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Master's thesis

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**Financial liberalisation in Zimbabwe:
what went wrong ?**

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Introduction

Zimbabwe officially abandoned financial repression when it introduced financial liberalisation in 1991. Since independence in 1980, the government had used interest rate controls and strict foreign exchange regulations in order to control the economy.

This mini-dissertation will analyse financial reforms in Zimbabwe from 1991 to 1997. The analysis will consider whether there were statistical grounds to believe that the financial liberalisation hypothesis would work. That is, do real interest rates in Zimbabwe have a statistically significant and positive relationship with real money demand and real savings? This paper will show that in Zimbabwe this relationship does indeed exist. The existence of such a relationship suggests that the freeing of interest rates in 1991 should have raised savings and financial intermediation as the theory predicts. However, as this did not happen, this paper will put forward reasons why, from 1991 to 1997, lifting controls in the economy did not increase savings as expected.

Chapter outline

Chapter one discusses the literature on financial repression and financial liberalisation. The chapter is divided into two sections. The first section defines theoretical concepts and attempt to explain the implications of replacing financial repression with financial liberalisation. The second section presents a general discussion of financial reform in Sub-Saharan African countries. The particular experience of Kenya will also be looked at as a specific study.

Chapter two presents a general picture of macroeconomic trends in Zimbabwe from 1980 to 1997. The purpose of this presentation is to provide background information before performing any analysis in the ensuing chapters.

Chapter three considers why Zimbabwe did not see a radical policy change in its financial sector policy during the first decade of independence. In other African countries an attempt was made to 'Africanise' the financial sector. In Zimbabwe, however, no such attempts were made to change the characteristic of the financial sector. In particular, the commercial banking sector retained both its oligopolistic

structure and its foreign ownership. The chapter will also show that the government extensively used financial repression during the first decade of independence.

By 1990 the government could no longer afford to run a policy of financial repression. The period of financial reforms would begin in 1991.

The reforms of 1991 were largely based on the McKinnon-Shaw model of financial liberalisation. A chief objective of such reforms is using real deposit rates to boost the volume of savings. Chapter four tests empirically whether a significant relationship exists between real deposit rates and savings in Zimbabwe.

Chapter five shows that financial liberalisation did not succeed because certain prerequisites were not in place prior to liberalisation. These include the absence of macroeconomic stability and supervisory regulations. From these shortcomings numerous policy suggestions will follow.

Chapter One

Literature Review

1.1. Review of Theoretical Concepts

The main concepts in the financial development literature will be discussed in this section. This discussion will focus on explaining terms such as 'financial repression', 'financial deepening' and 'financial liberalisation'.

1.1.1 Financial Repression

a) Definition

The phrase financial repression originates from the work of Ronald McKinnon (1973) and Edward Shaw (1973). It was used to describe a developing country environment whereby the financial systemis repressed (kept small) by a series of government interventions that have the effect of keeping very low (often at negative levels) interest rates that domestic banks can offer to savers (Agenor & Montel 1996, p.152)". These 'government interventions' are often in the form of interest rate regulations, directed credit schemes and high reserve ratios.

McKinnon notes that directed credit schemes can involve the government actively channelling the bulk of loanable funds available in the economy to certain enclaves....such as marketing boards and publicly controlled utilities. Even ordinary government deficits on current account frequently pre-empt the limited lending resources of the deposit banks (p.68)." Such government control over credit rationing means that finance for the rest of the economy must be extracted from the shallow resources of moneylenders, pawnbrokers and co-operatives. Effectively, the rest of the economy is financially repressed since it cannot gain access to capital finance. This dearth of capital finance consequently impedes further financial development.

b) Consequences of repression

Financial repression has commonly been associated with financial dis-intermediation. Interest rate ceilings encourage financial dis-intermediation as savers switch from the acquisition of claims on the banking system to the accumulation of real assets, assets

traded in informal markets, and foreign assets¹. In response to this, the imposition of foreign controls is often the knee-jerk reaction on the part of governments and with it comes certain problems such as the burgeoning of informal markets². Financial dis-intermediation is characterised by:

- Reduced pool of savings

Ironically, while dis-intermediation is associated with a greater inducement to hold real assets such as real estate and gold, it is not associated with high levels of investment. While the notional demand for investment may be high, many prospective investors will be unable to secure financing since repression has reduced the pool of available savings³.

- Increased cost of credit

Paradoxically, a repressed financial system can actually lead to an increase in the cost of credit resulting from legal restrictions designed to lower this cost. Where there are excess credit demands, an unorganised financial sector⁴ is encouraged (McKinnon 1980). Because this unorganised market does not provide the legal guarantees provided to depositors and others in the organised system, the supply price of credit to this market tends to include default risk that depositors and others would not demand in the organised market. Hence there is a 'default spread' which raises the cost of credit in such markets.

Furthermore, those borrowers fortunate enough to receive formal bank loans can act as moneylenders to customers without direct access to bank credit. In such a scenario, a dual financial system develops. Transaction costs are duplicated and a nepotistic credit system is encouraged outside organised and supervised institutions.

- Inefficient capital markets

Interest rate controls encourage the use of non-price rationing devices. In so doing

¹ Agenor & Montel, p.156

² Mathieson & Rojas-Suarez 1993

³ Although interest rate ceilings lower the cost of borrowing funds, there are insufficient funds available since the low interest rates are unattractive to potential savers.

⁴ It is often referred to as an 'extra-bank market' since it operates illegally.

they diminish the efficiency of capital markets in allocating 'investible' resources to their most productive uses.

Capital finance will not necessarily go to the projects offering the highest returns at the margin. In fact, loan rate ceilings discourage financial institutions from making risky loans, since premia for risk cannot be charged when such ceilings are binding (Wilkins 1993, p.16).” Potentially high-yielding investments are sacrificed because in financially repressed economies the low interest rate accommodates investments which yield returns barely above the interest rate ceiling. This may indeed be the most adverse consequence of interest rate control.

c) Why do government's use financial repression?

Governments in developing countries continue to use financial repression despite its adverse effects. The literature offers a plethora of reasons to explain why governments opt for repression even if this policy has been responsible for reducing the real size of the financial system relative to non-financial magnitudes”⁵.

The first reason is that low interest rates are associated with high social benefits. This association can assume one of three forms:

- Keynes (1936) contends that, if left alone, the interest rate does not adjust to a level conducive to social advantage. Therefore a wise government is concerned to curb it by statute and custom and even by invoking the sanction of moral law (p.351).”
- Harvey (1991) suggests that governments use repression to get credit flowing to neglected sectors, more cheaply and longer term, while
- Killick (1991) notes that a strong anti-usury tradition in some Islamic countries prohibits the charging of interest for loans.

The revenue that governments can generate from financial repression is another reason why this policy is used. Fry (1982), suggests instead that many developing countries inadvertently” used financial repression when the initial intended policy

⁵ Shaw 1973, pp.3-4

was that of 'financial restriction'. A policy of financial restriction encourages institutions from which government can expropriate a large seigniorage, and discourages all others.⁶ Where such financial restriction has been successful, we find:

- a higher proportion of funds from the financial system are transferred to the public sector,
- a rightward shift in the demand for money function is accompanied by higher income and lower cost elasticities.

Fry notes that the above changes permit a greater public sector deficit to be financed at a given rate of inflation and a given level of nominal interest rates.

A second revenue source is the implicit subsidy from which the government benefits by obtaining access to bank financing at below-market interest rates.⁷ Giovannini & de Melo (1993) also allude to the implicit tax collected through the banking system on private sector bank deposits that are remunerated at below-market interest rates.

1.1.2 Financial Liberalisation

This section will focus on the concept of financial liberalisation. Related issues such as 'financial deepening' and 'financial intermediation' will also be explained in this section.

a) Definition

Financial liberalisation has commonly been associated with the mere freeing of interest rates. However, our understanding of financial liberalisation today extends beyond the elimination of directed credits and high reserve requirements.

Financial liberalisation is now understood to involve a wider set of objectives. These objectives include:

- the easing of portfolio restrictions, changes in the ownership of banks,

⁶ Fry gives the following as examples: high reserve requirements and obligatory holdings of government bonds are imposed to tap this source of saving at zero or low interest cost to the public sector; private bond markets are suppressed through transaction taxes and an 'unconducive' legal framework since private bond and equities do not easily yield seigniorage; interest rate ceilings are imposed to stifle competition from the private sector.

- enhanced competition among banks,
- integration of domestic entities to international markets, as well as
- changes in the monetary policy environment (Agenor & Montel 1996).

While the relative importance of each of the above objectives and the speed of the reform process may vary between countries, in all cases such reforms have been motivated by the need to pursue stabilisation and broader structural reform objectives in an efficient and effective manner .

b) Financial intermediation and financial deepening

For developing countries the chief reason the McKinnon-Shaw approach has been so central in policy-making is because of its recognition that ‘finance matters for development’. While mainstream analysis of money and finance in the growth process neglected an independent role for such factors, the McKinnon-Shaw hypothesis states that the lack of ‘financial deepening’ is a relevant obstacle to development.

The concept of ‘financial intermediation’ helps to explain what is meant by a lack of ‘financial deepening’. As Gillis et al (1983, p.323) testify, the process of financial intermediation involves the gathering of savings from multitudinous savers and channelling them to a smaller but still sizeable number of investors.”

The main advantage of intermediation is that financial intermediaries exploit economies of scale in lending and borrowing. For example, the lending intermediary can invest and manage investments in primary securities at unit costs far below the experience of most individual lenders, while the borrowing intermediary benefits from having a relatively predictable schedule of claims for repayment. Gurley & Shaw (1960) observe that these economies of scale can then be distributed to:

- the intermediary’s debtors in the form of favourable lending terms,
- its creditors in the form of attractive interest payments, and
- its stockholders in the form of sufficient dividends to attract additional capital funds.

⁷ Agenor & Montel, p.157.

The conclusion we draw is that the greater the extent of financial intermediation in an economy, the greater the level of financial deepening. A lack of 'financial deepening', however, implies that the market for the intermediation of funds are incomplete and imperfect. Consequently, growth will be hindered because under incomplete and imperfect markets some contracts between savers and investors will not be possible or will stipulate wrong prices. A lack of financial deepening thus results in a paucity of savings and the mis-allocation of investment resources.

While both McKinnon and Shaw agree that 'finance matters', they express different views on the exact nature of the relationship between finance and development.

- McKinnon's complementarity hypothesis

In explaining his 'basic complementarity between money and physical capital', McKinnon contends that for semi-industrialised economies, real money balances are complements rather than substitutes for tangible investment. Thus, McKinnon's 'complementarity hypothesis', rests on two assumptions:

- 1) all economic units are confined to self-finance; and
- 2) indivisibilities in investment are of considerable importance, that is investment expenditures are lumpier than consumption expenditures.

What emerges from this hypothesis is that any individual intending to invest in physical capital must first accumulate money balances, that is, **outside money**. Hence, the more attractive the process of accumulating money, or the higher the real deposit rate of interest, the greater the incentive to invest. Furthermore the relative lumpiness of investment expenditure implies, in this situation, that aggregate demand for money will be greater, the larger the proportion of investment in total expenditures (Fry 1982, p.733)."

- Shaw's debt-intermediation view

Shaw on the other hand, contends that the theory of finance in developing countries should adopt a 'debt intermediation' view. This view is based on an **inside money**

model where investors are able to borrow from savers. Thus, in contrast to McKinnon's 'complementarity hypothesis', economic agents are not constrained by 'internal finance' since 'external finance' exists.

Shaw's emphasis on credit contrasts with conventional monetary economics which has a bias in favour of the assets side of the economy (Agenor & Montel). According to Shaw, a higher real deposit rate will attract a greater volume of savings deposits. These additional savings deposits enlarge the supply of credit funds available. This enlarged pool of credit is then used to accommodate a greater level of investment demand. Not only does the quantity of investment increase, but so too does the quality since the greater financial intermediation increases the average efficiency of investment⁸.

c) Pre-requisites for financial liberalisation

It is now accepted that financial liberalisation is futile in the absence of certain pre-requisites. Villanueva & Mirakhor (1990) name these pre-requisites as macroeconomic stability, strong and effective system of bank supervision and the gradual removal of controls on interest rates.

Furthermore, the correct sequencing of these prerequisites is crucial. The Villanueva-Mirhakor framework, widely used as the benchmark by in Sub-Saharan Africa (SSA), suggests four approaches for correctly liberalising interest rates:

1. unstable economies with inadequate bank supervision should first achieve macroeconomic stability and strengthen the bank supervisory framework before liberalising interest rates;
2. unstable economies with adequate bank supervision should ensure economic stability, maintain firm bank supervision and embark on *gradual* interest rate deregulation;
3. stable economies with inadequate bank supervisory stability should boost bank

⁸ With more investments to consider financing, intermediaries gradually learn to distinguish between good quality investments and shoddy ones.

supervision and *temporarily* regulate interest rates before embarking on interest rate liberalisation;

4. immediate interest rate liberalisation is recommended only for countries that have both macroeconomic stability and adequate bank supervisory framework.

To the list of pre-requisites, Agenor & Montel (1996) add institutional factors such as the legal infrastructure, the bankruptcy code and the disclosure and prudential regulations. They acknowledge that such institutional factors influence the quality of the infrastructure for financial transactions. By this, they refer to both the systemic elements and the operational efficiency of firms in the financial sector (p.15).”

- Systemic factors

Of the systemic factors, the one relating to the imperfections in the functioning of the legal and regulatory framework stands out in particular since it raises both *ex ante* and *ex post* costs of contracting⁹. These imperfections are not confined merely to difficulties in designing contracts, defining property rights and consummating contracts, but also include the degree of efficiency and the moral fibre of the judiciary system.

The existence of such difficulties breeds ‘institutional uncertainty’ which adversely increases the degree of credit risk. Under certain states of nature, such ‘institutional uncertainty’ may induce a disproportionate increase in the amount of the external finance premium. Indeed in extreme cases, this premium charged for the financial instrument can climb so high that the market for the financial instrument disappears altogether.

Another systemic factor pertains to the quality of accounting and auditing standards. Often, financial contracts are left unsigned due to the dearth of reliable and credible information. Such shortages of information worsen the asymmetry of information dilemma.

⁹Ex ante costs are incurred because the contract must be drafted before the transaction takes place while ex post costs are incurred in securing the deal as originally struck.

- Operational factors

With respect to the operational efficiency of the firms performing the intermediation of funds, the issue of allocative efficiency is a decisive one. To maximise the markets' operational efficiency, the firm needs to allocate funds at the minimum possible expense.

To achieve allocative efficiency, the risk-adjusted cost of funds must be the same for all borrowers. Similarly, the rate of return offered to savers must be also be consistent. However, deviations from operational and allocative efficiency exist due to a certain degree of market power exerted by banks, the existence of market segmentation and difficulties in exploiting fully the economies of scale because of the smallness of domestic markets (Mehran et al 1998, p.16)."

For financial liberalisation to succeed, therefore, reforms must be implemented in a milieu where macroeconomic stability and a strong and effective system of bank supervision are in place. Where macroeconomic stability and correct sequencing of reforms are absent, financial liberalisation is often associated with sharp increases in real interest rates, bankruptcy of financial institutions and the loss of monetary control (Agenor & Montel, p. 477)." The logic underpinning this argument is that macroeconomic instability raises the risk of projects funded by banks. As a result, the riskiness of bank portfolios also rises. According to the Stiglitz-Weiss (1992) model of credit rationing under conditions of information asymmetry, banks will respond by lowering interest rates and rationing credit more severely if deposit insurance is absent or correctly priced. However, where deposit insurance is inadequately priced, moral hazard induces banks to raise interest rates to attract deposits and fund high-risk projects. This, notes Agenor & Montel, is because banks face a one-way bet: if the projects pay off, bank owners reap the profits, whereas if they do not, the government foots the bill to pay off depositors, with bank owners risking only their limited capital (p.478)." Furthermore, where macroeconomic instability persists, it is highly likely that bank portfolios already harbour a large number of bad loans. In such situations, bank capital is impaired and the moral hazard problems associated with deposit insurance are accentuated. Consequently, lending rates reach unusually high levels, firms engage in distress borrowing and bankruptcies spread.

d) Direct versus Indirect Monetary Control

Traditionally, 'financial sector reform' has been synonymous with the liberalisation of interest rates, the proliferation of new money and capital market instruments, and the improvement of systems of regulation and supervision (Roe & Sowa 1997). However, an additional element has been appended to 'financial sector reform', namely the abandonment of direct methods of monetary control in favour of indirect or market based methods.

Financial liberalisation can proceed independently of a decision to adopt indirect methods of monetary control, it is unlikely that the countries where direct controls are retained will be able to reap the full benefits of financial reform in terms of deeper and more adaptable financial sectors (Roe & Sowa, p.214)."

The link between direct monetary control and financial repression is clear. Direct controls not only provide governments with tools to manipulate the volumes of the main monetary aggregates, but they also afford 'dirigiste' governments an opportunity to combine their attempted control over monetary aggregates with the ability to direct credit in very specific ways (Roe & Sowa, p.216)." However, even the more unyielding regimes are beginning to steer themselves away from direct controls. Why is this?

