*Blue Book*' of the UNDESA and UNCDF (2006) observes that in most developing economies financial services are available only to a minority of the population. For instance, about 60 percent of the population in Southern Africa have no access to financial services. In Zimbabwe, a survey conducted by the National Task Force on Microfinance in 2006 showed that the formal financial system provides services to only about 30 percent (lower than the regional average of 40 percent) of the economically active population. Financial-sector development strategies have largely focused on strengthening overall financial stability and increasing the availability of services to major economic actors – large firms, the government and wealthy households – leaving out the small-scale sector that constitutes the majority of economic actors. The *Blue Book* recommends an inclusive financial-sector development strategy that makes financial services accessible to the low-income groups and small enterprises. As argued by the then UN Secretary General, Kofi Annan:

> *'Building inclusive financial sectors improves people's lives, in particular those of the poor. A small loan, a savings account or an insurance policy can make a great difference to a low-income family. They enable people to invest in better nutrition, housing, health and education for their children. They ease the strain of coping with difficult times caused by crop failures, illness or death. They help people plan for the future'.* (UNDESA and UNCDF, 2006: iii Foreword)

An inclusive financial system framework recognizes the pivotal role of microfinance institutions in reaching out to the marginalized poor segments of the population. Microfinance is the provision of a range of financial services, including savings, small loans, insurance, and money transfer services, to marginalized members of the population and Small and Medium-scale Enterprises (SMEs) that do not have access to finance from formal financial institutions. Leaders at the 2004 G8 Summit endorsed a set of 'Key Principles of Microfinance' as building blocks for inclusive finance put forward by the Consultative Group to Assist the Poor (CGAP, 2004b). These principles noted that excluded people will only gain adequate access if financial services for the poor are integrated into all three levels of the financial system, viz., the micro level, the meso level and the macro level.

It is noteworthy, however, that the concept of inclusive finance should not be restricted to the role that microfinance institutions play in extending financial service to segments of the population traditionally ignored by formal sector financial institutions. As the '*Blue Book*' argues:

> '*Inclusive finance recognises that a continuum of financial services providers work within their comparative advantages to serve poor and low-income people and micro and small enterprises. Building inclusive financial sectors includes but is not limited to strengthening microfinance and MFIs (Microfinance Institutions)…*'(UNDESA and UNCDF, 2006: 5)

1.3 FINANCIAL LIBERALIZATION AND CRISES

The financial liberalization thesis argues that the financial sectors of most developing countries are repressed by misguided financial and monetary policies, over-regulation, other forms of public sector intervention, and excessive public borrowing from the financial system. The solution suggested is a liberalized financial sector that can efficiently and extensively intermediate between savers and borrowers. From the mid-1980s to the mid-1990s, many sub-Saharan African countries implemented financial liberalization programmes to improve domestic resource mobilization and the quality of investment. According to Serieux (2008) an assessment two decades later of these efforts showed financial liberalization to have coincided with weaker growth propensities for both measures of financial deepening, namely the liquidity and private sector credit ratios[1]. However, on the positive side, these aggregates were observed to have become more responsive to potential policy instruments such as the rate of interest and public sector credit, as well as other non-policy variables such as Official Development Assistance (ODA) after liberalization (see Serieux, 2008). The significance of this lies in the fact that these data might be seen as indicating that the enabling conditions were laid during the earlier liberalization efforts of the 1980s onwards, and that given time lags sub-Saharan African economies may now be able to reap the benefits of these previous efforts.

The series of financial crises witnessed in the 1990s and more recently have led many observers to revisit the pros and cons of financial liberalization. While it is generally accepted that more open capital markets can contribute to growth, recent experiences show that there exists a trade-off between financial liberalization and vulnerability to external shocks. Federici and Caprioli (2009) found evidence that countries with very low financial development are immunized from crises. The finding is hardly surprising given that such economies often also have few linkages with the global economy and therefore fewer transmission channels for external contagion.

One possible policy implication is that 'premature' reform of a country's capital markets can be highly risky if not supported by collateral reforms. Such collateral reforms should include policies aimed at promoting and ensuring adherence to world-class standards for accounting, auditing and information disclosure, facilitating enforcement of sound rules of corporate governance to protect investors and lenders from fraud and unfair practices.

The recent global financial crisis precipitated by sub-prime home loans in the USA raises further questions on the role of official regulation and self regulation in the financial sector. Globally, there is a re-assessment of risks in the financial sector and the appropriate tools to mitigate them. While the global financial crisis was a product of market failure, the Zimbabwe economic crisis was the product of specific events and decisions that in turn resulted in market failure. One key distinguishing feature is that while most countries currently battling with the global crisis had sound macroeconomic management policies in place, Zimbabwe is suffering from the after effects of macroeconomic mismanagement. Therefore, prescriptions that are being pursued globally might not necessarily constitute the correct medicine required for sustainable recovery in Zimbabwe. Nonetheless, existing global risk-aversion has serious implications for the country because its recovery will be reliant on foreign direct investment inflows, portfolio investment inflows and investments in equities, as well as diaspora remittances, all of which the global crisis has adversely affected.

[1] Financial deepening denotes increased usage of financial services over time so that bank liquidity increases and then be able to increase lending to the private sector.

Section 2

Overview of the Zimbabwe Financial Sector

2.1 DEVELOPMENT PRIOR 1980 (PRE-INDEPENDENCE)

Foreign banks started operations in Zimbabwe (formerly Rhodesia) as early as the nineteenth century. Hanke (2008) reports that Zimbabwe had free banking[2] from 1892 when the first bank was established. This system was replaced with a currency board[3] in 1940. The system was discontinued because government wanted to profit from issuing notes. Hanke believes that Zimbabwe – when a member of the Federation of Rhodesia and Nyasaland (1953–1963) – was wrong to abandon the currency board system that had existed since 1940 and replace it with a central bank. He believes that under a currency-board system the country would have had lower inflation and higher economic growth than under a central bank regime. With regard to Zimbabwe this cannot be validated by empirical evidence given that for the first half of the sanctions period (1965–1979), when the country operated with a central bank, inflation averaged 4 percent a year and the economy grew faster (8 percent annually) than at any time since independence in 1980. This could be an indication that there might not necessarily be a link between a country's specific monetary system and its economic performance.

Despite the country having a range of financial institutions (stock exchange, discount houses, accepting houses and a Postal Bank), financial depth – as measured by the ratio of money supply to GDP – was low. The ratio actually declined from 27 percent to 21 percent between 1954 and 1963, while commercial bank lending as a percentage of GDP increased only slightly from 9 percent to 11 percent. The low financial-deepening ratio meant that commercial banks were able to increase their lending by running down their balances with their overseas head offices rather than through mobilizing domestic deposits. Financial deepening did, however, register significant progress after 1963, with the financial-deepening ratio rising to 35 percent by 1980.

2.2 POST-INDEPENDENCE DEVELOPMENTS

At independence in 1980, Zimbabwe had a more sophisticated sector than any African country other than South Africa. Throughout the 1980s (as before independence) the financial sector was tightly controlled and highly oligopolistic, with multinational banks (Barclays Bank and Standard Chartered Bank) dominating the sector, market entry was restricted and competition limited. Operations were distorted by ceilings imposed on lending and deposit rates, portfolio restrictions, government-directed lending programmes, and exchange controls. Insurance and pension funds were essentially captive government-debt markets through the prescription of assets. Small firms and low-income groups had virtually no access to credit. Those with small savings in the rural areas could only invest with the Post Office Savings Bank (POSB), which used the funds for on-lending to government. There was no lending window for these savers.

During the World Bank/IMF-sponsored Economic Structural Adjustment Programme (ESAP) of the 1990s, financial reforms were initiated with a view to the removal of controls and widening the scope of services. Initially, the reforms led to the growth of the financial sector at an average rate of 3 percent per annum when other sectors of the economy were contracting. While foreign banks still dominated the market, new entrants – new commercial banks, merchant banks, finance houses, unit trusts, leasing firms, exchange bureaux, venture capital companies, formal and informal

[2] Free banking leaves private commercial banks to issue notes and other liabilities with 'minimal regulation'. The banking system would be unregulated – no reserve ratios, no legal restrictions on bank portfolios and no lender of last resort.

[3] A currency board must hold foreign reserves equal to 100 percent of the domestic money supply determined at a fixed exchange rate.

microfinance institutions – emerged that created competition. However, the reforms did not address the structural causes that hindered financial inclusiveness. The formal banking sector continued to serve prime clients, as it had done for more than a century, leaving the small-scale sector unbanked[4]. In addition, the majority of new entrants preferred to go into merchant and discount banking rather than into commercial banking in order to engage in trading risk-free government securities.

Empirical evidence has shown that financial sector reforms would still have not resulted in deepening financial inclusiveness because the macroeconomic environment was not stable (Boyd *et al.*, 2001). With inflation rates in Zimbabwe averaging 32 percent per year during the reform period of the 1990s – double the critical threshold of 15 percent,[5] inflation had already started to adversely affect the productive sector. Therefore, it is hardly surprising that neither existing banks nor new banks were not in a position to service the untapped small-scale sector, but instead competed for government business and established corporate customers. The reforms did not improve access to credit for poor and marginalized groups and did not bolster development finance. A study by Chipika *et al.,* (2000) reported that financial reforms had a largely negative impact on agricultural credit. In four districts surveyed it was found that there had been a decrease in access to credit, an increase in the cost of credit, with personal sources of finance accounting for over 86 percent of total household finance.

Government interpreted this market failure as reflecting reluctance by banks to service the small-scale sector. Instead of providing an enabling environment, the government's response was to increase the resources for subsidized schemes such as the Small Enterprise Development Corporation and the Capital Guarantee Corporation, initiatives that conflicted with the market orientation of the reforms. These schemes were not sustainable, and by end of the 1990s they were struggling to secure financial resources.

It is also noteworthy that the Zimbabwean financial sector had been subjected to extended periods of financial repression,[6] with the exception of the reform period that lasted less than a decade. Empirical evidence shows that long periods of financial repression can result in structural changes to economic activities (McKinnon, 1973). In Zimbabwe, the sectors that could not obtain finance from commercial banks became increasingly reliant on government intervention, producing a dependency syndrome that is evident to this day.

2.3 THE CURRENT STATUS OF THE SECTOR

Presently, the financial sector comprises the Reserve Bank of Zimbabwe (RBZ) at the apex, discount houses[7], commercial banks, merchant banks, finance houses, building societies, the People's Own Savings Bank (POSB), insurance companies, pension funds, venture capital companies, asset management companies, developmental financial institutions, the Zimbabwe Stock Exchange, microfinance institutions and money transfer agencies (that intermediate remittances). As at the end of 2008 there were 28 banking institutions (down from 32 as at 31 December 2003), 17 asset management companies and 75 operating microfinance institutions (see Table 1). What is clear from Table 1 is that the instruments of financial inclusion, namely

Table 1: Number of Banking Institutions

Type of institution	December 2003	December 2008
Commercial Banks	13	15
Merchant banks	5	6
Discount Houses	6	3
Finance Houses	4	0
Building Societies	4	4
Total	32	28
Asset management companies	n.a.	17
Microfinance institutions	1,700	75

4 The term 'unbanked' means having no access to financial services, especially to the credit facilities of commercial banks.

5 This is the inflation-rate threshold beyond which inflation starts to undermine the development of the financial sector (Boyd *et al.*, 2001).

6 The term describes a state of the financial sector characterized by controls on interest rates, market entry, competition, reserve requirements and lending.

7 Discount houses, once a dominant feature of the financial sector landscape, are increasingly applying for commercial banking licenses as their traditional functions of discounting government have ceased.

microfinance institutions, have suffered the brunt of macroeconomic instability.

Three commercial banks have some degree of state ownership, namely, Z Bank, CBZ and ZABG. Four of the private commercial banks – South African-owned Stanbic Bank Limited and the Merchant Bank of Central Africa (MBCA), and British-owned Standard Chartered Bank and Barclays Bank – are multinational banks with a majority of foreign ownership. As at September 2007 these multinational banks collectively commanded 55 percent of the commercial bank market share. Since then they have faced the prospect of losing their majority foreign ownership as a result of the new Indigenization and Economic Empowerment Act (No. 14 of 2007) that requires them to indigenize 51 percent of their shareholdings.

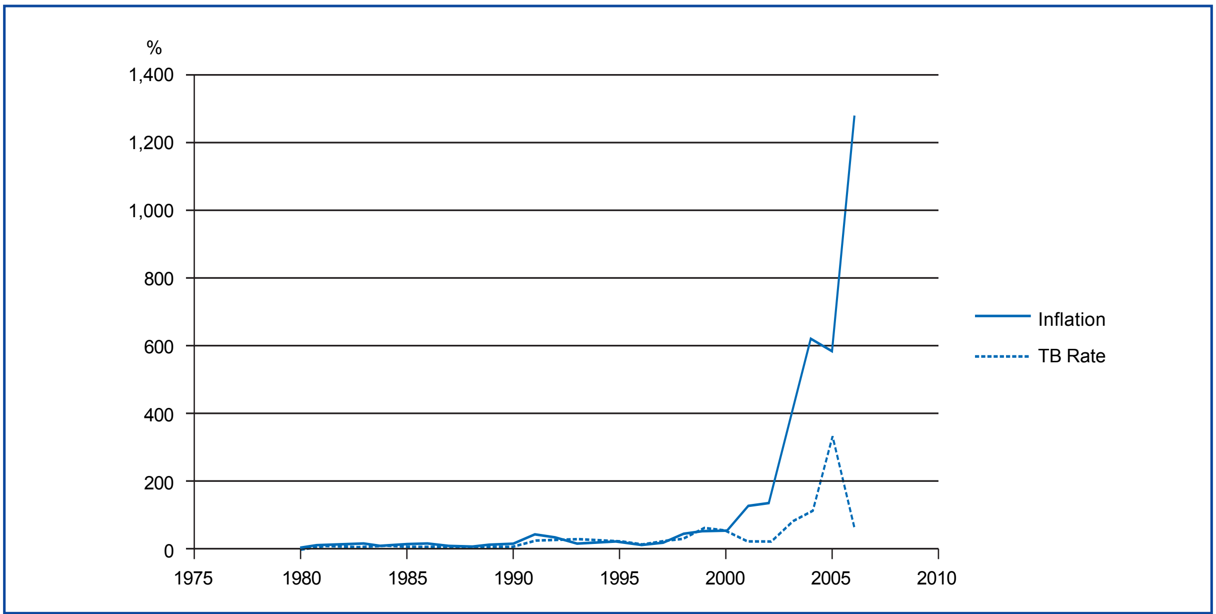
While most institutions have the majority of their branches in major towns, there is a relatively good spread of branches throughout the provinces of the country, with the POSB and Central Africa Building Society (CABS) having networks that extend to rural and remote areas. Lack of infrastructure such as reliable energy supplies, telecommunications and road network has, however, hindered rural penetration. According to a survey by the National Task Force on Microfinance concluded in 2006, the size of the market not served by existing financial institutions is still large. The average banking density was found to be one financial institution outlet per 17,000 inhabitants. In the rural areas it was found to be one financial institution outlet per 6,000 inhabitants which meant that less than three percent of rural households have access to financial services. As the economic crisis deepened, financial institutions reduced the number of their branches further adversely affecting the banking density.

2.4 OVERVIEW OF PAST PERFORMANCE

The performance of the sector is best analysed over three periods. The first period is 1980 to 1990 when it was under explicit financial repression. The second period is 1991 to 1999 when some financial reforms were initiated. The third period is from 2000 to 2008, when a reversal of reforms set in. A number of performance indicators such as the impact of interest-rate policy on savings, financial deepening, and lending to the private sector, are evaluated using RBZ statistics shown as Annex A.

Analysing performance by comparing annual inflation rates and the 90-day Treasury Bill (TB) rates provides insights into the impact of interest-rate policy. Figure 1 shows that from 1980 to 1990, when there were interest-rate controls, the average annual inflation rate was above the TB rate, meaning that savers earned negative real returns.

Figure 1: Interest-rate policy impact on savings over years



Source: Derived from Reserve Bank of Zimbabwe statistics

From 1991, when interest rates were deregulated, the situation reversed marginally. However, as Figure 1 shows, from 2000 onwards, interest-rate controls became so binding that the negative spread between the inflation rate and the TB rate widened to give highly negative real returns to financial savings. From 2007 onwards, the annual average inflation rate rose exponentially reaching 231 million percent by July 2008 and is estimated to have peaked at 500 billion (109) percent in September 2008,[8] while the TB rate decreased exponentially rendering financial intermediation meaningless.

At a macroeconomic level, savings and investment show a progressive decline over the years (see Table 2). It should be noted that the ratio of savings to GDP surprisingly rose in 2004 and 2005. This perverse behaviour could have been the result of an underestimation of nominal GDP arising from price controls, and the fact there were very few investment opportunities given high inflation.

Table 2: Savings and Investment

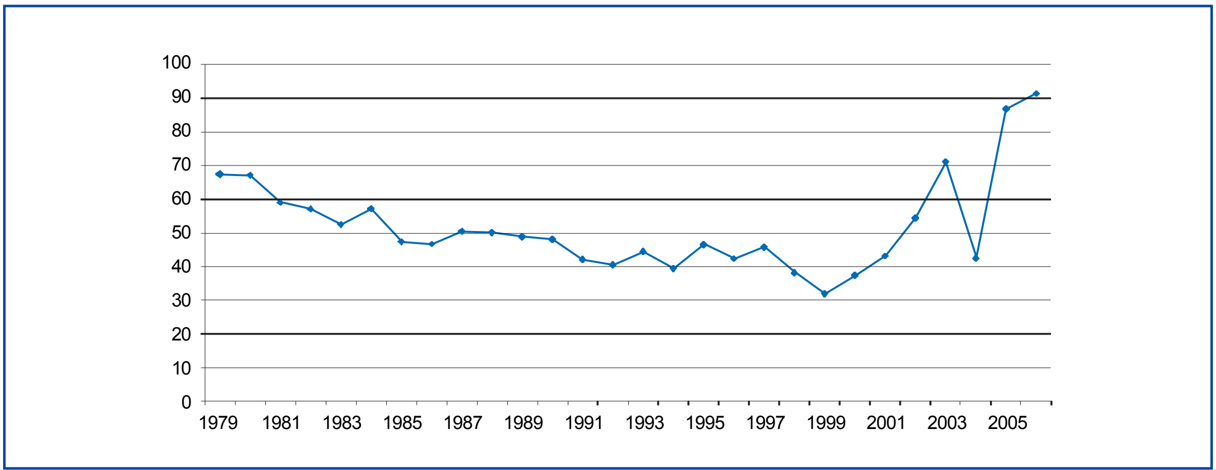
Year	Investment as percent of GDP*	Savings as percent of GDP
1995	20.8	29.4
1996	18.9	23.3
1997	10.0	19.9
1998	16.2	17.1
1999	14.0	15.5
2000	12.2	14.0
2001	8.7	5.0
2002	7.7	9.0
2003	3.9	9.0
2004	2.6	17.0
2005	1.6	14.0
2006	2.0	n.a.

*The investment figures are Gross Fixed Capital Formation (excluding stocks)

Source: Central Statistical Office, Harare, Quarterly Bulletin (2000) and National Accounts (2005 and 2006) (Unpublished)

When performance is analysed using the basic indicator of financial deepening – the ratio of money supply (M3)[9] to GDP – a dichotomous result is produced. First, as expected and illustrated in Figure 2, financial deepening had a downward slope during the 1980s when there was financial repression. During the reform period, the ratio first stagnated at lower levels than in the pre-reform period, indicating the restricted impact that reforms had on financial deepening. Thereafter, the ratio started to decline in the last years of the 1990s. Figure 2 illustrates a trend that shows a sharp decline from 1997 onwards to levels that surpassed those of the 1980s.

