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Credit Creation Challenges Faced by Zimbabwean Banks Since the Introduction of the Multicurrency System: Causes and Effects

Hlupeko Dube
Great Zimbabwe University, Faculty of Commerce, Department of Banking and Finance, Masvingo, Zimbabwe
E-mail hdubebhachi@gmail.com

Dzikamai Shoko Muzvidziwa
Great Zimbabwe University, Faculty of Commerce, Department of Banking and Finance, Masvingo, Zimbabwe
E-mail dmuzvidziwa@gma.com

Abstract
The purpose of the study was to establish credit creation challenges that commercial banks have faced since 2009 when the Zimbabwean government introduced the multi-currency system. The study employed the descriptive survey design. Both primary and secondary data sources were employed in the study. The study found out that commercial banks faced a myriad of challenges which included inability to attract long-term deposits, high levels of non-performing loans, low levels of capitalisation and high levels of political risk. The challenges in credit creation have caused the manufacturing sector to continue to be undercapitalized. The sector has therefore failed to fully recover from the economic downturn the economy experienced. The study is important in that it helps equip commercial banks with strategies that can be employed in their role of creating credit. This will help to finance the recovery of the economy which is underperforming because of challenges in the availability of debt financing.

INTRODUCTION

Banks play a pivotal role in the development and growth of any economy. As financial intermediaries they facilitate the movement of money from the surplus economic units to the deficit economic units. This involves the asset transformation process whereby banks transform savings deposits from customers into loans of varying tenors. This process results in the increase in economic wealth across board in an economy. Banks create credit for the deficit economic units. This involves the asset transformation process whereby bank transforms savings deposits from customers into loans of varying tenors. The ability of banks to transform deposits into loans can yield massive profits for banks. Stoop (2010), notes that banks through credit creation are able to create and allocate credit and as such play a powerful role in the economy.

The Zimbabwean economy has gone through various transformations since independence in 1980 with banks playing key roles in every situation. Following the hyperinflationary period of 2007 – 2008 the Zimbabwean government in 2009 adopted a multi-currency regime. This effectively meant that the government no longer had full control over the monetary policy. As a result the central bank could no longer influence credit creation and money supply through its monetary policy statement.

According to the African Economic Outlook (2012) report on Zimbabwe nominal lending rates in the country remained high due to the prevailing liquidity crunch and high country risk profile. Savings deposits in the country remained very low ranging from 2.6% to 6% between August 2011 and August 2012 (Reserve bank of Zimbabwe, 2012). Total deposits in the banking system maintained an upward trend rising by 1.3% to US$ 3.25 billion up from US$ 3.21 billion in 2011. Short term deposits consisting of demand deposits, savings and under 30 day deposits constitute 89.3% of the total deposits reflecting the transitory nature of the country's deposits. Long term deposits according to the report account for only 10.7% of total deposits.

In view of high liquidity risk and limited asset transformation abilities, more than 70% of the banking sector loans are for terms less than 12 months. The banking sector has continued to roll over loans and offer revolving credit facilities such as overdrafts and these a have cushioned the economy from the adverse effects of short term loans. It is clear that banks as creators of credit play a central role for the accumulation and mobilization of capital which is needed for economic growth. This paper seeks to highlight the credit creation challenges faced by Zimbabwean banks in terms of its causes and effects.

STATEMENT OF THE PROBLEM

The credit creation capabilities of financial institutions in any economy are the key drivers of production and economic growth. The Zimbabwean financial institutions have since the introduction of the multi-currency system been unable to create adequate credit as evidenced by the short term nature of loans on offer in the sector. This paper therefore seeks to expose the causes and effects of the credit creation challenges faced by Zimbabwean banks since the introduction of the multi-currency system

OBJECTIVES
The study will be based on the following objectives:
- To establish the causes of the credit creation challenges that commercial banks have been facing since 2009.
- To establish the effects of the credit creation challenges that commercial banks have been facing since 2009.
- To recommend solutions to credit creation challenges that is faced by commercial banks in Zimbabwe.