The first reason is that direct controls result in high administration costs. As Bhagwati (1978) testifies, direct controls are 'cumbersome' and expensive to administer since credit limits have to be defined and monitored at the level of each individual bank. Related to this, direct controls have proved an uncomfortable choice in financial systems with a modicum of scope for innovation. As Llewellyn et al (1982) attest, controls on particular financial institutions have encouraged the growth of new, un-taxed, non-traditional banking institutions. In such situations, the authorities are left with the choice of either allowing the financial sector to operate on a dualistic basis-one part controlled and the other part largely uncontrolled-or of extending their costly bureaucratic net to match each and every new innovation as it occurs (p.217)."

The second argument is that direct controls force banks to adopt portfolio positions dissimilar from those they would choose if there were no controls in place. Indeed the familiar 'high risk, high return' configuration is distorted as politicians demand of

banks to lend more to the higher risk but lower return sector. The banks are not compensated for this additional burden through some form of direct budgetary transfer (but are instead) subjected to high rates of implicit taxation through high reserve requirements among others (Roe & Sowa, p.217).” Furthermore, the economy is robbed of the benefits associated with the delegated screening and monitoring of credit risks; benefits which are available in more liberal systems.

Financial sector reform seeks to increase the size, improve the efficiency and strengthen the risk management of financial systems. While the drift towards indirect controls has not traditionally been included in financial reform policy packages, the preceding discussion has shown how the continued existence of direct controls mitigates against the objectives of financial reform. At the same time, indirect controls aid financial reform policies as they assist commercial banking institutions in the policing of ‘risk and return’ and in the allocation of credit .

1.2 Empirical Review

SSA countries have historically attached greater importance to developing their respective real sectors. The financial sector’s role has largely been peripheral. Evidence lies in the fact that soon after independence, most SSA countries strongly believed that they could support their development objectives through selective credit allocation mechanisms (Mehran et al 1998, p.1).” Consequently, governments in these countries assumed the role of chief player in the operations of their respective financial sectors. Nearly all the governments went as far as setting up financial institutions to ensure that the monetary and financial system aided their development objectives (Harvey 1991). Such a policy constituted a form of financial repression.

1.2.1 The era of financial repression in SSA

This section will briefly explain why SSA countries opted for financial repression policies upon attaining independence. The nature of repression as well as its adverse consequences will also be assessed in this section.

a) Reasons for financial repression

While financial repression would eventually unravel, at independence it seemed the wisest policy to pursue for the fledgling SSA states because:

- during the colonial era, commercial banking had been set up primarily to finance foreign trade (Seidman 1986);
- any local financing engaged in by the banks was either to assist foreign-owned companies or companies owned by the non-African business communities (Harvey 1991);
- building societies provided housing finance for the better off, entirely in the main towns (while)agricultural finance companies lent to white settlers, and (perhaps) to a few improved African farmers (Harvey 1991, p.258).”

Effectively, these financial systems served the special enclaves of urban whites, white settlers, foreign trade and foreign business. Africans and their development objectives were totally excluded from this system. At independence, therefore, the African leaders resolved to get credit flowing to the African population by using the policy of financial repression.

b) The character of repression in SSA

As Harvey notes, financial repression initiatives undertaken in the SSA countries were of three main types:-

- i) macroeconomic measures such as interest rate policy and exchange rate controls
- ii) changing the behaviour of the existing commercial banks
- iii) setting up development financial institutions (DFIs)

Under financial repression, the trend in almost all the newly independent SSA states was similar. Firstly, the re-routing of bank resources to finance both the budget deficit and state-owned enterprises was commonplace (Mehran et al). Simultaneously, interest rates were repressed at below the market-clearing rate (often negative in real terms) while credit rationing and private sector crowding out was widespread throughout the SSA countries. In Malawi for example, because commercial banks

were compelled to significantly increase their proportion of lending to agriculture, commercial lending to agriculture rose by 50 percent while the sector's share of bank advances escalated from 10 percent to 54 percent (Harvey 1991).

Foreign exchange restrictions were also synonymous with the financial repression policies. The principal motive behind choking the free flow of foreign exchange was to augment the pool of finance available to local borrowers. Indeed the Governor of the Bank of Zambia would claim that bank credit to Zambians improved during 1969 largely as a result of the restrictions on lending to non-Zambians (Bank of Zambia Annual Report, 1969)."

c) Consequences of financial repression

As much as the governments of the newly-independent SSA countries believed that financial repression would confer access to the financial system on their people, it simply did not work.

While financial repression crippled the banking system, the financial intermediation process was also severely undermined. While it is true that money was already rapidly losing its store of value function, the waning efficiency of the payments system and the erosion of financial and borrower discipline were further impediments. Effectively, banks ceased to be a safe haven for savings, (thus) distorting resource mobilisation and allocation (Mehran et al, p.2)." Crucially, this financial malaise proved an obstacle to economic policy management and performance, while real incomes and prices were ruinously affected.

1.2.2 Financial reform in Kenya

Encouraged by the IMF and the World Bank, as well as by the success of the 'gang of four' states of the Far East¹⁰, the SSA states embarked on structural adjustment programmes (SAPs). Under these programmes the market mechanism is assigned a greater role in the allocation of resources. While their decision to abandon financial

repression was hardly surprising given their straitened economic circumstances, the SSA countries also hoped that the economic reforms would aid significantly in dismantling the myriad of controls and restrictions that had become institutionalised in their respective economies.

In all, nearly twenty SSA countries attempted reform programmes. This empirical case study, however, will only review the experience of Kenya. Kenya has been selected because the initial conditions in both Kenya and Zimbabwe, prior to economic reforms, are very similar. For example, Soyibo (1997) notes that (prior to reforms) the financial systems in Zimbabwe and Kenya typified the sub-group of financial systems with institutions of mixed ownership¹¹ and whose types of financial institutes are fairly diversified (p.2).”

Apart from South Africa, Kenya and Zimbabwe are credited with having two of the most sophisticated financial structures in the region. Both countries already boasted institutions such as commercial, merchant and investment banks. In addition to these banking firms, there was already in existence a plethora of non-banking financial institutions (NBFIs) such as insurance companies, finance houses and leasing companies. In both countries, a suitably operational stock exchange was also in operation¹².

The study on Kenya will first consider Kenya’s economy prior to financial reforms. The next stage of the analysis will include a short discussion on the nature of the financial reforms as well as an evaluation of their success or failure.

a) Kenya’s Initial Conditions

Kenya’s financial sector had several structural flaws prior to financial reform:

- There appeared to be a destabilising bias in favour of NBFIs. Between 1971 and 1979, the growth of NBFIs was encouraged by the utilisation of differential

¹⁰ Singapore, Taiwan, Hong Kong and South Korea

¹¹ ‘Mixed ownership’ recognises that there are a significant number of privately owned institutions operating alongside public ones. This is in contrast to countries such as Tanzania, Malawi and Mozambique whose financial systems are largely controlled by government-owned institutions

¹² In the majority of SSA economies, NBFIs are few while capital and stock markets are absent.

interest rate regulations between them and commercial banks. As Ngugi & Kaburo (1994) attest, being able to charge more on loans and other charges, NBFIs attracted a greater share of deposits than commercial banks. Thus NBFIs grew at the expense of commercial banks.

- The financial system was characterised by a high level of concentration. Grosh (1990) notes that of the 161 bank branches in Kenya as at 30 June 1983, 123 of them (76 percent) belonged to the four largest banks¹³. Added to this high level of concentration was the direct participation of the government in the financial system as a chief owner.
- Just as the Nigerian government attempted to 'Nigerianise' its financial system (Seidman 1986), the government in Kenya also believed that usurping control of commercial banking would be more responsive to the borrowing needs of Kenyans of African origin (Soyibo, p.122).” In the period 1970-71 various indigenous banks were spawned. One such bank was the Kenya Commercial Bank (KCB) which managed to expand lending to Kenyan Africans by 225 percent (Soyibo) in one year. These banks usually operated beneath the yoke of political pressure. For example, the (KCB) was perpetually pressured to grant credit to politicians and their cronies. It was also 'persuaded' to supply credit to other government parastatals without adhering to commercial bonus mores (Grosh). Consequently, this bank's portfolio was saddled with non-performing loans.

b) The Move to Reforms

According to Ngugi & Karubo's testimony, the main impetus behind the reform programme were the divergent regulatory framework across financial institutions, inadequate and weak prudential supervision, and weak monetary control (cited in Soyibo, p.125).”

On interest rate liberalisation, Kenya appeared to favour 'gradualism' rather than the 'Big Bang' approach. This entailed implementing the harmonisation of interest rate regulation of commercial banks and NBFIs gradually rather than swiftly. This helped allay fears in Kenya that interest rates would increase dramatically. For example,

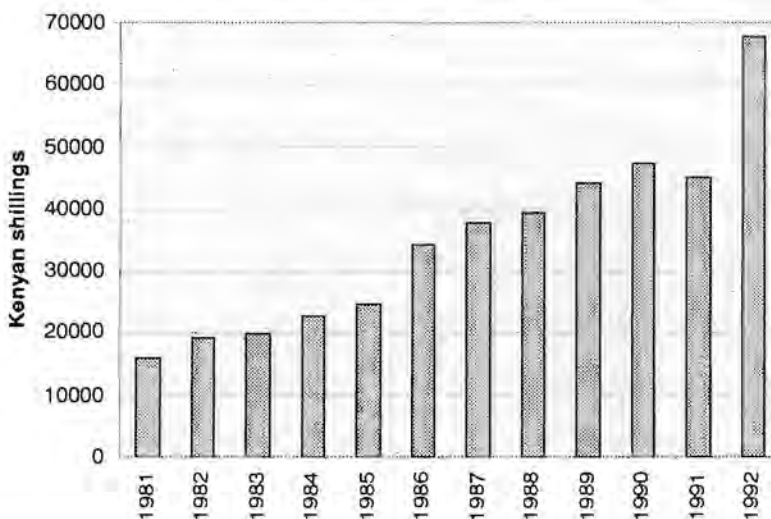
¹³ Kenya Commercial Bank, Barclays Bank, Standard Chartered and National Bank of Kenya.

ceilings on savings deposit rates were raised from 10.0 percent to 13.5 percent for both commercial banks and NBFIs. Simultaneously, ceilings on bank lending rates were increased to 17.5 percent from 15.0 percent while those for NBFIs were lifted to 19.0 percent from 18.0 percent (Soyibo 1997).

As liberalisation took hold in Kenya, money market changes were soon observed. These changes included:

- The rapid increase in money supply. The rate of real monetary growth escalated by 11 percent between 1991 and 1992 (Soyibo).
- The complete conversion to indirect instruments of monetary policy (Mehran et al). Under the previous policy of direct controls, the system of credit ceilings had been the foundation of Kenyan monetary policy (Roe & Sowa, p.250)". However, from November 1990, the treasury bill rate was set at a market price determined by a weekly auction.
- The freeing of the exchange rate; the exchange rate was no longer controlled under the leviathan Foreign Exchange Act but was now determined using the auction system.
- The introduction of Open Market Operations in early 1992 when daily meetings of the open market committee of the Central Bank of Kenya were introduced'
- The replacement of stringent reserve requirements with a more relaxed 'reserve money monitoring' in 1991.

Figure 1: Growth in real money supply (M2), Kenya 1981-92 (1990=100)



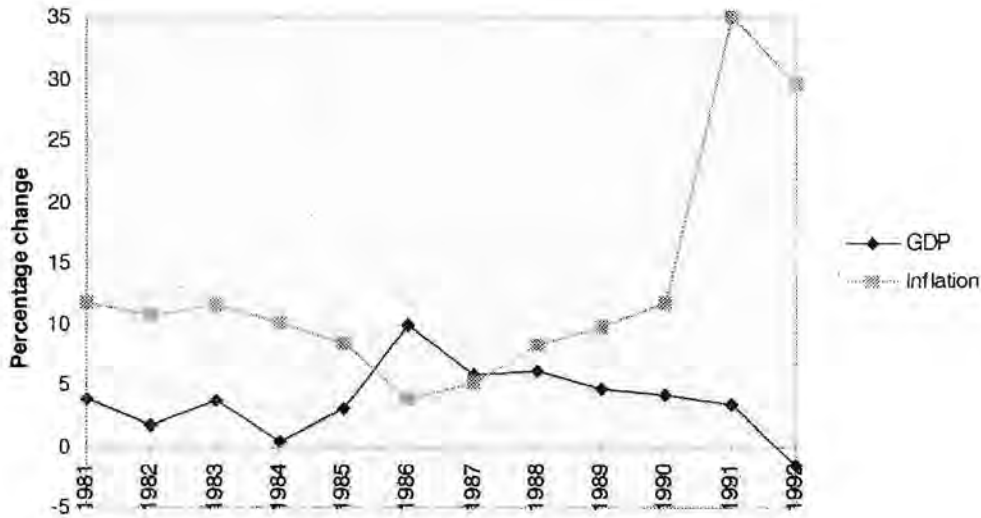
c) Performance Evaluation

The performance of Kenya's economy under financial liberalisation can best be described as 'mixed'. The earlier broad-based reforms of the early 1980s produced only 'sluggish growth' and Kenya had to wait until after 1986 before enjoying any substantive growth. Indeed, this latter period also coincided with single-digit inflation and positive real interest rates (Grosh),

During the initial reform stages, Kenya's representative index of financial deepening, the ratio of M2 to gross domestic product, remained at or near the 30 percent mark (Table 1). This seemed consistent with the McKinnon-Shaw hypothesis. By 1992, the index had reached 72 percent 1992 (Soyibo).

The post 1989 era was not good for Kenya. While the M2/GDP ratio rose, the real growth rate of GDP perplexingly slowed down, falling as low as -1.5 percent in 1992. In addition to this, inflation soared (see Figure 2), rising into double digits by 1990, advancing to 35 percent in the following year, before declining a little to 29.6 percent in 1992 (IMF International Statistics).

Another source of concern was Kenya's perpetual budget deficit during the period after reforms (see Table 2). Such fiscal profligacy served to undermine Kenya's macroeconomic stability which has been recognised as a key pre-requisite for a successful structural adjustment programme. Such a large deficit may have induced the government to finance the deficit by raising its domestic borrowing from the banking system. A possible result of this would have been the increased crowding out of private sector borrowing, the erosion of capital formation and the stunting of economic growth. This may explain Kenya's declining GDP during the reform period.

Figure 2: Growth in real GDP and inflation, Kenya 1981-1992 (1990=100)

Source: International Financial Statistics, (IMF 1998)

Table 1: Ratio of money supply and budget deficit to GDP, Kenya 1981-92

	1981-86	1987	1988	1989	1990	1991	1992
M2	30 %	35%	35%	38%	44%	51%	72%
budget deficit	4.5 %	8.4 %	4.5 %	5.2 %	6.3 %	8.1 %	9.3 %

Source :Grosch 1990

As far as monetary reform is concerned, Kenya successfully completed the transition from direct to indirect methods of monetary control. However, other areas in this realm remain unsettled:

- To begin with, there is still very little activity in, or development of, the secondary market for government securities (Mehran et al, p.19)". Furthermore, Kenya's notorious inflation legacy has dampened the demand for existing longer-term government securities.
- Secondly, the use of weekly auctions for setting the treasury bill rate has yielded only modest results. The auctions were supposed to intensify activity in the money market but instead discount rates in the auctions have hardly moved from one

week to the next. Commercial banks for their part have displayed no obvious change in their attitudes to the holding of such bills (Roe & Sowa, p.253).”

In the area of financial legislation and supervision, Kenya has made ‘sufficient’ progress. Along with South Africa and Botswana, Kenya is recognised as one of the three countries which are becoming tougher with poorly and imprudently managed institutions (Mehran et al, p.14).” Considered a regional leader in following best practices, Kenya has also managed to set up a credible limited-coverage deposit insurance scheme. Added to this, the central bank has been courageous enough to let flagging banks fail, fraudulent managers have not escaped prosecution and those depositors not covered by deposit insurance schemes have been allowed to lose money. The government should also be given credit for Kenya’s improving supervisory record because it has generally supported rather than overruled the central bank. However, there remains scope for improvement. As is the case in all SSA countries (with the exception of South Africa), Kenya does not have an effective court system that will ensure enforceability of contracts and enhance banks’ financial security. While special arbitration courts have been convened in Kenya, progress is inevitably slow.

