TABLE OF CONTENTS

EXECUTIVE SUMMARY		**1**
ACRONYMS		**2**
1.	**THE IMPORTANCE OF THE FINANCIAL SECTOR IN THE ECONOMY**	**3**
2.	**THE STATE OF FINANCIAL INCLUSIVENESS**	**4**
3.	**INTERNATIONAL EVIDENCE AND LESSONS ON FOREIGN BANK OWNERSHIP**	**6**
4.	**THE ZIMBABWE FINANCIAL SECTOR AND CHALLENGES SINCE ADOPTION OF DOLLARIZATION**	8
4.1	Overview of the Banking Sector	8
4.2	Performance of the Banking Sector	9
4.3	Mobilization of Remittances	11
4.4	Risks facing the Banking Sector	12
4.5	Bank Capitalization and Financial regulation	18
4.6	The Deposit Insurance Scheme	22
4.7	Challenges posed by Dollarization	24
4.8	The Capital Market	25
5.	**EFFORTS IN BUILDING FINANCIAL INCLUSIVENESS**	**28**
5.1	The Microfinance Vehicle	28
5.2	Mobile and Internet Banking	28
6.	**STRATEGIES FOR RESOURCE MOBILIZATION**	**30**
6.1	Mobilization of Domestic Savings	30
6.2	Facilitate Development of Interbank Market and Build LOLR Facility	30
6.3	Remove Barriers to FDI in the Financial Sector	31
6.4	Embrace Public-Private Partnerships in the Banking Sector	31
6.5	Unleash the Potential of the People's Own Savings Bank (POSB)	32
6.6	Promote the Setting up of Microfinance Banks	32
6.7	Adopt Migration Policy that fosters mobilization of diaspora savings	33
6.8	Provide incentives for the Diaspora to hold Deposit Accounts locally	33
6.9	Create a capital market in Diaspora Bonds	34
6.10	Promote remittances through the formal financial system	34
7.	**GOVERNMENT ROLE IN BUILDING CONFIDENCE**	**35**
7.1	Ensuring macroeconomic stability	35
7.2	Strengthening oversight of the financial sector	35
7.3	Providing infrastructure	35
8	**CONCLUSION**	**37**
REFERENCES		**38**

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EXECUTIVE SUMMARY

Cognizant of the fact that sustained economic growth depends upon a healthy and developed financial sector, the overarching objective of this policy paper is to explore resource mobilization strategies that should be implemented in Zimbabwe. It commences by examining the role of the financial sector in the economy and reviewing the state of financial inclusiveness - globally, regionally and then focusing on Zimbabwe.

In the light of the ongoing debate on indigenization, the paper reviews international experience on the role of foreign owned-banks. The lessons drawn from experience are that foreign-owned banks are largely beneficial to host countries. They complement the domestic banking sector in a positive manner.

The paper goes on to make a situational analysis of the state of the financial sector in Zimbabwe and the challenges it is facing and the impact of dollarization. It finds that the banking sector is facing many challenges that include, among others, inadequate capitalization, liquidity problems, funds circulating outside the system, governance problems, non-performing loans and high rate of domestic bank failures. These challenges have led to the loss of confidence in sector.

In an effort to regain confidence and mobilize savings for development, the paper recommends a number of strategies and confidence building measures. The strategies for resource mobilization suggested include, among others:

- Reforming the deposit insurance scheme;
- Development of an interbank market;
- Building of lender of last resort fund;
- Re-capitalization of the RBZ and building of reserves;
- Removing barriers that are preventing small banks to downscale to microfinance banks;
- Removing barriers to FDI in the financial sector;
- Embracing public-private partnerships in the banking sector;
- Capitalization and reforming of the POSB through public-private partnerships; and
- Adoption of appropriate policies to tap the wealth of the Zimbabwe Diaspora.

Finally, the paper suggests some confidence building measures that include ensuring macroeconomic stability, promoting good governance and oversight of the financial sector, setting realistic minimum capital requirements that enable adequate returns to be earned, building financial infrastructure (especially credit bureaux) and adopting consistent policies. With respect to promoting good governance the paper specifically recommends that the Ministry of Finance appoints a Commission to investigate corporate governance practices in the banking sector with a view of drawing up a Code of Conduct acceptable to all stakeholders. Furthermore, in order to enforce compliance with regulation, it is recommended that the Banking Act be amended to incorporate the appointment by all banks of compliance officers with specific statutory duties.

ACRONYMS

BancABC	African Banking Corporation
BCCI	Bank of Credit and Commerce International
CABS	Central Africa Building Society
CBZ	Commercial Bank of Zimbabwe
CGAP	Consultative Group to Assist the Poor
DFID	Department for International Development
DPB	Deposit Protection Board
FDI	Foreign Direct Investment
FSC	Financial Sector Charter
GDP	Gross Domestic Product
GNU	Government of National Unity
HHI	Herfindahl-Hirschman Index
ICT	Information and Communication Technology
LOLR	Lender of Last Resort
M & A	Mergers and Acquisitions
MBCA	Merchant Bank of Central Africa
MFIs	Microfinance Institutions
NPL	Non-performing Loans
OECD	Organization for Economic Co-operation and Development
POSB	Post Office or People's Own Savings Bank
RBZ	Reserve Bank of Zimbabwe
ROA	Return on Assets
ROE	Return on Equity
SACCOs	Savings & Credit Union Cooperatives
SADC	Southern African Development Community
SAFEX	South Africa Futures Exchange
SMEs	Small and medium enterprises
SMMEs	Small, micro and medium enterprises
UCBL	Uganda Commercial Bank Limited
UNDP	United Nations Development Programme
UNCDF	United Nations Capital Development Fund
UNDESA	United Nations Department of Economic and Social Affairs
ZABG	Zimbabwe Allied Banking Group
ZDPB	Zimbabwe Deposit Protection Board
ZSE	Zimbabwe Stock Exchange

1. THE IMPORTANCE OF THE FINANCIAL SECTOR IN THE ECONOMY

It is now generally acknowledged that financial sector development is a crucial ingredient for economic growth. The World Bank (2007) has emphasized that the services provided by the financial sector of mobilization of savings and facilitating transaction services and risk management services are critical for development. The financial sector mobilises savings from those with surplus funds and channels them to those in deficit to enable investment and production to take place. The flow of funds can either be direct if savings are mobilised through capital markets (e.g. stock and bond markets) or indirect when savings are channelled through financial intermediaries (financial institutions) which in turn lend to households, firms and government. In this way financial markets and institutions perform a fundamental allocative function by allocating resources to the sectors that need them and can produce an adequate return on them. In addition to the intermediation role, the financial sector facilitates the payment system and performs risk management services for households, firms and governments. In summary, the financial sector provides five key services: (a) savings facilities, (b) credit allocation and monitoring of borrowers, (c) payments, (d) risk mitigation, and (e) liquidity services.

There is a positive relationship between financial sector development and economic growth that runs bi-directionally together with a mutually reinforcing effect. In other words, financial sector development promotes economic growth while economic growth itself stimulates further financial sector development, and the two mutually influence each other. Furthermore, it has been observed that the mutually reinforcing relationship between financial sector development and economic growth is stronger in the early stage of economic development, and that this relationship diminishes as sustained economic growth gets under way (Fung, 2009). Thus developing low-income countries with a relatively well-developed financial sector are more likely to catch up to their middle- and high-income counterparts while those with a relatively under-developed or under-performing financial sector are more likely to be trapped in poverty. This empirical fact has very important policy implications for Zimbabwe in its search for pro-poor growth strategies because the country can use a healthy financial sector as one of its instruments for fighting poverty.

Furthermore, there is a link between financial markets and FDI. When foreign firms enter a host economy, they make use of the host financial markets. By opening bank accounts in the host country they increase the lending capacity of domestic banks. Foreign firms are also more likely to demand high quality internationally comparable services and thus their presence should promote the domestic banking sector development. When they do their multinational capital budgeting and analyse country risk, they are likely to prefer invest in a country where the banking system is more developed and where they can easily access funds if needed. The degree of efficiency of the local stock market also matters for foreign enterprises as they may want to raise extra equity funding once they have entered a host country. Therefore, well-developed stock markets should attract more FDI and FDI in turn leads to further development of the domestic market. Adam and Tweneboah (2009) found a significant positive relation between FDI and stock market development in Ghana such that a percentage increase in FDI could lead to a 1.5% rise in market capitalization in the long run. Other studies in a number of developing countries found strong support that FDI does affect the development of domestic stock markets and that it may even jumpstart financial development regardless of excessive patronage and strong ties between politics and business (Zakaria, 2007; Kholdy and Sohrabian, 2008). Further, the causality between FDI and budgeting and analyse country risk, they are likely to prefer invest in a country where the banking system is more developed and where they can easily access funds if needed. The degree of efficiency of the local stock market also matters for foreign enterprises as they may want to raise extra equity funding once they have entered a host country. Therefore, well-developed stock markets should attract more FDI and FDI in turn leads to development of the domestic market.

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A study on financial markets and FDI focusing on Africa by Agbloyor (2012) found significant bi-directional causality between financial markets and FDI. FDI is observed to promote stock market development as foreign investors may want to list on a domestic stock market to satisfy government regulations or to raise equity capital to expand operations. Banking sector development is observed to result in more FDI flows because foreign investors need to raise finance from the banking sector to fund their operations. On the other hand, FDI flows also result in more banking sector development because they make more funds available for intermediation. It is further observed that a better developed banking system promotes cross border M & A, and by making more funds available to the banking sector to intermediate, cross border M & A can promote banking sector development.

In the SADC region, a study done for South Africa has shown that both financial development and economic growth leads to poverty reduction (Odhiambo, 2009). South Africa had since acknowledged the crucial importance of the financial sector for development so that in 2003 it released the South African Financial Sector Charter (FSC) after over a year of debate among the stakeholders. The FSC provides for increased access to financial services for poor households and communities and has a goal of directing substantial investment into transformational infrastructure, agricultural development, low-income housing and small medium black businesses, and black ownership increasing to a level of 10%. Some of earliest outcomes of the charter included the Mzansi basic bank account, offered by all major banks and the Post Office to low-income earners; provision of R42 billion in affordable housing; R5 billion for SMME funding, and R15 billion for empowerment funding. low-income earners; provision of R42 billion in affordable housing; R5 billion for SMME funding, and R15 billion for empowerment funding.

The ownership target of 10% of the charter was pegged at that level for a reason. According to international banking regulations[1], bank ownership shareholding above 10% confers a status known as shareholder of reference. This means in the event that a bank needs to be recapitalised, shareholders of reference have to contribute according to their shareholding. For instance if, say, Standard Bank of South Africa faced a crisis and required a $2 billion bailout, the Industrial Commercial Bank of China which has a 20% stake in the bank, would have to contribute up $200 million. Thus it was felt that black empowerment partners, who often have to borrow to finance their deals in the first place, would have difficulty to raise such amounts if they get the status of shareholder of reference. However, as smaller shareholders below the status of shareholders of reference, they do not face such obligations[2].

2. THE STATE OF FINANCIAL INCLUSIVENESS

According to McKinsey (2009) research on global financial access, the following findings are pertinent:

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[1] These are guidelines set out by the Basel Committee on Banking Supervision and they are generally applied to international banks. In the case of Zimbabwe these guidelines may be applicable to multinational banks such as Barclays, Standard Chartered and Stanbic.

[2] In theory there is a possibility of there being multiple indigenous shareholders each with no more than 10% stake. However, in practice ownership tends to be concentrated because of the desire by investors to have effective control of an organization.

2.5 billion adults, just over half of the world's adult population, do not use formal financial services to save or borrow.

2.2 billion of these adults (62% of the world's adult population) without access live in Africa, Asia, Latin America, and the Middle East.

Of the 1.2 billion adults who use formal financial services in Africa, Asia, and the Middle East, at least two-thirds, a little more than 800 million, live on less than $5 per day.

In Sub-Saharan Africa 80% of the adult population, i.e. 325 million people, have no access to financial services compared to only 8% in high income OECD countries.