RESEARCH QUESTIONS
- What are the causes of the credit creation challenges facing Zimbabwean commercial banks since the introduction of the multi-currency system?
- What are the effects of the credit creation challenges facing Zimbabwean commercial banks since the introduction of the multi-currency system?
- How can the credit creation challenges be solved?

LITERATURE REVIEW
The concept of credit creation
Stoop (2010) defines credit creation as the act or process of creating a facility that enables the consumption of goods and services before payment. It can also be defined as the process by which new money is produced through fractional reserve banking and lending by the banking system.

The financial statements of a bank show that in a bank's balance sheet loans constitute the bulk of the assets that a bank holds while the deposits by customers constitute the liabilities of the bank. The credit creation process is illustrated below.

Step 1

Bank A receives a deposit of $1000 and given the statutory reserve requirements of 10%, the bank's balance sheet will look as follows.

BANK A			
Assets		Liabilities	
Reserves	100	Deposits	1000
Loans	900		

Bank A keeps $100 as reserves and extends loans to Bank B of $900.

Bank B thus receives the $900 as a deposit and keeps 10% as reserves while loaning out the remainder.

Bank B			
Assets		Liabilities	
Reserves	90	Deposit	900
Loans	810		

This way from the deposit of $1000, $1710 worth of loans has been issued in the economy and this constitutes credit creation. This process can continue until the extendable loans goes to zero.

It is thus clear that in an economy money can be created through extending loans. This is done through lending and relending amongst banks. The limit to the money created in an economy is set by the central banks as they are the ones that create money out of thin air through their setting of money supply.

Empirical Literature
Many studies have been carried out on credit creation challenges in various countries. Dullien (2009) conducted a research on credit creation in developing countries. The findings of the study were that credit creation by banks was limited by the level of non-performing loans. Non-performing loans force banks to increase the level of loan loss provisions. As Dullien (2009) puts it, the increase in non-performing loans forces banks to increase interest rates which in turn limit credit creation. Stoop (2010) is of the opinion that underestimation of probability of default disturbs the optimal credit creation process. This is because underestimation of the probability of default will result in high levels of non-performing loans. Non-performing loans have an opportunity cost in the form of the creation of loans that is forgone when the level of non-performing loans increase.

Horvath, Seidler and Weill (2012) examined the relationship between capital and liquidity creation using Granger-Causality evidence. The results of the study were that in small banks, capital was found to negatively Granger-cause liquidity creation. A study by the International Monetary Fund, 2010) concluded that undercapitalization of banks limits their ability to create credit. Another study by Berger and Bruwman (2009) found that bank value had a positive impact on liquidity creation. Higher market-to-book value and price-earnings ratios were found to be positively correlated with liquidity creation.

Political risk is another important determinant of credit creation. The World Bank (2010) stated that political risk was one of the biggest challenges in foreign direct investment as it political instability generates business losses. According to Sandstrom (2008) political risk impacts negatively on business climate as it creates uncertainty that affects business decisions. Sandstrom (2008) goes on to state that political risk can influence credit risk. Another study by Ramon-Ballester (2007) concluded that increases in political risk results in increased capital outflows.

The level of bank deposits is another important factor that can limit credit creation. A recent research by Al-rawashdesh et al. (2013) and Oni and Ozemhoka (2013) found out that the volume of bank deposits influenced the ability of banks to create credit. Credit creation and the volume of deposits were found to be positively correlated. However, Hahn (1963) quoted in Hagemann (2010) had the view that the level of savings was not a determinant of credit creation.

The inability of firms to meet bank requirements is another major limitation in credit creation. Many firms and individuals fail to access credit from commercial banks because either they lack collateral or they do not conduct profitable business operations (International Monetary fund, 2013 and Dullien, 2009). Dullien goes on further to say that some firms in the informal sector do not have legal status and are therefore their credit worthiness in low.

