CENTRAL BANKING IN A DOLLARISED ENVIRONMENT: INSIGHTS FROM ZIMBABWE

BY

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Distinguished Guest Lecture, Centre for Global Finance, SOAS University of London, 9th October 2018

Introduction-What is Dollarisation?

- *Definition*: holding by residents of a significant share of their assets, in the form of foreign currency-denominated assets

- Term "*dollarisation*" now generic: any use of another country'scurrency to perform standard monetary functions
    - Mainly: US$, British Pound, Euro, Rand, AU$, NZ$

- In Zimbabwe official term used is Multi-currency regime (MCR)—a number of foreign currencies have a legal tender status.

Forms of Dollarisation

- *Unofficial (de facto) dollarisation*
  - foreign currency being used alongside the domestic currency as means of exchange. Of 3 types:
    - currency substitution or transactional dollarisation
    - Asset substitution or financial dollarisation
    - Real dollarisation—indexing local prices and wages to foreign currency
- *Official-semi-dollarisation*
  - Foreign currency allowed to circulate along side the local currency as a legal tender
- *Full or official (de jure) dollarisation*
  - foreign currency is given sole legal tender status.
- All three forms experienced in Zimbabwe's dollarisation history

Dollarisation in Zimbabwe

Major Currencies in Use

Period up to end 2008: unofficial

- Central bank introduced foreign exchange licensed shops (FOLIWARS),FELOCS, FELOPAD
- Economic agents refusing to transact in local currency
- Widespread informal use of USD, S.A RAND & BWP alongside Z$

January 2009-semi-official dollarisation

- Authorised use of US$, ZAR, BWP, BP, and Euro
- Z$ still circulating as legal tender

Dollarisation in Zimbabwe

Permissible Currencies

Full or Official Dollarisation- Feb 2009

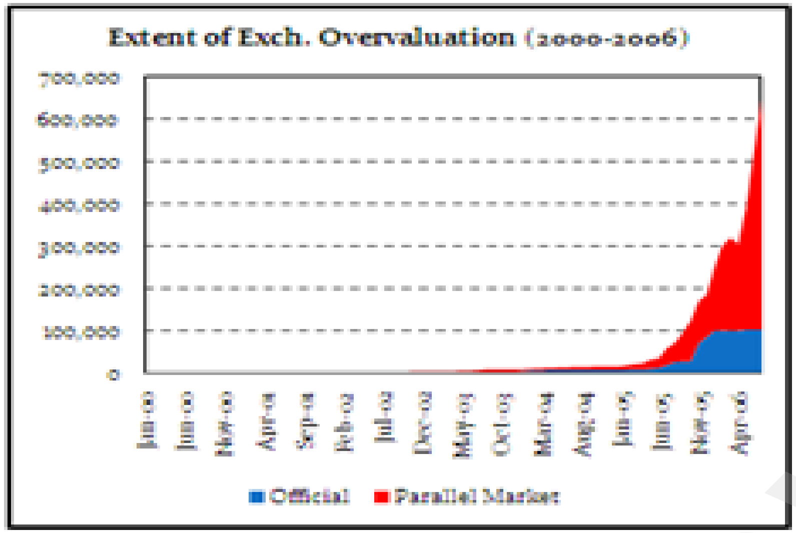
- In February 2009-GNU
- the Z$ was abandoned as legal tender
- Five currencies authorised as legal tender for all transactions in the country *viz*: US$, ZAR, BWP, B£ and €
- (initially) ZAR used as a reference currency

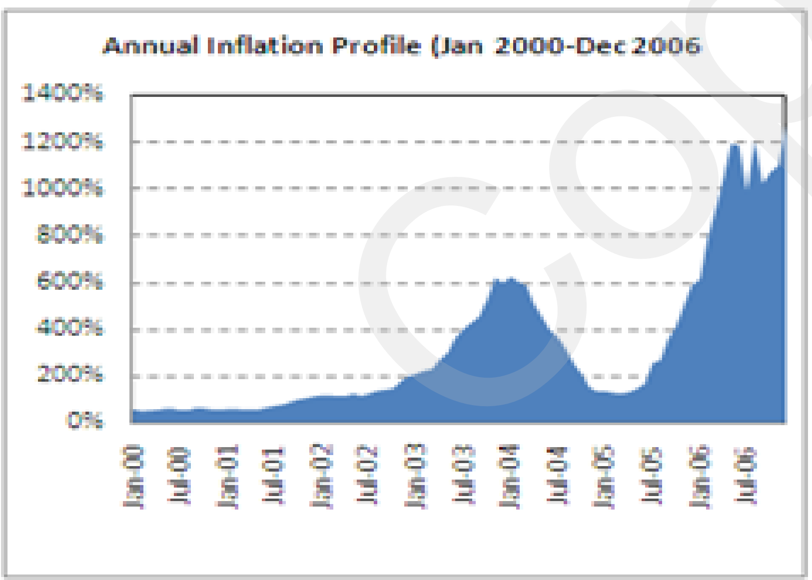
Trends: USE OF CURRENCIES UNDER THE MULTI-CURRENCY SYSTEM

Currency	2009	2013	2014	2015	2016
USD	49%	50%	60%	70%	95%
Rand	49%	50%	40%	30%	5%
Other	2%	-	-	-	-

- Usage of USD and Rand was almost the same at the start
- Depreciation of the rand starting from 2014, saw it being side-lined
- By 2016 the USD had become more dominant

Why Zimbabwe Dollarised





- Severe hyperinflation with inflation reaching 231 million percent by July 2008

- Highly over-valued exchange rate
  - 1997 Z$/US$ was 18.6
  - 2008 Z$/US$: 3,641,246,000

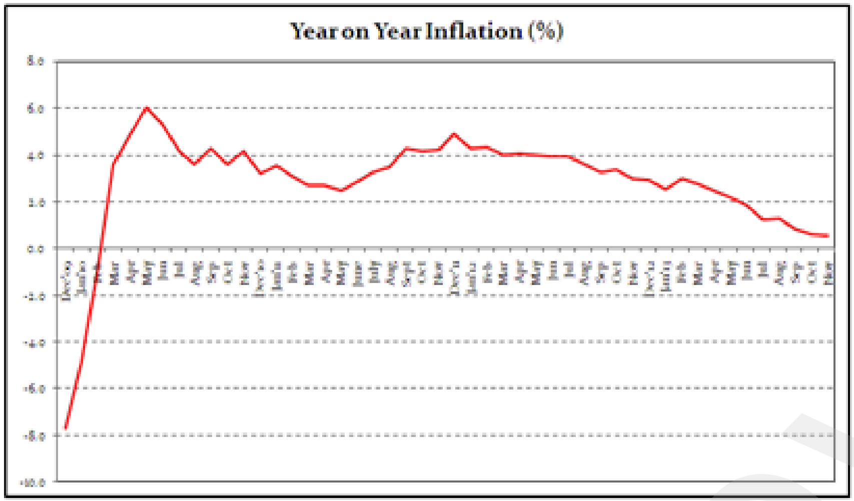
Why Zimbabwe Dollarised

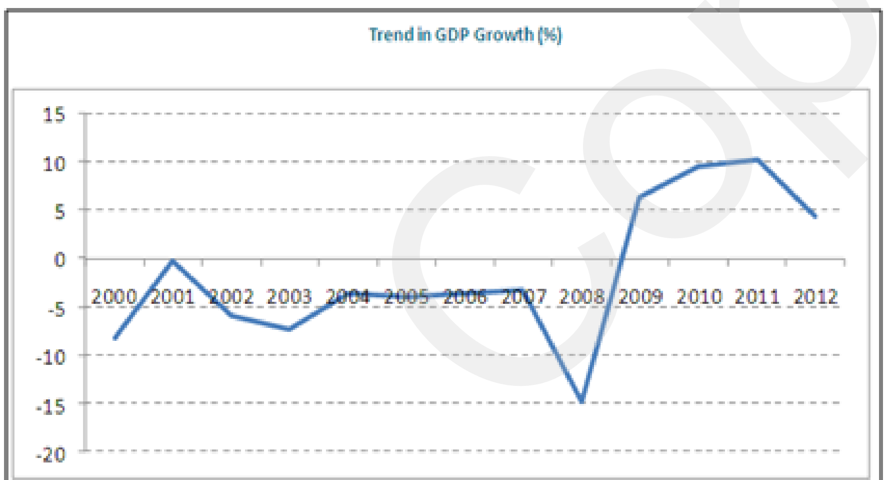
Foreign Currency Dealers

Z$100 Trillion Dollar Note

- Loss **of confidence** in Z$ by the public
- to counter inflation- printing of very high denominated Z$ notes up to (Z$1 trillion).
- RBZ forced to revalue the Z$
  - Aug. 2006- 3 zeroes removed
  - Aug. 2008- 10 zeroes removed
  - Feb 2009- 12 zeroes removed
- Shortages of local currency due to shortage of printing paper
- Shortages of Basic Goods