Chapter Two

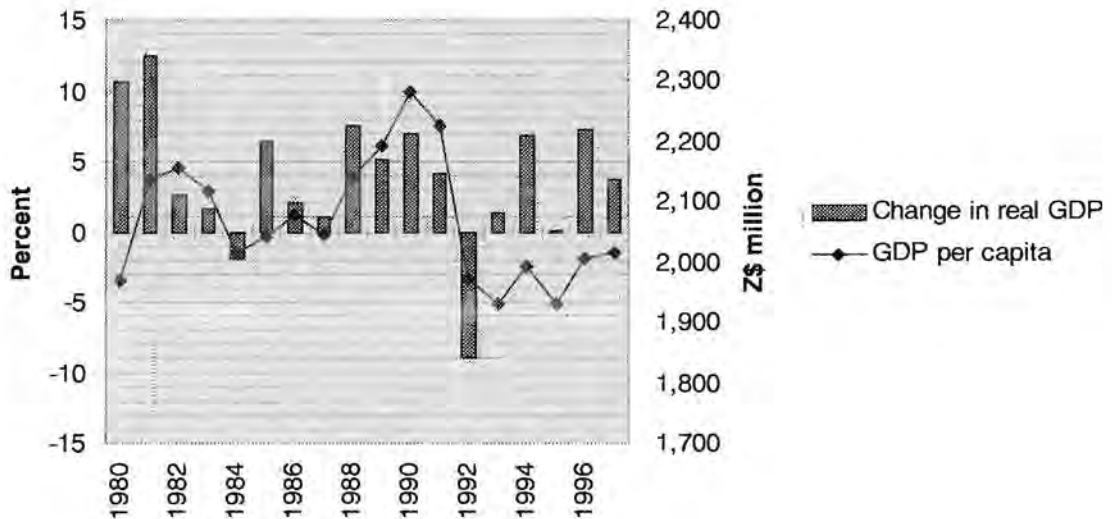
Zimbabwe's Macroeconomy: 1980 to 1997

This chapter outlines the general structure of Zimbabwe's macroeconomy between 1980 and 1997. The chapter will focus on trends in the business cycle, monetary policy, fiscal policy, and the external accounts. As subsequent chapters will be divided into the pre-reform and post-liberalisation era, the purpose of this chapter is will be the only chapter to present an overview of the macroeconomy since independence.

2.1 The business cycle

The change in GDP growth is used to measure economic activity. Figure 3 compares changes in economic growth and per capita incomes for the period 1980-97.

Figure 3: Real GDP and income per capita growth, Zimbabwe 1980-97 (1990=100)



Source: Quarterly Economic & Statistical Review (RBZ)

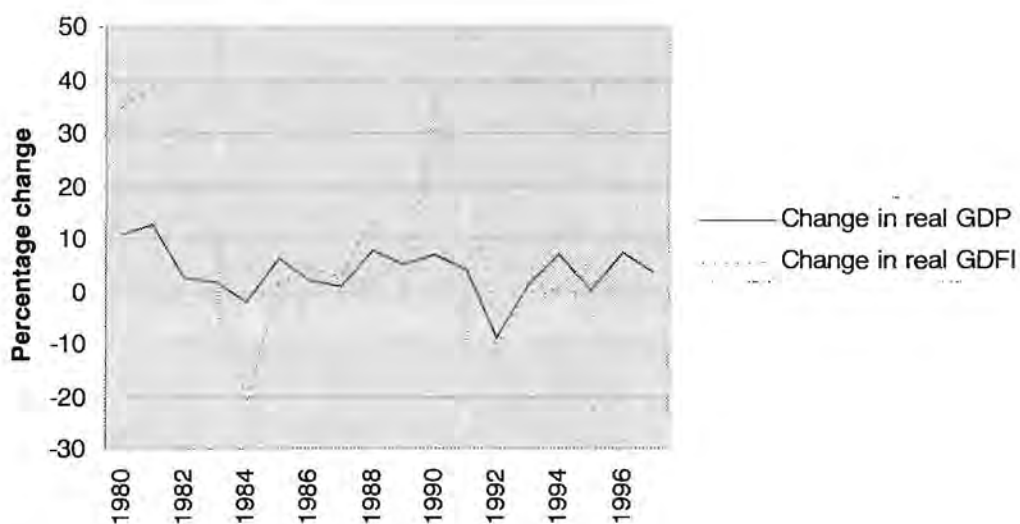
Figure 3 highlights some important issues:

- The country was in a recession from 1982 to 1984. This was largely a result of drought which adversely affected agricultural output (Mandaza et al 1986).
- After 1984 the economy's recovery was rather erratic but positive real growth rates were maintained until 1992.
- 1992 was another drought year and the economy experienced its worst downturn since independence. The economy shrunk by approximately 9 percent, and real incomes also fell.
- Throughout the period, real incomes have followed the business cycle.

2.1.1 Investment and the business cycle

The relationship between economic output and investment has been very close in Zimbabwe. Figure 4 presents this relationship for the period 1990 to 1997.

Figure 4: Real Gross Domestic Fixed Investment and economic growth, Zimbabwe 1980-97

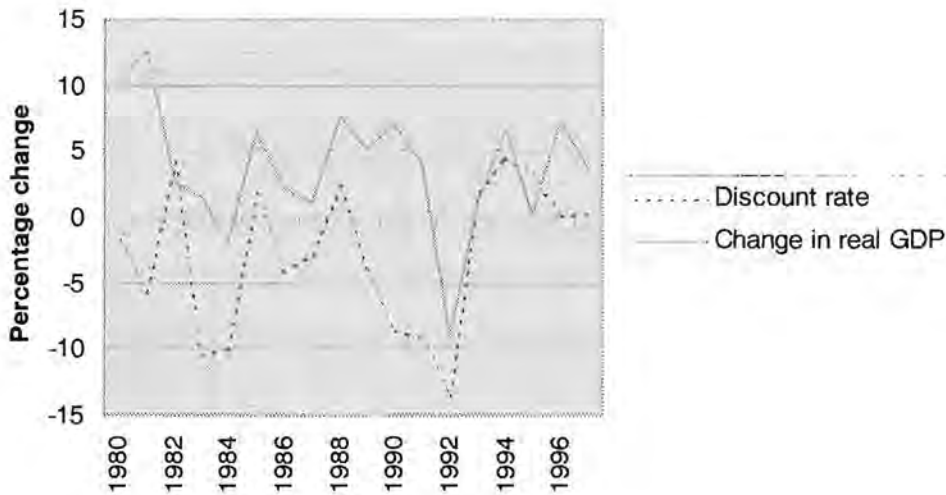


Source: Quarterly Economic & Statistical Review (RBZ)

2.1.2 Interest rates and the business cycle

Figure 5 illustrates the relationship between the business cycle and real interest rates.

Figure 5: Real interest rates and the business cycle, Zimbabwe 1980-97 (1990=100)



Source: Quarterly Economic & Statistical Review (RBZ)

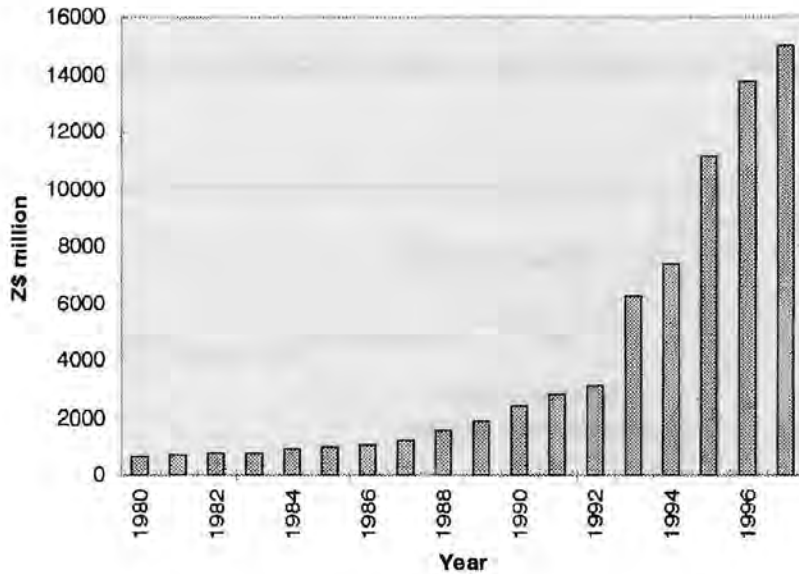
2.2 Monetary Policy

Money supply growth was significantly lower in the 1980s compared to the post-reform period after 1991. The low money supply of the 1980s is largely attributed to the existence of financial repression (Moyo 1998). Various restrictions on the activities of financial institutions (see chapter four) limited monetary expansion.

The low money supply of the 1980s reflects the restrictive monetary policy of this decade. Interest rate ceilings, reserve requirements and liquid asset requirements were used extensively to limit bank lending, monetary growth and inflation¹⁴.

¹⁴ Another possible explanation of the low monetary growth could be the low levels of credit demand by borrowers who would have otherwise qualified for bank loans.

Figure 6: Zimbabwe's nominal money supply for the period 1980-97



Source: Quarterly Economic & Statistical Review, RBZ (various issues)

2.2.1 Types of money

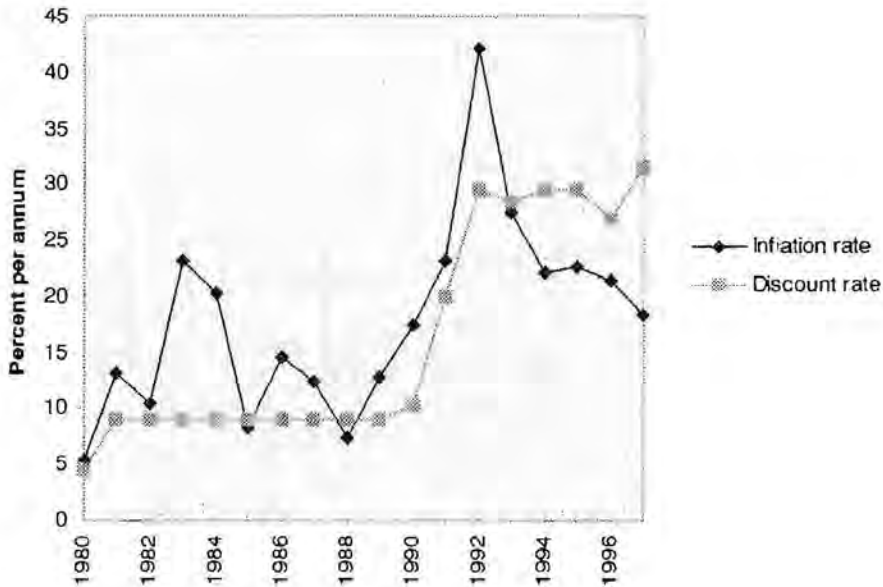
There are three types of money supply measures in Zimbabwe. These are M1, M2 and M3:

- M1 is made up of notes and coins in circulation plus demand deposits with the banking system.
- M2 consists of M1 plus other short- and medium-term deposits. Short-and medium-term deposits are defined as savings deposits plus under 30 day deposits with the banking system.
- M3 consists of M2 plus over 30-day time deposits with the banking sector.

The composition of Zimbabwe's total money supply is illustrated in Figure 7.

Two important features stand out in Figure 7:

- The first is the relatively small size of the currency component of the money supply.
- The second is the growing share of short-and medium-term deposits in the money supply. These deposits have grown at the expense of long-term deposits which

Figure 8: Inflation and interest rates in Zimbabwe, 1980-97

Source: Quarterly Economic & Statistical Review (RBZ)

Two distinct phases are highlighted in Figure 8:

- Real interest rates were negative during the 1980s. Inflation was higher than nominal interest rates largely because financial repression kept interest rates artificially low. This period indicates an era of unsuccessful monetary policy.
- The second phase shows the conversion to interest rate control. Sharp increases in interest rates were supposed to achieve real positive rates. The first increase in 1991 raised the discount rate from 10 percent to 20 percent in 1991 (RBZ). Another increase in 1992 saw interest rates raised by another 9.5 percent. These two increases indicate a 20 percentage points increase in the discount rate within a space of two years.

2.3 Fiscal Policy

This section shows the government's budget policy from 1980 to 1997. The trends shown here will focus on the effect of government expenditure on the budget deficit and on government debt.

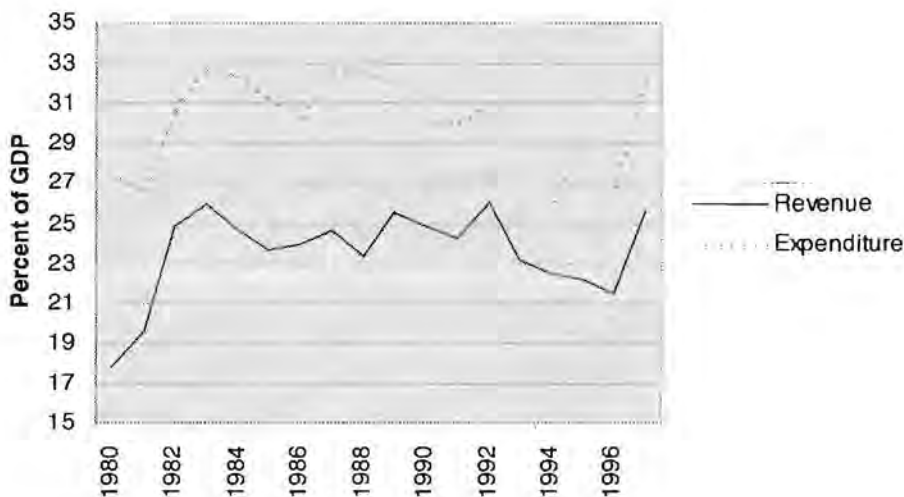
2.3.1 Government expenditure

The percentage of the government's budget to GDP provides a measure of the government's size relative to the size of the economy. Figure 9 presents the total of central government expenditure and taxes as a percentage of GDP for the years 1980-97.

Two issues are apparent from the diagram:

- The ratio of the government's budget relative to the size of the economy has hovered around 30 percent throughout the period. While this does not necessarily mean that the budget has been growing (GDP could have fallen instead), it does mean that the government has been responsible for one third of Zimbabwe's aggregate demand.
- Government expenditure has persistently exceeded its revenue. This has resulted in a constant budget deficit and a rising public debt.

Figure 9: Government expenditure and taxes as a percentage of GDP, Zimbabwe 1980-97



Source: Quarterly Economic & Statistical Review (RBZ)

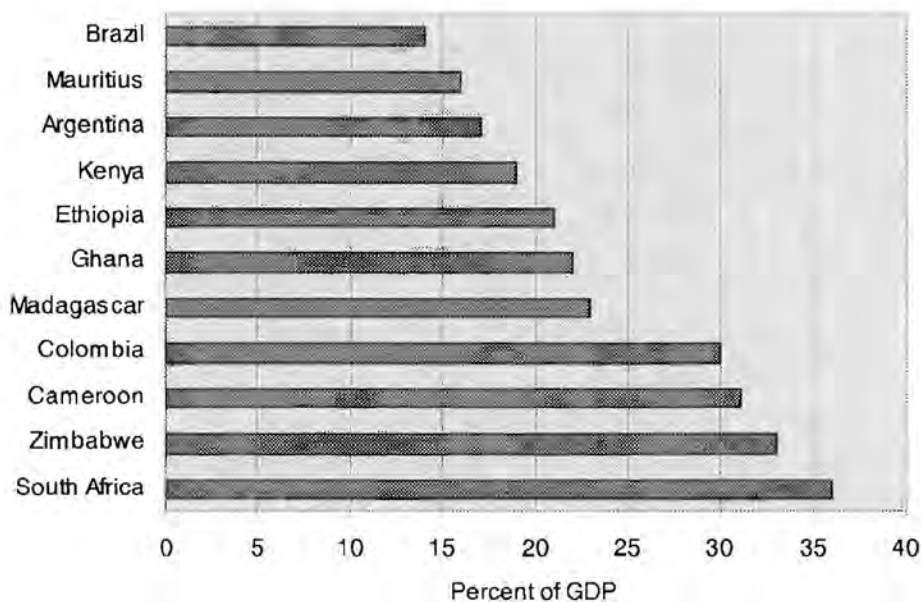
2.3.2 Comparative size of government

To put the size of the government's budget into context, we need to compare it to other countries. Figure 10 looks at government spending as a percentage of GDP for

selected countries. To allow for a fair comparison, only countries classified as developing economies have been selected.

Looking at the entire spectrum of countries, Zimbabwe's level of spending is high. Brazil is ranked as the seventh largest economy in the world (World Bank 1997) and yet Zimbabwe's budget relative to its size is twice that of Brazil.