Table 1 shows the situation for SADC countries in 2008. In terms of usage of financial services Mauritius ranks top followed by Botswana, South Africa, Swaziland and then Zimbabwe in 5th position.

Table 1: Financial Service Usage by the Adult Population in SADC Countries

Country	Usage of financial services (% adults)	Rank among SADC Countries
Botswana	47%	2
Lesotho	17%	8
Madagascar	21%	7
Malawi	21%	7
Mauritius	54%	1
Mozambique	12%	10
Namibia	28%	6
South Africa	46%	3
Swaziland	35%	4
Tanzania	5%	11
Zambia	15%	9
Zimbabwe	34%	5

Source: Honohan (2008)

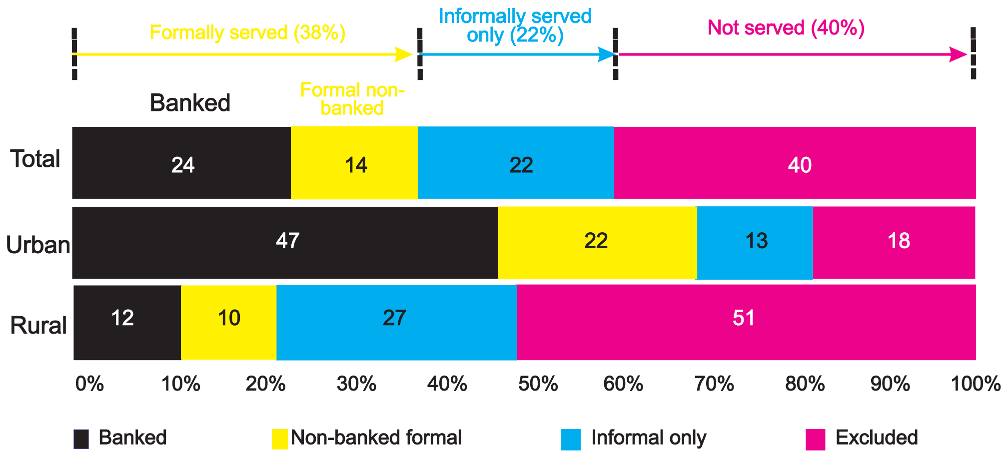
Recently, the FinScope[3] survey on financial inclusion in Zimbabwe conducted in 2011 found that 65% of the country's population live in rural areas while 35% live in urban areas, and that on average 80% of the adult population earn less than $200 a month, while about 17% do not have an income. The gender distribution of the population was found to be 60% female and 40% male. Considering that 60% of the sampled population were women, poverty levels and financial exclusion should be greatest among women.

The survey established the level of financial inclusion as indicated in Figure 1 below. Noteworthy is that only 24% of the total population is banked and of this only 12% of the rural population is

[3]FinScope, a FinMark Trust initiative in South Africa, is a nationally representative study of consumers' perceptions on financial services and issues, which creates insight to how consumers source their income and manage their financial lives. The sample covers the entire adult population, rich and poor, urban and rural, in order to create a segmentation, or continuum, of the entire market and to lend perspective to the various market segments (http://www.finscope.co.za)

banked. There is a large population not having access to financial services at all either through the formal or informal system, 40% in the case of the whole population and 51% in the case of the rural population. The FinScope results show a deterioration of financial inclusion since the McKinsey study in 2008, an indication of declining usage of formal financial services.

Figure 1: Level of Financial Inclusion in Zimbabwe



Source: FinScope 2011 as reported by RBZ (2012)

The 2006 UNDESA and UNCDF report observes that in most developing economies financial services are available only to a minority of the population. It further observes that financial-sector development strategies have largely focused on strengthening overall financial stability and increasing the availability of services to large firms, the government and wealthy households leaving out the small-scale sector. Yet the latter constitutes the majority of economic actors in numbers. Hence the UN Report recommends an inclusive financial sector development strategy that makes financial services accessible to the low-income groups and small enterprises.

3. INTERNATIONAL EVIDENCE AND LESSONS ON FOREIGN BANK OWNERSHIP

In view of the ongoing debate on indigenization in Zimbabwe pursuant to the enactment of the Indigenization and Economic Empowerment Act of 2007 that requires foreign firms including banks to cede 51% of ownership to indigenous people, it is imperative to review international evidence on foreign bank participation. A number of studies have observed significant potential benefits and costs from having foreign bank presence in a country. Peek and Rosengren (2000) cite five potential benefits.

Firstly, foreign banks are likely to be able to provide bank financing in the event of a domestic shock when local banks are severely impaired. The advantage of multinational banks is that they have a global presence so that a domestic shock in one host country may represent a small proportion of exposure to be adversely affected.

Secondly, foreign banks can be a major source of funding in the aftermath of banking crises. Recapitalization of domestic banks after a severe banking crisis requires private investors who have not been exposed to the domestic shock and foreign banks are better poised to fill the funding gap.

Various countries including Argentina, Mexico and Brazil allowed more foreign bank entry after debilitating financial crises left the majority of domestic financial institutions critically undercapitalized and unable to extend loans to fund local projects. These countries managed to stabilize their economies by allowing foreign banks to take over struggling and failed financial institutions in the aftermath of the Tequila Crisis[4]

Thirdly, foreign banks bring to the host country improved financial and regulatory reporting requirements as they need to comply with both the home and host country requirements. More often foreign banks are required by their home countries to make more disclosure in reporting which requirements would have positive spillover effects in the host country.

Fourthly, since in many cases foreign banks are among the most efficient in their home country, they are likely to impart improved management and information technologies to the host banking market (Focarelli and Pozzolo, 2000). Levine (1996) has observed that one way of quickly transferring the best practices in use in more developed banking markets is through foreign banks. They have the potential to immediately improve the efficiency and range of financial services in the host country.

Fifthly, foreign banks may lessen the severity of domestic shocks as they can provide a safe haven for depositors who otherwise might remove their funds from the country rather than take the risk of keeping the funds in a failing domestic bank. Thus, foreign banks can mitigate the capital flight during an economic crisis when depositors have lost faith in domestic banks.

Notwithstanding the many benefits arising from allowing foreign banks to enter domestic banking markets, there are a number of concerns regarding foreign bank presence in host countries. Peek and Rosengren (2000, p. 49) aptly puts it: " Often voiced are concerns that foreign banks will not have an attachment to domestic borrowers, and that regulatory and monetary authorities may have less control with a sizable foreign bank presence". Furthermore, the willingness of foreign banks to lend in the host country may be affected by the home country regulator whose regulations may place a binding constraint on their behaviour.

Another concern that relates more to protection of the domestic banking market is that domestic banks cannot compete globally and hence could be adversely affected by the presence of foreign banks. Stiglitz (1993) has observed that domestic banks may incur costs to compete with large multinational banks with better reputation and that local entrepreneurs may not be served because foreign banks generally concentrate on big businesses and multinational firms. In addition, there are political fears that foreign banks are not responsive to domestic credit needs. As a result of these perceived concerns and fears, free foreign bank entry has tended to happen mostly as either a consequence of severe domestic banking crisis or as a vehicle to privatize government-owned banks. The experience of Latin American countries is instructive. The relaxation of restrictions to foreign bank ownership in these countries invariably occurred as a consequence of crises.

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[4] Linda Goldberg, B. Gerard Dages & Daniel Kinney –May 2000: Foreign and Domestic Bank Participation in Emerging Markets: Lessons from Mexico and Argentina.

However, the benefits that foreign banks bring to a host country have been observed to outweigh the costs. Claessens, Dermirguc-Kunt and Huizinga (2001) who investigated performance differences between foreign and domestic banks in eighty countries- both developed and developing conclude that "results are consistent with a hypothesis that in the long run, foreign bank entry may improve the functioning of national banking markets, with positive welfare implications for banking customers."

Unite and Sullivan (2003) observed relaxation of restrictions to foreign bank ownership in the Philippines made domestic banks more competitive and efficient. McFadden (1994) reviewed foreign bank entry in Australia and observed improved domestic bank operations. Bhattacharaya (1993) reported on specific cases in Pakistan, Turkey, and Korea, where he noted that foreign banks had facilitated access to foreign capital for domestic projects.

Lwiza and Nwanko (2002) point out that the introduction of foreign banks in Tanzania following the liberalization of the banking sector in 1991, after more than 2 decades of nationalization (from 1967 to 1991), "intensified competition and exposed local banks to new dynamic methods, systems, technology and attitudes of doing business and in particular how to create superior value to customers." In addition, they observed that foreign banks brought some depth in terms of more sophisticated product offerings, citing Citibank's introduction of products which included commercial paper, forward contracts and on-line banking among other examples. However they also point out although retail banking constitutes 80 percent of Tanzania's banking activities; foreign banks are more likely to focus on wholesale banking, serving "high net-worth" customers, leaving local banks to deal with the majority of the customers, most of who are in the low-income category.

4. THE ZIMBABWE FINANCIAL SECTOR AND CHALLENGES SINCE ADOPTION OF DOLLARIZATION

4.1 Overview of the Banking Sector

As at the end of July 2012 there were 25 banking institutions[5], 172 microfinance institutions (MFIs) and 16 asset management companies. Table 2 below shows the position as at the end of 2008 and as at 30 July 2012.

Table 2: Number of Banking Institutions

Type of institution	December 2008	**July 2012**
Commercial Banks	15	**18**
Merchant Banks	6	**2**
Discount Houses	3	**0**
Finance Houses	0	**0**
Savings Bank (PSOB)	1	**1**
Building Societies	4	**4**
Total	**28**	**25**
Asset management companies	17	**16**
Microfinance institutions	75	**172**

Source: RBZ Mid-Term Monetary Statement (2012)

[5] The number includes Interfin that was placed under curatorship but excludes Genesis and Royal Bank that surrendered their banking licences.

In terms of ownership, there are five majority foreign-owned banks –Ecobank, Stanbic Bank Limited, Merchant Bank of Central Africa (MBCA), Standard Chartered Bank and Barclays Bank. There is one wholly-owned state commercial bank, Agribank, and two commercial banks with significant degree of state ownership, namely, CBZ and ZBank. The POSB is also wholly-state owned. Most institutions have their branches in urban centres. It is only the POSB and Central Africa Building Society (CABS)- 100% owned by Old Mutual Zimbabwe which in turn is majority owned by Old Mutual South Africa- and some MFIs that have networks that extend to rural and remote areas. Since dollarization, MFIs have registered the greatest growth, an increase of 109% from number beginning of 2009 representing an annual growth rate of 36%. This is clearly an indication of the high demand for microfinance services in the country. They are meeting the demand for credit for the majority of the small-scale sector unable to obtain credit from the banking sector.

4.2 Performance of the Banking Sector

According to RBZ statistics the banking sector's total revenue (turnover) was \$870 million as at the end of 2011 in which foreign banks accounted for 34% while domestic banks accounted for 66% of the revenue. There was improvement in the aggregate cost to income ratio that declined to 69% in 2011 from 80% in 2010 and having been at a high of 94% in 2009. The main revenue drivers for the banking sector included interest income (55%), ledger and handling fees (12%) as well as management and establishment fees (10%) and foreign exchange fees and commission (7%).

The banking sector witnessed significant growth in deposits, loans and advances in 2011 and the trend has continued into 2012. However, demand for credit continued to outweigh the available supply of funds as evidenced by the high loan to deposit ratios by domestic banks (see Figure 3 below). As at 31 December 2011 total deposits were \$3.3 billion, representing a 27% growth from \$2.6 billion as at 31 December 2010, and as at 30 June 2012 total deposits had risen to \$4.02 billion. The growth in deposits should be treated with caution because the RBZ reports end of period balances which do not show monthly volatility of deposits. The deposit market share was distributed as 94% for commercial banks, 1% for merchant banks, 4% for building societies and 1% for the POSB. Table 3 below which compares the years 2011 and 2010 shows that total bank deposits are concentrated in five banks.