The role of the Central Bank in a country is also an important determinant the ability of commercial banks to create credit. Research by Haran (2008) established that level of the reserve requirement ratio set by the Central Bank influenced the ability of banks to create credit. A high reserve requirement ratio reduces the amount of cash available for banks to create credit. The central bank has the lender of last resort role. The inability of the central bank to increase money supply limits credit creation (Dullien, 2009).

Mcleay, Radia and Thomas (2014) are of the opinion that lending can also be constrained by steps that are taken by commercial banks to manage credit risk. Banks can tighten their lending policies in order to reduce the level of default. Bank ownership is another important variable that influence credit creation. A study by Claesses and Horan (2012) concluded that the presence of foreign banks was negatively correlated with credit creation in developing countries.

The capital structure of a bank influences the ability of a bank to create credit. The IMF (2013) posits that highly leveraged banks may have difficulties obtaining loans. This inability of banks to access credit will reduce their liquidity which is a limitation of credit creation. In the same way highly indebted firms will be consider to have poor credit quality by commercial banks. This will limit access to credit creation by firms.

Credit creation is an important determinant of economic growth and development. It helps to create goods and services which otherwise will remain where they are without credit extension (Hahn, 1963 in Hagemann 2010). This is supported by Abdulrasheed and Etudaiye-Michtar (2010) who mentioned that credit creation will stimulate economic growth and development. Economic depressions can be overcome by efficient credit creation (Hagemann, 2010. Lawrence (2008) pointed out that the financial system helps production and distribution of goods as well as economic growth and development.

METHODOLOGY

Research Design

Descriptive survey was employed in this study. This research design was chosen because it allowed the researchers clearly expose the causes and effects of credit creation challenges. This research design allowed the researchers to collect data by means of questionnaires. The data collected was analysed using SPSS software.

Population of the Study

The population of the study comprised credit analysts from the banks' retail banking and corporate banking divisions. This population was found to have the hands on information on the topic under study. A sample of 40 credit analysts from Masvingo and Harare was chosen as representative of the population. Credit analysts from Masvingo were considered to possess representative knowledge of the credit creation challenges facing the retail banking sector. Masvingo was chosen because of the convenience and ease of access to the researchers. Credit analysts from Harare we considered to possess representative knowledge of the credit creation challenges facing the corporate banking sector. Harare was chosen because it is the leading financial centre in Zimbabwe.

Data Sources

Primary data was sourced through the use of questionnaires. Secondary data was sourced from ZIMSTAT, Reserve Bank of Zimbabwe and World Bank bulletins. These data sources were considered to be accurate by the researchers and to be free from bias. ZIMSTAT and Reserve bank of Zimbabwe are government which collect and disseminate data on economic activities in the country and the World Bank is an international bank which is well recognized globally. . They were also chosen because they provided all the information required by the researchers over the whole time frame of the study.

RESULTS PRESENTATION

The purpose of the study was to investigate credit creation challenges that commercial banks have been facing since 2009. The results of the study are discussed below.

