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FINANCIAL LIBERALIZATION[1] AND CRISIS: EXPERIENCE AND LESSONS FOR ZIMBABWE

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[11] For purposes of this paper we use the financial reforms or liberalisation inter-changeably.

Contents

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Executive Summary

This paper provides a synopsis of the international and country experiences with financial liberalization/reform. The ultimate objective is to draw lessons from cross-country experiences on the design and implementation of financial reforms. The development of Zimbabwe's financial sector since the 1980s can be categorised into four distinct periods namely: (i) explicit financial repression period (1980 to 1990) (ii) reform period (1991 to 1999); (iii) period of reform reversals (2000 to 2008); and finally (iv) dollarization or multi-currency period (2009 to 2013). The explicit financial repression period (1980 to 1990) is characterised by a number of government controls on interest rates determination and credit rationing. Most of the controls were however removed during the reform period (1991 to 1999) when government adopted a financial reform policy agenda under the Economic Structural adjustment Program (ESAP) and the Zimbabwe Program for Economic and Social Transformation (ZIMPREST). The reform period saw a number of liberalization taking place including interest rate decontrol, licensing of new banking institutions which saw the emergence indigenous banks, establishment of bureau de change to facilitate buying and selling of foreign currencies and defragmentation of the functions of financial institutions.

The period of reform reversals (2000 to 2008) is characterised by policy reversals and the main highlights include foreign currency rationing following the banning of bureau de changes. This development induced the emergency of parallel market activities. The last period, the dollarization/multi-currency period (2009 to 2013) saw the suspension of the local Zimbabwean dollar currency from functioning as legal tender and instead allowance of multicurrency regime where currencies including the US dollar, South African rand, British pound, Botswana pula and Euro, among others were accepted as legal tender.

The experiences of countries, which embarked on financial reforms, have not always vindicated the predictions of financial liberalisation theory. Numerous studies have investigated the reasons for poor performance by the early reformers and lessons have been drawn from these countries. In some countries negative welfare effects of financial reforms, macroeconomic instability, capital outflows following capital

account liberalisation, poor designing and implementation of reforms, lack of finance (donor support) and sheer lack of political will to continue with reforms led to policy reversals.

Financial sector liberalization experiences from other countries provide a number of major lessons for countries such as Zimbabwe. A few lessons derived from the experience of different countries are highlighted in this study. These lessons need to be looked at within the context of Zimbabwe’s strategy for the development of the financial sector. As shown in the study Zimbabwe has developed financial sector that has been under performing in recent years owing to the adverse effects of hyperinflation and erosion of confidence in the financial sector following the adoption of the multi-currency system without going through a conversion process of the Zimbabwe dollar bank deposits. The paper concludes by drawing lessons from the other country experiences.

One of the key lessons is that financial reforms have the potential of resulting in negative welfare effects including macroeconomic instability, capital outflows following capital account liberalisation, poor designing and implementation of reforms, lack of finance (donor support) and sheer lack of political will to continue with reforms led to policy reversals.

1. Introduction

The financial sector development history of Zimbabwe has been dominated by episodes of financial repression. The main instruments of financial repression have included interest rate ceilings, selective credit rationing policies, restrictions on the remittance of capital, exchange controls and taxes on financial assets, zero-interest reserve requirements and a mesh of liquidity ratios. Inflation tax has also been used as a subtle form of financial repression. The rationale for financial repression has been based on the premise that government intervention would remedy the existing structural weakness of the market, channel resources to priorities sectors, which were considered as the engines of growth. Thus, the targeted sectors or companies that received subsidised credit (especially public enterprises) had easy access to scarce foreign currency (through import licences) and/or government guarantees (Chigumira, 2000).

The episodes of financial repression have been accompanied by low savings, excessive credit rationing and low investment. This adversely affected the quality and quantity of investment as bankers adopted credit-rationing policies and practices that encouraged inefficient and/or capital intensive projects. Banks are also likely to have invested less in risk assessment and monitoring systems especially where banks were forced to lend to targeted sectors.

There has been a burgeoning literature that questioned the wisdom of financial repression and provided financial liberalisation as an alternative framework for managing the financial sector. Within this literature financial repression has been considered as a second best strategy that is adopted when institutional constraints prevented Governments from collecting enough tax revenue to finance expenditure.

Asset price distortions caused by financial repression have inhibited the development of the financial sector and undermined the sector’s contribution to economic development. In particular, administered deposit rate ceilings in an environment of high nominal inflation rates resulted in negative real interest rates, which curtailed savings mobilisation. In this regard measures that repress the financial sector consequently reduce the size of the banking system and stifle financial intermediation. The emergence and perpetuation of financial dualism (the co-existence of the formal and informal financial sectors), has in part been attributed to repressive financial sector policies among other factors. The financial price differentials and market segmentation caused by this dualistic structure caused further distortions in the economy.

The main policy recommendation by McKinnon (1973) and Shaw (1973) and more recently from the endogenous financial development literature is to liberalise the financial sector. This entails decontrolling of interest rates, removing other controls that inhibited the development of the money and capital market. It was envisaged that positive real rates of interest would stimulate financial savings and thus expand real supply of credit within the financial sector. The increase in credit would consequently increase the volume of investment in productive sectors of the economy. This would ultimately stimulate growth not only through increased volume of investment but also due to increases in the average productivity of capital (see King and Levine 1993). Increase in productivity will arise because market determined interest rates, based on appropriate risk assessment will eliminate low risk and low-yielding investments in favour of high risk and high return investments.

Financial liberalisation featured as a major component of the International Monetary Fund (IMF) and World Bank supported structural adjustment programmes (SAPs) that were adopted and implemented in a number of African countries in the 1980s. Country experiences with financial liberalisation have been varied and wide depending on a number of factors including the initial conditions; market failures and sequencing of the reforms, among others. In some instances, financial liberalisation induced financial sector deepening and in others financial crisis. This paper provides a synopsis of the international and country's experience with financial liberalization/reform. The ultimate objective is to draw lessons from cross-country experiences on the design and implementation of financial reforms.

2. Summary of International Experiences on Impact of Financial Liberalisation

The experiences of countries, which embarked on financial reforms, have not always vindicated the predictions of financial liberalisation theory. Numerous studies have investigated the reasons for poor performance by the early reformers and lessons have been drawn from these countries (see Caprio et al (1994), McKinnon (1991) and World Bank (1989) and Fry (1997)). In some countries negative welfare effects of financial reforms, macroeconomic instability, capital outflows following capital account liberalisation, poor designing and implementation of reforms, lack of finance (donor support) and sheer lack of political will to continue with reforms led to policy reversals[2].

Key Lesson: Financial reforms have the potential of resulting in negative welfare effects including macroeconomic instability, capital outflows following capital account liberalisation, poor designing and implementation of reforms, lack of finance (donor support) and sheer lack of political will to continue with reforms led to policy reversals.

Fragility in the banking sector has been reflected by the accumulation of non-performing assets and declining profitability in the banking sector. High interest rates have tended to discourage long-term physical capital investment in favour of short-term portfolio and speculative investments.

Relaxation of entry restrictions into the banking sector favoured the emergency of new players in the banking sector (particularly locally registered/indigenous banks) in most Sub Saharan Africa. However, the expansion of the banking sector preceded the adoption of modernised legal and supervisory frameworks that took into account the new developments within the bank and non-bank financial institutions. Consequently the under supervised banks took excessive risks and in some cases engaged in over trading. Increased competition also led to the narrowing of margins and hence reduced profitability and mounting non-performing loans in banks (from the risk loans).

Insider lending, mismanagement and in some cases outright fraud have led to the collapse of some banks. In addition, deposit insurance schemes (either implicit or explicit) which shifted the cost of bank failure to the tax payer led to moral hazard problems where bank managers risked depositors' funds by undertaking risk ventures.

[2] See World Bank 1989

These factors threatened the viability of the financial system and in some cases led to bank failures[3].

The dismal results from the financial reform experience of many Latin American countries in the 1970s raised concerns about the implementation (sequencing and timing) of reforms and institution building (for example, the supervisory and regulatory frameworks). The equally poor performance and incidence of banking failures and increasing financial fragility in some SSA countries have reinforced these concerns. The response of investment and savings ratios in SSA following the introduction of financial sector reform fell far short of the overly optimistic expectations held by most governments and donors prior to adoption of SAPs (see World Bank, 1993 and 1994). Furthermore, the Mexican crisis in 1994 and 1995 as well as the 1997 Asian crisis highlighted the dangers of premature liberalization of the capital account and weak regulatory and supervisory framework to monitor the level of risks carried by banks and non-bank financial institutions.

Empirical investigations on the predictions of the financial repression/ liberalisation literature have uncovered the positive relationship between investment or economic growth and real interest rates or financial development indicators. However, some of these empirical studies also uncovered a negative and significant relationship between the real interest rate and economic growth, savings and investment. There are numerous surveys of this literature. Fry (1995) gives a concise summary of the cross-country studies on investment; savings and economic growth (see also World Bank, 1989, Gibson, et al., 1994, Levine, 1997 and Fry, 1997).

In particular the view that financial liberalisation has a positive influence on economic growth, investment and savings is defended by Fry (1997). Dornbusch (1990) argued that while there appears to be a positive relationship between economic growth and real interest rates, this relationship could not be attributed to the savings channel as suggested by the McKinnon-Shaw thesis. Dornbusch found that financial savings are not related to the level of interest rates and that the positive effect of real interest rates on growth came from the volume of investment. Khan and Villanueva (1991) and

[3] See Brownbridge (1998, pp. 172-188) on financial distress of local (indigenous) banks in Kenya, Uganda, Nigeria and Zambia.

Gregorio et al. (1995) interpret the positive impact of real interest rates on economic growth as the productivity (efficiency) of investment.