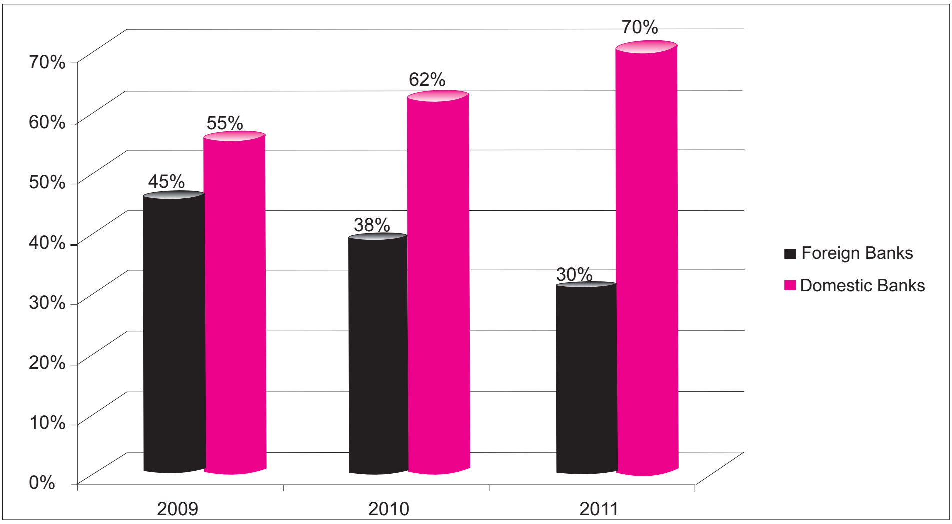
Table 3: Deposit Concentration

Bank	2011 market share of deposits	2011 market share of deposits
CBZ	32.10%	22.50%
BancABC	9.67%	11.70%
Stanbic	9.48%	8.60%
Standard Chartered	7.69%	7.10%
CABS	7.07%	6.00%
Total	**57.01%**	**55.90**

Source: MMC Capital Investment Research (2012)

Figure 2 shows that the share of total banking deposits of foreign banks has continued to decline, having decreased from 45% in 2009 to 30% in 2011. On the other hand, the share of domestic banks has risen to 70% by 2011 from 55% in 2009. Evidently, the deposits market is dominated by domestic banks. The distribution of deposits is however skewed towards one bank –CBZ-which at the end of 2011 had a share of 32% of deposits largely because of government deposits. Ordinarily, the RBZ should be playing this role of banker to government. The use by government of preferred bank (s) for its deposits is creating unfair competition and moral hazard as the preferred bank (s) may not be allowed to fail.

Figure 2: Foreign vs Domestic Banks' Contribution to Deposits (2009-2011)



Source: MMC Capital Investment Research (2012)

Computing the Herfindahl-Hirschman Index (HHI)[6] for the banking sector for the deposits, we find that market concentration decreased from 1300 in 2009 to about 900 in 2010 and increased again to 1 020 in 2011. This shows that there is an upward trend in market share concentration in few top banks.

In response to the huge demand for loanable funds the banking sector total loans and advances grew by 70% from \$1.7 billion in 2010 to \$2.9 billion in 2011 with slightly more than half (53%) concentrated in five banks as Table 4 below shows. The 70% growth rate in total loans and advances outstripped the 27% growth rate in deposits by a factor of 2.6. This is a sign of unsustainable credit growth and an indication of the deterioration of the quality of the loan portfolio. This is indeed proved by the statistics that show the non-performing loans to total loans ratio (NPL) rising from 2% in 2009 to 7.55% by the end of 2011. The growth trend in loans and advances continued into 2012 reaching \$3 billion by May 2012 and so as the deterioration in the loan quality, signified by the NPL ratio rising to 9.9%.

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[6] The Herfindahl -Hirschman Index (HHI) measures the level of competition that exists within a market or industry, as well as the distribution of market share. It can have a theoretical value ranging from close to zero to 10,000. A single market participant with 100% of market share would have an HHI of 10,000. The following are benchmarks:

- When the HHI value is less than 100, the market is highly competitive.
- When the HHI value is between 100 and 1000, the market is said to be not concentrated.
- When the HHI value is between 1000 and 1800, the market is said to be moderately concentrated.
- When the HHI value is above 1800, the market is said to be highly concentrated.

Table 4: Loans and Advances Concentration of Top 5 Banks

Bank	2011 market share	2010 market share
CBZ	24.78%	25.50%
Stanbic	9.57%	5.80% (position occupied by Stanchart with 6.50% share)
Banc ABC	8.55%	5.10% (position occupied by Interfin with 6.00% share)
CABS	6.60%	3.50% (position occupied by Stanbic with 5.80% share)
Standard Chartered	3.97%	6.50% (position occupied by BancABC with 5.10% share)
Total	**53.48%**	**48.90%**

Source: MMC Capital Investment Research (2012)

In 2011 commercial banks had a market share of 89% for loans and advances compared with 91% in 2010, while building societies and merchant banks had a market share of 8% and 1% respectively compared to 2% and 5% respectively attained in 2010. The aggregate loan to deposit ratio increased from about 65% in 2010 to about 88% in 2011 a level within international norms of 70%-90%. By May 2012 the loan to deposit ratio had fallen to 84% but still within international norms.

Total bank assets grew to $4.7 billion in 2011 from $3.3 billion in 2010, an increase of 42% with commercial banks accounting for 87% of the total assets while building societies and merchant banks accounted for 10% and 1% respectively. Five banks accounted for 60% share of total assets CBZ (24.74%), BancABC (9.56%), Stanbic (9.11%), CABS (8.44%) and Standard Chartered (8.19%). As at 30 June 2012 total bank assets had risen by 17.3% to $5.56.

4.3 Mobilization of Remittances

Since dollarization (which removed exchange rate risk), the diaspora has increasingly channelled remittances through the formal banking system. Remittances going through formal channels grew from $78.5 million in 2008 to $279 million in 2011, an increase of 255%. Based on the UNDP (2010) working paper that estimates annual remittances flowing (through formal and informal channels) into Zimbabwe at over $1 billion, it can be argued that roughly over 30% of remittances are now being received through the formal banking system[7]. This is corroborated by the FinMark Trust (2012) study that estimates South Africa-SADC remittances through the formal system at 32% of the total flow. The more remittances flow through the formal banking system the more they can contribute to savings mobilization.

A number of empirical studies have observed a positive impact of remittances on household savings and the use of formal banking institutions. Empirical evidence by Dustmann and Mestres (2010) have estimated that during the years 1992 to 1994 about 48% of immigrant households in

[7] These are gross remittance flows and not the amount that stays in the financial system for which statistics are not available. It is often observed that by virtue of remittances destined to support poor households they do not stay very long in the financial system. Invariably, they are withdrawn as soon as they are received in the financial system

Germany held deposit savings accounts in their countries of origin. Leblang (2009) estimates that a 1% increase in the migrant stock from source country A in destination country B could increase portfolio investment from country B to country A by 0.2%, or an average of US$450 in portfolio investment per migrant. In some countries, this observed positive impact has resulted in financial institutions increasingly paying attention to designing savings accounts and other banking products tailored to the needs and preferences of diaspora families. India's ICICI Bank is reported to have opened operations in Britain and Canada for this purpose while Banco do Brasil is reported to have plans to open 15 new branches in the USA to target an estimated 400,000 Brazilians who reside there (Terrazas, 2010).

One mechanism that has been employed to broaden the assets held by domestic banks in remittance-receiving countries is through the securitization of remittance future-flows. The term “future-flow securitization” is the use of expected or future assets to secure debt. The World Bank has observed that in cases where remittances have become substantial and fairly predictable over time, they have been used to improve a country's creditworthiness resulting in access to international capital markets. Several banks in developing countries such as Brazil, Egypt, El Salvador, Guatemala, Kazakhstan, Mexico, and Turkey have been able to raise cheaper and long-term financing from international markets via the securitization of future remittance flows[8]. Future remittance flow securitization reduces currency risk and allows securities to be rated better than the sovereign credit rating of the home country. For instance, El Salvador's remittance-backed securities were rated investment grade two to four notches above the sub-investment sovereign rating of the country.

Furthermore, remittances are now factored into sovereign ratings in Middle Income Countries and in debt sustainability analysis for Low Income Countries. Zimbabwe being a low income country with high sovereign debt levels stands to benefit from having a large proportion of its diaspora remittances flowing through the formal banking system.

4.4 Risks facing the Banking Sector

The growth of deposits is a function of economic growth and confidence in the banking system. According to the Financial Access 2010 report the world average deposit/GDP ratio was 66% in 2009 which was a decline from the 72% level in 2008. However, according to RBZ statistics, as at 31 December 2011 the deposit/GDP ratio dropped to 41% from its level of 45% in 2009, a level below the world average but still within the regional average (excluding South Africa and Namibia, see Table 9). Confidence in the banking system could be low for a number of reasons.

The extended period of economic crisis characterised by hyperinflation and loss of Zimbabwe dollar savings following dollarization sapped depositor confidence. The frequent collapse of a number of domestic banks since 2003 is further denting confidence. As Table 5 below shows, in just one decade the banking sector has experienced as many as 20 failures. Four of the failures occurred in the first half of 2012. An analysis of Table 5 shows that the major causes of bank failures in Zimbabwe boil down to inadequate risk management systems, poor corporate governance, inadequate capitalization, diversion from core business to speculative activities, rapid expansion, creative accounting, overstatement of capital, high levels of non-performing insider loans, unsustainable earnings and chronic liquidity challenges

[8] See Ratha (2007) of the World Bank.

Table 5: Bank Failures in Zimbabwe 2003-2012

Year	Failing Bank	Reason	Action by Authorities
2003	National Discount House	- Liquidity challenges - Solvency problems due to non-performing insider loans	- Capital injection by new shareholders
2003	ENG Asset Management	- Diversion from core business to speculative activities	License cancelled
2004	Century Discount House	- Insolvency and serious liquidity problems emanating from imprudent lending activities.	Placed under liquidation. Directors sued in their personal capacities for negligence.
2004	Rapid Discount House	- Insolvency and unsound administrative and accounting practices and procedures. - Imprudent, unauthorized non- performing insider loans. - Departure from core business to unauthorized business	- placed under curatorship on 26 April 2004 - placed in compulsory liquidation.
2004	Barbican Bank Limited and Barbican Asset Management	- Liquidity challenges largely emanating from the unding of sister companies - Fraudulent foreign exchange activities - Poor corporate governance practices.	- Placed under curatorship in March 2004 -Bank assets incorporated into ZABG in January 2005. - Asset Management company liquidated
2004	Trust Bank	- Liquidity and solvency challenges - High levels of nonperforming loans. - Poor corporate governance structures	- Placed under the management of a curator on 23 September 2004. - Assets of the bank were sold to ZABG.
2004	Royal Bank	- Chronic liquidity problems and was insolvent - Malpractices e.g. granting of insider loans, illegal foreign currency dealing, siphoning of depositors funds and poor corporate government practices.	- Placed under curatorship -Assets were sold to ZABG in January 2005
2004	Time Bank	-Insolvency, unsound administrative and accounting policies - Liquidity challenges due to poor Corporate governance practices and weak risk management systems.	- Initially placed under curatorship - Given back operating license but failed to commence operations within stipulated time frame.
2004	CFX Bank	- Poor corporate governance practices - Inadequate capitalization - Imprudent insider dealings, illegal foreign currency dealings and ineffective risk management.	- Placed under curatorship - Merger between CFX Merchant Bank Limited and CFX Bank Limited
2004	CFX Merchant Bank	- Technical insolvency and liquidity problems due to exposure to the troubled CFX Bank.	- Merger with Century Holdings to become CFX Holdings.
2004	Intermarket Banking Corporation	- Imprudent risk management practices - Poor corporate governance arrangements - Externalization of foreign currency	- Curatorship - Restructuring of the bank - Conversion of debt to equity
2004	Intermarket Discount House	- Severe solvency and liquidity problems. - Non-core activities	-Initially placed under curatorship - Debt-equity conversion.
2004	Intermarket Building Society	- Severe liquidity problems emanating from exposure to the troubled Intermarket Discount House	- Initially placed under curatorship - Inter-company debts within the Group were set off against the assets of the discount house