Demand for Loans

Table 1: Demand for loans greater than supply

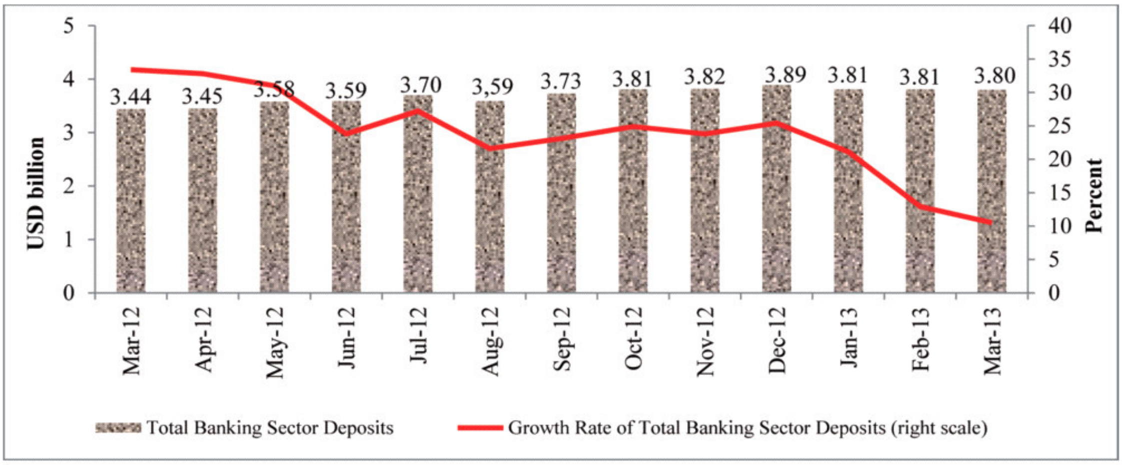
		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Yes	39	97.5	97.5	97.5
	No	1	2.5	2.5	100.0
	Total	40	100.0	100.0	

The results in Table 1 above show that 97.5% of the respondents indicated that demand for loans exceeded the supply from 2009 to 2014. Most firms in Zimbabwe were found to be demanding loans for recapitalization since the introduction of the multi-currency system.

The Level of deposit

The study established that the level of bank deposits increased over the period of the study. However, the annual growth rate was declining. Credit creation was positively related to the level of deposits. Table below shows the growth rate in the level of deposits. The study also found out that the level of deposits grew at a decreasing rate for the greater part of the period of the study. Figure below the total bank deposits increased by 10.5% and the growth rate in the level of deposits declined from about 35% in March 2012 to about 10% in March 2013. This decline in the growth of bank deposits caused a slowdown in credit creation by banks.

Figure 1: Total banking Sector Deposits and Growth Rate of Total Banking Sector Deposits



Source: RBZ Monthly Economic Review

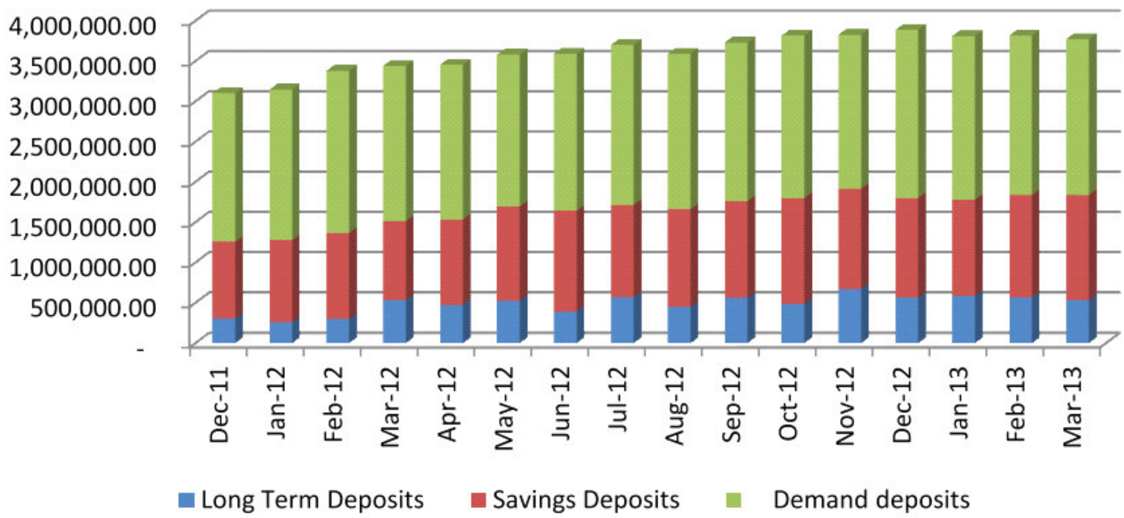
Nature of Deposits

Table 2: Banks unable to meet long-term loans due nature of deposits

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Agree	6	15.0	15.0	15.0
	strongly agree	33	82.5	82.5	97.5
	Disagree	1	2.5	2.5	100.0
	Total	40	100.0	100.0	