However, it has been shown that prohibitively high nominal interest rates, following financial liberalisation, can have a negative impact on output where firms are heavily dependent on banks for working capital. This could arise from intensification of credit rationing, increased production costs or increasing indebtedness among firms as the costs of debt servicing increase. Gregorio et al. (1995) argued that the uncovering of a negative and positive relationship between economic growth and real interest rates might suggest an inverted U-curve type relationship. This argument has found empirical support from Fry (1993, 1997) and Pill (1997).

The ratio of domestic credit to private sector to gross domestic product (GDP) or broad money M2 to GDP has been used in the literature as a proxy for financial intermediation or financial development (see Gregory et al., 1995; King and Levine, 1993 and Levine, 1997). King and Levine (1993) found evidence that financial development indicators are positively correlated to economic growth indicators. Hermes and Lensik (1993) and Ghani (1992) report similar evidence. Some studies do report a negative relationship between financial indicators and investment or economic growth (see Odedokun, 1996; Oshikoya, 1994; and Thorton, 1996).

The general conclusion that seem to emerge from the literature examining the effect of interest rate liberalisation is that savings are not sensitive to interest rate changes (see Fry, 1995; Edward, 1996; Villagomez, 1994; Isaksson, 1997; and Bandiera et al., 1999). Evidence based on the Feldstien and Horioka (1980) type regressions also suggest that financial liberalisation improved capital mobility or improved access of developing countries to capital markets (see Isaksson, 1997 and Montiel, 1994).

3 Zimbabwe's Financial Sector Development

The development of Zimbabwe's sector since the 1980s can be categorised into four distinct periods namely: (i) explicit financial repression period (1980 to 1990) (ii) reform period (1991 to 1999); (iii) period of reform reversals (2000 to 2008); and finally (iv) dollarization/multi-currency period (2009 to 2013). Within each period there are episodes of financial sector reforms which the study seeks to interrogate in terms of their influence in shaping the development of the financial sector and some of the policy challenges that emerged.

3.1 Episode of Administratively Controlled Interest Rate and Credit Rationing

In the period 1980-1990 the financial sector in Zimbabwe had administrative controls on deposit and lending rates as well as various implicit and explicit taxes on their financial products. The administratively controlled interest rates were infrequently adjusted to take account of rising inflation. The policy of financial repression which was based on the conventional wisdom of the 1960s and 1970s financial sector development literature was extended from the pre-1980/independence era. For example, all categories of interest rates of commercial banks, building societies and the Post Office Savings Bank did not change from 1974 to 1980. In 1981 there was an across the board adjustment in all interest rate which again remained unchanged until 1991. The table below shows the profile of selected interest rates between 1980 and1990.

Table 1: Nominal Interest Rates and Annual Inflation Rate (Percent)

Rate Type	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990
NCD	4.88	9.5	12.4	12.6	10.6	10.9	10.1	10.8	10.5	10.3	10.6
TB	3.46	5.74	8.52	8.49	8.46	8.52	8.70	8.69	8.33	8.13	8.80
BR	4.50	6.75	9	9	9	9	9	9	9	9	9.63
CBD	4.4	8	11.6	11.5	10.3	10.1	9.8	9.9	9.8	9.7	9.5
C BL	7.50	10.3	13	13	13	13	13	13	13	12.3	11.8
Infl	5	13	11	23	20	8	14	12	7	13	17
RCBL	2.5	-2.7	2	-10	-7	5	-1	1	6	-0.7	-5.2
RCBD	-0.6	-5	0.6	-12	-9.7	2.1	-4.3	-2.1	2.8	-3.3	-7.5
RNCD	-0.1	-3.5	-0.6	-10	-9.4	2.9	-3.9	-1.2	3.5	-2.7	-6.4
Spread	3.1	2.3	1.4	1.5	2.7	2.9	3.2	3.1	3.2	2.6	2.3

Sources: Reserve Bank Quarterly Bulletin of Statistics, 1992 and Author's calculations.

Notes: NCD-90 day negotiable certificate of deposit rate, TB-Treasury Bill Rate, CBD-average commercial bank deposit rate, CBL- average commercial bank lending rate, Infl- average annual inflation rate, RCBL and RCDB real commercial bank lending rate and deposit rates respectively. RNCD-real NCD rate and Spread- difference between nominal commercial bank lending (CBL) and deposit (CBD) rates.

The interest rate for much of the 1980-1990 decade followed the bank rate, which was fixed for much of the period. Inevitably because of rising inflation, both real deposit and real lending rates were negative for much of the period. Negative interest rates persisted even after the commencement of financial reforms in 1991 until 1993, when they became positive.

3.1.1 Credit Rationing

The government also used prescribed asset ratios; preferential rates to public enterprises and moral suasion to allocate credit to priority sectors such as agriculture. However, the predominant means of credit allocation was the foreign exchange control mechanism. In the 1980s the foreign exchange allocation system became the most important policy instrument affecting short and long-term decisions of enterprises both in the private and public sectors. The government allocated all foreign exchange to firms for both working capital and investment purposes. The allocations were based upon historical allocations to firms as well as specific assessments of the current needs of enterprises and the availability of foreign exchange.

Thus, the foreign exchange allocation system provided a de facto control over the allocation of credit. Established users of foreign exchange got regular shares, and could apply ad hoc for extra allocation. Companies applying for foreign exchange had to demonstrate net savings on foreign exchange in investment proposals. This meant that export oriented firms were more favoured by this system as their foreign exchange earnings were likely to minimise their demand for foreign exchange. Import licences also went automatically to firms or some individuals, allocated foreign exchange (see Davies, 1990). Thus, the allocation of foreign exchange to a producer effectively guaranteed profitability.

Furthermore, firms that were unable to qualify for foreign exchange allocations were likely to be regarded by banks as not creditworthy. This had adverse implications on these firms' future profitability given that expansion of operations could have been hindered by the failure to acquire foreign exchange to import intermediate inputs. Commercial Banks generally considered past and future profitability of an enterprise and collateral security when extending credit. In this regard, exchange controls directed credit to industries which government considered as engines of growth without instituting the standard explicit directed/selective credit policies.

Given the relatively small number of such large companies or export oriented firms this policy was likely to lead to high loan concentration ratios. The central bank also used various controls in conjunction with the foreign exchange allocation mechanism to influence the flow of credit away from traditional uses towards those, which the state considered conducive to growth, like the export sector. For example, the multiple discount rate system lowered the cost of discounts of favoured types of commercial paper (from the money market) so as to reduce the cost of funds to those activities from which the paper originated from.

3.1.2 Government Ownership of Banks

Government ownership of banks was considered strategic in the 1960s to 1980s in most developing countries. The key rationale for this policy position was Governments' desire to influence the direction of credit in order to spur development which was elusive. In Zimbabwe there were four commercial banks and four merchant banks all of which were foreign owned in 1980. The government was generally concerned with this ownership structure where foreign owned banks controlled the financial sector.

Other countries in independent Africa had dealt with this perceived anomaly through nationalisation of foreign banks but not without adverse impact on the development of the financial sector. Having observed the disastrous consequences of nationalisation of banks in other African countries in the region the Zimbabwean government was cautious not to interfere with the financial sector let alone nationalising banks.

This cautious approach was influenced by a number of factors. Firstly, by 1980 the time when Zimbabwe got independence, development opinion was shifting away from excessive government control of financial markets towards more market-oriented policies. Secondly, the experience of other Sub-Saharan African (SSA) countries particularly Tanzania and Mozambique indicated that state ownership of commercial banks does not guarantee that savings will increase significantly and that resources will flow towards sectors of the economy which are likely to contribute more to economic growth.

Thirdly, expert advice given to the government in 1980 suggested that the easier and more effective alternative for the State to participate in the financial sector was through creating its own banks which would compete with the foreign owned banks. This arrangement coupled with foreign exchange controls to prevent foreign owned banks from transferring abroad funds raised in Zimbabwe was seen as being more effective than nationalisation or buying out foreign owners of banks[4] (see Tsumba 1980). It was envisaged that the Central Bank would supervise all banks so as to ensure credit will flow to those areas of investment activity the State considered crucial for economic growth. In this regard the key to mobilisation and allocation of savings to productive investments was seen as a control of the financial system rather than ownership (see Tsumba, 1980, Chigumira, 2000).

In 1980 the Government bought 62 percent of RHOBANK (a subsidiary of Netherlands Bank of South Africa (NEDBANK)) and changed its name to Zimbabwe Banking Corporation (ZIMBANK). This was prompted by NEDBANK's withdrawal from the Zimbabwean financial sector and the Government's desire to maintain confidence in the banking system. By 1993, the Government's share of Zimbabwe Financial Holdings Limited, which held 100 percent of ZIMBANK was reduced to 49,6 percent (Finhold Annual Report 1992/1993).

The government also bought 47 per cent shares in the only commercial bank (deposit taking financial institution) set up in the 1980s, the Bank of Credit and Commerce Zimbabwe (BCCZ). This bank was established in partnership with Bank of Credit and Commerce International (BCCI), which held 53 percent of the shares. Consistent with its implicit Deposit Insurance Policy the Government bought all BCCI shares following the international collapse of the BCCI. Consequently, the banking license of BCCZ was cancelled and a new bank the Commercial Bank of Zimbabwe, which was wholly owned by government, was registered in its place. Harvey (1998) observed that this was an accidental nationalisation which was consistent with government's de facto policy of buying failing firms through the Industrial Development Corporation (IDC) in order to prevent closure and save jobs.

[4] Buying of private banks by the State in a country where banks were not bought or sold on a daily basis was seen as not being a viable option, because there was no sufficient information to evaluate the quotations offered by current owners (Tsumba, 1980).

In the financial sector this meant maintaining the soundness and confidence in the financial system. After undergoing some restructuring and setting up a Nominee company to administer its bad debt book, the CBZ became profitable and has been one of the leading commercial banks in Zimbabwe since the late 1990s. In 1998 CBZ was privatised and the government's shareholding was reduced to 20 percent. The CBZ was also listed on the Zimbabwe stock exchange in 1998.