Figure 10: Government expenditure as a percentage of GDP in 1990



Source: Nattrass et al (1995)

2.3.3 The budget deficit

Figure 11 illustrates the budget deficit relative to government expenditure and GDP for the period 1980-97. Certain features are observed:

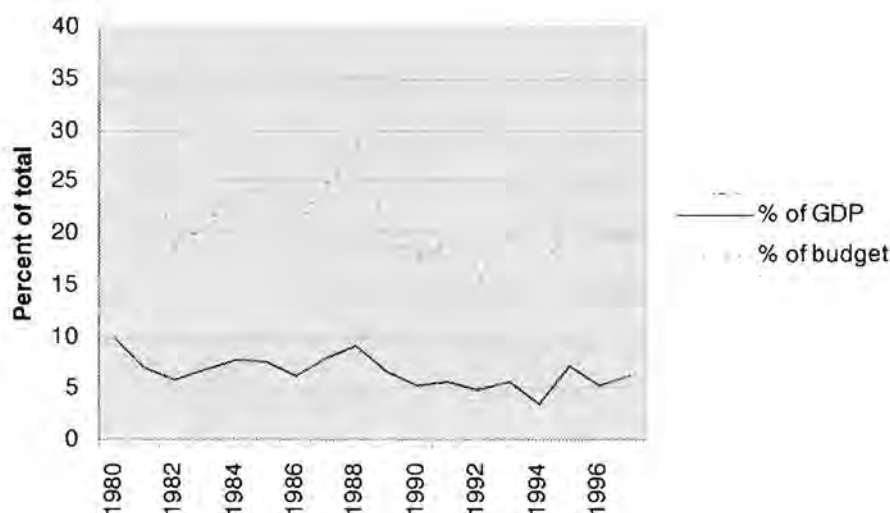
- There has been considerable variation in the budget deficit relative to GDP and expenditure.
- While no short-term patterns have emerged, the long-term trend in the two ratios has been constant.

As Black et al (1997, p.313) note, little concern need exist about the observed variability of the budget deficit" since variability can be advantageous. If increases in the budget deficit tend to coincide with recessions, and decreases coincide with

economic booms, then this indicates that the budget is acting as an effective built-in-stabiliser.

However, in Zimbabwe's case huge outlays on loss-making parastatals has been significant in raising the deficit (Harvey 1998, RBZ 1997). If one refers back to the earlier section on the business cycle, one does not find increases in the budget deficit to be synchronised with periods of recession. In light of this, Zimbabwe's budget deficit is a cause of concern.

Figure 11: Budget deficit as a percentage of budget and GDP, Zimbabwe 1980-97



Source: Quarterly Economic & Statistical Review (RBZ)

The size of the debt is as significant as how this deficit is financed. There are three sources of funding of the budget deficit in Zimbabwe. These are the banking sector, the non-banking sector and the foreign sector. The banking sector consists of the Reserve Bank, commercial banks, accepting houses and discount houses while the non-banking sector comprises individuals and non-bank corporations. Figure 12 presents the composition and financing of the budget deficit for the period 1980-97.

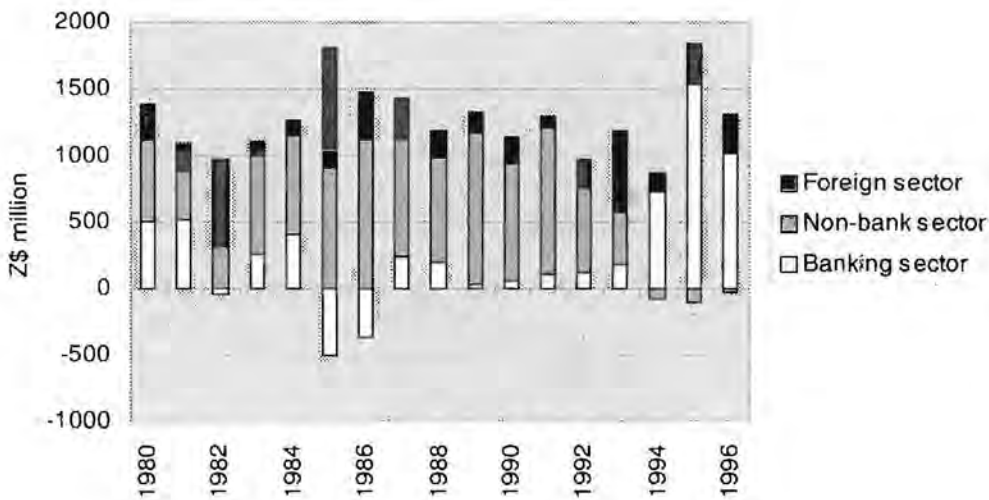
Some observations from the graph merit mention:

- Borrowing from the banking sector was comparatively low during the 1980s. In 1986 there was actually an episode of negative borrowing (repayment of debt).

This reluctance to borrow from the banking sector is consistent with the restrictive monetary policy of this period (see Monetary policy section).

- Borrowing from the non-banking sector has been the preferred source of financing the budget deficit up until 1992. Foreign sector borrowing has fluctuated throughout the entire period. This may reflect foreigners' uneasiness to lend to a country with a 'high risk' rating.
- Since 1993 the major source of financing of the budget deficit has been the banking sector. At the same time the non-banking sector has been repaid. This increase in borrowing from the banking sector is one of the main causes of rapid monetary growth during the 1990s.

Figure 12: Financing the budget deficit, Zimbabwe 1980-97 (1990=100)

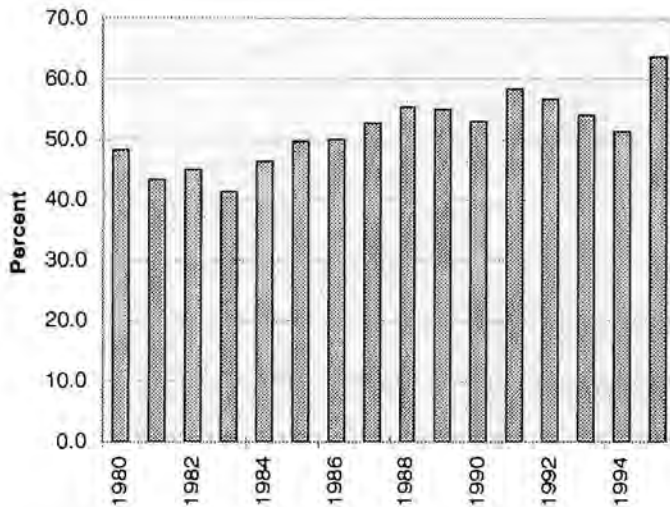


Source: Reserve Bank of Zimbabwe (1997)

2.3.4 The public debt

The increasing budget deficit has impacted adversely on the public debt. Figure 13 shows a rising long-term trend in the total public debt as a percentage of GDP.

Figure 13: Public debt as a percentage of GDP, Zimbabwe 1980-97



Source: Reserve Bank of Zimbabwe

2.4 The balance of payments

This section looks at Zimbabwe's external account variables. These include the nominal and real effective exchange rate, the trade balance and the overall balance of payments position.

2.4.1 Exchange rates

The trend in Zimbabwe's exchange rate for the years 1980-97 is presented in Figure 14. The two sets of data refer to the nominal and the real exchange rate.

The nominal exchange rate simply states the price of one country's currency relative to another's. The real exchange rate, however, is a measure of the nominal exchange rate adjusted for differences in the inflation rate between countries (Black et al, p.281).¹⁵ The real exchange rate determines a country's degree of international competitiveness. A rise¹⁵ in the real exchange rate increases competitiveness while a fall in the real exchange rate decreases it.

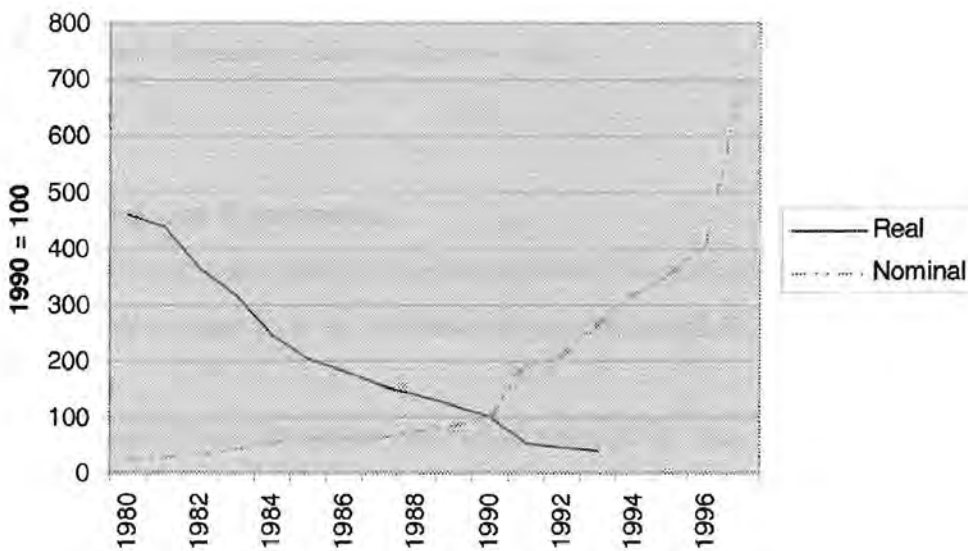
Some important features are evident in Figure 14:

¹⁵ The real exchange rate is defined as $REX = eP^*/P$, where e =nominal exchange rate, P^* =world prices and P =domestic prices. A rise in REX means that the nominal exchange rate is rising faster than domestic prices. This means that the country's goods are becoming cheaper and more competitive internationally.

- The rapid depreciation of the nominal exchange rate accelerated after 1990.
- The trend in the real exchange rate has been downward since 1980. This suggests that domestic prices have risen faster than the nominal exchange rate's depreciation.

The falling real exchange rate indicates that Zimbabwe's international competitiveness has declined since 1980. This decline would be expected to induce an increase in imports relative to exports. Figure 15 indicates that this happened in Zimbabwe. Imports have been significantly higher than exports since 1990 and the trade balance has deteriorated¹⁶.

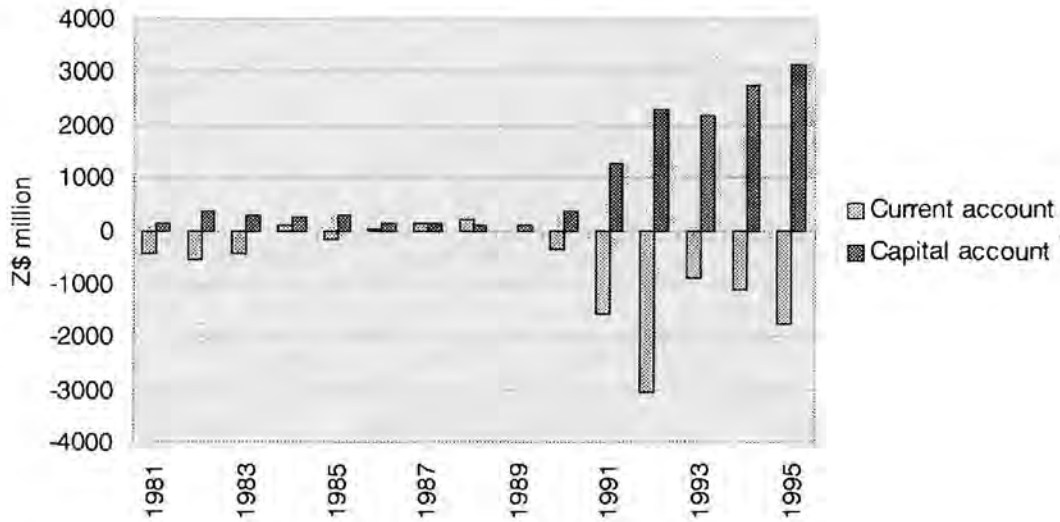
Figure 14: Nominal and Real Effective Exchange Rate, Zimbabwe 1980-97



Source: Quarterly Economic & Statistical Review (RBZ)

¹⁶ Since they are price takers, exports are no less competitive on international markets. However, due to the exchange rate policy, the returns on investment are higher for domestically traded goods.

Figure 16: Zimbabwe's capital and current account, 1980-95



Source: Quarterly Economic & Statistical Review (RBZ).

2.5 Summary

The brief survey of Zimbabwe's macroeconomy highlighted the following:

- The economy experienced negative growth rates in 1984 and 1992. Severe drought was identified as a major cause of this. Economic growth in other years was erratic and low.
- Monetary policy was restrictive during the 1980s. The authorities' attempt to control inflation accounted for this policy stance. Financial repression kept nominal interest rates artificially lower than inflation during this decade while money supply expanded rapidly in the 1990s. Financial repression was abandoned in 1991 and, since then, positive real interest rates have been achieved by keeping nominal rates above inflation. The share of long-term deposits in total money supply has been steadily declining.
- The government's budget relative to the size of the economy is high by developing world standards. Government revenue has been consistently lower than government expenditure. This has resulted in an increasing budget deficit and public debt. This deficit was financed mainly by the non-banking sector during the 1980s. This was consistent with the passive monetary policy of the period. However, since 1992 the deficit has been financed mostly by the banking sector.

- The country's international competitiveness has waned markedly since 1980. This lack of competitiveness has reduced exports relative to imports. The trade balance has consequently deteriorated. The capital account has recorded negative net capital flows. The current account and capital account deficits have caused an overall balance of payments; this deficit has been financed through the running down of the country's foreign exchange reserves.

Chapter Three

The period of financial repression: 1980 to 1990

Independence in many SSA countries saw an immediate attempt to 'indigenise' the financial sector in these states. This chapter will present the argument that in the first decade of independence, no attempt was made by the authorities in Zimbabwe to increase indigenous participation in the financial sector.

The first part of this chapter will argue that the economic boom in the immediate post-independence period helped to prevent calls for the immediate 'indigenisation' of the financial sector. Mugabe's policy of reconciliation also served to confirm that the oligopolistic, foreign nature of the banking sector would remain intact. Consequently, while the new government advocated socialism, the issue of financial sector policies was not a feature of any official government economic policy or pronouncements.

The second part of the chapter will show that a combination of droughts and capital outflows ended the earlier economic boom. At this stage the government decided to increase its expenditure in order to achieve its aim of economically empowering its African constituency. However, at no stage did the government forcefully direct the financial sector into lending to indigenous businessmen or rural farmers. Moral suasion was used, along with various tools of financial repression (inherited from the previous government) such as interest rate controls and foreign exchange restrictions. However, the failure of financial repression would eventually force the government into introducing financial reforms.

3.1 The initial post-independence period

At independence in 1980, many observers expected Zimbabwe's financial sector policies to reflect the government's stated populist agenda. As in the other SSA countries, the new government faced demands from its African support base. These demands included new jobs, higher incomes and basic social development. It was expected that changes in the financial sector would complement the government's own efforts to satisfy these demands. For example, the ability to borrow from

commercial banks was expected to develop and empower blacks both socially and economically.

The signs during the first two years after independence seemed very promising. During this period, Zimbabwe enjoyed a massive economic upswing as the few selected macroeconomic indicators shown in Table 2 reveal.

Table 2: Percentage change in selected macroeconomic indicators in Zimbabwe, 1980-82 (%)

	1980	1981	1982
Real income/capita	7.4 %	9 %	1%
Employment	3 %	2.8 %	1 %
Capacity utilisation	83 %	95 %	91 %
Investment/GDP	14.8 %	15.5 %	17.5 %

Source: CSO, Quarterly Digest of Statistics, September 1985

The boom of 1980-82 had little to do with changes in the financial sector. Instead, Mandaza et al (1987) believe that the boom was a fortuitous windfall from largely transient factors such as:

- A once-off terms-of-trade boon with the lifting of sanctions; The lifting of sanctions would have also renewed access to external capital finance.
- A high excess of 25 per cent meant that large increases in production output could be achieved fairly quickly.
- The particularly good rains of 1980 and 1981 impacted favourably on agricultural production.
- The effect of various statutory manipulations. Minimum wage legislation raised urban wages and salaries while the gazetting of higher producer prices increased agrarian incomes. At the same time, the exodus of whites after the removal of overt racial labour legislation saw gains (though small) registered in black employment.

3.1.1 No immediate changes to financial sector policy

Chapter one noted that nearly all of the newly independent SSA countries immediately tried to use the financial sector to bring about economic change for the constituencies that had supported their struggle for independence. However, in Zimbabwe's case there was no apparent eagerness to transform one of the most sophisticated financial systems in sub-Saharan Africa. Despite the imposition of United Nations sanctions in 1965¹⁷ foreign-owned commercial banks managed to successfully mobilise local savings. These savings were directed into investment projects that yielded ten years of relatively high growth rates (Seidman 1986). This explains the expansion of the financial sector during the UDI era.

As the National Accounts¹⁸ attest, the financial sector's annual contribution to GDP increased six times between 1963 and 1978, exceeding GDP growth twofold. Simultaneously, profits of the private financial institutions rose from 1.8 per cent to 6.9 per cent of the nation's gross operating profits.

Thus at independence, the new government inherited an efficient financial system which had successfully defied UN sanctions. This system had well-managed commercial and merchant banks, discount houses, finance houses and a well-regulated stock exchange.

a) Character of banking unchanged

Two noticeable characteristics of this financial system were the oligopolistic and foreign nature of the banking sector. Four foreign-controlled commercial banks handled Zimbabwe's commercial banking business at independence. Nedcor, the South African bank, controlled Rhobank while Barclays and Standard were British-controlled banks. The fourth bank, National Grindlays, catered mainly for British and some American interests.