The data in Table 2 above indicates that about 98% of the respondents indicated that lack of long-term deposits impacted negatively on credit creation by commercial banks since 2009. The commercial banks were unable to advance long-term loans due to the transitory nature of deposits. Because of low confidence in the financial system, a large proportion of deposits were short-term. Demand deposits constituted the bulk of the deposits this hindered the financial institutions from creating long-term loans needed to resuscitate the economy. The proportion of long term deposits was the smallest as table shown in Figure 2 below.

Figure 2: Structure of Bank Deposits 31 December 2011 to 31 March 2013



Source: Zimbabwe: Ministry of Finance Fiscal Policy Statement

Table 3: Low confidence impact heavily on credit creation

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Agree	12	30.0	30.0	30.0
	Strongly agree	26	65.0	65.0	95.0
	Disagree	2	5.0	5.0	100.0
	Total	40	100.0	100.0	

The results from Table 3 above show that 95% of the respondents were of the opinion that low confidence level in Zimbabwe's financial system since 2009 contributed to credit creation challenges by banks since this caused depositors to concentrate on short term deposits. This resulted in banks being unable to create long-term deposits.

Table 4 :High Bank Charges impact on credit creation

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Agree	10	25.0	25.0	25.0
	Strongly agree	20	50.0	50.0	75.0
	Disagree	9	22.5	22.5	97.5
	Strongly disagree	1	2.5	2.5	100.0
	Total	40	100.0	100.0	

High bank charges were another major challenge in credit creation by commercial banks. Nearly 98% of the respondents pointed out that high bank charges impacted negatively on credit creation by commercial banks as they deterred savings from the informal sector. The informal sector which normally makes small deposits could not afford the high bank transactions.