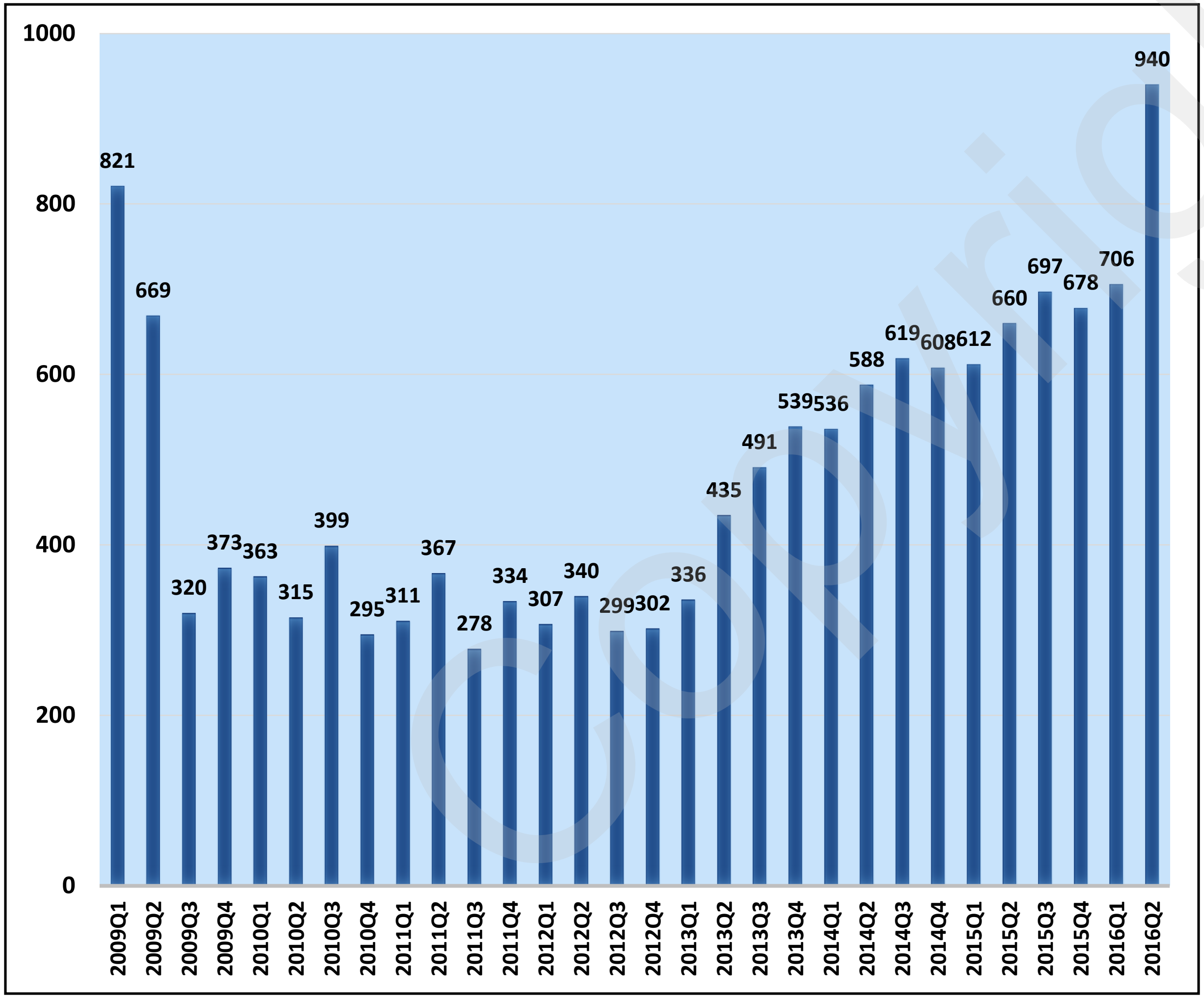
How Zimbabwe Benefitted from Dollarisation





- Agent of restraint- does not allow monetisation of fiscal deficits
- Macroeconomic stability ending the episode of hyper inflation
- eliminates the risk of future currency crises
  - Concern: US$/ZAR
- Positive economic growth trajectory as witnessed by the growth rates of 6.3% in 2009, 9.6% in 2010, and 10.3% in 2011 and 10.6% in 2013.

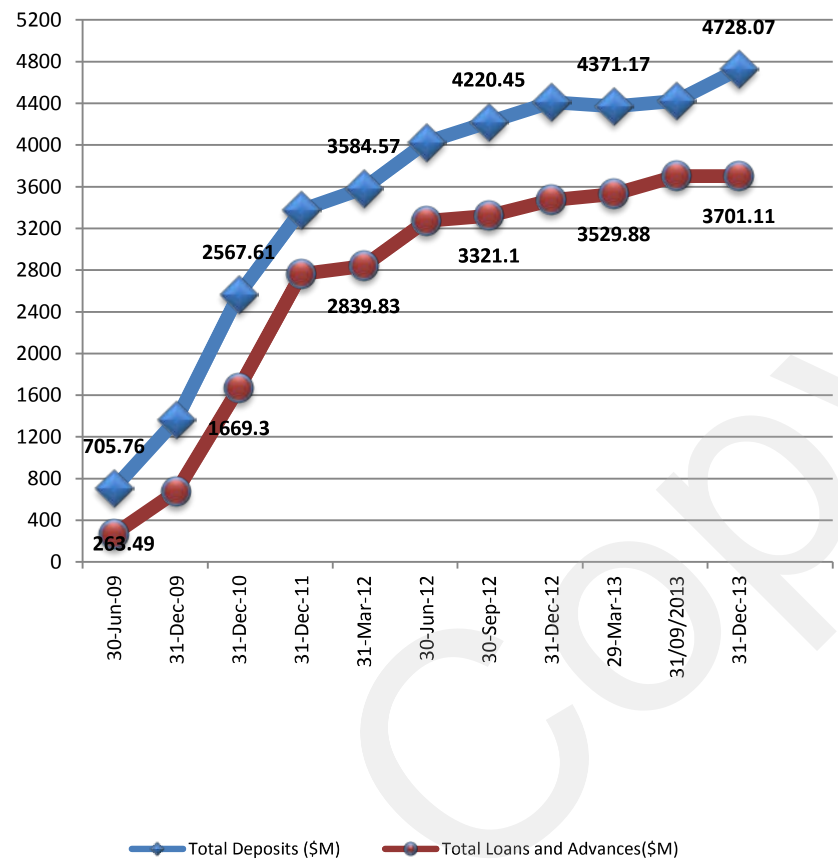
Benefit 3. Improved Confidence: Deposits of Resident Zimbabweans in Foreign Banks as reported by BIS



- The stock of deposits held by Zimbabweans in BIS reporting banks fell from 2009 (Q1) and only began to increase in mid 2013.
- The figure was around US$940 million in December 2016

How Zimbabwe Benefitted from Dollarisation

Growth in Deposits and Loans (US$m)



Confidence in the banking system

- Growth in deposits, from a paltry $0.7 billion in June 2009 to US$4.7 billion in Dec 2013.
- Growth in loan-deposit ratio: Improved bank intermediation
- But the deposits base is mainly transitory in nature.
  - This has also translated to short term loans mainly for working capital purposes

…but there were also costs to Dollarisation

Standard costs included the following:

- Loss of independent monetary and exchange rate policy
- Loss of seignorage revenues
- Lack of lender of last resort
- Loss sovereignty
- Threat of deflation