2005	First National Building Society	- Severe solvency and liquidity problems.	- Liquidated
2011	Renaissance	- Poor corporate governance - Imprudent lending activities	- Placed under curatorship
2012	Remo Investment Brokers	- Irregular dealings and non-permissible banking activities.	- License cancelled
2012	Interfin	- Poor corporate governance - Imprudent lending activities	- Placed under curatorship
2012	Genesis Investment	- Inadequate capitalization	- License cancelled
2012	Royal Bank	- Inadequate capitalization - Poor corporate governance - Imprudent lending activities	- License cancelled

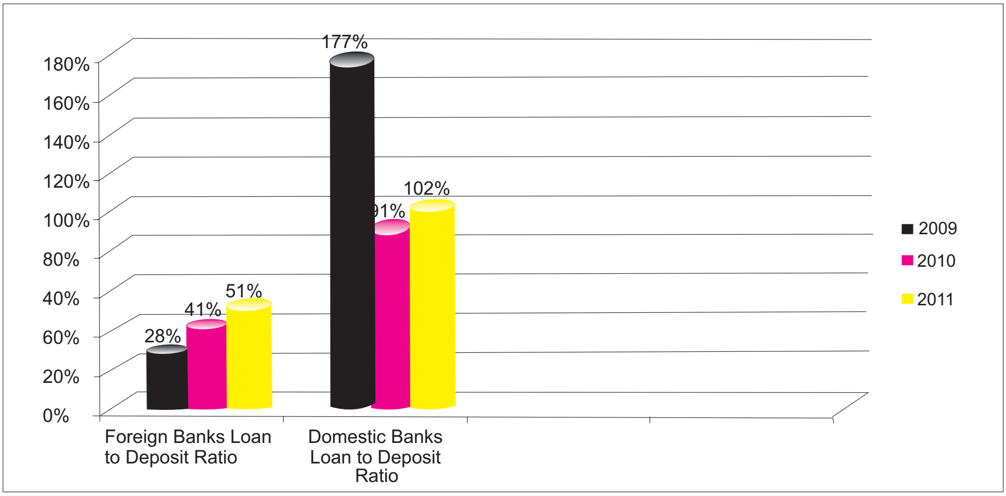
Source: Various RBZ reports (2003-2012)

The reasons for the high rate of bank failures are indicative of inadequate oversight and poor compliance with regulatory requirements. Faced with similar problems, various regulatory authorities have recently made it a statutory requirement for institutions falling under their regulatory jurisdiction to assign responsibility for ensuring compliance with legislation to a full-time compliance officer. In South Africa the compliance function was introduced in the financial markets, first for the South African Futures Exchange (SAFEX) in 1989 and then for the JSE in 1995. Subsequently, Regulation 49 of the Banks Act of 1990 ushered in the need for banks to have in place an independent compliance function as part of their risk-management framework. It required financial institutions to appoint compliance officers approved by the regulator with specific statutory duties who would facilitate interaction and compliance with regulations. The delinquency in the Zimbabwe financial sector clearly requires the imposition of a mandatory compliance function on the sector.

Banking fragility is also being exacerbated by the inability by banks to have a proper balance in matching risks and tenures between the main source of income (loans and advances) and funding sources (deposits). While foreign banks have adopted a conservative approach to lending, domestic banks have adopted a very risk aggressive lending approach as Figure 3 below illustrates.

70%

Figure 3 : Loan to Deposit Ratios –Domestic and Foreign Banks (2009-2011)



Source: MMC Capital Investment Research (2012)

The aggressive model adopted by most domestic banks is backfiring as most are encountering challenges in recovering loans and in meeting depositors' with drawal demands[9]. Furthermore, the negative consequences of the aggressive model has resulted in an increase of the non-performing loans to total loans ratio (NPL) from 2% in 2009 to 7.55% by the end of 2011, and by June 2012 the ratio had raced to over 12% and is now within the watch list category of 10%-15%[10].

In the absence of credit bureaux credit risk is bound to be high so that the pursuit of internationally accepted loan to deposit ratios of 70%-90% as encouraged by monetary authorities could be counter-productive. Economies that follow international norms have credit bureaux that assist banks to screen borrowers and have stable mix of depositors (short-term and long-term). In 2011 banking sector short-term deposits that comprise demand, savings and under 30 days constituted 89.3% meaning that the deposit base mainly comprises short-term deposits. While the deposit base is largely short-term, end of period statistics reported by the RBZ show aggregate deposits to be fairly stable and actually on the increase. In the absence of within-month deposit balances, it is difficult to establish the volatility of deposits. The 2012 Mid-Year Monetary Policy Statement however reported a slower growth in deposits noting that year on year growth declined to 16.7% in June 2012 compared to 56.5% over the same period in 2011.

In an environment of short-term deposits and absence of credit information infrastructure, banks can only minimize non-perofrming loans by following a conservative approach to lending. On the other hand, monetary authorities are urging banks to achieve high loan to deposit ratios to satisfy high demand for credit which unfortunately can lead to a large proportion of non-performing loans with the potential to destabilize the banking sector. Monetary authorities should instead push for improvement of the creditworthiness of borrowers through facilitating the creation of credit bureaux.

Furthermore, the asset-liability mismatch whereby high lending rates co-exist with very low deposit rates creating a high interest rate spread[11] is another factor that could be leading to declining depositor confidence. As Table 6 below shows Zimbabwe has one of the highest interest rate spread in Southern Africa only surpassed by that of Malawi, the poorest country in region. All countries in the region have single digit interest rate spreads save for those of Malawi, Zimbabwe and Zambia that are double digits.

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[9] Now and again long queues are witnessed outside some domestic banks' banking halls.
[10] The internationally accepted Basel II threshold is 5%.
[11] Interest rate spread is the interest rate charged by banks on loans to prime customers minus the

Table 6: Interest rate spread (lending rate minus deposit rate; %) in Southern Africa

Country	Interest rate spread %, 2010
Angola	9.8
Botswana	5.9
Lesotho	7.5
Malawi	21.0
Mauritius	4.1
Mozambique	4.0
Namibia	4.7
South Africa	3.4
Swaziland	5.9
Tanzania	8.0
Zambia	13.5
Zimbabwe	15*
	*(average computed from RBZ rates)

Source: World Bank Financial Indicators except for Zimbabwe

There is a negative relationship between the interest rate spread and banking sector development. High spreads (especially those that are double digit) are indicative of an inefficient banking system whose costs are passed on to customers. This may explain why we observe bank charges being levied by banks are excessive to the extent of being the second largest source of revenue of banks. For the ordinary depositor, it is not worthwhile to keep money in the bank as it loses value rather than gain. In fact, the short-term savings or deposits currently taking place are forced in the sense that employers pay directly into the bank accounts of people rather the giving out cash[12].

The liquidity squeeze has been compounded by little foreign capital flows trickling into the economy because of political uncertainty. Few banks manage to secure external lines of credit due to the high risk tag attached to the country. A significant risk in the banking sector is the prospect of foreign banks losing their majority ownership as a result of the pending implementation of the Indigenization and Economic Empowerment Act that requires them to indigenize 51% of their shareholdings. Should this happen to the banking sector, fragility in the sector will increase resulting in further loss of depositor and investor confidence because of the following reasons.

First, the simple act of buying out foreign investors directly leads to capital outflows as foreign currency moves abroad[13]. Under dollarization such payouts are a direct reduction in money supply and liquidity because the monetary authority is not in a position to sterilize such outflows as money supply is simply a function of foreign capital inflows.

Second, majority funding (i.e. 51%) for any further recapitalization of banks that may arise in the future will have to be sourced domestically. Experience in the last decade has shown that domestic banks do struggle to raise fresh capital despite being given extended grace periods by authorities to meet prescribed capital requirements. The current distress in the banking sector signified by the recent failure of Genesis, Interfin and Royal Bank shows the constrained capacity of indigenous investors.

Third, in the event of a domestic shock destabilizing the domestic banking sector there will be no backup funding provided by foreign banks. The bailout will have to come from either distressed domestic investors or the government itself which is already facing budgetary constraints. The result is that the entire domestic banking sector could cripple or collapse with dire consequences for the economy. On the other hand, foreign banks are in a better position to deal with a systemic crisis because they can easily raise capital or liquid funds on international financial markets. Furthermore, these banks are usually foreign bank subsidiaries having access to financial support from their parent banks which for reputational considerations are inclined to rescue a subsidiary.

Fourth, confidence in the domestic banking sector has been eroded over the years because of the high rate of bank failure, perennial governance problems besetting the sector and the public experience during the recent hyperinflationary period. The loss of confidence is signified by an estimated $2 billion of money perceived to be circulating outside the banking system. This widely cited statistic should be treated with caution as it may not be plausible given the RBZ is not printing the currency. In a dollarized economy money circulating outside the financial system can only be reasonably estimated through household surveys. Nevertheless, given that only an estimated 30% of over $1 billion of remittances pass through the formal financial system, there is a substantial amount of money circulating outside the financial system.

Foreign banks have been shown to mitigate capital flight through externalization because depositors generally trust them more than domestic banks. They are less vulnerable to shocks because they employ more sophisticated risk management techniques and have a better system of internal controls. They are also less likely to be bailed out by the government and hence do not present the moral hazard problem. Furthermore, foreign banks are less amenable to political pressures to support preferential sectors or customers irrespective of attendant credit risks.

It is not that multinational banks cannot fail but that such failure has first to occur in their home country before being transmitted to the host country[14]. However, the transmission or contagion effect is often mitigated by the dual regulatory structure these global banks have whereby they have to satisfy regulatory and supervisory requirements of two jurisdictions –their home country and that of the host country.

Five, domestic banks tend to be entangled in web of relationships with local businesspeople and firms resulting in insider lending, a phenomenon that often undermines corporate governance. Governance problems have been a common feature of the domestic banking market that has resulted in several bank failures as Table 5 above shows. In an effort to minimize systemic failure of the financial system, the RBZ has been forced to raise the prescribed prudential liquid asset ratio requirements for banks from 10% in 2009 to 30% in 2012, a practice that further exacerbates the general liquidity in the banking sector. On the other hand, foreign banks which usually operate globally and hence subject to high scrutiny of their corporate governance rarely pose such problems to monetary authorities. They actually play a stabilizing role to the banking sector.

[14] Bank of Credit and Commerce International (BCCI) is an example of a foreign bank that failed in 1991 resulting in the government acquiring it to form CBZ

Furthermore, the manner in which the Indigenization and Economic Empowerment Act (No. 14 of 2007) is being implemented is introducing policy inconsistencies and uncertainties in the financial sector. For instance, despite the Act having been assented to by the President in 2008, in 2010 a foreign bank, Ecobank, was allowed to acquire 70% of Premier Finance Group with the approval of the RBZ, Competition and Tariff Commission and the Ministry of Youth Development, Indigenization and Empowerment, the very Ministry which one year down the line wants this reversed to a 49% stake. Ordinarily, the Ministry should not have approved a 70% foreign stake because the Act was already in force.

4.5 Bank Capitalization and Financial regulation

The Reserve Bank of Zimbabwe (RBZ) regulates the sector and prescribes minimum capital requirements in liaison with the Ministry of Finance. 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. In an effort towards an integrated approach, a Multi-Disciplinary Financial Stability Committee comprising the RBZ, the ZDPB, the Insurance and Pensions Commission and the Securities Exchange Commission was formed in 2011 with a view to identifying financial risks and assessing financial stability across the financial services sector on an ongoing basis. External auditors of banking institutions are required by law to submit their annual audit reports to ZDPB and RBZ.

With respect to capital requirements, the RBZ endeavours to follow the levels advocated by Basel Accords but incorporates local risk conditions by setting them at significantly higher level. In this regard the 2012 Mid-Year Monetary Policy Statement revised minimum capital requirements as per Table 7 below, notably raising the level to $100 million for commercial and merchant banks.