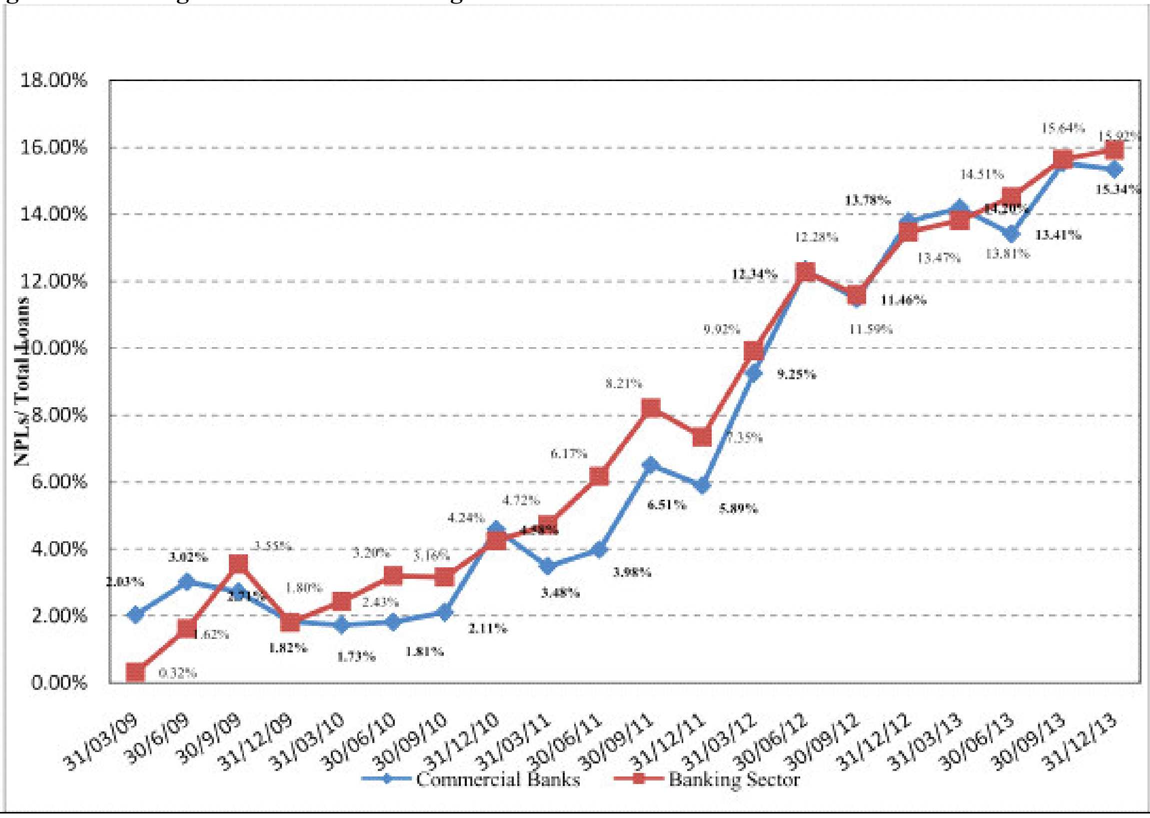
Non-Performing Loans

Table 5: High default impact on credit creation

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Agree	13	32.5	32.5	32.5
	Strongly agree	22	55.0	55.0	87.5
	Disagree	3	7.5	7.5	95.0
	Strongly disagree	2	5.0	5.0	100.0
	Total	40	100.0	100.0	

The study also established that the increase in the level of non-performing loans was another challenge that impacted negatively on credit creation. The credit quality of commercial banks deteriorated as indicated by the worsening of the level non-performing loans which increased by 667% between 31 March 2009 and 31 December 2013. An increase in the level of non-performing loans forces commercial banks increase the level of loss provisions. However, provisions have an opportunity cost in the form of amount of loans that could have been made. Non-performing loans therefore reduce the level of cash flows that can be used to create more loans.

Figure 3: Banking Sector Non-Performing Loans 2009-2013



Source: Reserve Bank of Zimbabwe Policy Statement 2013

Political Risk

Table 6: High Political Risk Impacts on Credit Creation

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Agree	4	10.0	10.0	10.0
	Strongly Agree	35	87.5	87.5	97.5
	Disagree	1	2.5	2.5	100.0
	Total	40	100.0	100.0	

Another critical challenge in credit creation that was faced by commercial banks was the high level of political risk. 97.5% of the respondents indicated that high levels of political risk hindered banks from creating credit. High political risk deters investment in the financial sector. Some commercial banks needed capital ejections from abroad to meet minimum capital requirement but could not attract this because high levels of political risk. Lower capital levels affect the ability of commercial banks to absorb losses. In the light of increasing levels of non-performing loans, lower capitalization negatively affected the ability of banks to create credit.

Table 7: Deposit rates impact heavily on credit creation

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Agree	14	35.0	35.0	35.0
	Strongly Agree	25	62.5	62.5	97.5
	Disagree	1	2.5	2.5	100.0
	Total	40	100.0	100.0	

Deposit rates

The results depicted in Table showed that 39 respondents, representing 97.5% indicated that deposit rates contributed to credit creation challenges which were experienced by commercial banks since 2009. Since 2009 when the economy dollarized, commercial bank deposit rate were too low to attract savings. In 2012, deposit rates averaged 4% (Reserve Bank of Zimbabwe, 2013). Zimbabwe has $2.5 billion circulating outside the formal banking system (ZIPARU, 2011). The low savings rate crippled the commercial banks' ability to attract deposits. Between January 2011 and August 2012, the real savings rate was below 5% as shown in the figure 4 below.