3.1.3 Establishment of Development Financial Institutions

The Government, in partnership with other international institutions[5], established the Zimbabwe Development Bank (ZDB) in the early 1980s. The ZDB was set up to provide medium-to-long term finance for development projects, which generally fall outside the domain of commercial banks given the nature of their liabilities. In addition the ZDB also arranged foreign currency facilities for its customers and provided a soft loan facility in the form of equity type capital to small-scale enterprises. The Small Scale Development Corporation (SEDCO) which is wholly funded by government was, also set up in 1984 to cater for the historically neglected small-medium scale enterprise sector. The government also had minority shareholding in other non-bank financial institutions. To a large extent the bulk of the Zimbabwean financial institutions remained under the control of the private sector.

4. The Need to Liberalize the Financial Sector

The Government's intention to liberalise the financial sector was first raised in the three-year Transitional Development Plan ((TNDP) 1982-1985, p. 46). In this policy document Government planned to set up a Monetary, Credit and Financial Commission to investigate and study recommendations on appropriate reforms in area of money, credit and finance[6]. The Government noted at the time that the existing financial system would not cope with requirements of the new socio-economic order which would impose enormous demands on the system (TNDP, p. 45), hence the need for reform.

However, the Monetary, Credit and Financial Commission did not materialise. The

[5] Constituting of government of Zimbabwe 51%, DEG (Germany), European Investment Bank, and Reserve Bank of Zimbabwe, Finfund (Finland), FMO (Holland), Commonwealth Development Bank and the African Development Bank.
[6] See also Tsumba (1980, p. 407)

subsequent First Five Years National Development Plan (1986-1990) was silent on financial liberalisation. The idea of liberalising the financial sector was resuscitated under the Economic Structural Adjustment Programme (ESAP 1991-1995). The main objectives of the financial reforms programme under ESAP were to remove controls on the direction of bank lending; decontrolling interest rates; liberalising the licensing of new banks and non-bank financial institutions (NBFIs); improving delivery of financial services and removal of legal barriers that inhibited financial institutions to operate across markets.

Legislative segmentation had historically nurtured limited competition in the financial sector. Government also intended to enhance competition among existing domestic institutions. Restricted entry into the financial sector had encouraged the development of an oligopolistic financial sector. Thus, the licensing of new banks was expected to increase competition and hence eliminate the collusive behaviour that had long been an entrenched feature of the Zimbabwean financial sector especially in the deposit taking financial institutions (DTFIs).

5. Moral Hazard and Financial Fragility in the Zimbabwe Banking System

Liberalizing the bank licensing regime in an environment where the supervisory and regulatory framework is not strengthened can facilitate moral hazard (or adverse incentives) among bank owners. Moral hazard occurs where bank owners act contrary to the interest of their creditors, mainly depositors or government especially where deposits are implicitly insured. In this regard banks gamble with depositors' funds through lending at high interest rates to high-risk borrowers, which if unsuccessful will adversely affect the solvency of the bank. Bank owners have an incentive to undertake such strategies if they have limited liability. In this case they will only bear a portion of the down side risk while gaining in huge profits if the gamble succeeds. In contrast, depositors (or deposit insurer) gain little when the venture succeeds but bear the huge costs if it fails. The inability of depositors to monitor bank owners adequately, because of asymmetric information and free rider problems, allows bank owners to undertake high-risk investments (not fully compensated for by deposit-rate risk premium).

Stiglitz and Weiss (1981) observed that an increase in interest rates could lead borrowers to choose investments with higher returns when successful, but with lower probability of success. Thus, a rise in deposit rates following the liberalization of interest rates leads banks to adopt more risky investment strategies through adverse selection. Macroeconomic instability can also worsen adverse incentives, if it affects the variance of profits of banks' borrowers, especially when there is co-variance between borrowers' profits. This would happen if a large share of borrowers is in the same industry or if loan portfolios are not well diversified among borrowers (McKinnon, 1988).

The expectation that the Government will bail out a distressed bank may weaken incentives of bank owners to manage their asset portfolio prudently. For example, following the collapse of United Merchant Bank in 1998, some banks were exposed because of UMB's fraudulent sale of fake Cold Storage Company Bills. In response to this crisis the Reserve Bank of Zimbabwe (RBZ) put in place temporary liquidity arrangements under which short-term secured funding was made available to banks experiencing temporary liquidity problems. Similarly, the RBZ took over the management of Zimbabwe Building Society (ZBS) which was seriously undercapitalized. These measures were consistent with the Implicit Deposit Insurance Policy of the Government at the time. However, such measures built in expectations that may have lowered incentives for depositors to choose only those banks with a reputation for prudent management and for banks to enhance risk management.

Moral hazard tends to be rife where the owners of undercapitalized banks have little shareholder capital to lose from risky investments (Caprio and Summers, 1993). Moral hazard becomes even more acute when a bank lends to projects connected with its own directors or managers (insider lending). In such cases the incentives for imprudent lending are greatly increased because all the profits from the project are internalized where as that part of the loss incurred by depositors is externalized. It can be argued that bank failures and accumulation of non-performing loans that have been evident in recent years in Zimbabwe had their origins to moral hazard problems in particular insider lending.

For example, in 1996 Zimbabwe Financial Holdings (FINHOLD) disposed a book of non-performing debts to another company (Climax Investments) in an effort to rid itself of its non-performing loans (see FINHOLD Annual Report, 1996 and ZSE, 1997). The bulk of non-performing loans originated from the lending activities of the commercial bank sector (ZIMBANK).

Similarly, a nominee company was formed to administer Commercial Bank of Zimbabwe's book of non-performing assets. The problem of non-performing assets was highlighted in several RBZ annual reports (see RBZ, 1995.p.36, 1996. p.33, 1997, pp.31-32, and 1998, p. 35-36). Imprudent investment decisions and increasing competition in the financial sector, have been cited as the main causes of the accumulation of non-performing loans. The deterioration in asset quality coupled with increased competition from newly formed banks has reduced profitability of most banks, as margins were squeezed. For example, net margins (proportion of net interest income to total interest income) on average fell from 25.5 percent in 1994 to 14.2 percent in 1995 and to 11.6 per cent in 1996 (see RBZ, 1998).

Problems of insider lending, breaching loan exposure limits, maturities of assets and liabilities mismatching, loan concentration and excessive concentration of ownership caused bank failures in other Sub Saharan African that undertook financial reforms without strengthening the regulatory frameworks (see Brownbridge, 1998).

6. Outcome of Interest Rate Decontrol in Deposit Taking Financial Institutions (DTFIs)

One of the highly publicised effects of financial reforms is the prohibitively high interest rates. Several factors such as distress borrowing, high and variable inflation, increased competition for credit between the private and public, restrictive monetary policies and increasing cost of intermediation propelled interest rates upwards after they were decontrolled. High operating costs can be a symptom of inappropriate bank management as banks, which suffered losses in their capital base, invest in risk projects to recover losses quickly. Such banks would increase deposit rates to attract new deposits. High reserve requirements and discount (bank) rates dictated by the RBZ to restrict money supply are generally passed on to clients as high lending rates.

The short-term negative effects of trade reforms could have created a false demand for credit by firms, as they perceived the losses to be temporary. This generally occurs when trade reforms are not credible. The high interest rates could also be due to an overvalued exchange rate, which generated expectations for devaluation. The exchange rate was devalued by 17 percent in 1994, which shows that at the beginning of the reform period when the country experienced very high interest rates, the exchange rate was overvalued. The divergence between the re-discount rate (which reflects the monetary policy stance) and the lending rate may indicate slow adjustment of interest rates caused by collusion in the oligopolistic banking sector. Limited competition in the banking sector makes interest rates relatively sticky downwards. Overall the performance of interest rates after they were decontrolled in 1991 can be explained by factors discussed above. High lending rates of the magnitude shown in the table 2.9 increased the real cost of borrowing. The real lending rate exceeded the real return on capital, which for most investments did not exceed 4 percent.

Table 2: Nominal Interest Rates and Annual Inflation Rate (Percent)

	1991	1992	1993	1994	1995	1996	1997	1998*
90 day NCD Rate	22.5	37.0	29.0	30.3	31.0	19.3	32.5	36.0
Treasury Bill Rate	13.9	35.5	27.0	29.6	29.5	18.5	29.9	31.5
Re-discount Rate	15.2	29.0	28.5	29.5	29.5	29.1	30.0	31.5
Overnight Rate	20.0	32.5	28.5	29.5	32.4	29.1	32.4	34.2
Lending Rate	36.7	39.3	31.8	30.3	34.7	33.6	34.7	44.0
Annual Inflation Rate	30.2	46.4	18.6	21.1	25.8	16.4	20.1	33.7
Real Lending Rate*	6.5	-7.1	13.6	9.2	8.9	17.2	14.6	10.3
Real Deposit Rate*	-7.7	-9.4	10.4	9.2	5.2	2.9	12.4	2.3
Spread **	14.2	2.3	2.8	0	3.7	14.3	2.2	8
Spread ***	21.5	10.3	3.3	0.8	5.2	4.5	4.7	12.5

Source: Reserve Bank Annual Report 1998 p. 58, *lending rate and 90 day NCD net of inflation and ** difference between nominal 90 day NCD rate and Lending rate; *** difference between re-discount rate (bank rate) and lending rate

Consequently, most companies downsized their operations or closed shop resulting in large job losses. Concerns of looming de-industrialisation in the manufacturing sector have been linked to high cost of borrowing (see Ndlela, 1998 and Moyo, 1998)[7]. There were 29 companies that were liquidated from 1990-1992. Companies struck from the Company Register amounted to 1,273 for the period 1990 to the first quarter

[7] High cost of credit has been detrimental to industrial growth and has raised concerns of de-industrialisation in SSA (Lall, 1992, Taylor, 1993).

of 1995 and 564 of these were de-registered in 1992 alone (CSO, 1998, p, 65). In this regard the outcome of financial liberalisation was not consistent with the stated goals of increasing investment and economic growth.