Table 7 : Minimum Capital Requirements of the Banking Sector –Present and Future

		Capital requirements				31 Dec 2014
Institution	**Current**	**31 Dec 2012**	**30 Jun 2013**	**30 Dec 2013**	**31 Jun 2014**	**Verification**
					Full Compliance	**Full Compliance**
Commercial Banks (US$m)	12.5	25.00	50.00	75.00	100.00	100.00
Merchant Banks (US$m)	10.00	25.00	50.00	75.00	100.00	100.00
Building Society (US$m)	10.00	20.00	40.00	60.00	80.00	80.00
Finance Houses (US$m)	7.50	15.00	30.00	45.00	60.00	60.00
Discount Houses (US$m)	7.50	15.00	30.00	45.00	60.00	60.00
Microfinance Banks (US$m)	1.00	1.25	2.50	3.75	5.00	5.00
Microfinance Institutions	5.000	10.000	15.000	20.000	25.000	25.00

Source: RBZ Mid-Term Monetary Statement (2012)

There are two main propositions that guide regulators in prescribing capital requirements[15]. The first is the moral hazard proposition, that is, the capital requirements are needed to curb excessive risk taking. It is feared that unregulated banks could be tempted to undertake excessively risky investments which maximize the returns to equity at the expense of debt-holders or the deposit insurance fund. The second proposition posits that the bank's capital is a kind of a cushion against losses for depositors. The idea is that if a bank starts to lose money, the equity value must fall to zero before depositors start to lose their money, and regulation ensures the bank either closes down or recapitalize before this occurs. On the basis of these two propositions, capital regulation has the desirable effect of discouraging unsound and unreliable institutions from setting up operations. A regulator who wishes to weed out bad banks would set capital requirements more tightly beyond simply solving the moral hazard problem presented by undercapitalized banks. The new capital requirements announced by the RBZ could be viewed in this context.

Capital requirements are also used by monetary authorities to solve adverse selection problems, i.e. deciding who to licence to operate as a bank or not. Solving these problems in a pessimistic economy[16], as could be said to the state of the Zimbabwe economy at present, requires setting capital requirements more tightly than they would be in solving the same problems in an optimistic economy. The idea is to curb unsound agents or investors in the sector who in a pessimistic economy are more inclined to apply for a banking licence.

In a normal and optimistic economy that has a regulator with a good reputation of oversight, capital requirements are set moderately only to deal with moral hazard problems. However, in a pessimistic economy characterised by a crisis of confidence monetary authorities tend to have two stark choices. If the monetary authorities have good supervisory skills, they respond to the crisis by not tightening capital requirements but rather rely on their oversight skills to weed out bad banks. On the hand, if monetary authorities have poor supervisory skills, they respond to the crisis of confidence by tightening capital requirements to solve the adverse selection problem of banks.

The tightening of capital requirements announced in the 2012 Mid-Year Monetary Statement is clearly a response to the crisis of confidence and the apparent lack of adequate capacity to supervise the banking sector. Notwithstanding the logic behind the move, it should be borne in mind that there is a trade-off between bank capital and profitability. On a scale of a reasonable return on equity (ROE) of 15% to 20% being achieved by South African banks, the Zimbabwean banking sector has not been performing well for its investors despite having one of the highest interest rate spread in the region. Table 8 shows dismal return on assets (ROA) and return on equity (ROE) for all banks as at 31 March 2012. Notably, none of the banks have double digit returns.

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[15] See for instance, Morrison and White (2005).
[16] In a pessimistic economy, the banking sector is characterised by a crisis of confidence

Table 8 : The Returns and Capital Ratios of Zimbabwean Banks as at 31 March 2012

	Net Capital Base	Total Assets	ROA	ROE	Capital to Assets Ratio
COMMERCIAL BANKS					
BANCABC Corp	36,758,706.10	427,208,364.60	0.27%	2.49%	8.60%
AGRIBANK	21,676,165.77	102,468,110.47	-0.93%	-4.50%	21.15%
BARCLAYS	33,159,171.00	280,913,744.74	0.31%	1.52%	11.80%
CBZ	91,150,729.00	998,227,961.55	0.98%	8.51%	9.13%
ECOBANK	13,480,635.62	71,148,106.88	-0.55%	-3.01%	18.95%
FBC	19,485,989.86	300,021,936.13	0.67%	5.00%	6.49%
INTERFIN	-25,199,491.05	209,855,726.74	-1.72%	-22.54%	-12.01%
KINGDOM	18,330,083.72	145,512,044.26	-2.18%	-11.36%	12.60%
MBCA	21,703,600.94	177,187,155.09	0.92%	5.77%	12.25%
METROPOLITAN	22,872,156.00	112,414,271.73	0.39%	1.34%	20.35%
NMB BANK	20,378,557.66	166,429,802.90	0.54%	3.08%	12.24%
ROYAL	4,349,135.32	11,689,629.77	-8.82%	-23.75%	37.21%
STANBIC	34,765,693.74	388,319,009.78	1.24%	9.60%	8.95%
STANCHART	62,334,028.65	418,317,798.40	1.26%	6.75%	14.90%
TN BANK	13,430,419.96	129,136,395.11	-0.55%	-3.62%	10.40%
TRUST	24,063,922.50	50,615,878.45	-1.84%	-8.21%	47.54%
ZABG	-9,996,205.54	16,104,032.59	-3.61%	3.97%	-62.07%
ZB Bank	31,491,170.69	252,631,793.44	0.13%	0.64%	12.47%
TOTAL - AVERAGE	**434,234,469.93**	**4,258,201,762.63**	**-0.75%**	**-1.57%**	10.20%
MERCHANT BANKS					
CAPITAL	15,871,443.15	112,384,465.09	0.15%	0.96%	14.12%
TETRAD	13,409,566.43	82,002,134.31	0.86%	5.40%	16.35%
TOTAL - AVERAGE	**29,281,009.57**	**194,386,599.40**	**-0.76%**	**-4.81%**	15.06%
POSB	**11,868,098.24**	**69,931,456.00**	**0.94%**	**5.56%**	**16.97%**

Source : Financial statements of banking institutions

Evidently, the banking sector is not delivering an adequate return to its equity investors. The unintended effect of increased capital levels could be a further lowering of returns of investors as the equity base increases without commensurate increase in returns. Thus while higher capital requirements do curb excessive risk taking by limiting the amount banks can lend, when set too high they impact negatively on profitability.

When present capital levels of the banks shown in Table 8 are viewed in terms of capital adequacy ratios, the majority appear adequately capitalised. Assuming the reported assets are risk-adjusted and given the requirement to meet a capital adequacy ratio of 12%, it would appear that at least 15 of the institutions meet the requirement[17]. While the RBZ prescribes capital adequacy ratios, it considers them as a complementary tool to meeting minimum capital requirements.

A regional comparison in Table 9 below shows that Zimbabwe's minimum capital requirements in terms of GDP and the deposit base -current and proposed- are out of line with regional trends.

Table 9 : Regional Comparison of Capital Requirements in terms of GDP and Deposits

Country	Min Capital Requirements (US$)	No. of Banks	GDP(US$b)	Deposits (US$b)	Deposits to GDP
South Africa	39,000,000	32	408.0	248.9	61%
Tanzania	3,200,000	45	58.6	18.2	31%
Mozambique	2,520,000	16	24.9	8.5	34%
Kenya	13,000,000	42	32.2	14.5	45%
Malawi	5,000,000	12	13.0	2.7	21%
Namibia	1,240,000	5	14.6	9.8	67%
Angola	500,000	23	100.9	47.4	47%
Botswana	662,000	10	17.6	7.1	40%
Zimbabwe - current	12,500,000	25	10.1	4.1	40%
Zimbabwe - proposed	100,000,000	25	10.1	4.1	40%

Source: Country Reports, author own computations and Tetrad Analysis of Mid-Term Monetary Statement (2012)

Realistically, the minimum capital requirements levels should take account of GDP and aggregate bank deposits and guidelines suggested by Basel Accords. Guidelines suggested by Basel Accords are the most viable option for two reasons. First, they set realistic requirements for each bank based on its size. Second, they advocate for stricter regulation and better quality of assets. These guidelines should however be applied taking into account the local high risk environment and the sophistication of the regulatory authority.

With regard to regulation, the Report of UNDESA and UNCDF (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

[17] It should be noted that the reliability of the capital adequacy ratio depends on the ability of institutions to adjust their assets for risk. Royal Bank is a classic case; having a capital to assets ratio of 37% as at 31 March 2012, it experienced failure in July 2012 due to imprudent lending and was placed under curatorship.

as to keep regulations appropriate, simple and straightforward. In Zimbabwe microfinance institutions which total 172 in 2012 are supervised by the RBZ through the Moneylending and Interest Rate Act. Typically, this Act imposes limits on interest rates to be charged on loans and these interest rate ceilings are viewed to be stifling operations and hence are regularly not observed by the sector. While the National Microfinance Policy acknowledges the retrogressive nature of interest rate caps, it nevertheless advocates for the regulation of interest rates as a means of protecting the consumer. The result has been that one of the main supervisory features of the RBZ regarding MFIs is tracking non-compliance with interest rate caps.

As recommended in the National Microfinance Policy the RBZ has adopted a tiered approach for the regulation of the microfinance sector in accordance with international standards set by CGAP, and the Microfinance Bill is intended to provide the necessary legal framework. Table 10 below shows the nature of the tiered approach

Table 10 : RBZ's Tiered Approach to the Regulation of Banks and MFIs

MFIs Tiers	MFIs	Supervising 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 UnionCooperative Socieities (SACCOS)	Discretionary Prudential Supervision	Ministry responsible for Cooperatives
Tier 4	Microfinance Institutions	Non-Prudential Supervision	Reserve Bank

Source: RBZ National Microfinance Policy (2008)

In this tiered approach, the licensing and regulating of Tier 1, 2 and 4 is by the RBZ. Tier 3 is licensed and supervised by the Ministry responsible for co-operatives. 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. These non-prudential regulations include measures such as registration with the RBZ for transparency purposes, keeping adequate accounts, prevention of fraud and financial crimes, and various types of consumer protection measures. The Microfinance Bill is intended to address the special features of the microfinance sector.

There are however some arguments against special regulation of microfinance. For instance, Christen and Rosenberg (2000) observe that more successful microfinance markets in Latin America, Bangladesh and Indonesia flourished without special microfinance regulation. Notwithstanding these misgivings, a tiered approach appears to be a “middle of the road” approach that might withstand the test of time. Indeed this approach seems to be working well in the case of Ghana whose financial sector historically developed along similar lines with that of Zimbabwe.

4.6 The Deposit Insurance Scheme

Deposit insurance can be defined as a measure implemented in many countries to protect bank depositors, in full or in part, from losses caused by a bank's inability to pay its debts when due. Deposit insurance schemes are therefore one element of a financial system safety net meant to promote financial stability. Cognisant of the fact that bank failures have the potential to trigger harmful effects to the entire economy, it is usually the norm and best practice that it is that policy makers maintain deposit insurance schemes to protect depositors and to give them comfort that their funds are not at risk.

In Zimbabwe, deposit insurance is managed by the Deposit Protection Board (DPB) which was established under the Banking Act (Chapter 24:20) in 2003. The need for deposit insurance was underscored by a couple of bank failures at the turn of the millennium and the hardships that such failures inflicted on the banking public, especially the small, less financially sophisticated depositors. Thus Government embraced deposit insurance in a bid to enhance soundness, growth and stability of the financial sector by promoting depositor confidence in the banking system. With the passing into law of the Deposit Protection Corporation Act (Chapter 24:29) in March 2012, deposit protection is now a separate entity outside the Banking Act.

The Act makes DPB one of the key financial safety net players with authority to exercise early detection and timely intervention and resolution of troubled banks. The DPB is also mandated to participate in on-site supervision of member banks, participate in resolution of failing or failed member banks, set conditions and standards for deposit insurance, decide on deserving applicants for insurance cover, and act as curator in a failed bank. Under the new set up, the governance structure of the DPB blends public and private systems as its board of directors is composed of an appointee of the Minister of Finance, an appointee of the RBZ, four directors appointed by contributing institutions, and a functional CEO.