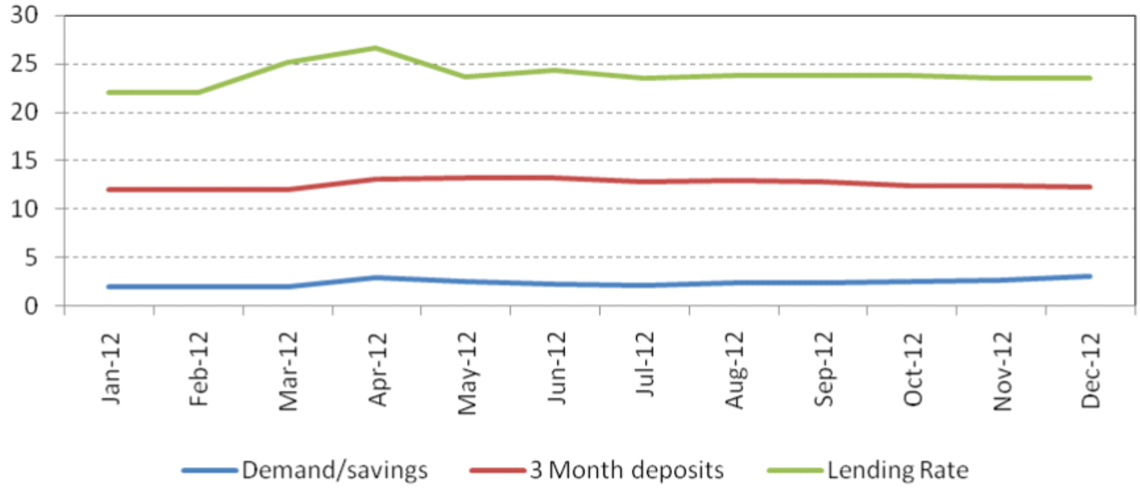
Figure 4: Average Deposit and lending Rates

Source: Reserve Bank of Zimbabwe Monetary Policy Statement 31 January 2013

The Lending Rate

In contrast to the low deposit savings rates, lending rates were averaging about 25% between in 2012. High lending rates increase the cost of borrowing. Highly leveraged firms will find it difficult to borrow when lending rates are high. This implies that effective demand for loans may be lower than possible. The figure below shows the lending rates in 2012.

Figure 5: Banking sector lending rate 2012



Source: RBZ (2013) Monetary Police Statement

Other Findings From the Study

Investment in dead capital was also found to be a major cause the inability of the commercial banking sector to advance loans to the manufacturing sector. When the economy dollarized there was a rush by firms to buy dead capital such as cars. Some of the acquisitions increase the operational costs of firms which resulted in high default rates.

It was also found that some manufacturing firms lacked turnaround strategies. As a result commercial banks were unwilling to finance such firms. The risk is high were management has no clear direction in which they are stirring the firm.

The study also established the capital structure in most of the manufacturing firms was not favourable to finance providers. Most firms were reported to have high debt bases from the period before dollarization which increased the probability of default as high levels are associated with high interest payments.

DISCUSSIONS AND CONCLUSIONS

The study sought to expose the causes and effects of the credit creation challenges faced by Zimbabwean banks since the introduction of the multi-currency system. This challenge was highlighted by the fact that demands for loans continue to outstrip the supply of loans in the financial system and the manufacturing sector continues to collapse due to lack of debt financing. The study found that the major reasons for this mismatch were that banks were unable to attract enough savings that could be transformed into loans due to low confidence in the country's financial system. The perceived country risk for Zimbabwe is very high. The lack of confidence motivated depositors to make transitory deposits. Respondents also indicated that the low confidence resulted in commercial banks failing to attract external credit lines. This is in agreement with findings from the study which was done by Ramon-Ballester and Wezel which concluded that high political risk was positively associated with capital outflows. Sandstorm (2008) also found out that political risk impacted negatively on credit risk.