…but there were also costs to Dollarisation

But Three Major Challenges faced Zimbabwe

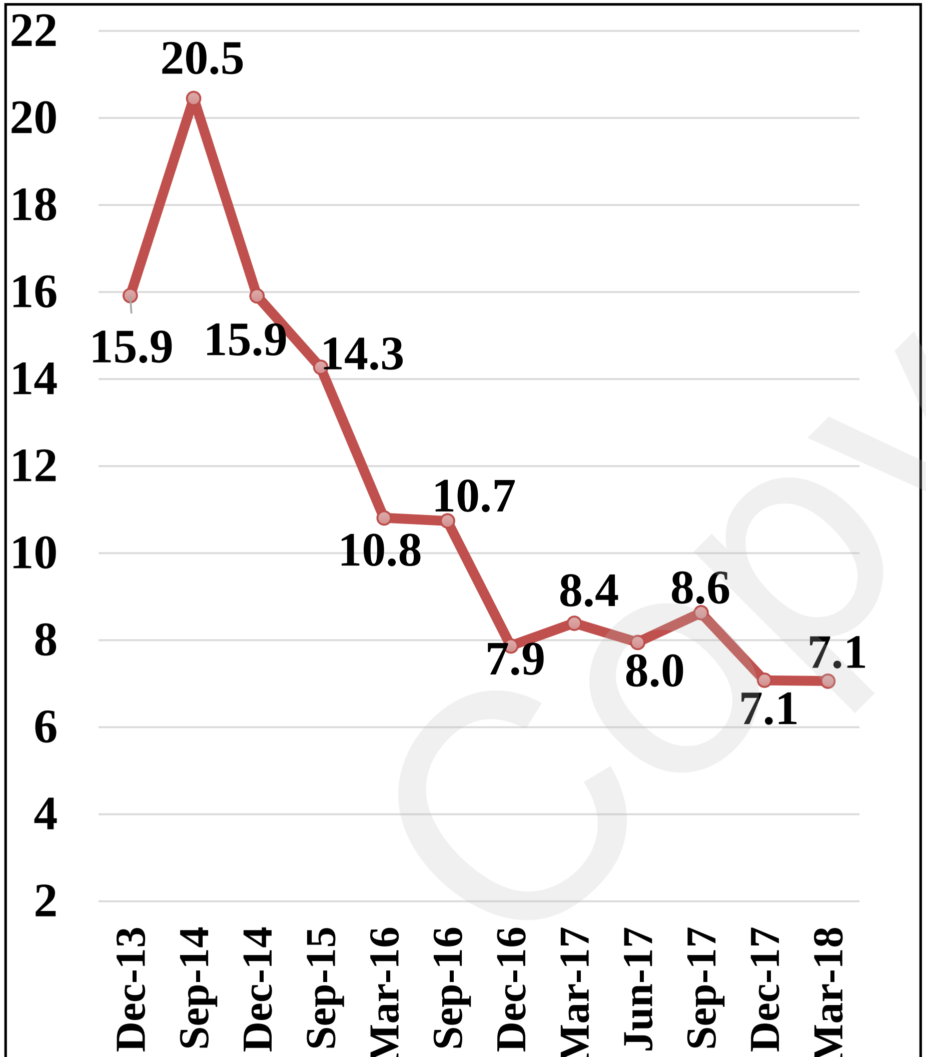
- Persistence of vulnerabilities in the Banking sector
- Loss of export competitiveness
- Liquidity management in the face of foreign exchange shortages

1. Vulnerability of the Banking Sector

- High interest rates at the onset of dollarisation (as high as 30%) reflecting high country risk and lack of an inter-bank bank market
  - ✓ Leading to bank failures--Five (5) Commercial Banks collapsed between 2009 and January 2015
  - ✓ High levels of non-performing loans
  - ✓ Also solvency conditions became more stringent, further making financial intermediation more costly:
    - *Holding of higher liquid assets which raise lending rates*
- **Financial stability mandate was broadened to compensate for the lack of Lender of Last Resort Function under dollarisation.**

High Credit Risks Environment

Non-Performing Loans



- High interest rates on dollar denominated loans triggered huge corporate and individual defaults
- RBZ instituted holistic measures to address NPLs through:
- Increased minimum capital requirements in 2012
- AFTRADES to act as an interbank market (underwritten by Afreximbank)
- ZAMCO's purchase of toxic assets from banks ($1.01 billion).
- Establishing a credit reference bureau to enhance credit infrastructure
- Encouraged banks to strengthen credit risk management systems (risk based supervision)

How Fragile is Zimbabwe's banking Sector?

Z-scores for Selected SADC Banking Sectors

Country	2009	2010	2011
Angola	11	12	11
Botswana	13	15	17
Malawi	26	26	24
South Africa	9	9	10
Tanzania	10	9	9
Zambia	12	10	11
Zimbabwe	--	2	2

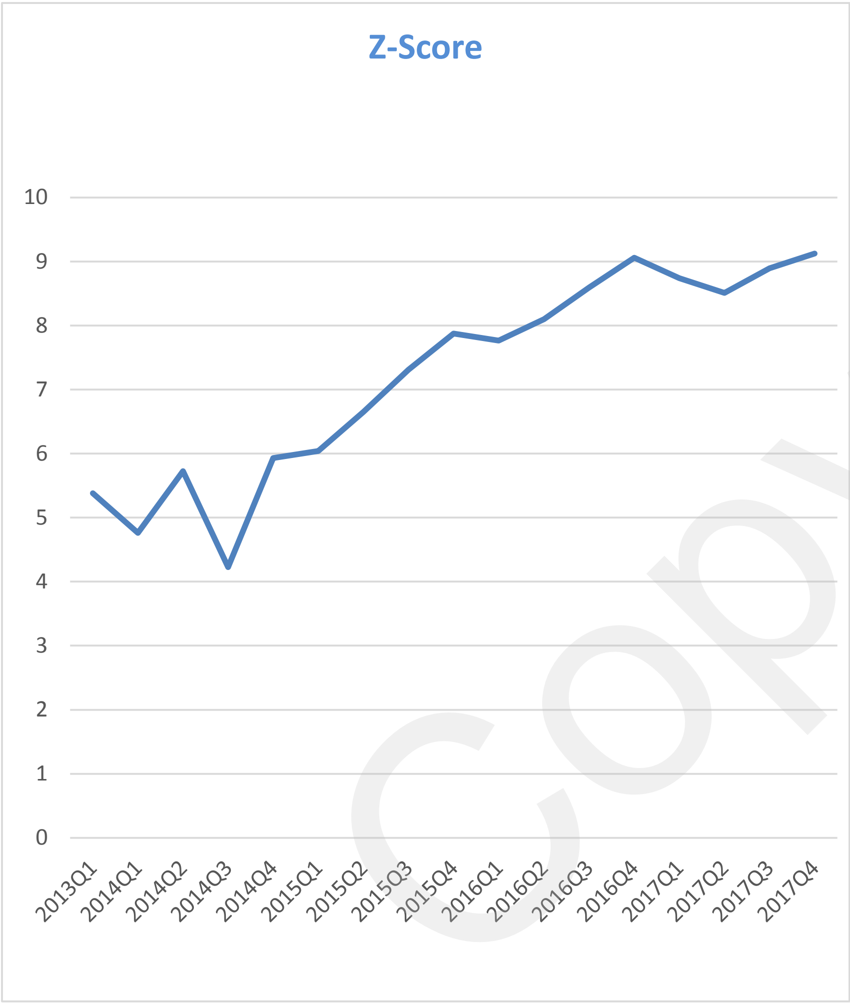
Source: World Bank Data base

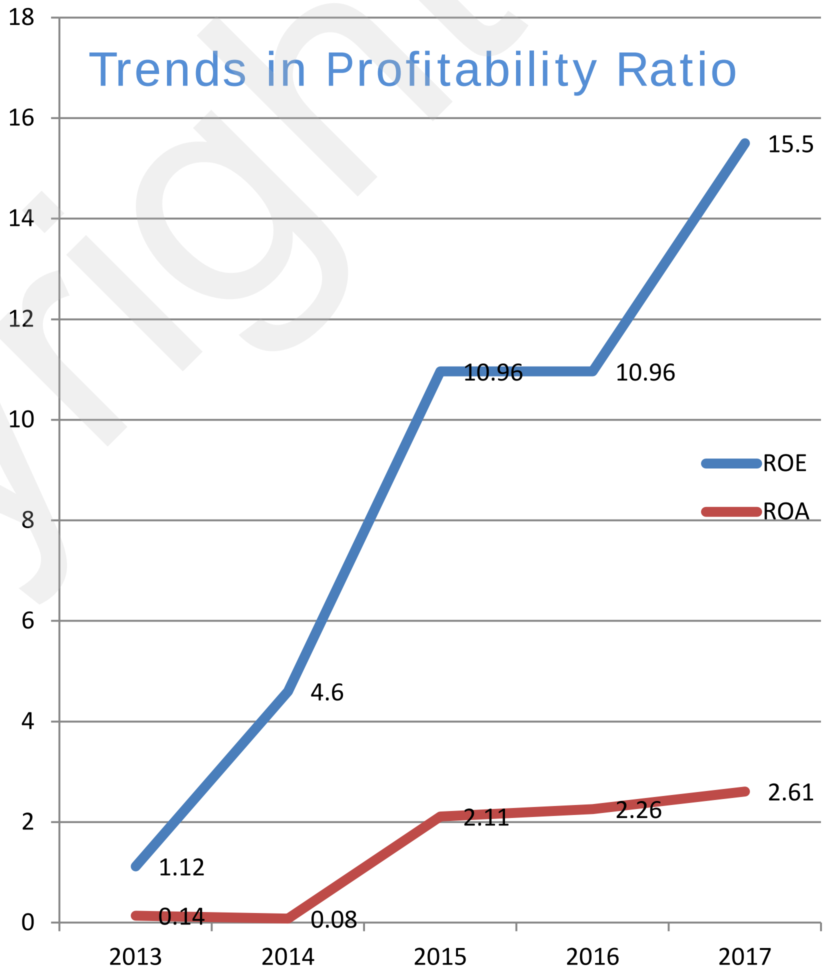
- Z-score is a measure of individual bank risk:

$$z = (CAR + ROA)/\sigma_{ROA}$$

- Z measures the number of stdevs a return realisation has to fall in order to deplete capital (distance to default)
- Higher z-score implies a lower probability of insolvency risk
- In the SADC region, the banking sector in Zimbabwe is the most fragile.