Figure 2: Financial-deepening ratio



Source: Derived from Reserve Bank of Zimbabwe statistics

8 IMF Staff Report: Zimbabwe-Staff Report for the 2009 Article IV Consultation p.5.

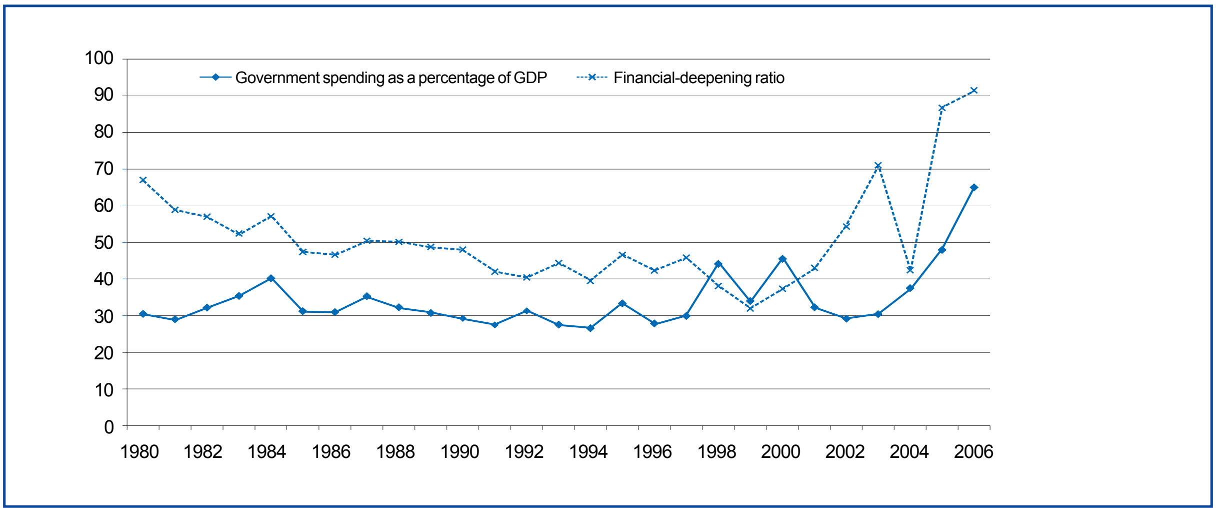
9 Money supply measures are as follows:
M1 includes currency held by the public, plus travellers' cheques, demand deposits and other checkable deposits;
M2 includes M1 plus time deposits other than large certificates of deposit; and
M3 includes M2 plus all large time deposits, institutional money-market funds, short-term repurchase agreements, and other deposits at institutions that are not banks.

The ratio shows a very revealing trend after 2000. From 2000 to 2003 the financial-deepening ratio took an upward trend so that by 2003 it had reached the level it was at independence. Incidentally, this upward trend took place during the period when there were many new indigenous bank entrants to the sector that included Kingdom Bank, Century Bank, Barbican Bank, Trust Bank, Royal Bank, numerous asset management companies, etc. However, after 2003 the ratio of money supply to GDP declined sharply, from 70 percent to 40 percent by the end of 2004. This was expected as this was the period when a shake-up in the sector culminated in the collapse of many of these new entrants in the sector.

A puzzling trend emerged after 2004. The financial-deepening ratio took an upward trend in defiance of fundamentals. The ratio no longer reflected a process of healthy financial sector development, but rather the effect of money printing and underestimation of prices (in line with controls) in the measurement of GDP. USAID (2007) which, owing to hyperinflation, computed the ratio as an average of broad money over the whole period (rather than the end of the period) to GDP, made similar observations. The upward trend in the financial-deepening ratio post-2004 coincided with the explosion of quasi-fiscal operations. The share of non-earning assets emanating from quasi-fiscal activities rose from 22 percent in 2003 to 46.5 percent in 2004, 70.3 percent in 2005 and 83.3 percent by October 2006. It is during this period that private sector lending fell dramatically. As a share of total money supply, private sector lending fell from over 80 percent in 2002 to 34 percent in 2006. The average for sub-Saharan Africa is 76 percent while the average in conflict economies is 44 percent, meaning that Zimbabwe performed worse than countries in conflict. At the same time, government spending as a percentage of GDP rose from 25 percent in 2003 to 65 percent in 2006 against the rise in the financial-deepening ratio from 40 percent to 90 percent. Figure 3 shows a trend that indicates that government expenditure was actually driving the perceived financial deepening.

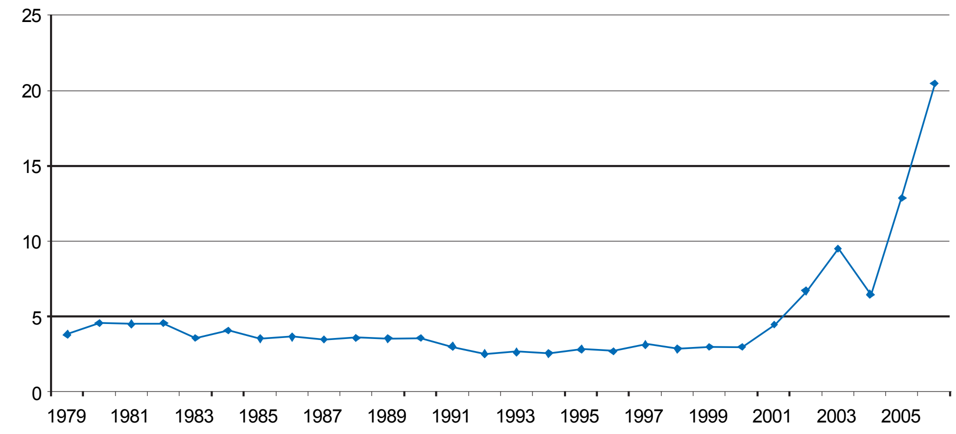
USAID (2007) estimated that the real interest rate on bank loans averaged -27.7 percent in the five years to 2005. This was in contrast with an average of +10.7 percent for low-income sub-Saharan African countries, 5.6 percent for South Africa and 7.7 percent for Zambia. The critical role that interest rates play as a price mechanism for screening out inefficient or unproductive investments was completely negated by these high negative real interest rates. Borrowers were in more favourable positions than savers because they repaid banks less than the amount they borrowed after adjusting for inflation. Hence, there was an increasing incentive to borrow as the pace of inflation picked up.

Figure 3: Evolution of government spending and financial deepening



Source: Derived from Reserve Bank of Zimbabwe statistics

Figure 4: Currency in circulation in the economy as percentage of GDP



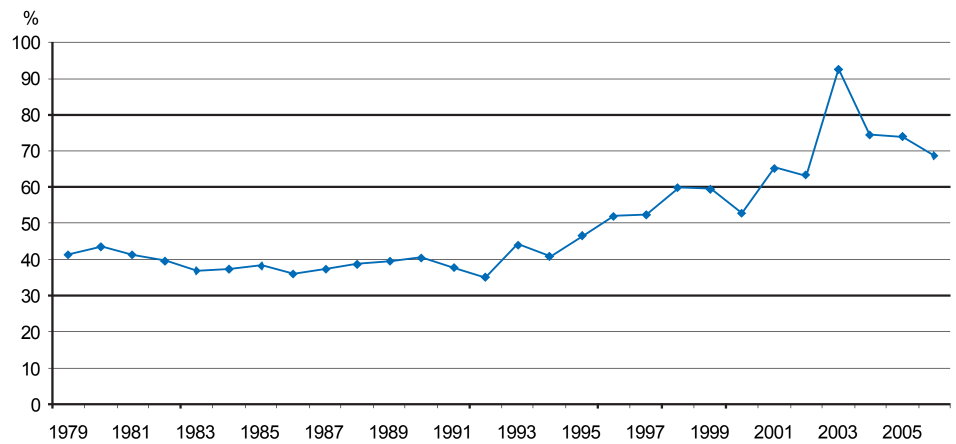
Source: Derived from Reserve Bank of Zimbabwe statistics

In line with rising inflation and demand for money, the currency (notes and coins) in circulation in the whole economy saw an exponential upward trend as shown in Figure 4.

In line with countries with developed financial systems, the ratio of the currency in circulation to GDP had remained below 5 percent until 2002, after which it started to rise exponentially, reaching 20 percent by 2006. In South Africa the ratio is well below 5 percent, an indication of a well-developed financial sector and a trend towards a cashless economy, where 'plastic money' is more widely used than cash (Akinboade and Makina, 2006). Thus, the exponential rise of the ratio showed that Zimbabwe was retrogressing to a position similar to countries (usually failed states) with very weak financial sectors that operate largely on a cash basis.

Given concerns about the underestimation of GDP owing to price controls, and the fact that the larger part of the economy had become informal, the ratio of narrow money (M1) to broad money (M2) provides a more reliable picture of the retrogression of the financial sector. The M1 to M2 ratio should be inversely related to a country's level of financial development wherein there is increasing usage of financial services. If this ratio decreases, financial-sector development can be said to be occurring

Figure 5: Ratio of M1 to M2



Source: Derived from RBZ statistics

because savings deposits would be increasing more rapidly than transaction (demand) balances. When there is a preference for liquidity, as was the Zimbabwe situation, demand deposits have an abnormal weight in the total deposits. A ratio of 100 percent would suggest that all deposits are on a sight (demand) basis. Figure 5 shows that the ratio in Zimbabwe had been moving towards 100 percent since 2003, meaning that most deposits were on a sight basis. In sum, this means that there was tremendous pressure for the withdrawal of funds from the banking sector. Controls on withdrawals were holding back a run-down on deposits. Ironically, quantitative controls on withdrawals by the Reserve Bank might be seen as having contributed to the stability of the banking sector in that they were preventing capital flight. Otherwise the hyperinflationary environment could have precipitated a run on deposits.

However, by October 2008, pressure for withdrawals had become so severe that the RBZ partially allowed dollarization. Subsequently, on 2nd February 2009, dollarization[10] was formalized whereby a 'multicurrency system' in transactions was adopted which involved the use of hard currencies alongside the Zimbabwe dollar. While controls on withdrawals of the domestic currency were then abandoned, the Zimbabwe dollar ceased to be acceptable tender even for government transactions in a process that was largely market-driven. The effective full dollarization was officially acknowledged by the new Minister of Finance of the Government of National Unity in a Budget Review Statement presented in Parliament in February 2009, in which domestic currency was formally declared moribund. The new monetary regime rendered performance ratios earlier calculated no longer comparable with those in the post-dollarization period. The implications of the new monetary regime are discussed in subsequent sections of this working paper.

[10] Dollarization is used here in its broadest sense to mean the adoption of another country's currency as legal tender, rather than solely the adoption of the US dollar.

Section 3

Legal and Regulatory Framework

A well-functioning legal system facilitates the operation of the financial system. On an improving scale of 0 to 10 in the World Bank's *Doing Business Report*, Zimbabwe was given a poor score of 6.0 on its index of Legal Rights of Borrowers and Lenders for 2006[11]. Of particular concern is that when evaluated in terms of the rules that affect the scope, accessibility and quality of credit information available through either public or private registries, the World Bank gave Zimbabwe the lowest possible score of 0.0 on its index of Credit Information depth.

The Reserve Bank of Zimbabwe (RBZ), the monetary authority responsible for the oversight of the financial system and for all monetary operations, was established according to the Reserve Bank Act of 1964, which required it to consult the Ministry of Finance on certain decisions, such as registration of banks and cancellation of banking licenses. Two pieces of legislation – a new Reserve Bank Act [Chapter 22: 15] and a new Banking Act [Chapter 24: 20] relating to bank operations and supervision – were enacted in 1999. They were intended to enhance the supervisory role of the central bank.

Table 3: Acts Governing the Financial Sector

Act	Financial Institution
Reserve Bank Act	Reserve Bank of Zimbabwe
Banking Act	Commercial Banks Finance Houses Discount Houses Merchant Banks
Building Societies Act	Building Societies
Collective Investment Schemes Act	Asset Management Companies
The Post Office Savings Bank Act	People's Own Savings Bank
Moneylending and Rates of Interest Act	Microfinance institutions
Stock Exchange Act	Zimbabwe Stock Exchange
Pension and Provident Fund Act	Pension Funds
Insurance Act	Insurance Companies
Co-operative Societies Act	Credit Unions

Table 4: Distribution of Regulatory Authority

Financial Institution	Regulatory Authority
Banking institutions	Reserve Bank of Zimbabwe
Asset management companies	Reserve Bank of Zimbabwe
Insurance companies and pension funds	Insurance and Pension Commission
Zimbabwe Stock Exchange	Securities Commission[12]
People's Own Savings Bank	Ministry of Finance
Credit Unions	Ministry of Youth, Gender & Employment Creation
Microfinance institutions	Reserve Bank of Zimbabwe
Unit Trusts	Reserve Bank of Zimbabwe

[11] World Bank, Doing Business; Getting Credit Category: Methodology & Surveys <http://www.doingbusiness.org/MethodologySurveys/GettingCredit.aspx>

[12] Prior 2008 the stock exchange was regulated by a management committee.

Today there are various Acts that regulate the financial sector. Table 3 summarizes the main Acts as they apply to institutions.

The regulatory authority for individual kinds of institutions is dispersed as shown in Table 4.

Essentially, the regulation of the financial sector is premised on the silo approach whereby regulation is divided along functional lines – banking, insurance, pension and securities industries. The RBZ has traditionally been responsible for prudential and systemic regulation of banks through the Banking Act, while non-banking entities are regulated through their individual Acts under the administration of the Minister of Finance. The present structure of regulation suffers from a number of constraints:

1. The silo approach has limitations in regulating financial groups that operate simultaneously in several segments of the financial sector, e.g., banking, insurance, pension and securities industries. Under this approach, a single financial group would have several regulators. Since tighter regulation is imposed on the banking sector relative to other financial institutions, there is scope for regulatory arbitrage. For instance, a financial group has an incentive to reduce the required capital by spreading risks where capital requirements are lower, e.g., in the securities and insurance sectors. The RBZ responded to this challenge by adopting a consolidated supervisory approach. However, such an approach relies on the availability of expertise to monitor innovation and risk taking in the financial sector, which the RBZ has lacked.

2. The new Reserve Bank Act of 1999, though being an improvement in relation to the old Act given the strengthened supervisory powers contained in the former, still does not grant the central bank independence in carrying out monetary policy.

3. The supposedly new Banking Act of 1999 made provision for segmentation in the banking sector. For instance, Section 6(2) of the Act provides that no banking institution shall be registered in more than one class of business. The implication of this provision is that an institution has to apply for a separate licence for a particular banking business.

4. Section 3 of the Banking Act, under which the microfinance institutions are also regulated, does not adequately cater for the specific features of these institutions.

Section 4

The Monetary Policy of the Reserve Bank

Among the functions of the Reserve Bank of Zimbabwe (RBZ) lies the responsibility for the formulation and implementation of monetary policy in its pursuit of price stability.[13] The RBZ does not however, have operational independence in carrying out this responsibility because it is required by statute to consult with the Ministry of Finance.

The evolution of Zimbabwe's monetary policy framework in the post-independence period can be broken down into five periods:

- The control regime of the 1980s, when monetary policy was inactive;
- The shift in monetary policy strategy from controls towards monetary targeting of the early 1990s, whereby the operational target was net domestic assets[14];
- The shift in monetary policy strategy towards reserve money[15] targeting in the mid-1990s;
- The monetary policy regime, from 2003 to 2008 that accelerated the reversal of earlier financial reforms; and
- Formalization of dollarization in early 2009.

4.1 THE CONTROLLED REGIME OF THE 1980S

From 1980 to 1990, economic conditions were characterized by extensive controls on domestic economic activity, ranging from controls on prices, wages, interest rates and credit, to controls on foreign-exchange allocations. Monetary policy was largely inactive, and based on direct instruments that included controls on lending and deposit rates (interest-rate caps), quantitative controls on credit (credit ceilings), use of Reserve Bank bills, prescribed liquid asset ratios, moral suasion, and other monetary measures designed to discourage non-essential and deferrable consumption expenditures.

Since the use of interest rates as an active instrument of monetary policy was limited, interest rates were largely stable throughout the 1980s. While the rate of inflation averaged 12 percent per year, the bank rate was fixed at 9 percent for most of the 1980s. Savers earned negative real interest rates which discouraged savings mobilization and competition in the financial sector. Further limiting the scope of monetary policy were the high fiscal deficits that characterized the 1980s that absorbed disproportionately high levels of scarce domestic savings. Budget deficits averaged 8 percent of GDP in the 1980s. The banking sector played a significant role in financing the budget deficit, thereby contributing to inflationary pressures and crowding out the private sector.

4.2 THE SHIFT TOWARDS MONETARY TARGETING IN THE EARLY 1990S

The economic liberalization programme initiated in the 1990s saw the removal of controls on interest rates. This allowed the Reserve Bank's monetary policy strategy to shift to one based on targeting intermediate monetary aggregates, i.e., money supply measures such as M1, M2 and M3 open market operations and a flexible interest-rate policy became the principal instruments through which monetary policy was conducted.

[13] In terms of the Reserve Bank Act [Chapter 22:15].

[14] This involved regulating central bank lending to government with a view to achieving price stability (controlling inflation), but the central bank could not control inflation because it could not control government borrowing. Net domestic assets comprise net government borrowing and credit to banks.

[15] Reserve money comprises currency issued by the central bank and bank reserves held by the central bank. Under reserve-money targeting, the central bank fixes the level of reserve money consistent with the targeted level of money supply.

From 1991 onwards, the Reserve Bank adopted the use of net domestic assets as its operating target, whereby monetary operations focused on regulating the amount of credit made available to government and the banking system to ensure that it was in line with the desired level of net domestic assets. This approach did not work because the expansion in net domestic assets was largely driven by Government borrowing from the banking sector which was inflationary. In the 1990s annual inflation rates were over 20 percent for the greater part of the period.

4.3 MID-1990S SHIFT TO RESERVE-MONEY TARGETING

The RBZ observed that targeting net domestic assets could not contain inflation because of the weak link between net domestic assets and domestic inflation (Mabika, 2001). Drawing from empirical evidence in other countries that indicated a stable relationship between reserve money and broad money supply (M3), the RBZ shifted to reserve-money targeting. Under this regime it fixed the level of reserve money consistent with the targeted level of M3.

Notwithstanding the change in approach, inflation continued to soar upwards, reaching nearly 60 percent by 1999. The assumed stable relationship between reserve money and money supply did not hold. Reserve money was very volatile, largely as a result of the following three main factors:

(1) Statutory reserve ratios were subject to frequent changes.

(2) The propensity to hold cash rather than bank deposits rose as inflation accelerated.

(3) The RBZ was financing budget deficits via money creation. In other words, the RBZ was part of the problem contributing to the ineffectiveness of its own monetary policy as early as the 1990s.

In fact, the use of reserve-money targets as agreed with the IMF in 1998/99 was short-lived because government spending exceeded agreed targets, thus forcing the RBZ to finance the budget deficits and abandon reserve-money targeting. While recent IMF programmes have tended to focus on the monetary base (reserve money), IMF research in Zimbabwe has found a reasonably consistent relationship between notes in circulation (M0) and inflation, suggesting that this might have been a more suitable anchor for a short-term stabilization programme.

