



ISSUING TREASURY BILLS IN A DOLLARIZED ZIMBABWEAN ECONOMY

Executive Summary

This policy brief offers advice on the necessary conditions that should be created in order for Government to successfully issue Treasury Bills in the context of a dollarized economy. Cognizant that dollarization implies fully embracing an open economy, the policy brief recommends fostering more participation of international banks; allowing banks to hold US Treasury Bills and other quality foreign securities for both liquidity and collateral purposes; building of foreign reserves and establishment of a lender of last resort facility as prerequisites ahead of the issuance of domestic Treasury Bills.

Background

Prior to dollarization the Reserve Bank of Zimbabwe (hereinafter referred to as RBZ) used to issue Treasury Bills in the course of performing the functions of controlling money supply, raising short-term finance for Government and providing financial institutions with a liquid and trade risk-free security which they could also use as collateral for borrowing. The adoption of dollarization (i.e. a foreign multicurrency regime) by Government in 2009 resulted in a loss of monetary autonomy. The RBZ was no longer able to print currency and hence, could not control money supply anymore. The absence of foreign currency reserves, coupled with the RBZ's indebtedness of over US\$1 billion accumulated during the hyperinflationary period also meant that it could not perform its role as lender of last resort for financial institutions. Its role became largely limited to regulating and supervising financial institutions. In these circumstances, worsened by a huge Government debt overhand, the RBZ was no longer in a position to issue Treasury Bills

The absence of Treasury Bills in the money market crippled the inter-bank market as banks could not lend to each other without a credible liquid security as collateral which these bills used to provide. This situation, combined with the inability of the RBZ to act as lender of last resort, made the banking sector very vulnerable to both internal and external shocks. It is indeed one of the contributing factors to a string of bank failures that have occurred since dollarization as the RBZ had no resources to intervene to mitigate shocks.

Policy Interventions

Cognizant of the dysfunctional situation in the financial sector, policy makers mooted the establishment of a lender of last resort facility in the context of a dollarized economy and the resuscitation of the inter-bank market. The establishment of a lender of last resort facility entailed the RBZ building adequate foreign currency reserves for the purpose while the resuscitation of the inter-bank market meant re-introducing Treasury Bills that could serve as collateral as well as being capable to smooth Government working capital needs. Ideally, the sequencing of intervention should have been to first build reserves and establishing the lender of last resort facility before proceeding to issue Treasury Bills.

However, the Government prioritized smoothing Government working capital needs and instructed the RBZ to issue Treasury Bills in the absence of reserves and a lender of last resort facility. To this end, the RBZ issued Treasury Bill tenders on five occasions in 2012 which were largely unsuccessful as Annex A shows. The tender issues were unsuccessful for a number of reasons that included the following:

- The Treasury Bills lacked standard features, viz.: tradability and collateral features that were crucial for enhancing the function of the money market;
- The RBZ had no foreign currency reserves and neither was the lender of last resort facility in place and hence redemption of the Treasury Bills on maturity was not assured;
- Market participants were concerned with the undercapitalization and indebtedness of the RBZ and hence, had no confidence in the issuing authority;
- The allocation of bids did not take account of country risk as the RBZ only considered currency risk resulting in the rejection of tender bids that took account of all attendant risks of the issue;
- The Treasury Bills were only issued to banks rather than to the entire financial sector as is the usual practice; and
- The Treasury Bills did not have a repurchase feature and thus, further raising the probability of default and diminishing the collateral value of these securities.

Policy Options

In examining pros and cons of various policy options, regard must be given to the experiences of other dollarized economies. A Latin American country, Panama, the oldest dollarized country offers some useful insights. Panama has been able to issue both short-term debt (Treasury Bills) and long-term debt on the basis of its sovereign rating and the fact that its international banks act as lenders of last resort. The crucial lesson from the Panama experience is that international banks can be nurtured to support the stability of the financial system. Crucially, the country allows free entry to foreign banks and its economy is so open that it allows banks to hold external financial assets such as US Treasury Bills and this has had the effect of deepening Panama's financial markets.

On the basis of international experience, one policy option for Government is to persuade its multinational banks to take on the role of lender of last resort and in return allow them hold

foreign securities such as US Treasury Bills and other quality foreign securities. The Government could then re-introduce its own Treasury Bills with a yield higher than those of the USA to reflect country risk so as to make them attractive. Thus, removing restrictions to entry and operation of well-capitalized multinational banks would create liquidity and deepen the financial system and foster the issuance of Treasury Bills and the development of a vibrant inter-bank market. This policy option may, however, be viewed as being inconsistent with the Indigenous and Economic Empowerment Act. Furthermore, given the huge debt overhang, the Government is unlikely to get an investment grade sovereign rating, which is crucial in reducing country risk.

The second possible policy option is for Government to create the necessary conditions for Treasury Bills to be issued in the context of a dollarized economy. Such conditions entail certain actions in a sequenced fashion. First, through the RBZ, the Government needs to create foreign currency reserves which are at least greater than the issue of Treasury Bills to give confidence to the market of its ability to honour such short-term debt on maturity. Second, the RBZ should have in place, a lender of last resort facility, which should accept Treasury Bills as collateral and be in a position to provide a repurchase facility. Third, the Treasury Bills should be accorded all the standard features, viz.: satisfying statutory liquidity requirements, acceptable collateral for both inter-bank and RBZ borrowing, tradable in the money market and accessible to the general public and not limited to a particular market. Fourth, the RBZ's balance needs to be restructured, re-capitalized and freed from debt to make it a credible institution.