In addition, high interest rates also led to a shift in resources from fixed capital formation to lucrative money market securities. It can be argued that the high spreads between borrowing and lending rates were a reflection of high operating costs, transactions and default cost. These factors coupled with the increasing level of uncertainty in the economy led banks to alter their portfolio from long-term to short-term maturities. Information deficiencies and lack of reputation can also cause banks to prefer short-term loans in-order to keep borrowers at arm's length (Collier, 1993). Focusing on short-term lending by banks undermined their function of maturity transformation. Banks' role was restricted to brokerage were they matched maturity of their deposits to loans.

The maturity transformation function of banks is intended to facilitate liquidity creation especially for the long-term side of the market. When banks engage in maturity transformation the incentives to monitor and screen borrowers is increased and financial intermediation is enhanced. The shortage of long-term capital surfaced during the financial liberalisation period. Companies, which failed to raise long term capital, had to cut back on their investment plans including replacement of obsolete equipment. This undermined capacity utilisation, productivity and competitiveness of Zimbabwean industries.

Growing levels of indebtedness of both private and public sector enterprises mainly due to high interest rates resulted in an accumulation of non-performing loans held by banks. Consequently the financial sector became increasingly fragile as some banks became under-capitalised[8]. Most banks became risk averse and reverted to lending criterion based on collateral security as opposed to project viability, an idea some banks were beginning to buy into. This was another blow to small-medium scale enterprises (SMEs) which lacked physical assets in place that qualify as collateral

[8] In Tanzania and Senegal a high level of non-performing loans from loss making or bankrupt state owned enterprises, led to banking crisis.

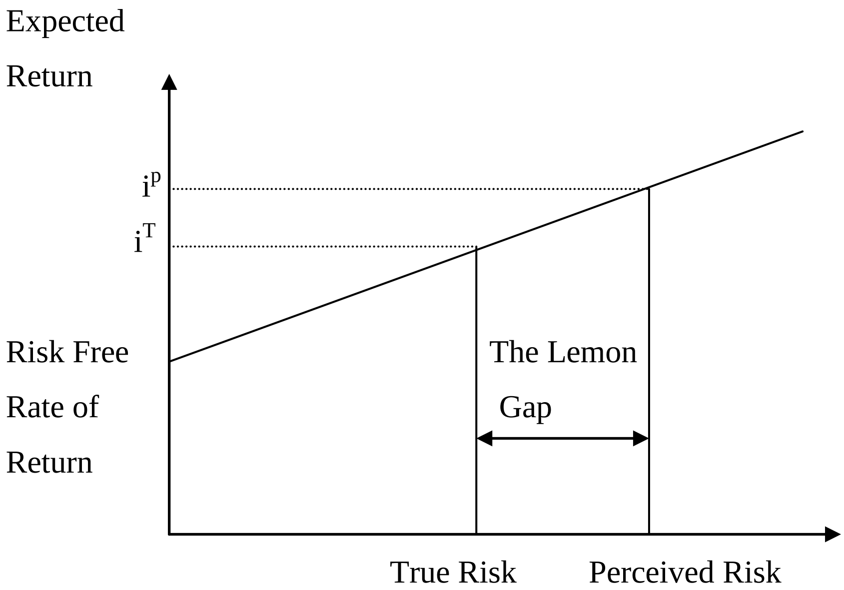
security. This sector has for long been denied credit on the basis of lack of collateral security.

7. Financing Small-Medium Scale Enterprises under a Liberalized Regime

Generally access to finance by small-medium scale enterprises (SMEs) is difficult in most developed countries. One of the objectives of financial reforms has been to easy credit constraints faced by SMEs. Anecdotal evidence from country experiences shows that there is generally a bias in lending by commercial banks in favour of large enterprises. The rational for this trend is generally ascribed to high risks associated with lending to SMEs. The systematic bias against SMEs financing, even in a liberalized environment, can be explained by Akerlof's (1970) theory of the "market for lemons". Because, small businesses are regarded as high risk, the level of risk associated with the riskiest small business tends to be applied to all businesses.

Consequently, bad businesses tend to drive good businesses out of financial markets, as the latter have to raise equity or debt on terms that exaggerate their risk. The gap between the true risk and the perceived risk can be termed the "Lemon Gap". Only in cases where financiers are in a position to assess correctly the true risk of small businesses can the cost of capital match the true risk. This may be the case with local moneylenders, but is seldom the case with formal sector financial institutions (Kitchen, 1989).

Figure 1: Risks and Rate of Return Faced by SMEs



Source: Akerlof (1970)

The costs of loan investigation and administration are not proportional to the size of the loan, and weigh more heavily on smaller loans than larger loans. The cost of loan investigation can largely be eliminated if the lender requests for collateral instead of monitoring the use of the loan. However, reliance on heavy collateral security is an impediment to SMEs that have high growth potential but limited tangible assets that qualify as collateral. Borrowers that are endowed with assets in place (mostly established businesses) tend to be favoured by the collateral security requirement at the expense of small and new entrepreneurs. In an economy such as Zimbabwe where banks collude rather than compete, a borrower denied credit by one bank is unlikely to obtain credit in another bank. In this regard high collateral requirements can lead to under-investment.

Financial reforms that led to the removal of controlled interest rates and high reserve requirements were expected to alleviate credit rationing for SMEs. Financial sector reforms measures adopted in the 1990s also shifted the focus from directed and concessionary lending in favour of market based lending. This resulted in binding credit constraints for SMEs that could not access credit at the prevailing high interest rates that were not commensurate with their rate of return on investment. However, it is important to note that the elimination of the lemon gap may be socially desirable in relation to the benefits derived of increased investment and employment in the SMEs sector.

In most developing countries the lemon gap has been reduced through the provision of subsidized institutional finance for SMEs and credit guarantee schemes. Government in its bid to promote the development of the SMEs sector encouraged banks to consider project viability in their lending criteria as opposed to using lending models that focus mainly on traceable banking record and valuable collateral. Banks responded by opening SMEs windows with products designed for this category of borrowers. However, most of these facilities did not have adequate funds to meet the huge demand for SMEs funding.

During the financial reform period there were also moves to diversify options for funding SMEs and start businesses through the promotion of the formation of venture capital companies that provided equity finance to high risk but high return SMEs projects. Anderson and Khambata (1985) argued that an efficient supply of finance to SMEs requires the simultaneous liberalization of the level and structure of interest rates and the development of schemes for sharing risks and administrative costs between the public and private sectors.

They observed that focusing on one (interest rate) without considering other risk sharing factors was unlikely to lead to positive developmental impact. They suggested that lending schemes to SMEs should be subsidized but not through concessional interest rates. Subsidies can be justified by the externalities that arise as lending institutions learn from experience to discriminate between potentially efficient and inefficient investments (Anderson et al., 1985) and on the grounds that SMEs are more efficient and dynamic than larger enterprises (Kitchen, 1989) [9].

Commercial banks also opened internal SMEs windows or departments during the financial reform period. However, the high interest rate regime that followed the liberalization of interest rates in the 1990s increased the cost of borrowing for SMEs and thus restricted access to credit for some SMEs. In addition commercial bank lending was more focused on short-term working capital as opposed to medium to long-term capital that was required by SMEs to expand and grow their businesses. This funding gap for medium to long-term capital was supposed to be filled by the Small Enterprise Development Company (SEDCO) and Zimbabwe Development Bank (ZDB). Both SEDCO and ZBD were not adequately capitalized to meet the growing demand for medium to long-term credit.

8. Financial Sector Reforms & Venture Capital Companies

Financial sector reforms in the early 1990s brought with them new financial institutions that were not part of the financial sector landscape. For example, the first venture capital company was launched in May 1991 by the Reserve Bank of Zimbabwe in conjunction with the commercial banks, insurance companies, local industrial companies, the International Finance Corporation (IFC) and the

[9] To summarise, the prima facie case for policy interventions in favour of SMEs as a means of raising overall welfare in developing economies must rest on evidence that small units on average use factor inputs more productively than larger counterparts, so that a shift of resources in favour of smaller units would yield net increase in output as well as an increase in the demand for unskilled labour (Little, 1987).

Commonwealth Development Corporation (CDC). By 1997 there were two venture capital companies (VCCs). Their main function was to provide equity capital to support the growth of emerging business enterprises lacking adequate capital. The VCCs participated in partnership with small enterprises in commercially viable projects, either alone or as a syndicate with other financiers. This ensured the spreading of risk.

In this regard the venture capital companies reduced the "lemon gap" and compensated for the weaknesses of commercial banks in that they were not nurturing promising and viable small businesses through the provision of strategic, managerial and technical support. This strengthened the usually thin and hard-pressed management of SMEs and reduced the risk of failure.

However, the development of venture capital finance/equity finance was restricted by the paucity of funds and institutions willing to offer equity finance. In some cases equity financing has been restricted by government-induced and "natural" financial market imperfections. The development of equity financing requires instituting favourable tax policies, dis-investment channels (for example the development of stock market) and a positive attitude towards risk takers (innovators). This means providing an operating environment that motivates investor to undertake profitable wealth creating activities.

9. Financial Sector Reforms & the Zimbabwe Stock Exchange (ZSE)

The commencement of financial reforms generated a great deal of optimism and consequently 1991 was a boom year on the ZSE. However, this boom was short-lived as the stock market experienced a slump in 1992. This has been attributed to the devastating drought in 1992 and the high nominal interest rates (on the money market). In a bid to resuscitate the ZSE the, government allowed foreign participation on the ZSE and consequently there was an increase in the flow of foreign capital as from 1993.

The opening of the stock exchange to foreigners significantly increased activity on the ZSE and facilitated the mobilisation of foreign savings. Partly as a response to these measures the rate of capitalisation of ZSE rose from US$0.63 billion in June 1993 to almost US$1.86 billion at the end of March 1994. The net cumulative value of shares by foreigners increased from zero in mid 1993 to US$48.5 million by March 1994.