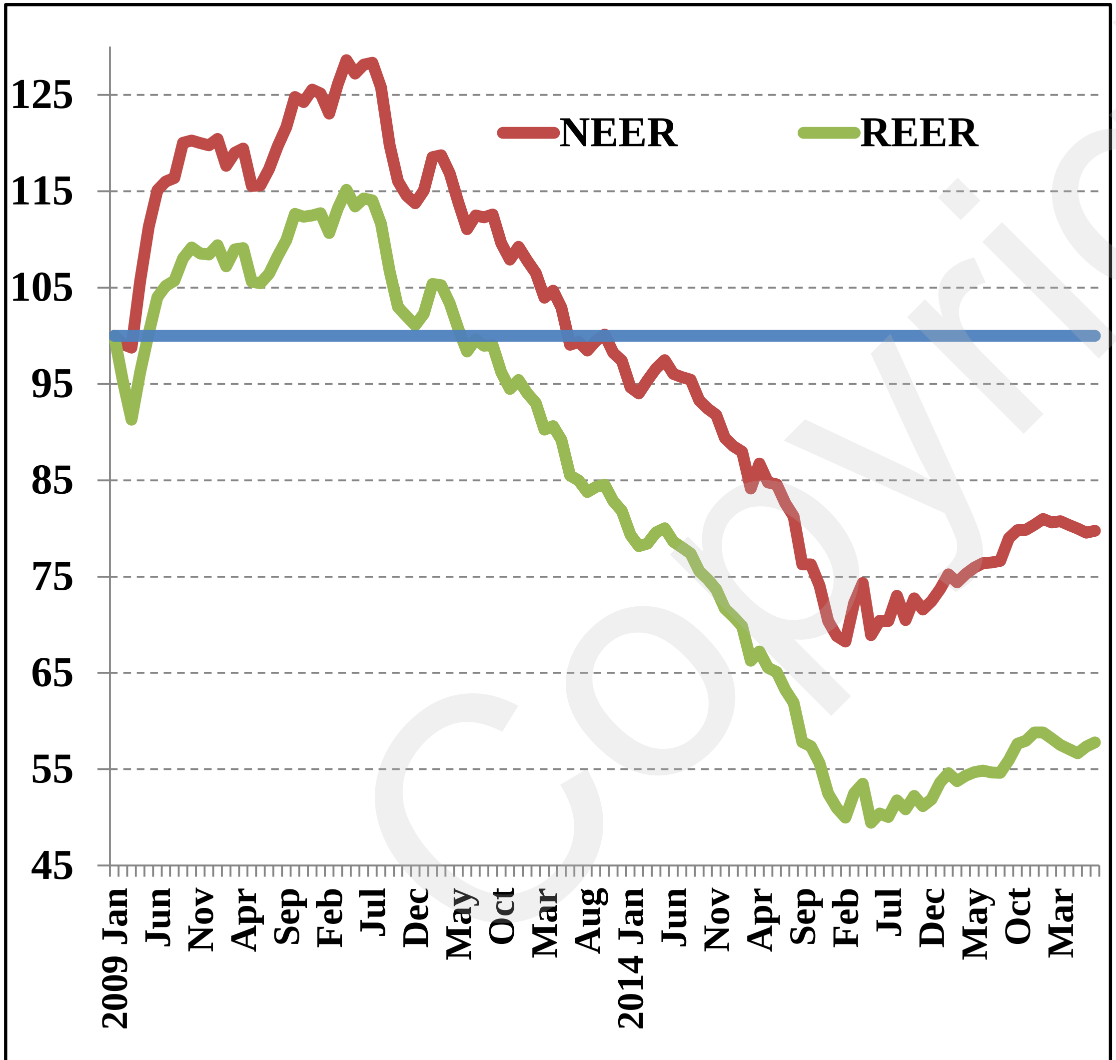
Improvement in z-scores





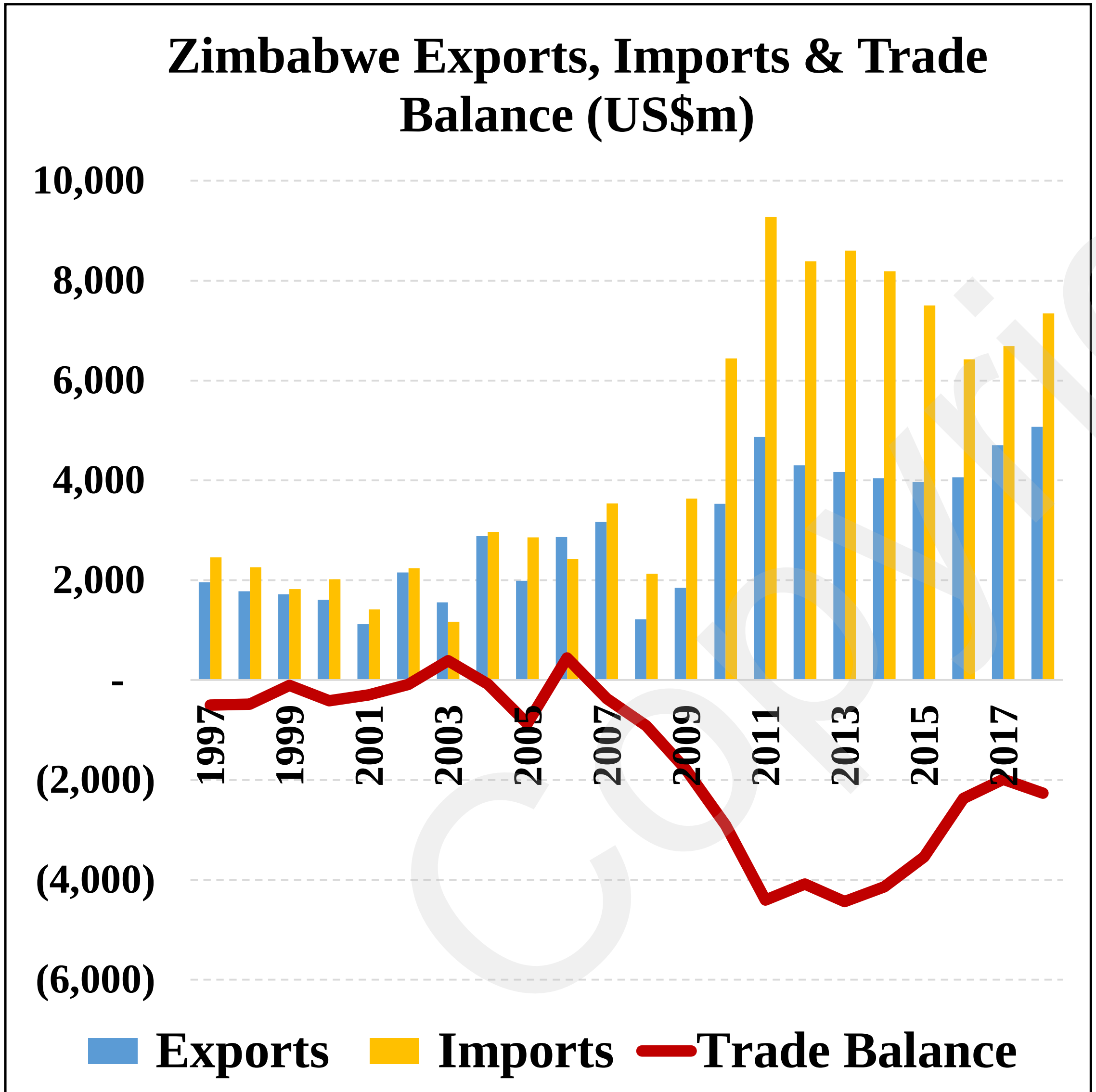
2. Lack of Export Competitiveness

Trends in Real Effective and Nominal



- Real exchange rate overvaluation between 2012 and 2016
- Reflect depreciation of most trading partner currencies (esp. ZAR) to US$
- Hurt exports and encouraged imports
- South Africa accounts for about 75% of Zimbabwe's exports and 47.8% of imports