Table 11 below summarises key features of the DPB

Table 11: Key Features of the DPB

Feature	Description
Management	Board comprises CEO, appointee of the Ministry of finance, appointee of the RBZ and four directors appointed by contributing institutions
Membership	Compulsory for all commercial banks, building societies and merchant banks. Assets management firms and POSB are not covered.
Funding	Levies collected from member banks. Depositors do not pay premiums.
Premium System	Flat rate system Banks pay 0.3% of total deposits per annum with a maximum cap of $30 000 per quarter.
Deposit covered	Demand time and savings deposits, Class B and Class C shares as well as all individual, corporate and trust accounts in insured institutions. NCDs, Ba's and Interbank deposits are excluded.
Compensation	Strives to compensate a least 90% of depositors in full in the event of bank failure. However, with a maximum insurable limit of $150.00 per depositor per bank, the ZDPB only covers about 75% of depositors in full.

Source: Deposit Protection Corporation Act (Chapter 24:29)

Since its inception in 2003, the DPB compensated depositors in three failed institutions, namely Century, Rapid Discount House and Sagit Finance House. However, there are a number of shortcomings arising from the deposit insurance scheme.

First, the low compensation level set at $150 per depositor does not give depositors enough incentives to deposit their funds in banks. It is insufficient to engender depositor confidence and enhance financial stability. Even contributing institutions are questioning the logic of continually paying premiums when the amount of compensation received by depositors is insufficient to meet the goals of the scheme.

Second, the flat rate premium system favours weak banks at the expense of strong ones. Ordinarily, the premium paid by a bank should be commensurate with the level or risk that it poses to the financial system. The DPB argues that a shift to the risk-adjusted differential system might have destabilising effects on weak banks since they have to pay higher premiums. Such reasoning promotes a “too important to fail” mentality among banks thereby tempting bank executives to gamble with depositors' funds.

Third, capacity for timely reimbursement to depositors is crucial. Depositors need to be assured of rapid redress to have confidence in the deposit insurance scheme.

Fourth, deposit insurance is known to work well in an environment where private property rights are respected, contracts are easy to enforce, there is rule of law and bank regulation and supervision is robust. Public opinion regarding rule of law, property rights and contract enforcement in Zimbabwe has been negative. Against that background, conventional wisdom challenges the ability of the DPB to instil depositor confidence and enhance financial stability without promoting moral hazard among contributory institutions and depositors.

4.7 Challenges posed by Dollarization

The adoption of dollarization in 2009 fundamentally changed the financial sector. The immediate impact was that the supply of money became a function of the performance of the export sector, international capital inflows, diaspora remittances and donor funds. The RBZ could no longer create money and hence had no control on the supply of money.

From a fiscal perspective, in a dollarized environment, the central bank 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 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. Besides having been unable to convert domestic money balances of the banking system, the RBZ could not provide the lender of last resort function. In fact dollarization in the absence of reserves to re-capitalize the central bank essentially wiped out its capital. Hyperinflation had also wiped out domestic savings of the public and money capital balances of banks. Since then public confidence in banks has been dented.

As the RBZ Governor Dr Gono (2012) observes, international best practice requires that the Lender of Last Resort (LOLR) fund in a dollarized economy to constitute between 50% to 150% of banking sector capitalization or 5% to 15% of the banking sector deposits. If we take the RBZ's view that such a fund should be based on the deposit base as it is a better indicator of potential liquidity developments, then on the basis a deposit base of $3 billion, the LOLR fund should between $150 million and $450 million. In this regard, the establishment of a $150 million LOLR fund announced by the Minister of Finance in the 2012 Mid-Year Fiscal Statement budget is inadequate because it is not forward looking. It is based on a historical deposit base of $3 billion obtaining in December 2011. In fact by June 2012 the deposit base had risen by 31.8% to $4.02 billion. The forward looking approach would require the LOLR be set at the median of 5%-15% of banking sector deposits. It is not also enough to have the fund without adequately recapitalizing the RBZ. The weakly capitalized central bank without a LOLR fund further contributes to the public loss of confidence in the banking system leading to money circulating outside the system.

Ideally, the LOLR should complement an active interbank market (which is absent at present) through which banks can provide overnight lending to one another. In fact, the interbank market should be the first line of defence for banks facing temporary shortage of funds rather than the LOLR. The development of an interbank market can be facilitated if the RBZ issues treasury bills that banks would then use as collateral when they lend to each other. The interbank market would facilitate the efficient allocation of money from surplus units to deficit units and minimise the liquidity challenges being faced in the economy. Furthermore, the interbank market would align interest rates and result in their decline from the current relatively high levels. However, in a dollarized economy the inability of the central bank to print money creates some risk to any government tradable paper that can be issued to facilitate the functioning of the interbank market. First, there is a risk that the central bank may issue out Treasury Bills with a value much higher than the reserves it has got. Second, the proceeds from such issues may be used to fund long-term government projects so that the bearer of the bill may not be 100% certain to receive the full amount of the face value on the bill on maturity. Therefore, the key issue in issuing government tradable paper in a dollarized economy is adequacy of reserves to ensure that repayment of such paper is honoured upon maturity.

In the absence of adequate reserves, perhaps Zimbabwe should take cue from the experience of other dollarized economies where foreign banks have instead played the role of lender of last resort. For instance, dollarized Panama has no domestic lender of last resort. Domestic banks have negotiated lines of credit with foreign banks, mainly US banks, with branches in Panama from which they have been able to draw on during liquidity crises. This was made possible because from 1970 Panama liberalized its financial markets and allowed full entry of foreign banks. Today its capital account is entirely open, enabling banks to freely invest excess funds in Panama or abroad. For Panama, the ability of banks to freely adjust their portfolios between domestic and foreign assets has been a crucial mechanism of domestic adjustment, preventing the booms and busts in bank lending.

The experience of dollarized Panama has important lessons for Zimbabwe. The foremost lesson is that as a result of dollarization the mobilization of savings for investment by the financial sector is effectively dependent on attracting foreign capital in any of the forms- export proceeds, FDI, foreign portfolio flows, diaspora remittances and donor funds. Therefore, the limited participation of foreign investors imposed by the Indigenization and Economic Empowerment Act does not only place constraints on attracting external capital sources but actually leads to an outflow of the scarce capital resources as foreign shareholders have to be paid out in hard currency. On the other hand, domestic investors would be hard pressed to raise capital in foreign currency because to have it they have to earn from either exports or remittances.

4.8 The Capital Market

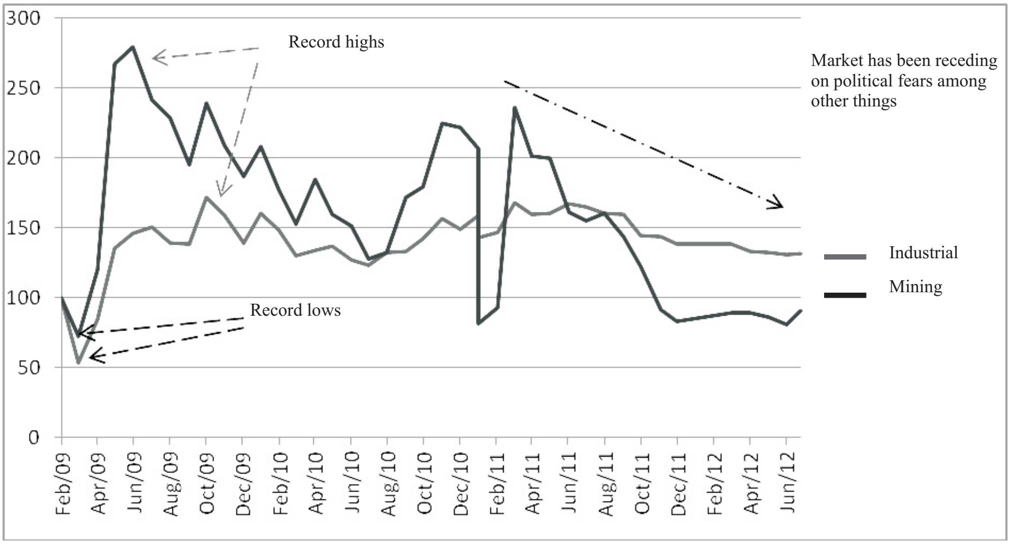
Investors are more comfortable to invest where capital markets are well-functioning. Sound capital market fundamentals they look for include the following:

- Adequate disclosures and transparency;
- Regular trading;
- Efficient stock market infrastructure (trading platform);
- Good accounting standards (use of international accounting standards or good quality local standards);
- Good governance of the stock market and its listed companies;
- Adequate stock market liquidity; and
- An active bond market.

The Zimbabwe Stock Exchange (ZSE) should be judged against these criteria in order to evaluate its role of mobilizing funds for companies. During the hyperinflationary period of 2006-2008, the ZSE became a speculative and useful avenue for investors to protect their capital in real terms. Finally, the stock market bubble collapsed on 18 November 2008 and trading was suspended. Trading resumed on in mid-February in 2009 when dollarization was adopted. Both the industrial index and the mining index opened at 100 points. Stock prices were initially down as traders got accustomed to dollar valuations so that within two months both indices all times lows of 51.41 points and 64.75 points for the industrial and mining index respectively.

However, the new political dispensation ushered in by the Government of National Unity (GNU) and the macroeconomic stability brought by dollarization gave the stock market a new life and it quickly took on a bullish tone. Buoyed by foreign investors who hoped for economic recovery, the industrial and mining indices trended upwards most of 2009 and only to subside sharply in 2010 and then finally lost momentum from 2011 onward as shown in Figure 4.

Figure 4: The Trend of ZSE Industrial & Mining indices



Source: ZSE

From Figure 4 we observe that equities suffered a sustained losing streak since early 2011. As of July 2012 the industrial and mining indices stood at 131.03 and 105.61 respectively which levels are well below the peaks reached in 2009. Table 12 illustrates an unimpressive performance since dollarization

Table 12 : ZSE Performance Indicators

Year	2009	2010	2011	H1 2012
Number of listed companies	79	79	78	79*
Market Capitalisation	US$3.80m	US$3.87m	US$3.68m	US$3.39m
Value of new issues (including rights issues)	US$107.9m	US$45.97m	US$4.1m	US$5m
Volume traded	4,496,169,981	6,141,542,271	3,348,751,442	1,763,430,029
Value traded	US$399m	US$355m	US$387m	US$226m
Industrial index	151.99	151.27	145.86	131.96
Mining index	185.5	200.4	100.7	75.7
Capitalization ratio % GDP	65.5%	51.8%	37.2%	
Turnover ratio % capitalization	10.5%	9.2%	10.5%	6.7%
Value traded ratio % GDP	6.8%	4.7%	3.9%	

**Six of the 79 listed companies are currently suspended from trading*
Source: ZSE and author computations

The number of listed companies has remained flat. New issues have been minimal and on a downward trend ever since 2009. The only new listings were TN Holdings (now Lifestyle Holdings) and TN Bank which came out of the former through a demerger. Market capitalization has been equally flat and declining from 2011. The volume traded and the values of stocks traded have been equally down trending.

A number of reasons have been attributed to the poor performance of the stock market.

(1) **Political uncertainty.** Although the Global Political Agreement (GPA) under which the GNU was formed was initially embraced as a viable alternative to the chaotic political environment that preceded it, it remained a 'marriage of convenience'. As such stakeholders, including the principals to the GPA increasingly became uneasy with it and did not honour it fully. Foreign investors have adopted a wait and see approach and hence FDI inflows are not as robust as had been hoped.

(2) **Indigenization.** The Ministry of Youth, Indigenisation and Empowerment has been calling for foreign owned firms to cede 51% shareholding to locals and thus scaring away foreign investors.

(3) **Capital shortage.** Most companies are finding it hard to raise capital to replace aged plant and machinery and foreign investors are reluctant to bring in funds. The shortage of capital is being reflected in the high cost of borrowing from banks.

(4) **Import competition.** With the US Dollar as a functional currency Zimbabwe has become a preferred export destination for South African firms. The local industry cannot compete with the cheaper and higher quality imports from South Africa. South African firms have competitive advantage as they can access finance more cheaply and have higher economies of scale by virtue of size.