The study found that inability of the central bank to take up its role as the lender of the last resort impacted negatively on credit creation. The current financial systems also lack of effective inter-bank lines of credit. However, data collected from secondary sources showed that the loans deposit ratio increased over the period under study but the increase was not enough to meet the high demand for loans from the manufacturing sector and other sectors of the economy.

Low confidence in the financial system was found to be a major impediment to credit creation in Zimbabwe. Depositors lost their deposits when the economy dollarized in 2009 and to date the government has failed to compensate depositors for their losses. Prior to the introduction of the multi-currency system depositors also lost their deposits during the Zimbabwean banking crisis of 2003-2004. These two unrelated events have since eroded deposit confidence in Zimbabwe's financial system. This has resulted in the low levels of longer term deposits in the financial system which is critical in deposit creation. Related to the lack of long term deposits is the result that banks in this study have been unable to offer loans with longer tenors. The short term loans that are generally on offer are expensive and make it harder for borrowers to meet their loan obligations especially given the liquidity crisis prevailing in the country.

The study also found that the high levels of non-performing loans also deter credit creation. From the data analysed the levels of non-performing loans has been increasing since the introduction of the multi-currency system. A study by Dullien (2009) established that non-performing loans limited credit creation by increasing the levels of provisions. The high levels of political risk in the country were found to deter credit creation in Zimbabwe. Banks in developing countries rely of foreign direct investment and external lines of credit in order to support their operations. These avenues have been drying up due to the high levels of political risk.

As a consequence of the credit creation challenges facing Zimbabwean banks, the recapitalization of the manufacturing industry following the introduction of the multi-currency system has been in limbo. Companies mainly rely on bank loans to finance their operations because during the course of them effecting banking transactions they are able to build solid relationships with their bankers. The fact that most bankers are currently constrained to issue loans to their customers has led to recapitalization efforts failing. The study also found that because of the credit creation challenges capacity utilization continues to dwindle in all productive sectors. This has resulted in most companies folding and laying off workers. This loss of household income sources has resulted in the increase in the number of people living in poverty in the country.

In light of the above findings and conclusions the study recommends that the regulators of the financial institutions in the country embark on financial sector stabilization programmes so as to restore depositor confidence in financial institutions. The study also recommends that regulators should be in a position to remedy problem institutions before situations require drastic measures such as placing financial institutions under curatorship. The study also recommends that financial institutions should offer meaningful rates on deposits to encourage more deposits in the financial system. With time these meaningful deposit rates would encourage more stable deposits which are conducive for credit creation.

Financing of the Manufacturing Sector

The study established that commercial banks were unable to fund the revival of the manufacturing sector due to a number of reasons. Lack of collateral was identified as one of the major obstacles in financing the manufacturing sector. The use of collateral is one of the techniques of managing credit risk. Infrastructure in industry collapsed when the economy collapsed. The manufacturing industry is also operating at low capacity levels. Beside collateral, respondents also indicated that severe competition from imported goods increased credit risk of the manufacturing sector. Competition from imports was found to be one of the factors negatively affecting the financial performance of the manufacturing industry in Zimbabwe. Some respondents pointed out that competition resulted in long cash conversion cycles and eroded profit margins of manufacturing firms which increased their default risk. As a result commercial banks were not keen to fund this sector due to fear of defaults. The Commercial banking sector was also concentrating on short-term loans due to transitory nature of deposits. Some respondents pointed out that long-term credit is risky and they could not offer long-term loans due to uncertainty in the economy. The other reason why the commercial banks were finding it difficult to fund the manufacturing sector was that they were not fully capitalized. A well-capitalized bank is able to absorb losses.

The study also found that the cost of funds was too high to the manufacturing sector which faced high operational costs. The average lending rate was 22% (RBZ, 2013). Table below shows lending rates for 2013.

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