4.4 THE MONETARY POLICY REGIME (2003–2008)

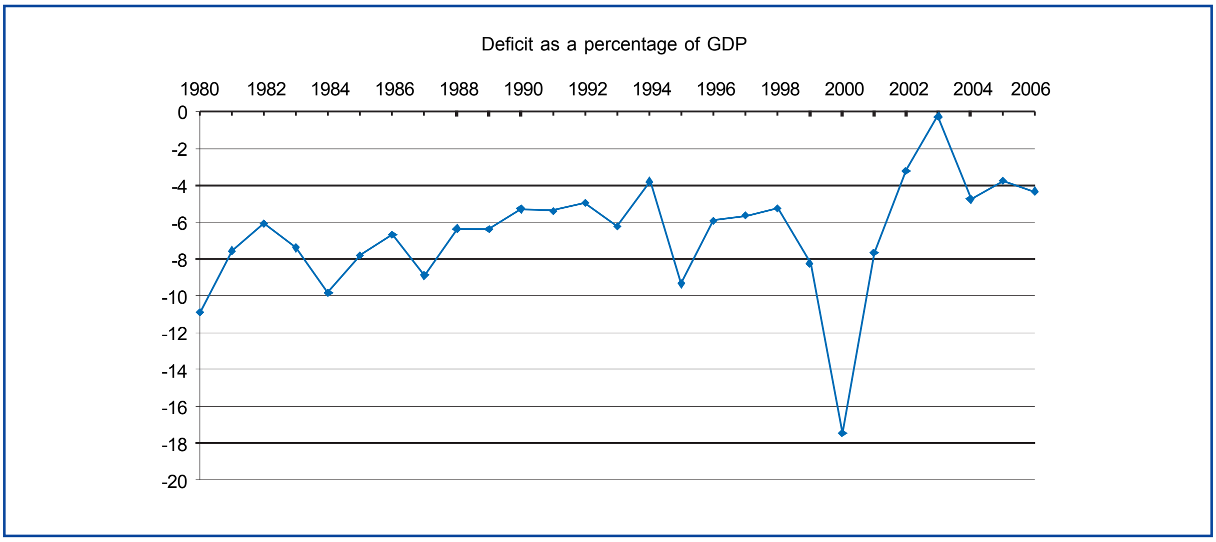
The abandonment of monetary reforms actually started in 2001, when the government fixed the yield on Treasury Bills in an endeavour to bring down a rising fiscal deficit. The 90-day Treasury Bill rate that stood at around 48 percent in early January 2001, dropped to 10 percent by the end of April 2001 when annual inflation was running at 70 percent, plunging real interest rates into strongly negative territory. The monetary system of indirect monetary control that had been adopted in 1998 was abandoned. When the new central bank governor, Gideon Gono, took office in December 2003, there was a fundament change in the functions of the RBZ. The Reserve Bank increasingly took over the fiscal operations of the Ministry of Finance. In addition, it assumed some of the functions of commercial banks in that it engaged in significant direct lending to the private sector.[16] The central bank also began to undertake other private sector and public sector functions outside its remit that included, among others, agricultural support activities, manufacturing and retail activities (e.g., operating people's shops).

From 2004 onwards, the RBZ engaged in quasi-fiscal activities that were primarily funded by printing money. The IMF estimates that US$1.1 billion was used in 2008 alone to finance these activities which 'included election-related expenses, transfers to parastatals, subsidized directed lending, free provision of equipment and fertilizers to farmers, and allocation of foreign exchange at subsidized exchange rates'[17]. Credit was provided at derisory

[16] Reserve Bank data show that the share of RBZ lending to the private sector increased from 0.6 percent in 2004 to 43 percent by end 2007.

[17] IMF Staff Report: Zimbabwe-Staff Report for the 2009 Article IV Consultation p.7.

Figure 6: Trend of central government budget deficit (excluding quasi-fiscals)



Source: Derived from Reserve Bank of Zimbabwe statistics

nominal interest rates to favoured sectors whose prospects of repaying were so low that these credits should more properly be viewed as subsidies.

Furthermore, despite operating in an inflationary environment, the RBZ did not employ inflation-accounting but used historical-cost accounting, thereby misstating the true economic position.[18] The IMF (2007) reported discrepancies between the budget financing requirements and financing data from banking and other sources. The latest published data in the IMFs *Government Finance Statistics Yearbook* are for 1997, and no recent data had been provided for publication in its *International Financial Statistics*.

Since quasi-fiscal activities were not being consolidated in the fiscal budget, the budget deficit as a percentage of GDP was understated. Figure 6 shows the trend of a declining budget deficit as a result of the exclusion of the quasi-fiscal activities.

Coorey *et al.*, (2007) have re-estimated the financing requirement after adjusting for quasi-fiscal activities to show the true position, which is illustrated in Table 5.

Table 5: Adjusted fiscal position

	2004	2005	2006[a]	2007 passive scenario[b]
		Percentage of GDP		
Central government				
Revenue	33.8	43.7	51.3	40.1
Expenditure	41.5	49.6	58.6	66.6
Of which: Wage bill	15.3	18.1	17.1	16.1
Overall balance	-4.7	-3.1	-5.4	-25.6
Primary balance	-1.7	3.7	2.3	-13.9
Adjusted fiscal position				
Primary balance	-26.9	-17.2	-24.7	-40.2
Financing requirement	-29.9	-64.3	-80.3	-88.0

a Estimate b Conservative estimate

Source: Coorey et al., *(2007)*

[18] Historical accounting is a record keeping method that uses prices at the time a transaction occurred whereas inflation accounting adjusts prices to take account of inflation. However, inflation accounting becomes inappropriate under a hyperinflationary environment because the currency is quickly rendered worthless.

*Table 6: Contributions to changes in reserve money**

	2003	2004	2005	2006
Reserve money	10.6	6.7	13.8	20.2
Net foreign assets	-4.1	-7.1	-43.2	-1.4
Claims on banks	4.2	2.3	0.6	1.8
Net claims on government	4.3	-0.1	-3.3	-0.2
RBZ securities	0.0	-21.5	-32.2	-32.4
Other items net	6.2	33.1	91.9	52.4
Of which:				
Subsidies	4.0	13.9	20.3	15.4
Realized exchange losses	1.2	11.4	0.6	7.7
Interest cost of RBZ bills	0.0	5.1	40.4	41.0

* Change since end of previous year, as a percentage of annual GDP

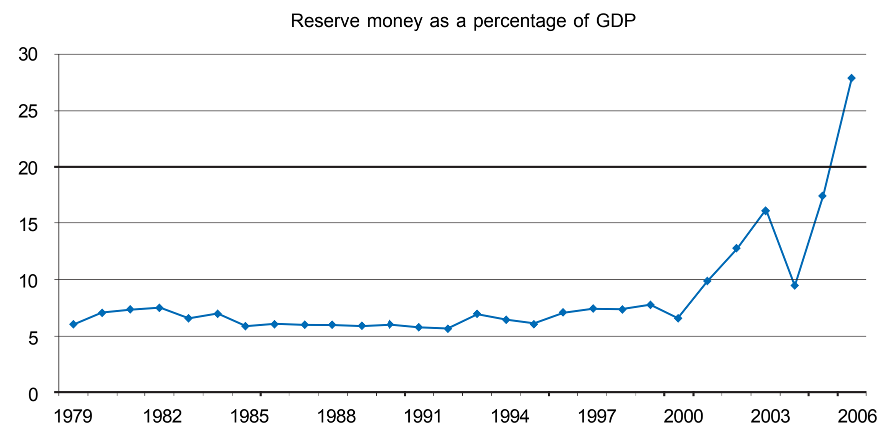
Source: Munoz (2006)

Notably, there was a widening gap between the primary balance and the financing requirement, indicating the magnitude of quasi-fiscal activities and possibly hidden expenditures under contingencies. Munoz (2006) has illustrated that the escalation of inflation since 2004 was fuelled by rapid reserve money growth emanating from the RBZ's quasi-fiscal activities. Table 6 shows contributions of individual balance-sheet items to changes in reserve money from 2003 to 2006. Quasi-fiscal losses, indicated as 'Other items net', were evidently the major contributors.

Analysis of the trend of reserve money as a percentage of GDP since 1980 shows a sharp increase since 2004, meaning that the monetary policy of targeting reserve money had been abandoned in favour of printing money (see Figure 7).

Predictably, the printing of money by the RBZ led to hyperinflation, with inflation rising from an annual average of 386 percent in 2003 to over 231 million percent by mid-2008. The domestic currency was rendered worthless, and was redenominated on three occasions in two years. First, in order to make ever-rising denominations manageable for the public and business, three zeroes were removed in August 2006 when annual inflation averaged 1,017 percent. Second, ten zeroes were removed on 1 August 2008 when annual inflation was officially estimated at over 231 million percent. Third, twelve zeroes were lopped off in February 2009 when inflation could no longer be measured. The last official inflation figure was 231 million percent for July 2008. The IMF estimated that inflation reached 500 billion percent in September 2008. The January 2009 Monetary Statement reported that broad money supply (M3) growth increased sharply from

Figure 7: Trend of reserve money over years



Source: Derived from Reserve Bank of Zimbabwe statistics

81,143.1 percent in January 2008 to 658 billion percent in December 2008. By the end of 2008 the domestic currency had become so worthless that the majority of transactions were being conducted in foreign currencies, mostly the US dollar and the South African rand. Seen against this background, it could be argued that creeping dollarization was more a reflection of market preferences than public policy.

4.5 A NEW MONETARY REGIME FROM 2009

The reality of market-driven dollarization was inevitably and formally accepted in February 2009. It had the following main features:

- The use of the US dollar as the main medium of exchange, while at the same time allowing the use of other hard currencies such as the rand, the pound, the pula, the euro, etc., for transactions in a system termed multi-currencying[19];
- The rand was made the reference currency for the purposes of evaluating price and wage levels in the economy; and
- Dollarization was not backed by any international reserves as is normally the case for countries that choose such a monetary regime, and as a result domestic money balances in the banking system were not converted into foreign currency.

The adoption of dollarization effectively meant loss of control of the money supply. The supply of foreign currency was now a function of the performance of the export sector, international capital inflows, diaspora remittance bonds (see forthcoming UNDP working paper on the diaspora) and donor funds. The exchange rate was no longer an available tool for adjustment purposes. The burden of adjustment was squarely placed on the fiscal side. This meant that in order to maintain competitiveness, price and wage levels have to be flexible and should reflect productivity gains.

Dollarization changes the nature of the central bank in fundamental ways. It cannot finance budget deficits through money creation. Budget deficits can only be financed from international flows such as external loans (subject to favourable credit rating), aid flows and diaspora remittances. The central bank's stated goal of price stability can only be achieved through fiscal adjustments (over which it has no control), and the soundness of the banks. If the latter are not sound, the public would operate informally outside the financial system, a practice which increases the velocity of cash in circulation and hence distorts prices.

The RBZ still has a role in a dollarized environment. With regard to interest-rate policy, it has set the London Inter-bank Offer Rate (LIBOR) plus six percent as the recommended interest rate. Its statutory reserve ratio policy which it still retains has a major impact on bank operations. It also sets capital ratios that will impact on the level of lending and liquidity in the economy, as well as the risk preferences and profitability of banks. It continues to be involved in the regulation and supervision of the banking industry, and the provision of crucial payment services to the banking system, though these services could also be performed by the private sector. Crucially, however, it will no longer be able to perform one key function of central banks, namely that of the lender of last resort to avoid liquidity crises.

The process of dollarization in Zimbabwe was peculiar in that it was not backed by international reserves as is normally the case with countries that have dollarized. As a result the RBZ was not able to convert domestic money balances of the banking system. This rendered both domestic savings of the public and money capital balances of banks worthless. In anticipation of dollarization the RBZ recalled all Treasury Bills held by banks and redeemed them in local currency even before maturity.

As a result, the recovery of the financial sector is thus effectively dependent on foreign currency capitalization of banks and the attraction of foreign

[19] Initially, the domestic currency was supposed to be legal tender alongside other currencies, but hyperinflation had rendered it worthless and it seized to be legal tender even in government transactions. Nevertheless, the government continued to pay civil servants in local currency in addition to a US$100 hard currency allowance.

currency deposits from the public. The limited participation of foreign investors imposed by the Indigenization and Economic Empowerment Act places constraints on recapitalization of banks from external sources. On the other hand, domestic investors would be hard pressed to raise capital in foreign currency. Furthermore, it will be difficult to attract the necessary and considerable deposits in foreign currency given the public's loss of confidence in the banking sector.[20]

Moreover, as of this writing, the payment and settlement system in the dollarized economy is not yet in place. Initially, there were only two forms of payment and settlement systems, namely the telegraphic transfer and the cash settlement. There are a number of constraints in using these forms of payment and settlement systems. At a minimum, telegraphic transfers take 48 hours for funds to reflect in a recipient's account. It makes this form of payment unattractive as the transacting public requires same day value transactions. The cash settlement system is unsuitable for large value transactions between counterparties. Banks incur huge costs (cash-in-transit security and insurance costs) to safeguard against robberies and theft. One result might be that the public will be unwilling to make foreign currency deposits, opting instead to hold their money in the form of cash for convenience as they did under conditions of hyperinflation. Given the recent experiences of the banking public, occasional references by national authorities to the possibility of reintroduction of a domestic currency might also serve as a disincentive. Recent developments in terms of the payments system, such as the introduction of the Real Time Gross Settlement (RTGS) system, has enabled faster transfers (24 Hours). Further adjustments to the realities of dollarization are going to be required, such as the issuing of cheques and plastic money denominated in US dollars.

The multicurrencying system that has been adopted places further constraints on the operation of the payment and settlement system. In essence, multicurrencying means that any given economic agent can choose a preferred unit of account, with some agents opting for the US dollar, others using the rand, others using the pound, others using the pula, and so on.[21] This scenario creates economic fiefdoms within the same country whereby exchange rate risk is created among the different currencies being used, and yet it cannot be hedged due to absence of relevant institutions and instruments.

The Government's decision to adopt the rand as a 'reference currency' for evaluating competitiveness (price and wage levels) might be seen as an acknowledgment of the initial mistake of 'opting' for the US dollar (though the 'decision' might be more properly interpreted as having been thrust upon the government by the realities of hyper-inflation). By definition a reference currency should be one used to mediate the largest number of external transactions of an economy in terms of trade, labour and capital mobility. In theory, therefore, it should be the choice of currency anchor for the 'dollarization' decision. By preferring the rand as a reference currency, Zimbabwe should actually have randized rather than dollarized. Experience shows that countries that adopted dollarization (defined strictu sensu as the adoption of the US dollar) such as Ecuador, El Salvador and Panama, for instance, have a high degree of integration with the US economy. By contrast, when Lithuania established a currency board in April 1994, the Lita (Lithuania's local currency) was initially fixed against the US dollar. The country eventually adopted the Euro as its anchor currency in February 2002 after experiencing exchange problems with the US dollar because of its closer ties with the European financial and trade markets.[22]

Despite most of its exports being denominated in US dollars, Zimbabwe does not have a high degree of integration with the US economy. Instead, it has a relatively high integration with South Africa, and for those reasons the rand was chosen as the reference currency. Under the multicurrencying system firms using rands can directly compare

[20] Memories of controls on withdrawals and expropriation of foreign currency accounts by the RBZ will take years to unwind.

[21] The Government sector had initially chosen the dollar as its unit of account as is evidenced by the most recent budget which was presented in US dollars. Being the largest sector, we can deduce that the dollar was to be the main currency under multicurrencying.

[22] Currency Boards and Dollarization/Modern Monetary Systems/Country Listings/Zimbabwe. <http://www.dollarization.org/> by Schuler (2005).

competitiveness with South Africa. On the other hand, organizations that use the dollar would have to go through the trouble of first converting into rands to evaluate price competitiveness. If we take into account that there is considerable volatility between the dollar/rand exchange rate, evaluating competitiveness becomes extremely difficult.

Notwithstanding the challenges posed by dollarization, the government has managed to stabilize inflation. Monthly inflation figures for January, February, March, April and May 2009 were reported to be respectively -2.3 percent, -3.1 percent, -3.0 percent, -1.1 percent, and -1.0 percent. Cumulatively this represents -10 percent over the 5 month period.

Section 5

Exchange Rate Arrangements

5.1 A HISTORICAL PERSPECTIVE

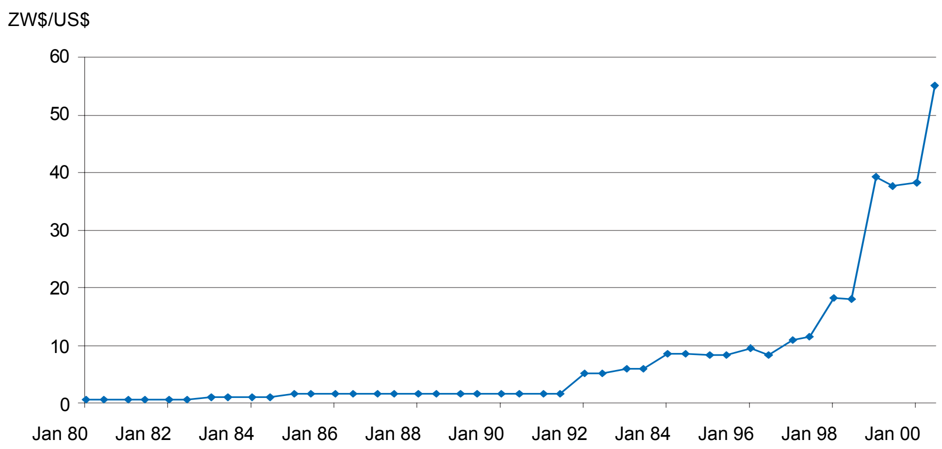
When Zimbabwe gained independence from Britain on 18 April 1980, the Rhodesian dollar (R$) was replaced at par by a new currency, the Zimbabwean dollar (Z$ or ZWD). The exchange rate arrangement remained essentially the same, with the new currency pegged against a trade weighted basket of 14 currencies adjusted for inflation differentials.[23] These currencies included, amongst others the South African rand, British pound, US dollar, the Germany deutschemark, the Japanese yen and the Botswana pula.

Figure 8 below shows the trend taken by the Zimbabwean dollar exchange rate against the US dollar as it depreciated from ZW$0.6798/US$1.00 in January 1980 to ZW$55.00/US$1.00 in January 2000. The exchange-rate peg was maintained for the first eleven years after independence with the rate allowed to fluctuate within a very narrow range of plus or minus two percent of the official rate.

Zimbabwe also inherited an elaborate system of exchange controls on both current and capital accounts from the previous administration. These controls made the currency basically non-convertible against major currencies. Most current and all capital account transactions were financed through a foreign currency allocation system administered by the RBZ. A black market, which can be traced back to the 1950s, was also a part of Zimbabwe's inheritance. The black market premium was highly variable during the first 3 years after independence, reaching a peak of 231 percent in July 1983.[24] This may be explained by the further tightening of controls and the uncertainty surrounding the economy's performance under the new administration. Moreover, the limits on emigrant allowances forced a lot of former Rhodesians who were leaving the country to turn to the black market for additional foreign currency as they were required to leave all their balances in blocked accounts for local use.

A dual exchange-rate system existed during the period between 1991 and 1994 as the RBZ continued to set the official exchange rate while the other rate was market determined. The official exchange rate was devalued by 92 percent to ZW$5.011/US$1.00 in 1991, by a further 19 percent to

Figure 8: Zimbabwe dollar/US dollar exchange rate from January 1980 to January 2000



[23] Albert Makochekanwa (2007), Zimbabwe's Black Market for Foreign Exchange <http://web.up.ac.za/UserFiles/WP_2007_13.pdf>

[24] Currency Boards and Dollarization/Modern Monetary Systems/Country Listings/Zimbabwe. <http://www.dollarization.org/> by Schuler (2005).

ZW$6.0354/US$1.00 in January 1993 and by 41 percent to ZW$8.4942/US$1.00 in January 1994. The official and market determined rates were unified on 4 July 1994 under the managed float exchange-rate regime following the liberalization of the financial sector under the Economic Structural Adjustment Programme (ESAP).

By the end of July 1994 exchange controls had been removed from current account transactions which made the Zimbabwean dollar fully convertible for all current account transactions. Controls did remain in place for capital account transactions. In the meantime, the black market rate premium dropped drastically to the lower teens as the parallel market rate almost converged with the market determined official exchange rate. However, by the end of the 1990s, growing concern that the local currency was overvalued sent foreign currency holders back to the black market where they increasingly got better rates.