(5) **Slow economic recovery.** The economy which has been on upward trend since 2009 grew by 8.1% in 2010 and 9.3% in 2011 and is forecast to fall to 5.6% in 2012.

In the long term the performance of the ZSE will be driven by improved economic fundamentals. The primary debt capital market in the form of the bond market had active in the pre-2000 era and before hyperinflation when government, parastatals and municipalities could raise funds. Since then only the government – through the central bank – has been the only visible participant in the primary bond market. According to the Ministry of Finance (2006) [18], the development of an active bond market would be beneficial to both the private and public sectors of the economy – through reducing stress on the balance of payments in the form of interest and capital. However, the policy issues surrounding the bond market in Zimbabwe and efforts to reform it have been suppressed by economic instability that characterized the country for the last few years (RBZ, 2008)[19]. If the macroeconomic stability brought about by dollarization is sustained, it should be possible to resuscitate the bond market. An active bond market could be major source of long-term financing for banks to mitigate their problem of relying shorter-term deposits.

5. EFFORTS IN BUILDING FINANCIAL INCLUSIVENESS

5.1 The Microfinance Vehicle

Cognisant that only 38% of the Zimbabwean population is served by the formal banking sector and that the majority of the unbanked population live in rural areas, an inclusive financial system framework is required, i.e. one that reaches out to the small-scale sector and the marginalised poor segments of the population whose majority are women. The RBZ has long recognized the problem and monetary policy statements always urge financial institutions to devise innovative ways of ensuring availability of financial services to the unbanked and underbanked communities.

According to CGAP (2006) 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 level (clients), meso level (building financial infrastructure) and the macro level (government playing a role). Provision of microfinance has been accepted as one vehicle to achieve financial inclusiveness. Its clients are often self-employed and typically home-based entrepreneurs and the informal sector which now forms a large component of the Zimbabwe economy. In rural areas they are small farmers many of whom are women and others engaged in small income-generating activities. In urban areas the clients are more diverse and include street vendors, shopkeepers, service providers, artisans, and formally employed people. These clients often lack access to credit and other financial services from the traditional banking sector.

The microfinance sector in Zimbabwe is thriving given the existence of a large informal sector and the huge demand for credit that cannot be met by the banking sector. Having been only 75 MFIs at the end of 2008, they have risen to 172 by June 2012. Being not deposit-taking institutions, their sources of funds are limited to owner equity, loans from banks, and donor funds. Loans from banks are their main source and bank lending rates being very high, they are forced to pass on to clients by charging very high interest rates in order to survive. This puts them in conflict with monetary authorities who have capped interest rates they should charge and predictably they flout the rules to sustain themselves.

Notwithstanding the central role of MFIs in building inclusive financial system, financial services for the poor are said to stand a better chance of growing when the larger commercial banks also get involved. The involvement of banks is currently curtailed because the sector is characterised by fragility and high levels of non-performing loans. However, there is no reason why the state-owned POSB and Agribank should not be active in the microfinance sector. These institutions have a branch network that reaches the unbanked rural areas.

[18] Ministry of Finance of Zimbabwe's Annual Economic Bulletin (2006).
[19] Reserve Bank of Zimbabwe Mid Year Monetary policy (2008).

5.2 Mobile and Internet Banking

ICT is now recognized as of the instruments for promoting an inclusive financial system. This is achieved through the instruments of mobile banking and/or internet (electronic) banking commonly known as e-banking. The number of mobile phone users per 100 inhabitants in Zimbabwe, i.e. teledensity, grew from 2.1 in 2000 to 31.98 mobile subscribers per 100 inhabitants and hence facilitating the growth of mobile banking. Cognisant that mobile phones can enable access to financial services at a reasonable cost to the majority of the population, the RBZ approved the establishment of mobile banking initiatives. In the January 2012 Monetary Policy Statement the RBZ reported that 15 banking institutions had introduced mobile banking products in partnership with mobile operators. Besides being cheaper, transacting on mobile phones preserves productive time that might have been spent travelling to banks. With projections that by 2015, mobile banking will constitute 8 percent of Africa's GDP, this form of banking will reduce financial exclusion and boost productivity. Where confidence in mainstream banking has been lost as is the case with Zimbabwe, mobile banking may restore public confidence. This is exactly happening in Zimbabwe as the mobile banking products are gaining currency and the public has begun to use them with even more confidence than they appear to have in the formal banking system.

There has been also a steady development of electronic banking that has been underpinned by the growth of internet connectivity in the country. Internet has changed the dimensions of competition in the retail banking sector as it lowers banking costs. Electronic banking services were first visible in the early 1990s when Standard Chartered Bank and CABS set up the first ATMs. Over the years other electronic banking products have mushroomed such as the electronic funds payment systems, telephone-banking, PC banking and even internet banking.

The growth in internet connectivity since 2008 has greatly improved financial inclusion of previously marginalized and excluded communities[20]. Table 13 below shows a growing trend of internet usage which is bound to translate to more internet banking usage.

Table 13: Trend of internet Usage in Zimbabwe

Year	User	Population	User/Pop. Ratio
2000	50 000	14 712 000	0.3%
2002	500 000	13 874 610	3.6%
2005	820 000	12 247 589	6.7%
2008	1 351 000	12 382 920	10.9%
2009	1 481 000	11 392 629	13.0%
2011	1 445 717	12 084 304	13.0%

Source: http://www.internetworldstats.com/stats.htm

Notwithstanding the good intentions of leveraging ICT to achieve financial inclusion, there are a lot of challenges facing Zimbabwe's ICT sector. These include inadequate national communications infrastructure (especially in rural areas), inadequate power infrastructure, high access cost to internet and broadband, lack of ICT skills, limited bandwidth and a non-liberalized regulatory environment. If not addressed, these challenges will militate against efforts towards achieving financial inclusion through mobile and internet banking.

[20] Rural people are now able to have internet connectivity through mobile phones.

6. STRATEGIES FOR RESOURCE MOBILIZATION

6.1 Mobilization of Domestic Savings

Given that gross savings is a function of government savings, business savings and household savings, resource mobilization requires the participation of all economic agents. The government, though constrained, can still contribute to resource mobilization by balancing its budget and privatizing inefficient state enterprises. Business sector savings arise naturally from a profitable business operating environment underpinned by macroeconomic stability and a favourable taxation regime. Household savings need to be channelled through the financial system in which the public has confidence in.

Policies that enable more money to be saved or channelled through the banking system are the responsibility of both monetary authorities and financial sector stakeholders. Monetary authorities have to ensure the stability of the banking sector in order to re-gain confidence of a wary public. Ensuring financial stability requires the RBZ to exercise appropriate and timely oversight and enforce rules consistently and predictably and thus minimize bank failures. Simply having a public deposit insurance scheme is not sufficient to instil full confidence because such schemes do not fully reimburse depositors in the event of total bank failure. Monetary authorities should consider increasing the level of compensation under the deposit insurance in the event of bank failure. A level of $150 per depositor is too low to encourage mobilization of savings into banking institutions.

The banking sector also needs to play its part. It should recognize that deposit mobilization is a function of positive real deposit rates and a reasonable spread between lending rates and deposit rates. The fact that the banking sector is not earning good returns on equity despite having relatively higher interest income margins in the region is an indication of operational inefficiencies, high operating costs and weak lending practices. Going forward, individual banks will have to address these issues in order for them to be able to continue attracting further capital from investors.

6.2 Facilitate Development of Interbank Market and Build LOLR Facility

The RBZ should promote an interbank market by issuing bills which banking institutions would use as collateral when they lend to one another. An interbank market will allow reallocations of liquidity between banks, i.e. during temporary shortages occasioned by customer withdrawals and borrowings, banks with surplus funds will lend to those in deficit.

Financial stability and confidence in banking sector can be restored if the central bank has capacity to provide funding to solvent banks facing liquidity challenges. In this regard the lender of last resort fund should be established at a level consistent with best practice for a dollarized economy, i.e. it should constitute between 50% to 150% of banking sector capitalization or 5% to 15% of the banking sector deposits. A level of $150 million promised by the Ministry of Finance is not forward looking as it is the minimum in terms of historical banking sector deposits of $3 billion obtaining in December 2012. While it is recommended that the lender of last resort fund be based on the proportion of the deposits as this provides an appropriate relationship to potential liquidity developments in the Zimbabwean banking sector, the level should be set at the median of 5%-15% of an estimated core deposit base.

In addition to restoring the lender of last resort function, the government need to re-capitalize the RBZ so that it can develop the requisite human resources and technology to carry out its oversight functions effectively. Currently, it lacks expertise that can timeously supervise the financial sector and be able to provide advice on corrective action before matters get out of hand. For instance, governance problems are not being detected at an early stage and by the time they are detected it is too late to save the failing institution. The RBZ strives to follow international best practices and this is evident from the policy guidelines that are in place; it is the implementation that falls short and this indicative of lack of capacity.

Furthermore, the RBZ's role of banker to government should be restored so as to create a level playing field in the banking sector.

6.3 Remove Barriers to FDI in the Financial Sector

A one-size-fits-all indigenization policy is not appropriate with regard to the financial sector as it fails to take account of the special features of the sector. The fact that the sector is governed by specific acts of Parliament (e.g. the Banking Act and the Reserve Bank Act) is recognition of the central role and vulnerability of the financial sector so as to require additional checks and balances with regard to any changes to its ownership. In essence, domestic investors wishing to enter the sector simply need to apply for licences to the regulator of the financial sector which dispenses them upon being satisfied with compliance with the Banking Act.

It should be noted that since independence the financial sector has not attracted much FDI. The dominant foreign banks- Barclays Bank, MBCA, Stanbic (formerly ANZ Grindlays) and Standard Chartered Bank –have been in existence before independence. The only significant foreign bank after independence was the Bank of Credit and Commerce International (BCCI) which failed in 1991 and was acquired by CBZ. Another new foreign bank, Ecobank, only entered the domestic market in 2010. The fact that only two foreign banks entered the market in the three decades of independence is indicative little FDI in the financial sector. Barriers to FDI in the form of one-size-fits-all indigenization policy should be removed so as to attract foreign capital.

6.4 Embrace Public-Private Partnerships in the Banking Sector

Usually, the entry mode of foreign investors in the financial sector is through acquisitions and not organic growth. When government intends to achieve an inclusive financial sector through FDI it can adopt the private-public partnership approach whereby it sets the parameters of outreach of financial services when approving the foreign investment. The government could emulate one successful approach adopted by the government of Uganda shown in Box 1 below.

Box 1: Stanbic Uganda: Acquisition, not organic growth

In February 2002, Stanbic Bank, which had only one branch in Uganda, bought a 90 per cent stake in Uganda Commercial Bank Limited (UCBL), a largely retail government-owned bank that operated a 66-branch countrywide network. As part of the acquisition, the Government of Uganda required Stanbic to maintain UCBL' branch network to provide financial services including payments, savings, and rural or microfinance services. The acquisition of UCBL introduced microfinance to Stanbic's operations, which would not likely have been part of an organic growth strategy.

Stanbic's commitment to serving the low-income market shows growth in lending operations and broader access to deposit services. Profitability through lending, a deepened deposit base and additional fee income has allowed Stanbic to maintain and grow its microfinance operations and other activities, particularly in rural areas. In turn, UCBL's clientele, as well as the low-income market segment in general, are benefiting from Stanbic's better management, technology, and competitive market presence. Since acquisition, Stanbic has added a net increase of 150,000 new deposit accounts with lower minimum balances than UCBL while reducing the number of dormant accounts, which had averaged as high as 50 per cent of total accounts at some branches. As of 2004, Stanbic had 29 per cent of the small lending and deposit market in Uganda and was particularly strong in the rural areas (DfID, 2005, p. 34-38)

Source: UNDESA and UNCDF (2006)

Public financial institutions with rural countrywide network that the Government could leverage through private-public partnerships are POSB and Agribank. Given government budget constraints to recapitalize these institutions, private-public partnerships with foreign investors would accelerate resource mobilization.