2. Result: Persistent and High Trade Gap



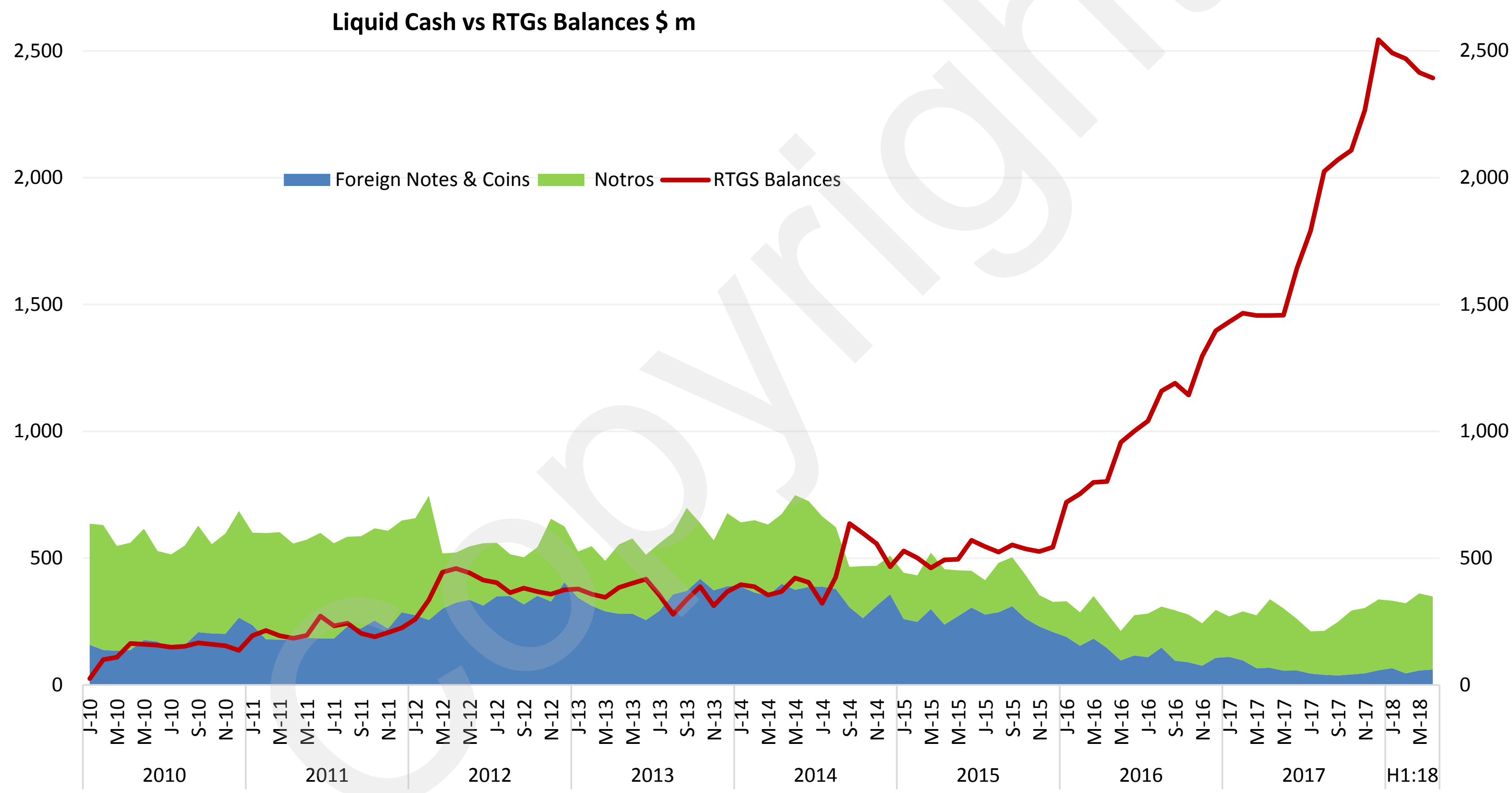
- Imports remained consistently higher than exports.
- High propensity to import as everyone had access to foreign currency
- Less incentive to export as the ZAR depreciated agains the USD
- This resulted in chronic current account deficit and falling foreign reserves.

3. Scarcity of liquidity the most significant a major policy challenge

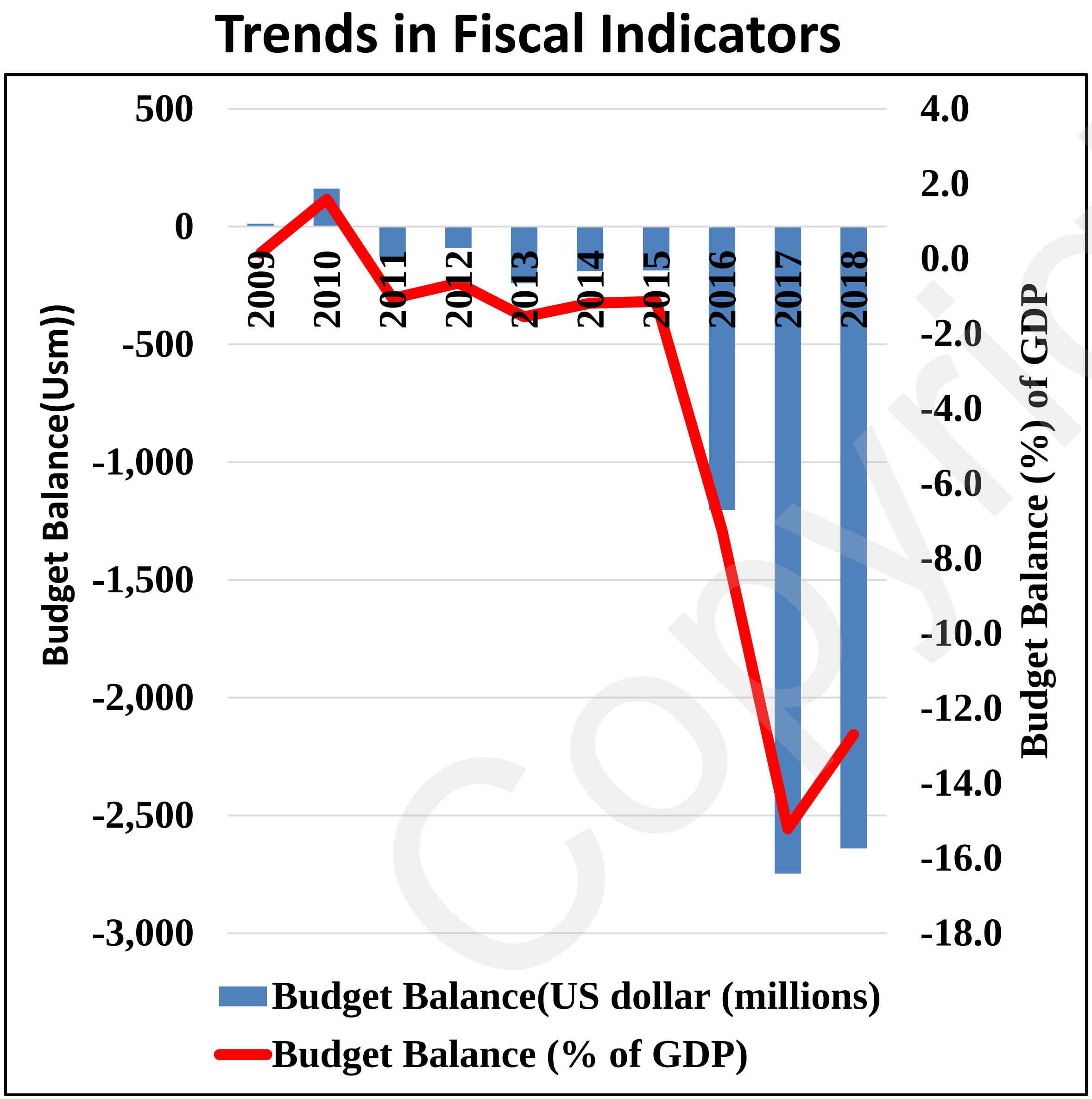
The major challenges under dollarisation relates to the management of scarce liquidity

- Conduct of monetary policy usually impaired since capital inflows or outflows automatically change the stock of money supply in the economy.
- Money supply contracts with outflows of foreign currency and expands with inflows
- In 2015 we began to experience serious liquidity challenges
- By Q1 2016 full blown cash crisis

Why the liquidity crisis? Growing mismatch between the RTGS and Nostro Balances



Why the mismatch? (2) Growing fiscal imbalances



- Dollarisation generally implies a hard budget constraint
- Zimbabwe adopted a balanced budget from 2009 up to 2013 – ***“eating what we kill”*** .
- Budget deficit deteriorated to 15.2% of GDP in 2017
- High wage bill – about 90% of revenues.
- Huge fiscal expenditures on agriculture since 2016 – command agriculture.