This post-1994 period might be better characterized as a managed float exchange rate arrangement. The RBZ would intervene to remove excess liquidity from the market to prevent a sharp appreciation of the local currency. This was often the case during the April to September tobacco sales season. Alternatively, the RBZ would also intervene and inject some US dollars in the market when the market was short to prevent a sharp depreciation of the local currency. For the most part, this arrangement worked very well during the first phase of the liberalization period and the exchange rate steadily depreciated from ZW$8.4900/US$1.00 in July 1994 to ZW$10.964/US$1.00 in Jan 1997. However from the beginning of 1997, a combination of internal socio-political-economic issues and a global financial crisis put a lot of pressure on the currency which resulted in increasing speculative attacks as all economic agents expected a formal devaluation of the local currency by the RBZ. By November 14th 1997, now dubbed *Black Friday*, the exchange rate had depreciated to ZW$14.00/US$1.00.

5.2 BLACK FRIDAY

By the end of the first half of 1997, the economic outlook in Zimbabwe was looking less stellar than projected at the beginning of the year, as most key macroeconomic indicators had been revised downwards. At a ZANU PF summit in Mutare in September 1997, President Mugabe announced his government would pay a lump sum of ZW$50,000 and a monthly gratuity of ZW$5,000 for life to each Liberation War veteran. The cost was estimated at more than ZW$4.0 billion.[25] Although the first payments were not made until December 1997, the implications to the fiscus of this unbudgeted largesse, in addition to a declining macroeconomic environment, were grave enough to erode business confidence and fuel rumours of an imminent devaluation of the Zimbabwean dollar.

By October 1997, the contagion of the Asian financial crisis which began by the collapse of the Thai Baht in June 1997 had ravaged most Far East Asian economies and spread to South Africa as most foreign investors withdrew from emerging markets. Inevitably, the South African rand came under heavy downward pressure which caused high intraday volatility in the foreign-exchange market. The rand suffered a weighted 4.3 percent depreciation against major currencies in the month of October despite intervention by the South African Reserve Bank (SARB).[26] Nervous Zimbabwean importers and ordinary citizens, speculators included, rushed to cover their short-term foreign commitments (with South Africa in particular) and/or hoard more foreign currency as the devaluation of the Zimbabwean dollar seemed increasingly imminent. Meanwhile, exporters held on to their foreign currency earnings. These actions resulted in a considerable increase of holdings in foreign currency accounts by local banks on behalf of resident accountholders beginning in October 1997.[27] This prompted a run on foreign currency reserves as the Reserve Bank of Zimbabwe tried to support the Zimbabwean dollar by injecting

[25] *The Herald,* 17 September 1997.
[26] South African Reserve Bank: <http://www.resbank.co.za/Economics/qbul398/foreign.html>
[27] Albert Makochekanwa (2007), Zimbabwe's Black Market for Foreign Exchange. <http://web.up.ac.za/UserFiles/WP_2007_13.pdf>

foreign currency into the dry interbank market. Subsequent statistics released by Kingdom Financial Holdings after Black Friday confirmed that foreign currency reserves fell from US$760 million in January 1997 to US$255 million by November 1997.[28]

On Friday, 14 November 1997, the Zimbabwean dollar opened at ZW$14.00 against the US dollar. The local currency came under heavy pressure within the first few hours of trading as banks searched the market for foreign exchange to cover their positions, and reached an intraday low of ZW$26.00 against the US dollar.

5.3 EXCHANGE-RATE MANAGEMENT (1998–2008)

It is against the background of the events of Black Friday that future policy choices must be seen. From 1998 to 2003 two approaches were used to influence the direction of the exchange rate. The first approach involved moral suasion by the previous Governor of the Reserve Bank, Leonard Tsumba, where 'gentleman's agreements' on the desired level of the exchange rate were sought from the banking sector through the Bankers' Association of Zimbabwe. The RBZ employed this approach because it no longer had sufficient reserves to defend the Zimbabwe dollar. When these 'agreements' broke down the RBZ increasingly moved back to the position of the 1980s. The rate was pegged at an overvalued level but varied by multiple exchange rates for different sectors – all below the market rate. The multiple exchange rates encouraged arbitrage in the sense that some sectors or individuals obtained foreign exchange at cheap rates and changed it for profit at parallel market rates causing distortions on the foreign-exchange market.

The successor Governor, Gideon Gono, who assumed office in December 2003, continued to operate a fixed exchange-rate system characterized by multiple exchange rates. He unsuccessfully experimented with an auction system from January 2004 and later abandoned it in favour of multiple exchange rates. The foreign-exchange market was partially liberalized on 5 May 2008 for private agents, while the government continued to access foreign exchange at a tiny fraction of its market value. The partial liberalization did not work as the interbank market was only buying foreign currency and not selling it to the public, and hence the informal parallel market thrived offering better rates and buy-and-sell services.

The informal parallel foreign-exchange market was further aided by RBZ controls on foreign currency deposit accounts, the number of which had grown since the mid-1990s. The result was that people held foreign currency outside the domestic banking system. Migrant remittances were also intermediated on the informal market and there were no incentives to deposit them in banks.

The formalization of dollarization at the beginning of 2009 closed a long and painful episode regarding national efforts in terms of designing appropriate exchange-rate arrangements. This has implications on authorities' desire to revive the Zimbabwe dollar in the future. For the country to revive a credible currency in the future, it might take a generation to allow bad memories of past experiences to fade.

[28] Godfrey Marawanyika (2007), Zimbabwe marks 10 years since 'Black Friday'. 10 November 2007. <http://www.zimgreats.com/index.php?option=com_content&task=view&id=1738&Itemid=33>

Sector 6

The Banking Sector

6.1 AN OVERVIEW

At the beginning of 2009 there were 28 banking institutions representing 65 percent of the entire financial sector in terms of assets. The commercial banking sector is the major player with 80 percent of all assets, followed by merchant banks and then building societies

From the 1980s to the late 1990s Zimbabwe's financial sector appeared quite sound in terms of capitalization levels, even though it was not inclusive in the sense that it largely served prime clients, ignoring small and untried clients. However, weaknesses in the banking sector involving newly established local banks were encountered during the last quarter of 2003 resulting in four institutions being liquidated and nine institutions placed under curatorship. The IMF (2005) cited these weaknesses as arising from poor standards of corporate governance; inadequate risk-management, and the use of depositors' funds for speculative investments; pervasive self-dealing including unreported insider transactions; the use of subsidiaries and affiliates to evade prudential limits; the use of RBZ liquidity advances to support group companies; and deliberate misreporting to RBZ to conceal losses and overstate capital. Another contributing factor to the weaknesses was inadequate central bank supervision arising both from a deficiency in the number of supervisory staff and skills level.

Subsequent to the aforementioned IMF recommendations which flowed from an earlier 2004 mission, and in an effort to address the underlying weaknesses, a number of policy measures were introduced that included the following:

- Strengthened supervision and prudential standards were set in addition to the continuation of earlier initiatives to introduce risk-focused supervision and consolidated supervision of banking groups.

- New prudential guidelines were issued in 2004 to establish minimum standards for corporate governance, internal audits, and the relationship between the supervisor and external auditors.

- The powers of the Registrar of Banks in the Ministry of Finance were transferred to the RBZ through the Financial Laws Amendment Act in August 2004 so that the RBZ was now in a better position to ensure that potential new entrants to the market met stringent standards. This somewhat enhanced the RBZ's ability to take corrective actions.

The IMF (2007) observed that although the banking sector was reporting profits in nominal terms, profitability had declined in real terms and that the sector faced liquidity risks. Factors that exacerbated liquidity risks included frequent *ad hoc* changes in interest rates, high levels of statutory reserves which were changed frequently, the lengthening of maturity of Treasury Bills at highly negative real interest rates and the requirement that end-of-day excess bank liquidity be converted to long-term bills at highly negative real rates.

Frequent changes to statutory reserve requirements contributed to the unpredictability, and the role of commercial financial intermediation was transferred from the banking sector to the central bank. Table 7 shows that since 2000 the share of bank credit going to the private sector had been only marginally above 50 percent. However, the definition of private sector credit is unusual because of the abnormal situation in Zimbabwe whereby the central bank had increasingly become a major lender to the private sector. Prior to 2004 the RBZ's private sector loans were negligible, but in 2005 the central bank accounted for 16 percent of total bank lending to the private sector, rising to 20 percent in 2006 before doubling to 43 percent in 2007.

Table 7: Private sector share of bank credit

	Public (percent share)	Private (percent share)	(of which) RBZ lending to the private sector (percent share)	RBZ lending to private sector as share of total credit (percent share)
2000	40	60	–	–
2003	20	80	–	–
2004	31	69	0.6	0.4
2005	55	45	16	8
2006	41	59	20	15
2007	55	45	43	34

Source: Reserve Bank of Zimbabwe: Monthly Bulletin (various issues)

Dollarization has brought in new statutory reserve requirements (See Table 8).

Table 8: Statutory reserves under multicurrency system effective, February 2009

Deposit clusters	Reserve ratio on foreign currency deposits
Commercial Banks and Merchant Banks	10%
Demand and call deposits	10%
Savings accounts	10%
Repos and buybacks	10%
Discount Houses	10%
Finance Houses	7%
Building Societies	2.5%

While the reserve requirements were substantially lowered, they remained too high so that they impacted on the profitability of financial institutions. The level of reserves is usually expressed as the ratio to deposits, these ratios being either mandatory (set by regulation), or a prudential ratio (set through a bank's own judgement though there would still be an obligation to inform the central bank). Essentially, financial systems aspire to move to prudential ratios. However, where reserve requirements ratios are set by regulation, they are set at low levels as Table 9 shows for a few developed countries (before the European Central Bank came into being) and South Africa. South Africa further prescribes a ratio of 5 percent deposits that should be invested in prescribed assets. It is noteworthy that the ratios are a small fraction of those the RBZ set for the banks in Zimbabwe in February 2009.

6.2 DEEPENING CRISIS (2008-2009)

The collapse of the formal productive sectors of the economy led to a growing informal sector that in turn reduced demand for formal bank lending. In response, banks tended to protect themselves by shifting asset composition towards short-term low-risk securities (treasury bills) and limiting loans to the private sector. The objective was to maintain liquidity or solvency, as it was not possible to achieve real profitability because of highly negative real rates of interest on government securities amidst hyperinflation. However, this protection was threatened by the actions of the RBZ whereby it lengthened maturities of Treasury and RBZ bills and thus exacerbated the negative real interest rates being earned. In addition, banks' end-of-day liquidity excesses were automatically being channelled into compulsory Financial Stabilization Bonds. These actions were pushing banks into liquidity problems. Ironically, the financial system was prevented from total collapse by RBZ controls on daily cash withdrawals and limits on the amount of cash given to banks to dispense to depositors. Financial stability was therefore being enforced by trapping

Table 9: Reserve requirements ratios (percent of reservable liabilities)

	France	Germany	UK	USA	South Africa
Demand deposits	1.0	5.0	0	12.0	2.5
Time deposits	0.5	2.0	0	3.0	2.5

Source: Howells and Bain (1998) and South Africa Reserve Bank depositors' funds which would otherwise have been quickly withdrawn and converted into foreign exchange and commodities as protection from hyperinflation.

The major banks responded to the unstable macroeconomic environment by constantly restructuring their balance sheets. Table 10 below gives a distribution of market share among the major banks in terms of banking products.

Market share in local currency current liabilities was being matched with the share in demand deposits in all banks, and domestic banks had the largest share. The multinational banks commanded the largest share in foreign currency deposits, an indication that they were already shifting their balance sheets in favour of foreign currency transactions in anticipation of dollarization, which by October 2008 had unofficially taken root.

Borrowing from banks in local currency was depressed as the Zimbabwean dollar gradually lost its relevance as a medium of exchange. As more businesses were licensed to sell in foreign currency while others did so without seeking licences, the volume of transactions in local currency through the formal banking system declined significantly. This resulted in a sharp decline in interest income in real terms for banks. By the end of 2008 some banks had already suspended opening new accounts because the cost of maintaining the accounts far exceeded the revenues from those accounts. According to the RBZ (2009), the banking sector was heavily involved in non-core activities during the year 2008 which included trading of foreign currency on the parallel market, equity trading and speculative trades. It was further noted that banks were funding some of these activities with depositors' funds which depositors could not access due to controls on withdrawals. The ability of banks to honour their obligations was severely impaired and dollarization in early 2009 actually saved the banking sector from a complete collapse.

6.3 THE IMMEDIATE IMPACT OF DOLLARIZATION ON THE BANKING SECTOR

Initially, dollarization had severe negative effects on banking business. Due to the low confidence in the banking sector, the public kept their foreign currency transactions outside the formal banking system.

There has been a sharp decline in revenues as the banks' traditional sources of income such as interest income from loans, Treasury Bills and government bonds, as well as sources of funding or liquidity including inter-bank funding, RBZ liquidity support, customers' deposits and the use of Treasury Bills as trading assets, are no longer available. Furthermore, the RBZ at present does not have foreign currency and hence is not able to accommodate those banks running short positions on their books. The only existing funding options are new capital in foreign currency, foreign currency deposits which are depressed because of low confidence and revenue from operations which have declined sharply.

Table 10: Market share distribution by October 2008

Bank	Earning assets	Total local currency current liabilities	Demand deposits	Savings deposits	Time deposits	Foreign currency deposits
Barclays	2%	15%	15%	32%	0%	11%
CBZ	4%	25%	26%	14%	5%	11%
FBC	82%	4%	3%	16%	45%	0%
Kingdom Bank	7%	47%	48%	16%	47%	5%
MBCA	1%	2%	2%	0%	0%	31%
Stanbic	3%	6%	5%	10%	0%	20%
Standard Chartered	1%	1%	1%	1%	0%	16%
ZAGB	0%	0%	0%	5%	0%	4%
Z Bank	0%	0%	0%	6%	3%	2%

Although the demand of capital might be high as companies make efforts to resuscitate their operations, its availability is going to be tied to the cost of capital, among other things. For years, firms and government had become used to operating with massively negative real rates of interest. They are now being forced to borrow at very high positive real rates of interest – in excess of 10 percent in US dollars and more than 15 percent in rands. Furthermore, credit lines are unlikely to be subsidized, and firms operating on tight margins with sluggish domestic demand are likely to struggle to repay any loans that they may access.

Notwithstanding capital constraints, some banks are selectively giving out loans to high net worth and blue chip companies to manage their credit risk, further promoting financial exclusion.[29] On the positive side, banks are developing an interest in channelling diaspora remittances. Fees and commissions earned from Money Transfer Agencies (MTAs) arrangements between locally registered banks and international money transfer agencies such as MoneyGram and Western Union are proving to be highly reliable sources of revenue.

Now that all costs are denominated in foreign currency, there is a huge mismatch between revenues and operating costs for banks. Banks have started employing drastic measures that include unpaid leave for staff, reduced working hours, and the withdrawal of some of the benefits previously enjoyed by the employees. These measures are a pointer to a possible future downsizing in the banking sector.

[29] In the early days of dollarization, multinational banks were reportedly to be not lending largely due to perceived country risk.

Section 7

Agricultural Financing Mechanisms

In the pre-independence period, lending to agriculture (especially long-term) was mainly undertaken by the Agricultural Finance Corporation (AFC) – then known as the Land Bank – which was established in 1924 by Act of Parliament. It was the country's first specialized development bank funded by the Government to cater for the credit needs of farmers and rural development. In the 1970s it extended its lending to African small-scale commercial farmers to whom government had granted freehold tenure in specially designated areas called the African Purchase Areas.

After independence, lending to farmers in communal and resettlement areas was boosted. Brownbridge and Harvey (1998) reported that there was a sharp increase in borrowers in the communal and resettlement areas, from 4,400 in 1980 to 70,000 in 1984. However, this represented only 8 percent of an estimated 850,000 farming households, meaning that access to credit by the small-landholder sector was low. Notwithstanding the small size of the communal farmers' loans, their repayment record was poor for several reasons. These included droughts – especially in 1982/3, 1984/5, 1987/8, and even more seriously in 1992/3, and because loans were guaranteed by the government there was no incentive for the AFC to recover debts. Because of the poor loan-repayment rates, smallholder credit tailed off considerably. By the 1989/90 cropping season, only 44,000 small-scale farmers received loans, a drop of over 40 percent from the peak 1985 levels (Rohrbach *et al.*, 1990).

In 2000 the AFC was commercialized and renamed Agribank so that it could operate as a sound financial institution, able to mobilize savings and allocate credit to projects that were judged financially sound on the basis of market criteria. However, its intended customers, the resettled small landholders and communal farmers, had become accustomed to low, subsidized interest rates and protection from the consequences of the non-payment of loans. Table 11 examines the trend of all commercial banks' loan concentration/distribution over sectors.

Since the introduction of the fast track land reform programme, commercial bank lending to the agricultural sector has been limited, because existing collateral arrangements, including the recently introduced 99-year leases, do not provide adequate

Table 11: Loan concentration/distribution over sectors

Loan concentration (percent)	1999 %	2000 %	2001 %	2002 %	2003 %	2004 %
Agriculture	15.8	14.5	12.8	11.2	10.9	21.4
Construction	1.5	4.3	1.9	2.3	3.1	2.2
Communication	1.6	0.7	3	1.3	0.7	2.5
Distribution	17.4	16.5	27.8	23.8	22	15.3
Finance and investments	3.1	12.1	10.8	5	1.7	0.4
Financial organizations	2.7	7.4	1.6	6.8	2.1	0.3
Manufacturing	17.6	14	20.6	20.9	19.1	20.6
Mining	7.2	9.7	4.4	2.5	6	9.5
Services	19.9	11.3	6.7	14	18.7	15.1
Transportation	3.3	3.4	2.3	3.3	2.3	3.1
Individuals	8.7	5.6	6.5	7.8	11.6	7.6
Others	1.2	0.4	1.6	1.2	1.8	2.0

Source: IMF (2005). Based on commercial banks only which account for about 80 percent of local banking sector assets security of land tenure (Coorey *et al.*, 2007)[30]. The RBZ (2008a) reported that in the 1990s lending to agriculture accounted to over 80 percent of total commercial bank loans but by 2003 it had declined to under 12 percent of total commercial bank loans due to the changed risk assessment profiles in agricultural finance. The RBZ filled this funding gap by subsidized loans funded through printing of money. The main facilities through which this was done were the Agricultural Sector Productivity Enhancement Facility (ASPEF), the Agricultural Mechanization Programme and the Grain Procurement and Commodity Producers' Support Prices Programme.

In contrast, private sector funding of agriculture produced some notable results. Some innovative financing arrangements – that included out-growers' schemes operated by Olivine and Consolidated Farming Industries (CFI) and input schemes operated by the Cotton Company of Zimbabwe (Cottco) and later on by Cargill Cotton – have had a fairly good repayment record. Box 1 below gives an example of one input scheme that does not require beneficiaries of credit to have title deeds to the land they are working on.

Box 1: Cotton input scheme

In the 1980s Zimbabwe's commercial farmers accounted for about 80 percent of cotton production, and since they had access to commercial credit, there was no need for a special input-credit scheme. The need for an input-credit scheme was felt only in the 1990s, when the share of small-scale farmers rose to 60 percent of total production. This scheme was introduced following the drastic 1991/92 drought season. The average yield of small-scale farmers had fallen dramatically (to 158 kg per hectare from 71 kg per hectare in the previous year) and it was clear that the small farmers would not have the cash to purchase inputs for the next crop. Credits extended by the World Bank and the IMF were used to launch a new credit scheme which proved very successful. Within a year the production of small farmers was back to pre-drought levels.