6.5 Unleash the Potential of the People's Own Savings Bank (POSB)

A survey by CGAP reported in 2006 observed that government-owned postal banks account for the largest share of savings among institutions that provide financial services to the poor such as financial co-operatives, rural banks, MFIs and state/agricultural/development banks. The Zimbabwe POSB has a countrywide network in both urban and rural areas and is not associated with bank failures and hence is trusted as the safest place for savings by the common person.

The Government can adopt a strategy whereby it transforms the POSB into a fully-fledged commercial microfinance bank offering diverse services including credit to small-scale businesses and small landholders. The POSB's current business model whereby it only provides working capital finance to elites is not developmental and is at variance with the objective of financial inclusiveness. More so its current core capital base of $11.5 million is clearly inadequate for it to leverage its countrywide network. The government should therefore consider recapitalizing the POSB through public-private partnerships as outline above.

6.6 Promote the Setting up of Microfinance Banks

The informal sector constitutes a large fraction of the economy and these businesses are not served by large banks. MFIs and microfinance banks have a track record of reaching such businesses. Hence, investors interested in serving the informal sector should be given licences to operate as microfinance banks. These institutions are better positioned to serve SMEs.

The National Microfinance Policy outlines strategies for financial inclusion 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. These strategies should be pursued with vigour and the Microfinance Bill should provide the enabling legislation.

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 its efforts to enforce the Interest Rates Moneylending Act have shown that regulating interest rates of MFIs is counterproductive. While a fully deregulated microfinance sector could be dangerous, one solution is to enact consumer protection laws that enforce transparency in disclosure of interest rates charged and penalise predatory practices. Cognisant that there are nearly 200 MFIs operating in the country, full and public disclosure of services and interest rates they offer would create competition among them resulting in lower interest rates charged to clients.

Furthermore, it is necessary to remove specific barriers preventing small banks to downscale to microfinance banks by:

- Deregulating deposit and lending rates;
- Permitting foreign currency transactions, especially remittance transfer services; and
- Permitting the cheque system.

By removing these barriers, small banks that are struggling to raise capital could be persuaded to transform into microfinance banks and still be able engage in the same business operations. Existing MFIs will also find it attractive to upscale to microfinance banks.

6.7 Adopt Migration Policy that fosters mobilization of diaspora savings

The Government should adopt a Migration and Development Policy that enables it to tap into the wealth and patriotism of its Diaspora population estimated to be over 3 million. If well-harnessed, the Diaspora can be a crucial partner in mobilizing resources to finance development. It has been empirically observed that diasporas, defined as migrants and their descendants, have the potential to be investors in their countries of origin. They can achieve this as either direct investors in enterprises or as portfolio investors in capital markets of their home countries. The participation of the diaspora as investors in the home country stems from two reasons.

The first reason is that the diaspora is more likely to have superior knowledge about investment opportunities and business practices in the home country than other international investors. This superior knowledge may make the diaspora more open to investments that other international investors may perceive as too risky. Like most international investors, migrant nationals tend to have a bias toward home-country investments.

The second reason is that it could be less costly for the government with a sizable diaspora to borrow from its migrant nationals because such nationals might perceive investment risks in their home countries differently from other foreign investors. This is so because the default risk attached to the home-country by the diaspora is bound to be less than that perceived by foreign investors.

Zimbabwe is not fully tapping into the wealth of its diaspora. Despite having a sizable diaspora, it is yet to come up with a migration policy that incentivises its migrant nationals to contribute to resource mobilization for development. Such policy should address the following key policy areas:

- Mainstreaming labour migration issues in national policies (fiscal and monetary), national development plans, National Employment Policy Framework and the Zimbabwe Decent Work Country Programme;
- Establishing a recognition system for skills gained from abroad;
- Promoting productive use of migrant workers' remittances and widening of remittance channels;
- Creating a conducive environment that facilitates the participation of migrants in the home financial system, and
- Providing return and reintegration services.

6.8 Provide incentives for the Diaspora to hold Deposit Accounts locally

Both the Government and the banking sector should give incentives to the diaspora to open bank accounts locally. The Government could relax exchange control regulations on such accounts so that funds are freely repatriated while banks could offer diaspora depositors positive real interest rates better than those earned in host countries with a lower country risk profile. Diaspora bank deposits are likely to be more stable and fairly longer termed than local deposits which are withdrawn at short notice. Such deposit accounts have the effect of increasing domestic bank assets which in turn will result in increased bank lending.

As a way of mobilizing diaspora savings, local banks should consider establishing a presence in countries with a large Zimbabwean diaspora so as to market banking services directly to the diaspora. Domestic banks such as Kingdom (now AfrAsia Kingdom Bank) and BancABC Banking Corporation which have a presence in the region are well placed to pursue this strategy in the countries in which they operate. Equally, foreign banks such as Barclays, Standard Chartered, Stanbic and MBCA whose headquarters are in countries with the largest Zimbabwean diaspora (i.e. South Africa and the UK) should be persuaded to directly market their financial services to the Zimbabwean diaspora. The net effect would be more remittances flowing through the formal banking system.

6.9 Create a capital market in Diaspora Bonds

One mechanism for resource mobilization in the capital market is through issuance of diaspora bonds. Diaspora bonds are long-dated sovereign debt instruments issued by governments to their nationals in the diaspora. Diaspora bonds are structured like standard, sovereign-backed bonds, but sold to diaspora populations to fund new infrastructure and development programmes. The minimal preconditions required for a successful diaspora bond issue are a sizable first generation diaspora bonds, good governance, political stability, ability to meet external financial obligations and the presence of a stable banking system. Given some positive development in the political will and governance structures, Zimbabwe can satisfy these conditions. Given that diaspora bonds only work if the diaspora population trusts the issuing government, one way of going around this issue is to create a de-politicized entity with well-structured oversight mechanisms to issue and manage the bonds. Alternatively, respected banks rather than the government could issue the bonds for specific infrastructure projects as was the case with the first diaspora bond managed by CBZ and Afreximbank. Following the success of the CBZ/Afreximbank $50 million Diaspora Bond in 2011, more efforts should be pursued to tap the wealth of the Zimbabwean Diaspora.

6.10 Promote remittances through the formal financial system

Of the over $1 billion estimated remittances flowing into Zimbabwe, only 30% of these flows pass through the formal system. Remittances pass through unofficial channels because formal services are either unavailable in remote areas, or because remitters do not trust the banking system. Increasing the flow of formal remittances does strengthen the financial system by contributing positively to financial liquidity as well as the national balance of payments.
Successful policy initiatives show that the most effective way of bringing remittances into formal banking channels is to make these channels more accessible, cost effective, timely, and safe for both senders and receivers. One solution is having more outlets offering remittance transfer and banking services. In this regard microfinance institutions with the capacity to handle remittances should be licensed to take on this extra service. Many clients of microfinance institutions probably receive remittances but are reluctant to deposit funds in banks because of high bank charges and perceived high risk of failure.

One effective way of bringing remittances into the formal system is through attracting FDI in mobile remittance services. This involves financial institutions going into partnership with international remittance providers to provide remittance transfer services through mobile phones. The advantage of mobile phones is that they are accessible to the rural people. In the Philippines the strategy of using mobile remittance services has been found to satisfy the needs of previously underserved segment of the population and thus contributing to financial inclusiveness. For the investors, it has also proved to be a sustainable and profitable business strategy.

7. GOVERNMENT ROLE IN BUILDING CONFIDENCE

7.1 Ensuring macroeconomic stability

Empirically, it has been established that there is a negative relationship between inflation and financial development, and that sustained inflation is detrimental to the financial development (Barnes et al. 1999). 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. Furthermore, it encourages disintermediation (i.e. operating outside the financial system). It is thus imperative for government to ensure macroeconomic stability for financial development and resource mobilization to take place.

The government has an important role to play in setting policies that will create an enabling macro-economic environment which will allow the growth of an inclusive and sustainable financial sector.

7.2 Strengthening oversight of the financial sector

Financial and human resources should be allocated to regulatory authorities so that they can strengthen regulatory and supervisory roles. The design of an oversight system should take into account that the major causes of bank failures in Zimbabwe boil down to inadequate risk management systems, poor corporate governance, diversion from core business to speculative activities, rapid expansion, creative accounting, overstatement of capital, high levels of non-performing insider loans, unsustainable earnings and chronic liquidity challenges. Poor corporate governance tops the list despite elaborate guidelines being in place, a situation that has led to the waning of public confidence in the banking system.

In order to ensure timeously oversight to the financial sector, it is recommended to enforce compliance with regulations through amending the Banking Act so that it requires financial institutions to appoint compliance officers with specific statutory duties. Continuous interactions of monetary authorities and these dedicated compliance officers would ensure enhanced disclosure in financial statements, improved transparency and enhanced regulatory oversight. This will go a long way to the restoration of public confidence in the financial system.

Cognizant of the fact that poor corporate governance is rampant and is the main cause of bank failure, it is recommended that the Ministry of Finance appoints a Commission of Inquiry to investigate corporate governance practices in the banking sector with a view of drawing up a Code of Conduct acceptable to all stakeholders.

7.3 Providing infrastructure

The government needs to prioritise infrastructure necessary for the smooth functioning of the financial sector for the public to have confidence in placing their funds with it. The critical infrastructure for the financial sector includes power supply, financial infrastructure, ICT and telecommunications. Continuous power supply gives confidence that the public can access their funds without interruption.

Financial infrastructure includes payments and clearing system that allow the transfer of money among financial institutions and information infrastructure of which credit bureaux are critical. With regard to ICT and telecommunications, government policies that support the expansion of the telecommunications sector are necessary. This requires the liberalization of the telecommunication sector to allow entry of foreign capital

8. CONCLUSION

Cognizant that sustained economic growth depends upon a healthy and developed financial sector, this occasional paper has recommended policy measures to achieve six key strategic objectives, viz:

To restore confidence in the financial sector;

To achieve an inclusive financial sector;

To remove barriers to FDI in the financial sector;

To promote the pivotal role of foreign banks in a dollarized economy;

To promote public-private partnerships in the financial sector; and

To tap the wealth of the Zimbabwe Diaspora for development.

The key policy recommendations are herewith summarized.
First, restoring confidence in the financial sector entails embracing the following policy recommendations:

(a) Reforming the deposit insurance scheme so that it adequately compensates depositors;
(b) Ensuring macroeconomic stability by striving for low single digit inflation rates;
(c) Strengthening the oversight of the financial sector through capacitating the Regulatory Authority; and
(d) Provision of the requisite infrastructure that in include financial infrastructure (credit bureaux and payment and clearing systems), uninterrupted power supply and ICT.

Second, a national strategy for financial inclusion should be an integral component of the financial sector development plan. Key policy recommendations for achieving an inclusive financial sector include:

(a) 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;
(b) Providing avenues for MFIs to link into the infrastructure serving the major financial institutions;
(c) Removing barriers that are preventing small banks to downscale to microfinance banks; and
(d) Promoting mobile banking and mobile remittance services by building the ICT infrastructure that makes it possible.

Third, given that there has been very little FDI flowing into the financial sector, one-size-fits-all indigenization policy will not be consistent with the efforts to revive the sector. Therefore, barriers to FDI should be removed so as to attract foreign capital.

Fourth, given that in a dollarized economy foreign banks, by virtue of having easy access to international financial markets, can complement the role of lender of last resort in providing liquidity, their entry should not be unduly restricted. Policy makers should therefore give consideration to the benefits that foreign banks can bring to the domestic economy.

Fifth, given that the common entry mode of foreign investors in the financial sector is through acquisitions and not organic growth, the key policy recommendation is to embrace public-private partnerships as a means of recapitalizing state-owned banking institutions such as the POSB and Agribank so that they can adequately serve rural communities.

Six, cognizant that the Zimbabwe Diaspora is huge (estimated at one-quarter of the population) and given that it has potential to contribute resource mobilization, there is need for a strategy to harness its wealth for development. It is therefore incumbent upon Government to adopt a migration and development policy that incentivises its migrant nationals to contribute to resource mobilization for development.

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