While this policy option is the natural course of action that should be followed, its adoption is constrained because the balance of payments position of Government is such that it cannot accumulate the necessary foreign currency reserves (the debt overhang is also part of the problem) and the RBZ is under-capitalized, indebted and under-resourced to establish an

adequate lender of last resort facility.

This brings us to the third possible policy option, namely, maintaining the status and creating confidence in the financial sector by further opening up of the capital account. The further opening up of the capital account in this instance would entail allowing financial institutions to hold foreign financial securities such as US Treasury Bills and other quality foreign securities, and according these securities satisfying liquidity requirements and acceptable collateral for borrowing. This would have the effect of resuscitating the inter-bank market and deepening liquidity in the financial sector. Crucially, it would allow the banking sector to have access to foreign credit lines as they would use US Treasury Bills they hold as collateral. Through moral suasion, banks would play the role of lender of last resort as they would be using US Treasury Bills as collateral. The increased liquidity in the financial sector would enable the RBZ to accumulate foreign reserves and create confidence so that over time, the Government is able to issue its own Treasury Bills in competition with the US Treasury Bills.

Despite the attractiveness of this policy option, policy makers are likely to argue that further opening of the capital account in this manner would aid capital flight. However, such argument is actually misplaced because, in theory, the adoption of dollarization implies full opening up of the capital account. In essence, restrictions of capital flows are inconsistent with dollarization as it implies the economy would have lost monetary autonomy.

Policy Recommendation

This policy brief recommends a policy that blends some elements of each of the three policy options discussed above in pursuant of the goal of successfully issuing Treasury Bills in the context of a dollarized economy. The building blocks of the policy should therefore have the following five anchors:

- Increased participation of international banks to take advantage of their access to

international financial markets for lines of credit necessary to increase liquidity in the economy;

- Permitting banks to hold US Treasury Bills and other quality foreign securities which they could utilize as collateral for lending to each other on the inter-bank market;
- Building confidence in the financial system through accumulation of foreign currency reserves, the creation of a lender of last resort facility and restructuring of the RBZ's balance sheet;
- Introducing Treasury Bills with standard features that include, among others, tradability, collateral and repurchase features and unrestricted participation of market players; and
- Ensuring issued Treasury Bills are appropriately priced to reflect country risk using either an open tender or auction system.

In a dollarized economy, the presence of a significant number of international banks has the effect of increasing liquidity in the financial sector because these banks have international lines of credit in addition to being well-capitalised. In order to attract international banks, the Government needs to relax restrictions on foreign bank ownership espoused in the Indigenous and Economic Empowerment Act. Furthermore, the Government should consider allowing both domestic and international banks to hold US Treasury Bills and other quality foreign securities which it should deem acceptable as satisfying statutory liquidity requirements as well as being acceptable collateral for either inter-bank or central bank borrowing. These actions would have the effect of deepening the money market and increasing foreign currency reserves circulating in the economy and enable the RBZ to subsequently issue its own Treasury Bills at a premium yield over that of the US Treasury Bills. In addition, as the RBZ builds reserves, it could offer to buy US Treasury Bills once these bills are allowed to freely circulate in the economy.

Since dollarization removes the central bank's

ability to print money, the default risk of Treasury Bills on maturity is elevated and becomes an issue with investors. Default risk is only mitigated by the existence of adequate foreign currency reserves and a lender of last resort facility. Thus, it is recommended that the RBZ build reserves and set up a lender of last resort facility to give confidence to investors that issued Treasury Bills would be honoured on maturity and facilitates their trading in the secondary money market.

Domestically issued Treasury Bills should possess the same standard features with similar securities like the US Treasury Bills. First, their price should be market-determined using either an open tender or an auction system. Second, they should be liquid and tradable in the money market. Third, they should be eligible for satisfying statutory liquidity requirements. Fourth, they should have a buy-back feature in the sense that RBZ should be in position to repurchase them. Fifth, they should be acceptable collateral for borrowing in the inter-bank market and in the credit market including the RBZ.

Implementation

The Ministry of Finance in consultation with the RBZ can sequence the implementation of this policy recommendation as follows.

Step 1: Seek exemption of international banks from some provisions of the Indigenous and Economic Empowerment Act and through moral suasion, ensure that these provide more liquidity in the financial sector through their easy access to international financial markets.

Step 2: Open up the capital account to allow banks to hold US Treasury Bills and other quality foreign securities to deepen the money market.

Step 3: The RBZ should take advantage of the ensuing liquidity brought about the two steps above to build foreign reserves and establish a lender of last resort facility.

Step 4: The RBZ should be re-capitalized and the balance sheet restructured to remove the indebtedness.

Step 5: Issue domestic Treasury Bills that will compete in the secondary market with US Treasury Bills and other quality foreign securities.

Annex A: Largely Unsuccessful Treasury Bill Issues in 2012

Auction Details	04 Oct-2012	24 Oct-2012	24 Oct-2012	26 Oct-2012	06 Nov-2012
Amount on Offer (US\$ million)	15	15	15	15	30
Bids (US\$ Million)	7.7	6.5	4.7	11.05	8.65
Number of Bidders	9	6	6	12	13
Uptake (Bids/Offers) %	51.33	43.33	31.33	73.67	28.83
Accepted (US\$ Million)	0	0	0	9.85	0
Amount Rejected (US\$ million)	7.7	6.5	4.7	1.2	8.65
Tenor (Days)	91	91	91	91	91
Minimum Interest Rate (%)	5.5	5	5	5	8.5
Maximum Interest Rate (%)	15	14.5	14.5	13	12

Source: Reserve Bank of Zimbabwe



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