Table: 3 Stock Exchange Indexes: Share Price Index (1967 =100) and Share Turnover Index (1976 = 100)

	1991	1992	1993	1994	1995	1996	1997	1998*
Industrial Share Index	1953.6	865.6	2325.3	3160.8	3972.6	8786.3	7196.4	8795.7
Mining Share Index	388.3	180.3	515.8	1043.1	1329.0	1083.7	458.4	476.1
Volume	302.3	253.3	2705.2	1477.2	1772.7	5383.7	2597.2	3894.4
Value	375.2	203.6	3041.7	3880.0	2111.5	19610.6	8554.1	9079.1
Dividend Yield (%)*	6.06	11.32	3.65	5.40	5.80	3.66	3.56	3.71
Earnings Yield (%)*	7.05	2.83	9.03	7.05	6.84	5.40	9.59	11.63

Source: Reserve Bank Annual Report 1998. * Industrial shares.

The share indexes and share turnover also firmed considerably following the increase in activity on the ZSE from 1993 up to 1996 when they started to decline (see table above). The poor performance of the mining index after 1995 reflects poor prices on the world market of Zimbabwean mineral exports[10]. In 1996 the ZSE was regarded as one of the top performers among emerging markets. By December 1996 there were 64 listed companies on the ZSE with a total market capitalisation of 33.5% of GDP. This was an increase from 54 listed companies in 1989 (pre-reform) with a total capitalisation 16.3% of GDP[11].

In spite of the increased foreign participation following liberalisation of the ZSE, local participation was still limited and the stock exchange was characterised by low volumes of script, as the number of listed companies was still low. The requirement that a company should have audited company accounts dating back five years may have inhibited the listing of new companies. Furthermore, such requirements cut out the floatation of many SMEs and thus inhibited the development of venture capital

[10] Prices on some of Zimbabwe's minerals such chrome, tin and gold have not been performing well in recent years resulting in reduced mineral exports and consequently the closure of some mines (for example Kamativi tin mine and some marginal gold mines).

[11] See Oyama (1997) for empirical evidence on the relationship between stock prices and macro-economic variables in Zimbabwe.

funds, as opportunities of dis-investment from SMEs were limited.

Other country experience have shown that equity markets around the have introduced a second tier markets as part of the reforms designed to foster the deepening of the equities markets. The second tier markets increase direct access for funds (including start-up capital) by players in the SMEs. The entry requirements into the second tier markets are generally less demanding and less costly. This has afforded upcoming companies to raise equity capital when they do not meet the minimum requirements of the general Stock Exchange. In some countries this has been achieved by setting up of the over the counter (OTC) market as the second tier of the stock market[12]. In Zimbabwe a similar though not identical arrangement exists where companies can offer shares to the public via the Post Office system.

During the 1990s when financial reforms were being implemented it was envisaged that a more developed Stock Market with wider participation by the investing public would enhance the financing of SMEs; provide government with an alternative way of issuing bonds and raising capital and provide an avenue to broaden the ownership of economy by the indigenous population. In particular a developed Stock market was considered as one avenue through which government divest from the public enterprises. Privatisation was part of the broader economic reform agenda. Furthermore, a developed stock market was also considered as an effective means for attracting foreign portfolio investment or venture capital into the economy to boost production. However, other country experiences have also shown that as the stock market develops, destabilising speculation, insider trading and other dishonest activities may nullify the benefits derived from a developed stock market. In this regard financial reforms measures meant to develop of the stock market can be destabilising unless they are accompanied by measures to strengthen the regulatory framework.

[12] Examples include the United States of America, the United Kingdom; Sweden, Saudi Arabia, Singapore and Kuwait and the USA NSDAQ market is the largest OTC market. However the experience with OTC markets has been mixed. Countries like Sweden, Singapore and Saudi Arabia have scored some success and the reputation of the OTC markets have been tarnished in the UK and Kuwait by dubious promotions of some market makers (see Kitchen 1989 p. 303-4 for details).

10. Financial Sector Reforms and Unit Trusts

Unit Trusts, which invest in both quoted and unquoted companies, was another new addition to the financial sector landscape that followed financial sector reforms in the 1990s. The first Unit trust was launched in 1993 followed by some in 1994 and 1995[13]. The Zimbabwe Association of Unit Trust was formed in 1995 in an effort to co-ordinate developments in this sector. Related to Unit Trusts are Investment Trusts. Since the inception of financial reforms there has been a mushrooming of different companies operating as investment brokers or investment trust companies. At the time of their formation there were no formalised investment trust regulations that governed the operations of these entities and provide clear-cut limits on gearing and avoidance of pyramid schemes. These developments showed that financial liberalisation in Zimbabwe opened up opportunities for setting profitable and innovative financial institutions without the requisite regulatory frameworks. The crises in the financial that arose from delinquent behaviour of the players in the 2000s can be traced to mushrooming of under-regulated financial institutions.

11. Financial Reforms and Macroeconomic Performance

11.1 Economic Growth

The average annual economic growth rate for the period 1980-1989 was 2.7 percent, which was below the population growth rate of about 3 percent. During the period 1986-1990 the economy registered a moderate economic growth rate averaging 4 percent per annum with the highest growth rate in 1990.

Contrary to the pre-reform expectations economic growth fell far below the pre-reform levels. During the first phase of economic reforms (1991-1995) the economy registered an annual average growth rate of only 0.8 percent. Lack of fiscal adjustment, deteriorating balance of payments and subdued investment and negative short-term effect of trade liberalisation were possible causes of the poor economic growth performance.

[13] These include First Mutual Unit Trust Management, Intermarket Southampton Asset Management Limited, Syfrets Corporate and Merchant Bank, Von Seidels Trust Company limited and Data World Nominees.

Investors had doubts about the credibility and sustainability of reforms in general which resulted in a weak response in investments. Ndlela (1998) observed that many Zimbabwean companies have not taken full advantage of trade liberalization because there were stuck in pre 1990 mind sets and not properly able to cope with the opening up of the economy. In this regard Zimbabwe's reform experience has been characterised by loss of credibility on the sustainability of reforms, particularly with regard to price and import controls. Lack of fiscal discipline, high inflation and escalating cost of living further undermined the credibility of reforms culminated in policy reversals in the 2000s decade.

Economic performance was also adversely affected by two droughts in 1992 and 1995, a period during which government was implementing economic reforms including financial reforms. These droughts were accompanied by negative economic growth rates to the tune of -5.5 and -1.1 percent respectively. Drought reduced agricultural production and huge food imports widened the current account deficit. The contraction of incomes caused by the drought also reduced effective demand for manufactured products, thus constraining further development of the manufacturing sector which strong forward and backward linkages with the agricultural sector. The initial conditions of an underperforming economy did not provide a conducive environment for undertaking financial reforms.

11.2 Investment

Implementation of economic reforms and financial reforms under the Economic Structural Adjustment Programme (ESAP) generated great optimism in the private sector that had endured a restrictive investment climate that existed prior to economic reforms. Investment increased on average by 4.2 percent from an average of 16.8 percent of GDP in 1986-1990 to 21 percent of GDP in 1991-1995. The increase in investment at the beginning of the reform period was based on expectations about future profitability.

Firms borrowed to invest in projects they and banks expected based on current profitability would generate profits more than sufficient to repay their debts. Paradoxically, the increase in investment over the period 1991-1995 was associated with lower GDP growth. The decline in domestic demand due to drought and the harsh economic conditions prevailing under ESAP sharply reduced production levels, so that new capacity remained underutilized.

High interest rates that followed the financial reforms; increase in competition and low consumer demand also increased the level of indebtedness among firms and the volume of non-performing loans in banks. Consequently banks curtailed lending to the real sector as the amount of risks increased. The unstable macroeconomic environment coupled with interest rates that far exceeded returns on real capital encouraged investors to have a short-term view about their investment activities. Instead of investing in long-term fixed capital investors opted more for short-term investments in trading and financial markets to make quick profits. Government investment did not compensate for the fall in private investment as it fell from 1.8 percent in 1986 to 0.3 in 1994.

11.2 Savings

In 1991-1995 saving rate as a percentage of GDP fell by 0.2 percentage points from the average of pre-reform (1986-1990 period) of 17 percent. The decline in aggregate savings was contrary to the pre-financial reform expectations that positive real interest rates would stimulate savings. The contraction in income in 1992 through 1995 took its toll on domestic savings. The relaxation of credit controls and import controls[14] led to an increase in demand for credit by private investors, thus increasing competition for savings which, prior to reforms, were channeled to budget financing.

Increasing budget deficit and decline in government revenue reduced government savings. Thus, ultimately aggregate savings as a percentage of GDP fell. This negated the positive impact of savings on investment and economic growth as evidenced by the decline in economic growth over the period 1991-1995. Investment in the early 1990s is likely to have been financed through a reduction in stocks rather than increase in savings as evidence by a fall in stocks. Stocks as a percentage of GDP fell on average by 1.4 per cent in 1991-95.

The ESAP target was to reduce the budget deficit from about 10 percent of GDP in the 1980s to 5 percent by the end of 1995. The average budget deficit (excluding

[14] The Open General Import License (OIGL) and its final abolition removed foreign exchange control constraint.

grants) registered 8.2 per cent of GDP for the period 1991-1995. This was not significantly different with the pre-reform figure of 8 per cent of GDP for the period 1986-1990. Revenue collection as a percentage of GDP declined by 0.8 percent points from the pre-reform average of 27.2 percent.

The budget deficit was 11.2 percent and 5.8 percent in 1996 and 1997 respectively. The high budget deficit, particularly in 1995 and 1996, has largely been due to the increase in salary and wages bill, increase in interest payments on government debt and subsides to loss making parastatals/public enterprises.

