Liquidity Crunch – The Survival Strategies

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1. Introduction

Zimbabwe continues to experience slowdown in economic activity across all sectors of the economy. There is visible deterioration of economic fundamentals and economic stress signals in the country evident through:

- Worsening Current Account balance and deterioration in the Balance of Payments
- Low aggregate domestic demand
- Revenue underperformance
- Worsening capacity utilization levels
- De-industrialisation
- Company closures and increasing joblessness
- Shrinking deposits in the economy
- Liquidity challenges

2. What does Liquidity mean?

Liquidity relates to the ability of an economic agent to exchange his or her existing wealth for goods and services or for other assets. Two important concepts are important in the definition 0f the liquidity concept.

Firstly, liquidity can be understood as a flow (as opposed to stocks concept. This means liquidity refers to the unhindered flows among the agents of the financial system, with a particular focus on the flows among the central bank, commercial banks and markets.

Secondly, liquidity refers to the ability of realizing these flows. Inability of doing so would render the financial system illiquid. Hence,

- An asset is liquid if it can be bought or sold quickly at low transaction costs at a reasonable price.
- Liquidity also refers to the availability of instruments (market and nonmarket) that can be used to transfer wealth across time periods.
- An asset is liquid if it allows agents to consume inter-temporally as they please.

Liquidity encompasses three forms: market, funding and accounting liquidity.

- Market liquidity is the ease with which an asset can be converted in to a liquid medium, mainly cash.
- Funding liquidity refers to ease with which borrowers, both firms and individuals can obtain funding in the form of credit.
- Accounting liquidity refers to institutional, especially a bank's balance sheet health, with regards to short term (cash like) assets. This determines the ability of a bank to meet its obligations when they fall due.

When the three forms of liquidity do not work in tandem they may induce an economy wide shock that result in a financial crisis and in some cases bank runs. During a liquidity crunch obtaining credit becomes difficult and when available, interest rates and collateral requirements are high.

3. Experience with Multi-Currency and Liquidity

The adoption of the MultipleCurrency System in January 2009 has been accompanied by persistent liquidity shortages and these compounded the challenges in the banking sector to a large extent. This adverse development has had debilitating effects on Government's initiatives to firmly steer the Zimbabwean economy onto a recovery path. This reflects the negative effects of repeated disruptions to the traditional mechanisms of liquidity creation and transmission, both at the aggregate and individual levels.

It is important to note that, within the auspices of a multiple currency regime, where the Reserve Bank does not issue currency, liquidity sources are limited. In this respect, the country's liquidity situation is contingent upon developments on the external sector front.

Other than domestic deposit mobilization, which, to a large extent, is currently limited, the major sources of liquidity are:

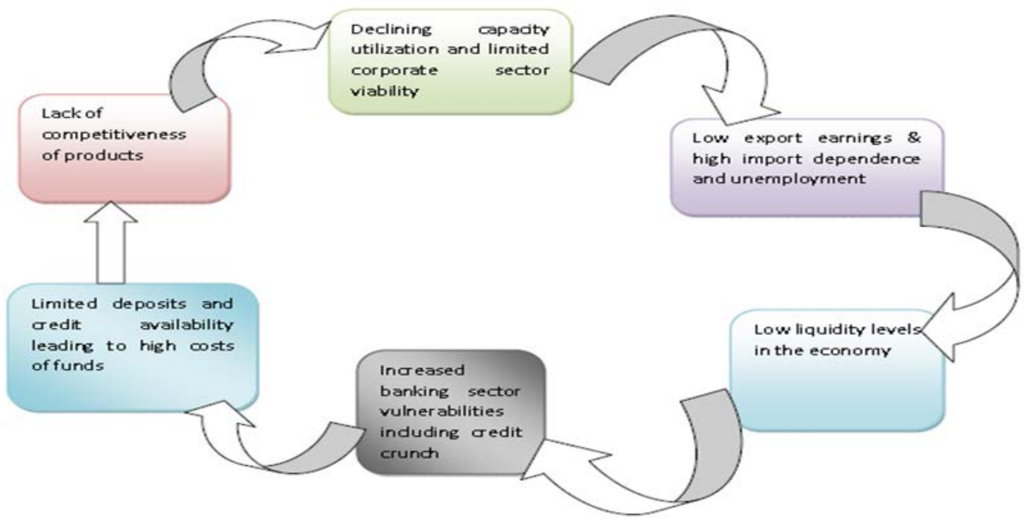
1. Export earnings
2. Diaspora Remittances;
3. Offshore credit lines;
4. Foreign direct investment inflows; and
5. Portfolio investment inflows.