When the Cotton Marketing Board was abolished in 1995, subsidies to the textile sector were reduced; inefficient mills closed down, and the share of fibre (cotton lint) that had been sold at a discount to domestic textile mills fell from 40 percent to 20 percent. When the producer prices improved as a result of competition between buying companies, particularly following the entry of Cargill, the successor to the Cotton Marketing Board, Cottco decided to extend the operations of the input-credit scheme. When in 1999 Cottco took over Cotpro, a relatively smaller player in the market, it captured 75 percent of the market share, and this was attributed mainly to its efficient input-credit scheme.

The input-credit scheme is a group scheme in which farmers, organized into a close-knit group, are given input credits individually, but the continuity of the facility is dependent on the whole group's ability to repay the offered credit at the end of each season. In the event of one individual in the group defaulting, all the other members of the group will not be extended credit in the next season. Because of this typically Grameen Bank-style scheme,[31] the pressure is on all the members of the group to support each other during the season and to minimize the possibility of defaulters. As a result the scheme has been successful, and Cargill, the second largest player in the Zimbabwean cotton market, later started its own input-credit scheme. The downside of the scheme is the temptation for individual farmers to engage in 'side-marketing', i.e., sell their cotton to 'poachers' who are normally small buyers who announce more attractive prices, which they can afford by not clearing input credits. To limit 'poaching', Cottco screened farmers more carefully and rewarded the most creditworthy by granting them the status of 'Gold Club Members'.

[30] 'Report of the Presidential Land Review Committee on the implementation of the Fast Track Land Reform Programme, 2000–2002' [Chairman: C. M. B. Utete], 2003. Unpublished.

[31] This is a group lending scheme, whereby lending is done to a group of individuals that is collectively liable for repayment, popularized by Grameen Bank, a Bangladeshi microfinance institution. Repayment is enforced through peer pressure, so no physical collateral is required by the bank.

Section 8

The Diaspora Remittance Transfer Mechanism

An IMF Working Paper by Gupta *et al.*, (2007) observes that while the volume of aid flows to sub-Saharan Africa (SSA) is higher than remittance flows, the latter have become increasingly significant and in addition to mitigating poverty they are promoting financial development. Formalizing remittance flows contribute to financial inclusiveness as such flows could serve as an effective access point for the unbanked. Remittances can give banks an opportunity to reach out to both unbanked recipients and senders, and the banking relationship that ensues makes it possible for clients to create credit histories that foster access to credit (Orozco and Fedewa, 2006).

Prior to 2004, diaspora remittances in Zimbabwe were intermediated through bureaux de changes. The RBZ abolished Bureau De Change services after allegations that they were fuelling the parallel exchange market. From 2004 onwards, the RBZ granted licenses to money transfer agencies (MTAs) to provide remittance services to the diaspora. The Reserve Bank also established its own MTA, incorporated as Homelink (Private) Limited.

Before dollarization, most banks shied away from operating as MTAs. The services offered by MTAs were restricted – they were, for instance, not allowed to conduct full bureau de change services. Specific operational restrictions included, among others: (1) not being allowed to purchase foreign currency from any person or institution, and (2) not being allowed to demand any fees, commissions or charges from the recipient customer. Instead, they were paid an agency's commission in Zimbabwe currency by the RBZ.

The first prohibition prevented MTAs from having a competitive edge over the informal remittance sector which bought and sold foreign exchange without restrictions. The second prohibition reduced MTAs to being simply agents of the RBZ. As a result MTAs did not operate as independent businesses. Furthermore, the RBZ gave Homelink the responsibility of supervising other MTAs, a set-up which allowed it to be both referee and player with the power to recommend de-registration of competitors.

Generally, the performance of MTAs was sub-optimal until 2008 as illustrated in Table 12. Diaspora remittances passing through official channels constituted a small but increasing proportion of total foreign-exchange receipts. The RBZ (2008a) attributed the sudden increase in remittances flowing through official channels in 2008 to be the result of the option granted to recipients to receive the payouts in foreign currency.

Using incomplete data, the International Fund for Agricultural Development (IFAD) estimated that diaspora remittances to Zimbabwe in 2006 amounted to US$361 million, constituting 7.2 percent of GDP. However, other estimates put annual remittances flows (both informal and formal)

Table 12: Foreign-currency receipts (US$), 2006–2008

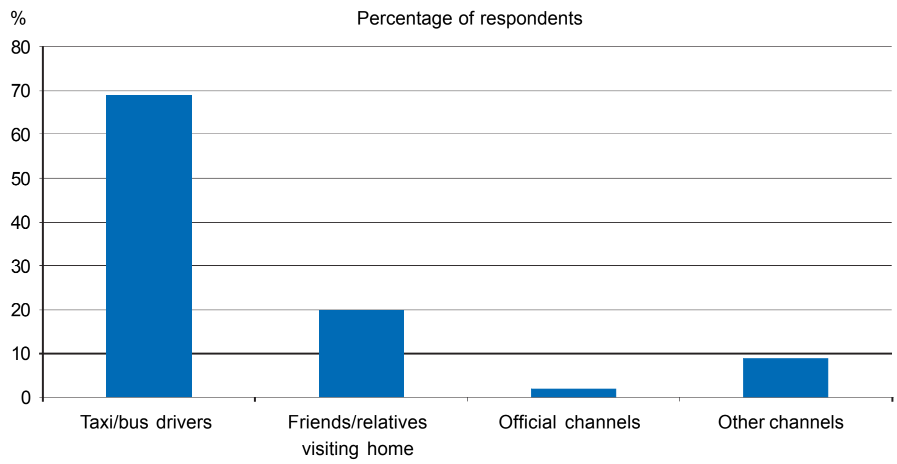
Type of receipts	Year 2006	% contri.	Year 2007	% contri.	June-2008	% contr
Export proceeds	847,766,400	62	872,868,184	61	510,223,981	58.71
Free funds	256,298,697	19	284,469,112	20	192,395,566	22.14
Gold receipts	126,773,818	9	104,586,120	7	62,087,334	7.14
Loan proceeds	102,930,006	8	132,447,757	9	49,755,194	5.73
Income receipts	24,264,596	2	19,341,782	1	5,459,500	0.63
MTAs	5,201,138	0	23,916,546	2	45,753,289	5.27
Capital investments	1,214,917	0	29,459	0	3,328,961	0.38
Total	1,364,449,572	100	1,437,658,960	100	869,003,724	100

Source: Reserve Bank of Zimbabwe (2008a) at between US$500 million to US$1 billion, constituting between 7 percent and 10 percent of GDP (Makina, 2007). A recent study by the University of Leeds has estimated that remittance flows from the UK alone could be as high as US$1 billion per year.

There are problems in measuring remittance flows because the bulk of remittances are intermediated through informal channels, which makes it difficult to leverage remittances for development. A survey study conducted in South Africa in 2007 found that only 2 percent of Zimbabwean migrants in the country used formal channels and that 98 percent used a variety of informal channels as illustrated in Figure 9.

Dollarization has brought opportunities for banks to fully participate in remittance transfer services. Banks have realized that fees and commissions earned from MTA arrangements between locally registered banks and international money transfer agencies could be substantial if the environment of facilitating remittances to be channelled through the formal banking system is improved. Banks would likely participate in efforts to address factors that deter financial inclusion such as limited physical bank presence (low geographic penetration) and the high cost of using banking services (opening and maintaining accounts, lending fees, etc).

Figure 9: Mode of remittance transfer from South Africa



Source: Makina (2007)

Section 9

The Capital Market

The role of capital markets in development processes is seen in terms of the opportunity they provide to companies to raise finance through the issuing of shares and providing a secondary market for the trading of these shares. Zimbabwe has been fortunate in having had such a capital market for many decades

The Zimbabwe Stock Exchange (ZSE) is a relatively well-developed stock market, with 80 trading firms, which achieved a market capitalization of over 70 percent of GDP in 2005, ahead of the median of 14.3 percent of low-income sub-Saharan African countries but still lower than South Africa's, which is over 200 percent. USAID (2007) noted, however, that this could be an overestimation because of the underestimation of GDP caused by the spread of black-market transactions and unrecorded inflation. Despite a deep economic recession, it offered investors the highest returns in Africa in 2005 and for most of 2006. However, this was simply driven by local investors pumping money into the stock exchange in the midst of hyperinflation. The industrial index in Figure 10 below shows an exponential trend from 2004 to 2005[32].

Such a trend that was not supported by sound fundamentals suggested high levels of speculative activities. Trading volumes surged significantly in 2008 despite the suspension of trades on 18 November 2008 (see Table 13). Volumes on the industrial counters increased by 236 percent during the year 2008 compared to 2007. Volumes traded on the mining counters surged by 518 percent during the same period. The sharp increase in trading volumes was attributable to the significant increase in money supply during the year 2008.

Figure 10: Industrial index (000's)

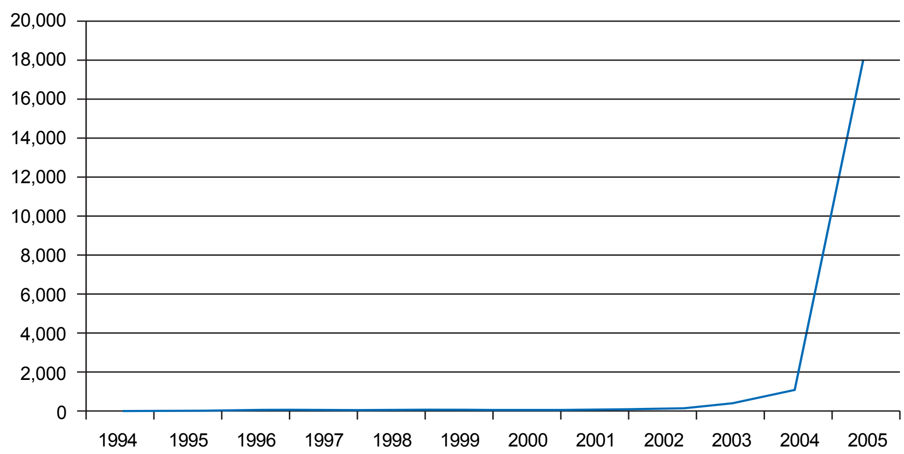


Table 13: Annual trading volumes

Index	2006	2007	2008
Industrials	5,048,233,864	5,051,908,651	16,985,817,689
Mining	19,830,524	25,899,139	160,067,210

[32] The graph was not extended beyond 2005 because it was revalued in 2006 following domestic currency redenomination so that the period post-revaluation is not comparable to the pre-revaluation period.

Imara Asset Management reported that the ZSE had gained 225,000 percent in nominal terms by the end of November 2007.[33] Real returns were achieved. For a while the ZSE became a useful avenue for investors to protect their capital in real terms in the midst of hyperinflation.

Imara Asset Management further observed a close correlation between the amount of money that is created by the RBZ and the ZSE. Since its Monetary Policy Statement in October 2007,[34] the RBZ had been flooding the money market with BACOSSI and ASPEF public funds in addition to government and quasi-fiscal funds.[35] While these funds might not have gone directly into the stock market, the liquidity of the banking system was increased as corporate and personal bank accounts were credited with the new monies from the RBZ. Having obtained these loans, the borrowers needed to spend the funds very quickly, or to invest the funds into the stock market, in order to preserve the real value of their capital.

The stock market bubble finally collapsed on 18 November 2008 when trading was suspended by the RBZ to allow the Securities Commission to draw new trading rules. By then it had also become evident that in the midst of hyperinflation the domestic currency was no longer appropriate as a trading unit. Dollarization was already widespread, especially after the RBZ had licensed companies to transact in foreign currency in October 2008.

According to Imara Asset Management foreign investors had been attracted by the potential of high returns in Zimbabwe and it estimated that between US$200 million and US$250 million was invested in the ZSE by foreigners between 2006 and 2008, most of whom were from the US and UK. It further observed that foreign investment peaked in March 2008 when investors foresaw political change on the horizon. However, this optimism evaporated a few months later following the disputed 2008 elections and policy changes by the RBZ that restricted investors' ability to exit certain investments.

Trading on the stock exchange resumed on the 19 February 2009 three months after it had been closed. As the economy had largely been dollarized, trading is now conducted in US dollars. Despite the dollarization, the exchange still faces a number of constraints that continue to impede its operations.

Firstly, while foreign participation is allowed it is limited to 40 percent of total equity, with a single foreign investor being allowed to acquire a maximum of 10 percent of shares. In addition to limiting foreign investment, this rule has the effect of lowering liquidity given that foreign investors have more liquidity in foreign currency than domestic investors.

Secondly, the Indigenization and Economic Empowerment Act (No. 14 of 2007) passed in September 2007 that provides for a 51 percent local ownership in all foreign firms will further adversely affect foreign investor participation which is critical for recovery.

Third, the stock exchange was being affected by the deep recession that gripped the country since 2000. It has not been able to play the role of being a leading economic indicator of the economy but rather has been a vehicle for speculative activities.

Fourthly, trading on the stock exchange requires an effective and efficient payment and settlement system which was not yet in place in these early days of dollarization.

Notwithstanding the cited constraints, the dollarization of the stock exchange presented opportunities for active participation on the exchange by the Zimbabwe Diaspora. While most remittances were going towards consumption (supporting livelihoods of relatives left home),

[33] Investment Notes, December 2007.

[34] <http://www.rbz.co.zw/pdfs/2007mid/mpsmidyear011007.pdf>

[35] BACOSSI, an acronym for Basic Commodities Supply Side Intervention, was a subsidized lending scheme of the RBZ to the private sector for the purpose of producing basic commodities such as bread, mealie-meal, sugar, cooking oil, etc. ASPEF stands for Agriculture Sector Productivity Enhancement Facility, which is another RBZ subsidized lending scheme for the working capital needs of farmers.

remitters could channel funds to the stock market as a form of investment given that trading was now in a stable currency. Surveys indeed suggest that Zimbabweans abroad would like to invest in Zimbabwe given opportunity as Table 14 below indicates.

Making the stock market an attractive channel for diaspora investment would contribute to financial development. Empirical evidence actually shows that remittances have a positive and significant impact on market capitalization (Billmeier and Massa, 2009).

Table 14: Five most popular ways that Zimbabwean migrants would like to contribute to development

	UK	South Africa	Total
Investment in business	62%	53%	58%
Transfer skills through working in Zimbabwe	44%	31%	38%
Transfer skills through training in Zimbabwe	44%	31%	37%
By sending remittances	32%	27%	29%
Investment in land development	34%	22%	28%

Source: Bloch (2005)

Section 10

Building Financial Inclusiveness

A survey conducted by the National Task Force on Microfinance between December 2005 and March 2006 showed that 70 percent of the economically active population in Zimbabwe are excluded from access to formal financial services. It was further observed that this 70 percent is often served by the informal financial sector through microfinance institutions, moneylenders, friends, relatives and credit unions. Monetary authorities have since recognized the problem and recent monetary policy statements have been accompanied by the statement: 'The Reserve bank continues to call upon all financial institutions to devise innovative ways of ensuring availability of financial services to the unbanked and underbanked communities'.

This is in line with growing international concerns regarding the problem of limited access to, and use of, financial services by large segments of the population in developing countries which has led to major international efforts to both understand the scope and nature of the problem as well as to advance solutions in order to help countries build inclusive financial sectors. As one source has noted:

> *'This reflects what must be – and increasingly is – a concern of development and poverty eradication policy at national and local levels: the recognition of the important contribution a broad-based financial sector makes to economic development and poverty alleviation'.* (UNDESA and UNCDF 2006: 1)

10.1 AN INCLUSIVE FINANCIAL SYSTEM FRAMEWORK

Microfinance has been accepted as one vehicle to achieve financial inclusiveness, though as argues above not the only one. An inclusive financial system is designed from recognition that the massive number of excluded people will gain access only if financial services for the poor are integrated into all three levels of the financial system: micro, meso, and macro levels (CGAP, 2006).

Micro level interventions involve defining microfinance clients and the service providers. For a financial system to be inclusive, it should meet the needs of everyone including the poor. Poor people need a variety of services that include insurance, remittances and transfer, pensions, loans for emergency needs, microenterprise loans and safe places to save. Microfinance clients are often self-employed and typically home-based entrepreneurs, in rural areas they are small farmers and others engaged in small income-generating activities, and in urban areas the clients are more diverse and include street vendors, shopkeepers, service providers, artisans, etc. Research sponsored by CGAP (2006) has identified three broad features of microfinance clients:

- Most clients come from moderately poor and vulnerable non-poor households, with some clients from extreme-poor households also participating;
- Programmes that explicitly target poorer segments of the population generally have a greater percentage of clients from extreme-poor households; and
- Destitute households are outside the reach of microfinance programmes.

It has been argued in the literature that microfinance, especially microcredit, is not appropriate for the destitute and the hungry with no reliable means of repayment. Small grants, infrastructure improvements, employment and training programmes, and other non-financial services may be more appropriate for such people.

Meso level interventions are about building financial infrastructure and associated systems. Financial infrastructure refers to the payments and clearing systems that allow the transfer of money among participating financial institutions. Usually financial institutions like MFIs that serve the poor lack direct access to the payments system. Hence, they must work through public and private banks by forging alliances.

Transparency and information infrastructure are other critical elements in building inclusive financial systems. Accurate, standardized, and comparable information on financial performance is fundamental in integrating microfinance into the financial system. Credit bureaux are critical building blocks of transparency.

Macro level interventions have to do with the role of government in building inclusive financial systems. CGAP (2006: 76) identifies three ways in which governments get involved in the financial system.

(1) Governments deliver financial services directly and indirectly, usually by disbursing credit to preferred groups or channelling resources to financial institutions through wholesale arrangements. Usually, most of the funding is sourced from international donors. While governments are not good at offering credit to poor people, government-owned banks, especially postal banks, have had a good track record in savings mobilization or money transfer.

(2) Governments set policies that affect the financial system. Such policies include ensuring macroeconomic stability, liberalizing interest rates, and establishing banking regulation and supervision which make viable microfinance possible.

(3) Governments can proactively promote inclusion by offering fiscal incentives or requiring financial institutions to serve poor or low-income people. However, there is much less reliable data on the success or otherwise of this type of intervention in developing countries.

It is obvious that microfinance institutions (MFIs) alone cannot meet the huge demand for loans by small and informal-sector businesses. Hence it is essential that commercial banks should also be involved if microfinance is to have an impact on global poverty. It is after all the privately owned commercial banks that dominate the financial markets. Bell *et al.*, (2002) have noted that though microfinance is currently being commercialized, this still mostly involves MFIs becoming commercial banks – such as K-REP (Kenya) and BancoSol (Bolivia), or the setting up of commercial banks doing only microfinance, such as Centenary Rural Development Bank (Uganda). Commercial banks that have moved into microfinance largely comprise state banks – for example Bank Rakyat Indonesia (BRI), National Microfinance Bank (Tanzania), and Banco Nacional de Costa Rica. Cases of pre-existing, privately owned commercial banks that have started microfinance operations are still relatively few. Several reasons have been cited to explain why commercial banks do not want to venture into microfinance (Baydas, Graham and Valenzuela, 1997).[36] These include the fact that:

- Commercial banks are answerable to their shareholders who are more concerned with the bottom line and maximum returns which most do not think could be obtained from microfinance activities.

- Commercial banks have standards and regulatory requirements that they have to comply with, e.g., regarding unsecured lending and interest rates that are not appropriate for microfinance.

- The organization structures, procedures, products and delivery methodologies of commercial banks are not appropriate for microfinance.

- There are cultural barriers that inhibit change. Staff and managers often still perceive the poor as unbankable.

Notwithstanding these misgivings, there are examples of private commercial banks that have been successful in downscaling to microfinance, and who have shown that with a high level of commitment, the right advice, and appropriate policies, it can be done. In Africa there are two private commercial banks, the Commercial Bank of Zimbabwe (CBZ) and the Co-operative Bank of Kenya (CBK) that started microfinance

[36] These perceptions are largely born from the experience of failed programmes of government and donor provision of low cost funds for on-lending to the poor.

operations during the 1990s with support from the British Department for International Development (DFID). So far their experiences have been positive. In addition, the Economist (2007) reported that Pichincha, Ecuador's largest bank established a microfinance subsidiary, which was contributing 12 percent of total profits, with arrears of less than 2 percent, while providing loans to the poor at competitive rates.