The interest component of the budget became more pronounced during the ESAP period, increasing by 1.1 percent from the 1986-1990 average. Interest payments as a percentage of GDP were 9.3% and 7.7% for the fiscal years 1995/96 and 1996/97 respectively. In the fiscal year 1997/98 the wage bill and interest rates on government loans (both domestic and external borrowings) made up 76 percent of total revenue and 61 percent of total expenditure respectively (see Chigora, 1998, pp.5-6). The cost of servicing external loans was worsened by the collapse of the Zimbabwe dollar on “black Friday” November 14 1997 while that of domestic borrowing has been worsened by high domestic interest rates.

Central to the problem of containing the budget deficit is the poor performance of government revenue. The poor performance in government revenue was due in part to the inefficient tax collection system, loss of experienced personnel in the Department of Taxes and the narrowing of the tax base (see Davies, 1997 and Robinson, 1998 and RBZ, 1997, p. 12)[15]. In a bid to improve revenue collection the government set up the Zimbabwe Revenue Authority (ZIMRA) as a semi-autonomous and centralized revenue collection institution.

11.3 Inflation during the Reform Period

Inflation averaged 23.2 % for the period 1991-95 and in 1995/96 and 1996/7 it averaged 19.3% and 21.3%, respectively. High inflation has translated into high

[15] In 1996 a one-off door-to-door campaign was launched where tax officer visited firms at their places of business. Millions of dollars of unpaid taxes were recovered within the space of weeks. This was an indication of inefficiency of the tax collection system, which allowed tax evasion to go unchecked.

nominal interest rates which ranged from 30 to 45 percent in the 1990s thus making the cost of borrowing prohibitive and adversely affected investment. With high inflation and unsustainable fiscal deficits, there was always a looming temptation of policy reversal (instituting financial repression) thus undermining the credibility and sustainability of financial reforms.

The RBZ maintained a tight monetary policy regime to constrain monetary growth for most of the reform period. Statutory reserves ratio were raised from 12.5 percent to 13.5 percent in February 1994. In June 1994 it was increased from 13.5 percent to 17.5 percent. In the same year the RBZ used treasury bills, special treasury bills, government stock and restrictive accommodation policy to mop excess liquidity in the economy. These measures were used in conjunction with adjustments of rediscount rate (bank rate) depending on the level of money supply growth.

In December 1996 the required reserve ratio was further increased from 17.5 percent to 20 per cent and compliance with the new ratio was changed from being fortnightly to weekly. In 1998 the statutory reserve ratio was increased to 25 percent. The restrictive monetary policy regime characterized much of the 1990s as the monetary authority battled to reduce and stabilize inflation. However, this was undermined by the increased reliance by government on credit from the central bank and the money market. Consequently, the inflation rate remained high and increased in the late 1990s. The annual rate of inflation increased from 53 percent in May to 55,2 June 1999[16].

The use of statutory reserves as an instrument of monetary control was weakened by the transfer of deposits from banks which were subject to reserve requirements to discount houses which were not. As we noted earlier, the RBZ responded by increasing statutory reserve on commercial banks and merchant banks and introduced reserve requirements for discount houses. This, among other things, was designed to redirect the non-bank deposits through the banking system, where they would be subject to reserve requirements (see RBZ, 1997, p.15).

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[16] Agenor and Montiel (1996) observed from data from a number of developing countries that reserve ratios on bank deposits and inflation are positively correlated. Countries using inflationary monetary expansion tend to combine higher tax rates with a larger tax base in the form of higher required reserve ratios (see Fry, 1995 and 1998, p.50).

11.4 Seigniorage and Inflation Tax and Implications of Financial Reforms

Government also raised seigniorage revenue through the monopoly privilege of currency issuing granted to through the Central bank. The use of the central bank to generate seigniorage revenue is particularly attractive where the traditional tax base is narrow/ shrinking and where the cost of collection of other forms of revenue is high. However, liberalisation of exchange controls and asset markets lowers the average and marginal seigniorage capacity of governments by increasing the elasticity of substitution between base money and other financial assets (see Ndulu et al., 1996 p. 531). The implications of this argument is that in the absence of stronger fiscal adjustments and improvements in tax revenue, as has been the case in Zimbabwe then, the government may have had an incentive to delay the implementation of some aspects of financial reforms to exploit implicit taxes.

For example, the government could have appropriated seigniorage through asset holding by the central bank which earned market interest rates while liabilities earned no interest. Implicitly, this allows the central bank to absorb the real interest to cover its costs. Here seigniorage revenue becomes government non-tax revenue when central bank profits are transferred to government. The Reserve Bank of Zimbabwe contributed profits arising from seigniorage in the 1995/96 (Z$781 million) and 1996/97 (Z$923 million) to government budgets, which is around 1% of GDP in each of these financial years (see Robinson 1998, p.8).

When the central bank extends interest free loans to government, the central bank's profits from such loans will be zero as it earns no interest on assets and pays no interests on liabilities. Thus, seigniorage revenue reduced government's interest costs rather than raise new revenue. The RBZ estimated that seigniorage revenue was in the region of Z$600 million per annum over the period 1990-1996. This shows how government relied on money creation by the RBZ during the ESAP period, as government expenditures remained high against declining revenue (see RBZ, 1997, pp. 27-28).

Country experiences have shown that in response to IMF pressure to reduce primary fiscal deficits, governments have delegated some quasi-fiscal activities to the central bank. These included the provision of implicit subsidies through loan guarantees, directed credit policies through subsidised rediscount rates, bailing out insolvent financial institutions, providing exchange rate guarantees and subsidizing implicit or explicit deposit insurance (Fry et al., 1996, p. 39). Thus, the amount of seigniorage generated will be reflected by the central bank expenditure quasi-fiscal activities.

The RBZ's involvement in the Credit Guarantee Company of Zimbabwe, bailing out of Zimbabwe Building Society and the provision of short-term liquidity to banks exposed by United Merchant Bank's collapse in 1998 qualify under quasi-fiscal functions of the RBZ during this period. More recently the RBZ concessionary agricultural financing programme; distressed companies facilities among other fall under quasi fiscal activities.

Zimbabwe's experience with hyperinflation and the ultimate rejection of the local currency by the transacting public amply demonstrates the dangers of financing quasi-fiscal activities through excessive printing of money. Firstly, it undermines central bank independence and credibility and its capacity to stabilise prices and the financial system. Secondly, by undertaking quasi-fiscal activities the central bank may acquire substandard assets, which will undermine its profitability and core operations. Consequently the central bank's solvency, profitability and its capacity to generate seigniorage will fall. Ultimately the central bank (golden goose) goes bust under the costly burden of quasi-fiscal activities.

Inflation tax as a means of raising government revenue is also attractive when the tax base is weak. Inflation tax results from the loss that is sustained by the holder of real money balances and non-indexed government bonds due to inflation. The tax collector for inflation tax is the central bank, the tax base is the reserve or high-powered money and the tax rate is the inflation rate. Holders of currency pay the tax through the erosion in the purchasing power of their currency and banks pay by holding reserves in the form of required reserves. Implicit taxes on financial assets add to explicit taxes resulting in over-taxation of the financial sector. Capital controls have also been used to prevent capital outflows from the financial sector that would erode the tax base (bank reserves). In this regard, financial repression transformed from explicit interest rate controls to implicit taxes from seigniorage and inflation tax, thus rendering financial reforms ineffective.

12. Sequencing of Reform Measures

The success of financial reforms depends to a large extent on how they are implemented and the initial conditions prior to reforms. The state and structure of the financial sector, the financial position of borrowers, the position of the economy in the business cycle, macroeconomic stability and the nature and effectiveness of the regulatory framework are some essential elements that determine the outcome of financial reforms. These building blocks cannot be put in place all at once but in an appropriate sequential order in the mosaic of economic reforms. Sequencing and timing of financial reforms are critical to the success or failure of financial reforms (Khatkhate, 1998, p. 1831)[17].

Macro-economic stability characterised by low inflation and sustainable budget deficits is regarded as a key desirable precondition for the effectiveness of financial reforms. Low and stable inflation increase the likelihood of achieving positive and moderate real interest rate, reducing the risk premium on holding financial assets and increasing the information content of financial variables. International evidence indicates that countries that reformed the financial sector when budget deficits were reduced to sustainable levels and prices were stable achieved better results (see McKinnon, 1991, pp. 4 -10 and Fry, 1997).

Financial reforms reduce government revenue by the extent of revenue previously generated from financial repression. High real interest rates on the other hand increase the cost of servicing and marketing new government debt. Thus, if government expenditure is not reduced concomitant with the loss of revenue from financial repression then the budget deficit is likely to increase to unsustainable levels. However, this outcome can be averted if tax collection is improved and/or the tax base is expanded to replace lost revenue due to financial reforms.

[17] Improper sequencing of reforms in Zambia resulted in re-imposition of interest rate restrictions (policy reversal) after the radical economic reforms of 1985 to 1987 (Soyibo, 1996). Stieglitz, (1998) commenting on the causes of the 1997 Asian crisis also notes that several countries in Asia had poorly managed financial liberalization, lifting some restrictions including restrictions on bank lending to real estate before putting in place sound regulatory framework.

The synergies that exist between financial reforms and other components of the broader structural reforms make the sequencing and timing of reforms crucially important. There is no generally applicable blue print on sequencing economic reforms and the timing of economic reforms. Effective sequencing depends on the initial conditions in each country.

The issue of whether domestic financial reforms should come after or before external (real) sector liberalization is not clear. Liberalising the domestic financial sector before trade liberalization could lead to credit flowing to a tradable sector which is only profitable because of barriers to trade. On the other hand liberalizing the domestic financial sector after trade liberalization could hamper the ability of the domestic industry to compete in world markets and investment would be stifled (due to credit constraints), preventing the employment of up- to-date techniques (Gibson et al., 1994).

One view regarding the liberalisation of the capital account is that it should follow the liberalisation of the current account and the domestic financial sector (see McKinnon, 1973 and 1982; Frenkel, 1982; Edwards, 1996). If domestic capital flows are liberalised while domestic interest rates are still below world levels, then there will be capital outflow. Domestic banks will also find it difficult to compete with foreign banks because the former will still be subject to a variety of controls and regulations, which increase intermediation costs.