Why the mismatch? (2) Growing fiscal imbalances

- Government deficit financed through issusuing of Treasury Bills and a central bank overdraft and cash advances
  - Treasury Bill issuances have increased from US$2.1 billion in 2016 to a cumulative US$7.6 billion, by end of August 2018
  - In 2014, Treasury Bills to GDP ratio was at 4.4% and has increased sharply to 36.5% by end of August 2018.
  - The overdraft with the Central bank stands at US$2.3 billion, as at end of August 2018, well above the statutory limit of US$762.8 million.
  - Deficit also financed through arrears and loans from the private sector

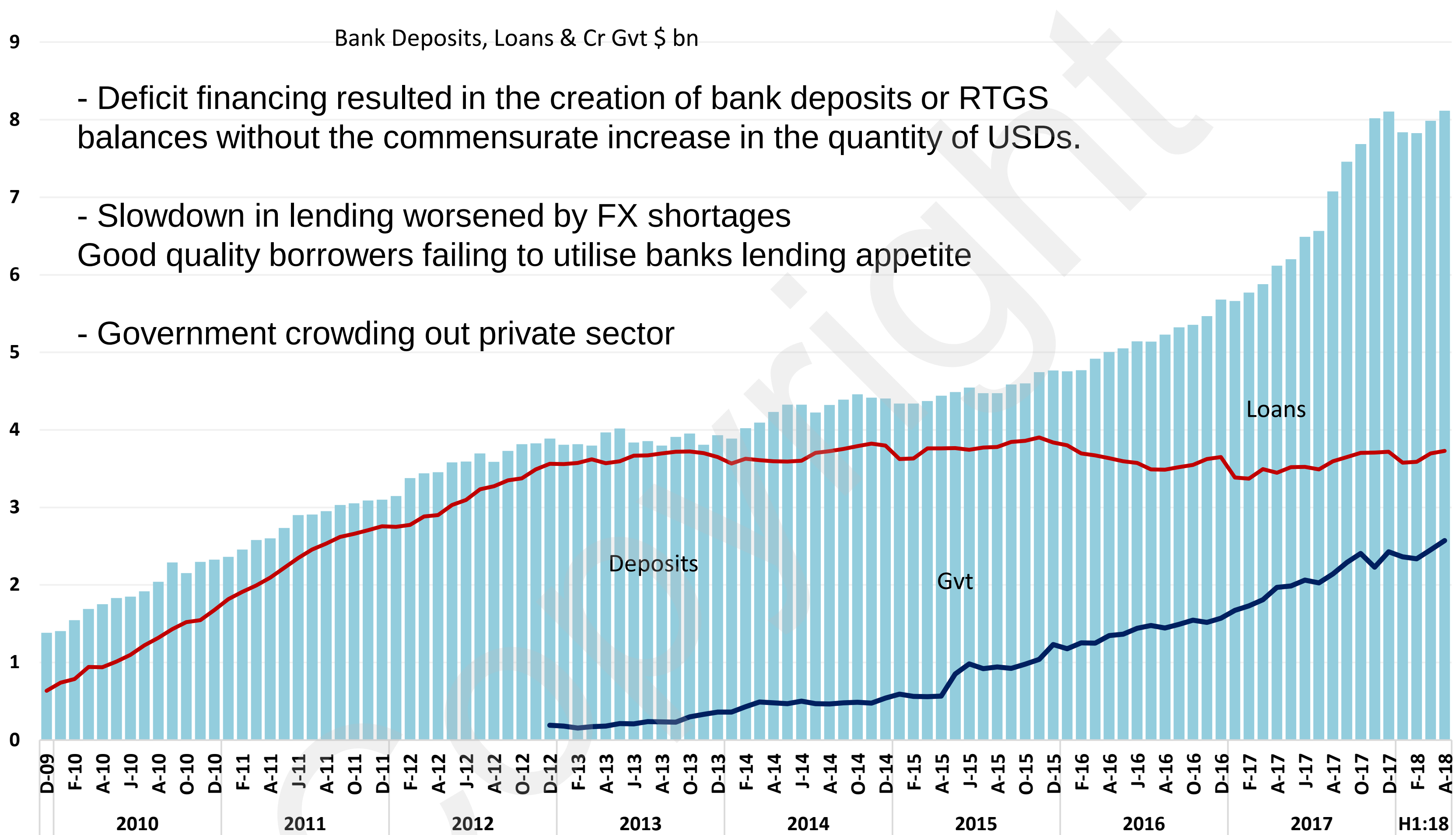
Effects of mode of deficit financing

- Mode of deficit financing using short-term instruments has resulted in:

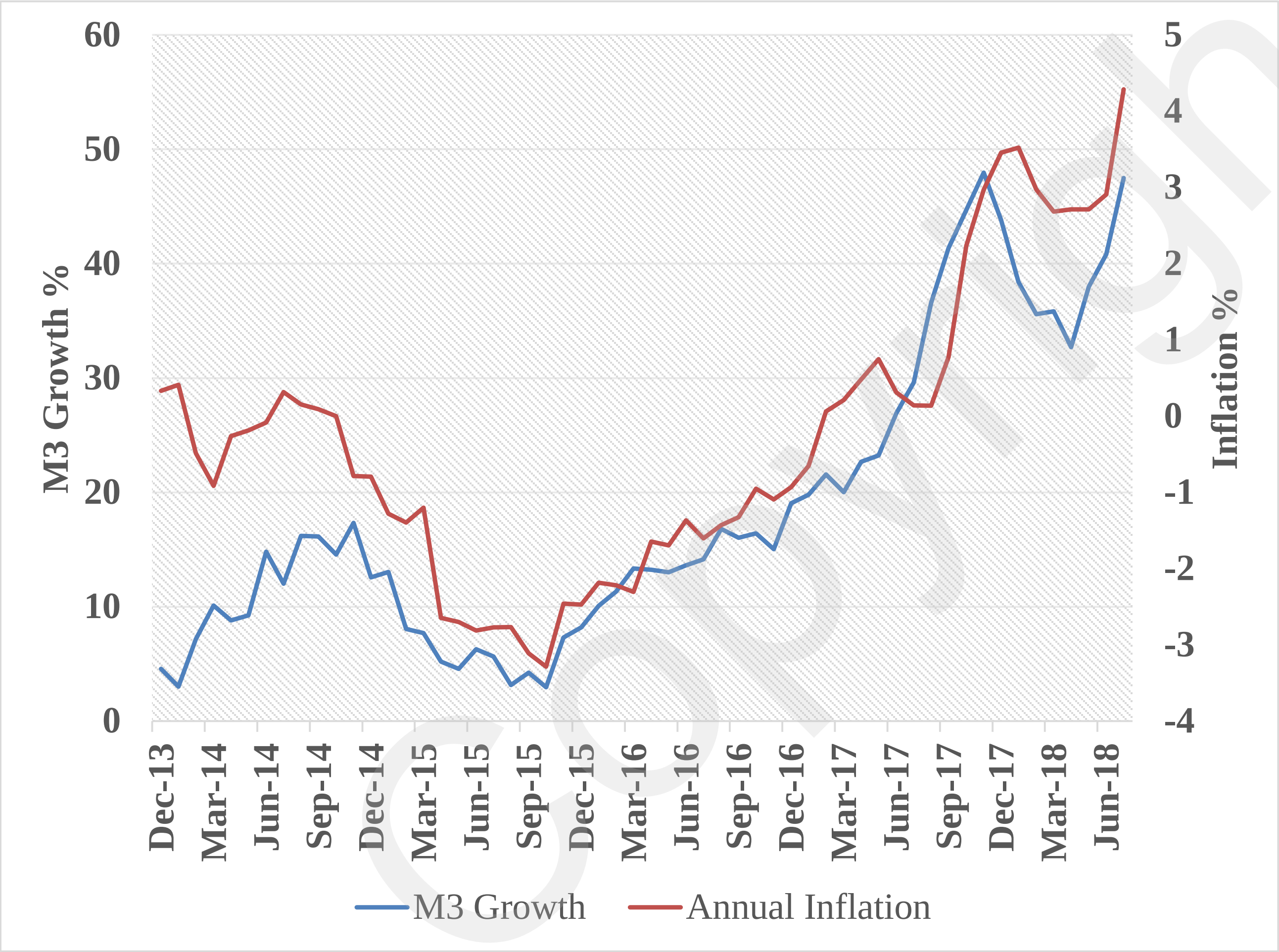
  - High growth of money supply
  - High domestic debt
    - In 2012 domestic debt stood at $275.8 million
    - End August 2018 was $9.5 billion