At independence the status quo remained. This surprised those who had expected Zimbabwe to emulate Nigeria's 'Nigerianisation' and Tanzania's 'Nationalisation of

¹⁷ In 1965, the Rhodesian Prime Minister unilaterally declared independence (UDI) from Britain. For such temerity, international sanctions were imposed on Rhodesia.

¹⁸ Central Statistical Office (CSO), various publications.

the Banking System'. After all, the new government's African support base had been denied access to commercial credit under the previous regime. Furthermore, the new government had assumed office espousing an unequivocal socialist ideology. A fundamental socialist notion is that the state should nationalise all means of production.

b) No official financial reform policy

The financial sector in general, and the commercial banks in particular, were not prominent in the early major statements of government economic policy. While announcements were made that government would encourage savings' institutions to extend services to rural areas, nothing substantial materialised. A National Development Fund was mooted (GoZ 1981, pp.14-15) but never implemented. Similarly, in both 1982 and 1983, a Money & Finance Commission was proposed but never established.

Mugabe instead gave assurances to the white population and business community that any changes in policy would be implemented on a gradual basis. When, the 'First Five-Year National Development Plan' in 1986 contained no mention of financial sector reform, it became clear that as a major policy issue, financial sector reform was not on the government's immediate agenda.

Mugabe's assurances to the white-controlled banking sector contrasted with the policy of 'Nigerianisation' adopted in Nigeria's financial sector. Independence in Nigeria was followed by the rapid imposition of legal restrictions on foreign banks. This was done to increase African participation in the financial sector.

Through legislation, all foreign banks operating in Nigeria were required to incorporate in the country. The Nigerian Enterprises Promotion Act (1977) set minimum guidelines for indigenous participation in the financial sector. For example, it became a legally binding requirement that 60 per cent of any bank's shares had to be held by Nigerian interests.

In Zimbabwe, however, the government left the 100 per cent foreign ownership of commercial banks undiluted. While its purchase of 62 per cent Rhobank, seems to

contradict this statement, the purchase must be assessed in context. Firstly, the sale took place on a 'willing buyer-willing seller' basis. Secondly, the price paid by the government, (91 per cent of the shares' trading value), was described as 'very fair' by the sellers. Harvey argues that the sale was inevitable as the foreign owners wanted to withdraw from Zimbabwe. Possibly, the government bought the shares to maintain confidence in the banking system. Another possible explanation is that Rhobank's major shareholder was Nedbank, a South African bank. Perhaps the government found it politically unpalatable to allow a South African bank to operate inside the country.

In any event, the purchase of the majority shareholding in this commercial bank was not motivated by the government's desire to direct its lending operations. Sufficient evidence exists to support the above claim:

- The bank's management was unaltered at acquisition while subsequent new directors and senior managers were hired from the private sector. This development contrasted sharply with that in other SSA countries where senior politicians and civil servants were appointed to head parastatal financial institutions.
- Zimbank did not seem to enjoy a disproportionate share of the banking business of non-financial parastatals for such business continued to be shared out among all the commercial banks.
- Throughout the years, the government continued to decrease its shareholding in Zimbank ¹⁹until by the early 1990s it held less than 50 per cent of the shares.

Meanwhile, while pressure may have been applied on the other three commercial banks to localise management, no legislation was passed which would have forced them to lend to favoured sectors. This contrasts markedly with the Nigerian experience.

¹⁹ It must be acknowledged, however, that the government's own weak financial position may have been another reason why it did not take up its rights when new shares were issued by Zimbank.

c) The non-appearance of indigenous banks

Besides the lack of interference with foreign-controlled banks, the expected proliferation of new 'indigenous' banks did not happen. A new commercial bank, the Bank of Credit and Commerce in Zimbabwe (BCCZ), did come into existence but its majority shareholding was foreign. In fact, BCCZ engaged mainly in trade bills and loans to government statutory bodies rather than in providing finance to the general black population. Plans were announced for BCCZ to extend credit to peasants and small African businesses in the previously neglected areas, but as long as BCCZ adhered to the same lending criteria as the other commercial banks, this was unlikely to happen.

d) Limited changes to central bank

The new government's treatment of the Central Bank was also markedly different from that of other SSA countries. In Nigeria, the Central Bank was used as an active agent of 'Nigerianisation'. For example the Central Bank in Nigeria took concrete steps to remedy the widespread complaint that commercial banks discriminated against Nigerian borrowers (Seidman, p.82).² In this effort, the bank:

- attempted to control the sectoral distribution of credit by setting limits to the total credit that different sectors could acquire, and
- tried to stimulate a wider geographical spread of banking by tying approval of new urban branches to a definite commitment by applicants to open new rural branches.

Even the profits of commercial banks in Nigeria were regulated by the Central Bank as banks were forced to transfer 25 per cent of their net annual profits into a reserve fund.

In Zimbabwe, however, the operations of the Reserve Bank (RBZ) were left largely intact. The man seconded by the South African Reserve Bank to head the RBZ under the previous regime remained in office for the first two years after independence, while one of the RBZ's first tasks was to actually lift the prohibition on remittance of profits by transnational corporations. The RBZ made it possible for these companies

to remit up to 50 per cent of their after-tax profits, while the commercial banks continued to make decisions concerning foreign exchange requests from their clients.

The RBZ, however, addressed the lack of African personnel in its structures. To address this anomaly, the bank focused on developing training schemes for African staff. Indeed this was a continuation of the personnel reforms started in 1979 under the Muzorewa administration. At no stage did the RBZ attempt to interfere with the day-to-day operations of commercial banks or in the banks' use of their profits.

The relative 'maturity' of the RBZ has in fact been submitted as a reason for the lack of any revolutionary changes in Zimbabwe's financial sector. At independence in 1980, the RBZ had already been in business for 24 years. In other SSA countries, political independence coincided with the creation of their central banks. Consequently central banks in these countries lacked the institutional authority to defend the banking system from government interference. Zimbabwe, on the other hand, possessed a thoroughly competent RBZ staff, an established reputation and an unyielding belief in market principles. This belief in market principles suited the general climate of development opinion which had shifted to support for market-oriented policies. This situation contrasted to that facing other SSA countries that had gained independence in the 1960s when world opinion was still for centralised development planning, and a dominant role for the public sector.

e) The policy of reconciliation

The new government's reconciliatory approach at independence also helped to protect commercial banks from government intervention. Zimbabwe's comparatively late independence allowed the new leaders to contemplate the heavy costs of unsound government intervention. In Mozambique 90 per cent of whites left at independence and took with them any hopes of post-war economic prosperity. Zambia and Kenya had also suffered economically because of their recalcitrant attitude towards reconciliation with whites. In Zimbabwe, a similar hard-line attitude would have been fatal. Not only was 88 per cent of all marketed agricultural output from white-owned farms, but these farms (especially tobacco) accounted for half of the country's exports and 35 per cent of formal sector employment. Even manufacturing, which accounted

for a quarter of GDP, was under white ownership and management as it was closely linked to agrarian output.

3.2 1982-1990: The post-independence boom ends

Initially, there appeared no need for the government to address the issue of banking sector reforms. Various factors were given earlier in this chapter to explain the impressive two year post-independence growth spurt. This prosperity seemed to buy time for the government. As for as long as incomes and private consumption were rising, the predominantly rural population was quite content to enjoy the euphoria unleashed by independence. However, after 1982, the boom faded.

3.2.1 Causes of the recession

The causes of the economic downturn include (Mandaza et al):

- the capital outflows which followed the lifting of UDI sanctions,
- the under-utilised capacity that had propelled the initial growth spurt had been exhausted and,
- the severe drought of 1982/83.

Of the above reasons, the outflow of capital could have had the biggest impact on financial sector policy. With the lifting of UDI sanctions in 1980, government partially eased exchange controls²⁰. Table 3 shows the considerable outflows which ensued. These increases incorporated higher emigrant and pension remittances, payments of interest, profits and dividends. Pension remittances were an inescapable charge on natural resources as they were legally guaranteed by the provision of the Lancaster House Constitution.²¹ The effect of such considerable outflows was to create considerable disequilibria in the external and fiscal balances.

²⁰ However, during the 1980s, such emigrant remittances were reduced and in 1983/4 their initial liberalisation was reversed.

²¹ This document, brokered by the British at Lancaster House in 1979, stated the terms and conditions of Zimbabwe's independence.

Table 3: Capital outflows from Zimbabwe, 1980-83 (Z\$ Million)

	1980	1981	1982	1983
Net factor	-72.4	-122.7	-206.4	-285
Payments				
Net Transfers & Remittances	-40.4	-23.0	-62.3	-75

Source: Quarterly Economic & Statistical Review, RBZ (various issues).

3.2.2 The character of the recession

The recession of 1982-84 manifested itself through a cyclical pattern of production bottlenecks, job losses, and tremendous pressure on the BOP's current account. In fact the inability to sustain imports of essential inputs largely caused these bottlenecks and the concomitant joblessness. While the current account deficit grew, real GDP declined by 2 per cent in 1982, by 3.5 percent in 1983 before registering a slight positive recovery in 1984.

During the same period, unemployment grew by as much as 3 per cent. Under such economic hardship, the realisation of the government's populist ideals was not possible. The immediate question facing the government seemed to be how to economically empower its African constituency without interfering in the white-controlled financial domain?

3.2.3 The government's response

The government decided that it would compensate for the banking sector's failure to provide blacks with credit. This would be achieved by turning the annual government budget into the central and independent instrument for resource mobilisation and distribution in Zimbabwe (Mandaza et al 1986).

Under optimal conditions, people can borrow from financial markets in order to finance their human capital development. Such borrowing would then be repaid from the realised future income streams. However, poor people cannot borrow against their future income since their lack of collateral carries credibility problems. In such

situations, financial markets can be forced to lend to such people or the government can provide these funds by itself. The latter seems to apply for the Zimbabwean case. Evidence of this lies in the amount of public funds directed to ministries such as the Ministry of Co-operatives, and the Ministry of Rural Planning which served as active vehicles of resource allocation in favour of the rural black population. Tellingly, however, the bulk of the spending was directed towards health and education; two areas where human capital development amongst black people had lagged behind the rest of the population.

Thus, in spite of the white-controlled banking sector, the government promised to economically empower African people through the populist use of the budget. As a consequence of this resolve, the budget would become the major mechanism for the structuring of economic and financial policy. Such populist interventions by the government were a common feature of budgets, especially during the first ten years after independence. The issue of actually 'indigenising' the economy itself, only became a prominent issue after 1990.

3.2.4 Consequences of government's increased spending

a) Domestic debt

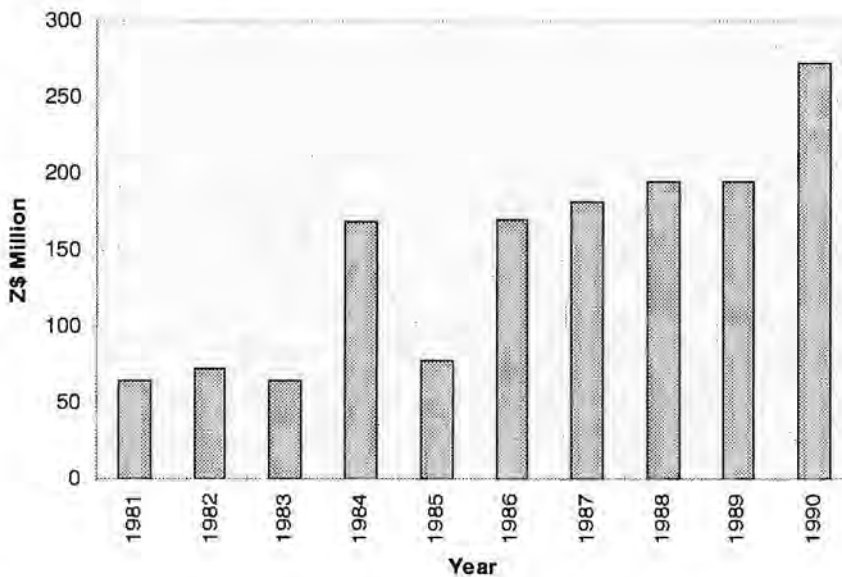
One serious consequence of this decision was a rising domestic debt. Harvey notes the irony of this situation: the government would itself borrow from commercial banks and other financial institutions rather than to encourage or force these institutions to lend directly to the masses. Incidentally, this arrangement seemed to suit both sides; the government 'scored political points' by acting as the sole vehicle of black economic emancipation and, since interest payments on government debt are tax-free in Zimbabwe, financial institutions generated higher clear profits from their increased lending to government.

b) Increasing inflationary pressure

A significant effect of the government's escalating domestic debt was that inflationary pressure was heightened. Since the domestic public debt was expanding in order to finance primarily non-productive activities, it was contributing to inflationary

pressures by raising the money supply without expanding the production of real goods.

Figure 17: Monetary banking sector's holding of government stocks and bonds, 1981-90 (1990=100)



Source: Reserve Bank of Zimbabwe, 1993 Quarterly Bulletin

c) Increased cost of government debt

At independence, in line with IMF advice to limit inflationary pressure, the RBZ had raised the bank rate from 4.5 to 9.5 per cent. At the same time, the average tender rate for 91-day bills more than doubled, from 3.57 to 8.18 per cent. This adversely affected the government's debt situation as Seidman (1986) notes:

- The repayment cost for the increased issuance of treasury bills increased by a whopping 260 per cent between 1980 and 1982 (Seidman 1986).
- The interest rate on three-year government stock rose from 9.5 to 13 per cent.
- The cost of repaying the increased government debt in the form of stocks and bonds almost tripled within a space of two years.
- The debt cost for 1981 alone was 8 per cent of tax revenues for that year.
- With the exception of education and defence, debt repayment became the largest single item of government expenditure.

d) High private borrowing costs

Another problem was the increased burden rising interest rates placed on firms in the private sector. This rise in private borrowing costs coincided with other cost increases. For example, Harvey reveals that from 1980 to 1982 average depreciation and bank charges paid by manufacturing firms rose 45 per cent. Paradoxically, this seemed to be more harmful to the few African emergent businesses whose working capital outlays were heavily dependent on borrowed funds. Thus, not only was the government's own interest bill unacceptably high, but so too was that of small emergent businessmen whom the government had committed itself to assisting.

3.2.5 The use of financial repression

While the government's expenditure on health, education, social welfare and public enterprises rose appreciably, such spending would not solve the immediate need for commercial credit. For example, many rural farmers required access to credit particularly since the 1980s was characterised by frequent droughts. At the same time small emergent businessmen could not expand without financial assistance as their profitability dwindled due to low private consumption during drought years. The government's response was to use two orthodox tools of financial repression, namely foreign exchange controls and interest rate ceilings.

a) Foreign exchange controls

Foreign exchange controls in Zimbabwe were not a new phenomenon. During UDI, controls to preserve this precious commodity were enforced rigidly and accepted stoically. While the new government briefly relaxed these controls immediately after independence, the resultant growth of imports proved unsustainable and the government's response was to intensify import and foreign exchange controls.

A crucial spin-off of foreign exchange controls was that they effectively granted the government de facto control over the allocation of credit. In this respect Zimbabwe was following the precedent of Zambia which had notoriously exhausted its copper export revenues in credit allocations to indigenous Zambian producers. Often, the difference between profitability and bankruptcy for a producer was determined by that producer's ability to procure foreign exchange from the government (Davies 1991).

Through generous allocations from the foreign community, the government was also in a position to finance indigenous ventures. For example, foreign donor funds were used to help finance:

- The Agricultural Finance Corporation (AFC) which specialised in lending to indigenous small farms. Thus the AFC provided a service that the commercial banks might otherwise have been forced to undertake. From serving only 4400 African borrowers in 1980, the AFC had expanded its coverage of small African farming households to 70 000 by 1984 (Central Statistical Office 1990).
- The Small Enterprises Development Corporation (SEDCO) which assisted small emergent businessmen. At a time when commercial bank credit was priced at 39 per cent for prime borrowers, SEDCO was able to provide lending for rural and urban borrowers at rates of 21 per cent and 25 per cent respectively. This of course was made possible by SEDCO's own ability to borrow from the government at a preferential rate of 9 per cent. SEDCO would then use the spread to cover the costs of administration, extension work (providing business advice to borrowers) and short training courses for clients (Harvey 1998).

While the AFC and SEDCO were the two main lending bodies, other facilities such as the Credit Guarantee Company, also provided a cheaper line of credit for indigenous businesses.

Predictably, the demand for this cheap credit far exceeded its supply. However, borrowers preferred queuing for it rather than attempting to obtain expensive credit from the commercial banks. With its control over foreign exchange allocation allowing it to dictate lending to African borrowers, the government did not need to impose directed credit provisions on commercial banks.

b) Interest rate ceilings

Interest rate ceilings were wholly inadequate. While ceilings could theoretically decrease the cost of borrowing, in practice they did not increase the volume of credit extension since the commercial banks were not compelled to deviate from their stringent lending criteria. Furthermore, credit ceilings may actually have reduced the volume of savings. This would have diminished the pool of resources available for

credit²². In fact, the only party that seemed to benefit from this tool of financial repression was the government which was able to borrow from the banking sector at artificially low rates.