The negative impact of the prevailing liquidity challenges have also been felt on the inter-bank market, a key component of the money market and the starting point of the monetary transmission mechanism. Regrettably, the potency of policy initiatives geared at enhancing access to finance has been severely undermined by liquidity constraints that have remained an albatross around economic recovery efforts. Lack of Balance of Payments and budgetary support as well as limited access to offshore lines of credit have also compounded the liquidity conditions.

Liquidity is important in an economy because, the functioning of the entire financial system, the implementation of Monetary Policy, the efficiency of payment systems, and the borrowing conditions of households and firms depend both on an adequate amount of liquidity in the economy and on its adequate intermediation through the banking system.

4. Vicious Circle of liquidity

The Monetary Policy statement announced by the RBZ in January 2014 identified that the liquidity problems currently affecting the country presents themselves in a vicious cycle. The circle identifies the following as the challenges; lack of competitiveness of the products, declining capacity utilization, low export earnings, low liquidity levels, increased banking sector vulnerabilities, and limited deposits and credit availability.

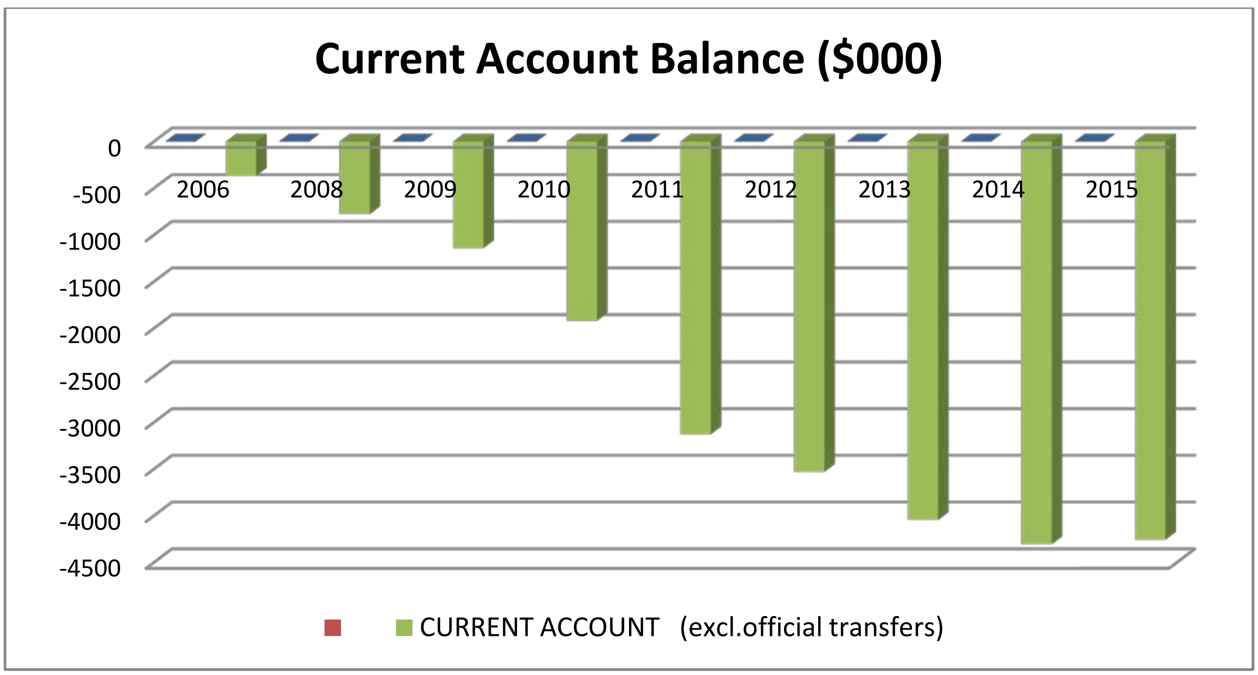


The question is; how do we break the circle? This vicious circle shows that the liquidity problem currently affecting the economy pervasively permeates the financial, export and manufacturing sector.

5. External Sector Developments

i. Current account balance

Growth in exports of goods and services has remained low while at the same time, imports have accelerated as domestic industry production has declined. Expansion in imports, as against static exports, means that the current account is widening and the economy is thus hemorrhaging liquidity. The challenge is that there are no incentives for exporters.



ii. Lines of credit

The lines of credit are few and high priced due to the risk premium attached to the current external debt and arrears. The current debt overhang of US$6.1 billion continues to be an albatross on the neck of the economy, hence the need to continue to adhere to the various programmes which the Government has initiated with the support of multilateral financial institutions.

iii. FDI and Portfolio Inflows

The economy is not realizing any significant FDI and Portfolio flows and attracting required capital in key sectors of the economy will largely correlate with building of confidence in the economy. Diaspora flows have been adversely affected by the slowdown of the global economy. In addition, there is no framework guiding Diaspora investment, to cater for Zimbabweans who want to invest their funds.

6. Strategies of improving liquidity

i. The most important aspect of improving liquidity is to improve the confidence in the banking sector and the economy at large. This would ensure that banks are able to attract deposits from both the formal and the informal sector. Improved confidence is usually accompanied by increased investment inflows which in turn support key productive and export sectors.