  - Add external debt of $7.4 billion→ total public debt is $16.9 billion

Rapid growth in Banking Sector deposits after 2016

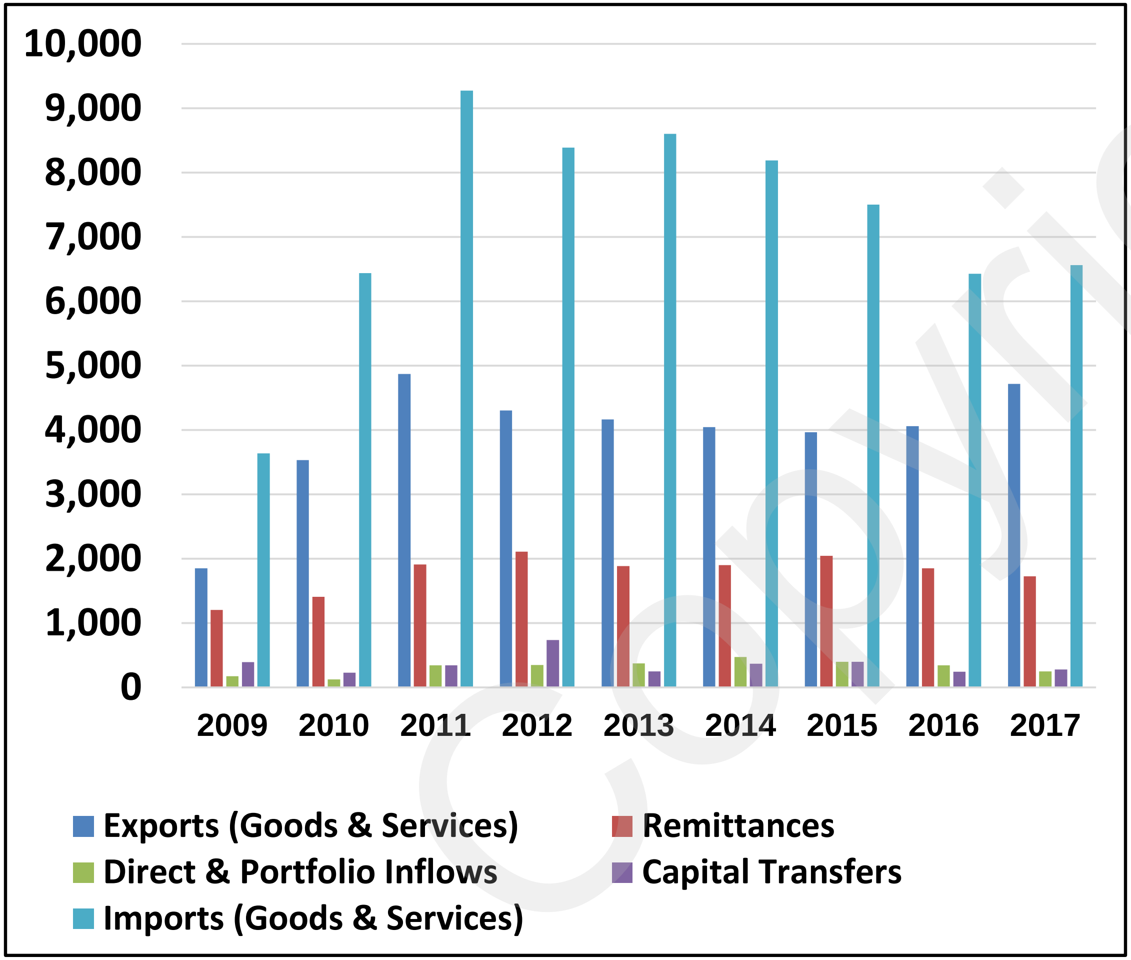


Result: High money supply growth and increasing inflation



- Monetisation of fiscal deficits.
- Money supply and inflation on the rise

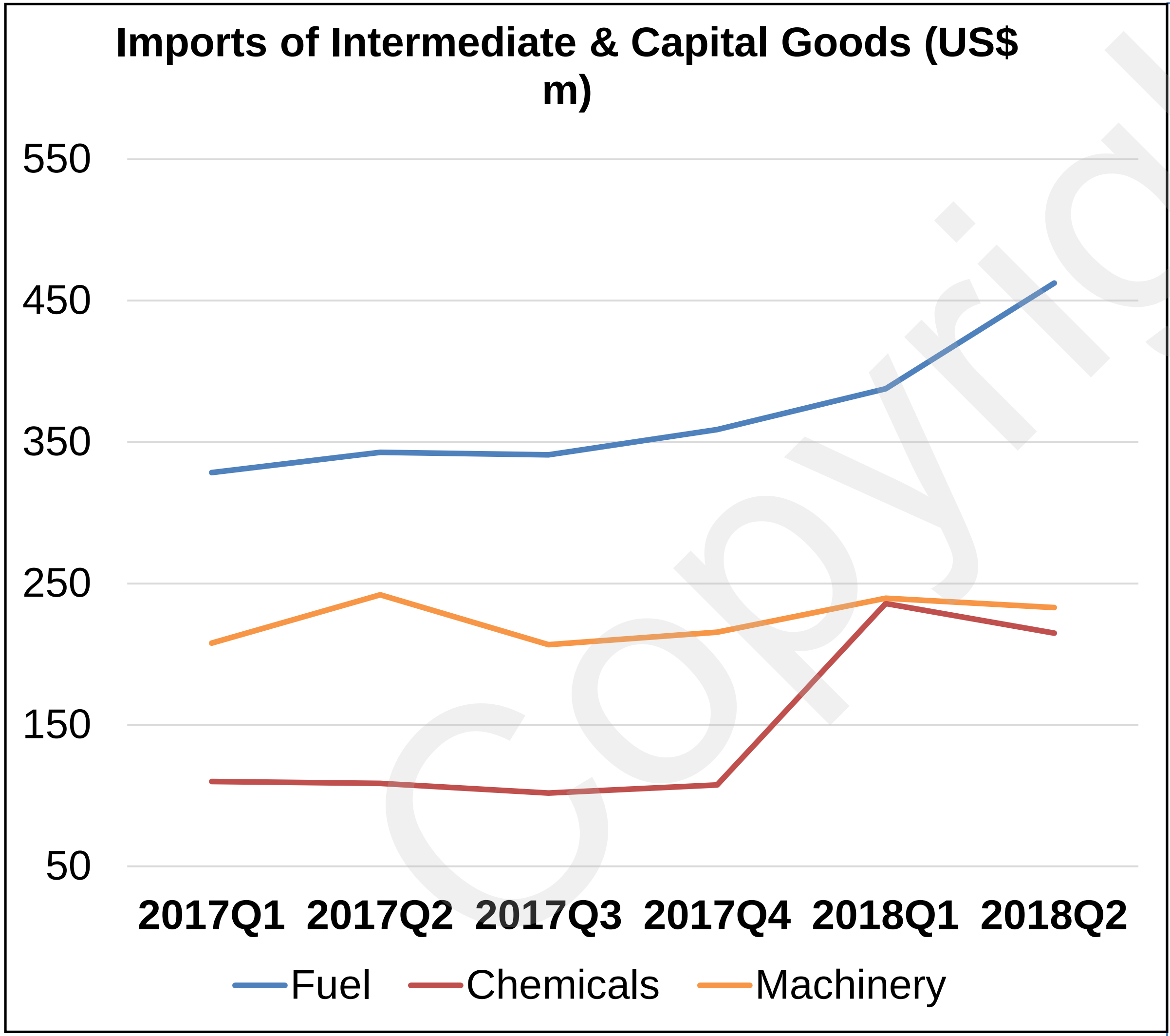
Why the Nostro balances are low? Pressure on main sources of Liquidity in Zimbabwe



Liquidity shortages in Zimbabwe due to:

- Low Export Earnings Vs High Imports;
- Low Diaspora Inflows (Remittances);
- Limited Offshore credit lines;
- Low Foreign and portfolio investment inflows; and
- Low Capital transfers including grants.

INCREASING DEMAND FOR FOREX



Source: ZIMSTAT, 2018

Economic rebound since 2017 spurred demand for imports and hence forex

The bulk of imports are, however, necessary for production. (intermediate goods, notably fuel, chemicals and other raw materials)

Fuels, chemicals, machinery and other raw materials constitute about 71% of the total import bill.