3.2.6 Need for reform

By 1990, the government's banking sector policy was beginning to unravel. While stealth by its very nature is difficult to document, it was reported that funds procured by institutions such as the AFC and SEDCO, were not reaching their intended recipients (Harvey 1991). Instead, the temptation to 'round trip' was too great, and many beneficiaries of cheap institutional credit simply re-deposited it in commercial banks and accrued profits from the spread. For example, borrowing at 5 percent and lending at 25 percent could yield a healthy 20 percent profit margin. Paradoxically, this practice may have enhanced the profitability of the old commercial banks which were also benefiting from the government's failure to license new banks.

There was also discontent among Zimbabwe's foreign backers over the increased costs of government intervention in the financial sector. Perturbed by Zimbabwe's persistent double-digit inflation, the IMF demanded financial sector reform. Another concern was that Zimbabwe's population growth rate exceeded its real GDP growth rate, which effectively meant that living standards were falling. Increasing unemployment levels towards the end of the 1980s (CSO 1992) seemed to justify this concern.

The government's own accounts were in a woeful position. By the end of the 1980s:

- the government's budget deficit as a percentage of GDP was 6.6 per cent;
- the foreign debt to GDP ratio was near 45.2 per cent;
- the government's dis-saving rate had reached 20 per cent and
- the country's stock of reserves had been diminished in covering the growing balance of payments shortfalls (RBZ 1993).

²² The issue of interest rate ceilings and the rate of savings will be the next chapter's focus.

The government's attempt at using an interventionist strategy to empower black Africans had simply not worked. Using total real private consumption as a measure, living standards had actually fallen below pre-independence levels.²³ In need of IMF/World Bank monetary and technical assistance, the government introduced an economic structural adjustment programme in 1991.

²³ At independence, real private consumption stood at Z\$ 9.6 billion. By 1988 it stood at Z\$ 9.4 billion.

Chapter Four

Applying the McKinnon-Shaw Hypothesis to Zimbabwe

This chapter will attempt to empirically test whether there is a statistically significant and positive relationship between real interest rates and real savings.

The McKinnon-Shaw model of financial liberalisation states that where such a relationship does exist, the freeing of interest rates should improve the degree of financial intermediation and financial deepening. The first part of the chapter will show that monetary policy between 1980 and 1990 was relatively passive. High fiscal spending and inflationary fears were effective constraints on monetary growth. However, inflation during this period was still higher than nominal interest rates meaning that real deposit rates were negative. It will be shown that the volume of gross national savings was adversely affected by these negative real deposit rates.

The second part of the chapter discusses Zimbabwe's attempt to boost national savings and other financial ratios by using the McKinnon-Shaw framework. Regression analysis will be used to determine whether there is a significant and positive relationship between the real deposit rate and financial deepening.

4.1 Monetary policy in Zimbabwe 1980 -1990

Monetary policy entails the manipulation of the stock of money or interest rates with the aim of attaining some specific objectives. It also implies the controllability of the money supply and the reliability between that money supply and the policy objective.

Traditionally, monetary policy has four broad objectives; to promote price stability, to support balance of payments stability, to encourage employment and to enable economic growth. In Zimbabwe, though, the goal of price stability seems to have superseded the other three during the 1980s. In fact, a strong argument can be made that monetary policy was restrictive in Zimbabwe during the period 1980-90,

especially if one compares it to monetary policy after 1990 (see Figure 6 in chapter two).

4.1.1 Causes of restrictive monetary policy

Two factors may explain the contractionary monetary stance during the 1980s:

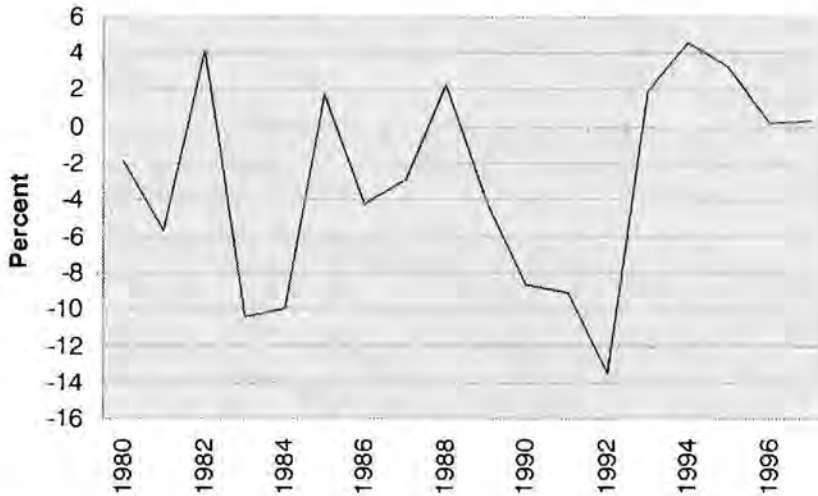
- The budget deficit was an effective constraint on monetary growth. As the government's deficit escalated in proportion with its expenditure²⁴, the RBZ was forced to contain monetary growth in order to maintain price stability.
- The existence of a policy of financial repression in the 1980s accounts for the second reason. This policy restricted both the number of financial institutions in the economy and the holding of foreign currency by citizens. The possession of foreign denominated accounts (FCAs) was prohibited while off-shore finance trading was particularly low. One consequence of these restrictions was to significantly curtail the activity of merchant banks.

An added restriction was the imposition of interest rate ceilings. Ceilings were imposed on both deposit and lending rates. To support this, the RBZ's own rediscount rate remained unchanged throughout the entire decade.²⁵ These artificially low interest rates would not have adversely affected the level of savings and financial deepening had the inflation rate remained below the interest rates level. However, throughout the decade, the inflation was persistently above the nominal deposit rate. Consequently, real deposit rates were negative during most of the 1980s as Figure 18 indicates.

While Zimbabwe's negative real deposit rates were not attractive, they were not as low as they were in other SSA countries such as Zambia. At one stage in 1989, real deposit rates in Zambia sank to -117.3 percent. In Zimbabwe, however, the average gap between the nominal deposit rate and the inflation rate was a comparatively modest -4.1 percent and was never higher than -10 percent in any particular year.

²⁴ The bulk of this expenditure was in bailing out loss-making parastatals, debt repayments, health, education and defence.

²⁵ The rediscount rate was raised to 9 percent from 4.5 percent in 1981 in line with IMF advice to curtail inflationary pressure. It remained at 9 percent for the rest of the decade.

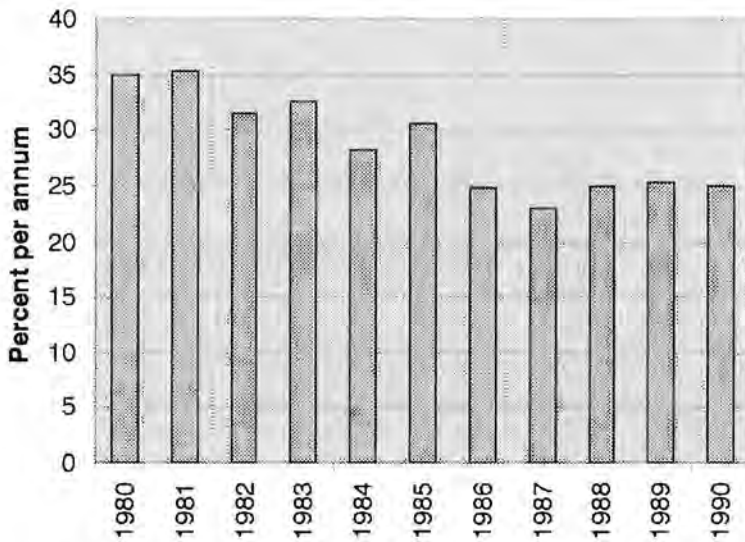
Figure 18: Real deposit rates in Zimbabwe (% p.a.), 1980-97

Source: International Financial Statistics Yearbook, IMF (1996)

This, coupled with the RBZ's contractionary monetary policy, should have prevented inflationary expectations from taking root and should not have considerably diminished the rate of financial intermediation.

The fall in financial deepening can also be explained by the taxation of the interest earned on deposits. The 'real' rates depicted in Figure 18 do not account for this taxation. It is difficult to calculate the 'post-tax real return' on interest-bearing deposits. This is because different depositors are liable for different rates of taxation. Harvey (1998) notes that since the marginal tax on interest ranged between 17 and 28 percent, even in the three years when real deposit rates were positive, taxation would have eliminated any positive returns. Thus for the entire decade, real after-tax returns on deposits were negative for most depositors.

Predictably, the major effect of negative real rates of return was a drop in the level of financial deepening as a glance at the ratio of 'M3' to gross domestic product highlights. Similarly, the ratio of interest-bearing deposits to gross domestic product fell from 52 percent in 1980 to just under 38 percent by 1990 (RBZ Quarterly Bulletin).

Figure 19: Ratio of M3 to gross domestic product, Zimbabwe 1980-90

Source: Quarterly Economic & Statistical Review, RBZ (various issues)

4.2 Empirical test of the McKinnon-Shaw Hypothesis

Data sources

Data for the testing procedure has been extracted from various issues of the RBZ's Quarterly Economic & Statistical Review. The use of quarterly instead of annual data is preferred because the accuracy of the testing increases with more data points. The data set runs from 1980 to 1997 and only real variables will be used. A dummy variable has been inserted to separate the period of financial repression (1980-90) from the period of financial liberalisation (1991-97).

Only the results of certain statistics are shown in this chapter. Full results of the regression tests are tabled in an appendix at the end of this paper.

Results of testing

4.2.1. McKinnon's Money Demand Theory

Also known as the 'complementarity hypothesis', this is McKinnon's explanation of how the real deposit rate (real interest rate) affects savings and ultimately investment

and growth. McKinnon asserts that since potential investors in developing countries are compelled into 'self-financing' their projects due to the paucity of external sources of finance, they must accumulate money balances on their own prior to investment. Thus the higher the rate of return on investment (i.e. the real interest rate), the more attractive the process of accumulating money becomes and hence the greater the incentive to invest. McKinnon's basic complementarity between money and physical capital is specified as (McKinnon 1973, p.59) :

$$M^d / P = f (\underset{+}{Y/P}, \underset{+}{I/Y}, \underset{+}{d-\pi^e})$$

where:

M^d / P = the real money stock (M3)

Y/P = real gross domestic product (GDP)

I / Y = the ratio of gross domestic investment to GDP

$d-\pi$ = real deposit rate of interest (the twelve month fixed deposit rate)

Theoretically, McKinnon's money demand specification seems correct for a country such as Zimbabwe. Seidman asserts that approximately 70 percent of all private firms' working capital requirements are procured internally off the balance sheet. This means that investors are relying on their own accumulated savings to accommodate their capital needs. That is, most of Zimbabwe's investment is financed internally'.

The test results are tabled below:

Table 4: Results of McKinnon's demand for money theory

	Coefficients	t-statistic	Probability
Y/P	2.143080	3.451687	0.0010
I/Y	0.144228	0.524971	0.6014
d-π	0.006449	1.980133	0.0487
Dummy	-0.159991	-1.553740	0.1251

Durbin-Watson statistic 1.992694 Adjusted R² 0.89 F-statistic 0.00000

Certain aspects of the results are in accordance with McKinnon's 'complementarity hypothesis':

- The coefficients of the three explanatory variables are each positive.
- The results indicate that the real deposit rate and real GDP are both significantly and positively related to the demand for real money balances.

However, the ratio of investment to GDP is not a significant variable. A probability statistic of 0.6 implies that there is only a 40 percent chance of incorrectly stating that the ratio of investment to GDP is not significant. Lowitt (1996) also found this ratio to be insignificant in the context of South Africa. She concluded that the direction of causality in South Africa was opposite to the one suggested by McKinnon. That is, money demand causes interest rates and not the other way around.

4.2.2. Shaw's Demand for Money Function

Unlike McKinnon, Shaw points to external rather than internal finance as being the effective constraint on capital formation. Thus the hypothesis to be tested here contends that higher real interest rates induce increased savings deposits which then stimulate investment since credit is available. With greater financial intermediation a rise in the average efficiency of investment also occurs. The notion that higher interest rates can stimulate higher, and more efficient, investment is explained by Shaw:

with more savings deposits financial intermediaries can then raise real returns to savers and, at the same time, lower real costs to investors by accommodating liquidity preference, reducing risk through diversification, reaping economies of scale in lending, increasing operational efficiency and lowering information costs to both savers and investors through specialisation and division of labour (Shaw 1982, p.734)."

The 'debt intermediation' view takes the following form (Shaw 1973, p.62):

$$M^d/P = f(Y/P, v, d-\pi^e)$$

+ - +

where:

M^d / P = the real money stock (M3)

Y/P = real GDP

v = the opportunity costs, in real terms, of holding money (the 15 year bond yield).

$d-\pi^e$ = real deposit rate of interest

Table 5: Results of testing Shaw's demand for money theory

	Coefficient	t-statistic	Probability
Y/P	1.422746	2.883989	0.0214
Y	-0.003290	0.771284	0.4452
d-π	0.007372	1.825882	0.0755

Durbin-Watson statistic 2.237896 Adjusted R² 0.09 F-statistic 0.0000

The results of this test are unsatisfactory because of the low significance attached to the real deposit rate and the vector of opportunity costs. The adjusted R² suggests that the independent variables explain only 9 percent of the total variation in money demand. This is evidence that Shaw's model is a poor specification of real money demand in Zimbabwe.

The presence of two interest rates as independent variables is not explained by Shaw. This could be a possible source of mis-specification. Shaw's model was tested again without the real deposit rate as an argument. The results appear below:

	Coefficient	t-statistic	Probability
Y/P	2.202719	3.450744	0.0010
V	0.001221	0.318619	0.7510
Dummy	-0.178917	-1.717911	0.0905

Durbin-Watson 2.044128 Adjusted R² 0.88 F-statistic 0.0000000

The model is once again incorrectly specified. The improved R² can be discounted as it is largely due to the insertion of an autoregressive term (first order) to remove autocorrelation. While real GDP retains its significance, the sign on the coefficient for the 15-year government bond yield is incorrect. Furthermore, the significance of this variable is rather dubious.

3. Savings Function

To date, the most detailed empirical testing of the McKinnon-Shaw savings function has been performed by Maxwell Fry (1978, p.466). The savings equation used by Fry is:

$$\text{Sd/Y} = f(\text{g}, \text{y}, \text{d}-\pi^e, \text{Sf/y})$$

+ + + +

where:

Sd/Y = real domestic aggregate savings/GDP

g = growth rate of real GDP

y = real GDP per capita

d-π^e = real rate of return on savings

Sf/Y = foreign savings ratio

Attempting to reduce savings into a regression equation is a contentious issue. It would be simplistic to state that any particular variables alone are the chief determinant of savings. This is because so many disparate factors have a direct bearing on a country's level of savings. Factors such as the level of innovation in the country, education standards and even the general psychological profile of people in a country can all impact on savings. However, for the purpose of this paper, the relationship between real deposit rates and real savings is particularly important.

The Granger Causality Test was used to test the null hypothesis that the real deposit rate does not cause real total savings.²⁶ The F-statistic was 4.519, while the probability of falsely rejecting the null hypothesis was only 0.00320. Thus, with 95 percent certainty, one can make a strong case that the real deposit rate strongly affects the level of savings in Zimbabwe. In order to ensure that there was only one direction of causality between the two variables, a similar test was performed to test whether it is in fact savings that cause the real deposit rate and the test results rejected this proposition. With the F-statistic this test a low 1.541 and the probability statistic 0.2, the null hypothesis was accepted that real total savings in Zimbabwe do not cause real deposit rates.

²⁶ Savings are defined as all deposits with financial institutions excluding demand deposits (RBZ).

The significance of this relationship can be tested using the OLS regression procedure. Table 6 shows the results of regressing real savings against the real deposit rate.

Table 6: Results of test to see if savings respond to deposit rates

	Coefficient	t-stat	Probability
$d-\pi$	0.006382	2.247325	0.0310

The causality determined by the Granger Causality Test is confirmed by the OLS regression estimation test.