Others have argued for simultaneous liberalization of the current and capital accounts (see Krueger, 1984). Hanson (1994) suggested that a stable macro-economy and domestic financial liberalisation are preconditions to international financial liberalisation. Johnston et al. (1997) argues that the capital account liberalization should be treated as an integral part of economic reforms. The liberalisation of foreign direct investment being part of real sector reforms, while the liberalisation of portfolio flows forms part of financial sector reforms.

However opening up of the capital account requires the existence of a minimum set of instruments, institutions and markets for the effective management of monetary and exchange rate policy with an open capital account. High capital mobility alters the effectiveness of different monetary instruments in achieving the objectives of monetary policy. Credit ceilings or high non-remunerated reserve requirements may be circumvented more easily by disintermediation through the capital account and therefore become less effective. Most countries adopted a gradual and cautious approach to capital account liberalization because of the likely destabilising effects.

Financial reforms in most countries started by interest rate liberalisation. This was followed by the introduction of market-based instruments of monetary policy, initial measures to strengthen banking supervision and regulatory framework, development of secondary markets for government securities and the inter-bank and money markets and further strengthening of regulatory and supervisory framework. Measures to enhance competition among banks, the development of equity markets and non-bank financial services generally came later in the reform process as second generation reforms (see Jbili et al., 1997 and IMF, 1998).

13. Partial Implementation of Fiscal Reforms and Financial Reforms

Generally there has been a half-hearted approach to fiscal reforms. For example, during the period 1991 to 1995 the government of Zimbabwe targeted the commercialisation of twelve government departments. The government managed to commercialise only one (the Examinations branch) and abolished the Central Purchasing Authority and the other ten[18] remained intact by the end of 1995.

Delays in privatisation/commercialisation of loss making public enterprises (PEs) led to further decline in net-worth of these institutions. This was worsened by interest rate liberalization before the balance sheets of PEs were healthy. Thus, financial reforms further weakened the balance sheets of PEs and their contribution to economic performance. Increasing losses of PEs also increased distress borrowing from the money market and continued demand for subsidies from government by the loss-making PEs.

[18] Central Mechanical Equipment Department (CMED), Department of Civil Aviation (DCA), Printing and Stationary (P&S), Public Health Laboratories (PHL), Medical Stores (MS), Dental Services (DS), Research and Specialist Services (R&SS), National Park and Wildlife Management (NP&WLM), Department of State Roads (DSR) and Standard Development Fund (SDF) (see Chigora, p.10).

The underperformance of the economic during the reform period reduced government tax revenue. Consequently Government increased its reliance on borrowing from the domestic banking sector leading to an increase in domestic debt. Increase in real interest rates also increased repayments on government debt. In this regard government had the incentives to postpone some financial reform measures in order to continue to access cheap credit. The increasing competition for domestic credit between the public sector and private investors penalised more the emerging small-scale enterprises, making them more credit constrained. Large companies had the option to raise equity capital or borrow offshore.

The increase in uncertainty due to increasing macroeconomic instability reduced government options of raising non-inflationary debt in that the cost of marketing government debt increased as bondholders demanded higher risk premiums. The consequent inflation-debt trap spiral undermined the prospects and credibility of economic reforms. Inevitably this affected the pace and effectiveness of economic reforms in general and financial reforms in particular.

As can be noticed in table 4 below, the cost of marketing government debt, as reflected by the coupon rate, increased following financial reforms. The table also shows a marked preference of short-term government debt to long term debt. This shows the dwindling confidence by investors in holding government debt, as they factored in a higher risk premium on the coupon rates.

Table: 4 Government Bonds

Date of Issue	Period (Years)	Coupon (%)	Amount Raised (Z$M)
02/11/93	5	22.0	330,54
06/12/93	15	16.5	48,59
06/01/94	6	21.0	447,99
10/02/94	4	21.5	344,35
03/03/94	3	22.0	68,76
06/04/94	10	17.5	65,62
25/08/94	8	21.0	257,36
01/09/94	11	19.0	126,28
04/10/94	10	19.5	554,9
25/11/94	8	21.5	307,9
02/12/94	15	17.0	71,72
03/03/95	7	24.0	638,8
13/03/95	3	26.0	200,99

17/08/95	3	25.0	484.9
01/09/95	5	22.0	256.0
29/09/95	4	24.5	772.4
12/12/95	6	24.0	718.9
19/12/96	7	15.5	-
11/12/97	10	21.5	-

Source: RBZ Annual Reports (Several 1993-1997).

The table below shows portfolio shifts by deposit taking financial institutions (DTFIs) to invest in government bonds and treasury bills.

Table: 5 Holders of Government Stock and Bonds (Z$ million)

Year End June	Monetary Banking Sector[1]	Building Societies	POSB	Insurance Companie s	Pension Funds	Other[2]	Total
1989	195,0	17,5	226,1	296,7	170,8	43,9	950,0
1990	271,9	138,5	226,1	116,4	420,2	85,2	1240,0
1991	213,7	47,3	207,8	220,4	148,3	27,1	979,6
1992	4.8	-	322,8	352,4	182,7	30,9	705,8
1993	89,7	-	135,0	501,8	301,9	89,1	1007,5
1994	42,9	20,4	25,0	799,7	222,8	104,8	1305,6
1995	149,0	104,4	115,0	1755,6	592,5	260,7	2862,4
1996	17,0	20,0	-	12,0	109,8	25,0	183,8
1997	-	-	30,0	1049,0	142,8	-	1221,8

Source: RBZ Quarterly Bulletin of Statistics, Sep/Dec 1998, p. S 49. 1. Reserve Bank, Commercial Banks, Merchant Banks and Discount Houses. 2. Finance Houses, commercial, industrial and mining companies, trade unions, government sinking funds and non-residents

Table below shows an increased uptake of Treasury bills by DTFIs. This may be attributed to risk-free returns on Treasury bills as opposed to financing fixed capital formation in the real sector. This again is a reflection of increasing government demand for credit. Thus, in order to safeguard revenue from this avenue the government could have either increased interest rates on treasury bills or increased supply.

Table 6 Holders of Treasury Bills (Z$ million)

End of Year	RBZ	Commercial Banks	Merchant banks	Discount Houses	Building Societies	Financial Hses	Other*	Total
1989	1,6	-	2,7	64,8	-	-	202,8	271,9
1990	-	-	11,3	121,5	-	-	126,2	259,0
1991	436,6	20,0	-	-	-	4,9	-	461,5
1992	-	50,0	-	165,1	0,1	-	110,9	326,1
1993	-	290,2	9,1	691,4	166,1	45,3	978,4	2180,5
1994	-	363,1	82,3	202,9	569,3	31,1	2485,7	3734,4
1995	57,6	1656,9	1284,9	2685,0	1606,1	127,6	5761,1	13179,2
1996	1142,9	3040,7	1630,3	2267,6	2269,0	275,3	11535,9	22161,7
1997	2713,0	2547,1	2068,5	2057,7	1450,6	400,0	8127,6	19634,5

Source: RBZ Quarterly Bulletin of Statistics, Sep/Dec, 1998, p. S 50. * Includes insurance companies, pension funds, individuals and corporates.

14. Period of reform reversals (2000 to 2008)

While the focus of this paper was to review the financial reform period it would not suffice to complete the paper without highlighting the developments in subsequent periods to date. The period 2000 to 2008 can be characterised as a period of financial reform reversal which started in 1997 when bureau de changes where closed following the currency crush. The genesis of intense parallel market activities that characterised the period 2000-2008 can be traced back to this policy decision.

The impact of undertaking financial reforms prior to strengthening the regulatory framework and licensing new financial institutions when the macroeconomic conditions are weak resulted in increasing financial sector fragility. The weak supervisory and regulatory frameworks created a conducive environment for Banks to adopt more risky investment strategies which led to bank failures over this period.

Financial distress over this period worsened moral hazard problems, because as the value of the banks' capital fell, the incentives by the owners of banks to pursue even more risky strategies increased. Insider lending, abuse of depositor's funds and flouting of corporate governance procedures were some of the irregularities that characterised the banking sector over this period. Confidence in the banking sector plummeted as banks failed to honour their obligations to deposits as local currency run out during the hyperinflationary period. A number of banks were put under curatorship. Banking licences of some of these banks were cancelled.

A major institutional reform that occurred during this period is the creation of the Deposit Insurance Board which started operations on 1 July 2003. The main objective of this institution is to build confidence and foster stability in the country's banking industry. Country experiences show that excessive printing of money and financing of quasi-fiscal activities the central bank ultimately undermine the central bank's solvency, profitability and its capacity to generate seigniorage will fall. The cliché that the golden goose that lays the golden eggs (central bank) will go bust under the costly burden of quasi-fiscal activities was experienced in Zimbabwe in a classical fashion.

The rise in lending rates following the liberalization of interest rates; competition for quality clients as new banks were licensed led banks to adopt more risky investment strategies. Inevitably banks were faced with an adverse selection which was exacerbated by the lack of a credit bureau that would provide information on delinquent borrowers. As the macroeconomic conditions deteriorated during the period 2000-2008 the performance of bank clients deteriorated leading to an increase in non-performing loans.

15. Dollarization/multi-currency period (2009 to 2013)

The adoption of the Multi-Currency Regime (MCR) in early 2009, transformed the macroeconomic policy environment in Zimbabwe. The MCR brought hyperinflation to an end; helped to stabilise the economy and establish the conditions for the restoration of positive economic growth. The MCR is also credited with bringing stability and restoration of confidence in the financial sector while at the same time imposing binding liquidity constraints. There has been debate on the future currency reform for Zimbabwe (see Chigumira et.al (2009 and 2013).