Need to unlock domestic supply of raw materials starting with agriculture to manage imports

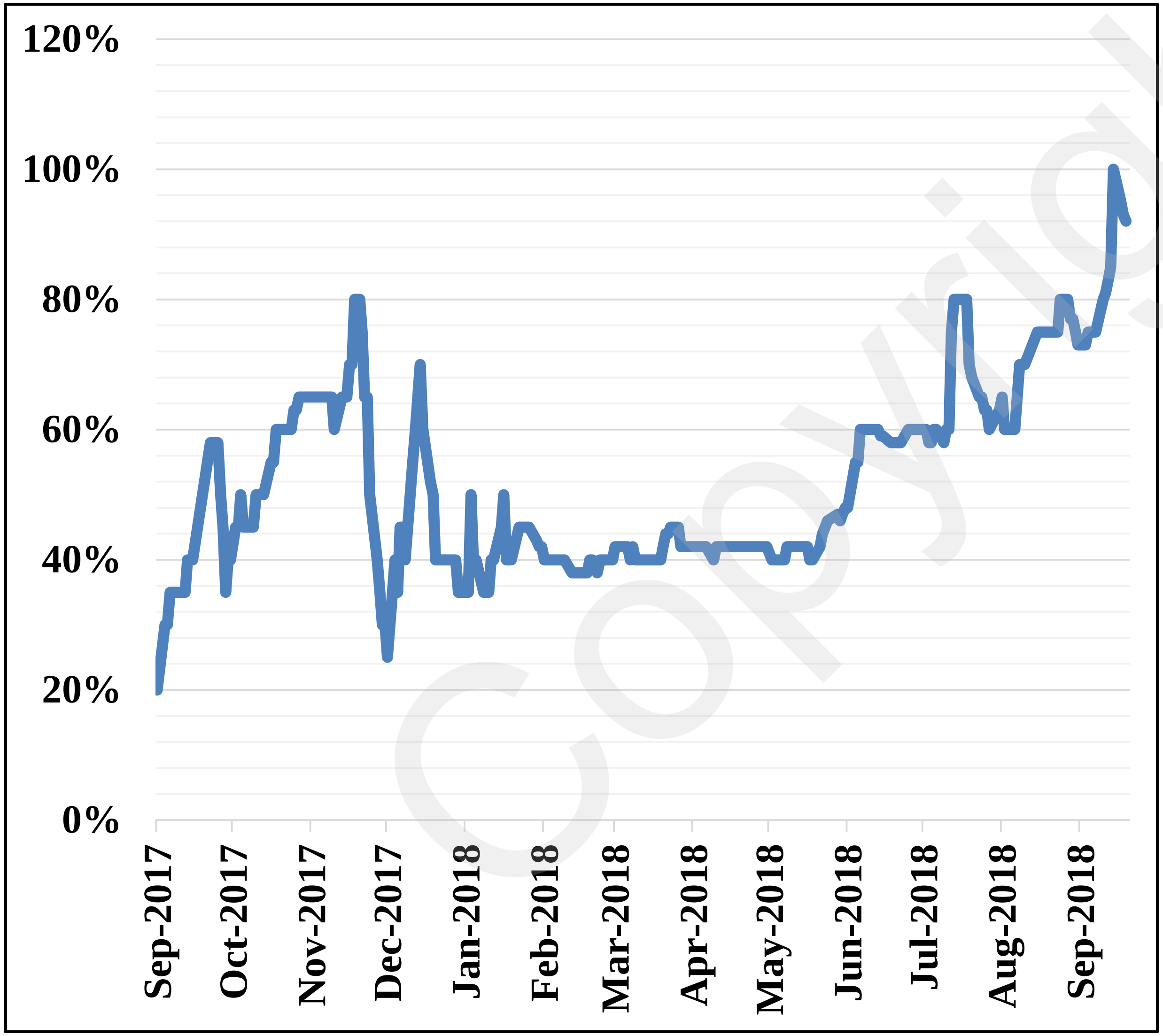
Zimbabwe also has a big problem of Illicit Financial flows

- Afrodad estimates Zimbabwe lost US$2.83bn between 2009 - 2013, through illicit flows—translates to about US$570.75m a year. Of this:
  - ✓97.88% (US$2.793 billion) were in the mining sector
  - ✓0.98% Fisheries
  - ✓0.61%, Timber
  - ✓0.53% in wildlife

- Some 280 Zimbabweans named in the Panama papers

- A t the onset of the multicurrency era RBZ allowed transfers from personal or individual accounts as free funds (no questions asked)

MISMACHES BETWEEN RTGS MONEY AND FOREIGN ASSETS RESULTED IN PARALLEL MARKET PREMIUMS



- Fiscal imbalances resulted in creation of electronic money not backed by foreign currency

- Increase in premium shows increased mismatch between RTGS money and banking sector Foreign assets.

- Premiums reached almost 100% in September 2018

Key Policy Responses

1. In 2016 RBZ began to promote the us of digital financial services as the main mode for transacting

E-payment Streams:- Values and Volumes for the six months period ended June 2017/8

PAYMENT STREAMS!	2017 *January to June*!	2018!	Proportion of Total June!	% Change!
		VALUES !		
RTGS!	14,499,231,288.40!	37,637,564,118.55!	58.12%!	159.58%!
POS!	1,583,489,239.03!	4,151,729,138.56!	6.41%!	162.19%!
ATMS!	118,617,660.73!	77,972,379.51!	0.12%!	-34.27%!
MOBILE !	2,828,024,721.20!	17,268,033,670.82!	26.66%!	510.60%!
INTERNET!	1,456,553,800.54!	5,628,587,532.29!	8.69%!	286.43%!
TOTAL VALUE!	**20,485,916,709.90!**	**64,763,886,839.73!**	**100.00%!**	**216.14%!**
		VOLUMES !		
RTGS!	1,420,517!	3,220,722!	0.38%!	126.73%!
POS!	47,685,061!	130,085,342!	15.20%!	172.80%!
ATMs!	2,170,358!	1,652,192!	0.19%!	-23.87%!
MOBILE !	140,846,148!	717,947,730!	83.89%!	409.74%!
INTERNET !	896,416!	2,931,865!	0.34%!	227.07%!
TOTAL VOLUME!	**193,018,500!**	**855,837,851!**	**100.00%!**	**343.40%!**

Key Policy Responses

2. In November 2016 RBZ introduced a 5% incentive scheme in the form of a Bond Note to promote exports

- The BN was backed by a $200 million gold facility from Afreximbank
- The BN officially traded at 1:1 with the USD. In reality trades at a discount

3. RBZ also negotiated a number of Nostro stabilisation facilities with international institutions—principally Afreximbank

4. October 1, 2018 introduces separate Foreign Currency Accounts (FCAs) for Nostro and RTGS funds

Key Policy Responses

5. Policies to mop up excess RTGS liquidity

- in 2017 RBS introduced an 7% tax-free Savings Bond. As at 31 August 2018 the Savings Bonds had raised $1.5 billion
- Re-introduction of Statutory Reserve requirement: with effect from 1 November 2018 a 5% statutory reserve requirement will be levied on RTGS FCAs on a weekly compliance basis in order to mop u excess liquidity in the market

6. Fiscal consolidation and overall economic reforms

7. As a country, Zimbabwe is now pursuing a policy of international re-engagement with the international community

- Arrears clearance of multilateral debt (AfDB and World Bank)
- Political re-engagement (incl. re-joining the Commonwealth)

POLICY DILEMMA :HAS ZIMBABWE DE-DOLLARISED?

- If dollarisation is measured by a significant ratio of foreign currency deposits to broad money or foreign currency reserves to monetary base, then Zimbabwe could be considered a successful case of a country that de-dollarised
- However, a greater proportion of transactions still take place at the Local currency -USD parity of 1:1 which is hard peg
- The public still believes that the country is in a dollarised regime
- Escalating parallel market premiums points to unsustainability of the current exchange rate regime

Question: What are the currency reform options?

CURRENCY OPTIONS Post Multi-Currency Regime

- Three possible options:

i. Continue with the multicurrency regime with Bond notes trading at an exchange rate – currently fixed (1:1). This is current RBZ position

ii. Joining the Common Monetary Area (CMA)—offers policy credibility and access to South Africa deep capital markets. But Zimbabwe may not meet some of the conditions (e.g. having a viable local currency); ZAR one of the most volatile currency in the world.

i. Re-introduction of a local currency supported by strong fundamentals and a currency board. Credibility problems and would require significant accmulation of foreign reserves and binding fiscal rules.

THANK YOU