Results of Fry's version of the full savings model are just as significant:

Table 7: Results of Fry's savings equation

	Coefficient	t-statistic	Probability
G	-0.024778	-3.385338	0.0014
Y	0.000961	4.792834	0.0000
$d-\pi$	0.006602	2.639748	0.0110
S/Y	5.35E-05	0.944861	0.3492

Durbin-Watson statistic 2.078697 Adjusted R^2 0.75 F-statistic 0.000014

Several conclusions can be drawn from these results:

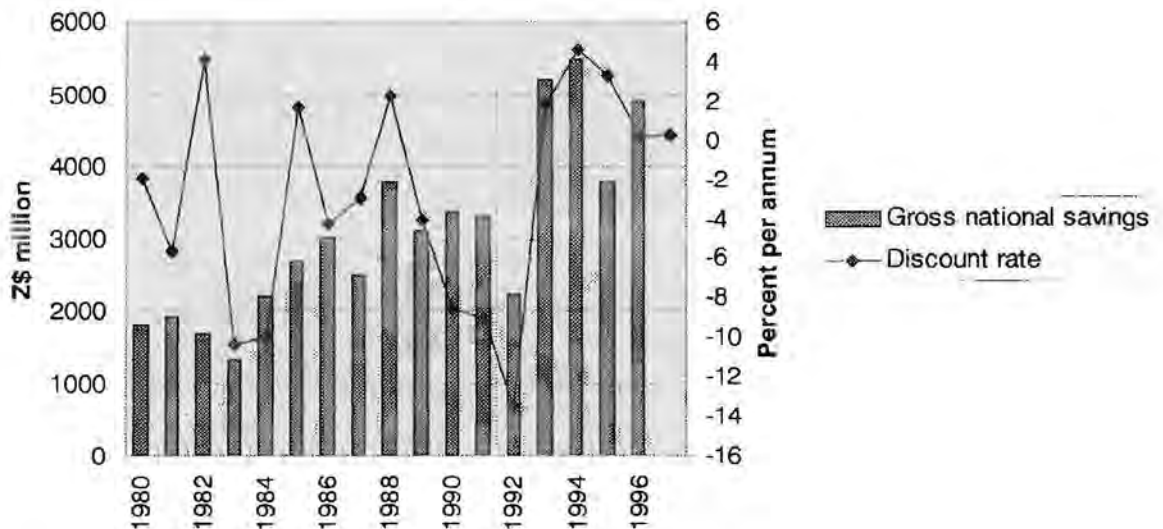
- The coefficient on the real deposit rate confirms that deposit rates are significant determinants of financial deepening in Zimbabwe. This is an important result since the financial liberalisation hypothesis stresses the role of deposit rates in boosting savings and other financial ratios.
- The growth rate of real GDP is also significantly and positively related to savings. This suggests that income is also a determinant of savings.
- The coefficient foreign savings ratio for the ratio of financial savings has the correct positive sign but it is not sufficiently significant. Thus, foreign savings have not been a significant influence on domestic savings.

4.2.3 Summary of tests

This chapter attempted to determine whether the abolition of financial repression in Zimbabwe could be expected to induce greater financial deepening. The regression results revealed that the entire McKinnon-Shaw model is not perfectly specified for Zimbabwe. However, the results show that there is a persistently significant and positive relationship between real interest rates and the respective levels of money demand and savings. Because of this relationship, the lifting of interest rate controls should have encouraged financial deepening and enhanced economic growth as the model predicts.

Furthermore, financial reforms were supposed to include the licensing of new commercial banks. This would increase competition amongst individual commercial banks and thus reduce the interest rate spread. That is, lower profits for commercial banks (due to lower lending rates) would be complemented by greater access to commercial bank credit for a larger proportion of the population. Thus, increased savings deposits due to higher deposit rates and increased access to credit due to more licensed banks would raise financial intermediation in Zimbabwe.

Figure 20: Real deposit rates (% p.a.), real national savings, Zimbabwe 1980-90



Source: Quarterly Economic & Statistical Review, RBZ (various issues).

Chapter Five

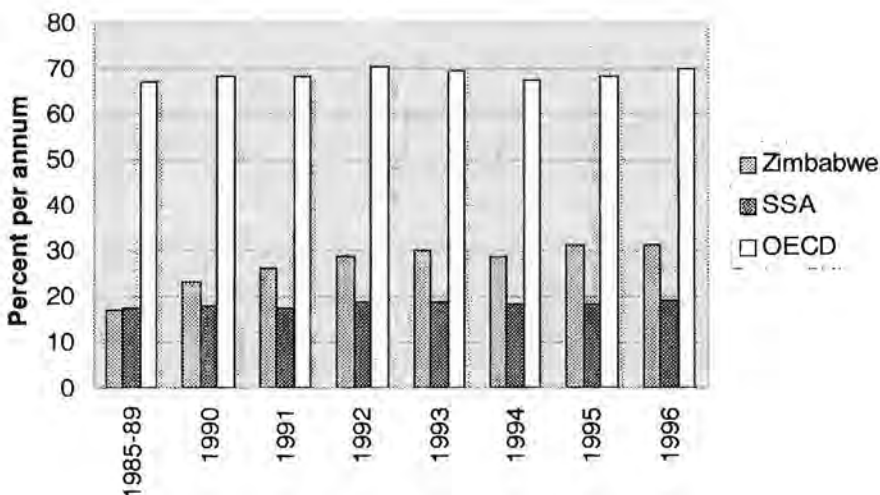
Explaining the lack of financial deepening

This chapter will show that the freeing of interest rates did not induce greater financial deepening because the government failed to contain inflation. In addition to this, the sequence of reforms was flawed. The anticipated increased competition between commercial banks did not materialise. This chapter will show that rather than lowering bank margins, commercial bank interest rate spreads actually increased due to the government's hesitation to issue new commercial bank licenses.

5.1. The absence of financial deepening

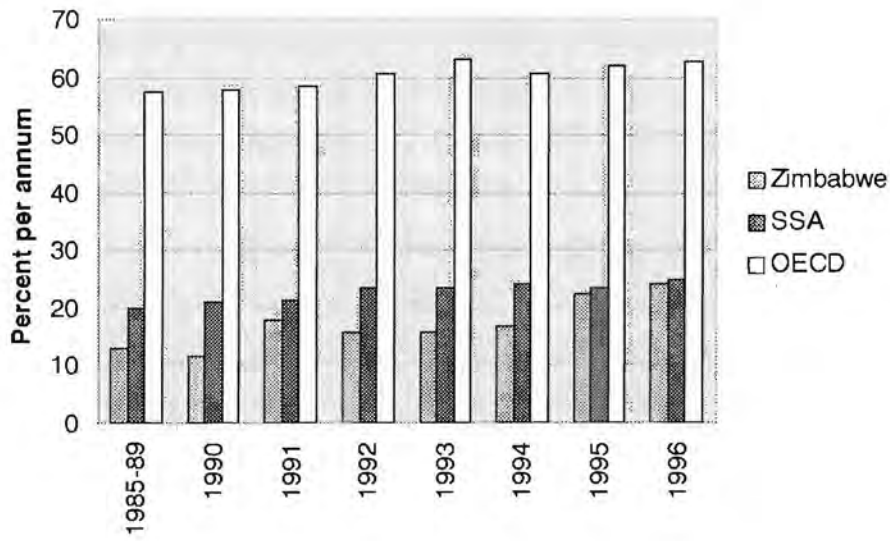
An analysis of selected indicators of financial intermediation reveals that Zimbabwe's reforms have not been very successful. Indicators of financial deepening from twenty three selected SSA countries and from OECD countries were compared with those achieved in Zimbabwe. Figures 21-24 illustrate show that Zimbabwe's financial intermediation ratios are far inferior to those of OECD. Of greater concern, Zimbabwe lags behind the SSA average in several categories.

Figure 21: Bank claims on private sector in percent of GDP, 1985-96



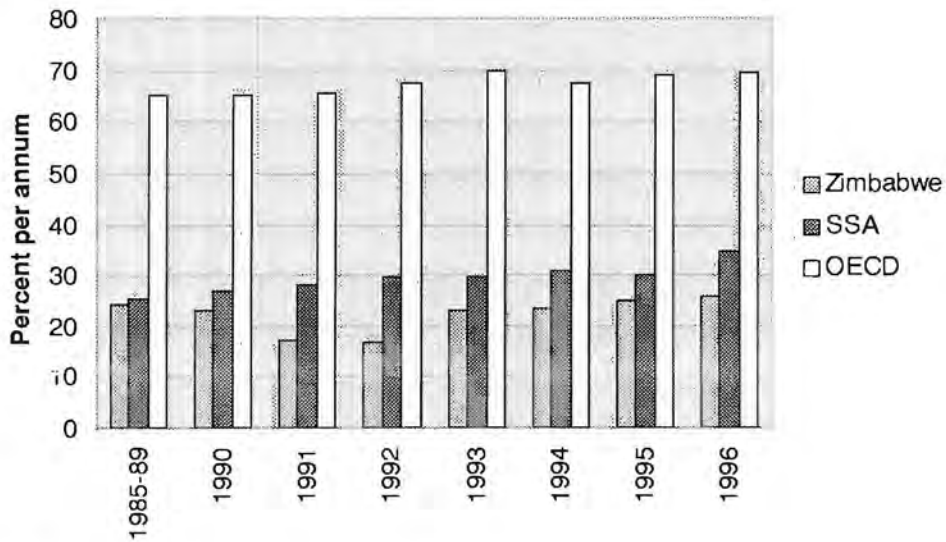
Source: International Financial Statistics (1998)

Figure 22: Demand & time deposits in percent of GDP, 1985-96

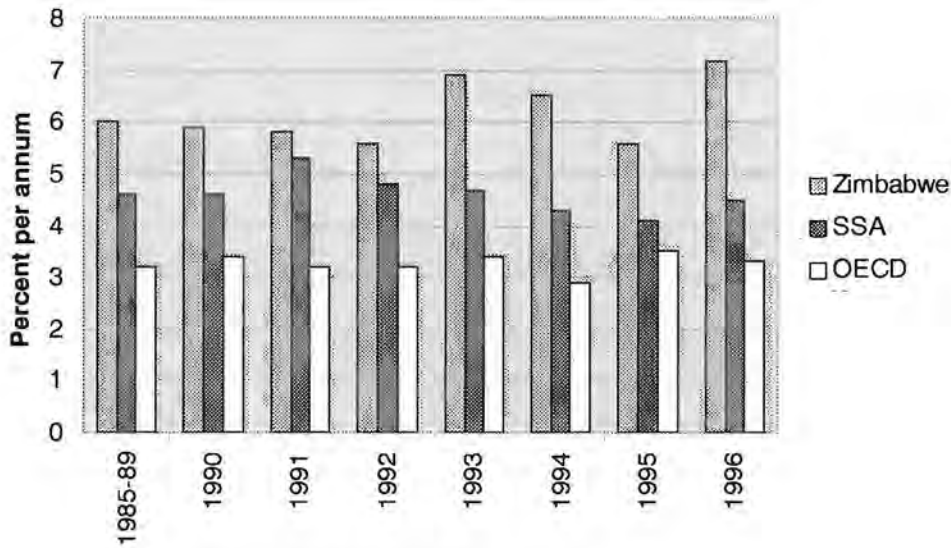


Source: International Financial Statistics (1998)

Figure 23: Broad money in percent of GDP, 1985-96



Source: International Financial Statistics (1998)

Figure 24: Reserves with central bank in percent of GDP, 1985-96

Source: International Financial Statistics (1998)

While Zimbabwe has certainly improved each ratio from its pre-reform (1985-89) average, the current level of financial deepening is still far behind that of the OECD countries. Zimbabwe's 'deposits to gross domestic product' ratio is lower than the SSA average. This observation is supported by the fact that the ratio of savings to gross domestic product averaged 20 percent between 1991 and 1997 (RBZ 1998). In other words, this ratio has remained unchanged from its pre-reform level. Zimbabwe's holding of reserves is abnormally high. Its ratio of reserves to gross domestic product is higher than both the SSA average and the OECD average. Reserves are essentially a tax on the financial system as resources tied up in reserves cannot be used to expand the financial intermediation process.

5.2. Explaining the lack of financial deepening

The following section puts forward several explanations of why interest rate liberalisation did not significantly improve financial deepening in Zimbabwe.

5.2.1 Failure to achieve important pre-conditions for reforms

To be successful, financial reforms must be sequenced correctly. The Villanueva-Mirhakhor framework states that a country should consider its current level of

macroeconomic stability as well as the strength of its supervisory framework before it frees interest rates. According to the framework:

“countries with unstable economies with inadequate bank supervision should first achieve macroeconomic stability and strengthen the bank supervisory framework before liberalising interest rates”

While Zimbabwe falls into this category, it failed to achieve the pre-conditions before freeing its interest rates.

a) Macroeconomic Stability

Low inflation and a low fiscal deficit are key characteristics of a stable macroeconomic milieu. Low inflation rates enable positive (but moderate) real interest rates, lower the risk premium on holding financial assets and increase the information content of financial variables (Chigumira 1998). A responsible fiscal policy enhances the credibility of financial reform. Indeed, a frugal fiscal regime is seen as evidence of the government’s commitment to allow financial intermediaries a greater role in the economy with less government intervention.

- **Budget Deficits**

Financial liberalisation typically reduces the revenue a government can generate from financial repression. As interest rate controls are lifted, the cost of servicing government debt increase. Unless the government can tap other compensating revenue sources, the possibility exists that the budget deficit will rise. If the government decides to monetise this deficit increased inflation is likely.

The indicators during the first phase of the reform programme in Zimbabwe reveal a growing budget deficit (see Table 8). At the onset of reforms in 1990, Zimbabwe’s budget deficit was 8.6 percent of its budget deficit. A commitment was made by the government to reduce this figure to 5 percent by 1995. However, by 1995/96 this percentage had actually increased to 9.4 percent. That is, it was nearly twice as high as the optimal 5 percent target. The synchronisation of financial liberalisation and a decreasing budget deficit simply did not happen in Zimbabwe.

Table 8: Budget deficit and interest on government debt as percentage of gross domestic product, Zimbabwe 1989-97.

	1989/90	1991/95	1995/96	1996/97
Budget deficit (%) of GDP	8.6	8.8	9.4	6.7
Interest on govt.debt (% of GDP)	6.7	6.7	9.3	7.7

Source: RBZ (1998)

Contributing to this deficit problem was the government's rising expenditure. The government's real expenditure during the reform phase (1991-97) was 20 percent higher than in the pre-reform decade (1980-90).

At the root of this rising expenditure was the government's support for loss-making parastatals. With the removal of interest rate ceilings, rising interest rates worsened these parastatals' debt burden. The cost of servicing loans and the cost of new credit was increasing at a time when parastatals' balance sheets were already unhealthy (Harvey 1998).

Besides facing a harder budget constraint, poor management and inflexible strategies in a changing milieu worsened the plight of parastatals. In 1994/95, parastatal losses totalled Z\$ 2 billion and Z\$ 1.8 billion in 1995/96 (Harvey).

Faced with such losses, the government should have hastened the privatisation of these public entities. This would not only have presented the government with a capital windfall, but it would have placed the parastatals on a more commercial footing. However, the government opted to use subsidies and distress borrowing to keep its parastatals barely afloat.

This proved a costly exercise. In 1994/95 alone, the government took up parastatal debts valued at Z\$ 4.2 billion (RBZ). Government support for parastatals would adversely affect the direction of domestic credit extension. As Fry (1996) notes, in 1995 domestic credit to the private sector increased by 18 percent (a decline in real terms); by 39 percent for parastatals and by 106 percent for the government.

Table 10: Rapid expansion in the number of financial institutions, Nigeria 1985-92

	1985	1992
Deposit-taking banks	40	523
Commercial banks	28	66
Merchant banks	12	54
Foreign exchange	0	132
Finance companies	0	666
Total bank branches	1 323	2 385

Source: Soyibo 1997

The solvency of many of Nigeria's financial institutions was dubious while the portfolios of banks were replete with non-performing assets. The supervisory efforts of Nigeria's central bank were also impeded by the constant threat of ad hoc intervention by the military authorities. The issue of policy reversals, policy credibility and consistency is thus inextricably linked to issues of supervision and monitoring.

Zimbabwe appears to have made the same mistake as Nigeria. The government only began piecing together new banking legislation in 1991-the same year that the financial reform process began. That is, the supervisory framework was not strengthened prior to reforms.

Commercial banks in Zimbabwe operate within the legal framework of the Banking Act of 1964. In accordance with this Act, the RBZ supervises commercial banks through the Inspector of Banks. The licensing of banks, however, is performed by the Ministry of Finance through the Registrar of Banks & Financial Institutions.

Licensing and supervision are thus not co-ordinated within the same structure. In appraising a commercial bank's overall soundness, the RBZ employs the CAMEL (capital adequacy, asset quality, managerial competence and liquidity level) rating system. However, this supervisory framework could not avert the 1997 collapse of

United Merchant Bank.²⁷ A survey (Moyo 1998) indicated that most financial institutions believe this bank failure could have been averted had new banking legislation been enacted prior to liberalisation. Weaknesses in the current Banking Act include the following:

- The division of supervision and licensing between the RBZ and the Ministry of Finance undermines the RBZ's effectiveness. When issuing licenses the Ministry does not confer with the RBZ; the RBZ is thus seen as operationally weak, with very little autonomy.
- There is no precedent of a banking license being revoked. If the RBZ identifies irregular bank behaviour it is only empowered to offer advice. It can not punish corrupt or reckless behaviour by revoking, suspending or restricting licenses. Even fining offenders is beyond the RBZ's authority. Many banks operate well below the required Basle capital adequacy ratios²⁸ and yet the RBZ can only advise these offenders. The problems at UMB were well known to the RBZ but it could not take decisive action to prevent the bank's demise.
- The RBZ relies heavily on off-site supervision and moral suasion. This makes it easier for banks to conceal non-performing loans through balance sheet manipulations.
- The Act has no provision for deposit insurance. Instead there is an implicit understanding of a 'safety net' amongst banks.