10.2 MICROFINANCE INSTITUTIONS (MFIS) AND COMMERCIAL BANKS' INVOLVEMENT

In Zimbabwe most MFIs emerged in the 1990s and experienced phenomenal growth so that by 2003 there were 1,700 players. To a large extent their growth was a reflection of the failure of the large-scale commercial banking sector to cater for the small-scale borrower. The RBZ (2000) reported that the microenterprise sector continued to assume increasing significance in terms of employment creation and contribution to national output in response to the changing macroeconomic environment. It was estimated then that there were about 3.8 million people employed in the sector, and that its contribution to GDP had reached about 15 percent by the end of the 1990s. According to CGAP, regulated microfinance institutions included Commercial Banks, Building Societies, Cooperative Societies, Credit Unions, Finance Houses, and other Non-Banking Finance Institutions (defined as institutions which distribute micro-credit and are prohibited from taking deposits). Non-regulated sources of microfinance included NGOs and informal money lenders. There was also extensive donor support to the micro-finance sector in the 1990's in the form of either loan funds or technical assistance. (UNDP, 1997).

One interesting national experience was that of the Zambuko Trust, a NGO. Zambuko Trust was started in the early 1990s by a group of Zimbabwean business, community, and church leaders as a dedicated MFI, whose services included individual, group and trust-fund loans to microentrepreneurs. By August 1995, the Trust had a client base of 2,197 and had disbursed 2,786 loans totalling US$0.5 million. An additional case was that of the CBZ, a commercial bank with significant state-ownership, which launched its 'Credit for the Informal Sector Project' (CRISP) in conjunction with CARE International in 1995. The objective of the project was to increase incomes and create jobs through improving access to credit for informal micro- business located in the urban areas. By 2000, CBZ's microfinance loan portfolio totalled US$32 million with over 3,000 active clients, and it expected to have served 7,500 clients and to disbursed 20,000 loans by the end of 2005. A survey of key features of major players in the microfinance sector in the late 1990s done by UNDP (1997) is presented in Table 15.

It is noteworthy from Table 15 that there was low involvement of the traditional banking sector in the provision of microfinance, with only two commercial banks present. The majority of MFIs were donor-funded and their performance was reported to be modest with only two – Zambuko Trust and Zimbabwe Women's Finance Trust (ZWFT) – having a national coverage. As indentified by the UNDP study, the key constraint to the growth and long term viability of the microfinance sector was lack of institutional capacity to meet market demand and effectively absorb available funds for on-lending. In 1997 a rough estimate of the supply of credit to micro and small enterprises was US$2.6 million against an approximate credit demand of US$31 million.

The worst performing MFIs were those operated by government – Small Enterprise Development Corporation (SEDCO) and the Social Development Fund (SDF) – thus confirming the widely held view that governments are not good at delivering credit. Set up to alleviate the effects of ESAP, the SDF began operations in 1992 by giving loans directly to micro and small enterprises (MSEs). The Fund performed poorly due to ineffective or non-existent systems and under-staffing. Repayments of loans were very low. The UNDP report observes that between July 1994 and September 1995, the repayment rate was 8 percent, and that by February 1996 the repayment rate fell further to about 4 percent. Since the SDF was a government department retaining its social grant fund and loan disbursement and monitoring roles, and was also subject to government budgetary cycles and influence, these were bound to hinder the effective delivery of microfinance which requires flexibility

Table 15: Major MFIs in operations in 1997

MFI Player	Date of commencement of operation	Loan delivery method	Geographical coverage	Partners
Barclays Bank	1988	Individual loans	Harare and Bulawayo hubs and 46 centres nationwide	World Bank, HIVOS
Collective self-financing schemes	1989	Membership and individual loans	Offices in Harare and Bulawayo but most clients located in rural areas and agricultural based	Zimbank (now Z Bank), AFC (predecessor of Agribank)
CBZ	1995	Self-selecting groups with members given individual loans	Harare and Bulawayo	CARE, DFID
Credit Against Poverty (CAP)	1996	Group lending based targeting women on Grameen Bank approach	Masvingo	Government
Dondolo Mudonzvo	1986	Both group and individual loans targeted at women	Harare and Midlands and through women organizations in other areas	NORAD, OXFAM America
Phakama Savings and Credit Cooperative Society	1995	Group and individual loans	Around Bulawayo	USAID
Self-Help Development Foundation (SHDF)	1963 confined to rural areas and developed national network in 1985	Group loans	National network	CARE
Zambuko Trust	1990	Group and individual loans	National coverage	USAID, Royal Netherlands Embassy, HIVOS, etc.
Zimbabwe Women's Finance Trust (ZWFT)	1992	Membership and individual loans	National coverage	Barclays Bank, Swedish donor
Small Enterprise Development Corporation (SEDCO)	1994	Individual loans	National coverage	Government
Social Development Fund (SDF)	1992	Individual loans	National coverage	Government, UNDP

and the need to respond quickly to the needs of clients. Likewise SEDCO, which started a microenterprise lending scheme in 1994, had to suspend new lending by mid-1996 due to non-payment of loans. Thereafter its activities focused on debt collection rather than the provision of microfinance. The UNCDF *Blue Book* has observed that government lending programmes in countries with weak overall governance are often used as vehicles for political patronage. Furthermore, they introduce market distortions, and result in extremely low repayment rates.

Despite the microfinance sector in Zimbabwe having undergone phenomenal growth, it faced a number of constraints. While Government recognized the role of microfinance in development it had not put in place an appropriate regulatory environment. The sector was being regulated under the Banking Act, which is inappropriate for the unique features of the sector. The Moneylending and Rates of Interest Act that stipulated interest rates the sector should charge was outdated, so that the official lending rates were completely sub-economic. The unstable macroeconomic environment characterized by hyperinflation did not spare their operations. The number of MFIs dwindled from 1,700 in 2003 to a mere 75 by the beginning of 2009.

The 2006 survey by the National Task Force on Microfinance, carried out under the auspices of the RBZ, further identified the following weaknesses:

a) **Weak institutional capacity:** It was observed that the prolonged sub-optimal performance of many existing Savings and Credit Cooperative

Societies (SACCOS), microfinance and development finance institutions was largely attributed to incompetent management, weak internal controls, poor corporate governance, lack of deposit protection, and restrictive regulatory/supervisory requirements.

b) **Weak capital base:** It was observed that the existing microfinance institutions had weak capital bases which could not adequately provide a cushion for the risk of lending to microentrepreneurs without collateral.

In 2008 the National Task Force on Microfinance published the National Microfinance Policy (RBZ, 2008b) that was aimed at the establishment of a vibrant microfinance sector that integrated into the mainstream financial system. The Policy acknowledges that microfinance can be provided by a continuum of institutions that include credit only MFIs, NGOs, Savings and Credit Cooperative Societies (SACCOS), microfinance banks, building societies and commercial banks. Furthermore, the Policy recognizes that providers of microfinance services have the potential to integrate the provision of credit with developmental activities such as community and leadership development, recreation, training in practical skills, entrepreneurship and financial management and delivering health education to their clients, especially with respect to HIV and AIDS awareness.

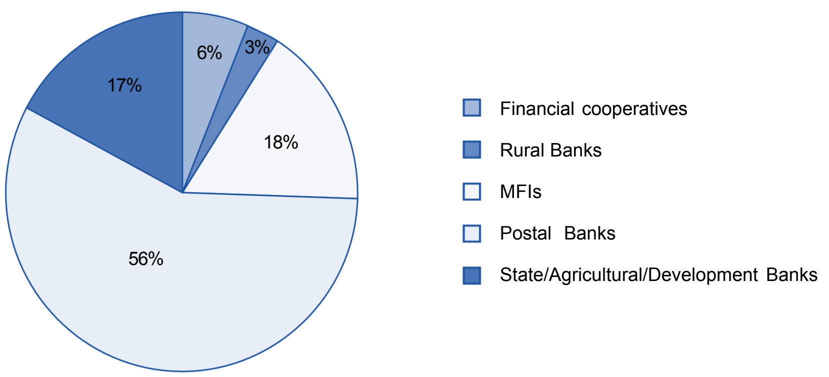
10.3 PEOPLE'S OWN SAVINGS BANK (POSB)

Globally, Government-owned postal banks have been observed to do a very good job in savings mobilization and reaching out to remote areas. A survey by CGAP of financial service providers to the poor worldwide indicates that postal banks account for the largest share of savings, see Figure 11 below. They are followed by MFIs and then state-agricultural and development banks.

Basically, the POSB complements the payments processing infrastructure via its branch network. It facilitates communication and provides convenient alternative banking services in remote areas that lack the presence of other types of banks. Services offered include cash transfer facility through money and postal orders, cash payment of government benefits, and savings and fixed deposit account facilities

The new POSB Act of 2001 removed its dependence on the PTC (now Tel*One) with regard to conditions of service, staff training and development, data processing, purchasing and securing rented accommodation (though it still depends on the Tel*One network infrastructure). The POSB nevertheless continues to face a number of constraints. Although the new Act gave the POSB Board discretion to approve profitable

Figure 11: Savings accounts by institutional type



Source: CGAP (2006)

investments in the money market, including investments in government and public enterprise paper, the practice has been that almost the entire POSB portfolio has been invested in government stock, public enterprise and municipal paper. The fact that government guarantees POSB deposits has played a major role in influencing investment decisions. The arrangement worked well under the regulated economic environment prior to ESAP when the prevailing interest-rate controls gave the POSB preferential treatment by shielding it from competition. This protection enabled it to record surpluses before ESAP because its average rate of return on investments, mostly government securities whose yields were administratively determined, was higher than the interest payable on deposits.

The deregulation of interest rates following the introduction of ESAP in 1991 saw the POSB experiencing a sharp outflow of funds as depositors switched investments to banks and other financial institutions that offered high rates of interest. Notwithstanding these setbacks, the POSB is widely known and visible both in the urban and rural areas. It has a large customer base, estimated at over 2 million customers. It has simple convenient products that are easily understood by all groups in society. There is security of deposits through government guarantee, thus appealing to more risk-averse rural people. The interest paid to depositors is exempt from tax. Furthermore, the POSB has the potential to engage in secured lending for micro and small enterprises (MSEs) and smallholder farmers and becoming a full-fledged commercial bank with countrywide network, capable of carrying out remittance and fund management services for the poor.

Section 11

The International Experience and Policy Implications for Recovery

11.1 THE IMPORTANCE OF MACROECONOMIC STABILITY

It has been empirically observed that there is a negative relationship between inflation and financial development, and that sustained inflation is detrimental to both the long-run growth and the financial system (Barnes *et al.*, 1999). A cross-country study that included Zimbabwe on the impact of inflation on financial sector performance for the period 1960–1995 by Boyd *et al.*, (2001: 224–225) produced three main findings.

1. A strong negative association between inflation and (a) lending by the financial sector, (b) quantity of bank assets, and (c) the volume of liabilities issued by banks was observed at low-to-moderate rates of inflation (defined as single-digit rates). The policy lesson is that low inflation is conducive to financial development.

2. An inverse relationship between inflation and measures of stock market liquidity and trading volume was observed at low-to-moderate inflation rates. A robust positive relationship between inflation and stock return volatility was also observed. Again, the policy lesson is that stock market development is fostered under stable inflation.

3. It was observed that as inflation rises, financial sector performance falls and that the performance falls rapidly once the threshold of 15 percent inflation has been exceeded. The correlation between inflation and intermediary or equity market activity observed at low-to-moderate inflation rates essentially disappears after this threshold has been exceeded. Once again, the policy lesson is that financial development requires a stable macroeconomic environment.

Evidently, efforts towards recovery of the financial sector should be preceded by stabilization of the macroeconomic environment identified as a key major constraint. In 1989 the World Bank had already observed that financial reforms would not succeed in an unstable macroeconomic environment characterized by high and unstable inflation, balance-of-payments crises and external debt.

The single most important thing that a government can do to facilitate financial inclusiveness is to ensure inflation remains low because inflation:

- erodes the capital base of financial institutions;
- makes efforts to mobilize resources difficult; and
- increases the volatility of interest, exchange rates, and other prices in the economy.

According to CGAP (2006) microfinance has tended to flourish in countries like Bangladesh and Bolivia with relative good macroeconomic stability. Despite having enormous potential, Brazil has had little microfinance because it took too long to stabilize inflation. CGAP further observes that once microfinance is well established in a country, it can be resilient to macroeconomic crises, citing Bank Rakayat Indonesia (BRI) which thrived throughout the Asian financial crisis of the late 1990s while the rest of Indonesia's banking sector that served wealthier and corporate clients did not cope so well.

International experience thus suggests that even with the best intentions, Zimbabwe's financial sector reforms implemented in the 1990s could not have achieved financial inclusiveness given the macroeconomic environment that then prevailed. With inflation rates averaging 32 percent per year – double the critical threshold of 15 percent – inflation had already started to adversely affect real sector activity. Credit rationing had already become widespread so that both existing banks and new banks shied away from serving the untried small-scale sector. Indeed, the new banks that were licensed in the 1990s preferred to go into merchant and discount banking where prime clients were large corporates, government and the parastatal sector. These trends were compounded during the 2000–2008 period as the country's economic regression picked up pace and the country descended into hyperinflation.

11.2 FINANCIAL INCLUSIVENESS AND LIBERALIZED INTEREST RATES

While governments in developing countries have often imposed limits on the level of interest rates that financial service providers can charge on loans in a bid to protect consumers from unscrupulous lenders and excessive interest rates, these limits have unintentionally hurt poor people. Interest-rate ceilings do not take into account that it costs much more to a provider to make many small loans rather than a few large loans and this therefore drives microlenders out of the market leaving poor clients without access to financial services.

Recent research conducted in the UK by the Department of Trade and Industry (2004) found that interest-rate ceilings had a negative effect on low-income people because they reduce the choice of loan products offered by financial institutions, thus limiting competition and forcing poor clients to either borrow more than they need or resort to informal sources.[37] CGAP also cites evidence of market contraction in Nicaragua when in 2001 parliament introduced interest-rate ceilings.

The Moneylending and Rates of Interest Act in Zimbabwe, which governs MFIs, imposes limits on interest rates to be charged on loans. Predictably, these interest-rate ceilings, coupled with macroeconomic instability, have stifled financial inclusiveness. The National Microfinance Policy published by the RBZ in 2008 is ambiguous on the resolution of the problem of interest-rate ceilings. While acknowledging the retrogressive nature of interest-rate caps, it advocates for the regulation of interest rates as a means of protecting the consumer. Global experience would indicate, however, that policies that promote competition among financial service providers in combination with relevant consumer protection have been observed to be the most effective way to reduce interest rates and transaction costs.[38]

11.3 FINANCIAL INCLUSIVENESS AND BANKING SECTOR REGULATORY AND SUPERVISORY PRACTICES

The global financial crisis has raised issues of adequacy and appropriateness of regulatory regimes of financial institutions. The orthodox approach has been a preference for large banks deemed easier to regulate and supervise and which are assumed to exercise due diligence more strongly than smaller institutions. However, the lessons from the crisis include the fact that big financial institutions can also engage in excessive risk taking and in regulatory arbitrage, practices that have been contributory factors to the crisis resulting in large institutions being either rescued by government or liquidated. One possible consequence of the current crisis, and the ongoing shakeup in the banking sector globally, may be that the 'big bank' model could be replaced by one characterized by a larger number of smaller operators. This would redound to the benefit of financial inclusiveness considerations since these smaller banks might be more willing to tap previously unexplored customers.

One of the debates on financial inclusion via microfinance provision has been how best to deal with microfinance regulation and supervision. It is generally accepted that as microfinance matures it is likely to migrate towards institutions that are licensed and supervised by the central bank or other financial authorities. In this respect, governments should only apply the more burdensome prudential regulation when the financial system and

[37] The number of people admitting to borrowing from unlicensed or illegal lenders was twice as high in France and Germany as it was in the UK.

[38] CGAP (2006: 85) cites microfinance market pioneer BancoSol, which when it started operating as a Bank charged 56 percent per annum in 1992 but when the operating environment became competitive, interest rates fell to 22 percent. Similarly, in Cambodia's relatively new but highly competitive microfinance market, interest rates have fallen from around 5 percent to 3.5 percent per month over the past few years.

Table 16: Possible adjustments to prudential regulations for microfinance

Standard banking regulations	When applied to microfinance
Minimum capital requirements	Need to balance promotion of microfinance with the capacity to supervise
Capital-adequacy ratios	Many need more equity because of repayment volatility
Limits on unsecured lending	Impractical for character-based lending, i.e., lending on the basis of social characteristics of client rather than collateral
Registration of collateral	Too expensive for tiny loans
Requirements for branches: security standards, working hours, daily clearing of accounts, limitations on location	May interfere with innovations that reduce costs and bring more convenient services to clients
Standard loan documentation requirements	May be too expensive and time-consuming for tiny loans

Source: CGAP (2006)

depositors' money are potentially at risk and apply non-prudential regulations to specialized microcredit institutions.[39] CGAP suggests adjustments to standard banking regulations to accommodate the specificities of microfinance as per Table 16 above.

Some countries, for example, Bolivia and Uganda, have resorted to regulating microfinance through the introduction of specific laws. Box 2 below outlines the approach taken by Uganda.

With regards to the overall regulatory environment of the financial sector, the UNDESA and UNCDF *Blue Book* (2006) recommends the designing of regulatory structures in tiers to recognize the differences in the structure of ownership, governance, capital, funding and risks faced by different financial institutions so as to keep regulations appropriate, simple and straightforward. As a strategy for financial inclusion, Zimbabwe's National Microfinance Policy published in 2008

Box 2: Approach to specialized microfinance regulation and supervision

Uganda is one of those countries that have introduced specialized microfinance regulation and supervision. Ugandan law adopts a tiered approach, defining four categories of financial institutions that can offer microfinance services:

Tier 1: Commercial banks

Tier 2: Credit (-only) institutions

Tier 3: Microfinance-deposit-taking institutions (MDIs) allowed to take deposits from the public and supervised by the Bank of Uganda

Tier 4: Non-deposit-taking institutions and small member-based institutions, mobilizing funds only from members, which would not be regulated or supervised by the banking authorities.

The microfinance-deposit-taking institution (MDI) law that was passed in November 2002 covers Tier 3 institutions. It allows MDIs to accept deposits from the public and then on-lend those deposits to credit clients. MDIs can offer certain types of services, such as foreign-exchange transactions or current accounts, only with the approval of the central bank. The most interesting aspect of the MDI law is the participatory process of consultation that produced it. Concerns were voiced on such issues as whether the minimum capital requirements (equal to US$300,000 in late 2004) would exclude small institutions, and what to do about high microcredit interest rates.

Source: CGAP (2006)

[39] Prudential regulations include capital adequacy norms to ensure that a financial institution has enough equity in case of a crisis, and reserve and liquidity requirements to ensure there is enough cash to pay off depositors in the event of a run. In contrast, non-prudential regulations include measures such as registration with some authorities for transparency purposes, keeping adequate accounts, prevention of fraud and financial crimes, and various types of consumer protection measures.

Table 17: Zimbabwe's proposed tTiered System

MFI tiers	MFIs	Supervisory category	Supervising agency
Tier 1	Banks and Building Societies	Prudential supervision	Reserve Bank
Tier 2	Microfinance Banks	Prudential supervision	Reserve Bank
Tier 3	Savings & Credit Cooperative Societies (SACCOS)	Discretionary prudential supervision	Ministry responsible for Cooperatives
Tier 4	Microfinance Institutions	Non-prudential supervision	Reserve Bank

adopted the tiered approach to regulation but what is currently lacking the enactment of the necessary enabling legislation. Table 17 above depicts the tiered system.