The liquidity crunch in the financial sector has resulted in underperformance of the economy which in term has exacerbated financial sector fragility as reflected by increased non-performing assets. Weak corporate governance in some financial institutions has raised concern on the need for deeper institutional and regulatory reforms. Nhavira et.al (2014) provides a deeper assessment of the regulatory and supervisory system in Zimbabwe and proffered some reform options to enhance these frameworks.

Some of the policy challenges facing the financial sector over this period include: restoring confidence in the financial sector; restoration of the RBZ as the lender of last resort; strengthening the supervisory and regulatory frameworks in particular regulations of mobile banking and deepening the financial sector. There need to pursue reform measures that enhance financial inclusion. A well-functioning, healthy and competitive financial system are an effective tool in spreading opportunity and fighting poverty through offering people a wide range of needs such as savings, credit, payment, and risk management services (Makina et.al 2014).

Zimbabwe needs extensive policy reforms that will improve the economic and business environment, addressing for instance, the prevailing fiscal challenges, the foreign debt burden, banking sector fragility, the underdeveloped capital market, and strengthening security for property rights (see Chigumira et.al 2013). Financial sector reforms needs to be a major component of the reforms which should take cognisance of the international experience to avoid some of the latent pitfalls.

15.1 Restructuring of the RBZ

The RBZ incurred a deficit for the year ended 31 December 2009 of US$229 million and as of that date its total liabilities exceeded its total assets by US$1.1 billion 9RBZ 2009, Annual Report). This structure impaired the capacity of the RBZ to perform its functions. Inevitably the Board and management of RBZ agreed to undertake a restructuring exercise which entailed:

- Reducing operating costs through a 75% retrenchment that resulted in 1445 employees leaving the bank. This left the bank with a head count of 530.
- Ceasing all non-core and quasi-fiscal activities;
- Disposing its major subsidiaries and non-core investments to raise supplementary resources to meet the bank’s financial obligations;
- Charging service fees for its major services to the market in the areas of Exchange Control and National Payments system management.

Government in the 2014 National Budget announced its RBZ debt assumption comprising of US$754 and US$596 of domestic

16. Lessons for Drawn from Country Experiences

A number of lessons can be gleaned from the literature and country experiences reviewed in this paper. The following are some of the lessons which need to be considered when undertaking financial sector reforms in future. One key lesson from the literature and country experiences is that the context or initial conditions under which reforms are undertaken is critical for success. To a large extent outcome of financial reforms in the 1980s and 1990s occurred when the country was already experiencing macroeconomic instability characterised by high inflation and excessive budget deficits which limited the positive effects of liberalization. Thus, the environment was not favourable and not that financial liberalization per se impacted negatively on growth. Furthermore, owners of banks exploited loopholes in the supervisory and regulatory frameworks to engage in non-core banking activities that and abuse of depositors' funds. While Zimbabwe has to a large extent functioning financial markets, these need to be deepened through well focused and appropriately timed financial sector reforms.

Financial reforms in most countries started by interest rate liberalisation, followed by the introduction of market-based instruments of monetary policy, strengthening of banking supervision and regulatory frameworks, development of secondary markets for government securities and the inter-bank and money markets and further strengthening of regulatory and supervisory framework. Measures to enhance competition among banks; the development of equity markets and non-bank financial services generally came later in the reform process as second generation reforms. In the Zimbabwean attempts to reform the financial sector these steps were not followed through consistently. One lesson that emerges from country experiences financial sector reforms are not a once off event but a complex and continuous process designed to make the financial sector more robust and resilient to dynamic shocks.

Some observers have claimed that financial liberalization is not good for growth because of the crises associated with it, empirical evidence suggest otherwise. Empirical analysis done by Tornell et al (2003) shows that, across countries with functioning financial markets, financial reforms lead to faster average long-run growth, even though it also leads to occasional crises.

The growth-enhancing financial deepening that follows liberalization is not a smooth process. Evidence from countries which liberalized their financial sector indicates that, rather, it takes place through boom-bust cycles. Occasional crises are the price that has to be paid to attain faster growth in the presence of severe contract enforceability problems. To minimize the possible negative impacts of the business cycles, a country would need to implement legislative and regulatory reforms that support the expanding financial sector and the emergence of sophisticated financial products. Financial deepening that accompanies financial reforms reduces credit rationing constraints faced by firms and this spurs greater investment and growth. In the process credit risks need to be managed effectively to avoid financial sector fragility that can undermine economic growth.

Financial reforms lead to an increase in international financial flows, which allows financially constrained firms to borrow more. If the majority of these firms are in the non-tradable (NT) sectors, a currency mismatch on firms' balance sheets develops, making the economy vulnerable to currency crises. In short, financial liberalization may generate crises in countries with contract enforcement problems because financial reforms are associated with international lending to the NT-sectors. Hence, the benefits of financial reforms are likely to be fully realised in environments where contract enforcement procedures are in process and functional.

Financial reforms have achieved better results where they were accompanied by regulatory reforms and the implementation of appropriate prudential regulation. In this regard authorities developed appropriate strategies and instruments for mitigating the effects of destabilising financial inflows (particularly short-term portfolio flows) and outflows induced by financial reforms. Most developing countries have an unsaturated appetite for foreign direct investment to boost investment and growth. However, country experiences have shown that not all FDI is beneficial to the economy. In this regard the authorities need effective prudential regulations to safeguard against risky financial flows.

Country experiences have shown that moral hazard tends to be rife where the owners of undercapitalized banks have little shareholder capital to lose from risky investments. The placing of banks under curatorship's starting in 2003, reflected the inherent weaknesses in the financial sector whose origins can be traced to moral hard and adverse selection problems among other factors. The underperformance of the economy over the financial reform period and beyond compounded the problem of nonperforming loans (NPLs) which have weakened the banks' balance sheets. The fundamental causes of NPLs include weak corporate governance practices and risk management systems. In this regard the weakening asset quality has undermined the intermediary role of banks as banks have thin capital buffers to absorb additional increases in loans provisions.

Monetary authorities through the monetary policy statements have put in place measures to ensure recapitalisation of banks. The rationale of these measures is anchored on the logic that strong and highly capitalised banks have capacity to underwrite more loans. However, the issue of NPLs still needs to be addressed holistically through a co-ordinated approach. One question that needs to be resolved is whether a policy under which all NPLs are recognized at once and the accompanying fiscal costs are all paid up front is preferable to a piecemeal policy.

Sustainable economic growth envisaged under the Zimbabwe Agenda for Socio-Economic Transformation (ZIMASSET) program cannot be achieved without adequate financing of domestically oriented firms. The tradable sector depends on inputs from the non-tradable sector. In this regard it is necessary that the non-tradable sector also grows in order to attain a balanced and sustainable growth path. This requires adequate financing for domestically oriented firms and structural reform in key sectors, such as energy and infrastructure, among others. Limited investment in the non-tradable sector will constrain export growth.

As noted earlier crises are part of the growth process in financially liberalized countries with contract enforcement problems. At the "tipping point," beyond which it is unlikely that capital outflows will reverse, authorities should focus on what to do after the crisis instead of attempting to forestall the crisis. Delaying an inevitable crisis will tend to make the effects of the full-blown crisis far worse.

There is possible danger when a country embarks on financial liberalization when it has limited financial knowledge. Given that the reform is much more than technical adjustments, there is need to invest in building regulatory and supervisory institutions to monitor and manage the emerging risks caused by changes in financial sector structure and the introduction of any array of complex financial products and contracts.

Country experiences have shown that appropriate timing of financial reforms is critical for the country to reap the positive benefits of financial reforms. Well timed reforms will help the country avoid pro-cycle trends in its economic activities. Furthermore, timing will ensure that the country's regulatory authorities will ensure that banks capital ratios are strengthened and that the supervisory system is reformed to meet the envisioned role in a liberalized environment. Timing will also ensure that the country's fiscal policy and the taxation system are reformed to conform to the demands of a reformed and deeper financial sector.

Experiences from other countries have shown that a cautious and gradual approach had better outcomes that the rushed or 'big bang' approach. Gradual implementation will allow the country to take corrective measures wherever the need arises. This may include actions by authorities to maintain financial sector stability

In particular swift action is required when dealing with symptoms of a financial crisis before the crisis becomes full blown in order to maintain stability and confidence in the banking system. Inability to react quickly on the part of the authorities may result in bank runs, whose long run impact on the negative perception of the public on the banking sector may be difficult to reverse. Furthermore, the authorities should also be able to take swift and appropriate actions to contain moral hazard when dealing with a banking crisis.

The overall experiences show that well managed and timed financial reforms have long-run benefits for growth and development. Monetary authorities need to be alert and mitigate the adverse effects of financial reforms that can induce economic crisis.

17. Conclusion

An analysis of the macroeconomic performance and the developments in the financial sectors during the financial reform period reveals limited impact on financial deepening and modest improvements in the efficiency of the financial sector. The oligopolistic structure of the commercial banking sector remained intact. In this regard the high nominal rates of interest may indicate the extent of market failure where fixing of interest rates shifted from government to a banking cartel. It appears from our analysis that during the reform period access to credit by the SMEs did not increase considerably due to crowding out by public sector demands and prohibitive lending rates. Most SMEs borrowers had no fixed assets that qualified as collateral security or banking history that shows their creditworthiness.

As noted above macroeconomic instability continued during the reform period. An unstable macroeconomic environment is bound to undermine financial reforms and the high-level of domestic debt delays the complete liberalization of interest rates and development of the financial sector. The RBZ in its bid to control inflation and stabilise the exchange rate over-relied on interest rate as an instrument of monetary policy. The interest rate policy was also used to stimulate the mobilising savings, within the context of financial reforms. However, the failure by the monetary authorities to contain inflation undermined efforts to mobilise financial savings through the deregulation of interest rates.

While ill managed and timed financial reforms can induce an economic crisis, financial reforms are a critical pillar in the economic growth and transformation strategy of a nation. In this regard Zimbabwe needs to deepen its financial sector reforms that result in a broad spectrum of products to meet the demands of the investing public.

18. References

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