ii. There is need for the country to put in place the right policies that will attract foreign direct investment and lines of credit. A good track record with international financial institutions has the potential to unlock resources for the country.

iii. The Government as pronounced in the Budget Statement, should fully resource the central bank through Re-capitalization and injecting the resources for it to activate the interbank market where it the CB will play the lender of last resort.

iv. Measures to unlock resources in Non-performing loans are also important given that a lot of the assets of the banks are now tied up in non-performing assets. The Monetary Policy Statement has alluded to the government finalizing the legal framework for credit reference bureaus which will strengthen credit risk management in banking institutions and assist in reducing over-indebtedness

v. The effective and efficient exploitation of the country's resources will allow the economy to benefit from revenue inflows from these sectors hence lead to improvement in the liquidity situation. This requires transparency in the accounting for resources flowing from these natural resources.

vi. Continuous reengagement with the international community and pursue the staff monitored programme (though the benefits to liquidity will be long term) and re-establish creditworthiness with foreign lenders to tap into long-term foreign savings.

vii. Measures to protect the country from abuse by regional countries -being dollarized we have become cheap source of hard currency for citizens of other countries in the region

viii. Understanding the Global dynamics and determine where money is and follow it. This would require cooperation among various economic agents (government, industry and the financial institutions) as they approach potential funders to fund the productive sectors of the economy and infrastructural needs of the country.

ix. There is need for the financial sector stakeholders to join hands to roll out programs on financial inclusion and financial literacy programmes throughout in the country to educate the people on the importance of using the financial services sector. This would go a long way in attracting some of the resources currently circulating outside the banking system.

x. Developing a culture of exporting and reducing imports. Imports are acting as a drain on domestic liquidity. An import substitution strategy buttressed by higher exports is required to improve liquidity in the long term.

xi. Continue efforts to reverse the widespread perceptions of incoherent and ineffective economic management though avoid policy inconsistences and reversals. Also review ownership restrictions and industrial policies that discourage investment.

xii. Review the infrastructure requirements of export sectors and adopt an investment program to remedy obstacles.

xiii. Address loan portfolio problems; remove the stress on the banking system arising from indigenization requirements on the big local banks.

Disclaimer:

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