Essentially, the approach is that the licensing and regulating of Tier 1, 2 and 4 would be done by the RBZ, while SACCOS would be licensed and supervised by the Ministry responsible for cooperatives. As with commercial banks and building societies, microfinance banks would be subjected to prudential regulation and supervision, while non-deposit taking MFIs would be subjected to non-prudential regulation.

Some commentators caution against this approach pointing out that more successful microfinance markets in Latin America, Bangladesh and Indonesia were born and have matured without special microfinance regulation (Christen and Rosenberg, 2000). It is argued that specialized microfinance laws could end up marginalizing microfinance rather than integrating it within the financial system. Financial services for the poor are said to stand a better chance of growing when the larger commercial banks also get involved. Notwithstanding these misgivings, a tiered approach appears to be a 'middle of the road' approach that might withstand the test of time.

11.4 NATIONAL STRATEGIES FOR FINANCIAL INCLUSION

The *Blue Book* recommends that a strategy for financial inclusion should be an integral component of a country's financial sector development plan in order to contribute towards achieving the Millennium Development Goals (MDGs). Key stakeholders within each country should build a common vision of inclusive finance and address three specific areas of concern, namely, how to integrate microfinance into the broader financial sector; how to cater for the distinctive characteristics of microfinance; and how to focus on properly meeting the needs of poor and low-income customers. Box 3 provides a number of key references in terms of current international best practices. The standard diagnostic and planning process would involve:

- Taking stock of the state of financial-sector development and access;
- Analysis of constraints;
- Collaboration with external partners, especially with the Financial Sector Assessment Programmes of the IMF and the World Bank; and
- Mobilizing technical and financial support from developing partners.

Furthermore, the *Blue Book* recommends that policy-makers should complement efforts towards financial inclusion by doing the following:

- Giving priority to those elements of the financial infrastructure that are essential in managing risk and reducing transaction costs, e.g., credit bureaux and information technology;
- Supporting the establishment of guarantee funds for correcting market failure, especially with respect to microfinance; and
- Providing avenues for MFIs to link into the infrastructure serving the major financial institutions.

Box 3: Key reference documents on international good practices on access to finance

Key Principles of Microfinance (CGAP, 2004)

CGAP developed eleven key principles of microfinance. These were endorsed by the 31 member donors of CGAP and further endorsed by the Group of Eight leaders at the G8 Summit on 10 June 2004. More information available at: www.cgap.org/keyprinciples.html.

Building Inclusive Financial Systems: Donor Guidelines on Good Practice in Microfinance (CGAP, 2004)

The donor guidelines on good practice microfinance provide practical guidance for donor staff on how best to interact with, and support, the various actors in microfinance. Through a highly participatory process, including comments from 20 CGAP member donors and 10 other civil society organizations and individuals, the authors sought to balance all views in updating the Donor Guidelines. More information is available at: www.cgap.org/docs/donorguidelines.pdf

Building Domestic Financial Systems that Work for the Majority (Women's World Banking, 2005)

In April 2005, Women's World Banking reconvened the 1994 Expert Group on Women and Finance, joined by members of the Advisors Group of the International Year of Microcredit. The result is Building Domestic Financial Systems that Work for the Majority, *a consensus document that reviews the key accomplishments of the last ten years and the challenges for the next ten. It also sets forth the need to build country-level financial systems that work for the poor majority, key actions needed to build retail capacity, key roles that global community need to play, the shared vision of the group for the next ten years and key actions for the next three years. More information is available at: www.swwb.org/English/PDF/Expert_Group_Booklet.pdf*

Access to Finance Resolution (World Savings Banks Institute, 2004)

In its Access to Finance Resolution, *members of the World Savings Banks Institute call upon policy-makers to facilitate access to finance through recognition of the importance of access to financial services by the poor and its impact on economic growth and poverty reduction and a corresponding set of policies. The Resolution encourages support for the collection and analysis of information on the 'unbanked' and for building financial literacy, strengthening corporate governance and expanding and refining institutional arrangements. More information is available at: www.savings-banks.com*

Source: UNCDF (2006: 157)

The National Microfinance Policy of Zimbabwe published in 2008 more or less followed best international practice. It was developed through collaborative work by the National Taskforce on Microfinance whose membership comprised Government Ministries, apex organizations of microfinance and moneylenders, MFIs, development partners and the central bank. The Policy sets out five specific objectives:

- To promote the development of a robust inclusive financial sector;
- To promote synergy and mainstreaming of the informal sub-sector into the national financial system;
- To enhance service delivery by MFIs to the economically active poor and SMEs;
- To contribute to rural transformation; and
- To promote linkage programmes between commercial banks, building societies, development banks, specialized institutions and microfinance banks and other microfinance stakeholders.

The Policy goes on to outline strategies that include, among others, the development of an appropriate regulatory and supervisory framework for the microfinance sector, encouragement of commercial banks and building societies to go downstream into microfinance either wholesaling funds to MFIs or retailing to consumers of MFIs, and establishing a credit reference bureau to enhance credit-risk management practices.

While the Policy goes a long way in terms of reflecting international best practice, it still falls short in terms of its stated intent to regulate interest rates as a means of protecting the poor. As already discussed above, both international experience and Zimbabwe's own track record in terms of its Moneylending and Rates of Interest Act have shown that regulating interest rates of MFIs is counterproductive.

The CGAP (2008), which lists Zimbabwe as one of those countries that have managed to produce a national policy, observes that the broad consultative process that accompanies the development of a national microfinance strategy has fostered improved communication among practitioners, donors, and policy-makers – increased knowledge of the sector, and fostered a commitment to good practices.

11.5 THE ECUADORIAN EXPERIENCE OF DOLLARIZATION

One recent country experience that might have some relevance to Zimbabwe is that of Ecuador following that country's official adoption of dollarization. An accelerated deterioration of Ecuador's macroeconomic and political environment between 1997 and 1999 prompted authorities to respond through a series of devaluations of the local currency, the sucre, against the US dollar. The Asian Financial Crisis which began in 1997 led to a reduced demand for oil, Ecuador's chief export, and this in turn sent global oil prices tumbling. In addition, most investors withdrew from Emerging Markets including Ecuador, as a result of the crisis. Ecuador's principal agricultural exports (bananas and cocoa) were severely affected by the El Nino weather phenomenon. The sucre/US dollar exchange rate declined from 5,000 in August 1998 to 20,243 in December 1999 and the country defaulted on its foreign debt in 1999. The last devaluation prompted a run on local currency deposits as citizens switched to US dollars. After a temporary freeze on withdrawals, and with a virtually collapsed banking sector[40], a besieged president Jamil Mahuad announced plans for dollarization on 9 January 2000. This was not well received by members of the public and immediately sparked widespread demonstrations that led to the president's ouster within a few days. His successor, however continued with his predecessor's plans for dollarization and made the monetary system official on 13 March 2000. Unlike Zimbabwe, Ecuador was blessed with sufficient foreign reserves and was able to convert 97.4 percent of sucres in circulation to US dollars at the rate of 25,000 by December 2000[41].

As shown in Figure 12 above, although Ecuador's inflation spiked to 107.9 percent in January 2000, nowhere near Zimbabwe's record shattering levels, prices stabilized within a few months of dollarization and inflation has averaged about 4.7 percent since December 2001. Annual inflation was 5.41 percent as at 31 May 2009[42]. Ecuador's economy which had contracted by 6.3 percent in 1999 grew by 2.3 percent in 2000 and by 7.9 percent in 2004[43] as shown on Figure 13.

Initially, the chief contributors to this growth were the financial and retail industries which accounted for 31.2 percent in 2003, up from 27.6 percent in 2002. Meanwhile, the real sector has been lagging behind. Manufacturing fell from 13.6 percent in 1999 to 10.6 percent in 2003 while agriculture and forestry/fishing fell from 10.6 percent to 8.8 percent. 'Lack of investment, expensive credit, low levels of technology; and high costs of production' are cited as the reasons the productive sector has failed to catch up with international competition.[44] As a result, most retail goods were imported. Although Zimbabwe's economy is projected to grow by 2.8 percent in 2009, it faces the same constraints with its productive sector as Ecuador. A more conducive environment for long term production is required for the revival of the real sector.

[40] More than 20 banks collapsed, half the number of banks in Ecuador between 1998 and 1999: <http://www.econ.umn.edu/~ricaurte/teaching/Dollarization%20in%20Ecuador.pdf>

[41] Dr Carlos J. Emanuel, Minister of Economy and Finance, Ecuador: Dollarization in Ecuador: A definite step toward a real economy. Feb 2002. <http://www.comunidadandina.org/ingles/documentos/documents/ecuadollar.htm>

[42] Banco Central del Ecuador: <http://www.bce.fin.ec/resumen_ticker.php?ticker_value=inflacion>

[43] The Effect of Dollarization in Ecuador: <http://www.mindspring.com/~tbgray/dollar.htm>
This was also due in part to the opening of a new pipeline that doubled oil output.

[44] El Comercio Newspaper, June 6, 2004: <http://www.mindspring.com/~tbgray/dollar.htm>

Figure 12: Ecuador's annual inflation from 1993 to 2006[45]

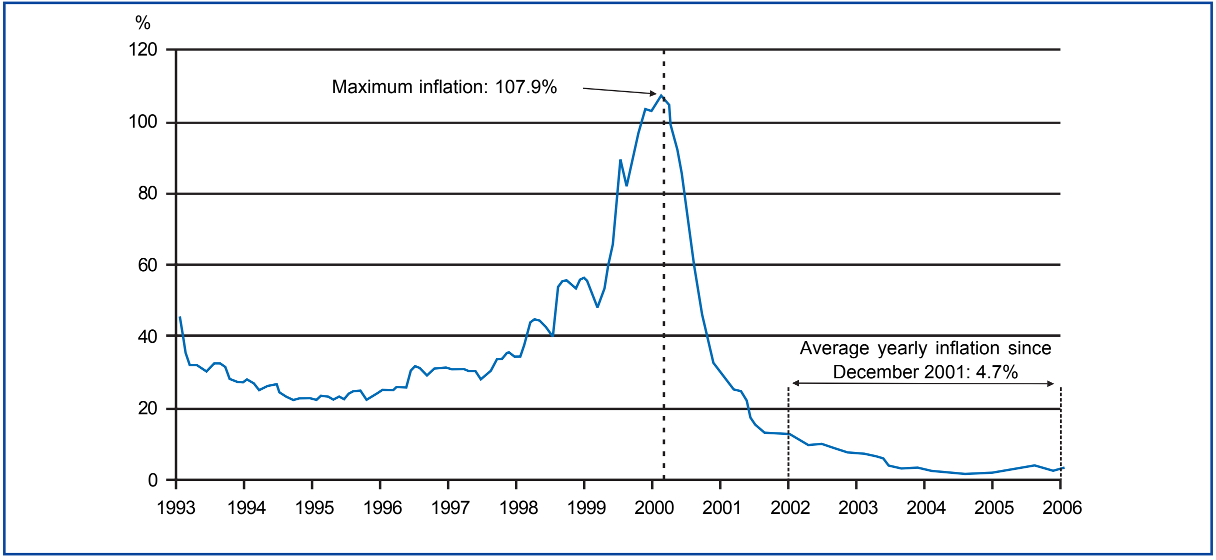
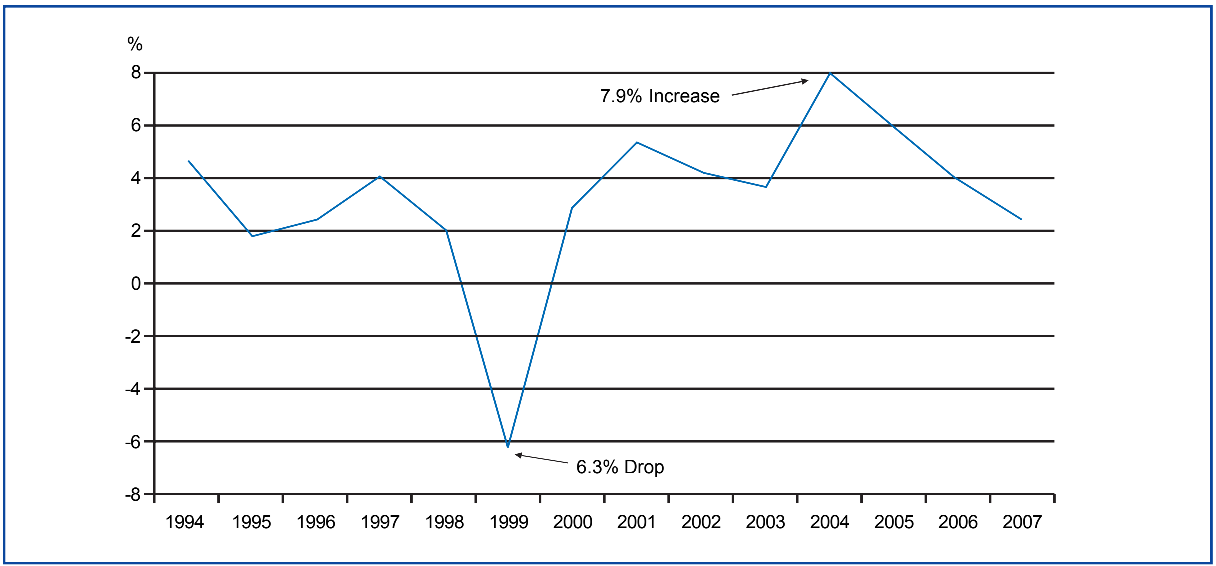


Figure 13: Ecuador's GDP growth[46]

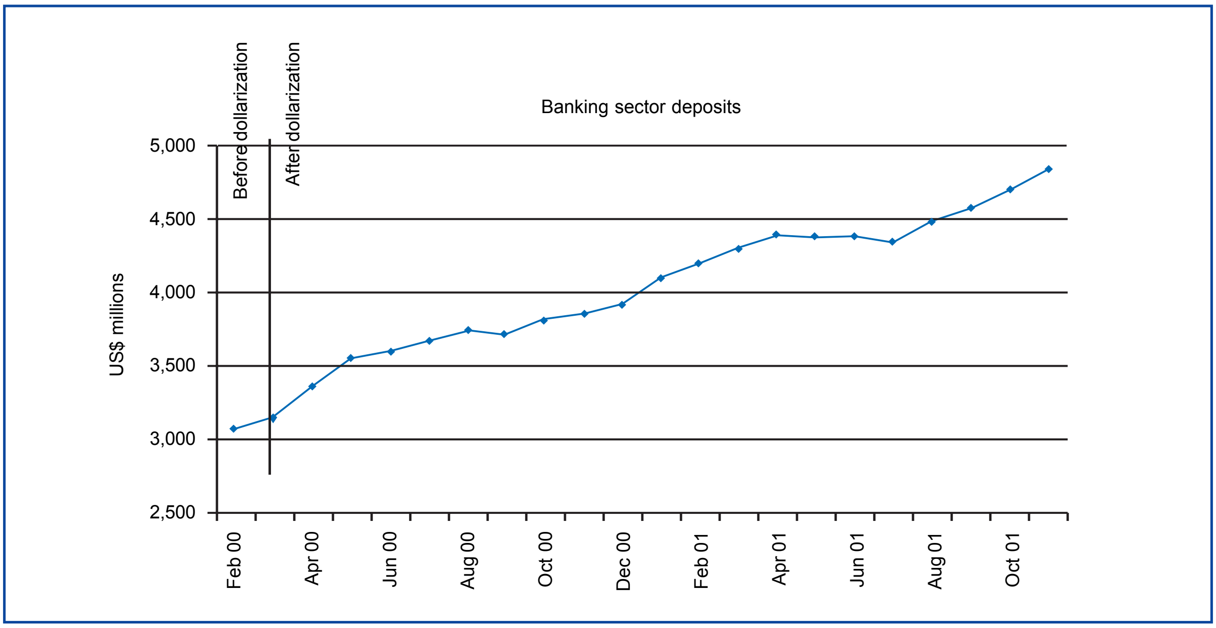


While the printing of the sucres stopped with dollarization, Ecuador's government's spending has remained an issue as it has been able to borrow locally and externally. Internal debt grew from US$607.4 to US$1,056.8 million from 1999 to 2003 (El Comercio, 2004)[44], with the chief source of funding being the country's Social Security Services. Coupled with economic stability which made the country attractive to lenders, the country's oil reserves have made it possible to borrow from external sources. Interestingly, El Comercio pointed out that there is increasing awareness among community pressure groups that as the government cannot print money, there are limits on items that can be added to the annual budget using their political clout. Zimbabwe will not have problems with excessive borrowing in the near future. Potential local sources are dry, and with virtually no foreign reserves and a poor credit rating, the country is currently experiencing extreme difficulties in raising funds from international sources. Ironically, this reality is helping to foster fiscal discipline after years of profligacy.

[45] Miguel F. Ricaurte (2009), Ten Years of Dollarization in Ecuador. <http://www.econ.umn.edu/~ricaurte/teaching/Dollarization%20in%20Ecuador.pdf>

[46] Miguel F. Ricaurte: <http://www.econ.umn.edu/~ricaurte/teaching/Dollarization%20in%20Ecuador.pdf>

Figure 14: Ecuador's banking sector deposits[47]



Growing confidence in the banking sector operating in a stable environment led to an increase in banking sector deposits from US$3.0 billion in February 2000 to US$4.8 billion in December 2001 as shown in Figure 14 above.

The early stages of dollarization prompted a wave of emigration from Ecuador to greener pastures as unemployment initially grew but stabilized to 8.8 percent in 2007. Remittances from the diaspora have remained a significant source of finance for the country's economy, a clear similarity to Zimbabwe's situation at present.

The mixed results of Ecuador's experience show that dollarization in itself is not a complete panacea but a stop gap measure that lays the foundation for future sustainable economic growth. Complementary structural changes need to be introduced in order to reap the full benefits of dollarization. In addition, a stable political environment needs to be maintained in order to reduce the country's risk premium and attract investment. Ecuador is known for having had eight leaders in less than ten years from 1996 to 2005[48].

[47] Dr Carlos J. Emanuel, Minister of Economy and Finance, Ecuador. Dollarization in Ecuador: A definite step toward a real economy. Feb 2002. <http://www.comunidadandina.org/ingles/documentos/documents/ecuadollar.htm>

[48] <http://www.mindspring.com/~tbgray/dollar.htm>

Section 12

Features of a Strategy for Financial Sector Recovery and Financial Inclusiveness

The government has an important role to play in setting policies that will create an enabling macroeconomic environment which will allow the growth of an inclusive and sustainable financial sector. At macro level, three types of policies that the government needs to focus on are macro-economic stability, liberalized interest rates, and appropriate banking and supervisory practices. Micro and meso level interventions require a stakeholder approach.

12.1 MACROECONOMIC ENVIRONMENT

While official dollarization has brought down inflation, this should be seen as simply the first step in terms of the stabilization of the economy which will require fiscal adjustment. This is even more important in the case of Zimbabwe where preconditions for dollarization were not met before the system was formalized. One key precondition was adequate levels of foreign reserves in order to buy back notes and coins in circulation as well as replace bank deposits with the new legal tender at a market-determined rate.

Sound macroeconomic management urgently needs to be strengthened by adopting the following processes:

- Conducting public expenditure reviews;
- Establishing and publishing fiscal rules;
- Developing rolling medium-term expenditure frameworks (MTEFs);
- Conducting mid-term budgetary reviews;
- Introducing budget caps for public enterprises; and
- Strengthening public financial management, accounting and reporting systems and budgetary processes.

Dollarization drastically reduced the Reserve Bank of Zimbabwe's role of interest rate determination which is now primarily in the hands of market forces. Since interest rates of major currencies have historically been largely stable (though recent years have witnessed a high degree of volatility related to the global financial crisis), interest-rate premiums are going to be very much tied to Zimbabwe's country risk profile. Unless the longstanding legal (primarily property rights) and socio-political (primarily human rights) issues are addressed, country risk is going to be a major sticking point in stabilizing interest rates in Zimbabwe.