The above flaws of the Banking Act highlight the need for an "innovative regulatory framework" and "re-invigorated supervisory capacity" (Chigumira 1998, p.23). This need will be even greater as new financial products emerge and as the domestic financial sector is assimilated into the global financial system. The new banking legislation is supposed to address these issues but seven years after considering changes to the Banking Act, nothing tangible has been achieved. Such delays diminish the credibility of the reform process.

²⁷ United Merchant Bank's (UMB) bankruptcy in 1997 nearly sparked wide-spread financial chaos. The bank had illegally underwritten loans by issuing fake promissory notes. UMB was one of many non-commercial bank financial institutions which emerged after 1991.

²⁸ In 1992 commercial banks in Zimbabwe had risk-weighted ratios between 5.3 % and 11.8%. These ratios are below the Basle benchmark of 12 %.

5.2.2 Failure to license new banks

Financial liberalisation is associated with the abolition of interest rate controls and subsequently higher interest rates. However, the simultaneous increase in the number of new commercial banks raises competition sufficiently to keep interest rates low.

Financial liberalisation raised interest rates in Zimbabwe but there was no proportional increase in the issuing of commercial bank licenses. Consequently, the oligopolistic character of the commercial banking sector remained. In addition, the banks increased their profit margins. Between 1985-90 the average margin (spread) between the lending rate and the deposit rate was 3.8 percent. In the period 1993-1997, the average spread rose to 10.1 percent. This large increase in the spread indicates that commercial banks were profiteering²⁹.

The government was expected to use financial liberalisation as an opportunity to issue licences to indigenous commercial banks. This would have yielded several benefits:

- First, the new indigenous banks would compete for deposits and in so doing induce established banks to improve their financial products and/or to lower their costs.
- Second, the provision of credit to smaller scale borrowers would have increased because the indigenous banks possess better knowledge of small scale borrowers than established banks (especially with foreign management). That is, there is less information asymmetry.
- Finally, the small capital bases of new indigenous banks would have left them with capacity sufficient for small-scale lending only.

By 1995, fifteen years after independence, there were still no indigenous commercial banks in Zimbabwe.

5.2.3 Reasons for non-appearance of indigenous banks

- Deliberately conservative licensing policy

²⁹ The extent of profiteering is not as high as the spread. The spread is a direct function of the degree of competition as well as the level of the statutory reserve ratio. Thus the higher spreads of the 1990s reflect financial liberalisation plus the increase in reserve bank statutory ratios.

Of all the SSA countries, Zimbabwe's licensing policy was the most conservative (Harvey 1998). It seems that the authorities in Zimbabwe were anxious to avert the problems that other SSA countries had encountered as a result of their liberal licensing policies. This risk-averse behaviour helps to explain the lack of indigenous banks. A typical license application would be sent to The Registrar of Banks in the Ministry of Finance. The Registrar would examine the applicant's business plan, the calibre of the proposed management team and the applicant's ability to mobilise resources. If the Registrar is satisfied, the application then goes to a panel with representatives from the Ministry of Finance and from the Auditor-General. The process is not only slow, but it provides numerous chances to reject applications.

- High minimum starting capital requirement

Many potential applicants found the minimum capital requirement prohibitively high. The banking legislation of 1965 required Z\$0.5 million as minimum capital. However, inflation since 1965 pressed the authorities into raising the requirement to Z\$15 million. Numerous African businessmen have found this amount impossible to raise (Moyo 1998).

- Easier to start non-bank financial institutions

Licensing policy seemed more liberal for non-commercial bank financial institutions. For example, the authorities set the initial capital requirement for merchant banks at Z\$10 million, and that for discount houses at Z\$5 million. Furthermore, other types of institutions faced lower overhead expenses. A merchant bank or a discount house could be run from a rented office in the cheaper parts of Harare, whereas commercial banks required larger banking premises and elaborate equipment for customer use. The entry cost for non-banking institutions was thus reduced.

Harvey (1998) suggests that the authorities perceived non-bank institutions as less risky because they took no deposits from individuals. Additionally, non-bank institutions were unlikely to accumulate portfolios of doubtful debt because they invested mainly in government paper and placed deposits with other financial institutions. Commercial banks on the other hand, take deposits from the public which the authorities have a duty to protect. Consequently, between 1991 and 1997, only

two new commercial banks were licensed compared to ten new merchant banks, and six discount houses.

Conclusion

Financial repression was officially used in Zimbabwe from 1980 until the end of 1990. Interest rate and foreign exchange controls were stringently enforced during this period. The government had hoped that the availability of cheap credit would fulfil the socio-economic aspirations of those who had been previously denied credit. Artificially low interest rates would reduce borrowing costs, while the government's control of foreign exchange would be used to supply credit to 'priority sectors'. These measures were preferred to imposing directed lending provisions on commercial banks.

The literature review identified dangers inherent in financial repression. The most perverse dangers being:

- negative real interest rates
- declining savings
- dis-intermediation

Zimbabwe encountered each of the above during the era of financial repression. The majority of people were still without access to credit, while government controls in the financial sector may have undermined confidence in the holding of financial assets.

Financial reform began with much optimism in 1991. Higher interest rates were expected to attract more savings deposits. The licensing of new indigenous banks would increase competition between banks and lower the cost of credit for potential borrowers.

This paper found sufficient empirical justification for such optimism in Zimbabwe. The McKinnon-Shaw framework was used to test whether real deposit rates are significantly and positively related to savings and to the demand for money. While the entire framework was deemed to be unsatisfactorily specified for the Zimbabwean context, this was no cause for alarm since this is consistent with tests performed by

other economists on developing economies. Indeed, the testing unearthed a positive and significant relationship between real deposits and real savings.

However, in spite of this relationship, there was no significant increase in Zimbabwe's financial deepening. Zimbabwe's level of financial development is still very poor by First World standards and rather average by the standards of other SSA economies.

The literature emphasised that freeing interest rates is a necessary but insufficient condition for successful financial reform. Certain pre-requisites must complement the removal of financial controls. These pre-requisites include macroeconomic stability and a sound system of financial sector supervision.

Zimbabwe had not achieved macroeconomic stability prior to the policy shift in 1991. The paper found that the 'monetisation' of the budget deficit increased inflationary pressure. Inflation undermines the financial deepening process as it erodes the value of financial assets. While positive real interest rates have been achieved, they have been associated with very high nominal interest rates. Such 'punitive' nominal lending rates may have reduced the demand for bank finance. This presented another obstacle for financial intermediation.

The supervisory framework in Zimbabwe is weak and out-dated. The Banking Act has not been amended since 1965 and it is simply not in tune with modern financial markets. Furthermore, the Reserve Bank of Zimbabwe is powerless to discipline deviant banks. This has created an authority vacuum in the banking sector.

The anticipated proliferation of new did not occur. The government appears to have adopted a conservative attitude to licensing new commercial banks. As a result, the traditional banks have not faced any new competition. It had been hoped that increased competition in the banking sector would lower borrowing costs and promote financial innovation. Instead, commercial banks seem to have increased their profit margins.

Appendix: Summary of McKinnon-Shaw Test Results

A.1 Mckinnon hypothesis – real variables

Dependent Variable: RM3
 Method: Least Squares
 Date: 07/03/99 Time: 22:52
 Sample(adjusted): 1980:2 1990:4
 Included observations: 43 after adjusting endpoints
 Convergence not achieved after 100 iterations

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	1430.529	3007.679	0.475626	0.6371
RATIO	-45.77667	2155.522	-0.021237	0.9832
RGDP	0.649030	0.508033	1.277536	0.2092
RDEPR	30.33124	14.31294	2.119148	0.0407
AR(1)	0.798590	0.115157	6.934813	0.0000
R-squared	0.590638	Mean dependent var		4121.176
Adjusted R-squared	0.547548	S.D. dependent var		456.9048
S.E. of regression	307.3351	Akaike info criterion		14.40270
Sum squared resid	3589285.	Schwarz criterion		14.60749
Log likelihood	-304.6580	F-statistic		13.70686
Durbin-Watson stat	1.934096	Prob(F-statistic)		0.000001
Inverted AR Roots	.80			

A.2 McKinnon's hypothesis - real logarithms

Dependent Variable: LRM3
 Method: Least Squares
 Date: 07/20/99 Time: 10:57
 Sample: 1980:1 1997:4
 Included observations: 72

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	1.668285	2.317878	0.719746	0.4742
LRGDP	0.798716	0.276298	2.890773	0.0052
RDEPR	0.019197	0.004227	4.541758	0.0000
LRATIO	-0.052260	0.129598	-0.403249	0.6880
DUMMY	0.140428	0.092782	1.513528	0.1348
R-squared	0.598052	Mean dependent var		8.464565
Adjusted R-squared	0.574055	S.D. dependent var		0.291337
S.E. of regression	0.190139	Akaike info criterion		-0.415203
Sum squared resid	2.422252	Schwarz criterion		-0.257101
Log likelihood	19.94730	F-statistic		24.92201
Durbin-Watson stat	0.341342	Prob(F-statistic)		0.000000

A.3 Real M3 against real deposit rate

Dependent Variable: LRM3

Method: Least Squares

Date: 08/02/99 Time: 03:49

Sample(adjusted): 1980:2 1997:4

Included observations: 71 after adjusting endpoints

Convergence achieved after 10 iterations

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	10.46963	9.087082	1.152145	0.2534
RDEPR	0.007316	0.003436	2.129234	0.0369
DUMMY	-0.145251	0.100929	-1.439133	0.1548
AR(1)	0.991918	0.037518	26.43822	0.0000
R-squared	0.890744	Mean dependent var		8.467972
Adjusted R-squared	0.885852	S.D. dependent var		0.291962
S.E. of regression	0.098641	Akaike info criterion		-1.739961
Sum squared resid	0.651919	Schwarz criterion		-1.612486
Log likelihood	65.76862	F-statistic		182.0801
Durbin-Watson stat	1.953496	Prob(F-statistic)		0.000000
Inverted AR Roots	.99			

A.4 Mckinnon's complete money demand model

Dependent Variable: LRM3

Method: Least Squares

Date: 08/02/99 Time: 03:53

Sample(adjusted): 1980:2 1997:4

Included observations: 71 after adjusting endpoints

Convergence achieved after 11 iterations

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	-9.575016	5.251644	-1.823242	0.0729
LRGDP	2.143080	0.620879	3.451687	0.0010
RDEPR	0.006449	0.003580	1.980133	0.0487
LRATIO	0.144228	0.274736	0.524971	0.6014
DUMMY	-0.159991	0.102971	-1.553740	0.1251
AR(1)	0.875979	0.051947	16.86282	0.0000
R-squared	0.898969	Mean dependent var		8.467972
Adjusted R-squared	0.891197	S.D. dependent var		0.291962
S.E. of regression	0.096304	Akaike info criterion		-1.761883
Sum squared resid	0.602846	Schwarz criterion		-1.570670
Log likelihood	68.54683	F-statistic		115.6729
Durbin-Watson stat	1.992694	Prob(F-statistic)		0.000000
Inverted AR Roots	.88			

A.5 Shaw's money demand function

Dependent Variable: LGRM3

Method: Least Squares

Date: 07/03/99 Time: 22:11

Sample(adjusted): 1980:2 1990:4

Included observations: 43 after adjusting endpoints

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	0.014617	0.019664	0.743367	0.4617
LRGDP	1.422746	0.958730	2.883989	0.0214
RDEPR	0.007372	0.004037	1.825882	0.0755
RB	-0.003390	0.004395	-0.771284	0.4452
R-squared	0.163317	Mean dependent var		0.006934
Adjusted R-squared	0.098956	S.D. dependent var		0.079445
S.E. of regression	0.075411	Akaike info criterion		-2.243307
Sum squared resid	0.221789	Schwarz criterion		-2.079475
Log likelihood	52.23111	F-statistic		2.537540
Durbin-Watson stat	2.237896	Prob(F-statistic)		0.070603

A.6 Shaw's alternative money function

Dependent Variable: LRM3

Method: Least Squares

Date: 08/02/99 Time: 04:04

Sample(adjusted): 1980:2 1997:4

Included observations: 71 after adjusting endpoints

Convergence achieved after 10 iterations

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	-10.14697	5.435240	-1.866885	0.0664
LRGDP	2.202719	0.638332	3.450744	0.0010
RB	0.001221	0.003833	0.318619	0.7510
DUMMY	-0.178917	0.104148	-1.717911	0.0905
AR(1)	0.881682	0.051307	17.18456	0.0000
R-squared	0.893871	Mean dependent var		8.467972
Adjusted R-squared	0.887439	S.D. dependent var		0.291962
S.E. of regression	0.097954	Akaike info criterion		-1.740828
Sum squared resid	0.633263	Schwarz criterion		-1.581484
Log likelihood	66.79939	F-statistic		138.9712
Durbin-Watson stat	2.044128	Prob(F-statistic)		0.000000
Inverted AR Roots	.88			

A.7 Fry's Savings model (1981-1990)

Dependent Variable: RTOTSAVGDP

Method: Least Squares

Date: 07/04/99 Time: 21:48

Sample(adjusted): 1981:2 1990:4

Included observations: 39 after adjusting endpoints

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	-0.304454	0.450266	-0.676164	0.5035
RGRATE	-0.014095	0.013880	-1.015499	0.3170
RGDPCAP	0.000732	0.000216	3.390093	0.0018
RDEPR	0.006426	0.002921	2.200134	0.0347
RTRADEBAL	-0.000260	7.31E-05	-3.556538	0.0011
R-squared	0.494648	Mean dependent var		1.231762
Adjusted R-squared	0.435194	S.D. dependent var		0.113501
S.E. of regression	0.085300	Akaike info criterion		-1.966067
Sum squared resid	0.247389	Schwarz criterion		-1.752790
Log likelihood	43.33831	F-statistic		8.319943
Durbin-Watson stat	1.308942	Prob(F-statistic)		0.000086

A.8 Savings regressed against the real deposit rate

Dependent Variable: LRTOTSAV

Method: Least Squares

Date: 07/04/99 Time: 21:17

Sample(adjusted): 1981:3 1990:4

Included observations: 38 after adjusting endpoints

Convergence achieved after 5 iterations

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	8.732217	0.262221	33.30095	0.0000
RDEPR	0.006382	0.002840	2.247325	0.0310
AR(1)	0.941256	0.094439	9.966857	0.0000
R-squared	0.745654	Mean dependent var		8.597788
Adjusted R-squared	0.731120	S.D. dependent var		0.123083
S.E. of regression	0.063823	Akaike info criterion		-2.589752
Sum squared resid	0.142568	Schwarz criterion		-2.460469
Log likelihood	52.20528	F-statistic		51.30402
Durbin-Watson stat	2.152384	Prob(F-statistic)		0.000000
Inverted AR Roots	.94			

A.9 Granger causality tests

a) Real total savings and real deposit rate

Pairwise Granger Causality Tests

Date: 08/02/99 Time: 04:31

Sample: 1980:1 1997:4

Lags: 4

Null Hypothesis:	Obs	F-Statistic	Probability
RTOTSAV does not Granger Cause RDEPR	63	1.54153	0.20330
RDEPR does not Granger Cause RTOTSAV		4.51887	0.00320

b) real financial savings and real deposit rate

Pairwise Granger Causality Tests

Date: 08/02/99 Time: 04:36

Sample: 1980:1 1997:4

Lags: 4

Null Hypothesis:	Obs	F-Statistic	Probability
LRBSAV does not Granger Cause RDEPR	63	2.39398	0.06173
RDEPR does not Granger Cause LRBSAV		4.42351	0.00243

A.10 Fry's Savings Function (1981-1995)

Dependent Variable: RTOTSAVGDP

Method: Least Squares

Date: 08/02/99 Time: 16:18

Sample(adjusted): 1981:3 1995:4

Included observations: 58 after adjusting endpoints

Convergence achieved after 8 iterations

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	-0.748775	0.417995	-1.791348	0.0792
RGRATE	-0.024778	0.007319	-3.385338	0.0014
RGDPCAP	0.000961	0.000201	4.792834	0.0000
RDEPR	0.006602	0.002501	2.639748	0.0110
RTRADEBAL	5.35E-05	5.66E-05	0.944861	0.3492
DUMMY	-0.114163	0.037052	-3.081202	0.0033
AR(1)	0.554135	0.103767	5.340212	0.0000
R-squared	0.779278	Mean dependent var		1.170225
Adjusted R-squared	0.753311	S.D. dependent var		0.134903
S.E. of regression	0.067003	Akaike info criterion		-2.455388
Sum squared resid	0.228961	Schwarz criterion		-2.206714
Log likelihood	78.20626	F-statistic		30.01003
Durbin-Watson stat	2.078697	Prob(F-statistic)		0.000000
Inverted AR Roots	.55			

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