In order to improve liquidity in the banking system it would be necessary to further reduce statutory reserves to international norms. This measure should be in addition to the wider measures of restoring relations with the Bretton Woods Institutions and attracting foreign investment, diaspora remittances and aid. It should be borne in mind, however, that it is the headquarters of multinational banks that stipulate loan deposit ratios for the operations of its subsidiaries in any given country.

A serious objection to the choice of the dollar is that the business cycle in the USA, whose monetary policy is being 'imported', is unlikely to coincide with that in Zimbabwe, meaning that the Zimbabwe authorities might be forced into a deflationary monetary stance when domestic market conditions require a very different approach. As argued above, the government should consider the use of the rand (i.e., randization) as the official currency since there is a higher degree of regional integration with South Africa and rand zone countries in terms of both finance and trade. The recent scraping of visa requirements for Zimbabwean citizens by South Africa is, without doubt, going to boost this integration further.

12.2 FIXING THE LEGAL AND REGULATORY ENVIRONMENT

The issue of the new role of the Reserve Bank of Zimbabwe under the new monetary system needs to be addressed, and the Reserve Bank Act adjusted or replaced accordingly. Central banks usually cease to exist in officially dollarized economies as their residual functions can either be transferred to the Ministry of Finance or outsourced to the private sector. These residual functions include collecting and analysing financial statistical data, accounting, regulation of financial institutions and economic analysis.[49] This might not happen soon in Zimbabwe as the authorities have recently declared they will review the case for the return of the Zimbabwe dollar by the end of 2009.

It should be highlighted here that history has shown that the reversal of dollarization is very difficult. With the painful experience of the Zimbabwe dollar still fresh in everyone's mind, it is going to take even longer to restore public confidence in a national currency and the institutions associated with it. A more acceptable approach for the moment might be to convert the central bank to an independent authority responsible for financial statistics and financial regulation. Once a determination has been made on the new role of the RBZ, changes must be addressed through a constitutional amendment of the Reserve Bank Act that confers independence to the new establishment so that parliament has direct oversight over it, thus reducing the scope for interference by the Executive.

Cognisant of the fact that many financial institutions have evolved into financial groups undertaking a number of activities such as asset management, banking, property management, broking services, etc., a new approach to regulation is required in order to minimize regulatory arbitrage. There are two options that could be followed. The first is to centralize regulation by establishing a Financial Stability Committee comprising the three regulators – the central bank, the Insurance and Pensions Commission and the new Securities Commission – that would be tasked with setting up the modalities for supervising financial groups. A second option would be to adopt the partially integrated approach (as is practised in South Africa). In this approach, a Financial Services Board under the Ministry of Finance is established to supervise the pension, insurance and securities industries. The central bank would be responsible for the systemic and prudential regulation of banks, while a self-regulatory banking council conducts business supervision. The advantage of such an approach is that it beneficially combines both official and industry self regulation.

As regards an appropriate regulatory environment in the context of building financial inclusiveness, it is important to remember that many microfinance institutions have developed successfully without official intervention. Nevertheless, the government can still play an important supportive role in building an inclusive financial sector through actions such as:

- Bringing together all inclusive finance initiatives under the authority of a single ministry or office as recommended by the *Blue Book*;
- Providing an appropriate legislative framework that recognizes the unique features of microfinance and that fosters up-scaling to a financial systems approach (i.e., enabling the mobilization of savings in addition to provision of credit);
- Enacting legislation that encourages unbiased lending to low and moderate-income borrowers (individuals and businesses) and/or geographies by all deposit taking institutions. For instance, the Community Reinvestment Act (CRA) of the USA encourages banks to meet the credit needs of the communities in which they operate, including low- and moderate-income classes, in a safe and sound manner. Banks performances are evaluated periodically and the assessments are taken into account when considering an entity's application for deposit facilities including acquisitions and mergers.

[49] Joint Economic Staff Report, Office of the Chairman, Connie Mack, January 2000.

- Re-visiting the Moneylending and Rates of Interest Act that controls interest rates so as to allow microfinance institutions to set market interest rates commensurate with their cost structure; and

- Facilitating 'smart subsidies'[50] to fund the start-up of new institutions to cover capitalization and operating shortfalls.

12.3 RECAPITALIZING BANKS, CONSOLIDATION AND RESTORING CONFIDENCE

Hyperinflation and subsequent dollarization not backed by foreign currency reserves virtually wiped out the capital of banks. The only valuable assets banks were left with were probably buildings, vaults, technology equipment, furniture and fittings. The recapitalization of banks is an imperative for recovery. Most capital will have to come from private sources as the government's revenue base is currently extremely restricted. In addition, under dollarization the option of printing money (or what has come to be called 'quantitative easing' in Organization for Economic Co-operation and Development (OECD) economies to combat the effects of the international banking crisis) is no longer an option and so the government is unable to inject capital into the banking system to save it. As domestic sources of private capital are currently limited, there is an urgent need to attract external private capital. But the disincentives currently represented by the Indigenization and Economic Empowerment Act that limits the participation of foreign investors in the economy will have to be addressed. The Growth Commission Report of the World Bank emphasizes that one way to speed up financial sector development is to attract foreign financial firms to invest in the sector. It observes that the entry of foreign banks brings expertise just as other forms of FDI do, and help to strengthen domestic banks through the transfer of technology and best practices.

The liability side of the balance sheets of banks could also be improved through attraction of deposits from the public and diaspora remittance transfers. For this to happen, confidence in the banking sector has to be restored. Confidence is regained when banks are perceived to be well capitalized, customers can withdraw their funds without restrictions, bank charges are not too high, and when banks offer services that are value enhancing. The economic meltdown in Zimbabwe had proven to the public that keeping money under the mattress was more rational than entrusting their savings to banks.

According to the IMF Article IV Mission of March 2009, the economy of Zimbabwe's GDP has cumulatively declined by 54 percent since 2000, with the decline in 2008 alone estimated at -14 percent. The banking sector as currently configured may well be too big for the size of the economy. In the near future, the sector may see a process of consolidation, innovation and downsizing. Though necessary, these processes may have the temporary effect of militating against national financial inclusion efforts. Scarcity of capital would mean that achieving financial inclusiveness in the short- to medium-term would require the support of the international donor community and international financial institutions.

12.4 PROMOTING INNOVATIVE AGRICULTURAL FINANCING MODELS

Bearing in mind that the fast track land reform programme, through the dissolution of title deeds, has destroyed the collateral traditionally used for financing the agricultural sector, innovative financing models need to be considered for landholders.

Through the provision of the necessary infrastructure in the rural areas, it might be possible to encourage the setting up of microfinance institutions that service the needs of small landholders. Agribank has a rural outreach and what is needed is restructuring so that it operates on commercial principles.

[50] As observed in the *Blue Book*, p.104, this involves maximizing social benefits while minimizing distortions and mis-targeting. Smart subsidies are rule-bound, time limited, and are usually implemented through the use of performance-based contracts.

An enabling environment should be provided for more private actors to become involved in contract financing for agricultural produce, as is currently being done by Cottco, Cargill and others. Once again, security of tenure is an essential pre-condition for loan schemes.

Another possible approach is to request that a portion of donor aid be channelled through multilateral financial institutions for the following purposes:

- Providing set-up costs for microfinance institutions that service small landholders in rural areas.
- Providing seed capital for farmers with a track record who have been dispossessed.
- Covering transaction costs for Agribank, in particular, and any other commercial banks that are willing to lend to small landholders on commercial terms (at market rates of interest to avoid the introduction of distortions).
- Providing concessional lending to medium to large commercial farmers for capital development (e.g., offering grace periods for such loans).

12.5 RESTRUCTURING THE POSB

The potential of the POSB countrywide network to offer credit to small-scale businesses and small landholders, both in rural and urban areas, should be unleashed. This might involve two tracks.

The first option would be to transform it into a commercial microfinance bank, and leverage its countrywide network to non-prime clients not currently being served by the traditional banking sector. This would necessitate recapitalization of the institution by Government. However, given its serious budgetary constraints, public-private partnerships would be another alternative. Another strategy would be to seek donor funding in the context of establishing a microfinance commercial bank, a concept that has gained currency under poverty reduction programmes in other countries.

As a fully-fledged commercial bank, the POSB would be in a position to undertake more giro services, commercial lending and consumer lending, and also enter into strategic alliances with insurance companies, asset management funds, international financial institutions, etc. This would broaden the range of services provided through the post offices.

The second option for Government would be to seek its amalgamation into one of the existing financial institutions so that the POSB operates as a division serving non-prime clients in the same manner as the Community Banking Unit of the Commercial Bank of Zimbabwe.

Under either of the two scenarios, the POSB could then focus on the following product/market strategies:

- Catering for the needs of low and middle-income groups for consumer banking with standardized services provided through low-cost processing by leveraging technology; and
- Small-scale enterprise market for small-business finance and building up credit information of the low-income market.

12.6 IMPROVING CREDIT-INFORMATION INFRASTRUCTURE

Financial exclusion is linked to the absence of verifiable credit profiles of borrowers. This critical information constraint needs to be addressed through the establishment of credit bureaux charged with the effective distribution of high-quality credit information. This will be very important for facilitating the expansion of bank credit to small-scale borrowers beyond the prime clients currently being served by the traditional banking sector. The creation of a credit-information infrastructure should ideally be an industry initiative, as it is a common good for the whole sector that offers financial services. However, donors can provide capacity building for building the necessary infrastructure. The government still has a role to play, especially that of providing secure identity documents of its citizens as credit ratings are dependent on such documentation.

12.7 CAPITAL MARKET REFORMS

The potential of the stock exchange should be realized so that it can mobilize funding for both corporations and government. This can be achieved through the relaxation of laws that limit foreign participation, in particular the Indigenization and Economic Empowerment Act. Presently, foreign participation on the stock exchange is limited to 40 percent of total equity, with a single foreign investor being allowed to acquire a maximum of 10 percent of shares. In addition to limiting foreign investment, this rule has the effect of lowering liquidity given that foreign investors have more liquidity in foreign currency than domestic investors. In addition, foreign participation, including the Zimbabwe Diaspora, in government bonds should be considered. Allowing foreign participation on the bond market would assist to instil discipline on Government because it would require its macroeconomic performance to be subjected to credit rating by international rating agencies.

Tax incentives could also be used to deepen the capital market. Mauritius, for example, has successfully used an approach whereby companies listed on the stock exchange enjoy a lower tax rate than private companies. Such a policy would encourage privately owned companies to go public. Considering that the economic meltdown in Zimbabwe has reduced many large businesses to small businesses, tax incentives of this nature may help to rebuild the formal sector.

Furthermore, in order to foster financial inclusiveness in capital markets, serious consideration should be given to the establishment of a second tier capital market that will be used as a vehicle for raising finance by small and medium-scale enterprises (SMEs) which have now become an important feature of the economy. In accordance with experience elsewhere, such a second tier capital market would have less stringent listing requirements than the first tier (main) market, so that SMEs are able to participate in that market.

Section 13

Looking Ahead

While the transitional government of national unity has adopted dollarization characterized by multicurrencying, no legislative framework has been put in place to formalize the arrangement. Authorities are still debating what monetary regime to eventually embrace and these debates are centred on three options: (1) joining the rand monetary area, (2) continuing with dollarization (with multicurrencying) and (3) reviving the moribund Zimbabwe dollar.

13.1 THE RAND COMMON MONETARY AREA

The Common Monetary Area (CMA) that uses the rand as its currency comprises South Africa, Namibia, Swaziland and Lesotho. It is governed by a Multilateral Monetary Agreement which does not allow a member country to place any restrictions on the transfer of funds for current or capital transactions between members. In essence the exchange-control provisions of every party to the Agreement must be substantially in accord with those in South Africa. Furthermore, the management of gold and foreign-exchange reserves must be similar in all member countries. Should Zimbabwe join the CMA, it will have to subscribe to these tenets of the Multilateral Monetary Agreement. Monetary policy will be conducted within the framework of the Agreement, which in essence means loss of monetary independence.

The RBZ would, however, retain many of its core functions, including the ability to authorize its gold and foreign-exchange transactions. Should it decide to have its local currency, it will be determined by prescribed rand assets and the local currency will be convertible to the rand. It will also get a share of seignorage[51] from South Africa depending on the amount of rands circulating in the economy.

The crucial advantage of joining the CMA is that Zimbabwe will have access to the South African capital and money markets and a right to enter into bilateral agreements with South Africa and be able to avail itself of temporary central banking facilities of the South African Reserve Bank. Furthermore, South African banks would have an incentive to do cross-border banking, thus alleviating capital constraints currently being faced by local banks. An additional advantage may be that the rand is likely to depreciate over the medium to long term, thereby enhancing the price competitiveness of Zimbabwe exports. The case for the adoption of the rand is therefore compelling.

13.2 CONTINUING WITH DOLLARIZATION CHARACTERIZED BY MULTICURRENCYING

The adopted dollarization, characterized by multicurrencying, has its own shortcomings which have been highlighted in this paper. Randization has been advanced as the most appropriate solution, given that amongst other things it is in line with regional integration considerations.

Nonetheless, dollarization should be judged from the experience of other countries. The experience of Ecuador is instructive. While dollarization stabilized the macroeconomic environment and boosted the financial sector, ten years later the country still has to battle with following:

- Unemployment and informal employment remains relatively high (unemployment rate 10–12 percent and informal employment 50 percent).
- Few migrants have returned to Ecuador because labour markets are inflexible.

[51] Seignorage is the profit the central bank gets from printing money that goes into circulation.

Ecuador still needs to make markets more dynamic so as to guarantee an inflow of dollars through exports and foreign investment. It also needs to ensure there is political stability and fiscal responsibility. The same imperatives apply to Zimbabwe. In other words, dollarization is not necessarily a panacea for social and economic development.

13.3 REVIVING THE MORIBUND LOCAL CURRENCY

Though recently raised in various quarters, reviving the discredited local currency will not instil confidence in the financial system. In the absence of a credible central bank, it is a non-starter and would only serve to rekindle the temptation to print money. Lessons from experience show that countries that have revived their local currency are those that constitutionally made their central banks independent and free from political interference. Germany that had undergone a period of hyperinflation is one example of a country that went on to establish an independent central bank, the Bundesbank, which gained an international reputation through its fight against inflation.

13.4 BUILDING FINANCIAL INCLUSIVENESS AND MONETARY REGIME

There is a positive correlation between the credibility of the financial system and participation in it by the public. When people do not trust the financial sector they keep their money under their mattresses. The problem is compounded in the presence of hyperinflation when it would make no sense for people to deposit those savings given the rapid loss of value.

Dollarization, in one or another form, creates certainty in terms of returns on savings, and if the financial sector is judged to be well regulated people do trust their savings with financial institutions. The case of Ecuador is instructive. As shown in Figure 14, dollarization resulted in more deposits being placed with banks. One could hypothesize that the previously unbanked people found it worthwhile to use banks under a stable macroeconomic environment created by dollarization.

The case for opting for the rand is further supported by findings from the Optimal Currency Area (OCA) framework for evaluating the costs and benefits of a common currency. Countries in Southern Africa, a region anchored on the South African economy, have more or less similar production structures. Hence, they tend to face similar shocks, thereby making a common monetary policy optimal. Given that South Africa accounts for at least 60 percent of Zimbabwe's imports, the adoption of the rand would actually stimulate trade between the two countries and reduce transaction costs. Labour mobility (as provided through visa relaxation agreements) and financial transfers (as provided by the Multilateral Monetary Agreement) would act as shock absorbers for the members of the CMA. Moreover, as an optimal currency area, the CMA has already stood the test of time. Therefore the inclusion of Zimbabwe would be a matter of leveraging an already existing framework in order to cover a wider geographic region.

Annex A

Reserve Bank of Zimbabwe Statistics

	TBR	Over-night rates	Lending rates	Average lending rates	3 Month deposit rates	M1	M2	M3	Currency in circulation	Reserve money	NGDP	Inflation year average
Year	tbr %	%	lenr %	alenr %	dpr %	ZW$bn	ZW$bn	ZW$bn	ZW$bn	ZW$bn	ZW$bn	%
1979	3.57	4.50	7.50	7.50	3.15	0.5	1.1	1.9	0.1076	0.172	2.8	12.6
1980	3.30	4.50	7.50	7.50	3.35	0.6	1.5	2.3	0.1572	0.242	3.4	8.6
1981	8.18	9.00	13.00	13.00	11.38	0.7	1.6	2.6	0.1986	0.325	4.4	12.4
1982	8.29	9.00	13.00	13.00	9.50	0.8	1.9	3.0	0.2375	0.387	5.2	13.8
1983	8.66	9.00	13.00	13.00	12.38	0.7	2.0	3.3	0.2274	0.416	6.3	18.0
1984	8.40	9.00	13.00	13.00	9.00	0.9	2.4	3.7	0.2588	0.449	6.4	16.4
1985	8.62	9.00	13.00	13.00	9.00	1.0	2.5	4.3	0.321	0.541	9.1	12.1
1986	8.62	9.00	13.00	13.00	9.50	1.1	3.0	4.8	0.380	0.626	10.4	14.3
1987	8.46	9.00	13.00	13.00	9.30	1.2	3.2	5.7	0.389	0.669	11.2	11.6
1988	8.41	9.00	13.00	13.00	9.25	1.6	4.1	7.1	0.503	0.843	14.1	7.0
1989	7.73	9.00	11.50	11.50	10.00	1.9	4.7	8.5	0.618	1.027	17.5	13.8
1990	9.68	10.25	12.00	12.00	10.25	2.4	5.8	10.3	0.770	1.290	21.5	12.4
1991	27.00	18.38	25.50	25.50	24.00	2.8	7.3	12.4	0.889	1.706	29.6	23.3
1992	31.39	0.00	47.50	37.90	38.00	3.1	8.7	13.9	0.861	1.933	34.4	42.1
1993	35.98	0.00	38.00	33.30	30.00	5.5	12.5	18.9	1.119	2.938	42.5	27.6
1994	29.58	29.50	40.00	36.39	31.50	6.6	16.0	22.2	1.432	3.632	56.2	22.3
1995	29.46	29.50	38.49	35.03	30.00	10.1	21.6	28.8	1.751	3.722	62.0	22.6
1996	18.46	27.00	37.07	33.59	19.25	13.3	25.7	36.8	2.342	6.174	87.0	21.4
1997	29.91	27.00	37.86	34.73	32.50	19.6	37.5	49.7	3.396	8.059	108.4	18.8
1998	35.28	39.00	58.00	47.75	40.25	24.7	41.1	56.6	4.265	11.052	148.8	31.7
1999	69.41	74.41	76.00	66.00	69.00	34.6	58.4	73.5	6.884	17.786	230.0	58.5
2000	61.24	60.65	81.50	68.25	62.00	52.6	99.7	117.6	9.451	20.638	314.7	55.9
2001	25.94	57.20	47.50	31.25	26.00	128.5	196.9	238.3	24.67	54.670	553.4	71.9
2002	25.92	57.20	56.50	45.75	35.00	348.5	549.0	631.0	77.91	148.25	1,160.3	135.1
2003	79.75	300.00	160.00	346.00	350.00	2,761.8	2,985.3	3,240.3	433.17	733.55	4,560.3	386.4
2004	119.00	115.00	270.00	202.50	100.00	6,867.0	9,219.1	10,454.4	1,591.17	2,329.52	24,664.3	369.5
2005	340.00	545.00	550.00	415.00	340.00	44,461.1	60,129.3	64,816.1	9,615.90	13,065.30	74,741.0	207.1
2006	66.30	500.00	700.00	500.00	500.00	629,062.8	918,232.6	982,947.3	220,368.60	299,706.10	1,076,512.0	1,016.7

Source: Reserve Bank of Zimbabwe statistics

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